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A great, brief analysis of problem with America's society – a model to follow when looking at other problems

Fabius Maximus | Jun 5, 2009

This post looks at an article very much worth reading. The author does something rare among sociological or political analysts: showing how current problems (sometimes) result from past reforms. This post sketches out his reasoning, not just to understand the origins of the destructive increase in US inequality of wealth and income — but also to as an example of how we should approach other problems."Nostalgianomics ", Brink Lindsey, Reason, June 2009 — "Liberal economists pine for days no liberal should want to revisit." This is a summary of "Paul Krugman's Nostalgianomics: Economic Policies, Social Norms, and Income Inequlity", CATO Institute, 9 February 2009.

Lindsey's opening quotation from Paul Krugman, the Nobel Prize–winning Princeton economist and *New York Times* columnist, in his recent book *The Conscience of a Liberal.*

> "The America I grew up in was a relatively equal middle-class society. Over the past generation, however, the country has returned to Gilded Age levels of inequality. … The middle-class America of my youth is best thought of not as the normal state of our society, but as an interregnum between Gilded Ages. America before 1930 was a society in which a small number of very rich people controlled a large share of the nation's wealth.
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> … Middle-class America didn't emerge by accident. It was created by what has been called the Great Compression of incomes that took place during World War II, and sustained for a generation by social norms that favored equality, strong labor unions and progressive taxation.

Lindsey explains some of the factors creating the large US middle class:

> The Great Compression is a term coined by the economists Claudia Goldin of Harvard and Robert Margo of Boston University to describe the dramatic narrowing of the nation's wage structure during the 1940s. The real wages of manufacturing workers jumped 67% between 1929 and

> 1947, while the top 1% of earners saw a 17% drop in real income. These egalitarian trends can be attributed to the exceptional circumstances of the period: precipitous declines at the top end of the income spectrum due to economic cataclysm; wartime wage controls that tended to compress wage rates; rapid growthin the demand for low-skilled labor, combined with the labor shortages of the war years; and rapid growth in the relative supply of skilled workers due to a near doubling of high school graduation rates.
>
> Yet the return to peacetime and prosperity did not result in a shift back toward the status quo ante. The more egalitarian income structure persisted for decades. For an explanation, Krugman leans heavily on a 2007 paper by the MIT economists Frank Levy and Peter Temin, who argue that postwar American history has been a tale of two widely divergent systems of political economy. First came the "Treaty of Detroit," characterized by heavy unionization of industry, steeply progressive taxation, and a high minimum wage. Under that system, median wages kept pace with the economy's overall productivity growth, and incomes at the lower end of the scale grew faster than those at the top.

The paper he refers to is "Inequality and Institutions in 20th Century America", Frank S. Levy and Peter Temin (both MIT Professors), 27 June 2007 — a must-read for anyone interested in this important issue. Abstract:

> We provide a comprehensive view of widening income inequality in the United States contrasting conditions since 1980 with those in earlier postwar years. We argue that the income distribution in each period was strongly shaped by a set of economic institutions. The early postwar years were dominated by unions, a negotiating framework set in the Treaty of Detroit, progressive taxes, and a high minimum wage – all parts of a general government effort to broadly distribute the gains from growth. More recent years have been characterized by reversals in all these dimensions in an institutional pattern known as the Washington Consensus. Other explanations for income disparities including skill-biased technical change and international trade are seen as factors operating within this broader institutional story.

However, in the 1960's the major trends reversed – social, technological, political, and economic factors all combining to increase inequality in wealth and income (and also, although not discussed here, decrease social mobility). The most commonly cited fall into two groups, each with different public policy implications.

> Under the conventional view, rising inequality is a side effect

> of economic progress — namely, continuing technological breakthroughs, especially in communications and information technology. Consequently, when economists have supported measures to remedy inequality, they have typically shied away from structural changes in market institutions. Rather, they have endorsed more income redistribution to reduce post-tax income differences, along with remedial education, job retraining, and other programs designed to raise the skill levels of lower-paid workers.
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> By contrast, Krugman sees the rise of inequality as a consequence of economic *regress* — in particular, the abandonment of well-designed economic institutions and healthy social norms that promoted widely shared prosperity. Such an assessment leads to the conclusion that we ought to revive the institutions and norms of Paul Krugman's boyhood, in broad spirit if not in every detail.

Lindsey then shows that there were a deeper set of social policies which supported a large middle class.

1. Cartelization of businesses — One of the major policy objectives of the new Deal, mostly done through a web of regulations which limited the ability of smaller companies to gain market share through business or technical innovation.
2. Cartelization of labor (unions) — Another major objective of the New Deal, which limited competition among workers.
3. Trade Barriers, formal and informal — Also limited business competition (from foreigners), allowing high business profits and high wages.
4. Racism — Restricting many minorities access to education and training, limiting labor competition.
5. Sexism — Ditto.
6. Limited immigration — Another powerful mechanism to limit labor competition and support high wages.
7. Social conformism — Mechanisms enforcing social norms, limiting individuals' ability to extract the maximum gain from their position in the economy.

Initiatives by both left and right have weakened or totally dismantled these. Greater inequality is the inevitable result.

- That does not mean that these reforms were bad things.
- That does not mean that public policy measures cannot mitigate (or even reverse) these trends.
- It does mean that too much analysis of the problem is superficial and hence likely to be (at best) ineffective.

We tinker with our society like a child banging on a keyboard, usually with little thought of the net (i.e., holistic) effect of our reforms. Lindsey's article is powerful illustration why this does not work very well. I recommend reading it.

About the author

Brink Lindsey is vice president for research at the Cato Institute, which published the policy paper from which this article was adapted.

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