Explaining Inequality

An Interview with James Galbraith

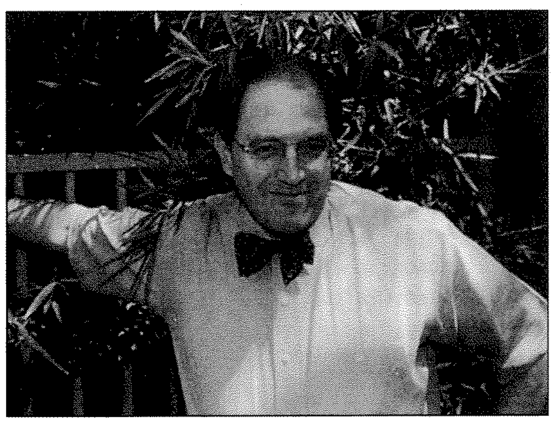
James K. Galbraith is professor at the Lyndon B. Johnson School of Public Affairs and at the Department of Government, University of Texas at Austin. He is former executive director of the Congressional Joint Economic Committee. He is author of *Created Unequal: The Crisis in American Pay* (1998) as well as *Balancing Acts: Technology, Finance and the American Future* (1989), and has published articles in the New York Times, The Washington Post, the Wall Street Journal, The American Prospect and many other publications.

Multinational Monitor: ***How significant is existing income inequality in the United States?***

James Galbraith: Measures of dispersion are hard to translate into intuitive dollar terms. But one can do it in historical terms. If one focuses on inequality in pay in the manufacturing sector, which is where we have the best data, my measures show inequality substantially higher in the 1980s than at any time this century, even greater than in the Great Depression of the 1930s. We are now actually in a period of slightly declining inequality, but the levels are still very high and I would argue still a major problem for American society and economy.

MM: ***You track the increase of inequality to around 1970. What changed then?***

Galbraith: Through the 1960s, and particularly the late 1960s, the government was committed to policies of full employment, and the unemployment rate was below 4 percent for most of the late 1960s. That turns out to have extremely good effects on relatively low income people. Their relative pay rises, as it is doing now with the unemployment rate just a little bit above 4 percent.



James Galbraith

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In 1970, these policies all changed. Starting with the Nixon administration, we embarked on a period of sustained instability in economic policy, using the Federal Reserve as the cutting edge of an anti-inflation policy. The lash fell on working people. Unemployment went up, and inequality increased.

When the Federal Reserve is used to attack inflation, whether real or imaginary, interest rates go up, and the weaker and smaller firms in the economy suffer more than the larger and stronger ones. As a result, both employment and pay in the relatively more competitive sectors of the economy suffer.

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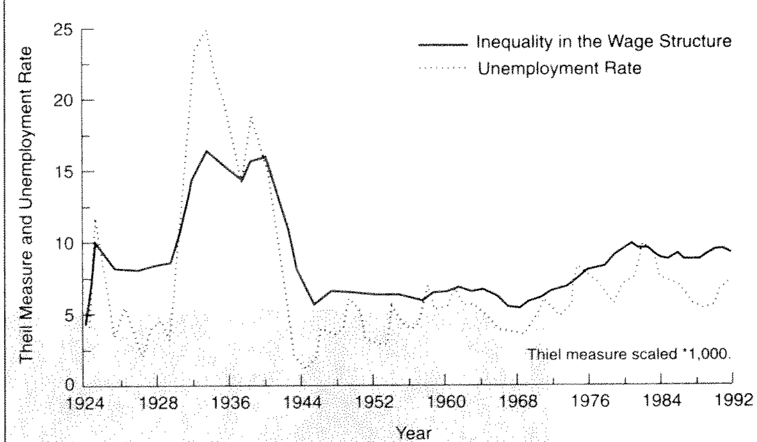
MM: ***Why does an increase in interest rates hurt the competitive sectors more?***

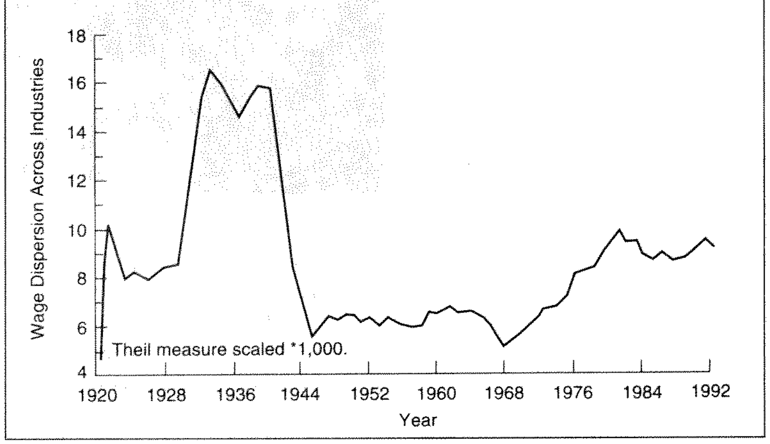
Galbraith: Say you are the Boeing or IBM or some other large industrial company with a global market position. You have the capacity to issue your own long-term bonds, your own corporate paper. You are basically not subjected to large, immediate swings in interest rates when the Federal Reserve raises the short-term interest rate.

