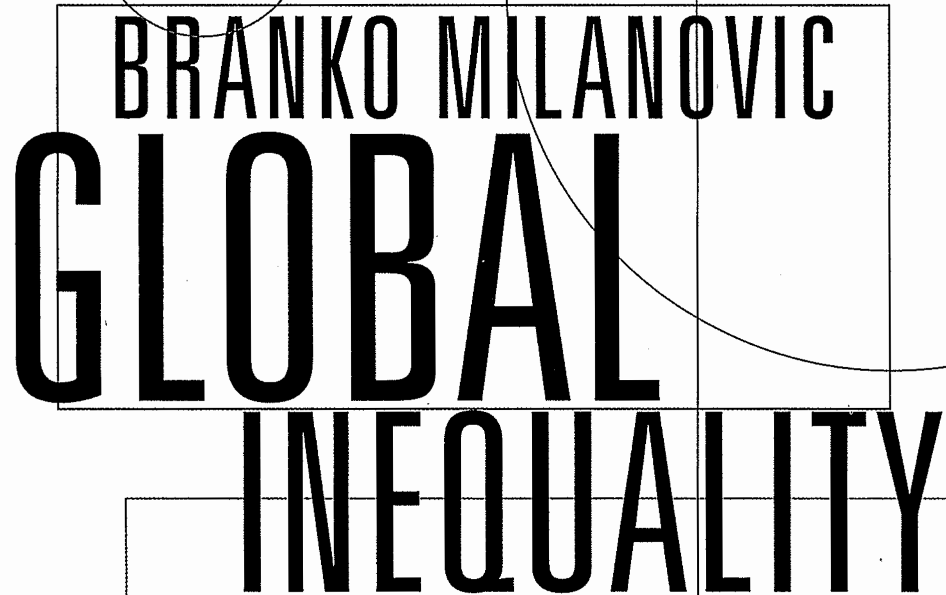

4

Global Inequality in This Century and the Next

> In my view every economic fact, whether or not it is of such a nature as to be expressed in numbers, stands in relation as cause and effect to many other facts; and since it never happens that all of them can be expressed in numbers, the application of exact mathematical methods to those which can is nearly always a waste of time, while in the large majority of cases it is positively misleading.
>
> —ALFRED MARSHALL (1901)

A Cautionary Introduction

In preparation for writing this chapter I read or reread several books, popular in their time, that tried to visualize or predict future economic and political developments. Reading those books today (when very few people still read them) provides us with a cautionary tale. We know that purely economic forecasts tend to be very wrong.[1] But I thought that less formal discussions of the political and economic forces that were considered most important for shaping the future would provide more accurate insights and projections. I discovered that was not the case. I looked at books written during three different time periods: the late 1960s and early 1970s, the period during and just after the oil crisis of 1973, and the 1990s. The overwhelming

impression is not only that they failed to predict or even imagine the most important future developments, but that they were strongly anchored in the popular beliefs of their age. Their predictions generally consisted of simple extensions of current trends, some of which had been in existence for only five or ten years and quickly disappeared.

The books of the late 1960s and early 1970s see the world of the future as being ever more dominated by behemoth companies and expanding monopolies, and they predict a widening gulf between shareholders and managers, with the latter having the upper hand (examples are John Kenneth Galbraith's *The New Industrial State* [1967], Lester Brown's *The World Without Borders* [1972], and Daniel Bell's *The Coming of Post-Industrial Society* [1973]). They all note similarities in the primacy of technology in both the United States and the Soviet Union. Gigantism in the USSR seemed to be a response to the same technological requirements that were observed in the United States: management of complex systems needed to be left in the hands of the best and the brightest, with help from the state. Large companies would prevail over small ones because technological progress was seen as involving increased returns to scale and requiring a more educated population, which could only be ensured through a more active state. This view of the requirements imposed by technology (which is quite Marxist in its essence) leads the authors to postulate a process of convergence between socialism and capitalism. And indeed the spread of limited market-based forms of economic organization in Eastern Europe (e.g., Yugoslav market socialism, the Soviet *khozrashchet* [cost-accounting] reform of 1965, and the Hungarian reforms of 1968) gave such a view a dose of plausibility. At the same time, in the West, the role of the state in ownership, management, and acting as an honest broker between employers and labor had never been greater. Thus, it seemed as though socialism was moving toward freer markets, and capitalism toward a greater role

for the state. This view on the convergence of the two systems was articulated in works by such renowned thinkers as Jan Tinbergen (1961) and Andrei Sakharov (1968). We now know, however, that the real change that occurred over the subsequent twenty years was entirely different. The second technological revolution made irrelevant many of the behemoths that were thought to be indestructible: socialism collapsed, and the capitalism that triumphed was of a very different type than was envisaged in the late 1960s. No one predicted the rise of China. Indeed, China is remarkable by its absence in these books.[2]

The 1970s, following the oil shock and the quadrupling of real oil prices, generated an entire literature concerned with the depletion of national resources and limits to growth (*The Limits to Growth*, by Donella Meadows et al., was one of the most famous books of that time).[3] A period of slower, almost zero, economic growth in the West suggested a much less optimistic view of the future.[4] Endless growth driven by technology was no longer envisaged. Unlike the preceding period, it was a time when people contended that "small is beautiful" (to quote the title of another influential book, by Ernest F. Schumacher, published in 1973). The future no longer seemed to belong to industrial giants like IBM, Boeing, Ford, and Westinghouse. It was a time to celebrate the flexibility and small scale of the German *Mittelstand* (mid-sized manufacturers) and the family enterprises in Emilia-Romagna, Italy. Japan's rise began to look unstoppable. No one took notice of China yet. And of course the end of communism was not foreseen at all.

A final wave of literature that I want to mention here is from the 1990s. It was dominated by the Washington Consensus (a set of policy prescriptions that emphasized deregulation and privatization) and the forecasting of the "end of history" (the title of an influential 1989 article by Francis Fukuyama, leading to the book *The End of History and the Last Man* [1992]). Japan still appeared to be ascendant,

but China made a cameo appearance. Many of the books celebrated neoliberalism and predicted its speedy extension to the rest of the world, including the Middle East. Later, the US invasion of Iraq would be justified by, among other things, an appeal to the "end of history."[5] The war was supposed to bring democracy to Iraq and indirectly to the rest of the Arab world, resulting in an end to the intractable conflict between Israelis and Palestinians in negotiations between the now democratic parties. Encomiums to American power make a frequent appearance in these books. (Interestingly, many of them were published less than a decade after the United States was supposed to be on a path of long-term decline.) Those who were unhappy with globalization and the triumph of Anglo-American individualistic capitalism and "short-termism" (focus on short-term business profits) used Japan and Germany as alternative models (Todd 1998). No financial crises were predicted, nor was the rise of the group of emerging economies now known as BRICS (Brazil, Russia, India, China, and South Africa).

To generalize, all of these works share three types of mistakes: the belief that the trends that appear to be most relevant at a particular time will continue into the future, the inability to predict dramatic single events, and an exaggerated focus on key global players, especially the United States. All three problems, even if accurately diagnosed, seem to be very difficult to solve.

The first mistake is common to all forecasting, whether formal and quantitative or impressionistic. *Natura non facit saltum* is the epigraph to Alfred Marshall's *Principles of Economics*. Economists and social scientists see the future as being composed of fundamentally the same substance as what makes up the present and the very recent past. We just extend into the future the most salient trends of today. What seems salient to us today, however, may turn out later to be inconsequential. But even correctly identifying the important trends does not solve the problem of prediction because of the second issue,

our inability to foresee game-changers—big events that cause major shifts.

This second mistake is in some ways an extension of the first. When we focus on incremental change, we lose sight of singular events that can significantly influence further events but cannot be predicted well. Thus, the Reagan-Thatcher revolution was impossible to predict; the same is true of Deng Xiaoping's ascendency and Chinese reforms, the breakup of the Soviet Union and the fall of communism, and the global financial crisis. We can see with hindsight that in all of these cases the individuals (or phenomena, in the case of the financial crises) behind such momentous changes were responding to deeper socioeconomic forces. But while we see that in retrospect, we cannot do so in advance. Moreover, predicting important discrete events may be a form of charlatanism. In perhaps 99 out of 100 cases, we are likely to be wrong. And even in the 1 case out of 100 where we happen to be right, the value of that guess will be considered to result more from pure chance than from any genuine ability to extract from the past and predict the future. These singular events will remain totally outside our predictive ability, just like the appearance of black swans, as popularized in Nassim Taleb's recent book *The Black Swan* (2007). And since we cannot believe that they will cease to occur in the future, it simply means that all our predictions will largely be faulty.

Although we cannot predict any particular event that might occur in the next century, we can consider some possible scenarios that could change the economic composition of entire continents or even the world:

1. Nuclear war between the United States and Russia or China that could lead to massive destruction and long-lasting radioactive contamination.
2. A nuclear bomb detonation by terrorists.

3. War between China and Japan.
4. Political revolution and/or civil war in China, leading to breakup of the country.
5. Civil war between Muslims and Hindus in India.
6. Revolution in Saudi Arabia.
7. Growing irrelevance of Europe as a result of decreasing population and inability to absorb migrants and refugees from the Middle East and Africa.
8. Conflict between Muslims and Christians that could engulf the Middle East and spread to Europe.

This list does not include any events centered in Latin America and Africa. This omission reflects the fact that in recorded world history these two continents, probably because of their distance from centers of civilization in the Mediterranean, India, China, and the North Atlantic, have never played an important autonomous role. But that itself may change in the coming decades, with the rising importance of Brazil, Nigeria, and South Africa.

The third mistake, an exaggerated focus on key players, is perhaps the only one we could avoid, but doing so remains difficult. We tend to simplify the world by focusing on what happens in the key countries that seem to shape the evolution of things to come. It is not surprising that the United States figures prominently in the literature I have reviewed here, as it probably does in all similar literature over the past seventy years. The United States is always contrasted with another country that, at a given point in time, represents its antipode or seems to be its chief competitor. The literature of the 1960s portrayed the world in terms of the communist-capitalist rivalry or convergence. Then, as the importance of the USSR dwindled and that of Japan increased, two different capitalisms came face to face: American and Japanese (with German capitalism playing a somewhat subsidiary role). China has now totally eclipsed other competitors, so much so that today's books—and this one is no exception—tend to be structured around that antinomy.

The approach of zooming in on several key countries is justifiable to the extent that powerful countries, through their example and soft power (and hard power, at times), and also through their position at the forefront of technological progress, have a preponderant effect on how the rest of the world evolves. Big countries are also important in purely arithmetic terms because their populations and economies are so large. But this approach essentially regards one-half or two-thirds of the world as mostly passive, which is unlikely to be true. Events in small countries sometimes have disproportionate political and economic repercussions, be it the Sarajevo assassination in 1914, the military coup in Afghanistan in 1973, or the 2014 crisis in Ukraine. Moreover, from a global or cosmopolitan perspective, the experiences of people in all parts of the world are just as important as the experiences of people living in key nation-states.

The reader should keep in mind the fundamental problems with our attempts to see into the future. Although we may be aware of these problems, and possibly of a few more, awareness of them alone is not sufficient to allow us to devise an alternative approach to avoid the mistakes that others have made. In the rest of this chapter I will try to avoid some of these pitfalls, but I am aware that if this book is read twenty years from now (that is, in the mid-2030s) many of its forecasts may be found wanting no less than the ones that I found wanting in the earlier literature.

