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THE IMPORTANCE OF BEING SUFFICIENTLY EQUAL*

By James K. Galbraith

> The liberal reward of labour, therefore, as it is the necessary effect, so it is the natural symptom of increasing national wealth. The scanty maintenance of the labouring poor, on the other hand, is the natural symptom that things are at a stand, and their starving condition that they are going fast backwards.
>
> —Adam Smith[1]

> He hated unemployment because it is stupid and poverty because it is ugly.
>
> —Joan Robinson, on John Maynard Keynes[2]

I. Introduction

Neither income nor wealth should be too highly unequal. But there is a fundamental distinction between pay for work and the ownership of capital assets. The reasons to moderate these inequalities therefore differ, and the arguments are best considered separately.

The case for sufficient equality in pay is aesthetic and pragmatic. Too much inequality is unpleasant and dysfunctional.[3] Because it is associated with high rates of poverty, it is ugly. Because it leads to unemployment and the evils thereof, readily avoided by simple, proven methods, it

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[1] Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* (London: Dent, 1970), book I, chap. 8, p. 65.

[2] Joan Robinson, "What Has Become of the Keynesian Revolution?" in Milo Keynes, ed., *Essays on John Maynard Keynes* (Cambridge: Cambridge University Press, 1975), 128.

[3] What *degree* of equality should be considered "sufficient"? This is an important question, but determining it is not the central task of this essay. The purpose of phrasing my argument as a case for *sufficient* equality is to frame the general issue in a precise way, that is, to argue that the shape of the distribution of income matters—that more equality has advantages, that inequality can be excessive. It is also to avoid the trap, into which philosophers and economists sometimes fall, of centering the argument at the extreme cases. There is no practical case for perfect equality, for Cambodia under the Khmer Rouge, just as even the most extreme conservative would not defend Mobutu in the Congo. The practical question is posed within the framework of modern capitalist social democracy. It is: should we care whether inequality rises or falls?

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is stupid. More equal societies have less unemployment, fewer poor, less crime, and better public services; they are on the whole more prosperous and stable and more peaceful places to live.

The case for sufficient equality in the distribution of wealth relates mainly to the construction of political life. Highly unequal societies are always dominated by the rich. Whatever the legitimacy of great wealth, it is sordid (an aesthetic consideration) to weight political influence by asset value. And speaking practically, deeply unequal societies cannot function as coherent social units; they cannot govern themselves on legitimate terms. Rather, they fracture and they fractionate. A sufficient degree of wealth equality is thus necessary for any collection of individuals properly to be considered as a society in the first place, and for such a society to function as a democracy.

This essay will take up the pay and then the wealth dimensions of the case for sufficient equality. Since aesthetic issues are mainly matters of taste, it will concentrate on the pragmatic arguments. The issues related to income and pay especially need careful consideration, for conventional theoretical treatments of equity and efficiency typically presuppose the conclusion that there exists a trade-off between these two values. And the conventional empirical treatment of the efficiency/equity relationship has also been flawed for other reasons, reasons that are partly conceptual and partly related to gross deficiencies in the interpretation of available data. These have led to widespread misinterpretation of the actual experience of America, Europe, and the developing world in recent years.

II. The Distribution of Pay

A. Theory: the market myth

The elementary textbook view of markets, wages, profits, and employment states a theological position. *From all according to their average product, to each according to his marginal product*. That is the rule. Everything that is required in order to make the rule hold, including constant returns to scale, perfect competition, a smoothly differentiable production function with well-defined factor inputs (with capital and labor measured in efficiency units and with well-behaved factor-price frontiers[4]), and full employment of resources, is assumed. The rule then implies that an optimum of efficiency and a Pareto maximum of social welfare will be achieved.

It follows that anything that interferes with the market mechanism, so to say, *artificially*, will produce a decline in efficiency. In particular, inter-

[4] For a definition of production functions and factor-price frontiers and a discussion of the technical issues involved in these assumptions, see Geoffrey Harcourt, *Some Cambridge Controversies in the Theory of Capital* (Cambridge: Cambridge University Press, 1972).

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ference in the price mechanism will certainly do so. Any increase in my wage—the price of my labor—relative to my marginal product can only discourage my employer from demanding my services. The resulting fall in my employment can only reduce average product, generating a "dead-weight loss" under the demand function. This is the "efficiency/equity trade-off": equality *produces* unemployment, and so reduces output and wealth below what they would otherwise be.

A *moral* argument for more equality can still be made. But it is an argument from the heart, not from the head. Those who espouse it are taking a stand against the greater wealth of the larger number. They are suggesting that the price of compassion should be paid. Against this view, there will stand the rigorous conservative, the inveterate logician, to make the case for more output, more accumulation, and a higher growth rate. And under the assumptions, the conservative is not wrong. Given a long enough run, everyone is better off with more output; the power of compound growth trumps the short-run solace of progressive tax and transfer schemes every time.

Usually, by the time a student has been brought along, through enough symbolic reasoning and mathematical derivation, to take seriously all the restrictions on the underlying model and its implications, he or she barely notices that nonsense is being slapped on nonsense.[5] For the entire construct is artificial to begin with. In a world that never was, under conditions designed *a priori* to achieve the ideal, in which, among other things, unemployment is ruled out by construction, change will of course make things worse. An exceptionally scrupulous teacher may remind the student that none of this has application to the world in which we actually live. But such scruples would undermine the incentive to learn the model, and so they are usually relegated to footnotes; the student perceives, first and foremost, the ideological lesson lying in plain view.

This is an academic issue, but only in part. For the elementary textbook view actually dominates popular and policymaking thinking about the great issues of social order in the industrial world today: inequality in America and unemployment in Europe. Rising inequality in America is regrettable, almost everyone claims to agree. But the textbook view tells us that this increase is the result of a changing pattern of marginal products, of "skill-bias" in technological change, a by-product of our informa-

[5] One odd feature of the simple textbook theory is that while it is often used to defend inequality, it actually predicts perfect *equality* of wage rates under the ideal conditions of the model. For if "labor" is a single homogenous input to production, all units of labor should be remunerated at the unique "marginal product of labor." (This is the *law of one price*.) Theorists escape this embarrassment by postulating that differences in pay are due to differing endowments of "human capital"—that they are in fact a form of profit rather than wage income. But that only raises another question, that of how human capital endowments are decided.

tion age.[6] It is therefore the price we pay for full employment. Any effort to regulate pay inequalities would only cost us jobs.[7]

In European discussions, by application of the same principle, unemployment is the price of the welfare state. European rightists, led by tart-tongued organs like the *Economist*, maintain that "a good sign of an efficient job market is a wide gap between the highest and the lowest paid";[8] Europe, they say, is not efficient, and the blame lies with the trade unions and the social democrats and their stubborn resistance to pay cuts. European leftists respond by defending their culture against barbarism *à l'amèricaine*. If unemployment is the price of civilization, they say, so be it! Meanwhile, up to 20 percent of the working-age population of Spain is left unemployed for over twenty years.

