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Why Inequality Does Not Fall

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Inequality has existed ever since human societies were able to produce an economic surplus and turn into "civilized" empires. No theory of justice, whether meritocratic or liberal, will justify the ensuing inequality. According to the meritocratic notion of justice, the ablest should be compensated. Nevertheless, the poorer in each society are not less endowed with talents, nor less hard-working. The liberal theory of justice justifies inequality provided that it is the price for some improvement in the standard of living of the worst-off members of society. Yet the huge differences of income and standard of living among people and among countries cannot be justified with this principle. On the other hand, increasing inequality among countries cannot be justified with the fact that it is accompanied by the modest increase in the income of the poor.

According to Michael Walzer's theory of justice, we may admit inequalities within each "sphere of justice" because each sphere will have a different principle of justice that is not necessarily based on straight equality. But there is a rule that should never be disregarded: no one is entitled to cross the borders of the spheres of justice. Yet, in capitalism, we observe that the rich usually and with no shame cross the borders of the spheres of justice; because they are rich, they believe that they are more entitled to power, or to social prestige, or to respect, or to education, or to divine grace, or even to healthcare—the social goods that define the other spheres of justice. This fact shows how crucial it is to reduce economic inequality. The aim is not to eliminate it, because this will never happen, but to limit its scope.

In discussing economic inequality, we will probably consider the numbers of people that suffer from hunger (around 20 percent of the world's population), and the numbers who live on less than one dollar per day (around a billion). According to Branko Milanovic, global inequality measured in 1998 by the Gini coefficient was as high as 64.1. This information is relevant, as are also relevant the normative political theories that discuss injustice, or the sociological theories that tie such inequality to capitalism or the class system, or the economic theories, such as the ones I will present here, that explain inequality in capitalist societies. Ideas are important in reducing social

injustice, but much more important is the political organization and struggle of the poor and the workers.

We know well that unfettered capitalism is an unjust mechanism for determining income distribution. The economic superiority of capitalism over the failed experiments to establish socialism derived originally from the fact that men and women are intrinsically unequal in talents and in cultural and economic heritage, coupled with fact that capitalism is not troubled by that inequality. Yet this "original inequality" causing inequality should not be understood in terms of the conservative tenet that since human nature is intrinsically unequal, societies will be always unequal.

The immediate challenge to a socialist party that wins elections is to reduce inequality while keeping the rate of profit attractive to capitalists —sufficient to motivate them to invest. Socialist political parties soon become social democrats because they have no power to install socialism; their real and difficult challenge has been to manage capitalism more efficiently than the capitalists. They proved successful since their policies of making capitalism less unjust did not reduce profits; that is, they did not prevent entrepreneurs and entrepreneurial business corporations from investing and innovating.

The three central questions that we must ask in relation to inequality within the capitalist system are: first, which are the structural economic constraints that nations face in reducing domestic inequality? Second, within such constraints, what level of freedom do they allow? Third, what can be done at the international level? This last question calls attention to the fact that inequality may increase or diminish at the national level, among the inhabitants (who are not necessarily all citizens) of a given country, and, at the international level, among the population of the entire world. Within a nation-state there is one major institution—the state—that acts, or may act, as an instrument of the collective action of civil society or the nation. At the international level, there are already institutions—international treaties, the United Nations—but no state. At the national level, civil society was separated from the state and eventually, in the context of democracy, was able to reduce inequality, although only to a limited degree. At the international level, a global civil society is still being structured, and an international political system associated with the United Nations is emerging, but we are still far from a global state.

To understand the structural constraints on income distribution or the reduction of inequality, it is practical to use the concepts Karl Marx adopted to formulate his thesis of the tendency of the rate of profit to fall, and to make one key variable, namely, technical progress measured in terms of the productivity of capital, vary historically. There is technical progress whenever labor productivity (which corresponds approximately to income per capita) is increasing. But, in terms of the productivity of capital, current technical

progress may be capital-using, neutral, or capital-saving, depending on the character of the output–capital relation, or the productivity of capital. If the output–capital ratio is decreasing, technical progress will be capital-using, or the productivity of capital will be falling. If it is constant, technical progress will be neutral; if the output–capital ratio is increasing, technical progress will be capital-saving, or the productivity of capital will be rising. When technical progress is neutral, wages can rise with productivity and distribution can be constant while the profit rate is constant; when it is capital-saving, wages can rise above the productivity rate, and distribution can improve or inequality can diminish while the profit rate remains constant at a satisfactory level.

