

Democracy and the “Washington Consensus”

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Summary. — This paper argues that there is a substantial body of economic advice, roughly summarized in the “Washington consensus,” that deserves to be endorsed across the political spectrum. Such endorsement would still leave a series of major economic issues, most notably the tradeoff between efficiency and equity, to be determined by the outcome of the political process. It is argued that the “left,” interpreted as those who give relatively more weight to equity, will advance its cause by embracing the mainstream economics summarized by the consensus.

1. INTRODUCTION

In mid-1989 I prepared a list of the principal economic reforms that were being urged on Latin American countries by the powers-that-be in Washington (see Williamson, 1990). I entitled the paper “What Washington means by policy reform” and rashly dubbed it the “Washington consensus,” a term immediately challenged by one of my discussants, Richard Feinberg, on the grounds that it was not universally endorsed in Washington, and was therefore not a consensus, while the geographical scope of its acceptance went far beyond the Beltway. He suggested that it would have been more apt to name it the “universal convergence.” My Latin friends in due course let me know that many of them also took a poor view of the term, since it suggested that Washington had figured out what they should be doing and was engaged in imposing “economic correctness” on them. Their latest barb (due to Carlos Prima Braga), which I endorse in substance, is that my term is a misnomer because the “Washington consensus” is being implemented in every capital of the hemisphere bar Washington. (This seems to overlook Havana.)

My view is in fact that the “Washington consensus” is the outcome of worldwide intellectual trends to which Latin America contributed (principally through the work of Hernando de Soto) and which have had their most dramatic manifestation in Eastern Europe. It got its name simply because I tried to ask myself what was the conventional wisdom of the day among the economically influential bits of Washington, meaning the US government and the international financial institutions. I did not intend to imply that they could claim any particular priority in having nurtured the conventional wisdom.

I tried to describe what was conventionally thought to be wise rather than what I thought was wise: that is, it was intended as a positive rather than a normative list. It happens, however, that I endorse everything on the list, which is hardly surprising since I live in Washington and like to think of myself as reasonably eclectic rather than temperamentally rebellious. The list is nonetheless materially different from the list that I would have drawn up had I been aiming to produce a normative list, since the latter would have had a substantially bigger equity-oriented component.¹ I deliberately excluded from the list anything which was primarily redistributive, as opposed to having equitable consequences as a byproduct of seeking efficiency objectives, because I felt the Washington of the 1980s to be a city that was essentially contemptuous of equity concerns.²

The questions addressed in this paper concern the political status of the “Washington consensus,” alias the “universal convergence.” Would political agreement that this is good economics be desirable? Or would democratic politicians have nothing worthwhile left to decide in the field of economics if they all subscribed to the universal convergence? How much consensus on economic policy would be desirable, and how

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much is it reasonable to expect might come about?

2. THE CASE FOR CONSENSUS

I can see no advantage to democracy in having major parties espousing economic nonsense. If they win an election, the economy will suffer; but to the extent that the electorate has a certain amount of earthy common sense, the chances are that they will lose and thus that the range of effective electoral choice will be reduced. To those of us who regard ourselves as left of center, it ought to seem particularly unfortunate when left-wing parties espouse economic rubbish that jeopardizes their prospects of being able to further egalitarian causes.

Consensus on good economics is important if economic reform is to succeed. Continual policy reversals are obviously disruptive. The pressures to manufacture policy differences produced by a two-party system, and then to lurch between the one position and the other as the parties alternate in power, help to explain the inferiority of the postwar economic performance of the United Kingdom in comparison to the continental countries where coalition government is the norm and the pressures are therefore to seek convergence rather than confrontation.

In many cases the benefits of reform depend not just on sensible policies being enacted but also upon confidence that those policies will remain invariant to political change. Perhaps the most obvious case in point, at least so far as Latin America is concerned, relates to capital flight. The prime cause of capital flight was populist macroeconomic policies, and hence the return of flight capital demanded restoration of macroeconomic discipline. But simply restoring macro discipline may not suffice, because wealth-holders look to the future and may repatriate their funds only when they are confident that the reformed macro policies are here to stay. The same thing is true with any decision that has long-term implications, notably the decision to invest.

