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Which income inequalities, if any, can be justified as incentive payments?

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"We need to create an adequate incentive structure for the most productive members of our society to ensure their contribution to the co-operative venture." This line of reasoning has come to occupy centre stage in two distinct debates over recent years. First, policy makers put great emphasis on "the right incentives" when it comes to fiscal as well as labour policy. They warn of high income taxes that potentially have a negative effect on the motivation of the workforce and may lead to a brain drain; and they call for action against unemployment traps, which render idleness financially more attractive than employment. Second, several theories of distributive justice suggest that certain incentive payments are justified not only as a means to economic efficiency, but also from the perspective of what is just. The most prominent of these arguments is implicit in John Rawls' famous difference principle (1999), which holds that "the talented" should receive a bonus to the extent that the so induced higher productivity can be deployed to the benefit of the worst off group in society.

This short paper primarily addresses the second of these debates, but I hope that it may also contain at least some preliminary thoughts about how to make sense of the concept of incentives in contemporary political debate. In order to address the central question – "What, in relative terms, should we as a society pay 'the talented'?" – I need to make explicit a set of assumptions on which my argument rests. Subsequently, I will introduce a distinction between income inequalities based on *exogenous* versus *endogenous* comparative advantages of workers and suggest that different theories of justice may condemn one or the other, or both. Finally, I will interpret and defend my own position, which regards income inequalities based on exogenous comparative advantage as legitimate but considers those traceable to endogenous comparative advantage unjust.

INCENTIVES AND THE MARKET – SOME PRELIMINARY REMARKS

1) An employer offers his workers a bonus if they attain a certain piece rate in production. 2) An employer lures a worker away from his main competitor by offering him a higher wage. 3) A heart surgeon is paid more than the average wage in society. 4) A fall in the price of a certain commodity induces consumers to buy more of it. – Which of these cases contain a genuine incentive? What is a useful definition of the concept? In particular, what is its relation to the market mechanism?

Ruth Grant convincingly argues that incentives "are understood better in contradistinction to market forces than as identical to them." (134) Incidentally, this position is consistent with the historical use of the term. Early economists like Adam Smith, who believed in the positive nature of the unintentional consequences of the market, never used the term. It was only introduced when some of the failures of the market became apparent and the search for correctives began. An incentive so understood constitutes an intentional intervention with the market mechanism that induces a person to behave differently than she would have in its absence. This already rules out the fourth example on our above list.

What does this imply for the context of income inequalities, which preoccupy us in this paper? As Grant spells out, "[a]n incentive is a bonus, which is defined as something more than usually expected, that is, something that exceeds normal compensation." (134) However, this definition merely pushes the question back to the notion of "normal compensation." Which level of compensation *is* normal and, once again, should market compensation be considered normal?[1]

At this point, I believe we need to refine Grant's analysis further by introducing the distinction between a perfectly competitive market on the one hand, and the various forms of imperfect competition on the other. By definition, agents on a perfectly competitive market are price takers, they are too small a buyer or seller to exert any influence on the market price. In other words, no one can successfully deviate from the market wage under perfect competition – there is no conceptual room for incentive payments understood as an intentional intervention with the market mechanism.

The situation changes under the more realistic regime of imperfect competition. Economies of scale allow firms to acquire market power, which implies a certain discretion to set prices, including wages. However, the presence of market power blurs the distinction between market price and incentive payment. After all, if one employer in a given industry offers a bonus to his employees, his competitors might be forced to follow suit in order to prevent their workforce from defecting to the more lucrative jobs. If the wages in a certain industry or even for subgroups of employees across the industry are hiked up in this way, should we regard this as a result of market interaction or as the consequence of a market intervention?

[1] Note that normal compensation here is to be understood relative to different professions. It needs to be distinguished from the notion of average compensation used in example 3 above.

This is a tough call, and I do not intend to find an answer to this question here. All I want to claim is that in such cases, there is at least *some* discretionary wage setting taking place. It is this intentional deviation from the price vector the market forces would lead to independently which we will take to be the constitutive feature of incentive payments in this paper.

If the above conceptualisation is accepted, then a normative evaluation of these discretionary incentive payments can be carried out without passing judgements on the resource allocation of the market mechanism. Since the demands of distributive justice are frequently discounted due to their alleged conflict with economic efficiency, this is a significant result.[2]
In sum, incentive payments constitute an intentional deviation from the vector of market prices, and as such induce economic agents to change their behaviour.[3] According to this definition, only the first of the four examples described above unambiguously contains an incentive payment; the fourth does not, the second and third only potentially do, depending on whether the income differential is due to market forces or discretionary wage setting.[4] Incentive payments so defined are subject to normative scrutiny.

