FIRST THINGS

Economic Justice and the Spirit of Innovation

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When the word *morality* comes up in connection with economics, income distribution and financial stability are usually the issues. Is it moral for rich countries to use such a high proportion of the world's resources or for investment bankers to earn large bonuses? And is it moral for financial markets to experiment with volatile derivatives that increase the potential for panics?

Across the political spectrum, the voices in the debate presume a *homo economicus* who is focused on maximizing consumption while taking prudent risks. And these voices presume that the economy in which this maximization takes place is a mechanical sort of system. But real human beings bear little resemblance to this ideal type. Any discussion of economics and morality must begin instead with real human beings who are not only acquisitive and risk averse but also inquisitive and adventurous and who sometimes feel the need to take a plunge, to leap into the unknown. Furthermore, in a healthy economy, each participant has to reckon on a future about which knowledge is imperfect, owing to the ventures being undertaken by the others.

If the matter of morality were limited to income distribution and stability, discussion of the topic would be as dull as being seated at dinner next to an actual *homo economicus*. Everyone agrees that better regulation is desirable to foster market stability, but this discussion devolves on practical details of bank capital ratios, risk models, and so forth.

As for income distribution, although the subject raises a great deal of emotion, there is little disagreement about economics between market-oriented economists and social interventionists. The prevailing view on the left, which derives from John Rawls' philosophy of fairness, concedes that inequalities of income are tolerable, on the condition that they benefit the lowest-paid workers. On the right, marketoriented economists in the tradition of Friedrich von Hayek contend that the poorest do benefit from a market system and would suffer under the stifling effects of collectivism.

The positions are not so different: By Rawls' criteria it is justifiable for Bill Gates to command $100 billion in assets, provided that every one of those billions was gained in such a way that the poorest in society are marginally better off as a result. One hears few voices on the left remonstrating with Bill Gates about his wealth, precisely because the general perception is that everyone is better off as a result of inexpensive personal computers. The moral issue that one would expect to divide the right and left vanishes, and its space is occupied by mere tradeoffs. For example: If we agree that successful market participants should pay taxes to assist the poorest, the question is, What tax rate will optimize government revenue? That is not a moral issue but a technical one.

Economics plays a central role in discussions of tradeoffs, as the arbiter of the technique by which society comes closest to achieving a desired outcome. But when economics plays this role, the question of morality never arises in its own right. Both the redistributionists of the left and the laissez-faire advocates of the right agree only to quibble about how much we may burden the *homo economicus* with taxes before we discourage him from creating the wealth that we propose to tax.

Politicians, to be sure, bring their prejudices to these debates. Liberal redistributionists in favor of heavy taxation place less weight on incentive than do small-government conservatives. Each side may think itself morally superior. But that does not get us any closer to defining the relation between morality and economics. There is a difference between applying economics in a moral fashion—which is to say, with intellectual integrity and the aim of improving conditions of life—and actually understanding the moral dimension of economics as such. In the debate over income distribution, economics is seen as being as morally neutral as shoemaking or eye surgery.

The importance of this function should not be deprecated, for it can offer constructive advice that makes life better for most people. Good economics shows the interconnections between different kinds of actions. Thus, for example, some people who haven't studied economics think, naively, that employers should be compelled to pay a "living wage." Everybody feels better about himself, his community, and his country if employers are paying workers well. Economics, though, teaches that if every employer is pressured to raise wages, some labor will be priced out of the market. So while those who are lucky enough to stay in their jobs in the face of this wage increase would have a higher wage, some people would be out on the street who would formerly have earned a wage that allowed them to support themselves.

The movement to ban nuclear power is another example. I am sure that this movement was well intentioned, but it prolonged and intensified our dependence on fossil fuels and led to more atmospheric pollution. It turns out that the nuclear power plants were safe after all and that there was no reason to bear the huge cost of doing without them.

At the simplest level, economics can better show us the consequences of our actions. Less simple are cases in which we don't have the knowledge to predict the full consequences. Global warming and climate change are examples. Actions that we believe will remedy a perceived problem may in fact lead to an unintended consequence, as in the case of the biofuels fiasco—when people died of starvation because the demand for ethanol drove up the price of corn.

