Economic Policy and Inequality: a Proposal for a Change in Economic Policy

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ABSTRACT

This paper aims to consider the relationship between economic policy and inequality. After having observed that the current economic policies of fiscal consolidation and structural reforms are increasing inequality, this paper proposes a change of economic policy based in three pillars: a) encouraging domestic aggregate demand, 2) a new role of the income policy and 3) reducing inequality by consolidating and intensifying Welfare State policies.

KEYWORDS:

Welfare state, inequality, personal income distribution, economic policy.

JEL CLASSIFICATION: D31, I38, J30, P16.

I- Economic crisis and unequal distribution.

Economic growth and the economic cycles associated with the pattern of growth play a decisive role in the distribution of income. Economic crisis and economic inequality are phenomena which feed off each other. So, the economic crisis is as much a cause as a consequence of the growing inequality in the distribution of income. It is, therefore, obvious that the current economic recession is a major influence on the distribution of income.

Nevertheless, the starting point of this increase in the inequality of income distribution did not coincide with the current economic crisis, indeed, a rise in economic inequality could already be observed during the period of economic growth. Since the beginning of the Eighties, empirical evidence shows that inequality has been on the rise in the great majority of countries, in spite of the economic growth. (Glyn, 2009; Milanovic, 2012; Stiglitz, 2012; OECD, 2011; OECD, 2012; World Bank, 2012; Koechlin, 2012; Joumard, Pisu y Bloch, 2012; Hoeller, Joumard, Pisu y Bloch, 2012; Koske, Fournier y Wanner, 2012; Wang, Caminada y Goudswaard, 2012). Thus, for example, Ortiz and Cummins (2011), show that, during the period 1995-2007, inequality grew in two thirds of the more than 140 countries which they analysed in their study. This has been especially marked in the EU countries, in which the rise in inequality was above the average of that experienced in the OECD countries (Moral and Genre, 2007; Estrada and Valdeolivas, 2012; Bonesmo, 2012;

Giammarioli et al., 2002; Checchi, Peragine and Serlenga, 2010) [1] . However, the economic crisis has had very disparate impact on wages and income distribution across countries, which shows that national public policies and institutions in each country have a decisive influence (De Beer, 2012: 362).

What may have been the causes behind the rise in inequality of the distribution of income? [2] . Let us name a few:

a) demographic changes (accompanied by a sharp rise in the passive population);

b) deregulated growth of the financial sector (financing, speculative investments, deregulation of the financial markets, "finance-led capitalism", etc.) (Hein, 2011);

c) progress and technological change (incorporation of capital-intensive technologies, information and communication technologies, etc.) (IMF, 2007; European Commission, 2007);

d) changes in the institutions of the job market (rise in unemployment; polarisation of the wages paid to skilled and unskilled workers; increased share of profits; deregulation, liberalization and flexibility of the job market, weakening of the bargaining power of workers and unions, increased flow of immigrants, etc.);

e) globalization of the economies (greater competition, relocation, greater openness to foreign trade, incorporation of unskilled workers from emerging countries, etc.) (Rodrik, 1997; IMF, 2007; Guscina, 2006; Burtless, 2007);

f) structural changes in the economies (sectoral reshaping , increase in the mobility of labour and capital, changes in how efficiently resources are assigned, etc.) [3] ;

g) fiscal reforms that favour those in the high-income bracket;

h) changes in macroeconomic regulation (abandonment of the policies of aggregate demand management,, fiscal and monetary regulations etc.);

i) changes in social policies (decrease in the level of protection, lower protective intensity,, limits on coverage, etc.);

j) growing inequality of opportunity (Checchi, Peragine and Serlenga, 2010) and, lastly,

k) factors related with the international political order.

Has inequality been one of the structural causes behind the current economic and financial crisis? This seems to be the conclusion reached by some recent research (Horn, Dröge, Sturn, Van Treeck and Zwiener, 2009; Rajan, 2010; Van Treeck, 2012; Kumhof and Ranciere, 2010; Kumhof,

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[1] For an analysis of the methodology behind this kind of research work, consult De Serres, Scarppetta and De la Maisonneuve (2001).