A further benefit of broad political consensus in favor of the universal convergence is that it will help to limit the damage that can be done by the political mafia hypothesized by public choice theory. Rules that make state help the exception rather than the rule, and require it to be transparent and based on agreed principles, will cramp the style of those politicians whose main objective is to feather their own nests rather than to further any concept of the public good that can be represented in a plausible social welfare function.

3. CONSENSUS AND DEMOCRACY

It would be ridiculous to argue that as a matter of principle every conceivable point of view should be represented by a mainstream political party. No one feels that political debate is constrained because no party insists that the Earth is flat. No one demands that one or other of the principal parties should advocate racism or the denial of human rights. Until those battles are won, of course, the establishment of human rights and the elimination of racism deserve to be high on the political agenda. But one hopes that in due course a consensus will be established in favor of human rights and against racism, and at that time those very important issues will cease to be subjects of political controversy between the mainstream parties.

The universal convergence seems to me to be in some sense the economic equivalent of these (hopefully) no-longer-political issues. Until such economic good sense is generally accepted, then its promotion must be a political priority. But the sooner it wins general acceptance and can be removed from mainstream political debate, the better for all concerned. Indeed, the chances of removing these basic economic issues from the political agenda should be better than those of keeping human rights and racism off the agenda, inasmuch as the latter depend solely upon value judgments whereas the superior economic performance of countries that establish and maintain outward-oriented market economies subject to macroeconomic discipline is essentially a positive question. The proof may not be quite as conclusive as the proof that the Earth is not flat, but it is sufficiently well established as to give sensible people better things to do with their time than to challenge its veracity.

Since the world has its share of cranks, however, we cannot expect unanimous endorsement of the universal convergence. A democratic political system needs a way of allowing dissent to be expressed. This is important both because suppression is the best way to convince the conspiratorially minded that there is something to hide, and because there must always remain some doubt as to whether what deserves to pass for conventional wisdom today will remain valid for the indefinite future. The system needs some mechanism whereby orthodoxy³ can be challenged, for truth is never absolute in the social sciences — and it also changes in a way that truth in the natural sciences does not.

I have no view on whether this escape channel is best provided by the existence of fringe parties or by the mainstream parties tolerating eccentric minorities. I see no reason to try and limit the

expression of dissenting viewpoints to one mechanism rather than the other.

Neither do I see any problem analogous to the "democrats' dilemma" — the question as to whether or not democrats should tolerate use of the democratic system by totalitarian parties that would not allow themselves to be democratically replaced if they ever gained power. Parties with crazy economic programs must obviously be expected to do economic damage if they gain power, but as long as they can be replaced democratically there is no case for limiting their political freedom. Thus my position is not that democracy should be in any way circumscribed so as to promote good economic policy, but rather that both economic policy and democracy will benefit if all mainstream politicians endorse the universal convergence and the scope of political debate on economic issues is *de facto* circumscribed in consequence.

4. THE SCOPE OF CONSENSUS

How much consensus on economic policy should one hope for? As much as is justified by the state of economic knowledge and the convergence in fundamental (ultimately political) values.

The hope that we can now develop far more consensus than would have been conceivable or appropriate in the 1950s is based ultimately on the fact that we now know much more about what types of economic policy work. At that time it looked as though socialism was a viable alternative to a market economy; now we know that it is not. At that time we had not discovered that pushing import substitution beyond the first ("easy") stage was vastly inferior to a policy of outward orientation that allowed nontraditional exports to develop; now we know better. At that time we thought that more expansionary macro policies produced more output rather than just more inflation even in the long term; there is now evidence that this is the opposite of the truth (De Gregorio, forthcoming). At that time it was still possible to hope that greed could be displaced by altruism as effectively as it can be made to work in the public interest by a competitive market economy; after the collapse of communism that just looks naive.

Consensus, however, will and should be circumscribed by two types of consideration: the limitations of our knowledge and differences in our values. We know from elementary economic theory that markets will not work satisfactorily where externalities are important unless some

deliberate action is taken to internalize them. We have also been learning about the sorts of situations where externalities actually are sufficiently important as to demand countervailing action: where spillovers affect the quality of the environment, with regard to invention, where the safety of financial institutions is at stake, where the labor training provided by one firm can be poached by another, and so on. At present many of these issues are still too novel to have established any robust knowledge of the best way of internalizing the externalities, and hence they will remain controversial for the time being. But over time experience will accumulate and controversy should accordingly diminish, except in countries such as the United Kingdom where the political system is so structured as to manufacture controversy artificially.

