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The Justice of Inclusive Free Enterprise: Aristotle, Hayek, Tocqueville and Rawls

Edmund S. Phelps*

In the 1990s I devoted several years to a crusade for greater *inclusion* in society's formal business economy. My theme was the *beneficial externalities* and the *justice* of enacting low-wage employment subsidies aimed at pulling up the demand for low-wage workers and thus raising their pay and employment. I would like to say a little about that work because it led naturally to my subject today – the property I call economic *dynamism* and the benefits of *free enterprise* both in greater inclusion and greater dynamism.

I began with the essentially classical argument that a subsidy paid to employers for every low-wage employee is a sort of matching grant that would induce the private sector to increase its hiring and thus to increase *its* outlay to the working poor; so low-wage subsidies are more cost-effective in getting money to the working poor than are welfare entitlements.[1] The consequent rise in pay rates and, in turn, the rise in hours worked among low-end workers would benefit the rest of society by making crime less attractive.

My main argument, though, drew on the importance of jobs. Justice demands integration into society's business life – integrating those at the margins into what is a secular society's central project, its formal business economy. The employment subsidies would serve this cause by stimulating the creation of new jobs among the low-paid, reducing their unemployment and expanding their labor-force participation. This was important because earning one's way in the impersonal world of business – supporting one's self – is, for most people, necessary for what John Rawls called self-respect; and also because, for most people, jobs are the only adequate vehicle there *is*, if any such vehicle is present, by which people may pursue some central goals of life – their self-actualization, or self-realization.[2]

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* McVickar Professor of Political Economy and Director, Center on Capitalism and Society, Earth Institute, Columbia University. This lecture was given June 22, 2006 at the Institut d'Etudes Politique de Paris on the award of a doctorate honoris causa. I am very much indebted to Jean-Paul Fitoussi and David Jestaz for numerous conversations on the contrasting economic systems and cultures of France and America. I am also grateful to Raicho Bojilov and Luminita Stevens for their talented research assistance.

[1] Phelps, "Low-Wage Employment Subsidies *versus* the Welfare State," *American Economic Review*, 84, May, 1994. If the given government budget available were instead just handed out to the working-age poor as an entitlement, whether they work or not, many of them might work less and the resulting fall in their earnings would offset some of the government outlay.

[2] Phelps, *Rewarding Work*, Cambridge, Mass;, Harvard University Press, 1997.

Many voiced radical disagreement with that. *They* claimed that a state program to boost access to the world of work was not appropriate and not even desirable. One of them said that public policy must aim always to be "neutral" as between different values – a life of indolence *versus* a life of contribution. Another said he was reminded of the motto *Arbeit macht frei* displayed in Nazi concentration camps. A deservedly respected commentator remarked that the blacks in America would not have voted for America's economic system had they been given a voice. Evidently, when I was writing of access to jobs I saw an economy offering invaluable non-pecuniary rewards, even though the pay at the low end was not as ample as it could and should be, while the economy they saw was a gray, necessary evil – one that people of low productivity ought to be excused from. We seemed to be on different planets, talking about two quite different *kinds* of economies.

We *were*, as I came increasingly to see. Passing over details one can discern on the Continent an *economic* model – a set of economic institutions and economic culture – that is distinctive. Although there are some basic similarities, it also differs in some respects from the American model. I will argue that there are consequent differences in economic performance, including the character of the economy's workplace.

To paint with a broad brush: There are two economic systems in the West – two systems of economic institutions. Though both systems are founded on private ownership, one of them is characterized by great *openness* to the implementation of *new commercial ideas* coming from persons in private business and by a great pluralism of views among the wealth-owners and financiers who select the ideas to nurture by providing them the capital and incentives necessary for their development. Although much innovation comes from established companies, as in pharmaceuticals, much comes from start-ups – particularly the most novel innovations. This is *free enterprise*, also known as "capitalism."

