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A new societal contract

Dennis J. Snower

Abstract

This paper argues that the traditional societal contract that underlies the market economy has run its course and needs to be replaced by a new contract, based on a new conception of the “empowering economy.” Whereas different societal contracts are relevant to different societies, there must be some features that all societal contracts will have in common, in order to address some basic human needs that every thriving society must satisfy and to promote popular approval for multilateral agreements to address multilateral problems. The paper proposes a new societal contract that promotes three building blocks of economic policies: (1) automatic stabilizers that reduce inequalities of economic power, (2) policies that focus not just on material prosperity, but also on personal and social empowerment and (3) policies that develop the human capabilities of cooperation and innovation.

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Keywords Societal contract; empowerment; social cohesion; inequality; cooperation; innovation; free markets; welfare state; incentives

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1 Introduction

Underlying every market economy, there is a societal contract setting people’s norms, values and beliefs, thereby determining how people are expected to behave within the economy and how the economy is to be run. The neoliberal market economy, which has been pursued in the United States and like-minded countries in Europe and elsewhere, is failing to address the basic needs of most of their citizens. This economic model has generated rising inequality, reduced social mobility, social fragmentation, a broad sense of disempowerment, and a deep resentment that people’s hopes for a good life have been ignored. These developments undermine the sense of trust that is essential for well-functioning market economies and the sense of common purpose that is necessary for democracies to work, thereby threatening the future peace and prosperity of nations.

Changing this economic model requires not just technocratic reforms, but a new societal contract. Whereas different societal contracts are relevant to different societies, there must be some features that all societal contracts will have in common, for two main reasons. First, while human cultures differ, there are some basic human needs that every thriving society must satisfy and these needs must be covered in the societal contract. And second, the integration of the global economy and the massive increase in the world’s human population have generated problems – from climate change to cybersecurity to financial crises – that are global in scope. Tackling these problems requires the countries of the world to cooperate and if this cooperation is to be successful, the underlying societal contracts must have some commonalities. These commonalities are highly relevant to policy making in the G20, since the ultimate purpose of G20 agreements must be the fulfillment of basic human needs. In times of economic dislocation, such as in the aftermath of the financial crisis of 2008, it is appropriate for the G20 to focus virtually exclusively on economic and financial affairs, since this is where the fulfillment of human needs is primarily threatened. In other times, particularly ones when social fragmentation and environmental disruption are prominent – as is the case nowadays – it is appropriate to focus on the features of a new societal contract.

The outlines of these features are becoming increasingly clear. They involve moving from neoliberalism and welfare statism, on the one hand, to a new conception of the “empowering economy,” on the other. This new conception aims to recouple economic prosperity with the satisfaction of basic human needs.¹

¹ The new conception is central to the OECD initiative on “New Approaches to Economic Challenges” (<https://www.oecd.org/naec/>) as well as the visions underlying the Global Solutions Initiative (<https://www.global-solutions.international/initiative>).

2 Division of Responsibilities

The neoliberal societal contract rested on a clear division of responsibilities between firms, households, and governments. Firms were to maximize their profits. For companies, this meant focusing exclusively on shareholder value. In the words of Milton Friedman, “the business of business is business.” Households were viewed primarily as “consumers” and “workers”, whose goal was to maximize their self-interested utility, which was whatever generated a payoff to oneself. The job of workers was to work as little as possible for the greatest possible consumption gratification. Governments were to set the “rules of the game” for the economy, so that selfish firms and selfish households would be led, as if by an Invisible Hand, to make everyone as well off as possible. With regard to supranational problems, such as cyber threats and climate change, it was the job of supranational institutions to permit mutually beneficial negotiations among selfish governments.

The welfare statist societal contract recognizes the market failures associated with free market activities and seeks to reduce inequalities through tax and transfer arrangements and to correct externality-driven inefficiencies through regulations and tax-subsidy schemes. This approach assumes the same division of responsibilities between firms, households and governments as that underlying the neoliberal societal contract, but it significantly extends the domain of legitimate government interventions in the market economy. Since these government interventions are themselves associated with inefficiencies and often also with inequalities, the welfare statist approach generally involves replacing market failures by government failures.

The conflict between the neoliberal and welfare statist societal contract set the stage for the debate between left- and right-wing political parties in most countries over the postwar period. This debate was focused virtually exclusively on how to create material prosperity and how such prosperity is to be distributed. The expansion of the welfare state in advanced industrialized countries in the early postwar decades – involving primarily an expansion of government involvement in education, health, pensions and social welfare – led to increased awareness of government failures, through disincentives to work, bureaucratic inefficiencies and unresponsiveness to changing human needs. Such awareness led to the neoliberal movement initiated through the Regan-Thatcher reforms in the 1980s.