But if you are a small business or small manufacturer, and your principal source of financing is bank loans, things work differently. If you have some deal with the bank that says you have a prime rate plus a percent, and the Fed raises rates and the banks raise their prime rate, then you are in hole for whatever the additional interest charges may be.

GRAPHS FROM: CREATED UNEQUAL



INEQUALITY AND UNEMPLOYMENT, 1920–1992



INEQUALITY IN THE WAGE STRUCTURE, 1920–1992

MM: ***How do your categories of knowledge, consumer and services industries relate to the concept of inequality?***

Galbraith: In the book, I'm reflecting the way the data sort themselves out. I tried to come up with a simple characterization of the main sectors of the economy. I offer the following breakdown: At the top of the ladder one finds those industries which are producers of knowledge goods and capital equipment for the rest of the economy, particularly capital equipment which embodies rapidly changing technologies. Those include things like aircraft, communications equipment, computers and electronics, pharmaceuticals and scientific instruments — a range of things of that nature in which, incidentally, the United States has a strong position in global markets.

Those industries sell to other industries, which produce the day-to-day goods that most people consume — the automobiles, the appliances, the foodstuffs, the various kinds of chemicals in the daily consumption basket of most households.

I call the knowledge sector the K-sector and the consumption sector the C-sector. The basic difference between them from a pay standpoint is that there has been a steady increase in the relative pay of the K-sector industries, because those industries really depend on employees who have particular technological skills, and also because their monopolistic position has become stronger in the last 20 years, so they have had more money in those sectors to dispense to their workers.

Pay trends in the C-sector vary — in good times, pay goes up and in bad times it goes down. In order to really participate in the surplus of revenues of good times, workers in the C-sector have to be organized, and that is where you get unionization.

Between the two of them, these sectors account for maybe 30 million people in an economy of 130 million or 135 million working people.

The other 100 million are located in what one might call the S-sector, the services sector, where they are basically not working with a lot of capital equipment, not working with a lot of specialized technology. They are easily replaced. Pay for that vast majority of working Americans in this category is essentially set by social decisions.

The minimum wage is extremely important in setting a floor in the S-sector. And there are other norms which come into the place. Only approximately 10 million people actually make the minimum wage — most make a bit more than that — but when the minimum wage goes up, there is an effect on the whole sector of raising standards. Since employees who are paid at a higher rate tend to stick around longer, you tend to get a more stable workplace; and as a result of that you tend to get more labor organization. For most working Americans, the basic pay decision is one which is made socially and in many respects politically.

MM: ***The knowledge sector is the one that is most characterized by monopoly, but you don't seem to suggest that that is altogether a bad thing. In what ways are monopolies helpful?***

Galbraith: This is the great dilemma of the technologically advanced economy. The whole purpose of developing a new technology from the standpoint of the technologist is not to do good work in society, but rather to get rich. But the way a technology developer like Bill Gates gets rich is by coming up with something that no one has come up with before, and by creating a market at the expense of whatever was performing that function before. The microprocessor drives out the vacuum tube, word processing software drives out the manual typewriter and so forth. Needless to say, you want that to happen.

But on the other hand, it unquestionably concentrates wealth in the hands of the technologist, and concentrates income in the hands of the very small number of people who work in these sectors. In the K-sector, it is 5 to 10 million, depending on how you classify things, and that is not a very big piece of the whole economy.

So it becomes a balancing act for the society to decide just how big these incentives should be, and at what point you limit them. This is not a new problem. This is the problem of the Robber Barons of the nineteenth century, whose technology was the railroad. You can go back to any number of historical moments. They all have the same dynamic in which society has to come to grips with how to regulate vast accumulations of income and power. We did so in the Progressive Period, in the New Deal, in the Second World War. We are going to have to do that again, and we are going to have to continue to do it. A democratic society simply has to do it.

MM: ***How do you suggest promoting equality from the top down, leaving aside for a moment the question of how to bring the bottom up?***

Galbraith: I'm in favor of a range of measures. A strongly redistributive income tax is certainly a piece of it. I'm sympathetic to the notion of a modest wealth tax.

I'm also sympathetic to the notion that one should regulate the distribution of income essentially at the starting gun — that is to say, there should be some reasonable social mechanisms for ensuring that the American corporation distributes its gains internally in a more balanced way.