Under what conditions does the productivity of capital decrease or increase? It usually falls in the first stage of industrialization, when business enterprises substitute machines for labor. It rises in the later stages of industrialization when business enterprises have already substituted machines and software for labor, and now primarily substitute new and more efficient machines for old ones. It is neutral when the two kinds of technical progress are balanced, one checking the other.

If we assume that the economy is growing or labor productivity is increasing and that the profit rate is constant, what will happen to wages and to income distribution or inequality? Given a constant rate of profit, if technical progress is neutral (or the output–capital ratio is constant), inequality will remain constant, and average wages or the wage rate will increase at the same rate as labor productivity. If technical progress is capital-using (or the productivity of capital is falling, as happened in Marx's time), inequality will increase and the wage rate will increase more slowly than productivity or even fall. If technical progress is capital-saving (or the productivity of capital is increasing), inequality will diminish and wages will grow faster than the increase in labor productivity.

Taking Britain as a reference (because it was the first country to complete the Industrial Revolution), and given mainly these types of technical progress, we can divide capitalist development after the long primitive accumulation period, in which the basis for economic growth was established, into five phases: first, the Industrial Revolution phase, approximately in the 50 years before 1800; second, the post-Industrial Revolution or Marxian phase between 1801 and 1850; third, the "classical" phase between 1851 and 1948; fourth, the "30 golden years of capitalism" between 1949 and 1978; and, finally, the "30 neo-liberal years of capitalism," between 1979 and 2008. Naturally, these dates beginning and ending the phases are approximate; transitions from one phase to another are not always clear and are not completed in only one year.

In four of the five phases, the rate of profit was constant. In the Marxian phase, it was falling because technical progress was capital-using; thus, to

keep the profit rate constant, wages should be falling. Because, in the previous phase, the proletarianization process had driven the remuneration of workers to subsistence level, the only logical possibility was a falling rate of profit.

In the first period, the primitive accumulation and Industrial Revolution period between 1750 and 1800, inequality increased because wages were probably falling. Technical progress was capital-using since industrialization is a process of mechanization or of substitution of machines for labor that takes place approximately according to a rational sequence. First, firms substitute the less costly or the more efficient machines for labor, and after, step-by-step, they substitute less efficient machines that are still more efficient than direct labor. Given this sequence, whenever a less efficient group of machines replaces labor, the productivity of labor will increase, but the output–capital relation will fall. As a consequence, the average productivity of the stock of capital will decrease. Since technical progress was capital-using and the profit rate was constant at a high level, the wage rate had necessarily to grow more slowly than the productivity rate or to fall, and inequality had to rise.

In the second phase, the post–Industrial Revolution or Marx's phase, mechanization continued or technical progress remained capital-using, but inequality ceased to increase and remained constant. Since the wage rate had reached subsistence level and could not be further reduced, the profit rate necessarily had to decrease. This happened in Britain in the fifty years after the Industrial Revolution. Yet capitalist development was not endangered, investments were not paralyzed, because the profit rate fell from an exceptional level that prevailed during the Industrial Revolution to a level that was still attractive to business entrepreneurs. I like to call this period "Marxian" because it was the period that Marx was living in and directly observing—and the only period in which the rate of profit was, exceptionally, falling.

Technical progress, however, would not consist of "mechanization" (the substitution of increasingly inefficient machines for labor) forever. Approximately between around 1851 and 1950, in the time of classical capitalism, technical progress changed from capital-using to neutral (a constant output–capital relation). Given also that the profit rate remained constant, wages should increase along with productivity, as did happen.

