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Income Inequalities, Public Debt And Social Cohesion: A Postkeynesian-Institutional Approach

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Abstract

This paper aims at discussing the links existing between the increasing income inequality on the global scale and the processes of financialization, with particular reference to the increase of public debt. It will be argued that i) the increase of income inequality reduces the rate of growth and contribute to the explosion of public debt; ii) the increase of public debt involves a redistribution of the fiscal burden at the expense of workers, thus fuelling income inequalities.

Keywords: distributive justice, income inequality, public debt, social order

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1 – Introduction

Two basic features characterize contemporary capitalism on the global scale: the increase of inequality of income distribution and the explosion of public debt. The dominant view supports the idea that income inequality fosters economic growth, mainly because it stimulates effort and, therefore, increases output to the benefit of low-income families. So-called trickle-down economics is still at the basis of this thesis, which falls within supply-side economics. On economic policy grounds it is maintained that "structural reforms" are needed, mainly via labour market deregulation. Moreover, it is a widespread conviction that the increase of public debt depends on the increase in public spending and that policies designed to reduce public debt by cutting public spending are beneficial for economic growth (Giavazzi and Pagano, 1996; Alesina and Perotti, 1995, 1997; Alesina and Ardagna, 1998, 2010).
PostKeynesian scholars support the opposite view. Increasing income inequality reduces the rate of growth because it negatively affects the dynamics of aggregate demand. In this theoretical framework, it is stressed that public debt to GDP increases because of the recessionary effects of austerity policies. On the economic policy plane, it is stressed here that an increase in net public expenditure is necessary in order to reduce income inequality and sustain aggregate demand.
While these issues have been the object of a widespread debate, little attention has been devoted to the links existing between increasing income inequality and the dynamics of public debt. This paper aims at discussing the links existing between the growing income inequality on the global scale and the processes of financialization, with particular reference to the increase in public debt. This issue will be dealt with in a PostKeynesian-Institutional framework. It will be argued that i) the increase of income inequality in most OECD countries is a major cause of the explosion of public debt, ii) the increase of public debt involves a redistribution of income to the benefit of rentiers, via the redistribution of the tax burden. An argument drawn from the Institutional theoretical framework is also considered. Based on O'Connor's view that a capitalist State must reach two objectives – namely, to promote capital accumulation and to 'legitimate' the existing social order – it will be shown that increasing inequality generates increased public debt also because it pushes the Government to increase unproductive public spending for the maintenance of public order and social cohesion.
The exposition is organized as follows. Section 2 deals with the links existing between increasing income inequality and public debt; in section 3 an analysis of the effects of increasing public debt on income distribution is provided, and section 4 concludes.

3 – Income inequality and public debt

Capitalist economies are characterised by increasing income inequality and growing public debt. OECD reports that the Gini index, the index most commonly used to measure the degree of income inequality, has risen in all industrialized countries in last thirty years[1]. Figures 1a and 1b describe this dynamics with reference to the path of the Gini index on a global scale.

[1] http://www.oecd.org/social/Focus-Inequality-and-Growth-2014.pdf.

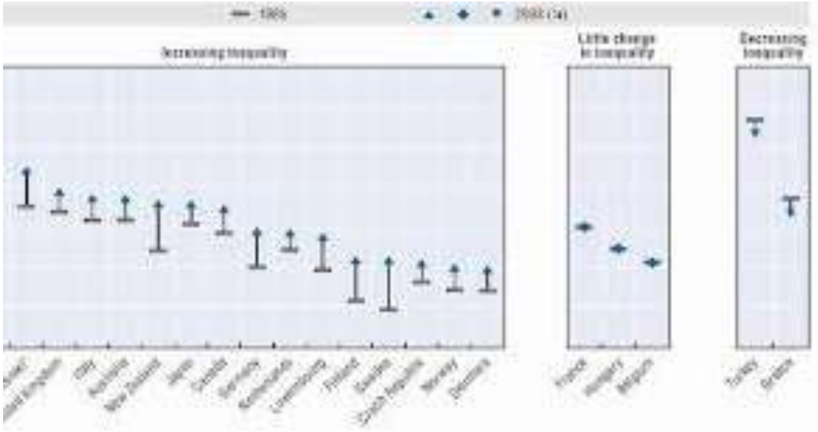

Figure 1a: the dynamics of income distribution in OECD countries (Source: OECD 2013)

