

CHAPTER 1

Introduction

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Social inequality, say of income and wealth, has been an ancient public concern among philosophers, economists, political thinkers, social movements, and policymakers, particularly since capitalism replaced older modes of production. The unprecedented potential for wealth creation, entrepreneurship, and innovation developed under capitalism has often come along with persistent income and wealth inequalities. In this vein, one view argues that capitalism, notwithstanding its economic dynamism and capacity to adapt and transform itself, is an inherently inequalizing system of economic organization that requires remedying public action to correct inequality. In contrast, an alternative view argues that capitalism succeeds precisely by rewarding, differentially, higher levels of risk taking, entrepreneurship, talent, and effort among market participants. In this context, observed inequalities reflect, mainly, differential economic performance among individuals in society. This debate about the causes and effects of inequality under capitalism has been strongly influenced by three currents of social and political thought: social democracy (and liberalism), Marxism, and libertarianism.

Social democracy recognizes the inequalizing tendencies of capitalism but admits that through state action inequality can be reduced so as to match the economic dynamism of capitalism with the demands for social justice from the less privileged in society. In contrast, Marxism sees a fundamental contradiction between the economic potential for resource mobilization and growth unleashed by capitalism and its inegalitarian character that will threaten the stability and eventually the very survival of the system. Accordingly, Marxism sought the replacement of capitalism with a socialist regime as the ultimate cure for inequality. The libertarians, in turn, focus on the basic natural rights of the individual, whose fulfillment is best enhanced by the combination of a minimal state with a free-market economy. According to libertarian views, inequality of income and wealth is a natural consequence of a market society, and policies to reduce these disparities are bound to interfere with the process of wealth creation and eventually lead to a growing state that can reduce individual freedom.

In the last three decades political philosophy and philosophical economics have been developing a growing literature on distributive justice and social inequality oriented toward examining the ethical, economic, and political dimensions of inequality and justice. Moreover, these disciplines seek to derive criteria for designing economic and political institutions conducive to a "just society." This theme is highly complex, as it involves difficult questions regarding the nature of inequality, the role of individual rights, the common good, the conditions for a fair social contract, and the role of background conditions, relative to individual responsibility, in generating income and wealth inequality, among other issues.

Historically, the twentieth century has witnessed two main economic and political responses to the problem of social inequality and market-related instability: (1) the creation of the welfare state in advanced capitalist countries and its equivalent of the dirigiste state in developing countries; and (2) the instauration of socialism in Russia, Eastern Europe, and China during the first half of the twentieth century, and other countries (e.g., Cuba) later on, around the project of creating an egalitarian socialist society as an alternative to capitalism.

Nevertheless, the collapse of socialism in the East and the demise of state dirigisme in developing countries followed by the rise of free-market economics have relegated the issues of distributive justice and social inequality to a secondary place in the public debate.

The purpose of this volume is to argue for a thorough reexamination of social inequality from three different angles:

1. The ethical and philosophical dimensions of inequality and distributive justice
2. The effects (and interactions) of income and wealth inequality on other dimensions of economic performance such as the rate of economic growth, the level of saving and investment, and the degree of social stability
3. The effect of redistributive policies aimed to reduce inequality on the size of the state and the accountability of government actions

Inequality and Distributive Justice: Recent Literature in Philosophy and Economics

There are several strands of literature on this subject, coming from both economics and political philosophy, with recent attempts at synthesis under the heading of philosophical economics.

Utilitarianism (Bentham, Mill, Pareto) and welfare economics (Pigou,

Bergson, Samuelson) argue that a “just” (or “socially optimal”) pattern of resource allocation is one that maximizes the sum of total utility across individuals in society irrespective of how these utilities are distributed among the members of society.