Technical progress, however, continued to evolve when countries were already fully mechanized. Thus, in the fourth phase of capitalist development, in the thirty golden or glorious years of capitalism, after World War II (1949–78), technical progress became modestly capital-saving. Instead of primarily substituting machines for labor, business firms were now mainly (but not exclusively) substituting less costly or more efficient machines for old machines. The computer industry dramatically illustrates this process. That is the reason why, in that golden age of capitalism, inequality diminished in the rich countries, whereas the profit rate remained constant and

attractive to businessmen. The constancy of the profit rate was consistent with wages rising faster than the productivity of labor because the productivity of capital was increasing. In fact, in that period, the advanced economies experienced high rates of growth and financial stability, while inequality clearly diminished.

After the 1970s, however, new historical facts changed the picture. Given just the variables that I have being using so far, and given a constant profit rate and an increasing output–capital ratio, wages should continue to increase faster than productivity, and inequality should continue to fall. Instead, wages stalled and inequality increased. How to explain that? The key explanation of this perverse change is political.

In the 1970s, the pressure of organized labor for more wages, the first Organization of Petroleum Exporting Countries (OPEC) oil shock, and the general increase in commodity prices, squeezed the profit rate, which fell sharply in the United States along with the growth rate. The response, principally of the two more severely affected countries, United States and Britain, was neo-liberalism and financialization, a return to and radicalization of economic liberalism and the development of financial innovations that created fictitious wealth, that is, a great increase of the remuneration of capitalist rentiers and of the bright young professionals—the financiers—who invented and managed such speculative and risky financial instruments. Yet, to understand the neo-liberal years and the increasing inequality that then occurred in rich countries, domestic factors alone are not sufficient. We need to take into consideration two international or global factors that made the neo-liberal political coalition so aggressive: increasing competition from developing countries, and increasing immigration to rich countries. Trade liberalization made possible increased competition from low-paid workers in developing countries and depressed wages in rich countries.

To this fact, we have to add the major increase in immigration to rich countries, which directly depressed their wage levels. This rise in immigration did not result from rich countries opening their borders—on the contrary, they strictly controlled their frontiers—but from the pressure on the poor to emigrate in order to improve their usually miserable standards of living, combined with the reduction in the costs of transport and communication. This, along with the unacknowledged interest of rich countries in employing cheap labor, explains the increase of immigration.

The neo-liberal and meritocratic domestic response to these challenges was market-oriented institutional reform: privatization, deregulation, a flattening of the existing progressive income tax system, flexibilization of laws protecting labor, and economic incentives for workers and professionals. Between 1978 and 2008, the world experienced the "neo-liberal years." In the rich countries, increased competition and policies repressing wages were

effective in keeping wages stagnant, whereas productivity and economic output continued to increase, although at lower rates than in the golden age.

Does this mean that the profit rate increased? Although the data on this matter is imprecise, I believe that it did not; the profit rate was kept at a satisfactory level. To whom, then, was transferred the increased economic surplus resulting from wages growing more slowly than productivity, or even becoming stagnant, whereas capital-saving technical progress allowed for increased wages? The dominance of the neo-liberal ideology and the consequent deregulation of financial markets allowed the political coalition behind capitalist rentiers and financiers to capture a major part of the surplus, in the form not of profits but of dividends, increases in financial wealth, and bonuses. Modern rentiers or inactive capitalists, living on interest, rent, and dividends, were unhappy with the low rates that prevailed in the golden age. It was eventually to "solve" this problem that a coalition of financial operators, or financiers and capitalist rentiers, was formed.

Financiers did not offer this gain to rentiers for free. Since the golden age, the professional class and particularly the high executives of all corporations were able to substantially increase their pay—in the form not only of direct salaries, but also in bonuses and stock options—in the name of meritocratic values. The professional or techno-bureaucratic class, that is, the controllers of administrative, technical, and communicative knowledge, benefited. In principle, benefits should have accrued to the workers as the productivity of labor as well as of capital increased. In fact, they accrued mainly to high executives and financiers. Since the 1950s, high professional executives, and since the 1980s also financiers—both part of the professional or techno-bureaucratic class—gained sufficient political power to be able to capture a substantial part of the economic surplus that was being produced by the economic system.