Generally speaking, global energy systems are so complex that interfering with them almost certainly leads to unintended consequences. Some may be happy surprises, where an unexpected second benefit arrives atop the first. But in the case of biofuels the unintended consequences are disastrous. Here economics has the moral function of requiring responsibility and accountability from policymakers. Economics provides the means to vet an ideological agenda to determine its full range of consequences. By examining the consequences of policy choices in full context, economics can offer cautionary advice that prevents us from erring in the arrogant belief that we are able to know outcomes that are beyond our capacity to calculate. A good economist acts morally by producing a good product—that is, economic analysis.

As practitioners of a craft, economists don't have much incentive to own up to their mistakes or to their fallibility: to say every morning to their clients, "Well, you know, potentially everything

I say is quite wrong.” Of course, there are moral pressures on economists, as there are on those in any other profession. Economists are tempted to placate powerful constituencies; shoemakers are tempted to use inferior materials. To resist such temptations, economists as well as shoemakers require personal morality.

Unlike shoemaking, however, economics has something to say about every human activity (with the possible exception of ascetic religious practices). The subject of economics is the study of human activity in every field of endeavor and therefore must include human nature, human aspiration, and human values. The definition of economics with which most textbooks begin—“the study of the allocation of scarce resources”—is accurate but misleading, for it leaves out the most interesting part of the problem.

In truth, we are forever innovating to stretch our resources. Transportation was one of the scarcest goods during the first half of America’s nineteenth century, but by the end of the century the railroads had made it so abundant that the face of America changed irreversibly. That could be said today about information. Innovation makes scarce goods abundant. This quest to do better, to go farther, to extend our reach is part of what makes us human. There is more to economics than the desire to consume and to avoid risk.

Which brings us a step closer to connecting morality and economics. Morality, after all, is more than obedience to the rules of social conduct; to be moral is to foster the betterment of humankind. If we place innovation at the center of economics, then we in effect make a sweeping assertion about human nature—for we claim, at some level, that man is an innovator.

I personally hold that the classical spirit of challenge and self-discovery is a fundamental human trait. By showing how the risk-taking activity of individuals contributes to social benefits, economics helps societies to accommodate what Augustine called our “restlessness of heart.” This is the better part of our human nature. Societies that suppress this restlessness stagnate and die. The issue of morality in economics is neither the fairness of income distribution nor the stability of financial systems. It is how human institutions can be shaped to correspond to human nature—to man’s nature as an innovator.

Economics has not done enough to define its own premises. A small part of the economics literature addresses the role of entrepreneurs, the risk-takers who, in attempting innovations, choose to face true uncertainty, with the result that outcomes can’t be predicted. But it is not only a small group of entrepreneurs who want to take risks and try new things. Adventure and discovery appeal to people in every walk of life.

This consideration allows us to assert the *morality of the marketplace* itself, as opposed to requiring morality *in* the marketplace. Capitalism is the only economic system thus far discovered that allows human beings to realize their nature to innovate, discover, and take risks. Because human freedom is a good thing, capitalism is in this respect a good system. It is good apart from its instrumental function of presenting opportunities for income and consumption.

I’ve used the word *restless* to describe the classical spirit (in my foreword to Leo Tilman’s book *Financial Darwinism*). Human beings have a restless edge, an impulse to tinker, to do things in a different way. And that fact is a huge and vital thing. Mankind is capable of original ideas, concepts that have not been conceived before—and those who attempt to suppress this create a prison of the mind and spirit. It is good to have books to read and a Rubik's Cube to play with, but a prison it would nonetheless be if people couldn't follow their own instincts and conscience. If they couldn't leap into the unknown. That's what business is all about.