Outline of the Main Forces: Economic Convergence and Kuznets Waves

Our thinking about the evolution of global inequality in the next few decades is informed by two powerful economic theories. The first is that with globalization there should be greater income convergence,

that is, that incomes in poor countries should be catching up with those in rich countries because poor or emerging economies are expected to have higher growth rates on a per capita basis than rich countries. This prediction is not invalidated by the decline in the growth rate of some emerging economies (such as China); the process of convergence continues as long as poor and emerging countries have *higher* growth rates than rich countries. Two caveats are, however, in order. First, we are talking of a broad pattern, which does not mean that all poor countries will participate in the catch-up. Actually, one of the surprises of the current globalization process has been precisely how many countries have fallen even farther behind, let alone failed to catch up. The same thing cannot be ruled out in the future. The second caveat is that when we are dealing with the welfare of individuals, as we do here, income convergence in the most populous countries is what matters the most. This perspective puts a special emphasis on the importance of countries like China, India, Indonesia, Bangladesh, and Vietnam continuing with the catch-up process.

The second powerful theory has to do with the movement of inequalities within nations, which, as argued in Chapter 2, is characterized by movement along different portions of either the first or the second Kuznets wave (depending on where an economy finds itself). Individual countries may be going through different Kuznets waves and different parts of each wave, depending on their income level and structural features. Thus, inequality in China may begin to go down, sliding along the downward portion of the first Kuznets wave, while some very poor countries may witness increases in inequality as they start climbing up their first Kuznets wave. The richest economies, which are well advanced in the process of the second technological revolution, may go further up the rising portion of the second Kuznets wave (as I think the United States will; see below) or may soon start on its downward portion. So we may find a variety of

experiences; but the most important patterns will be determined by what happens in the United States and China because of the size of the countries and their emblematic character.

There are two additional things to worry about as we consider the evolution of global inequality. The first is the balance between the benign and malign ways in which economic inequality can be reduced. We may be used to emphasizing the first set—rising education, declining skilled wage premiums, and greater demand for social security—but the second set, as in the run-up to World War I, is also compatible with globalization. Powerful national political interests may, as they did a century ago, combine to produce several dispersed wars, which then, following their own logic, could bring the world to the brink of, or to an actual, third world war. The Iraq war provides a good illustration of how economic interests are never far below the surface of wars that are ostensibly fought for another reason, whether it be antiterrorism or the spread of democracy (see Bilmes and Stiglitz 2008). James Galbraith, in *Inequality and Instability* (2012), shows that the profits earned by the economic beneficiaries of government outlays for the Iraq war (lobbyists, private security firms, military companies) were so significant that they were evident in income distribution statistics for the Washington, DC, area. One need only to open a copy of *Politico*, a free Washington, DC, daily that is targeted at Capitol Hill, to notice that most of the advertisements are for military hardware, from helicopters to fighter jets. The financial interests of people who benefit from destruction—the famed military-industrial complex—is a huge and unexplored area, and one hopes that the type of empirical analysis that Page, Bartels, and Seawright (2013) recently undertook to shed light on the influence of money in US politics will be done about those who have manifest financial interest in wars. At the risk of simplification, it could be said that in the United States today, wars are fought by the poor (including many who are not even US

citizens), are financed by the middle class, and benefit the rich. This situation is unlikely to be different in countries such as Russia and China.[6]

The second thing to worry about is a set of factors that are almost by definition impossible for an economist to account for, even though they could have huge economic effects. These are political, social, or ideological developments that lead to dramatic events like civil wars or the breakup of countries. Note the difference between, on the one hand, the malign effects of inequality that may lead to wars and, on the other, autonomous political developments. The former are political developments induced by economic factors; the latter are entirely "pure" political developments (to the extent that any event could be said to be purely political) with possibly tremendous economic consequences. One such important event could be a political transition to democracy in China, or, to be less teleological, its political evolution. Nothing guarantees that such a transition would be peaceful. A violent turn of events would have a huge impact on the Chinese growth rate, global economic convergence, the rise of the global middle classes, and practically every other globalization-related phenomenon—so influential is China. Yet a transition like this is outside economics proper. A similar example is the rise of violent fundamentalist Islam, a force that can only in part be explained by economic causes, but which has huge economic consequences. One of these consequences is the destruction of the middle classes and reasonably well-educated modern, secular societies in Iraq and Syria. Europe is not exempt from such political developments: anti-immigration and right-wing nativist politics may yet reduce Europe's commitment to globalization. There would be economic costs, but politics or ideology might matter more to people than income growth. We shall return to some of these imponderables at the end of this chapter. For now, however, we stay within the economic framework sketched earlier, turning first to the prospects for income convergence and what it would mean for global inequality.

Income Convergence: Will Poor Countries Grow Faster Than Rich Countries?

Are income levels in poor countries converging toward those in rich countries? The answer appears to be obvious. Globalization is supposed to make access to technology, including the best economic policy, much easier and faster for poor countries.[7] It is also supposed to make it easier for them to get capital and to buy the goods they need in order to develop. So even without the movement of labor (that is, even in an era of incomplete globalization), poor countries should have higher growth rates of income than rich countries. But as Figure 4.1 shows, this was not the case until at least the year 2000. The dashed line in Figure 4.1 shows the Gini coefficient calculated across mean GDPs per capita for practically all countries in the world, with each country's weight being the same.[8] When this line rises, it means that the gap in mean income among countries is getting bigger; when it declines, the gap is getting smaller. This measure of inequality increased between 1980 and 2000, the era of "high globalization," because Latin America and Eastern Europe (parts of the world that are around the middle of international distribution by GDP per capita) experienced large recessions or depressions. Russia's per capita GDP went down by more than 40 percent between 1989 and 1998, and although the extent of the decline was larger in Russia than almost anywhere else, the decline itself was not uncommon. Brazil's GDP per capita in 2000 was only 1 percent above its 1980 level. Africa, the poorest continent, had practically ceased growing in the 1990s and even went into reverse: African real GDP per capita in 2000 was 20 percent below its 1980 level. Meanwhile, rich countries continued to grow, not at spectacular rates, but at a steady rate of approximately 2 percent per year, which resulted in their GDP per capita being some 50 percent higher in 2000 than in 1980.

Thus, contrary to expectations, income convergence failed to materialize between 1980 and 2000. But after 2000, as all three regions

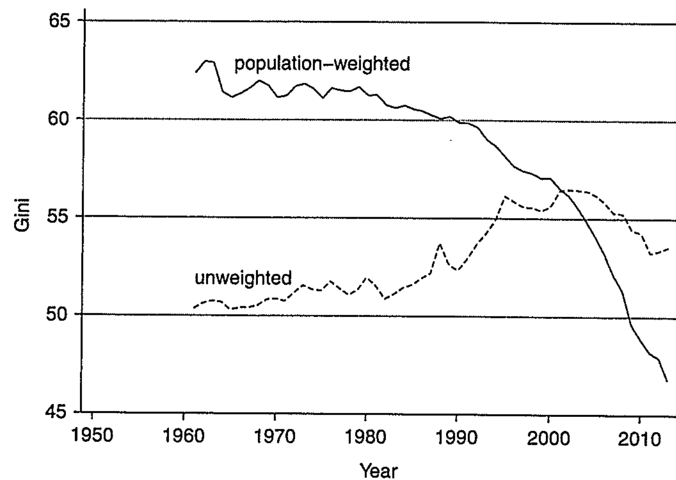

FIGURE 4.1. Global income inequality among countries, 1960–2013, weighted and unweighted for population size

This graph shows inequality (measured by Gini values) among countries' real GDPs per capita for most countries in the world, using two different measures: the unweighted Gini, where each country counts equally (dashed line), and the population-weighted Gini, where each country's importance reflects its total population (solid line). The strong increase in GDP per capita in China and India significantly reduced the population-weighted Gini, especially after 2000. GDPs per capita are in 2005 international dollars (based on 2011 International Comparison Project). Data source: Calculated from the World Bank's World Development Indicators (WDI) database (http://data.worldbank.org/data-catalog/world-development-indicators, version September 2014).

(Latin America, Eastern Europe, and Africa) picked up growth, and the rich world was struck by the financial crisis, convergence did happen. So the current era of globalization has a rather mixed record on convergence, and it is possible that another slowdown in, say, demand for raw materials, which largely underwrote the growth in Latin America and Africa in the first decade of the twenty-first century, may again put a halt to convergence.

But we get a different result if we weight countries by the size of their populations (rather than giving each country the same weight),

as indeed we should do in a work concerned with people. Using this measure of inequality, income convergence did indeed occur: population-weighted intercountry inequality, shown by the solid line in Figure 4.1, has been uniformly decreasing since the late 1970s, since about the time when China introduced the "responsibility system" (de facto private ownership of land) in rural areas and growth picked up. Moreover, convergence (the decrease in intercountry, population-weighted Gini values) has been remarkable and has accelerated in the first decade of the twenty-first century. We have already seen that this movement was the key factor behind the decrease in global inequality and the broadening of the global middle class. Moreover even when China is excluded from the analysis, convergence is still evident beginning in around 2000 (not shown in the graph). This result is very important because it shows that population-weighted convergence no longer depends on economic and social evolution in just one large country; convergence could continue even if China's growth were to sputter. Nevertheless, it is true that the future of global income convergence is very strongly influenced by the per capita growth rates of China and India on the one hand, and the United States on the other. But other populous countries matter too.

To show the rising importance of fast-growing populous countries other than China for the process of convergence, we contrast in Figure 4.2 the average combined (population-weighted) annual per capita growth rate of the principal emerging economies *excluding* China (India, Brazil, South Africa, Indonesia, and Vietnam) and the combined per capita growth rate of the rich world (the United States, the European Union, and Japan). The figure shows the gap between the two. The emergence of a growth gap in favor of the emerging economies after 1980, and especially strongly after 2000, is quite clear. Since 2000, the average per capita growth rate of the emerging economies has consistently been greater than the average per capita growth rate of the rich world, and the gap was large: emerging

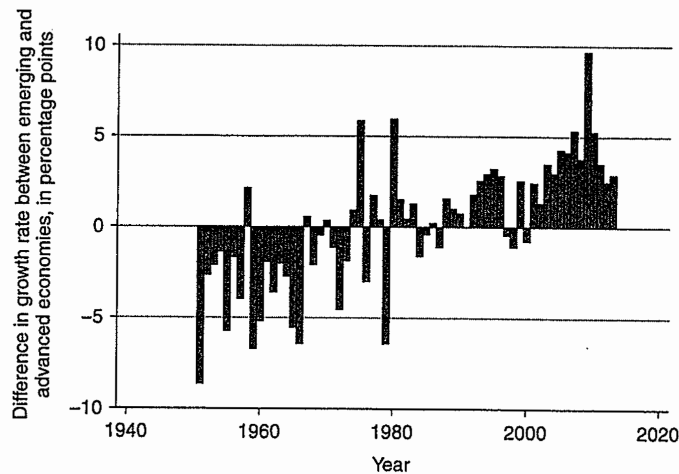

FIGURE 4.2. Difference in the combined (population-weighted) growth rates between the principal emerging economies (excluding China) and the advanced economies, 1951–2013

This graph shows the difference in population-weighted GDP per capita growth rates between emerging economies other than China (India, Brazil, Indonesia, South Africa, and Vietnam) and advanced economies (United States, European Union, and Japan). When the bar is above 0, the emerging economies have grown faster than the advanced economies. Since the mid-1980s, this has been true in all years but three. GDPs per capita are in 2005 international dollars (based on 2011 International Comparison Project). Data source: Calculated from the World Bank's World Development Indicators (WDI) database (http://data.worldbank.org/data-catalog/world-development-indicators, version September 2014).

economies had a growth rate of 4.7 percent per annum, compared with only 1 percent for the rich countries.[9] This gap was the key force behind the decline in global inequality, resulting in a decrease of the global Gini value starting in around 2000 (as discussed in Chapter 3). Between 1980 and 2000, the gap in growth rates was not as large: it was, on average, 1 percentage point (2.9 percent vs. 1.9 percent), but the emerging economies were still growing faster. We have to go back to the period before the 1970s to find a gap that

was mostly in the other direction, when Europe, North America, and Japan were growing faster than what were then called "developing countries." During the past thirty-five years, there is only one year (1998) when the key emerging economies (excluding China) grew at a perceptibly lower rate than the rich world. This was the year of the Asian financial crisis, when Indonesia's economy shrank by 15 percent and the contagion affected Brazil and South Africa too, leading to modest negative growth rates (minus 1 percent) in those countries.