The other reason why consensus will remain limited is that normative values differ. The classical view of politics is that it provides the mechanism whereby society decides whose normative values will prevail. The winning party or coalition specifies the social welfare function to be maximized by the choice of economic policies. Since I cannot conceive of a social welfare function that would specify means (such as the choice of economic system or the extent of the role of the state) rather than ends (notably the degree to which equity is to be traded off against efficiency, as sketched in the appendix), this suggests that the fundamental political divide (on economic issues) is not between capitalism and socialism, or between free markets and state intervention, but between those concerned to promote an equitable income distribution ("the left") and those concerned to defend established privileges ("the right"). Note that this dividing line helps explain why it seemed natural for communist hardliners to be called right-wing in recent Soviet debates while those seeking the transition to a market economy were called the left. (But there can be circumstances in which the distinction is less clear, notably where a privileged elite has been partially replaced by another — as in 1979 Britain, where the old elite had been partially replaced by the trade union barons and the displacement of the latter gave the Thatcher government a claim to being considered radical.)

Thus economic policies can be classified into three categories:

- (a) those where consensus has been established;
- (b) those where controversy still reigns, but where the controversy is nonideological in the sense that there is no inherent reason for an egalitarian to be driven to favor one type of outcome rather than another;

(c) those where controversy reigns now and should be expected to remain in the future, since the appropriate choice depends on political (normative) values.

Let me take the 10 headings of the Washington consensus and suggest the degree to which policies in those fields ought to fall in one or another of these three categories.⁴ While the list was compiled with reference to Latin America, it seems to me to be generally applicable.

Fiscal Discipline. Budget deficits, properly measured to include provincial governments, state enterprises, and the central bank, should be small enough to be financed without recourse to the inflation tax. This typically implies a primary surplus (i.e., before adding debt service to expenditure) of several percent of GDP, and an operational deficit (i.e., the deficit disregarding that part of the interest bill that simply compensates for inflation) of no more than about 2 percent of GDP.

This I place unreservedly in category (a). The only scope I see for sensible debate concerns the extent to which it may be rational to allow cyclical budget deficits in the interest of stabilization policy (something not precluded by my wording), which I place in category (b).

Public Expenditure Priorities. Policy reform consists in redirecting expenditure from politically sensitive areas which typically receive more resources than their economic returns can justify, like administration, defense, indiscriminate subsidies, and white elephants, toward neglected fields with high economic returns and the potential to improve income distribution, like primary health and education, and infrastructure.

I phrased this to cover as much as I felt could have commanded a consensus in the Washington of the 1980s, and I suspect this is not that different from what can be expected to command a consensus, i.e. fall in category (a), in Latin America or elsewhere. But this is the area par excellence where I would want and expect political debate, category (c), to focus. The left will want expenditures aimed at improving income distribution even where they do not have a particularly favorable impact on growth, while the right will not. In another paper (Williamson, 1991) I have discussed the sorts of expenditure that seem to me to deserve priority in Latin America if something is to be done about the region's appalling income distribution.

Tax Reform involves broadening the tax base and cutting marginal tax rates. The aim is to sharpen incentives and improve horizontal equity without lowering realized progressivity. Improved tax administration is an important aspect of broadening the base in the Latin context. Taxing interest on

assets held abroad ("flight capital") should be another priority in the coming decade.

Once again that was worded with the intention of making it acceptable across the political spectrum (category a), but not with the expectation that this would remove tax policy from the political arena. If the left is to achieve higher public expenditure without compromising fiscal discipline then it will have to raise more revenue by taxes, including higher marginal tax rates, although perhaps still recognizing the tradeoff with efficiency that this implies. In Williamson (1991) I suggest the desirability of land value taxation, as well as taxing interest on flight capital, as tools to improve equity with no efficiency cost in the Latin context.

Financial Liberalization. The ultimate objective is market-determined interest rates, but experience has shown that, under conditions of a chronic lack of confidence, market-determined rates can be so high as to threaten the financial solvency of productive enterprises and government. Under that circumstance a sensible interim objective is the abolition of preferential interest rates for privileged borrowers and achievement of a moderately positive real interest rate.

