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Wealth and whim: Should the wealthy spend their money as they wish

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Wealth does not always fall into a single ‘source’ category.

SUMMARY

It’s not about judging someone else’s spending on moral grounds, but a framework exists for us to answer that question in the context of an economy’s structure—think institutional soundness, outcome fairness, success incentives, etc—and whether its prospects are getting brighter or dimmer.

Of late, there have been many discussions on how much spending or ostentation is “too much" for a rich person. And the views are polarized along, “It is bad/ immoral/ unforgivable to spend so much when most of your fellow citizens need free food" to “It is their money and how they spend it is no one else’s business."

Without getting moralistic, the question is whether there a way or framework to think about this in pure economic terms?

That is what I attempt to do in this piece. My analysis is largely based on a research paper, ‘Perspectives: Explaining Influence Rents: The Case for an Institutions-Based View’ by Gautam Ahuja and Sai Yayavaramand, published in the journal Organization Science, and some discussions with Professor Ahuja. Any distortions or over-simplifications are, of course, mine.

The framework, very broadly, is this: There are five types or sources of wealth creation, and the freedom to spend the money as desired should depend on how that wealth has been earned. These five can be roughly ranked in ‘moral’ terms. ‘Moral’ not in a spiritual sense, but determined by whether the money is ‘deserved’ in economic terms.

Thus the questions are: How much of the wealth was earned by means of the honest efforts and capabilities of its current owners? And there is a hierarchy to this which determines the moral right to that money.

The logic? For an economic system to work well, rewards and efforts should be aligned, businesses should pay for their related costs, and the market should allow reasonable competition—meaning that another player should have a fair chance of replacing the incumbent.

Coming back to the five sources of wealth, here are the five in decreasing order of desirability:

The first are returns from a talent (or an ability) and/or effort. You design clothes or jewellery that your customers love, for example, or start a D Mart in a crowded business arena and make a success of it. These are legitimate ways to earn wealth.

The second is wealth created from innovation or an invention. It could be an electric bulb, Viagra or a iPod. In such circumstances, it is only fair that the innovator be rewarded—both for making the world better and for incentivizing other inventors.

In both these categories, it can be argued that the wealth created belongs completely to the owner, to spend as they deem fit, whether it is on buying a private plane or an island, or partying with the biggest names in showbiz.

Now we start to move into relatively grey areas.

The third category relates to externalities. These are cases where a business may be making profits where a part of the costs of that business are being borne by the economy or society at large. Textbook examples include the health damage caused by cigarettes and pollution from automobiles, neither of which is paid for by the company making these.

Then comes income and wealth made on account of monopolistic advantages. For example, some sectors like railways, ports, airports, oil exploration or even large-scale oil refining, electric utilities, telecom, etc, tend to develop natural monopolies.

In such cases competition, especially new competition, is either missing or weak due to the structure of the industry. This is why most monopoly businesses have traditionally been either government run or heavily regulated.

This is also the reason why anti-monopoly laws exist in most jurisdictions. In more recent times, a platform like Facebook or Google can provide the incumbent many monopolistic advantages, including very high entry barriers for anyone else.

The last type is ‘influence rents,’ as economists call them. This is the worst way to generate wealth (short of actual crime). These arise because the person or business controls the institutions and rules by which the economic activity is regulated.

Those who benefit from this often have access to market opportunities and contracts that are not available to others, and frequently receive exceptional treatment. Plus, rules and laws are fashioned to favour them and disfavour their rivals.

Under this framework, economically speaking, it is fine if someone spends money that has been earned through talent and/or effort, or by innovation. Money from externalities, monopolies or the exercise of influence, however, is a different story.

Wealth does not always fall into a single ‘source’ category. For example, in its business of e-commerce, Amazon started out as an innovator and a business doing things more efficiently.

But, later on, it allegedly did not hesitate to use and misuse its monopoly or dominant position. Therefore, in every case, one would need to make a judgement on the mix of wealth sources before we can say whether its holders are entitled to spend it as they wish.

But why do we need to do that? Is it for gossip or remarks about extravagance on social media?

Actually, the issue goes much deeper. Influence rents, for example, can impair the productive capacity of an economy because they distort and destroy incentives to invest or work hard, and thus condemn everyone to longer-term sub-optimal outcomes.

In economic theory, it has been shown that societies characterized by certain market features and processes work better to maximize economic development and growth.

An ideal economic system features fair competition as well as a robust institutional, legal and regulatory structure, with appropriate laws that cover competition, contracts, consumer protection and more.

These are not just theoretical constructs. As the paper's authors point out, the US's economic system during the Cold War was heavily driven by that logic, in contrast with the socialist economic system adopted by the Soviet Union.

The Soviets were able to match the US on military strength and technology, but were not able to match the efficiency of the economic and legal institutions of the US. Ultimately, the collapse of the Soviet Union was an economic phenomenon, and not on account of a military defeat.

A society and economy will not prosper if it is weakened by hollowed-out institutions, where wealth is created via capturing and influencing these. We can see this play out in many resource-rich countries around the world that continue to struggle economically, or for that matter even in post-Soviet Russia, controlled as it has been by oligarchs or others close to the power centre.

Hence, it is not just about judging someone's spending, but what that tells you about the structure of an economy and the brightness or otherwise of its future. At least we now have a framework to think about this.