To argue that the growth of the emerging global middle class, which is "fed" by these countries and by China, will slow down, we would need to argue that there would be a significant reversal in the growth pattern that has characterized the past thirty-five years. Even if China were to slow down, these other large economies may be expected to continue growing at approximately the same rates as in the past decades. What is needed for income convergence to continue, and for the global middle class to grow, is for this rate to continue to be greater than the growth rate of the rich countries. It seems more likely that this tendency will continue than that it will reverse.[10]

Is Convergence an Asian Phenomenon?

A convergence in per capita incomes (or GDPs per capita), when they are population-weighted, is evident from the data and is, as we have seen, the main factor behind the recent decline in global inequality among citizens of the world. However, recall that convergence does not appear (except in the first decade of the twenty-first century) when we look at unweighted GDPs per capita among countries (that is, conventionally defined unconditional convergence). This contrast suggests that the main factor behind the population-weighted convergence is the fast economic growth of populous Asian countries. This conjecture is confirmed when we plot countries' average growth rates during the 1970–2013 period against their GDPs per capita in

the 1970s. Figure 4.3a shows such a plot for all countries in the world except Asia. The long-term growth rates are neither increasing nor decreasing with 1970 GDP per capita levels. If we were to draw a regression line it would be flat at less than 2 percent per capita per year, suggesting that both rich and poor countries grew at the same rate. Figure 4.3b shows only Asian and Western countries, with Western countries defined as Western Europe, North America, and Oceania (Australia and New Zealand), or WENAO. The regression line now displays a very clear downward slope. The poorer countries, and they are invariably Asian, have grown faster over this forty-three-year period than the rich Western nations.[11] Not only is population-weighted convergence an Asian phenomenon, so is unweighted convergence: it is only Asian countries that have been catching up with the rich world.

This conclusion has implications for what we may expect regarding income inequality among countries in this century and the next. First, it provides us with a more cautionary tale about the power of economic convergence because large parts of the globe are not achieving it. Second, it introduces additional caution in our estimates because it is precisely in the "left-out" regions of Africa where we expect the largest demographic increases. Thus, nonconvergence, from being manifest in population-unweighted data, might "spread" to the population-weighted data too, and in turn check the projected decline in global inequality. In other words, as population numbers in Africa grow, the lack of convergence of African incomes with those of the rest of the world might begin to make a strong appearance not only in data comparing poor and rich countries, but also in data comparing poor and rich individuals.

Let us consider the position of Africa in more detail. In 2013, population-unweighted (that is, calculated simply across countries) GDP per capita in Africa was 1.9 times higher than in 1970 (see Table 4.1, column 2). This is the lowest ratio of the five regions. GDP per capita in Asia was multiplied by a factor of almost 5 during the

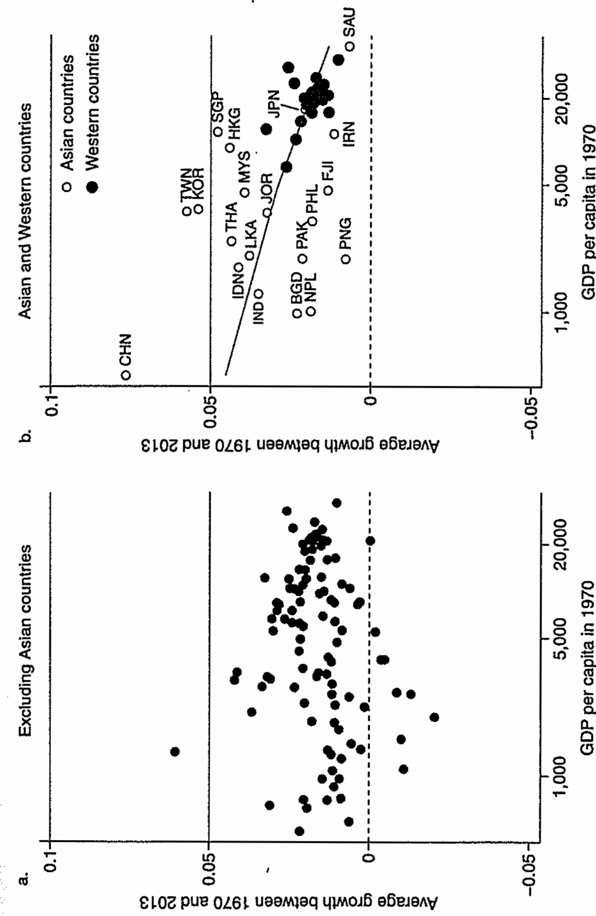

FIGURE 4.3. Level of GDP per capita in 1970 and the average growth rate in the subsequent period (a) for all countries excluding Asia and (b) for Asian and Western countries

These graphs show the average annual growth rate in the period 1970–2013 against real per capita income in 1970. When we exclude Asian countries (a), there is no relationship between the two. When we look at Asian and Western countries only (b), we see that countries that were poorer in 1970 had grown faster. Growth rates expressed in fractions (0.05 = 5% growth). GDPs per capita are in 2005 international dollars (based on the 2011 International Comparison Project). Western countries include Western Europe, North America, and Oceania (Australia and New Zealand). Country abbreviations: BGD Bangladesh, CHN China, FJI Fiji, HKG Hong Kong, IDN Indonesia, IND India, IRN Iran, JOR Jordan, JPN Japan, KOR Korea, LKA Sri Lanka, MYS Malaysia, NPL Nepal, PAK Pakistan, PHL Philippines, PNG Papua New Guinea, SAU Saudi Arabia, SGP Singapore, THA Thailand, TWN Taiwan. Data source: Calculated from the World Bank's World Development Indicators (WDI) database (http://data.worldbank.org/data-catalog/world-development-indicators, version September 2014).

TABLE 4.1. Growth record of various regions of the world between 1970 and 2013

Region	(1) Average 1970 GDP per capita (population-weighted)	(2) Ratio of 2013 GDP per capita to 1970 GDP per capita (across countries)	(3) Average percentage shortfall in 2013 from the historical peak (across countries)
Africa	2,900	1.9	10.2
Asia	2,200	4.9	0.6
Latin America	7,000	2.0	1.8
Postcommunist transition countries	8,300	2.4	5.3
WENAO	19,700	2.3	2.5
World	6,400	2.6	2.8

Note: GDP per capita in 2005 international dollars (based on 2011 International Comparison Project results). WENAO = Western Europe, North America, and Oceania.
Source: World Development Indicators (http://data.worldbank.org/data-catalog/world-development-indicators), various annual versions.

same period, but even Latin America and the postcommunist transition countries had ratios equal to or greater than 2. Rich Western countries (WENAO) were 2.3 times better off in 2013 than in 1970. If income convergence were occurring we would have expected Africa, which in 1970 was poorer than any region except Asia, to have grown faster than most other regions and its 2013-to-1970 ratio to be close to that of Asia. But this is far from being the case: African countries grew the slowest.

The divergence of Africa was not caused only by slower per capita growth than in the rest of the world, as would be one way to interpret the figures here: for example, Africa's ratio of 1.9 implies an

average per capita growth rate of 1.5 percent per annum, while WENAO's ratio of 2.3 implies 2 percent per year. The problems in Africa are more complex than these numbers suggest. African countries have often had spurts of growth followed by swift declines, and it is the inability to sustain even modest rates of growth for long periods that seems to be the major problem. The fluctuations in growth are driven by political conflicts, civil wars, and cyclical price trends that affect the natural resources on which much of Africa's output and exports are based. To illustrate these fluctuations in growth, let us denote the highest GDP per capita ever reached by a country as 1, and then look at how the actual 2013 GDPs per capita compare with that historical maximum. In WENAO, the average ratio of 2013 GDP per capita to the peak value across countries was 0.975, so the shortfall (the difference between 1 and 0.975) was 2.5 percentage points (entirely caused by the Atlantic recession) (see Table 4.1, column 3).[12] Latin America and Asia were, on average, less than 2 percent below their historical peaks, and the post-communist transition economies were 5 percent below. But this pales in comparison with Africa, where the shortfall from the historical peak was over 10 percent. African countries can and do grow, but they also have sudden and sharp income declines. The final outcome is absence of income convergence with the rich world, and even with other regions.

In some extreme cases, the failures are so overwhelming that our data are insufficient to illustrate them fully. Thus, the GDPs per capita of Madagascar and the Democratic Republic of Congo are lower today than they are estimated to have been before independence (around 1950). It is reasonable to suppose that incomes in the 1930s and 1940s were below those in 1950 (that is, we assume some growth during these decades). It follows that Madagascar and Congo first reached the income levels they have today some eighty or even ninety years ago. In terms of development and catch-up with the richer countries, an entire century has been wasted.[13] We don't have any

EXCURSUS 4.1. Forecasts of Global Inequality

How will the level of inequality among all citizens in the world change during the next several decades? If Asia's income convergence with the West continues, this will be a very strong force for the overall convergence of individual incomes. However, once China's mean income is at a level such that more than half of the world population, when ranked by their countries' mean incomes, are behind China, continued growth in China will lead to global incomes becoming less equal (especially given high interpersonal inequality within China itself).[14]

In an interesting exercise, Hellebrandt and Mauro (2015) have tried to predict the evolution of global inequality from 2015 to 2035. They estimate that global inequality will, in the most likely scenario, decrease by almost 4 Gini points. This exercise rests on three building blocks: GDP per capita growth rates, population growth rates, and within-nation inequalities. For countries' growth rates, Hellebrandt and Mauro use forecasts from the OECD, the IMF, and Consensus Forecasts (a private forecaster); for population growth rates, they use the United Nations' median forecast; and for inequalities within nations, they assume no change. Although I am very skeptical about forecasts in general, and the authors themselves point out that such forecasts almost always turn out to be overly optimistic and that the error increases dramatically with the time-horizon, their three conclusions are worth considering.

