

# INSTABILITY IMPLICATIONS OF INCREASING INEQUALITY : EVIDENCE FROM NORTH AMERICA

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## World Economic Forum - Global Risks Report 2012 – Risks of Inequality & Instability highlighted

### Top 5 Risks in terms of Likelihood

- Severe income disparity
- Chronic fiscal imbalances
  - Rising greenhouse gas emissions
  - Cyber attacks
  - Water supply crises

### Top 5 Risks in terms of Impact

- Major systemic financial failure
  - Water supply crises
  - Food shortage crises
- Chronic fiscal imbalances
- Extreme volatility in energy  
and agriculture prices

# Which of the following do you think is the biggest threat to the global economy?

EKOS Poll - February 2012 2,891 Canadians

Growing debt crisis in advanced economies

36

An extreme and growing concentration of wealth in the richest 1% of the population

32

An aging population

11

A lack of innovation and productivity

5

Climate change

5

Other

9

DK/NR

3

0 10 20 30 40 50 60

BASE: Canadians: January 27 – February 8, 2012 (n=2,891)

## Increasing Inequality implies Instability

- U.S. & Canada
  - Increasing Inequality □ Unbalanced Growth by Income class
  - Increasing inequality cannot be a steady state
    - *SO WHERE ARE WE GOING? HOW DOES THIS STORY END?*
  - Interacting Instabilities of Imbalances – Debt Fragilities & Hangovers
  - No Automatic Economic Tendency to Uniform Income Growth
- Mexico
  - Structural Changes of Development can grow low incomes
  - Political Economy of Social Policy – if Elites feel credible threat
- Can Political Economy produce a new balanced growth path?

# Not in this talk.....

## Cross-Sectional Steady State Comparisons

- LIS + ISSP + WVS + OECD + WDI
- Many cross-country comparisons of implications of levels of economic inequality
  - Health
  - Happiness
  - Crime
  - Democracy
  - Economic Growth

## Analysis of Shifting Fortunes of “Middle 90%”

- Survey micro-data explosion
- Many papers on minimum wage, unions & other institutional changes, female LF participation, homogeneity, changing returns to education, skill bias of tech change, globalization, demography, etc.
- BUT net changes in income shares are relatively small

## Unbalanced Growth □ Increasing Inequality

- U.S. & CANADA – unbalanced Market Income growth 1987-2007:
  - Top 1 % @ 4%; Bottom 80% @ 0.5%
  - Canada – 1995+ shift to less redistribution by government
- Mexico since mid 1990s – declining inequality
  - Structural changes + Social transfers (*Progresa*)
    - *Similar to U.S. & Canada post 1940 ?*
- Steady State Equilibrium = Special Case of Balanced Growth
  - Unbalanced Growth => Linked Instabilities
- 1930s: U.S. New Deal stabilized system – can it be renewed?

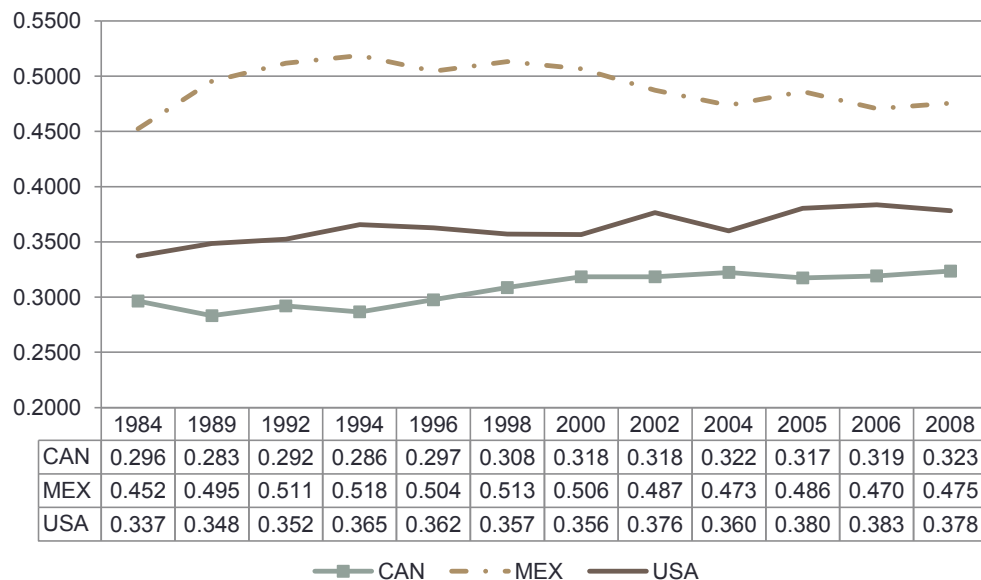
How Different are we? - 2009			
	<u>CANADA</u>	<u>MEXICO</u>	<u>U.S.</u>
Population - (millions)	33.7	107.4	307.0
GDP per capita (PPP 2005 \$)	34,600	12,500	41,700
Tertiary level education: ages 25-64	47%	15.4%	39.5%
Female 15+ Labour Force Participation	62%	44%	58%
Life expectancy at birth, total (years)	81.2	75.3	78.7
Agriculture (% of total employment)	2.5	13.5	1.4
Crude Birth Rate Change (1980-2009)	-3.9	-15.8	-2.1