The other private-ownership system has been modified by the introduction of institutions aimed at protecting the interests of "stakeholders" and the "social partners." The system's institutions include most or all (depending on the country) of the massive components of the corporatist system of interwar Italy – big employer confederations, big unions and monopolistic banks. Since the second world war a great deal of liberalization has taken place, no doubt. But new corporatist institutions have sprung up: Co-determination (*cogestion*, or *Mitbestimmung*) has brought "worker councils" (*Betriebsrat*) and now, in Germany, a union representative generally sits on the investment committee of the corporation.[3] On its face, the system operates to impede or discourage or simply block changes, such as relocations and entry of new firms. The system's performance depends on established

[3] For an account of recent developments see Gerrit Wiesmann, 'Anxiety at SAP as the unions win a voice on campus,' *Financial Times*, June 21, 2006, p. 15.

companies in cooperation with local and national banks. What it lacks in flexibility it tries to compensate with technological sophistication. So different is this system that it has its own name – or names: the *social market economy* in Germany, *social democracy* in France and *concertazione* in Italy.

The dynamism of a well-functioning capitalist system

The two systems are *not* operationally equivalent, contrary to the neoclassical view. A key part of my thesis is that the former system possesses more *dynamism* than the other does. By "dynamism" I will mean the *fertility* of the economy in coming up with innovative ideas believed to be technologically feasible and hoped to be profitable; the *adeptness* with which it selects among them the ideas for development; and the attitude of *experimentalism* with which the market receives the new products and methods – in short, the economy's talent at commercially successful innovating. Note that this "dynamism" is *not the same as high productivity* or *rapid increase of productivity*: even undynamic economies may catch up – more or less – to the dynamic ones if the latter stay for a long time in the doldrums. In this terminology, my thesis is that the free enterprise system is structured in such a way that it facilitates and stimulates dynamism while the Continent's system impedes and dissuades it.

Historically, both systems have been seen as structured for dynamism! When building the massive structures of corporatism in interwar Italy, the *corporatist* theoreticians explained that *their* new system would be *more* dynamic than capitalism – maybe not more fertile in little ideas, such as might come to petit bourgeois entrepreneurs, but certainly in big ideas. Not having to fear fluid market conditions, an entrenched company could afford to develop a radical innovation. And with industrial confederations and state mediation available, such companies could arrange to avoid costly duplication of their investments. The state and its instruments, the big banks, could intervene to settle conflicts about the economy's direction. Thus the corporatist economy, thanks to its "dynamic efficiency," was expected to usher in a new *futurismo* that was famously symbolized by Severini's paintings of a fast train. (What was important was that the train was *rushing forward*. Mussolini, no doubt acting in part on their symbolism, made sure that the trains ran on time.)

Among *capitalist* theoreticians, Joseph Schumpeter in his great 1911 book does *not* see any dynamism.[4] His invaluable point is that scientific discoveries and inventions are not commercial innovations: Implementing the unexploited commercial opportunities created by the existing technology takes someone of organizational ability to *undertake* the job of development – the Schumpeterian *Unternehmer*. Schumpeter sees the capitalist economies he knew as performing this task perfectly well and offers no insights to suggest how well or badly the corporatism soon to come would perform it.

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[4] This paragraph has been added to the June 2006 text for the sake of completeness. The reference is to *Theorie der wirtschaftlichen Entwicklung*, Vienna, 1911, 2nd. edn. circa 1924.

One generation later, Friedrich Hayek set out the first theory to see capitalism as dynamic (not just responsive) – more so than socialism or corporatism. But not right away. Hayek *began* what we may term *modern* capitalism theory with the work from his middle years – the mid-1930s to the mid-1940s.[5] Virtually every participant right down to the humblest employee has private knowledge, or "know-how," about his work, his firm and his industry – not just the formal knowledge in books.[6] The decentralized decision making in the capitalist economy is well-adapted to make use of this informal, highly specialized knowledge – much better than centralized socialism. But does capitalism have more *dynamism* than corporatism? In this middle period Hayek says little on this point. However, it is natural to think that out of this great soup of informal, dispersed knowledge a *new idea* for commercial innovation may be born – an idea hit upon by someone that few, if any, other business people would be likely to have thought of already. Clearly an economy might generate a plethora of ideas this way. In the 1960s Hayek sketches the "discovery process," in which the conceiver of a new idea, such as a novelist, brings his idea to the market (presumably with the cooperation of an entrepreneurial publisher), having little idea of whether the public will buy it except that he knows that he himself likes it.