Figure 1a shows that the Gini index increased *in all OECD countries*, although with different paths imputed to the specificity of the Institutional contexts. One should observe that the increase of inequality differs among countries and that this phenomenon is less evident, in particular, in the Scandinavian countries, where the Welfare State is stronger and precariuosness is lower than the European average.
Figure 1b shows the path of the Gini index in most OECD countries. Importantly, as the IMF reports, wealth inequality is higher than income inequality in all OECD countries.

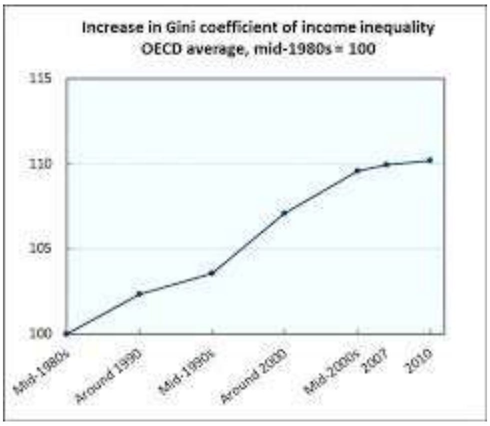

Figure 1b: the dynamics of income distribution in OECD countries – median (Source: OECD 2013)

As widely recognized, the following factors trigger the increase of income inequalities on a global scale:
1. Globalization, insofar as it is a mechanism generating competition among countries in order to attract investment via wage moderation;
2. Policies of labour market deregulation, combined with the dramatic decline of union density, reduce workers' bargaining power and, as a consequence, both direct and indirect wages, involving a reduction of Welfare services.
3. Financialization, being accompanied by a reduction in the investment growth rate, leads to a rise in the unemployment rate.
<u>More generally, income inequalities increased when the neo-liberal agenda become the basis of the economic policies of most OECD countries.</u>

The rising inequalities occur in a scenario marked by the constant increase in public debt[2]. Recent research by the Max Plank Institute shows that from 1970 to 2011 the public debt/GDP ratio rose exponentially *in all OECD countries* (See. Streek, 2013), as shown in Fig.2.

Figure 2: the path of public debt in OECD countries (Source: OCSE 2013)

The traditional explanation[3] of this phenomenon is related to the supposed tendency of democratic countries to "live above their means", especially on account of the growing Welfare spending, imputed to the growth in democratic participation: the so-called *democratic failure*. In actual fact, this is a clearly false argument which, at the most, may have applied in the stage of the State's so-called fiscal crisis, when political power had the double role of facilitating capitalist accumulation and of legitimizing it, by means of public spending hikes and redistribution policies[4].
Today this argument can be easily rejected by looking at the drop in voter turnout at the national elections and the reduction in union density. If anything, today it is the *deficit* of democracy and the great drop in working class bargaining power that generates the explosion of debt: there is copious evidence to show that the worsening of income distribution has negative effects on the growth rate, generating constant increases in the public debt/GDP ratio[5].
The dominant view is also based on the conviction that significant income inequality stimulates economic growth via the so-called trickle down effect. This effect rests on the (questionable) assumption that wealthy people are rich because they are more productive than low-income workers, and a policy of redistribution to their benefit generates higher average labour productivity,

[2] Cf. Tsakalatos and Lacksos (2013).
[3] See the pioneering study by J. Buchanan, *Public principles of public debt* del 1958.
[4] Cf. J.O'Connor (2002 [1976]).
[5] Of the copious literature on this issue, see in particular Stiglitz (2013).