First, the forecast shows that in a growth scenario based on reversion to the mean (a slowdown of poorer countries' growth rates as they get richer), the reduction in global inequality would be minimal (less than 1 Gini point).

Second, the projections underscore the huge importance of India's economic growth for reducing global inequality. The reason is that China's role as the main engine driving the reduction in global inequality becomes less important as the country gets richer. In 2011, China's mean per capita income, calculated from household surveys and expressed in international dollars, was 22 percent below the global mean and was greater than the mean incomes of 49 percent of the people in the world (assumed to have the mean incomes of their countries).[15] The world will very soon be in the position where China's high growth rate begins to add to global inequality, not detract from it.[16] India's mean income is currently ahead of only 7 percent of the world population, and India cannot be expected to "turn the corner," that is, to become, in average per capita terms, richer than more than 50 percent of the world population, in the next twenty years. Thus it will, if it grows fast, take over from China as the main engine of global income equalization.

Third, Hellebrandt and Mauro find that only very substantial increases in inequalities within nations (a Gini increase of more than 6 points for all countries in the world) would overturn the equalizing impact of mean income convergence from the most likely scenario. If the convergence of mean incomes is slower, the offsetting increase in within-nation inequalities need not be as high. Nevertheless, this result illustrates that even as inequalities within nations become more important, they will not, at least in the next twenty years, play as much of a role in global inequality as the catch-up of poor countries.

During the next twenty years, absent any of the dramatic negative events which we listed at the beginning of this chapter, the prospects for continued reduction in global inequality are good but not extraordinary. One cannot expect global inequality to be reduced by more than one-fifteenth of its current level. While such a reduction would be remarkable in historical terms, we are hardly likely to live in a world of an egalitarian global utopia any time soon.

guarantee that the same thing will not occur in this century. If it does, the convergence story takes on an entirely different hue: convergence might still happen, but the odds are longer.

The Other Side of the Equation: Inequalities in China and the United States

The other side of the global inequality equation, in addition to the change in inequalities *between* nations, is the change in inequalities *within* nations, and especially in China and the United States. These two countries are important not solely on account on their size but also because they provide the prime examples of the changes in inequality in emerging and rich economies. If the tendency toward mean income convergence continues, the prospects for the reduction of global inequality could still be derailed by what happens to inequality within individual countries. We cannot look at the evolution of inequality in most of them. But expectations or educated guesses regarding what might happen in China and the United States are worth making. Let us start with China.

Mr. Kuznets goes to Beijing? The facts regarding inequality in China since 2010 are murky because the Chinese National Bureau of Statistics (NBS), which has never been forthcoming with data and has never distributed microdata (at the household level), has become even more closed. For a quarter of a century, household surveys in China were organized differently for rural and urban areas (creating problems for researchers wishing to combine the two); they were reformed in 2013, and the NBS then ran the first unified all-China household survey. This survey was supposed to be an important marker for improving knowledge of changes in inequality and other social and demographic variables. As of January 2015, however, the NBS had not released any data. So instead of knowing more, we now

know less. One can speculate that the reason for this sudden silence is that some results were unexpected or difficult to reconcile with the results obtained from earlier surveys.

Based on the evidence we do have, it looks as though income inequality did not rise in the five to six years before 2013 and may in fact have declined a little. The data from household surveys show that the all-China Gini coefficient has stayed relatively stable since 2000 (Figure 4.4). The NBS made the same claim in a press release. Income inequality calculated from urban household surveys has been stable since 2002 (Zhang 2014; not shown in the figure here). According to Zhang (2014), intersectoral wage inequality declined between 2008 and 2012. Intersectoral wage inequality measures inequality between wages

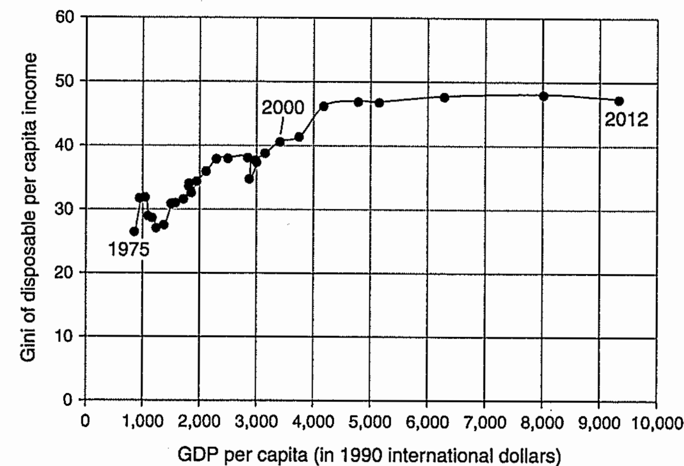

FIGURE 4.4. Income inequality in China, 1975–2012

This graph shows the evolution of income inequality across individuals (measured by Gini values) in China against China's real GDP per capita. We see that inequality in China has increased steadily since the reforms started (after 1975) but has recently been stable. Data sources: Ginis: All the Ginis database (http://www.gc.cuny.edu/branko-milanovic), calculated from the official Chinese household surveys. GDP per capita from Maddison Project (2013).

in different industrial sectors; it is not the same as wage inequality between individuals or income inequality among households, so it is at best a proxy of "real" interpersonal inequality.[17] Nevertheless, Zhang's results may reflect a similar trend in interpersonal inequality, especially because in the past, changes in intersectoral wage inequality closely paralleled those in overall income inequality.[18]

If evidence showing absence of a further increase in income inequality is confirmed, it may be that China's level of income inequality has reached a plateau and will soon begin moving downward, in line with Kuznets's theory. The pattern in China would then perfectly fit the shape of the first Kuznets wave, with increased inequality occurring during the period of structural transformation of the economy, combined, in China's case, with a transition from socialism to capitalism. The subsequent fall in inequality would be driven by the usual benign forces: equalization of levels of education (at a higher overall level), aging of the population and thus greater demand for old-age security and social transfers, and perhaps most importantly, the push for increased wages that comes at the end of a period of so-called Lewisian growth, during which the supply of low-wage (rural) labor is almost limitless. The theoretical support for the proposition that China might be turning the corner on increasing inequality comes from several sources. As mentioned, the usual Kuznets interpretation would lead us to expect China's level of inequality to decline, but so would Tinbergen's emphasis on the declining returns to education: as the supply of highly skilled workers expands, their relative wages should be reduced. And finally, so would Arthur Lewis's story of the low-skill wage-push coming from the exhaustion of cheap sources of labor. China could thus reach both the Kuznets and the Lewis turning points at the same time.

But other forces could work against this scenario. Pervasive corruption and a political system that generates it could counteract the purely economic forces of income equalization. Recent political

moves, especially the targeting of corruption at all administrative levels and a vast government plan of regional "rebalancing" that is supposed to lower inequality between the maritime and inland provinces (in itself a major contributor to all-China inequality), seem to be motivated by the leadership's realization that inequality poses dangers for the maintenance of their own power. Another element that could work in the direction of rising inequality is the country's rapidly increasing wealth and the resulting increase in the share of net income that comes from the ownership of capital. Such shifts are usually associated with wider interpersonal inequality because ownership of capital is heavily concentrated. China is no exception to this rule. Using Chinese household surveys, Wei Chi (2012) showed that the share of capital income received by urban households is rising and that it is becoming very concentrated.

The question is then which set of forces will predominate. On balance, however, one can be optimistic that China's income inequality may have peaked.

But is the Chinese political system completely resilient, or does it contain internal features that could lead to its weakening or even collapse? The political system has a top-down structure much like that in imperial China, with the communist bureaucracy rather than the imperial bureaucracy at the apex (Xu 2015). The top bureaucracy controls the judiciary but allows some policy flexibility among regionally decentralized units, such as provinces and even counties. The combination of centralization with local flexibility has been used, with huge success, to motivate competition between lower-level units in achieving material targets (like GDP growth rates) and to spur experimentation with various economic policies and forms of ownership. The system has allowed experimentation ranging from the Special Economic Zones in the 1980s to the Shanghai bourse in recent years. But while this political structure has performed very well in the past half century, it contains a number of vulnerable points.

The first is illustrated by the greed of local authorities who, either because they are corrupt or because they need to compete with other local authorities, resort to brutal forms of exploitation, confiscating land at nominal prices from farmers or imposing unbearable working conditions on workers. Such instances of mistreatment have led to a veritable epidemic of strikes and local protests across China. According to official statistics, there were about five hundred thousand of these in 2013 (National Bureau of Statistics of China 2014, table 24-4). As long as the protests are localized and do not erupt at the same time in many places, and the center, which essentially means the leadership of the Chinese Communist Party, is sufficiently united, the strife does not pose a major threat to political stability.

But unity of purpose or interest at the center is far from being guaranteed in a system that lacks accepted legal rules about how people get to the top, what powers they hold, and how long they stay there. In a decentralized system where local "barons" wield significant power, any vacillation at the center is bound to produce even greater freedom of action at the provincial and local level, with the ultimate result being that the center becomes whatever the provinces decide that it is. This would lead to either formal or informal dissolution of the country and is, I think, the most serious danger China faces in the coming decades. After all, during its 2,800 years of well-documented history, China has been unified for fewer than 1,000 years (Ma 2011, appendix, 35).

The United States: A "perfect storm" of inequality? There are two substantive differences between the United States and China in terms of our predictions about changes in inequality. First, we have more complete data and a better understanding of the economic forces underlying recent changes in inequality for the United States than we do for China. Second, the forces that would tend to drive inequality down in China do not appear to exist in the United States.

There are a number of developments that may lead to a "perfect storm" of rising inequality in the United States. They can be divided into the five following themes, which I will discuss in turn:

- Higher elasticity of substitution between capital and labor, in the face of increased capital intensity of production, will keep the share of national income that accrues to capital owners high.
- Capital incomes will remain highly concentrated, thus leading to high interpersonal inequality of incomes.
- High labor and capital income earners may increasingly be the same people, thus further exacerbating overall income inequality.
- Highly skilled individuals who are both labor- and capital-rich will tend to marry each other.
- Concentration of income will reinforce the political power of the rich and make pro-poor policy changes in taxation, funding for public education, and infrastructure spending even less likely than before.

Let us go over each of these possible developments in greater detail. The very technical issue of the elasticity of substitution between capital and labor has to do with whether the share of capital in net income rises or not when the capital intensity of production (ratio of capital to labor) goes up. It has been a standard view in economics that factor shares tend to be constant, with some 70 percent of national income going to labor and some 30 percent to capital. This nostrum has been overturned in the past couple of decades as it has become clear that capital shares are increasing in all advanced economies. Karabarbounis and Neiman (2013), who document this trend, ascribe it mostly to the reduced prices of investment goods, which leads companies to substitute capital for workers. A continuation of this trend of machines (such as robots) becoming less expensive

would be expected to lead to further declines in the labor share, and thus to the increase in the share of capital. In the United States, Elsby, Hobijn, and Şahin (2013, fig. 1) show that the share of capital in net income increased from 35 percent to more than 40 percent between 1980 and 2013. (Note that the timing of the increase in the capital share coincides with the increase in interpersonal income inequality in the United States, discussed in Chapter 2.) Will capital share continue to rise? In a world as envisioned by neoclassical economics, where factor earnings are determined by economic forces alone, a way for the share of capital to increase is if capital can gradually replace labor without its own return decreasing commensurately. Thus, if robots displaced labor without reducing the return to the robots' owners (that is, the shareholders in the companies that produce or own the robots), the share of capital in net income would rise. This is one of Piketty's points in *Capital in the Twenty-First Century*. If the rate of return is more or less fixed as capital replaces labor, we have exactly this outcome: the share of the national income from capital rises.