The *Theory of Justice*, by the philosopher John Rawls, published in 1971, was a major breakthrough in political philosophy in the search for criteria to define a just society. Rawls departs from utilitarianism and welfare economics in two key respects. First, the concept of utility is replaced by that of “primary goods,” composed of commodities such as food, shelter, and clothing as well as an entitlement of basic civil and political rights concerning the rights to vote, to speech, to be elected for representation, and others. Second, Rawls’s theory of justice focuses not on the maximization of total utility, as utilitarians did, but on the conditions for a fair social contract negotiated by the citizens (or their representatives) under an “original position” in which the “veil of ignorance” assures that the negotiators do not know their future place in society in terms of ownership of productive assets, talents, and social background. Under those conditions, the rational negotiator chooses a set of rules and institutions that maximize the amount of primary goods available to the worst off in society (the maximin principle and “justice as fairness”) because, in the end, the negotiators may end up being the worst off in society after the veil of ignorance is lifted. Interestingly, Rawls’s concept of justice is derived as the outcome of a social contract negotiated under conditions of uncertainty. In other words, society acts as an insurer through a given set of institutions embodied in the social contract.

Rawls’s *Theory of Justice* was contested by a main exponent of the Libertarian School, Robert Nozick, who published, in 1974, his *Anarchy, State, and Utopia*. This book shifts the focus from the “social good” and the design of just institutions and a fair social contract to the individual and his personal political and economic rights to dispose of the fruits of individual efforts (self-ownership) and the legitimacy of private self-ownership of productive wealth as a superior arrangement to common ownership. Nozick’s proposal is for a minimal state with no compulsory powers of taxation and redistribution.

In contrast to Rawls, in Nozick the justice of a given distribution of income and wealth in society depends on the historical evolution that led to that distribution, focusing mainly on procedural justice and the origin and assignment of property rights.

Another source of criticism of Rawls comes from Marxism. A main Marxist critique to Rawls is that in a capitalist society in which most of productive wealth is owned and managed by a small social class (the capitalists), they have a special advantage and influence in setting the rules of the game on how income and wealth are distributed. Moreover, Marxism argues that the basic institutions in society are far from being designed from a “veil of

TABLE 1. Theories of Distributive Justice

Representative/School	Main Dimension
Utilitarians (liberals)	Maximize aggregate utility as a concept of the social good
Rawls (liberals—social democrats)	Fair social contract (maximin criteria and difference principle)
Nozick (libertarians)	Primacy of individual (self-ownership and minimal state)
Marxists	Distributive patterns shaped by class structure and capital ownership

ignorance” on the ownership of productive resources; quite the contrary, those institutions are oriented toward protecting existing patterns of resource ownership. (For a comparison of these theories of distributive justice, see table 1.)

Coming back to Rawls, his contribution gave a new impetus to the analysis of distributive justice and social inequality, particularly on what is the right dimension (or vector of variables) on which to focus. Amartya Sen, for example, argued for an emphasis on “capabilities” and “functionings” as a link between goods and welfare. The issue was further developed in the early 1980s by Robert Dworkin, who suggests that the right (set of) variables, or dimension(s), to focus on when evaluating the justice of distributive patterns is the access to resources and opportunities by individuals and not the level of welfare (utilitarians), primary goods (Rawls), or functionings and capabilities (Sen). An important innovation in Dworkin’s work was to include among resources not only physical capital, land, money, and financial assets but also nontransferable or internal resources such as talent. In addition, Dworkin focused attention in the discussions on inequality on an important factor only implicit in Rawls and Sen, that is, the issue of individual responsibility. This is an important dimension with far-reaching implications. What really matters in evaluating the degree of justice of a given distribution is not the equalization of outcomes—say, welfare, income, or wealth—but the equalization of access to resources, or, in other words, the equality of opportunities. The emphasis on personal responsibility supports the idea that individuals are responsible for transforming resources and opportunities available to them into actual outcomes through hard work, invention, and risk taking. An individual’s fortunes in life are not predetermined entirely by background conditions; personal initiatives and decisions also matter a great deal.

The neat distinction between resources, opportunities, and personal responsibility arising from Dworkin’s work was qualified, and partially challenged, in the late 1980s and early 1990s by authors such as P. Arneson and G. A. Cohen. They contest the notion that resources and preferences can be considered truly independent dimensions. In fact, they argue, background variables and resources (family, social status, ownership of productive resources)

influence the preferences of people, their attitudes toward risk, their ambitions, and their effort levels. The idea is certainly intuitive: the children of a poor peasant family in Haiti are unlikely to have the same entrepreneurial attitudes as do the children of a successful industrialist or banker in Manhattan. No wonder their chances for success in life are very different.