Clearly, the rate of such innovation will depend not only on the number of persons oriented toward conceiving new ideas and their talent at it – what we might call the economy's innovational *creativity* – but also on the *selectivity* of the economy in choosing among new ideas and the *receptivity* of the economy to the new ideas chosen for developing and offer on the market. It was left to subsequent theorists to point out some crucial factors.[7]

The *pluralism* of experience and knowledge that a capitalist economy's *financiers* bring to bear in their decisions widens radically the range of entrepreneurial ideas that have a chance of an informed, insightful evaluation. And, very important, under capitalism the financier and the entrepreneur do not need the approval of the state or of social partners. Nor are they accountable later on to such a social body if the project goes badly, not even to the financier's investors. So projects can be undertaken that would be too opaque and uncertain for the state or social partners to endorse.

A pioneering spirit among the economy's other actors is also crucial for the degree of dynamism. The body of *knowledge*, formal and informal, that *managers* and *consumers* bring to bear in deciding which innovations to try

[5] This runs from a 1935 publication *The Spontaneous Order* and 1936 lecture "Economics and Knowledge" to the famous 1944 book *The Road to Serfdom*.

[6] A column in the Wall Street Journal told of a deliveryman who was asked whether he found it best to work from the top floor down or the reverse. "It depends on the time of day," he replied. A beautiful Hayekian moment.

[7] The literature includes works by, among others, Nelson and Phelps, Frydman and Rapaczynski, and by Bhidé.

and which of those to adopt is crucial in giving a good chance to the most promising innovations launched. Where the Continental system convenes experts to set a product standard before any version is launched, capitalism gives market access to all versions.

This modern capitalism theory argues against the corporatism that sees a problem of dormancy in private business and a solution in putting firms in a state-run contest to be the "national champion" in their industry. The theory suggests that corporatist institutions and culture reduce dynamism by hampering managers' adoptions of new methods or products and by hindering start-up entrepreneurs from forming companies to develop innovations. And, owing to the deficiency of pluralism within the state, this harm to dynamism is unlikely to be offset by the state's sponsorship of national champions. The question, then, is whether capitalism's edge in dynamism matters.

The main benefits and costs of dynamism

Are there decisive benefits of dynamism? The issues about capitalism today are generally issues about its high dynamism. The main *benefit* of a dynamic economy is *commonly said* to be a higher level of productivity – and thus, generally speaking, higher hourly wages and a higher quality of life.[8]

There is a huge element of truth in this belief, no matter how many tens of qualifications might be in order. Much of the huge rise of productivity that the world has seen since the 1920s can be traced to new commercial products and new business methods developed and launched in the relatively capitalist economies.[9] There were often engineering tasks along the way, yet business entrepreneurs were the drivers.

There is one conceivable qualification that ought to be addressed. Is productivity not finally at the point, after a century and a half of rapid growth, that having yet another year's worth of growth would be of negligible value? D. H. Lawrence, writing about Ben Franklin, spoke of America's "everlasting slog." Whatever the answer, it is important to note that advances in productivity, in generally pulling up wage rates, makes it affordable for low-wage people to avoid work that is tedious or grueling or dangerous in favor of work that is more interesting and formative.

Of course, productivity levels in the smaller countries will always owe more to innovations developed abroad than to those they develop themselves.

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[8] This productivity effect is a shorthand way of saying that when a society restrains its consumption expenditure in the present in order to divert resources to an innovative project, the society can consume not just more in the future; it can consumer more – or better – than what it sacrificed in the present. In other terms, there is a positive social rate of return to investing in new products and methods, just as there is from investing in more physical capital.

[9] These include household appliances from vacuum cleaners to refrigerators, sound movies, frozen food, pasteurized orange juice, television, transistors, semi-conductor chips, the internet browser, the redesign of cinemas, and the recent retailing methods.

Some might even go so far as to suspect that the domestic market is so small in a country as tiny as Iceland that, even in per capita terms, only a very small number of home-made innovations would bring a satisfactory productivity gain – thus an adequate rate of return. In fact, most of the Continental economies, including the larger ones, have been content to sail in the slipstream of a handful of economies that do the preponderance of the world's innovating. The late Harvard economist Zvi Griliches commented approvingly that in such a policy the Europeans "are so smart."

