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The Engines of inequality

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The Engines of Inequality

In Europe and in the United States, one of the legacies of the economic and financial crisis will no doubt be a high and particularly worrying level of economic inequality. Inequality has roots that go well beyond the 2008 collapse, but the stagnation that has followed it has made disparities in income and wealth more serious and more difficult to eradicate.

The challenge posed by high inequality – in particular in European countries and the United States – has attracted considerable attention, leading to important studies – such as those by Stiglitz and Piketty[1] – and growing policy concerns by international institutions such as the OECD and the IMF.[2] However, a comprehensive understanding of the mechanisms at the root of inequality remains lacking, and a reduction of disparities in income and wealth is still far from a priority in governments' agendas. In this article – and in our book[3] – we suggest an interpretation of inequality that is parsimonious enough to identify the fundamental mechanisms at work, capable of accounting for its complexity and, at the same time, adequate for identifying appropriate policy measures. We begin with the basic facts on the rise of inequality in advanced countries.

Income inequality: the facts

The basic facts we summarise in this section concern income inequality in advanced countries in recent decades. We address first the distribution of income between wages and profits, second the rise of top incomes, and third the increasing disparities among labour incomes and in the overall distribution of disposable incomes. Additional evidence is provided by the other contributions to this Forum.

Wages and profits

We start with the functional distribution of income, i.e. the analysis of the shares of national income going to wages and profits respectively.

In advanced countries, labour's share of national income ranges from 55% to 70%; this share generally increased during the 1970s and has fallen since the 1980s, with between ten and 15 percentage points of total income shifting from labour to capital. There is a substantial difference – in particular for the US and UK – when the income of the top one per cent of wage earners – mostly top managers who receive a combination of capital and labour income – is excluded from this comparison. Overall employee compensation has undergone a modest decline since 1980, while compensation for the bottom 99% of wage earners has dropped by nearly ten percentage points in terms of the net value added by the business sector.

The International Labour Organization's Global Wage Report 2014/15 provides an effective summary of such trends and shows the impact of the crisis in the G20 countries.[4] Figure 1 shows the share of national income going to labour in six of these countries between 1991 and 2013.

* This article summarises the arguments of our book. See M. Franzini, M. Pianta: Explaining Inequality, Oxon 2016, Routledge. Additional investigations can be found in M. Pianta: Nove su dieci. Perché stiamo (quasi) tutti peggio di 10 anni fa, Rome 2012, Laterza; M. Franzini: Disuguaglianze inaccettabili. L'immobilità economica in Italia, Rome 2013, Laterza; M. Franzini, E. Granaglia, M. Raitano: Dobbiamo preoccuparci dei ricchi? Le disuguaglianze estreme nel capitalismo contemporaneo, Bologna 2014, Il Mulino.

1 Detailed empirical investigations and studies on different aspects of inequality are in: A. Atkinson, F. Bourguignon (eds.): Handbook of Income Distribution, Vol. 1, Amsterdam 2000, Elsevier; A. Atkinson, F. Bourguignon (eds.): Handbook of Income Distribution, Vol. 2A, B, Amsterdam 2014, Elsevier; W. Salverda, B. Nolan, T.M. Smeeding (eds.): The Oxford Handbook of Economic Inequality, Oxford 2009, Oxford University Press; W. Salverda, B. Nolan, D. Checchi, I. Marx, A. McKnight, I.G. Tóth, H. van de Werfhorst (eds.): Changing Inequalities in Rich Countries. Analytical and Comparative Perspectives, Oxford 2014, Oxford University Press; F. Alvaredo, A.B. Atkinson, T. Piketty, E. Saez: The Top 1 Percent in International and Historical Perspective, in: Journal of Economic Perspectives, Vol. 27, No. 3, 2013, pp. 3-20; T. Piketty, G. Zucman: Capital is Back: Wealth-Income Ratios in Rich Countries 1700-2010, in: Quarterly Journal of Economics, Vol. 129, No. 3, 2014, pp. 1255-1310; J. Stiglitz: The Great Divide. Unequal societies and what we can do about them, New York 2015, W. W. Norton & Company.