But the same outcome may be brought about by other factors besides marginal productivity. One of the most important of these is the relative power of labor versus capital, as reflected, for example, in the percentage of workers in trade unions and the percentage of the labor force employed in steady, open-ended jobs. A continued weakening of labor's relative power, as has been going on during the past three decades, can result in rising capital share too. There is not a strong likelihood that either of the two processes—namely, greater capital intensity of production and the institutional changes which weaken the bargaining position of labor—will be reversed in the decades to come, and so we can expect that the same forces will bring the same outcome: rising, or at least nondiminishing, capital share in net income.

Now, the increase in the share of capital does not by definition directly translate into greater interpersonal inequality. Suppose, for example, that all individuals in a country had the same share in national capital: then, clearly, a rise in capital share would benefit everybody equally, and there would be no increase in interpersonal inequality. But the reality is different. In all modern capitalist societies, capital ownership is heavily concentrated (that is, it is in the hands of the few). That, too, would not be a problem if the few were not also rich. To understand why, suppose that capital were held by the poor. (I know that this situation is hard to imagine, because we are simply used to the fact that rich people are capitalists; technically, capitalists could be poor.) In that case, too, an increase in the share of capital would not increase inequality. But, of course, neither of these hypothetical situations exists: capital ownership is heavily concentrated, and capital owners who get large profits or rents from their property also tend to be rich.[19] Thus, an increase in the share of capital *plus* the concentration of capital ownership among the rich will definitely increase interpersonal income inequality. This is the second part of the perfect storm scenario.

Note that in principle this element of the scenario could be reversed by means of a "deconcentration" of capital ownership. Such a deconcentration, however, is not even on the horizon in the United States. Data from Edward Wolff indicate, on the contrary, that net assets and equity ownership have become even more concentrated. In 2007, 38 percent of all stocks were owned by the wealthiest top 1 percent of individuals, and 81 percent were owned by the top 10 percent. Both figures are higher than in 2000 (Wolff 2010, 31–32). These shares are higher than the shares of the top 1 percent or top 10 percent in all net assets (which include housing) because the composition of wealth varies in such a way that the *share* of financial assets in the wealth portfolio increases with the level of wealth. The

richest 1 percent (by wealth) hold three-quarters of their wealth in the form of corporate stocks, financial securities, and unincorporated business equity, while the middle three quintiles hold less than 13 percent of their wealth in that form (Wolff 2010, table 8). The poorest hold almost nothing at all in equity.[20] In other words, financial assets are the most concentrated form of capital ownership; they are the quintessence of capitalism.[21] Thus an increase in the share of capital incomes directly translates into a greater concentration of overall wealth and income.

Another impetus to the concentration of personal incomes comes from an increasing tendency, documented by Lakner and Atkinson (2014), for the same people to receive high incomes from both labor and capital. This situation creates a potentially new, seemingly more meritocratic, style of capitalism, but ironically, it is a style with a potential for greater income inequality. The best way to visualize this is to go back to a simplified notion of nineteenth-century capitalism, what we might call classical, or old, capitalism, where capital owners were all rich and workers were all poor (and the reverse: all rich people were capitalists and all poor people were workers). Both capitalists and workers had only one factor income: capitalists' income came from owning property, and workers' income came from wage-labor. Now, let inequality among workers increase, so that some of them receive salaries that place them among the rich. We no longer have the straightforward identity of rich = capitalist. Such a process has actually been going on for almost a century in the advanced countries and has changed the composition of income among the top income groups in favor of labor. As Piketty and Saez (2003, 16, fig. 4) and Piketty (2014, chap. 8) show, among the top 1 percent, labor income is far more important today than it was a century ago.[22] This shift need not exacerbate inequality as long as the top wage earners are different people from the top capitalists.

The problems of inequality become more acute, however, when rich capitalists are the same people as those who receive the highest labor incomes. Lakner and Atkinson (2014) show, using information from US fiscal records, that the likelihood that a person (more exactly, a tax unit) in the top 1 percent according to the distribution of labor incomes is also in the top decile by capital income has increased from under 50 percent in 1980 to 63 percent in 2010 (Figure 4.5). A person with a very high labor income (top 1 percent) is almost assured (80 percent probability) of being in the top quintile of capital owners. The reverse association—being among top wage earners while having a high income from capital—has increased over the

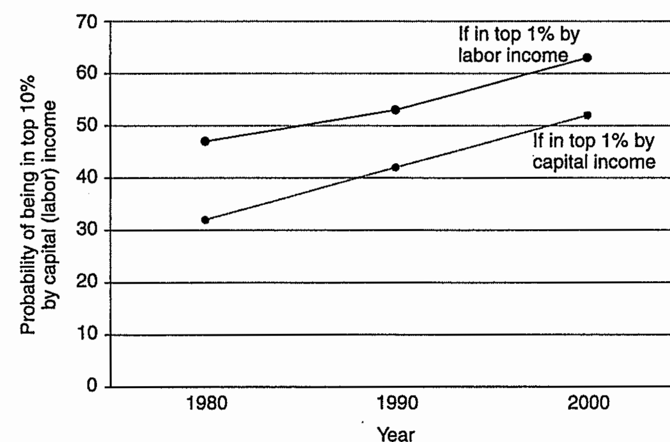

FIGURE 4.5. Probability (in percent) of being in top 10% by capital (labor) income if a person is in top 1% by labor (capital) income, 1980–2000

This graph shows the probability that a US tax unit (generally a household) that is in the top 1% according to labor (capital) income is also in the top 10% by capital (labor) income. Increased probability over time shows that more people are becoming both labor- and capital-rich, that is, they have both high wages and high income from property. Data source: Lakner and Atkinson (2014).

same period as well. To realize the importance of this association, note that in the extreme case of old capitalism, where all capital owners have only income from capital and all workers have only income from wages, the probability of overlap between capital and wage income would have been zero. The present-day association is also different from a situation where, say, the top 1 percent of workers had randomly drawn capital incomes; in that case, only 10 percent of them would be in the top decile by capital income. In reality, the top wage earners are over six times more likely to be in the top decile. Describing in statistical terms a much more complex reality, we can say that capitalism has moved from being a system with complete separation between capital and labor incomes to a variant where the correlation between the two was negative (those who had labor incomes had very little capital income) to the "new capitalism," where this correlation is positive.[23]

The same results are obtained from US household surveys, which have the advantage of covering the entire distribution (unlike fiscal data, which miss about 5–6 percent of the population). Figure 4.6 shows the increased correlation between income from labor and income from capital (which includes interest and dividends, rental income, and royalties) received by US households. The correlation, as in old capitalism, was close to zero in the 1980s; it then increased throughout the 1990s and early noughts, reaching a value of about 0.12, where it has stayed ever since.

One can speculate that the main mechanism by which this association operates is that people with very high labor incomes (e.g., CEOs of financial firms) save a sizeable portion of their income (or get paid in stock options) and become large capital owners. Thus, they increasingly draw high incomes from both labor and capital. If one projects this trend into the future and over at least two generations, with parents investing a lot in their children's education and children getting highly paid jobs while inheriting large capital assets,

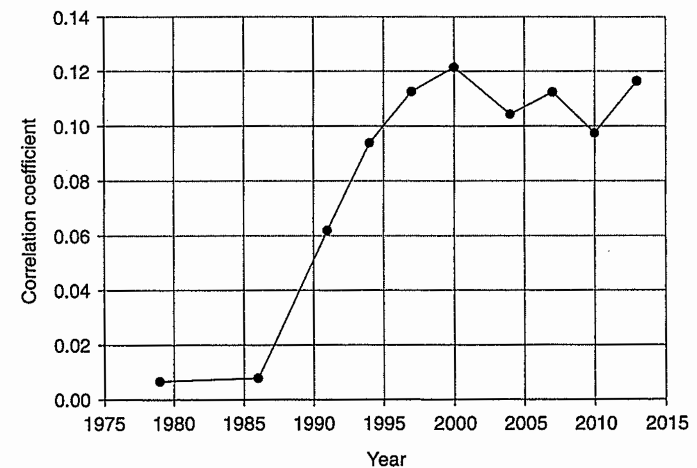

FIGURE 4.6. Correlation between labor and capital income received by US households, 1979–2013

This graph shows the correlation between income from labor and capital for US households. Greater correlation indicates that high incomes from labor and high incomes from capital are increasingly received by the same households. Data source: Calculated from Luxembourg Income Study database (http://www.lisdatacenter.org/) based on US Current Population Survey.

inequality becomes more entrenched within families and more stable (because it draws its source from both labor and capital), and it acquires an appearance of meritocracy that makes it politically more difficult to overturn.[24] A new capitalism, very different from the classical one based on the division between capital and labor embodied in different people, is thus born.

In the new capitalism, rich capitalists and rich workers are the same people. The social acceptability of the arrangement is enhanced by the fact that rich people work. It is moreover difficult or impossible for the outsider to tell what part of their income comes from ownership and what part from labor. While in the past, rentiers were commonly ridiculed and disliked for doing work that involved nothing

more demanding than coupon-clipping, under the new capitalism, criticism of the top 1 percent is blunted by the fact that many of them are highly educated, hardworking, and successful in their careers. Inequality thus appears in a meritocratic garb. Inequalities generated by new capitalism are harder to tackle ideologically, and probably politically as well, because there is no popular groundswell of support to limit them. They appear—and to some extent they may also be—more justifiable and are therefore more difficult to uproot.

The next development promoting inequality in the United States is closely related to the one that we have just discussed. It may originate in the same social mores that favor high levels of education and hard work as desirable features that justify high incomes no matter how high they are. This development is the documented tendency of highly skilled, and thus generally rich, individuals, to increasingly marry people who share similar characteristics. Here again, a simplified contrast with the past allows us to best capture the difference. In the 1960s, when relatively few women worked (the participation rate in the labor force for women in the United States was 40 percent, vs. more than 90 percent for men),[25] it was common for well-off men to marry women who did not work outside the household and thus did not contribute a monetized income. This practice tends to diminish inequality, in comparison with a situation where highly paid men marry highly paid women. The latter has indeed been happening more often in the past quarter century. Greenwood et al. (2014) document the increasing trend of homogamy (assortative mating) among American couples and consider it one of the contributing factors to rising income inequality. It is paradoxical that increasing inequality has resulted from a change in social norms that has seen the labor participation rate of women almost catch up with that of men (73 percent for women, 84 percent for men in 2010) and has encouraged marriages that are based on a model of equal partnership between people with similarities of interests and backgrounds rather than a hierarchical model where the husband is the breadwinner and the wife a homemaker. This trend may continue in the future, as the gap in both educational achievement and labor force participation between men and women disappears. It will, however socially desirable in some ways, add to interpersonal income inequality.[26]

Finally, we come to the fifth element that makes the reversal of inequality in the United State particularly difficult: the growing importance of money in electoral politics. No political campaign can nowadays be run without huge amounts of money. The 2012 US presidential elections are estimated to have cost $2.6 billion.[27] While the amounts spent in state and local elections are smaller, money is no less indispensable for winning, or even participating. The major contributors who fund political campaigns are, by definition, rich (poor people cannot afford to do so), and they are not interested in throwing their money away. To believe that the rich do not use their money to buy influence and promote policies they like is not simply to be naïve. Such a stance contradicts the key principles of economics as well as the ways in which the rich people have amassed their wealth—surely not by throwing it around while expecting no return on it.

