Inequality and Instability

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I. INTRODUCTION

1. Inequality, especially of wealth (value of assets minus liabilities) and income (money received in return for services rendered, goods sold, or profits from investments), is currently a hotly debated subject not only in the academy but also in society more generally. This paper gives many examples of the academic debate; to take only two examples of the wider discussion: Pope Francis wrote his first encyclical against it, and President Obama in his final State of the Union Address in 2016 called inequality “the defining challenge of our time”.

2. The protagonists disagree about how inequality should be measured. But however they measure it – whether by Gini coefficients, the share of the total distribution earned by a particular group (e.g., the top one per cent), or other ways – they generally agree that inequality has greatly increased in a wide range of countries since the mid-1970s. To take only one piece of data from a multitude of statistics, by 2017 the richest 42 individuals in the world owned as much private net wealth as the poorer half of humanity, more than 3.7 billion people.¹

3. Agreement does not exist, however, about what causes inequality, what problems result from it, and what might be done to solve them. This paper attempts to answer these questions by reviewing and assessing a diverse literature drawn from economic theory, political science, sociology, philosophy, and economic and financial history.

II. CAUSES

1. Short-Term Explanations

   a) Those who have examined the growth of inequality over the past few decades have advanced a variety of factors that might explain it, including:

      i. Changing Family Structures: the growth of poor single-parent families, generally supported by low-paid working-mothers at the bottom of the distribution, and the growth at the top of “assortative mating”, for example, two university-graduate households enjoying two large incomes.

      ii. Faulty Corporate Governance: allowing grossly excessive monetary rewards to be paid to senior managers, even when they fail to deliver appropriate results.

      iii. Tax Dodging: failing to prevent high-net worth individuals and large corporations from paying tax by, for example, using complex tax avoidance schemes and sheltering their income and wealth in offshore tax havens.²
iv. **Technological Change:** favouring highly skilled workers in information technology, biotech and medicine, banking and other industries; disadvantaging workers particularly in manufacturing and transportation, where artificial intelligence is replacing mid-level management jobs and semi-skilled manual jobs with robots.³

v. **Corporate Market Power:** increasing as industries become more concentrated and less competitive, thereby enabling firms to, among other things, raise prices, increase profits, and spend more on political lobbying.

vi. **Winner-Takes-All Markets:** translating small difference in performance into large differences in reward, thereby enabling the best performer(s) to capture a very large share of the revenues, while leaving the other competitors with very little (e.g., sports, entertainment, and computer software markets).

vii. **Developing Capital Markets:** providing massive early-stage finance to scalable businesses, particularly in IT, which enables entrepreneurs to monetise equity interests at high valuations, thereby allowing them to accumulate great wealth based on intellectual property rights and little or no original capital.⁴

viii. **Countervailing Power:** weakening as the membership of various interest groups and organisations, such as trade unions in the private sector, declines.

ix. **Globalisation:** enabling firms to rapidly export their business models and products throughout the world, while at the same time putting employees in high-salary countries in competition with low-salary employees in the developing world.

b) Others – especially Thomas Piketty and Walter Scheidel – have taken much longer-term views of inequality and, after analysing large quantities of historical evidence, have advanced less ad hoc, more coherent, explanations of its dynamics.

2. **Long-Term Explanations**

a) Piketty, in his book *Capital*,⁵ has examined long-term trends in the quantity of capital, the return on it, economic growth, and economic inequality, particularly in France and Great Britain but also in some other countries (e.g., the USA and Germany).

   i. He finds that over the very long-term (i.e., the last two thousand years) the rate of return on capital, \( r \), has been greater than \( g \), the growth rate of the economy (i.e., \( r > g \)), except for most of the twentieth century when \( g > r \). Piketty believes this period was exceptional, a historic one-off, because of the following factors: the two world wars and, in some countries, the nationalisation of industries greatly reduced the accumulated stock of private capital; the wars and the backlash against the market system caused by the Great Depression of the 1930s led to radically more progressive tax rates on
incomes, assets, and inheritances; and post-war reconstruction after 1945 caused a rapid increase in the growth of GDP.

ii. From the 1980s, however, economic growth has slowed, while the return on capital has begun to rise, primarily because in several countries the market system became fashionable again, the financial sector was deregulated, and income taxes in the highest brackets were greatly reduced. Piketty predicts that we are now approaching the usual situation for capitalist economies where \( r > g \) because the owners of capital will continue to save a large proportion of their incomes, while the prospects for economic growth are poor, not least because of lower demographic growth.

iii. Piketty’s prediction leads him to conclude that since a rentier elite will become increasingly rich and exercise disproportionate economic and political influence simply by living off its investments, a point will be reached where most people will see the economic system as incompatible with meritocratic values and social justice, as unfair and a threat to democracy, and hence will reject it. The way to save both capitalism and democracy is, in his view, to reduce excessive economic inequalities by raising top marginal tax rates on incomes and by introducing a progressive wealth tax on assets.

iv. In answering the question of why Piketty’s \( r > g \) matters, the Economist gave three reasons: “It means, first, that the ratio of an economy’s wealth to its output tends to rise, which increases the relative economic power of wealth in society. Second, because the distribution of wealth is usually less equal than the distribution of incomes, faster growth in wealth than in GDP means a steady increase in inequality. Third, it implies that income from capital will grow as a share of income (and income from labour will fall). So being born rich (or marrying well) becomes a surer route to success than working hard or starting a firm. It is a recipe for social stagnation, and perhaps crisis.”

