

The great marginalization: why twentieth century economists neglected inequality

Eli Cook [University of Haifa, Israel]

Copyright: Eli Cook 2018

You may post comments on this paper at

<https://rwer.wordpress.com/comments-on-rwer-issue-no-83/>

Abstract

Since Thomas Piketty's work took the economics discipline by storm in 2014, the study of economic inequality has quickly moved to the center of academic inquiry for the first time since the nineteenth century. But why was the topic of inequality and distribution largely neglected by mainstream economists for much of the twentieth century? In examining key economic treatises and textbooks, this paper argues that it was the hegemonic rise of neoclassical economics which effectively marginalized the issue of economic distribution in the twentieth century. It contends that three central theoretical pillars were most responsible for this development: marginal productivity, a utility theory and Pareto optimality.

Introduction

Six years after the worst economic depression in decades, a 600-page book on economic inequality took the United States by storm, becoming a surprise best seller. Despite its populist message, the book was largely in conversation with orthodox economic thinkers, not radical ones, and thus retained the former's conceptual categories, worldview and language. And yet, despite its conventional approach – or perhaps because of it – the book sent a shockwave through the field of economics. Using the master's tools, it took a hammer to some of the most cherished tenets of contemporary economic thought, disrupting accepted wisdoms, destabilizing basic convictions and upending theoretical models.

The source of the book's power lay in the fact that it refused to countenance the notion that the study of economics could and should be insulated from distributional questions. While many economists of the era peddled feel-good stories about the harmonious interests of workers and elites, this book politicized economic thought by revealing that capitalism produced winners and losers, productivity and inequality, progress and poverty.

Inspiring grassroots organizations, social movements and various reform proposals, the book became not only an American or even European phenomenon, but a global one. Tedious, unwieldy and redundant at times, it nevertheless managed to capture the imagination of a shell-shocked generation still reeling from a major economic crisis. It did so for two main reasons. First, it offered a simple argument: Inequality was caused by the ever-increasing concentration of unearned wealth in the hands of an elite class of unproductive rentiers. Second, it offered a simple solution: A single tax on wealth that would prevent such elites from profiting off the mere possession of property. With such a straightforward message, small wonder the book became an international sensation.

The dismal science had given birth to an economic rock star. His name was Henry George. The year was 1879.¹

¹ Edward O'Donnell, *Henry George and the Crisis of Inequality: Progress and Poverty in the Gilded Age* (New York: Columbia University Press, 2015).

The Piketty effect

A few years ago, I opened my review of Thomas Piketty's *Capital in the 21st Century* in the *Raritan Quarterly Review* with this "bait and switch" vignette. I thought the striking similarities between George and Piketty revealed that while history does not repeat itself, the "Pikettymania" that washed over the world in 2014 might bring forth once more an era in which – much like during the "Gilded Age" of Henry George – economic inequality was at the forefront not only of economic thought but political agitation, social anxiety and cultural discourse.²

Looking back now to those heady days in 2014, it is clear that Piketty's groundbreaking study was just the beginning. The floodgates of inequality studies have been opened. The wave ushered in by Piketty has, in the past few years, come in many shapes and sizes: We now have global analyses such as Branko Milanovich's *Global Inequality*, centuries-long histories such as *Unequal Gains*, and a collected volume dedicated entirely to the economic agenda titled *After Piketty*. The dramatic titles of other recent books reveal the current mood of inquiry, be it Thomas Shapiro's *Toxic Inequality: How America's Wealth Gap Destroys Mobility, Deepens the Racial Divide, & Threatens Our Future*, Dean Baker's *Rigged: How Globalization and the Rules of the Modern Economy Were Structured to Make the Rich Richer* Steven Teles and Lindsay Brink's *The Captured Economy: How the Powerful Enrich Themselves, Slow Down Growth, and Increase Inequality* or Brian Alexander's *Glass House: The 1% Economy and the Shattering of the All-American Town*. It appears, that the "1 percent" have not only been gobbling up much of the wealth and income these past few decades but, in recent years, also the attention of economists, journalists and public intellectuals.³

The "Piketty effect" has spread into political and policymaking circles as well. If there is one constant in the left rhetoric of Bernie Sanders, the most popular politician in the United States in 2017, it is his dogged emphasis on the massive wealth disparities between the super-rich and the "99%". A visit to inequality.org reveals, moreover, a long list of think tanks, academic centers and public interest groups who now focus on inequality, be it the Economic Policy Institute, the Washington Center for Equitable Growth, or the LSE International Inequality Institute. Inequality has even seeped into the staid world of central banking. U.S. Federal Reserve Chair Janet Yellen spoke at a Fed conference in Boston in the fall of 2014, just as Piketty's book was taking off. "The extent of and continuing increase in inequality in the United States greatly concern me," Yellen said. "I think it is appropriate to ask whether this trend is compatible with values rooted in our nation's history, among them the high value Americans have traditionally placed on equality of opportunity." As the *New York Times* rightly

² Eli Cook, "The Progress and Poverty of Thomas Piketty," *Raritan Quarterly Journal* 35 (Fall, 2015): 1-19.

