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High Inequality and its Impact on the Economy: Issues and Solutions*

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Summary: This brief argues that increasing inequality had deep macroeconomic consequences as it contributed, in combination with credit institutions, to either stagnating aggregate demand or to increasing public and private debt. Inequality may also contribute, along with supply factors, to the drifting towards secular stagnation. Income distribution would then be one of the major determinants of the increasing global imbalances that made the world economy extremely fragile at the outset of the crisis. The crisis in turn exacerbated inequality, especially in peripheral Eurozone countries. The path towards sustainable future growth passes therefore for a reduction of inequality that, in particular in European countries, needs to be coordinated. Finally, if rent-seeking plays an important role in the past increase of inequality, then active fiscal policies and regulation need to be part of the effort to curb inequality.

1. Introduction: Why the Increase in Inequality since the 1970s?

It is widely established that inequality increased substantially, both in developed and in emerging economies, starting from the late 1970s (IMF, 2007; OECD, 2008; Piketty and Saez, 2013; Piketty, 2013; Piketty et al., 2011). In some countries, in particular in Europe and in the US, those who lost ground were the middle classes, while in others (e.g. China) were the very poor. But in all cases the redistribution has benefited mainly the rich and the very rich (the top one percent of the population, see Figure 1), giving birth to what Dew-Becker & Gordon (2005) defined the "Superstar Economy".

In the past decades, the increase of inequality was mostly ignored by mainstream economists. This is explained by the revival of the neoclassical tradition, after the crisis of Keynesian economics in the 1970s. The neoclassical theory relies on the traditional textbook dichotomy between efficiency and fairness in the allocation of resources, which in turn is rooted in a fundamental tenet of the theory: the equality between productive factors' remuneration and their marginal product.

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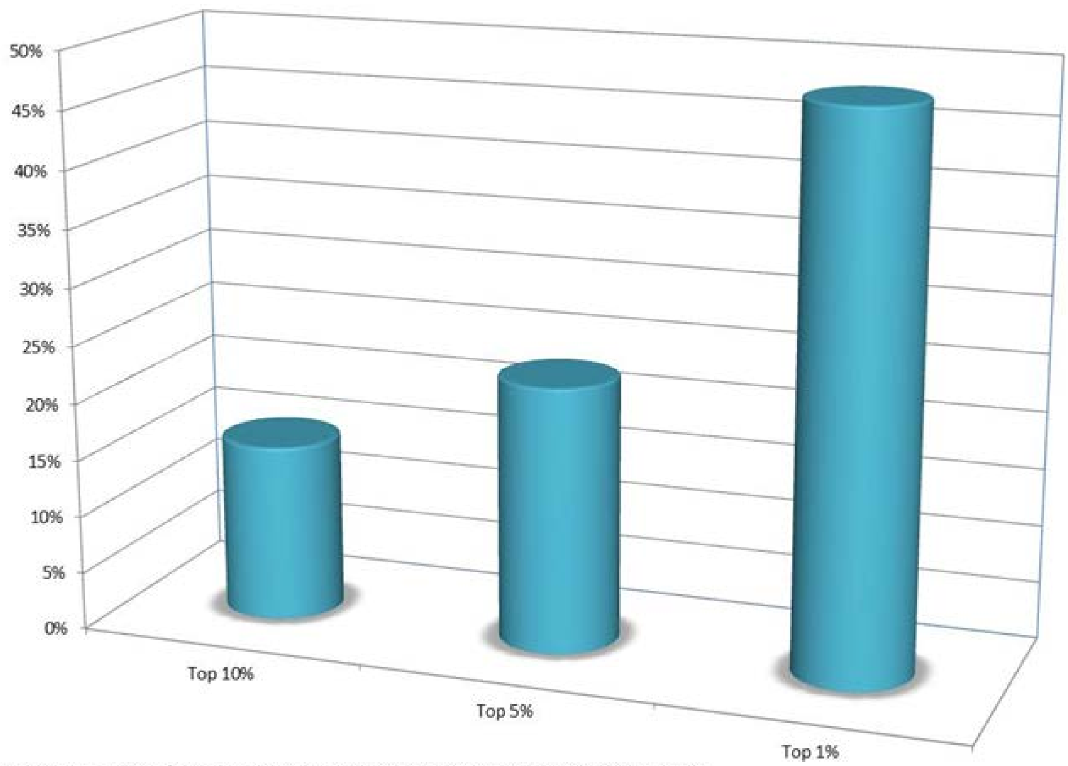
Productivity is an "objective" criterion for determining the efficient allocation of resources among participants to the economy. This has the very strong implication that the social desirability of such an allocation, its fairness, is not a concern for the economist. Sociologists and political scientists may of course prone redistribution on the basis of extra-economic concerns, like social stability, fairness, and the like. Economists only need to make sure that such redistribution does not introduce distortions, i.e. that it does not break the link between marginal productivity and factor's income.

