The drivers of inequality

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Content

1. Drivers – **orthodox** (unsatisfactory) view

2. Drivers – **emerging** (more convincing) view

3. What might be done to reduce inequality?

..but first, a word of caution

- Debate around inequality suffers from a lack of precision: inequality of income or wealth? Before/after taxes and transfers? Individual or household?
- Serious dearth of quality Scottish and UK focused research; contrast with wealth of evidence for US
- Therefore, presentation focuses on income inequality (best available information) and looks at various countries to illuminate trends. Unavoidably incomplete account!

The orthodox view – rising inequality is inevitable

Rising inequality is primarily a function of two tightly interlinked trends:

- **Skill biased technological change** (SBTC): growing returns to investment in skill, less routine jobs, increasingly hour glass shaped labour market
- **Globalisation**– increase in trade between nations

Seems to work as an explanation?

- **Timing works** - trajectory of inequality matches that of above trends
- **Economists like it** – it's just supply and demand!
- **Politicians like it** – it's nobody's fault!

And yes, there’s truth in the orthodox view!

- Trade and SBTC have contributed to rising inequality – can’t ignore
- Also important to acknowledge that global trends will continue to influence level and trajectory of inequality in Scotland. In particular, next wave of **automation** could further reduce low to middle skill/pay jobs and provide massive rents to owners of intellectual property (but highly contentious!)

But the orthodox view is also inadequate

- At best explains a rising gap between less/more educated workers – not what's happened!
- Doesn't explain differences between nations
- All advanced economies subject to similar global trends yet trajectories of inequality differ markedly - indeed some of the most equal nations also those most exposed to trade
- Researchers increasingly turning to explanations based around norms, institutions and industrial structure: approach links rising inequality today with huge post war falls in inequality (the 'Great Compression'); explains differences between nations (see Krugman 2008 for summary)
- ***Domestic policy matters!***

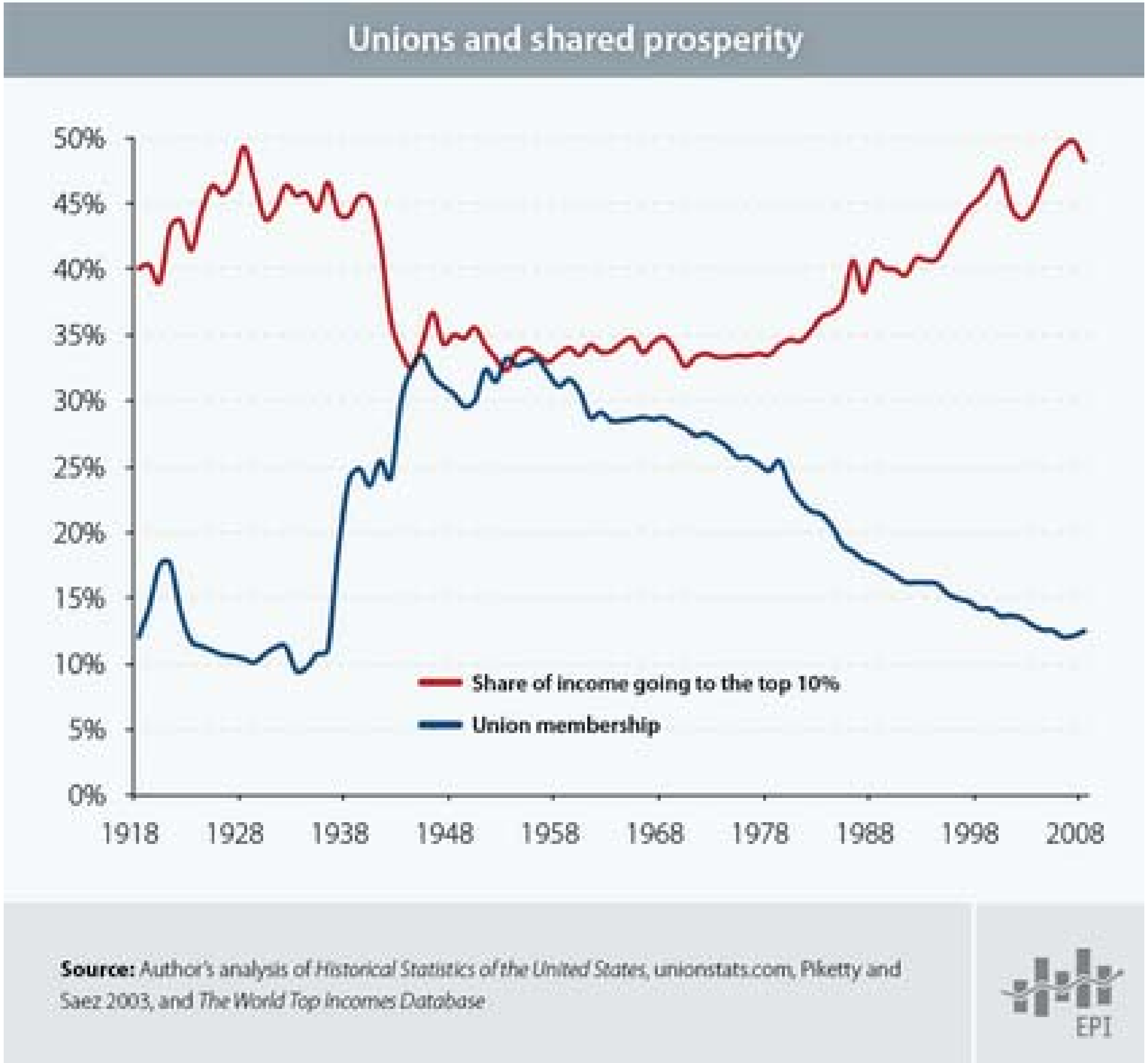
“*The fact that high-income countries with similar technological and productivity developments have gone through different patterns of income inequality at the very top supports the view that institutional and policy differences play a key role in transformations. Purely technological stories based solely upon supply and demand of skills can hardly explain such diverging patterns*”.