³ Branko Milanovich, *Global Inequality: A New Approach for the Age of Globalization* (Cambridge, MA: Harvard University Press, 2016); Peter H. Lindert and Jeffery G. Williamson, *Unequal Gains: American Growth and Inequality Since 1700* (Princeton: Princeton University Press, 2016); *After Piketty: The Agenda for Economics and Inequality*, eds. Heather Boushey, J. Bradford DeLong and Marshall Steinbaum (Cambridge, MA: Harvard University Press, 2017); Thomas Shapiro, *Toxic Inequality: How America's Wealth Gap Destroys Mobility, Deepens the Racial Divide, & Threatens Our Future* (New York: Basic Books, 2017); Dean Baker, *Rigged: How Globalization and the Rules of the Modern Economy Were Structured to Make the Rich Richer* (Washington DC: Center for Economic Policy Research, 2016); Steven Teles and Lindsey Brink, *The Captured Economy: How the Powerful Enrich Themselves, Slow Down Growth, and Increase Inequality* (New York: Oxford University Press, 2017); Brian Alexander, *Glass House: The 1% Economy and the Shattering of the All-American Town* (New York: St. Martin's Press, 2017).

noted at the time, “by the cautious standards of central bankers,” Yellen’s words were “downright radical.” As we will see, this is not how Fed Chairs spoke about inequality before Thomas Piketty.⁴

The goal of this article, however, is not to focus on the rebirth of inequality economics. Rather, it is to try to answer an oft-overlooked question: what took so long? For all the attention it has garnered, it is easy to forget that Piketty’s book became a smash hit not because of its explanatory power (few have actually agreed with his $r > g$ model) but rather mostly thanks to his fairly straight forward empirical project which measured, over the course of the twentieth century, how income and wealth were distributed in the United States and Western Europe. While Piketty’s impressively Sisyphean archival work- especially with government tax records - should be commended, the question still must be asked: If western society in the mid-to-late twentieth century was hardly lacking in economists, how come Piketty’s study had not already been carried out on numerous occasions? In the few cases in which similar, albeit far more modest, studies were undertaken, why were they mostly neglected? Or, to put it another way: If Henry George’s *Progress and Poverty* and the question of economic inequality took the Western world by storm in the nineteenth century, why was it marginalized for much of the twentieth, only to return with a vengeance in the twenty-first?⁵

I am not the first person to recognize the fall of distributive economics in twentieth century Western thought. In April 1996, Sir Anthony Atkinson – who Piketty has labeled the “godfather” of inequality economics – gave the presidential address to the Royal Economic Society of England. Atkinson opened his talk by noting that “the subject of income distribution has in the past been marginalized. For much of this century, it has been very much out in the cold.” Continuing, Atkinson noted how, for the past 50 years, only about 4 percent of *The Economic Journal* articles, one of the leading economics journal for much of the twentieth century, had dealt with income distribution. In comparison, Atkinson demonstrated how international economics produced on average four times as many articles during that time span. In the 1970s, just as income inequality was beginning to significantly rise, a quarter of the articles in the *Journal* were on globalization but only about *one* article per a year was on distribution or inequality.⁶

Why did this happen? Relatively low income inequality in the middle decades of the twentieth century certainly played a role in its diminished position, especially during the post war years. When economist Simon Kuznets invented the “Kuznets Curve” theory in 1954, which posited

⁴ Drew Schwartz, “Bernie Sanders is the Most Popular Politician in America, Poll Says,” *Vice.com*, Aug 25th, 2017; www.inequality.org/resources/organizations; Neil Irwin, “What Janet Yellen Said, and Didn’t Say, About Inequality,” *New York Times*, Oct 17th, 2014.

⁵ For the typical enthusiastic response to Piketty’s data yet disagreement with $r > g$ see Paul Krugman, “Why We’re in a New Gilded Age,” *New York Review of Books*, May 8th 2014; James K. Galbraith, *Kapital for the Twenty-First Century?* *Dissent*, (Spring, 2014); To be sure, there are a number of important exceptions in which economists did study inequality in the twentieth century. See the life’s work of Anthony Atkinson, including such works as *The Economics of Inequality* (New York: Oxford University Press, 1983); Claudia Goldin and Robert Margo, “The Great Compression: The Wage Structure in the United States at Mid-Century,” NBER Working Paper 3817 (August, 1991); James D. Smith, eds., *Modeling the Distribution and Intergenerational Transmission of Wealth* (Chicago: Chicago University Press, 1980).

⁶ Anthony Atkinson, “Bringing Income Distribution in From the Cold,” *The Economic Journal* 107 (Mar, 1997): 297-31; For other works that have suggested that inequality was marginalized by economists in the twentieth century see Daniel Hirschman, “Inventing The Economy: How We Learned To Stop Worrying and Love the GDP,” (Ph.D Dissertation, 2016), 158-206; Michele Alavich and Anna Soci, *Inequality: A Short History* (Brookings Institution Press, 2017), 29-53; Maurice Dobb, *Theories of Value and Distribution Since Adam Smith: Ideology and Economic Theory* (New York: Cambridge University Press, 1975).

that as capitalist societies develop their inequality tends to go down, he was basing his hypothesis on empirical data which showed a decline in inequality since the stock market crash of 1929. This allowed future economists, when confronted with the issue of inequality, to mumble a few words about the Kuznets curve and move on to what they felt were more pressing inquiries. As late as 1980, a leading economist could still brush off the issue of inequality by noting that “income inequality was just about the same in 1977... as it was in 1947.” Some economists of the era even believed that labor’s share of income was so consistently stable in the postwar years that economic distribution must be the workings of some natural law.⁷

These explanations for the marginalization of inequality, however, will not suffice. When actual income inequality began to climb in the 1980s, the study of income inequality did not follow suit. What is more, the neglect of inequality economics in the twentieth century is so striking it cannot be explained away so easily. Economists did not start ignoring inflation or unemployment in eras when they happened to be low. What then was the main impetus? This paper argues that it was the hegemonic rise of neoclassical economics which effectively marginalized the issue of economic distribution in the twentieth century in favor of the maximization of economic production. More specifically, I contend that three central theoretical pillars of neoclassical economics were most responsible for the downplaying of inequality and distribution: marginal productivity, a utility theory of value and Pareto optimality.