Since then, the rise of the neoliberal societal contract in many countries has led to successive waves of consumerism, deregulation in product and financial markets, stripping down of welfare provision to promote alleged efficiency gains, and “me-first” government policies. This contract, together with waves of globalization and skill-biased technological change, led to widening disparities of income and wealth, so that those in the bottom 90 percent of the US income distribution experienced stagnant real wage incomes for the past four decades.² Deregulation in financial markets led to hidden fragilities that erupted with overwhelming force in the financial crisis of 2008.³ Deregulation in product markets, particularly those associated

² For example, Krause and Sawhill (2018).

³ For example, Huwart and Verdier (2013).

with digital networks, led to the rise of “superstar firms” accompanied by rising product market concentration and the inefficiencies associated with monopoly power.⁴ Corporate tax reductions and reduced welfare provision promoted the economic fortunes of the few, who used their newly found economic power to influence the political process and the discourse in the media to their own advantage.⁵

The self-reinforcing interactions between successful business leaders, politicians and journalists helped promote the cycle of inequality, deregulation and the gradual dismantling of social safety nets. The neoliberal societal contract was kept alive through the “American dream” and its equivalents elsewhere, as well as the theory of “trickle-down prosperity.” In the process, the middle class became hollowed out, while progressively more and more of GDP growth was channeled to the top 1 percent of the income distribution. Though these developments were particularly pronounced in the US and UK, many other advanced and emerging economies experienced broadly similar developments.⁶

3 Three Inconvenient Truths

As the neoliberal societal contract delivered ever more harmful social consequences, the public discourse lost sight of three inconvenient truths:

- 1) **Free markets generate inequality:** Unfettered markets lead, as if by an Invisible Hand, to growing inequalities of economic power, leading to inequalities of income, wealth, education, skills and empowerment. The reason is simple. Free markets generate heterogeneous economic outcomes for market participants. The successful participants in labor, product and financial markets (the “insiders”) use their economic power to erect market entry barriers and to acquire political power relative to the “outsiders.”⁷ The rising entry barriers given them rising market power and their growing political power gives them privileged influence over taxes, subsidies and regulations. These developments reinforce the initial inequalities, in a vicious cycle, and thereby gradually undermine countries’ social cohesion and the legitimacy of their governance institutions. It is commonly assumed that the vicious cycle must be checked by governments, but this function of governments is systematically undermined through the economic and political power generated by the inequalities. This is an inconvenient truth since it undermines the myth that free markets are self-equilibrating.
- 2) **Economic performance involves more than material prosperity:** Material prosperity and its distribution is not the only basic human need affected by economic activity.

⁴ For example, Autor et al. (2017).

⁵ For example, Stiglitz (2019).

⁶ For example, Picketty (2014).

⁷ For example, Lindbeck and Snower (1989) and Olson (1984).

Consequently economic performance should be evaluated in terms of more than material prosperity. Two other basic human needs are empowerment and social solidarity. Empowerment involves the ability to influence one's own fortunes through one's own efforts. In the economic sphere, it concerns the responsiveness of one's economic rewards to one's skills and work efforts. In the political sphere, it pertains to active participation in the governance relevant to one's social allegiances, with respect to both entitlements and obligations. Social solidarity involves conducting meaningful personal relationships within social communities, generating a sense of identity, belonging and mutual responsibility. Empowerment and solidarity need not be closely linked to material prosperity. Universal basic income can guarantee that one's basic material needs are satisfied, but cannot guarantee empowerment or solidarity. The recent waves of globalization and automation have threatened empowerment, particularly among economically, socially and politically disadvantaged groups. Consequently, economic policy should be evaluated by more than national income and its distribution; company performance by more than shareholder value; and civil performance by more than the satisfaction of arbitrary consumption demands. This is an inconvenient truth since it undermines the myth that economic success consists merely in the satisfaction of maximum consumption with minimum resources and that economic performance can be adequately measured through GDP and shareholder value.

- 3) **Human progress rests primarily on cooperation and innovation:** The economic progress that the world has witnessed over the past 300 years rests on two foundations: cooperation and innovation. In the absence of cooperation, humans can achieve little. The growth of knowledge, the management of the commons, the provision of vital public goods and the suppression of inequalities all require us to cooperate with one another.⁸ This cooperation stems from social and political institutions that prevented people from pursuing their selfish ends to the detriment of others. Innovation requires curiosity, openness to change, willingness to challenge established truths, adherence to the scientific method and ... cooperation. All innovations are built on previous innovations. Knowledge sharing is crucial. This is an inconvenient truth since it undermines the myth that economic progress arises primarily through competition in free economic markets.