In truth, though, not even simple microeconomic theory supports the notion that there is necessarily an efficiency/equity trade-off according to which cutting prices or boosting wages necessarily cuts output. At the start of the Second World War, American price controllers realized that slapping restrictions on prices and controls on high-end wages—radically equalizing the pay structure and the real wage—did not reduce output.[9] Quite to the contrary, production soared, even of civilian goods. A little bit of monopoly-model reasoning helped to explain why: when price controls were imposed, production went from the monopoly-profit maximum toward the competitive-profit maximum, which is higher.[10] In other words, the theoretical idea of the efficiency/equity trade-off *depends* on the competitive-market assumption. But there are no perfectly competitive

[6] The concept of "skill-bias" in technological change is now fading from the economic literature; a thorough appraisal and critique of the concept is given in James K. Galbraith, *Created Unequal: The Crisis in American Pay* (New York: Free Press, 1998), chap. 2.

[7] And so inequality is, as U.S. Federal Reserve chairman Alan Greenspan once testified to Congress, "*outside the scope, so far as I am concerned, of the issues with which we deal*." Alan Greenspan, testimony to the House Banking Committee, Subcommittee on Domestic and International Monetary Policy, March 5, 1997, quoted in ibid., viii (italics mine).

[8] "Economics Focus: Rich Man, Poor Man," *Economist*, July 24, 1993, 71 (p. 73 in the magazine's UK edition).

[9] Among these price controllers, notably, was the late Walter Salant of the Brookings Institution, a veteran of the Office of Price Administration, from whom I heard this interpretation at a conference in the early 1980s. This argument is of course not intended to explain the full degree of productive expansion during the war; it merely points to the contribution of controls. A recent and dramatic example of the same principle operating in reverse arose in the winter of 2000–2001 in the California electric power crisis. In that case, deregulation and freeing of prices *failed* to produce needed increases in investment and output, and Californians suffered from the predictable consequences of introducing monopoly conditions into what had been a successfully regulated industry.

[10] In the textbook monopoly model, a firm chooses output so that marginal revenue is equal to marginal cost, and prices at the rate the market will bear. This produces the restriction on output, high prices, and excess profits characteristic of classical monopoly. Price controls, however, eliminate the capacity of the firm to raise prices by restricting output; in effect, they flatten the marginal revenue curve. Thus, when subjected to controls, monopolistic firms can be expected in principle to find a new profit maximum at a higher level of output.

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markets in real life, and under any other market structure, output and efficiency may increase instead of fall when equality increases.[11]

Larger theoretical issues—macroeconomic issues—also hang over the trade-off idea. John Maynard Keynes's *The General Theory of Employment, Interest, and Money* forced a generation of economists to abandon the assumption that full employment would prevail under free markets.[12] The "paradox of thrift" meant that efforts to increase savings—the exercise of the Victorian virtues of parsimony and abstinence—would only reduce effective demand, consumption, business investment, national income, and so savings itself. Thus, policies to concentrate wealth in the hands of those who would not consume it were misguided. The right thing to do was to drive *down* the rate of profit by forcing *up* the pace of investment, and to do that by spreading out purchasing power and effective demand. As the Cambridge economist Joan Robinson explained:

> The whole elaborate structure of the metaphysical justification for profit was blown up when [Keynes] pointed out that capital yields a return not because it is productive but because it is scarce. Still worse, the notion that saving is a cause of unemployment cut the root of the justification for unequal income as a source of accumulation.[13]

Keynes provided, in other words, a macrotheoretical underpinning for the efficiency of equal distributions. His idea was that the benefits of full employment would prove transcendent.[14] And he saw the reduction of idle financial accumulations, through a more equal distribution of pay and a reduction of the share of profits in total output, as the central element in a policy aimed at full employment. The objective should be to raise spending, not saving. For this, purchasing power had to be delivered to those who would spend freely. This could be done by governments directly, of course, if individuals willing to shoulder the burdens could not be found. But if individuals and households would do it, so much the better:

[11] A similar monopoly/monopsony argument underpins David Card and Alan Krueger's explanation as to why increasing minimum wages does not reduce employment. See David Card and Alan Krueger, *Myth and Measurement: The New Economics of the Minimum Wage* (Princeton, NJ: Princeton University Press, 1995).

[12] John Maynard Keynes, *The General Theory of Employment, Interest, and Money* (London: Macmillan, 1936).

[13] Joan Robinson, *Economic Philosophy* (London: Pelican, 1964), 72–73.

[14] The idea that full employment should be the fundamental policy objective was, of course, always opposed by conservative economists, who in the late 1960s constructed a formidable theoretical argument according to which high rates of unemployment should be accepted in order to avoid runaway rates of inflation. The experience of the late 1990s finally discredited this proposition, and the concepts of a "natural" rate of unemployment and its close relative, the "nonaccelerating inflation rate of unemployment" (NAIRU), have now largely been abandoned.

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> Therefore, O patriotic housewives, sally out tomorrow early into the streets and go to the wonderful sales which are everywhere advertised. You will do yourselves good—for never were things so cheap, cheap beyond your dreams. Lay in a stock of household linen, of sheets and blankets to satisfy all your needs. And have the added joy that you are increasing employment, adding to the wealth of the country because you are setting on foot useful activities, bringing a chance and hope to Lancashire, Yorkshire and Belfast.[15]

There is no general reason in economic theory to favor grossly unequal distributions, and there may well be, on several grounds, a pragmatic preference for more equal distributions. But the issue cannot be left as a matter of taste between alternative versions of economic theory. The next question is: which works better in practice?

B. Evidence: equality, employment, and growth

1. Inequality and unemployment across Europe. Take the case of Denmark.[16] It is a small country, nestled in the north of Europe. Unlike its near neighbors Norway, Great Britain, and Holland, it is not floating on seas of oil or gas. Unlike Belgium, which grew rich on the rape of the Congo, Denmark never had major colonies; Greenland is a dud. Unlike Switzerland, Denmark was occupied in World War II; it did not prosper by laundering German money. Denmark also lacks major industry and, apart from fundamental contributions to twentieth-century theoretical physics, it is not a technological power.

And yet Denmark is today the third-wealthiest country of Europe,[17] evidence of strong, consistent, stable economic growth over the decades. It is also roughly the most equal. And it enjoys roughly the lowest unemployment rate in Europe, as well as one of the highest ratios of employment to active population.

Denmark is a prima facie counterexample of the efficiency/equity tradeoff. It is, indeed, a test case for the Keynesian propositions that equality is good for employment and that steady full employment is the key to

[15] John Maynard Keynes, "Economy (1931)," in Keynes, *Essays in Persuasion: The Collected Works of John Maynard Keynes* (London: Macmillan, 1972), 9:138.

[16] I am grateful to Bengt-Aage Lundvall, Sven Larson, and Per Gunnar Berglund for their various insights on the Danish case.

[17] After Norway and Switzerland, judging by per capita gross domestic product (GDP). According to the Luxembourg Income Studies, Denmark's inequality of net household income clocked in at about .24 on the Gini scale in the early 1990s, compared to a value of .34 for the United States at the same time. See the table at Luxembourg Inequality Study, "Income Inequality Measures," available on-line at http://lisweb.ceps.lu/keyfigures/ineqtable.htm. Unemployment rates in Denmark in recent years have been at or below 4 percent.