## Differing Trends in Inequality

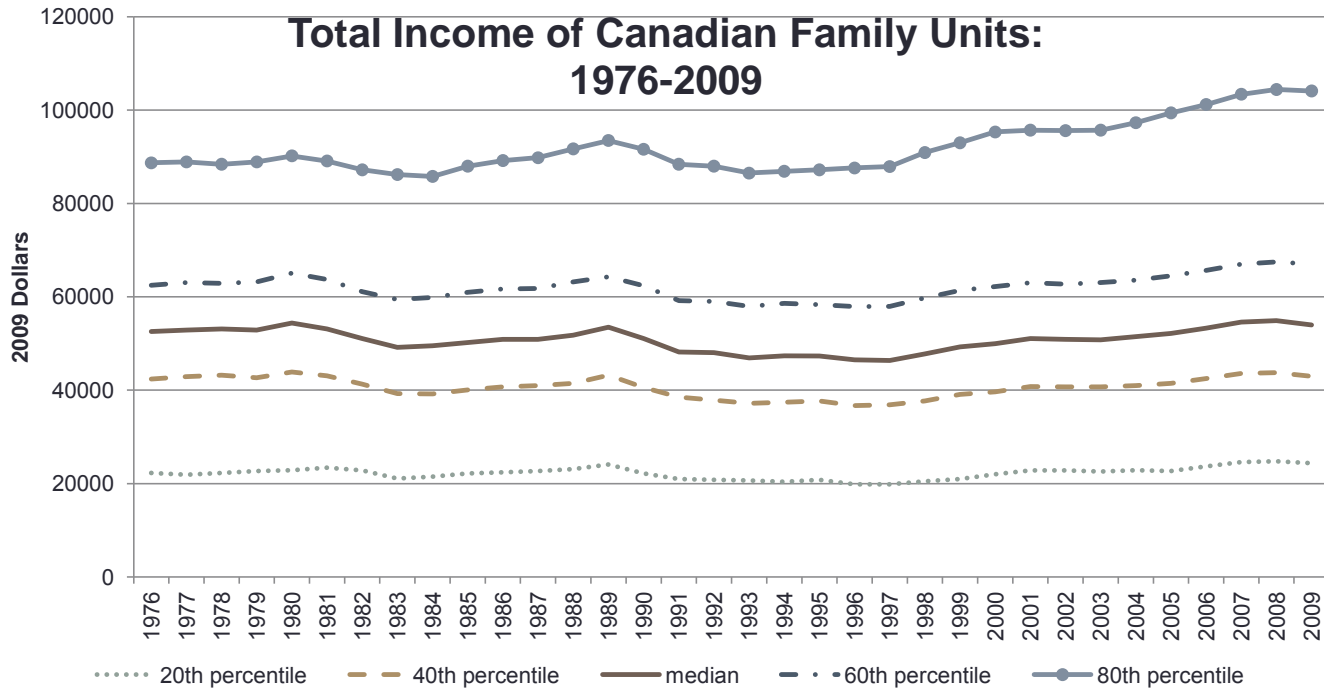
- Canada
  - Rising since 1995
- USA
  - Rising since early 1980s
- Mexico
  - Increasing until mid 90s
  - Declining since 1996

### Gini Index of Inequality: Equivalent After-Tax Money Income

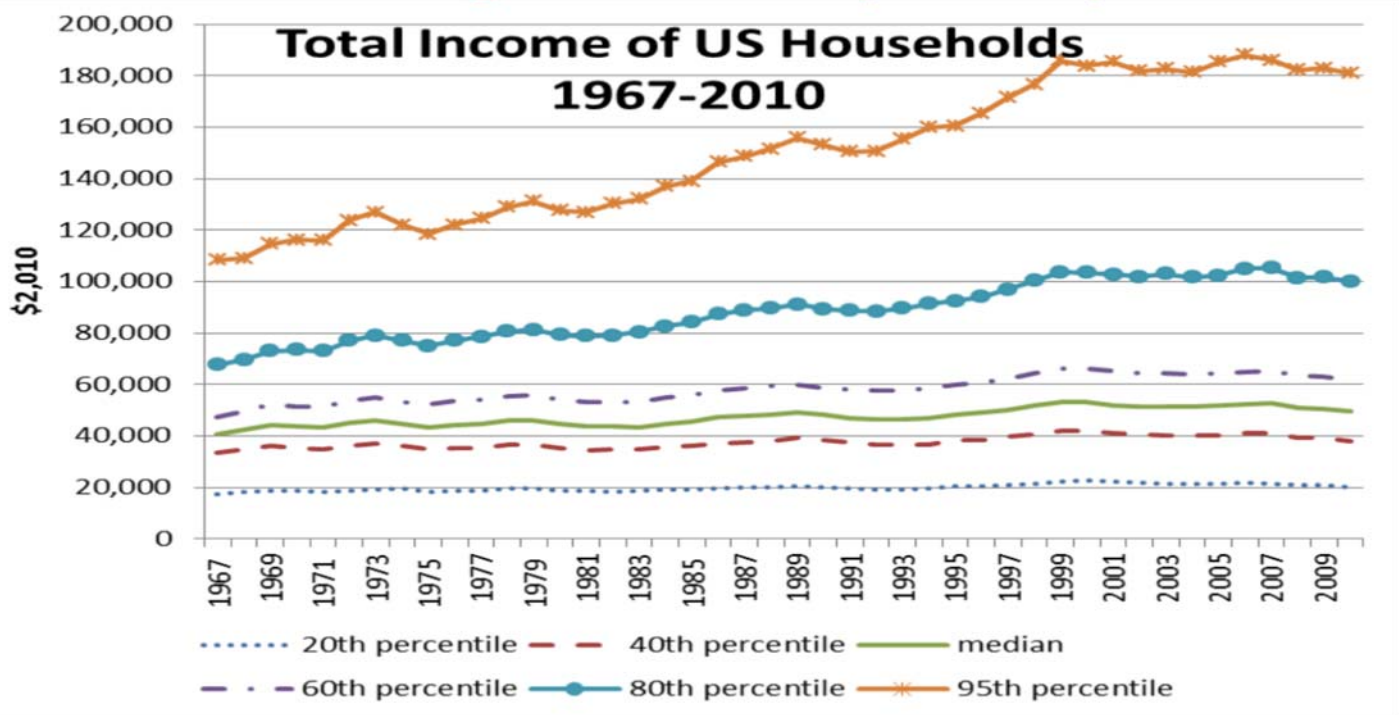
Divided We Stand: Why Inequality Keeps Rising - © OECD 2011