v. Much more could be written about Piketty’s monumental work, but it would take us too far away from this paper’s focus on inequality and instability. Suffice it to note, to quote the Economist again, that “Mr Piketty’s expectation of rising wealth concentration is not outlandish. However, it is a prediction based on extrapolation from the past, not an inherent model of capitalism. He assumes that the returns to capital will not fall substantially even as the stock of wealth rises. That may prove to be true, but the Piketty prediction is a hypothesis, not an iron law.” Although Piketty’s prediction is a hypothesis, it is based on world-wide data, including Asia where growth is very strong; in Western Europe and the USA, growth has dropped to a maximum of two per cent per year. “In this part of the world, as De Grauwe notes, \( r > g \) is already a fact.”

b) Scheidel, in his book *The Great Leveller,* takes a wider range of societies and a longer-term view than Piketty by examining trends in inequality from the Stone Age to the present day.
i. He finds that the inequality of the past few decades is not exceptional: for thousands of years, inequality within countries has generally been either high or rising because of the ways that political and economic power buttress each other – power creates wealth and wealth creates power – and both pass down the generations.

ii. In short, high or rising inequality is the default option: it declines only when carnage and disaster strike; it increases when peace and stability return. More specifically, the great levelling forces, what Scheidel calls the “Four Horsemen of the Apocalypse” – mass mobilisation warfare, transformative revolutions, state collapse, and catastrophic plagues – have repeatedly destroyed the fortunes of the rich. When these factors are not present – and today they have greatly diminished – inequality is persistent.

3. **Rent-Seeking and Marketplace Rules**

a) Piketty’s basic findings – stripped of their “iron law” overtones and policy prescriptions – coupled with those of Scheidel – without their undercurrent of history “inevitably” repeating itself – can be recast using the economist’s concept of rent-seeking: the tendency of powerful elites in society – whether early despots and their extended families, feudal kings and their barons, modern capitalists and their managers, or others – to seek “rents”: an excess, undeserved income, which elites obtain by erecting barriers to competition and, more generally, by using their power, both economic and political, to change in their favour the rules governing how markets and the wider economy are organised and operated.  

b) As Robert Reich has argued in his book *Saving Capitalism: For the Many, Not the Few*, these rules do not initially exist in a state of nature free from government interference. “Free” markets exist because governments and their agencies create rules that regulate *property* (what can be owned), *monopoly* (what degree of market power is permissible), *contracts* (what can be exchanged and under what terms), *bankruptcy* (what happens when purchasers cannot pay), and *enforcement* (what sanctions are applied when someone cheats on any of the rules).

i. Hence the question is not whether there should be government interference in markets and the wider economy – the usual debate between the left and the right of the political spectrum – but in whose interests should the government intervene. Reich believes that inequality has significantly increased over the past few decades because the growing political power of corporate and financial elites has enabled them to influence government to change the rules by which the economy is run – “market rules that seem to apply to everyone and appear to be neutral, but that systematically and disproportionately benefit them [p. 10].” Examples of such intervention include cutting top tax rates; facilitating company mergers, acquisitions and other barriers to competition; and weakening financial regulation.

ii. The consequence has been markets “organized by those with great wealth for the purpose of further enhancing their wealth”, resulting “in ever-larger
upward pre-distributions inside the market, from the middle class and poor to a minority at the top [p. xviii].” And because these pre-distributions occur inside the market, they are largely hidden from view, thereby allowing the role of powerful elites in shaping the rules of the marketplace to escape scrutiny and challenge.

c) Lindsey and Teles in their book *The Captured Economy* take the rent-seeking argument further by describing its dynamics and linking it to economic growth.\(^{14}\)

i. They begin with a paradox. Economists have generally argued that a tradeoff exists between economic equality and economic growth: if we want more growth we must accept greater inequality, because the prospect of greater economic rewards encourages individuals to develop new initiatives that boost productivity and growth.

ii. But what the USA and some other societies are facing today is a combination of slowing growth and rising inequality.\(^{15}\) Lindsey and Teles identify a common major factor behind these twin ills: breakdowns in democratic governance that allow wealthy special interests to capture the policymaking process for their own benefit — what economists and political scientists call “regulatory capture” leading to “regulatory rents”.

iii. Lindsey and Teles document in considerable detail how the proliferation over the last four decades of regressive regulatory barriers (e.g., subsidies for the financial sector’s excessive risk taking, overprotection of copyrights and patents, occupational licensing schemes, and land-use controls) have worked to shield the powerful from the rigours of competition, thereby not only inflating their incomes, but also stifling and slowing entrepreneurship, innovation, and economic growth.

III. PROBLEMS

1. No Problem, Wrong Problem

a) Some neo-classical economists claim that people’s pay is the natural and inevitable consequence of impersonal market forces: what they are paid is simply a measure of what they are worth in the market in which they are selling their labour. And, according to this view, attempts to reduce inequality run the risk of distorting the market, causing it to be less efficient and more likely to produce harmful consequences such as unemployment. But this claim, usually based on the assumptions of perfect competition, is merely a tautology — it is true because of its logical form — and ignores how markets are organised.

b) William Watson does not explicitly make this claim in his book, *The Inequality Trap: Fighting Capitalism Instead of Poverty*,\(^{16}\) but it underpins his basic argument that a preoccupation with inequality is an error and a trap. He believes it is an error because inequality can be good, bad, or neutral; it is a trap because it leads us to focus on the top
end of the income and wealth distributions, the rich, instead of on policies to help the bottom end, the poor, where the bulk of human misery lies.

c) He accepts that “maybe” we can worry about both the top and bottom ends of the distributions at the same time. His uncertainty is unwarranted. We clearly can concern ourselves with two problems at the same time: a politician or a policy analyst who can’t ride two horses at once does not belong in the political or policy circus. To cite only one example, the late Anthony Atkinson, a distinguished British economist, wrote numerous books and papers over four decades analysing both inequality and poverty and advancing policies to deal with both. He accepts that “maybe we can worry about both the top and bottom ends of the distributions at the same time. His uncertainty is unwarranted. We clearly can concern ourselves with two problems at the same time: a politician or a policy analyst who can’t ride two horses at once does not belong in the political or policy circus. To cite only one example, the late Anthony Atkinson, a distinguished British economist, wrote numerous books and papers over four decades analysing both inequality and poverty and advancing policies to deal with both.17 He concluded that “we have to view our societies as a whole and to recognise that there are important interconnections: economics tends to assume away or downplay any interdependency between the economic fortunes of individuals (or households)”. But “we can ask whether countries can achieve low rates of poverty at the same time as having high top income shares.” To answer this question, he examined the evidence for fifteen OECD countries and found that only Switzerland has achieved below-median poverty while having above-median top income shares. He concluded that “higher poverty tends to go together with larger top shares [pp. 24-5].”

