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Inequality and the crisis

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Policy recommendations

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Greater numbers of economists are now agreeing that inequality was a fundamental driver of the economic crisis. Therefore it is only logical that greater equality is required to achieve a sustainable recovery. Some government actions including austerity measures can serve to increase inequality. By taking measures to boost equality the government can contribute to sustainable growth of aggregate demand, which in turn will lead to lower unemployment and greater equality. Such a virtuous circle can be the basis for a sustained economic recovery.

Introduction[1]

'Fundamentally, the growth model that co-existed with globalization was unbalanced and unsustainable. ... Inequality may have actually stoked this unsustainable model.' -Dominique Strauss-Kahn, former Managing Director, International Monetary Fund[2]

The financial crisis of September 2008 represented an economic earthquake, the stresses and imbalances for which had been building for years. Among these, the period leading up to the financial crisis was marked by a large increase in inequality, as had the period leading up to the Wall Street Crash of 1929 and the subsequent Great Depression. This increase in inequality was mostly due to disproportionate rises in the incomes of those at the top, while the income of middle income earners relative to the poor was stable in most countries. In the US, in 1915 the top 0.01% earned 400 more than the average, in 1970 this was 50 times, but by 1998 it was 250 times (Saez and Piketty 2003).

For some time the financial system was able to disguise the fundamental imbalances caused by rising inequality and offset some of its effects. This was aided by deregulation of the financial sector over the past 30 years. Specifically, the downward pressure on demand that one normally expects from sluggish wage and mass income growth was hidden and compensated for by the availability of credit in countries such as the US and, in Europe, Ireland and the UK, and by export-led demand and output growth in Germany and some other countries. However, the inevitable could only be delayed, and the fundamental imbalances revealed themselves in the crisis.

Such seismic events release the stresses and imbalances and restore the economy to a more sustainable equilibrium through a process poetically referred to as 'creative destruction'. Unfortunately such adjustments are extremely painful as equilibrium is restored by the bankruptcy of existing firms and as new firms are subsequently created. In the interim, which can be long-lasting, unemployment rises sharply. If increases in *inequality* were a fundamental cause of the global recession then one might expect an increase in *equality*, a restoration of distributional 'equilibrium', to be an outcome of the financial crisis. A lesson of the crisis would also seem to be that greater equality will be necessary to sustain recovery in the longer term. It is therefore important to examine how the economic crisis has affected inequality. If inequality has not been reduced it might be that inequality was not, in fact, a fundamental cause of the crisis or, alternatively, it might indicate a future vulnerability to renewed crisis.

1 I wish to thank Andrew Watt, Maria Jepsen and Sotiria Theodoropoulou for their comments and suggestions. Any errors or ommissions are my own.

2 http://www.imf.org/external/np/speeches/2010/110110.htm

Though there is a *moral* or normative case for reducing inequality, this aspect is totally ignored in this policy brief and only the *economic* aspects are examined. I will first highlight how inequality can be a cause of crisis. I then present the available empirical evidence, focusing on Europe, which does suggest that inequality has been an important element before and during the crisis. Finally, I conclude.

A causal link between inequality and crisis?

In contrast to pre-industrial economies, modern economies are not only *capable* of satisfying people's basic needs such as food, clothing and shelter, but also have much 'spare' capacity to produce other things. This leads a potential problem of maintaining demand, that is, aggregate spending, for what is produced.

In a modern economy with wage earners and business (capital) owners, workers do not earn enough to purchase all of what they produce. Some of the income goes to business owners in the form of profit and interest. This alone would not cause an economic problem if everyone spent their money in a similar manner. However, this is not the case. Those on the lowest incomes consume almost all their income to meet their basic needs. Those on middle incomes tend to save some money (Dynan, Skinner et al. 2004) to provide financial security (which they then consume later, for instance when they retire) and in the current period this money is available for investment purposes.