[2] In the studies by Torres (2009 a), Moral and Genre (2007) and Casadevall and Crespo (2007) some of these causes are named.

[3] Thus, for example, Moral and Genre (2007 : 94-95) show that in the group of countries making up the Economic and Monetary Union, "the reduction in the wage share has been more pronounced in those sectors that are more open to competition, and particularly in those in which the new economies that have appeared on the stage of international trade exhibit a greater comparative advantage".

Lebarz, Ranciere, Richter and Throckmorton, 2012; Hein, 2011) [4] . What does appear to be clear is that an unequal distribution of income is negatively correlated with long-term economic growth or, what is the same, that an improvement in the distribution of income helps to favour economic efficiency and long-term economic growth [5] .

II- A proposal for a change in economic policy.

The current economic austerity policies and hard line fiscal consolidation are stressing inequality. There is considerable empirical evidence that the contractionary economic policies are having a significant regressive impact on income distribution and are emphasizing social problems such as unemployment, poverty and social exclusion (Darvas and Wolff, 2014). Numerous papers try to analyze the relationship between the policy of fiscal consolidation and the unequal distribution of income (Ball, Leigh and Loungani, 2011; Bastagli, Coady and Gupta, 2012; Azzimonti, De Francisco and Quadrini, 2012; Agnello and Sousa, 2012 a and 2012 b; Callan, Leventi, Levy, Matsaganis, Paulus and Sutherland, 2011). The IMF itself recognizes that fiscal adjustment policies have a major influence on the economic downturn and that if fiscal consolidation is based on the adjustment of public spending, the fiscal strategy will have a more regressive impact on income distribution (Guajardo, J., Leigh, D. y Pescatori, A., 2011; Blanchard, O. y Leigh, D., 2013; Ball, Furceri, Leigh and Loungani, 2013; Woo, Bova, Kinda and Zhang, 2013). In October 2012, the IMF estimated that a fiscal adjustment of 1% GDP would increase inequality by 0.6% (measured by the Gini coefficient) (IMF, 2012) [6].

It is therefore necessary to change the course of the current economic policy. In our opinion, this new economic policy strategy should be based on three pillars:

a) a policy stimulating domestic aggregate demand (this would involve an increase in real wages),

b) a new role of the income policy and

c) consolidation and intensification of Welfare State.

II.1- Economic growth based on the wages.

According to Hein (2011) the developed economies have followed two models of economic growth:

1) the "*debt-led consumption boom model*" and
2) the "*export-led mercantilist model*".

Both models have been complementary and have formed an alliance which, taking into account the current economic crisis, has clearly shown itself to be fragile and unstable. Neither of

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[4] Although other authors, like Atkinson and Morelli (2011), conclude that there is no clear,one-way relationship between the financial crises and the distribution of income.

[5] See Stewart (2000). Even the IMF itself has had to accept that economic inequality and unsustainable growth are two sides of the same coin (Berg y Ostry, 2011).

[6] These austerity policies are have a negative impact, in particular in the European periphery countries (Calero and Maroto, 2013; Del Pozo and Martin, 2013; Rosnick and Weisbrot, 2015). The Spanish case is paradigmatic in this regard: application of harsh adjustment policies and fiscal consolidation is leading to a considerable increase in inequality.

these models (associated with neoliberalism and financialisation) are feasible in the future. No recuperation strategy which aims to be sustainable over the medium-to-long term can continue to reproduce these two growth models.

It is necessary to change the economic policy implementation towards what Hein (2011: 70) has called "a *Keynesian New Deal*". This means applying a recovery strategy in the medium term, based on income or wages. Numerous studies have supported the idea of applying a strategy based on the growth of domestic demand and growth of real salaries. An economic growth policy based on salaries should combine both political and macroeconomic and microeconomic reforms [7].