Within this traditional view, two related phenomena would help explain the increase of inequality. The first is the skill bias introduced by the recent waves of technological progress. The impact of the IT revolution was unequal, affecting the productivity of high-skilled workers more than that of those with no or little education (Katz and Autor, 1999; Rajan, 2010). Diverging wages would therefore reflect the widening productivity gap. The second phenomenon impacting wage inequality is globalization. Low-skilled workers entering the global labour market from emerging and developing economies lowered the average marginal productivity of labour, thus lowering its share of national income with respect to capital. Furthermore, the increase of competition in labour markets reduced the bargaining power of on unions and wage setters. Taken together, skill-biased technical progress and increased competition in global labour markets could explain increasing

Figure 1 Average Change in Income Shares for Different Percentiles - 1980-2007



Unweighted average of the following countries: SP,DK,NZ,FR,SW,NL,NZ,UK,IR,SG,SD,IT,JP,US

Source: Author's Calculation on data from the Piketty-Saez Top Incomes Database (wage) inequality as an unavoidable process that policy was not supposed to address, if not at the price of reduced efficiency and growth. The idea that the "tide lifts all boats" would then serve as a justification for the impetuous growth of high and very high incomes that accompanied the two prosperous decades 1990s and 2000s. The traditional view also admits other drivers of inequality, for example imperfect financial markets that prevent liquidity constrained agents from investing in human capital. These, nevertheless, are easily dealt with, once structural reforms limit market imperfections.

The financial crisis challenged the traditional view, among other things because in spite of the heavy hit taken by the financial sector, it disproportionately hit middle and low incomes (iAGS, 2013; OECD, 2011). In particular, Galbraith (2012) and Stiglitz (2013) argue convincingly that much more than the "fundamentals", like globalization and technological progress, what accounts for most of the increase of inequality in the past decades is the rise of predatory behavior. Precisely because the elites have been appropriating more than a fair share of national wealth, increasing inequality has been hampering well-being and distorting the economy. The rise of rent-seeking and predatory behaviour has coincided with the paramount role played by an increasingly deregulated financial sector, where the disconnect between wages and marginal productivity quickly became evident. Empirical evidence also seems to run counter the traditional view. Recent work (see e.g. Ostry et al., 2014) shows that there is a robust negative correlation between inequality and growth and that, as a corollary, countries with some form of redistributive policies in place tend to grow faster.

Emphasizing rent-seeking (Gaffard and Saraceno, 2014) helps explain why the increase of income inequality in the past decades benefited the very top incomes (Piketty et al., 2011); more importantly, it also highlights the importance of policy choices. The economic power of the elites and the conservative revolution in politics mutually reinforced each other, leading to increasingly less progressive tax systems, and to a downsizing of the welfare state. (Creel and Saraceno, 2010; Hacker and Pierson, 2010). Rent-seeking and the excessive weight of finance in GDP seem more convincing than the traditional view in explaining the rise of the superstar economy.

2. The Crisis, Debt, and Inequality

At the outset of crisis, in the summer of 2007, the world economy was in a situation of structural weakness, caused by the progressive accumulation of external imbalances. Some countries, most notably the United States and peripheral European countries had an excess of demand over domestic production, shown by increasingly important trade deficits. This deficit was financed by the excess savings that, with different causes, characterized other regions like East Asia, oil producing countries, and last but not least core European countries. These opposite imbalances compensated each other for almost two decades, resulting in an overall balance that the crisis showed to be fragile. Excessive debt of the deficit countries, be it public or private, suddenly became a burden that triggered a race to deleveraging and a generalized drop in spending.

Inequality has a large role to play in explaining the accumulation of debt (Charpe et al., 2009; Cynamon and Fazzari, 2008; Fitoussi and Saraceno, 2010, 2011). The transfer of resources from the poor and the middle class to the wealthiest, i.e. from those who consume almost all of their income to those who have a high propensity to save, caused a reduction in the average propensity to consume, and increased the global mass of savings. This had two effects, that both played a role in the current crisis. The first is a huge mass of liquidity that fuelled a series of speculative bubbles. High returns in finance, and its increasing weight in GDP triggered a vicious loop by which no real sector investment could compete with the yields offered by the financial sector. Resources were therefore diverted from productive uses of savings into financial assets whose value was mostly inflated. The tendency of advanced economies to jump from bubble to bubble can therefore be explained, among other things, by the increase of inequality (Fitoussi and Saraceno, 2011; Galbraith, 2012; Stiglitz, 2013).