Summing up this debate, it can be said that conceptions of justice should focus mainly on the set of “morally arbitrary” factors (in philosophical terms) or “background-initial conditions” (in economic terms) that are often beyond individual control, but are of crucial importance for wealth generation and its distribution, and shape people’s place in society. In turn, what people actually achieve in life (outcomes) depends, given a set of initial conditions, also on factors pertaining to the realm of personal responsibility. Thus, observed inequality constitutes a moral problem when it largely reflects the effect of “morally arbitrary” factors, for example, a society in which by design or default a majority of the population has limited access to opportunities for education and jobs could be deemed to be “unjust.” Finally, an often neglected but relevant case that affects the justice of distributive patterns is the acquisition of wealth by illegal means, such as corruption or drug trafficking. This is becoming a widespread practice in some countries and often involves a very significant volume of resources concentrated upon a small number of people. This practice constitutes a serious moral, economic, and political problem, affects the legitimacy of basic institutions in society, and is a big source of social inequality.

Inequality, Growth, and Development

Let’s move from the philosophical questions of distributive justice to the second main theme of this volume, the economic interactions between inequality, economic growth, and long-run development. Is income and wealth inequality the price to be paid for accelerated economic growth? Or, conversely, does inequality retard economic growth? How does inequality evolve during the course of economic development? These questions invite us to examine the issue of social inequality in terms of its effects on other dimensions of economic development.

Classical economists viewed output growth as a savings-driven process. In that context, if profit earners save in a greater proportion than wage recipients do, a pattern of income distribution more concentrated on capital (e.g., inegalitarian distribution) will increase national savings and accelerate the rate of economic growth. In these models, there is no independent investment function (all of what is saved is invested) and the savings rate drives the growth path. In this model, a more egalitarian pattern of income distribution (toward labor) involves a trade-off in terms of slower economic growth acting through a decline in national savings.

Conversely, neo-Keynesian and the endogenous growth theories view the process of economic growth mainly as an investment-driven process. In this context, countries with large personal income and wealth inequalities invite, through a political mechanism, higher taxation and redistributive policies that depress the profitability of capital, hampering investment and slowing down output growth. The corollary here is that inequality is bad for growth. Other channels have also been highlighted to show a negative correlation between personal income inequality and economic growth: inequality can lead to political instability and/or populist economic policies that are ultimately destabilizing and hamper private capital formation and economic growth. The new literature combines an investment-driven growth process with a political mechanism transmitting public preferences, or social pressures, into actual government policies. These policies, in turn, affect capital accumulation and growth. The causality goes from initial inequality to subsequent growth.

The relationship between development levels (proxied by the level of per capita income) and inequality (measured by Gini coefficients or the ratio between top and bottom income quintiles or deciles) postulated by Simon Kuznets has been subject to controversy and empirical testing for a long time. As is well known, the Kuznets hypothesis states the existence of a nonlinear relationship between per capita income and an index of income inequality, reflected in an inverted U-shape curve; income inequality worsens at the initial stages of development, characterized by low per capita income levels, improving thereafter as income per person rises. The Kuznets mechanisms focused on the shift from a surplus-labor agricultural sector paying subsistence wages to a modern industrial sector with higher wages during the initial stages of development. Later on, inequality declines due to a narrowing of wage differentials as the pool of labor surplus is exhausted and the skills profile of the work force gets upgraded through formal education and learning by doing during the course of development. The causality in Kuznets goes from development levels to inequality, and the sign of the relationship evolves over historical time during the process of economic development.

Other mechanisms for the switch from unequalizing to more equalizing development can be postulated as well; they involve a lower sociopolitical tolerance for inequality in societies with higher per capita incomes, which leads to income redistribution in exchange for greater social stability and support for the development process. This may require greater access to education, credit, and other resources for low-income groups in response to political demands for redistribution.

This volume seeks to reassess some of these relationships in light of recent analytical developments and empirical evidence. Also, special attention is devoted to some key transmission mechanisms, such as the relationship between inequality and savings and investment at macro- and microlevels, and then to output growth.