Once again this was carefully worded in the hope of capturing common ground, but it is probably true that among economists this recommendation would be more controversial than those concerning fiscal policy. Some successful modernizing countries (France, Korea) retained state direction of credit till they were well beyond the stage where Latin America is today: thus this recommendation may fall in category (b) rather than (a). Williamson (1991) suggests that the Bangladeshi Grameen Bank is a social innovation that makes it possible to channel credit to micro enterprises where it has an unusually high rate of return as well as benefiting the poor, which should place it in category (b) rather than (c) although one would hope the left would give particular priority to the transplantation of such institutions.

Exchange Rates. Countries need a unified (at least for trade transactions) exchange rate set at a level sufficiently competitive to induce a rapid growth in non-traditional exports, and managed so as to assure exporters that this competitiveness will be maintained in the future.

Given the success of export-led growth and the evidence that a competitive exchange rate is the key to such success, this recommendation falls in category (a). Given also the compelling evidence that markets cannot be relied on to take exchange rates to competitive levels that will

support prudent macroeconomic policies and export-led growth, I do not see that this is consistent with allowing the exchange rate to float (but I am not sure that this is yet universally conceded). Of course, there is always a tradeoff between securing a competitive exchange rate and restraining inflation, and there may be times when a government will choose to give a greater weight to the latter, e.g., by joining an institution such as the EMS exchange rate mechanism. But I would argue that there probably would be (and certainly ought to be) a consensus that this should be done only if the prospective cost in terms of diminished competitiveness is tolerable.

Trade Liberalization. Quantitative trade restrictions should be rapidly replaced by tariffs, and these should be progressively reduced until a uniform low tariff in the range of 10 percent (or at most around 20 percent) is achieved. There is, however, some disagreement about the speed with which tariffs should be phased out (with recommendations falling in a band between 3 and 10 years), and about whether it is advisable to slow down the process when macroeconomic conditions are adverse (recession and payments deficit).

This is the one topic where I explicitly recognized the existence of a significant difference of opinion in Washington, and there is no question but that a similar disagreement exists in the profession at large. Perhaps one could get consensus on my wording given that it includes this caveat, but the need for that caveat obviously means that we are closer to category (b) rather than (a).

Foreign Direct Investment. Barriers impeding the entry of foreign firms should be abolished; foreign and domestic firms should be allowed to compete on equal terms.

This would presumably provoke political disagreement, not from the left or right, but from nationalists. It would be nice to be able to assign it to category (a), but I am not sure it would be justified.

Privatization. State enterprises should be privatized.

One frequent criticism of my list as an exercise in reporting was that I should have included the restructuring of public enterprises as an alternative way of handling the problem of poor public-sector performance that would in some instances be more practical than privatization. With that addition, perhaps even this entry may fall in category (a).

Deregulation. Governments should abolish regulations that impede the entry of new firms or restrict competition, and ensure that all regulations are

justified by such criteria as safety, environmental protection, or prudential supervision of financial institutions.

Perhaps the general form of this recommendation would be acceptable in category (a), but there are still lots of category (b) debates about how it should be implemented.

Property Rights. The legal system should provide secure property rights without excessive costs, and make these available to the informal sector.

I would hope that this recommendation would fall in category (a), but I urged in Williamson (1991) that it be supplemented by land reform, which is surely a category (c) topic.

Thus most of the universal convergence falls in category (a). It is drawn from that body of robust empirical generalizations that forms the core of economics. I do not for a moment doubt that it is possible to conceive of pathological circumstances under which all of the advice listed in the universal convergence would be inopportune. The interesting question is whether these pathological circumstances actually occur with sufficient frequency to make it important to be alert to their possible presence. My judgment is that they in fact arise sufficiently infrequently to make it likely that far more mischief will be done by making a fetish of their possible presence than by advising policy makers to ignore their possible occurrence. Of course, good economists will still try to stay alert to the possibility that pathological circumstances will sometimes arise, and will advise a government (or opposition) to modify its policies appropriately. But they should be pressed to explain their reasons for deviating from orthodoxy, and certainly not allowed to get away with a Baloghian inference that it is justification in itself that advice be unorthodox.