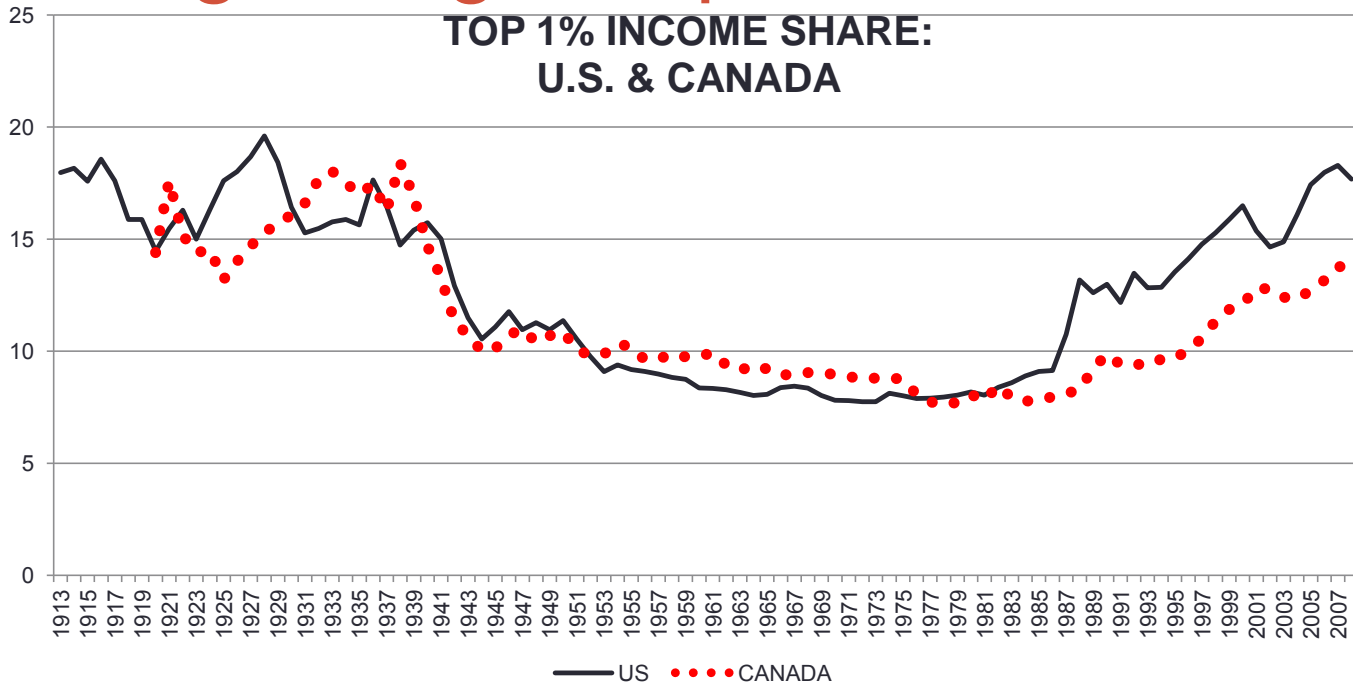
# Canada – nil real growth for most



# U.S. – real growth only at top

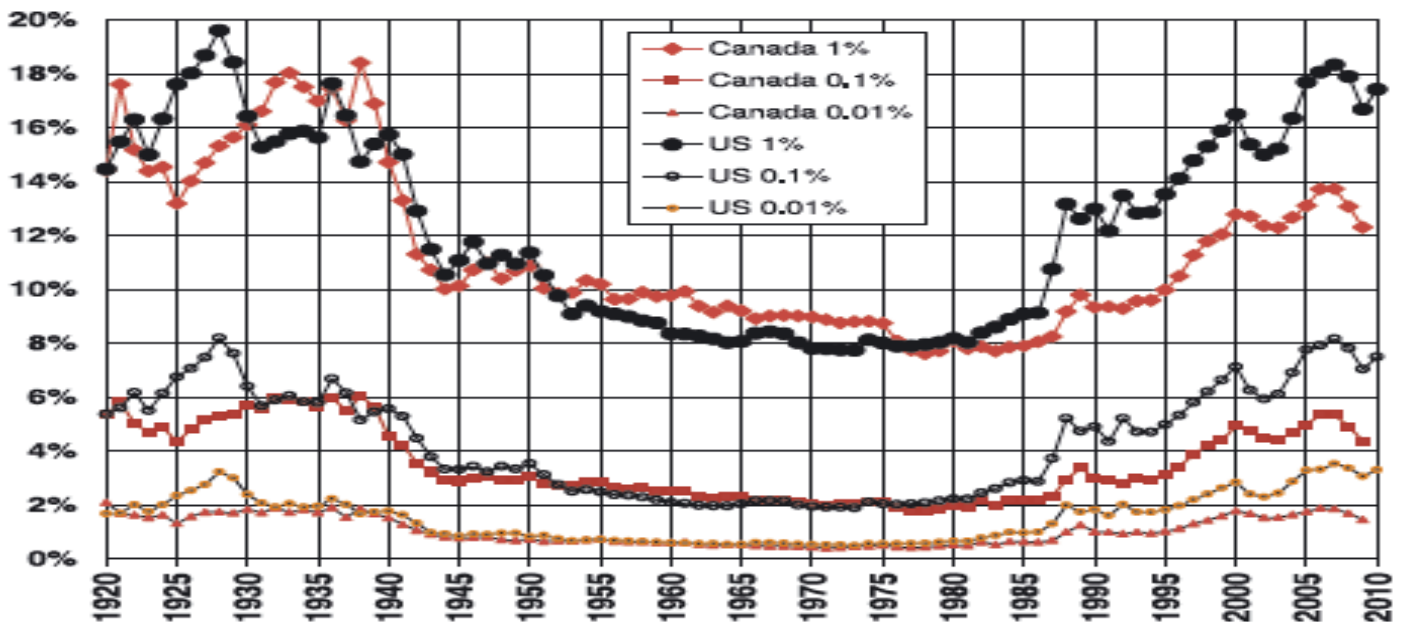


# Long Swing in Top 1% Share



# Top 1%, Top 0.1% & Top 0.01% Share: Canada & USA

Top Income Shares in Canada: recent trends and implications, Mike Veal, Canadian Journal of Economics, November 2012



**FIGURE 1** Income share of the top 1%, 0.1%, and 0.01%, Canada, 1920–2009; United States, 1920–2010

# Income Share = Ratio

- Income Share of Top 1% =  $\frac{\text{Incomes of Top 1\%}}{\text{Incomes of 99\% + Incomes top 1\%}}$
- Increase / Decrease in a Ratio can occur either because
  - Numerator grows faster / slower OR
  - Denominator grows slower / faster
- So where has the action been in Income Shares?
  - Numerator (Incomes of top 1%) ?
  - Denominator (Incomes of Bottom 99%) ?

## Differences in Rates of Growth Drive Changing Income Shares

1940-1975 – strong growth in bottom 99% incomes + slow growth for top 1% = declining share for top 1%

1982-2012 – income stagnancy for bottom 99% + strong growth for top 1% = rising income share for top 1%