a consequent rise in economic growth and the *possibility* that low-income workers may gain from this. Two main criticisms are in order: *i)* wealthy people may be rich because of hereditary transmission of wealth, quite independently of their merit and hence of their productivity; *ii)* the link between economic growth and redistribution of wealth to the benefit of low-income households is not a logical necessity. It basically depends on political choice and, in this theoretical context, redistribution policies cannot be justified because they promote economic growth, but for *extra-economic* arguments (such as the need to preserve social cohesion or the Government's desire to expand its electoral support). Moreover, in the Neoclassical approach, it is also argued that the reduction of income inequality discourages effort thus reducing the rate of growth also at the expense of low income workers. Finally, it is a widespread conviction, in this theoretical approach, that the demand for social justice is fuelled by *envy* and that, since this is essentially a non-moral motive, the Government should not pander to this demand. A more radical position, supported, among others, by Mankiw (2014), is that wealth inequality can be a *moral* problem, but it *is not an economic problem.*

By contrast, it can be argued that the increase of income inequality reduces the growth rate for two main reasons which involve both aggregate demand and the path of labour productivity.

a) On the demand side. The reduction of the labour share involves a decline of consumption and, for a given level of investment, a consequent decline of aggregate demand and the rate of growth. This effect is amplified by the fact that the propensity to consume on the part of low-income households tends to be higher than that of high-income households[6].

b) On the supply side. The reduction of the labour share encourages firms to compete via wage cutting and, as a result, there is a reduction of innovation and the growth rate of labour productivity falls (v. Dutt, 2012). The wage cuts, combined with precarious jobs, also tends to reduce the growth rate of labour productivity because, due to the competition *among workers*, it has a negative effect on economies of team production (Forges Davanzati and Salvatore, 2012).

Clearly, while the wage moderation currently in force can generate growth through the higher volume of exports for a single country, it cannot have this effect on a global scale, since international trade is a zero sum game (cfr. Onaran and Galanis, 2013). Moreover, as Seguino (2007) emphasises, wage moderation and the tendency for firms to compete via cost cutting and not via innovation, is implied by "globalization", insofar as it allows full mobility of capital and therefore pushes Governments to try to attract investment by means of policies aiming at reducing workers' bargaining power. The author concludes that, due to this mechanism, the productivity growth on a global scale tends to fall over time. One should also observe that the decline of the labour share may boost the labour supply in the underground economy, involving a decline of the growth rate.

The main channels through which increased inequalities contribute to higher debt are the following:

i) since the growth of inequalities is also associated to the increase in unemployment, this generates higher public spending due to the so-called automatic stabilizers (first and foremost, unemployment benefits). The increase of social spending for unemployment benefits – consequent to the increasing unemployment rates – can be explained considering that the Governments pursue due potentially conflicting aims: promoting capital accumulation and preserving the 'legitimation' of the existing social order (O' Connor, 2002 [1976]);

ii) the growth of inequalities is associated to an increase in the political power of capital resulting in tax cuts on profits and a reduction of the tax revenue from this source (Streek, 2013)[7]. The consequent increase of taxation on low-income households reduces consumption both directly and indirectly, insofar as this tends to stimulate precautionary savings as a result of expected further taxation. Consumption declines and so does aggregate demand and the rate of growth. The shift of political power from workers to capitalists (and rentiers) affects economic policy also in the direction of the reduction of social spending and privatizations. Insofar as welfare services (health

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[6] Cf., among others, Kaldor (1957) and Bhaduri and Marglin (1990).

[7] To this one can add the increase in military spending on a global scale (cfr. Harvey, 2003).

and education above all) contribute to increase labour productivity growth, this strategy proves to be inefficacious for both generating economic growth and decreasing the public debt/GDP ratio. Moreover, particularly in the case of the European Monetary Union, policies of fiscal consolidation combined with structural reforms (labour market deregulation above all) – aimed at increasing net exports via wage moderation and the reduction of import via the reduction of domestic demand – negatively impacted on European GDP, thus generating an increase of public debt/GDP ratio;

iii) the growth of inequalities makes it necessary to increase spending on controlling conflict (see below);

iv) since the growth of inequalities contributes to lowering the growth rate, and therefore raising the risk of insolvency, this implies the increase of the interest rate on government bonds[8]. Furthermore, as pointed out especially by Salti (2011), in most OECD countries government bonds are held by residents with high incomes and the measures designed to limit expansion of the debt tend to generate redistributive effects to the detriment of low income earners[9]. In addition, there is the empirical observation that interest rates on government bonds tend to be higher for residents than for foreign investors (Salti, 2011);

v) the growth of inequalities, associated with short term jobs and with gender and racial discrimination, produces a drop in the birth-rate and therefore keeps pension spending high (v. Crounch, 2013, pp.127 ss.).