But those on the highest incomes have more than enough money to meet their basic and even sophisticated needs. They have other motivations (such as a wish for financial security or a desire to be wealthy and have control over their own lives and perhaps the lives of others). They save income that they will never consume. This does not cause an economic problem provided their money is spent – directly or indirectly through the financial system – in a way that creates output and employment, i.e. real investment. In the short run these prop up demand (for the output of capital goods industries) and, in the longer run, such investments have the potential to raise productivity and thus output.

If wages rise in line with the increase in output it is clearly easier to maintain demand for what is produced. If wages do not keep pace, then investors will not have a market for the output of their investments. What happens if investors suddenly realise that their productive capacity is too great to meet expected demand (as has repeatedly happened, for instance, with investment in radio companies in the late 1920s and 'dot-com' and technology companies in the late 1990s)? They slash investment, depressing aggregate demand, and driving up unemployment. This in turn weakens demand further, leading, in the absence of counter-action, to a downward spiral, an economic crisis

A number of solutions have been put forward to deal with the problem of a lack of aggregate demand. Following the Second World War, inspired by the insights of Keynes, redistributive policies such as progressive taxation and the welfare state, as well as government investments, helped to ensure that reasonably stable aggregate demand for what was being produced was maintained, cushioning the economy against fluctuations. In the US such policies began to be reversed during the 1980s, wages and disposable mass incomes more generally did not keep up with the productive capacity of the economy (Lemieux 2008), and there was a lack of demand *out of current income* for what was being produced.

Traditionally central bankers have responded to such recessions by cutting interest rates. Reducing interest rates makes it easier to borrow money, and so makes it cheaper to invest in projects. Low interest rates also reduce the propensity to save. However, given the lack of demand due to sluggish wage growth, who would buy the output from such investments? In a number of countries, most prominently in the USA, low income groups borrowed money to increase their consumption (a formalised model of this idea has been put forward by Kumhof and Rancière (2010)). So, rather than investing in productive projects, high earners effectively loaned money to low earners, mediated through the financial system. The low interest rates also encouraged people to invest in highly risky assets, from commercial property to financial derivatives, hoping the greater risk would lead to greater gains. This allowed high earners to continue to save, and aggregate demand to be maintained. Asset prices rose, initially feeding the boom, because it facilitated access to more credit. However this led to steadily rising indebtedness. The inevitable could only be delayed, and the house of cards collapsed in the financial crisis.

Another approach taken to the same basic problem was that of export-led growth. Some countries (Germany being the most notable example) kept wage growth at a low level, below the growth of labour productivity, reducing the labour share of income. This reduced domestic demand, but the shortfall in demand was replaced by exports. This was possible due to exporter nations (such as Germany and China) being highly price competitive, but also because they effectively lent money to importers to buy their goods. This lending was mediated through the financial system and led to a build up of claims in the banks of surplus countries. However, this process too can be seen through the lens of inequality, but at a global level. It was the high profits earned (even in relatively poor countries like China) in exporter countries that were the source of funds to be loaned abroad to importers. But the same basic issue is that workers who were producing goods did not have sufficient income to buy the goods they produced. Some countries relied on expanding domestic credit (and tended to have current account deficits) while others relied on boosting exports (and posted large current account surpluses).

The evidence

What do the data tell us about the development of inequality during the crisis? The data presented in this section only cover the early stages of the economic crisis. Unfortunately, statistical agencies (such as Eurostat) do not give indicators of inequality the same priority as other economic indicators, and/or they may be inherently more difficult to collect, so it will be some time before more timely data is published. Thus the analysis necesssarily remains provisional.