Responses to Inequality: The Scope and Limits of State Action

Historically, a chief factor behind the steady growth in the economic role of the state—particularly the formation of the welfare state—throughout the twentieth century has been the responsibility attached to the state in providing economic security to counteract adverse market-related outcomes like unemployment, absolute income deprivation, absence of income after retirement, and lack of access to universal health care and education. To finance the provision of those services by the state, the government has the “power to tax” higher income groups. Redistributing income is at the heart of the state’s action.

Mounting criticism on the economic and social role of the state has developed since the 1970s, coinciding with the rise of conservative economics in the United States and the United Kingdom, the demise of state dirigisme in developing countries, and the collapse of socialism in Eastern Europe and Russia during the late 1980s and early 1990s.

The critique maintains that growing involvement of the state in the economy through taxation, regulation, and ultimately budget deficits reduces the private incentives to work, accumulate capital, and innovate, thwarting economic efficiency and reducing the potential for economic growth. Moreover, the income redistribution carried out by the state is allegedly dominated by special interest groups and lobbies and does not necessarily favor low-income and more vulnerable groups.

In spite of the relative validity of this critique, it is still unclear that a retreat of the role of the state, particularly in the social sectors—as opposed to its withdrawal as a producer through policies of privatization and deregulation—is either socially desirable or politically feasible.

A sensible approach is to ask for more effective social policies through a combination of state policies and broader social participation. For example, centralized state provision of social services such as education and health care can be replaced with decentralized management and provision of social services through local governments. Other reforms, which may include mixed systems in which the private sector supplies the services and the government subsidizes the demand through mechanisms such as voucher systems or others, can be envisaged to foster freer choice and competition in social sectors. Moreover, nongovernmental organizations are institutions different and autonomous from the state that can provide a vehicle for the voice and participation of the beneficiaries in the formulation and management of social policies.

Another dimension of the action of the state is of a more political nature. The issue raised here refers to the accountability of government. In fact, the problem is how to avoid situations in which the government, which has a mandate to design and implement social policies and redistribute income,

either wastes resources or redirects them to other uses. The problem is largely political in a sense that highlights problems of enforcing popular mandates and often involves failures in the feedback enforcement mechanisms between elected officials and voters. The central issue becomes how to make more effective the control by the principal (voters, the people) over the agent (the government and the state) to implement certain agreed-upon policies and deliver results.

Outline of the Chapters

The volume is divided into three parts. Part I focuses on philosophical and methodological issues of inequality.

Chapter 2, by Andrés Solimano, surveys alternative theories of distributive justice: the utilitarians, welfare economics, the liberal theories of Rawls and Sen, neo-Marxist theory, and Nozick and Hayek as exponents of the libertarian school. The crucial distinction between “initial and background conditions,” or “morally arbitrary” factors (initial wealth, talent, family background), and personal responsibility (effort and preferences) in determining distributive outcomes is assessed through alternative theories of justice. The chapter also discusses issues of self-ownership, self-realization and well-being, property relations, social contracts, and alternative concepts of equality. This chapter provides an analytical overview of the philosophical and economic foundations behind existing debates on inequality.

Chapter 3, by Stephen Marglin, discusses the methodological foundations of economics, critically assessing the emphasis given to scarcity, desire, and individualism in mainstream economic theory. Marglin’s point is that the central problem in economics is not how to allocate scarce resources to unlimited ends—the scarcity problem—as in many economies the availability of resources is enough to cover much more than the basic needs of most families. From this perspective, distributional motivations, social status, and the pursuit of social differentiation become very important as driving forces behind the organization of economic activity, the accumulation of capital, and the potential for growth in market societies. Marglin calls for an “economics of community” that deemphasize rivalry, competition, and atomization and stresses the achievement of self-realization in economic and social life through enhanced community links.

Part II of the book is devoted to exploring the interactions between inequality, growth, and development. Chapter 4, by Andrés Solimano, examines the relationship between income distribution and growth from a macro perspective. The analysis focuses on how income distribution fits in a variety of macro and growth models, distinguishing between savings-driven (classical, Solow, neo-Marxist) and investment-driven (endogenous-growth, Keynesian, structuralist) growth models.