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growth and wealth. Moreover, Denmark is *not* an exception to any rules. There are no tricks of policy here—such as the "active labor-market policies" and flexible work hours often given credit for relatively low unemployment rates in the Netherlands.[18]

Denmark is, rather, the endpoint on a continuum that covers most of the countries of Europe. The rules of this continuum are straightforward. First, lower unemployment means higher income. The high-income countries of Northern Europe systematically enjoy lower rates of unemployment than their less wealthy Southern cousins. Second, lower inequality means lower unemployment. The strong welfare states of Northern Europe have higher employment rates and lower unemployment rates than the relatively inegalitarian countries of the South. These rules apply across all of Europe, as my associates and I have shown in other work.[19] Denmark, about the most equal of them all and one of the richest, merely sets the standard from which other countries of Europe may be judged.[20]

How does this equality/employment connection work, opposed as it is to the logic of the supply and demand model? The answer is truly simple, once you see it. Unemployment is, in part, an expression of stress and of discontent. Measured unemployment rates reflect the desire, and the ability, of people who would otherwise be peasants or on the dole to seek better employment at better pay. When there are few jobs and major pay gaps, it is normal for large numbers of people to go hunting for the few available good jobs. Long queues are the inevitable result.

But in a fairly equal society, low-productivity workers are already being paid well—within shouting range of their more productive compa-

[18] The Netherlands is commonly cited for low unemployment rates, but it has a lower employment-to-population ratio than Denmark, and many fewer hours worked, indicating that part of the Dutch success lies in discouraging people from seeking work, rather than from providing it. The concept of "active labor-market policies" generally refers to training people for appropriate positions, but in the Dutch case the more important element appears to be accommodating the structure of jobs—through short time and flexible hours, for instance—and the attitudes of the population to a low absolute level of employment.

[19] See James K. Galbraith, Pedro Conceição, and Pedro Ferreira, "Inequality and Unemployment in Europe: The American Cure," *New Left Review*, no. 237 (1999): 28–51, also published in James K. Galbraith and Maureen Berner, eds., *Inequality and Industrial Change: A Global View* (Cambridge: Cambridge University Press, 2001). These sources also provide a detailed statistical evaluation of the relationship between income, inequality, and unemployment.

[20] In 1998 Denmark had a GDP per hour of only 92 percent of the average for Organization of Economic Cooperation and Development (OECD) states, well below European norms; moreover, unlike the Japanese, Danes do not work abnormally long hours. They benefit from a larger working population, a higher labor-force participation rate in the population, and low unemployment, and together these factors raise Denmark's GDP per person to 103 percent of the OECD average. Deplorable performance on the same factors explains why the EU-14 as a group yields 103 percent of the OECD average in output per hour but nevertheless has only 90 percent of the OECD average in per capita GDP. See Bart van Ark and Robert H. McGuckin, "International Comparisons of Labor Productivity and Per Capita Income," *Monthly Labor Review* 122, no. 11 (1999): 33–41. (The OECD includes most countries of Western Europe and North America as well as Japan, Korea, Australia, and New Zealand.)

triots. They have, therefore, much less incentive to search for a better job. And highly equal societies subsidize many of the amenities of life, from education to health care to housing. That being so, who wants to leave a pleasant and undemanding low-productivity job? In an equal society, people stay employed where they are, often for a working lifetime. The resulting society may well lack excitement. But it is very capable of producing high levels of output and economic well-being, and it is not an accident that Denmark is both egalitarian and rich.

2. *The United States and Europe*. Moreover, the laws of economics are the same on all inertial continents. The United States and Europe are not at opposite ends of an inequality/unemployment spectrum. Contrary to what many believe, the United States did not reach full employment by cutting the wages of the poor. To the contrary:

- Were we living under an iron efficiency/equity trade-off in the United States, rising minimum wages would cause unemployment, but as economists David Card and Alan Krueger demonstrated, they do not. California and New Jersey raised minimum wages in the 1980s and unemployment fell; the same thing happened when the national minimum wage was raised in the 1990s.[21]
- Were we living under an iron efficiency/equity trade-off, less skilled workers should be more heavily employed, relatively, in the United States than they are in Europe, but as economist Richard Freeman demonstrated, they are not.[22] The United States and Europe employ roughly similar proportions of skilled and unskilled workers.
- Were we living under an iron efficiency/equity trade-off, then in the United States unemployment should have fallen when inequality rose in the early years of the 1980s, and pay inequalities should have gone up when unemployment fell in the 1990s. But the exact reverse is the case. Unemployment and inequality rise and fall together, month by month and year by year. Using a measure of inequality that relies on manufacturing wages, my associates and I have shown that this relationship holds monthly as far back as January 1947,[23] and annually as far back as 1920.[24]

[21] Card and Krueger, *Myth and Measurement*, marshals this evidence.

[22] Richard Freeman, "The Limits of Wage Flexibility to Curing Unemployment," *Oxford Review of Economic Policy* 11, no. 1 (1995): 63 ff.

[23] James K. Galbraith and Vidal Garza Cantú, "Inequality in American Manufacturing Wages, 1920–1998: A Revised Estimate," *Journal of Economic Issues* 33, no. 2 (1999): 735–43, also published in Galbraith and Berner, eds., *Inequality and Industrial Change*.

[24] Thomas Ferguson and James K. Galbraith, "The American Wage Structure, 1920–1947," *Research in Economic History* 19 (1999): 205–57, also published in Galbraith and Berner, eds., *Inequality and Industrial Change*.

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Indeed, the relationship between pay equality and employment is so close[25] as to raise the question of whether these two phenomena are really anything other than different ways of measuring the same underlying economic condition. Unemployment is a measure of the distress of those at the bottom of a statistical distribution of economic outcomes. Measures of pay inequality reflect the divide among those who remain at work. Anything that increases the distress of those at the bottom, weakening the access of low-wage workers to employment, should in principle also weaken the grip of the remaining low-wage workers to their pay—reducing their hours worked each week, and weeks worked each year, as well as their average rate of pay for each hour. And the historical evidence suggests that this is exactly what does happen.

There is thus a continuum between those who are least successful in their working lives and those who do not work at all.[26] This continuum implies that inequality and unemployment should rise and decline together; ample empirical evidence now supports this proposition.[27] Inequality produces unemployment. Unemployment produces inequality. Measures that reduce inequality also reduce unemployment, and measures that reduce unemployment also reduce inequality.[28]

Equality, then, is good for employment and vice versa. But how does this square with the perception that the United States is a low-equality, high-employment country, while Europe has chosen a "high road" of good jobs but high unemployment?

Apart from the matter of capital income,[29] the key to this puzzle lies in another problem of data and perception. The comparison of pay and income inequality between the United States and Europe is always done on a country-to-country basis. For example, the United States might be compared first to Germany, then to France, then to Spain.

And indeed, the United States is more unequal in its distribution of pay than almost any European country: much more so than the Nordic countries or Germany, somewhat more so than France or Britain, and slightly

[25] Economist Sonmez Atesoglu finds that time series of these two variables are highly co-integrated, and that "in the long run there seems to be bi-directional causality between [them]." Sonmez Atesoglu, correspondence with author, July 9, 2000.

[26] As Marx once put it, "[T]he general movement of wages are [*sic*] exclusively regulated by the expansion and contraction of the industrial reserve army, and these again correspond to the periodic changes of the industrial cycle." Karl Marx, *Capital* (London: Lawrence and Wishart, 1974), 1:596.

[27] See Galbraith, *Created Unequal*.