Alvaredo, Atkinson, Piketty and Saez 2013

THE EMERGING VIEW

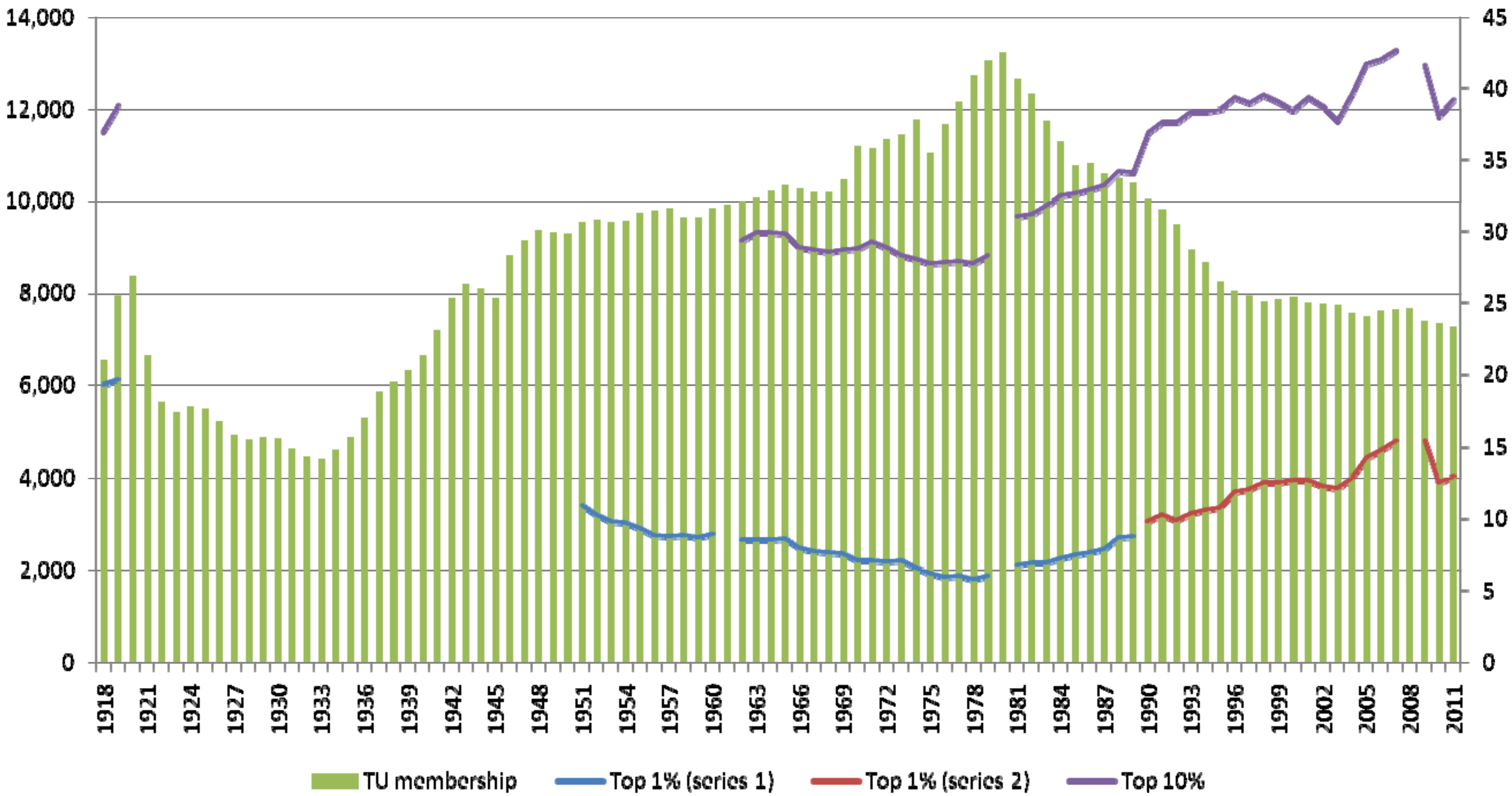
1) Inequality ultimately reflects growing asymmetries of economic power