Before turning to the question what motivates employers to make such incentive payments, i.e. before turning to a detailed analysis of the 'talents' of their workers, one last clarification is in order. Incentive payments are made by employers. Yet, in the formulation of the central question of this paper, I asked what we, *as a society*, should pay the talented. How do these two perspectives fit together? The short answer is that fiscal policy allows us, via a democratically elected government, to correct for those incentive payments we deem unjustified from the perspective of distributive justice. The taxes and subsidies employed to this end are paradigm examples for incentives themselves. A more elaborate answer would have to take into account the warning from economic theory that any fiscal measure is bound to have repercussions on the allocation of resources, too. Given the space constraints, I allow myself to bracket this set of issues here.

[2] A lot rides on the relative magnitude of those income differentials that are due to discretionary decisions. I recognise that the relevance of my argument partly hinges on this point, but I do not yet feel in a position to say anything about the actual value of this relative magnitude that would go beyond mere speculation.
[3] An interesting question arises as to whether this definition of incentives overlaps with the distinction between compensatory and non-compensatory incentives payments used by Colin Macleod in his contribution to this collection.
[4] This analysis of examples 2 and 3 implies that my definition of incentives differs from that offered by John Rawls. Whereas Rawls would regard any income inequality, i.e. any bonus above average compensation as an incentive payment, my account restricts incentives payments to income differentials external to the market mechanism. The heart surgeon's wage in situation 3, for instance, only constitutes an incentives payment to the extent that it is due to a discretionary decision, i.e. one that represents an intervention with market forces.

BETWEEN LIBERAL EGALITARIANISM AND LIBERTARIANISM

An employer's motivation to make an incentive payment is clear. He wants to improve the productivity of his workers at a certain task, or to induce them to perform a new task altogether. It is less clear whether the beneficiaries of these incentive payments have a right to keep this extra income. Different theories of distributive justice give different answers.
Libertarians say that provided the distributive outcome is the result of a voluntary exchange, the beneficiaries are entitled to their extra income. From this perspective, incentive payments are morally unproblematic.

John Rawls proposes a conditional acceptance of incentive payments; his difference principle holds that extra pay to "the talented" is justified, provided the resulting increased productivity can be deployed to the benefit of the worst off group in society. The most prominent criticism of Rawls on this issue claims that his argument requires an implausible restriction of the scope of the difference principle to what he calls the "basic structure of society" – as opposed to those principles of justice that govern individual conduct.[5]
Post-Rawls liberal egalitarians, finally, would tie the legitimacy or not of incentive payments to the question of whether the skills that attract them are deserved or not. Ronald Dworkin, for instance, would presumably condemn incentive payments when the underlying skill can be traced to a natural talent; he would accept them as legitimate, on the other hand, when the underlying skill is a consequence of certain choices the individual in question has made.
In what follows, I suggest that the Rawlsian way of framing the discussion omits an important distinction. The *talents* we are born with are not identical to the *skills* remunerated on the labour market. Taking into account this distinction opens up a new perspective on the legitimacy of incentive payments, one that may affect the stance of libertarians and liberal egalitarians on the issue, too.

Whereas talents are generic and innate, skills are specific and need to be developed – intelligence is the paradigm example for the former category, the ability to fly an aeroplane illustrates the latter. There is an important difference between the two categories. Whereas talents are inalienable, skills are acquired. In most of today's economies, the acquisition of skills is a function of a very sophisticated division of labour. In a different paper (Dietsch, forthcoming), I make the case that this division of labour calls for an equal distribution of the co-operative surplus; the latter is defined as the difference in output between the actual world and a counterfactual one, where individuals have to cope without the co-operation of other specialised labour. I will not repeat this argument here, nor does the present paper presuppose acceptance of its conclusion. The only insight I want to draw on is the following: Although skills do form just as important a part of our identity *ex post*, i.e. once we have

[5] Cf. Cohen (1997) and Murphy (1999) for statements of this criticism. Williams (1998) as well as Voorhoeve (in this collection) present a defence of Rawls. Thomas (in this collection) contains a lucid discussion on what is at stake in the proposed division of principles of justice into those that govern the basic structure and those that refer to individual conduct.

acquired them, society arguably has a stronger claim on their productive force than in the case of talents.
In virtue of their differential talents and skills, individuals differ in their performance at various tasks – in the terminology of trade theory, they develop a comparative advantage in the production of certain goods or services. We can distinguish between an *exogenous* comparative advantage, which is based on a talent, and an *endogenous* comparative advantage, which is based on a skill.[6,7]

So how does all of this relate to the question of incentive payments? I want to claim that incentive payments towards exogenous comparative advantages are legitimate from the viewpoint of justice, whereas incentive payments directed at endogenous comparative advantages are not. In other words, paying a bonus for intelligence or physical dexterity is fine, whereas receiving extra pay in virtue of having learned how to fly an aeroplane is not.[8]
The rationale for this position is the following. Both talents and skills are the product of a complex interaction between innate characteristics, social factors, and individual choices. Yet, in a distributive context, we need to decide who is to receive the benefits that flow from the employment of these talents and skills. I believe two considerations should influence this decision. First, neither individuals nor society have any influence on individuals' innate talents. Yet, since talents are an inalienable characteristic of the individual, this is where the resulting benefits should fall by default. Hence the legitimacy of incentive payments made towards exogenous comparative advantage. Second, no particular individual can claim to have made a significant contribution to the division of labour in society, and hence the resulting benefits should go to society, that is to all individuals equally. Hence the illegitimacy of incentive payments made towards endogenous comparative advantage.