While some economists frame the history of economic thought as being driven mostly by the internal improvement of the discipline in its long march towards scientific truth, these neoclassical pillars did not emerge in an historical vacuum strictly because they were empirically more accurate than past models. Historians in recent years have shown that neoclassical economics was shaped by an assortment of political, social and cultural forces be it the rise of consumer culture, corporate finance, modern psychology, social democracy or thermodynamic physics. In this brief article I cannot touch on all the forces that led to the rise of neoclassical economics. I will, however, stress one crucial and oft-overlooked engine of neoclassical theory that is most relevant to our discussion: the desire to downplay, marginalize and mitigate distributional questions and conflicts because they were deemed either too dangerous, moralizing or unimportant. In other words, the meteoric rise of neoclassical economics did not only lead to a sharp decline in distributive economics, but was partially constituted by this very goal.⁸

⁷ Simon Kuznets, “Economic Growth and Income Inequality,” *American Economic Review* 45 (March, 1955): 1-28; The economist was Alan Blinder. See Sheldon Danzinger and Peter Gottschalk, *Uneven Tides: Rising Inequality in America* (New York: Russel Sage Foundation, 1993), 3. In his own work, Piketty leans mostly on the Kuznets Curve as the reason why inequality has been ignored by mainstream economists.

⁸ For the history of neoclassical economics see Yuval Yonay, *The Struggle for the Soul of Economics: Institutional and Neoclassical Economists in America Between the Wars* (Princeton: Princeton University Press, 1998); Phil Mirowski, *More Heat Than Light: Economics as Social Physics, Physics as Nature’s Economics* (New York: Cambridge University Press, 1989); Eli Cook, “The Neoclassical Club: Irving Fisher and the Progressive Origins of Neo-liberalism,” *Journal of the Gilded Age and Progressive Era* 15 (July, 2016):246-262; Jamie Morgan, ed. *What is Neoclassical Economics? Debating the Origins, Meaning and Significance* (New York: Routledge, 2016).

The centrality of distribution to classical economics

Henry George's *Progress and Poverty* was the last great work of what historians have referred to as "classical" economics. At the heart of his book was a basic question regarding the relationship between economic growth and economic distribution. "Where the conditions to which material progress everywhere tends are most fully realized," George pointed out in his opening statement, "we find the deepest poverty, the sharpest struggle for existence, and the most enforced idleness." Continuing, he stunned many readers by declaring that "material progress does not merely fail to relieve poverty—it actually produces it."⁹

It was this notion that capitalist development brought with it great wealth to some but terrible suffering to others that gave George's book its radical and critical bite. Yet despite this – and the fact that his call for a "single tax" on the unearned rent of land monopolizers directly challenged the most basic liberal tenets of private property – his work was still very much in line with the English classical tradition of Adam Smith, David Ricardo and John Stuart Mill. While not reaching the same subversive conclusions as George, these men had also been most interested in understanding how the fruits of market production were *divided* between the three classes of society – land-holding aristocrats, profit-seeking capitalists and wage-laboring workers. They did so in part because they believed distribution to be an important social and moral issue that should not be ignored. But they also did so because they believed that it was the social relationships *between* these three social classes (rather than mere supply and demand) that determined not only the rate of compensation of each class in the form of rent, profit and wages but the price of all market commodities. In classical economics, in fact, the market does not really set the price of goods at all. Rather, the "natural price" of any commodity is set by the rates of wages, rent and profit which, in turn, are set by the social relations between workers, capitalists and landholders. In this theoretical world, which focuses mostly on economic *production*, exchange serves only as the tool through which market prices become aligned with natural prices. In short, to study any aspect of "the economy" in classical economics, you had to study the distribution of wealth and income.¹⁰

George's focus on inequality, therefore, was no great departure from the classical economists who came before him, especially Ricardo and Mill. They too, had placed the distribution of income at the center of their discipline. Ricardo, for instance, famously began his magnum opus of 1817 by stating:

"The produce of the earth - all that is derived from its surface by the united application of labor machinery and capital, is divided among the three classes of the community: namely the proprietor of the land, the owner of the stock of capital for its cultivation, and the laborers by whose industry it is cultivated. But in different stages of society, the proportions of the whole produce of the earth which will be allotted to each of these classes, under the names of rent, profit and wages, will be essentially different...to determine the laws which regulate this distribution, is the principal problem in political economy."

Mill would continue Ricardo's emphasis on distribution, noting how "it is only in the backwards countries of the world that increased production is still an important object; in those most

⁹ Henry George, *Progress and Poverty: An Inquiry into the Cause of Industrial Depression and of Increase of Want with Increase of Wealth* (New York: 1879), 5.

¹⁰ Samuel Hollander, *Classical Economics* (Oxford: Blackwell, 1987); Mark Blaug, *Economic Theory in Retrospect* (Cambridge: Cambridge University Press, 1997) ch. 2-7. Dobb, *Theories of Value*.

advanced, what is economically needed is a better distribution.”¹¹

George, moreover, was not only continuing the tradition of classical economics but also that of American republicanism and producerism. The United States came into being as a society of freehold farmers who placed an enormous emphasis on the basic freedom (if you were white) to receive a “full return of one’s labor.” Steeped in the labor theory of value not of Karl Marx but Benjamin Franklin, nineteenth century white men in the United States were raised to believe that an unequal distribution of wealth or income was far from natural and therefore *must* stem from exploitative social relations in which laborers do not receive all that they have produced. As the prototypical American economic thinker Edward Kellogg noted in his 1849 book *Labor and Other Capital*, “to obtain labor without rendering a fair equivalent is also a violation of the rights of property.” In his eyes, like that of most Americans, this meant that “the great disparity in the conditions of the rich and poor is the natural result of unjust laws.”¹²

Such Americans also found a basis for their claims in European classical economics. Following in the footsteps of Ricardo and Mill, most nineteenth century economic thinkers in Europe and the United States believed that a capitalists’ profit stemmed from his selling of goods for more than his workers had been paid to make them. This approach positioned laborers and capitalists in a zero-sum struggle for the economic surplus. “If... wages should rise,” Ricardo repeatedly stated, “profits would necessarily fall.” Or, as Mill noted in 1869, if a capitalist “has to pay more for labour, the additional payment comes of his own income.”¹³