There is no particular reason that corporate executives should be making 200 times the pay of the least paid worker in the company — 20 times, 30 times, 50 times, numbers which are much more common elsewhere in the world, are perfectly functional, once one gets used to them. These ratios tend to produce a better result in that you don't end up with a small group of essentially self-dealing plutocrats running your industrial sector.

I think it is perfectly legitimate for society to say, for example, that there might be a tax penalty for companies where the gap was beyond a certain size. Or there might be a provision that whatever particular perks are offered to a class of employees, say the top executives, also had to be offered to the other classes of employees, at least in the same form if not to the same degree. For example, a company could not get away with paying one class of employees health benefits and not another class of employees.

But I would stress that when you raise things at the bottom, when you compress the bottom half of the distribution with more comprehensive unionization, higher minimum wages, this is going to have an effect on the upper end of the distribution as well. When the bottom is less desperate, it will inevitably be more focused on achieving equitable social solutions all the way through the distribution.

MM: ***You point to the exchange rate as an important factor contributing to inequality. How does that play out, and how is the United States doing right now?***

Galbraith: With advanced goods being our export goods and consumer commodities substantially being our imports, the effect of the exchange rate going up is not symmetrical on these two sectors.

The advanced sectors are hurt when the exchange rate goes up, because they have competition with the Germanys and the Japans of the world, but they are not hurt very much. A Boeing is a Boeing, and no amount of appreciation will turn it into an Airbus.

On the other hand, a shirt made in China is a very close substitute for a shirt made in Texas. When the exchange rate goes up, you have a tremendous effect on the industries at the lower end, as consumers switch to relatively lower-priced

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imports. So an appreciation of the exchange rate raises inequality in the United States, and it did so really dramatically in the early 1980s.

Right now, the situation is certainly better than it was in the early 1980s, but it has been deteriorating because of the crisis in Asia and recently Latin America. With the depreciation of those currencies, the dollar has in fact been rising, and I'm sure that is having an effect at keeping inequality higher than it would otherwise be at 4 percent unemployment.

MM: ***But the largest factor is the unemployment rate.***
Galbraith: For sure. And the fact that we have had several years of unemployment that is close to 4 percent has been a boon.

MM: ***What portion of the inequality equation do you attribute to unemployment?***
Galbraith: That is hard a question to answer, but a lot. Something in the range of 70 percent.

MM: ***You dismiss a common explanation for inequality, which is that with technological change some people with certain skills are more valuable than others. That seems plausible on its face, and it certainly has widespread acceptance. What is your basis for tossing it out?***
Galbraith: It is only plausible if you don't look at it very closely, and its acceptance rate has been falling sharply in the last year. People who were taken with this idea have been retreating from it at an extraordinary rate.

But to get down to the question of what is wrong with it: This idea is largely driven by the notion that the personal computer has had some fantastic effect on productivity in the workplace, and that what personal computers do is enhance the skills of people who use them. This is a pleasant idea if you happen to be an economics professor, and you buy a personal laptop and feel immensely more productive than you would have been without it. But for most working people, computers don't work that way.

Take a banal example. Say you are a checkout clerk, and you move from having a manual machine to having an electronic computer (this is not even classified as a computer in the statistics, but it certainly is one). What that does is permit your employer to hire a worker with less skill than previously was the case, because the computer will take over some of the brain functions of the checkout clerk — making change in one's head.

The idea that the use of a computer is going to have mainly the effect of enhancing skills just doesn't make sense in most contexts. Like other forms of automation, it is a labor-saving and skill-reducing device.

The other problem, even more telling, is that the timing of the introduction of these devices does not correspond to the rise in inequality. Most of the rise in inequality in pay rates in manufacturing occurs by the middle 1980s at the latest. And the personal computer does not hit the desktops until later than that; it was just being invented and introduced in the early 1980s. Dissemination of those devices really gets under way in the late 1980s and early 1990s, and goes on to the present at very high rates, even though inequality starts to fall. The whole story has lost plausibility rather precipitously in the last few years.

MM: ***As a political matter, do you think that the skills agenda — what you call the competitive internationalist agenda — has now been displaced among the liberal sector?***
Galbraith: As a political matter, if I may so, I think I've made some progress — myself and my friends and those who have a common view. It seems to me there has been a great deal more discussion of Federal Reserve policy and the minimum wage, relative to job training partnerships in recent years. And that is a really good thing.

Someone I have to give credit to here is Alan Greenspan. Greenspan has provided us with three or four years of evidence — a gift of inestimable value — that, first of all, a 4 percent unemployment rate does not produce accelerating inflation, contrary to what the economics profession asserted. So long as the unemployment rate never fell below 6 percent, you couldn't contradict them, but now you can.