d) But Watson has another reason for suggesting that we downplay inequality: “an obsession” with inequality is “dangerous” because it “may cause poor and non-poor alike to doubt capitalism. An economic system that, in his view, has been largely responsible for “our species’ dramatic leave-taking from the more or less perpetually low incomes and high death rates, especially among children, that until 1750 or so had been our fate for the 5,000 years of our written history and – more than likely, if evidence from anthropology and archaeology is admitted – for all our millennia before that [p. xii].” Many would agree with Watson that capitalism has brought about a great improvement in the human condition over the last two and a half centuries. Many would also accept, however, that capitalism has failed to guarantee sufficient material prosperity for large segments of the population and that it generates inequality, often gross inequality.

e) Watson accepts that capitalism produces inequality – “that is how it works” – and that inequality is a major factor discrediting modern capitalism and endangering its future (pp. xiii, 8). That is why he is anxious to downplay it and to explain it away. But the danger inequality presents to capitalism is not going to be repulsed by such a strategy. An alternative strategy followed by those like Reich – whose objective is not to destroy the capitalist system but, as the title of his book suggests, to save it – is to recognise the system’s merits, but to confront its defects directly and to try to remove or at least to mitigate them. In trying to do so, the constructive critics of capitalism are more likely than its bullish cheerleaders to ensure its effective working and survival. Indeed, those who defend an unreformed capitalism are its greatest enemies.18

f) Be that as it may, Watson’s most fundamental reason for downplaying inequality – “What do we do about it? ... not nothing but not much [pp. xiv, 109]” – is that he believes most of it can be justified. He suggests that some inequality is “neutral” (e.g., “assortative mating”). He grants that the inequality which “occurs when people prosper from morally dubious or even illegal actions or from some unfair advantage they have contrived for themselves or conspired with others, often through governments, to acquire [p. xiv]” is “bad” and should be vigorously prosecuted. He even goes so far as to accept the need
for a “war” – a war that both the left and right of the political spectrum would support – on rent-seeking by removing privileges that people and organisations create for themselves by acquiring protection and preferences from government. But, although he writes about rent-seeking at some length (pp. xvi-xviii, 145-52, 172, 186-7), unlike Stiglitz, Reich, Lindsey and Teles, he does not make rent-seeking central to his analysis and implies that a war against it would not significantly or “dramatically” lessen inequality (p. xvii).

g) The reason Watson believes that such a war would not have a dramatic impact is that, in his view, most inequality is “good”. It “occurs when the “economic virtues” – thrift, industry, invention, innovation, initiative, and so on – are rewarded. To support his view, Watson devotes a chapter of his book to “The Deserving Rich”, people such as the late Steve Jobs of Apple. In contrast, Reich devotes one chapter of his book to “The Rise of the Non-working Rich” and another to “The Rise of the Working Poor”. Ad hoc, debatable examples of the deserving and undeserving could no doubt be produced ad infinitum. More telling is Wolff’s point that in the USA “there is direct survey evidence that intergenerational transfer of wealth may explain upwards of 40 percent of the total household lifetime accumulation of wealth. … If this is the case, we are led to the rather bleak conclusion that the United States is not a land of equal opportunity for all but rather one in which social class plays a very important role.” And Wolff’s evidence dates from before the baby-boom generation has died off, which when it occurs will bring about an even greater transfer of intergenerational wealth. Whatever the merits of this transfer, the recipients can hardly be described as “the deserving rich”.

h) Clearly, however, some inequality – perhaps even a good deal of it – does arise from rewarding the “economic virtues”. But does most inequality arise in this way? And has most of the significant increase in inequality over the past few decades arisen in this way? For example, the compensation of CEOs in American large corporations relative to the pay of average workers has increased from a ratio of 20 to 1 in 1965, to 30 to 1 in 1978, 123 to 1 in 1995, and over 300 to 1 in 2015. Has this soaring compensation resulted from CEOs having become dramatically more thrifty, industrious, inventive, innovative, initiative-taking, and so on? The available evidence suggests not. Lindsey and Teles present evidence that indicates Schumpeter’s “creative destruction”, the ongoing displacement of old firms and existing ways of doing things by new firms and new ideas, and other indices of business dynamism are declining. They also present evidence of a rise in rents across the American economy. Hence a more likely reason for the dramatic rise in the compensation of CEOs is their increasing power to influence the rules that regulate the operation of markets. An additional reason is faulty corporate governance that, as a City of London grandee recently claimed, has allowed capitalism to be “hijacked by the management class”, with the rewards of owner-entrepreneurs made available to mere managers.

i) To summarise, inequality, and its increase in recent decades, have much less to do with justified returns to the “economic virtues” and much more to do, as most of the authors cited above have argued, with large corporations and wealthy individuals obtaining rents by, in Reich’s words, “gaining power over market rules that generate outcomes favouring them – power that has been compounded as the additional wealth has accorded them even more influence over the rules [p. 157]” – and, indeed, wealth and power that is passed on to future generations. In reaching this conclusion, they are in the tradition of
Adam Smith, regarded by many as the father of capitalism, who pointed out in 1776 in *The Wealth of Nations* that “consumption is the sole end and purpose of production; and the interest of the producer ought to be attended to only so far as it may be necessary for promoting that of the consumer”, but who went on to observe that “people of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices.”

