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The American Way of Welfare: Political-Economic Consequences of a Consumer-Oriented Growth Model[1]

Monica Prasad

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INTRODUCTION: LAND OF TOO MUCH

European countries have lower levels of poverty and inequality than the United States, in any way that we can measure poverty and inequality.[2] The conventional explanation for this has been that Americans are reluctant to use government to intervene in the market, even to help citizens escape poverty. But recent scholarship has revealed a great deal of governmental intervention in the United States throughout the twentieth century, in many cases surpassing Europe. For example, the American tax system has historically been more progressive than the tax systems of European countries (Lindert 2004; Prasad and Deng 2009; Prasad 2012), and, for most of the twentieth century, the U.S. was marked by higher taxes on capital than other countries, and lower taxes on labor (Mendoza, Razin, and Tesar 1994; Carey and Rabesona 2004; Lindert 2004; Cusack and Beramendi 2006). American regulations separating investment and commercial banking were never adopted in Europe (Benston 1994), nor were the regulations that historically prevented American banks from engaging in branch banking across state lines (Grossman 1994). U.S. bankruptcy laws have been much more favorable to debtors and remain so today, even

after the bankruptcy reform of 2005 (Tabb 2005). Food and drug regulation and health and safety regulation have been systematically more stringent in the U.S., although increasingly less so since the 1980s (Lundqvist 1980; Brickman, Jasanoff, Ilgen 1985; Jasanoff 1991; Badaracco 1985; Wilson 1985; Braithwaite 1985; Benedick 1998; Verweij 2000).

These examples of state intervention are not exceptions or anomalies; rather, they are characteristics of a model of political economy that can best be described as "consumerist," in contrast to the "producerist" model found in many countries of Europe. The American state is not necessarily smaller or less interventionist, it is merely organized on different lines than the states of Europe—specifically, American state intervention promotes consumption, while European state intervention restrains consumption. For example, the American tradition of progressive taxation has constrained the development of taxes on consumption, so that American consumption taxes (including those levied at the state and local level) are less than one-half of the average OECD level.[3] American regulations against branch banking worsened the crisis of finance during the Great Depression, and politicians resuscitated finance by developing a political economy based on consumer debt, while European countries developed policies designed to help consumers save.[4] Even at the height of the current economic crisis, European countries refused Keynesian methods of promoting consumption, preferring to continue their embrace of producers, particularly exporters. Meanwhile, the United States has been in the vanguard in the argument for stimulating consumption as the way out of crisis. Europe exports; America consumes.[5]

Contrary to what one may immediately assume, these differences are not the result of different cultural traditions. In fact, which countries have been more oriented to consumption has varied over time, and we can find values in the national traditions of all countries that both promote saving and promote borrowing. Just as there has been cultural receptiveness to consumption and credit in Europe, there have been cultural attempts to promote savings throughout American history.[6]

Rather, these distinctions between Europe and the United States originate in the nineteenth century, when American productivity began to overwhelm world markets, and—because of the gold standard—caused price declines throughout the world, particularly in agricultural products. In Europe, the response was to appease farmers by closing borders through protectionism. Americans were also protectionist, but it was American farmers' own productivity that was causing the problem, and protection could not help them. Instead, the United States saw a powerful political movement emerge from agrarian areas that succeeded in establishing a form of agrarian state intervention.

These precedents—American productivity and agrarian state intervention, and European struggles with American productivity—had very different consequences after the Great Depression and the Second World War. In Europe, the question was how to rebuild war-devastated economies that were producing too little. European planners explicitly chose a policy of *restraining consumption and subsidizing production,* and channeled profits toward export industries, the secret of Europe's post-war economic miracle. For example, in France, Jean

Monnet and his famous group of planners decided that "capital investment was the key" to recovery, and therefore "the planners wanted to lower the output of consumer goods as much as possible without arousing opposition to the [plan]…The planners chose investment over consumption, modernization over reconstruction, or the future over the present…financial resources would be available, it was held, if consumption were controlled through such means as rationing. Then personal savings would accumulate and furnish the necessary investments" (Kuisel 1981, 222, 225, 233-234). Similarly, Germany was doing everything in its power to try to restrain inflation, including restricting consumer credit (Eichengreen and Mitchener 2003), reducing lending by banks (Voth 2003), and channeling funds to investment (Overy 1996, Logemann 2007). German politicians "subordinated domestic demand to the needs of industrial capital" (Allen 1989, 263). The German growth model was: "moderate wages [which] enabled the buildup of plant and equipment to take place, ensured the stability of the new currency, and permitted Germany's return to the world market through competitive exports" (Hardach 1980, 171).

In the United States, however, the problem came to be seen as one of producing too much: particularly in the early 1930s, when the government embarked on a policy of destroying crops to maintain agricultural prices, horrified observers asked how it could be that the capitalist machinery was producing so much that we now had to explicitly destroy what had taken so much effort to produce. Although analysts now believe the problem was one of restricted money supply, at the time the problem came to be understood as one of maintaining purchasing power. Instead of restraining consumption and subsidizing production as in Europe, *increasing consumer purchasing power* became the paradigm that drove policy in the United States. Labor leaders and economists argued that the nation "must increase consumption and reduce savings" (quoted in Garon 2012, 327; Cohen 2003). Government officials proclaimed that the country's "rich abundance of natural resources and an undreamt-of capacity to convert this natural wealth into useful goods and services" required that "the consumers of the Nation are able to buy the output of goods and services which industry can produce" (quoted in Garon 2012, 327). President Franklin Roosevelt agreed: "Our task now is not discovery, or exploitation of natural resources, or necessarily producing more goods. It is the soberer, less dramatic business of administering resources and plants already in hand, of seeking to reestablish foreign markets for our surplus production, of meeting the problem of underconsumption, of adjusting production to consumption, of distributing wealth and products more equitably" (quoted in Kennedy 1999, 373).

In the United States, policies to increase consumer purchasing power often focused on increasing consumer credit (Trumbull 2010; Hyman 2011). The centerpiece of the effort was the attempt to increase homeownership by encouraging citizens to borrow heavily for the purchase of homes. Observers from all areas of the political world agreed that supporting housing was the best way to support the economy. The Chairman of the Federal Reserve wrote: "almost a third of the unemployed were to be found in the building trades, and housing was by far the most important part of that trade. A program of new home construction, launched on an adequate scale, not only would gradually help put those men back

to work but would act as the wheel within the wheel to move the whole economic engine. It would affect everyone, from the manufacturer of lace curtains to the manufacturer of lumber, bricks, furniture, cement, and electrical appliances. The mere shipment of these supplies would affect the railroads, which in turn would need the produce of steel mills for rails, freight cars, and so on" (quoted in Quinn 2010, 149–150; Gotham 2000, 299; Radford 1996, 179). The American Federation of Labor agreed that "home reconstruction provides the broadest single base for production and re-employment in major industries. In keeping with other plans for an economy of abundance, we should carry on slum clearance and re-housing of families whose incomes keep them out of reach of the private building markets" (quoted in Logemann 2007, 245).

During the Great Depression both Herbert Hoover and Franklin Roosevelt experimented with policies to provide credit for the housing sector. Early experiments culminated with the Federal Housing Administration (FHA) and the Federal National Mortgage Association (FNMA), programs to support the economy by underwriting loans for housing (Radford 1996; Green and Wachter 2005; Quinn 2010; Hyman 2011, 49–70).

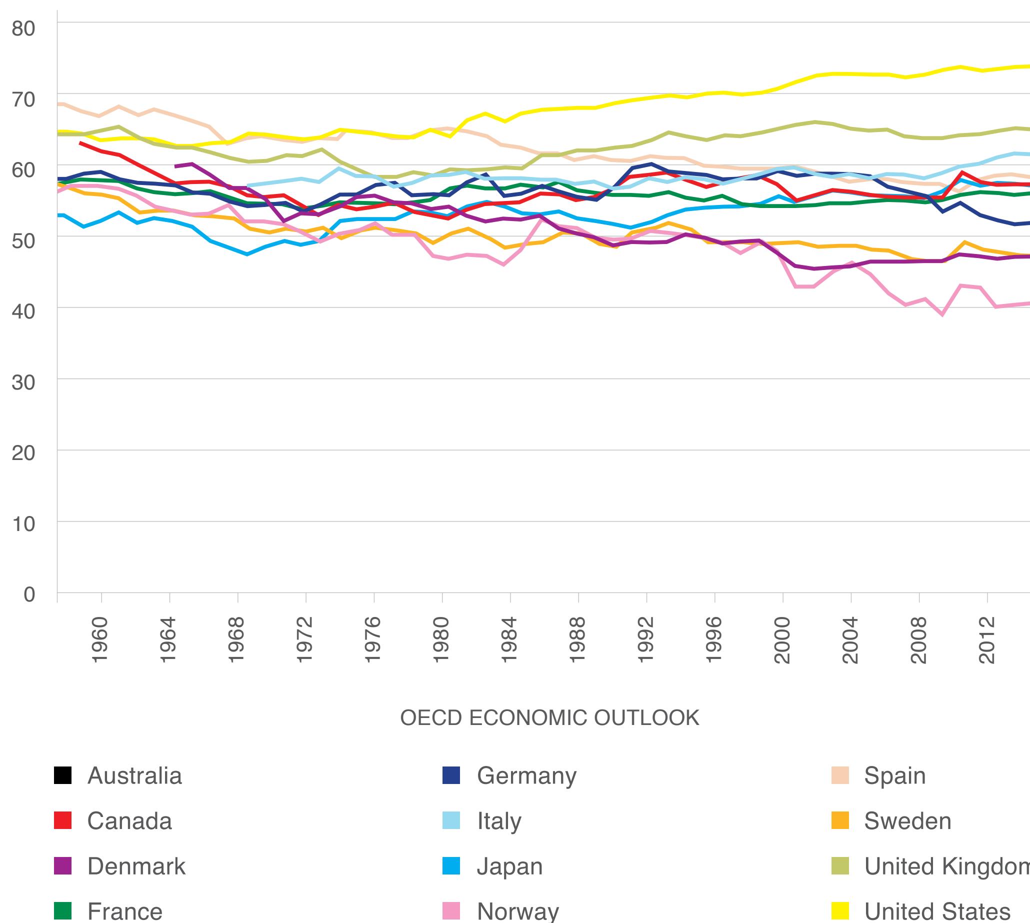
Thus, Europe and the United States found themselves on two diametrically opposed economic paths, and followed these paths for the next several decades. As one astute observer noted in the 1960s: "President de Gaulle not long ago 'declared that France's economic future depended on more savings, more investment, and less consumption.' By contrast, the United States Treasury, at almost the same time, emphasized that its recent tax moves—the Revenue Act of 1964 and the Excise Tax Reduction Act of 1964—'provided a substantial stimulus to consumer demand.' What the United States seeks to achieve is exactly what France seeks to avoid" (Norr 1966, 390).

Over the next decades the countries' commitment to these different growth models only increased, and several other aspects of American politics came to support the consumer bias. For example, American foreign policy increasingly focused on securing access to low-cost oil, without which the oil-dependent American consumer economy would have ground to a halt; and in the mid-twentieth century a legal tradition emerged that began to support consumer rights in the U.S. at the same time as laws supporting producerism were being consolidated in Europe (Whitman 2007). Other less visible but extremely consequential policies and practices arose to support homeownership, such as the policy of "fractional assessment," assessing property taxes on only a fraction of the true value of a home. By the 1970s fractional assessment was costing governments $39 billion annually, an amount second only to outlays on Social Security and Medicare (Martin 2008, 9-10).

The most obvious consequence of these inter-related policies has been higher consumption in the United States compared to Europe. Figure 1 shows the role that private consumption plays in 19 OECD economies. In the United States, consumption has played a larger role than in France, Germany, Sweden, the United Kingdom, or indeed, most other advanced industrial countries, since 1960. The post-war economic miracle in Europe convinced Europeans that they should not stray too far from the model they had adopted.

And the U.S., for its part, became even more committed to a kind of "mortgage Keynesianism" by which debt-fueled homeownership underwrote the economy. Whereas Europeans thought—and still think—that restraining consumption and focusing on production and exports is the way to generate growth, Americans focused—and continue to focus—on increasing consumption as the way to generate growth.

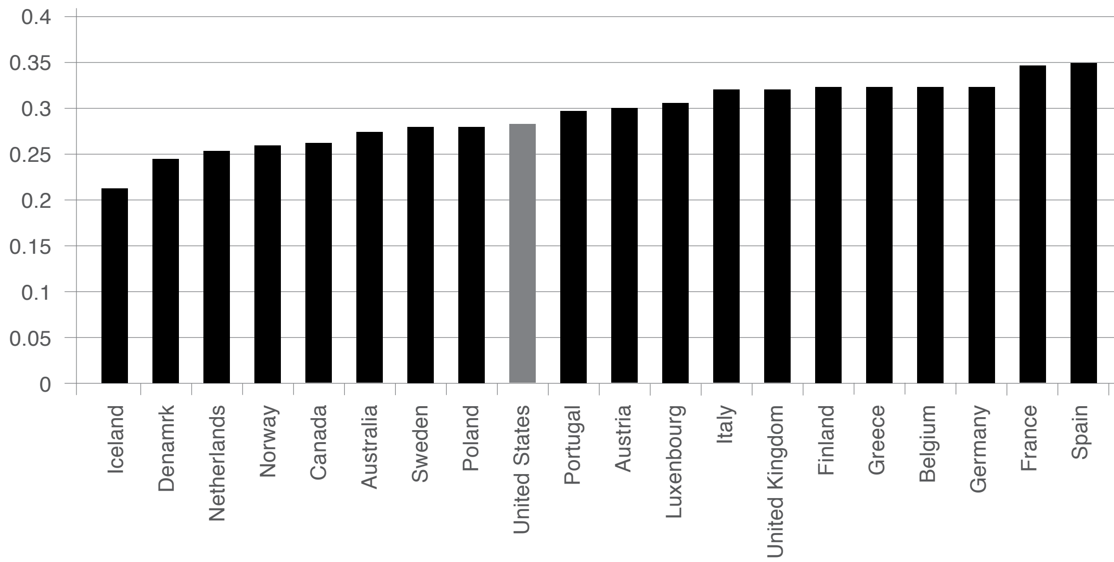
Figure 1. Private Consumption as % GDP



CONSEQUENCES OF THE CONSUMER-ORIENTED ECONOMY

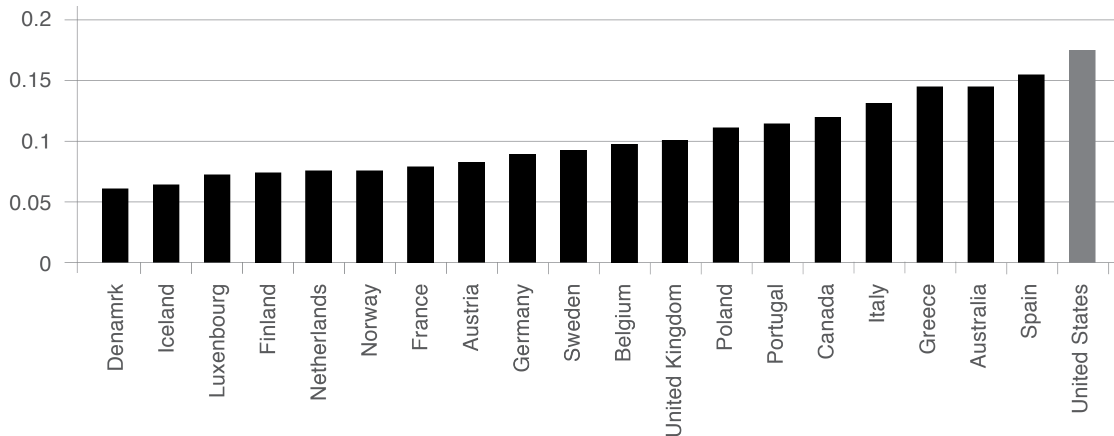
Although an economy biased toward consumption brings low-cost goods to citizens, over the years several negative consequences of such an orientation have become visible. First, producerist and consumerist growth models have very different effects on poverty and inequality. European and American poverty rates diverge dramatically. This divergence is not the result of a market that produces more poverty in the United States, however. Surprisingly, if we look at poverty rates *before* government intervention—that is, before the government steps in and takes taxes from some and gives transfers such as welfare and unemployment and pension benefits to others—then the United States has much lower poverty than many other European countries, including Italy, the U.K., Germany, and France (figures 2a-2b).

Figure 2a. Poverty Rate Before Taxes and Transfers, 2010



† *OECD stats.oecd.org, "poverty rate before taxes and transfers, poverty line 50%"*

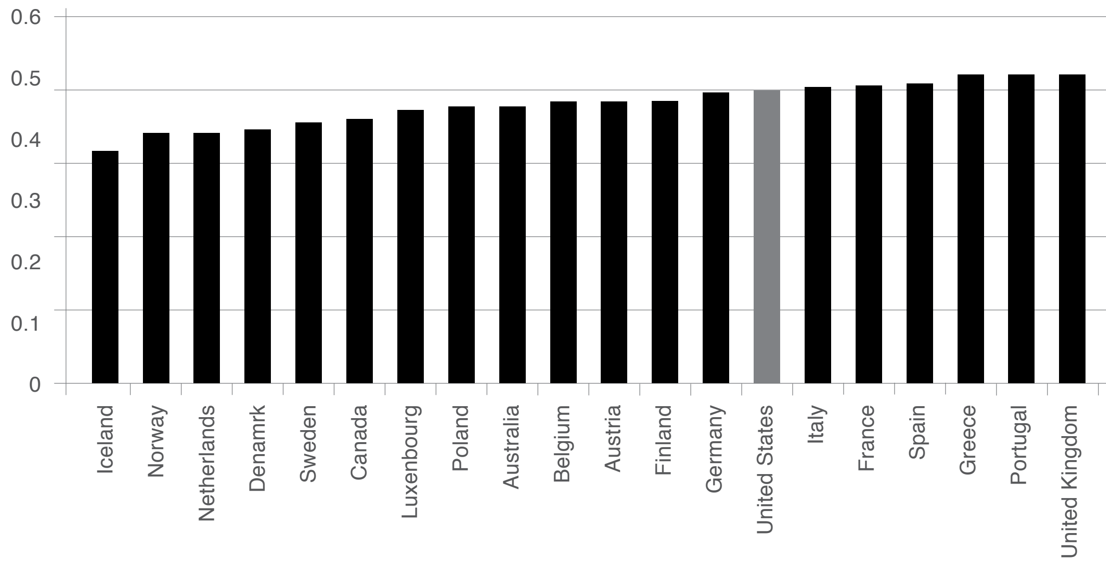
Figure 2b. Poverty Rate After Taxes and Transfers, 2010



† *OECD stats.oecd.org, "poverty rate after taxes and transfers, poverty line 50%"*

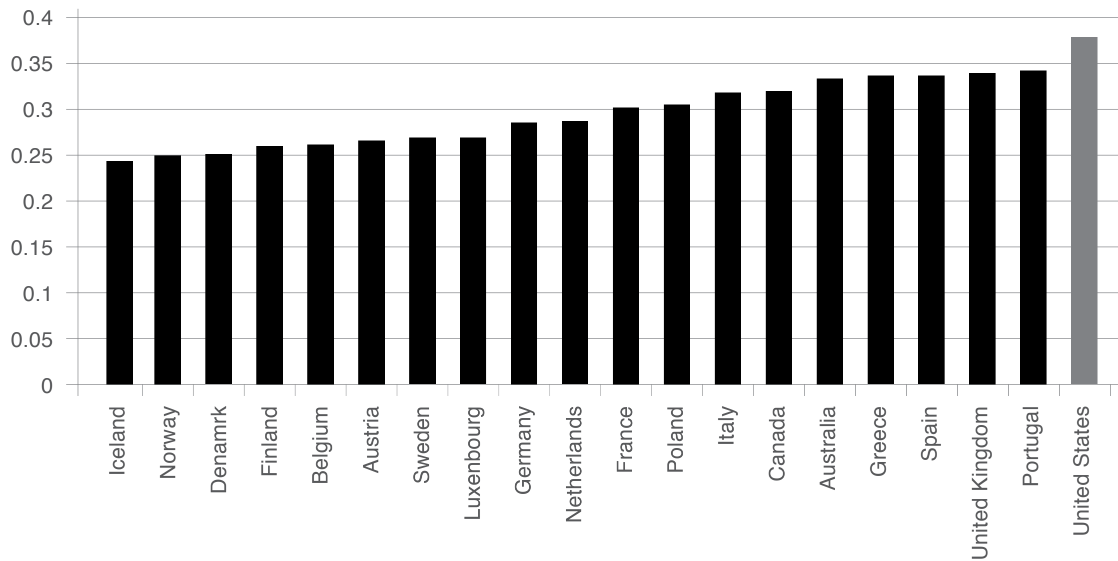
Only after governmental intervention does the familiar picture of greater poverty in the United States emerge (figure 2b). The picture is similar if we use different definitions of poverty, including absolute or relative measures of poverty; and the picture is similar if we examine inequality rather than poverty (figures 3a-3b): while the U.S. has the highest disposable income inequality, that is, inequality after taxes and transfers, *market* income inequality in the U.S. is only slightly higher than in Germany, Finland, and Belgium, and actually slightly lower than in Italy, France, Spain, and Great Britain.

Figure 3a. Inequality (Gini Index) Before Taxes and Transfers, 2010



† OECD.Stat, "Gini before taxes and transfers"

Figure 3b. Inequality After Taxes and Transfers, 2010



† OECD.Stat, "(Gini at disposable income, post taxes and transfers)"

These graphs cast doubt on one of the most common storylines in recent American political economy: that rising poverty and inequality are a consequence of stagnant wages, and that the answer to poverty and inequality is therefore a push for higher wages. If poverty and inequality rates before governmental intervention are not so different in the United States and Europe, then market wages are not responsible for the higher poverty and inequality in the U.S. It is true that minimum wages in the U.S. are less than the OECD average (although not the lowest of the OECD countries), and that market incomes at the very top are high in the U.S. But when we examine the labor force as a whole, not just at the top and bottom ends, it is *governmental* policies of taxes and transfers—the "welfare state"—that create the pattern of divergence between the United States and Europe.

Welfare states grew in Europe as a byproduct of the producerist growth model. To purchase acquiescence to this model of growth, which required lower wages and restraint of consumption, European countries developed extensive welfare states, in many cases in an explicit quid pro quo with labor, trading lower wages for social benefits. For example:

> In Belgium, the first postwar government adopted a social security scheme in return for labor's adherence to a 1944 social pact limiting wage increases. In return for the unions' promise of wage restraint, the Norwegian government offered legislation mandating paid vacations and limiting the length of the workweek. The Dutch government introduced unemployment insurance and old-age pensions, while extending social security coverage, as a quid pro quo for wage moderation. Starting in 1955, the Swedish government offered compulsory health insurance, an expanded system of disability insurance, and an array of retraining programs in return for labor's acquiescence to policies of wage restraint and solidarity. The Danish government offered an expanded system of sick pay in 1956, when the agreement to link wage increases to productivity negotiated during the reconstruction phase showed signs of breaking down. .... The Austrian government extended tax and social insurance concessions to labor in return for wage moderation" (Eichengreen 2007, 33–34).

Such bargains were not necessary or possible in the United States, because there was no overarching focus on wage restraint in the service of growth. Instead, the purchasing power paradigm demanded high wages, bolstered by expansionary credit, to underpin the strategy of consumption-driven growth.

The consumer economy that arose after the Great Depression and Second World War undermined the welfare state in the U.S. in two specific ways, one direct and one indirect. First, several studies have shown that homeownership has negative effects on citizens' willingness to support redistribution (Kemeny 1980; Conley and Gifford 2006; Ansell 2013). We do not yet have a full understanding of why this might be the case, but analysts have suggested that homeownership functions as a form of economic security that makes homeowners less dependent on the welfare state, and also that homeowners may be more resistant to taxes because they compete with mortgage payments. Second, the United States emerged from the Second World War with low taxes on consumption; but one of the lessons of scholarship of the last several decades is that consumption taxes are much more

solid bases of revenue generation than taxes on income (Lindert 2004). One reason is that consumption taxes do not penalize savings, as income taxes do: "If you are subject only to a 15 percent consumption tax now and forever, with no income tax, your incentive to save is not strongly affected…Income taxes, by contrast, take from your saved income twice, both when you initially earned the income you decided to save and again when your savings earns new capital income" (Lindert 2004, 241–242; Hines 2007). A higher savings rate is in turn correlated with higher growth. There is a remarkable degree of consensus in the discipline of economics that consumption taxes are more compatible with economic growth than income taxes (see e.g. Summers 1981; Pecorino 1993; Pecorino 1994; Kneller, Bleaneay, and Gemmell 1999; Jorgenson and Yun 1986; Widmalm 2001). Consumption taxes are also less susceptible to the effects of globalization, as they do not wither in the face of capital flight (Ganghof 2006, 2007, 2008). Moreover, income taxes also seem to provoke more political resistance than consumption taxes (Wilensky 2002), and income taxes are more prone to the proliferation of tax preferences, which have encouraged the development of a private rather than public welfare state (Prasad 2012). Ultimately, if counter-intuitively, the comparative evidence suggests that calls for more progressive income taxes in the United States may be misplaced if the goal is to reduce poverty and inequality. In fact, many countries with much lower poverty and inequality have regressive-leaning tax systems in which consumption taxes play a major role. These taxes are more efficient than progressive income taxes, and European states have thus been able to spend much higher amounts on social benefits without damaging their economies.

For all of these reasons, one of the consequences of the consumer-oriented economy has been greater poverty and inequality in the United States.

Of course, many Americans are not convinced that poverty and inequality are problems at all. But even citizens unconvinced of this should be worried, because the second problem with the consumer bias of the American economy is that it produces financial volatility.

Most analysts of the financial crisis of 2007-2008 have understood it to be the result of the increasing role that finance capital and credit play in the American economy, and how this creates debt bubbles that have the power to bring down the whole economy. The process of financialization is generally understood to have begun in the 1970s, when savings rates began to fall and debt levels to rise. One view that has become prominent recently—if under-appreciated in its deep implications—is that financialization was an easy way to avoid difficult distributional questions during the economic crisis of the 1970s, because expansions of consumer credit provided households with a way to make ends meet without needing to expand the welfare state (Krippner 2011, Rajan 2010). As the economy slipped into crisis, policymakers discovered that expanding access to consumer credit was a cheap and easy way to avoid making more fundamental changes. Greta Krippner writes: "as conditions supporting broadly based prosperity in the economy eroded…policymakers transformed an era of capital scarcity and perennial credit shortages into apparent prosperity, obviating the need for an emergent social consensus" on issues of distribution (2011, 147-149). Krippner notes

that "a series of unresolved distributional questions lurk just below the surface of the credit expansion that has occurred in the U.S. economy in the decades since the 1970s" (165).

The problem with this argument is that, by the 1970s, the United States was already more financialized on several dimensions than the countries of Europe. For example, in credit to the private sector as a share of GDP, the United States ranked second after Switzerland in 1970 (Demirgüç-Kunt and Levine 2001, and associated database), and third as far back as 1948 (International Monetary Fund, 2009, ratio of lines 22d + 42d to line 99b following Djankov, McLiesh, and Shleifer 2007). In 1968, compared to France, Germany, and Sweden, the U.S. was already more financialized in terms of stock market capitalization and various other measures (Rajan and Zingales 2003, 14-15). Since the 1940s, credit in the household sector had been rising as a percent of GDP (James and Sylla, 2006a). In 1971, one-half of Americans but only one-tenth of Germans used installment credit (Logemann 2008, 525). In 1965 consumer credit represented 6 percent of GDP in the U.S., but only 2 percent in France (Effosse 2010, 79).

Financialization was not just a response to economic crisis in the 1970s: it was a deeper outgrowth of the consumer-oriented model that emerged from the Great Depression, a model that depended on expansive credit as a kind of safety net for growth. Something new did happen in the 1970s, in that savings rates plunged. Whereas the credit model of the post-war period was one in which consumers borrowed often, and then repaid quickly, in the 1970s consumers continued to borrow as they had always done, but did not repay as promptly (Hyman 2011). As Lewis Hyman writes, "A credit system premised on rising wages and stable employment [before the 1970s] was reappropriated to shore up uncertain employment and income inequality [after the 1970s]" (2011, 4). Growing from an already divergent baseline, by 2012 domestic credit provided by the banking sector in the U.S. equaled approximately 230 percent of GDP, compared to rates of 124 percent in Germany, 136 percent in France, and 145 percent in Sweden.[7]

To understand the origins of today's financialization, we need to examine why the credit-driven model had become so popular by the 1970s that it was used to "shore up" an economy in crisis.

Understanding this requires understanding a dilemma that lies at the heart of a credit-driven consumer economy: if private consumption (rather than a public welfare state) is the route towards satisfying needs, then all those who are too poor to engage in significant consumption will be left out of the economic mainstream. On the other hand, if these citizens are brought into the system through the extension of credit, some of them will not be able to repay; this can make the entire financial system vulnerable, because large-scale inability to repay can occur during economic crises, when citizens who are just making ends meet are pushed into default. In a mature financial system in which debts are securitized, the consequences will ripple throughout the economy. Financial regulations such as restraints on securitization can prevent such scenarios, but in a credit-driven consumer economy there are *no constituencies for regulation of the financial sector,* because credit helps

the poor as well as the rich. Of course, there are usually no real constituencies for regulation of finance anywhere, but such regulation is needed much more in credit-driven consumer economies than elsewhere: the credit-driven consumer economy undermines the very regulation that it needs to survive. Thus, with these contradictions, the credit-driven consumer economy leads to *either* high levels of poverty, *or* financial volatility.

In the post-war period, because of the high correlation between race and poverty, racial restrictions on credit served to keep the poor out of the credit system. In the 1970s, grassroots activists were no longer willing to tolerate high levels of poverty and racial exclusion, and they were able to organize and make that unwillingness known to policymakers. Because of rising rates of divorce, feminist groups also worked to increase credit access for women. Activists focused on credit because, as one feminist leader explained in 1973, "Denial of credit is not a one-time action… In our credit-oriented economy, it determines where and how a person lives, what kind of home she lives in, whether she owns a car or can obtain a loan to send her children to college...these practices cause a double hardship on minority women. Denying credit because of marital status, sharply limits the ability of the minority woman who is head of a household—and that includes 57 percent of minority women—to provide for her dependents."[8] Activists pushing for greater credit access for African Americans as well as for women saw equal access to credit as a question of justice. Because credit was how the American economy functioned, excluding groups from credit access meant consigning them to second-class citizenship. This made credit access an issue that gained support from across the political spectrum in the 1970s, from Democrats as much as from Republicans, including those most committed to helping the disadvantaged. The grassroots activists pushing for greater credit access for the economically excluded were drawn into coalitions with representatives of the financial industry who pushed for more expansive credit for their own reasons. Regulations that might have prevented the unstable development of the financial sector were scaled back, with the support of Democrats as well as Republicans.

In other words, financialization is itself an outcome of the American consumer-oriented political economy, because a consumer economy builds political coalitions in favor of easy credit. It is the second horn of the dilemma. In the 1970s, it led to a political situation in which all actors supported measures to make finance more widely available, a situation that persisted for decades and has fed the boom and bust cycles of finance. As technological and policy changes led to more income flowing to upper-income classes who are more likely to save and invest and less likely to spend, consumer demand came to depend on low-income consumers taking on ever more debt (Rajan 2010), to the point that credit outpaced the ability of consumers to repay it.

This suggests that the financial crash of 2008 calls into question not just the financial industry, but indeed, the whole of our consumer-oriented economy, because a consumer-oriented economy builds political coalitions for greater credit access, and weakens incentives to restrain the financial sector and develop the welfare state.

STRATEGIES FOR MOVING AWAY FROM THE CONSUMER MODEL

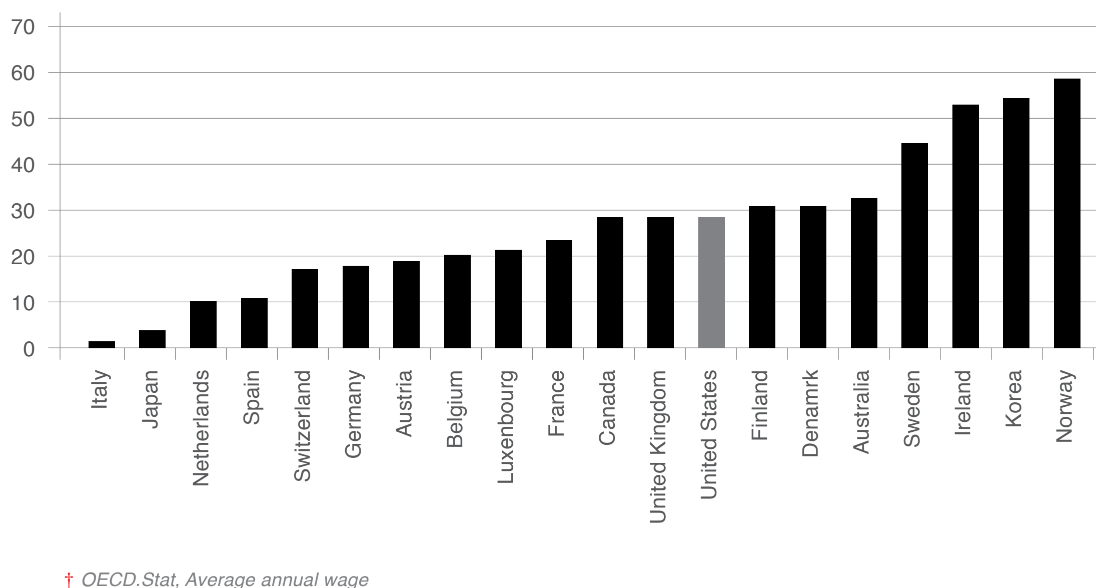
The consumer-oriented economy that we inherited from the post-war period has been an engine of growth not only for the United States, but also for the world. But there are signals that it has outlived its usefulness and is producing negative consequences that may not be worth the price.

What, then, are the policies that could move us away from the consumption model? This section first identifies problems with three popular ideas: that regulation is all we need to avoid financial crises; that wage stagnation is the central problem, and higher minimum wages and collective bargaining the solution; and that demand-driven "middle out economics" is the pathway for restoring American prosperity. Instead, this section proposes two policy strategies that move the focus away from private sector solutions.

The main idea that has emerged as a policy response to the financial crisis is that we need more regulation to prevent credit being expanded recklessly. Regulation is important and necessary to protect against practices such as predatory lending. But regulation treats the symptom, not the disease. I have shown elsewhere that deregulation of finance did not lead to greater credit in other countries (Prasad 2012), because people did not have the same need for credit in other countries. In the U.S., in the absence of developed social welfare programs, new rounds of regulation will simply make credit more difficult to access, leading to hardship for large numbers of families. In this scenario, we will inevitably see a replay of the politics of the 1970s, in which coalitions for deregulation arose from across the political spectrum, from advocates for the poor as much as from the financial industry. Because regulation treats the symptom, and not the disease, in a credit-driven economy financial regulation will never be politically sustainable.

Another idea commonly heard today is that the problem is wage stagnation, to be solved with some combination of higher minimum wages and collective bargaining. As mentioned earlier, several analysts have noted the political nexus between wage stagnation and credit expansion: by expanding credit, business and government avoided taking any responsibility for declining economic security and mobility in a large part of the country (Rajan 2010; Krippner 2011). However, wage stagnation in the United States has not been much worse than wage stagnation in Europe, including in countries that did not embrace American-style financialization; Figure 4 shows growth in the average annual wage (for both full-time workers and part-time workers at a full-time-equivalent rate) for twenty OECD countries. But despite similar levels of wage stagnation in several countries, Europeans have not turned to borrowing to the same extent, suggesting that it is stagnant wages *in combination with an underdeveloped welfare state* that has led to the need for ever greater levels of borrowing in America. In Europe, stagnant wages have led to cutbacks in quality of life, but in the United States, stagnant wages have led to inability to pay for necessities such as health care. Certainly, raising minimum wages and strengthening collective bargaining provisions would help low-wage Americans, but if the question is why Americans are forced to borrow, comparison of the U.S. and Europe points to the absence of a well-developed welfare state as the main difference.

Figure 4. Growth in Average Annual Wage, 1991–2001



† *OECD.Stat, Average annual wage*

Third, there has been much talk these days of what some people are calling "middle out" economics. As a reply to "trickle down" theory, which is a nickname for the argument that tax cuts for business will benefit workers, progressives recently have developed the argument that "national prosperity does not trickle down from wealthy businesspeople or corporations; rather, it flows in a virtuous cycle that starts with a thriving middle class….Rich businesspeople are not the primary job creators; middle-class customers are. The more the middle class can buy, the more jobs we'll create" (Liu and Hanauer 2013). Even President Obama has adopted the middle-out rhetoric: "when middle class families have less to spend, businesses have fewer consumers…an economy that grows from the middle out, not the top down, that's where I will focus my energies not just for the next few months but for the remainder of my presidency" (speech at Knox College, July 24, 2013).

As we have seen in this paper, this "middle-out" idea is not a departure from post-war American patterns. Indeed, these current phrases are strong echoes of the arguments quoted above and exemplified by New Jersey CIO leader Carl Holderman's statement in 1947: "Unless a worker's earnings can support his family, we [will] find our whole capitalistic set-up deprived of the market for the great production of which it is capable" (quoted in Cohen 2003, 154).

The "middle-out" idea is essentially advocating a return to the era of the "purchasing power paradigm." And if it is not instantiated carefully, it will have the same results as the purchasing power paradigm. For example, President Obama recently said: "I'm also acting on my own to cut red tape for responsible families who want to get a mortgage but the bank is saying no" (Knox College, July 25, 2013). Certainly, we should continue to eradicate discrimination in lending, but if our attention remains on mortgages, and home mortgag-

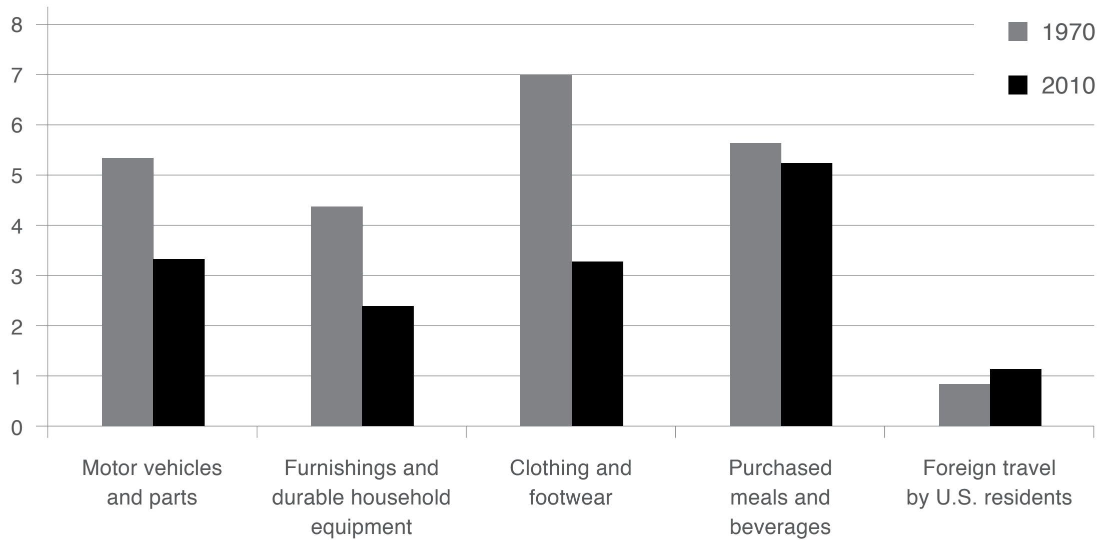
es remain the central economic strategy for the middle class, political coalitions will once again arise to make credit more and more easily available. Another worry is that middle-out may just mean cutting taxes for the middle class, as when the President says "we locked in tax cuts for 98 percent of Americans" (Obama, Knox College, July 25, 2013). Relentlessly focusing on tax cuts precisely contradicts the central lesson of the recent financial crash: to maintain living standards without unsustainable borrowing, we need more public support for households, requiring higher public revenues.

Supporters of "middle out" also ignore the problem that businesses are not as dependent on domestic demand as they were in the post-war era, given the ability to market worldwide. They are less likely to sign on to such a paradigm today. Relatedly, some of the consumption of "middle out" will come from abroad, weakening the effects on the domestic economy. Even where it does affect domestic businesses, greater consumption might simply end up increasing profits rather than feeding back into more or higher-paying jobs. Most importantly, greater consumption does not necessarily increase productivity, which is the surest recipe for long-term growth.

The greatest danger of "middle out," however, is that it will create categorical distinctions between "middle class" workers who are deserving of benefits, and others who are relegated to more peripheral and unpopular welfare programs. This situation allows those who would cut back all government programs to find a powerful political foothold in demonizing the recipients of peripheral programs. Anti-statist rhetoric is extremely potent when residual programs that do not benefit the middle classes can be held up as (exaggerated, but symbolically powerful) exemplars of government waste and used to discredit all government action.

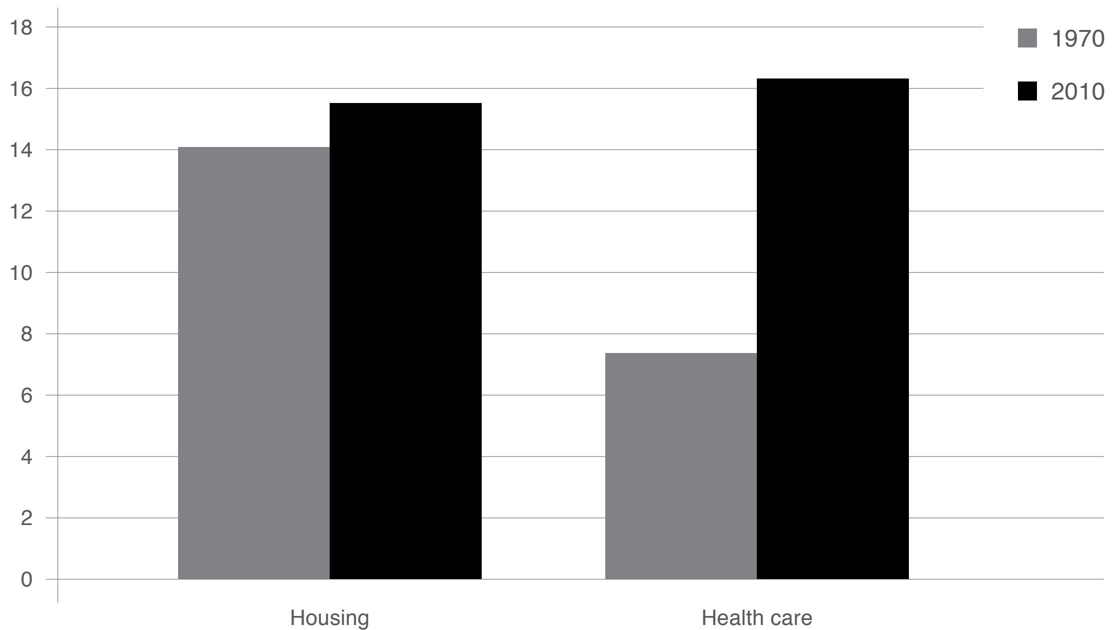
If these three strategies are problematic, we can develop a better strategy by understanding what the main problem is. To get at the heart of the issue, we need to consider why borrowing and indebtedness are so popular in the United States, and why savings are so anemic. There is a stereotype of the American consumer that says if consumers are over-indebted, it's because they're throwing away money on flat screen TVs. But this is not true at all. In fact, consumption expenditure has gone *down* in most luxury categories (as a percentage of total consumption) since the 1970s (figure 5), including furnishing, clothing and footwear, motor vehicles, and purchased meals and beverages; the one exception is foreign travel, which has seen a tiny rise from .8 to 1.1 percent. Instead, the two largest categories of consumer expenditure are housing and health care (figure 6), with health care spending having seen a big increase since 1970.