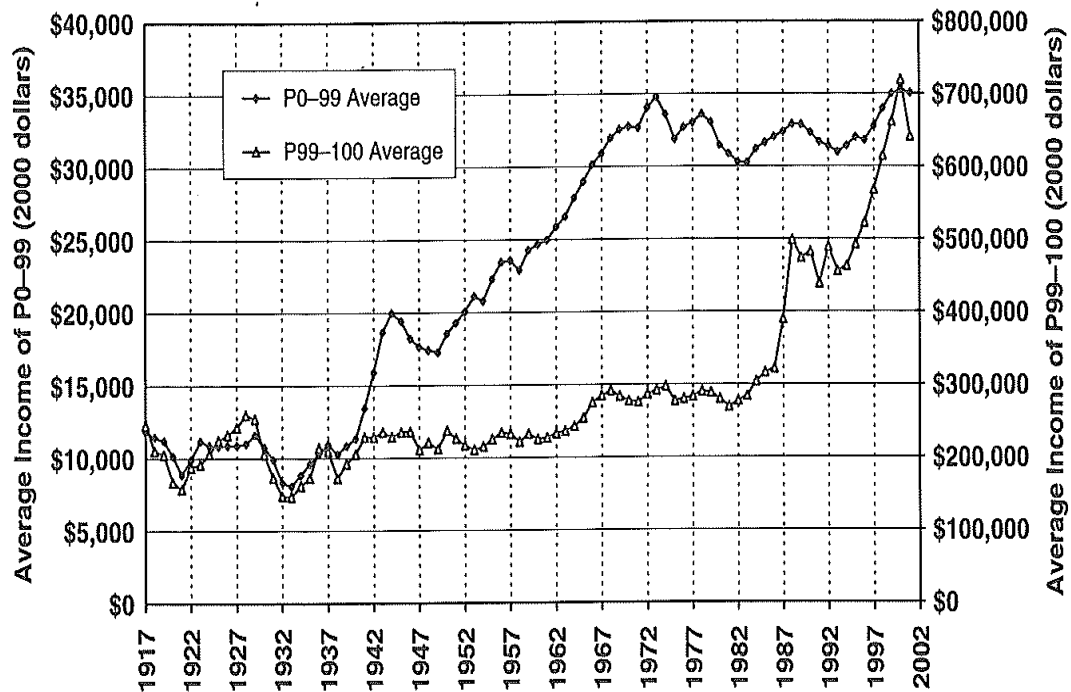
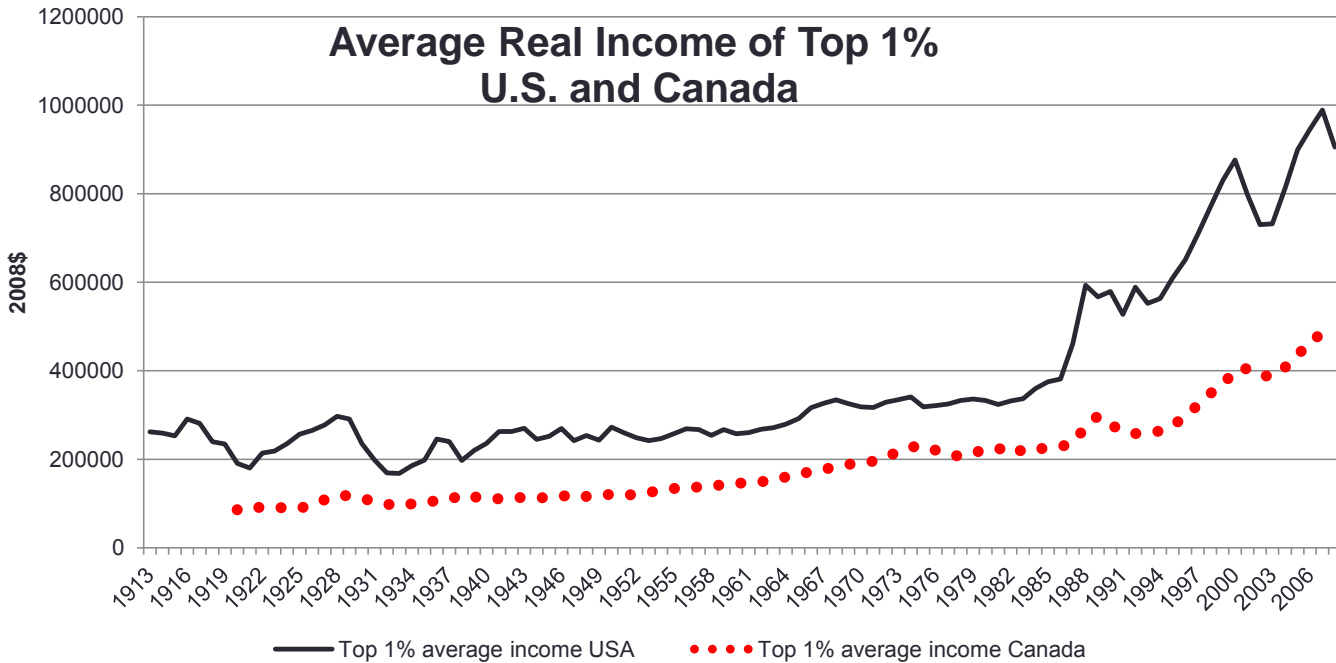