5. CONCLUDING REMARKS

Acceptance of the proposition that there is a substantial body of economic advice, roughly that summarized in the "Washington consensus/universal convergence," that deserves to be endorsed across the political spectrum does not mean the "end of politics," although it may help curb the anti-social style of politics described by the "new political economy." But civilized politics, meaning the use of the electoral and parliamentary systems in order to determine the specification of the social welfare function that economic policy should seek to maximize, still has a crucial role to play, because there will be a tradeoff between equity and efficiency when Latin America finally gets its policies sufficiently in order to reach the frontier. Doing something

to remedy the region's disgraceful inequalities is going to be a major challenge to the left, though it is one that the left will be in a position to take on only when it liberates itself from its historical legacies of antipathy to the market, populism, and inward-looking nationalism. This is not a hopeless cause, since in some countries (notably Australia, New Zealand and Spain) the universal convergence was pioneered by the left, while in many others it has now been endorsed by the left as much as by the right.

Wide political endorsement of mainstream economics will also leave room for another type of political contest, one in which the political parties search for policy proposals that will better correct for externalities. This search is essentially nonideological, i.e. there is no inherent reason why an egalitarian should be more or less interested in devising a scheme that will (for example) encourage companies to provide the optimal amount and form of training than a conservative. But the fact that all parties believe that they can gain votes by developing proposals for better management of the system will improve the prospects for constructive reform, especially in comparison with a situation in which left-wing parties feel themselves under an ideological obligation to force any reform into the mould of an extension of the state's power to direct economic activity.

6. POSTSCRIPT

One question that arose during the conference at Forlí was the relation of the Washington consensus to what was called "neoliberalism." When I asked how I should understand this term, I was told that it encompassed Austrian economics, monetarism, new classical macroeconomics, and public choice theory. (Since these are more or less the bits of economics that are customarily dressed up as positive economics even though only conservatives subscribe to them, I must say that I would find the alternative term "neoconservatism" more apt.) If interpreted in that sense I would certainly deny that the Washington consensus is neoliberal (or neoconservative).

I suspect that the discovery that it was being interpreted this way may have been the stimulus to a list that I subsequently drew up of issues on which the Washington consensus does *not* imply a particular view (Williamson, 1992). This list is as follows:

- the desirability of maintaining capital controls
- the need to target the current account
- how rapidly and how far inflation should be reduced
- the advisability of attempting to stabilize the business cycle
- the usefulness of incomes policy and wage/price freezes (sometimes called "heterodox shocks")
- the need to eliminate indexation
- the propriety of attempting to correct market failures through such techniques as compensatory taxation
- the proportion of GDP to be taken in taxation and spent by the public sector
- whether and to what extent income should be deliberately redistributed in the interest of equity
- the role of industrial policy
- the model of the market economy to be sought (Anglo-Saxon *laissez-faire*, the European social market economy, or Japanese-style responsibility of the corporation to multiple stakeholders)
- the priority to be given to population control and environmental preservation.

These topics were not included under the Washington consensus because, chronic consensus-seeker as I am, I did not perceive that any particular view could come close to commanding a consensus in Washington. In some cases (e.g., as regards population control) I thought this was scandalous, while in other cases it struck me as quite natural. In most cases my personal views on these controversial issues are far removed from those of neoconservatives, so I find it ironic that some critics have condemned the Washington consensus as a neoconservative tract. I regard it rather — as Luiz Carlos Bresser Pereira said at Forlí — as an attempt to summarize the common core of wisdom embraced by all serious economists.

NOTES

1. I tried to complete the list from a normative standpoint in a recent paper: Williamson (1991).

2. Another of my original discussants, Stanley Fischer, challenged me on that, and argued that at least so

far as the World Bank was concerned I should have added cost-effective social expenditures.

3. Perhaps Keynes's most unfortunate legacy to the economics profession was his habit of parodying ortho-

doxy. It was actually rather funny when he did it, and doubtless some of his targets deserved the treatment, but lesser followers reduced it to a cheap routine. The fact is that in most cases things become orthodox because they contain a large element of sense, so to dismiss something because it is orthodox is silly. I hope

that this banal observation will not be interpreted as my saying that orthodoxy is always right or should never be challenged.