Figure 5. Luxury Consumption (as % of total consumption)



† *Bureau of Economic Analysis, 2012, National Income and Product Accounts, Table 2.4.5 ("Personal Consumption Expenditures by Type of Product").*

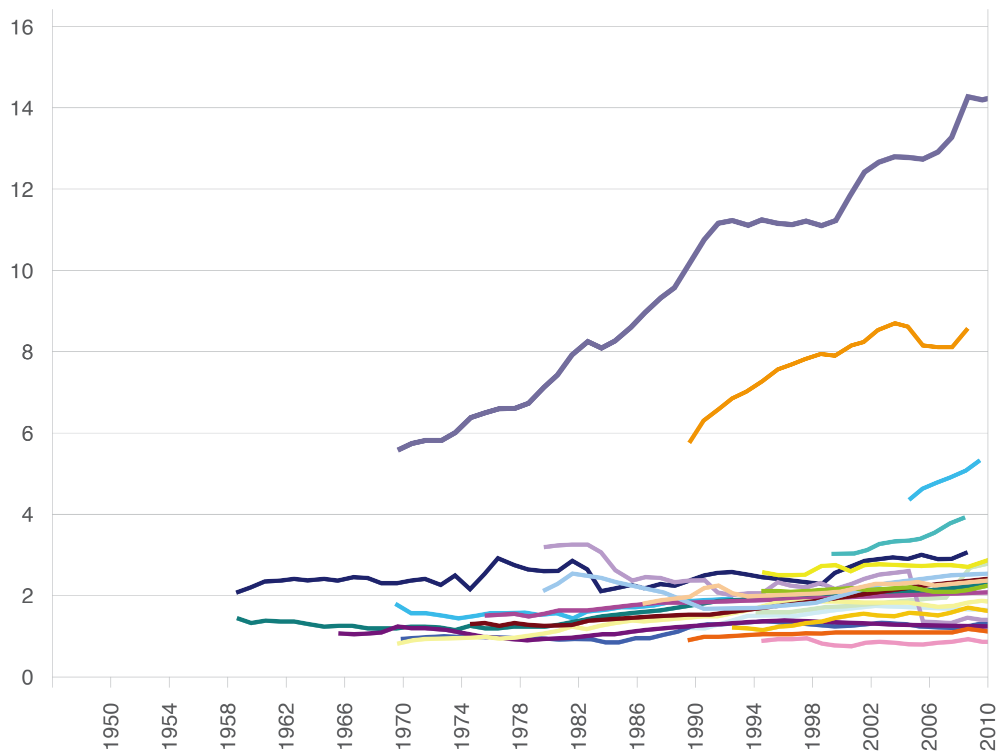
Figure 6. Housing and Health Care (as % of total consumption)



† *Bureau of Economic Analysis, 2012, National Income and Product Accounts, Table 2.4.5 ("Personal Consumption Expenditures by Type of Product").*

If we look comparatively, it is clearly health care that is the outlier (figure 7). Consumers in other countries spend 2-4 percent of their income on health care, whereas in the U.S. in recent years they have spent 14 percent of their income on health care. The reason for lower savings rates and higher debt since the 1970s is no mystery. Since home mortgages and other loans secured by residential property make up over half of consumer credit, we can conclude with only slight exaggeration that since the 1970s Americans have been taking out loans on their homes to finance private health care.

Figure 7. Household Expenditure on Health as Percentage of GDP



OECD ECONOMIC OUTLOOK

Australia
Austria
Belgium
Canada
Denmark
Finland
France
Germany
Greece
Iceland
Ireland
Italy
Japan
Luxembourg
Netherlands
New Zealand
Norway
Portugal
Spain
Sweden
Switzerland
United Kingdom
United States

† *OECD Dataset on Final Consumption Expenditures*

The reasons for this spending on health care are also clear: first, because there has been less comparative spending on public health care, consumers are forced to pay privately for health care; and second, because costs cannot be controlled by a private health care industry as well as by a program of public health care, the absolute amounts that consumers pay to the health care industry are much higher than in other countries.

It should be obvious from this that if the goal is reduction of American reliance on credit, expanding the public welfare state is a key component of that goal. Indeed, although many analysts worry about the costs of the recent health care reform, these graphs suggest that such measures will benefit the economy by smoothing out the financial volatility caused by private borrowing to finance health care needs. Although health care has been the major driver of the patterns seen above, education costs are also a significant factor, particularly the explosion in recent years of college debt, and child care costs have also recently strained family budgets. High-quality public education, from preschool through college, would not only help improve the human capital of low-income students, but would also directly improve households' savings.

A second set of policies to shift resources away from unsustainable consumption is to focus on directly promoting savings over borrowing. Currently, savings accounts with low balances are penalized with minimal balance policies and a host of fees and charges for falling below the minimum. Banks justify these fees with the argument that they cannot otherwise afford to service those with small savings. Every other developed country has resolved this conundrum by using the state to subsidize small savings. Instead of subsidizing borrowing, as the American state does now, we should be subsidizing savings. The most straightforward way would be to imitate the "postal savings accounts" common in Europe and Japan, which are savings accounts limited to those with very small savings (Garon 2012). The United States Postal Savings System was discontinued in the 1960s, on the argument that banks had begun to provide the services and guarantees that postal savings had once provided. However, without the competition from the postal service for small accounts, in the intervening decades banks have increased their fees on small accounts, which suggests that a return to postal savings could be useful. An alternative would be to regulate the fees that banks can charge small savers.

A similar strategy would be to reduce or eliminate penalties on IRA account withdrawals for those with limited income or assets. Those of limited means need liquid assets, and the ironclad nature of IRA contributions prevents them from choosing this important savings vehicle.

Exempting savings from taxation is an idea that has already received some policy attention. Recently, Robert Frank of Cornell University has suggested a "progressive consumption tax," essentially an income tax that exempts savings from taxation. Frank's intention is to incentivize savings, but also to limit what he calls "expenditure cascades," in which all consumers have to ratchet up consumption; the strongest example of such a cascade is in housing, where consumers have to pay higher and higher housing costs in order to

remain in districts with good public schools. A consumption tax of this sort also has the revenue-raising potential of the value added taxes seen in Europe, because it may be able to avoid the economic distortions of income taxes (Lindert 2004); but by exempting savings rather than directly taxing consumption, such a tax sidesteps the issue of insufficient transparency in the European value added taxes.

When considering incentivizing savings, a particularly promising area to target is the pension savings of those with limited incomes: the bottom quintile of earners saves about 9 percent of their income in pensions, and matching these contributions with credits can be an easy way to boost the savings rate of those of moderate means. An important principle is that policies on the tax side will only help those of moderate means *if they come in the form of refundable tax credits*. If they come in the form of deductions and exemptions they may not help at all, because many in these categories will not have incomes high enough to be paying a great deal of income tax to begin with.

To find the money to subsidize savings, the flip side is that we need to reduce or take away subsidies for debt; in particular, we need to reduce incentives and benefits for upper-income households that take on debt. The easiest way to begin is by means-testing the mortgage interest tax deduction, and requiring higher down payments for expensive homes and second homes. Karen Dynan (2013) has proposed capping at 28 percent the rate at which retirement savings deductions can reduce tax obligations, as well as adopting measures such as automatic enrollment into retirement savings plans that would increase the proportion of the workforce that benefits.

Some may object that if we focus all of our efforts on increasing savings for the poor and middle classes, inflation will wipe away those savings. However, it seems clear that, as a country, we have committed to fighting inflation over the long term, even if it means pulling the economy into crisis (as occurred in the 1970s). Focusing on savings for the poor and middle classes allows them to benefit from these attempts to hold inflation at bay.

Universal welfare programs (including high quality public education) and a focus on savings are components of a *producerist* strategy, especially when combined with spending on infrastructure and research and development. For these are exactly the investments needed to create sustainable economic growth: infrastructural investments such as smart grids, investments in scientific education, building up households' assets, and welfare expenditures that create a healthy and productive workforce. These policies go beyond the growth strategy of low taxes and deregulation that has driven American political economy for the past three decades; but they also offer a more effective and sustainable alternative to the "demand side" strategies that prevailed in the post-war period. This combination of welfare, wealth-building, and productivity policies is a better foundation for equitable and sustainable growth in the twenty-first century.

CONCLUSION

I have argued in this paper that the unique situation of the United States in the nineteenth century, when abundant agricultural productivity under a gold standard put us on a path to deflation, gave rise, during the Great Depression, to an economic model that focused on countering deflation by increasing consumer purchasing power. The central means to boosting purchasing power was an infrastructure of mortgage debt, a kind of "mortgage Keynesianism." This approach has remained at the core of the American model of political economy, but it has dangerous political consequences: a credit-driven consumer society will lead *either* to higher poverty and inequality, *or* to greater financial volatility. In the 1970s through the 1990s, credit access was expanded to include ever more segments of American society. The consequent financial crisis has led to a politics in which credit may become more highly regulated, but if so, this will come at the cost of greater poverty.

Some readers may be willing to grant that a consumer-oriented economy can worsen poverty and inequality and worsen financial volatility, but may find themselves wondering: if America does not consume, who will? Those exports that underwrote the German economic miracle would have had nowhere to go if *all* countries chose to restrain consumption and increase production as Germany did. We live in a global economic order in which American consumption powers not just the American economy, but the world economy.

It seems evident that in a world in which one billion people live in extreme poverty, consumer demand will have to come from the developing countries. China, in particular, is often cited by many analysts as having overdeveloped savings and underdeveloped consumption. This means that the breakneck pace of Chinese economic growth is largely benefiting firms at the expense of consumers. Particularly at low levels of GDP, consumption is an easy way to increase productivity, because it develops health and human capital. But it is clear that China will only embark on a sustained program of developing domestic consumption if it becomes convinced that the United States is no longer willing to be the world's consumer. Until then, demand in the United States will continue to back Chinese economic growth, but that growth will benefit Chinese industry more than Chinese consumers.

Thus, in the short run, developing countries have the potential to be the locomotive of the world economy. In the long run, however, a more stable scenario would be for all countries to develop more of a balance between exports and imports, with neither perennial trade surpluses nor perennial trade deficits.

For the United States, one might also reasonably ask if the recommended strategies are politically possible. There will be great opposition to programs such as scaling back the mortgage interest tax deduction, of course, but a push to increase savings has the major advantage that it can be backed by both right and left. Historically, it is Republicans who have pushed for programs to increase savings. But Democrats may also be converging on the argument that *savings are a civil rights issue*. The decades-long push towards greater credit access for African Americans and women was successful partly because activists were able

to show how discrimination in credit disadvantaged these groups directly. There is a similar case to be made for savings. For example, although only 8.2 percent of all households lack any kind of deposit account, this number rises to 21.4 percent of blacks, 19.1 percent of households headed by single women, and 20.1 percent of Hispanics (FDIC 2012, 5). The credit rights revolution of the 1970s accomplished only half of the goal by allowing disadvantaged groups to borrow; the other half of the goal is to help them get out of debt and build up savings. There is a narrow but viable path for agreement across the political aisle on strategies to increase savings and decrease consumer debt.

Finally, it is worth stressing that the strategies outlined here are intended as long-term measures for the reorientation of the American economy. In the short term, stimulating consumer demand makes eminent sense in the face of a weak economic recovery. But that short-term measure should not be mistaken for a sound basis for future long-term growth. Moving the United States into a new era of growth requires leaving behind the consumer model, and focusing on the development of public infrastructure and human capital and building household assets. The consumer-oriented economy that arose from the Great Depression was a remarkable motor of capitalist growth. But it has also produced poverty, inequality, and financial volatility. Moving the United States into its next era of growth requires moving beyond consumption.

1. The first part of this paper is adapted from my book The Land of Too Much: American Abundance and the Paradox of Poverty (Prasad 2012). For comments on this paper I am grateful to Bruce Carruthers, Lew Daly, Peter Hall and Ganesh Sitaraman.
2. See e.g. Brady 2009; Buhmann, Rainwater, Schmaus, and Smeeding 1988; Rainwater and Smeeding 2004; Kenworthy 2004; OECD 2008; Smeeding 2005; Smeeding 2006.
3. In the two main political episodes when consumption taxes might have been adopted in America, they were rejected by agrarian politicians for their regressivity (Prasad 2012: 99-124).
4. On the role of regulations against interstate branch banking in worsening the crisis of finance during the Great Depression, see Prasad 2012: 212-221.
5. For example, the American share of worldwide merchandise exports is roughly equal to the German share, even though the U.S. has an economy four times larger than Germany's.
6. E.g. Trumbull (2010) compares surveys in France showing willingness to buy on credit with American reluctance to buy on credit. For an amusing overview of American cultural efforts to promote savings bonds throughout the twentieth century, see http://www.youtube.com/watch?v=9Ysj0L8ODOQ.
7. World Bank data, "Domestic Credit Provided by the Banking Sector (% of GDP)," http://data.worldbank.org/indicator/FS.AST.DOMS.GD.ZS
8. Arline Lotman, Executive Director of the Pennsylvania Commission on the Status of Women, "For Release Sunday, March 25, 1973," Patsy Mink Papers, Box 56, Folder 7, Banking and Currency Credit Unions Sex Discrimination 1972–1976 (1 of 2), Manuscript Division, Library of Congress.

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Antitrust:
A Missing Key to Prosperity, Opportunity, and Democracy

Barry C. Lynn

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When a people set out to structure an economy, the most important decisions revolve around how they make markets and regulate competition. Such decisions determine not merely whether their economy will thrive, and how political power will be distributed. They also shape the character of individuals, communities, and society as a whole.

For two centuries, the foremost subject of economic debate in America was how to maximize liberty and opportunity in our economy, by blocking or closely managing concentrations of power over our markets. But a generation ago two radical changes entirely altered this conversation and hence how we addressed concentration. First, economic elites largely concluded such consolidation was generally a good thing. Second, the Reagan Administration flipped the goals of antimonopoly law on their head; rather than distribute power the aim now was to promote its consolidation in the hands of a few.

In the years since, the corporate actors thus freed have reordered almost every corner of our domestic and international political economies. Many other factors have played a role in the changes we have witnessed, including digitization and the radical expansion of trade (itself a subset of competition policy). Yet there has been almost no examination of the effects of these radical changes in the distribution of economic control, whether among

academics, policymakers, or the general public. The resulting lack of understanding of what took place—the collapse of antitrust—is a serious liability for economic reformers and for the future of our economy and our democracy.

THE REAGAN "REVOLUTION"

As is true for so many of today's biggest economic and political problems, the beginning of this story traces to the election of Ronald Reagan in 1980. In January 1981, William Baxter, president-elect Ronald Reagan's choice to head the Antitrust Division of the Justice Department, said the new administration planned to alter how the government enforces America's antimonopoly laws. Rather than seek to promote competition, his regulators would instead promote "efficiency." Rather than focus on market power his regulators would instead focus on whether a combined company could promise to lower prices.

Senate moderates, led by Ohio Democrat Howard Metzenbaum and Pennsylvania Republican Arlen Specter, objected vehemently. Why abandon a policy of promoting open markets that had worked so well for so long? A policy that, further, traces to the founding of the country? To these legislators, the radical nature of the new policy seemed perfectly clear: the Reagan Administration planned to give free reign to corporate executives to concentrate power over America's markets. Specter, in an interview, called Baxter's plan "a most unusual and extreme situation."

But the battle lines soon blurred. Baxter was a member of the "Chicago School" group of economists and legal scholars, which many moderate Democrats believed promoted the interests of corporate executives and the wealthy. But Baxter's arguments in favor of efficiency soon found strong support from a vocal group of economists on the "left" of the Democratic Party, especially those clustered around John Kenneth Galbraith. They agreed with the Chicago Schoolers that greater concentration of power and control would result in more efficient use of resources, thereby enabling corporate managers to better serve the interests of America's "consumers." (Thanks largely to the writings of legal scholar Robert Bork, Baxter's antitrust "efficiency test" was soon recast as the "consumer welfare" test.)

Three decades on it's clear this abandonment of America's traditional antimonopoly laws did in fact unleash a revolutionary consolidation of economic power. In sector after sector, control is now more tightly concentrated than at any time in a century. This means higher prices, less choice, and lower quality for many products. It appears to affect the number and quality of our jobs and overall rates of growth and technological advance. Worse, this ongoing concentration of power is fast eroding many of our individual liberties, the sovereignty of our communities and our nation, and our democracy.

It would be wrong, however, to conclude that we face merely a rerun of the plutocratic era of a century ago, when economic power was similarly concentrated. Three factors make today's situation more perilous than the last time a small oligarchy used interlocking private corporate governments to rule over economic activity in America:

Technology. Big data greatly amplifies the ability of the people who control large corporations to gather information about individual citizens, and to use that information to manipulate the actions and even thoughts of those citizens.

Connectivity. The radical blending together of national industrial, financial, and communications networks into complex, highly interdependent "global" systems—in combination with concentration of industrial capacity—exposes citizens to a much wider variety of potential shocks, and greatly speeds transmission of shocks.

Ideology. For most of our history, most citizens believed economic activity was entirely political in nature; all commerce must take place, after all, in human-made markets. In recent years, however, many Americans have been taught to believe that one or a few *metaphysical* forces (technological or biological or mechanical in nature) determine economic outcomes.

Thanks largely to the Tea Party and Occupy, concentration of economic power is once again a topic of political discussion in America. But despite the radical nature of the monopolization that has taken place, the issue remains all but unaddressed by economists, executives, and policymakers. The one exception is banking. Yet—despite the near collapse of the entire system in 2008—the main result here has been even greater concentration of power, combined with a tighter interweaving of the public and private sectors.

In sum, we face a highly complex cluster of problems that pose profound dangers to our political, economic and social wellbeing. Yet we entirely lack any common and coherent intellectual frame that would empower us as a society to make sense of the problem, let alone address the problem in a politically constructive manner.

CONCENTRATION TRENDS

There are many ways to measure economic concentration. As we'll see in more depth later, this includes looking closely at how such power affects our liberties and our politics. To get a sense of the magnitude of the revolution in America's political economy over the last 30 years, a brief look at changes in market share in key industries will suffice.

A good place to start is banking. This is the one sector of the economy where concentration has raised the greatest concerns so far among policymakers. And indeed, the numbers here are stark. The total number of banks in America has fallen by some 60 percent since 1981, even as the population has grown substantially. Just between 2001 and 2011, the share of total assets controlled by the five largest commercial banks soared from 30 percent to nearly half.

In retail, the concentration of power is even more dramatic. In the late 1970s, no one retailer controlled more than 10 percent of any market, and most retailers were highly local in nature. Today by contrast one company—Walmart—controls as much as half of the entire national market for the sale of numerous items, including detergent and pet food. Much the same is true in department stores and in outlets for music, electronics, office supplies, and hardware.

The story is even worse in book sales. In the 1970s, business was divided among thousands of independent stores, and no chain controlled more than a fraction of total sales. Today, a single dominant retailer, Amazon, sells upwards of half of most books, and as much as 75 percent of ebooks. One effect? Extreme consolidation among publishers. Where a generation ago scores of small publishers competed, today five giants control the bulk of trade book sales.

Much the same is true in heavy industry. Here, the prevailing model was sketched out by General Electric CEO Jack Welch within months of Baxter's announcement. The new goal? To be "number one or number two" in every line of business. Or, put another way, to forge duopolies wherever possible. Sectors where Welch's advice has been followed include: airliners, where the number of major competitors went from six to two; high-tech glass, where most activities are dominated by one company, Corning; electronics assembly, where Foxconn now controls more than half the business worldwide; bottling, where Owens Illinois rules over more than half of all activity in the world.

Among defense contractors, the process of consolidation was driven largely by the government, in the early and mid-1990s. Almost immediately after Bill Clinton entered the White House, Deputy Secretary of Defense William J. Perry set in motion a process of consolidation that reduced the number of large defense firms from 107 to five.

Telecommunications has followed a similar pattern. Congress promised that the Telecommunications Act of 1996 would "promote competition." Instead, it cleared the way for massive consolidation at almost every level of business, including, more recently, advertising and public relations. Thanks to the most recent set of mergers, one company, Omnicom, will control upwards of 40 percent of all television advertising dollars in America. The top two will control upwards of 70 percent.

In energy, the Clinton Administration's approval of such mergers as Exxon with Mobil, BP with Amoco, and Chevron with Texaco went a long way toward restoring the Standard Oil of old. Less notice was paid to the merger of two uranium miners in February 2007, even when the companies doubled the price of a pound of uranium over the next four months. Nor was there much notice when the two biggest offshore oil exploration and drilling companies—U.S. Transocean and GlobalSantaFe—merged in 2007.

In search, Google controls upwards of 70 percent of the business in the United States and nearly 90 percent in Europe (Microsoft, thanks to its experience with Bing, has repeatedly declared that search is a "natural" monopoly that should be regulated). In enterprise software, a long wave of mergers and acquisitions has reduced the industry to two major players, Oracle and SAP.

Seed breeding has been an open source activity for thousands of years. Over the last two decades, a small cluster of chemical companies, including Monsanto, DuPont, and Syngenta, have captured control over almost the entire industry. Much the same is true in grain handling; although this business is divided among four giant firms most regions are dom-

inated by only one or two. In livestock, meanwhile, the biggest four firms control some 90 percent of the U.S. market, up from 25 percent in the late 1970s, and here too local dominance tends to be far higher.

The market for single family homes in America is still largely open, although we do see national developers like Toll Brothers and big investors like Warren Buffett playing a much bigger role than in the past. When it comes to buying washing machines for those homes, however, citizens will likely find themselves subject to a single company, Whirlpool, which since its purchase of Maytag has controlled some 75 percent of the market. The mattress industry has followed suit. A few years ago, no company controlled more than 20 percent of the market. Now the top two control more than 60 percent.

In airline travel, the story is much the same. Even if the Department of Justice succeeds in blocking the proposed merger between American and US Airways, recent deals between United and Continental, Delta and Northwest, and Southwest and Airtran have already resulted in far higher prices for many Americans, and large cuts in service. When you get off the plane, moreover, you will find the car rental counters dominated almost completely by three corporations, hiding behind a variety of brands. These are: Enterprise (Enterprise, Alamo, National); Hertz (Hertz, Dollar, Thrifty); and Avis (Avis, Budget).

In healthcare, meanwhile, hospital corporations have captured control over more than half of physician practices, up from less than a quarter in 2002. In pharmaceuticals, five giants now dominate the entire industry. In prescription eyeglasses, a single Italian company, Luxottica, has captured control over most retailing, and wields increasing power in services and insurance. In medical devices, like syringes and stents, purchasing is controlled by two middleman corporations. According to a recent paper by former antitrust regulator Robert Litan, lack of competition in this market costs Americans a phenomenal $36.5 billion each year.

In food processing, two or three companies now dominate almost every sector. In recent years Kraft alone has purchased Nabisco, Groupe Danone's biscuit division, and Cadbury. Grocery store dairy cases are often monopolized by a single regionally dominant supplier, like Dairy Farmers of America, although the milk is sold under a variety of labels. Procter & Gamble's takeover of Gillette greatly increased that company's already dominant hold on toothpaste, detergents, and razor blades. In such an environment, independent firms find it ever harder to keep it that way; just ask the founders of Tom's of Maine, Ben and Jerry's, Niman Ranch, Honest Tea, or Stonyfield Farm, all of which have been forced to sell out to bigger companies.

There are exceptions. In some industries, buyers enjoy more choice today than they did 30 years ago. At the same time, in almost every case, this variety is accompanied by consolidation at some other point along the chain of production.

Take automobiles. Americans seeking to buy a van or sedan can turn to any one of eight established popular manufacturers, as well as a handful of luxury brands and marginal play-

ers. This is roughly double what was available a generation ago. Yet this increase in competition has been accompanied by a dramatic consolidation at the level of supply; one or two companies, for instance, increasingly dominate the production of most components.

Then there's beer. More than 3,000 companies now brew ales and lagers in the United States, up from about 50 in 1978. Yet the biggest brewer back then controlled no more than 25 percent of the market. Today, the top two brewers control 90 percent of sales.

In semiconductors, a generation ago there were about 20 major manufacturers, all vertically integrated. Today, there are scores if not hundreds of companies that design semiconductors. But actual manufacture of wafers is increasingly dominated by a few giants, such as Intel and TSMC.

Other than a few cases in the United States, about the only real antitrust enforcement in recent years has been by foreign states. Regulators in the European Union have been very active, and China has begun to use antimonopoly law. But in most cases, these actions are not designed to enforce genuine antitrust standards such as competitiveness or fair business practices. More often, such actions are designed to protect the commercial interests of particular native companies. To complicate matters, many of the most predatory firms—U.S. examples include meat packer JBS and beer maker Anheuser-Busch Inbev—enjoy strategic support from their home governments.

OUR ANTI-MONOPOLY TRADITION

America's antimonopoly tradition predates the founding of the Republic and, indeed, was a catalyst for the War of Independence. The Boston Tea Party is often cast as a simple rebellion against taxation. The event was also—perhaps mainly—a rebellion against monopoly over trade by the British East India Company. Notably, the objections to that monopoly were mainly political in nature. In a 1773 letter, Samuel Adams and John Hancock called the Tea Act dangerous because it was "introductive of Monopolies which, besides the trains of evil that attend them in a commercial view, are forever dangerous to public liberty."

In the early years of the Republic, Americans embraced antimonopoly law as a way to extend the concept of checks and balances into the political economy. Over the course of two centuries, Americans used these laws to promote two central political goals. One was to ensure the liberty of individual citizens to engage freely in whatever line of business they wished. The second was to preserve democracy through the careful distribution of economic power. As pioneering railroad regulator Charles Francis Adams, Jr., writing in the era of Cornelius Vanderbilt and Jay Gould, put it, the aim was to avoid the rise of any sort of "Caesarism" in which "a class of men… wield within the state a power created by the state, but too great for its control."

For most of the nineteenth century, citizens used local and state governments to enforce these laws. But with the rise of the railroad, the telegraph, and corporate- friendly states like New Jersey, Americans concluded they had to use the federal government as well.

The main goal continued to be preservation of individual liberty and the protection of democracy. In 1890, Senator John Sherman, eponymous author of the first of the modern American "antitrust" acts, put it this way: "It is the right of every man to work, labor, and produce in any lawful vocation. . . This is industrial liberty and lies at the foundation of the equality of all rights and privileges." Sherman described his legislation as a "bill of rights" and a "charter of liberty."

The fight against concentration of economic power shaped many of the most important debates of American history over our first 200 years. The fight between Hamilton's Federalist Party and Jefferson's Democratic Republican Party, Jackson's "war" on the Second Bank of the United States, the Civil War, the Populist rebellion, the fight between Teddy Roosevelt's New Nationalism and Woodrow Wilson and Louis Brandeis's New Freedom, the conflict between the centralizing "First" New Deal and decentralizing "Second" New Deal, the consumer safety and environmental movements of the 1960s—all hinged on the ability of citizens to limit or control private concentrations of economic power. In practice, this meant constructing markets and establishing clear rules to govern corporations, both through external regulation and competition, and through the careful construction of internal charters.

In the first years after passage of the Sherman Antitrust Act, U.S. antitrust law was primarily used against farmers' cooperatives and labor unions in aggressively targeted ways. But over the course of two generations up through the 1930s, America's citizens devised a clear set of principles to guide enforcement, evolving into three distinct but coordinated approaches to competition policy.

Network industries like electricity, telephones, and airline service were generally regarded as "natural monopolies" that must be regulated by the public. In some instances, as with airline service, central regulation was combined with private, competitive enterprise.

In the case of industrial corporations engaged in the art of applying science to mass production, citizens accepted much vertical integration and concentration of capital. But beginning in the 1930s citizens also began to insist that all such corporations compete to some degree. This resulted in a policy of aiming to have at least three or four firms engaged in every industrial activity. Beginning in the late 1930s, this also resulted in a policy of forcing many large industrial firms to share their patents.

In sectors of the economy that did not require high degrees of scientific knowledge—such as retail, farming, and banking—the aim was to promote as wide a distribution of power and opportunity as possible. Policies promoted local control over retail, the localization of control over livestock and grain markets, and community-based banking. In these lines of business, vertical integration and price predation were largely prohibited.

During this "classic" period of antitrust, citizens recognized the importance of promoting the efficient use of human and natural resources. But they also believed that other goals should take precedence over efficiency—such as distribution of power, competition, and open and transparent markets. (Many also believed that competition within open markets

was a better way than monopoly to promote efficiency.)

The Justice Department's Antitrust Division and the Federal Trade Commission usually take the lead on establishing competition principles. But many other federal agencies play some role in making and maintaining markets. Through direct regulation, this includes the Patent Office, the Federal Communications Commission, the Federal Reserve, the Treasury Department, the Alcohol and Tobacco Tax and Trade Bureau, the Grain Inspection, Packers, and Stockyards Administration, the Securities and Exchange Commission, the Commodity Futures Trading Commission, the Federal Energy Regulatory Commission, the Surface Transportation Board, the Federal Aviation Agency, the National Aeronautics and Space Administration, and the Transportation Department.

Competition policy is shaped in several other key ways: through the procurement policies of the Defense Department; through grants and loans from the Energy Department and the Small Business Administration; and through Congressional earmarks for specific businesses. The U.S. Trade Representative and international trade policy also play a significant role. Enforcement by states, all of which have some sort of formal antimonopoly function, and municipal governments, adds another layer to competition policy.

By almost any economic measure, the antimonopoly policies put into place over the first half of the twentieth century proved hugely successful. They ensured the rapid and fair build-out of network industries in transportation, communications, and electrical power. They resulted in a period of remarkably swift technological advance; as the industrial historian Alfred Chandler put it, antitrust regulators were the "gods" who "set the stage" for the information revolution. They resulted in the restoration of the family farm in America; the top five meat packers' share of the market was reduced from about 90 percent in 1920 to about 25 percent in 1975. They resulted in the localization of control over food sales and retail goods markets, as well as banking.

More than any other dimension of modern economic policy, antitrust regulation was motivated by political and ethical principles reaching back to the American Revolution. Restoration of community and individual sovereignty was the central goal of the antitrust tradition. As Supreme Court Justice William O. Douglas wrote in a 1949 case that focused on efforts by big oil companies to control independent gas stations, "When independents are swallowed up by the trusts and entrepreneurs become employees of absentee owners," the result "is a serious loss in citizenship. Local leadership is diluted. He who was a leader in the village becomes dependent on outsiders for his action and policy."

From the 1930s into the 1980s, policies that specifically aimed to eliminate absentee corporate control ensured that America's communities were once again largely self-governing in most corporate sectors (the one major exception was manufacturing, which remained national in structure). These policies also ensured that the individual citizen could largely choose his or her own path within the political economy. Although many observers have focused on the decline of unionization in America over the last three decades, the great

middle class of twentieth-century America stood atop two foundations. One was freedom to organize the industrial workplace, to erect a "countervailing power" within a necessarily hierarchical governance structure. The other was freedom *from* organization, the freedom to be one's own boss, the freedom to build up a business that—thanks to anti-monopoly law—was largely safe from predation.

Citizens who wanted the security of a weekly wage could hire themselves out to an industrial giant or government monopoly, confident that robust labor law and open market systems protected them against economic exploitation and arbitrary power in the workplace. A citizen who wanted to be her own boss, or run his own family business, could count on robust anti-monopoly law to protect farm, factory, or store from predators wielding massed capital. The diffusion of economic power gave communities and citizens freedom in the marketplace that paralleled their civil freedom under the Constitution.

THE EFFICIENCY REVOLUTION

Ever since the Constitution took effect in 1789, strong factions have opposed—sometimes vehemently—laws designed to open markets and promote competition. Outside of the slave economy, private entrepreneurs and investors routinely advocated monopoly in manufactures, transportation, and banking. In most instances, citizens chose to closely regulate those monopolies through state charters. In some cases, as with the U.S. Postal Service and the Springfield Armory, they opted for national monopoly.

In general, however, beginning in the early nineteenth century, Americans moved steadily towards ever greater competition among private actors within open markets. One of the more widespread reforms of the era, for instance, saw citizens promote "freedom of incorporation" statutes designed to allow anyone to enter a business.

Soon after the Civil War, however, Americans across the country began to realize that some of these corporations had grown big enough to rule over entire realms of economic activity. In part, this was due to the fact that railroads and telegraphy made it possible to operate coherently over much greater distances. In part, it was due to the concentration of capital necessary to equip mass armies in the Civil War.

It was during these years that popular groups like the National Grange and Jeffersonian republicans such as Charles Francis Adams Jr., grandson of President John Quincy Adams, set out to break or tame these powers. Not surprisingly, it was also during these years that the two groups that would, a century later, combine to overthrow America's twentieth-century antimonopoly regime first took shape. From their beginnings, both promoted political-economic ideas and structures radically different than those envisioned in America's democratic-republican heritage.

The first group centered around some of the most powerful corporate and banking chieftains of the era. Men like J.P. Morgan, Andrew Carnegie, and John D. Rockefeller repre-

sented their vast new corporate empires as a form of organization far superior to the open market systems they had enclosed. Competition, they said, was wasteful. Monopoly, combined with centralized systems of command and control, was efficient, hence the best way to increase the material wealth of the nation.

This group used many arguments in addition to that of efficiency to buttress their claims to power. One of the most effective was they had a "right" to rule their "property" as they alone saw fit; in essence, they refined the corporate libertarian argument that remains so powerful today. Another argument was that their power was simply the outcome of "natural" evolutionary processes, hence there was little anyone could do about it. Andrew Carnegie, to support such ideas, not only imported Herbert Spencer to America, he also paid for the lecture tour in which Spencer introduced Americans to his concept of "survival of the fittest."

The second coherent ideological antithesis to democratic republicanism took shape after the robber barons, as they were popularly described, were firmly in control. Led by academics like the economist Simon Patten and journalists Walter Weyl and Herbert Croly, this group was strongly influenced by the German "progressive" movement of the late nineteenth century.

Like the robber barons, the Progressives held that competition was wasteful, and that systems of command and control monopoly were more efficient at boosting material production. Also like the robber barons, this group often buttressed its political arguments with metaphysical arguments about the "natural" development of large-scale firms and market monopolies. Yet, in contrast with the robber barons, the Progressive also held that the state should more or less directly control the giant industrial corporations, and that professional experts should direct the power of these enterprises towards specific material and social outcomes.

For our purposes in understanding the downfall of antitrust, it is very important to understand another political concept introduced by the Progressives—that of "consumer-ism." Whereas the democratic-republicans had focused almost solely on the rights of the citizen to produce and trade—be it labor or goods or ideas—the Progressives believed that focusing on the citizen's interests as a "consumer" of goods and services would enable them to overcome the factionalism of the producers and thereby concentrate greater political power.

The journalist Walter Lippmann, who worked closely with Croly and Weyl, distilled the essence of this thinking in his 1914 book *Drift and Mastery*. "Collectivism or 'state socialism' is… the chief instrument of the awakened consumer," he wrote. The task of the progressive elite is, therefore, "the organization and education of the consumer for control."

In the 1912 presidential election, the American people were presented with three distinct visions of political economy, each represented by a specific party. William Taft and the Republican Party represented the corporate libertarianism of Morgan and Carnegie; Theodore Roosevelt and the Bull Moose Party represented the statist "progressivism" of Croly and Weyl; and Woodrow Wilson and the Democratic Party represented the democratic repub-

lican tradition of Jefferson and Jackson, as updated by Wilson's chief adviser and future Supreme Court justice Louis Brandeis.

In the event, voters opted for Wilson's New Freedom, which promised to break up corporate monopolies and to restore the sovereignty of the community and citizen. In doing so, the voters set the basic pattern that would prevail through the middle of the twentieth century.

Corporate libertarians did capture the presidency for eight years in the 1920s, under Harding and Coolidge, and command and control statists did enjoy a vogue during the presidency of Herbert Hoover and the first two years of the New Deal. But for three quarters of a century, Americans generally moved to build and protect markets, to restore and maintain competition, and to distribute both power and opportunity.

It was not until the 1970s that either group was able to reestablish an ideological and political position coherent enough to mount a real challenge to the regime put in place by Wilson and consolidated by Franklin Roosevelt in the later phases of the New Deal. On the right, this was achieved by a loose group organized around the University of Chicago's school of economics and led by the economists Milton Friedman and George Stigler. As was true of the corporate libertarians a century before, their political arguments centered on the promise of greater material welfare through efficiency. Once again the argument was buttressed by metaphysics, in this case the mechanistic vision of "free market" functions promoted by Friedman.

On the left the key economic thinker was John Kenneth Galbraith. As was true during the time of Patten and Weyl, Galbraith's political argument was based on the promise of creating greater material welfare through a focus on efficiency. Once again the argument was buttressed by metaphysics, in this case an updated version of the same industrial determinism employed many decades earlier. Galbraith was a close student of the economist Thorsten Veblen, and in his 1968 book *The New Industrial State* he updated Veblen's vision of a "directorate" of engineers that uses corporate monopoly to take control of the national economy and run it, in a rational and non-political fashion, for the good of society as a whole. In his 1973 book, *Economics and the Public Purpose*, Galbraith went a step further, identifying himself as a "socialist" and advocating the elimination of antitrust law.

The first large-scale political attack on twentieth-century democratic republicanism came in 1964, when Barry Goldwater embraced the corporate libertarian vision. But it was not until the 1970s that either group figured out how to effect a fundamental change in the political economic regime. The key for both was to embrace the then-increasingly powerful consumer movement. Although in its origins this movement was profoundly anti-corporate, both the Chicago Schoolers and the Galbraithians used the movement as an opportunity to resurrect their old arguments that the best way to create material wealth was to consolidate power in the name of efficiency.

But at this juncture, notably, they did so together. When Robert Bork wrote that "the only legitimate goal of antitrust is the maximization of consumer welfare" it was the left that said "amen."

Many actions contributed to this revolution. In 1975, for instance, left and right joined to support the Consumer Goods Pricing Act, which broke down the system of "fair trade" pricing established with such care in the early twentieth century. But the crowning political event was the Reagan Administration's overthrow of antitrust in 1981. For two centuries antimonopoly had been used foremost to protect the economic liberties of the citizen and our democracy. Virtually overnight, from the outset of the Reagan Administration, this body of law was replaced with a new philosophy and policy approach designed to promote the concentration of power in private corporations and also, in some cases, in the state. The new philosophy put consumer welfare at the center of competition policy, replacing republican ideals of communal and individual sovereignty with the idea that promoting consumption is the key to citizens' welfare and the only legitimate goal of market interventions. Thus, as a matter of policy, antitrust adjudication shifted completely away from ideals of distributing economic power and opportunity and came to rely exclusively on arguments about price. Subsequently, no matter how monopolistic the outcome in terms of market share and structure, efforts to consolidate corporate power had only one standard to meet in the eyes of federal regulators: will the result be lower prices for consumers?

ECONOMIC & POLITICAL EFFECTS

The economist Paul Krugman recently wrote that consolidation of power had resulted in "fundamental" changes in how the economy works. Not only can consolidation result in fewer jobs, he wrote, it also can result in less productive activity overall. "A monopolist can," Krugman wrote, "be highly profitable yet see no good reason to expand its productive capacity."

In addressing consolidation, Krugman is almost alone among economists today. In general, very few other academics have devoted much time to studying or writing about the effects of concentration, either in America or around the world. There is, however, no shortage of data to support the case that this concentration of power has harmed many of the basic interests of the average American citizen. This is true whether we view individuals as consumers, as workers and entrepreneurs, as citizens, or as members of a global community that depends on complex systems of supply.

Consider, first, the consumer. Even though the changes in antitrust enforcement a generation ago were supposed to result in more efficient systems, hence greater material wealth to distribute among consumers, there is growing evidence that the exact opposite is happening. On the contrary, we see:

Higher Prices. Some of these are all but hidden from our view, as with the recent steep spikes in the prices for basic inputs like potash and aluminum. Other prices have been raised

more or less right before our eyes. We saw this with mass market beers: Anheuser-Busch Inbev and SAB Miller-Coors both raised the price of their standard lagers in August 2009, right at the low point of the great recession and within a year of the last in a long series of mergers that resulted in duopoly control of the beer market. The story is much the same with airline service. Here too prices soared during the great recession, following a long series of mergers.

Less Choice. The average American supermarket appears to provide shoppers with a cornucopia of options. Yet, not only are the great bulk of products on the shelves controlled by only a few firms, these firms actively cooperate with one another. As a largely ignored study by the Federal Trade Commission in early 2001 revealed, large retailers often require large suppliers to engage in a process called "category management," by which suppliers cooperate in apportioning shelf space and determining prices.

Second, there is growing evidence that consolidation is bad for the average worker and entrepreneur. Here we see:

Fewer and Lesser Jobs. Almost every merger results, sooner or later, in the firing of workers. Some firings can be quite large; when Pfizer took over Wyeth in 2009 managers immediately let go 19,000 people. In other instances, big companies simply use their dominance over a particular labor market to hold down wages and restrict mobility. Several years ago, Apple, Google, Intel and three other companies formed a formal hiring cartel to control the labor market for high tech workers.

Fewer New Businesses. In 1977, Americans created more than 35 new employer businesses for every 10,000 citizens age 16 and over. In 2009, Americans created fewer than 18 such businesses, a phenomenal 50 percent drop. As a recent Wall Street Journal article concluded, this decline is due at least part to the "new dominance of large corporations in many industries." The results of this fall-off are wide and deep. Not only does it mean fewer new businesses and fewer new jobs, as the Journal detailed, it may help to explain the "increasingly sluggish economic recoveries after the past three recessions," the Journal added.

Slower Technological Advance. Consolidation means that every year fewer firms control a larger proportion of our ideas. In 2004, Oracle, already a dominant player in enterprise software, launched a buying spree that resulted in the takeover of more than 80 firms, along with their scientists, engineers, technologies, and customers. Over the last decade, Google has purchased more than 100 firms, along with their talent and their proprietary knowledge. Such consolidation can make it far harder for even the most innovative scientists and engineers to assemble the patents, people, and capital—and other permissions—they need to bring new and better products to market.

Consider, third, the growing evidence that consolidation has had grave effects on our political wellbeing. Here we see:

Power Concentrated Among Citizens. One of the main goals of twentieth-century reformers was to promote a more equal distribution not merely of opportunity but of wealth itself. They succeeded. Between 1930 and 1980 we saw a dramatic decrease in the differential between the earnings of the average worker and those of corporate executives. In the three decades since, with the imposition of the "consumer welfare" test in antimonopoly enforcement, this process has been reversed. We see this reflected in corporate profits, which are at record levels, and in skyrocketing CEO pay. Perhaps the single most telling fact, however, is that one family—the heirs of Walmart founder Sam Walton—control as much wealth as the bottom 41.5 percent of all American families.

Power Concentrated Among Regions. Another main goal of the New Freedom and New Deal was to promote a more equal distribution of opportunity and wealth among regions. Here too they succeeded. Between 1930 and 1980 the differential between per capita wealth in financial centers like New York, Connecticut, and Boston and the rest of the nation fell dramatically. Over the last 30 years, however, these differentials have shot right back up. In 1980, citizens of West Coast states earned about 98 percent of what the average citizen of Connecticut earned; today the figure is about 75 percent. In 1980, citizens of the Great Lakes region earned about 88 percent of what citizens of Connecticut earned; today the figure is about 68 percent.

Power Over Media. Another central goal of the reformers was to ensure local control over newspapers, radio, and television. Hence, the Federal Communication Commission's rules that strictly limited who could own media companies, and how many such outlets any one person or corporation could control. Over the last 30 years, most of these rules have been greatly relaxed, clearing the way for an extreme concentration of ownership, and a shift of control from local citizens to distant owners. In recent years, we have seen a growing number of people who have made their wealth through concentration of power in other sectors take direct stakes in some of our most important media companies. The most well-known of these deals took place this summer, when Amazon founder Jeff Bezos bought the Washington Post for $250 million. But there are others. The world's richest man, Mexico's Carlos Slim, owns a major stake in the New York Times. And the Koch Brothers have shown a strong interest in buying the Tribune Company, which owns the *Chicago Tribune* and the *Los Angeles Times*.

Last, consider the growing evidence that consolidation is destabilizing many of our most important financial and industrial systems. Here we see:

More Fragile Systems. After the financial crash of 1929, one of the main goals of bank reformers was to protect the banking system against similar collapses in the future. They did so by requiring banks to hold more capital, by separating banking and investment activities, and by limiting the size of banks so as to limit the risk concentrated in any one institution. Over the last 30 years, almost every one of these restrictions has been eliminated. The result is far bigger banks, more highly leveraged, more tightly chained together. This was a main

factor behind the cascading—nearly catastrophic—financial collapse of September 2008. The story is much the same in large swaths of our industrial system. Over the last two generations we have seen two processes—outsourcing and globalization—result in an entirely new physical structure of production. The main difference: where once the capacity to build any one particular component was highly dispersed, that capacity is now often highly concentrated, sometimes in a single place in the world. The result is a system in which a natural disaster like an earthquake or a political disaster like a war can trigger a cascading collapse of multiple vital systems. The wide and long-lasting production and economic disruptions after the March 2011 earthquake off Japan's northern coast were a minor sampling of what other events might create.