Hence those who wish to achieve market efficiency and maximise consumer welfare, the supposed benefits of capitalism, should be greatly concerned about high and increasing economic inequality. Another reason they should be concerned is that however inequality is generated, and even if it is “good” or “neutral”, it can have unintended negative consequences and “externalities” for society. It can, among other things, be unfair, lessen societal well-being, and create economic, social and political instability – an array of undesirable consequences that need to be addressed.

2. Fairness

a) The most fundamental problem presented by gross inequalities of income and wealth is that they are unfair, and hence lack social legitimacy.

i. Rawls in his *Theory of Justice*, a work that has greatly influenced modern political philosophy and ethics, holds that a democratic society is in some sense an agreement among all those within it to co-operate for mutual advantage. And he asks how rational persons would choose to organise that society if they were behind a “veil of ignorance”: that is, if they did not know what natural abilities they had or what place they would occupy in the society being formed.

ii. His answer to this question is that they would choose a social structure – including a set of rules to distribute the economic surplus generated by that society – which would maximise their welfare if they happened to end up in the least desirable position.

iii. Even among those who accept Rawls’ veil-of-ignorance methodology and his idea that the methodology supports the maximin (i.e., maximise the minimum) principle, room still exists for debate about which distributions are achievable and hence about which satisfy his principle. But it is very hard to believe that, of all the achievable distributions of income and wealth, the massively unequal distributions typical of many societies today maximise the position of those at the bottom. To accept that you would have to demonstrate that any attempt to redistribute, even moderately, would fail – perhaps because of its negative effects on incentives and productivity – which is most unlikely.

b) Rawls’ work initiated a wide-ranging debate about the nature of social justice and, among other things, the connection between economic inequality and equality of opportunity.
i. Following the work of Roemer, economists now tend to separate the determinants of economic outcomes into those resulting from "circumstances" that are beyond personal control (e.g., family background and upbringing, race and ethnicity, age, and gender) and "effort", for which an individual can be held responsible (e.g., the intensity of application in achieving a task). Equality of opportunity is achieved when "circumstances" do not play any role in the resulting outcome.

ii. But full equality of opportunity is impossible to achieve. Some people are simply better placed to take advantage of opportunity because of, for example, family upbringing. Dinish D'Souza, a political commentator and film maker, has described how he and his wife’s parenting of their daughter undermines equality of opportunity: “My wife goes over her workbooks. I am teaching her chess. Why are we doing these things? We are, of course, trying to develop her abilities so that she can get the most out of life. The practical effect of our actions, however, is that we are working to give our daughter an edge – that is, a better chance to succeed than everybody else’s children.” Many, particularly aspiring middle-class, parents – regardless of their political and ethical views – do the same for their children, and some go much further by sending their children to private schools and private tutors.

iii. Trying to eliminate all differences in parenting would be undesirable and, in any case, impossible. Paul Krugman, a Nobel economics laureate who generally follows the Rawlsian approach, accepts “life is unfair, and that there’s only so much you can do about that at the starting line”. He is right. Leaving aside that between a third and a half of our talents are determined at birth, differences in parenting, to stay with the same example, mean that not everyone has the same starting point in life. Equitable, as distinct from equal, treatment would try to promote fairness by providing extra help and resources to those who start further behind. Doing so would mitigate some of the unfairness, but it would not produce full equality of opportunity: giving everyone the same starting point in their journey through life and the same chance of obtaining the same outcomes. Since many of the worst-off would have done better with full equality of opportunity, a society aiming for greater fairness needs to introduce policies designed to bring the outcomes of the disadvantaged closer to what they would have been if such equality had been achievable.

iv. Atkinson takes this point a step further by linking tomorrow’s equality of opportunity with today’s equality of outcome. “Concern about unequal opportunity, and about limited social mobility, has intensified as the distributions of income and wealth have become more unequal. This is because the impact of family background on outcome depends both on the strength of the relationship between background and outcome and on the extent of inequality among family backgrounds. Inequality of outcome among today’s generation is the source of the unfair advantage received by the next generation. If we are concerned about equality of opportunity tomorrow, we need to be concerned about inequality of outcome today.”
v. The reason the United Kingdom and, despite its myth of mobility, the United States are the least socially mobile countries in the developed world is that they are also the most unequal. Moreover, as Goldthorpe has shown for the UK, the rates of relative social mobility, which compare the chances of individuals of differing class origins arriving at different class destinations and thus indicate the extent of social fluidity, have not changed for a century: today, a British boy born middle class is fifteen times more likely to end up middle class than a boy born into the working class, odds that are the same as they were a century ago. Similar data do not seem to exist for the USA and other countries but, as Corak and others have demonstrated, countries with more inequality at one point in time also experience less earnings mobility across generations, a relationship that has been called the “Great Gatsby Curve”.

3. Societal Well-Being

a) Two epidemiologists, Richard Wilkinson and Kate Pickett, in their book The Spirit Level: Why Equality Is Better for Everyone, provide a great deal of empirical evidence to demonstrate that social well-being—a wide range of social factors including life expectancy, physical and mental illness, crime and illiteracy, educational performance, and social trust—are generally worse the more unequal the societies.

b) They also demonstrate that more unequal societies are dysfunctional not only for the poor but also for the well off. “As John Donne said, ‘No man is an Island’ even from the effects of inequality. . . . What the studies do make clear . . . is that greater equality brings substantial gains even in the top occupational class and among the richest or best-educated quarter or third of the population . . . In short, . . . the benefits of greater equality seem to be shared across the vast majority of the population [p. 181].”

c) The dysfunctional aspects of inequality are one of the factors that led the philosopher Michael J. Sandel to argue that markets have moral limits and that market economies should not become market societies.