The analysis explores: (1) the “model closure” (e.g., what variables adjust) to attain macroeconomic balance, (2) the sociopolitical mechanisms of the models, and, (3) how causality links between (1) and (2) affect the sign and shape of the growth/inequality relationship. In addition, the chapter discusses the stability of the Kuznets curve in view of new empirical evidence on the relationship between inequality, per capita income, and growth. This chapter seeks to integrate alternative theories of growth and distribution, making explicit the economic and sociopolitical mechanisms of each view.

Chapter 5, by Nancy Birdsall, Thomas Pinckney, and Richard Sabot, discusses the relationship between inequality and growth from a microeconomic perspective. The chapter focuses on the microbehavior of low-income households regarding their savings and investment decisions and highlights the potentially high rates of return of projects undertaken by the poor when they have access to credit. After developing a theoretical model illustrated with country experiences, the authors favor a labor-intensive development strategy that provides access to finance to poor households holding potentially profitable investment projects as a mechanism to show that a more egalitarian pattern of income distribution can foster economic growth.

Chapter 6, by Klaus Schmidt-Hebbel and Luis Servén, reviews analytically and empirically the links between aggregate savings and income distribution from a macroeconomic perspective. The authors consider the impact of distribution on the savings behavior of different groups and examine the impact of this heterogeneity on aggregate savings. The chapter finds, for a large cross-section sample of countries, only weak evidence that increased income inequality goes along with higher national savings ratios once other standard determinants of savings are taken into account. Therefore, the chapter can be interpreted as lending little support to the notion that it is necessary to concentrate income distribution in favor of high-savings groups in order to raise national savings and accelerate economic growth.

Chapter 7, by Felipe Larrain B. and Rodrigo Vergara M., focuses on the empirical impact of personal income distribution on economic growth in a sample of 45 (developed and developing) countries, including countries in Latin America and East Asia. The analysis is conducted in the framework of the new growth theory and gives explicit consideration to the impact of income inequality on private investment and the rate of GDP growth. The authors find that, after controlling for other growth determinants, an increase in income inequality of 10 percentage points in the ratio of the income of the top quintile to the income of the bottom quintile results in per capita growth dropping by 0.9 percent per year. They also find a negative impact of income inequality on private investment, although inequality is found to affect growth through other channels as well. This study provides evidence that a more equitable income distribution brings a positive “bonus” in terms of extra investment and more rapid growth.

Chapter 8, by Oscar Altimir, explores the evolution of poverty and in-

equality in Latin America under the strategy of import substitution in the 1950s, 1960s, and 1970s and then market-based reform in the 1980s and 1990s, addressing the growth-distribution link and the relation between inequality, reform, and development. The chapter also attempts to distinguish between short-run fluctuations due to external shocks and macropolicies and long-run changes in policy regimes and “styles of development” in terms of their impact on income distribution.

Part III of the book deals both with the historical evolution of the state in response to demands for public action in face of economic insecurity, poverty, and income inequality and with issues of political accountability of government and economic efficiency of the state.

Chapter 9, by Vito Tanzi and Ludger Schuknecht, studies the tendency for steady growth in the size of government throughout the twentieth century in industrial countries. The authors document the rapid expansion of government as caused largely by expenditures normally associated with the welfare state. The dynamics in the growth of government associated with the redistributive role of the state reflects also complex influences of lobbying groups, organized sectors, bureaucrats, and a favorable attitude, at least until a couple of decades ago, toward an increasing role of government in the economy.

The authors call for scaling back the size of the state, especially in “big government industrial countries,” provided that they already show favorable levels of social welfare, which would not be affected, according to the authors, by the reform of the state.

Chapter 10, by Adam Przeworski, explores conditions for an effective role of the state in the economy in which the “quality” of state intervention in the economy—say, justified for redistributive reasons—requires adequate mechanisms of political accountability by the citizens. The author evaluates alternative theories of the role of the state in the economy using the principal-agent approach and compares the neoliberal state, concerned with efficiency considerations, and the interventionist state, more focused on distributive objectives. The author stresses the idea of a double relation between the citizen and the state in which the state is empowered to pursue collective goals, such as distributive justice, security, and solidarity, but is subject to control by its citizens through an effective institutional and political system.