There were, of course, plenty of conservative economists who pushed back on this idea throughout the nineteenth century. Economists like Frederic Bastiat and Nassau Senior argued that the profits of capital did not come from their power struggle with labor or their appropriation of the surplus but rather from risk, abstinence, skill, entrepreneurship and other positive qualities. “Capital has its roots in three attributes of man,” Bastiat typically declared in 1850, “foresight, intelligence, and thrift.” Yet try as these conservatives might to separate profits from wages, the labor theory of value which stood at the center of classical economics made this very hard to do since it was assumed that wealth was created mostly by workers. To make matters worse for such economists, by the late nineteenth century a far more radical thinker than Ricardo, Mill or even George had turned to the classical labor theory of value in Europe in order to argue that the exploitative basis of capitalist accumulation meant it must be overthrown. All across Europe, socialists turned to Karl Marx’s economic writings in order to prove that capital profits were nothing more than the appropriated “surplus value” of exploited labor. It was, in part, in the midst of these political pressures that our first neoclassical pillar was born.¹⁴

¹¹ David Ricardo, “Preface to Principles”, in *The Works and Correspondence of David Ricardo*, ed. Piero Sraffa (Cambridge: Cambridge University Press, 1951) 1: xviii; John Stuart Mill, *Principles of Political Economy*, (London, 1871), 755.

¹² Edward Kellogg, *Labor and Other Capital: The Rights of Each Secured and the Wrongs of Both Eradicated* (New York, 1849), 80; See also James Huston, *Securing the Fruits of Labor: The American Concept of Wealth Distribution, 1765-1900* (Baton Rouge: Louisiana State University Press, 1998); Michael Thompson, *The Politics of Inequality: A Political History of the Idea of Economic Inequality in America* (New York: Columbia University Press, 2007).

¹³ David Ricardo, *On the Principles of Political Economy* (London: 1817), 65; John Stuart Mill, *Thornton On Labor Claims* (London, 1869), 645.

¹⁴ Frederic Bastiat, *Economic Harmonies*, ed. George B. de Huszar, trans. W. Hayden Boyer, <http://www.econlib.org/library/Bastiat/basHar7.html>; On Europe see Albert Lindemann, *A History of European Socialism* (New Haven: Yale University Press, 1984); On Marx’s theory of exploitation see Karl Marx, *Wage Labor and Capital*, trans. Freidrich Engels (London, 1891).

Marginal productivity and the justice of capitalism

The year was 1899 and Columbia Economics Professor John Bates Clark - the undisputed American father of neoclassical economics – was gravely concerned. He felt that all this talk in Europe and the United States about inequality and exploitation was threatening to destabilize the very foundations of a modern, capitalist society. As he saw it,

“the welfare of the laboring classes depends on whether they get much or little; but their attitude toward other classes—and, therefore, the stability of the social state—depends chiefly on the question, whether the amount that they get, be it large or small, is what they produce. If they create a small amount of wealth and get the whole of it, they may not seek to revolutionize society; but if it were to appear that they produce an ample amount and get only a part of it, many of them would become revolutionists, and all would have the right to do so. The indictment that hangs over society is that of ‘exploiting labor.’ ‘Workmen’ it is said, ‘are regularly robbed of what they produce. This is done within the forms of law, and by the natural working of competition.’ If this charge were proved, every right-minded man should become a socialist; and his zeal in transforming the industrial system would then measure and express his sense of justice.”¹⁵

Luckily for “the stability of the social state,” in the same book in which Clark voiced these concerns, he also presented a novel economic theory which claimed to prove that the distribution of wealth in a competitive market society was, in fact, inherently just and that there simply was no such thing as labor exploitation. On the contrary, according to Clark, every class in society got what it deserved for it earned what it had produced. The book was titled *The Distribution of Wealth* and its main goal was made perfectly clear in its opening pages:

“It is the purpose of this work to show that the distribution of the income of society is controlled by a natural law, and that this law, if it worked without friction, would give to every agent of production the amount of wealth which that agent creates.”¹⁶

Unlike in classical economics, where laborers and capitalists fought over the same pool of surplus production, Clark sought to insulate the economic mechanism through which wages were determined from the economic mechanism through which profits and rents were determined. Here too, Clark was refreshingly open about the political reasons for wanting to do this, noting that “it was the claim advanced by Henry George... that first led me to seek a method by which the product of labor everywhere may be disentangled from the product of cooperating agents and separately identified.” As neoclassical economist Frank Fetter later recognized, “one can hardly fail to see on almost every page” of Clark’s writings the single-tax specter of Henry George.¹⁷

¹⁵ John Bates Clark, *The Distribution of Wealth* (New York, 1899) v; On Clark see John F. Henry, *John Bates Clark: The Making of a Neoclassical Economist* (New York: Springer, 2016); Joseph Persky, “The Neoclassical Advent: American Economics at the Dawn of the 20th Century,” *Journal of Economic Perspectives* 14 (Winter, 2000): 95-108.

¹⁶ Clark, *Distribution of Wealth*, vi.

¹⁷ *Ibid.*, viii; Frank Fetter, *Capital, Interest and Rent: Essays in the Theory of Distribution* (Menlo Park: The Institute for Humane Studies, 1977) 127.