4. Economic Instability

a) Economic inequality can also encourage economic instability by increasing the competitive pressure to consume. As inequality grows and the rich spend more and more on status or luxury goods—what Thorstein Veblen in his Theory of the Leisure Class (1899) called “conspicuous consumption” — the desire for such things, encouraged by advertising, cascades down to those on lower incomes who struggle to keep up—what Frank calls “luxury fever”.

b) The latest example of this fever occurred in the USA. The inequality of per capita household wealth there increased greatly over the last four decades. During this period, as Wolff shows, almost the entire growth in household wealth accrued to the
richest 20 per cent of households and almost two-thirds to the richest 1 per cent alone.\textsuperscript{40}

c) Not surprisingly, gross consumption increased rapidly. With those at the top of the wealth and income distributions setting the pace, those lower down spent wildly in an attempt not to fall behind and thereby maintain their relative status. Spending beyond their means, the household debt of the middle classes more than doubled from 67 to 157 per cent of their income, and their ratio of debt to net worth climbed from 37 to 61 per cent.\textsuperscript{41} The debt was mainly secured by home mortgages – many of them “sub-prime” or lower quality – and when rapidly rising house prices crashed in 2007, it helped to precipitate the Great Recession.

d) Although Ray Dalio, the head of Bridgewater, one of the world’s most successful hedge funds, forecast the end of the housing boom, the collapse of the banks, and the implosion of credit markets in the Great Recession of 2007-08, he is today worried about inequality for political rather than economic reasons. He believes that the increase in inequality in the United States has been so great that it has created “multiple economies”: the elite live in an expanding economy, but “for the bottom 60 to 80 per cent, there is a depressed economy that is not growing well”. He thinks this inequality is creating so much strife that it will be political conflict – not economics – that drives markets in 2018 and beyond. What investors should now watch is not just the next statement from the Federal Bank, but “the next election in France or in the UK, or how hospitable will Jeremy Corbyn be to capital?”\textsuperscript{42}

5. Social & Political Instability

a) As Dalio’s remarks suggest, inequality has social and political as well as economic consequences. Citizens will tolerate economic reversals, uncertainty and unfairness for a time, sometimes a long time, if they trust that the system governing them will eventually change and ultimately produce a better outcome. But persistent, massive inequality promotes a feeling among the underclass that the system and the type of people who control it are self-interested and are not going to change; it corrodes that trust – trust that is necessary for the effective working of an intertwined economic, social and political system. As Confucius told his disciple Tsze-kung, three things are needed for government: weapons, food, and trust. If a ruler can’t hold on to all three, he should give up the weapons first, and the food next. Trust should be guarded to the end: “without trust we cannot stand”.\textsuperscript{43}

b) The corrosion of trust resulting from massive inequalities is currently leading to social and political instability that is lessening societal well-being, reducing market effectiveness and citizen’s confidence in the economic system, and generating extreme divisions and populist demagogy that is undermining the inclusivity and cohesion of democratic societies.\textsuperscript{44} The election of Donald Trump in the United States and Brexit in the United Kingdom are examples of what happens when trust is withdrawn. So, too, to take another British example, is the take-over of the Labour Party, which has historically owed more to Methodism than to Marxism, by the far left – a well-organised group of Marxists led by Jeremy Corbyn – that is now Her Majesty’s Official Opposition and will perhaps soon be her next government. This
prospect led a senior official of Morgan Stanley to tell clients in 2017 that “we could see the biggest shake-up in the political backdrop since the 70s”, which “is much [scarier] from an equity perspective than Brexit”. Mr Corbyn agreed with him, replying that those in the financial sector were “speculators and gamblers who crashed our economy”, and warning banks operating in the City of London that he would be a threat to their business – “a threat to a damaging and failed system that’s rigged for the few” – if he became prime minister.45

c) Examples from Continental Europe include nationalist governments in Hungary and Poland threatening the rule of law; and parties of the extreme left or right returning record election results in Italy, Austria, Greece, and Germany; indeed, following the German elections in September 2017, the far-right, populist Alternative for Germany (AfD) became the third largest party, entered the Bundestag for the first time, and became the official opposition.46

d) More generally, a “trust barometer” produced in 2017 by Edelman, a PR agency, showed an “unprecedented crisis of trust” across the Western world, not only in politics, but also in most public institutions, the media and charities.47

e) This corrosion of trust is causing business leaders in Britain and some other European countries, and even in the United States,48 to criticise the state of modern capitalism, and to admit that anti-competitive practices, management greed, corporate tax dodging, investor short-termism, and other faults have broken, to quote an editorial in the Financial Times, “the underlying promise of western capitalist economies – that a rising tide lifts all boats”. The editorial went on to note that “there are plenty of ways to reform the capitalist system without tearing it up. . . . Any significant change will be painful. But if capitalism’s defenders continue to fight reform while lamenting the state of affairs, they may soon face a more unpleasant reckoning.”49

f) Martin Wolf, the respected Associate Editor and Chief Economics Commentator of the Financial Times, believes that one possible reckoning “is the sort of ‘plutocratic populism’ that has become such a feature of the US . . . . The future could then consist of a stable plutocracy, which manages to keep the mass of the people divided and docile. The alternative might be the emergence of a dictator, who rides to power on the back of a faux opposition to just such elites.”50 Such “dark scenarios” are in the general interest of neither the underclass at the bottom nor the elites at the top of democratic societies. Nor are they in the interest of those who wish to preserve democracy and capitalism.