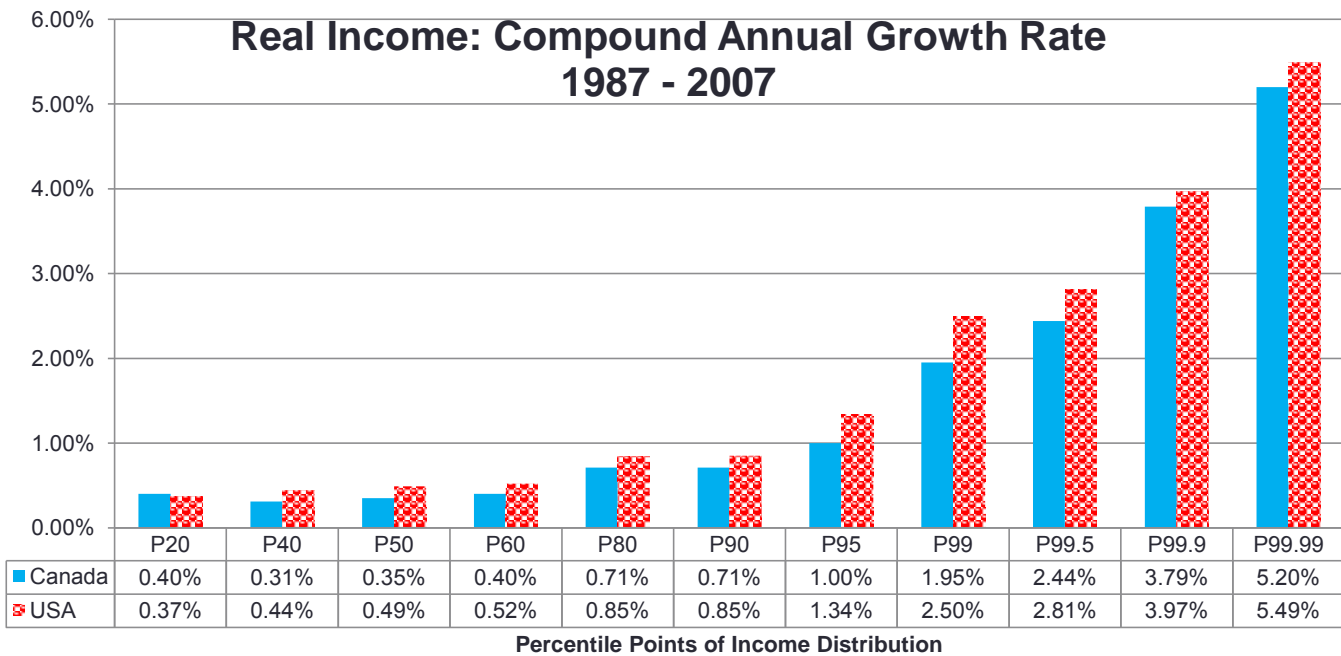
Figure 5A.1 Average real income of bottom 99% and top 1% in US, 1917–2002