A WAY FORWARD

Americans can restore growth, distribute opportunity and responsibility more fairly, retake control of our communities, and shock-proof our most vital systems. Along the way we can reestablish the foundations for a twenty-first century political and economic renaissance that equips us to help lead our world in a time of accelerating change in our natural world.

But we can do so *only* once we understand the intellectual nature of the revolution that has taken place, and exactly how this revolution has affected our economics, our politics, and the complex networked systems on which we rely for our food, energy, and basic goods. In conclusion, therefore, I outline two sets of recommendations, one that focuses on the intellectual challenge and one that focuses on specific policies.

Facts and Ideas:

1) ***Understand the problem.*** Our most pressing challenge is to understand what is, and how this differs from what was. This is especially true of the effects of technologies like the internet on market structures, and the effects of high degrees of physical concentration on the stability of industrial and financial systems. We should immediately launch a deep, wide, and strategic program of research and reporting on the effects—and causes—of consolidation.

2) ***Reestablish principles.*** Three decades ago, the American public allowed a small group of people to change the principles we use to guide how we—through our governments—shape our political economy. Citizens should begin an open discussion to reconsider our economic goals as a people, and hence the principles we use to achieve those goals. In short, do we continue to aim foremost at one specific form of "efficiency," or do we aim at the traditional goals of liberty, democracy, community, sovereignty, and stability.

Policies:

1) ***Restore antitrust traditions.*** We should cease to use the "Consumer Welfare" frame to guide enforcement of our antimonopoly policies. We should update and restore the "competition within open markets" frame put into place beginning a century ago, to protect our liberties, our democracy, our communities, our sovereignty, and our stability.

2) ***Outlaw most price discrimination.*** Price discrimination takes place when one firm sells the same good to different people at different prices. Price discrimination by large firms is one of the main factors that has promoted concentration. Such price discrimination—especially by market dominant firms—tends to blur into various forms of political discrimination. We should restore the laws we long used to control price discrimination, such as our "Fair Trade" laws and "Common Carriage" rules.

3) ***Confront foreign mercantilism.*** America's citizens must guard against foreign-based efforts to dominate U.S. markets just as they guard against domestic-based efforts. Practically, this requires restoring traditional trade policies. We may also wish to study how the European Union, China, and other states use antitrust law in the international arena.

4) ***Revise procurement policies.*** Many of the most egregious examples of private monopsony—such as for the Group Purchasing Organizations that dominate U.S. medical device markets—are the product of government policies put into place since the 1980s. We should reverse those policies. We should also immediately ensure that all government purchasing promotes open, competitive markets, over the long term.

5) ***Prohibit vertical integration in commodities and big retail.*** Traditional federal and state government policy in the twentieth century prevented packing houses, food processors, and big retailers from going into direct competition with their suppliers. We should restore most such policies.

6) ***Report commodity flows.*** A generation ago, open and competitive markets gave the public, producers, and traders a very clear idea of available supplies of grains, livestock, energy, and other inputs. Today most such information is kept private and proprietary by a few giant corporations, like Cargill and BP, which use the information to raise prices and to profit off trading. We should require full, real-time disclosure of all commodity flows.

7) ***Localize where possible.*** In 1933, Congress granted states the power to regulate most aspects of the liquor business. One result was 50 different regimes. Another was the only system of distribution that has promoted real diversification in any American market over the last 30 years—the beer market. The American people should transfer more regulatory powers from the federal government to states.

8) ***Rethink corporate governance.*** In the 1980s and 1990s, the rights of investors to shape corporate actions and determine the distribution of profits were greatly expanded. The result was a radical alteration of the fundamental character of many if not most of America's larger corporations, which became far more focused on generating profits. We should restore the traditional limits on big investors and reassert a multi-stakeholder view of corporate governance.

In almost every one of these areas, it is vital to start the process of reform now. Every day we wait, consolidation of economic and hence political power restricts the willingness of citizens to speak out and of politicians to act. Every day the risk of large-scale industrial and financial disruption grows, even as so many of our communities are weakened or broken for lack of a just distribution of economic power and opportunity.

The good news is we don't have to invent anything new. The basic principles we need to apply were distilled over the long course of the nineteenth and twentieth centuries. The political economic model we require already exists, and needs only to be updated to account for today's technologies and international political structures.

On the BRICS of Collapse?
Why Emerging Economies Need a Different Development Model

Paper prepared by the Centre for the Study of Governance Innovation (GovInn)
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The Centre for Study of Governance Innovation (GovInn) is the first research institution in Africa dedicated entirely to governance innovation, focusing not only on cutting-edge research but on creating an 'innovation laboratory' capable of generating new thinking about governance processes and attracting governance innovators from all over the world.

INTRODUCTION

Ever since the investment bank Goldman Sachs coined the acronym BRICs and launched it in the global debate in the early 2000s, there has been much talk about the rise of new powers in the international political economy. Brazil, Russia, India, China and, later on, South Africa have thus become the symbols of a global shift, from an old global economic system led by the so-called West (the US and, to a lesser degree, European countries) to a new development trajectory, in which traditionally "under-developed" countries have come to play a leading a role. The immediate aftermath of the 2008 financial crisis further reinvigorated such a thesis, as the emerging powers continued to grow their economies at a speed unparalleled by any advanced economy, seemingly unaffected by the fall of Wall Street that plunged both the US and Europe into a prolonged economic recession.

Yet, the reality appears much more complex than the "global power shift" discourse would have us believe. First of all, the BRICS countries have little in common in political terms. As many analysts have argued, the "alliance" can be better described as a marriage of convenience rather than a real partnership for change. The only uniting factor is the scale of their economies in terms of gross domestic product (GDP) and their sustained growth rates in

the past two decades. They are, for all intents and purposes, a "GDP club." As resource-rich economies, they have adopted a development paradigm based on intensive extraction of natural resources (e.g. fossil and bio-fuels, minerals, etc.), which drive most of their exports, and cheap labor, especially in China and India. They have pursued GDP growth with little or no investment in human development, thereby allowing the gap between the haves and have-nots to widen. In the few common initiatives developed so far, such as the proposal for a BRICS Development Bank, the focus has been on infrastructure investment for new forms of extractive practices, an approach to economic development that is increasingly volatile and unsustainable in a global context marked by extreme financial instability, costly and potentially catastrophic environmental pressures, and rising inequality. In line with their focus on extractive development, Brazil, China, India and South Africa sank the world's hopes for a binding agreement on climate change in the Copenhagen negotiations of 2009. Yet, as some have argued, "if the international community fails to confront its most serious challenges—from the need for a sound global economic architecture to addressing climate change—[the BRICS countries] are the ones that will pay the highest price."[1]

In part, this is already happening. While the BRICS countries were relatively unscathed by the 2008 financial collapse and its immediate aftermath, their GDP growth rates have begun to slow down and, in some cases, they have fallen dramatically since 2011. Income inequality has spiralled out of control, while social cohesion is fundamentally challenged by a development paradigm that has produced significant negative externalities on social relations. Finally, environmental degradation has compounded all these problems, hampering human development and exacerbating inequality.

This paper provides an overview of development trends in the BRICS countries, focusing on economic, social and ecological trends. Section 2 analyzes the lack of a common political vision behind the BRICS alliance and identifies GDP growth as the only uniting factor. Section 3 discusses recent economic trends in these countries and points out deficiencies and challenges. Section 4 moves on to analyze some critical social and environmental trends, using a variety a data from different international sources. Finally, the concluding section identifies the changes that need to happen to support an alternative BRICS development path, one that will enable equitable and sustainable progress within the large developing economies and also promote common action toward transforming the global economy on the same principles.

THE BRICS AS A "GDP CLUB"

The acronym BRIC was coined in 2001 by the then head of asset management at Goldman Sachs, Jim O'Neill, with a paper titled "Building Better Global Economic BRICs." In his analysis, O'Neill singled out Brazil, Russia, India and China as the largest emerging markets, whose rate of growth he saw as challenging the leading role of the G7 economies.[2] In a 2003 follow-up paper, the Goldman Sachs team projected the BRIC's economic expansion into the next decades and concluded that these countries were on track to overtake the

G7 by 2040. As they reported, "The relative importance of the BRICs as an engine of new demand growth and spending power may shift more dramatically and quickly than expected."[3] In 2005, they introduced a Growth Environment Score, which placed the BRIC countries consistently in the top half of the global rankings, among the best environments for sustained economic growth.[4] Skyrocketing consumption levels and continuous extraction and exportation of commodities and manufactured goods was, in the Goldman Sachs' analysis, the main reason to be "optimistic" about the rise of the BRICs.[5]

Since its inception, the BRIC concept has been founded on economic growth projections, with no reference to other parameters such as political/social development and inclusivity, let alone sustainability, as these dimensions are entirely neglected by GDP. As evinced in Goldman Sachs' underlying assumptions, contemporary global governance is indeed increasingly influenced by economic parameters, which have, by and large, replaced traditional military factors. GDP size is the main prerequisite for membership in multilateral dialogue platforms such as the G7-8 or the G20, as well as for membership in powerful policy institutions such as the Organization for Economic Cooperation and Development (OECD) and for voting power in the World Bank and International Monetary Fund (IMF). In the global race for economic success, GDP has come to count more than any other factor, which explains why analysts believe that, by sustaining high rates of GDP growth, the BRIC countries are likely to generate a fundamental power-shift in global governance institutions.

The critical importance of the "GDP factor" in defining the very nature of the BRICS became even more apparent in the controversy (in 2010) surrounding the inclusion of South Africa, Africa's largest economy. As O'Neill himself declared: "South Africa has too small an economy. There are not many similarities with the other four countries in terms of the numbers."[6]

Besides the inherent GDP-link uniting these five nations, there is little else they have in common. Politically, the BRICS comprise three democracies (including the largest in the world, India), a totalitarian regime (China), and a nation characterized by significant authoritarian tendencies (Russia). China and India have been forced to an uneasy cohabitation, due to longstanding geopolitical rivalries, including territorial disputes over Tibet.[7] The two countries are also divided with respect to Pakistan. China has also been opposed (or at least lukewarm) to India's bid to join the permanent members of the UN Security Council. Although trade between the two giants has been growing rapidly, Indian authorities have been vocal against the slow pace in opening Chinese markets, while China has accused the Indian government of carrying out a containment policy through its outreach to East Asian nations such as Japan, Indonesia and South Korea.[8]

As continental powerhouses, South Africa and Brazil have been ambivalent as to how to combine their regional commitments with their membership in BRICS. In addition, while Brazil, India and South Africa have traditionally supported a progressive human rights agenda, both China and Russia (the only two permanent members of the UN Security Council among the BRICS) have systematically opposed it. Moreover in Africa (and in

South Africa too), there is growing unease with the type of resource-focused investment policy pursued by China in parts of the continent, which has prompted some leaders to speak of "a new form of imperialism."[9] Along with India, China has been making large strategic land purchases in Sub-Saharan Africa (and also in South America), a form of aggressive investment (popularly termed "land grabbing") the aim of which is to increase food production and the associated water provision for Chinese internal consumption, with the collateral effect of reducing resources available for African consumption. These foreign investment patterns are decidedly at odds with South Africa's (and Brazil's) commitments to promote development in their respective regions.[10] Moreover, growing demand in Asia for ivory and rhino horn, which are protected by national wildlife regulations, has turned poaching into a serious security problem in South Africa.

The fundamental characteristics of the BRICS export-driven economies are also different. Brazil, Russia and South Africa are exporters of minerals and energy and, in the past decade, have taken advantage of rising commodity prices to fuel their economic expansion (*e.g.*, oil and natural gas account for 58 percent of all exports in Russia). India and China have leveraged their low labor costs to increase market shares in services and manufacturing respectively.[11] As a group, their relationship is somewhat symbiotic: higher demand for raw materials in India and China has been boosting the GDP of Russia, South Africa and Brazil. Although they vow to cooperate in restructuring the global financial architecture, they have not been able to achieve consensus on virtually any major issue thus far. For instance, they did not agree on a candidate for the leadership of the IMF (as opposed to Europe-backed Christine Lagarde), nor did they unite forces to support an alternative candidate for the presidency of the World Bank (against US-backed Jim Yong Kim).

Since 2009, when the BRICS heads of state and governments met for the first time, there have been five consecutive summits.[12] In 2012, they pledged $75 billion to boost the IMF's rescue plan for the global financial crisis, but tied the loan to voting reforms within the Bretton Woods institutions. In 2013, they agreed on founding a new "development bank" aimed at mobilizing resources (worth $4.5 trillion over an initial 5-year period) for infrastructure projects in BRICS and other emerging economies and developing countries. In theory, the idea is to supplant the World Bank as the main lending institution for the developing world. They also established a business council to facilitate private-sector partnerships, a trade and development "risk pool," and a contingent reserve arrangement, with a pool of $100 billion to cushion member states against any future economic shocks. China is expected to contribute $41 billion to the reserve, followed by Brazil and Russia ($18 billion each) and South Africa ($5 billion).

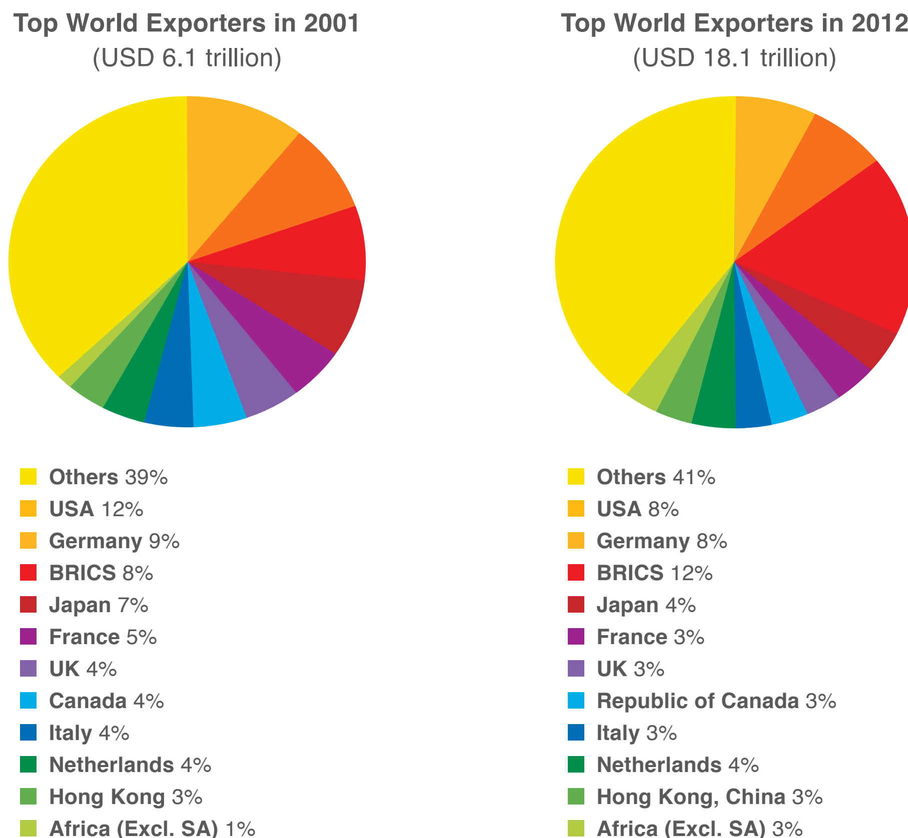
ECONOMIC TRENDS IN THE BRICS

The BRICS countries collectively represent almost 3 billion people (43 percent of world population), with a combined nominal GDP of $14.8 trillion (about a quarter of global income), 17 percent of world trade, and an estimated $4 trillion in combined foreign reserves. They

occupy 20 percent of world territory and, over the past 10 years, their aggregate income has more than quadrupled. By 2018, overall economic output in the BRICS may overtake that of the US. By 2020, 33 percent of world GDP may be accounted for by the BRICS. By 2027, China's GDP is expected to equal the United States' and, by 2050, the BRICS economies may absorb 50 percent of global markets. Consumption in the BRICS countries has also grown steadily and, in the next decade, 70 percent of global car sales growth is projected to occur in these emerging economies.

The BRICS have been successful in attracting foreign direct investment (FDI). A large part of FDI inflows in China has focused on manufacturing, while the bulk of FDI in Brazil, Russia and South Africa has been oriented toward the exploitation of natural resources, particularly oil and mining. In India, by contrast, FDI primarily flows to the service sector. The BRICS' combined share of total world exports has more than doubled in the past decades, from 8 percent in 2001 to 17 percent in 2012, with China accounting for the lion's share, comprising 54 percent of BRICS' exports in 2001, and 64 percent in 2012 (Figure 1). The share of capital goods exports from the BRICS has been increasing, from 14 percent in 2001 to 24 percent in 2012, while consumption goods exports have seen their share decline from 34 percent to 28 percent during the same period.

Figure 1. BRICS' Share of Global Exports From 2001 to 2012

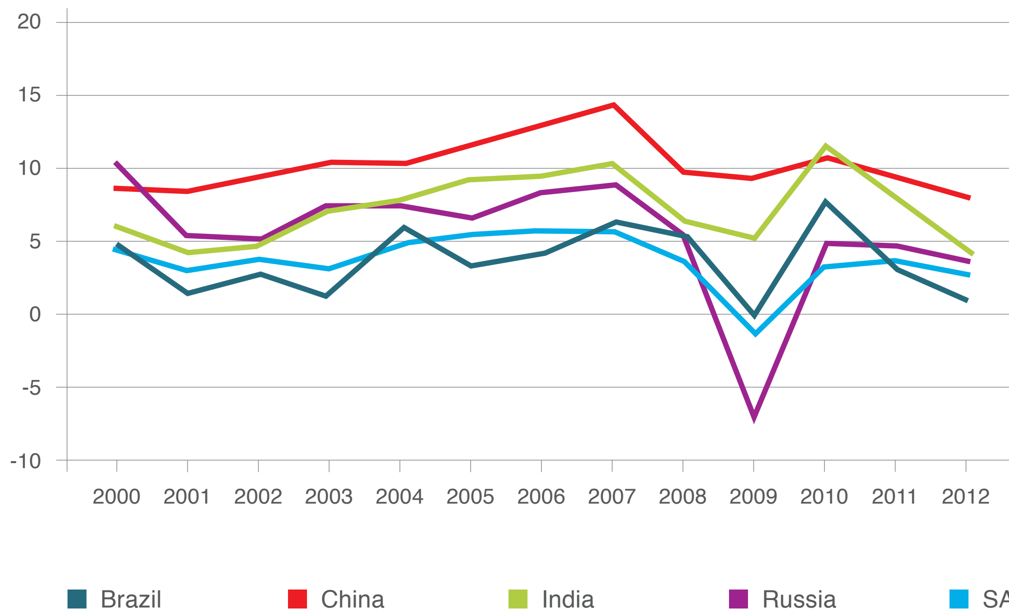


† *J. Maia (2013) 'Trade Patterns Between South Africa and the BRICS, and Future Export Opportunities', Industrial Development Corporation, presentation given at BRICS Economic Outlook Conference, Sandton, 4-5 June 2013.*

The BRICS' common focus on accelerating economic growth has helped them leverage their position in various governance forums, but recent years have seen a significant deceleration in their growth trajectories. As Figure 2 shows, GDP growth in the BRICS has experienced a sharp deceleration in the years following the 2008 global financial meltdown.

Throughout the past decade, most of growth in the BRICS was due to the scale of China's "economic boom," with its surge of exports, thirst for commodities, and build-up of foreign-exchange reserves. Since the late 1990s, China's economy has been fuelled by public credit expansion, with state-owned banks encouraged to finance as many new skyscrapers, highways, airports, dams and other infrastructure projects as needed to sustain the GDP-centered growth model. Free-flowing liquidity kept stocks and real estate prices buoyant, foreign investors were generously rewarded, and many citizens started filling the ranks of the country's new middle class. Total credit reached 200 percent of GDP in 2013, up from 130 percent in 2008. However, as reported by Bloomberg in June 2013, "China's leaders avoided bursting one bubble in 2008 by creating new ones," especially in the transport and real estate sectors. "Yet China cannot forever delay its day of reckoning."[13] *The Economist* agrees that "China's turbocharged investment and export model has run out of puff. Because its population is ageing fast, the country will have fewer workers, and because it is more prosperous, it has less room for catch-up growth."[14]

Figure 2. Economic Growth in the BRICS (% of Real GDP Growth 2000-2012)



† *Author's elaboration based on IMF World Outlook 2013*

In mid-2013, China's imports and exports also declined. Overseas shipments fell by 3.1 percent compared to 2012 (while surveys had estimated a 3.7 percent gain), imports dropped by 0.7 percent (while the median projection was for a 6 percent increase). Plagued by overcapacity, especially in sectors such as shipping, cement, steel and car production, many Chinese industries have found themselves in dire straits and in need of significant state support. At the same time, the State Council has presented a hard line on financial risks arising from China's overcapacity problems. In a statement released in June 2013, they declared: "We will strictly prohibit providing new credit supply or direct financing in any form to illegal construction projects in sectors with overcapacity, so as to avoid reckless investment exacerbating the problem of excess production capacity."[15] More power was also given to banks to write off "bad loans." A few days later, China's largest private shipyard, Rongsheng Heavy Industries, appealed to the state for a bailout.[16]

Chinese policymakers face multiple tradeoffs between real estate controls, monetary policy and propping up internal consumption, even as the latter increasingly appears to be the only possible way for the country to continue achieving high rates of economic growth. The most critical issue for the Chinese economy and, as a consequence, for the BRICS (which largely depend on Chinese investment and purchasing power) is not the short-term slide in growth, but the potential long-term effects of a systematic decline in the Asian giant's economic performance. It seems unlikely that China will hit its official target of 7.5 percent growth in 2013, which is in any case a far cry from the double-digit rates the country boasted in the past. At the BRICS level, there is evidence that China's slowdown is already impacting the other members of the club. The most vulnerable counterparts are Russia, Brazil and South Africa, which have traditionally propelled their GDP thanks to rising energy and commodities prices driven upward by Chinese growth. Russia is set to reach about 3 percent growth this year, after having been the only BRICS country to be heavily affected by the global financial crisis, which sank its GDP growth to -8 percent in 2009. In Brazil, economic growth in 2012 was a meagre 0.87 percent and, in South Africa, it has hovered around 2.5 percent. GDP growth in India has also fallen to about 5 percent, less than half of what it was prior to 2008. Collectively, the BRICS are likely to average 3 percent in 2013.[17] As the Chinese economy slows down, Brazil has joined South Africa as the only two BRICS countries to experience a trade deficit in 2013.

In 2013, capital flight has undercut the stocks, bonds and currencies of Brazil, Russia, India and China in a common pattern. South Africa's national currency (the *rand*) has also collapsed because of uncertainty over the economic trajectory of the country and extensive social unrest in the mining sector. As of July 2013, investors had withdrawn $13.9 billion from equity mutual funds invested in Brazil, Russia, India and China. In Brazil, the central bank alerted policymakers to the risk of stagflation (high inflation coupled with a stagnating economy) as projected inflation exceeded 6 percent while the depreciation of the national currency (the *real*) reached the lowest levels since the global financial crisis.[19] Inflation, especially in the real estate sector, has been a fundamental problem in China as well. In Feb-

ruary 2013, the government circulated "new measures" to regulate the real estate market. The State Council not only reiterated the importance of curbs on purchases and loan restrictions, and the determination to crack down on speculative and investment-driven home purchases, but it also demanded that local governments announce property price-control targets each year. In addition, it committed to establishing prompt implementation of purchase restrictions in cities where property prices have risen too fast, and it pledged to develop a system for the stabilization of property prices. A recent *Foreign Affairs* forum titled "Broken BRICS" captures the feeling of many observers of these destabilizing economic and political trends.[20]

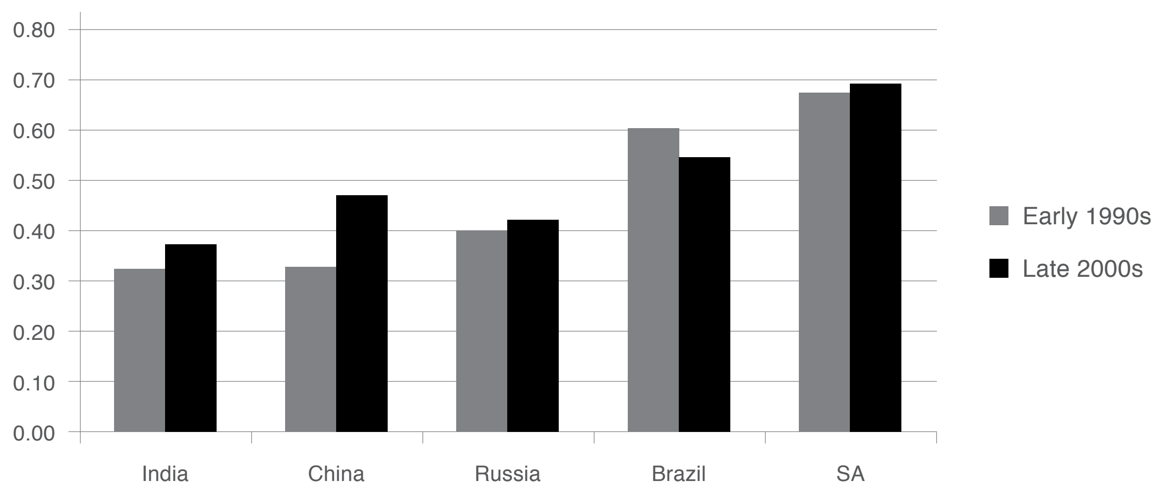
SOCIAL AND ENVIRONMENTAL TRENDS IN THE BRICS

As the BRICS countries have few social safety nets (*e.g.* welfare mechanisms are weak and often under-resourced), they are particularly susceptible to external economic shocks such as cyclical drops in demand for commodities, or currency fluctuations. Given that external shocks undercut exports and drive up unemployment, or in some cases drive up inflation, weak social safety nets (coupled with limited accountability and widespread corruption) naturally lead to social unrest. In some cases, as we saw in Brazil recently, stark contrasts between high-profile public works (the World Cup 2014 stadiums) and inefficient, low-quality public services, spark large-scale protests. Moreover, while the BRICS still see themselves as "developing" countries, their societies are already suffering from a variety of negative externalities generally associated with advanced stages of industrial development, such as environmental degradation, pollution-related health hazards, and income inequality.

Parallel to the growth of GDP, income inequality has risen steadily in the BRICS countries over the last two decades, with only one exception (Figure 3). South Africa still tops the list, actually showing a slight increase compared to the apartheid era. For many South Africans, growing inequality casts doubt on how democracy has been implemented after apartheid. Several reforms in the field of land redistribution, minimum wage, public healthcare, and education, which were championed by the liberation movements during the struggle for democracy, have been systematically delayed or shelved because of a rather myopic emphasis on structural adjustment policies aimed at privatizing public services, reducing public expenditure, and supporting rent-seeking positions in the economy (especially in the mining sector).[21] South Africa's wealth is still largely concentrated in a few hands, mostly within the white racial group, although the number of black millionaires is also growing (the so-called "black diamonds"). While the country's prosperous areas enjoy world-class (private) healthcare and education, most of the country is still lagging behind, with public schools and hospitals in abysmal conditions. Social unrest is escalating dramatically, with continuous protests triggered by lack of service delivery in townships and rural areas. These protests sometimes mutate into xenophobic attacks against migrants from other African countries, in what is becoming a dangerous war of the marginalized. The mining sector, one of the traditional pillars of the country's extractive development strategy, has been marred by turmoil ever since late

2012, when the police fired against striking miners and killed more than thirty. Reflecting on the ever-more difficult social situation in the country in mid-2013, the governor of the South African Reserve Bank invited the government, business groups, and labor organizations to "stabilize" economic relations and address the country's "vulnerability."[22]

Figure 3. Income Inequality in the BRICS Countries (Gini Coefficient)



† *OECD, Divided We Stand: Why Inequality Keeps Rising, 2011.*

Note: A Gini coefficient of 0 indicates perfect equality (each member of the population has the same share of income), while a coefficient of 1 indicates complete inequality (one member of the population controls all the income).

Writing about the income gap in India in a recent editorial for *The New York Times*, the Nobel laureate Amartya Sen underscored how a system of elite education supported by a narrow focus on GDP growth has created areas of excellence, while leaving "nearly one in every five males and one in every three females illiterate." While the country boasts the largest production of generic medicines, "its health care system is an unregulated mess" and the poor have to rely on low-quality "and sometimes exploitative" private medical insurance schemes. According to Sen, India's state of affairs in the social field is due to a failure to learn that "rapid expansion of human capability is both a goal in itself and an integral element in achieving rapid growth." Russia's wealth is also highly concentrated. The explosion of wealth in Russia is not so much a phenomenon of the 1990s, when the term "oligarch" was coined, but rather of the 2000s, when Putin's leadership boasted high rates of GDP growth. According to *Forbes*, the 10 wealthiest Russians in the late 1990s had a total wealth equal to less than 3.5 percent of the country's GDP. This jumped to 8.5 percent in 2003 and to 15.2 percent in 2008, after a period of sustained GDP growth. By 2009, in the wake of the financial crisis, the net worth of the super rich fell to 8.6 percent.[24]

In China, as manufacturers relocate to interior provinces to take advantage of lower costs and some industries seek state aid to survive, workers (especially those aspiring to join the new middle class) face the spectre of stagnating or even declining wages. After over a

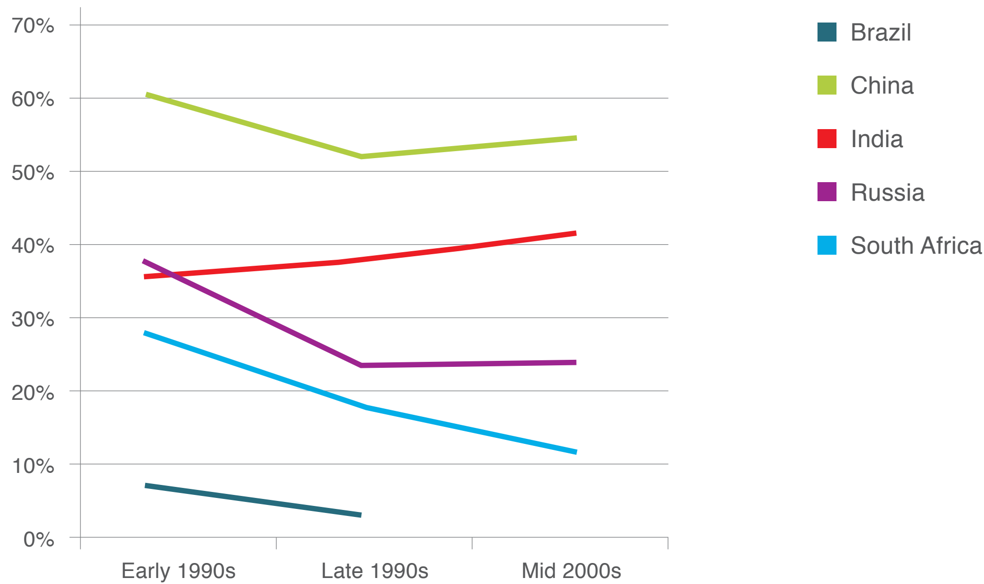
decade of silence on inequality data, the Chinese National Bureau of Statistics published Gini coefficient estimates in 2013, finding a level of about 0.47 (with a peak of 0.49 experienced in 2008)—well above the 0.4 level that is usually considered a critical threshold for potential unrest.[25] Yet, even these figures—all the more alarming for a country that is still officially inspired by socialist ideology—are too low according to other estimates. A study of 8,438 households carried out by the Survey and Research Center for China Household Finance, a body set up by the Finance Research Institute of the People's Bank of China and Southwestern University of Finance and Economics, found that the Gini coefficient in China was 0.61 in 2010, with 10 percent of households capturing up to 58 percent of the country's disposable income.[26] The Chinese Academy of Social Sciences, a state research institute, estimated inequality at 0.54 in 2008.[27] The International Monetary Fund confirms that income inequality in China has risen more than in any other Asian economy in the last two decades.[28] It appears that China is among the ten most unequal societies on the planet, after a handful of sub-Saharan African countries, and overtaking Brazil. In January 2013, the Chinese leadership published a 35-point plan to address income redistribution.[29] According to the Chinese Academy of Social Sciences in Beijing: "The income gap in China is so big now that it brings huge risks of derailing China from its growth path.[30]

Brazil is the only BRICS country in which measured inequality has been reduced over the past decade. Arguably this has been possible through a set of innovative policies aimed at supporting the poorest segments of the population, such as *Fome Zero* (Zero Hunger), which has included cash transfers to needy families, compulsory vaccinations, financial aid for school-going children, support for subsistence family farming and various forms of microcredit. One of its key components, *Bolsa Familia* (Family Allowance) is among the largest welfare mechanisms in the world, reaching over 11 million families or over 26 percent of the population.[31] Despite the success of these policies (which should be replicated in other BRICS countries), Brazil is still one of the most unequal societies in the world. Moreover, its education and healthcare systems have been largely privatized, which means additional costs for households (albeit these may escape official statistics).[32] There is little doubt that the recent social unrest in Brazil, pointed to earlier, has also been motivated by popular dissatisfaction with the pace of reform, especially in times of high inflation.

Interpersonal trust, a fundamental ingredient of social cohesion and social capital, has also experienced a downward trend in most BRICS countries (Figure 4). In Brazil, about 7 percent of citizens interviewed in the mid-1990s believed that "most people can be trusted" (which is the standard question used in comparative surveys to measure public trust). The same opinion was shared by only 2.8 percent of respondents at the end of the decade. South Africa also experienced a collapse of public trust, down from 28 percent in 1990 (when apartheid was still in existence and four years before the first democratic elections) to about 12 percent in the early 2000s. Russia also saw a dip in public trust (from 37 percent to 23 percent), while India moved in the opposite direction, with a growing minority of citizens who trust each other (from 35 percent to 41 percent). China is the only country in which a

majority of citizens believe that most people can be trusted. Yet, the trend has been downward here too: from 60 percent to 54 percent.

Figure 4. Public Trust in the BRICS
(% of those who believe that most people in their country can be trusted)

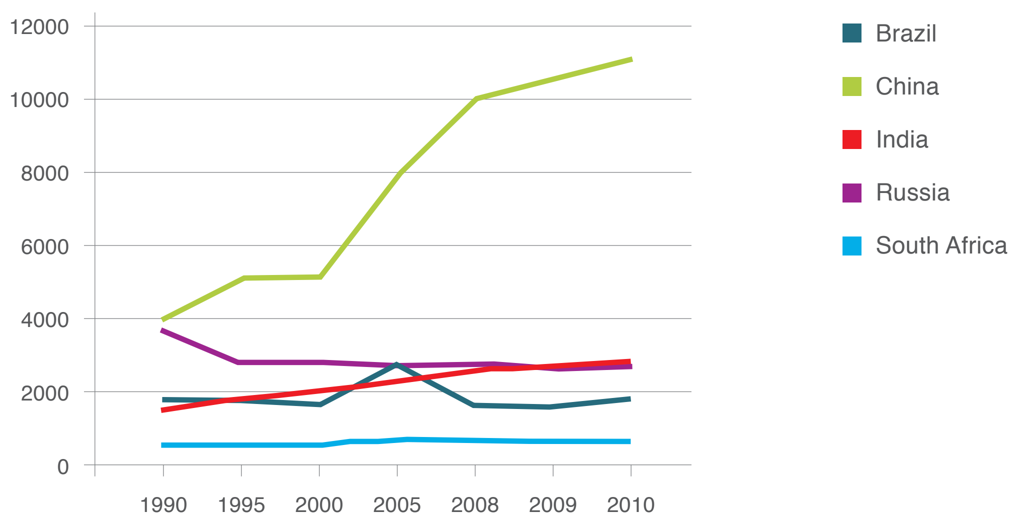


† *World Values Survey (Databank)*

When it comes to environmental degradation, the BRICS countries show numerous signs of unsustainable development. The emissions of greenhouse gases (GHG) have steadily increased in the BRICS, largely propelled by the energy-intensive growth of the Chinese economy and, to a lesser degree, of India (Figure 5).

At the per-capita level, however, the worst emitters are South Africa, Brazil, and especially Russia. Ever since the mid-1990s, when the former Soviet Union's highly polluting industrial system was partly replaced with new technologies, resulting in a sharp but temporary decline in emissions, Russia has been on an upward curve in both collective and per capita GHG emissions. There are considerable differences among the BRICS in terms of the intensity and composition of renewable sources of energy. The diffusion of wind and solar photovoltaic technologies appears to have developed rapidly in China and India, much less so in the other BRICS countries. This is mainly due to the abundance of fossil fuels in Russia and South Africa, the availability of hydro energy in Brazil, and the presence of national policies that support nuclear technology (especially in Russia and South Africa, which have signed an agreement for technology transfer in the nuclear energy field).[33]

Figure 5. Aggregate GHG Emissions in the BRICS (Metric Tons of CO2 Equivalent)



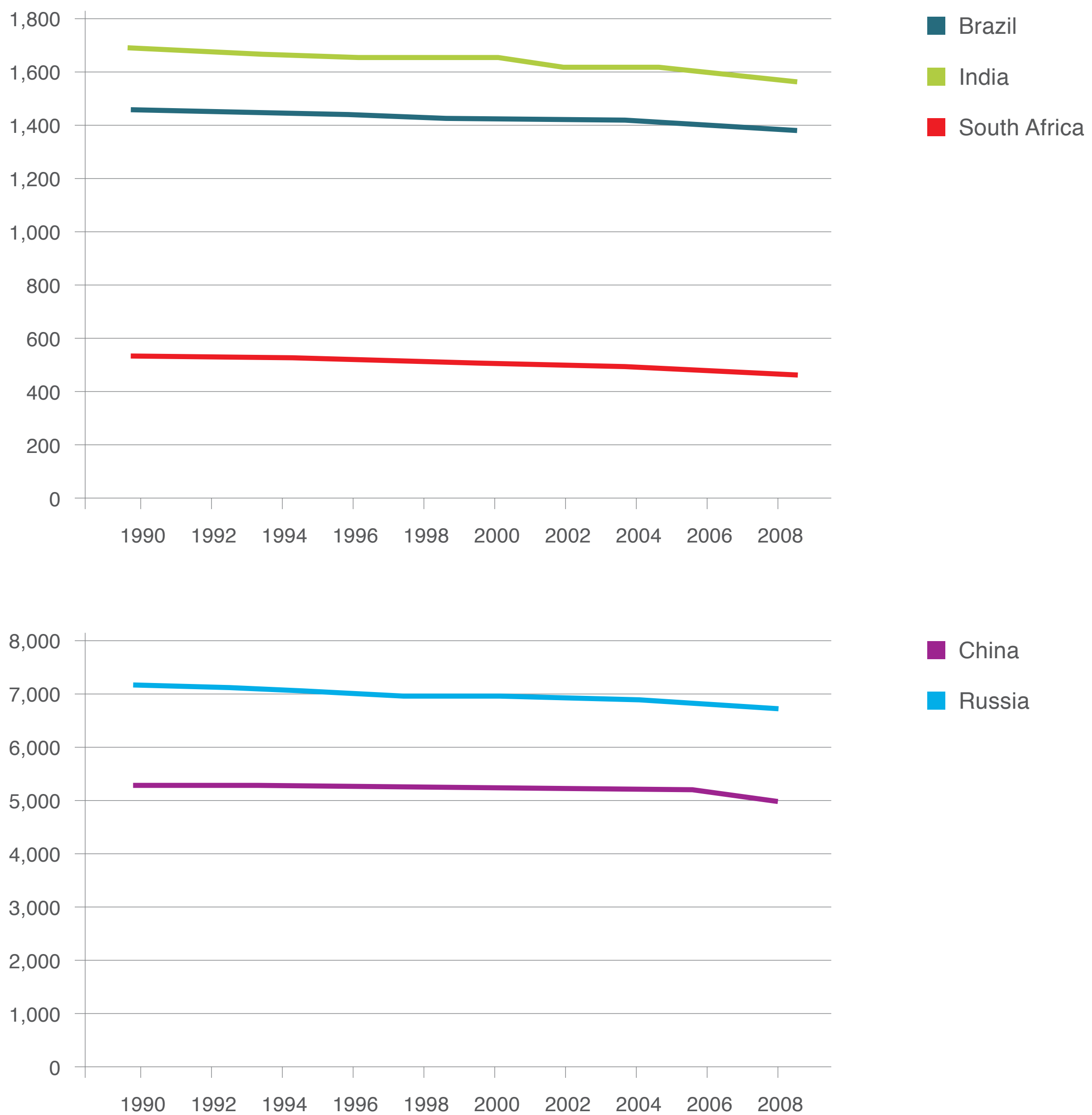
† *World Values Survey (Databank)*

All BRICS countries have also experienced significant losses in terms of per capita biocapacity (that is, the capacity of a segment of land or sea to supply resources and absorb waste), while at the same time relentlessly enlarging their ecological footprints.[34] Brazil tops the list in terms of biocapacity loss, with a decline from over 23 global hectares per capita in 1961 to about 10 in 2009. While China experiences a lower biocapacity loss (at least compared to Brazil), its ecological footprint has skyrocketed: from less than one global hectare per capita in the early 1960s to about 2.5 in 2009. The per capita biocapacity of India has also decreased (from 0.6 to 0.5 in fifty years), while its ecological footprint has grown, from about 0.7 to 0.9. In South Africa, biocapacity has halved (from over 3 to 1.5 hectares per capita) and in Russia per capita ecological footprint has grown to 4.4 from less than 3 in the 1960s. The Environmental Performance Index (published by Yale University in partnership with the World Economic Forum), which assesses the performance of a country's environmental policies, identifies Brazil as the only BRICS country whose policies can be considered "good," with a ranking of 30th out of 132 countries. Russia and China are considered bad performers (106th and 116th respectively), followed by India and South Africa, which rank near the bottom of the Index (125th and 128th respectively).

Also, natural capital, that is, the measured asset value of natural resources such as agricultural land, cropland, forests, timber, fossil fuels, and minerals, has decreased steadily in the BRICS countries due to extractive practices (Figure 6). In China, minerals and fossil fuels have accounted for most of the loss, while Russia has experienced severe reductions in terms of agricultural land and cropland, coupled with loss of natural capital associated with the extraction of natural gas. In India, pastureland, cropland and agricultural land have seen a slight upward trend, with minerals accounting for most of the depletion in nat-

ural capital. In the case of South Africa, depletion of natural capital mainly has been due to the extraction of coal. Although Brazil had managed to reduce deforestation in the past few years, recent data released by the government show that the positive trend has been reversed.[35] Brazil's national space agency has registered 465 square km of deforestation during the month of May 2013, nearly a five-fold year-over-year increase. From August 2012 to May 2013, a total of 2,338 square km—an area roughly three times the size of New York City—was registered as "lost."