Clark's great innovation was to treat the labor of workers, the capital of capitalists and the land of landholders as three utterly separate "factors of production" whose respective incomes in the form of wages, profits and rents were determined in three utterly separate markets by their owner's own marginal productivity. According to Clark, a worker earned 5 dollars an hour not because his boss may be exploiting him but rather because that was the contribution of his final (or marginal) hour of labor to the production process. On the other hand, a capitalist earns \$5,000 in profit not because he had the social power that came with owning the means of production but rather because this was the productive contribution of the machinery he owned. The moral of the model was obvious: the distribution of wealth in free market societies was inherently fair. So long as the government or unions didn't interfere in the workings of a competitive market, both worker and capitalist would receive their just deserts.¹⁸

As the title of his book makes plain, Clark clearly did not ignore or downplay the issue of economic distribution. Quite the opposite in fact. Yet as his marginal productivity theory grew to become one of the central pillars of neoclassical economics in the twentieth century, its effect was largely to sideline questions of distribution. For if each person in society received what they had produced, then what mattered most was not the issue of economic inequality but rather economic *productivity*. So long as neoclassical economists studied ways in which to increase productivity, they had little need to examine the mechanisms through which it was distributed. As a result, the neoclassical economists who followed in Clark's footsteps put far less of an emphasis on distribution. For example, Yale Economics Professor and neoclassical savant Irving Fisher derided socialists who thought "the problem of economic mass welfare is primarily one of *distribution*," arguing, rather, that "it is primary one of production." Clark's claim also took the ethical sting out of inequality. Since each person gets what he deserves, whatever inequality that does exist in society is legitimate. As noted by Cambridge economist Alfred Marshall, Clark's avid follower in England and author of the leading neoclassical textbook of the first half of the twentieth century, "most earn just about what they are worth."¹⁹

To see the long-term impact of Clark, look no further than Paul Samuelson's *Economics: An Introductory Analysis*, which became the best-selling economic textbook of all time in the latter half of the twentieth century. In the seventh edition from 1967, there are over 800 pages. How many directly examine the issue of wealth or income inequality? About two dozen. Why? We will get to the other reasons in a moment but it is interesting to note that in his discussion on economic distribution Samuelson instructs his readers "to appreciate J.B. Clark's advance over such classical economics as David Ricardo." Moreover, he argues not only that "the Clark neoclassical theory of distribution, although simplified, is logically complete and a true picture of idealized competition," but also that empirical evidence "seems to provide rough corroboration for [his] theories of production and marginal-products."²⁰

The Chicago School's theory of "human capital," which took off in the 1960s and 1970s, also reveals how marginal productivity led many economists to focus more on productivity than

¹⁸ Nancy Cohen, *The Reconstruction of American Liberalism* (Chapel Hill: University of North Carolina Press, 2002), 279-285; Jon Levy, "Capital as Process and the History of Capitalism," *Business History Review* (2017): 1-28.

¹⁹ Irving Fisher, "An Address on the Irving Fisher Foundation, Sept. 11, 1946" in *The Works of Irving Fisher*, ed. William J. Barber (London: Pickering and Chatto, 1997) 1: 29 Earlier in his career, Fisher had placed a somewhat larger focus on inequality. See Fisher, "Economists in Public Service: Annual Address of the President," *The American Economic Review*, 9:1 (Mar. 1919; Alfred Marshall, *Principles of Economics* (London: Macmillan, 1890), 335.

²⁰ Paul Samuelson, *Economics: An Introductory Analysis*, 7th edition (New York: Mcgraw-Hill, 1967), 521.

distribution. In the late twentieth century, human capital theory quickly became the most dominant approach by labor economists for not only valuing people but explaining inequality. In treating people as capitalized factors of production much like machines, human capital theory posited – just like Clark – that labor wages were largely determined by labor productivity which, in turn, were largely determined by how much a worker “invested” in themselves to improve the “rate of return” on their human capital. In following Clark’s theory of marginal productivity, these economists usually did not bother to examine how the economic pie or national income was divided between labor and capital. Rather, since they assumed that each worker earned what he or she in fact produced, they focused only on the question of labor productivity and how it could be increased via self-investments in training and education. Just as Clark had intended over one hundred years before, gone were the classical economic questions regarding the ways in which social or power relations influenced the distribution of wealth or income between labor and capital.²¹

The utility theory of value and spiteful egalitarianism

Another key reason neoclassical economics tended to downplay distribution was its shift from a labor theory of value which focused on production to a utility theory of value which emphasized exchange and consumption. Unlike classical economics, in neoclassical economics the distribution of wealth between social classes plays no role in the determination of commodity prices. This is not only because there *are* no social classes in neoclassical economics, only individual utility-maximizing exchangers, (incredibly, labor can buy capital in neoclassical models just as capital buys labor) but also because neoclassicists believe it is the prices of goods that help determine the rate of wages, profit and rent and not *vice versa*. The price of any commodity, meanwhile, is determined by the final (or marginal) amount of subjective utility it offers individual consumers and has little to do with the distribution of wealth.²²

The move from a producerist labor-theory-of-value to a consumerist utility value theory also marginalized distribution by offering an alternative meaning of freedom and wellbeing. While American farmers and European socialists had used a labor theory of value to argue that to be free and prosperous entailed a full return of the fruits of their labor, the invention of marginal utility reflected a consumerist turn which envisioned freedom as the consumption of the fruits of industrial progress. Laborers should not care what the profits of their employers were in comparison to their own wages, the argument went, so long as their “standard of living” and consumer comfort was increasing.²³

A perfect example of this consumerist marginalizing of inequality took place in the late nineteenth century in the United States, just as neoclassical economics was coming into being. As a PhD Student at Columbia in the 1880s, Charles Barzilai Spahr wrote a

²¹ On human capital see Jacob Mincer, “Investment in Human Capital and Personal Income Distribution,” *Journal of Political Economy* 66, no. 4 (August 1958): 281–302; Gary Becker, *Human Capital: A Theoretical and Empirical Analysis* (Chicago: Chicago University Press, 1964);

²² Richard Howey, *The Rise of the Marginal Utility School, 1870-1889* (New York: Columbia University Press, 1989); Margaret Schabas, *A World Ruled by Number: William Stanley Jevons and the Rise of Mathematical Economics* (Princeton, NJ: Princeton University Press, 1990); Dorothy Ross, *The Origins of American Social Science* (New York: Cambridge University Press, 1991), 172–219.