# 1940-80: Top 1% incomes grew slower than others

– Unequal Relative Growth rates => Changed Shares



# Much Higher Real Income Growth @ Top





# Stable Inequality □ Balanced Growth

## Same Rate Income Increase @ Top & @ Bottom

- **BUT** U.S.: Annual Income growth 1987-2007:
  - Top 1 % = 4% ; Bottom 80% = 0.5%
- What chances now for bottom quintiles incomes to grow @ 4%?
  - U.S. Continuing High Unemployment; Poverty still near peak;
  - Canada & US: Unions weak; Low-wage competition strong; small marginal returns to HK investment & structural change
- Why would Income Growth @ Top slow?
  - High Incomes => Wealth => Capital Income
  - “Winner Take All” Positional Rents = f(global market size)
  - Control over CEO compensation process undiminished

## Income & Wealth Accounting

- **Income = Consumption + Savings**
  - *Income Increases @ top => Savings => Increase Loanable Funds*
  - *Macro Balance in Real Expenditure requires ↑ Savings of top 1% = ↑ spending rest*
    - *PLUS: Escalating Consumption Norms – set @ top and ripple down*
    - *“Expenditure Cascades” => ↑ consumption norms for stagnant middle*
- **U.S. & Canada : ↑ inequality of consumption < ↑ inequality of income ?**
  - *DEBATE: If true: mitigates short run welfare implications of greater inequality*
  - *IGNORED: If true: implies changing distribution of assets and liabilities*
- **Financial Assets = Financial Liabilities**
  - *Financial Instrument: Asset for Holder = Liability for Issuer*
  - Net Savings @ top imply Increased Debts @ bottom
  - Financial Fragility => Crises => Recessions => Counter-cyclical stimulus

# The Power of Accounting Identities

$$D_t = (1 + r_t) * D_{t-1} - PB_t$$

$D_t$  = Debt in period t

$r_t$  = average rate of interest in period t

$PB_t$  = Primary Balance in period t

= (Receipts<sub>t</sub> – Program Expenditures<sub>t</sub>)

$$\Delta (D/Y)_t = (r_t - g_t) * (D_{t-1}/Y_t) - (PB_t / Y_t)$$

$Y_t$  = GDP

$g_t$  = growth rate of GDP

$\Delta (D/Y)_t$  = change in Debt/GDP ratio

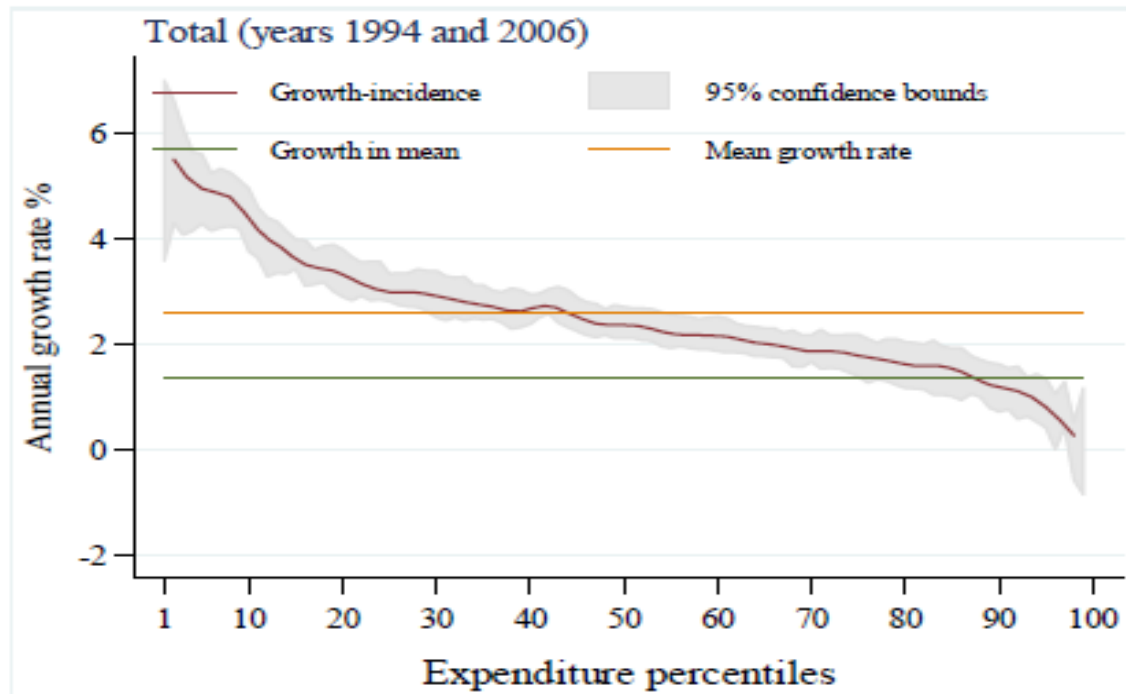
## Debt Instability

– not just a Public Sector Problem !