Figure 6. Natural Capital in the BRICS (Billions of Constant US $ of Year 2000)



† *UNEP, UNU-IHDP (2013) Inclusive Wealth Report 2012 (Cambridge: Cambridge University Press)*

The economic costs of environmental degradation in China took center stage in public debate with the introduction of an official "green GDP" assessment in 2006. With data from 2004, the first report showed that the economic losses caused by pollution amounted to 511.8 billion yuan ($66.3 billion), equivalent to 3.05 percent of the national economy. Broken down, environmental costs from water pollution, air pollution and solid wastes accounted for (respectively) 55.9%, 42.9% and 1.2% of the total costs.[36] With a view to conducting proper environmental assessments, the State Environmental Protection Administration (SEPA, which was upgraded to Ministry of Environmental Protection in 2008) ordered the closure of 30 construction sites worth over $14 billion, including some projects associated with the controversial Three Gorges Dam, the world's largest power station that has caused the displacement of 1.3 million people since 2005. The National Bureau of Statistics, which led the data gathering process, affirmed that the green GDP initiative was introduced to help people understand the hidden costs of development, urging them to realize that "it is unreasonable to purely seek economic growth while ignoring the importance of the resources and environment."[37] SEPA also admitted that the pilot was "only the beginning of our efforts in a Green GDP calculation," as estimates were based on partial measurements and sectoral damage, which excluded significant areas of environmental degradation.[38] According to Pan Yue, China's Vice Minister of the Environment, the country's economic performance is in peril: "This miracle will end soon because the environment can no longer keep pace." He believes that environmental damage has cost China 8 to 15 percent of GDP per year (well beyond the official green GDP estimates of 2006) and concludes "that China has lost almost everything it has gained since the late 1970s due to pollution."[39] More recently, this data has also been confirmed by the World Bank, which estimates the cost of environmental degradation in China at 9 percent of GDP.[40] The green GDP assessment was discontinued after the 2006 pilot, mainly because of opposition from political leaders in high-pollution provinces such as Ningxia, Hebei, Shanxi and Inner Mongolia. However, in 2013, as environmental clean-up costs spiked while official GDP growth began to slow down, the central government took steps to revive the calculation of green GDP.[41]

According to the Global Burden of Disease Study 2010, published in the medical journal The Lancet, 1.2 million people die in China every year from pollution-related causes; the term "airpocalypse" has now become a catchword among foreign observers living in the country.[42] The much-discussed transition of the Chinese economy from investment-led growth to a consumption-based model does not promise relief from this environmental crisis; in fact, expanding internal demand may outpace export growth in terms of resource pressures and emissions, while adding massive new consumer waste flows within China.

Although Chinese megacities top the world's rankings of the most polluted areas of the world—including Linfen (which sits in the heart of the country's coal belt), Tianying (one of the nation's centers for lead mining and processing) and of course Beijing—the world's most polluted air is found in South Africa, about 100kms east of Johannesburg, in the town of Emalahleni (previously known as Witbank). According to a study funded by the European

Union and carried out between 2011 and 2013, the levels of chromium and barium are so high that conventional monitoring instruments have been unable provide accurate measurements.[43] The area is at the heart of South Africa's coal industry, one of its major exports to China and India (South Africa is the world's fifth largest coal exporter and the sixth largest consumer of coal). According to the Geosciences Council, a government research body attached to the Department of Minerals and Energy, at least 6,000 mines in South Africa have been abandoned in pursuit of more profitable sites and clean-up costs are estimated at about 100 billion rand (about $10 billion dollars), which is the equivalent of 2.5 percent of the country's GDP.[44] Despite growing concerns about the environmental and health-related impacts of intensive extraction of coal, the South African government obtained a $3.75 billion loan from the World Bank in 2010 to build the Medupi Power Station, the world's fourth largest coal-fired plant.[45] The African Development Bank also supported the initiative with an investment of $500 million. The overall cost of the project is estimated at 150 billion rand (about $15 billion dollars), which makes it the most expensive coal-fired plant in the world.[46]

The World Bank recently estimated that environmental damage costs India $80 billion per year, an equivalent of 5.7 percent of its GDP. The most serious causes include air pollution, the degradation of croplands, pastures, and forests, and poor water supply and sanitation. According to the team that conducted the assessment, "India has performed remarkably well economically, but that's not reflected in its environmental outcomes. […] 'Grow now, clean up later' really doesn't work."[47] The country suffers from dust and exceptionally bad air pollution, mainly caused by coal-fired power stations, vehicles, and industry, especially in the construction field. For the Environmental Performance Index, India has the world's worst air pollution effects on human health (and is home to 13 of the 20 most polluted cities among big economies), sitting at the bottom of the global ranking, a few positions below China.[48] The World Health Organization has found that acute respiratory infections are among the most common causes of deaths for India's children.[49] For the World Bank, as many as 23 percent of deaths among children may be attributed to environmental factors, "which means that about 350,000 under-fives die each year as a result of bad air, contaminated water or similar problems."[50] Environmental disasters are also rather frequent in a country experiencing more severe climate conditions every year. Recently, severe floods in the northern state of Uttarakhand killed about 6,000 people. According to the National Institute of Disaster Management, a governmental research institution, the causes of the tragedy are to be found in the combination of heavy rains, deforestation (including tree cutting for road construction), other activities such as building construction, mining, and hydroelectric projects, as well as out-of-control development in what used to be an old river bed.[51]

CHARTING A SUSTAINABILITY TRANSITION FOR THE BRICS

There are compelling reasons to believe that the BRICS are experiencing a convergence of crises that may not only offset the gains of economic growth, but also threaten the over-

all political and social stability of these countries. Their ambition to lead the international community in a different direction (as compared to the type of leadership exercised so far by the US and, to a lesser degree, European countries) is undermined by the lack of a clear political vision and by the inconsistencies affecting their own development model. The question therefore is: Will the BRICS be able to question the long-term sustainability of their development model? Will they provide a new global leadership built on a different economic paradigm?

Path dependency, in this regard, poses a serious risk. Business-as-usual is comfortable for political leaders, especially when accountability channels are weak and entrenched powers are supported by complacent business interests. Moreover, the omnipresence of GDP as a global governance tool is more resilient than many critics of conventional development statistics may believe. Countries strive to achieve high rates of GDP growth to get access to global decision-making power. Recently, for instance, Nigeria has challenged the role of South Africa in both the BRICS and the G20, as the West African country may soon become Africa's largest economy after changing the way in which its GDP is calculated.[52] Nevertheless, as the BRICS struggle to find their feet in a world dominated by conventional economic powers and largely anchored to an unsustainable development model, these emerging economies may very well turn into a force for a new kind of progress.

To change this state of affairs, the BRICS countries should—at a very minimum—rethink their stances on a series of fundamental issues for both domestic and global economic governance. To begin with, the BRICS need to take a different approach to the global governance of climate change. Although their emphasis on historical responsibility is undoubtedly fair, the BRICS cannot hide the fact that their contributions to climate change are growing at alarming rates. Even from a purely self-interested perspective, tackling climate change should be a priority for the BRICS, as their citizens are more vulnerable to harsher climates than is the case in most advanced industrial economies. In the field of global financial reform, the BRICS would reap significant benefits from a stable and productive financial sector. As the hubs of contemporary global production, they have a profound self-interest in re-embedding finance in society to limit speculative markets that misallocate resources and produce imbalances. Although neo-liberal agendas have influenced some critical policies in these countries (especially in the field of education and healthcare), the BRICS are also marked by substantial popular resistance to the type of market fundamentalism supported by Washington. They could easily build on their own institutional diversity and pragmatism "to articulate a new global narrative that emphasizes the real economy over finance, policy diversity over harmonization, national policy space over external constraints, and social inclusion over technocratic elitism."[53]

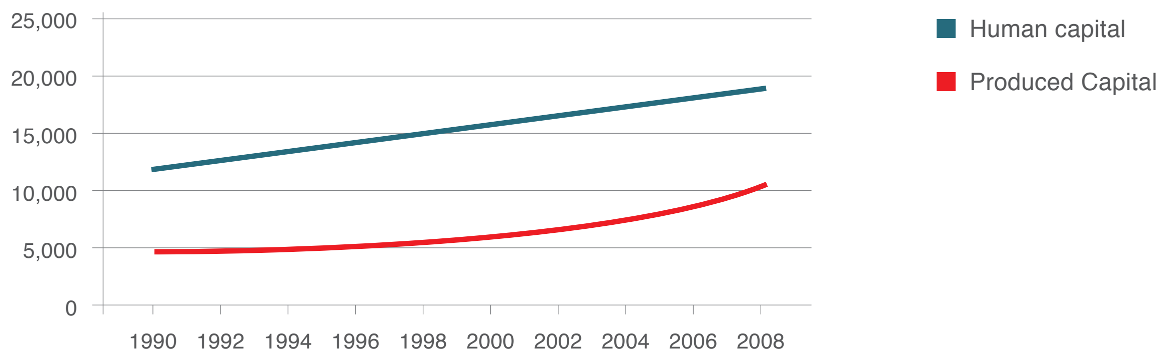
At a deeper level, however, the BRICS would need to fundamentally rethink what it means to be "developed" in the twenty-first century. As we have seen, their macro-economic approach has largely fallen in line with the mainstream developmental discourse of the mid-to-late-twentieth century: market liberalization, privatization of social services, export-driven

economy, cheap labor, and industrial growth based on the depletion of natural resources. In some ways, China and Russia have taken their own paths, yet their overall developmental trajectories are neither socially nor environmentally sustainable. Although this development model has propelled the BRICS GDP growth rates, it has generated several imbalances and negative externalities. As growth slows down, fundamental questions regarding the lack of social inclusion and the costs of environmental damage can no longer be avoided.

The UN distinguishes three types of capital that can drive economic growth: natural, produced and human capital. We have already discussed how natural capital has been following a downward trend in all BRICS countries, thus endangering the capacity of these countries to sustain their environments. Produced capital, that is, the fixed capital assets and infrastructure that support most conventional economic activities (such as roads, buildings, machinery, etc.), has experienced a more ambivalent trend, with growth in some sectors and slumps in others, following more directly the type of curves we have seen in the case of GDP. It is only in the field of human capital that the BRICS have been able to generate new resources and promote a general growth of wealth. Human capital has to do with people. It embodies the value of education, knowledge, and innovation and how these forms of wealth contribute to economic performance. As Figure 7 shows, human capital, not produced capital, comprises the real "wealth of nations" in the BRICS countries, accumulating at a ratio of nearly 2-to-1.

While conventional growth requires an incessant depletion of natural resources and skyrocketing environmental costs, investing in people is arguably the most cost-effective and sustainable trajectory for the BRICS economies. In order to harness the potential of human capital as a driver of economic and social progress, the BRICS will have to re-design their educational policies, especially at the level of primary education, where there are wide performance gaps. While the BRICS have designed their political economies around the "tangible" assets produced by GDP growth, it is now time to realize that most of their wealth is to be found in the intangible value represented by the knowledge and creativity of their own citizens.

Figure 7. Human vs. produced capital in the BRICS (billions of constant US$ of year 2000)



† *UNEP, UNU-IHDP (2013) Inclusive Wealth Report 2012 (Cambridge: Cambridge University Press)*

A people-driven transition is an enabling context within which to pursue a shift to a low-carbon economy in the BRICS. This transition will need to be based—at the very least—on natural resource management, income redistribution and new approaches to energy. While the introduction of renewable resources is paramount, it will not achieve much if the overall parameters of conventional development are not reconsidered. A different form of natural resource management, capable of showing the economic as well as the ecological value of natural capital, would help direct policies toward the preservation and promotion of environmental resources and biodiversity. Extractive industrial practices will need to be reconsidered, as they often tend to consume more wealth than they actually produce, thus undermining a country's effort to save for the future. New metrics of inclusive wealth, which take into account the social, economic and ecological dimensions of development, will need to replace GDP as the guiding parameter for the design, implementation and monitoring of economic policies. Social policy reforms will be needed to tackle income inequality, not least through broadening access to education and healthcare. As many now recognize, in a knowledge-intensive global economy, the conventional theory of tradeoffs between social investment and economic growth is no longer useful. There is general agreement today that human development—largely a public responsibility—is the fundamental factor behind inclusive, sustainable, long-term growth.

Finally, the BRICS countries will need to rethink their approach to energy, especially how it is produced and distributed. As remarked by the UN Industrial Development Organization—not a traditional champion of environmental governance—the BRICS countries "installed capacity to produce renewable energy will need to be enhanced significantly in the near future, if growth in the BRICS is to be sustainable."[54] While large infrastructure projects constituted the backbone of the previous centuries' development policies (since, at least, the Industrial Revolution), including huge investments in railroads, national grids and power plants, the twenty-first century demands a fundamental shift toward decentralization and more efficient transport. Microgrids and off-the-grid solutions could provide much-needed energy independence to hundreds of millions of people in the developing world, including the BRICS. Technological advances in the field of 3D printing and open-source hardware, which allow individuals to design and produce their own artifacts (and sell them locally), hold the potential to reorganize the current industrial system into a network of local small-scale producers, where innovation and creativity (rather than mass productivity and low cost) are the drivers of growth. Through genuine leapfrogging in technology and through horizontal (rather than vertical, top-down) energy systems, the BRICS countries could spearhead a global transition toward "sustainable energy for all," as the UN has pledged to achieve by 2030.

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Divergent Fates: The Foundations of Durable Racial Inequality, 1940-2013

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"Let no one delude himself that his work is done . . . While the races may stand side by side, whites stand on history's hollow. We must overcome unequal history before we overcome unequal opportunity." –Lyndon Johnson[1]

INTRODUCTION

Few people would deny that African Americans made enormous economic and political gains from the New Deal to the twenty-first century. There is also little doubt that racial inequality remains a formidable problem. From news reports of the dismal employment rates of black men to discussion of the massive incarceration of black men and women to debates over affirmative action and black poverty, Americans are constantly reminded of the unfinished business of the civil rights era. We have not overcome our unequal history.

This paradoxical history of black economic success and persistent racial inequality is usually told as the story of the success of civil rights legislation and the failure of individual African Americans to take advantage of the opportunities created with the dismantling of legal seg-regation in the 1960s. But it is not just a story of legal victories or cultural failure. In fact, the common supposition that durable racial inequality can be explained by individual black indo-lence and a dysfunctional culture is wrong; it cannot sufficiently account for

the persistence of durable racial inequality (Brown and Wellman 2005, 189–193). We will get a better grasp of the matter if we analyze the structure of durable racial inequality and economic opportunity over time. Durable racial inequality did not begin with the great recession, though the combination of a steep and prolonged rise in unemployment and the disparate racial effects of the subprime mortgage crisis threaten recent progress. Its roots lie in the racialized competition for jobs in changing labor markets since the New Deal and in public and private policies that opened up economic opportunities for African-Americans yet, ironically, embedded the color line in the U.S. welfare state. Of course, similar social barriers and gaps experienced by Latinos are also a large part of our economy's racial structure and future, but with unique characteristics stemming from substantially different (and more recent) patterns of integration into American society.

Latinos experience similar racial barriers and gaps, but with unique characteristics that stem from the substantially different (and more recent) ways they have been integrated into the American economy. As Latinos are a large part of our economy's racial structure and future, how the overlapping but in some ways different inequalities faced by blacks and Latinos can be solved together is an important and challenging question for analysts and leaders alike.

Understanding why durable racial inequality persists bears not just on whether there will be a viable black and Latino middle class or any foreseeable possibility of reducing poverty rates among people of color. It is central to the question of whether young African Americans and Latinos face sharply diminishing economic opportunities in the future or face a future of economic stagnation and declining opportunities. It is no secret that economic mobility in the United States has sharply declined over the last 30 to 40 years, particularly for men. Based on a measure of the extent to which parental earnings are passed on to children, the United States has substantially lower economic mobility than most European democracies. One recent study estimates that 42 percent of those individuals born in the bottom quintile of the income distribution will stay there; only 6 percent will make it into the top quintile of income. But for people born in the top quintile, the chance of staying there is 42 percent and the probability of significant downward mobility is very low (Hertz 2006, 9, tbl 3). This lack of mobility is strongly associated with America's very high income inequality (Krueger 2012; Corak 2013).[2]

There is, however, a very clear and substantial gap between black and white economic mobility. African Americans experience lower levels of upward mobility than whites and significantly more downward mobility (Isaacs 2008). Tom Hertz has demonstrated that at any given level of income, the probability of black children moving up the economic ladder is lower than that of white children. Of black children born in to the bottom ten percent of the income distribution, 42 percent will end up remaining at the bottom of the income ladder as adults; only 17 percent of whites born into poor families will remain there. There is a 33 percent gap in the adult incomes of black and white children who grow up in families with similar incomes. Neither family nor personal characteristics can explain this racial

mobility gap; the explanation is due likely to "forces that operate outside of the family setting."[3] (Hertz 2005, 165; Hertz 2006, 13, 19)

A STRUCTURAL THEORY OF RACIALIZED INEQUALITY

In this report, I analyze the persistence of embedded black disadvantage as a product of a history of black disaccumulation and white opportunity hoarding and accumulation. The analytical framework is based on the theory of accumulation and disaccumulation (Brown, et al. 2005, 193–196; Brown, M. K., et.al. 2003, 22–25). The basic idea is that racial inequalities are cumulative. They are a consequence of "opportunity hoarding," which is the efforts of a social group to acquire and monopolize economic resources and privileges, and the disparate racial effects of public policies and the practices of intermediary institutions such as banks, insurance companies, and hospital and health organizations, among others.[4]

The idea of accumulation refers to the way that small advantages—racially preferential treatment of loan applications or the disparate effects of union seniority rules—compound and lead to large positive social and economic outcomes over time. Disaccumulation is the opposite and parallel idea; it refers to a process of negative accumulation. Failure to pay off credit card debt only increases the amount of the debt and leads in many cases to personal bankruptcy. Limited access to education or other government benefits or jobs with a potential for the acquisition of valuable skills leads to the disaccumulation of economic advantage and limits an individual's economic well-being and mobility. Disaccumulation may operate either to reverse economic gains or to deny groups the full benefits of economic growth and rising incomes. For example, blacks actually lost gains they made in manufacturing industries in the 1920s because of discrimination during the Great Depression. Or, to take another example, a group may gain income relative to another group but fail to close income or wealth gaps. The idea of disaccumulation does not imply that racial group competition is necessarily a zero sum process; it does mean that economic advantages and disadvantages are parceled out through opportunity hoarding and the racially disparate effects of so-called color-blind social policies.

This framework illuminates the structural foundations of durable racial inequality—how the fruits of white control of labor markets and residential segregation since the New Deal have been harvested in the U.S. welfare state and produced a profound imbalance in income, jobs, and opportunity between African Americans and whites. The history of durable racial inequality is a history of the relationship between these two core dimensions of our political economy, labor markets and housing markets, compounded by inequitable or exclusionary aspects of social policy.

Opportunity hoarding is ubiquitous in labor markets. It refers to the ability of one group of workers to stack the deck against other groups through manipulation of the hiring process, creation of wage differentials and discriminatory job protections through overt discrimination or the impact of so-called color blind procedures such as union seniority rules

(Tilly 1998, 10, 91–93). Opportunity hoarding may be passive when networks of workers or employers selectively hire only members of their own social group. It also produces vicious competition between workers for scarce resources and jobs. White monopolization of labor markets and black-white labor market competition has been a phenomenon of the American economy since the 1830s; white claims of reverse discrimination are just the latest manifestation of this struggle. The intensity of racial labor market competition depends on the scarcity of jobs and fluctuates with the business cycle and economic dislocation. Robust economic growth and full employment reduce but do not eliminate racial labor market competition.

Welfare states were invented to reduce economic security: to stave off immiseration when the economy tanks, to relieve the poverty of those left behind by economic change, and to replace workers' income when they retire. All welfare states are redistributive to some degree but all are also geared toward work either by rewarding it—Social Security is widely understood as an earned benefit—or compensating for its absence. The U.S. welfare state is bifurcated between a universalistic and relatively generous welfare state based on Social Security and Medicare for the elderly and a more porous, segmented system of social protection for working-age citizens. Social protection for nonaged citizens is divided between social insurance for the unemployed, a variety of means-tested programs, and employee benefits, mainly health insurance. The new health care law establishes more or less universal access to health insurance for working-age citizens but does not modify the segmentation of the nonaged welfare state. I call this system truncated *universalism*.

Since the 1930s, American social policy has been characterized by sharp distinctions of race and gender. Yet, only the 1935 Social Security Act, which excluded black farm workers and sharecroppers from coverage under the law, introduced a form of statutory discrimination. In fact, this aspect of Social Security, which has often been characterized as the New Deal's "original sin," actually had few lasting effects, as black workers migrated north, entered the industrial work force, and, newly classified, enrolled in Social Security. Nevertheless, few social policies or institutional practices have been immune from racial bias and disparities. If the history of the American welfare state since the New Deal teaches us nothing else, it is that putatively race neutral or so-called color-blind policies can have racial consequences. More important than statutory racial exclusions were requirements for wage-related eligibility, which reproduce and magnify the effects of labor market discrimination. The architects of the 1935 Social Security Act distinguished between social insurance and welfare in order to reward long-term workers with a record of stable employment and exclude individuals they labeled "malingerers," workers who were intermittently employed regardless of the reason. Eligibility depends on a stable work record and benefits are tied to wages. The effects of wage-related eligibility were readily apparent in the late 1930s: 42 percent of black workers who worked in occupations covered by Social Security and coughed up payroll taxes were uninsured in 1939 compared to only 20 percent of white workers (Brown, M. K. 1999, 71, 82).

The "malingerers" and those individuals who could not work would be taken care of through means-tested cash payments. Such policies comprise a much larger part of the American welfare state than of most European welfare states, and since the 1960s means-tested policies have been a growing share of the federal budget. In 2012, means-tested cash transfers accounted for 15 percent of federal cash transfers; Social Security made up another 22 percent. Means-tested transfers increased sharply during the recent recession but the uptick started in the early 1990s. Many policymakers favor means-tested policies because they believe such policies efficiently redistribute income to those in need and cost less than policies with broader coverage. Such "efficiency" comes at a rather high price. Means-tested policies disproportionately benefit poor African Americans and Latinos—in 2004 the average monthly participation rate in means-tested programs for blacks was 37.1 percent, for Latinos 30.1 percent and for non-Hispanic whites 10.8 percent—but they are inherently stigmatizing. Despite the U.S. preference for means-tested policies, the U.S. welfare state does less to redistribute income and reduce inequality than European welfare states. In 2004, taxes and transfers reduced income inequality in the United by 18 percent compared to 40 percent in Denmark and Sweden, 31 percent in Germany, and 23 percent in Great Britain (Immervoll and Richardson 2013, 20).

The third way race shapes the U.S. welfare state is via federalism. Unlike many European welfare states, the U.S. welfare state began, and in many respects remains, highly decentralized. State governments controlled eligibility criteria and benefit levels for unemployment insurance and until 1972 for all the cash welfare titles of the original Social Security Act. Racial discrimination in the administration of AFDC flourished in both North and South from the 1930s to the 1960s (Lieberman 1998; Bell 1965). Things began to change in the early 1970s with the growth of food stamps and the creation of the Earned Income Tax Credit, both national means-tested programs. The welfare reform law of 1996 further centralized control over federal social policy for the poor, yet states still retain wide leverage over social welfare policy.[5]

Both the universal and segmented sides of truncated universalism operate to produce racial distinctions that shape how individuals are included in the welfare state and the kind of benefits they receive. One of the chief causes is racial labor market competition, which affects employment and wage levels and thus one's relationship to the welfare state. The template for this was set during the Great Depression. White workers acted to displace African Americans from their jobs, in many case grabbing "Negro jobs" they had previously scorned. New Deal work relief policies compounded the difficulties facing black workers. Because WPA jobs were scarce—the WPA never covered more than 30 percent of the unemployed—blacks faced the same competition with white workers for WPA jobs as they did for private sector jobs. Local officials and craft unions hoarded WPA jobs and excluded many black workers. There was no nondiscrimination policy that would have prevented this (Brown, M. K. 1999, 68–70, 77–86). As blacks were denied work in the private sector or access to work relief, they turned to the only available source of income: local cash relief. Relief rates for

blacks in northern cities increased as unemployment declined in the late 1930s. Long ago, Gunnar Myrdal captured the essence of this process when he observed that whites coercively substituted relief for jobs, relegating African Americans to stigmatized welfare rolls (Myrdal 1944, 301). By denying access to steady employment, racial labor market competition also affects an individual's eventual Social Security benefits and access to unemployment compensation. The problem, of course, is that this not only tilts welfare state benefits toward whites, and thus is an element of the (until very recently) economic stability of most white Americans; it also calls the legitimacy of the welfare state into question.

In order to see how the relationship between labor market competition and the welfare state unfolded for blacks and whites, we examine first the history of labor markets since the 1940s and then the implications for the distribution of social welfare.

OPPORTUNITY HOARDING AND RACIAL LABOR MARKET COMPETITION SINCE THE NEW DEAL

The last 73 years of economic history is usually divided into two periods—a prosperous economy of rising real wages and income among all classes and groups between 1945-1972, followed by 40 years of stagnating wages, particularly for non-college educated workers, and rising income and wealth inequality. All social classes rode up the income and employment elevator in the 1950s and 1960s, and all but the top 10 percent or so languished on an economic treadmill going nowhere after 1973. Real family income for all income quintiles grew, on the average, 2.2 to 2.5 percent in the first period, but in the second period the bottom 40 percent of the income distribution lost ground or faced stagnant incomes. Only the top 20 percent gained, yet even this group, on average, only gained about 1.2 percent. The real income gains in this period, it is well known, were grabbed by the top 1 percent of earners (Krueger 2012, figure 1). Similarly, both black and white workers prospered in the two decades after World War II and suffered from the six recessions and the deindustrialization of manufacturing after 1973. Yet neither the gains of economic growth nor the pain of recessions and economic change have been distributed equally among blacks and whites.

Whether measured as family income or personal income, the wages and salaries of African Americans have lagged behind whites throughout both periods. There is no doubt that African Americans made real income gains during and after World War II. Real black median family income doubled between 1947 and 1972, as did the median income of white families. Black families gained relative to white families; the ratio of median family income increased to 59.5 percent from 51.2 percent. Yet the absolute median income gap between black and white families increased over this period by almost $5,000, a 35 percent gain for whites. In fact, blacks lost ground to whites by the late 1950s and only regained momentum during the economically booming 1960s. After 1973, even though the median family income of both whites and blacks rose by a little over one-fifth, black family income still lagged substantially behind Non-Hispanic whites. The ratio was unchanged: 57.4 percent in 1973 and 58 percent in 2011. The absolute income gap also widened by another $5,000, and

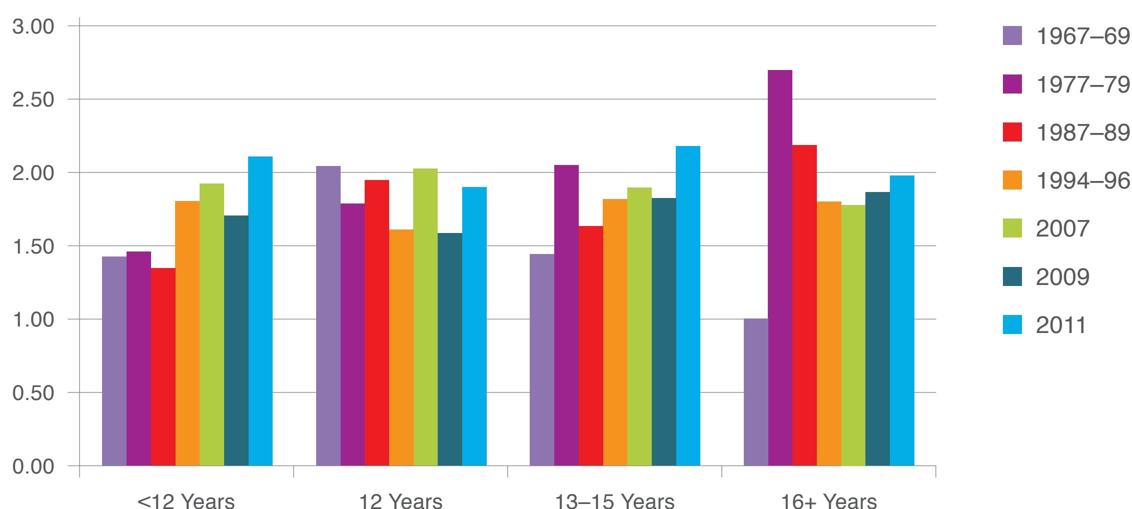
over the entire 73 year period this gap grew by 115 percent. Even so, these data overstate black economic gains over the last 35 years since they exclude African Americans who were imprisoned during the incarceration boom (Pettit 2012).

At the same time that blacks have made income gains, black employment relative to white workers has decreased. Black men of all ages and education levels experience more unemployment. The black unemployment rate is twice that of white workers, a ratio that has not changed since the early 1950s. Between 1948 and 1969, black unemployment averaged 8.4 percent compared to a rate of 3.9 percent for white workers. In 7 of these 22 years, the black unemployment rate exceeded 10 percent. Black workers faced even worse employment prospects during the 39 years after 1973: black unemployment averaged 12.3 percent; white unemployment averaged just 5.7 percent. During this period black unemployment was *below* 10 percent in only 7 of 39 years. Black workers have experienced what amounts to Depression-era unemployment for most of the last 4 decades (see Figure 1).[6] Large numbers of black men have also dropped out of the labor force since 1940, a development that precedes the deindustrialization of the American economy during the 1970s and 1980s (Katz, et al. 2005).

Figure 1. Male Unemplpyment Rates by Race (16 Years and Older)

College educated black workers, like their white counterparts, do have lower unemployment rates than high school dropouts or workers with only a high school education. But their unemployment rates are almost double those of white college-educated workers. Figure 2 shows that the black unemployment rate is higher than the white rate at all educational levels, and in the 1970s, the 1980s, and the recent recession the unemployment rate for black college- educated workers was double that of **college-educated** whites. Indeed, in the recent Great Recession, white high school graduates with some college had lower unemployment rates than black college graduates; and as the economy improved after bottoming out in 2009, white workers at *all* levels of education found jobs faster than black workers. The ratio of black unemployment to white unemployment increased between 2009 and 2011, a trend that is identical to the experience of black workers in the late 1930s (Brown 1999, 84-87).

Figure 2. Black-White Male Unemployment Ratios by Years of Education



† *OECD, Divided We Stand: Why Inequality Keeps Rising, 2011.*

So, looking just at incomes and employment, the picture is mixed: the emergence of a black middle class with consistent income gains but devastatingly high black unemployment most of the time and income gaps for all African Americans that have changed relatively little in the last 7 decades. This outcome is best understood in light of changes in the structure of racial labor market competition, the oscillation between those moments when whites had the upper hand in labor markets and when government policies circumscribed them. Black economic gains were concentrated during three periods in which economic growth was robust and unemployment rates were low: the late 1940s; the 1960s; and the 1990s. African Americans made major income and occupational gains as they shifted from plantation to factory and entered the industrial work force in the 1940s. A second shift occurred in the 1960s and early 1970s when blacks moved up the occupational ladder and into middle class and professional occupations in a growing public sector. But they lost ground in the 1950s and the 1980s as racial labor market competition intensified only to gain some of it back in the economic boom of the 1990s.

In most cases, when an African American man or woman moved from sharecropper to factory worker, they received an immediate and significant wage boost. Wartime policies that compressed wages and union success in bargaining for higher wages and benefits augmented these monetary gains. As blacks were recruited by CIO unions, they benefited. Yet white control of jobs and occupational ladders, often abetted by unions, sharply limited the economic mobility of these workers. Confined to unskilled, dirty factory jobs, migrating blacks found themselves at a dead end because of segregated seniority lists and job ladders that blocked advancement and entry into skilled jobs. Discrimination was overt in southern factories and, although more subtle, equally potent in northern factories (Brown, M. K., et.al. 2003, 70–71).

Those blacks who reached the Promised Land after the war confronted a more hostile economy and faced widespread discrimination. Migrating black sharecroppers were three times as likely to be unemployed in the north as white migrants. In fact, black residents of northern cities were more likely to be unemployed than white migrants (Sorkin 1969, 272). Black economic gains were further eroded as economic growth slowed in the late 1950s and technological change in manufacturing firms reduced demand for workers. As these factories replaced workers with machinery, black workers lost out because the "jobs in which Negroes were concentrated were eliminated and the displaced Negroes were not permitted to bid into or exercise their seniority in all-white departments." (Northrup 1970, 26; Sugrue 1996, 144). Notably, the sharpest drop in the labor force participation rate of black workers relative to white workers during the last 73 years occurred in the 1950s. At the same time, blacks faced discrimination in openings for skilled craftsmen and white-collar jobs, both of which were expanding. The proportion of blacks employed as salaried workers declined from 4.6 to 3.4 percent between 1940 and 1960 (Northrup 1970, 26).

Educated blacks in the 1950s fared no better and their unemployment rates were typically higher than those of blacks with less than 12 years of schooling. White workers, particularly white veterans, made the real income and occupational gains of the 1950s. Powered by the G.I. Bill, one-third of the veterans who received educational and readjustment benefits climbed out of working class jobs into the ranks of managers and professionals. White men were the beneficiaries of these jobs. Although the Veterans Administration (VA) distributed GI education and readjustment benefits equally between blacks and whites, African American veterans, many of whom lived in the south, could use college subsidies only at segregated, overcrowded colleges. They were substantially less likely to be enrolled in college under the GI bill. And even when they could take advantage of the GI readjustment benefits, they faced rampant discrimination in labor markets throughout the country (Brown, M. K. 1999, 180–184, 189–191; Katznelson 2005, 128–138). On the eve of the civil rights revolution, white control of labor markets allowed white workers to weather the economic changes of the 1950s and advance into skilled blue collar jobs and white collar or managerial positions. Blacks gained manufacturing jobs during the war, but job ceilings limited the upward mobility for most black workers and exposed working-class blacks to the cutting edge of technological change.

In the 1960s, economic doors opened up for African Americans as a result of strong economic growth, the implementation of Great Society programs that created new public sector jobs, and affirmative action policies. Blacks made substantial gains in public sector jobs mainly in state and local government. By 1970 over half of black college-educated men and three-quarters of black college-educated women worked in public sector jobs (Carnoy 1994, 162–165). Affirmative action policies shifted the demand for black workers in the private sector, benefiting both educated middle-class blacks and low-income blacks. Jonathan Leonard estimates that 7 percent of black employment gains in manufacturing and one-third of occupational gains in the 1970s were due to affirmative action policies (Leon-

ard 1990, 150–151; Leonard 1984, 381–384). Vigorous federal enforcement of Title VII of the 1964 Civil Rights Act desegregated many southern factories and resulted in real wage gains for African Americans (Heckman 1990). In both the north and the south, federal employment policies cracked open the job ceilings for skilled blue collar jobs and white collar managerial and professional jobs that blocked African American economic mobility in the 1950s.

However, black economic gains were undermined in the 1980s as deindustrialization hollowed out America's manufacturing industries and the Reagan administration rolled back affirmative action policies, eliminated federal job and job training programs, and sharply reduced federal grants-in-aid to state and local governments. Three deep recessions within ten years amplified these economic and policy changes and shifted the structure of labor market competition toward white workers. Between 1973 and 1983 black unemployment averaged 14.2 percent; white employment averaged 6.4 percent. The bottom literally fell out for those black workers displaced from manufacturing largely because they were concentrated in low-skill, dispensable jobs. Many of them shifted into low-wage service sector jobs, but white workers displaced from factories were more likely to end up in better paying white collar jobs. The proportion of black and Latino workers in low-wage jobs increased from 43.5 percent to 46.4 percent over the 1980s while the proportion of white workers in these jobs remained about 30 percent during the decade. Although the number of African Americans in high wage professional and managerial jobs increased by about 100,000, the number of whites in these jobs exploded, increasing from 2.9 million to 4.6 million. Displaced black manufacturing workers experienced downward mobility relative to white workers (Carnoy 1994, 95–99, tbl 5.3). College educated blacks fared no better. Their wages dropped relative to whites and their unemployment rates were almost three times those of college-educated whites by the late 1970s (in the late 1960s, by comparison, the unemployment rates of these two groups were identical—see chart 2).

The evidence clearly indicates that displaced black workers lost the job competition set in motion by deindustrialization and recession. "Downwardly mobile white workers in the 1980s acted just like unemployed white workers in the 1930s: they played the race card to keep or acquire good jobs." (Brown, M. K., et.al. 2003, 84; Darity and Myers. 1998, 51; Wellman 1997, 322-323). Neither education nor wage gaps explain the reversal of black economic gains during this period. Blacks made substantial educational gains during the 1970s, erasing the gap in secondary education. And even though all low-income workers experienced declining wages, the difference between the wages of young black and white family heads actually increased. Those blacks who lost blue collar manufacturing jobs often ended up in sales jobs but took a 13 percent pay cut; white workers displaced from manufacturing jobs typically landed well-paying sales or white collar jobs, according to William Darity and Samuel Meyers, yielding a 36 percent pay increase (Darity and Meyers,1998, 47-48, 65-67). These changes, which coincided with the de facto end of affirmative action and the Reagan-era budget cuts, resulted in declining incomes for many black families.

One sees the results of these changes in the distribution of family income. Between 1980 and 1992, all white non-Hispanic families except those in the bottom quintile gained real income; those white families in the bottom quintile saw their income decline by 5 percent. The experience of black and Latino families was very different. All black families in the bottom 60 percent lost income during the Reagan years, and the black poor, those in the bottom quintile, experienced a 25 percent decline in real income. Among families in the second quintile, black families lost 10 percent of their income but white families gained. The experience of Latino families was similar to that of African Americans, although the poorest Latino families lost only half as much as the black poor (see Figure 3).

Figure 3. Percent Change in Average Income By Quintile

% Change 1980-1992	Lowest	Second	Third	Fourth	Fifth	Top 5%
White Families	**-5.04%**	**1.87%**	**6.14%**	**10.54%**	**22.02%**	**35.45%**
Black Families	**-24.97%**	**-9.34%**	**-0.26%**	**5.00%**	**17.31%**	**30.20%**
Latino Families	**-13.31%**	**-6.71%**	**-3.85%**	**0.37%**	**11.01%**	**17.83%**

% Change 1992-2000	Lowest	Second	Third	Fourth	Fifth	Top 5%
White Families	**15.33%**	**13.07%**	**14.33%**	**16.51%**	**32.25%**	**49.59%**
Black Families	**54.68%**	**49.30%**	**33.57%**	**24.50%**	**27.65%**	**34.97%**
Latino Families	**27.31%**	**25.43%**	**21.84%**	**19.05%**	**33.35%**	**57.66%**

% Change 2000-2011	Lowest	Second	Third	Fourth	Fifth	Top 5%
White Families	**-15.60%**	**-10.34%**	**-7.54%**	**-4.06%**	**-3.43%**	**-5.46%**
Black Families	**-23.60%**	**-12.75%**	**-7.40%**	**-3.44%**	**2.19%**	**6.44%**
Latino Families	**-21.38%**	**-12.16%**	**-10.86%**	**-7.56%**	**-6.76%**	**-13.66%**

2011 Dollars
† *U.S. Bureau of Census, Historical Statistics*

Latinos, like African Americans, face job discrimination and residential segregation. But their experience over the last four decades is different. Latinos are more likely to be unemployed than white workers but less likely than black workers. Their unemployment rates averaged 9.2 percent since 1973 and the rate was below 10 percent for 22 years during this period. The black unemployment rate, recall, was below 10 percent for only 7 years. Yet the median real wage and salary income of Latino men averaged 90 percent of that of black men since 1977. And over that period, black median wages increased by 18 percent while Latino wages declined by 5 percent. However, median wages of both lagged substantially behind the wages of non-Hispanic whites.

One reason for these differences is that Latinos probably faced less job discrimination than blacks, but when blacks got jobs, those jobs tended to pay better. In a study of labor markets in five big cities, Roger Waldinger found that blacks with a high school degree were less likely to hold jobs than the least skilled white men, but Latinos with high school degrees had employment rates comparable to similar white workers (Waldinger 2001, 95). One might say that blacks face racial barriers to jobs while Latinos, particularly recent arrivals, are more likely to be constrained by education and skill deficits. The other difference is that Latinos tend to be concentrated in low-wage jobs in construction, hotels and restaurants, and agriculture. Many African Americans, on the other hand, tend to work in government jobs and the health sector, where wages are higher.

Historically, Latino men faced less wage discrimination than African American men and Latino poverty rates were lower (Carnoy 1994, 118). This changed in the 1990s and a major reason is that the 1986 Immigration Reform and Control Act actually stimulated discrimination against Latinos. Douglas Massey concludes that the "IRCA's employer sanctions radically restructured the market for unskilled labor . . . increasing discrimination on the basis of legal status, exacerbating discrimination on the basis of ethnicity, and pushing employers toward labor market subcontracting. . ." (Massey 2007, 145). Wage and salary income of Latino men relative to African American men sharply declined in the 1990s, dropping from parity in 1987 to 80 percent by the end of the century. The Latino poverty rate also sharply increased over the decade.

Black workers and their families made up some of the economic ground they lost in the 1980s during the Clinton-era economic boom, but much of it could not be recovered. The economic gains of the 1940s and 1960s were undercut when deindustrialization and deep recessions in the 1950s and 1970s intensified racial labor market competition; and now the Great Recession has undercut even the Clinton-era economic gains. One of the lessons of this history is that simply investing in education and allowing market outcomes to prevail will be insufficient to overcome durable racial inequality.

THE ECONOMIC AND POLITICAL CONSEQUENCES OF A RACIALLY STRATIFIED WELFARE STATE

The welfare state compensates for the losses of racial labor market competition—to some degree. But federal social policy since the New Deal has also institutionalized and augmented white advantage, even as the legitimacy of the social safety net for poor and working class citizens was called into question.

Income transfers mitigate economic security and African Americans and Latinos would be much worse off without such support. Government cash and non-cash transfers like food stamps pack a bigger punch in reducing inequality than taxes. Using a standard measure of income dispersion, the gini index (the higher the value, the greater degree of income inequality), U.S. Census Bureau studies show that taxes lower inequality in market income

(income minus government transfers) very little, from .502 to .492. Adding in all transfers lowers it by 20 percent, to .405. Cash and non-cash transfers are far more important to black and Latino households than to white households. The net effect of all taxes and transfers raises black family income to 66 percent of white income, from 61 percent. Latino family income increased to 77 percent of white income, from 72 percent. Transfers raised black market income $5,353 or 18 percent and Latino income by $4,386 or 12 percent. White households' incomes increased by $4,264, 9 percent.[7] These are not negligible effects, but neither do they tell the whole story.

Even though government transfers are more important to black and Latino households' well-being, transfers are less effective in lowering their poverty rates than those of white households. This was the case 33 years ago and it remains so today (Danziger 1983, 66). Figure 4 shows the pre- and post-transfer poverty rates for White Non-Hispanic, Black, and Latino households. Non-means-tested transfers, mainly Social Security, reduce poverty among white seniors by 82 percent but only 56 percent for black seniors and 57 percent for Latinos. Adding in means-tested transfers and the value of noncash transfers such as food stamps and health care reduces poverty among white seniors by another 4 percent but by an additional 14 percent in the case of black and Latino seniors. Among working age households, those persons between the age of 20 and 64 years, non-means-tested transfers reduce white poverty by one-third but by only a little over one-fifth for blacks and Latinos. Once we account for means-tested transfers and non-cash benefits, the reduction in poverty rates is about the same for white and black working-age households, but Latino working-age households do not fare as well.

Figure 4. Percent Change in Average Income By Quintile

	20-64 Years			65+ Years		
	White	Black	Latino	White	Black	Latino
Non-Means-Tested Transfers	**32**	**23**	**21**	**82**	**56**	**57**
Means-Tested Transfers	**38**	**31**	**26**	**86**	**65**	**66**
Cash plus Non-Cash Transfers	**44**	**41**	**35**	**87**	**70**	**70**

† *U.S. Bureau of Census, Effects of Benefits and Taxes on Income and Poverty, 2006*

The lower effectiveness of transfers in reducing poverty among black and Latino elderly, compared to whites, is partly a consequence of wage-related eligibility, which reproduces the effects of racial labor market competition and other long-term effects of durable racial inequality.[8] Although Social Security is redistributive, black benefits lag behind those of whites. Social Security clearly raises black and Latino income relative to whites, on average to a ratio of 75 to 84 percent; and rates of return (the ratio of Social Security taxes to benefits) are estimated to be about equal or marginally higher for blacks. Yet Stuerele, Carasso and Cohen conclude that "less educated, lower-income, and nonwhite groups benefit little

or not at all from redistribution in the old age and survivors insurance (OASI) part of Social Security," a conclusion echoed in other studies (Steuerle, Carasso and Cohen 2004; Ozawa and Kim 2001, 10; Favreault and Mermin 2008). Social Security compensates for low wages to some degree but does not override a long history of wage and occupational discrimination.

The other reason blacks have lower lifetime benefits is because they die sooner than whites. The poor health of black retirees stems from a long history of limited access to adequate health care and poor treatment for cancer and cardiovascular disease (Brown, M. K., et.al. 2003, 45–48). Blacks are less likely than whites to have health insurance; in 2011 they accounted for 20 percent of the uninsured (8.2 million people). Latinos accounted for 30 percent of uninsured individuals (U.S. Bureau of the Census 2012, 22, Table 7). [These uninsured rates will surely diminish once the Affordable Care Act is implemented]. In addition, black neighborhoods have been disproportionately affected by urban hospital closings and many private nursing homes remained segregated long after the 1964 Civil Rights Act prohibited such discrimination (Smith 1999, 176, 264–265, 267).