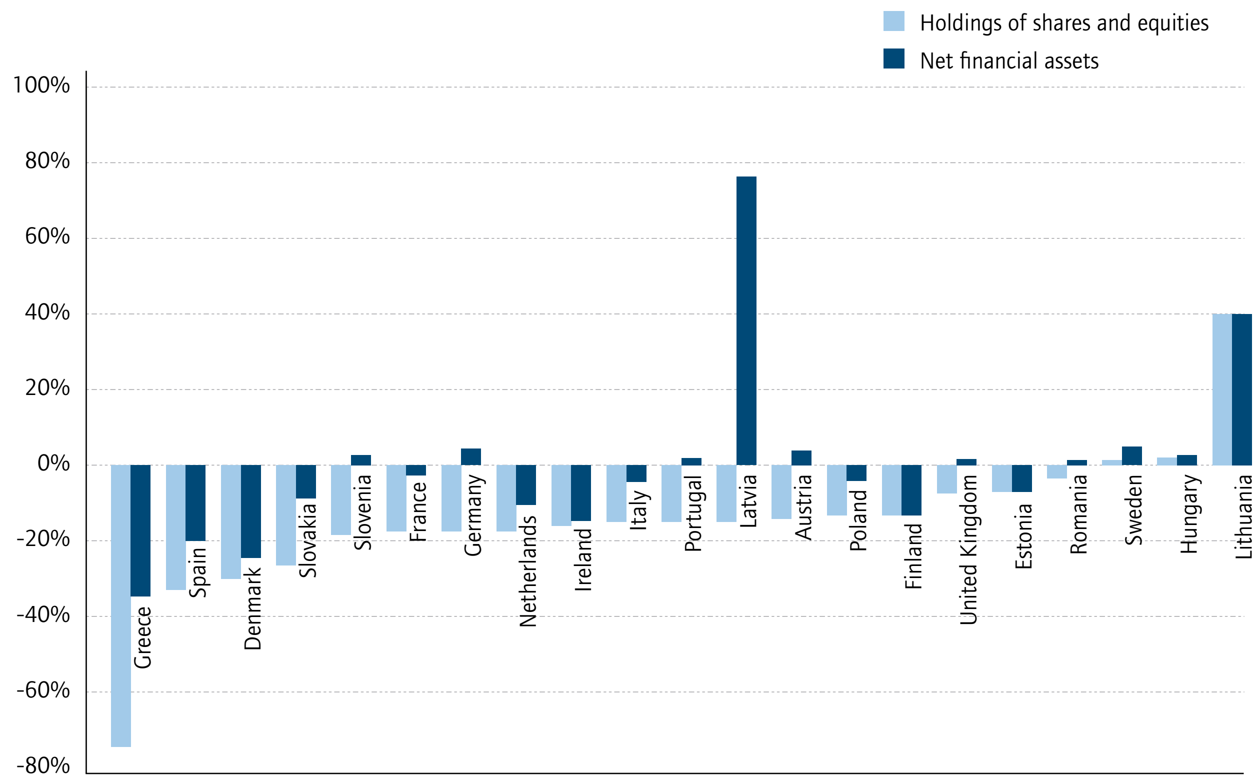
Within the EU, there is evidence that, on some measures, inequality has fallen. The crisis has brought about greater *wealth* equality. Figure 1 shows changes in household holdings of shares and equities, and also changes in net financial assets (which include all financial assets, such as shares or bank deposits, minus all financial liabilities, such as mortgages or credit card debt). These changes can be due to changes in the value of assets or changes in transactions. Changes in transactions could lead to an increase in net financial assets if households are repaying loans or increasing saving, or a decrease if those who lose their jobs run down their savings to maintain their lifestyles. Changes in the value of shares and equities are most likely due to the fall in share prices since 2007.

As can be seen in Figure 1 holdings of shares and equities have fallen for every country except Hungary, Lithuania, and Sweden. For almost all countries holdings of shares and equities have fallen more than holdings of net financial assets. As it is mainly the wealthy who own shares and equities, while net financial assets is a broader category, the rich have suffered a greater fall in wealth. Hence overall wealth inequality is likely to have decreased.