The second effect of income redistribution towards the very rich, is a chronic tendency to depressed aggregate demand. At the IMF Fall 2013 annual meeting Larry Summers conjectured that advanced economies in the future will face a low, possibly negative, equilibrium interest rates, that may lead to a "new normal" made of hard choices between unstable, debt-driven growth, and a quasi-depressed economy. A number of factors, from aging and demographics to slowing technical progress, may support the conjecture that globally we may be facing permanently higher levels of savings and lower levels of investment, leading to negative natural rates of interest.

Summers' conjecture has been widely discussed. Surprisingly, the focus was mostly on supply side factors; the long run tendency of the propensity to consume to decrease because of inequality was not mentioned in the discussion. And yet, redistribution, by compressing aggregate demand, may have contributed, along with demographics and slowing innovation, to the slow drifting of the global economy towards secular stagnation.

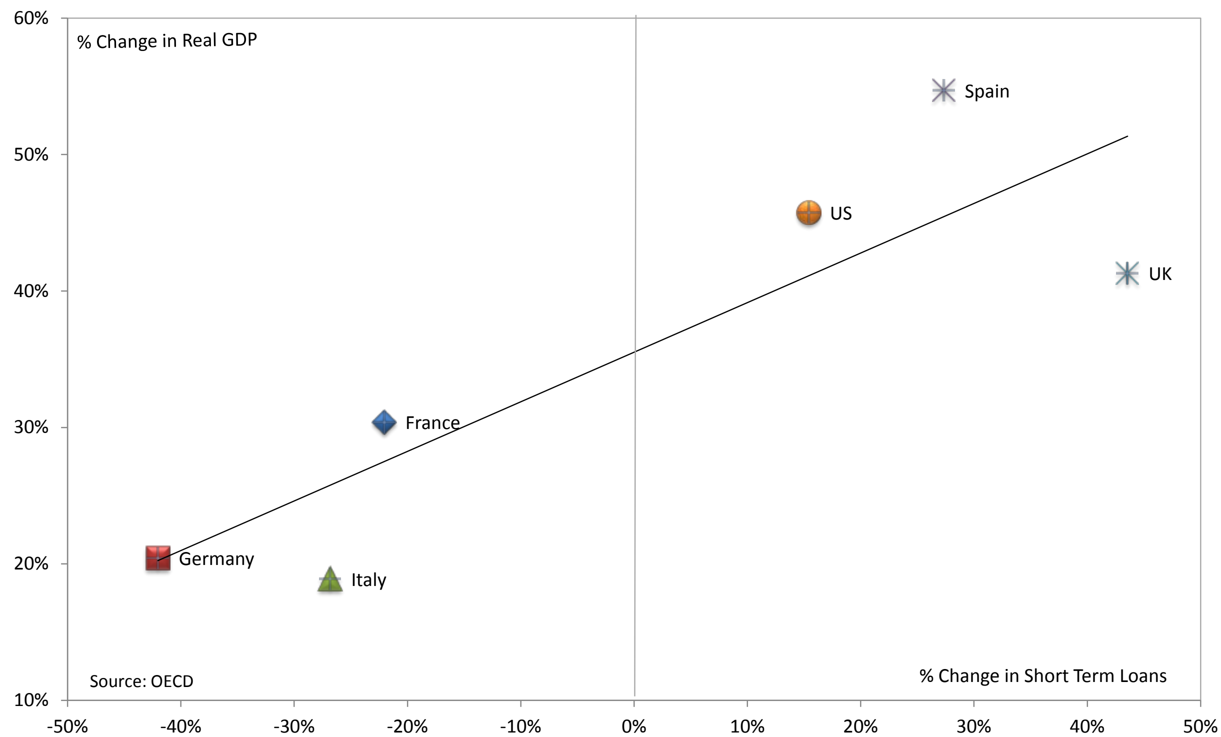
But how did inequality contribute to global imbalances, which we claim above are among the structural causes of the crisis?