I take a different view. For one thing, it is a good business to be an innovative force in the "global economy." Globalization has diminished the importance of scale as well as distance. In tiny Denmark, the world is its oyster: it sets its sights on markets in the U.S., the E.U. and elsewhere. Iceland has entered into European banking and biogenetics. France has long done this – and can do more of it. But it could do it more successfully if it did not insulate its innovational decisions so much from evaluations by financial markets – including the stock market – as Airbus does. The U.S. is already demonstrably in the global innovation business. To date, there is an adequate rate of return to be expected, though not always realized, from "investing" in the conception, development and marketing of innovations for the global economy – a return on a par with the return from investing in plant and equipment, software and other business capital. That is a better option for Americans than suffering diminished returns from investing solely in the classical avenue of fixed capital.

I emphasize a benefit of dynamism that I believe to be far more important, however. Instituting a high level of dynamism, so that the economy is fired by the new ideas of entrepreneurs, serves to transform the workplace – in the firms developing an innovation and also in the firms dealing with the innovations. The challenges that arise in developing a new idea and in gaining its acceptance in the marketplace provide the workforce with high levels of mental stimulation, problem solving and thus employee engagement and personal growth. Note that an individual working alone cannot easily create the continual arrival of new challenges. It "takes a village", preferably the whole society.

The concept that people need problem-solving and intellectual development originates in Europe: There is the classical Aristotle, who writes of the "development of talents," later the Renaissance figure Cellini, who jubilates in achievement, and the baroque writer Cervantes, who evokes vitality and challenge. In the 20th century, Alfred Marshall observed that the job is in the worker's thoughts for most of the day. And Gunnar Myrdal wrote in 1933 that the time will soon come when more satisfaction derives from the job than from consuming. This view, sometimes called *vitalism*, is now strongly associated with the pragmatist school of philosophy founded by the American William James, to which Henri Bergson in France and John Dewey in the U.S. belonged. The American psychologist Abraham Maslow coined "self-actualization" – and John Rawls the terms "self-realization" – to refer to a person's emerging mastery and unfolding scope.

The American application of this Aristotelian perspective is the thesis that most, if not all, of such self-realization in modern societies can come only from career. Today we cannot go tilting at windmills, but we can take on the challenges of career. If a challenging career is not the main hope for self-realization, what else could be? Even to be a good mother it helps to have the experience of work outside the home.

I must mention a "derived" benefit from dynamism that flows from the effects on productivity and self-realization. A more innovative economy tends to devote more resources to investing of all kinds – in new employees and new customers as well as new office and factory space. And although this may come about through a shift of resources from the consumer good sector, it also comes through the recruitment of new participants to the labor force. Also, the resulting increase of employee engagement serves also to lower quit rates and hence to make possible a reduction of the "natural" unemployment rate. Thus, high dynamism tends to bring a pervasive prosperity to the economy on top of the productivity advances and all the self-realization going on. True, that may not be pronounced every month or year. Just as the creative artist does not create all the time but rather in episodes and breaks, so the dynamic economy has heightened high-frequency volatility and may go through wide swings. Perhaps this volatility is not only normal but also productive from the point of view of creativity and, ultimately, achievement.

I know I have drawn an idealized portrait of capitalism: the reality in the U.S. and elsewhere is much less impressive. But we can nevertheless ask whether there is any evidence in favor of these claims on behalf of dynamism. Do we find evidence of greater *benefits* of dynamism (or benefits we might impute to dynamism) in the relatively capitalist economies than in the Continental economies as currently structured? In the Continent's Big 3, as is familiar, hourly labor productivity is lower than in the U.S. Labor force participation is also generally lower. And here is new evidence: the World Values Survey indicates that the Continent's workers find *less job satisfaction* and *derive less pride from the work they do* in their job. **Table 2** has the data.