[28] The *Economic Report of the President* (Washington, DC: Government Printing Office, 2000) contains an effective discussion of the relationship between inequality and macroeconomic performance, and admits that this relationship calls into question past assumptions that rising inequality necessarily accompanies improved technology or expanding trade. See ibid., 23–40.

[29] Of which the United States has more than Europe, because the United States has fewer state-owned productive assets and has enjoyed a sustained profits boom in the past decade.

more so than Italy. Thus, a country-to-country comparison can lead to a trade-off view in which the European countries mostly have less inequality and more unemployment. This leaves only a few cases (such as Denmark and the Netherlands) to be explained as anomalies or as users of enlightened interventions such as active labor-market policies.

But we have already noted the presence of a systematic relationship *across* Europe between unemployment and income levels. The richer countries have had, ever since the late 1970s, lower rates of unemployment and higher employment-to-population ratios. Unemployment is minimal in Norway, serious in Germany, harsh in France, and catastrophic in Spain.

The fact that there is a systematic statistical relationship between unemployment rates and national per capita income levels is, in itself, proof of the integration of the European economy in practice. Spain is not an independent and isolated national economy anymore. There are no barriers to trade, or capital flow, nor any formal barriers to the movement of labor throughout Europe. There is now, as well, a single currency unit across the entire region. It is therefore necessary, from a statistical and practical point of view, to measure inequality and employment at the European level and not at the national level.

When this is done, the notion of Europe and the United States being at the opposite ends of an employment/equality spectrum disappears. Inequality within countries of Europe is relatively low. But inequalities between them are very high; much higher than those across comparable distances in the United States. Adding together the two components, inequality within and between countries, one finds that overall inequalities of pay are actually higher in Europe than they are in the United States. Taking account only of pay, Europe, for the present, is both *more* unequal and *less* fully employed than the United States.[30]

To put the matter in another way, low-income European *regions* now behave very much as do lower-income *population groups* in the United States. To be Spanish as opposed to German, for instance, is statistically similar to being black as opposed to white in America: in each case, the former group has roughly 60 percent of the income, and twice the unemployment rate, of the latter. And there is nothing that the Spanish, by themselves, can do about it. Only a reduction of the income gap between Spain and the rest of Europe will reduce the gap in unemployment. And

[30] I have explored the policy implications of this for Europe in other papers, notably Galbraith, Conceição, and Ferreira, "Inequality and Unemployment in Europe." Adding Mexico to the United States would tend to even the comparison, of course, but it would not change the analytical point: along with higher inequality, adding in Mexico would raise the measure of unemployment on the North American land mass. (Adding in Canada, a much smaller country than Mexico, would in past years have reduced measures of inequality and unemployment for North America slightly, but Canadian inequality figures seem to have converged toward U.S. values in recent years.)

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a reduction of the income gap can only come about through an expansion of the transfer mechanisms of the European Union (EU).[31]

The larger macroeconomic questions mentioned at the end of the previous, theoretical subsection emerge clearly when Europe as a whole is compared to the United States. How did the United States achieve full employment? In part, it did so by recycling savings and profits into consumption and investment. The technology sector, for instance, has been a mechanism for recycling stock valuations into the employment of young professionals. But equally, and much more important, housing-price increases have been routinely leveraged, through mortgages and home equity loans, into consumption spending, so that ratios of household debt to income reached a historic high of 165 percent in the early part of the year 2000. The household sector, in other words, undertook the expansionary borrowing that the government sector, bent on balancing its accounts, declined to do. The United States does not suffer from any paradox of thrift.

Europe, on the other hand, does suffer from a massive paradox of thrift, made especially intractable by the fact that it falls across national lines. Germany, in particular, is afflicted by an older generation that never recovered from the frugalities of war and postwar reconstruction. That generation has been accumulating vast, unexpected wealth, which it does not know how to consume. And yet there are no adequate means to transfer this purchasing power to Spain, Portugal, Greece, Italy, and Turkey, where there are entire worlds to build, and thirty million unemployed men and women who might be available to build them. Indeed, the residual national identities and separation of populations within traditional boundaries serve as powerful barriers, for the time being, against private recycling of German money to Spain.[32] This in one sentence is the

[31] Presently the EU engages in significant fiscal transfers to national and regional governments; the EU contribution to Portugal, for instance, is on the order of 3 percent of Portugal's GDP. But transfers through the central mechanism of the EU to individual citizens of Europe—the model pioneered in the United States by the Social Security system—are lacking. Such transfers, because they are automatic entitlements and very cheaply administered, are a much more efficient means of reducing income disparities than programs requiring the design and execution of development projects such as highways and housing. It is worth noting, too, that while in accounting terms these systems appear to be transfers from richer to poorer countries, the economic effect is, rather, to mobilize resources that would otherwise be unemployed in the poorer countries, and it is by this means, and not an actual transfer of wealth, that inequalities are mainly reduced. In other words, giving Euro-denominated purchasing power to the elderly in Spain will lead largely to the employment of other Spaniards in caring for the elderly, not in the physical movement of goods and services from Germany to Spain. The proposal, in other words, is for the EU to assume certain responsibilities that the fiscal restrictions of the European Treaty prevent national governments from effectively assuming on their own.

[32] Why are Germans not making mortgage loans on a large scale in Spain? First of all, precisely because Spaniards are too poor! But also because privately managed German capital is as mobile as any other, and in recent years the highest returns have been first in Asia, then in New York and California. Concentrating European resources on European problems will require public mechanisms dedicated to that task.

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tragedy of European integration, European inequality, and European unemployment.

3. Inequality and growth in the developing world. Another large area of practical misconception concerns the relationship between economic inequality and economic growth, particularly in the developing world. The great Harvard economist Simon Kuznets long ago hypothesized that in the earliest stages of economic development economic growth might generate increases in inequality. But after the transition to industrialization got underway, Kuznets argued, further increases in total income would tend to bring inequality down. Thus the project of economic development would bring about for poorer countries what it had already achieved in rich ones: the creation of a unified and relatively egalitarian industrial middle class.

This optimistic view has not fared well with recent researchers, and a new consensus has largely rejected Kuznets's conjecture. In a new paper, David Dollar and Aart Kraay of the World Bank note that there is in the recent development literature a "striking absence of any correlation between (changes in) income and (changes in) inequality," and go on to affirm this result in their own analysis.[33] The practical implication is exactly as conservatives argue *a priori*: that a pro-growth strategy need not concern itself with inequality; raising the absolute living standards of the poor at the average growth rate is the best one can do.

But on what is this conclusion based? It is based on a large collection of household-income inequality statistics, assembled by Klaus Deininger and Lyn Squire at the World Bank from virtually every substantial household survey conducted over the postwar period. This data set is now being used in many papers that attempt to assess the role of inequality in economic development. Yet it turns out that Dollar and Kraay are able to find, in this mass of data, just 245 acceptable observations of household-income inequality, covering eighty countries, to match to measures of change in economic growth. This is an average of just three five-year intervals per country—often spaced over very long and erratic intervals of time.

The World Bank's data set is not reliable, not consistent, and not representative of the world economy. Only a handful of countries regularly report income inequality data. Outside of this handful (the United States, the United Kingdom, Sweden, Japan, and Taiwan), the data set is based on estimates that are highly inconsistent through time, simply because social science researchers operating at widely separated intervals on a subject as complex and sensitive as income inequality—without coordinating their efforts, for the most part—are unlikely to come up with estimates that can be sensibly compared. The new consensus finding that

[33] David Dollar and Aart Kraay, "Growth Is Good for the Poor" (working paper of the World Bank Development Research Group, March 2000), 12.