What Have We Learned?

Although definite conclusions are hard to derive in this subject, some of the main findings (and open questions) of this volume follow.

1. In the tradition of political philosophy, revitalized in the early 1970s by Rawls’s *Theory of Justice*, the ultimate goal of the analysis of social inequality and distributive justice is in illuminating the choices of institutions

that reflect a social contract that can be considered just and fair in a democratic society. Our examination of the modern literature on distributive justice shows the importance of the distinction between factors that are outside the control of the individual—say, background conditions or “morally arbitrary factors” (initial endowments of wealth, talent, race, or family status)—and elements of “personal responsibility” (attitudes toward risk, individual ambition, and work effort).

This distinction suggests that seeking “equality of opportunity” and fair and effective access to physical and human capital accumulation through equal access to education and credit, complemented by the rights of political participation and voice, is a more sensible concept than seeking “equality of outcomes.” In fact, outcomes are more influenced by individual choices and actions, whereas opportunities are many times a “given” for most individuals.

2. The theoretical models and country experiences reviewed in this book suggest a complex relationship between income distribution and economic growth. In general, savings-driven growth models in which income distribution affects national savings imply a trade-off between a more egalitarian income distribution and the rate of economic growth. However, the cross-section macroevidence presented by Schmidt-Hebbel and Servén (chap. 6) in this volume suggests very weak positive effects of income inequality on national savings, lending little or no support to the equity-growth trade-off view operating through national savings. On the other hand, Birdsall, Pinckney, and Sabot (chap. 5) show, at the microlevel, evidence for a positive savings potential of low-income households entertaining productive investment projects. These two studies, one macro and the other micro, cast doubts on the long-held view that more equitable income distribution tends to depress national savings and output growth.

3. In investment-driven growth models, initial income inequality is expected to lead to depressed private investment through several channels such as (i) induced capital taxation to finance redistributive policies, (ii) inequality-led social instability, and (iii) the rise of macroeconomic populism under conditions of sharp social inequality. Larraín and Vergara, in chapter 7, find cross-country evidence of a negative effect of income inequality on private capital formation, although they find that inequality can negatively affect economic growth through other channels as well.

Altimir’s analysis in chapter 8 illustrates, for Latin America, a considerable variation in the relationship between income distribution and economic growth, both over time and across countries. Moreover, he suggests that macroeconomic stabilization and adverse external shocks can initially deteriorate income distribution during the course of reform. Long-term policy reform has ambiguous effects on income distribution. His analysis, in a way, cautions against broad generalizations on the social impact of market reform, noting the importance of specific national characteristics in shaping that impact.

4. The historical analysis of a growing role of the state in the economy suggests that it is closely linked to the redistributive role of government. Tanzi and Schuknecht provide considerable evidence for this in industrialized countries throughout the twentieth century and argue in favor of serious disincentive effects of the welfare state on the decisions to work, save, and invest. An open question remains: to what degree does divesting the social role of the state contribute to higher savings, investment, and productivity growth in the economy? Could a state stripped of its responsibilities for social protection be socially desirable and politically feasible?

Reform of education, health care, and social security requires greater private and communitarian participation in the provision of social services. The precise mechanisms through which these new forms of delivery of social services are effective in avoiding the allegedly disincentive growth effects of the welfare state have to be investigated more fully.

5. The political effects of social inequality is a theme that appears repeatedly in this volume. New (and some old) growth and distribution models emphasize that the adverse effects of income and wealth inequality on economic growth is filtered by the political system. There is a "demand for redistribution" that often leads to higher taxation and business regulation by government. One specific political mechanism postulated in these models is the median-voter model, although other mechanisms such as worker-union activism, social conflict, and political polarization can be also relevant in transmitting social demands for income redistribution to the society at large and its institutions, including, of course, the state.

Another political dimension of inequality is raised by Przeworski in chapter 10 of this volume, which asks how we can make (redistributive) governments more accountable to the citizens that elect them in a democracy. Issues of effective enforcement of popular mandates and principal-agent dilemmas are important when government officials become autonomous and start pursuing their own agendas, failing to implement popular mandates, particularly social mandates seeking a more egalitarian distribution of income and wealth in society.