4 A New Societal Contract

A new societal contract must reconnect us to these three inconvenient truths. In particular, the new contract should be built on three pillars, corresponding to the three truths. These three pillars are far-reaching implications for the responsibilities of government, firms and households.

⁸ See, for example, Henrich (2016).

4.1 Automatic Stabilizers for Economic Power

First, the new societal contract must provide market economies with automatic stabilizers that reduce inequalities of economic power whenever they arise and whatever form they take. At the national level, this function is currently fulfilled through antitrust and competition authorities. There are also some organizations pursuing this function at the supra-national level, ranging from the highly effective Directorate-General for Competition in the EU Commission to voluntary networks such as International Competition Network and the OECD Competition Forum. However, this regulatory framework generates inefficiencies of its own, is vulnerable to political interference driven by economic power, and is inadequate for the new digital age. Digital network monopolies (such as Google, Apple, Amazon, Facebook, YouTube and Microsoft) gain large shares of global markets and can thus often evade national antitrust and competition authorities; they wield immense market power that is often used to gain political influence; and they frequently avoid taxation, erode privacy and create addictive products. These are natural monopolies, whose market value grows in relation to their user numbers.

There is a broad consensus in the economics, business and law professions that monopolies, including natural monopolies, need to be regulated and there is a large literature providing guidelines on how to do so.⁹ However these guidelines – ranging from price regulation to market entry regulation to market share regulation – are all blunt instruments, many of which are not relevant to digital network monopolies and all of which generate new inefficiencies themselves. Furthermore, the regulation of global monopolies, which are becoming increasingly important in the new digital age, would require international coordination on a scale that has proved unachievable so far.

To make progress, it is important to recognize that the social problems generated by monopolies (including natural monopolies) are closely tied to the objectives of these companies, namely, the maximization of shareholder value. It is this objective that makes the companies unresponsive to the public interest whenever it diverges from that of the shareholders. Redesigning company law – requiring companies to define their social purposes, to make boards of directors responsible for delivering on these purposes, to measure company performance in terms of these them, and to implement remuneration schemes reflecting delivery on them¹⁰ – would provide new automatic stabilizers that mitigate the adverse social consequences of monopoly power.

On this basis, the job of regulating global monopolies becomes more manageable, since competition authorities would no longer be locked into the traditional principal-agent problem of promoting consumer welfare by constraining the actions of self-interested firms. Instead, the competition authorities could evaluate the social purposes of companies in relation to the wider public interest and design regulations to bring these into greater consonance with one another. These regulations could, in turn, affect the companies' defined social purposes, and so forth in a

⁹ For example, Joskow (2007).

¹⁰ See Mayer (2018).

virtuous cycle that is driven by our understandings of human needs rather than by shareholder value alone.

The implicit societal contract underlying such reform involves departing from the traditional division of responsibilities between firms, households and governments. Instead of governments bearing the sole responsibility for designing rules that make self-interested firms serve the public interest, a new legal and institutional framework makes governments and firms jointly responsible. This development may be expected to make citizens more aware of potential abuses of economic power and consequently make voters more supportive of the new framework and customers more supportive of companies serving the wider public interest.

4.2 Empowerment- and Solidarity-Oriented Policies

Second, the new societal contract must go beyond our current policy focus on material prosperity and distribution of wealth. It must include the objectives of personal empowerment and social solidarity.

The traditional debate between the left- and right-wing politics largely ignores these objectives, except with regard to material prosperity. Left-wing parties favor more redistribution at the expense of less economic efficiency; while right-wing ones favoring less redistribution for the sake of more efficiency. The underlying equity-efficiency tradeoff is frequently a myth, since the insecurity, social fragmentation and health problems that accompany severe inequality are all highly destructive of economic efficiency.

But even when this tradeoff exists (for example, through disincentives to work and train), the inefficiencies can largely be overcome by moving from a *welfare state* that redistributes money to an *empowering state* that redistributes incentives and creates requisite skills.¹¹ In the new societal contract, the unemployed and unskilled should automatically receive employment and training incentives, financed through taxes on the employed and skilled. Similarly, an *empowering firm* provides employment and training opportunities to promote upward mobility in the workplace. Such empowering redistribution transcends the traditional controversy between left- and right-wing politics, since empowerment is a goal that both sides share.