With a brief interuption due to the recession at the turn of the century, there has been a long-term decrease in the labour share of income. The labour share of income increased at the beginning of the crisis, in 2008 and 2009, but has decreased again somewhat in 2010 (figure 2). This reflects the fact that profits are more cyclically sensitive than wage incomes, with many firms posting substantial losses in the depths of the recession. The labour share declined in 2010 as some firms lay off workers or cut wages, and profits recover. It remains to be seen what the longer term effect will be. In some countries the over investment during the boom and resulting surplus capacity will serve to keep non-wage costs (such as rent) down, and may help to reverse the downward trend in the labour share of income. However, high levels of unemployment can also serve to put downward pressure on wages, so overall changes are ambiguous. We observe a short-term correction in the labour share in the crisis, but an ambiguous picture into the future.

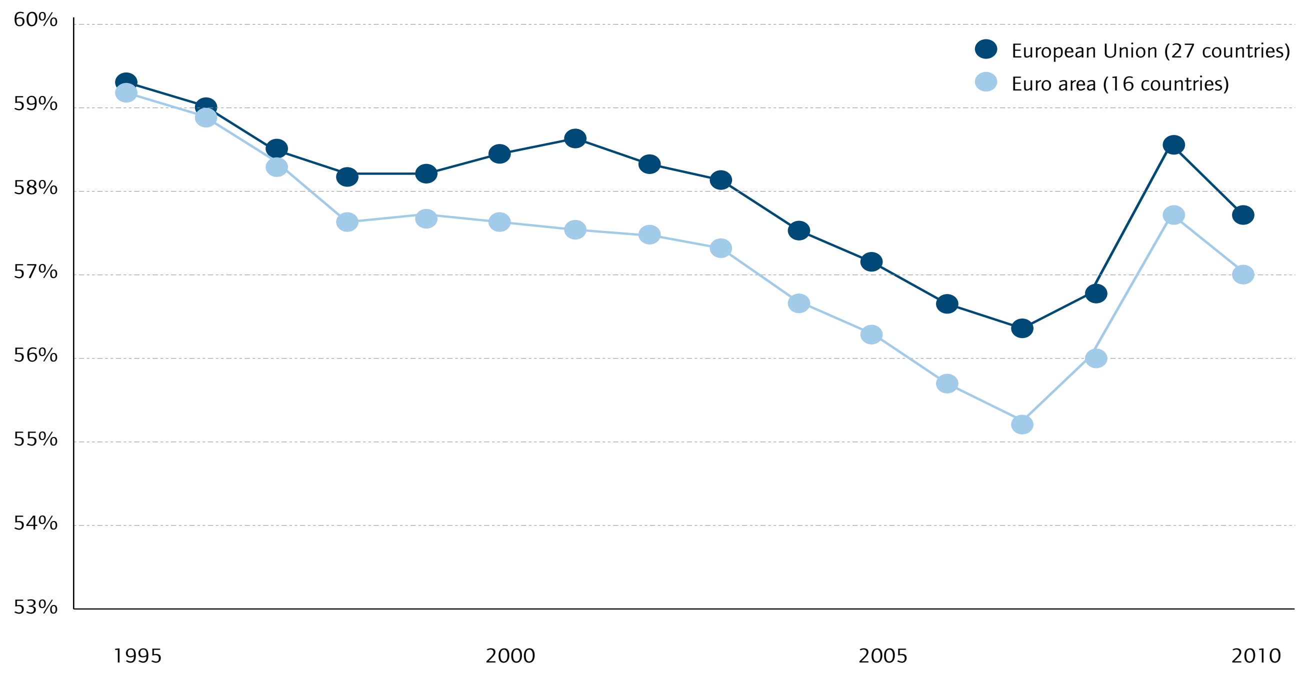
Figure 3 shows changes in the 80/20 income ratio between 2007, the year before the crisis and the latest figures, which are for 2009. The 80/20 ratio gives a measure of how disposable income (after taxes and transfers) is distributed. It compares the share of total disposable income going to the top 20 percent of the population to the bottom 20 percent. For 14 countries this has declined, but it has increased for 9 other countries. So far the effect of the crisis on inequality has been ambiguous on this measure. It is interesting to compare the case of Spain and Ireland. Both had similar booms prior to the crisis which involved an over reliance on construction and ballooning household debt and borrowing from abroad. Spain has shown a large increase