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there is no relationship between changes in inequality and changes in growth may either be due to the fact that no such relationship exists, or to the inadequacies and inconsistencies of the data set.

The World Bank's data set is also at variance with facts of common observation. It appears to show, for instance, Spain emerging as the most equal country in Europe in the 1990s. In the 1980s, India is shown as a low-inequality country, in the same ranking quantile as Finland. Between the 1980s and the 1990s, if these data are to be believed, inequality declined in half the countries for which data pairs exist in both decades. This is, of course, complete nonsense.

The only way to examine inequality better is to find better data. In a comprehensive adaptation of major international data sets on industrial employment and payrolls, my colleagues and I at the University of Texas Inequality Project (UTIP) have done exactly that. We have produced a data set capable of showing annual changes in earnings inequality, in manufacturing, for 103 countries over up to thirty-four years, 1963–97—a total of 2,539 separate observations, just over ten times the number of data pairs in the Dollar/Kraay analysis. We have also produced *monthly* estimates of changing earnings inequality over long time periods for Mexico, Brazil, Canada, and the United States.

Analyzing the relationship between changes in inequality and changes in growth in our data set is slow work. So far, though, we have found a systematic negative relationship between inequality and growth in annual data for each of nine large countries in Latin America, with the further finding that actual declines in per capita GDP almost always coincide with increases in inequality of earnings.[34] Contrary to the explicit assertion of Dollar and Kraay, crises are very bad for income distribution. We also find a very striking linear, negative relationship between inequality and growth using measurements based on monthly observations for Mexico and Brazil, and for Mexico we document that currency crises, associated with sharp devaluations of the peso, have drastic effects on distribution of pay.[35]

In contrast to a finding of no relationship, a consistent, stable *negative* relationship cannot be attributed to bad data. Bad data can destroy relationships. But unless there is a showing of systematic bias in measurement (for which no rationale exists in the present context), bad data cannot forge a relationship that is not real. We therefore conclude that the evidence supports what Kuznets argued decades ago against what the

[34] James K. Galbraith and Vidal Garza Cantú, "Grading the Performance of the Latin American Regimes, 1970–1995," in Galbraith and Berner, eds., *Inequality and Industrial Change*. Similar findings have recently been made for about twenty Asian countries, with just a few exceptions.

[35] Paulo Du Pin Calmon et al., "The Evolution of Industrial Wage Inequality in Mexico and Brazil," *Review of Development Economics* 4, no. 2 (2000): 194–203, also published in Galbraith and Berner, eds., *Inequality and Industrial Change*.

World Bank is arguing today. Economic growth is good for equality, and reductions in inequality are generally associated with higher growth.[36]

The UTIP data pose a challenge to the emerging consensus among some development economists that increases in inequality can be disregarded. This emerging consensus is, indeed, rapidly passing into the folk wisdom. Jagdish Bhagwati, an eminent insider in the economics profession, has articulated it forcefully:

> The United Nations Development Program and the World Bank have fallen prey to repeating endless condemnatory variations on the theme that globalization has led to greater income inequality. But even if such a causal relationship could be established—and it has not been—they do not explain why it should matter, given that inequality's consequences will differ hugely across countries, from negative to positive effects.[37]

The UTIP data do not establish a per se relationship between globalization and inequality. But the reason for this is only that the word "globalization" lacks a precise definition, and we cannot evaluate what we cannot measure.[38]

What we do show is that in the overwhelming majority of countries, economic inequality increased drastically in the 1980s and 1990s, most of all on the Eurasian land mass as the Communist economies and their near neighbors collapsed. We further show that these increases in inequality are strongly associated with declines in GDP growth.[39] Our complaint, therefore, is not with globalization alone, but also with the failure of globalized economic institutions to deliver strong and stable economic growth. These failures are indisputable. The serious question is whether they are *necessary* attributes of globalization, or whether better institutions might not produce better results.

[36] All rules have exceptions, and the important one in this case is not the lowest-income countries (as Kuznets supposed) but rather the very highest income countries, those that supply capital goods to the rest of the world economy. In the cases of the United States, the United Kingdom, and Japan, there is a weak positive association between growth and pay inequality, attributable to the fact that the strongest growth rates occur in the investment boom at the start of an expansion.

[37] Jagdish Bhagwati, "Globalization in Your Face," *Foreign Affairs*, July/August 2000, 134–39.

[38] In analyses postdating the drafting of this essay, we do find two mutually distinguishable effects, both of which increase inequality in the global economy. The first is declining national rates of GDP growth, and the second is a dramatic and systematic general increase in inequality levels around the world, beginning in 1981 and persisting through the end of our data set in 1998. We think the most likely explanation for this rise in inequality levels independent of changing GDP is the rise in global real interest rates that took effect in 1981.

[39] Further evidence for this relationship is provided by the nations of Southeast Asia. Unlike most of the rest of the world, inequality in these nations fell in the 1980s and 1990s—at least prior to 1997—but this decline was associated with strong economic growth.

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And, contrary to Bhagwati's assertion, there are essentially no cases where rising *pay* inequality—leaving aside the effects of a profits boom on capital valuations—can be shown to have had positive effects on economic development. The policy failures of the era of globalization have produced, and are continuing to produce, economic and social disaster.

C. What is to be done?

Within the advanced industrial countries, the mechanics of maintaining a sufficiently equal distribution of pay and income are well worked out. To maintain wages at the bottom of the pay structure, a decent minimum wage is essential; in the United States in recent years, this has been supplemented effectively by the earned income tax credit (EITC).[40] Progressive taxation is the main check on pay at the top of the structure; unions provide an egalitarian impulse at the middle. Social security programs put a floor under the living standards of the elderly and others who are unable to work; public health care (for the elderly only, in the U.S. case) reduces the risk of poverty from catastrophic depletion of savings. Public education and subsidies to higher education complete the picture in most advanced countries. The point to appreciate is not that these institutions exist and function: they plainly do. It is, rather, that they contribute to *improved efficiency* as much as they contribute to *sufficient equality*. They are not, as simple-minded economic theology would sometimes have one believe, mysteriously originating impediments to the achievement of some much richer society that could be achieved through the supposed magic of the market.

To achieve sufficient equality across national lines is a much more difficult problem. The failure to solve this problem is, indeed, the crippling inadequacy to date of the EU. The gap between Spain, Portugal, Greece, and Italy on one side, and Norway, Germany, Denmark, and Sweden on the other, must be narrowed. In other work, I have suggested the steps Europe might take: a "European Pension Union," a continental "topping-up scheme," and a European Morrill Act leading to the establishment of a network of European universities.[41] The usual reaction is that these suggestions are far-fetched and unrealistic. But those reacting

[40] The minimum wage and an EITC scheme (called "topping up") were both recently introduced in the United Kingdom.

[41] James K. Galbraith, "European Unemployment: What Is the Solution?" (remarks presented at the Learning2000 Conference, Lisbon, Portugal, June 6, 2000). A European Pension Union would supplement the national pension payments of lower-income regions and countries, thus working toward the same convergence already achieved for creditors in financial markets through the common currency and equalization of interest rates. A topping-up scheme would amount to a tax credit for working Europeans with relatively low wages. A European Morrill Act would be the European analogue of the American Morrill Act of 1862, the Civil War legislation that established the U.S. system of land grant universities.

in this way rarely have plans of their own for bringing thirty million Europeans into productive employment.