Whereas redistributing incentives to become employed and skilled can address economic empowerment, political empowerment call for opportunities to participate in the governance of social groups to which one belongs, within political processes in which individual behaviors are monitored, violations of rules are punished, and conflict resolution mechanisms permit disagreements to be resolved quickly and fairly.¹²

Furthermore, social solidarity can be addressed by giving broken communities – particularly ones that have suffered from disruptions driven by globalization and automation – privileged

¹¹ See Snower (1993, 2018).

¹² For further elaboration, see Wilson, Ostrom and Cox (2013), for example.

access to education and quality infrastructure investment. Empowerment and solidarity, in addition to environmental impacts, should become a standard ingredient in the evaluation of economic performance, in addition to GDP and shareholder value. It should also become an integral part of cost-benefit analyses for education and infrastructure investment.

However in the new digital age, smart machines are increasingly taking over routine work from humans, first in a variety of low-skilled tasks (leading to “skill-biased technological change”) and then in a widening range of routine skilled tasks (leading to the “polarization of work”) and thus traditional employment and training incentives may not be sufficient to ensure economic empowerment. What is increasingly required to secure satisfying, empowering jobs is education and training in areas where humans are difficult if not impossible to displace, namely, in tasks involving social skills, noncodifiable creativity and skills in assuming legitimate human responsibility – all combined with the technical skills to make machines complementary to people. Social skills – such as empathy, compassion,¹³ mentalizing and perspective taking – can be trained and measured.¹⁴ The relevant training can promote human-centered productivity in a wide variety of jobs that are currently under threat from automation, from low-skilled jobs in health care, care of the elderly, retail sales and cleaning, to higher-skilled jobs in banking, finance and medicine.

On this account, “empowering states” and “empowering firms” must become involved not just in the redistribution of incentives, but also the creation of skills that permits empowering relations between humans and machines in the new digital age. The new social skills may also be expected to strengthen social solidarities within civil communities. These developments once again involve a departure from the traditional division of responsibilities among governments, firms and households.

4.3 Cooperation and Innovation

And third, the new societal contract must recognize the central role of cooperation and innovation in generating economic progress. The contract should promote economic policies that do not merely promote competition for its own sake, but rather develop the human capabilities of cooperation and innovation. The implications are far-reaching and profound.

Recognizing the importance of cooperation – not only in providing public goods (such as basic education, greenhouse gas abatement and cybersecurity) and preventing problems of the commons (such as overfishing, overgrazing and rainforest destruction), but also in providing a vital sense of social belonging in living communities – decisively invalidates the myth of the Invisible Hand, whereby selfish private enterprise alone works in the public interest.

Furthermore, since human cooperation generally takes place in social groups of limited size, which are nested into larger groups (such as nations), the design of economic policy must move

¹³ See, for example, Weng, Fox and Shackman (2013).

¹⁴ See Schleicher (2018).

beyond the debate between centralized planning and free enterprise.¹⁵ Instead, the organization of economic activities should follow the organization of social activities, so that people's natural social drives for social cooperation may be brought into the service of material prosperity.

Finally, economic policy must focus innovation on wealth creation and empowerment creation, rather than the extraction of wealth and empowerment by the privileged at the expense of the unprivileged. The measurement of economic activity – both GDP and shareholder value – must be changed to reflect the distinction between creation and extraction. This distinction should also be observed with regard to manufactured capital and natural capital. A rise of manufactured capital at the expense of empowerment, social solidarity or natural capital should not count as a net gain.

Recognizing a new societal contract that is built on these foundations can help recouple economic activity with the satisfaction of fundamental human needs. The new contract is based on a new understanding of the responsibilities to be borne by firms, households and governments. Instead of the traditional division of responsibilities – whereby the government is left with the hopelessly difficult task of setting rules to ensure that the self-interested activities of the private sector reflect the public interest – each of the participants in the market economy is embedded in a network of reciprocal rights and responsibilities that clearly serve the wider public interest. This recognition can provide values and norms on which popular acceptance of multilateral agreements to address multilateral problems can be built.

Addressing our major global problems – such as climate change, financial crises, pandemics, technological unemployment, overfishing, and so on – requires the cooperation not only of governments, but also private sector decision makers, working across national boundaries. Furthermore, government policies generally require citizen approval to become legitimate and effective. On these accounts, the implicit societal contract underlying the activities of firms, households and government has overarching significance. The new societal contract can thereby help generate a human-centered capitalism that serves the evolving public interest.

¹⁵ See Wilson (2019).

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