Figure 1 **Changes in wealth; percentage change in household asset holdings, 2007 to 2009**



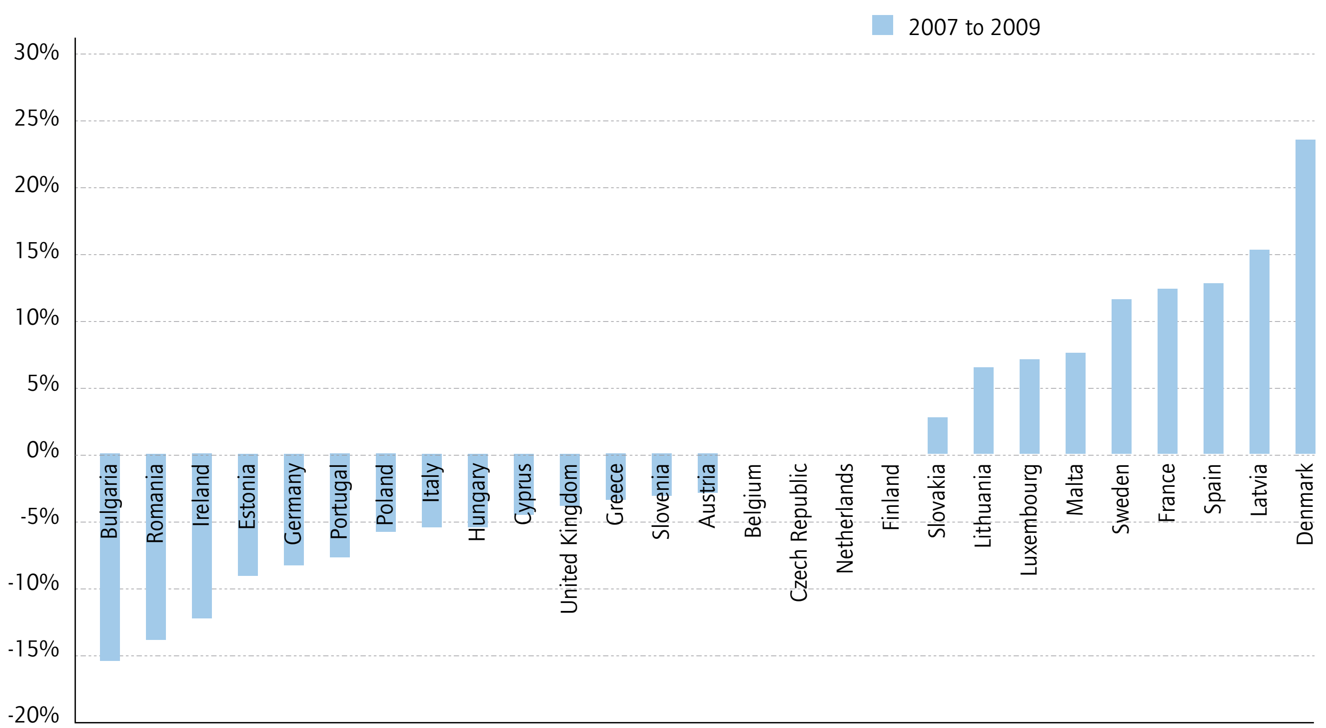
Source: Eurostat

Figure 2 **Labour share of income**



Source: AMECO database

Figure 3 **Changes in the share of income going to the top 20% versus bottom 20% of the population, 2007 to 2009**