2 For the OECD, see OECD: Growing Unequal? Income Distribution and Poverty in OECD Countries, Paris 2008; OECD: Divided we stand: Why Inequality Keeps Rising, Paris 2011; OECD: Employment Outlook 2012, Paris 2012, pp. 109-161; OECD: In It Together: Why Less Inequality Benefits All, Paris 2015. For the IMF, see J.D. Ostry, A. Berg, C.G. Tsangarides: Redistribution, Inequality, and Growth, in: IMF Staff Discussion Note, No. 14/02, 2014; E. Dabla-Norris, K. Kochhar, N. Suphaphiphat, F. Ricka, E. Tsounta: Causes and Consequences of Income Inequality: A Global Perspective, in: IMF Staff Discussion Note, No. 15/13, 2015.

3 M. Franzini, M. Pianta, op. cit.

4 International Labour Organization: Global Wage Report 2014/15: Wages and income inequalities, Geneva 2015.

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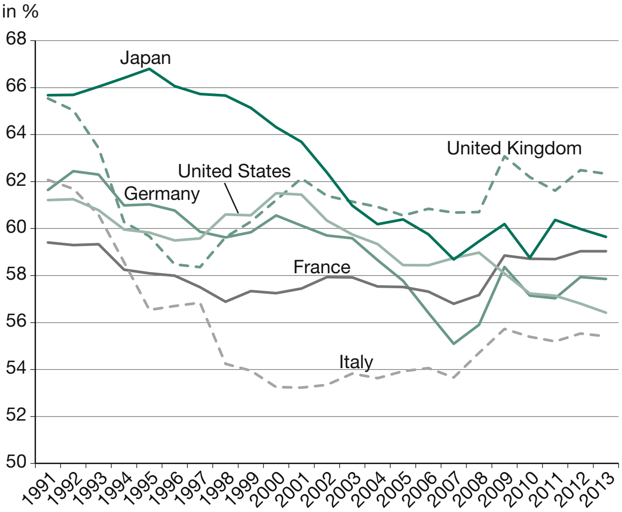
Figure 1

Adjusted share of labour income in GDP in selected G20 countries, 1991-2013



Note: Wage share of GDP adjusted for the income of the self-employed (compensation per employee as a percentage of GDP at market prices per person employed).

Source: Data from European Commission AMECO database. Adapted from International Labour Organization: Global Wage Report 2014/15: Wages and income inequalities, Geneva 2015, p. 11.

This share is measured based on total labour compensation (wages and social insurance contributions paid by employers), adjusted for the income of the self-employed. In 1991 shares ranged from 59% (in France and Australia) to 66% (in the UK and Japan); by 2013 they had fallen below 60% everywhere but the UK, and to as low as 55% in Italy and Australia. Italy, the US and Japan have been the countries where labour has suffered the steepest losses. In this general downward trend, the values in 2007 and 2008 marked the lowest labour shares in all countries; this is due to the recession of 2009, which hit profits hardest, which was to be expected. However, the rise of labour's income share in that year was followed first by a new drop in 2010 in all countries and then by modest changes in either direction since then.

A breakdown of such data shows that, at least since the 1990s, the falling labour share is not the result of shifts in the sectoral composition of the economy (from labour-intensive to capital-intensive sectors), but can instead be attributed to greater profits within all industries, especially in financial services and medium-high technology.[5] The ILO report also provides a focus on the EU countries hardest hit by the crisis. Between 1991 and 2013 in Spain, the labour share fell from 62% to 54%, with half of this drop occurring after 2009. In Greece the labour share decreased from 57% to 48%, with a loss of seven percentage points since 2009.