In general, there is little difference today in means-tested payments between working age blacks, whites, and Latinos. In some cases, those payments are slightly higher for blacks and Latinos. One reason these payments do less to raise working-age blacks out of poverty is that they start with much lower incomes to begin with and have less access to other forms of support such as Social Security survivor's benefits or, more importantly, unemployment compensation. Despite much higher rates of unemployment, African Americans are less likely to receive unemployment benefits than non-Hispanic whites. This is has been the case for a long time and it is due to the stringent wage-related eligibility provisions for unemployment insurance and the way states implement these rules. In the early 1990s, unemployed white workers were 40 percent more likely to receive unemployment benefits than blacks or Latinos; black workers, on the other hand, were 20 percent less likely than other unemployed workers to receive benefits (Michaelides and Mueser 2012, 37–40). Recent analysis of the Great Recession indicates that only 24 percent of unemployed blacks obtained unemployment benefits compared to 33 percent of unemployed whites. These differences persist even after accounting for education and other factors affecting unemployment. For example, among high school drop outs, 25 percent of whites received benefits compared to 12.5 percent of blacks (Nichols and Simms 2012).

Like unemployment insurance, states determined whether African Americans and Latinos received cash welfare benefits and how much they received. There is far less discrimination today, partly because SSI, food stamps, and the Earned Income Tax Credit, all national policies, have replaced the old cash welfare programs and established universal benefit and eligibility standards. And, when it is fully implemented, the Affordable Care Act will diminish state control over Medicaid eligibility and benefits. But states still retain significant control over Temporary Assistance to Needy Families (TANF), and the program has been implemented in racially stratified ways, with outcomes reminiscent of the discriminatory welfare regimes of the 1950s and 1960s in the north and the south.

The 1996 welfare reform law caps federal expenditures and distributes the money to the states through block grants. This fiscal scheme allows states considerable flexibility in spending the money, but it is tied to tough federal requirements for work and behavioral change. State welfare offices were transformed from cash-dispensing operations to employment centers and given the authority to sanction individuals who do not live up to the requirements for work effort. TANF is ostensibly race-neutral but it has been implemented in ways that reinforce racial stereotypes and racial inequalities. Work-related sanctions may deny benefits to every member of a family receiving benefits or only the adult. What we find from recent studies is that black recipients are more likely to be sanctioned than whites, and when they are, the sanctions are more severe. TANF, Sanford Schram and his co-authors write, "is carried out today in ways that allow preexisting racial stereotypes and race-based disadvantages to produce large cumulative disadvantages." (Schram, Soss, Fording Richard C., et al. 2009, 413,415; Soss, Fording and Schram 2011).

In addition to advantages white workers obtain through the welfare state, most white families have a cushion that black and Latino families lack: household wealth—including home equity, cash savings accounts, and investments. Wealth is not just a cushion during bad economic times; it also helps people climb economic ladders. Wealth explains differences in college graduation rates and the ability of parents to pass on their occupational status, as recent studies of economic mobility have shown (Conley 1999, 72–73; Oliver and Shapiro 1997, 162–163). Median wealth of white families was 10 times that of black families in 2009, at the bottom of the recession, and whites in all income quintiles have more wealth than blacks. The racial disparity in median wealth was much larger in 1984; then it was 15 times as much (Shapiro, Meschede and Osoro 2013, 2). Even though wealth accumulation for both black and white families rose over the last 30 years on the back of the stock market boom and the relentless rise in the price of houses, the racial wealth gap widened. Despite the enormous loss of wealth during the Great Recession among all income classes, most white families retained sufficient wealth to ride out the storm. The Urban Institute calculates that the wealth of Latino families suffered the largest drop, 40 percent; black families' wealth declined by 31 percent; and white families lost 11 percent (McKernan, et al. 2013, 2–3).

The roots of the current disparity lie in the history of federal housing and veterans policies after 1945. There is no need to go back to slavery to explain this phenomenon. In addition to the federal readjustment benefits distributed through the G.I. Bill, the Veterans Administration offered returning World War II and Korean veterans subsidized mortgage loans. Unlike the readjustment allowances, which were more or less distributed equitably between black and white veterans, VA mortgage loans were 2.5 times more likely to go to whites than blacks. The Veterans administration along with the Federal Housing Agency (FHA) funded one-third of all mortgage loans in the 1950s. Together these two agencies underwrote 3 percent of black mortgage loans and 42 percent of white loans. FHA redlining policies, which banks adhered to, caused this disparity, and even if a black family got a federally subsidized loan they could purchase housing only in a segregated neighborhood.

As a result of FHA redlining policies, private investors pulled money out of black neighborhoods, leading to a downward spiral in housing prices. White flight further drove down the price of black-owned homes. It is no surprise that the amount of equity in white-owned homes is 1.5 times more than the equity in black-owned homes (Brown, M. K., et.al. 2003, 77–79). For many of the same reasons, Latino wealth has lagged behind that of whites.

White World War II and Korean War veterans acquired enormous economic gains from the G.I. Bill and their control of labor markets. A mid-1950s study estimated that one-fifth of veterans receiving non-service connected pensions had a net worth over $10,000 (about $62,500 in 2009 dollars), no minor sum at the time. The President's Commission on Veterans' Pensions (known as the Bradley Commission) concluded in its massive study of the G.I. Bill that the "present position of World War II veterans suggests that, as a group, their earnings and progress in later life will permit them to maintain their present advantage. This will mean . . . . that most veterans will acquire more savings and qualify for larger retirement pensions [under Social Security] than non-veterans"—and black veterans, we should add (Brown, M. K. 1999, 183; The President's Commission on Veterans' Pensions 1956, 145).

FACING THE FUTURE: RACE, EQUALITY OF OPPORTUNITY AND THE CLASS DIVIDE

As the evidence gathered here attests, racially-biased housing policies and other aspects of the U.S. welfare state have magnified racial disparities generated through white control of labor markets. Yet, many Americans are completely oblivious to these discriminatory realities and they view racial differences in a historical vacuum, relying instead on cultural stereotypes that are fed by the media. Whites by and large attribute their success to individual efforts, imagining they raised themselves by their bootstraps and earned what they have received. Many whites also believe that the welfare state coddles blacks; they see only "welfare mothers" or "affirmative action babies," believing that African Americans have connived with the federal government to obtain government benefits they do not deserve and have not worked for (Kinder and Mendelberg 2000, 61). The black poor are vilified, cast as lazy, promiscuous freeloaders undeserving of help (Gilens 1999, 67–69). Food Stamps, the Earned Income Tax Credit, Medicaid, cash welfare payments, the very safety net that poor blacks and, I need to add, poor whites depend on are racially stigmatized as a result. A majority of white Americans have consistently opposed increasing spending for the means-tested safety net and strongly support time limits for welfare benefits. These attitudes are correlated with measures of racial resentment and ethnocentrism—whites who display racially hostile attitudes toward black Americans strongly favor limiting spending and support eviscerating the safety net. If these white citizens associate welfare with lazy blacks, they associate Social Security and Medicare with hard-working whites. It is a program for whites, not blacks, and thus it is no surprise that racially resentful or ethnocentric whites strongly desire increased spending for these programs (Kinder and Kam 2009, Table 9.1, 9.2; Winter 2006).

Willard Townsend, a prominent African American union official, warned of this possibility in the 1940s. In an speech to faculty and students at Fisk University, Townsend pointed out that, "You can't have unencumbered and prosperous white workers and unemployed black workers—for, if you let that happen, the white worker will have to carry the black worker on his back through relief or the dole" (Townsend 1974, 524). The public policies that advantaged whites disadvantaged blacks, leaving them with limited economic opportunities. By juxtaposing white independence and hard work with black indolence and failure, many white Americans delude themselves about their own independence and obscure the advantages they reaped from the federal social policies of the last 73 years. One question in contemplating a new economic paradigm for the future is whether this knot can be untied.

Compounded by these stereotypes, today, durable racial inequality is nested in a widening gyre of class and income inequality. At the same time, income and wealth inequality have widened, the wages of middle and low-income earners have either stagnated or declined. More important, the new inequality coincides with a shift in class structure and changes in the organization of work that reinforces class and racial inequality. Even before the Great Recession, labor markets were deeply insecure; layoffs, displacement, outsourcing, and part-time temporary work no longer affect only blue collar workers but also white collar workers, even managers. Now, absent higher levels of economic growth, it is likely that very large numbers of black and white workers will not reenter the labor force any time soon, if ever. Underlying these trends is the polarization of the labor market, an economy that is increasingly divided into high-wage and low-wage jobs. The bottom has dropped out for middle income, stable jobs.

These developments have pounded both black and white workers, eclipsing possibilities for upward mobility, though black workers have arguably taken the harder hit. The danger is that growing class and wealth inequality and polarization of the labor market will intensify structural racism, leaving not just the black poor but much of the black middle class living precarious lives of economic instability. White opportunity hoarding is alive and well, and a shrinking public sector means that one of the key avenues for blacks into middle class stability is disappearing (Ditomaso 2012). Higher rates of economic growth and productivity, likely depending on significant public investments in education, research, and infrastructure, will be needed to forestall such an outcome. Whether that is possible is an open question. It is just as likely that the class and racial polarization of this era will produce economic stagnation and intensified racial conflict over public policies.

In these circumstances, the United States faces a work-welfare state dilemma: absent the creation of new well-paying middle class jobs and new avenues of upward mobility, the only acceptable alternative is to expand the social safety net in order to support those men and women who are unemployed, work in dead-end low-wage jobs, or are unable to work. We are already coping with prolonged economic stagnation and unemployment through an expanded safety net—the growth of food stamps and the Earned Income Tax Credit are examples. But expanding the social safety net may not be sustainable over the long term, because

it is racially stigmatized and white opportunity hoarding persists. To some extent, we these dynamics playing out in the manifold efforts to overturn or weaken Affordable Care Act.

Dealing with durable racial inequality also requires extensive social policy reforms. The most important challenge is stopping the incarceration boom and fixing the problems it has caused in black communities. Extraordinary numbers of black men and women have been imprisoned over the last thirty years. Yet imprisonment is only one part of the disciplinary policies encompassing the lives of African Americans. For instance, the U.S. Department of Education recently reported that black school children account for 39 percent of all expulsions but make up only 18 percent of students. As noted earlier, the use of sanctions and punishment under TANF fall heavily on black women.

Since these policies diminish the resources and future opportunities of blacks, they are a form of disaccumulation. One scholar estimates that incarceration reduces the annual income of black men by 37 percent (Western 2006, 119). At the same time, the vast movement of prisoners out of and back into low-income black neighborhoods erodes community stability and diminishes local economic opportunities. None of these policies, however, have lifted the burden of violence from those communities: after nearly forty years of mass incarceration, the *average* life expectancy of black men in poor neighborhoods in Los Angeles nevertheless fell by five years because of homicides.[9] Nor does the black middle class escape the consequences as it is their sons and daughters who are targeted by police for marijuana use or stop and frisk policies, not just black residents of poor neighborhoods. Arrests for possession of marijuana exploded in the first decade of this century. Blacks are almost four times more likely to be arrested for possession of marijuana and this disparity persists regardless of household income. In fact, the racial disparity is greater in counties with high median incomes than in the poorest counties (ACLU 2013, 17).

Achieving high rates of economic growth, ending the polarization of the job market with new investments, and unwinding the disciplinary state will not be possible without confronting the racial divide that remains at the core of American politics. Prior to the civil rights movement, the public saw no relationship between civil rights policies and economic and social policies—taxes, regulation, the social safety net, etc. After the 1960s, any distinction between civil rights and racial policies and economic and social policies disappeared. In national surveys before the civil rights movement there is no relationship between voters' opinions of racial and economic policies—the correlation was 0.03; after 1965 the correlation was .68 (Kellstedt 2003, 78, 80 tbl 3.3). Clearly, debates over scope of government's role in the economy and the shape of the welfare state are also, in many ways, debates about race and the relationship between black, white, and Latino Americans.

There is a parallel with the New Deal that bears mentioning. The New Dealers put their faith in a class coalition and class-based agenda, and assumed that raising the incomes of all citizens would ameliorate racial prejudice and put the Nation on the road to a greater degree of racial equality. Yet the New Deal inserted racial distinctions into many of its policies and

failed to confront racial discrimination. We are living in a period of massive economic fear and dislocation, much like the New Dealers faced. But we do have the advantage of history and we need not make the same mistakes. This time around any new economic paradigm must confront the legacies of durable racial inequality.

I am indebted to David T. Wellman; the research reported here derives in part from our long collaboration. Also, I would like to acknowledge the contributions to this research of my co-authors of *Whitewashing Race: The Myth of a Color-Blind Society*.

1. Quoted in Randall B. Woods, *LBJ: Architect of American Ambition* (New York: The Free Press, 2006).
2. Studies of economic mobility use the intergenerational elasticity of earnings as a measure of upward (or downward) mobility. This measure estimates the change in a child's earnings for eve-ry 1 percent change in parental earnings. Corak estimates that the intergenerational elasticity of earnings in the U.S. is .47, which is exceeded only by Italy and the United Kingdom, compared to .15 in Denmark. This measure is correlated with the gini coefficient of income inequality. See Corak 2012, 7–8.
3. Hertz shows that race explains 17 percent of the intergenerational income elasticity independent of a host of personal characteristics, e.g. parents' education and occupation among others. Bowles and Gintis estimate the independent effect of race to be 22 percent (Bowles and Gintis 2002, 22–23). The important question is why race has such a powerful effect on income mobili-ty.
4. Michael Katz and his colleagues use the idea of opportunity structures, defined as a network of sieves in which individuals are filtered in or filtered out, to study the modern history of racial inequality (Katz, Stern and Fader 2005). This approach complements the theory of accumulation and disaccumulation and produces similar results. The advantage of the theory of accumulation and disaccumulation, however, is that it assumes actors have agency, something that the idea of opportunity structures lacks.
5. The remaining bastion of state influence outside of unemployment insurance is Medicaid. But that will change once the Affordable Care Act, which establishes universal eligibility and benefit criteria, is implemented.
6. These data are based on unemployment rates for individuals 16 years and older. The picture looks marginally better if one uses data on rates for people 20 years and older—but not very much better. Black unemployment rates are still above 10 percent in 24 out of 39 years.
7. These data are drawn from the 2006 census report on *The Effects of Benefits and Taxes on In-come and Poverty,* at http://www.census.gov/hhes/www/cpstables/macro/032007/alttoc/toc.htm, accessed on July 31, 2013. For a discussion of the methods used in producing these estimates see (U.S. Bureau of the Census 1993).
8. Wage-related eligibility does not exclude individuals who move in and out of the labor force over a lifetime. All that is required is 40 quarters of work. But benefits are calculated as the av-erage monthly earnings of the highest 35 years of a worker's earnings, and those years in which a worker is out of the labor force are counted as zero. Moreover, even though replacement rates are progressive, absolute benefits are reflect taxes paid (this is the annuity side of Social Securi-ty). A recent study concluded that "using the most inclusive concept of income that accounts for the earnings potential of both head and spouse, the Social Security system does not appear to re-duce inequality in any meaningful way" See Brown, Coronado and Fullerton 2009, 30.
9. Personal communication to author from Elliot Currie.

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Financialization and a New Paradigm for Financial Markets

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INTRODUCTION

The time is ripe to define a new paradigm for the dynamics of the financial markets. The historically prevailing paradigm, the Efficient Market Hypothesis ("EMH"),[1] has suffered many blows since its publication 43 years ago.[2] Many observers, if asked directly, would question its usefulness and this is supported by numerous academic studies spawned by the financial crisis of 2008. Nonetheless, it lives on, embedded in the public's collective psyche. EMH still informs policymaking and research. The Hypothesis endures largely because it fits so well into a constellation of beliefs that are commonplace in our society. We are trained to believe that unfettered commerce serves the common interest and has enhanced wealth creation and economic power for hundreds of years. Price is a function of information[3] and liquid markets that enable competition. EMH describes financial markets that are, by nature, marvelously efficient because of broadly shared information regarding the financial value of the traded securities or derivatives. EMH holds that a trader seeking short-term profit from price moves will not find it absent luck or an external force (such as insider information or a tax rule that results in a specific outcome for a trader). It allows us to believe that markets are inherently fair and efficient.

The appeal of EMH aligns with the economic libertarian ideology that became prevalent with the rise of Ronald Reagan.[4] It reinforces the notion that government intervention into (especially) commercial activity imposes burdens that are often unjustified in terms of the common good. EMH was the intellectual foundation for the deregulation of financial markets. Belief in this elegant and easily understood explanation of the financial markets reinforces a core value, but it also has significant and troubling implications. If EMH is the accepted paradigm, there is no need for inquiry into the dynamics of financial market structure. Inherent efficiency means that anomalies of the market are squeezed out as long as the market forces are free of outside influence or constraint. This is embodied in the corollary to EMH, the Representative Agent Model, in which the marketplace is viewed as monolithic for purposes of analysis. Even learned academics who challenge EMH routinely lapse into the paradigm when describing the markets. Policymakers and opinion leaders are even more susceptible to such lapses.

The epistemological approach that has dominated economics in recent years is one source of the resilience of EMH. EMH, the Representative Agent Model and the related Rational Expectations Hypothesis allow for simplifying assumptions of diversity in modeling data sets so that results can be said to encompass all outcomes. A counter to this approach is Behavioral Finance Economics that focuses on motivations other than price, so-called "irrational behavior," such as herding. This approach also searches for pre-determined behavioral rules that can be modeled for their predictive value. The alternative concept of Imperfect Knowledge Economics is perhaps more useful. It abandons the goal of universal predictive outcomes based on single probability distributions, seeking a set of probability distributions. Markets are seen as moving through the set of probability distributions over time.[5] Imperfect Knowledge Economics seeks to identify boundaries for what contemporary economics can achieve in terms of predicting behavior.

This paper is not directly concerned with predicting behavior in markets or even examining boundaries to predictability. It adopts an ontological approach to identify characteristics of market structures that provide guidance to identify the types of regulatory tools that can be employed to address those characteristics that do not enhance the social value provided by financial markets. To that end, it identifies an alternative paradigm:

- Without constraint, financial markets are inherently and increasingly (a) inefficient, and (b) unstable. Financial *inefficiency* is marked by poor and costly performance of the capital intermediation function, whereby owners of surplus capital are connected with those who need capital. Financial *instability* is marked by persistent and large deviations from fundamentally sound values.[6] Short-term deviations, such as intra-day price volatility or chronic transaction mispricing, create inefficiencies in capital intermediation. Longer and more extreme deviations can be systemically threatening, often taking the form of price bubbles followed by crashes.
- Both inefficiency and instability are functions of (a) increasing asymmetric information and capacity to exploit information advantages, limited to identifiable agents (capital intermediaries), and (b) increasing complexity.

- Capital intermediaries are incented to maximize the value of information by increasing complexity, and they have the power to do so. As a result, the financial markets are characterized by a feedback loop that increases inefficiency and instability to the point of crisis.

Stated more simply, deregulated financial markets allow financial intermediaries to exploit inevitable information asymmetries and complexity in ways that cause capital intermediation to be inefficiently costly and prone to runs on the financial system like the financial crisis of 2008. As a result, regulatory intervention to simplify financial markets is essential to achieve a system of capital allocation that is both fair and stable.

At the core of this paradigm is the concept of "fundamental value." The problem is that the price of a stock, bond or derivative that reflects fundamental value is impossible to calculate precisely because of the number of factors that differ depending on the idiosyncratic views of potential buyers and sellers.[7] For instance, the value of potential future stock dividends may be different for two market participants because one may value near-term returns far more than long-term returns. The best expression of fundamental value is the price generated by the market, but the way to evaluate the performance of a market structure is to test how well it consistently delivers fundamental value. This head spinning circular logic suggests that there is nothing more to be said about fundamental value.

However, it is possible to detect and even measure *non-fundamental* forces that affect prices generated in a given market structure. While we might not be able to calculate the "correct price," we can identify forces that would cause market-derived prices to fail to reflect it and estimate the power of those forces. The identification and analysis of market practices that generate non-fundamental forces can be used to evaluate whether a market structure that permits or encourages such practices effectively generates prices that reflect fundamental value.

THE ROLE OF THE FINANCIAL SECTOR

The substantial and unique public interest in the role of the financial sector was a central concern for the American founders. In the debate over the First Bank of the United States, Alexander Hamilton pointed out that the financial sector must be sufficiently robust to fuel the growth of commercial activity, enhancing the public's welfare and the economic strength of the nation.[8] Thomas Jefferson observed that an overly large and powerful financial sector would risk parasitic redistribution of wealth and power to financiers tasked with handling flows of money.[9] While they were opponents regarding the Bank, they were both right.

The public's interest in the financial sector has historically been different from its interests in other commercial activity. Hamilton recognized that the value to society of the financial sector is defined in terms of the value it adds to other activities, namely commerce and government. Jefferson pointed out that bankers are incented to extract more value than needed to secure the social value that Hamilton identified and, because of their powerful

role as intermediaries, have the ability to do so. The U.S. government has repeatedly sought to balance these public interests by constraining the financial sector in a variety of ways throughout the nation's history. The debate has swung back and forth, characterized by episodic movement toward greater constraint in response to financial disasters (*e.g.,* the Pujo Committee hearings leading to creation of the Federal Reserve following the Panic of 1907; New Deal financial regulations; the 2010 Dodd-Frank Act) followed by periods of diminished regulation during periods of exuberance.

The most recent financial crisis has led us to revisit the balance between the two strains of thought in the context of today's financial system. This has posed unprecedented challenges. The dynamics of the financial system are tremendously more complex than ever before, including global interconnections that bring into question the ability of individual jurisdictions to effectively regulate.

As the founders observed, it is essential that the balance be based on the core purpose of the financial markets. Aside from insurance (risk transfer) and payment systems, the core service of the financial sector is capital intermediation.[10] Sources of capital (funds that need to be "put to work," such as savings and pension funds) must be matched up with users of capital who are financing productive activities. Intermediaries operate a "pipeline" that transmits and allocates investment capital to users—businesses, institutions, governments and households.

One element of this process is mechanically matching current investment supply with capital demand. But the needs of investors and consumers of capital are often not the same. For instance, investors may want to lend at floating rates of interest while a borrower may want to have a fixed rate. An important feature of the service provided by capital intermediaries is to reconcile these differences.

Traditional commercial banking provides capital intermediation. In that model, a bank deploys customer deposits and capital to fund capital needs of the economy. The mismatches between the two, such as term, interest rate, currency denomination and credit, are absorbed by the bank's capital base. If the sources of capital and its uses become unbalanced (*e.g.,* if customers withdraw deposits or the bank suffers loan defaults) the banks' own capital is available as a cushion. If the demands are large and/or uncertain, a bank run may ensue in which bank funding sources, particularly deposits and short-term lending by other banks, are withdrawn. To secure integrity of the system, the U.S. government provides FDIC deposit insurance to the customers to discourage panicked withdrawals, and the Federal Reserve allows banks to borrow at the discount window to provide liquidity.

A second model of capital intermediation is the trading market. This has become the predominant form of capital intermediation over the last 35 years.[11] The trading market, like the commercial bank model, can be thought of as an intermediation pipeline. In the "primary market," a business or company issues new securities into the pipeline to raise capital. At the same time investors supply new capital funds by putting money into the pipeline to

acquire the newly issued securities. In a trading market, however, investors can put their investment back in the pipeline whenever they wish to, in exchange for cash or replacement investments. The investments are said to be liquid. Liquidity is thought of as a major advantage for investors, one that can make capital less expensive for productive users of funds raised in the primary market. Intermediaries facilitate liquidity by buying and selling investments that are in the pipeline (*i.e.*, market making), intermediating this "secondary market." This secondary market trading is absolutely vital to capital intermediation through the trading market model. Without it, investors cannot easily trade out of their positions and they cannot anticipate prices if they are considering doing so. Many of the numerous "innovations" developed by Wall Street in recent decades, such as derivatives, algorithmically driven high speed trading, securitization, exchange traded funds and hedge funds, to name a few, are focused on trading markets, not commercial bank intermediation.

Secondary market trading is essential to capital intermediation through trading markets, but this does not mean that all trading activity, in terms of the volume of trading or the quality of the trading activity, provides liquidity that is useful in terms of the efficiency of capital intermediation. If the financial sector is performing its core function well, the matching systems will be efficient in terms of intermediation. The price paid for intermediation (*i.e.*, its net cost to the economy) will be rationally related to the quality of the service provided. In terms used by economists, the economic rent extracted for capital intermediation will be optimally small.

If EMH is the paradigm for the financial markets, this analysis is relatively simple and relies on the Representative Agent Model for assumptions needed to evaluate how capital intermediaries operate in the economy. Assuming that the markets offer no potential for riskless gain to traders from price moves, efficiency is determined by transaction cost. Since prices are determined by broadly available information, there is no way to achieve superior capital intermediation other than prohibition of factors such as insider trading and distortions such as those generated by factors like tax incentives.[12] Further, technological advances are certain to increase capital intermediation efficiency. Under the paradigm proposed herein, the analysis requires examination of many other factors.

FINANCIALIZATION

The term "financialization" has been widely used to describe changes to the financial markets over the period of deregulation that began in the 1970s.[13] It refers to the process by which the volume and significance of financial instruments and contracts has grown relative to the economy as a whole. This term has been defined in several ways, including the following:

- "[T]he transformation of one dollar of lending to the real economy into many dollars of financial transactions."
- "[T]he increasing importance of financial markets, financial motives, financial institutions, and

financial elites in the operation of the economy and its governing institutions, both at the national and international level."

- "[T]he growing importance of financial activities as a source of profits in the economy."

As we shall see below, each of these descriptions accurately reflects characteristics of the modern trading market. However, as definitions, they are not sufficiently connected to the fundamental social function of the financial markets. A better definition of financialization may be:

> The increase in financial market activity that does not improve, and may impair, the efficiency (i.e., net cost to the economy) of capital intermediation by the financial sector.

This definition ties the activity to the core social value of financial markets. It focuses attention on the question whether the activity provides value to the "real" economy. As used herein, financialization will have that meaning.

MEASURING FINANCIALIZATION

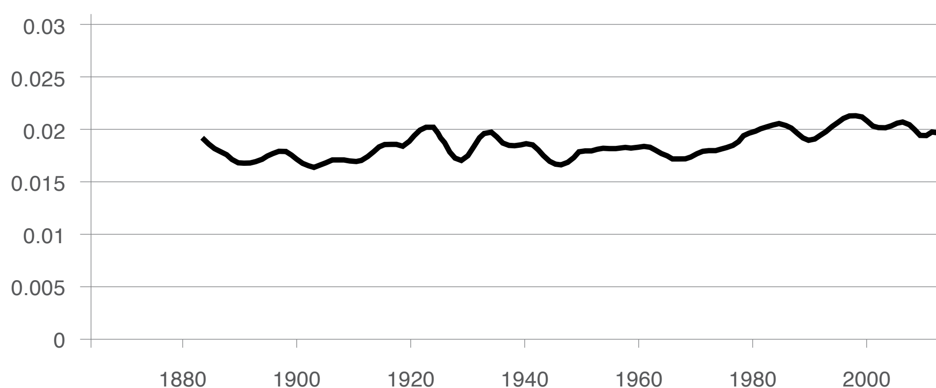
Demonstration of the existence of financialization and its significance to the economy requires the evaluation of changes in the net cost (*i.e.,* efficiency) of the capital intermediation service experienced in the economy over time.

A groundbreaking study of intermediation costs by Thomas Philippon of New York University's Stern School of Management reaches dramatic conclusions.[17] Philippon postulated that advances in technology should have increased the efficiency of intermediation, an inescapable outcome under EMH.[18] The study used the neoclassical growth model (which focuses primarily on productivity, capital accumulation and technological advances) to examine financial intermediation in the United States over a 140-year period. Philippon constructed an index that measures the unit cost of financial intermediation. His work indicates that the finance industry has become less efficient in providing intermediation services over time. He summarizes his findings as follows:

> The second main point is that the finance cost index has increased since the mid-1970s. This is counter-intuitive. If anything, the development of information technologies (IT) over the past 40 years should have disproportionately increased efficiency in the finance industry. How is it possible for today's finance industry not to be significantly more efficient than the finance industry of John Pierpont Morgan a century ago? [The data] presents a puzzle for future research.

The findings are illustrated by a chart from his study, reproduced below as Figure 1.

Figure 1. Quality-Adjusted Cost Index



† *Phillppon, 2008*

Figure 1 shows that the only time over the 140-year period that the Financial Intermediation Cost Index was comparable to the current era of deregulation was the Great Depression. High costs of intermediation make sense in the Great Depression when intermediation virtually ceased to exist—there was even a "bank holiday" for a period. But in the deregulation period, banks were profitable and investment capital was increasingly plentiful.[19] Reasoning under the tenets of EMH, Philippon correctly concludes that this is absolutely counter-intuitive. But from the perspective of an observer of trading behavior and market evolution, his results make perfect sense.

Key measures of the relative size of the financial sector reinforce Professor Philippon's findings. During the period since the 1970's, the financial sector share of the economy has increased to unprecedented levels, growing from 3.8% to 8.2% of the GDP, [20] while the manufacturing and services sectors have become relatively smaller (See Figure 2).

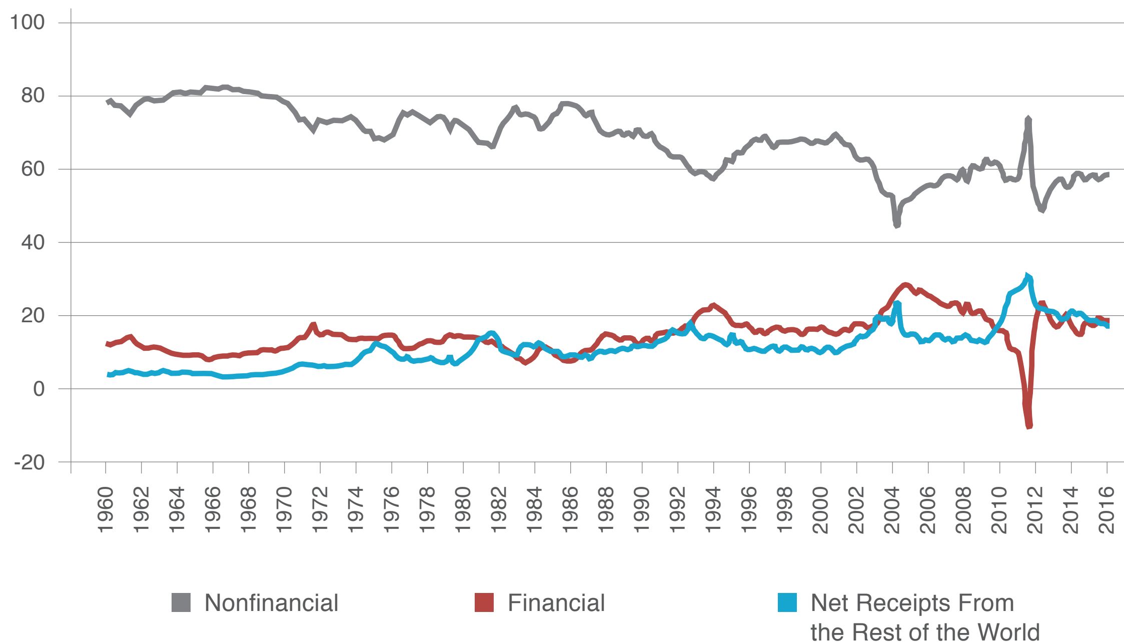
Figure 2. GDP share of U.S. Financial Industry

† *Phillppon, 2008*

Growth of the financial sector is not necessarily a problem if the services provided by the sector provide commensurate value to the overall economy. But if it does not cause the whole pie to grow, value is simply reallocated to the beneficial owners of financial firms. This drains resources that could be put to uses that would increase the productivity of the overall economy and the public's wealth. It has been demonstrated that the connection between financial sector growth and the growth of the productive manufacturing and service sectors is at best tenuous.[21] It might benefit the owners of financial firms (and bonus recipients), but to the extent that it only transfers wealth, it does not benefit the broad economy. The only way to assess this is to value the performance of the financial sector in executing its most basic task: providing efficient intermediation between sources of capital investment and productive consumers of capital investment.

Perhaps equally as telling is the financial sector share of profits in the entire economy. Figure 3 is a chart prepared by Yardeni Research that tracks 60 years of data on financial sector profits. The data illustrate that the financial sector profit share has ranged from 8 to 34 percent,[22] and it remained in the 20–30 percent range in recent years despite the financial crash of 2008.[23]

Figure 3. Corporate Profits by Industry (as percentage of corporate profits)



† Includes Inventory Valuation Adjustment (IVA) and Capital Consumption Adjustment (CCAdj).
Source: US Department of Commerce, Bureau of Economic Analysis.

Another indication of the increased size of the finance relative to the economy as a whole is the dramatic increase in gross domestic credit extended by the banking sector (other than credit extended to the U.S. government) as a percentage of GDP. The credit extended was 229 percent of GDP in 2012, while in 1980 the amount was 120 percent.[24]

This growth of the financial sector was not driven by increased demand for financial services generated by financial needs of other business sectors over the recent time period.[25] It is also clear that this cannot be explained as an outgrowth of the value of exporting financial services by U.S. institutions.[26] The explanation lies in the structure of the domestic financial system.

SIGNIFICANCE OF FINANCIALIZATION

A cogent explanation of Professor Philippon's findings is critically important. The answer is not simply the huge increases in trading volume. As we shall see, the findings are caused by the properties of specific trading practices. The great increase in trading volume in recent decades is a byproduct of those practices and amplifies their effects.

Financialization, representing the growth of trading activity that benefits intermediaries without commensurate improvement in the efficiency of capital allocation for productive uses, is a threat to U.S. productivity on several levels. First of all, the productive manufacturing and service sectors have been increasingly short-changed. An increasing share of the available capital is being devoted to trading activity that extracts value from the financial markets rather than facilitating investment in productive assets and businesses. Think of capital intermediation as a pipeline with investment capital on one end and consumption of capital on the other. The pipeline consists of the matching function, including secondary market trading and much if not all of the derivatives market. The cost of the pipeline is increased by several factors. For example, the uncertainty of the prices generated by secondary market trading affects prices required by investors. And high prices and risks associated with derivatives used to reconcile sources and uses of capital also increase costs. These are burdens on the growth of the manufacturing and service sectors and a drag on innovation since the costs of raising capital have increased beyond levels that are necessary.

Moreover, in down cycles, money pumped into the system increasingly fuels value-extracting trading rather than recovery from high unemployment in the typical business cycle. Federal Reserve policy during a recession is designed to make cheap funds available so that productive assets will be acquired or put back into service and jobs will be created anew. In a highly financialized economy, however, increases in the money supply may be channeled into yet more unproductive financial activities, resulting in much weaker stimulus for production and job creation.

This explanation appears to fit with fundamental and ominous changes to the business cycle that emerged over the last 35 years, as recession-driven unemployment proved increasingly resistant to the medicine of corporate profits and GDP growth. In the recoveries

following the last three recessions (1990-91, 2001 and 2007-2009), the return to pre-recession employment levels has taken much longer than was the case in previous recessions. Between the Second World War and 1990, employment rates recovered fully within eight months of the trough of each recession. In the 1990/91 recession, the recovery period was 23 months, and in 2001 the period was 38 months.[27] The employment recovery period for the recent recession, assuming recovery occurs, is unknown but far longer.[28] In short, the effect of a recession on employment has gotten progressively worse. There are likely several factors behind this phenomenon, including globalization and automation. Financialization, however, by diverting monetary stimulus away from productive investment, may be the most important source of progressively weaker recoveries since the early 1990s.

This suggests an important factor in business-cycle policy. In a financialized economy, monetary stimulus in a down cycle is less effective than it was in a non-financialized economy. Fiscal stimulus would be relatively more effective. The practical issue is that the ability to employ fiscal stimulus is highly constrained by political polarization. We have yet to see the long-term effect of high levels of monetary stimulus in a financialized economy, but it is apparent that it has not adequately addressed unemployment caused by the recent recession.

Financialization also competes for the capital of manufacturing and service companies that often find participation in the financialized investment markets more profitable than their underlying businesses. Goods and services are more expensive and productive activities are foregone because their costs cannot be justified. Funds are deployed to financial investments that echo the yields derived by intermediaries rather than to innovative and productive manufacturing and service businesses. Employment opportunities are restricted and consumption is burdened.

As we shall see below, financialization is also integrally related to instability of the financial system that, in its extreme form, causes runs on the financial sector as have occurred three times in the U.S. in the last 100-plus years: the 1907 Panic, the Great Depression and the Great Recession of 2008. Excessive rents encourage risk taking as the short-term cost/benefit ratios incentivize risk over prudency. In addition, the recent history of financialization is characterized by high levels of complexity that favor intermediaries, especially those benefitting from market power, but also obfuscate balance sheet strengths and weaknesses, causing uncertainty as to counter party credit quality. And, as discussed below, complexity increases the damaging forces unleashed in market crashes.

Therefore, financialization is directly related to both the daily extraction of inefficient levels of value from the capital intermediation process and to the systemic risks embedded in the financial markets. Indeed, as described below, the extraction of value is enabled by the non-fundamental price anomalies that in their extreme form are at the root of system-threatening financial crises.

SOURCES OF EXCESSIVE VALUE EXTRACTION BY THE FINANCIAL SECTOR

A large percentage of the increased financial sector share of the economy and virtually all of the increased cost of intermediation is derived from trading.[29] Logically, extraction of value by the financial sector disproportionate to value it has added to the intermediation process must be the result of asymmetric information favoring financial intermediaries. This is simply the contrapositive of EMH, which holds that the trading markets are efficient and permit no arbitrage, barring external forces, because of broadly and evenly shared information. EMH is not illogical; rather, it is based on assumptions (*e.g.*, the broad and rapid perception of relevant information) that are, at a minimum, not useful.[30] Securities and derivatives trading functions to intermediate capital flows. Therefore increased cost of intermediation must derive from profitability of securities and derivatives trading resulting from asymmetric information favoring intermediaries.

A hypothesis explaining how this has occurred must take into account circumstances affecting the financial markets that have coincided with the unexplained (and counterintuitive to those predisposed to EMH) inefficiency of capital intermediation. Four primary circumstances appear to be relevant:[31]

a. Advanced information technology and quantitative analysis allow market participants with superior ability to use these tools to accrue advantages of asymmetric information. These information advantages have very little to do with the intrinsic fundamental value of a stock, bond or derivative. The information concerns market processes, motivation of market participants and esoteric risk metrics that are impenetrable to all but a few sophisticated institutions. As a consequence, the banks and hedge funds are tremendously efficient; but the capital allocation system is less and less efficient. These tools are more effective in complex markets that are, as a result, characterized by greater inefficiencies. This incentivizes those who enjoy asymmetric information advantages to increase the complexity of markets, at a cost to overall capital intermediation efficiency to the extent that they are able to do so.

b. Extraordinary market power in the hands of a narrow group of financial institutions empowers them to more effectively exploit asymmetrical information, in part by increasing complexity.

c. Any particular regulatory framework that defines the market structure either enables, inhibits or prevents that exploitation. The unregulated markets pre-Dodd Frank Act enabled exploitation. To some extent, this continues because the approach to regulation embedded in regulatory reform was primarily to improve market transparency and risk management rather than to fundamentally alter market structure.

d. An increasing number of investment practices and structures rely on money managers who are evaluated in ways that mask the inefficiencies in the capital intermediation process and block the potential for market discipline imposed by the investor community. In particular, they are tested more by results comparable to short-term market trends rather than by more comprehensive longer-term results. As a result, investors do not effectively discipline the intermediaries so as to curb the extraction of excessive rents, even though some investors perceive that it is occurring.

There are several trading practices and "financial products" that incorporate information asymmetry. For example, technology advances have led to the rise of high frequency, algorithmic trading using powerful computing capability and extreme information transmission capacity.[32] And derivatives trading, especially in bilateral markets that are less transparent, is characterized by information asymmetry based on advanced quantitative analysis.[33] The system works well if a) it produces prices for the deployment of capital to productive uses that are predominantly a function of fundamental information and b) the value extracted by the intermediaries as compensation is proportionate to the quality of intermediation.[34] Fundamental information is an objective concept, so if information is misperceived for causes endogenous to the marketplace, the misperception is not fundamental information. The cited examples, high frequency trading and derivatives trading, are characterized by prices that are anomalous in terms of fundamental information. As described in the cited papers, these anomalies are vehicles for value extraction in excess of that which is efficient in terms of capital intermediation.[35]

The concept of "complexity" is closely related to value extraction based on asymmetric information. As stated, asymmetric information is more valuable in complex environments. Therefore the financial sector is highly incented to use any forces within its power to increase the complexity of financial markets. In many areas, the large intermediaries have accrued tremendous market power. For example, the Office of the Comptroller of the Currency reports that, in the fourth quarter of 2012, more than 93 percent of all U.S. derivatives held by banks were held by just four large banks.[36] Since virtually all over-the-counter derivatives include a bank as one of the counterparties, the market power to increase complexity is very high.

It is evident that the relationship between information asymmetry and complexity has functioned as a feedback loop. Over an extended period of time, the profitability of information asymmetry has incented the use of market power to increase complexity, which in turn enhances the profitability of information asymmetry. This increased complexity has profound consequences for our understanding of how financial markets function.

FINANCIAL MARKETS AS DYNAMIC SYSTEMS

A widely shared, but by no means exclusive, view among economists is that the EMH has been discredited.[37] At a minimum, it explains phenomena that do not have usefully broad application.[38] Despite the clear flaws in the theory, however, belief systems die hard. EMH still informs policy and academic analysis. Influential individuals cling to decades-old shibboleths and those who benefit from the theory continue to pitch their arguments using its terms.

The conceptual model that better fits with the events of the recent past is that of newly revered economist Hyman Minsky: "[O]nce we admit that institutions are man-made and at least in part the product of conscious decision, we must also face the effects of institutional

arrangements on social results."[39] He writes "that almost all systems which are multidimensional, nonlinear,[40] and time dependent" are inherently unstable.[41] In Minsky's view, periods of market stability are destabilizing and markets are inescapably unstable. Markets are far from relentlessly efficient. The new paradigm described in the introductory paragraphs fits within Minsky's conception of financial markets.

Today's markets are consistent with Minsky's thinking, not EMH. The biggest reason is the differing assumptions regarding information that underlie the two sets of theories. While some information is broadly shared by market participants, the ever-increasing speed and capacity of information technology assures that the more powerful market participants will always enjoy an information advantage. Especially in modern, high-speed markets, it is the *perception* of facts—perceptions sometimes existing only for time periods measured in milliseconds—that is the driving force. Perceptions can be influenced using high-speed technology and tactics. Induced or altered perceptions of current circumstances, even for small periods of time, can introduce tremendous distortions that can be exploited using trade execution speed.

The complexity of the markets means that market participants with superior quantitative analytics can comprehend information that eludes others. For example, the complexity of measuring the risks and costs of derivatives creates misperceptions of their value that can be exploited. High-level mathematics has become a major market advantage that is unavailable to all but a few large institutions, which have the size and market power to convert this capability into profit.

To understand Minsky's theories in mathematical terms, it is helpful to view the trading market as a massive dynamic system that determines prices based on perceived information. Economists, physicists and mathematicians study the dynamics of systems, defined as sets of interacting or interdependent components that can be measured as an integrated whole. Traders (humans and computer-driven "trader robots") interact among themselves, either directly or in venues provided by service providers such as exchanges. The traders are system components. Their interactions produce prices for capital investment that can be identified at any given point in time. These prices are the measurement of the integrated whole. System dynamics describes models of how the components interact and the effect of this interaction on the integrated system.