And of course, difficult as it is to secure equality throughout Europe, it is all the more difficult to secure it between the developing countries and the West. But there are periods of time that experienced better results on this latter score than have been achieved in recent decades. In the Bretton Woods period (1945–71), exchange rates rarely changed, and those countries that were parties to the Bretton Woods agreements had access to an international pool of liquidity to support full employment. The resultant financial stability permitted developing countries truly to develop—at growth rates that were characteristically in the neighborhood of 5 to 8 percent per year throughout the developing world. Since the early 1970s, the rise of free capital markets (as a result of the large-scale dismantling of capital controls and the return of private commercial banks to the predominant position in international lending) and floating currencies have cut this norm by half. It is not hard to see the general direction that a corrective policy should begin with. Successful development in the context of reasonably open trade relations requires a firm and stabilizing national and international framework of control over capital flows.[42]

D. A note on inequalities of pay and profit income

Readers may be perplexed by the claim that inequality *declined* in America during the long boom of the 1990s. Didn't reports of rising inequality dominate the news during this time? Weren't liberal commentators (especially) always speaking of the paradox of rising inequality amidst general plenty, and of the plight of those left out? Didn't the "digital divide" emerge as a central issue of recent years?

The resolution of this puzzle lies in the distinction between labor income ("pay") and capital income ("profit"). The former is related to work effort, and is the right construct for any consideration of a systematic relationship between equality and output. The latter is related to patterns of capital ownership. Since these patterns can take any form at all in principle, there is no *a priori* relationship between a shift of aggregate income from wages to profits and the inequality of distribution.

The effect of a shift between wages and profits in the aggregate on inequality depends on who owns capital, and on the sectoral distribution

[42] The construction of such a stabilizing framework in practice will require action in three broad domains: national policy in the developing countries, particularly large countries like China and India that have effectively maintained capital controls; global international policy, in the form of support from the International Monetary Fund and the World Bank for regime stabilization; and probably also regional international policy, in the form of the development of a new network of regional financial authorities, such as the Asian Monetary Fund proposed by Japanese vice-minister of finance Eisuke Sakakibara in the wake of the 1997 Asian financial crisis. Regional monetary funds would administer capital controls for member countries when the latter are too small or practically weak to handle the job alone.

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of increases in capital value. In a socialist country, capital is owned by the state, and a shift toward profits would *increase* equality, at least notionally, by raising the relative share of income held in common.

In the United States, some forms of capital are widely held (housing, for instance). Social Security wealth—a form of capital so intangible it is rarely counted, even though it is perhaps the largest form of private wealth in America—is held in common by every working and retired American, and it rises with every increase in Social Security benefit obligations. But financial wealth remains highly concentrated, and common stocks perhaps most of all.[43] Thus, a boom in housing will tend to decrease the inequality of wealth, while a boom in stocks—the defining characteristic of the late 1990s—will increase inequalities in wealth. A boom concentrated in a new-technology sector (by definition closely held) will increase inequality most of all.[44] And the profits boom of the 1990s did in fact increase measured inequalities of income, due to the rising share of capital in total income. As my UTIP colleagues and I show in other work, receivers of sharply higher incomes in the United States were remarkably localized in a handful of counties spread across the country: New York County, King County (Washington), and Santa Clara County (California) were prominent among them, for reasons that will not surprise anyone with a grasp of industrial geography in the United States.[45]

But none of these changes in capital-asset valuation has anything to do with work effort, the productivity of work, or the efficiency of economic life for most Americans.[46] For most Americans, it is *pay equality* that matters for the pragmatic questions of the factitious efficiency/equity trade-off. And pay inequality did decline with the decline of unemployment in the 1990s, improving economic efficiency and social welfare in measure. The inequality of the distribution of wealth, on the other hand, has mainly political implications, to which we now turn.

[43] Familiar statistics show, for instance, that ownership of financial assets in the United States is highly concentrated: the top 1 percent of households held 38.93 percent of net worth and 48.17 percent of financial wealth in 1989, according to Edward N. Wolff, *Top Heavy: A Study of the Increasing Inequality of Wealth in America* (New York: Twentieth Century Fund, 1995), 11. However, these numbers are sensitive to fluctuations in the valuation of corporate stock and housing (as Wolff shows), and also to the inclusion or exclusion of such intangibles as Social Security wealth. See also the important work of Lisa A. Kiester, *Wealth in America: Trends in Wealth Inequality* (Cambridge: Cambridge University Press, 2000), 87 ff.

[44] In the late 1990s, furthermore, the increasing use of stock options to pay high-level managers in the technology sectors caused a distinct blurring of categories, as rising capital values led to perceived increases in the inequality of measured *earnings* in the manufacturing economy.

[45] See the UTIP website at http://utip.gov.utexas.edu for illustrations.

[46] Had the shares of Microsoft been redistributed by Judge Thomas Penfield Jackson from William Gates to all past purchasers of his operating systems—truly a suitable antitrust penalty—then any further rise in Microsoft's share prices would have had an equalizing rather than a monopolizing effect on the distribution of measured wealth. Nothing else, apart possibly from the patterns of residential development on the shores of Lake Washington, would have changed at all.

III. The Distribution of Wealth

A. Equality and political participation

A basic theory of the relationship between wealth equality and the legitimacy of political life can be drawn from the philosopher John Rawls.[47] On his account, inequality is a form of information.[48] A more unequal society defines its members more sharply in terms of their positions in the distribution: the poor know that they are poor, the rich know that they are rich. Thus they are, and thus they will remain.

To be born into a society with a relatively *equal* distribution of capital wealth is therefore (and conversely) akin to being brought up behind the famous veil of ignorance about one's own future position in that society. As Rawls argues, only from behind such a veil can one make appropriate decisions and judgments about the rules of political life—including of course the appropriate distribution of capital assets.

Furthermore, as political scientist Thomas Ferguson has argued in a scathing blend of political theory and topical observation, the elementary economics of the savings function assures that only those with access to substantial capital income will participate fully in political life.[49] Usable capital assets are for the rich. For the middle classes they are largely illiquid: one cannot commit one's home or pension fund to a political cause. For working people they are largely hypothetical, and apart from trade union dues they cannot be mobilized effectively for political use. That being so, modern politics in the United States substantially excludes the nonrich populations, and boils down instead to competitions and coalitions among groups from the investor classes.

In a highly unequal society, therefore, there is a presumption of illegitimacy about social arrangements. These have been made with full regard to the political position and the wealth of particular competing industrial and financial groups, and with each of these groups fully knowing the direct effect, to them, of alternative outcomes. Only a strong dimension of countervailing power[50]—something far more visible in America fifty years ago than it is today—can assure participation by lobbies of labor, the elderly, racial minorities, and so forth. And no one speaks effectively for the unorganized worker or the truly poor, and partly for this reason such individuals do not find it worthwhile even to vote.

[47] John Rawls, *A Theory of Justice* (Cambridge, MA: Harvard University Press, 1971).