US senators and congresspeople are much more concerned with issues that affect their rich rather than their poor constituents, according to studies by Bartels (2010), Gilens (2012), and Gilens and Page (2014). Gilens (2012, 80, figs. 3.3, 3.4) shows in a striking graph that politicians' responsiveness to the concerns of the people at the 90th percentile of income distribution continuously increases as the issue becomes more pressing (to the rich). In other words, the greater the concern of the rich with an issue, the greater the responsiveness of the legislators. In contrast, for both the poor (people at the 10th percentile of the income distribution) and the middle class (people at the 50th percentile), legislators' responsiveness is a flat line: whether

the poor or the middle class care a lot or not at all about a given issue has no influence on legislators. The findings illustrate that the gap in political influence is enormous not only between the rich and the poor, but between the rich and the middle class. The rich spend billions on funding political campaigns and, like the oil and pharmaceutical industries, in lobbying; as a result, the policies that are in their interests are implemented.[28]

In a positive feedback loop, pro-rich policies further increase the incomes of the rich, which in turn makes the rich practically the only people able to make significant donations to politicians, and thus the only ones who get a hearing from the politicians. The political importance of each individual becomes equivalent to his or her income level, and instead of a one-person one-vote system, we approach a system of one-dollar one-vote, which is nothing else but the projection on the political plane of the existing distribution of income. This system is evident in a perhaps unwitting quotation from George W. Bush, when he was speaking to a rich crowd in Washington, DC: "This is an impressive crowd—the haves and the have-mores. Some people call you the elites; I call you my base."[29] A plutocracy is thus born.

These five developments are all strongly pro-inequality, and it is hard to see where any forces might come from that could counter rising income inequality in the United States.[30] The economic logic of the rising share of capital in net income is reinforced by the way that high incomes from capital and labor are distributed (high concentration of capital income and the personal association between high labor and high capital incomes), by social norms (homogamy), and finally by economic policies. It is this unusual confluence of economic, social, and political factors that seems likely to keep inequality at a high level for the foreseeable future in the United States. Forces promoting offsetting policies such as more widespread education, a higher minimum wage, and more generous welfare benefits seem weak compared with the almost elemental forces that favor greater inequality.

Now that we have reviewed the recent fortunes of income inequality in both China and the United States, we can compare the two countries in terms of the methodology developed in Chapter 2. Looking schematically at changes in income inequality, we can conclude that income inequality in China may be on the descending portion of the first Kuznets wave, whereas inequality in the United States is either still rising or is about to reach the peak of the second Kuznets wave (Figure 4.7).

One of the most pernicious consequences of the rise in inequality in the rich countries as they slide up the second Kuznets wave has been the hollowing out of the middle class and the rising political importance of the rich. This danger, however, is coupled with its nemesis, a popular class rebellion, which tends to morph into populism or nativism. Neither populism nor plutocracy is compatible with the classical definition of democracy. So the question arises as to whether inequality is a threat to Western democratic capitalism. We address this question in the next section.

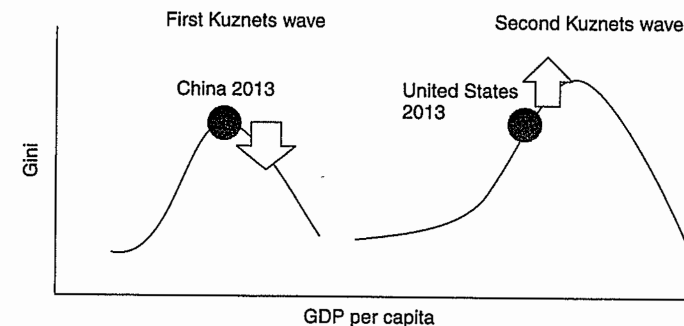

FIGURE 4.7. Kuznets waves for the United States and China

This graph presents a stylized estimate of the current position of China and the United States on the first and second Kuznets waves. The United States, being a more developed economy that went through the first technological revolution more than a century ago, is now approaching the peak of the second Kuznets wave. China may be around the peak of the first Kuznets wave, poised to become less unequal.

Perils of Inequality: Plutocracy and Populism

To answer the question "Does inequality threaten the sustainability of Western democratic capitalism?" we need to divide it into two parts. First, Does inequality threaten capitalism? And second, Does inequality threaten *democratic* capitalism?

The answer to the first question, at least in the medium-term, seems to be in the negative. For the first time in human history, a system that can be called capitalist, defined (conventionally) as consisting of legally free labor, privately owned capital, decentralized coordination, and pursuit of profit, is dominant over the entire globe. One does not need to go far back into the past, or to have a great knowledge of history, to realize how unique and novel this is. Not only was centrally planned socialism eliminated as a competitor only recently, but nowhere in the world do we now find unfree labor playing an important economic role, as it did until some 150 years ago.

Such is the hegemony of capitalism as a worldwide system that even those who are unhappy with it and with rising inequality, whether locally, nationally, or globally, have no realistic alternatives to propose. "Deglobalization" with a return to the "local" is impossible because it would do away with the division of labor, a key factor of economic growth. Surely, those who argue for localism do not wish to propose a major drop in living standards or a Khmer Rouge solution to inequality. Forms of state capitalism, as in Russia and China, do exist, but this is capitalism nevertheless: the private profit motive and private companies are dominant.

It is often stated that Islam is the only remaining ideological competitor to Western liberal capitalism. This is, I think, true in many respects as far as liberal society is concerned but not in the one that we address here, namely, the effects of inequality on *capitalism*. For Islam itself, not only as it exists in dominantly Muslim countries, but even in theory, is indeed a kind of capitalism, in its emphasis on private ownership of the means of production, the pursuit of gain, and the rejection of unfree labor.[31] The only area of economics where Western and Islamic capitalisms part ways is in the treatment of interest (as differentiated from profit, which, unlike interest, is a variable rather than a fixed source of income that depends on the success of the enterprise). But this is a relatively minor point which can be taken into account and made compatible with standard Western practice, as is done in Islamic banking. It could even be argued, and I believe that there is some truth in it, that rejecting a fixed and guaranteed interest on debt, as Islam does, allows the system to be much more flexible and not to get stuck in a situation, as happened in Greece and Argentina, where debtors cannot repay the entire debt but there is no mechanism to acknowledge this and move on.

Increasing inequality of income, however, undercuts some of capitalism's mainstream ideological dominance by showing its unpleasant sides: an exclusive focus on materialism, a winner-take-all ideology, and the disregard of nonpecuniary motives. But since no significant ideological alternatives currently exist, and since there are no powerful political parties or groups pushing for alternatives, the hegemony of capitalism looks almost unassailable. For sure, nothing guarantees that the situation will look the same in twenty or fifty years, for new ideologies can be invented, but this is how it looks to a reasonable observer today.

But is *democratic* capitalism sustainable? This is quite a different question. Note first that these two words (democracy and capitalism) have not often been combined in history. Capitalism has existed without democracy not only in Spain under Franco, Chile under Pinochet, and Congo under Mobutu, but also in Germany, France, and Japan, and even in the United States, when blacks were excluded from the body politic, and Britain, with its severely limited franchise. It does not thus take a huge leap of imagination to see that capitalism and democracy can be decoupled. And inequality can play an

important role in this decoupling. It already does so by empowering the rich politically to a much greater extent than the middle class and the poor. The rich dictate the political agenda, finance the candidates who protect their interests, and make sure that the laws that are in their interest are passed. The American political scientist Larry Bartels, whose work I mentioned before, finds that US senators are five to six times more likely to respond to the interests of the rich than to the interests of the middle class. Moreover, Bartels (2005, 28) concludes, "there is no discernible evidence that the views of low-income constituents ha[ve] any effect on their senators' voting behavior." Not only is the middle class being hollowed out, as we shall see next, but democracy is becoming more hollow too.

It is not for nothing that since Aristotle, and more recently since Tocqueville, the middle class has been seen as the bulwark against nondemocratic forms of government. There is no special moral virtue embodied among the "middlemen" that causes a person who has, for example, ceased to be rich and become middle-class to suddenly prefer democracy. People in the middle class favored democracy because they had an interest in limiting the power of both the rich and the poor: to keep the rich from ruling over them and the poor from confiscating their property. The large numbers of people in the middle classes also means that a lot of people share similar material positions, develop similar tastes, and tend to eschew extremism of both the left and the right. Thus the middle class allows for both democracy and stability.

Decline of the middle class. The existence and function of the middle class is under attack by rising inequality. The middle class in Western democracies is today both less numerous and economically weaker vis-à-vis the rich than it was thirty years ago. In the United States, where the change has been the most dramatic, the share of the middle class, defined as people with disposable (after-tax) incomes

around the median (more exactly, between 25 percent below and 25 percent above the median), decreased from one-third of the population in 1979 to 27 percent in 2010. In other words, one-fifth of the members of the middle class in 1979 are no longer there, most having been pushed below.[32] At the same time, the average income of the middle class, which was 80 percent of the US overall mean income in 1979, dropped to being 77 percent of the mean in 2010. The result of the decline in relative numbers and relative income is a sharp drop in the economic power of the middle class. In 1979, they accounted for 26 percent of total income (or consumption); in 2010, for only 21 percent.

The decline of the middle class is not limited to the United States. As with other indicators that deal with inequality, the changes in the United States have been more dramatic than elsewhere in the West, and the data to study them are more abundant. But often the United States simply displays in more extreme form the same changes that have occurred in all advanced economies. Figure 4.8 shows the decline in the share of the middle class in selected Western democracies between the early 1980s and 2010. In all countries shown here, and probably in all but a couple of OECD members, the share of the middle class today is less than it was thirty-five years ago. The figure illustrates a slight difference in the process of the hollowing-out of the middle between northern European countries (Germany, the Netherlands, and Sweden), where the declines were smaller, and the United States and the United Kingdom, where they were larger. However, we are dealing everywhere with the same phenomenon. The figure also shows that while the United States often regards itself as a middle-class society, its share of the middle class was much smaller than in the northern European countries, even in the early 1980s.