Source: Eurostat

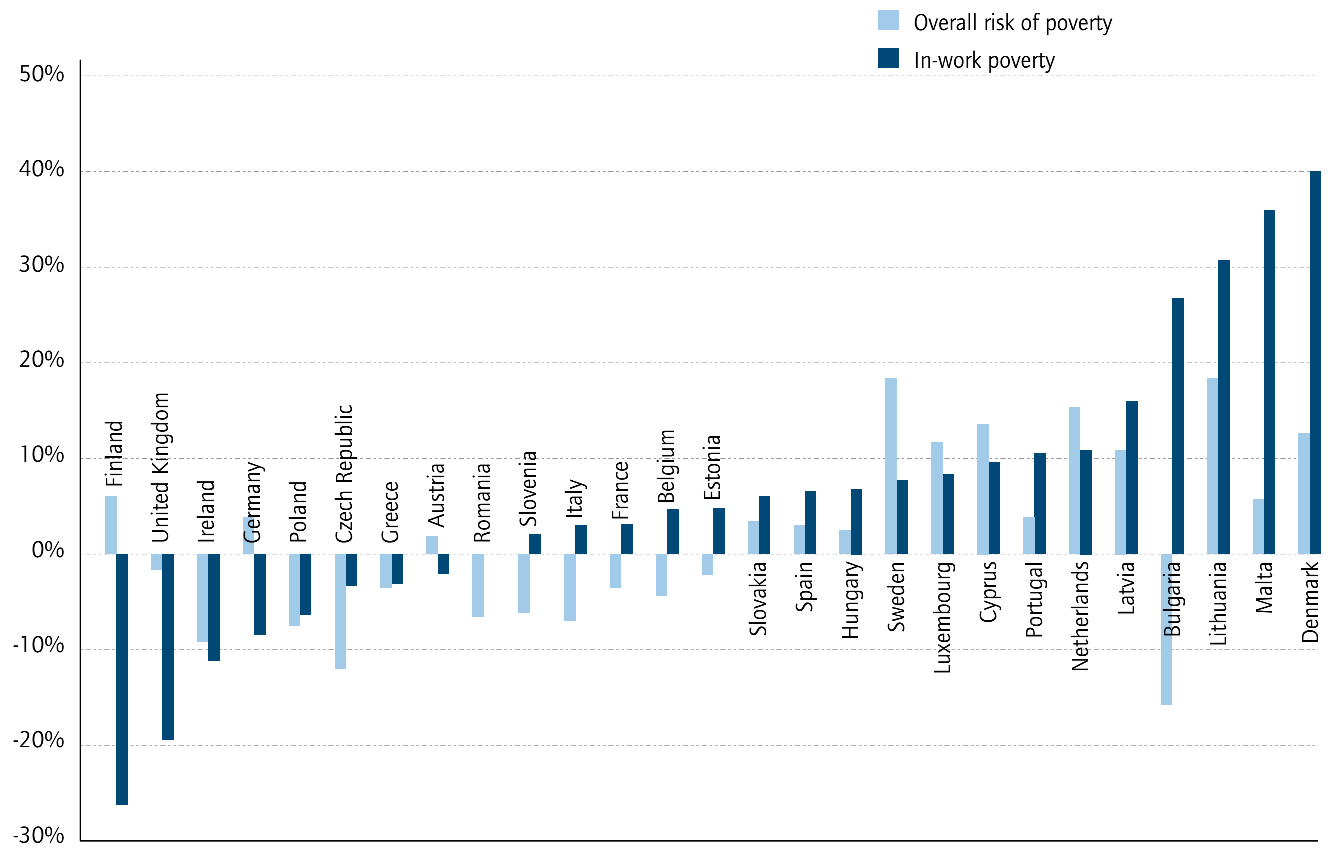
in inequality. This is most likely due to the large increase in unemployment as those working in the construction sector and people on temporary contracts lost their jobs (see Leschke and Watt (2010) for more information). In contrast Ireland shows the opposite effect. The contrast is likely due to differences in social welfare provision and labour markets in the two countries. In Ireland falls in profits and increases in taxes reduced the incomes of top earners, while the lower paid were relatively protected by the minimum wage (O'Farrell (2010) gives information on changes in the minimum wage and average wages since the crisis) and unemployment benefits (which were largely stable during the time period in question). In contrast, Spain is characterised by a 'dual' labour market, whereby vulnerable workers on temporary contracts bore the brunt of the adjustment.