OECD studies have pointed out the polarisation that has taken place within wages; in the past two decades, the "wages" of the top one per cent of the income distribution have increased by 20%, while labour income for poorer workers has declined. Thus, the decline of the labour share is significantly greater if we exclude the remuneration of the top one per cent. In the US and Canada, the drop in the labour share doubles to 4.5 and six percentage points respectively, and in Italy it reaches nearly nine percentage points.[6]

Complementary evidence comes from the evolution of the capital share in national income. Thomas Piketty, using national accounts, has documented the long-term rise of the share of capital from 1975 to 2010.[7] The period between 1975 and 1990 shows the most rapid increase of the capital share of income, with very sharp increases in France, Germany and the UK. Recessions always lead to a temporary drop in the capital share, and the one in 1992 was particularly serious; by 1994, however, capital had recovered its previous share and embarked on a substantial rise, supported by the full liberalisation of capital movements and the financial boom associated with the "new economy". The recession of 2001 again interrupted the rise of the capital share, and it was followed by a new recovery and overall stability. Surprisingly, the crisis of 2008 and the subsequent recession of 2009 did not lead to a generalised fall of the capital share in all countries.

The super-rich

The second piece of evidence we focus on is the rising share of income going to the richest people in society. This partly overlaps with the above evidence on the rising share of capital, as the richest ten per cent, one per cent and even 0.15% of the population concentrate income from business profits, financial rents, top management salaries and "star" professional activities.

Crucial evidence on this problem has emerged from detailed studies based on tax records that distinguish taxpayers by income groups.[8] A look at the long-run evolution – from 1900 to 2010 – of the share of income going to the top ten per cent shows that in the United States in 2000, this share had surpassed the level of 1930 and

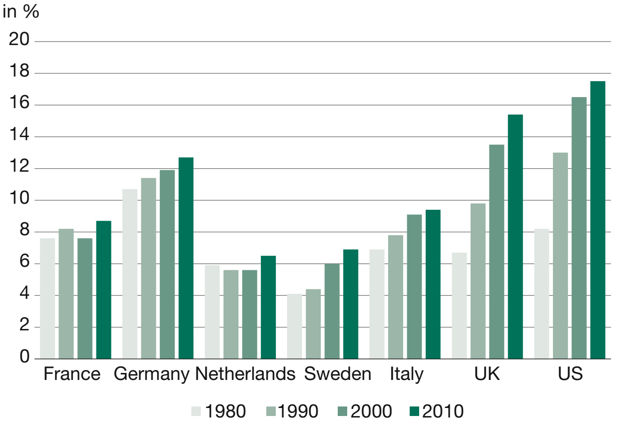
5 Ibid., p. 11.

6 OECD: Employment Outlook ..., op. cit., p. 115.

7 T. Piketty: Capital in the Twenty-First Century, Cambridge 2014, Harvard University Press. For the methodology, see T. Piketty, G. Zucman, op. cit.

8 F. Alvaredo et al., op. cit.; A. Atkinson: Inequality: What Can Be Done?, Cambridge 2015, Harvard University Press.

Figure 2
The top one per cent income share in advanced countries, 1980-2010



Source: Calculations on data from the World Top Income Database, available at http://topincomes.parisschoolofeconomics.eu/.

continued to increase to more than 45%. In the UK, Germany, France and Sweden, inequality at the start of the 20th century was as high as the current level in the US, but from the Great Depression on, trends in these European countries mirrored those of the US. The very rich's lowest share of income was reached in 1980, when they received less than 30% of total income. Since then their share has continued to rise, reaching 35%, and this rise has not been stopped by the 2008 crisis.