The decline of the economic power of the middle class means that the goods and services consumed by the middle class (that is, middle-class patterns of consumption) become of much less importance to

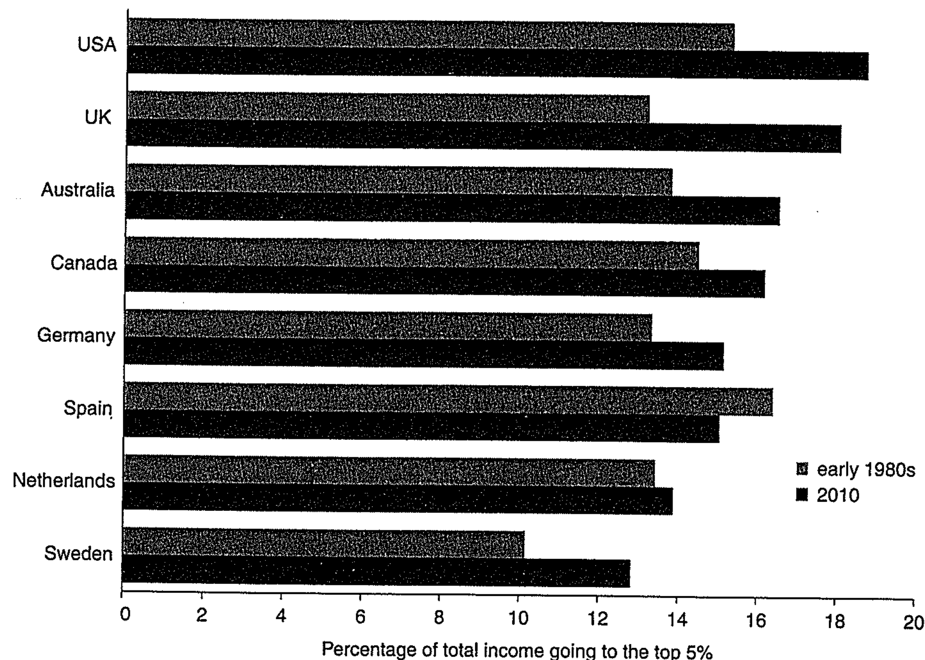

FIGURE 4.9. The rising income share of the top 5% in selected Western democracies, early 1980s–2010

This graph shows the share of total disposable income received by the richest 5% of people in each country, for selected Western democracies. We see that everywhere (except in Spain) the share of income received by the top 5% increased between the early 1980s and 2010. Countries are ranked by the share of the top 5% in 2010. Data source: Calculated from Luxembourg Income Study database (http://www.lisdatacenter.org/).

5 million workers in the United States are employed as guard labor. In addition, they argue that guard labor is more prevalent in more unequal countries.[33]

All of this leads us to one conclusion regarding the changes that have occurred during the past three decades: social separatism. This class bifurcation has many implications: politically, the middle class becomes increasingly irrelevant; production shifts toward luxuries,

and social expenditures change from being directed toward education and infrastructure to policing.

As the political importance of the middle class continues to dwindle, it is not difficult to project into the future the current trends, most vividly seen in the United States, where financial support from rich individuals and companies is indispensable for political success. While the political system remains democratic in form because the freedom of speech and the right of association have been preserved and elections are free, the system is increasingly coming to resemble a plutocracy. In Marxist terms, it is a "dictatorship of the propertied class" even if it seems, formally, to be a democracy. The government becomes nothing else but, in Marx's words from the *Communist Manifesto*, "the committee for managing the common affairs of the bourgeoisie."

And indeed, a gap between ideology and reality will not be anything new to a student of politics and history. Rome seamlessly grew to be an autocratic empire while masquerading as a republic ruled by a senate. A bureaucratic class ruled Eastern Europe while claiming that both economic and political power were in the hands of the people. Every dictator today argues that he embodies the will of the people—that is, believes himself to be a democrat.

The slide away from democracy can take two forms. One of these may be called American and resembles a plutocracy; the other may be called European and is characterized by populism or nativism.

Plutocracy. Consider the march toward plutocracy first. Exhibit A in the case for plutocracy consists of the studies mentioned earlier, that show that elected officials are responsive almost solely to the concerns of the rich. Money plays an unprecedented role in US politics, and the Supreme Court decision to treat corporations as individuals (*Citizens United v. Federal Election Commission*) has opened the doors, legally and formally, to an ever-increasing influence of money on political decision-making. Figure 4.10 shows total election

costs in inflation-adjusted dollar amounts since 2000, for each year in which there were both presidential and congressional elections. The costs have grown both in real amounts and as a share of GDP (the latter not shown in the graph).

Since it is in the interest of the rich to promote the current process of globalization, from which they are, as we saw in Chapters 1 and 2, strong beneficiaries, and since the middle class and the poor can at least formally derail that process, the focus of the rich is on democracy suppression (even though some of the measures are not consciously implemented as such). This suppression involves a two-pronged approach that includes (1) suppressing the vote of the poor, and (2) creating what I will refer to as false consciousness among the lower middle class and the poor.

Consider direct or indirect suppression of the vote. The United States is a country with a very skewed participation in elections, where 80 percent of people in the top income decile vote, compared with only 40 percent in the bottom decile.[34] Note that according to any economic theory, these numbers should be reversed: since no individual vote can influence electoral outcome, it is rational not to vote; and it is especially rational not to vote for people whose time is very valuable, that is for the rich. The fact that the situation is the reverse could result from several factors—greater civic consciousness of the rich, discouragement among the poor ("why bother to vote?"), or specific policies intended to keep the poor from voting, including holding elections on a workday and closing the polling booths by 8 pm, just a couple of hours after most people have left work and are rushing to get home.

Large groups of people are disenfranchised either because they are felons or are incarcerated (with the United States having one of the highest rates of incarceration in the world). Human Rights Watch estimates that about 2 percent of the US voting-age population is disenfranchised, one-third of whom are African American (Deaton

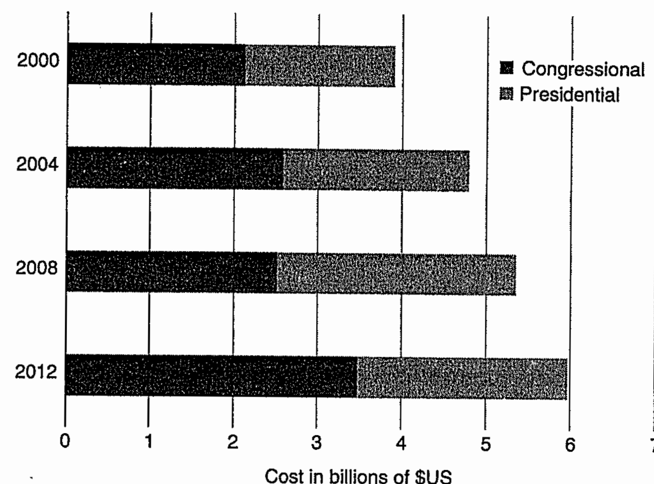

FIGURE 4.10. Cost of US congressional and presidential elections, 2000–2012

This graph shows the cost of US congressional and presidential elections (in the years when both were held) in billions of US dollars (constant 2000 prices). We see that the cost has steadily increased from 2000 to 2012. Data source: Calculated from the data provided in Open Secrets: Center for Responsive Politics, available at https://www.opensecrets.org/bigpicture/index.php?cycle=2012.

2013, 198). Finally, there is a rising tide of gerrymandering, whose objective is to redefine electoral districts in order to dilute the vote of the poor and minorities. These processes, like rising income inequality, have been going on for decades, and some of them date back to the very origins of American democracy, a political system created as a peculiar form of slave-owning democracy. They are more apparent now, however, because they have become stronger and because we have better data for documenting them.

The second part of rich people's strategy to suppress democracy is similar to what in Marxian terminology is called the creation of false consciousness or, to use Antonio Gramsci's terminology, hegemony. I do not like the term "false consciousness" because it seems to imply

that there is an "authentic consciousness," which I do not believe exists. I use it because I lack a better term. What I mean by it is that middle class and poor people are being diverted, largely by design, from looking after their own economic interests into caring about other concerns, especially social or religious ones that are often divisive. This diversion does not necessarily arise from any sort of backroom conspiracy, but rather from a collectively manufactured elite consensus. It is, to some extent, an understandable (and acceptable) strategy because voting decisions are multidimensional: people do not vote solely on economic issues and may care deeply about such matters as migration, religion, and abortion. But given the enormous amount of private money that is used in politics and media, one cannot but think that the aim of these investments is very similar. In one case (politics), influence is sought directly; in the other case (the media), influence is created through shaping public opinion so that it agrees with the opinion of the funders. The creation of false consciousness takes place through ideological *matraquage* (a French term that means a brain-beating as if by a nightstick), where newspaper readers, TV viewers, and Internet surfers are bombarded with issues—running from abortion and gun control to the threat of Islamic fundamentalism—that distract popular attention from basic economic and social problems like unemployment, the incarceration rate, war profits, and billion-dollar tax loopholes for the rich. In other words, the culture war has a function, and that function is to mask the real shift of economic power toward the rich.

An important part of false consciousness is the belief that social mobility is more feasible than it really is. I will not enter here into a discussion of the hugely influential (and much discussed) belief that the doors of success are open to practically everybody in the United States, except to point out that now that we are able for the first time in history to measure both actual intergenerational income mobility and people's subjective perceptions of mobility, we find that the latter vastly outstrips the former. People with lower incomes are especially prone to overestimate overall upward mobility (Kraus and Tan 2015).[35] This finding is comforting for social stability. But it goes against the grain of what we would normally expect, namely, that people at the bottom would believe that there are some systemic features which keep them there. Unless we believe that poor people blame themselves for their own poverty, the only explanation for the hugely optimistic view of social mobility held by the poor is that ideology plays a role in it. (Note that Kraus and Tan did not ask about people's view regarding the likelihood of their own upward mobility. One might expect the poor to believe that they themselves have more room to move up than the rich who are already at the top. The question asked was about their assessment of *overall* national upward mobility.)

The US political system, composed of two parties only, is particularly propitious for the spread of this kind of ideology because any candidates who break from the consensus of either party tend to return to the fold once the primaries are over, and the chance of a third-party contender is almost nil.[36] Even a third-party presidential candidate would face a huge number of technical and legal hurdles just to be listed on the ballot in all states. The emergence of alternatives to the dominant narrative is thus minimized, although the 2016 elections have thrown up unconventional candidates, at least in the primaries, from both the left and the right.

There is, I think, little doubt that the obsolescent and restrictive nature of the American political system and its slant in favor of the rich would have come under intense scrutiny had the United States only recently become a democracy. But since it has a venerable tradition of two centuries of (somewhat limited) democracy that has shown itself capable of solving problems peacefully (with the exception of the Civil War), the system is left unchanged. In reality, the

system has led to a party duopoly, an economic and social establishment that is at the same time both Republican and Democratic (as reflected in many companies that support candidates from both political parties), and to brazen attempts to manipulate electoral outcomes.[37] The recent quasi-dynastic look of American politics, which the country shares with India, Greece, the Philippines, and Pakistan, but which is unknown in other rich democracies, is a symptom of a deeply rooted problem with the American political system. Because of these aspects of the political system, the development of a plutocracy is the most likely response to the dissatisfaction of the middle class in the United States.

Populism and nativism. The situation in Europe is different from that in the United States. On the one hand, European systems are multiparty (as opposed to two-party), more democratic, and less subject to the unmitigated influence of money; hence, it is more difficult to turn them into plutocracies. But on the other hand, the problem of immigration and absorption of migrants even after one or two generations is strongly affecting, even poisoning, political life. Problems with migration add to the "ordinary" pressures of globalization that are common to all rich countries and have led to the stagnation of lower-middle-class incomes in the past twenty-five or thirty years. Thus, the pressures of globalization in Europe take two distinct forms—one due to the movement of labor (immigration) and the other due to the movement of goods (imports) and capital (outflows). The response to these pressures leads to middle-class populism or nativism.[38]

The first point regarding migration is to acknowledge that migration is just an aspect of globalization. The movement of people is, in principle, no different from the movement of goods and technology, or the movement of capital. So it is wrong to discuss it as if it were somehow independent from the massive income gaps between nations that have been revealed and often exacerbated by globalization (especially with respect to Africa).