vi) The increase of income inequality tends to reduce the rate of growth also because it is associated to the decline of population growth, and the consequent reduction of productivity deriving, in turn, from the higher average age of the workforce. This occurs because as income inequalities increase, the consequent decrease of wages involves a decline of the birth rate[10], which, in turn, generates a reduction of potential GDP growth and the decline of productivity growth consequent to the ageing of the workforce.

vii) Based on the so-called Kaldor-Veerdorn Law, the increase of income inequality, insofar as it is associated with the decline of the wage share and consumption, reduces investments, the rate of growth of labour productivity and, hence, the rate of economic growth. This effect is amplified by the fact that the decline of consumption, insofar as it reduces firms' profits reducing their solvency towards the banking sector, incentives banks to restrict their credit supply. Moreover, the decline of wages (combined with precarious jobs) stimulates workers to save for precautionary motive. This reduces aggregate demand, via the drop of consumption, and the rate of growth.

viii) As income inequality grows, the political power of the dominant classes increases and this affects the distribution of taxation, giving rise to an increase of taxes on low-income households. This contributes to a further increase of income inequality and increase of savings devoted to pay expected growth of taxes.

iX) Dabla-Norris et al (2015) reports that the increase in equality involves a decrease of health care on the part of the low-income households, the consequent reduction of the average age of the poor and the increase of the average age of the rich. A further effect should be taken into account. The increase of income inequality, insofar as it reduces aggregate demand, reduces monetary profits in the sector producing consumption goods. As a result, the demand for investment goods reduces too. As profits decline, firms' solvency reduces and banks tend to react reducing their credit supply. In other words, *income inequality can cause credit restriction.* Moreover, the reduction of firms'

[8] For a concise reconstruction of these effects, see J. Gladney, *La bassa crescita fa aumentare il debito pubblico,* "Keynesblog", 6 maggio 2013. The relation between economic growth and public debt trends is the topic of widespread debate revolving around the identification of causal links (i.e. whether it is low growth that "causes" the debt to rise or vice versa). In this paper, we simply refer readers to Stiglitz (2014).

[9] The author attributes this effect to the rise in the inflation rate (and the consequent reduction of real wages) resulting from the increase in public debt. In contrast, the interpretation proposed here attributes the redistributive effects to the increase in debt in proportion to the redistribution of the tax burden to at the expense of Labour.

[10] One need to clarify that this effect is not Malthusian, alhough apparently it would seem. The link between wage dynamics and the birth rate even holds in specific social and institutional settings. This is to say that differently from Malthus's view, there is nothing of purely *natural* in labour reproduction.

solvency stimulates banks to speculative activities (Mazzucato and Wyay, 2015). The increasing speculative activity on the part of banks, in turn, is a key variable for explaining the decline of investment and innovation in most OECD countries, with the consequent slow rate of growth (Mazzucato and Wray, 2015). Furthermore, since credit restriction is assumed to depend on banks undercapitalization, public spending is assumed to be necessary in order to "save" the banking sector. As a consequence, public debt increases.

This issue requires a more detailed discussion. The dominant view is based on the conviction that phenomena of credit crunch depend on the 'liquidity risk' on the part of the banking sector (Beltratti and Shulz, 2012). This is to say that – according to this view – banks restrict credit because they are undercapitalized. Importantly, this line of research assumes that banks undercapitalitazion is a given or the starting point of the analysis. In other word, the question of *why* they are undercapitalized falls outside the aim of these papers. A further argument is added, meaning that banks undercapitalization and the consequent restriction of credit supply would depend on bad management (Brummer, 2009).

