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Inequality and the crisis of liberalism

28.10.2021 Baltic Rim Economies

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Liberalism today is under attack from the far right and from rising economic inequality. Some on the left denounce it as a conspiracy of capitalism against democracy. But a different understanding of liberalism is possible. By recognizing that liberalism does not have to follow the path of ultra free-market laissez-faire liberalism, or what some call neo-liberalism, we can reestablish liberalism as a public philosophy that values market and political freedom in a social order that also protects fundamental social justice.

Classical liberalism held that all individuals should be equals both as citizens and economic actors. In the economy, this meant an open, free, fair competitive order with a roughly equal distribution of material resources. In the political sphere, it meant the right to exercise choice freely over policies and candidates seeking power. In the hands of ultra-conservatives and their wealthy backers, these principles were corrupted. They came to refer to the unfettered freedom of the wealthy and powerful to protect themselves from competitive pressure.

Largely forgotten is an alternative branch of liberalism that took shape in America, Germany, and elsewhere in the first decades of the 20th century. Its German variant is called "ordoliberalism," because the German thinkers who developed these ideas in the 1930s emphasized that a competitive economy and democratic polity needed to be institutionalized in a constitutional order. Its government had to be strong enough to protect competition and preserve the freedom of the individual to compete fairly and freely. German ordoliberalism was influenced by the American Progressives, who were appalled at the threat to democracy and capitalism posed by giant trusts and cartels. The ordoliberals opposed Fascism, Naziism, and Communism as well. They recognized that competition is a powerful force, but can easily be curbed by concentrated private power in union with the state. To drive growth and social well-being, the market must be embedded in law and society. The market must serve society, not the other way around.

Many economists argue that inequality is the inevitable outcome of market forces such as globalization and technological change. But European economies are equally exposed to globalization and technology change, yet manage to pay workers decent wages and to restrain compensation packages at the top. Some countries adopt market reform without creating massive concentration of incomes at the top or wage stagnation for everyone else. This tells us that politics

shape how market forces work. The point is that markets operate in society with existing sets of power relations. Opening up market forces always lets existing social hierarchies influence how the market distributes the gains and losses of growth. We do not enter the marketplace as equals.

Certainly, some of the rise in economic inequality that we have seen since the late 1970s does owe to market forces. Technological change that makes highly skilled workers much more productive does tend to drive higher wages for the more-skilled while keeping down wages for those without lower levels of education and skill. The coupling of digitalization and globalization has allowed outsourcing of more labor-intensive jobs as well as to opportunities to capitalize on externalities of scale. But political choices also deeply shape trends in inequality. In turn, high and rising inequality has become a serious threat to the viability of democracy.

How does competition protect freedom? First, competition dissipates rents. Rents are the income earned when a factor of production is shielded from market competition. The most pernicious rents are those created by government to benefit the wealthy and powerful.

Because democracy threatens the positions of the privileged, under conditions of high inequality, they will fight fiercely to restrict political rights in order to preserve their rents. Democracy endangers the privileged not only because it can produce redistributive taxing and spending but also because it can widen opportunity to compete fairly. This requires active government effort to supply public goods that the market cannot supply—such as public education, public health, safe food, clean air, and public safety.

Competition is a more important condition than property rights for prosperity and democracy. The University of Chicago economist Raghuram Rajan asserts simply: “when we have to choose between competition and property rights, we should invariably choose competition.” But this core idea of liberalism—that individuals should enjoy the freedom to compete as equals in both the political and economic arenas—is undermined when the powerful manipulate the rules of market regulation, antitrust law, tax law, labor law to protect their advantages and shift market risks to the poor and the general public.

As inequality widens, the gap between the advantaged and disadvantaged

compounds over time. Differences in income, education, social capital and other factors that contribute to opportunity in life become more locked in across generations. The middle class shrinks. Meantime, public education, public health, public amenities of all kinds deteriorate while we live increasingly in worlds separated by access to privately provided education, health, security, recreation and information. The confluence of geographic sorting with socio-economic and political sorting reinforces polarization, especially the kind that leads each camp to view the other as dangerous and evil.

Political equality is fundamental to democracy, while high concentrations of economic inequality threaten it. Political equality can be reconciled with political and market freedom so long as neither political or market power is too concentrated. The best way to check the ability of those gaining political and market power to claim rents and fortify their positions by curbing competition, therefore, is to encourage the competitive pursuit of material self-interest as a vital social interest while using government to curb the pursuit of rents by those with power and expand equal access to public goods. The greatest threat to political and economic freedom is not the risk that the masses will exercise their democratic rights and demand redistribution. It is that those with market power will prefer to ally themselves with those holding political power to suppress competition in both the market and political arenas. By recognizing this, we can use the tools of liberalism to rescue democracy.

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