IV. SOLUTIONS

1. Multiple Solutions

a) Numerous solutions have been suggested for making societies more equal. Atkinson, for example, has advanced policies ranging from directing technological change to increase the employability of workers, through making taxation more progressive and social benefits more generous, to broadening capital ownership by promoting greater saving and investment by ordinary citizens.51
b) Reich would not necessarily oppose these policies but believes that the emphasis should be on making taxes and transfer payments less necessary by changing the rules of the marketplace so that they lessen upward pre-distribution inside markets by, for example: weakening the nature and shortening the length of patent protection, strengthening anti-competition legislation, and raising the standards of corporate governance. “The pertinent issue is not how much is to be taxed away from the wealthy and redistributed to those who are not; it is how to design the rules of the market so that the economy generates what most people would consider a fair distribution on its own, without necessitating large redistributions after the fact [p. 219].”

2. Political Will

a) Hence the challenge for those wishing to reduce inequality is not a shortage of appropriate solutions – there are hundreds of them\(^{52}\) – but a lack of political will to implement them. Reich is optimistic that the majority of a nation’s citizens could acquire sufficient “countervailing power” to have government alter the rules of the market so they more closely meet their needs.

b) Lindsey and Teles are also optimistic that, at least in the United States, rent-seeking can be significantly reduced by a more “deliberative politics” that would increase democracy’s deliberative capacity to resist claims by the powerful for special legislative favours. Such capacity would be increased by, among other things, bringing these claims into the open and subjecting them to vigorous scrutiny – scrutiny that combines “the best of the two liberal traditions of the left and right into a liberalism” that creates “a state strong enough to support a capitalist economy, but one made less susceptible to exploitation by the powerful [p. 13].”

c) But the developments Reich, Lindsey and Teles believe are necessary to produce more “countervailing power” and more “deliberative politics” – first, for most citizens to come to recognise the benefits of greater equality and the ways the rules of the marketplace can be manipulated to frustrate its achievement; and, second, for them to become sufficiently organised and unified to bring about political change, which might involve political realignment and even the development of new political parties – indicate that acquiring the necessary power would be difficult.\(^{53}\)

d) And even if the citizens of particular nations did acquire the necessary power, Scheidel’s analysis of the long-term persistence of inequality, except in periods of social catastrophe and upheaval, implies that the exercise of this power might produce only marginal change rather than the significant change that Reich, Lindsey and Teles want. Significant change might also be frustrated by globalisation: national democracies cannot regulate and control transnational markets.

e) But the past does not necessarily determine the future; choice does exist. The degree of inequality varies considerably by country.\(^{54}\) Today, the United States is the most inequalitarian country among the advanced industrialised countries of the world, whereas the Nordic countries are among the least. The latter have chosen to
introduce policies that have brought about much more equitable distributions of income and wealth. Other countries could introduce similar policies if they believed their degree of inequality was too high, and if they had the political will to reduce it.

f) If the political will does not exist, however, Marxist dreams of those at the bottom of income and wealth distributions rising violently in revolt against those at the top are unlikely, at least in Western democracies, to be fulfilled. Marx developed a linear theory of the rise and fall of capitalism – a theory predicting that capitalism would disappear and be replaced permanently by some form of state control over the economy. De Grauwe, in contrast, has developed a cyclical theory predicting that capitalism is subject to a rise and fall followed by a resurrection, which in turn leads to a new rise and fall, ad infinitum. He argues that capitalism has not developed as a “pure” market system: it is a mixture of market and government control, and both have their limits because of differences between individual and collective rationality, with the result that “the history of the past 200 years is one of large pendulum swings in the scope of markets and governments.” To take the last century, in the 1920s market control was the more important factor; from the 1930s government control increased and in the period 1945-80 played the greater role; since 1980 market control has dominated.

g) Over the last few years, experience in several countries indicates that market control is reaching its limits and government control is becoming more important. Whether greater government control will lead to greater economic equality, however, is an open question. De Grauwe argues that democracy safeguards capitalism: “democratic institutions bring stability” to capitalism by identifying collective interests quickly and giving them a voice that “forces politicians to promote collective interests instead of the individual interests of the rich and influential” (p. 78). But, as Massie has pointed out, “we too easily forget that democracy is a recent development in much of Europe. It is barely 25 years old in the east and only in early middle age across much of the Mediterranean.” He goes on to cite results from various surveys showing that 20 per cent of Spanish and Greek citizens think representative democracy is a bad way of governing their countries, and 29 per cent of Italian voters approve of government in which “a strong leader can make decisions without interference from parliament or the courts”. Weak support for democracy also exists across the Channel and across the Atlantic: almost 40 per cent of British millennials no longer think democracy is vital, and only 30 per cent of American millennials believe it is “essential” to live in a democracy compared with 75 per cent of those born in the 1930s.55

h) Hence, even if the tide of neo-liberal economics continues to ebb and the pendulum in the mixed economy of capitalism continues to swing from less control by markets to more control by governments, governments will not necessarily introduce policies to reduce excessive inequalities. They will do so only if democratic institutions are strong enough to ensure that the interests of those at the top of societies will not trump those of the citizens who are below them. And whether these institutions will be strong enough is a question only the future can accurately answer.
NOTES

* The author is grateful to David Bain, Liam Kennedy, David Livingstone, Joe Martin, and Leslie Morrison for helpful comments on earlier drafts of this paper.

† A shortened version of this paper was given at the conference, “Are We Ready for the Next Financial Crisis?”, organised by the Global Risk Institute for Financial Services, Rotman School of Management, University of Toronto, 21 March 2018.

‡ Emeritus Professor, Queen’s University Belfast.


2 See, for example, the Paradise Papers, a huge leak of financial documents that throw light on the world of offshore finance; https://en.wikipedia.org/wiki/Paradise_Papers; accessed 6 January 2018.