Equilibrium Systems. For an EMH believer, the system constantly seeks equilibrium defined as fundamental value (though EMH adherents do not claim that the achievement of fundamental value at any time can be or needs to be measured).[43] It is like a sealed room into which a gas with a similar mass to oxygen's is injected. The gas will spread evenly throughout the room. EMH sees information like the newly introduced gas. Under the Hypothesis, price seeks equilibrium based on information relevant to the value of each security and derivative being traded in the market. Other costs of the intermediation process are kept to a minimum by perfect competition. If prices are efficiently established continuously, all day long, the intermediaries cannot charge much for the service they provide. There is

very little price distortion that can be exploited in the process of intermediation.[44]

A small perturbation will have a small effect on an equilibrium system and a large perturbation will have a large affect. The systemic response is proportional to the force of the perturbation because all elements of the system, being equally distributed, are equally affected. Therefore, systems in equilibrium are said to be "linear" since cause and effect can be graphed using a straight line. Because cause and effect are proportional in the equilibrium model of financial markets model, deregulation should result in prices and capital allocation that precisely reflect optimal values.

It is obvious that trading markets are not systems in equilibrium under all conditions, and in particular under conditions that are most important. The "Flash Crash" of May 2010 is a fine example of non-linearity. A single trade by a Midwestern mutual fund ignited a stock market free-fall that wiped out $1 trillion of value in a matter of minutes. This happened because computer-driven trading software misconstrued the implications of the mutual fund trade and automatically initiated sell orders that propagated throughout the market. This is just one example of nonlinearity and inherent disequilibrium.[45] In addition, the persistent inefficiency of the capital intermediation process suggests that equilibrium is not the predominant condition even on a day-to-day basis.

Thus, a useful system dynamics model for financial markets must be one that is consistent with Minsky's view of inherently unstable, multidimensional and nonlinear markets.

Fluid Systems. It is tempting to apply the fluid systems model described by Chaos Theory to modern financial markets. Weather has characteristics of a fluid system: the common analogy is that a butterfly flaps its wings in the Amazon rainforest and, through a series of unpredictable events, a hurricane strikes the Gulf Coast.

The central attribute of chaotic systems is that, even if the initial state of such a system is fully understood, its future state cannot be predicted. Yet one can observe forces at work in the financial markets that have predictable outcomes. In the Flash Crash example, the preconditions to the market sell off have been catalogued and studied so that we now understand the causes and effects. The occurrence of a price drop was completely predictable if one knew of the anomalous trade that triggered it. Explaining the force of the sell-off is the more intractable problem. That was driven by the interaction of the trading algorithms that were wired to sell everything if such a trade was observed, to react to the initial selling that was triggered and to continue reacting as the sell-off snowballed.

Organized Complex Systems. The trading markets are better described by a third type of dynamic system, characterized by phases of relatively stable organization and periodic transformations into radically different dynamics.[46] "The basic picture is one where nature is perpetually out of balance, but organized in a poised state—the critical state—where anything can happen within well-defined statistical laws." The standard illustration of such a system is a child at beach trickling sand into a pile. The sand she trickles first stays where it lands, forming a pile. If the grains were smooth, like marbles, the sand would never organize

itself into a pile. Friction from the irregular shape of the sand grains makes the pile coherent. Because of the complex variability of the grains of sand, the shape of the pile is unique. The shape of the pile depends on the collection of grains of sand and how they land. Thus, complexity is a core characteristic of Organized Complex Systems.

As the pile accretes, it becomes less stable so that additional sand increasingly does not stay where it lands. Ultimately, an avalanche is caused by adding sand that pushes the pile beyond its critical state. Such an avalanche is a "phase transformation," in the terminology of the physicists. This is very descriptive of financial markets characterized by Flash Crashes, bubble and burst cycles and bank runs, *i.e.,* market avalanches. Financial markets that are Organized Complex Systems would exist in multiple phases ranging from equilibrium to crashes, rendering statistical prediction based on universal probability distributions impossible.[47] The nature of these interactions is better understood as a process of constant reproduction and change, more like an evolving language than a bounded mechanical system.[48]

The potential force of the "avalanche" is greater if the system is more complex. The complexity of the irregularity of particles of sand allows the elements of the system to interact so that the potential force is stored until it is unleashed at the point of criticality. The complex characteristics of the modern financial markets are legion. The forces that hold the market in its apparently stable state until it reaches criticality include the obscurity of value of the securities and derivatives being traded and the interdependent trading operations that finance each other at the same time that they trade against each other.

It is useful to consider the behavior of the investors and banks that profited from the mortgage market crash in 2008 by shorting the market. The mortgage finance market was clearly an Organized Complex System: prime and subprime mortgages, floating, fixed and teaser rate mortgages, tranched bonds, credit default swaps based on mortgage-backed securities and ratings based on complex and opaque statistics, just to name a few complexities. These investors and undoubtedly others perceived that the mortgage markets were approaching a critical state of organization. The question for them was timing and the force of the impending burst of the residential real estate bubble. Though they may not describe their behavior in system dynamics terms, the critical step that they took was to short the market at the correct time. Others who chose a different timing experienced losses rather than profits from going short.[49]

A particularly disturbing feature of financial markets in the context of Organized Complex Systems is the measurement of the price risk of portfolios of financial holdings, as mentioned above. For example, as of this writing, JP Morgan Chase holds more than $3 trillion in assets, virtually all of which are subject to market price risk. Its market capitalization is about $182 billion by comparison. It can hold these assets because it and its regulators calculate the market risk assuming that if the market price of some portion of the assets goes down, the market price of other assets will go up. These hydraulic relationships are called "negative price correlations." The strength of the negative correlations depends on the historic behavior of the prices of the individual assets. The offsetting price risks result in a

calculated portfolio risk that is far lower than the aggregate of the risk of every single asset. In fact, the absolute size of the portfolio is much less important to calculated risk than its negative correlations.

The net risk, after offsets for negative correlations, determines in large part how much the bank and its regulators must set aside to provide for market losses. We can think of the $3 trillion as the pile of sand and the complex price correlations that determine net risk as the friction that holds the pile together.

But what of a phase transformation, or avalanche? This would be the consequence of a general market crash. As with the sand pile, we know that in a market crash virtually everything moves in the same direction. As panic sets in, all market participants become sellers and the correlations among asset prices become positive and approach 100 percent.[50] The premises behind the calculation of capital needed to assure against market loss are no longer true. The capital of the banks is inadequate and a run ensues.

Moreover, Organized Complex Systems are mathematically subject to "power laws." This means that if the potential "avalanches" are sorted according to frequency of probable occurrence, each category of increasing frequency represents a class of occurrence whose intensity is many times more forceful than the prior category. Intensity increases exponentially.[51] This relationship is most aptly analogous to the functionality of a Richter Scale (tectonic faults are Organized Complex Systems). A level 6.5 earthquake is many times more powerful than a level 6.0, although the probability of a 6.5 earthquake is not proportionally lower than that of a 6.0. This disproportion between probability and power derives from the complexity of the components of the seismic fault line that holds the system in place prior to the phase transformation in the form of an earthquake.

Commenting on wild market swings in August 2007 that created large losses in hedge funds, then Goldman Sachs CFO David Viniar said that "[w]e were seeing things that were 25-standard deviation moves, several days in a row."[52] He was ridiculed for the absurdity of the statement (25 standard deviation events statistically occur approximately once in 100,000 years), but it was actually very informative. Phase transformations under power laws result in dynamic conditions that are qualitatively different from those extant prior to the transformation. Statistics, such as Value at Risk, are not useful in describing the results.[53] Viniar, in his surprise, was reflecting the belief that historic market prices are predictive in future market conditions. In a Complex Organized System subject to power law, this reasoning is simply flawed.

Frequent earthquakes (and avalanches and market crashes) are less destructive because power law says that they are exponentially less forceful. That is why a ski patrol will induce smaller avalanches to reduce the forces building up in the complex snow pile. Conversely, conditions that delay an avalanche can cause the force to build up and be exponentially more destructive. Attempts to mitigate the effects of the avalanche, for instance by building

"dams" to impede its flows, are ultimately futile. The only way to reduce the violence of the release of pent-up forces is to reduce the complexity of the system.

CHANGING THE PARADIGM

Decision makers are still trapped in the logic of the EMH and equilibrium systems. They remain persuaded that regulations should be as light as possible to allow markets to achieve efficiencies through equilibrium that, in reality, do not exist.

Much of financial reform requires banks to set aside reserves as buffers against default. Under power laws, mere buffers against default could prevent a small series of financial avalanches only to cause the eventual avalanche to be exponentially more destructive. This suggests that setting money aside to weather the storm of a market crash in amounts based on historic negative price correlations within a portfolio is inadequate and very likely counter-productive unless the financial regulations also significantly limit permitted trading activities such that the system is less complex. To the extent that the financial markets become more complex, the inevitable avalanche in the form of a financial crisis will be more devastating.

Regulations that reduce complexity cannot stop periodic "avalanches," but they can lower the potential force of avalanches that occur. Such regulations would cause the interacting components of the system to be more like marbles than grains of sand.

The theoretical premises behind deregulation were flawed. But so are the premises behind much of today's new regulatory regime. Regulations that merely increase information transparency—access to information—are powerless against financial avalanches. That is because the meaning of the information is difficult to discern. And regulations that require more cash reserves simply delay the point of criticality, probably assuring that when the stored forces are released the avalanche is even more violent. Only direct reduction of complexity will work.

POLICY IMPLICATIONS OF THE NEW PARADIGM

The new paradigm has important implications for financial regulations. If the purpose of regulation is to ensure that financial markets efficiently carry out their core societal purpose of capital intermediation, then, in accordance with the theory expressed herein, regulations should be crafted with the specific purpose of reducing financial market complexity.

The Dodd-Frank Act's approach differs from the new paradigm. Its authors overtly intended to avoid fundamental changes to the financial markets.[54] Dodd-Frank creates rules designed to (a) promote management of the consequences of realized risk through larger and more reliable capital reserves and margining of derivatives; (b) increase derivatives market price transparency; (c) increase prudential regulatory oversight; and (d) increase the availability of operational data and regulatory authority that could aid in the winding up of failed financial institutions.

Some of these measures make trading generally more costly. As a result, complexity may be reduced as a by product. Others, such as derivatives price transparency, reduce the value of informational advantages. However, important and large portions of derivatives trading are exempted from transparency requirements.

On the other hand, suppression of small events can also lead to the occurrence of a large event. Much of Dodd-Frank is aimed at reducing the consequences of systemically important risks. Only direct limitation of complexity can effectively address capital intermediation inefficiency and systemic risk that is a consequence of such inefficiency.

There is also a practical concern. It is easy for regulators to conflate safety and soundness of the financial system with its profitability. So long as financial sector profitability is driven by information advantages and information advantages are most valuable in complex markets, the financial sector will be incented to increase complexity. It is incontrovertible that, compared to agents within the financial sector, regulators will be at a disadvantage in understanding new and complex financial market activities. Therefore, regulators are susceptible to drawing the conclusion that profitability from complexity increases safety and soundness, and to administering rules accordingly, reducing the serendipitous positive effects of Dodd-Frank on complexity. In reality, the profitability is a result of excessive rents that render the market inefficient and increase the likelihood of catastrophic financial crisis. Thus, regulators are very likely to administer rules in ways that are actually counterproductive in terms of their mission.

The best regulatory scheme de-emphasizes concerns with financial sector profitability. The financial sector must function profitably, but its functions must also serve the social purpose of enhancing productivity. Current levels of profitability, in both absolute and relative terms, are inconsistent with rectifying a system that is inefficient from a societal perspective.

Financial innovation in the era of advanced information technology and quantitative analysis is generating more costs than benefits in our society. This is particularly true with regard to innovations introduced by intermediaries whose incentive is to increase their profits. It is also true of many innovations by market infrastructure providers, such as exchanges, that are designed to attract the use of the infrastructure by intermediaries (liquidity providers) rather than to improve intermediation efficiency. Therefore, even innovations by infrastructure providers, which may lower transaction costs, are likely to also serve the interest of intermediaries in increasing the value that they can extract from the intermediation process.

Dodd-Frank is premised on the notion that the basic activities of the financial sector should be continued, but undertaken more prudently and fairly. Competitiveness of domestic financial institutions *vis-à-vis* non-U.S. institutions is actually a goal of Dodd-Frank, which is counterproductive in the context of competition across complex markets. All of this is based on a misconception of the value extracted and the value provided by the financial sector in its current form.

From a broader perspective, the Dodd-Frank regime is largely based on the same analytical construct that the financial sector has adopted from the foundational work of Black/Scholes/Merton in their option-pricing model published in 1973. Risk is valued and correlations are assumed using historic data and probabilities of their recurrence. This approach underlies the Value at Risk model that uses statistics to estimate potential financial risks of a portfolio. The regime is overwhelmingly devoted to erecting firewalls against the recurrence of the consequences of past market performance. Unfortunately, this model is a poor methodology for anticipating market results, especially in rarer but (under the principles of Organized Complex Systems) dramatically more catastrophic events. A model for regulation that is dependent on historic data to predict a range of future outcomes leads regulators to establish rules that address these outcomes. If the markets are viewed in the terms of Minsky's theories and Organized Complex Systems, this approach is, by definition, inadequate.

Specifically, regulatory approaches should assume a market that inherently experiences non linear phase transformations at different scales that transform its dynamics so that historic data becomes a poor predictor of future conditions. A good example of this is a hedging strategy that assumes historic negative correlations of price movements. At the point of criticality, price movements may become uniformly correlated and large. In other words, at the time it is most important, the hedging strategy may multiply the consequences of price movements instead of mitigating them.

In balancing costs and benefits of financial regulation, the presumption that innovations of the last 35 years have social value is not supported by analysis; in fact, such thinking is counterintuitive. Capital intermediaries are incented to innovate in order to increase intermediation inefficiency, not reduce it. Stifling, and preferably rolling back, innovation should not be presumptively evaluated as a cost to society and a burden on productivity. Instead, simplification of capital intermediation by narrowing the breadth of markets, reducing trading activity, and curbing the use of quantitatively complex derivatives constitute *per se* benefits that should be considered as such by policy-makers, regulators and courts.

1. “At its core, EMF implies that arbitrage opportunities for riskless gains do not exist in an efficiently functioning market and that if they do appear from time to time, they do not persist.” See: Burton Malkiel, “The Efficient-Market Hypothesis and the Financial Crisis,” Russell Sage Foundation (2012), http://www.russellsage.org/sites/all/files/Rethinking-Finance/Malkiel.%20The%20Efficient-Market%20Hypothesis%20and%20the%20Financial%20Crisis%20102611.pdf.
2. Originally articulated by University of Chicago economist Eugene Fama in “Efficient Capital Markets: A review of Theory and Empirical Work,” *Journal of Finance* 25 (1970): 383-417, http://efinance.org.cn/cn/fm/Efficient%20Capital%20Markets%20A%20Review%20of%20Theory%20and%20Empirical%20Work.pdf.
3. EMH is closely related to the theory of Rational Expectations Hypothesis, which holds that opinions based on distributions that reflect objective reality will be uniform as long as common information is shared.
4. Roman Frydman and Michael Goldberg, “Financial Markets and the State: Long Swings, Risk and the Scope of Regulation,” *Capitalism and Society* 4 (2009), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2209399.
5. Roman Frydman and Michael Goldberg, “Macroeconomic Theory for a World of Imperfect Knowledge,” *Capitalism and Society* 3 (2008), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2209264.
6. Fundamental value refers to the intrinsic value of a stock, bond or derivative based on available information. In the context of a share of stock: “Fundamental analysis entails the use of information in current and past financial statements, in conjunction with industry and macroeconomic data to arrive at a firm’s intrinsic value.” S.P. Kothari, “Capital Markets Research in Accounting,” *Journal of Accounting & Economics* 31 (2001): 105-231, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=235798.
7. The Capital Asset Pricing Model describes fundamental value for an individual investor. Its limitations in practice have been well catalogued. See Lynn Stout, "The Mechanics of Market Inefficiency: An Introduction to the New Finance," 2003, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=470161.
8. Alexander Hamilton, “To the Speaker of the House of Representatives, 1790: Report on a National Bank, available at http://american_almanac.tripod.com/hambank.htm.
9. Michael Benton, “Thomas Jefferson on Banks,” December 2012, http://aboutthomasjefferson.com/thomas-jefferson-on-banks/243; Thomas Philippon, “The Size of the U.S. Finance Industry: A Puzzle,” November 2011, http://www.newyorkfed.org/research/conference/2011/NYAMP/Fed_Philippon_v1.pdf.
10. Thomas Philippon, “The Size of the U.S. Finance Industry: A Puzzle,” November 2011, http://www.newyorkfed.org/research/conference/2011/NYAMP/Fed_Philippon_v1.pdf.
11. Simon Johnson and James Kwak, *13 Bankers: The Wall Street Takeover and the Next Financial Meltdown* (New York: Pantheon, 2010), 59.
12. An excellent example of this analytical approach can be found in a recent study of high-frequency trading. Charles M. Jones, “What Do We Know About High-Frequency Trading?” *Columbia Business School Research Paper 13-11* (2013), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2236201.
13. This period most often is said to commence with the election of Ronald Reagan in 1980. That is when deregulation, per se, became a policy of a political party in power.
14. Johnson and Kwak, *13 Bankers*, 59.
15. Gerald Epstein, “Financialization, Rentier Interests, and Central Bank Policy”(paper presented at the University of Massachusetts at Amherst, Political Economy Research Institute (PERI) Conference on Financialization of the World Economy, December 7 8, 2001, http://www.peri.umass.edu/fileadmin/pdf/financial/fin_Epstein.pdf.
16. Gretta R. Krippner, *Capitalizing on Crisis: The Political Origins of the Rise of Finance* (Cambridge: Harvard University Press, 2011), 27.
17. Thomas Philippon, “Has the U.S. Finance Industry Become Less Efficient: On the Theory and Measurement of Financial Intermediation,” National Bureau of Economic Research (NBER) Working Paper No. 18077 (2012), http://pages.stern.nyu.edu/~tphilipp/papers/Finance_Efficiency.pdf.

18. Under EMH, price formation in the trading markets is inherently efficient as new information is incorporated rapidly into the marketplace. Thus, the cost of individual transactions defines the cost of capital intermediation. Technological advances likely reduce individual transaction costs (though this is not uniformly the case). Under EMH, the reduction of individual transaction costs through technology by definition reduces the cost of capital intermediation.
19. Krippner, *Capitalizing on Crisis*, 52-54.
20. Thomas Philippon, "The Future of the Financial Industry," *Stern on Finance* Blog, November 6, 2008, http://w4.stern.nyu.edu/blogs/sternonfinance/2008/11/the-future-of-the-financial-in.html.
21. Thomas Philippon, "The Evolution of the U.S. Financial Industry from 1860 to 2007: Theory and Evidence," November 2008, http://economics.stanford.edu/files/Philippon5_20.pdf; Williams J. Baumol, "Macroeconomics of Unbalanced Growth: The Anatomy of the Urban Crisis," *American Economic Review* 57(1967): 415-426.
22. "Corporate Profits in GDP," Yardeni Research, Incorporated, August 8, 2013.
23. These data may dramatically understate the real world phenomena, however. Investment bankers have traditionally been compensated primarily by bonuses. Bonuses are calculated with reference to the firm's performance and the individual's performance. Therefore an investment banker is, practically speaking, a participant in the profits and losses of the firm. This is even starker for traders at banks and hedge funds. These individuals receive a stake in the form of an allocation of firm capital on which to trade. They conduct themselves as if they are running their own individual businesses and sharing the profits with their employer. Therefore the calculation of profit share should include a very large percentage of the bonuses paid to investment bankers and traders.
24. World Bank, "Domestic Credit Extended by Banking Sector (% of GDP)," available at http://data.worldbank.org/indicator/FS.AST.DOMS.GD.ZS/countries/1W-US?page=6&display=default.
25. Thomas Philippon, "The Evolution of the U.S. Financial Industry from 1860 to 2007: Theory and Evidence."
26. Philippon, "Financial Intermediation."
27. Raghuram Rajan, *Fault Lines* (Princeton: Princeton University Press, 2010), 84-89.
28. The period has already exceeded 47 months. "Business Cycle Expansions and Contractions," National Bureau of Economic Research (NBER), http://www.nber.org/cycles.html.
29. For example, trading revenues for FDIC insured banks increased from 1984 twice as fast as other revenues up to the financial crisis and have recommenced their increase thereafter. "Annual Income and Expense of FDIC-Insured Commercial Banks and Savings Institutions," http://www2.fdic.gov/qbp.
30. It is likely that the equilibrium dynamics implied by EMH exist under certain market conditions, but that financial markets move through phase transformations into other dynamic conditions, discussed below. *See* Rossitsa Yalamov and Bill McKelvey, "Explaining What Leads Up to Stock Market Crashes: A Phase Transition Model and Scalable Dynamics," *Journal of Behavioral Finance* (2011), available at http://www.tandfonline.com/doi/abs/10.1080/15427560.2011.602484#.UhN0sFPailM However, even if this is accurate, the conditions in which EMH controls are infrequent and unimportant in terms of real world concerns.
31. For a further discussion, see Wallace Turbeville, "Cracks in the Pipeline, Part One: Restoring Efficiency to Wall Street and Value to Main Street," Dēmos (2012), http://www.demos.org/publication/cracks-pipeline-restoring-efficiency-wall-street-and-value-main-street.
32. Wallace Turbeville, "Cracks in the Pipeline, Part Two: High Frequency Trading," Dēmos (2013), http://www.demos.org/publication/cracks-pipeline-part-two-high-frequency-trading.
33. Wallace Turbeville, "Cracks in the Pipeline, Part Three: "Derivatives: Innovation in the Era of Deregulation," Dēmos (2013) http://www.demos.org/publication/derivatives-innovation-era-financial-deregulation.
34. Fundamental information is used here to mean information that is relevant to the present value of the future cash flows from the security or derivative, discounted at a rate that reflects risk. Myron J. Gordon, *The Investment Financing and Valuation of the Corporation* (Homewood, Illinois: Irwin, 1962).

35. Regulatory regimes define the boundaries of market structures. Under an ideal regulatory regime, markets would be efficient, i.e. observed prices would be equal to equilibrium prices based on fundamental value, and they would also be stable, i.e., deviate little (or not at all) from those equilibrium prices. The conceptual measure, then, is (1) the extent of deviation (reflecting asymmetric information and oligopoly power), over the long-run and the short-run, of observed prices from efficient, fundamentally sound, prices under the regulatory regime being evaluated; and (2) the degree to which that "spread" varies both over the short run and long run (non-fundamental volatility and price bubbles, respectively).

36. OCC's Quarterly Report on Bank Trading and Derivatives Activity—Fourth Quarter 2012," Office of the Comptroller of the Currency, http://www.occ.gov/topics/capital-markets/financial-markets/trading/derivatives/dq412.pdf.

37. Alan S. Blinder, Andrew W. Lo and Robert M. Solow, editors, *Rethinking the Financial Crisis* (Ithaca: Cornell University Press Services, 2012).

38. For example, the explanation of price bubbles and bursts is difficult under EMH. Advocates resort to the explanation that one trader may know the price is too high, but he or she does not know if other traders know. This does not help with understanding the forces that create price anomalies that lead to bubbles.

39. Hyman Minsky, *Stabilizing an Unstable Economy* (New York: McGraw-Hill, 2008), 9.

40. Linearity refers to a condition in which effects are proportionate to causes. Thus cause and effect can be charted using a straight line. Nonlinearity, as used by Professor Minsky means that effects are geometrically related to causes and, if graphed, would be depicted by an ever-increasing curve.

41. Minsky, *Unstable Economy*, 11 (footnote 9).

42. *See* Didier Sornette, *Why Stock Markets Crash: Critical Events in Complex Financial Systems* (Princeton, New Jersey: Princeton University Press, 2003). This and related work undertakes to predict market crashes. The predictive use of system dynamics is less relevant to this paper than its value as descriptive from an ontological perspective.

43. Malkiel, "Efficient-Market Hypothesis."

44. George Soros has described financial markets in equilibrium as an extreme case of negative feedback between market participants' expectations and the actual course of events, and market price bubbles as an extreme case of positive feedback. George Soros, "Session 1: Anatomy of Crisis--The Living History of the Last 30 Years: Economic Theory, Politics and Policy" (paper presentation at the Institute for New Economic Thinking (INET) Conference at King's College, April 8 11, 2010), http://ineteconomics.org/sites/inet.civicactions.net/files/INET%20C%40K%20Paper%20Session%201%20-%20Soros.pdf.

45. For an excellent explanation in the context of commodity markets, *see* Vladimir Filimonov, David Bichetti, Nicolas Maystre and Didier Sornette, "Quantification of the High Level of Endogeneity and of Structural Regime Shifts in Commodity Markets," (Pre Printed discussion paper submitted to the United Nations Conference on Trade and Development, March 21, 2013), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2237392.

46. Per Bak, *How Nature Works—The Science of Self-Organized Criticality* (Göttingen, Germany: Copernicus, 1996); Didier Sornette, Why Stock Markets Crash.

47. Rossitsa Yalamov and Bill McKelvey, "Explaining What Leads Up to Stock Market Crashes."

48. Tony Lawson, "Really Reorienting Modern Economics," (paper presentation at the Institute for New Economic Thinking (INET) Conference at King's College, April 8 11, 2010), http://ineteconomics.org/sites/inet.civicactions.net/files/INET%20C%40K%20Paper%20Session%206%20-%20Lawson.pdf.

49. One is reminded of the famous 2007 quote of Citigroup CEO Chuck Prince: "When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance. We're still dancing." See Michiyo Nakamoto, "Citigroup Chief Stays Bullish on Buy outs," *Financial Times*, July 9, 2007, http://www.ft.com/cms/s/0/80e2987a-2e50-11dc-821c-0000779fd2ac.html#axzz2b2e6P0Kx.

50. Tobias Preis, Dror Kenett, H. Eugene Stanley, Dirk Helbing and Eshel Ben-Jacob, "Quantifying the Behavior of Stock Correlation Under Market Stress," Scientific Reports 2 (2012), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2170038.

51. This is easily understood. Since the complexity that holds the system in its organized state is multidimensional, the force that is stored in an Organized Complex System increases exponentially as the size of the system increases.
52. Peter T. Larsen, “Goldman Pays the Price of Being Big,” *Financial Times*, August 13, 2007, http://www.ft.com/cms/s/0/d2121cb6-49cb-11dc-9ffe-0000779fd2ac.html#axzz2cKoV7gyT.
53. Remarks of J. Doyne Farmer (videotaped presentation at the Institute for New Economic Thinking (INET) Conference at King’s College, April 8 11, 2010), http://ineteconomics.org/video/conference-kings/networks-and-systemic-risks-j-doyne-farmer.
54. Robert G. Kaiser, *Act of Congress: How America’s Essential Institution Works, and How it Doesn’t* (New York: Knopf, 2013), 26.

America the Unequal:
Origins and Impacts of a Policy Revolution

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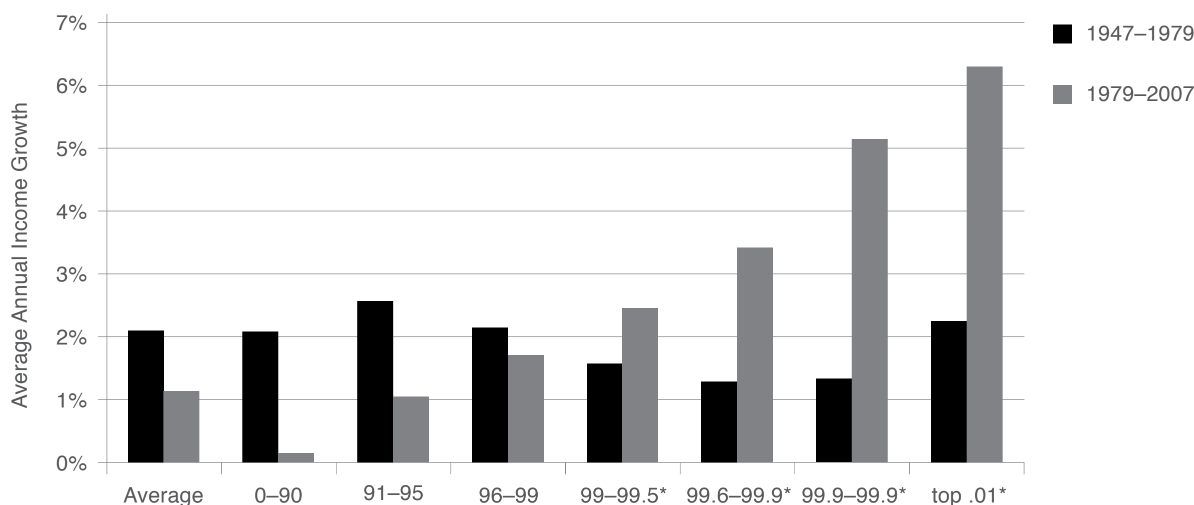
INTRODUCTION

In the three decades after the Second World War, low- and middle-income households enjoyed income gains that grew in tandem with rising GDP levels and actually outpaced the gains enjoyed by the richest households. In short, if you wanted to report how "the U.S. economy was doing" or "how the U.S. economy was working for the vast majority," you could just recite overall income growth rates.

Since the late 1970s, answering these questions requires a lot more nuance. Low- and middle-income families have seen income growth lag far, far behind overall averages, while income growth at the top has risen much faster than average. So how is "the U.S. economy" doing? Depends on which U.S. economy you are asking about. Figure 1 below shows this divergence in these two epochs. The blue bars show annual income growth—average first and then growth for various income fractiles—between 1947 and 1979. What's key is that there's just not much variance in growth rates; they range from a high of 2.6 percent annual growth to 1.3 percent. The lighter bars show annual growth rates for the same fractiles from 1979 to 2007. Here the growth rates range from 0.2 percent to 6.2 percent—reflecting a more than thirty-fold gap compared to only a two-fold gap in the earlier period.[1]

Figure 1. Average Annual Income Growth by Fractiles, by Time-Period



† *Author's analysis of data from Piketty and Saez (2003, updated)*

This fracturing of economic experience is the consequence, many now recognize, of a sharp rise in income and wage inequality since the late 1970s. While much attention is paid to our rising Gini coefficient and other measures of inequality, how inequality is playing out in terms of aggregate economic gains is less well-understood. When looking strictly at market-based cash incomes (*i.e.*, not counting government transfers like Social Security or non-cash benefits like employer-provided health benefits), the top 1 percent accounted for just under *60 percent* of the rise in overall average income between 1979 and 2007. Even when including the value of government transfers like Social Security, Medicare, and Medicaid, as well as including non-cash benefits like employer-provided health benefits, the top 1 percent accounted for just under 40 percent of the rise in overall average income between 1979 and 2007, more than the bottom 80 percent combined. In the same period, nearly all Americans—95 percent of households—experienced below-average income gains compared to their counterparts in the three decades after World War II.

While few analysts deny the evidence of inequality, there is far less agreement on why this is happening. The most prevalent type of explanation focuses on broad forces in the global economy, particularly globalized labor competition and rapid technological change. Together, these trends have driven a wedge, so the argument goes, between the highest skilled American workers and everyone else. But this type of explanation, while broadly compelling, is seriously incomplete. In fact, the weight of the evidence points to specific changes in domestic policy and politics, not global forces, as the primary driver of growing inequality.

This paper argues that growing inequality is not just the most salient economic fact of life for the vast majority of American families over the past generation; it is also a direct consequence of profound changes in economic policy, with systematic distributional implications.

We begin by charting out the changes in policy that were undertaken, and then provide an examination of why these changes were proposed and (more importantly) what led to their adoption. The paper concludes by assessing what can be learned about policy impacts on the distribution of economic rewards, and by identifying the challenges and opportunities inherent in undertaking a political campaign to brake or reverse the rise in inequality.

A CONSERVATIVE PARADIGM SHIFT

Until fairly recently, the role of policy changes in driving these stark trends in inequality were strangely under-examined. As noted, attention focused largely on disembodied, apolitical forces like "technology" or "globalization."[2] The inattention to policy was particularly strange given that, in a range of areas with significant distributional implications, dramatic changes in policy are quite evident in recent decades. At the same time, these changes were often interconnected and advanced together in an ideologically unified way. Thus, we describe the policy origins of growing inequality as part of a "conservative paradigm shift" (CPS). In what follows below, key elements of the CPS are detailed and assessed.

The label "conservative paradigm shift" is not, admittedly, the most illuminating descriptor. But because the conservative paradigm shift really *was* a paradigm shift and not one single discrete policy change, it is the best overall descriptor of the bundle of policy changes that have had, *in toto*, such strong effects over the past generation. Before naming some of these discrete policy changes, it's useful to note what largely unites them: they all undercut bargaining power for low- and middle-income households in the marketplace, while boosting bargaining power for already well-placed economic actors—both high-income households as well as corporations.

The two most visible policy changes in the conservative paradigm shift revolve around the federal minimum wage and top income tax rates:

Minimum Wage

For the first thirty years following its enactment (in 1938), the value of the federal minimum wage largely tracked overall productivity growth in the US economy. But the inflation-adjusted value of the minimum wage peaked in 1968—never rising past the 1968 level again even as economy-wide productivity more than doubled over that time-period. Further, between January 1981 and April 1990, the nominal value of the minimum wage was completely frozen—the longest stretch without a legislated raise in its history.

Top Income Tax Rates

Conversely, top incomes were boosted by changes in tax policy. Tax rates on high-income households coming out of World War II were over 90 percent, dropping to 70 percent in the early 1960s, and largely sticking there for the next twenty years. Between 1980 and 1988, however, top rates fell from 70 to 28 percent. Since then, they have risen and fallen in a much narrower band—rising to just under 40 percent during the Clinton administration and falling back to 35 percent during the Bush administration. As of 2013, the top rate is 39.6 percent.

While political battles over taxes and the minimum wage are clearly visible and the political economy of their outcomes clear, many other seemingly less direct policy changes have had significant impacts on bargaining power and the distribution of economic rewards:

Policy Barriers to Organizing Unions

One example of these less-transparent policy changes is the failure of labor law to keep pace with rising employer hostility and aggressive tactics mobilized against attempts to organize unions. In 2007, for example, well over half of all non-union American workers expressed the desire to be in a union or related organization. The rise in employer aggressiveness against unions has been well-documented by now, and a large body of research indicates that the resulting decline in unionization has had powerful effects on inequality.[4] The direct benefits of unionization for union workers are progressive in and of themselves, with the "union premium" for wages and benefits being larger for low-wage workers than for higher-wage workers. But research has also indicated that the spillover effects of declining unionization on the entire labor-force are large, and a significant portion of the rise in wage inequality has been attributed to the decline in unionization. Lastly, there is evidence that unions actually provide a needed check on excessive executive pay. Given that there seem to be deep market failures associated with corporate governance in the United States, and these failures are often exploited by managers of firms to divert large portions of overall firm growth to managerial pay, any countervailing pressure provided by unions can block this important channel of inequality.

Globalization's Rules of the Game

Globalization and how it has been managed provides perhaps the best example of how policy *commissions* and *omissions* combined to do maximal damage to low and moderate-wage workers. Any such integration between the labor-abundant non-U.S. global economy and the United States was going to provide a drag on living standards growth for most American workers. Yet this integration has been consistently pursued and managed in ways that do even further damage to these workers. For example, trade agreements consistently provide comprehensive protections for capital-owners looking to invest abroad, essentially harmonizing laws governing the treatment of investors' incomes up to the highest levels of national protection. Yet these same agreements provide no enforceable protections to insure that conditions for workers are harmonized up to the same high standards (nor do they include enforceable protections for environmental concerns). Further, many well-placed economic actors in the United States have been able to carve-out protections from competition from less well-paid equivalent workers in the rest of the global economy.[4]

The Unleashing of Finance

It is well-known by now that many of the highest incomes earned in the American economy are associated with the financial sector. This was not always the case. The wage-premium in financial sector incomes was large in the years preceding the Great Depression, but shrank quickly during the "Great Compression" between the 1940s and 1970s. Starting in the late 1970s—and, not coincidentally, hard on the heels of the beginning of extensive deregulation of financial markets—this wage-premium rose quickly again. Since the late 1970s, rising financial sector incomes nearly doubled finance's share of GDP by the mid-2000s. Yet this trend has *not* coincided with any measurable increase in the efficiency of the sector in the form of higher levels of tangible investments in plants and equipment or in a reduction of the frequency and/or severity of financial crises.[5]

The Retreat from the Commitment to Full Employment

Perhaps the least-recognized policy change that has hamstrung the ability of low, moderate, and middle-income workers to see acceptable living standards growth is the shift in macroeconomic policy makers' focus (particularly that of the Federal Reserve) from insuring full employment to insuring that inflation never threatens to go above the very low single-digits. A growing body of evidence suggests that less than full employment disproportionately reduces the wages of low and middle-income workers.[6] Throughout the 1980s and early 1990s policymakers consistently failed to reduce actual unemployment rates to even the overly conservative official estimates of full employment (or, in the jargon, the non-accelerating inflation rate of unemployment, or NAIRU) and the result was a fifteen-year wage meltdown for most workers. Real median wages actually fell between 1979 and 1995. Then, in the late 1990s, external events (international financial crises which forced the Federal Reserve to keep interest rates low) and admirable pragmatic heterodoxy from the Federal Reserve allowed unemployment rates to reach far below official estimates of the NAIRU, and the result was the first across-the-board growth in wages in decades, all with no uptick in inflation.

The Assault on Rights and Regulation

Other, more targeted policy changes further weakened bargaining power and economic opportunity in myriad ways. Draconian budget cuts to the Equal Employment Opportunity Commission reduced enforcement of equal opportunity laws. Labor standards (health and occupational safety standards, or prevailing wage standards, or standards as to which workers qualify for overtime pay), were either weakened or increasingly unenforced. Mechanistic comparison of "monetized" costs and benefits threw a wrench into environmental regulation, product safety, and other key areas of public well-being. Criminal justice policies and attacks on the social safety net further eroded economic opportunity in historically disadvantaged communities.

THE SUM OF POLICY IMPACTS IS GREATER THAN THE PARTS

While each of these policy shifts has had discrete distributional impacts, they often interact in ways that amplify their impacts.

For example, the growing influence of the financial sector clearly has contributed to the elevation of inflation concerns over employment concerns in macroeconomic policymaking. Lenders have an interest in insuring that inflation rates do not rise and erode the purchasing power of wealth, whereas debtors have an interest in higher rates of inflation that erode the value of their debt. Financial sector influence is not the only reason for the emphasis on inflation targeting—professional macroeconomists deserve at least part of the blame for this shift, for sure. But it surely did not hurt the cause of privileging inflation targeting over unemployment targeting to have such a powerful economic interest behind it.

Finally, the interaction of financial deregulation and the very sharp reductions in tax rates faced by the highest-income households likely led to larger amounts of income being transferred to the very top of the income scale than would have been predicted by simply adding up their separate impacts. To put it simply, much of the incomes claimed by the richest households likely stem from economic *rents*—that is, they are the excess returns that greatly

exceed what these households would get if competitive markets were operating smoothly. It is well recognized by now, for example, that the market for chief executive officers (CEOs) and other corporate managers is likely plagued by failures that keep competitive forces from keeping CEO compensation in check. Similarly, it is well recognized that deregulated financial sectors often create so many transactions of such opacity that it is very hard for market players to determine the economic worth of many of them. For example, much of what the financial sector of the U.S. did during the 2000s was to simply *disguise* financial risk (from exposure to assets backed by bubble-inflated home prices) that should have been dispersed and managed.

In a very real sense, then, the deregulation of finance expanded the opportunity for rent-seeking in the U.S. economy enormously. This *opportunity* was supplemented by the increased *motive* for engaging in this rent-seeking provided by large cuts in tax rates for the highest-income households. As tax policy changes allow corporate executives and financiers to keep much more the marginal dollar they claim in pre-tax incomes, this greatly increases the return to rent-seeking.

STRONG MEDICINE FOR AN AILING ECONOMY?

The relative inattention focused on these policies in driving inequality is even odder given that this whole constellation of policies was put forward as a large-scale *response* to major economic challenges thought to be facing the U.S. in the late 1970s, most prominently, the marked slow-down in productivity growth and the simultaneous rise of both high rates of inflation and unemployment. The CPS, in both its component parts and its broader business-friendly ideology, was thought to be strong economic medicine for what many felt was the most significant economic crisis since the Great Depression.

A key driver in generating respectability for the CPS in the 1970s was the growing backlash against Keynesian demand-management among macroeconomic theorists. This backlash was essentially codified and given momentum by Milton Friedman's 1968 Presidential Address to the American Economic Association, in which he asserted that Keynesian efforts to reduce unemployment by managing aggregate demand were hampering a more optimal balance between unemployment and low inflation.

The Friedman concept of an immutable "natural rate" of unemployment was sharpened into the "non accelerating inflation rate of unemployment," or NAIRU, in later extensions of Friedman's work, but the broader indictment of Keynesian demand management as inflationary had a deeper influence in the political sphere. In the meantime, core elements of the CPS gained academic respectability when Friedman won the Nobel Prize in Economics in 1976, followed by a string of similarly sympathetic Nobel prize winners including George Stigler, James Buchanan, Gary Becker, Robert Coase, and Robert Lucas.

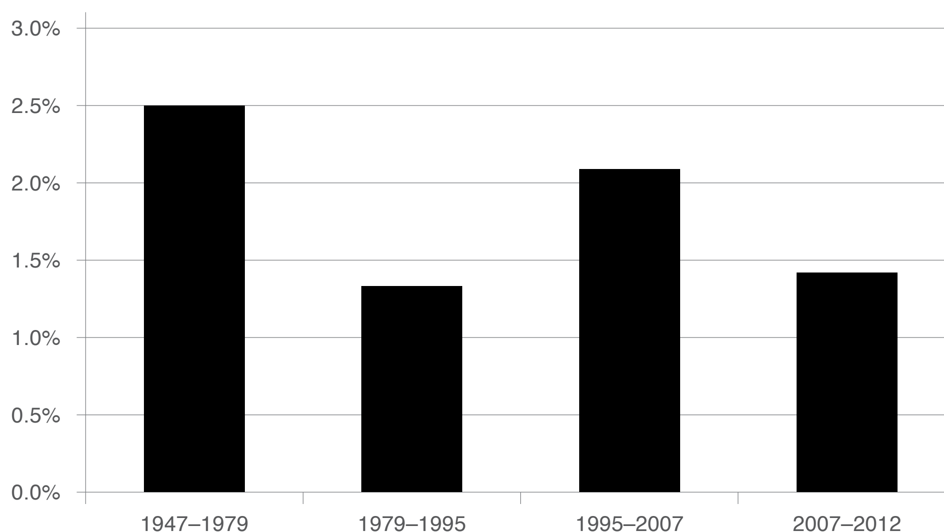
Among policymakers, the growing academic chorus arguing against active macroeconomic management merged with growing calls to remove what were seen as microeconomic “inefficiencies” such as wage floors, labor standards, unions, financial regulations, and any form of capital controls in trade agreements. Starting in the late 1970s, all of these perceived markers of “statist” inefficiency in the U.S. economy were subject to attack, from conservatives, of course, but often from self-identified centrists as well. The perceived technocratic seal of approval for this quite radical shift in policymaking explains some portion (not all, as the simple material interests of powerful economic players also, surely, played a significant role, which we’ll discuss in the next section) of the success in effecting this change.

THE STRONG MEDICINE PROVED TO BE A WEAK CURE

There seems to be very little scope for argument as to whether or not the conservative paradigm shift actually happened. Where there is much more debate is on the success of the CPS, even on its own terms of revitalizing productivity and economic growth.

When assessing the CPS's growth payoff, it is important to keep the historical context in mind. Between 1947 and the business cycle peak of 1973, productivity growth in the U.S. economy averaged 2.5 percent annually, without a lot of variation (outside of predictable variation over the business cycle). Over the business cycle between 1973 and 1979, productivity growth slowed dramatically, to just 1.6 percent annually. This slowdown provided great impetus for advocates of a radical change in U.S. economic strategy, and between 1979 and 1989 (the next full business cycle), the changes had fully taken place. Over this business cycle, productivity growth averaged just 1.2 percent.

Figure 2. Productivity Growth for Selected Periods, 1947–2012



* Growth rates are average the of three-year moving averages of the quarter over quarter change total economy productivity.

