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Drivers of Inequality: Past and Present Challenges for Europe

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This article provides an outline of why inequality continues to increase and the implications it will have on policies. The authors argue that the current policies promote a lack of contribution from the very rich and target low and middle income families which has resulted in a more fragile economy and harsher and unequal conditions in society.

The crisis has brought income distribution, and the issue of increasing inequality, to the front of the policy debate. As is widely documented, (IMF, 2007; OECD, 2008; Piketty and Saez, 2013; Piketty, 2013; Piketty et al., 2011), inequality increased substantially, both in developed and in emerging economies, starting from the late 1970s. There are reasons to believe that the increase in inequality was one of the determinants of increasing imbalances in the world economy which enhanced the fragility of the economy at the outset of the global financial crisis (Fitoussi and Saraceno, 2010, 2011). The crisis in turn deepened inequality and has created a vicious cycle that is imposing large social costs especially in European countries (iAGS, 2013; OECD, 2011; Pickett, 2013; Stiglitz, 2013). But why did inequality increase in the first place? And what generated the vicious cycle between economic performance and income distributions? What does this imply for the policies to be followed in the current situation and in the years to come? This article will outline an answer to all these questions.

The Traditional View on Increasing Inequality

The relationship between income distribution and economic performance did not play an important role in the economic debate of the past four decades due to the revival of the neoclassical tradition after the Keynesian crisis of the 1970s. Neoclassical theory postulates that incomes are "objectively" determined by the fundamentals of the economy, namely the marginal productivity of factors of production. This postulate leads to the traditional textbook dichotomy between efficiency and fairness, that underlies the concept of Pareto optimality, and has long fed the idea that the economist's job is to study the conditions for optimal allocation of resources among participants to the economic process (in order to maximize social welfare). Once overall welfare is maximized, economists left the task of choosing the distribution of income to sociologists, political scientists, anthropologists, provided this distribution did not distort the incentives of agents.

With this in mind, the increase of inequality would be explained by the joint operation of two phenomena. The first is the swift technological progress that characterized the end of the twentieth century; these advances are mostly linked to the IT revolution and to the diffusion of computers that mostly benefited high-skill workers, to the detriment of those with no or little education (Katz and Autor, 1999; Rajan, 2010). According to the traditional view, the second phenomenon impacting wage inequality is globalisation. The entrance of low-skilled workers, from emerging and developing economies, into the global labour market lowered the average

marginal productivity of labour. Furthermore, increased competition increased pressure on unions and wage setters to eliminate wage rigidities (see e.g. Card et al., 2004). The consequence of this has been a reduction of labour's share of national income with respect to capital. Skill-based technical progress and increased competition in the globalised labour market would explain increasing (wage) inequality as an ineluctable process that policy was not supposed to address unless at the price of reduced efficiency and growth. The idea that the "tide lifts all boats" would serve as a justification for the extraordinary growth of high and very high incomes (the "superstar economy", see Dew-Becker & Gordon 2005) that accompanied the two prosperous decades 1990s and 2000s.

Merit or Predation?

The financial crisis challenged the traditional view. First, because in spite of the heavy hit taken by the financial sector, it disproportionately hit people on middle and low incomes (OECD, 2011; Stiglitz, 2013). Second, because it called for a deeper understanding of the impact of income distribution on economic performance beyond its effects on incentives. The crisis marked in effect the arrival point of a process during which inequality either depressed growth, or triggered increasing debt by households at the bottom of the distribution (Cynamon and Fazzari, 2008; Fitoussi and Saraceno, 2010, 2011).

In particular, Galbraith (2012) and Stiglitz (2013) highlight that much more than fundamentals, like globalisation 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 the rent-seeking and predatory behaviour has coincided with the paramount role played by an increasingly deregulated financial system, where the disconnect between wages and marginal productivity quickly became evident. Galbraith and Stiglitz argue convincingly that most of the top earners gradually specialised in maximising the part of the pie they appropriated instead of contributing to making the pie larger. Predatory lending and abusive credit card practices, that lie at the core of the subprime bubble, are the most typical examples of rent-seeking behaviour that transferred vast amounts of resources from the lower and the middle classes to the rich and the very rich.

Emphasising rent-seeking 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 downsising of the welfare state. (Creel and Saraceno, 2010; Hacker and Pierson, 2010).

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. The result, Galbraith and Stiglitz argue, has been an enormous siphoning of resources 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 in inequality (see also Fitoussi and Saraceno, 2011).

Europe, more than the rest of the world, has entered a vicious cycle, in which inequality makes the crisis harder, and the crisis in turn has unequal effects on different social and income groups, therefore further deepening inequality and increasing the fragility of the economy.

Rent-seeking and the rise of finance seem more convincing than the traditional view in explaining the rise of the superstar economy. After all, it is hard to relate the top executive incomes to their marginal contribution to the revenues of their firm, not to mention social welfare.

Inequality and the European Crisis

Since 2010 the global crisis evolved into a European sovereign debt crisis, unveiled by serious public financial problems in Greece. Instead of being interpreted as the sign of major problems with the governance of the Eurozone (Fitoussi and Saraceno, 2013; Saraceno, 2013), it was tackled by European leaders as a problem of fiscal profligacy. Why a private debt problem, say in Spain and Ireland, became a public debt problem was not a question really investigated by the European authorities (Fitoussi, 2013). The consequence has been generalised austerity, in the periphery as well as in the core of the Eurozone, which stifled growth and delayed recovery. More importantly, austerity policies and liberal structural reforms disrupted the social fabric, especially in peripheral countries, and further deepened inequality. While profits and top earnings are today at the pre-crisis levels, an increasing part of the population lives at the threshold of poverty, and high unemployment is present in particular sections of society (women and youth; see iAGS, 2013). The course taken by policies in Europe remains a puzzle, confronted with a balance sheet recession which constrains the private sector to deleverage, there is no reason to deleverage the public sector as well, especially when the banking sector is rationing credit to the private agents. Confronted with a rate of unemployment historically high and in some countries higher than in the thirties, it is not such a good idea to foster supply policies (Saraceno, 2014). The result is an increasing fear of deflation in the euro area whose consequences on debts, whether private or public, would be awkward.

In other words Europe, more than the rest of the world, has entered a vicious cycle, in which inequality makes the crisis harder, and the crisis in turn has unequal effects on different social and income groups, therefore further deepening inequality and increasing the fragility of the economy.

This is not the place to discuss the roots of the European crisis, or to assess future perspectives (cf. Fitoussi, 2013). The policies followed by European countries, austerity and supply side reforms at a time when the root of the problem is aggregate demand, were not inevitable. These policies contributed a great deal to deepening the recession, and to imposing large costs to low and middle income families (and to small and medium enterprises), thus making inequality, and the ensuing economic fragility, harsher. These policies leave no way to discover the real potential rate of growth of the economy; instead they are favouring a chaotic path: growth through bubbles followed by financial and economic crises. ■

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