[48] From a mathematical standpoint, measures of inequality are actually derived from measures of information. See the discussion in James K. Galbraith and Pedro Conceição, "Constructing Long and Dense Time Series of Inequality Using the Theil Statistic," *Eastern Economic Journal* 26, no. 1 (2000): 61–74, also published in Galbraith and Berner, eds., *Inequality and Industrial Change*.

[49] Thomas Ferguson, *Golden Rule* (Chicago: University of Chicago Press, 1998).

[50] See John Kenneth Galbraith, *American Capitalism: The Concept of Countervailing Power* (Boston: Houghton Mifflin, 1952).

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These considerations are matters of plain common sense, but it may still be useful to consider them from a more abstract point of view. Why is it that a coalition of bankers, say, cannot be trusted with the larger public interest? The answer lies not in the specific moral deficiencies of banking, as such. Rather, it lies in the dynamics of any small group that operates in its own self-interest within the larger public domain.

As political participants, people have multiple identities. They are members of a neighborhood, citizens of a state, professionals or laborers of a certain type, members of a trade union, members of a particular ethnic group, members of a particular gender. Why do some identities come to dominate and others to recede? Why do bankers generally form a cohesive political force while retail clerks do not? Why, in America, do certain racial minorities (blacks, in particular) form a fairly cohesive political identity while the ostensible racial majority (whites) consists in fact of a mosaic of distinct and fairly rivalrous subgroups?

The answer lies in the ability of a group to *differentiate* itself from the median identity of the society as a whole. Identity *is* distinctness. "White" is not a distinct identity to most people who happen to be white in America (and among Northerners, at least in certain circles, the term carries a certain stigma). Whites are white to nonwhites but not, particularly, to themselves. Black, on the other hand, is an identity that those who are black cannot generally escape, even should they want to.

But while people may have many identities, surely the most powerful differentiator of otherwise similar individuals is capital wealth. This is because the *creation* of identity requires resources. Retail clerks—with every good reason to mobilize themselves politically in favor of, for instance, mandatory vacations or a higher minimum wage—lack the resources to create such an identity for themselves. Bankers, on the other hand, have both the motive and the means.

Anyone with experience of the politics of banking law[51] understands the consequences of this form of economic organization. Banking legislation is about the legal authority of banks vis-à-vis their clients, their depositors, and competing financial institutions. Of these three foci, typically the latter predominates. Why? Because it entails decisions among *competing* groups of the wealthy and powerful—between banks and investment banks (historically, over the terms of the Glass-Steagall law separating commercial and investment banking[52]), between banks and savings and loan institutions (over the terms of regulation historically

[51] The present author spent a number of years as the staff economist for the Committee on Banking, Finance, and Urban Affairs in the U.S. House of Representatives.

[52] The Glass-Steagall Act was enacted in 1933; it prohibited commercial banks from undertaking the functions of investment banks, and vice versa. Thus it separated the functions of lending to and evaluating business operations from speculative intervention in corporate ownership and control, and formed an important safeguard against the financial abuses that had led to the crash of 1929 and subsequent Great Depression.

favoring the latter), and so on. Issues relating to the rights of consumers (for instance, privacy legislation) or of neighborhoods (for instance, the Community Reinvestment Act[53]) play a far smaller role in the life of a banking legislator in the U.S. Congress.

An interesting case of constructed political identity in America (one that so far has not spread to other nations) can be found in the emergence over twenty years of the "information economy." Prior to 1980, this term was never heard; famously, the "technostructure" was considered an element of the large corporation—the intelligentsia of AT&T or International Business Machines.[54] But in the late 1980s a distinct identity emerged, and with it a political agenda, centered first on protecting U.S. electronics firms from Japanese competition, and later on such industry-specific national issues as immigration requirements for skilled programmers, the penetration of the Internet into schools and libraries, a tax moratorium on electronic commerce, and so on. Skillful political figures have not been slow to appreciate the fund-raising potential of this new and highly concentrated center of wealth; much of the adulation focused on the "new-economy entrepreneurs" can be seen as a form of flattery aimed at consolidating their political support, or at least preventing them from defecting to the other side.[55]

It may be that the political agenda of a particular sector will be narrow and of little direct concern to the larger public. It may be, in the case of the information industry's agenda, that the effects are more on the *form* of civic life than on the general well-being of the population. Nevertheless, all such agendas entail political choices. The drive to accommodate software companies on immigration comes into direct conflict with the desire of a particularly powerless group—recent immigrants from poor countries—to take advantage of the priority under existing law for family reunification. The pressure to exempt electronic commerce from state and local sales taxation creates a powerful incentive to buy on the Internet, and a corresponding drain on state and local tax coffers. School and library spending on computers, and the technicians to maintain them, comes directly at the expense of books, art supplies, and musical instruments. In all of these cases, a powerful and wealthy element is pitted against a diffuse and much more weakly organized one, and the preferences of the powerful element are likely to prove dispositive in the political system.

[53] The Community Reinvestment Act (CRA) imposes certain requirements on banks to make loans in neighborhoods from which they draw deposits, and to provide public accountability for their use of depositors' funds. Senator Phil Gramm (R–TX), formerly chair of the Senate Banking Committee, has declared that the CRA requirements are "worse than slavery." Even allowing that this quotation may reflect the good Senator's benign view of that antebellum institution, it is a particularly strong sign of the power of banking interests over banking law.

[54] John Kenneth Galbraith, *The New Industrial State* (Boston: Houghton Mifflin, 1967), 71.

[55] The elaborate courtship that attends a figure like William Gates on any appearance in Washington—notwithstanding his legal difficulties—is, of course, a premier case in point.

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It follows generally that one cannot expect for a group organized along sectarian lines and distinguished by great wealth to have a larger interest in mind. Wealth entails separation, separation entails special interest, special interest entails conflict—or at the least the risk of conflict—with the common well-being.

B. Inequality and the welfare state

Possibly the most severe consequence of the separation and distinctiveness engendered by highly unequal wealth distribution is felt by the welfare state. What is the welfare state? It is a set of public institutions that provide in common and on a universal basis for a number of goods that can be provided privately in principle and that historically have been reserved to those who could pay by private means. These include basic and higher education, health care, and insurance against disability and old age.

Welfare states exist only in egalitarian societies, and their strength is directly proportional to the equality of the distribution of wealth. In the extreme cases, under Communist regimes, capital assets are not privately held at all, and all social benefits have to be publicly provided.[56] Social democratic governments—the Scandinavians and Germans—elaborately provide the full panoply of welfare benefits from the public budget. But even in countries avowedly devoted to free markets, public provision is the rule. The government of the United States provides the bulk of retirement income to America's elderly, and covers about half of all U.S. expenditures on health care. American states and localities provide the vast majority of education services. Even such an ostensibly capitalist locality as Texas—historically dependent on Eastern capital—funds the major part of its higher education system by using public resources.

Still, the tendency of those with concentrated wealth is to continue to provide for themselves. In the first instance, this leads to the maintenance of private schools, colleges, universities, hospitals, and pension funds, as well as security services and other amenities of life.[57] None of these per se are to be objected to. But the natural next thought of the wealthy person is, if I am paying for all these services for myself, and at premium prices, why should I also pay for them for everyone else? There follows the unremitting pressure of the lobbies against progressive or even proportional taxation, with results that are everywhere in the tax code. We see the Social Security payroll tax capped such that it does not apply to

[56] Often, though, this was achieved through the institutional framework of the state-owned firm, an arrangement that tied the provision of social benefits to the fate of the enterprise when Communism collapsed (as in the Soviet Union) or when reform opened such firms to competition (as in China). The Western social democratic system, which puts education, health care, and most pensions *directly* under the state, has proved the more successful model.