$$\Delta (D/Y)_t = (r_t - g_t) * (D_{t-1}/Y_t) - (PB_t / Y_t)$$

- The compounding of debt overhang
- $r_t > g_t$ 
  - Accumulated Deficits => ↑ Debt/GDP => ↑ Deficit => ↑ Debt => etc.
  - Anti-Inflation Monetary Policy increases  $(r_t - g_t)$  at both ends
  - What chances for  $r_t < g_t$  in long-term ? What problems created?

# Mexico: Structural Changes imply Faster growth @ bottom – hence declining inequality

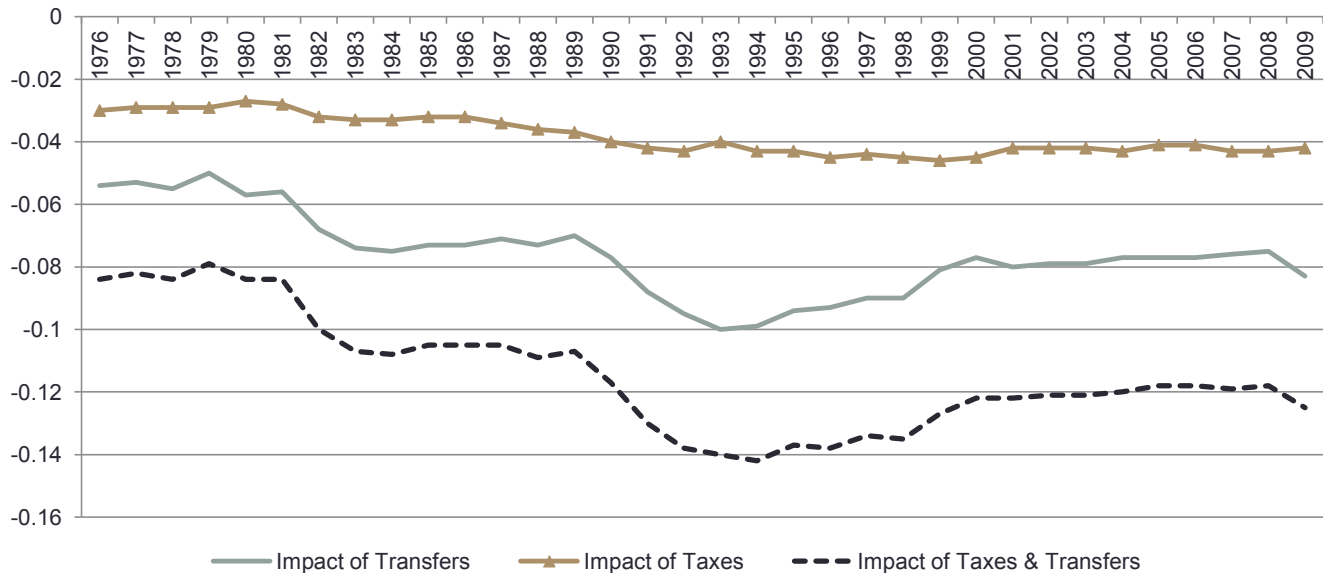


## Mexico: “One-time” Changes & Growth

- 1995: recession => un(der)employment
- PLUS Structural Changes with Major Income Impacts for families
  1. High % agriculture => rural out-migration => big wage gains
    1. Mexico: 2 step process: rural poverty → informal urban → formal urban
  2. Low % employed women => big impact of increase female jobs
  3. Low % complete primary & secondary => high marginal HK returns
  4. Capital deepening => increased  $MP_L$
  5. Large decline birth rate => large (educated) demographic bulge
- Political economy of social policy & ‘Progresa’ (1995)
  - 1994/5: NAFTA + Recession + ↓ PRI + Chiapas – Zapatista insurrection
  - Credible local ‘hard left’ political option => “threat effect” for elites