Even among the rich – i.e. the top ten per cent – income is unevenly distributed, with about half of the income of the top decile going to the "ultra-rich" top one per cent. The shares of income going to the richest one per cent vary widely among countries, as shown by Figure 2. The US and the UK are characterised by the highest values – between 15% and 18% in 2010 (and if capital gains are added to incomes, the share of the ultra-rich in the US further increases by three percentage points). Germany, Italy and France follow, while the Netherlands and Sweden have the lowest values, at less than seven per cent. However, all countries have seen a generalised rise since 1980. We could repeat the exercise and find that within the ultra-rich one per cent, the top 0.1% – the "incredibly rich" – receive nine per cent of total income in the US and six per cent in the UK, more than four times the level of the 1970s.[9]

Wage disparities

We now turn to the distribution of labour income. A recent Eurofound study examined wage inequality (for full-time equivalent wages) in the EU as a whole, finding an overall Gini coefficient of 0.346 in 2011.[10] Through 2008, wage disparities within Europe had declined as a result of the convergence of average wages in Central and Eastern European countries and wages that had more or less stagnated in Southern Europe and Germany. The crisis, however, has led to rising inequality again, driven by disparities within countries and major wage decreases in Southern Europe. Comparing countries and industries, it becomes clear that collective bargaining plays a significant role in fostering higher and more equal wages.[11] Moreover, the rise in "non-standard" forms of employment – temporary and precarious work, outsourced self-employment jobs, etc. – has been identified as a major factor in rising inequality, reflecting the changing balance of forces between capital and labour.[12]

Mainstream interpretations of wage disparities have argued that this is largely due to differences in skills and education, and that market outcomes reflect individual differences in education, abilities and effort. However, detailed empirical studies suggest that human capital variables such as experience and education are able to explain at most a third of the variance in wages, while residual wage inequality – i.e. wage dispersion among workers with the same educational backgrounds – represents the largest part of this variance. For example, looking at the weekly wages of full-time workers in Italy, the share of inequality due to educational attainment has constantly fallen since 1992 and now explains less than ten per cent of the wage dispersion.[13] Therefore, wage disparities are also the result of forces other than education and human capital.

Inequality in market and disposable incomes

For a comprehensive picture of the overall change in the personal distribution of income, we need to move from individual earnings (gross of taxes) to household income, where families share the incomes their members receive from different sources (employment, self-employment, firms, capital, rents). Such income is then transformed into personal income through equivalence scales that take into account the economies of scale enjoyed by larger families. If we also compute the taxes and transfers through which the state redistributes market income, we

9 F. Alvaredo et al., op. cit.

10 Eurofound: Recent developments in the distribution of wages in Europe, Luxembourg 2015, Publications Office of the European Union.

11 Ibid., pp. 61-62.

12 International Labour Organization, op. cit.; OECD: Employment Outlook ..., op. cit.

13 M. Franzini, M. Raitano: Income Inequality in Italy: Tendencies and Policy Implications, in: G. Sancetta, D. Strangio (eds.): Italy in a European Context. Research in Business, Economics and the Environment, London 2015, Palgrave Macmillan, pp. 50-75.

obtain the disposable income. We can compare the inequality emerging from market outcomes with the inequality of disposable incomes and assess the redistributive impact of public policy.

Extensive studies have documented the general rise in market income inequality in advanced countries in the last three decades.[14] In 2010 the UK, France, Italy, the US and Germany ranked (in this order) as the most unequal rich countries, with Gini values around 0.50, while the Netherlands, Denmark and Sweden had lower levels of inequality, with Gini values around 0.43.

How do redistributive policies affect such market outcomes? The impact of public policy is significant, especially in Europe, where high inequality levels are substantially lowered. In 2010 the US, the UK, Italy, France, the Netherlands and Germany ranked (in this order) as the most unequal countries after redistribution, with Gini values ranging from 0.38 to 0.28. Since 1985, however, the same general pattern of rising inequality has been evident, even after redistribution; for example, between 1995 and 2010, the more equal societies – Denmark and Sweden – experienced the largest rises in the levels of disposable income inequality of all countries. Looking at the OECD data for 2013, it appears that the increase in the Gini levels has continued in most countries.[15]