3 Gwynne Dyer, “Jobs, Moravec’s Paradox and AGI”, email, 13 February 2018. Moravec’s paradox is the discovery in the 1980s by artificial intelligence and robotics researchers that, contrary to usual assumptions, high-level reasoning requires little computation, but low-level sensorimotor skills require enormous computation resources: “it is comparatively easy to make computers exhibit adult-level performance on intelligence tests or playing checkers, and difficult or impossible to give them the skills of a one-year-old when it comes to perception and mobility.” Hence jobs in the middle that used to sustain a broad and prosperous middle class are dwindling and leaving only high-level, high-paying managerial and professional jobs and low-level, low-paying service and delivery jobs. “What’s left is a small group of rich people (who own the robots), an impoverished mass of people who provide them with services of every kind or have no jobs at all – and a level of resentment in the latter that is rocket fuel for a populist revolution.” See also Peter Temin, The Vanishing Middle Class: Prejudice and Power in a Dual Economy (Cambridge, Mass.: MIT Press, 2017) and Ganesh Sitaraman, The Crisis of the Middle-Class Constitution: Why Economic Inequality Threatens Our Republic (New York: Knopf, 2018), on the “hollowing out” of the American middle class.


6 Piketty believes that high marginal tax rates will not have a negative impact on productivity and growth for similar reasons to those of De Grauwe (see n. 13 below). He also believes that such tax rates will curb excessive executive salaries because top managers who receive only a small share of any salary increase above a certain level will have much less incentive to inflate their salaries than those who retain the majority of such an increase. This belief rests on his finding that the countries with the greatest reduction in top marginal tax rates since 1980 also had the greatest increase in top salaries.


Some people, such as President Trump, believe that cutting taxes on the rich will benefit the poor by encouraging investment that stimulates the growth of the economy – what is known as the trickle-down theory, “the less than elegant metaphor”, as John Kenneth Galbraith noted in *The Culture of Contentment* (1992), “that if one feeds the horse enough oats, some will pass through to the road for the sparrows”. But the IMF, after analysing tax rates in OECD countries between 1981 and 2016, did not find a strong relation between how progressive a tax system is and economic growth. In fact, the IMF noted that for countries wanting to redistribute wealth, there may be “scope for increasing the progressivity of income taxation without significantly hurting growth”; see [https://www.imf.org/en/Publications/FM/Issues/2017/10/05/fiscal-monitor-october-2017](https://www.imf.org/en/Publications/FM/Issues/2017/10/05/fiscal-monitor-october-2017); accessed 21 December 2017.

See also De Grauwe, op. cit.,71-73, who, after examining the relationship between the tax rates on the highest personal incomes and average annual growth in per capita GDP in the USA and Western Europe from about 1910 until 2010 found that “the prediction that lowering tax rates on the highest incomes would encourage private initiative, in turn leading to more investments and higher economic growth, has not been supported at all. . . During the post-war period, when tax rates were at their highest, economic growth reached a historic high. Since the 1980s tax rates have been dramatically lowered under the influence of a new market philosophy, and from that point on economic growth also dropped sharply.” His explanation of why taxing the very highest incomes does not have a negative impact on economic growth is that “above a certain income, taxation barely affects effort. A top manager who earns ten million pounds does not work any harder than one who earns ‘just’ one million. At that level intrinsic motivation (pleasure in management and power) plays a much greater role.”


See De Grauwe, op. cit., pp. 58-60 and 90 for data on trends in productivity and economic growth in the USA and Western Europe.

Edward N. Wolff, *A Century of Wealth in America* (Cambridge, Mass.: Harvard University Press, 2017), p. xv. See also Lars Osberg’s conclusion that “cross-country comparisons indicate (unsurprisingly) that more inequality of income is a good predictor of more inequality of opportunity and less intergenerational social mobility”;

Watson, op. cit., p. 12, rhetorically asks if “assortative mating” should be discouraged by developing policies to encourage rich men to marry poor women and vice versa? Most people would, like Watson, answer this question in the negative. But they might, for example, wish to remove legislative tax breaks for married couples (at least above a certain level of household income).

22 It is estimated that over the next few decades, baby boomers in the United States will pass down an estimated $30 trillion or more in assets to their children and grandchildren. See https://www.cnbc.com/2016/11/29/preparing-for-the-30-trillion-great-wealth-transfer.html; accessed 21 December 2017. See also “The Case for Taxing Death”, and “Death of the Death Tax”, Economist, 25 November 2017, pp. 13, 23-25. Watson, op. cit., p. 190, interestingly suggests, following John Stuart Mills’ advice, taxing inheritances as income to the recipient rather than taxing the estate of the deceased.

23 Whatever impact these factors have on determining earnings, however, they are significantly mediated, for better or worse, by the nature of the society in which people live. As Herman Simon noted in the context of the United States: “If we are very generous with ourselves, I suppose we might claim that we ‘earned’ as much as one fifth of [our income]. The rest is the patrimony associated with being a member of an enormously productive social system.” Cited by Reich, op. cit., p. 91.

24 Reich, op. cit., p. 97.


27 Watson, op. cit., p. xiv, is aware of this problem: “To complicate things, there is also the view that good inequality carried too far can itself be bad, that if rich people become too rich, even as a result of otherwise admirable behaviour, that can be bad for the rest of us, for society as a whole, and therefore ultimately even for them, too.”


32 Ibid.

33 Philip Collins, “The Social Mobility Myth”, Prospect, October 2013, pp. 32-5. See also Matt Ridley, “Forget Private School, It’s All in the Genes”, Times, 26 March 2018, which reports on Professor Robert Plomin and his colleagues’ research at King’s College London on intelligence and heredity.


35 Rates of absolute social mobility, the actual proportions of individuals of given class origins who are mobile to different class destinations, did increase in the UK over the 20th Century. But that is telling us nothing more profound than that the structure of the labour force changed markedly: it went from blue- to white-collar. “The people who in one era would have walked through the factory gate started walking through the office door instead. They went up the social scale and society seemed mobile just because a lot more clerical and professional jobs were created,” thereby generating “more room at the top”; Collins, op. cit., p. 34. This article is based upon John H. Goldthorpe, “Understanding – and Misunderstanding – Social Mobility in Britain: The Entry of the Economists, the Confusion of Politicians and the Limits of Educational Policy”, Barnett Papers in Social Research, 2/2012, Department of Social Policy and Intervention, University of Oxford.