A wage-based policy of economic growth should combine both macroeconomic and microeconomic policies and reforms. As Palley (2011 : 258) points out, "from a wage-based point of view, there is the need on a microeconomic scale for a restructuring of the job market institutions in order to put wages back in line with the growth in productivity. As far as the macroeconomy is concerned, it is vital to maintain an expansionist policy to counteract the demand deficit in the private sector as regards potential production".

According to the aforementioned author, the main elements of a national wage-based Keynesian growth programme are the following (Palley, 2011 : 259-268):

1) reconstructing the relationship between productivity growth and wages ;
2) considerable, intelligent and sustained fiscal stimulation;
3) refocusing the monetary policy on full employment;
4) regulating the financial market ;
5) reforming governance and accountability;
6) fiscal reforms;
7) trade deficit and external balance (need for the coordination of exchange rate policies);
8) reforming the architecture of globalisation (exchange rates, controls on the flow of capital, etc.);
9) labour standards;
10) worldwide minimum wage system and
11) reforming trade agreements.

According to Hein (2011), a wage-based recuperation strategy must be accompanied by the following policies:

1) the bargaining power of trade unions has to be stabilized and enhanced;
2) overhead costs of firms must be reduced, in particular top management earnings and interest payments, as well as profit claims of financial wealth-holders;
3) the sectoral composition of the economy has to be shifted away from the high-profits-share financial corporations towards the non-financial corporate sector and the public sector;
4) the tendencies towards increasing wage dispersion need to be contained and

[7] A good summary of works relative to this model of economic growth based on domestic demand can be found in Setterfield (2005).

5) the application of progressive policies, both social and taxation, in order to reduce the inequality in the distribution of disposable income.

Figure 1 shows the main economic policy measures taken by an economic growth model based on wages.

Figure 1

Main elements of a Keynesian national growth program based on salaries.

MACROECONOMIC POLICIES			STRUCTURAL REFORMS			
Fiscal policy	Monetary policy	Foreign policy	Labour market	Financial system	Institutional reform	Other supply policies
-Substantial intelligent and sustained fiscal stimulus -Fiscal Reform -Social and progressive fiscal policies to reduce inequality in the distribution of available income	-Focus monetary policy on full employment	-Correcting commercial deficit and external balance -Coordination of exchange rate policy -Reform of commercial agreements	-Connecting salaries and productivity -Labour regulation -Global minimum salary -Stabilizing and improving unions' bargaining influence -Limiting trends which tend to increasing salary dispersion	-New regulation	-Reforming governance and accountability policies -Reforming the global financial structure (exchange rates, monitoring cash flows, etc.).	-Economy's sectorial composition must be separated from financial institutions with high profit sharing and must be oriented towards the non-financial corporate and public sector -Reducing overall costs for businesses, in particular, senior management salaries, interest payments and earnings claims of financial wealth holders

Source: Chart elaborated on data from Palley (2011 : 259-268) and Hein (2011)

II.2- A the new role of the incomes policy: distributive conflict and collective negotiation.

The current context of economic crisis can revitalize, again, the use of the instrument of income policies. Nevertheless, the income policies should not limit to helping to reach the anti-inflationary aim (classic and traditional aim of this instrument of economic politics), but to guaranteeing the price stability with the economic growth and the most equitable income distribution (Sardoni, 2011 : 161).

Arestis y Sawyer (2013 : 10) write “incomes policy has been generally associated with the control of inflation but it should also be interpreted literally –that is a policy for incomes, and notable for the distribution of incomes. Thus, it is an unavoidable part of incomes policy to take some view on the features of a socially desirable distribution of income”

The wage and incomes policy must not only guarantee the purchasing power of wages, but should also assume the medium-term objective of improving the functional distribution of income [8] . Several studies have defended the position that a strategy based on the growth of real wages favours economic growth (Bhaduri and Marglin, 1990; OIT, 2011; Loaiza, 2012). There are existing empirical studies that confirm this hypothesis, not only in eurozone countries (Stockhammer, Onaran and Ederer, 2007; Onaran, 2011; Stockhammer, 2011a; Stockhammer, 2011b), but also in OECD countries (Hein and Vogel, 2008; Hein and Tarassow, 2010) and some Latin-American countries (Lindenboim, Kennedy and Graña, 2010; Loaiza and Sierra, 2010). Nevertheless, as demonstrated Onaran (2013), the effect of a change in the share of wages in national income on economic growth is not homogeneous in the G20 countries. [9] .