The market is an instrument—an imperfect and failure-prone instrument—whose purpose is to deliver social benefits. It is not an object of worship, nor should it be. There is no success without the prospect of failure, no adventure without possible mishap. That is where market economics comes in. The market does not need economists to invent it, much less apologize for it. But the market needs economists to help correct its frequent failings. An important task of economics is to allow innovators to take risks and succeed or fail on their own merits without causing calamitous effects for society. Witness the current situation in the United States: Economists must rehabilitate the financial sector so that it can again do what it used to do, addressing the financial needs of the business sector.

The contribution of the Austrian economist Friedrich von Hayek was to take adventurous, risk-taking entrepreneurs and situate them in the context of a modern kind of economy, where information and expertise begin with the people on the spot and flow upward. No state agency, he argued, could possibly gather the information and knowledge required to manage an organism as complex as a modern economy.

Even more important, Hayek added, is that not even experts know the outcome of ideas that haven't yet been tried. Capitalism permits innovators to discover these outcomes through the risk-taking of individuals. Moreover, centralized organizations, whether government agencies or corporate monopolies, will never sanction innovations that upset entrenched constituencies.

By acknowledging humankind's inherent restlessness and directing it toward the social goal of wealth creation, economics identifies the moral problem of reconciling restless human nature with the requirements of society. Economics is not, and should not pretend to be, indifferent to social institutions. On the contrary, the innovation that characterizes well-functioning capitalist economies is possible only when the right kinds of institutions are in place. These must be not only the institutions that protect political freedom but also financial institutions (and the regulatory institutions) required to enable entrepreneurs to acquire capital. Limited-liabilities companies are needed to manage risk, and they require, in turn, a legal and regulatory framework.

That is the positive moral content of economics—to realize an anthropology that starts with innovative human nature: *homo innovaticus*, not *homo economicus*. Existing economics has a negative moral content in that it treats economic factors as though they were pieces on a game board rather than human beings who learn, discover, and innovate. Politicians play the same game, channeling resources from one activity or social group to another without considering the effect on the creativity and judgment exercised within the economy and thus the deep rewards the economy imparts or fails to impart.

It seems to me—tentatively, of course, and subject to an important qualification—that to put economic life on a moral basis requires a well-functioning capitalism or its equivalent, if such could be found. Capitalism allows individuals to realize the demands and potential of the human spirit. Capitalism also has made careers unimaginably more interesting, exciting, and rewarding. Capitalism, in short, has delivered what the classical spirit taught us life was all about.

The qualification I have in mind is that a great many countries are not in a condition to make capitalism work well. In such cases, imposing a system that is outwardly or superficially capitalist (in the sense of nominally allowing innovation and nominally providing legal protections) could have worse outcomes much or most of the time than would some other system that does not pretend to innovation. Societies may require a well-functioning capitalism, but that does not mean a particular society can always get it.

At the present moment, the capitalism practiced in America is seen to be not well functioning. The great dynamism of capitalism, the source of all its benefits, material and otherwise, must also make it crisis prone. Yet the present financial crisis, which is not yet behind us, is a result of some malfunctions. The banking industry was left vulnerable to a correction of property prices, and that vulnerability was exploited by managers in reckless disregard of those who employed them—the shareowners. If we are to restore performance of the American economy to a high level, we will have to understand and correct most, if not all, of such egregious malfunctions.

Yet we have to realize that our present economy is an extremely complex system, which has become more complex over the years. As long as the system remains capitalist, it will run the risk of a bust. Can we build a system that is bust-proof—so that we are not hurt by the bust—without putting up so many walls that there is serious loss in innovation?

The Europeans thought that they could do it all with a system of security and community and consent—that they could have all those things and still beat capitalism at its own game. They thought they could have fast productivity growth, a good workplace, and low unemployment all at once.

Starting in the 1930s and resuming in the postwar decades, this belief inspired the construction in continental Western Europe of the communitarian-corporatist system we see today. But the notion that it is possible to have a high level of security from business swings while nonetheless generating indigenous innovation has surely proved itself by now to be an illusion. Their productivity did not surge ahead of the American level; at best, a few countries caught up, more or less, to the average level in the fifty states. Similarly, their unemployment did not fall below the U.S. rate. And they certainly failed to anticipate the extent to which their workplace would become stultifying.