²³ On the producer to consumer shift see Lawrence Glickman, *A Living Wage: American Workers and the Making of Consumer Society* (Ithaca: Cornell University Press, 1999); Jeff Sklansky, *The Soul’s Economy: Market Society and Selfhood in American Thought, 1820–1920* (Chapel Hill: University of North Carolina Press, 2002).

dissertation that likely would not have been written in the mid-twentieth century. Published later as a book titled *An Essay on the Present Distribution of Wealth in the United States*, Spahr meticulously mined the taxation data at his disposal to make one basic point: as time passed, the distribution of wealth in the United States was becoming more unequal. “Seven-eighths of the families [in America] hold but one-eighth of the national wealth,” Spahr concluded, “while one per cent of the families hold more than the remaining ninety-nine.” More than a century before Thomas Piketty, Spahr had discovered the infamous “one percent.”²⁴

Spahr, however, has been completely forgotten in large part because of the scathing review he received in the premier academic journal of the era by Columbia University Economics Professor Richmond Mayo-Smith, who just so happened to be a close colleague of John Bates Clark. “Having shown that property and incomes are unequally distributed and that (in his opinion) the inequality is increasing,” Mayo-Smith wrote, “Dr. Spahr seems to think that his task is ended. But that is only the beginning. The real question is whether such a concentration of wealth is not a good thing for the whole community.” Continuing, Mayo-Smith reflected the turn to subjective utility value by arguing that “the happiness of individuals is measured not according to their ownership of property ... but according to their command of the enjoyments of life.” Mayo-Smith’s argument that labor should focus on its subjective consumer enjoyments rather than the unequal gains of capital was repeated numerous times in the twentieth century. For instance, just as economic inequality was slowly returning to American economic discourse in the late 1990s, Harvard Professor and National Bureau of Economic Research President Martin Feldstein tried to shut it down. He did so by arguing that such a focus on inequality stemmed from an ideology of “spiteful egalitarianism” and that economists need not make such troublesome comparisons:

“According to official statistics, the distribution of income has become increasingly unequal during the past two decades. A common reaction in the popular press, in political debate, and in academic discussions is to regard the increase in inequality as a problem that demands new redistributive policies. I disagree. I believe that inequality as such is not a problem and that it would be wrong to design policies to reduce it. What policy we should address is not inequality but poverty.”²⁵

Yet the relationship between the rise of a utility theory of value and the demise of inequality economics in the twentieth century was not nearly so cut and dry. In the first generation following its inception - and crucially before the “Paretian Revival” of the 1930s that would place “Pareto Optimality” at the very center of neoclassical economics - marginal utility actually led many economic thinkers to focus *more* on the relationship between economic inequality and efficiency - not less. In fact, in the late nineteenth century the socialist Fabian society and its leaders Sidney Webb and George Bernard Shaw became enthusiastic proponents of the utility theory of value and its potential for reinvigorating the case for economic equality. This is because they, and many other utility theorists in the early twentieth century, were very “Benthamite” in their approach to social welfare.²⁶

²⁴ Charles Spahr, *An Essay on the Present Distribution of Wealth in the United States* (Boston, 1896), 69.

²⁵ Richmond Mayo-Smith, “Review,” *Political Science Quarterly* 12 (1897): 346-348; Martin Feldstein, “Reducing Poverty, Not Inequality,” *The Public Interest* 137 (Fall, 1999).

²⁶ See Mark Bevir, “Sidney Webb: Utilitarianism, Positivism, and Social Democracy,” *Journal of Modern History* 74.2 (June, 2002): 217-252; Yonay, *Struggle for the Soul*, chapter 9.

Like the eighteenth century utilitarian philosopher Jeremy Bentham, these economic thinkers believed that in order to measure the total welfare of a society all one had to do was *sum* up the utility consumed by every individual. They argued that it was theoretically possible to add together individuals' subjective feelings of satisfaction or happiness because individual utilities were *comparable* between people and thus also capable of aggregation. This interpersonal comparison approach to utility theory led to radically egalitarian conclusions: Since all neoclassical economists believed in the principle of diminishing marginal utility, Benthamites logically concluded that the marginal utility of a rich man was lower than that of a poor man. This meant that even if one disregarded the moral elements of inequality, the most *efficient* way to maximize social welfare was to redistribute money from the rich to the poor. As Cambridge economist Arthur Pigou (hardly a radical socialist) explained in his renowned 1920 book *Economics of Welfare*, egalitarianism was the most efficient way to maximize welfare because "more intense wants to be satisfied at the expense of less intense wants must increase the aggregate sum of satisfaction." Pigou, therefore, concluded that any redistributive policy "which increased the proportion of the national dividend by poor persons, provided that it does not lead to a contraction of the dividend...will, in general, increase economic welfare."²⁷

Pareto optimality and the dangers of comparison

The egalitarian era of marginal utility theory, however, was short-lived. Even at its peak in the early 1900s, there were numerous leading neoclassical economists, such as Stanley Jevons, Francis Edgeworth and Vilfredo Pareto, who rejected such arguments for equality. The Italian Pareto led the charge in this regard. A classical liberal before he turned to Italian Fascism, men like Pareto were disturbed by the notion that marginal utility theory could be used as a tool to legitimize the redistribution of wealth from rich to the poor. To counter these arguments, he made key modifications to utility theory in his 1906 book *Manual of Political Economy* that disabled such egalitarian arguments while also marginalizing the issue of inequality. First off, Pareto argued that one could *not* make interpersonal comparisons of utility. Since utility was subjective desire, Pareto argued, it was simply impossible to compare one person's marginal utility – no matter how rich they happened to be – with that of another. This modification to utility theory led Pareto and other neoclassicists to claim that "Benthamite" economists could not compare the utility of two people nor could they measure social welfare by adding up the utility of all individuals in a given society.²⁸

Basing his analysis on these key assumptions, Pareto came up with his own definition of social optimality. Since the utilities of individuals could not be compared or aggregated, Pareto argued, it was not necessarily economically optimal to take from the rich and give to the poor because it would not be clear if this was a net utility gain for society or not. In a world where interpersonal utility comparisons could not be made, Pareto continued, a definite efficiency improvement could *only* take place if one person was made better off without injuring anyone else – even in the slightest. According to Pareto's logic, even though a starving man could use a dollar far more than a millionaire, if that millionaire felt even an

²⁷ AC Pigou, *Economics of Welfare* (London: MacMillan, 1920); See also A. Bergson, *Essays in Normative Economics* (Cambridge, MA: Harvard University Press, 1966).