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[6] This, I hasten to add, is a purely conceptual distinction. In practice, we will never be able to disentangle the causal nexus behind particular instances of comparative advantage in order to identify the relative importance of talent and skill. However, this does not mean that the distinction is of no value. It can still inform policy decisions we make as a society.
Cf. also the argument of liberal egalitarians. Ronald Dworkin, for instance, readily admits that we cannot disentangle the relative influence of innate talent, social environment, and individual choice on income differentials, yet he nevertheless draws normative conclusions based on this distinction. (cf. 1981, 313)
[7] We can find first evidence of the debate over specific *versus* generic talent in Adam Smith and David Ricardo, two of the most prominent classical economists. Both attributed much significance to the division of labour in society and the specialisation it brings with it. Yet, they modelled talent in different ways. Smith "proposed what is now referred to as the concept of endogenous comparative advantage, which implies that economies of specialization and division of labor may exist even if all individuals are *ex ante* identical, and that the differences in productivities between various specialists are consequences rather than causes of the division of labor." (Yang, 2001, 44) Ricardo, in contrast, relied on a notion of exogenous comparative advantage, which amounts to the view that marketable skills are to a significant degree fixed by natural endowments.
[8] This does of course not preclude differences in compensation, i.e. wages, between different professions. It is also worth adding that the market mechanism does not make the above distinction between talents and skills in setting remuneration (cf. also footnote 6). I propose to employ it only with respect to incentive payments which, as we have seen in section 1, lie outside the market.

This position situates me between libertarians and liberal egalitarians. Libertarians will welcome the fact that an entitlement based on talents is congruent with the notion of self-ownership. At the same time, it is clear that my account – by declaring incentive payments towards endogenous comparative advantage unjust – imposes substantive constraints on voluntary exchanges between economic agents, a feature that both libertarians and liberal egalitarians will be reluctant to accept. Liberal egalitarians would object to my argument that accepting incentive payments towards exogenous comparative advantage amounts to rewarding one kind of undeserved differences, namely talent.[9] At the same time, the distributive *outcome* under my account may be not that far removed from what liberal egalitarians have in mind. One point for discussion between the liberal egalitarian and myself lies in tracing endogenous comparative advantages to individual and systemic factors respectively. Whereas the liberal egalitarian tends to emphasise individual choice, I put a lot of weight on the benefits from division of labour.[10]

John Rawls, it should be added, represents a special case. His remarks about talents as common assets (cf. 1999, 87) and the "mutually beneficial complementarities" in a specialised society (2001, 76) – of the members of an orchestra, for instance – are sufficiently vague to be compatible with the position set out here.

Before closing, let me add one clarification. I am conscious of the fact that from a bargaining perspective, the distinction between exogenous and endogenous comparative advantage has little bite. Because it takes years to train a pilot or a lawyer, the supply of these skills is very inelastic in the short term, allowing the incumbents to extract a premium on the labour market. My once again brief response to this observation is that this conflict is not surprising. Only under the exceptional circumstances of relatively equal initial bargaining power will the outcome of a bargaining game not diverge from what constitutes a just distribution.

CONCLUSION

I have argued that 1) incentive payments take place outside the logic of the market mechanism, and that 2) only those made towards exogenous comparative advantages are justified from the perspective of distributive justice. Two crucial questions have not been addressed in this paper. 1) What counts as market compensation and what should be classified as discretionary incentive payments? 2) How significant are exogenous and endogenous comparative advantages respectively?
Finally, can the above discussion help further our understanding of the use of incentives in contemporary politics? One insight would have to be that the short-term orientation of

[9] Cf. the last paragraph for why I disagree.
[10] For an interesting justification of incentive payments open to liberal egalitarianism, cf. Colin Macleod's contribution to this collection. On his argument, incentive payments made towards endogenous comparative advantage may be justified under non-ideal circumstances, even when their recipients are not entitled to them.

politics caught in electoral cycles certainly diminishes the chances of incentive payments towards endogenous comparative advantage being taxed away. The strong bargaining position of the skilled translates unchecked into growing income inequalities between groups of different qualification, most prominently those with a university degree compared to those without.

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