The average household disposable income was heavily affected by the recent crisis, with a stagnation or fall in real terms in most OECD countries. Looking at some of the countries hardest hit by the recession, the losses between 2007 and 2011 reached eight per cent per year in Greece, around six per cent per year in Ireland and Iceland, and nearly four per cent per year in Spain. Behind such averages, however, the fall in disposable income was concentrated in the poorest households; in Spain, for example, the bottom ten per cent of the income distribution showed a loss of almost 13% per year, while the richest ten per cent showed a reduction of only 1.5%.[16]

The four engines of inequality

Building on the facts reviewed above, we suggest an interpretation of inequality that identifies the engines of this process and accounts for its complexity. We argue that today's inequality in advanced countries is the result of four factors, namely the increased power of capital over labour, the emergence of an "oligarch capitalism", the growing individualisation of economic conditions and the retreat of politics.

The power of capital over labour

For advanced countries, all the available evidence points to the early 1980s as a turning point in inequality dynamics. The arrival to power of Margaret Thatcher in the UK in 1979 and Ronald Reagan in the US in 1980 ushered in the age of neoliberalism, as political power was captured by forces ready to break with the widely shared post-war Keynesian consensus on capital controls, wage bargaining with strong unions, and an active role for the state in the redistribution of incomes and the provision of welfare services. One after another, advanced countries aligned to a view of markets as efficient tools not just to allocate resources, but also to distribute rewards.

The rise of finance was the most important process. After the severe crisis of the 1970s, when labour and social movements contested the economic and social order, the response of capital was to move towards finance, which offered a new and faster rate of capital accumulation. The banking regulations introduced after the Great Depression of the 1930s were progressively cancelled, the free international movement of capital was allowed (which also made managed exchange rate systems impossible) and entire new fields of financial activities were opened up with huge potential for the growth of asset values and short-term speculation. The high returns to finance – capital gains, rents and pay for managers – have been concentrated among top earners, increasing inequality in both income and wealth.

At the same time, in the "real" economy, globalisation and the diffusion of information and communication technologies were reshaping production systems and investment flows, weakening domestic production, and destroying jobs. The use of labour deeply changed, with governments and businesses reducing labour rights, breaking union power, introducing "non-standard", "flexible" labour contracts, and lowering wages.

The new power of capital over labour since the 1980s is responsible for the shift of ten to 15 percentage points of GDP from the wage share to the capital share in advanced countries. It accounts for the even greater rise of wealth inequality, driven by mounting values of financial assets. It explains the unparalleled rise of top incomes, which combine unprecedented compensations for top managers, larger profits, and capital gains from financial and real estate assets. In 1978 the compensation of the top managers of the top 350 US firms was greater than

14 See OECD: Growing Unequal … , op. cit.; OECD: Divided … , op. cit.; OECD: In It Together … , op. cit.; F. Bogliacino, V. Maestri: Increasing Economic Inequalities?, in: W. Salverda et al.: Changing Inequalities … , op. cit., pp. 15-48.

15 OECD: In It Together … , op. cit., p. 24, Figure 1.3.

16 Ibid., p. 24.

that of the average employee by a ratio of 30 to one; by 2013 the ratio had increased to 296 to one,[17] powerfully reflecting the new power of capital over labour.

Oligarch capitalism

An inequality that is driven by the extreme rise of top incomes brings with it features that remind us of the *ancien régime*. A new "aristocracy of money" concentrates wealth in a way that has long been forgotten. The maintenance and expansion of the stock of such wealth take priority over the growth of the flows of incomes. The result – as shown by Piketty[18] – is a rising capital-to-income ratio and an ever-growing concentration of rewards to capital in economies that may record slower GDP growth. The manner in which such concentrated wealth is obtained is less and less the result of competitive processes, Schumpeterian innovations and market success. Increasingly, it has to do with monopoly rents, protection from competition, and bubbles in real estate and financial markets. The super-rich increasingly take on the features of oligarchs, whose wealth is derived from power and privilege – political protection, monopolies and the acquisition of privatised public companies – rather than from economic success. As with the pay of most top managers, there is no special economic "merit" in being part of the oligarchy. Moreover, concentrated wealth is transmitted over time within families – another element typical of the *ancien régime* – and the importance of wealth acquired through inheritance is rising in all advanced countries.[19] In such an "oligarch capitalism", the intergenerational transmission of inequality becomes more severe, the possibility of social mobility collapses, and the link between economic merit and distributional reward becomes irrelevant.[20]