And secondly, Greenspan has provided clear evidence that a 4 percent unemployment rate actually does produce declining inequality — this in spite of the fact that there has been no massive experiment in job training in the country.

It is very hard now for any realistic person who has some grip on economic developments to go back and make these milquetoast supply side arguments and dismiss the importance of low interest rates, a rising minimum wage.

The earned income tax credit, another great development, clearly has also had an important role in raising the income of low-income families. When you take the earned income tax credit, the minimum wage and low interest rates, and put them together, what happens to a working family that is making a wage that is supported by the minimum getting the earned income tax credit and that has low-interest rates available at the bank? They become credit worthy. Their incomes, which could not support a mortgage under a higher interest rate regime or a lower minimum wage regime, suddenly support a mortgage. So they buy a house. They buy a house, they give work to construction workers.

It seems to me there is an enormously healthy development in the economy in the last several years which basically rests on institutional support for the purchasing power of lower-income working people.

In fact, the cutbacks in welfare are small compared to the expansions of the earned income tax credit. So on the whole we have been expanding our support for low-income people in the last few years, and this has just been a tremendous success.

People talk about the stock market being a major driver of consumption in the economy, but there is no evidence of this. The driver of consumption in the economy has been the expansion of purchasing power and credit among America's households. Most of them don't own stock. And that is a much more stable basis for sustained expansion than the stock market boom ever could be.

MM: Created Unequal ***was published a year ago. You spend a fair amount of time attacking the idea of NAIRU (nonaccelerating inflation rate of unemployment, the notion that if unemployment falls below a certain rate then inflation will spin out of control). What is the status of NAIRU now?***

Galbraith: It is dead as a coffin nail, as Dickens said of Marley in *A Christmas Carol.*

MM: ***Dead, not just intellectually but politically as well; not acceptable to talk about and won't be in the near future?***

Galbraith: It marks you as a member of a wild-eyed fringe, to go around babbling about the NAIRU at this stage. It really does.

The only thing that worries me is that there are in fact people in positions of power who belong to this wild-eyed fringe. Some of them are simply straightforward advocates of higher interest rates under all conditions — a guy like Jerry Jordan, who is president of the Cleveland Federal Reserve Bank, or Bill Poole, who is president of the St. Louis Federal Reserve Bank. These guys are always for higher interest rates, and any excuse is good enough. Then there is a guy like Laurence Meyer, who made a career as a forecaster of predicting inflation on the basis of the unemployment rate, and simply isn't going to change. A man of the most extraordinary inflexibility, so far as I can tell. So there is a problem of such people holding on to positions of power.

But you go to a serious meeting of economists, people talking about the NAIRU and they snicker. How we as a profession spent 30 years in the thrall of this idea is absolutely beyond me.

MM: ***Despite that, as we speak the Fed is expected to raise interest rates in anticipation of inflation that may come some time in the future.***

Galbraith: There are people who like higher interest rates. Anybody who is a banker or has a large loan portfolio likes higher interest rates rather than lower ones. Speculators like higher interest rates. The effect of raising interest rates is to intensify speculation, because people will go after higher risk, rather than going after lower-risk, lower-returns kinds of investments, such as mortgages to low-income people, which are stable, but not very exciting.

Behind the intellectual arguments are always a set of political forces. And I suspect that is what is really driving this.

What can be said about it intellectually is the following: There is no case for a one-off quarter point rise in the interest rate. Nobody, by any theory that I've ever heard, believes that such an exercise — which the right-wing would have derided if it had been coming from me as "fine tuning" — has any effect on the inflation rate. None. The only way Federal Reserve policy can affect the inflation rate is by raising interest rates progressively so that the unemployment rate goes up, substantially.

We are either starting down that road, or we are not. If we are starting down that road, then people need to be very clear that that is the objective — that in a year or two from now interest rates will be double or triple what they are now, the economy will be in a recession, and the unemployment rate will be going up. That is the objective of the people who are pursuing this policy.

If we are not starting on that road, then what is the point of raising the rate by a quarter percent? It has bad effects on the emerging markets in Asia which are just barely stabilized after the catastrophe of last fall. Capital will start anticipating further increases in the United States and will start flowing into the United States again, and that will clobber them in Seoul, Kuala Lumpur, Jakarta. Why do we want to do that? Why do we want to be party to it? What is the point of this exercise?

Let's imagine that Alan Greenspan is fighting a rather valiant political campaign to limit the damage that the right-wing on the Open Market Committee can do. He'll give them a quarter point, and then try to prevent them from taking any more. One can understand that, but that doesn't make it the right thing to do from the standpoint of policy. From the standpoint of policy, clearly the right thing to do when you have a long experiment of great success with doing nothing, and absolutely nothing has happened to cause you to change that experiment, is to keep it up. ■

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