Prior to the crisis, much of the change in inequality was driven by changes in *pre-tax* earnings of workers, and much of the increase in inequality was at the top of the distribution (Piketty 2005). Unfortunately data is not available to see what changes have occurred here. However, data is available to look at the how *disposable* incomes have changed at the bottom of the distribution, and other data is available on disposable income at the top of the distribution.

Figure 4 looks at changes in *relative* poverty for those of working age (ages 18 to 64). There is an interesting difference in the patterns for in-work poverty and the overall measure of poverty. From 2007 to 2009 there was a strong increase in in-work poverty in most countries. These poverty measures are measures of *household* poverty. In-work poverty may have increased due to workers having their working hours cut, or another member of the household losing their job. In contrast, the overall measue of poverty has not increased as much. Many people who already had very low incomes in 2007 did not see a large decrease in their incomes. This is as in most countries social welfare benefits were not cut during the period 2007 to 2009. Though in-work poverty only decreased for eight countries between 2007 and 2009, it decreased in 14 countries between 2008 and 2009. This suggests some lagged effects of the recession, whereby those at the bottom are doing relatively better than those at the middle of the income distribution, provided they remained employed. Countries that had an initial increase in in-work poverty are seeing a partial reversal. This is as the low paid have their hourly earnings protected by the minimum wage, while workers on medium incomes are more likely to have their wages cut.

Relative poverty is a measure of how compressed earnings are at the bottom of the income distribution. Part of the decrease in poverty in some countries may be due to median incomes (the median income is the income of the person for whom half of people earn more, and half earn less) falling faster than the incomes of the poorest. This would improve the *relative* position of the poorest without them actually benefiting in terms of higher incomes themselves. Over the long term, there is a consensus

Figure 4 **Changes in the risk of relative poverty for those of working age, 2007 to 2009**



Notes: working age 18-64 - Source: Eurostat that changes in inequality in the bottom half of the income distribution is largely due to shifts in institutional factors such as the minimum wage or unionisation (Goos and Manning 2007).

As there are more workers who earn low incomes than high incomes the distribution of income is skewed. The ratio of mean incomes to median incomes of those in employment is a measure of this. The higher this ratio the more earnings are skewed in favour of top earners. Figure 5 presents this information. For 17 EU countries incomes have become more equal at the top of the distribution. This correction is in line with the idea that the growing wage inequality that existed before the crisis was unsustainable. In Germany there has been a sizeable decrease in how much top earners gain over middle earners. This is at least partially due to strong wage growth in Germany at the beginning of the recession (O'Farrell 2010).