† *Author's analysis of data from Piketty and Saez (2003, updated)*

The productivity malaise continued deep into the next business cycle (starting from the 1989 peak). Between 1989 and 1996, productivity growth averaged just 1.3 percent annually. It was not until the late 1990s that productivity growth in the U.S. saw a clear resurgence, averaging 2.1 percent between 1996 and 2002. The impetus for the late 1990s productivity resurgence is largely well understood; it was driven by a substantial increase in capital investments in information and communications technology (ICT) equipment, as firms saw opportunities afforded by falling ICT prices and the introduction of the Internet in most American households. However, as investment in ICT equipment decelerated rapidly in the 2000s business cycle, so did productivity growth, and productivity has continued to decelerate in the early phases of recovery from the Great Recession. Given that it took almost two decades after the conservative paradigm shift before productivity growth rates accelerated, and given as well that the mechanism of this acceleration—capital-deepening as firms invested in newly available ICT equipment—was impossible to foresee and essentially unconnected to the conservative policy portfolio, it seems extraordinarily hard to persuasively argue that the CPS was successful on its own terms of boosting productivity.

There are, in fact, very few sophisticated defenders of the conservative paradigm shift who emphasize its beneficial impacts on productivity growth. Occasionally one will hear a half-hearted defense to the effect that the productivity slowdown would have been even worse without this policy shift. More often one hears that that the productivity slowdown was inevitable, driven by global events—particularly rising competitiveness of U.S. trading partners—far outside the control of U.S. policymakers (see Conard [2011] for the most drawn-out version of the claim that rising foreign competitiveness was always doomed to end the era of high productivity growth).

There are a number of things to note about these pro-growth defenses of the CPS. First, as an empirical matter, there is zero support for the proposition that the slow-down in living standards growth post 1979 can be linked to rising international "competitiveness." The first-order determinant of average living standards growth is simply domestic productivity growth, which is driven by labor force quality, the size of the capital stock, and the state of technology. It is hard indeed to understand how, for example, a larger capital stock in Singapore or South Korea or Italy has any effect at all on these first order determinants of U.S. productivity. Of course, international competition could theoretically introduce a growing wedge between domestic productivity and domestic living standards growth if such competition eroded a country's terms of trade with the rest of the world. Imagine if the U.S. only produced automobiles. Now assume that, even though there has been no change in the pace of productivity growth in automobile production, international competition drives down the global price for automobiles, so we get less and less on global markets for each auto produced. This is possible, but it's important to note that even if this happened it would not affect measures of domestic productivity; it would only change measured terms of trade (that is, the value of exports compared to the value of imports). Most importantly for assessing this argument, it hasn't happened. The negative change in U.S. terms of trade between 1947 and 1979 was larger than the negative change between 1979 and 2007, so it was the earlier period where average living standards growth was dragged down more by foreign competition.

Second, it is difficult to square the claim that increased globalization has greatly damaged U.S. productivity growth with the advocacy of those who argue that breaking down barriers to global integration is the key to reviving U.S. productivity. The argument seems to run like this: "globalization is why U.S. living standards growth has sputtered so badly over the last generation, so we should try to spur lots more globalization."

Third, if the productivity slowdown was inevitable given the rise of global competition, then what, exactly, *did* the conservative paradigm shift accomplish except a large rise in income and wage inequality? The idea that this shift was always about changing the distribution of income, not economic growth, is explored in a later section.

WHITHER INFLATION? TALLYING THE GAINS AND LOSSES

Defenders of the conservative paradigm shift have an admittedly stronger empirical hand to play when claiming that its adoption slew American inflation. The 1970s was indeed the time of what Brad DeLong has called "America's Only Peacetime Inflation," and inflation clearly receded in the 1980s and into the 1990s.

The key drivers in this disinflation were contractionary macroeconomic policies—particularly monetary policy. Macroeconomic policymakers (particularly the Federal Reserve) consistently overshot even their own too-conservative estimates of the NAIRU during most of the 1979 to 1995 period.[7]

Of course, keeping unemployment rates consistently above the NAIRU is an expensive way to reduce inflation. This begs some questions: was this really necessary (*i.e.*, is there no other less-costly anti inflation strategy that could have worked?), and was it worth it?

Proponents of the CPS certainly thought the costs were worth it—in fact, they viewed these costs as essentially *inevitable*. In their view (best formalized by Friedman's 1968 address), inflationary pressures had been building up for at least a decade, as misguided Keynesian policymakers had used aggregate demand management (*i.e.*, expansionary monetary and fiscal policies) to keep the unemployment rate below its "natural" rate. Over time, these boosts to aggregate demand would fail to boost output and employment, and would spill entirely over to rising prices. Further, these proponents argued that institutions impeding the flexibility of labor markets—mini mum wages, unions, labor standards—actually raised this natural rate of unemployment. Thus, even efforts to just keep unemployment *stable* were inflationary given how government interference in labor markets was already keeping unemployment artificially low.

Evidence that inflation rates like those experienced in the U.S. economy of the 1970s are deeply damaging to either income growth or its fair distribution is very hard to find.[8] In the U.S. post-war experience, there is no consistent relationship between inflation rates and aggregate growth. Conversely, there clearly are large *distributional* shifts that can occur with unanticipated bursts of inflation. Most directly, inflation reduces the real value of wealth stocks. Inflation hawks tend to emphasize particularly sympathetic economic actors who

might be hurt by this—retirees living on fixed incomes, for example. Of course, even by the 1970s, most retirees' incomes were mainly comprised of Social Security benefits, which were largely shielded from price increases. When assessing the distributional impact of inflation on wealth, however, one must keep a crucial point in mind: most wealth is *inside* wealth, meaning that one person's asset is another's liability. So, just as inflation reduces the real value of assets, it also reduces the real value of liabilities. In essence, it causes a redistribution from net creditors to net debtors. So, for example, Americans who bought a home with a fixed interest rate mortgage in the late 1960s or early 1970s saw a windfall wealth gain as inflation eroded the real burden of their mortgage obligation.

Against these at best uncertain aggregate benefits, and largely regressive benefits of engineering disinflation, one should weigh the extremely large and regressive costs of recessions engineered largely to break inflationary expectations. The recessions of the early 1980s and 1990 were both caused in large part by interest rate hikes undertaken by the Federal Reserve to reduce inflation. The cumulative output loss of the two early 1980s recessions approached 80 percent of one-year's GDP at the time, while the early 1990s recession exacted a cumulative cost of nearly one-third of one-year's GDP.[9]

Given the considerable cost associated with engineering the disinflations of the 1980s and early 1990s, it is also worth exploring whether or not this costly intervention was even necessary to reduce the 1970s inflation. While the 1970s inflation was the first in history to not be associated with an all-consuming war effort, this does not mean that the inflationary episode's root cause is particularly mysterious. Clearly, it was oil price shocks caused by political unrest in the Middle East. The real price of oil tripled in 1973 (the Yom Kippur war) and then (after some significant declines after 1975) it doubled again in 1979 (the Iranian revolution). Further, these exogenous oil shocks were then amplified by wage-price spirals, as both firms and workers tried to raise the nominal prices under their control (product prices and nominal labor costs, respectively) to avoid bearing the full brunt of adjusting to higher input costs.

Implicit in this analysis is a view that inflation is at least in part an outcome not just of over accommodative macroeconomic policy (the conservative macroeconomic view), but of distributional conflict between capital and labor. When bargaining power is more equal, exogenous price shocks take longer to propagate through the economy and cause higher and more persistent inflation. After an exogenous price shock, firms raise their price level to preserve profit margins, at the expense of real (inflation-adjusted) wages. Workers who have some degree of bargaining power can respond by demanding higher nominal wages to claw back the lost ground. Firms then pass on the higher wage costs into higher prices and so on. The longer this process goes on, the steeper and more persistent is the inflation. Conversely, if firms are able to pass on higher prices in response to the initial cost-shock and workers lack the bargaining power to demand higher nominal wages in response, then the shock is muted and leads to lower and less persistent inflation.

What made the oil price shocks especially effective in generating subsequent wage-price spirals in the 1970s were the atypically strong perceptions held by American workers about

their own bargaining power, as well as expectations of real-wage growth fostered by decades of rapid and equal economic growth.

Coming into the 1970s business cycle, American workers had seen wage-growth track productivity growth for most of the past three decades, and this productivity growth averaged 2 percent per year. They had also come off a decade from 1959 to 1969 that saw unemployment average 4.8 percent, and that had reached lows of 3.5 percent in 1969. Further, key labor standards in the U.S. labor market were quite strong in historical terms. Private-sector unionization rates were 24.2 percent in 1973, more than twice as high as they are today. The inflation-adjusted value of the minimum wage reached its highest point ever in 1968 after three decades of rising (roughly) with economy-wide productivity.

An objection to an analysis putting the 1970s inflation at the feet of wage-price spirals has traditionally been that it implicitly "blames the workers" for inflation's rise, and seems to acknowledge the need for reducing workers' bargaining power as an anti-inflation strategy. This is not so. For one, the root causes of the inflationary episode of the 1970s were two oil price shocks. For another, a wage-price spiral following such an exogenous shock requires, by definition, *both* wages (driven by workers' desire to protect wages' purchasing power) *and* prices (driven by firms' desire to protect their profit margins) to rise. Blaming this spiral on workers alone would be odd. It's true that one hears the phrase "labor militancy" more than "capital militancy" when the subject is inflationary wage-price spirals, but I'd argue that this is mostly because it is generally *taken as given* that capital will be militant in protecting its share of income. What is remarkable are those episodes where the economic context actually provides labor the chance to push back and try to protect their gains when such an exogenous cost-shock happens.

As "labor militancy" is generally synonymous with broadly-shared distribution of economic growth during normal times, it seems that attacking American labor's bargaining power in the name of forestalling once-in-a-generation wage-price spirals occurring after large and unpredictable outside shocks is a demonstration of throwing the baby out with the bathwater. Given this, as well as the huge macroeconomic costs inherent in the early 1980s episode of recession-induced disinflation, Galbraith (1997) makes the obvious inference from this episode:

> It would therefore be reasonable to approach anti-inflation policy in general as a matter, first and foremost, of designing circuit breakers for shock episodes, so as to reduce the cost of adjusting to a new pattern of relative prices and therefore the need to do it through the brute-force method of mass unemployment. Some simple steps, like coordinating the timing of wage bargains and providing the president with limited discretion over cost-of-living adjustments in Social Security, federal pensions and other payment streams might help a great deal, as I once proposed.

In short, while the 1970s inflation was indeed tamed in the wake of the conservative paradigm shift, this does not mean that the CPS was most efficient way to tame this inflation, or that the benefits of the CPS's anti-inflation rationale outweighed the costs it imposed on

both the broader economy, and, especially, on the living standards of low and moderate-income households.

BOOSTING PRODUCTIVITY, OR JUST PROFITS? COMBATING PRICE INFLATION, OR JUST WAGE-INFLATION?

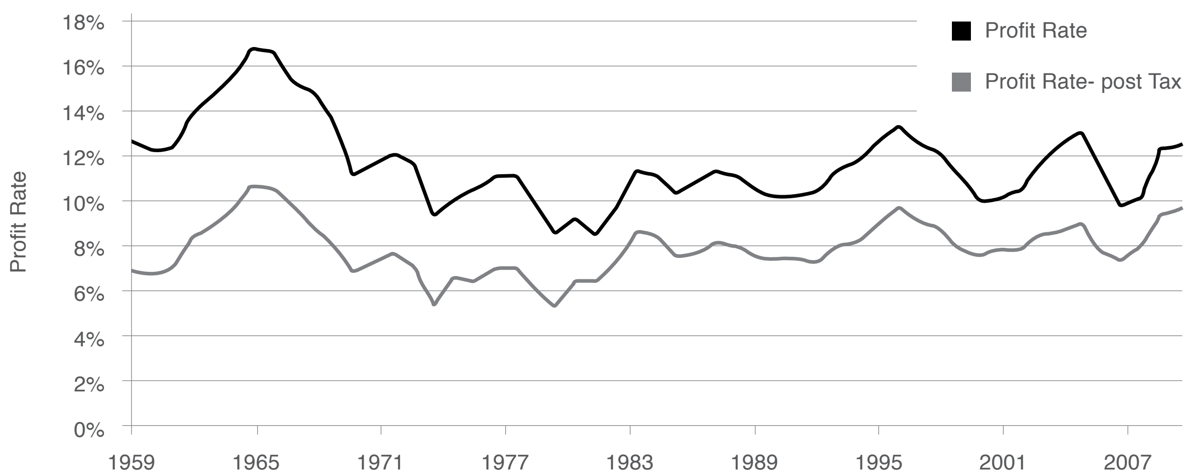
If there is little evidence to link the conservative paradigm shift to either accelerating productivity or efficiently-realized and valuable declines in inflation, the question is, ***should the CPS be considered a failure for the U.S. economy?*** The answer to this question brings us back to our opening observation: it depends which U.S. economy one is referring to.

If the economy in question is the one experienced by the vast majority of American workers and households, the answer is clearly, ***"Yes, it has been a failure."*** If the economy in question is the one experienced by the richest 1 percent of American workers and households, the answer is clearly, ***"No, it has been a roaring success!"***

Of course, the fact that the conservative paradigm shift has had much more profound effects on distribution than growth may well be no accident at all. Another way to view the trajectory and purpose of the conservative paradigm shift is to redefine the problem it sought to solve: not lower productivity growth and inflation, but simply reduced profitability.

The extremely tight labor markets and strong labor standards in the late 1960s and early 1970s boosted wage-growth and provided what some authors have labeled the "full employment profit squeeze." It is clearly the case (see Figure 3) that the corporate profit rate—which had been quite healthy during most of the post-war period, began falling in the late 1960s and fell further throughout the early 1970s.

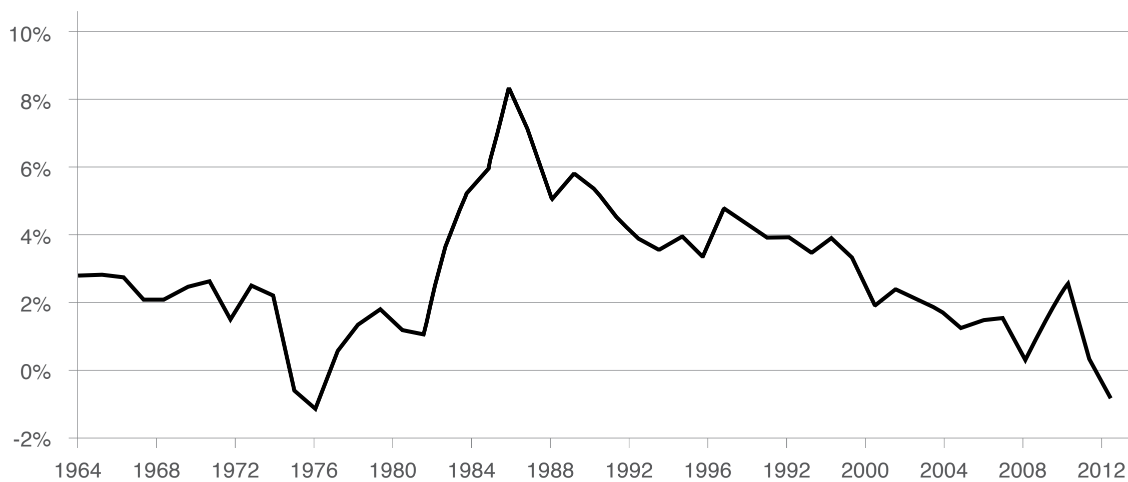
Figure 3. Pre- and Post- Tax Profit Rates, 1959–2011



† *Author's analysis of data from Bureau of Economic Analysis National Income Product Accounts tables (table 1.14) and Bureau of Economic Analysis Fixed Assets Accounts tables (Table 6.1)*

Further, the inflation of the 1970s was largely unanticipated—driven by exogenous shocks and unexpectedly strong (implicit) bargaining demands from American workers. This unanticipated inflation (along with a still tightly regulated financial sector, compared to today's) led to negative real interest rates for a significant portion of the 1970s (see Figure 4). In this light, Smithin (1996) has described the conservative paradigm shift as the "revenge of the rentier." In particular, low returns to investing pushed the financial sector to lobby ferociously for deregulation that would allow them to undertake more profitable (but risky) activities.[10]

Figure 4. Real Interest Rates on 10-year Treasury bills, 1964–2012



† *Author's analysis of Federal Reserve Economic Data, Federal Reserve Board, St. Louis (2013)*

Besides the increased bargaining power enjoyed by American workers as a result of the full employment period in the late 1960s, corporate interests also saw threats from other social movements. The famous "Powell Memo" is in some sense the Rosetta Stone of the conservative paradigm shift. In it, Lewis F. Powell (then a corporate lawyer working in the tobacco industry, later appointed to the Supreme Court in the Nixon administration) wrote of the dangers of all perceived threats to corporate profitability, including labor unions, consumer and environmental movements, and progressive taxation:

> "No thoughtful person can question that the American economic system is under broad attack... We are not dealing with episodic or isolated attacks from a relatively few extremists... Rather, the assault on the enterprise system is broadly based and consistently pursued... In addition to the ideological attack on the system itself (discussed in this memorandum), its essentials also are threatened by inequitable taxation and—more recently—by an inflation which has seemed uncontrollable."

Seen more simply as an attempt to insure that corporate profitability would no longer be threatened by overly-empowered workers (including workers able to force nominal wage increases rather than submit to having exogenous price increases show up solely as reductions in real wages) and other progressive social forces, the conservative paradigm shift looks like a much more sensible and straightforward exercise. It also looks like an exercise that could hardly fail once it was enacted; and it did not fail. Measuring from peak to peak, corporate profitability rose throughout the 1980s, 1990s and 2000s. And even today, with the overall economy depressed at levels *far* below the worst points of the recessions of the early 1990s and early 2000s, corporate profits are healthy—having long ago passed pre-recession peaks and registering the highest share of total corporate income since the early 1950s.

Corporate profitability is front-and-center in this narrative of the forces leading to the transformation of economic policies over the last generation. Skeptics might argue that, as a matter of arithmetic, the shift from labor income to corporate profits explains a non-majority (though still significant) portion of the entire rise income inequality. This is true. Yet the focus on profitability still serves extraordinarily well as a proxy for larger issues of inequality and economic power.

For example, while the single largest contributor to the rising share of total income claimed by the top 1 percent is growing inequality of labor income, in fact, the labor income enjoyed by the top 1 percent is influenced heavily by stock options and profit-based performance bonuses. In short, much of the "labor income" enjoyed by corporate executives and financial professionals (who together account for more than 60 percent of top 1 percent incomes) is actually more profit-like in origin and is tied mechanically to enhanced corporate profitability.

Further, while the decline of corporate profitability spurred the corporate defection from the prevailing social contract and gave rise to the conservative paradigm shift, the fallout of this defection was an across-the-board rewriting of the rules of the game concerning income distribution. So, beyond allowing well-placed economic actors to boost firm profits, norms regarding relative pay of managers versus production workers, and executives versus other white-collar workers, were often jettisoned. Take the influence of unions. Clearly, a suppression or rollback of union power was undertaken in large part to boost corporate profitability. Equally as clearly, unions not only influence the division of value-added between profits and wages, but also set norms concerning the intra-wage distribution. For example, unions are an important check on excessive executive pay.

So, while the immediate spur to the conservative paradigm shift was the perceived crisis of profitability, the resulting re-writing of the economy's rules of the game was not limited to enlarging capital's share of income compared to labor's share. Instead, well-placed economic actors strove for bigger gains across and within all income categories, and generally achieved them.

WHAT ALLOWED THE CONSERVATIVE PARADIGM SHIFT TO HAPPEN?

We have argued that the marketing rationale for the conservative paradigm shift was that it could solve the problems of slow productivity growth and stagflation, but the real rationale was to preserve (and expand) the economic rewards going to the very top. This begs the question—how is it possible for this policy shift, no matter how well-marketed, to have been passed by policymakers that are (presumably) answerable to the great mass of voters who were made worse off by it? Another angle on the same question recognizes that, presumably, it would always have been good for elite business interests to kick away props of labor's bargaining power to boost their own profits. So why were these props allowed to persist as long as they did, and/or what changed in the late 1970s that allowed the conservative paradigm shift to happen?

Levy and Temin (2007) identified the matrix of economic and social institutions that shaped income distribution in the thirty years after the end of World War II as "The Treaty of Detroit," and argued that it essentially constituted a social contract between American households, corporations and government to insure the broad distribution of gains from economic growth. The Treaty of Detroit was associated with steady and high profitability to business interests throughout the post-war period. Developments in the 1970s threatened this. One could imagine it was never worth the risk to business elites in the decades after World War II to mount a full assault on the prevailing social contract. Once profitability began falling and negative real returns to financial investment reared their head, this balance changed.

But there remains the puzzle of why this corporate defection was allowed. Part of the explanation for this is that the U.S. economy did indeed begin performing poorly in the 1970s relative to previous decades. This was an objective change in circumstances. Productivity slowed and inflation began accelerating. In short, the returns to American households historically delivered by the Treaty of Detroit began looking much less certain.

Additionally, there really was an objective change in the stance of the economics profession towards the desirability of active Keynesian demand management. Much of the academic macroeconomics community came to argue that such demand management could not keep unemployment lower in the long run, and would only lead to a buildup of inflationary expectations. It may seem aggrandizing to chalk up much of the actual change in policymaking to academic economics, but that does not make it untrue. A key lesson of much recent political science literature is the wide flexibility policymakers have to ignore public opinion. A related lesson is the heightened sensitivity of policymakers to elite opinion.

Academics and the recommendations they put forward are one form of elite opinion that may disproportionately influence policymakers. Another far more salient form of elite opinion is that proffered by corporations and individuals providing the financing for politicians' electoral campaigns. The increased role of money in politics (aided by several Supreme Court decisions that have rolled back limits) over the past generation does not map *perfectly* onto policy changes over this time, but the evidence is overwhelming that policies

favored by the affluent are much more likely to be adopted by policymakers than those favored by low and moderate-income voters.

Finally, it should be noted that one external, largely apolitical development may have also changed much of the calculus of business elites regarding the social contract: the acceleration of global integration with much-poorer countries. Trade "openness," measured simply as the sum of imports and exports measured as a share of GDP, actually grew more rapidly in the 1970s than in the 1980s—even when excluding oil. This growing global integration could be seen as vastly improving capital's bargaining position vis-à-vis labor. Essentially, the prospect of moving production offshore gave firms a much improved fallback position in bargaining over wage-demands. Previously, if such bargaining broke down, production stopped. Now, a breakdown in bargaining could lead to moving production offshore.

Between the objective change in economic circumstances that provided the motivation for undertaking a potentially risky campaign to radically change the terms of the social contract, the support from professional macroeconomists to begin targeting low rates of inflation regardless of the short term effect on unemployment, and the greatly improved fallback position in bargaining afforded by globalization, the conservative paradigm shift can actually begin to seem almost over-determined.

INEQUALITY BEFORE AND AFTER THE GREAT RECESSION

We noted before how damaging the rise in economic inequality was for the living standards of low and moderate-income American households in the three decades before the Great Recession began. This section will look more closely at the impacts of growing inequality, both in terms of living standards and in relation to analyses of the Great Recession and its causes.

Inequality's Relevance Before the Great Recession Began

The rise in inequality since 1979 had by 2007 essentially constituted an annual tax of 27 percent on the comprehensive household income of families in the middle-fifth of the income distribution. That is, had income growth for the middle quintile tracked average growth in the 1979-2007period (as it had in the decades following World War II) instead of lagging behind average growth, incomes for middle-quintile families would have been 27 percent (nearly $20,000) higher in 2007. The wedge between average income growth and middle-quintile growth is, of course, nothing but a function of rising inequality (as extraordinarily high growth rates at the top pulled up the overall average). The size of this "inequality tax" contrasts rather sharply with the roughly 3 percent federal income tax that these families pay. Further, this rise in inequality was much more damaging to income growth for moderate income families, compared to the impact of declining overall growth rates after 1979.

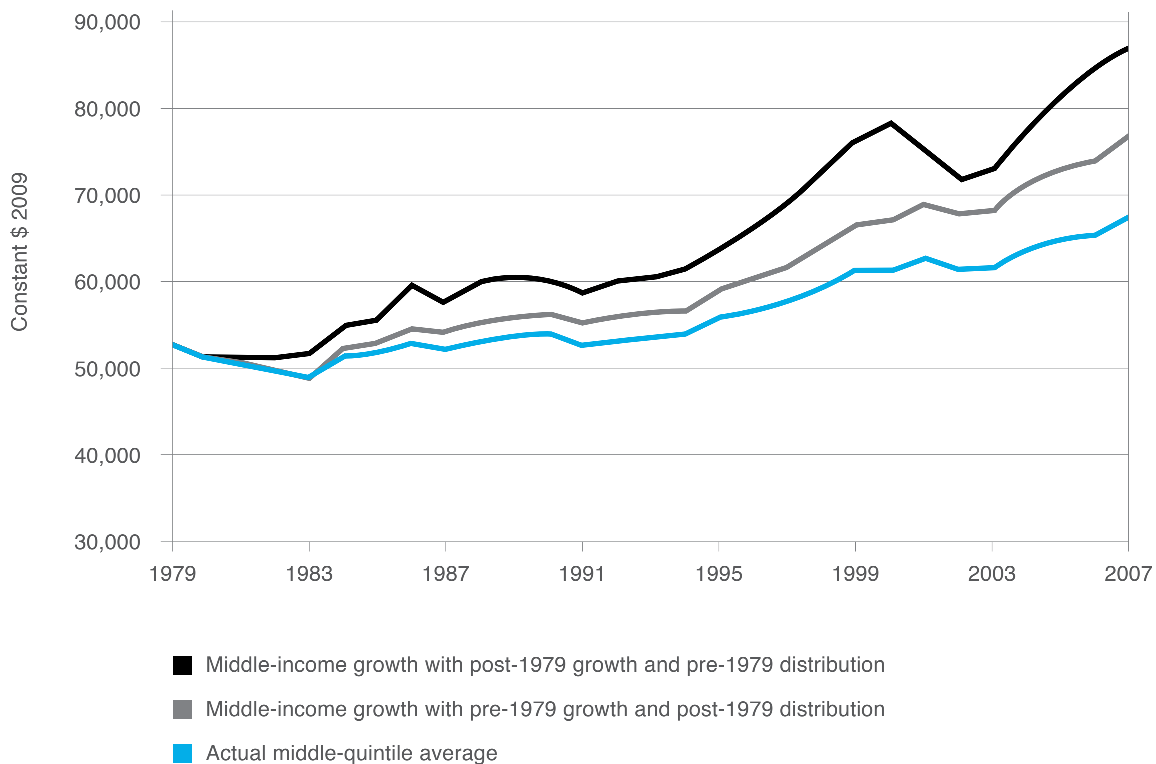
The figure below shows the wedge between growth in average *overall* comprehensive income (as measured by the CBO, and which includes non-cash benefits like employer-provided health care and the full value of all government transfers) and growth of the middle

quintile of the income distribution, from 1979 to 2007. Middle-quintile comprehensive income growth was 19 percent over this period, or roughly 0.6 percent per year, compared to overall growth rates of 1.5 percent.[11]

Figure 5 below shows actual comprehensive incomes for the middle quintile between 1979 and 2007 as well as what growth for the middle quintile would have been in two scenarios. In the first scenario, we essentially calculate what middle-quintile incomes would have been if *overall* income had risen at the rate that prevailed between 1947 and 1979 but the wedge between middle-quintile and average growth from 1979 to 2007 remained in place. In short, it shows the trajectory of middle-quintile incomes in the scenario where pre-1979 overall income growth came to pass, but post-1979 distribution prevailed.

In the second scenario, we simply allow middle-quintile income to rise at the overall average rate between 1979 and 2007. This scenario essentially charts their income if post-1979 average growth, but pre-1979 distributional patterns, held. By comparing these two scenarios, we can assess the sources of slower living standards growth at the middle, comparing the relative impacts of slower overall growth versus rising inequality.

Figure 5. Actual Middle-Quintile Growth and Two Scenarios



† *Author's analysis of Congressional Budget Office (2012), as described in text*

The findings are simply that the pre-1979 *average growth* combined with post-1979 *distribution* does indeed boost middle-quintile averages, from growth of 19.8 percent over the entire period to 28.9 percent growth. However, post-1979 (slower) *average growth* combined with pre-1979 *distribution* boosts middle-quintile income growth from 19.8 percent over the period to 53.5 percent.

In short, while the average income of middle-quintile households have clearly lagged in the latter period due to both influences, it is the post-1979 distribution that has more than twice the effect in stunting incomes for this group. Lastly, nearly 60 percent (19.8 percentage points) of the cumulative 34.4 percentage point gap between middle-quintile income growth and overall average growth between 1979 and 2007 can be accounted for solely by income growth of the top 1 percent.[13]

Inequality after the Great Recession

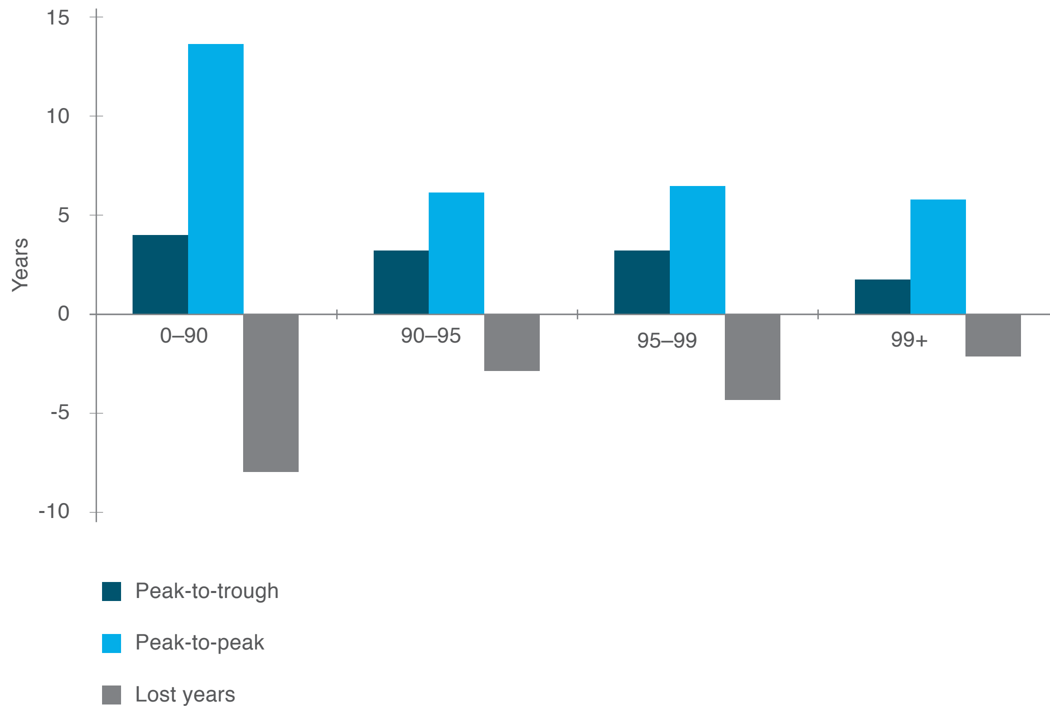
In the wake of the Great Recession, employment issues have supplanted growing inequality in the policy debates of concerned leaders. It is clearly correct that joblessness and underemployment are the most pressing challenges facing most people in the economy today. This is particularly true when considering how the impacts of high unemployment and underemployment reach far beyond those directly affected. For example, wage and income growth even for those workers and households that remain employed is much lower during periods of high unemployment, due to labor market slack. If unemployment follows the projected path seen by official and private-sector forecasters in the coming years, it is almost certainly the case that middle-income families will see two full decades of lost income growth, with incomes in 2018 below what prevailed in 2000.

However, there is much to learn about the crisis of joblessness from examining the conservative paradigm shift described in this paper. For one, even in the recovery from the worst recession since the Great Depression, inequality trends seem determined to plough forward. Top 1 percent incomes actually fell more sharply than others' in the *immediate* aftermath of the recessions of 2001 and 2007/09. The reason for this is pretty clear: recessions caused by bursting asset bubbles—as in 2001 and 2007 compared to the early 1980s and the early 1990s—are likely to strike hardest, initially, at the wealth-heavy households at the top of the income distribution The large drops in top 1 percent incomes following the past two recessions led some to speculate that the recessions could provide a permanent break in the rise of the top 1 percent's share (see DeParle [2011] and McCardle [2011]). Both times, however, this idea proved false and income growth of the top 1 percent quickly began outpacing middle- and low-income growth by large margins.

Figure 6 below shows some summary measures of how damaging recessions are to the income trajectory of various fractiles. The bars show the average time-lag between the peak and trough income registered for each fractile following recessions, the time for the previous peak to be surpassed, and how far back in the past one must go to find an income level below the given recession's trough (which we call "lost years" of income due to recession losses).

The figure averages data for recessions between 1979 and 2007. The take-away from the figure is clear: the top 1 percent sees fewer years of income declines, regains previous peaks more quickly, and actually experiences fewer "lost years" due to income declines accompanying recessions.

Figure 6. Income Losses During Recessions and Subsequence Bounceback by Income Percentiles: Years-to-Trough, Years-to-Peak, and Years Between Trough and Previous Instance of Low Income Levels, 1979–2007



† *Author's analysis of Congressional Budget Office (2012), as described in text*

For fractiles between the 0 and 90th percentile, the income trough following a recession is reached in 3.7 years on average, pre-recession peaks are reached an average of 12.7 years following, and a recession's trough is associated with 7.3 lost years of income. For fractiles below the top 1 percent but above the 90th percentile, the trough tends to be reached in 3 years, the pre-recession peak is regained in 5.7-6 years, and the trough represents 2.6-4 lost years of income. For the top 1 percent, the trough is reached in fewer than 2 years, the pre-recession peak is regained in 5.3 years, and the trough represents 2.0 lost years of income.

For the latest recession, this pattern has continued. For the fractiles between the 0 and 90th percentile, 2011 (the latest year available) represents the trough, while for the topmost three fractiles, incomes have been rising since 2009. The pre-recession peak has not been reached by any of the fractiles yet. Most strikingly, incomes for the 0 to 90th percentiles in 2011 were last this low in 1967 (note that no other recession since 1979 saw this group's

market-based cash incomes pushed back so far). Fractiles above the 90th percentile, on the other hand, experienced only modest losses; even at the trough in 2009, incomes for the top ten percent of households were only pushed back to levels that prevailed in the early to mid-2000s. Again, while it is true that, during the past two recessions, the top 1 percent have seen very large one-year declines in income associated with collapsing asset prices, it is very hard to make the case that recessions are somehow harder on the top 1 percent, or that we should expect the Great Recession to have broken the trend towards ever-greater inequality.

Further, there are lots of reasons to think that the cause and solution to the recession and its impact on labor markets is intimately tied up with long-run trends regarding inequality. For example, there is suggestive evidence that the housing bubble was not just the source of the Great Recession, but was itself a coping mechanism seized on by American households in the years before the Recession to provide living standards growth (ephemeral as this growth turned out) in the face of wage and income stagnation.

Moreover, the most direct way that inequality is relevant to the weakness of the current recovery is rooted in the extreme profit-bias of recent income gains. 2012 saw the highest corporate profit share since the mid-1960s, and since 2008, profits have accounted for about 66 percent of total income gains in the corporate sector. At the same time, while business fixed investment is actually performing well relative to historic averages (the only component of GDP for which this is true), it still lags far behind the rise in retained earnings, meaning that American corporations continue to accumulate ever-growing hoards of cash on their balance sheets. If these income gains were instead directed towards labor compensation increases rather than profits, it is a sure bet that aggregate demand would have grown faster and the recovery would be stronger.

Most importantly, the failure of public policy to support a robust recovery is itself, arguably, a consequence of growing inequality. As noted above, while most aspects of the U.S. economy remain deeply depressed relative to pre-recession performance, corporate profitability has fully recovered and then some. This aspect of inequality not only mechanically hurts recovery by concentrating income gains in the hands of those actors less likely to use them to spur demand, it also blunts the incentive for powerful actors (the corporate sector) to lobby aggressively for policies to reflate the economy. As a result, the traditional role of fiscal stimulus is undermined: if government spending since the official end of the Great Recession had simply matched its historical average over previous business cycles, the U.S. economy would have had roughly 5.5 million more jobs by the middle of the 2013 and would be two-thirds of the way back to full labor market health. Instead, government spending has been extraordinarily contractionary in relative terms over the most recent recovery. Normally, the corporate sector should be a powerful ally in demanding that deep recessions be countered with expansionary public spending, but when historically high profits exist with high unemployment, there is much less pressure for U.S. firms to join the fight for full employment.

CONCLUSION

Academics and policy-minded social scientists have begun to examine how rising inequality may or may not affect overall economic growth. This is clearly an important topic worthy of study. But it probably starts at too high a level of abstraction; for assessing whether or not rising inequality has been "good, bad, or neutral" with respect to either overall growth or low- and middle-income growth, one really needs to know what drove this rise in inequality. If we believed that inequality was being driven by efficient and competitive markets for labor and capital, rewarding skills and savings to the degree needed simply to elicit their supply, proposals to fix inequality would be seriously vulnerable to concerns about tradeoffs with economic growth.

As argued in this paper, such an understanding does not adequately describe the causes of rising inequality in the U.S. economy over the past generation. Instead, rising inequality is the direct result of a range of policy choices that predictably boosted bargaining power for those at the top of the income and wage distributions. Further, the evidence seems clear that this sort of inequality has clearly not boosted overall growth—meaning that it has simply resulted in stunted living standards growth for those at the bottom and middle of the income distribution. Given all of this, studies of what a "generic" rise in income inequality might or might not tend to do in a cross-section of country/year experiences seems uninformative as to just how damaging the rise in American inequality has been, and what will be needed to reverse it.

In closing, it is important to note the good news in this analysis. Inequality that is the outcome of competitive and efficient markets simply allocating talent and savings would be quite hard to solve without damaging economic growth. In short, the equity/efficiency trade-off would be steep indeed, due to binding economic constraints. Conversely, inequality that is the result of political choices can be solved without running into these steep trade-offs. To be clear, *political* constraints to reversing inequality are clearly daunting, but they are always preferable to genuine *economic* constraints.

1. It should be noted this data uses the cash, market-based incomes dataset compiled by Piketty and Saez (2003, updated). While the comprehensive income measure (which includes government transfers and non-cash employer benefits like health insurance) compiled by the Congressional Budget Office shows better growth at the bottom and middle, it also shows huge increases in inequality, and, the CBO data does not cover years before 1979, making these epochal comparisons impossible.
2. One of the most persuasive efforts at putting politics front and center in the debate over rising inequality was Hacker and Pierson (2010).
3. For evidence on policy's barriers to willing workers forming unions, see Freeman (2007) and Schmitt and Zipperer (2007). For evidence on unionization's impact on inequality, see Western and Rosenfeld (2011).
4. See Baker (2003) for examples of some of these protections. Perhaps the most obvious example is new licensing rules that cut the flow of foreign-trained physicians into the United States by 50 percent, following the lobbying of the American Medical Association for such restrictions.
5. See Haldane (2009).
6. See Mishel et. al. (2012).
7. See Mishel et al. (2012) for evidence on this.
8. See Blinder (1987), Bruno and Easterly (1996) and Epstein (2000).
9. Calculated as output lost during the official recession, as well as periods during the early recoveries when the output gap exceeded 1 percent.
10. Sherman (2009) has a good review of the regulatory changes made since the 1970s in the financial sector.
11. In the latest edition of CBO's comprehensive income data, they deflate nominal incomes by growth in the deflator for personal consumption expenditures. We are not convinced that this is the appropriate deflator, and maintain the CBO's earlier practice of deflating with the CPI-U-RS. While there are some problems potentially addressed by the PCE deflator (the problem of substitution bias and the too-small share of health expenditure in the CPI consumption basket), it remains the case that the universe covered by the PCE deflator is larger than households, and contains non-profit institutions. This potentially introduces problems; for example the share of PCE expenditures on information communications technology and equipment is significantly larger than their share in the CPI consumption basket. This has real consequences as ICT prices have fallen extraordinarily fast in recent decades.
12. While the comprehensive income measure does not go back beyond 1979, we know that overall personal income growth per capita (measured from NIPA data) was slower between 1979 and 2007 compared to the 1947 to 1979 period—2.2 percent in the former period compared to 1.7 percent in the latter. We also know that government transfer payments and non-wage market incomes did not grow faster in the latter period overall, so unless these have become much more directed towards the middle-quintile and less directed towards the top reaches of the income distribution, it is unlikely that these substantially offset the much slower growth rate of money income in the later period. Given this it seems possible to get a sense of what the impact of rising inequality between 1979 and 2007 has been on middle-quintile income growth, and to compare it to the likely impact of the slowdown in overall growth compared to the 1947-1979 period.
13. Of course, this exercise implicitly presupposes that one can assume that redistribution away from the top could have been (or could be) accomplished without damaging overall economic growth. Is this a safe assumption? We think the data bears it out. Besides the evidence assembled above indicating that the growth of these incomes are largely rents, a number of recent studies have looked directly at the issue of shifting top shares on overall economic growth. Piketty, Saez and Stantcheva (2012) and Andrews, Jencks and Leigh (2011) use international evidence to see if there is stark evidence that top shares effect overall growth.

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Agrarian Collectivities: Cooperative Approaches to Empowering Women and the Poor*

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In the 1980s, when Bangladeshi women formed work groups with support from the NGO, BRAC, and began working outside their homes, many for the first time, they said: "The most important thing I learned … is that we are strong as a group. We can withstand pressure but alone we are nothing. A house cannot stand on one post. Put a post in each corner and it is strong!"

Indeed, grassroots action across the globe demonstrates that collectivities of the poor can improve their well-being in ways that individual approaches cannot—by enhancing their incomes, their self-respect, their ability to challenge oppressive social norms, and their bargaining power in markets, at home and with the state.

Many developing countries today—India, China, Brazil, and others—are seeing high economic growth, but also widening inequality, persisting poverty, and a declining ecology and moral order. For the poor to gain, we need a new approach to development—one that does not place the individual at the center of all analysis and policy; and which displays low tolerance for poverty, inequality and environmental destruction.

* This essay is adapted from a lecture delivered on the occasion of the award of the degree of Doctor Honoris Causa to Bina Agarwal at the Lustrum Ceremony of the 55th Anniversary of the Institute of Social Studies, The Hague, The Netherlands, October 18, 2007.

The poor, especially in market economies, need the strength that collectivities can offer for their economic, social and political advancement. But these collectivities should provide the poor with real resources, not just credit; they should reach beyond micro-enterprises through horizontal and vertical alliances; and be able to challenge hierarchies and not be embedded in them.

In the past few decades we see two opposing trends. A growing attack on the idea of production collectivities on the one hand, and the emergence of a diverse civil society and micro-collectivities on the other. Production collectivities, one of the hallmarks of socialism, have come under increasing attack both from practicing socialists and free market theorists. Socialism's history of forced collectivization, especially under the USSR, with its inefficiencies and human costs, did little to endear concepts such as common property and collective functioning. Equally, most experiments with farmer cooperatives in non-socialist societies, promoted without due recognition of socio-economic inequalities among farming communities, had little success as production units, or as a means of empowering the poor. In the minds of most people, such failures of implementation regrettably discredited even the idea of production collectivities.

Increasingly in both socialist and other countries, economic reforms have strengthened individual property rights. In China, for example, a key element in the mid-1980s reforms was the shift from community-based use rights in land and communal farming to mostly household-based use rights and family cultivation. These shifts represented a pessimism about collective functioning, especially in efficiency terms.

A similar pessimism pervaded economic theory, be it Mancur Olson's book on *The Logic of Collective Action*, Garrett Hardin's article on "the tragedy of the commons," or game theory. Rational human beings, driven by self-interest, it was argued, will tend to free ride, and assuming that everyone thinks this way, none will have the incentive to produce the collective good, even if it were in everyone's interest to do so. Only coercion can lead people to act collectively. Is this pessimism warranted?

Recent developments, theoretical and empirical, suggest otherwise. In theory there is growing recognition even by economists that many factors can help cooperation, including: repeated interactions that promote assurance; trust and reciprocity; peer pressure, especially in small groups, which can rein-in free riders; and shared social and moral norms which help transcend narrow self-interest. In practice, there is recognition of a long history of group functioning—traditional labor exchange systems, social movements, and civil society formations. Indeed, today we are seeing the emergence of numerous collectivities, including collectivities of the poor.