To sum up, using Britain as the paradigm (since it was the first country to complete its Industrial Revolution), we can make these observations. First, after the long phase of primitive accumulation, in the Industrial Revolution, approximately between 1750 and 1800, inequality increased, because technical progress was capital using, but investment materialized because the profit rate was maintained at a high level while the wage rate or the standards of living of workers deteriorated to the subsistence level. Second, immediately after the Industrial Revolution, in the Marxian phase (approximately 1801–50), inequality remained constant while the wage rate remained at the subsistence level, in so far as technical progress remained capital-using, but the profit rate fell. Third, in the classical phase, between 1850 and 1950, inequality remained constant as technical progress became neutral, and it was possible to increase the wage rate in line with the increase in productivity while the profit rate remained attractive to capitalist entrepreneurs.

Fourth, in the golden age of capitalism, approximately between 1950 and 1980, inequality was reduced as technical progress became moderately capital saving, which allowed wages and salaries to increase while the profit rate remained constant. And fifth, since 1980, in the neo-liberal years, inequality increased even though technical progress continued to be capital saving, in principle allowing the profit rate to remain constant while wages and salaries increased faster than productivity; instead, wages increased more slowly than productivity or became stagnant because they were depressed not only by neo-liberal policies but also by the competition from immigrants and from fast-growing middle-income countries exporting manufactured goods, while the profit rate remained constant and the salaries and bonuses of the professional class—particularly of the richest two percent—increased greatly.

All of the aforementioned relates to distribution within rich countries. What to say of developing countries? In the transition from pre-capitalist to capitalist societies, especially its main episode, the Industrial Revolution, was highly income-concentrating in so far as it causes the proletarianization of the peasants. Yet, in Latin America and particularly in Brazil, where a mercantilist colonization combined with slavery prevailed, an egalitarian peasant society such as the one that existed in the north of United States never emerged. Inequality was inherent in the mercantilist colonization, the plantation system, and slavery. Thus, when industrialization begins, there is an unlimited supply of labor to manufacturing industry at very low wages.

To consider only the economic variables, inequality in a developing country will continue to increase so long as an "unlimited" supply of labor or a reserve army of unemployed or underemployed workers does not become exhausted. The economic surplus produced in manufacturing will benefit not only the capitalist class but also the professional middle class. These two groups, plus a layer of highly skilled workers, form the modern or capitalist sector of the dual or underdeveloped economy. Other workers remain in the "marginal" sector, which is no longer an untouched pre-capitalist or traditional sector, but rather a sector that is complementary and functional for the process of capital accumulation and growth.

Before this marginal sector is exhausted, what can put a stop to income concentration is democratic transition. Usually, the victorious political coalition that achieved democracy relied on the participation of the working class and, more broadly, of the poor. Thus, after coming to power, it is constrained to adopt income policies benefiting the poor. This is what happened in Brazil in the 1985 democratic transition. The democratic political coalition assumed political commitments to the poor that were relatively honored after the transition. Since 1985, successive administrations have adopted a variety of policies aiming to reduce inequality, by making healthcare and basic education universal services, by increasing the minimum wage, or by

adopting relatively focused minimum-income policies. In consequence, inequality in Brazil between 2001 and 2008, measured in terms of the Gini index, although still high, fell from 0.594 to 0.544, while, between 1999 and 2008, the minimum wage increased by 61 percent in real terms.

To summarize, rich countries have already reached the stage of capital-saving technology where a reduction of inequality is consistent with a constant and satisfactory profit rate. But, in contrast with what occurred in the thirty golden years of capitalism, their societies have been unable to use this opportunity in the succeeding neo-liberal and meritocratic years. Concurrent with this negative outcome, which occurred for political or ideological reasons associated with neo-liberalism and meritocracy, competition from middle-income countries began in the 1970s, when they started to export manufactured goods to rich countries and sections of their populations started to migrate to rich countries. These last two factors depressed wages in rich countries. In other words, the domestic constraints were reduced, but the international constraints and the hegemony of two reactionary ideologies (neo-liberalism and meritocracy) worked against equality.

Developing countries, on the other hand, are probably either in the phase of mechanization, when the productivity of capital is falling, or in the classic phase of capitalist development, where it is constant. The countries that are in this latter condition could grow without increasing inequality, but they face a major obstacle: the unlimited supply of labor. Democracy, however, may force elites and politicians to adopt effective redistributive policies.

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