[57] It is not coincidental that private universities—to name an ultimate luxury good—prosper mainly in close geographic proximity to major centers of capital income.

income above $76,200 at present writing. We see the reduced maximum tax rate on capital gains income—a form earned exclusively by holders of capital wealth. We see the pressure to abolish taxation of gifts and estates.[58] We see the pressure against income taxation and in favor of sales taxation, at both the federal and the local levels.

To the extent that these pressures are successful, the burden of payment for public services falls increasingly on the middle class.[59] And because the upper and lower classes are disproportionately large in unequal societies, the middle class finds the burden heavy and hard to take. Thus, excessive inequality in the distribution of capital assets is likely to set up a chain reaction down the bell curve; those in the middle may be motivated to oppose public benefits that they would actually like to have, simply because they cannot afford to provide them both for themselves and for those who cannot pay anything at all.

In this way, excessive and growing inequality of wealth—even in a wealthy country—is a pernicious enemy of public services. It is not an accident that declines in the political base of the welfare state are associated, everywhere, with increasing dispersion in the wealth distribution, nor that the media organs of the wealthy[60] are the most inveterate enemies of public programs.

C. What is to be done?

The remedy for all of this is surely not a perfectly egalitarian distribution of wealth. It is not (as was done in China under the Cultural Revolution) the tearing down of professional classes and the ending of economic differentiation. It is also probably not—as many good American liberals suppose—a campaign finance reform package that would somehow eliminate the pernicious influence of great wealth on political life without

[58] The move to repeal the U.S. estate and gift taxes in the summer of 2000 appears to have reflected in part the particular concerns and rising political importance of the new-economy millionaires. Though for the most part this was a party-line issue, repeal had support from Western Democrats and opposition from Eastern Republicans. This suggests a rift between the information economy tycoons, largely from the West, and the insurance companies, headquartered in the East. The former were protecting their newly won paper fortunes, largely tied up in the stock of their own companies, while the latter stood to lose a lucrative line of business insuring small enterprises against estate tax liability. Repeal ultimately passed Congress but was vetoed by President Clinton; the issue is, however, likely to return in the new administration.

[59] In rebuttal to this argument, conservatives sometimes cite the high fraction of federal income taxes that continue to be paid by those in the highest income percentiles. But this is mainly a reflection of the high fraction of total income earned by those in the highest percentiles, and of the fact that the federal income tax is one of the few taxes that are progressive in their incidence. It remains necessarily the case that as taxes are shifted from the upper percentiles toward the middle, the burden decreases on the former and increases on the latter.

[60] For instance, the magazines *Forbes* and the latter-day *Fortune*, as well as the editorial page of the *Wall Street Journal*.

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eliminating the concentration of wealth itself. This last measure will not do more than merely mask the influence of the wealthy.

Rather, the answer lies in seeking—as with pay and income, but for different reasons—a *sufficiently* equal distribution of capital wealth. The rich should be taxed. Their charitable gifts and foundations should be strongly encouraged by tax law, including especially estate and gift taxation. They should not be treated with undue deference by those who are not directly fawning over their money. But all this is only part of the solution.

The other part, much more important, lies in creating forms of capital wealth that the rest of society can partake of. Of these—to take the American case as an example—Social Security wealth has been historically perhaps the most important. The capital value of Social Security in the United States is enormous—it measures in the trillions of dollars—and it has lifted the entire elderly population of the country out of poverty since the early 1970s. It is not by accident that the elderly retain one of the more potent political voices in the country not directly tied to any *private* form of wealth-holding. All measures that strengthen Social Security transfer implicit capital wealth to the elderly.

Housing is another form of capital wealth of great importance. This is the middle American family asset. The extension of home ownership to two-thirds of American households by the end of the 1990s was a major accomplishment of the economic expansion of that decade. Unfortunately, however, there was a price: heavy indebtedness, so that in the near term home ownership is not necessarily synonymous with capital wealth. People are "house poor." This can be cured, of course—as it was in the 1960s and early 1970s—by measures of public policy that stabilize or even reduce mortgage debt relative to home value, the most important being a lower and stable interest rate. Indeed, the debates over U.S. monetary policy can be seen as a masked but direct argument over the distribution of wealth: should it be reallocated steadily from debtors to creditors, as a high real rate of interest necessarily implies, or should wealth instead be reallocated back toward the debtor classes—homeowners—through a rate of interest lower than the rate of growth of incomes?

Finally, there is education, the capital asset of the young. Higher education in particular has become the ticket to creditworthiness in the United States; you virtually cannot refuse a mortgage to an applicant with a college degree. At present, 26 percent of the adult population of the United States holds at least a college degree, a proportion not closely rivaled anywhere in the world, except for the Netherlands.[61] Measures that expand access to America's colleges and universities—such as grants and low-interest loans—are well-established, highly effective ways in which class barriers can be, and historically have been, reduced in the United States.

[61] And about half the U.S. adult population has the next best thing—*some* experience with college or university education.

Sufficient equality in the distribution of wealth—sufficient, that is, for a tolerable political life—can be constructed, even in a society characterized and partly dominated by private capital. It is a matter, mainly, of making sure that nonpecuniary forms of capital—social security wealth, housing, and education above all—are generously supported and paid for in good measure from capital incomes. This was, indeed, the mid-twentieth-century solution, though it was badly eroded toward the end. It was a sensible resolution of a classic problem—the reconciliation of capitalism with freedom, equity with efficiency, and democracy with private power—the first in all history, and the only one so far. A better one is not likely to come along.

IV. Conclusion

Sufficient equality in the distribution of income, within a country, is a proper goal of efficient economic policy, and is part of a strategy for shared prosperity and full employment; it is both effect and cause. The means for achieving sufficient equality are varied, but straightforward: minimum wages, collective bargaining, social insurance, and effective public payment of major medical expenses. The main obstacles to these modest goals are political; they are not economic.

Sufficient equality in the distribution of wealth helps to resolve the political questions. If ordinary households have adequate capital assets—education, housing, social security wealth, and a financial reserve—they will and do participate in democratic governance, with a decent respect both for those who have less than themselves and for those who have more.[62] Likewise, a functioning democratic society does not organize its members into ghettos, neither of the poor, nor of the rich.

Across international lines, these issues are more difficult. International lines exist, in part, to preserve inequality. But given global economic relations (or, as in Europe, continental integration), the question of inequality must be dealt with across national frontiers. Here, the essence of the issue is convergence. And the essence of convergence is, simply, getting more rapid economic growth in poor nations than in rich ones. To achieve this, on a sustained basis over decades, must become the task of a new international development architecture, one that includes a new system of international financial stabilization and control. This is no simple matter, but is clearly necessary, as the existing system of free global capital markets has failed.

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[62] In a famous old Texas story, Robert Montgomery of the University of Texas Department of Economics was once summoned to explain his views to the legislature of that state. The first question was, "Dr. Montgomery, do you believe in private property?" And the answer came back, "Why yes, Senator, I do believe in private property. I believe in it strongly. And I think everyone in Texas should have some." The hearing is said to have ended at once.

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