But it matters a great deal what kind of collectivities we foster. In recent years, the fastest spreading collectivities have been micro-credit groups, inspired especially by Bangladesh's Grameen Bank. These have become the panacea for poverty alleviation within mainstream development practice. But the impact of micro-finance institutions on poverty has been limited, and they have done rather little toward creating productive assets in the hands of the poor or challenging structural inequalities.

THREE TYPES OF COLLECTIVITIES

To be transformative, I believe collectivities of the poor need to go beyond the idea of groups simply as instrumental and apolitical social capital. They need to encompass at least four features:

- They should enhance poor people's control over productive resources;
- They should include the most disadvantaged, namely, poor women;
- They should reach beyond the micro and beyond the local; and
- They should be able to challenge social and economic hierarchy and so help transform social relations.

I will focus on three types of Indian collectivities, which involve the poor and the deprived, to see what lessons they hold on these counts. My core examples are women's group farming and community forestry groups. These are by no means the only types of production collectivities in the region—I could name many other rural and urban groups. But the two I have chosen have created new systems of property rights. Both relate to major resources—one to agricultural land, the other to forests—access to which is key to the well-being of millions. Both have transformative potential, and they also demonstrate the contrast in outcomes depending on whether collectivities challenge social hierarchies or ignore them. I also point to an example of a third type of collectivity—women's self-help groups—as a potential link for strengthening the other two and transforming itself.

GROUP CULTIVATION

Consider first women's group farming. A vast body of South Asia's poor remain dependent on household-based small-scale agriculture. Today we are also seeing a feminization of agriculture, as more men than women move to non-farm work. In India, for instance, 53 percent of male workers, compared with 75 percent of women workers, remain in agriculture, most cultivating under one hectare. Even as the face of the farmer becomes increasingly female, few women have direct access to the farmer's main resource—agricultural land. Families transfer land mostly to male heirs, the state transfers land largely to male household heads, and markets favor men over women, since men have more financial resources. Also, individual women cultivating small plots face resource constraints for buying inputs, and scale diseconomies in capital investment. However, if we set aside the assumption that farms are best cultivated only on a family basis, there is an institutional solution to these problems, namely, group-farming by women.

There are several success stories of landless women doing exactly that, with support from local NGOs. In Andhra Pradesh in South India, for example, with the support of the Deccan Development Society (DDS), poor, low-caste women have been leasing-in or purchasing land in groups, through various government credit schemes, and practicing group farming for subsistence. I have visited their program and talked with the women farmers on several occasions.

The group leasing program, started in 1989, now involves several hundred women, cultivating in groups of 5 to 15, across 52 villages. The groups are financially viable. The harvest is shared equally by the members. Many landlords now want to lease their land to these groups, confident that they, unlike individual leasers, will not default. Similarly, many low-caste landless women's groups have jointly purchased land, again using subsidized government credit. Catalyzed by DDS, women form a group, apply for the loan and buy land which is divided equally among the members and registered in individual names. Each woman owns one acre but pools the land for farming with other women, in groups of 8 to 10. Today, poor women's groups in 14 villages are cultivating several hundred acres of purchased land. On both leased and purchased land, women practice organic rain-fed farming and multi-cropping to reduce the risk of crop failure and provide a balanced diet.

Collective cultivation allows women flexible work time, cost sharing, and the pooling of differential skills. The women travel to town to meet government officials, buy inputs, and market the produce. As they affirmed to me: "Collective cultivation is better; both the labor and the produce is shared. It creates a better feeling. It builds solidarity."[1] Free riding is contained by penalizing work-shirkers in women's weekly meetings.

As a result, farm productivity and family food security have increased. Children's health care and education have improved. Women report less domestic violence. They now bargain for higher wages when they need extra work—since they now have a choice, they can refuse low paid work. They also get more community respect. As some women said: "They [the high caste people] used to call us with the caste name which was very derogatory….Now they put the motherly (respectful) suffix, and give us equal seats [in public gatherings]. It is only because we have an organization that they [the landlords] won't touch us—that they are scared to cross us."[2] Local government officials also give them priority over individual men.

This collectivity has four important features. Three of these—a gender-progressive NGO, a group approach, and a focus on landless women—are also found in many other grassroots initiatives. But the fourth feature—the focus on land and group farming—is rare. Also, these collectivities allow women to access land through the market-access which individual women seldom have. Further, pooling land for cultivation helps overcome problems of small farm size and fragmentation. Indeed, group farming offers potential benefits not only for landless women but also for women who own or have customary rights over small plots.

Unlike forced socialist collectivization, these initiatives are voluntary in nature. Unlike many non-socialist cooperatives, tried in India and elsewhere, which involved both big and small farmers, these groups are constituted only of the poor and of women. That they are all women's groups is important in that it gives women independent access to assets, control over income, self-confidence, and social support which they would not easily gain in cooperative, family-based farming. Although small in scale, the groups are an imaginative and effective way of creating collective property and dignified livelihoods for women and their families. Most importantly, they challenge hierarchies of caste and gender.

Women's farming groups can also be found in some other Indian states and in Bangladesh. The downside is that they are small in scale (a point to which I will return).

COMMUNITY FOREST MANAGEMENT

My second example of resource-related collectivities is of communities managing degraded government forests. In most developing countries, rural communities use forests for basic needs such as firewood, fodder, small timber, etc. Especially for the poor and women who own little private land, they have been critical for survival. Forests are also carbon sinks of crucial importance for decreasing global warming. In fact, over fifty countries are today working with local communities to better protect their forests.

In India today there are 84,000 community forestry groups (CFGs) involving over 8 million rural families protecting government forests in a co-management arrangement. States allow the villagers to make rules for extracting non-timber forest products and promise them a share of the mature timber when harvested. Typically the groups begin by banning forest entry to humans and animals. Some later allow restricted extraction of forest products.

In terms of forest regeneration, most CFGs have done well. India's forest cover increased by 3.6 million hectares between 1991 and 2001, a reversal of the earlier, alarming, downward trend. But from women's perspective, the picture is less rosy. Critically dependent on local forests for firewood, the initial ban on entry caused a manifold increase in poor women's firewood collection time. It was expected that, over time, as biomass availability increased the situation would ease and CFGs would allow collection. However, most groups continue with strong restrictions on extraction. As some poor women I interviewed said: "We go in the morning and only return in the evening. Since the end of the rainy season, we have been going every day… Earlier too there was a shortage of firewood, but not as acute." Substitute fuels, such as cropwaste, twigs and wood varieties unsuitable for fuel, increase cooking time and smoke emission, with adverse health effects for women and children, due to indoor air pollution.

Why isn't more firewood extracted? Apart from monitoring costs and the social invisibility of women's work time, an important factor is women's poor representation in CFG decision-making. In formal terms, CFG membership is open to all village households and the groups are based on modern ideas of equal citizenship rights, irrespective of class, caste or gender. In practice, in most CFGs, women constitute less than 10 percent of the decision-making bodies. Landless women are even less visible. The rules made for extracting forest products are thus overly strict.

Would women's better representation make a difference? My recent research, based on primary data collected for India and Nepal, shows that, indeed, it would. Groups with more women in their decision-making bodies—in particular if a quarter to a third of their executive committee is female—have better results on forest regeneration, and less firewood and fodder shortage. Most notably, where groups have a critical mass of landless women

on the executive committee, not only are they more likely to attend meetings and speak up at them, but they are also more able to change the rules to allow women greater access to firewood and fodder. The downside is that few committees have a critical mass of women, and especially of landless women.

Forest collectivities excellently demonstrate both the potential for cooperation in diverse contexts, and its limits if traditional hierarchies, such as social norms that exclude women from public decision-making, go unchallenged. In theory, these groups are based on ideas of social equality. In practice they remain embedded within unequal social systems. Much of the social capital and collective action literature which celebrates traditional norms as providing the cement for cooperation misses this gendered, dark side of norms. As recent critics of social capital point out, it also misses the economic and social hierarchies within which many networks that constitute social capital operate.

* * *

Both the collectivities I have described represent institutional innovations that have created new forms of collective property rights within a market economy. Both seek to involve the poor: all of women's farming groups and half the forestry groups are constituted of the poor. At the same time, the contrast between the groups is notable: group farming by poor low-caste women explicitly challenges social, especially gender, hierarchies, while forestry groups often further embed them. Group farming requires intensive NGO support in the beginning and is still geographically confined. Community forestry is geographically widespread but mostly gender exclusionary in practice. In other words, the form collectivities take, and the principles on which they are founded, are key to whether they help or hinder the disadvantaged.

Can the collectivities I have discussed overcome their limitations and broaden their reach and inclusiveness? Potentially yes, by building lateral and vertical alliances with other collectivities.

LATERAL ALLIANCES WITH SELF-HELP GROUPS

First, lateral alliances can help overcome the scale limitations of women's farming groups and the inclusiveness limitations of forestry groups. In particular, I have in mind a third type of collectivity—village self-help groups (SHGs).

There are around 2.2 million SHGs in India, almost all constituted of women. Although most SHGs begin as savings and credit groups, they differ from micro-credit groups in important ways. Micro-credit groups are formed basically around credit and often involve women with no proven record of working together. Loans go to individual women, and there is usually little focus on social advocacy. Many SHGs, by contrast, were catalyzed by NGOs for social empowerment rather than simply credit. Even those focused on credit select their own members, put in their own savings and need a proven record of working together before getting bank loans. Loans, if taken, go to the whole group, which then decides

how the money should be used. These features lay the ground for SHGs to take up group enterprises as well as advocacy work. Recent surveys suggest that about half the SHGs are formed of poor women.

Many have become pressure groups, lobbying village councils to improve water supply, education, healthcare and roads. Some also help very poor women directly, for example by purchasing daily items wholesale at low cost and providing them to poor women to tide them over during income troughs. In South India, especially, SHGs have empowered women by their sheer strength of numbers. As some groups told me: "when we turn up a thousand strong at a local fair, we don't have to say anything. Our strength is there for all to see." The downside is that SHGs do not always reach the poorest. Their being involved mainly in individual micro-enterprises is also a limitation.

Thus, we have three significant types of collectivities—women's group farming, community forestry groups and SHGs. Each has unique features as well as weaknesses. How do we overcome the latter? I believe the answer lies in strategic linkages between the three, that is between SHGs and CFGs on the one hand and between SHGs and women group-farmers on the other. This can empower poor women in all three institutions.

For instance, some NGOs encourage SHG women to attend forestry group meetings, thus creating a critical mass of female presence, and so influencing forestry decisions in women's interest. Similarly, some SHGs are collectively cultivating fish or tea. If they took up group farming it could expand the scale and geographic reach of women's farming and in turn move SHGs out of the narrow confines of individual activities toward economically stronger and more poor-inclusive group enterprises. *In short, strategic linkages between diverse collectivities of the poor with different strengths could transform each.*

VERTICAL ALLIANCES—FEDERATIONS

Second, collectivities of the poor need vertical alliances. Some forestry groups and SHGs have formed federations. But, as with groups so with their federations, much depends on the principles on which they are built. Used simply as a means of "scaling up," most federations fail to realize their transformative potential.

In Nepal, however, we have a unique example of a national level federation of community forest groups (FECOFUN). Formed in 1995, FECOFUN links CFGs across Nepal through elected representatives. It is the only federation of its kind which is national in scope, holds regular elections, and mandates that 50 percent of its members and office bearers be women. Influenced by this, village groups have also begun inducting women as office bearers. FECOFUN has in fact become a social movement, which participated in Nepal's democracy movement.

Of course, FECOFUN still has a way to go in terms of social inclusiveness. But its scale, democratic structure and efforts at gender equality are not just about scaling up but also about empowerment, and hold lessons for other regions.

TOWARD A NEW MORAL ORDER?

I now come to my final point. I have argued that the poor need the strength that production collectivities offer, for enhancing their socio-economic well-being and voice, and as a protection against free market individualism. But to deal with persistent inequality we need more. We need a new ethical code or moral order, such as one which explicitly challenges inequalities and exclusions, which upholds justice over personal gain, which recognizes the needs of future generations and not merely those of present generations, and which also values non-material well-being and not just material well-being.

In fact, the glimmerings of such a moral order already exist, in at least three streams of ideas:

- First, in the idea of equal citizenship, irrespective of race, caste, or gender, enshrined in numerous Constitutions across the globe.
- Second, in the idea that human capabilities and freedoms should be the basis for evaluating human progress.
- Third, in the idea of environmental sustainability, which highlights global interdependence, responsibility toward future generations and non-humans, and putting a cap on unmitigated consumption. As Mahatma Gandhi said: there is enough for everyone's need but not for anyone's greed.

Such ideas are already part of our public discourse. The challenge is to realize them in practice. But I believe they cannot be realized without including the poor. Here, collectivities of the poor, especially engendered collectivities, could be the key. I emphasize "engendered" since it is collectivities of poor women that are likely to have the most stake in and possibly the most potential for helping to shape an alternative moral landscape.

To sculpt such a landscape, we need both resistance and transformation. Let me illustrate these in women's own words. First I give an example of resistance, in the words of some poor women's groups in Bangladesh.[3]

> Why should we listen to the rich? They walked on our bodies.
>
> We do not listen to the mullahs (religious clergy) anymore. They did not give us even a quarter kilo of rice.
>
> We said to the *matbors* (village leaders): 'You may say whatever you like, but we will not listen to you. We are in the group and we will cultivate land.'

Next, consider two forms of transformation. The first quotation from a women's farming group shows how a collectivity can help people transcend individual self-interest and build solidarity to help others:

> Initially.... our families would ask: why are you going to meetings at night? But [then] we became a kind of mutual support group. If any woman fell ill or had a problem, the others would try and help. So it became a habit to meet, and we were not afraid of family disapproval. Gradually our families realized the importance of our [group] meetings.[4]

The second example, taken from a Bangladeshi women's group, illustrates the personal transformation that groups can bring. The women said:

> Before the village elders ... threatened us for joining the group, now they are silent... Before we did not know our rights to rations or medical services, now we are conscious and exert pressure to receive our due... Before we did not go outside our homes, but now we work in the fields and go to the town... Before our minds were rusty, now they shine...[5]

I do believe strategic linkages between such diverse collectivities can lead to transformative collective action and help forge a new moral order.

1. Bina Agarwal. 2003. "Gender and Land Rights Revisited: Exploring New Prospects via the State, Family and Market," *Journal of Agrarian Change*, 3 (1&2).
2. Agarwal, ibid, p.214.
3. Martha Chen. 1983. *A Quiet Revolution: Women in Transition in Rural Bangladesh*. Cambridge, MA: Schenkman Publishing House, pp 175-6.
4. Agarwal, op.cit., p. 214.
5. Chen, op.cit., p.165.

The Psychology of Economic Ideology: Emotion, Motivation, and Moral Intuition

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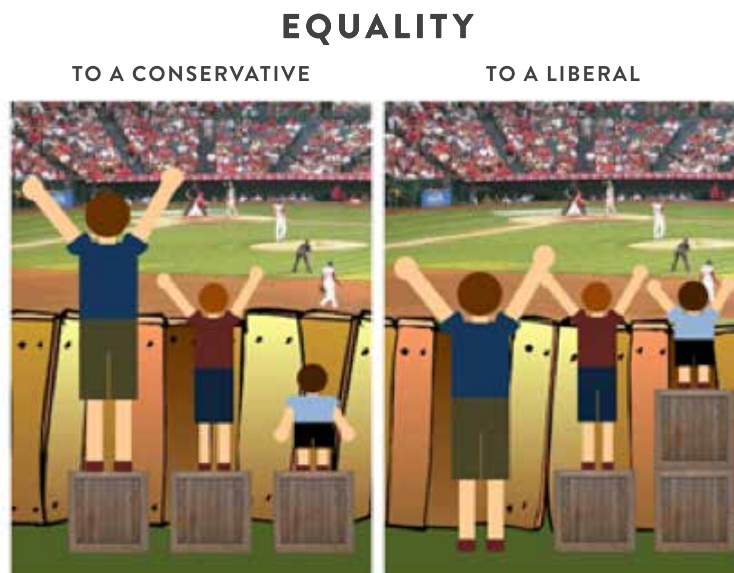
INTRODUCTION: GOING DEEPER THAN STRATEGIC COMMUNICATION

A popular recent meme on liberal social networks and left-leaning blogs summarizes ideological differences as follows:



While the partisan message is clear (only with liberalism's compassionate box-stacking does everyone get to watch baseball), conservative and libertarian critics of liberal equality also helped spread the image, mocking the inherent unfairness of giving some people more than others in order to ensure that outcomes are equal. What's more fair: giving everyone the same box to stand on (equality of opportunity), or distributing boxes so that everyone ends up in the same position (equality of outcomes)?

This conflict over a crudely-drawn picture on the internet illustrates a deep schism in American culture, coloring political debates over a wide range of topics—from affirmative action to health care to economic policy. Political campaigns have spent large amounts of money on strategic communications, trying to use key words or phrases to "frame" such issues in order to appeal to larger portions of the electorate (e.g., Lakoff, 2004). However, understanding ideological divisions over economic fairness requires going deeper than words and phrases, because these conflicting visions of fairness are rooted in different underlying intuitions, emotions, and motivations. Partisans on both sides tend to see their vision of fairness as the only vision a moral person could have, while the other side's vision must be either amoral (based on delusion, stupidity, or factual errors) or downright immoral (based on greed, dishonesty, or prejudice). However, psychological work on justice and morality provides evidence that *both* visions of fairness—which we refer to as equity vs. equality—are based on moral intuitions.

Main Point of This Paper

Our goal is to provide an empirical psychological review of the emotional and cognitive processes underlying economic ideologies, with a focus on fairness intuitions of equity vs. equality. Our main point is that these conflicting intuitions are powerful motivators for political and social behaviors (from voting to demonstrating), and understanding them will be crucial for motivating and enacting any societal changes in economic policy.

Roadmap of This Paper

In the next section of the paper we give an overview of current moral and political psychology, fields that have demonstrated the centrality of automatic intuitions in ideology, moral judgment, and moral behavior. In the third section we focus on the competing values of equality and equity, and the distinct goals, motives, and intuitions underlying these different visions of economic fairness. This section also uses the example of libertarians to show how a particular economic ideology has psychological roots in moral intuitions, interpersonal style, and degrees of emotionality in decision-making. In the fourth section we review evidence of experimental interventions that could be used to promote equality intuitions over equity intuitions. Finally, we end by describing future directions for the psychological understanding of economic fairness, highlighting further areas for policy applications.

BRIEF OVERVIEW OF CURRENT MORAL AND POLITICAL PSYCHOLOGY: THE IMPORTANCE OF INTUITIONS AND VALUE PLURALISM

Empirical psychology has seen a resurgence of interest in both morality and political ideology in the last 15 years, due in part to increased attention to non-conscious aspects of human thought and behavior (for detailed reviews see Haidt & Kesebir, 2008; Jost, Federico, & Napier, 2009; Nosek, Graham, & Hawkins, 2010). In this section we give an overview of this literature, beginning with political ideology.

A single left-right ideological dimension predicts a wide range of cognitive styles and behaviors. For much of the last century, the dominant thesis held by social scientists was that laypeople's political views were neither stable nor motivationally powerful enough for ideological differences to have a reliably meaningful impact on people's social policy stances (Jost, 2006). Instead, many scholars believed that public opinion was primarily manufactured by factors such as the temporary impact of current events and political rhetoric. While these factors clearly play a major role in the current state of partisanship in the United States and elsewhere, recent research suggests that the chasms between the policy positions of those on the left and the right also stem from more deep-seated individual differences. Psychologists have revealed biological and psychological differences between those on the left and those on the right, which play a significant role in people's views on economic inequality.

For instance, the results of twin studies suggest that political attitudes are partly heritable (Alford, Funk, & Hibbing, 2005). Though it is difficult to accurately quantify the influence that genes have on social attitudes, research suggests that about 20% to 40% of variability in political attitudes is related to people's genes (Martin et al., 1986). Similarly, recent physiological research has found predictors of ideological beliefs in non-conscious bodily reactions (Dodd et al., 2012). For example, political views can be predicted by physiological responses (startle eye blink, skin conductance) to threatening sounds and pictures (Oxley et al., 2012), with conservatives more automatically reactive than liberals. Finally, psychologists have recently discovered fundamental motivational differences between those on the left and those on the right. For instance, research suggests that conservatives attend more to aversive "avoidance" stimuli, such as perceived threats, whereas liberals attend more to pleasing "approach" stimuli, such as potential rewards; this manifests in debates about morality, with conservatives focused more on preventing the bad and liberals focused more on promoting the good (Janoff-Bulman, Sheikh, & Hepp, 2009).

Importantly, many critical individual differences affect political thought at an automatic or intuitive level, often outside of conscious awareness or control. One individual difference thought to have a non-conscious impact on policy views is "system justification," the motivated justification of existing social and economic inequalities (Jost & Hunyady, 2003). Conservatives are more likely than liberals to justify the economic status quo, while liberals are more likely to question the status quo in pursuit of greater economic equality. It is important to note that system justification occurs even when it is against one's own self-inter-

est to do so; for instance, conservatives who are relatively poor are more likely to justify the current level of economic inequality than poor liberals (Jost, Banaji, &Nosek, 2004).

It is also important to note that while research on left vs. right ideological orientations is often framed as a liberal-conservative dichotomy, most Americans fall in the middle of the spectrum (Pew, 2012), and those on the extreme left and extreme right represent a vocal minority. While cognitive and behavioral sciences have revealed many attitudes and preferences correlated with political ideology, it is thus important to keep in mind that for most Americans there can be some appeal to values most associated with liberals and those most associated with conservatives.

Like ideology, morality is increasingly understood as an intuition-driven phenomenon. As is the case with individual differences in ideology, individual differences in moral thought (judgments, beliefs, and attitudes about what is morally right or wrong) seem to largely derive from unconscious processes. According to Haidt's Social Intuitionist Model (SIM) of moral judgment and decision-making, most of moral judgment and decision-making is driven by people's initial affective intuitions (Haidt, 2001; Haidt & Bjorklund, 2007). Thus, for instance, a person might think that they judge economic inequality to be morally unacceptable because it violates their consciously-held moral ideals, but in actuality their judgment may be primarily driven by a flash of negative emotion (such as disgust) upon hearing about inequality. This idea has been substantiated by the results of myriad studies. For instance, disgusting smells and environments can increase the severity of moral judgments (Schnall, Haidt, Clore, & Jordan, 2008), even when disgust is activated through hypnosis (Wheatley & Haidt, 2005). In contrast, positive mood inductions have been shown to decrease the severity of moral judgments, making people more likely to deem a harmful action morally acceptable (Valdesolo & Desteno, 2006).

According to Moral Foundations Theory (Graham, Haidt, Koleva, Iyer, Motyl, Wojcik, & Ditto, 2013; Haidt & Graham, 2007), people have a discrete set of moral intuitions upon which cultures build moral systems, and upon which individuals make moral judgments. According to this view, these intuitive sensitivities to patterns in the social world (e.g., instances of cheating or betrayal) act like "moral taste buds" that may become more or less sensitive throughout the lifespan. Current theory suggests that the most important moral foundations are concerns about a) care/harm, b) fairness/cheating, c) group loyalty/betrayal, d) respect/subversion of authority, and e) purity/degradation (Graham et al., 2013).

In addition to work on Moral Foundations Theory, there also exists a substantial amount of research on general (i.e., not necessarily moral) values and personal concerns. One of the most studied sets of values is Shalom Schwartz' list of 11 theoretically and empirically derived basic human values (self-direction, stimulation, hedonism, achievement, power, security, tradition, conformity, benevolence, and universalism; Schwartz, 1992).

Moral intuitions and values predict political beliefs and behaviors. One of the more important findings of values research is that people's moral intuitions and values seem to

strongly predict their political beliefs, policy stances, and politically-relevant behaviors. While political liberals value care and fairness much more than loyalty, authority, or purity, conservatives value all five foundation-related concerns relatively equally (Graham, Haidt, & Nosek, 2009). These moral intuitions also appear to predict attitudes about a host of hot-button policy issues (e.g., gay marriage, stem cell research) over and above factors such as political ideology, education, religious attendance, gender, and age (Koleva et al., 2012). Similarly, research demonstrates that people's values predict their voting behavior—even more so than general personality traits like openness to experience, conscientiousness, extraversion, agreeableness, and emotional stability (Caprara, Schwartz, Capanna, & Vecchione, 2006). These findings suggest that liberals' and conservatives' disparate moral intuitions and values will also play an important role in their beliefs and behaviors concerning economic inequality.

Finally, there is reason to believe that a person's current moral intuitions and values are amenable to change. For instance, theory suggests that regardless of which moral intuitions dominate a person's moral thought at present, new moral beliefs may emerge throughout the lifespan if they are attached to the moral senses people possess (Rozin, 1999), and research suggests that people's moral intuitions and values change across the lifespan (Dunlop, Walker, & Matsuba, 2013). Recent research also suggests that people's current moral intuitions can be leveraged to change their moral beliefs. For instance, conservatives' intuitive moral concern about disgust can be activated in order to increase their support for environmental regulations (Feinberg & Willer, 2013); in the same way, it is possible that moral concerns that are seemingly unrelated to economic inequality (e.g., disgust, respect for authority, and/or loyalty to one's ingroup) could potentially be activated in order to increase people's concerns about economic inequality. This possibility will be explored below in section 5; first, we detail the distinct psychological processes underlying intuitions of equality and intuitions of equity.

EQUALITY VS. EQUITY

The distinction between Equity and Equality represents a fundamental cleavage in justice motivation. When research concerning intuitive primacy in moral decision making is taken into account, it is no longer surprising that logically sound rational arguments for liberal (e.g. Rawls, 1971) or conservative (e.g. Rand & Braden, 1964) visions of what constitutes a fair distribution of wealth in society have failed in convincing anyone who did not already subscribe to those respective philosophies. However, just as the intuitionist perspective has shown that while there are multiple moral concerns that people have, there are not an infinite number (Graham et al., 2013), so too has research specifically on justice and fairness shown that while there are many ways to define justice, there are a few specific ways of defining justice that capture most of the variance that we see in the world.

Many visions of fairness can be grouped into principles that relate to equality, where rewards are distributed equally, and principles that relate to equity, where rewards are dis-

tributed in proportion to inputs and deservingness. This distinction has a long history in psychology. Morton Deutsch (1975) conducted years of research showing how principles of equity are motivated by productivity goals, while concerns about equality are motivated by social goals. He also posited a third justice principle, need, where rewards are given to those who need it most, yet multiple other research groups (Iyer, Read, & Correia, 2010; Kazemi & Eek, 2007; Rasinski, 1987) have found that the equality and need dimensions of fairness are psychometrically very close to each other. A great deal of research concerns the distinction between groups that care more about equality/need and groups that care more about equity (e.g. people from collectivist vs. individualist cultures; Bem, 1974; Carson & Banuazizi, 2008; Clark & Mills, 1979; Leung & Park, 1986; Rasinski, 1987; Stake, 1985), whereas researchers almost never focus solely on separating groups that care about equality from groups that care about need, suggesting that the distinction between equality and need has little pragmatic utility.

The Equality/Equity distinction maps onto other basic psychological distinctions. This is not to say that it is impossible to distinguish other justice motivations from equality or equity. Rather, the distinction between equality and equity maps onto prominent broad distinctions in psychology between communal vs. agentic goals (Bem, 1974), approach vs. avoidance motivations (Janoff-Bulman et al., 2009), liberal vs. conservative morality (Lakoff, 2004), warmth vs. competence (Fiske, Cuddy, Glick, & Xu, 2002), and masculine vs. feminine culture (Hofstede, 1984), such that most posited justice principles are classifiable in terms of this fundamental cleavage. For example, Tom Tyler (e.g. Tyler & Lind, 1992) has done a great deal of research on procedural justice, yet procedural justice may simply concern the allocation of socio-emotional goods (e.g., Tornblom & Foa, 1983), and judgments of outcomes and procedures are highly correlated (Hauenstein, McGonigle, & Flinder, 2001). Finer distinctions made by researchers may be useful in certain domains. However, this broad distinction underlies the important political differences we see today, in terms of the debate between those who want to create a society that rewards our most productive (e.g., fiscal conservatives) and those who want to create a society that provides a relatively equal distribution of wealth (e.g., populist liberals).

Why do some people endorse equality while others focus on equity? Neuroscientists and evolutionary psychologists have connected moral reasoning with social function, summarized by the phrase “moral thinking is for social doing” (Haidt, 2007). Concerns about fairness are found across all human cultures (Roth, Prasnikar, Okuno-Fujiwara, & Zamir, 1991), suggesting an evolutionary social function for such intuitions. Across a wide array of research, caring for the social and emotional well-being of others has been shown to underlie endorsement of equality, while ensuring productivity has been shown to underlie endorsement of equity (Deutsch, 1975; Iyer, Read, & Correia, 2010).

In this way, considering the function of justice motivation brings coherence to a wide array of justice research. For example, groups that emphasize the morality of care tend to be more concerned about outcome equality. Women generally endorse equality more than

men, with men more concerned about "rights and justice" and women more concerned about "rights and care" (Lyons, 1983; Swap & Rubin, 1983). Bem's (1974) Sex Role Inventory was based on the observation that people believe it is more desirable for women to be "compassionate" and men to be "ambitious," which mirrors Bakan's (1966) description of the agentic and communal orientations and Fiske's (Fiske, Cuddy, Glick, & Xu, 2002) description of how individuals are primarily judged as being warm and/or competent. In the European Values Survey data women perceived the goal of "guaranteeing that basic needs are met for all, in terms of food, housing, clothing, education, health" to be more important than did men (Arts & Gellissen, 2001).

Liberals also tend to place a greater emphasis on empathy and care (McCue & Gopoian, 2000), as articulated by Obama's emphasis on empathy as an important quality in a Supreme Court Justice (Hook & Parsons, 2009)—a statement that was widely ridiculed by those on the right (Garrett, 2009). An analysis of European Values Survey data found that those who place themselves further left on the political spectrum were more likely to endorse "eliminating large inequalities in income among citizens" (Arts & Gellissen, 2001).

In contrast, individuals on the right are more likely to endorse "recognizing people on their merits" (Arts & Gellissen, 2001). While some scholars have characterized conservative opposition to inequality as rigidity (e.g. Jost & Thompson, 2000; Knowles, Lowery, Hogan, & Chow, 2009), conservative policies such as opposition to affirmative action have been found to be rooted in meritocratic (as opposed to anti-egalitarian) motivations (Bobocel, Son Hing, Davey, Stanley, & Zanna, 1998; Nosworthy, Lea, & Lindsay, 1995). Conservatives have been found to be less willing to provide aid to the needy, but when those in need of aid are seen to have fulfilled their social responsibilities, conservatives are indeed willing to provide such aid (Skitka & Tetlock, 1993). The liberal stereotype of conservatives as "heartless" has been shown to be exaggerated in both psychology studies (Graham, Nosek, & Haidt, 2012) and in some analyses of conservative behavior (e.g., charitable giving; Brooks, 2006).

Rather than being heartless, groups that place greater emphasis on equity and deservingness tend to have stable productivity orientations that may trump empathic feelings (Iyer, Read, & Correia, 2010). Men are more often described as ambitious (Bem, 1974), agentic (Bakkan, 1966), and competent (Fiske, Cuddy, Glick, & Xu, 2002) and therefore may be more willing to tolerate inequality in the service of greater productivity. Conservatives also care about economic growth more than liberals do (Rasinski, 1987).

The psychological roots of libertarian equity. Although most political psychology research focuses on liberals vs. conservatives, an increasing number of Americans refuse to self-identify as either of these because they self-identify as libertarian, generally understood to indicate that they are liberal on social issues and conservative on economic issues. In 2012 we conducted the largest study ever undertaken on this group, including dozens of morality and personality scales given to nearly 12,000 self-identified libertarians (Iyer, Koleva, Graham, Ditto, & Haidt, 2012). We first found that libertarians were on the low end of the distribution for all

five moral foundations: they had the relatively low care and fairness concerns of conservatives, but also the relatively low loyalty, authority, and purity concerns of liberals. Several other morality scales (measuring moral identity, empathy, etc.) showed the same characteristic low scores, while non-clinical measures of psychopathy showed libertarians scoring higher than liberals or conservatives. However, libertarians were the most concerned about liberty as a value in and of itself (regardless of care/harm concerns), and also had high scores on measures of the Protestant Work Ethic. Most importantly, we found that this libertarian endorsement of equity over equality—and of productivity over care motivations—was mediated by factors that on the surface seem to have little to do with economic ideology. Specifically, these mediating factors were interpersonal style (libertarians are particularly individualist, with less bonding and attachments to others) and cognitive style (libertarians are particularly likely to prefer systemizing to empathizing, and prefer reason to emotion).

The findings of this study serve as an example to illustrate the larger point that economic ideologies—even for people who take pride in their preferencing of reason over emotion—have their roots in non-conscious psychological factors such as temperament, personality, and interpersonal attachment. These factors also help determine what vision of fairness different people will gravitate towards; however, as the next section shows, this does not mean that such visions cannot be changed.

MOVING FROM EQUITY TO EQUALITY

Threat and scarcity promote conservatism, and promote equity over equality. The observation that productivity goals underlie equity motivations, while care goals underlie equality motivations, allows one to better understand historical fluctuations in societal visions of fairness. In times of scarcity, war, or depression, when productivity is essential for the group's survival, it is unsurprising that groups that emphasize productivity over care (e.g., the military, the Tea Party, or nationalistic groups) find it easier to attract membership. In general conservatives are more reactive to threat (Oxley et. al, 2008) and more risk averse (Schaffner, 2009), and thus they may perceive threatening situations more readily. Situations that engender threat (e.g., 9/11 [Landau et al., 2004] or economic scarcity [Skitka & Tetlock, 1992]) do tend to lead people, even self identified liberals, to be more conservative in their behaviors and attitudes.

When basic needs are satisfied or relationships are made salient, Equality considerations attain prominence. In contrast, as society gets wealthier and basic survival needs are satisfied (Inglehart, 1977), more resources are available to care for others, which means that society could be expected to shift toward an equality orientation. Indeed, recent years have seen a marked decrease in war (Goldstein, 2011) and crime (The Economist, 2013), along with increased support for marriage equality (Pew, 2013). Care goals can also be situationally activated in individuals. For example, simply calling an economic task The Community Game, as opposed to calling it The Wall Street Game (Ross & Samuels, 1993), changing the environment of a situation to a neighborhood, instead of a company (Leung & Park, 1986), or explicitly setting

the goal of a situation to be productivity or social harmony (Stake, 1985; Kazemi & Eek, 2007) all lead individuals to be more concerned about equality and less concerned about equity. People also tend to use the equity principle with individuals to whom they feel no connection (Kahn, Krulewitz, O'Leary, & Lamm, 1980; McGillicuddy-de Lisi, Watkins, & Vinchur, 1994), and individuals who desire a close relationship can even be offended when the equity rule is applied to them (Clark & Mills, 1979). Any intervention that improves the relatedness of individuals is likely to stimulate equality motivations relative to equity motivations.

Promoting equality over equity by charting national well-being in addition to national productivity. The most powerful reminder of a productivity goal is the focus on GDP (gross domestic product) as a measure of national progress, and thus it is unsurprising that liberals, who may put care goals ahead of productivity goals, have been most likely to question this focus. In his inauguration speech President Obama stated: "The success of our economy has always depended not just on the size of our gross domestic product, but on the reach of our prosperity; on the ability to extend opportunity to every willing heart – not out of charity, but because it is the surest route to our common good." Obama's opinion is consistent with that of psychologists who study subjective well-being and who have argued strongly that society needs to measure well-being (Diener & Seligman, 2004) to complement, if not replace, measures of national productivity, as our primary measure of societal progress. This line of research has developed enough that the government of Bhutan has agreed to use "Gross National Happiness" to measure development (Esty, 2004) and the government of France has plans to include quality of life as a measure of the country's economic health (Jolly, 2009). In this way societies could explicitly promote equality over equity, by emphasizing care as well as productivity in their indices of progress.

CURRENT RESEARCH AND FUTURE APPLICATIONS

Expanding fairness conceptions. As described above, perceptions of justice cannot be distilled into one unitary construct; people conceptualize justice in many different ways. The simplest way of making sense of the wide array of opinions about distributive justice is to categorize them as a) concerns about equity and b) concerns about equality (cf. Deutsch, 1975). Though this is an efficient way of categorizing beliefs about distributive justice, it may sometimes be overly simplistic, as theory (Deutsch, 1985) as well as recent research (Meindl, Iyer, & Graham, 2013) suggests that people often endorse at least three types of equity principles—effort-based distribution (based on the amount of effort people put into their work), skill-based distribution (based on the degree to which people possess valued skills), and contribution based distribution (based on the degree to which people positively contribute to their society); and at least five different "non-equity" justice principles—need-based (i.e., at least everyone's basic needs are met), needs-only (everyone receives *only* what they need, and no more), utilitarian (distribution is determined solely by what is best for society as a whole), liberty-based (distribution is determined by the marketplace, not the government), and equality (everyone receives the same amount). Thus, understanding peo-

ple's views on equality- and equity-based justice principles might provide a large amount of information about people's beliefs about economic inequality (and about policies designed to address it), but delving deeper and taking account of people's thoughts on a wider array of justice principles might allow for an even better understanding of the roadblocks that stand in the way of widespread endorsement of greater economic equality.

Value conflicts, and their significance to economic inequality. One reason why such an expansion of justice conceptions might be helpful for researchers and policy makers concerned with egregious economic inequality is that it might allow them to better understand—and hence better address—value conflicts. People who oppose policies designed to reduce economic inequality may oftentimes do so not because they are opposed to greater equality, but because they are concerned about the consequences that such change might have in relation to other values they hold (e.g., it might reduce liberty or work ethic). If researchers and policy makers only took into account whether people put more value on equity or non-equity-based principles of distributive justice, this could blind them to conflicts between more specific justice principles (e.g., equality vs. utilitarian, or effort-based equity vs. contribution-based equity) and how such conflicts can affect people's views on economic inequality.

At least two types of value conflicts might influence people's views on economic inequality. Moral values might conflict with other moral values (e.g., the desire to reduce suffering vs. the desire for a highly productive society) to produce a "moral-moral" conflict, and moral values might conflict with more egoistic values (e.g., the desire for others' well-being vs. the desire for one's own success and achievement) to produce a "moral-egoistic" conflict.

Eliminating these types of value conflicts is important because these conflicts are likely to temper the impact that moral intuitions and personal values have on policy preferences and political behavior. Addressing value conflicts may be especially important for increasing support for equality initiatives, because value conflicts might partly explain why it is so difficult to alter people's opinions about policies designed to reduce inequality. A substantial amount of research suggests that it is relatively easy to change the degree to which people consider current levels of economic inequality to be problematic. Simply educating people on the degree to which economic inequality exists appears to have an exceptionally strong influence on the degree to which people perceive economic inequality to be a problem (Norton & Ariely, 2011). But changing the degree to which people see current levels of inequality as problematic does not seem to change the degree to which they endorse specific policy initiatives designed to reduce inequality (Kuziemko, Norton, Saez & Stantcheva, 2013). One possible explanation for this pattern of findings is that people's new views pertaining to economic inequality (i.e., widening gaps between the rich and poor feel wrong and unfair) conflict with other deeply held values—either egoistic or moralistic (e.g., people should be rewarded based on their contribution to society). In order to increase support for initiatives designed to reduce inequality, policy makers may need to increase people's support for equality principles while simultaneously reducing support for equity or egoistic principles that conflict with equality principles.

Political moderates and independents. Although we have contrasted the fairness intuitions of equality (based on care concerns) and equity (based on productivity concerns), and highlighted the different admixtures of these concerns in liberals and conservatives, the fact remains that most Americans place themselves near the middle of the political spectrum, not on the ideological extremes. Most Americans, then, will respond to signs of unfairness along both equality and equity lines at one time or another. Our research indicates that moderates fall somewhere between liberals and conservatives in terms of the balance of equity vs. equality they use in making moral judgments (Iyer et al., 2012; Meindl, Iyer, & Graham, 2013). However, there is research indicating that moderates and those who are less extreme in terms of their ideology may be more willing to consider tradeoffs in policies (Fernbach, Rogers, Fox, & Sloman, 2013). With the possible exception of extreme libertarians (who specifically eschew care concerns), most individuals have concerns about both care/equality and about proportionality/equity. However, the most extreme partisans may be more certain of their beliefs (Fernbach et al., 2013) and therefore less willing to consider the fact that the outcomes of economic policies may be uncertain, or that economic policies often involve tradeoffs between helping the unfortunate and rewarding unproductive behavior. Conservatives may be more likely to be certain in their beliefs than liberals due to a greater need for cognitive consistency (Iyer, 2012; Liu & Ditto, 2013; Motyl & Iyer, 2013) and therefore less likely to accept that such tradeoffs exist, which may explain rhetoric that portrays helping the needy as actually detrimental to the less fortunate through the creation of a "culture of dependence."

But it is likely that many psychological tendencies follow a curvilinear trajectory across the political spectrum, with extreme partisans resembling each other more than moderates (e.g., Crawford &Xhambazi, in press; Kahan, 2013). Scientists are only beginning to examine moderates and independents as groups of interest in themselves, rather than just as control groups for liberalism or conservatism. For example, Hawkins and Nosek (2011) examined the explicit (self-reported) political party (Dem/Rep) preferences among self-described independents, as well as their implicit preferences, measured via a reaction-time task involving sorting Democratic and Republican pictures and words. They found that implicit or non conscious identification with Democrats or Republicans predicted whether the independents would prefer generous or stringent welfare programs, suggesting that many independents reliably lean one way or another, even if they don't report that leaning in their self-assessment—and possibly even if they aren't consciously aware of it themselves. There remains a great deal to learn about moderates and independents and how their motives and goals differ from the more well-studied liberals and conservatives.

Future research and policy implications. Fortunately, psychological research points to various strategies for combatting both types of value conflicts. When it comes to "moral moral" value conflicts, one way to make it more likely that a preferred moral value (e.g., economic equality) will win out over another moral value is to ask people to briefly write about the importance of the preferred value. This simple task has been shown to cause people to favor fairness over loyalty in situations in which the two values conflict (Waytz, Dungan, & Young,

2013). Another powerful strategy is to simultaneously activate multiple moral intuitions in the service of the preferred value. For instance, research suggests that when conservative Americans are led to think of the consequences of environmental degradation as disgusting (vs. harmful), they are more likely to endorse "green" policies (Feinberg & Willer, 2013).

Another simple technique to encourage people to adhere to moral values rather than egoistic values is to temporarily alter a person's psychological level of construal. According to Construal Level Theory (Trope & Lieberman, 2010), people construe situations and other people on either an abstract (high) level or a concrete (low) level. Research also suggests that people are more likely to act in accord with what they believe is right (as opposed to their more egoistic values) when they are in a state of abstract construal (Torelli & Kaikati, 2009). Abstract levels of construal can be activated through very quick and simple manipulations, such as asking people why (instead of how) certain actions are performed; this has been shown to actually reduce automatic racial prejudice (Luguri, Napier, & Dovidio, 2012). Some research even suggests that subtle changes to the wording in essays can subliminally activate abstract levels of construal (Fujita, Trope, Liberman, & Levin-Sagi, 2006), suggesting further avenues for promoting equality over equity.

CONCLUSION

Opinions about economic fairness are based in part on intuitive responses to signs of fairness and unfairness. People can radically disagree about the merits of different economic policies because there are multiple kinds of fairness intuitions. In this paper we have focused on intuitions of equity (involving values of work ethic and proportionality) and intuitions of equality (involving values of care and compassion), and the distinct goals and motivations associated with each. Different ideological temperaments (liberal vs. conservative) and situations (scarcity vs. plenty) can give rise to different emotions, motivations, and intuitions that support caring about one or the other. Changing public sentiment about economic policies, then, will largely concern evoking the right emotions and intuitions (more caring/hope, less outrage/scarcity/fear if you want more equality), and this will be more complicated than simply using the right buzzwords.

While equity/equality is a fundamental dichotomy in justice research, and individuals differ in which vision of fairness they most often resonate with, it should be noted that equality and equity are both values that *everyone* cares about to some degree. Conflicts between these values are not just interpersonal, as in liberal-conservative debates, but intrapersonal, with individuals feeling conflicts between different moral intuitions of what's right and what's wrong. Appeals that address equity concerns as well as equality concerns—for example by stressing equality of opportunity as well as equality of outcomes—could have the greatest impact, by resolving these conflicting moral visions we all share.

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