- From the ***Treaty of Detroit*** to the ***Washington Consensus*** (Levy & Temin 2007) or from General Motors to Walmart
- Increasingly ‘flexible’ (or insecure) labour markets: lower wages, higher self-employment, insecure employment contracts etc
- Lower wage share, higher profit share, higher household debt to fill the gap, bigger pool for destabilising speculative investment
- Runaway wages at top
- Resort to regulatory approaches to raise wage floor e.g. National Minimum Wage

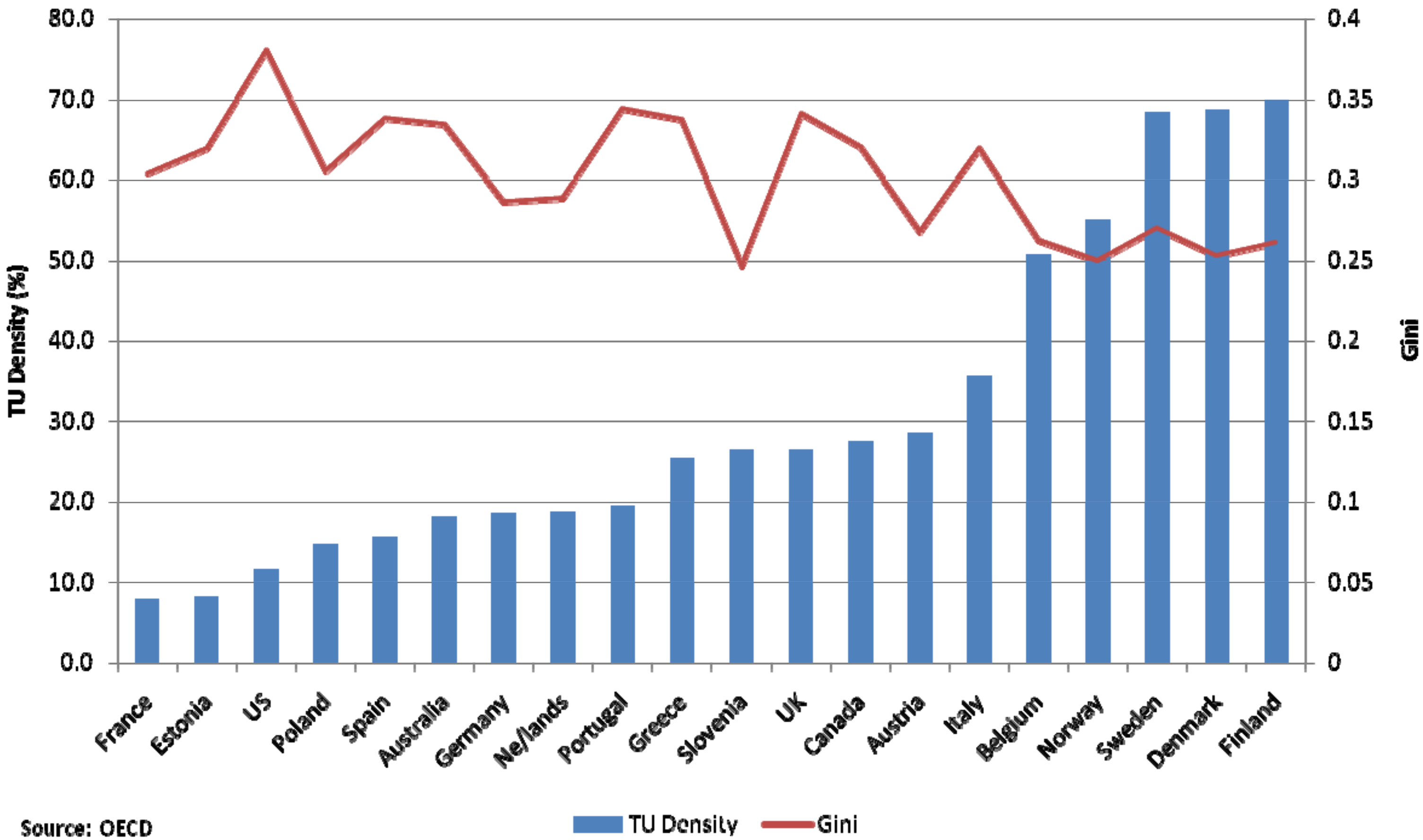


Unions and shared prosperity
50%
45%
40%
35%
30%
25%
20%
15%
10%
5%
0%
1918
1928
1938
1948
1958
1968
1978
1988
1998
2008
Share of income going to the top 10%
Union membership
Source: Author's analysis of Historical Statistics of the United States, unionstats.com, Piketty and Saez 2003, and The World Top Incomes Database
EPI