4. The summary under each heading is taken from the appendix to Williamson (1991).

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APPENDIX: THE SOCIAL WELFARE FUNCTION OF THE LEFT

Any civilized person would like to see social arrangements chosen in a way that would maximize a social welfare function of the general form

$$W = W(U_1, U_2, \dots, U_n),$$

with $W_i > 0$ for $i = 1, \dots, n$, the n individuals recognized as composing society in the sense that their welfare is relevant to the evaluation of social welfare, and where U_i is the i th individual's assessment of his or her own utility. In the past the left has devoted a lot of its energy to enlarging n , the domain of individuals recognized as being relevant in evaluating social welfare (from kings and lords to include the male propertied middle classes, the working class, serfs, women, slaves, foreigners, gypsies, natives . . . and perhaps in the future the effort will be to extend the domain of the welfare function to include species other than *Homo sapiens*).

The economic tradition has been to seek to avoid imposing more conditions on $W(\dots)$ than that it be an increasing function of each of its arguments, on the ground that the latter requires only a very weak value judgment that will be accepted by all civilized people. This gives rise to the criterion of Pareto optimality, which defines a social improvement as occurring when the welfare of someone improves without a diminution in the welfare of anyone else. Since almost no social change could realistically be expected to pass this test, however, an attempt was made a half century ago to extend the criterion to be able to deal with realistic cases where the gains of some come at the expense of others. If the winners were to compensate the losers, the Pareto criterion would be satisfied. The "compensation test" suggested that an improvement could be defined to have occurred if the winners *could* have compensated the losers, even though no actual compensation was paid.

This leads to a very conservative, but commonly used, welfare criterion, in which an extra dollar is

evaluated as being equally valuable to society no matter whether it accrues to a pauper or a millionaire. Society wants to maximize Σy_i . Paradoxically this criterion was developed by two left-of-center economists, Tibor Scitovsky and Nicholas Kaldor.

Let us overlook the technical objections to the compensation principle (notably its failure to pass the reversibility test) and assume that economic efficiency can be measured by the total value of income, Σy_i . Let us also agree that it is possible to measure the equity of income distribution by some measure such as the inverse of the variance of income (when income has been made comparable by transforming it to household per capita real income by allowing for the differing real income needs of family members at different stages of the life cycle), $1/\text{variance}(y_i)$. Then the "big tradeoff" of Okun (1975) is the curve shown in Figure 1A.

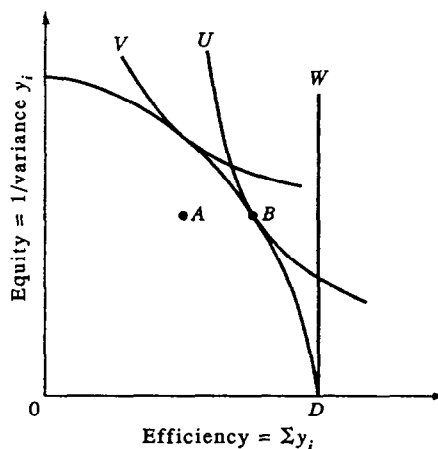


Figure 1A. *The Big Tradeoff.*

Political values can be characterized by the social welfare function used to evaluate alternative feasible outcomes. Assuming that we have resolved the issue of the domain of the welfare function, the most conservative *civilized welfare function* is that implied by the compensation principle and shown in Figure 1A by the vertical lines such as *W*. More egalitarian welfare functions are those shown by curves such as *U* or *V*, with *V* representing a more egalitarian set of preferences than *U*.

So long as left-wing parties are so misguided as to adopt policies that are populist, socialist, or protectionist they will tend to lead the economy to

inefficient points such as *A*. Endorsement of the Washington consensus/universal convergence will lead them toward the frontier, say at *B*. Since fewer people suffer lower welfare at *B* than at *A*, relative to the conservative choice *D*, their electoral prospects will be enhanced to the extent that the electorate understands the implications of the parties' policy programs. Hence the conclusion that the jettisoning of the Marxist baggage that the left has been saddled with for the last 140 years or so should enhance the prospects of the left and open the way for a more vigorous confrontation on the fundamental issue of income distribution.