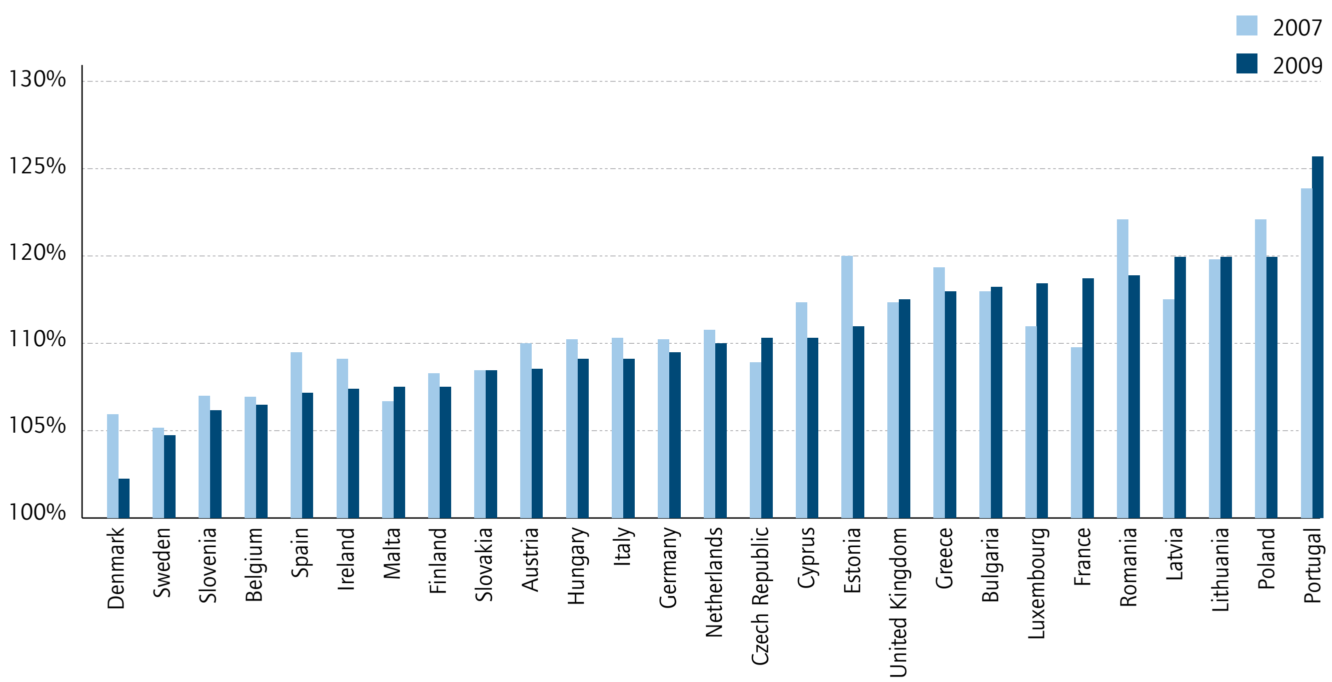
Conclusion

The 1929 financial crisis marked a seismic event in economic history. It had been preceded by a steep rise in inequality and also a bubble in the financial sector. What followed was a depression, followed by a period of rising equality that lasted a generation.

Does the current crisis represent such a tectonic shift? It is too early to tell. As it is likely that inequality was a fundamental cause of the current recession it is likely that recovery, at least if it is to be sustained, will be linked with greater equality. However, as with the aftermath of the dot-com bubble, it is possible that we will achieve the illusion of recovery, without greater equality, due to the creation of another bubble. In the US during the Great Depression it took ten years for recovery to happen, and ten years for top income shares to fall. There are some economic forces which are leading to greater equality (at least for those still employed), by reducing the value of stocks and shares, and also by increasing the labour share of income. However, it will require a sustained improvement in the labour market to ensure that overall inequality is reduced, by reducing the number of workers unemployed. The most effective way to do this will be to increase aggregate demand, which itself can be done by government taking action to increase equality. The tide can be turned on the negative feedback, of lower demand leading to firm closures and unemployment. A virtuous circle of growth can be created whereby increased equality can boost demand, thereby increasing employment and boosting equality.

Unfortunately, some government action has served to increase inequality. Cutting public spending for the explicit reason of giving this money to bondholders, which results from bailouts and austerity packages in many EU countries, will only prevent the economy achieving a sustainable recovery. It is an attempt to return the economy to where it was several years ago, in distributional terms, despite the fact that such a situation was clearly unsustainable. This is as such a policy is swimming against the tide of forces that would help create a more equal distribution of wealth and income. It is the transfering of income, from the poor to the rich, with leaky buckets. In contrast, by persuing policies that reduce inequality, such as wage led growth, we can assist countries in returning to long term sustainable growth.

Figure 5 **Ratio of mean to median incomes of those normally in employment**



Notes: working age 18-64 - Source: Eurostat

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