3. From Inequality to Structural Imbalances

How could the same phenomenon, increased inequality and the resulting compression of aggregate demand, lead in some areas to excess savings, and in others to excess demand? The answer to this apparent paradox lies in the interaction of the trend in income distribution, common to all countries, with institutional differences, and the policy responses that have instead taken very different forms. In the US the reduction in income was offset by private borrowing favoured by a less regulated financial system, but also by a widespread perception of "end of history" which led to believe that all constraints the unlimited growth of some sectors (finance, real estate) had been permanently removed (Cynamon and Fazzari, 2008). Consequently, aggregate demand (consumption and investment) remained high, even if increasingly financed out of debt and not out of income. This did not happen in most of Europe, where stricter regulation of financial markets, and less accommodating monetary policies, made borrowing for households and firms more difficult. Fiscal policy was also generally more restrictive in European countries, constrained by the Maastricht Treaty and the Stability Pact, while the United States, where the welfare system and automatic stabilizers are less developed, fiscal policies had to be more active to reduce fluctuations of income (Creel and Saraceno, 2010).

Thus, the downwards pressure on aggregate demand, prompted by growing inequality in income distribution, was hidden in the U.S. (and to a lesser extent in peripheral European countries) by increasing private and public indebtedness (which led to strong but ultimately unsustainable growth); in Europe (mainly continental), higher costs of borrowing, and greater inertia of macroeconomic policy have prevented an adequate level of aggregate demand, and the result was a long period of soft growth. The U.S. growth was financed by European savings and in turn lifted the old continent with its imports, at least partially compensating insufficient domestic

Figure 2 Cumulate change in household short term loans vs change in real GDP - 1995-2007



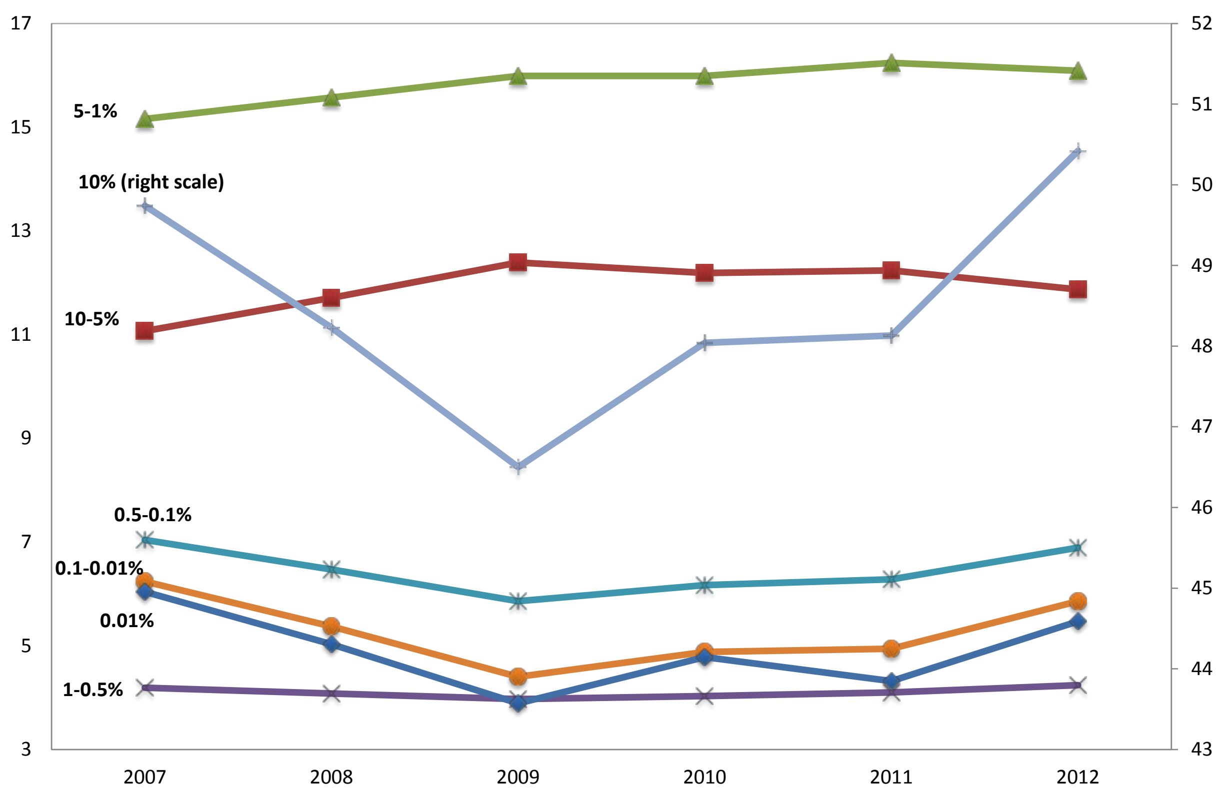
demand. The excess of savings in other areas (East Asia, oil producing countries) also helped to perpetuate this delicate balance, which nevertheless was sooner or later doomed to break.