Public intervention to "save" the banking sector (particularly in the Eurozone) has been legitimated by these theoretical approach, in sharp contrast with what one could consider a liberal agenda. In a liberal theoretical and political view, public intervention is almost always a source of inefficiency (apart the case of externalities and 'market failures') and the free operation of the market force – even in the credit market – is assumed to produce the most efficient outcome. In a sense, market operates as a Darwinian institution, so that the less efficient agents (in this case, the less efficient banks) fail, thus prizing the most efficient firms and as a consequence generating the highest rate of growth. By contrast, neo-liberalism as a political practice is based on a massive public intervention, mainly for redistributive purposes (at the benefits of capitalists and rentiers).

As public spending in the credit market contributed to increase public debt, the argument wich supported the necessity of public spending is questionable. In a PostKeynesian framework, money supply is endogenous and demand-driven (cf. Graziani, 2003). According to the endogenous money view, the banking sector *as a whole* cannot be logically undercapitalised, *provided that the central bank fully accommodate their demand for credit money* (cf. Forges Davanzati and Traficante, 2018). In fact, in this theoretical context (and as a matter of fact), the banking sector create credit money *ex-nihilo*, so that money is not a scares resource. Banks undercapitalization is therefore a *political* problem, not a technical issue. This particularly applies to the euro area, where the ECB can only control that the European banks do not risk default (i.e. the so-called "Risk Control Framework"), while in the case of an effectual risk of default it is the Government which must intervene (the so-called bail-in). Starting from January 2016 - Bank Resolution Recovery Directive or BRRD - the bail-out option is in operation, meaning that investors of an individual bank are the responsible for its capitalization.

Importantly, increasing inequalities produce increasing public debt because of their deflationary effects. Insofar as inequalities also occur in the form of wage moderation, and wage moderation is a (con)cause of deflation, the reduction of the inflation rate increases the *real* interest rate on Government bonds.

If one considers the growth of inequalities on a global scale, and the consequent increase of international labour migrations, one reaches the conclusion that – even for this effect – income inequality is associated with high and increasing public debt. This is due to the fact that the Government proves to block immigration via regulation of labour mobility (which is in sharp contrast with the fundamental principles of liberal philosophy) and the repression. Repression is costly, involving increasing of public spending for "unproductive" activities and involving, as a consequence, negative impacts on the dynamics of public debt.

It can also be argued that inequalities are an incentive to financialization also due to the growing use of consumer credit. The lowering of real wages, in fact, means that the only way poorer families are able to guarantee themselves a subsistence level of consumption is by getting into debt with the banking system. Faced with this dynamics, it can be seen the area that is most bearing the brunt of

the current crisis is the Eurozone. The crisis of the European Monetary Union can be thought to depend on the fact that it is the area where, in recent decades, income distribution has worsened most and where policies of stripping the welfare state and imposing temporary employment contracts have been implemented most intensely. .
As can be seen in Figure 3, sourced from Eurostat (latest figures), distributive inequalities measured on the Gini index are greater in the outlying countries of the Eurozone, and, at least in the case in question, the European countries with higher distributive inequalities have a lower growth rate[11].