UK: 100 years of rising income inequality…

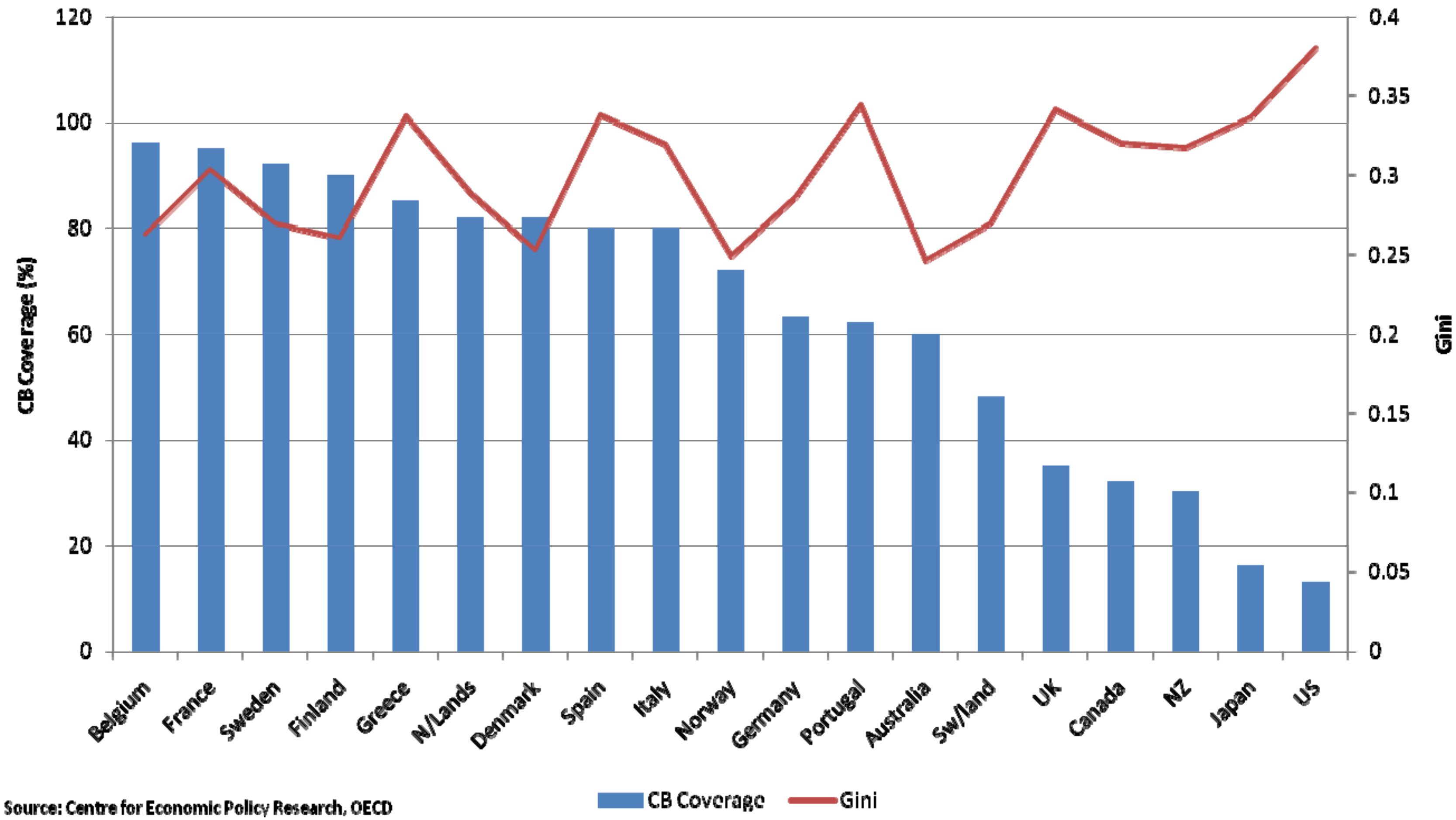


Trade Union density/Gini coefficient, 2011



Source: OECD

Collective bargaining/Gini, 2011

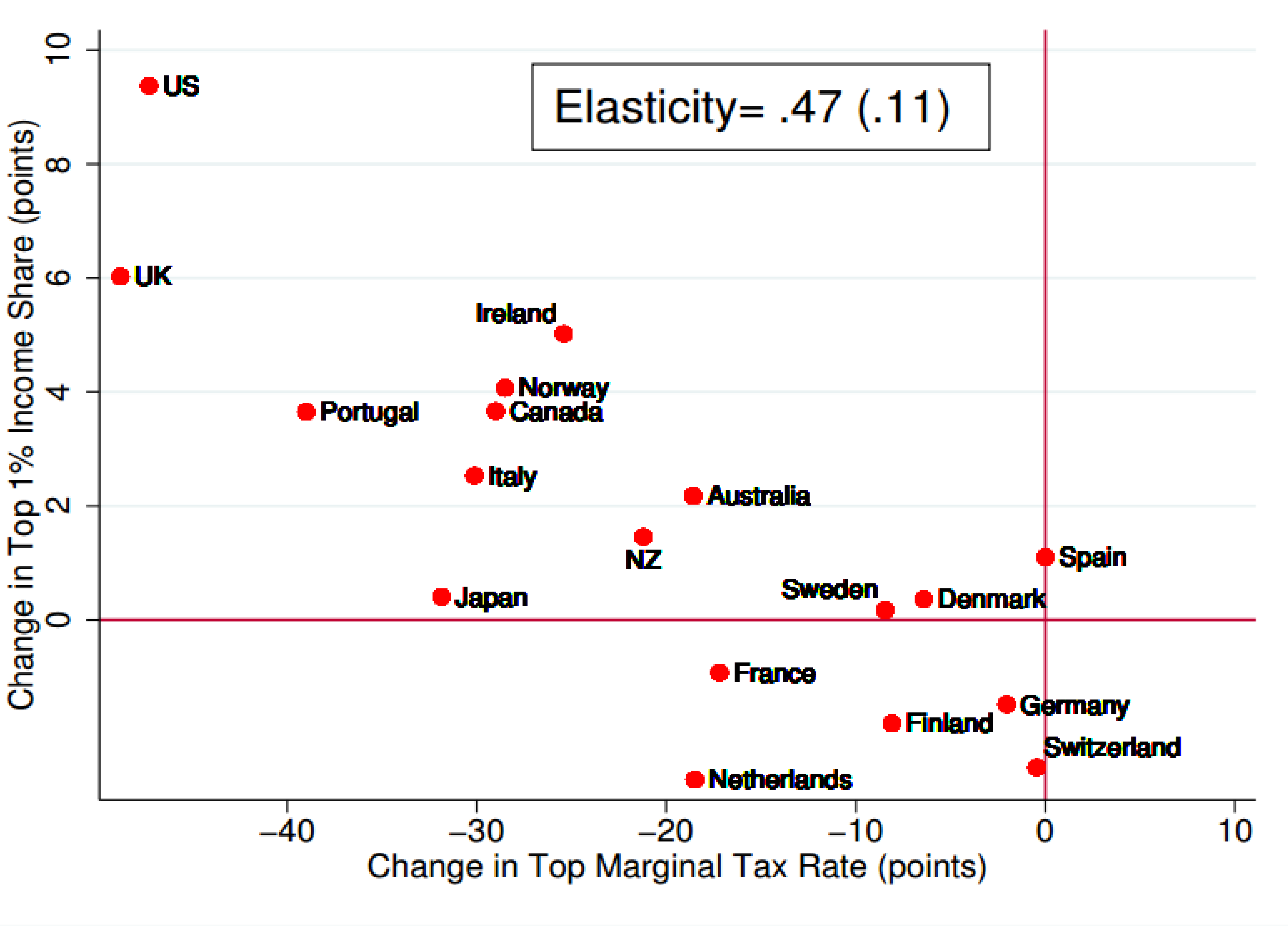


Source: Centre for Economic Policy Research, OECD

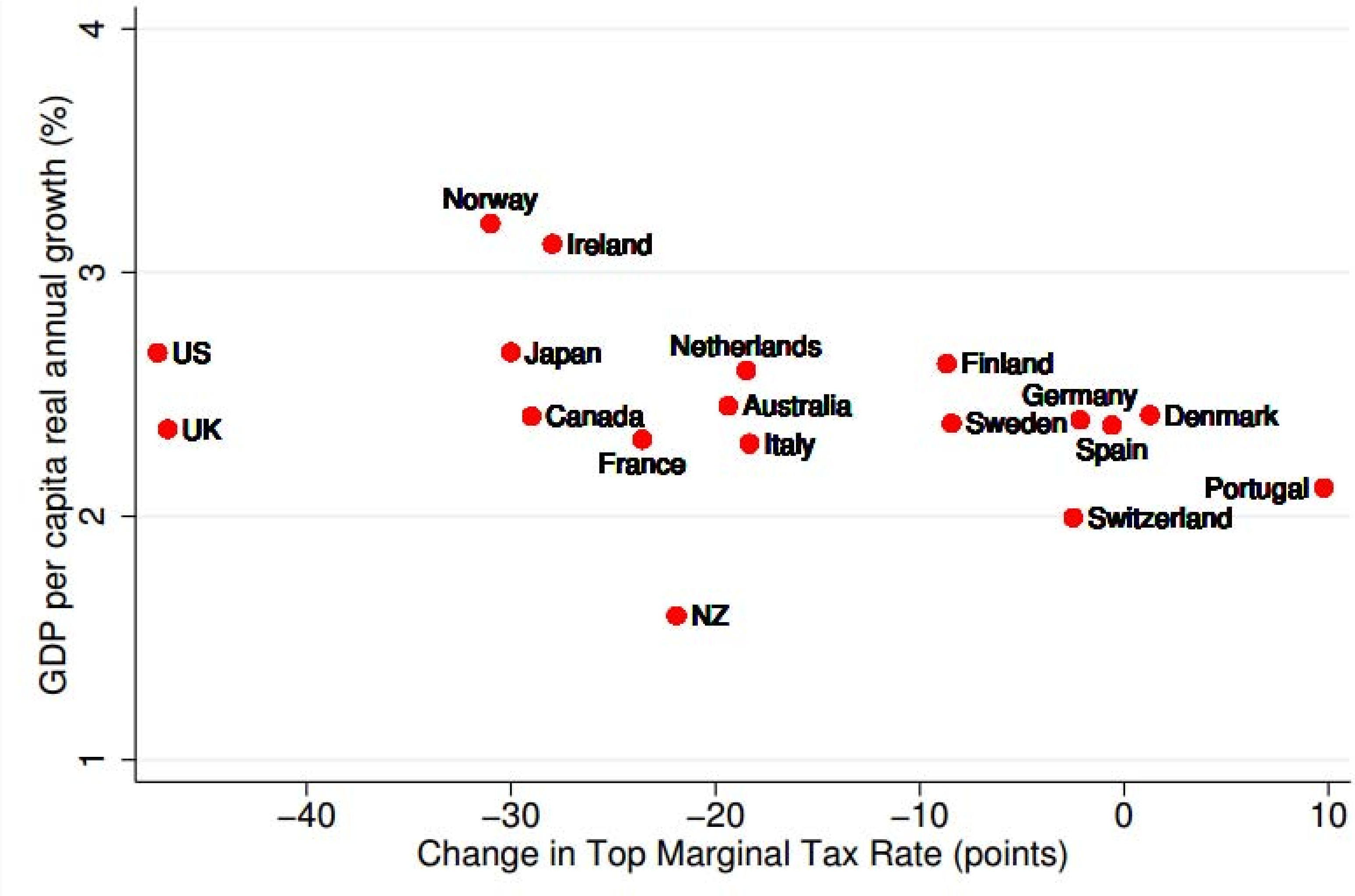
2) power asymmetries are compounded by tax changes and broken corporate governance

"The extent to which top earners exercised bargaining power may have interacted with the changes in the tax system. When top marginal tax rates were very high, the net reward to a highly paid executive for bargaining for more compensation was modest. ***When top tax rates fell, high earners started bargaining more aggressively to increase their compensation…Cuts in top tax rates can increase top income shares…but the increases in top 1% incomes now come at the expense of the remaining 99%***"
Alvaredo, Atkinson, Piketty and Saez 2013

Change in Top Tax Rate and Top 1% Share, 1960-4 to 2005-9



Change in Top Tax Rate and GDP per capita growth since 1960



Corporate Governance

"This governance structure has stood the test of time. ***But it is not without distributional consequences***. ***If power resides in the hands of one set of stakeholders, and they are short-termist, then we might expect high distribution of profits to this cohort, at the expense of ploughing back these profits (as increased investment) or distributing them to workers (as increased real wages).*** To some extent, this matches the stylised facts on rising inequality – rising executive and shareholder compensation and faltering real wage growth. The shareholder model may, ironically, have contributed to unfair shares". **Andy Haldane, BoE "Unfair Shares" 2014**