²⁸ Vilfredo Pareto, *Manual of Political Economy*, trans. Ann Schwier (New York: AM Kelley, 1971); Joseph Schumpeter, "Vilfredo Pareto, 1848-1923," *Quarterly Journal of Economics* 63 (May, 1949): 147-173; Maurice Dobb, *Welfare Economics and the Economics of Socialism: Towards a Commonsense Critique* (Cambridge: Cambridge University Press, 1975) 77.

inkling of pain in giving up that dollar, then by definition redistributing the money was inefficient and not optimal. The principle of “Pareto Optimality” which still dominates neoclassical economics was born. With its rise, economists’ interest in inequality would significantly wane.²⁹

In time, Pareto optimality would form the core of neoclassical economics’ case for free-market liberalism. As Pareto (and his Lausanne University predecessor Leon Walras) had argued, the wonder of the unregulated free market lay in its ability to *always* lead society to a Pareto optimal point in which no more transactions could be made that improved one person’s lot without harming anyone else’s. Translated into highly mathematical terms, the free market’s almost magical ability to result in Pareto optimal allocations came to be known as “the first fundamental welfare theorem of welfare economics.” For the generations of neoclassical economic students who followed, this theorem would be key, not only because proving it required a high-level of mathematical expertise, but also because it gave a scientific veneer to the idea of “the invisible hand.” As Paul Samuelson would explain to generations of economics students in his 1960s textbook, the idea of Pareto optimality had shown that

“Adam Smith, in his talk about an Invisible Hand, which led the selfish actions of individuals toward so harmonious a final result, did have some point...Under perfectly perfect competition...where the genuine desires and well-being of individuals are represented by their marginal utilities...then the resulting equilibrium has the efficiency property that ‘you cant make any one man better off without hurting some other man.’ What does this mean exactly? It means that a planner could not come along with a slide rule and find a solution, different from the laissez-faire one, which could improve the welfare of everyone.”³⁰

The idea of Pareto optimality not only helped to legitimize free markets but it also reflected the bourgeois ideology of classical, Lockean liberalism: the ownership of private property was a natural right above any artificial state intervention. As such, no infringement on private property, no matter how large the wealth disparities in a society may be, could possibly be socially desirable. Implicit in this argument was the claim that economists need not focus on inequality since any attempts at redistribution would distort the workings of the free market and thus lead to sub-optimal allocation points.³¹

Pareto’s approach to utility theory did not catch on right away. In fact, it was “Pigouvian” and not “Paretian” welfare economics that seemed to be more popular in the early twentieth century. As a result, one can still find in the early twentieth century many studies on wealth and income inequality, including a groundbreaking report by the American National Bureau of Economic Research in 1920, which rejected many of Pareto’s theories. All this changed, however, in the 1930s and 1940s. Within the span of less than two decades, neoclassical economics swung completely to the side of Pareto Optimality. While the Paretian Revival would encompass the entire discipline – from socialists like Oskar Lange to liberals like Paul

²⁹ Pareto, *Manual*, 266-269, 451-2.

³⁰ Samuelson, *Economics*, 609; Samuelson goes on to state that this does not mean that Pareto optimality necessarily promotes the “public interest;” On first welfare theorem see Allan Feldman, “Welfare Economics,” *The New Palgrave Dictionary of Economics, Second Edition*, eds. Steven Durlauf and Lawrence Blume (New York: Palgrave MacMillan, 2008); Joseph Stiglitz, “The Invisible Hand and Modern Welfare Economics, NBER working paper 3641 (March, 1991).

³¹ On Lockean Liberalism see *C.B. McPherson, The Political Theory of Possessive Individualism: Hobbes to Locke* (Oxford: Clarendon Press, 1962).

Samuelson to conservatives like Milton Friedman – the man most responsible for bringing this change about was Lord Lionel Robbins, a London School of Economics Professor and member of the “neoliberal” Mont Pelerin Society who gave Austrian School economist Friedrich Hayek his first job in England.³²

In the late 1930s, Robbins re-iterated Pareto’s arguments against the ability to make interpersonal utility and, therefore, comparisons between the rich and poor. In so doing, however, Robbins went one step further than Pareto by reaching the conclusion that *any* analysis of inequality or distribution was inherently normative and, therefore, should play a limited role, if any, in the positivist science of economists. Robbins’ 1938 article on interpersonal utility comparisons is widely regarded for turning the tide in the neoclassical economic approach to distribution. Here is the most quoted section:

“But as time went on, things occurred which began to shake my belief in the existence between so complete a continuity between politics and economic analysis.... I am not clear how these doubts first suggested themselves; but I well remember how they were brought to a head by my reading somewhere – I think in the work of Sir Henry Maine – the story of how an Indian official had attempted to explain to a high-caste Brahmin the sanctions of the Benthamite system. ‘But that,’ said the Brahmin, ‘cannot possibly be right – I am ten times as capable of happiness as that untouchable over there.’ I had no sympathy with the Brahmin. But I could not escape the conviction that, if I chose to regard men as equally capable of satisfaction and he to regard them as differing according to a hierarchical schedule, the difference between us was not one which could be resolved by the same methods of demonstration as were available in other fields of social judgment.”