However (and this is the second point), migration takes on particular importance for Europe for several reasons that are absent in other rich Western countries. For one thing, Europe has long been a continent of emigrants and lacks the experience that the United States, Canada, and Australia have in dealing with immigration. For another, European nation-states have historically been either ethnically homogeneous (or have been rendered such through central governments' policies, as in France and Germany) or, when they were not (as in Spain), the diverse groups have lived next to each other for such a long time that the cultural and normative differences between them would seem rather small to an objective observer.[39] The migrants who come to Europe, however, generally have dissimilar religious beliefs, cultural norms, and outlook on life.

The third point, which follows directly from the first two, is that Europe has serious problems in assimilating migrants, not only those of the first generation but also those of the second and third. This problem is perhaps the most difficult of all because it cannot be dealt with, to a first approximation, by the government, and a lack of contact and relationships between the native-born population and immigrants (especially if it persists for a couple of generations) often leads, as we see in major European capitals, to the creation of ethnic ghettos. The irony of the situation is that the immigrant issue in Europe has come to resemble in many ways the racial problems faced by the United States in the 1960s—whose handling was strongly criticized in Europe at the time. But unlike in the United States with respect to racial disparities, much less research has been done in Europe on income gaps, differences in educational attainment, and the existence of social and family relationships between the immigrants and the native population. Lack of data makes it very difficult to formulate an assimilation policy. The extreme example of this obsolete and self-defeating approach is the French government's insistence, until very recently, that everyone is simply a French citizen and that statistics on ethnicity and religious affiliation may not be

collected. In many areas, they still are not. For example, household surveys do not ask questions about the ethnic and religious background of the household, and there is thus no way to compare groups according to income distribution, mean family income, family composition, or other relevant statistics.[40]

I said that this problem cannot be dealt with by the government "to a first approximation" because no government can force people to make friends with immigrants or to marry them. But that does not mean that the government's role is nonexistent. By collecting information and then establishing affirmative policies in favor of minorities, one can gradually erase the income and education gap that exists between them and the native population. There is little doubt that this process would facilitate the assimilation of migrants as they move up the economic ladder and would lessen their own and natives' view of them as "others." In the future, Europe may indeed solve its immigrant problem in such a way—but at present, that day seems quite far off.

The fourth point is that migrants often bring different cultural norms which may undercut the sustainability of the welfare state. This issue is subject to misinformation, which tends to portray immigrants as disproportionate users of welfare services. Although this is not true, and indeed immigrants contribute more in taxes than they gain from social transfers and social services (partly because they are younger than the native population), popular perceptions may be distorted precisely because migrants are often "different" in their skin color, dress, speech, and behavior and thus are more visible.[41] But although the belief that migrants are "moochers" is inaccurate, we should remember that the European welfare state was built on the assumption of ethnic and cultural homogeneity of the population. Homogeneity not only increases affinity among different segments of the population but ensures that most people observe similar social norms. If no one pretends to be older in order to get a pension, or takes sick leave when not ill, the welfare state is self-

sustaining. But if these norms are not observed by all, the welfare state tends to crumble (see Lindbeck 1994). Peter Lindert (2014) and, going back to much earlier work, Kristov, Lindert, and McClelland (1992), argued that the main reason for the greater development of the welfare state in Europe, as compared with the United States, lies precisely in the greater affinity that exists between different layers of the population, or to put it another way, in the greater probability that people who are young and employed can visualize a time in the future when they will need social help. In the United States, by contrast, argues Lindert, it was precisely the economic distance between whites and African Americans that led to a much more modest welfare state. A similar situation—loss of affinity—may be developing now in Europe.

This pressure on the functioning and sustainability of the European welfare states comes on top of the partly imagined, partly real, pressure being exerted on welfare states and labor from globalization, through cheaper imports and outsourcing. The numerous attacks on the welfare state—including cuts in national health services, cuts in public education, increased fees for government services, a higher retirement age, a "flexible" labor market with zero-hours jobs (jobs where workers must show up but are not guaranteed any work)—are in reality attacks on the middle class, because the middle class was the largest supporter and beneficiary of the welfare state. It is true that most studies have found that the poor, through unemployment benefits and social assistance, gain a lot from the welfare state (Milanovic 2000, 2010a). But the middle classes gain even more through free or subsidized health care and education, pensions, and, more than anything else, through the presence of a safety net to catch them were they ever to fall to a lower station in life.[42] The welfare state was thus an indispensable element in the strengthening of the European middle class and democratic capitalism.

The reaction of the middle and lower middle classes to the gradual loss of welfare-state protection and encroachment on their other

acquired rights has been to shift politically to the right, toward populist and nativist parties. This trend has been facilitated, first, by the disappearance of alternatives on the left, which were discredited after the end of communism, second, by the co-optation of leftist parties (such as the Socialist Party in France and PSOE in Spain) by centrist or center-right parties from which they can hardly be distinguished any longer, and third, by the discrediting of the mainstream parties following their inept handling of the Great Recession. The crumbling of the left and of the mainstream parties has opened the way, in practically all Western and Central European countries, to the rise of mildly antisystemic populist parties. I use the term "mildly" because the objective of these parties, unlike that of true antisystemic parties such as fascist and communist parties, is not to destroy the existing political order. In appealing to voters, however, they do present themselves as antisystemic: Europeans' disenchantment with their political systems and parties is so huge that many of them perceive being "antisystem" as a plus.

Almost no country, from Greece with its Golden Dawn party to Finland with its True Finns, has been spared the populist upsurge. Figure 4.11 shows the most recent polling numbers for populist parties in national elections (where we can assume that the importance of a purely protest vote, from which these parties often benefit, is less than in the elections for a largely meaningless European Parliament). The most successful populist parties receive around 20 percent of the vote, a share which may become even higher in the next elections in France. In almost all the countries considered here, the popularity of the right-wing parties is higher than it was ten to fifteen years ago, when some of the parties did not even exist. The only exception is Belgium, where the Vlaams Belang party, formed after the Vlaams Blok party was banned on the grounds of racism, has failed to repeat its previous electoral results; many of its policy planks, however, have been absorbed by the ruling People's Flemish party.

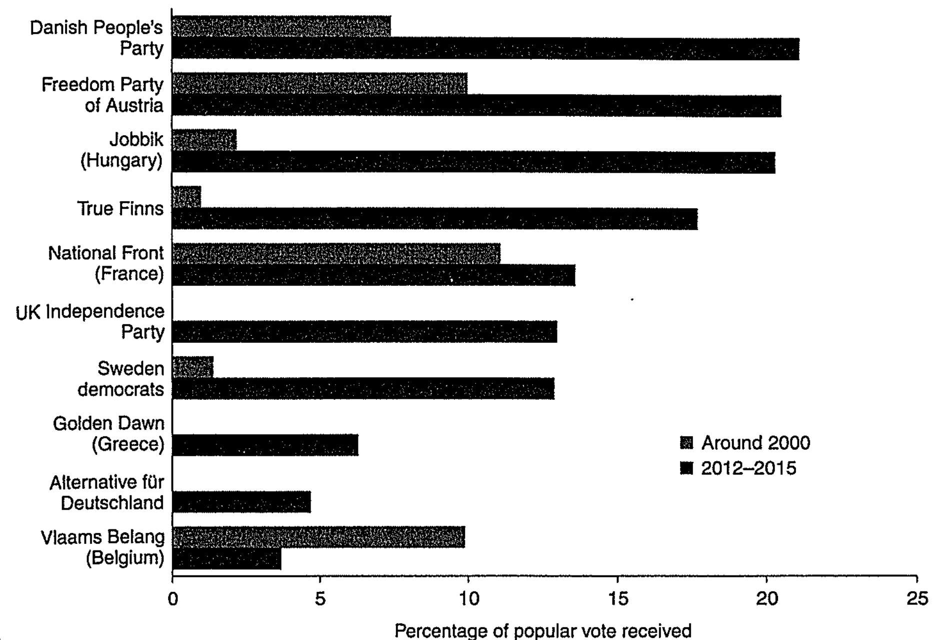

FIGURE 4.11. The share of the votes in legislative elections obtained by various European populist parties around the year 2000 and in the years 2012–2015

This graph shows the share of popular vote received in nationwide elections by right-wing nationalist or populist parties in various European countries. Popular vote is a better indicator of support than the seats the parties hold in national parliaments because the latter depend on countries' electoral rules. The graph shows, with the exception of Belgium, an increase in popular support for the right-wing populist parties since 2000. Legislative elections in 2012–2015 are the latest elections at the time of writing (August 2015): France (2012), Germany and Austria (2013), Belgium, Sweden, Hungary (2014), Greece, Finland, Denmark (2015). Parties are ranked from top to bottom according to their share in the most recent national election. Data source: Compiled by the author from various Internet sources.

The rise of such parties has had another effect: moving mainstream center-right parties more to the right. This shift is obvious in France, where the center-right party led by Nicolas Sarkozy is in many respects indistinguishable from the right-wing National Front (although Sarkozy's party attempts to highlight the differences and

ignore the similarities). It is also obvious in the United Kingdom, where conservatives have in many instances moved closer to the positions held by the far-right United Kingdom Independence Party (UKIP).

It is unlikely that a populist party will come to power on its own or become the most important coalition member, not least because many other parties would refuse to govern with it. But, even without sharing power, these parties have already changed the European political landscape, and will continue to do so in the future. Ideas that only five years ago seemed unthinkable have become commonplace and almost mainstream: the UK leaving the European Union, Germany renegotiating its position within the Union, France stripping of citizenship naturalized citizens who get in trouble with the police, Denmark introducing extremely difficult citizenship and language tests, the Netherlands declaring itself "full" and thus closed to further immigration. Populism has thus entered fully into political life and has gradually moved toward displacing the mainstream—or rather, is becoming mainstream itself.

The populist and nativist movement undermines democracy by gradually revoking or redefining some fundamental rights of citizen, regarding them not as inviolable but as contingent on approval by national majorities. It also undercuts Europe's ability to fully and productively participate in globalization by rejecting the use of one obvious mechanism, the influx of migrants, through which Europe could stave off its demographic decline and open itself to talent from abroad. Populism represents a retreat both from globalization and democracy.[43]

These two reactions (American and European) address in different ways the problem of the trade-off between globalization and democracy. With a plutocratic government, as in the United States, there is an attempt to continue with globalization while ignoring the opinions and wishes of the people on the bottom and even in the middle

of the national income distribution, in many ways rendering democracy meaningless. In the case of populism, as in Europe, the exposure to globalization is reduced both through obstacles to migration and through countries' attempts to protect themselves against unfettered flows of capital and trade while redefining citizenship and citizenship rights. To put it in an extreme form, plutocracy tries to maintain globalization while sacrificing key elements of democracy; populism tries to preserve a simulacrum of democracy while reducing exposure to globalization. Neither has so far succeeded—but what we have in mind here are their natural tendencies, which may become reality in the coming decades.