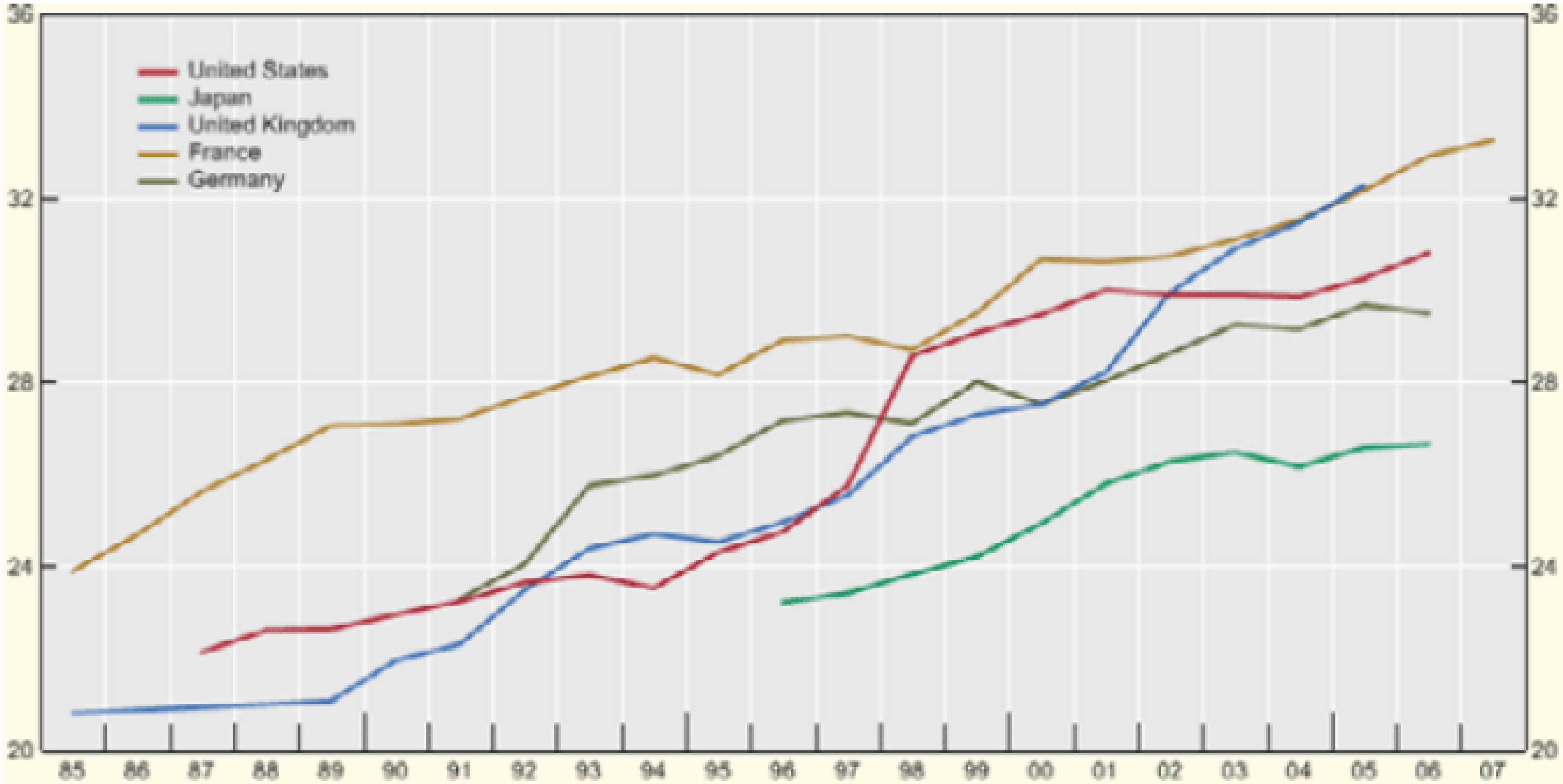
3) Scale and power of the financial sector

In the UK between 1979 and 2007,

- The top decile (10%) increased their share of total income by 14 percentage points, from 28.4% to 42.6%.
- The top percentile (1%) accounted for fully two-thirds of these gains, seeing their share rise from 5.9% to 15.4%.
- 60% of the increase in income share accruing to the top percentile has gone to financial service employees although they account for only around one-fifth of such workers. (source: Van Reenen 2013)

…concomitant influence on political process and outcomes (think-tanks, lobbying, campaign funds)

Share of the financial sector in GDP (in per cent)



The financial sector comprises financial intermediation, real estate, renting and business activities.