In conclusion, Robbins declared that “I still cannot believe that it is helpful to speak as if interpersonal comparisons of utility rest on scientific foundations – that is upon observation and introspection...I still think, when I make interpersonal comparisons, that my judgments are more like judgments of value than judgments of verifiable fact.”³³

Not everyone agreed with this argument. In the same year as Robbins article was published, Sir Roy Harrod warned that “if the incomparability of utility to different individuals is strictly pressed, not only are prescriptions of the welfare school ruled out, but all prescription whatever. The economist as an adviser is completely stultified.” By the late 1940s, however, Robbins’ argument that economists should not deal with issues of inequality or distribution because they were normative and thus unscientific had catapulted itself to the heart of the economics profession. In so doing, economists began to present themselves as objective number crunchers whose only goal was to maximize productive efficiency in such a manner that reaches a Pareto optimal point, regardless of what the distributive ramifications may be. The question of distribution, they claimed, should be left to the political realm. In fact, students

³² On Pigouvian Welfare Economics see Ian Kumeakawa, *The First Serious Optimist: AC Pigou and the Birth of Welfare Economics* (Princeton University Press, 2017); On the Paretian turn see SAT Rizvi, “Postwar Neoclassical Economics,” in *A Companion to the History of Economic Thought*, ed. Warren J. Samuels, Jeff Biddle, and John Davis (Malden, MA: Blackwell, 2003), 377-395; National Bureau of Economic Research, *Income in the United States: 1909-1919* (New York, 1921).

³³ Lord Robbins, “Interpersonal Comparisons of Utility,” *Economic Journal* (Dec 1938): 640-641; See also IMD Little, *A Critique of Welfare Economics* (Oxford: Clarendon Press, 1950) 55-56; On Robbins impact on neoclassical economics see Thiago Dumont Oliveira and Carlos Eduardo Suprinyak, “The Nature and Significance of Lionel Robbins’ Methodological Individualism,” *Economica* (October, 2017).

were taught – through what came to be called the “second fundamental theorem of welfare economics” – that governments could, via lump-sum tax and transfers that did not distort the Pareto-optimizing wonders of the free market, determine what level of inequality they desired in their society. Crucially, however, such distributive discussions would be held by politicians – not economists – since it was a political and ethical issue rather than a scientific one. As a result, the second welfare theorem gave generations of neoclassical economists the perfect excuse to neglect the question of inequality.³⁴

Once again, Samuelson’s textbook – which, it is important to remember, was clearly situated on the liberal side of neoclassical economics – offers a good articulation of this worldview by the 1960s:

“It is an ethical rather than a scientific question as to just how large, relatively, each person’s final income ought to be. AS a science, economics can concern itself only with the best means of attaining given ends; it cannot prescribe the ends themselves. Indeed, if someone decided that he preferred a feudal-fascistic kind of society, in which all people with little black mustaches were to be given especially high incomes, the economist could set up the pricing rules for him to follow to achieve his strange design best.”³⁵

The separation of economic inequality and economic efficiency was, perhaps, the most powerful force behind the marginalization of inequality economics in the twentieth century. It seeped into every nook and cranny of the discipline, while reaching the highest stages of economic decision-making. We have seen how, after Piketty’s book came out, Federal Reserve chief, Janet Yellen, warned of the dangers of inequality. In 2007, however, Fed chief and Princeton University economist Ben Bernanke made a very different argument, one that neoclassical economists had been making for more than half a century. In explaining why the Fed did not examine the issue of inequality, Bernanke explained that he would “not draw any firm conclusions about the extent to which policy should attempt to offset inequality in economic outcomes; that determination inherently depends on values and social trade-offs and is thus properly left to the political process.”³⁶

As Maurice Dobb and other historians of economic thought have shown, economists’ insistence to focus only on issues of efficiency would have a dramatic impact on the discipline. “Not only would egalitarian conclusions, distasteful to so many, be banished from sight,” Dobb explained, “but considerations about distribution... could apparently be banned from intrusion if not totally ignored.” Interestingly, however, most economists’ decision not to discuss distribution did not stop many of them from arguing – in what appears to be the very kind of normative claim that they derided – that free markets worked best for society. Thoughtful economists such as Paul Samuelson rarely spoke in such bombastic terms, but others were not so careful. And so, for instance, we can find in C.E. Ferguson’s 1969

³⁴ Roy Harrod, “Scope and Method of Economics,” *The Economic Journal* (Sept, 1938): 397; On second welfare theorem see Feldman, “Welfare Economics,” *New Palgrave Dictionary*; Stiglitz, “The Invisible Hand.”

³⁵ Samuelson, *Economics*, 613.

³⁶ Irwin, “What Yellen Said,” *New York Times*; See also James Coleman, “Equality,” *The New Palgrave Dictionary*.

textbook the argument that “a perfectly competitive, free enterprise system guarantees the attainment of maximum social welfare.”³⁷

Conclusion

Inequality economics today is witnessing a rebirth – but the depth and breadth of this intellectual impact on *actual* wealth and income inequality across the world remains to be seen. If this article on the past can tell us anything about the future, it is that for the economic study of inequality to really take off, and wealth inequities to significantly decline, the basic pillars of neoclassical economics may first have to be toppled.

Author contact: elicook@gmail.com

SUGGESTED CITATION:

Eli Cook, “The great marginalization: why twentieth century economists neglected inequality”, *real-world economics review*, issue no. 83, 20 March 2018, pp. 20-34, <http://www.paecon.net/PAEReview/issue83/Cook83.pdf>

You may post and read comments on this paper at <https://rwer.wordpress.com/comments-on-rwer-issue-no-83/>

³⁷ Maurice Dobb, *Welfare Economics and the Economics of Socialism: Towards a Commonsense Critique* (Cambridge: Cambridge University Press, 1975) 77; C.E. Ferguson, *The Neoclassical Theory of Production and Distribution* (London: Cambridge University Press, 1969) 444-445.