

Abstract

I propose a theory of inequality and the social contract which explains how countries with similar preferences and technologies, and equally democratic institutions, can nonetheless sustain such different systems of social insurance, fiscal redistribution and education finance as those of the United States and Western Europe. With imperfect credit and insurance markets some redistributive policies have a positive effect on ex-ante welfare, and this implies a political support which *decreases with inequality*, at least over some range. Conversely, with capital market imperfections lower redistribution translates into more persistent inequality. Hence the potential for *multiple steady-states*, with mutually reinforcing high inequality and low redistribution, or vice-versa.

Keywords: Income Distribution, Political Economy, Social Contract, Taxation, Welfare State, Education Finance, Inequality.

JEL classification: D31, E62, P16, O41, I22.