Some traits of this model – such as the importance of relationships over merit for finding jobs or for obtaining higher wages – are spreading throughout the economic system, leading to the dangerous preference for privilege over competence. As argued by Stiglitz and many others, such a pattern of extreme inequality leads to lower economic efficiency and lower growth.[21] Even more worrying is the prospect that the oligarchs' power may increasingly affect the political process, shaping public policy in their own interest and leading to a dramatic weakening of democratic systems.

17 L. Mishel, A. Davis: CEO Pay Continues to Rise as Typical Workers Are Paid Less, in: Economic Policy Institute, Issue brief No. 380, 2014.

18 T. Piketty, op. cit.

19 T. Piketty, G. Zucman, op. cit.

20 See M. Franzini, E. Granaglia, M. Raitano, op. cit.

21 J. Stiglitz: The Price of Inequality: How today's divided society endangers our future, New York 2012, W. W. Norton & Company.

Individualisation of economic conditions

The rising power of capital and oligarch capitalism are engines of inequality at the top of the distribution; they distance the top from the rest and – even more – from the poorest. But inequalities have also increased within the 99%. The fundamental mechanism here is a process of individualisation that has put employees in competition with one another for pay and their careers; it has led to a polarisation of skills and careers and has pushed professionals and the self-employed into increasingly competitive markets. Individualisation has meant that workers generally have more precarious jobs with a great variety of contractual forms – short-term, part-time, outsourced jobs – while young people have increasingly uncertain and diversified professional trajectories. Beyond employment, pensioners have also come to rely for their income on differentiated pension systems that are dependent on financial markets. When we consider the ways in which individuals are grouped into households, additional complexities emerge.

For people in employment, these dynamics have led to a polarisation of jobs on the basis of professional categories and skills, bringing with it a frequent polarisation of wages. A large share of earnings inequality is not explained by skills and education but rather by family background or relational activities. The generalised weakening of trade unions and centralised labour contracts has removed the most powerful forces for the convergence in labour incomes and for supporting wage dynamics; this has opened up space for firm-level bargaining and individual contracts that have increased disparities among wage earners. Policy changes have directly contributed to this outcome with the general reduction in the degree of employment protection.[22]

The complexity that has been documented in the patterns of inequality that concern the 99% is the result of fast-changing production and of changes in labour market institutions, which have led to reduced protections for employees and a fragmentation of contractual arrangements. This is a process that goes well beyond incomes and wages. Social identities have become more fragmented, class structures have become blurred and new divisions have emerged. The neoliberal emphasis on individuals, their choices and opportunities has gone a long way in shaping broad social behaviour among workers. Traditional mechanisms which created collective identities and a sense of solidarity – trade unionism for employees of the same industry and firm, community activism at the local level, etc. – have been weakened by an individu-

22 F. Bogliacino, V. Maestri, op. cit.

alisation that can be seen as an additional, deeper sign of the new power of capital over labour.

The retreat of politics

Until the 1970s, the state played a major role in reducing inequalities in advanced countries with a wide range of activities and policies. Income distribution was governed by overall policies concerning income policy, taxation, rent controls, the regulation of finance and capital flows. Disparities emerging from market outcomes were contained by a highly progressive tax system, by selective taxes discouraging conspicuous consumption, by high inheritance taxes and by the extensive provision of public services outside the market. Furthermore, income support was provided for the less fortunate.