There's something revealing in the fact that European society has birthrates so low. It suggests that Europe lacks a sense of opportunity for a rewarding, challenging, fulfilling life. Emigration is another sign. You can see the stultifying economy on the faces of young people in Europe, many of whom would dearly like to get out—to Silicon Valley or Shanghai or Singapore. The system on the continent fails to provide the opportunity for rewarding lives. Economic policy in recent years has been aimed at improving economic performances, but it has proved a tough row to hoe.

At American universities, the work of John Rawls is typically taught as the correct approach to the question of economics and morality. Offering an alternative to strict egalitarianism, Rawls does not call for equal distribution of material goods to all members of society. He urges instead what he calls the *difference principle*: Inequality is acceptable as long as the poorest are better off than they would be under equal distribution.

It seems to me, as it does to most people, a persuasive argument that societal inequalities are acceptable as long as they serve as an engine for lifting up the people with the lowest rewards.

The shortcoming I have come to see in Rawls' model is that it has no place for anything other than the distribution of material goods. He leaves out self-discovery, adventure, and leaping into the unknown. It is wrongheaded to maintain that a good society could be one that stifles challenge and personal growth if that is what it takes to provide the people at the bottom the last cookie that can be eked out of society's resources. People don't have the right to a few more cookies if it comes at the expense of all other people's self-realization, self-discovery, and self-fulfillment as *homo innovaticus*.

Economists have long tried to explain to the public that capitalism produces more engagement, exhilaration, and fulfillment than any alternative has done by far. The large fortunes made along the way are a pleasant byproduct and an inducement when our energies flag. But we economists also have to say, to those who are always trumpeting free markets, that there is no magic in the market. It's a highly fallible system capable of breakdowns.

Both the unreasoning rejection of capitalism by some and the baseless triumphalism of others are ridiculous. They are not grounded in a full look at the upsides and the downsides of the system over the past 200 years.

We economists are just beginning to understand the subject. Prosperity and the development of the human spirit are linked in the dynamism of the economy. The dynamism of the American economy over the past two hundred years was strong, and that helps to explain why prosperity was high both in the sense of high employment and the sense of a high degree of personal satisfaction compared to that in other countries.

In the 1950s, when John Kenneth Galbraith was in the ascendant, economists thought that the economy was all about oligopolies and that a few big corporations running on autopilot would dominate the economy. The function of the corporate chief executive officer was to make sure that the symphony orchestra was well funded or to help with the local museum.

Even now, in the midst of an economic downturn, there are signs of vitality that weren't present in the 1950s. There is exuberance, however irrational, in the banking system, and some originality here and there in hedge funds and private equity, and still some inventiveness in Silicon Valley. Although they may have caused more problems than they were worth, the exotic, new financial instruments showed that America is still the world's leader in invention. They reflect America's capacity to create. Unfortunately, the markets were unsophisticated and set mistaken asset prices. The CEOs and boards at the big banks, together with their supposed regulators, failed to stop the sorcerer's apprentices from flooding the world and themselves with toxic assets.

Which means that creativity isn't enough. Where there is creativity, there must also be judgment—the judgment that comes from insight and experience. Only where there is both creativity and judgment will there be true innovations—new things that prove to work well, that have some staying power and make a mark.

Most observers now acknowledge that capitalism, even in the midst of the 1930s depression, has long been creating unprecedented, unimagined levels of productivity and wage rates—for the rest of the world as well as for the handful of capitalist economies themselves. Now, however, some philosophers and social critics are suggesting that even capitalism has outlived its usefulness—that pursuit of new goals requires another system.

It must be clear by now that this analysis overlooks what has been the key dimension of capitalism from its first functioning early in the nineteenth century. This dimension is what capitalism's dynamism offers to human experience and human benefit—the true moral dimension of economics, in other words. Well-functioning capitalism, where it is attainable, is of undimmed value because it allows human beings to realize their true nature as creators and innovators.

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