An incomes policy which favours wage income would raise the expenditure on private consumption and, therefore, the level of both aggregate demand and economic activity. In the words of Torres (2009 b), “for the last thirty years, inequality has been on the increase, and reversing this process and achieving a fairer distribution of income represents more than a (desirable) moral aspiration. It is also the pre-requisite for future macroeconomic stability, the guarantee that the economy does not drift irreversibly towards a permanent global crisis and, of course, the only way to reactivate the markets and to create conditions which are suitable for the creation not only of employment but even of corporate profits that are not the result of simple financial speculation”.

Álvarez and Luengo express themselves in like terms (2011 : 18) when they point out that “a change in the patterns of the distribution of income which will boost the wage income and, with it, the aggregate demand, to the detriment of the dividends shared out among the stockholders, seems perfectly viable insofar as the financing of the productive activity has partially unliked from the marked growth experienced by capital income during the period 1996-2009. If the companies reduced the proportion of the profits distributed among the stockholders in the form of dividends, the resulting income could not only be used to raise wages, but also to finance gross fixed capital formation, and all without challenging the sacrosanct notion of competitiveness”.

As Kumhof and Rancière (2011: 216) state at the end of their study, “the reestablishment of a greater equality between the rich and poor by means of a redistribution of wages would not only be a source of satisfaction for the Robin Hoods of the world, but it would also help to save the world economy from entering into another serious crisis”.

[8] This idea has been stressed in previous studies. See, Ochando (2010) and Bilbao and Ochando (2012).

[9] According to the study Onaran (2013) a decrease of wages in income distribution leads to lower growth in the euro zone, Germany, France, Italy, UK, USA, Turkey and Korea, while stimulating growth economic development in countries like Canada, Australia, Argentina, Mexico, China, India and Sudráfrica. However, the study makes clear that the decline in wages leads to a decrease in global growth.

II.3- Consolidation and Intensification of Welfare State.

Let us analyze, briefly, the third pillar of the strategy of economic policy. Together with this strategy of redistribution, the new social pact must go hand in hand with a growth in social public expenditure and spending on public services, something which consolidates, universalises and broadens our weakened model of the Welfare State.

Social spending needs to be increased. This new social deal must include an expansion of social spending which consolidates, expands and universalizes our weakened welfare state model, for two reasons:

1) Its positive impact on the income distribution and the reduction of inequality and

2) Its positive impact on creating employment

A Welfare state encourages segments and potentially job-creating economic activities (public and private). Social services and personalized care (elderly, dependent people, children, etc.) are segments with a potential major employment growth in the coming years, especially in countries like Spain, where these social services are clearly underdeveloped. Reinforcement of these social services would have a significantly dynamic effect on the economy and would have two important effects on employment: a) a direct effect, as they represent a significant percentage of employments generated in the service sector and b) an indirect effect, since they contribute to increasing female participation in the labour market.

An expansion of the welfare state model would also have an effect on reducing inequality. We cannot forget that there are numerous theoretical and empirical studies which relate inequality reduction with higher rates of potential economic growth in the long term. Even the IMF recognizes that economic growth and equity are the two sides of the same coin (Berg and Ostry, 2011; Ostry, and Tsangarides Berg, 2014).

III- Conclusions.

The current austerity and fiscal consolidation policies are increasing inequality in most European countries. Fiscal consolidation policy is not only decreasing domestic demand but it is contributing to generate a more regressive distribution of income and wealth. This paper proposes a change of direction in the current economic policy, especially, in Europe. This economic policy strategy should be based on third pillars: 1) encouraging domestic aggregate demand based on the economic growth in real wages 2) a new role of income policy and 3) the consolidation and improvement of the welfare state, with a consequent reduction in inequality, which is crucial, to guarantee a long-term economic growth.

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