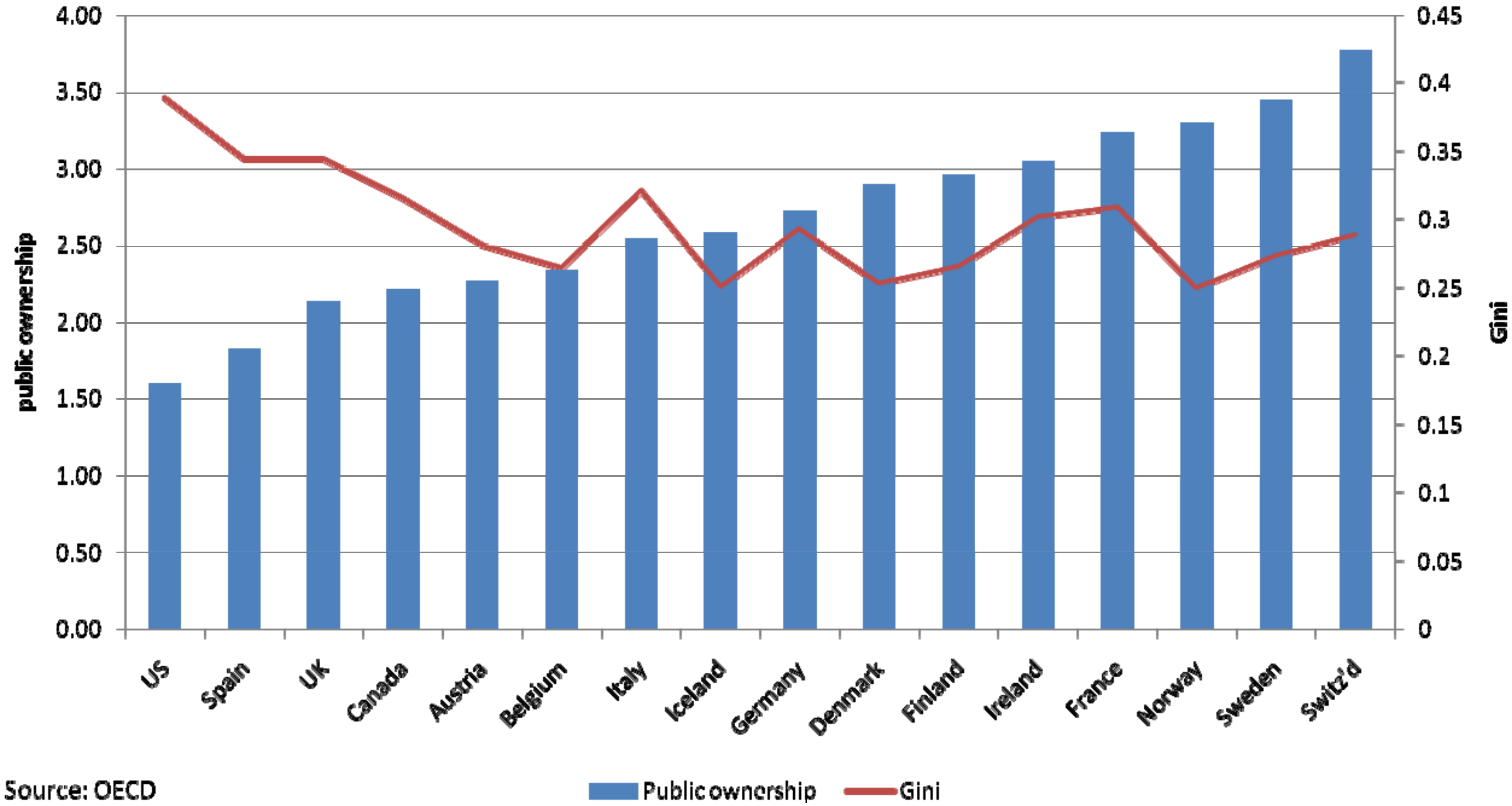
Source: OECD.

"the study of national experiences substantially confirms the evidence of the global statistics. In rich countries such as the US, we find that economic performance has become dominated since 1980 by the credit cycle; financial booms and busts drive the performance of employment and thus prosperity is associated with rising income inequality. ***Further, as we examine the structure of rising inequality we find practically everywhere the same signature of a rising share of total income passing through the financial sector. The difference between the financial sector and other sources of income is – wherever we can isolate it – a large (and even the prime) source of changing inequalities.*** *In the wake of the crisis, as we observe directly in the US and Latin America, the financial sector shrinks and inequalities tend to moderate".* **James K Galbraith, Inequality & Stability, 2013**

4) Ownership, control, privatisation and outsourcing

- Solid revenue streams for public reinvestment become economic rents for the few
- Stable secure lower skill/wage jobs become insecure minimum wage jobs
- Decisions made in interests of shareholders abroad rather than domestic citizens
- Quality of inequality reducing services diminished

Public ownership/Gini Coefficient, 2011



Source: OECD

5) Macroeconomic policy

- BoE’s mandate targets stable prices not full employment – macro policy has distributional consequences!
- Institutional antipathy towards demand management
- Austerity: rooted in a false premise (‘UK next Greece’), balanced towards spending cuts which hit the poorest

What can be done? (1)

Policy has facilitated rising inequality so policy can help reduce inequality

- Rebalance economic power through promotion of collective bargaining and TU rights
- Structural reform of banking sector – no more too big to fail
- Higher top tax rate as first step towards inequality reducing tax regime (quantity of tax collected matters!)

What can be done? (2)

- New approach to economic development – focus on ***the Foundational Economy*** (CRESC)
- Overhaul of corporate governance and intellectual property regime
- Higher regulated wage floor
- Mature approach to mitigating adverse global trends
- New macroeconomic framework – BoE ‘dual mandate’ as first step

Times are changing…

“On average, across countries and across time, the things that Governments have typically done to redistribute do not seem to have led to bad growth outcomes unless they were extreme” **IMF 2014**

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