40 Wolff, op. cit., p. xiii.

41 Ibid.

42 See Gillian Tett, “Lunch with the FT: Ray Dalio”, *Financial Times*, 13/14 January 2018. Bridgewater calculated that the proportion of the vote in Western countries captured by populist, anti-establishment candidates (e.g., Donald Trump, Marine Le Pen, Jeremy Corbyn) had risen from 7 per cent in 2010 to 35 per cent in 2017, an increase of such magnitude that has happened only once before, in the 1930s, just before the second world war. A few days later, following the publication by the World Economic Forum of its annual survey of the main concerns of its members, she wrote: “Economic and financial risks used to be at the forefront of delegates’ minds. At the start of this decade, for example, issues such as banking crises, rising debt and slow growth topped the rankings. Yet in 2018 those financial risks no longer appear on the dashboards; or certainly not close to the top. Instead, business executives, financial titans and political pundits fret about the issues that emphatically cannot be solved – or even modelled – by economists and financials. WEF members fear that inequality is sparking dangerous social fractures and the populism revealed by the Bridgewater” statistics. See “Populist Swing Alarms Financial Titans, *Financial Times*, 19 January 2018.


44 David Goodhart argues in *The Road to Somewhere: The Populist Revolt and the Future of Politics* (London: Hurst, 2017) that “greater economic and cultural openness in the West has not benefited all of our citizens. Among those who have been left behind, a populist politics of culture and identity has successfully challenged the traditional politics of Left and Right, creating a new division: between the mobile ‘achieved’ identity of the people from Anywhere, and the marginalised, root-based identity of the people from Somewhere. This schism accounts for the Brexit vote, the election of Donald Trump, the decline of the centre-left, and the rise of populism across Europe.”


46 See Daniel Finkelstein, “Populism Is Still on the March Across Europe, *Times*, 3 January 2018. Steve Bannon, the former chief strategist of President Trump, is providing a link between the American and European right by championing European far-right populist movements. At a speech in Zurich on 6 March 2018, organised by the Swiss right-wing magazine, *Die Weltwoche*, he told an enthusiastic audience of 1,400: “You are not going to have stability. The system cannot continue as it is. You are either going to have a right-wing popular revolt or you are going to have some form of socialist or state capitalism. Is there going to be turmoil? Yes, there’s going to be turmoil.” See Clare O’Dea, “Bannon Predicts Turmoil and More Right-Wing Populist Success in Europe”, *Irish Times*, 8 March 2018.


See his “Inequality Is a Threat to Our Democracies”, *Financial Times*, 20 December 2017. For a discussion of a similar “dark scenario”, see Osberg, op. cit., p. 333.

Op. cit., pp. 113-299. See also Stiglitz, *The Price of Inequality*, op. cit., chap. 10. Watson, op. cit., pp. 143-91, also discusses a variety of policies for reducing inequality, although he is doubtful about the efficacy of many of them.

Some countries – for example, Germany, Austria, Japan, and Hungary – have even considered giving mothers extra votes in elections on behalf of their children to redress the imbalance in favour of older voters, who are increasing in all democracies with the ageing of the postwar baby-boom generation, who are more likely to vote, and who are more likely to vote for conservative candidates who oppose change. See Anatole Kaletsky, “Pensioners’ Votes Should Be Given to Children”, *Times*, 27 April 2011, who argues that “politicians should be stopped from offering electoral bribes to current voters at the expense of generations yet unborn.”

A recent multivariate analysis of a unique data set in the USA that includes measures of the key variables for 1,779 policy issues found that economic elites and organised groups representing business interests have substantial independent impacts on government policy, but that average citizens and mass-based interest groups have little or no independent influence. See Martin Gilens and Benjamin I. Page, “Testing Theories of American Politics: Elites, Interest Groups, and Average Citizens”, *Perspectives on Politics*, 12(3), September 2014, pp. 564-81. For a fuller discussion, see Martin Gilens, *Affluence and Influence: Economic Inequality and Political Power in America* (Princeton: Princeton University Press, 2012).

Watson, op. cit., p. 105 accepts that “inequality must make at least some difference in a country’s politics”, but believes it is not problematic: “It is hard not to conclude that even if money and corporate interests do have a disproportionate or even, with rising inequality, a growing influence on policy, what the corporate elite wants, except for self-seeking bespoke wrinkles in the tax and subsidy systems, is not that far from what people in the middle of the political spectrum want. Even if rising inequality does mean politicians are ever more securely confined in the pockets of the wealthiest members of society, policy is always likely to respond to the overwhelming gravitational pull of the political and ideological middle [p. 108].” Commentators of a less conservative bent than Watson (e.g., Stiglitz, Reich, Lindsey, Teles, and Gilens) are less sanguine about the role inequality plays in politics.


Differences in inequality between countries are often not as great as the disparities within them; the extent of regional inequalities is striking. See “Left-behind Places: the Economics of Geography”, *Economist*, 21 October 2017, pp. 19ff.

Alex Massie, “Democracy May Not Be Dying, But It Is Sick”, *Times*, 8 March 2018; his sources include a Pew survey of global attitudes in 2017, and research for the *Journal of Democracy* in 2016. See also Philip Stephens, “Brexit Britain May Hum a Marxist Tune”, *Financial Times*, 9 March 2018; Edward Luce, *The Retreat of Western Liberalism* (London: Little, Brown, 2017); and William Galston, *Anti-Pluralism: The Populist Threat to Liberal Democracy* (London: Yale University Press, 2018). Galston argues, correctly I believe, that in addition to rising inequality, the failure of the USA, the UK, and the EU to deal with “waves of immigration in ways that commanded public support” was also an important element in the rise of populism.