Since the 1980s, almost all of these policies have been either outright cancelled, as in the case of the inheritance tax in many countries, or substantially weakened, such as progressive taxation. Public policies took the road of market liberalisation and deregulation, favouring in all possible ways the new power of capital over labour and the rise of finance. Politics made it possible for capital to break the resistance of labour and for finance to become the leading industry of our time. Policies were introduced to change an endless list of "rules of the game" in the name of improving market efficiency and reducing "public waste". Private enterprise was encouraged, public activities privatised – and sometimes handed over to oligarch capitalists – and regulations were weakened.

Until the 1970s, the large-scale provision – especially in Europe – of public services through non-market systems – including education, health, social security, pensions, environmental protection, public R&D, etc. – meant that the operation of markets, with their drive towards unequal outcomes – was limited and that people could access such services on the basis of their status as (equal) citizens, rather than on the basis of their (unequal) ability to pay. This was a powerful equalising factor in all advanced countries from the 1950s to the 1970s.

Moreover, in many European countries, state intervention was also widespread in economic activities, with public enterprises managing infrastructure, water, energy and communications, as well as large firms in a range of key industries, from steel to electronics. When economic activities are carried out by publicly owned organisations, profits either do not exist or end up as state revenue, reducing taxation; in any case, they do not increase the capital share or the importance of finance. Workers in publicly owned organisations are usually granted good wages, greater union rights and employment protection under labour contracts that tend to equalise conditions. Since the 1980s, the drive towards the privatisation of public firms and public services and the outsourcing of service provision to private organisations has shifted a large part of such activities into market contexts, expanding inequalities – in fact, some of the lowest wages are now paid in the service industry for the provisons of services that were formerly provided by the state but have since been outsourced.

As documented by a wide range of studies – in particular Atkinson[23] – the impact on inequality of this retreat by politics has been huge. The failure of policies to contain inequality has led to particularly visible and problematic effects – increased poverty, social deprivation and even a reduction of the life expectancy of the poor in many countries.[24]

It should be noted that these four forces of inequality operate at different levels but closely interact with one another, reinforcing their effects. A strengthening of capital versus labour makes it possible to introduce anti-labour and anti-poor policies that further consolidate unbalanced class relations. The individualisation of workers' position in labour markets is closely associated with a strengthening of capital's power over labour. A more individualised society offers less resistance to the rise of the wealthy and the power of oligarchs. A concentration of wealth in the hands of oligarchs means greater influence over the policy process, which further advances their privilege and rents. The reduction of the public sphere through privatisations and deregulation widens the space in which the polarising effects of market dynamics operate.

Indeed, these intertwined mechanisms are a further reflection of the complexity of today's inequality.

The need for egalitarian policies

These four engines of inequality explain to a large extent the rise and persistence of inequality in advanced countries. But they have a deeper impact, through changing the way capitalism works, making the economy less dynamic, society less equitable and politics less democratic. These dangerous prospects have to be addressed by a broad range of policies from national governments, by new institutional arrangements – including international ones – and by changes in the rules and practices of business that reflect the importance of less unequal econom-

23 A. Atkinson, op. cit.

24 G. Therborn: The Killing Fields of Inequality, Cambridge 2013, Polity Press.

ic outcomes. In our book,[25] we argue that the most important, viable and effective policies that could be introduced by national governments include the following:

- regulation and downsizing of finance
- limiting the positions of rent-seekers
- fair distribution of the benefits of technology and productivity
- an effective minimum wage and a greater role for national labour contracts
- controls on top incomes
- a high inheritance tax
- reducing the fragmentation of employment contracts
- strengthening an egalitarian public education
- international and national taxation of wealth
- greater progressivity in personal income taxation
- a minimum income.

Moves in this direction would be effective in limiting the operation of the engines of inequality, and many of them have been endorsed by scholars and international institutions.[26] The challenge now is to turn the injustice of current inequality into a theme of public mobilisation and political action.

25 M. Franzini, M. Pianta, op. cit., pp. 57-80.

26 See for example A. Atkinson, op. cit.