While there is no hard evidence about the interaction of institutions and inequality in explaining different patterns of indebtedness and growth, we can look at some stylized facts. Figure 2, taken from Fitoussi and Saraceno, (2011), shows that countries where short term (consumption) loans increased more in the decade leading to the crisis, are the ones in which growth over the period 1995-2007 was more robust. This points to a growth rate driven by domestic consumption and debt, bound to be fragile.

4. The Impact of the Crisis on Inequality

If income inequality contributed to building imbalances and to an increasingly fragile economy, the ensuing crisis in turn exacerbated inequality. The financial crisis of 2007-2008 mainly hit asset prices, thus having a major impact on the richest layers of the income distribution. This was short-lasted, nevertheless, as the prolonged recession, and the jobless recovery that followed, quickly restored, and further deepened the distance between the rich on one side and the middle and lower classes on the other (OECD, 2011). Piketty and Saez's Top Incomes Database unfortunately does not yet have data for 2012, except for a handful of countries. One of them is the United States, where it is clear that after the initial drop all top percentiles of the distribution recovered. As a consequence the income share of the top 10% is today one percentage point above its pre-crisis peak (Figure 3).

Figure 3 Evolution of Top Income Shares Including Capital Gains - United States



Source: Author's Calculation on data from the Piketty-Saez Top Incomes Database

The impact of the crisis on income inequality is particularly evident in Europe, where the sovereign debt crisis was met with draconian austerity plans and painful supply side reforms. The consequence was a double-dip recession from which the Eurozone is barely recovering. While top incomes and profits are today at the pre-crisis level, output is well below its peak, and the social fabric is seriously deteriorated. Unemployment and poverty hit in particular the weakest part of the population (iAGS, 2013).

5. What Policies to Reverse the Trend?

High inequality may be becoming the new normal (Piketty, 2013). Furthermore, If Summers' secular stagnation conjecture is correct, the pattern that led to the crisis is bound to be repeated in the future, as different countries will react differently to declining potential growth. A durable rebalancing of the global economy can only happen if we manage to escape chronically depressed aggregate demand. This means that as long as domestic imbalances are not reabsorbed, both in surplus and in deficit countries, there is little hope for achieving structurally solid growth. It is also an illusion to think that a mere realignment of exchange rates (real or nominal) would solve the problem, which originates in domestic disequilibria. While increasing popular, the option of more or less orderly eurexits would hardly allow contrasting the tendency towards secular stagnation of which inequality is one of the drivers.

On the other hand, in the current situation income distribution may turn out to be the easiest lever to pull in order to fight secular stagnation. Demographic factors, or innovation trends, are hard to govern and to orient. Inequality can instead be tackled by acting on multiple levels:

1) Increase the progressiveness of the tax system, in particular for high and very high incomes. This should happen in a coordinated way to avoid excessive high-skill workers mobility
2) Renew the focus on the provision of public goods, particularly intangible ones such as education and health.
3) Strengthen the insurance role of the government. The trend towards reduced importance of automatic stabilization should be reversed.

These measures mostly pertain to the national level. Nevertheless some form of coordination, at least at the European level, would be necessary to avoid tax competition, wage deflation, and social dumping, the modern versions of beggar thy neighbor policies. The reduction of income and consumption inequality would stabilize the economic cycle and reduce aggregate savings. This would allow for growth rates that may be less remarkable than in the past, but certainly more sustainable and equitable.

Three specific proposals, aired in the past few months, should become concrete legislative acts in the next European Parliament legislature:

1) A European Unemployment subsidy, to be adopted alongside existing national ones. While not flawless, a good starting point, could be the Commission proposal of October 2nd, 2013 ((European Commission, 2013). This would introduce solidarity among Member countries, contribute to fight macroeconomic divergence, and help dampen inequality.
2) Introduce a European minimum wage (iAGS, 2013), to sustain labour income and make tax competition harder.
3) Introduce a European corporate tax, also a way to limit tax competition, and possibly a way to finance an enhanced European budget (see Jacques Le Cacheux in this issue).

It is important to stress in conclusion that rethinking the role of tax policies is unavoidable. Efforts on capacity building, like on-job training and education, are always useful; but, if as Galbraith and Stiglitz argue the main cause of inequality is rent-seeking behavior, then curbing this through appropriate active fiscal policies becomes paramount. This also means that in Europe, prior to the implementation of specific economic measures we need a change in the political culture that dominated the European construction since the Maastricht Treaty.

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