Dynamism does have its downside. It creates a state of unpredictability that is unlike the bucolic equilibrium growth paths of neoclassical theory, in which the future is essentially known and everything is understood – up to a random disturbance term or two. The same capitalist dynamism that adds to the desirability of jobs also adds to their precariousness. The strong possibility of a general slump can cause anxiety.[10] But we need some perspective. Even a

[10] I notice that many continental Europeans focus more on the "stress" of jobs compared with the Americans, who complain little about it. My sense is that most Americans crave a certain amount of

market socialist economy might be vibrant: In truth, Continental economies are also susceptible to wide swings. In fact, it is the corporatist economies that have suffered the widest swings in recent decades. In the U.S. and the U.K., unemployment rates have been remarkably steady for 15 or 20 years. It may be that when the Continental economies are down, the paucity of their dynamism makes it harder for them to find something new on which to base a comeback.

The relatively capitalist economies suffer from incomplete inclusion of the disadvantaged. But that is a fault of electoral politics, not capitalism. Further, the relatively capitalist economies are not unambiguously worse than the Continental ones in this regard. In the former, low-wage workers have access to jobs, which is of huge value to them in their efforts to be role models in their family and community. In any case, we can hope to fix the problem.

Why, then, if the "downside" is so exaggerated, is capitalism so reviled in western continental Europe? It may be in part that elements of capitalism are seen by some in Europe as morally wrong in the same way that birth control or nuclear power or sweatshops are seen by some as simply wrong in spite of the consequences of barring them.

It appears that the recent street protesters associate business with established wealth; in their minds, giving greater latitude to businesses would increase the privileges of old wealth. By an "entrepreneur" they appear to mean a rich owner of a bank or factory while for Schumpeter and Knight it meant a newcomer, a *parvenu* who is an outsider.

A tremendous confusion is created by associating "capitalism" with entrenched wealth and power. The textbook capitalism of 1911 Schumpeter and the 1930s Hayek means opening up the economy to new industries, opening industries to start-up companies, and opening existing companies to new owners and new managers. It is inseparable from an adequate degree of competition. Monopolies like Microsoft are a deviation from the model.

It would be unhistorical to say that capitalism in my textbook sense of the term does not and cannot exist. Alexis de Tocqueville, writing about America, marvels at the relatively pure capitalism he found there. The greater involvement of Americans in governing themselves, their broader education and their wider equality of opportunity all encourage the emergence of the "man of action" with the "skill" to "grasp the chance of the moment."

The Rawlsian justice of entrepreneurship in a well-functioning capitalism

I want to conclude by arguing that generating more dynamism through the

stress. A New York physician, Robert Ascheim, told me that in his clinical experience stress is good in general, though presumably not in every case. The question is worth researching.

injection of more capitalism is not only not an injustice; it serve economic justice.

We all feel good to see people are freed to pursue their dreams. Yet Hayek and Ayn Rand went too far in taking such freedom to be an absolute – the consequences be damned. In judging whether a nation's economic system is acceptable, its consequences for the prospects of the realization of people's dreams matter also. Since the economy is a system in which people interact, the endeavors of some may damage the prospects (and outcomes) of others. So a persuasive justification of well-functioning capitalism must be grounded on its all its consequences, not just those called freedoms.

To argue that the consequences of capitalism are just requires some conception of economic justice, of course. I broadly subscribe to the conception of economic justice in the great 1971 work by John Rawls. In any organization of the economy, the participants will score unequally in the extent of their self-realization – how far they manage to go in their personal growth. An organization that leaves the bottom score lower than it would be under another feasible organization is unjust. So a new organization that raised the scores of some though at the expense of reducing scores at the bottom would not be justified. On the other hand, a high score is just if it does not hurt others. "Envy is the vice of mankind," said Kant, whom Rawls greatly admired.

What would be the consequence from this Rawlsian point of view of releasing entrepreneurs onto the economy? In the classic case to which Rawls devoted his attention, the lowest score is always that of the workers with the lowest wage, whom Rawls called the "least advantaged": their self-realization lies mostly in marrying, raising children and participating in the community and it will be greater the higher is their wage. So if the increased dynamism created by liberating private entrepreneurs and financiers tends to raise productivity, as I have argued, and if that in turn pulls up those bottom wages or at any rate does not lower them, it is not unjust. Does anyone doubt that the past two centuries of commercial innovations have pulled of wage rates at the low end and everywhere else in the distribution?

