The vicious circle of inequality

By Sandro Scocco

November 1, 2017 – *Social Europe*

For more than a decade, organizations such as the IMF, OECD, ILO and even World Economic Forum have issued stern warnings that the global trend of increased inequality will harm growth, social cohesion and the business community. So, is Europe doing anything about it? No, and the real question is: Why not?

One reason is that there is no consensus about how to describe what is really going on in Europe – or elsewhere. In the New York Times the economist J.W Mason stated:

> On Mondays and Wednesdays, economists argue that wages are low because robots are taking people's jobs. On Tuesdays and Thursdays, it's that we can't have wages rise because productivity growth is low. Both can't be true.

I am a Tuesday and Thursday economist concerning productivity. Productivity growth lost traction in the industrialized world in the seventies, and since the financial crisis of 2008 productivity has fallen even further. This is not just a case of bad statistics, which some Monday and Wednesdays economists argue.

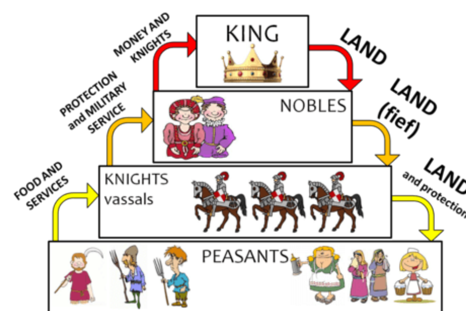
Low productivity growth is, of course, one reason why income development has been disappointing for an average worker, but not the only one. Another is increased wage disparities and decreased income share, since wages haven't kept up with even the poor productivity growth. And finally, public redistribution has been significantly reduced through tax cuts for the wealthy and lower social transfers for the rest. All these trends are, in various degrees, common to both Europe and the rest of the industrialized world. The result is the famous and depressing Elephant curve of Branco Milanovic.

One can also make an eyeball econometric observation. When productivity growth was high, between 1945 and 1975, income inequality decreased and since the eighties, a period of low productivity growth, inequality has increased. Is this just a coincidence or is there a causality?

Kings and nobles

Let us for pedagogical reasons consider two extremely oversimplified and stylized cases, an economy with zero and another with five percent productivity growth.

The first is a rather good description of the medieval world. Since the economy isn't growing by any other means than population growth, the only way to become wealthier is to redistribute income, in effect taking your neighbor's land.



Feudal Pyramid of Power

This will, of course, also determine which types of investment are profitable. For grabbing your neighbor's land you need political support (legitimacy) from those who control property rights (i.e. the king) and your own military force. Since larger armies tend to beat smaller ones, and the same goes for bribes, the system favors concentration of power and income – the rise of the rich and the mighty noble. The king, however, doesn't just give political protection; he also needs it from his noble friends.

In a world where investors expect zero productivity growth, investment in new machines and knowledge (real/human capital) seems both risky and unprofitable, especially

when compared with bribing the king. This means that any future productivity growth is also unlikely (even though it did eventually happen for reasons too long to explain here). That is the vicious circle of inequality.

On the other hand, in an economy with five percent productivity growth, you can more than double your fortune within just fifteen years – without stealing your neighbor's land. The fight will be over the new land – growth. The name of the game is now new machines and knowledge (and not rent-seeking investments in politics or military). Knowledge-based investment in labor increases workers' bargaining power and hence favors equality. The virtuous circle of equality.

Medieval relations

Unfortunately, the vicious circle of inequality seems a rather good description of what's going on now. Since the seventies, growth in both machines (real investments) and knowledge (human capital) has fallen. Investments in politics have on the other hand increased sharply, with the US Presidential campaign the most stunning example. The political preferences of the new patrons of politics for fewer taxes and upwards redistribution have also been very popular the last two decades among European politicians. After the mid-1990s inequality trends have mainly been driven by reduced public redistribution, not market forces.

In the previous period, however, between the mid-1980s and 1990s, the main driver for inequality was the market. All economists have their own take on this, whether the culprit is technology, trade or policy, but it's rather clear that politics has played a part in market-driven inequality. Deregulation of the labor market, lower unemployment benefits, union busting and higher unemployment have weakened the wage bargaining power of workers. These institutional changes have especially hit those with routinized job assignments and low individual bargaining power. This has not only increased wage disparities, but also in many countries reduced the total wage share.

Usually, this is understood as an increased share for capital. But a new paper from Chicago University by Simcha Birkai challenges this perception. He argues that capital's share has fallen as much as the labor's, since the cost (real rate) of capital has fallen rather dramatically in recent decades. He argues that what we have experienced is a growing gap between production costs (capital and labor) and revenues, which implies increased mark-up of prices.

Corporate clout

Barkai's explanation is that big business market power is so strong that they can influence prices. This would also explain why we often see mergers of market dominant companies, even though there seems to be no return to scale in production. There is, however, a gain in greater influence on prices.

The cost of mergers for large companies should therefore probably be understood as an investment in rent-seeking and not in productivity growth. What they are buying is power to reduce market competition and redistribute from consumers to managers and owners, the beneficiaries of the mark-up. Professor Luigi Zingales at the University of Chicago described this "being pro-business [as] basically being pro-S&P 500, it protects large corporations and doesn't promote growth and innovation."

So why is nothing happening? One explanation could be that all agents – politics, business and households – are adapting to an environment of low productivity and have increased their investments in rent-seeking while cutting those in real and human capital: the vicious circle of inequality.

How do we get back to a virtuous circle? The medicine isn't that difficult to prescribe; restore fiscal transfers' redistributive power, increase the wage bargaining power of workers,

increase real and human capital investments to boost productivity and restore free competition in product markets. So, to battle inequality we need much more pro-productivity and much less pro-business. But who will be the capable agent of this? Not big business. Not the one percent. Not ruling politicians in need of powerful friends. As Pink Floyd asked: "Is there anybody out there?". Let's hope there is because we badly need a Renaissance.

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