# Canada: 1990s fiscal crisis decreased redistribution - rising market inequality reinforced

Change in Gini Index of Equivalent Individual Income  
Canada 1976 to 2009



## Canada: what chances for stabilizing policies?

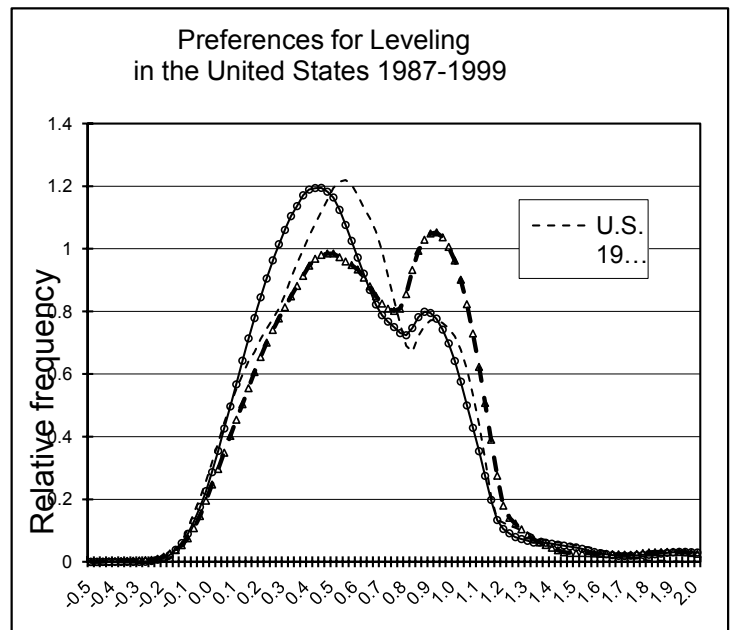
- Majority Governments can shift directions BUT expansion of Recycling role of state not likely soon
  - “Kinder & Gentler?” – a relatively recent national narrative
  - “Colder & Harder” until early 1970s
  - History of Hard Left Threat: Essentially Zero
    - 200 year civil violence death toll less than Mexico City 1968
- 2013: Electoral Politics: Split on ‘Left’ => Conservative Majority
  - Zero Concern for Poverty & Inequality + Philosophically opposed to unions/regulation + Obsessed with ‘tax competitiveness’
- No near term prospect of a political economy of redistribution and stabilization

# USA: What chance for a New “New Deal” ?

- 1930s: FDR & “New Deal”
- U.S. Policy Innovation Stabilized Growth & Inequality
  - Cyclical: Public Works Stimulus
  - Structural Reforms saved Capitalism from Itself:
    - Bank Regulation + NLRB + Social Security + Progressive Tax
- U.S.: Systemically stabilized for 50+ years
  - Restraint of top end income growth + recycling of top end incomes
  - BUT eroded in stages since early 1980s
    - Decline in top marginal tax rates => decrease income recycling

## USA: Conflicted attitudes + \$ politics

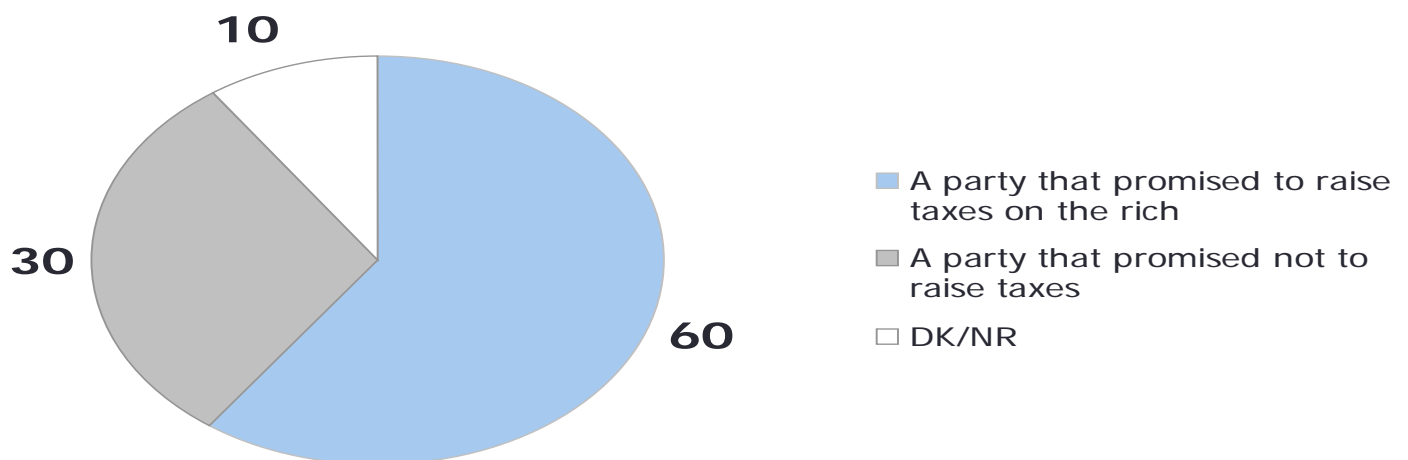
- Bimodal distribution → small migration tips majority balance
  - BUT short terms + division powers + courts => gridlock + soon tips back
- “Deeper Pockets”
  - Increased economic Inequality => Increased Inequality of Political Influence



# The unsustainable does not last – but what follows?

- Unbalanced Income Growth □ Ever Increasing Inequality
  - Cannot be a steady state equilibrium
    - Produces Interacting Instabilities – with cumulative impacts
- U.S. & Canada: Parallels with 1930s but many structural changes
- No Automatic Economic Tendency to self-correction is obvious
- Political Economy of Adaptation to Systemic Instability:
  - Europe in 1930s: both disastrous choices and enduring successes
  - Political choices matter

q. *In the next federal election, would you be more likely to support a party that promised to NOT raise taxes or a party that promised to raise taxes on the rich?*



BASE: Canadians; February 21-28, 2012 (n=3,699)