Yet the tone here is wrong. As Kant also said, persons are not to be made instruments for the gain of others. Suppose the wage of the lowest-paid workers *was* foreseen to be reduced over the entire future by the innovations conceived by entrepreneurs. Are those whose dream is to find self-expression and personal development through a career as an entrepreneur not to be permitted then to pursue their dream? Are would-be ballet dancers not to be allowed to train and perform in pursuit of their dream if low-end wages fell?

To respond we have to go outside Rawls's classical model, in which work is all about money. We have to recognize that in an economy in which entrepreneurs and dancers are forbidden to pursue their dreams of self-realization, *they* have the bottom scores in self-realization – no matter if they take paying jobs instead – and that counts whether or not they were born the "least advantaged." So, even if their activities did come at the expense of the lowest-paid workers, Rawlsian justice in this extended sense requires that entrepreneurs and dancers be accorded enough opportunity to raise their self-realization score up to the level of the lowest-paid workers – and higher, of course, if the workers are not damaged by support for entrepreneurship and dancing. In this case too, then, the introduction of entrepreneurial dynamism serves to raise Rawls's bottom scores.

Actual capitalism departs from well-functioning capitalism – monopolies too big to break up, undetected cartels, regulatory failures and political corruption. Capitalism in its innovations plants the seeds of its own encrustation with entrenched power. (Peter Martin in his last *FT* column proposed breaking up all firms after two decades of life.) These departures weigh heavily on the performance of capitalism, particularly the wages of the least advantaged, and give a bad name to capitalism. But I must insist: It would be a *non sequitur* to give up on private entrepreneurs and financiers as the well-spring of dynamism merely because the benefits of their dynamism will likely be less than they would have been in a more "perfected" system.

I conclude that capitalism is justified – normally by the expectable benefits to the lowest-paid workers but, failing that, by the injustice of depriving entrepreneurial types (as well as other creative people) of opportunities for their self-expression.

It has been a privilege for me to be able in this great institution to present to you my thoughts on this subject.

Edmund Phelps: Appendix to the Honoris Causa Lecture
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Table 1. Measures of Dynamism

	Decision-making freedom at work	Turnover of listed firms	Patents granted per working age person	R&D intensity adj. for industry structure
United States	7.4	118%	3.7	2.9
Canada	7.2	106%	1.3	1.8
United Kingdom	7.0	65%	0.8	1.9
France	6.4	79%	0.9	2.2
Italy	6.7	63%	0.4	1.0
Germany	6.1	42%	1.5	2.2

Decision making freedom at work is measured on a scale from 1 to 10, 10 highest, averaged for 1990-1993 (Human Beliefs and Values, Inglehart et al); turnover of listed firms represents the number of exits from and entries into each country's MSCI National Stock Index from 2001 to 2006 as a % of the number of firms in 2001; patenting data is averaged for 1990-2003 (World Intellectual Property Organization); R&D intensity adjusted for industry structure is the average % of business sector value added for 1999-2002 using the G7 industry structure (OECD).

Table 2. Benefits of Dynamism

	Pride derived from the job	Job satisfaction	Men in the labor force in % of work-age men	Employment in % of the labor force	Labor compensation per worker	Market output per hour
United States	2.9	7.8	85%	94%	$31,994	100
Canada	2.7	7.9	85%	92%	$23,751	-
United Kingdom	2.8	7.4	85%	95%	$22,008	73
France	1.7	6.8	76%	90%	$24,192	92
Italy	2.0	7.3	76%	91%	$21,822	-
Germany	1.8	7.0	79%	91%	$23,946	92

Pride derived from one's job is measured on a scale from 1 to 3, 3 being the highest, and job satisfaction on a scale from 1 to 10, 10 highest; both are averaged for 1990-1993 (*Human Beliefs and Values*, Inglehart et al); men in the labor force in % of working age men and employment in % of the labor force are computed for 2003 (OECD); labor compensation per worker is computed as the ratio of total compensation to the labor force using 1996 data (Extended Penn World Tables); market output per hour worked is for 1992 (Solow/Baily).