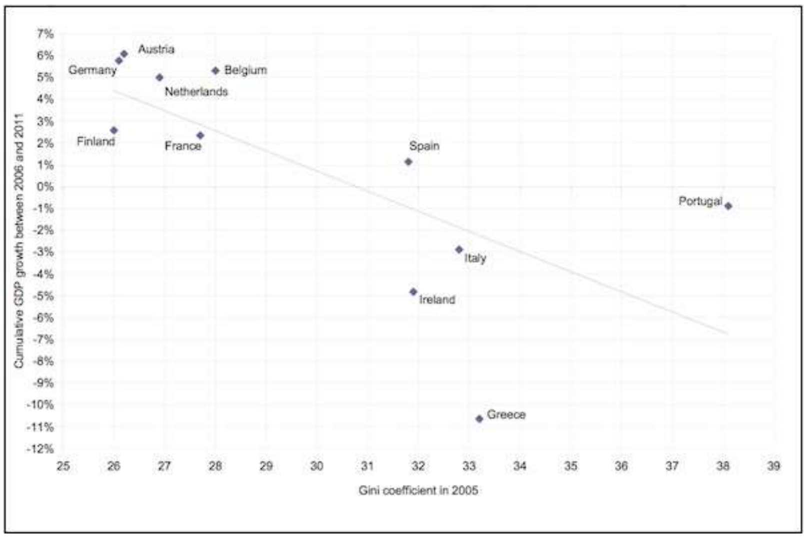

Figure 3: income distribution and economic growth in the Eurozone (Source: Eurostat: 2013)

3 – The redistributive effects of the increase of public debt

As public debt increases the Government must obtain resources in order to reimburse it. On the assumption that the economy is populated by three macro-agents (i.e. the banking sector, firms and workers), and that monetization of public debt is forbidden, the Government distributes the fiscal burden on the basis of this logic. Moreover, considering that the Government is interested in gaining electoral support, and that this crucially depends on the dynamics of pro-capita incomes, taxation on profits would be detrimental insofar as firms can react by delocalizing or postponing investment (the so-called capital strike). The reduction of investment, in turn, reduces the rate of growth. Moreover, if the banking sector is the owner of State bonds, it is not advantageous to tax it insofar as it is the main creditor of the State. Accordingly, workers are the sole agents who can be taxed. More generally, as stated by the so-called power resources theory (cf. Korpi, 1989), the bargaining power of capitalists and workers in the political arena crucially depends on their bargaining power in the labour market. As a result, as the unemployment rate increases, unions experience a decline in their power to influence economic policy.
Increased income inequality also produces an increase in public spending on controlling conflict. This occurs because as wages decline and unemployment grows, crimes tend to increase, thus involving a growth of unproductive expenditure and of unproductive labour. Notice that a high

[11]V. http://www.socialeurope.eu/2012/09/income-inequality-in-the-eurozone-what-are-the-effects-on-growth/

unemployment rate is associated with a double effect: *i)* the increase in the number of discouraged workers, normally related to high-income households (due to the possibility of getting income from accumulated savings); *ii)* the rise in economic crimes, which normally affects the low-income unemployed, according to an effect known as the age-crime curve in which people over forty tend to commit fewer crimes (cf. Farrington, 1986).

Evidence shows that countries which experience high income inequality also experience high rates of imprisonment, with particular reference to property crimes. This involves increased public spending on suppressing conflict and, at the same time, an increase of so-called guard labour (cf. Bowles and Gintis, 2007). Guard labour does not contribute to economic growth and, in this respect, it can be seen as *unproductive labour*. More generally, as Dabla-Norris et al (2015) point out, in a condition of high inequality and social immobility individuals have an incentive to resort to favoured treatment and protection, involving corruption and nepotism. The main problem resulting from this is the erosion of social cohesion and the decline of confidence in the Institutions.

The arguments proposed here describe a vicious circle which is based on increasing income inequality, reduction of the rate of growth, increased public debt and reduced employment, increased crime and higher public spending to maintain public order.

<u>It is relevant to consider that – in line with the arguments proposed here – the criterion of public debt sustainability is radically different from that proposed in the mainstream view. The conventional view supports the idea that public debt is sustainable if the rate of growth is higher than the interest rate. This is a mere technical solution, which does not consider the class nature of economic policy and the institutional setting which is at the basis of capital reproduction.</u>

<u>As a matter of fact, sustainability involves institutional and social variables. In particular, one can argue that public debt can expand until the repayment of creditors does not require an increase of taxation of labour which reduce disposable real wages below their subsistence level in a long-run perspective. The rationale for this conclusion is that – in line with O'Connor's view – the Government must guarantee the condition for social cohesion, and the maintenance of social cohesion is a prerequisite for capital accumulation.</u>

In formal terms:

$$\Delta T \Rightarrow \Delta w/\Delta t = 0 \qquad [1],$$

<u>Where T is taxation on labour, w is the real wage, t is time. Condition 1) establishes that public debt sustainability is such that the amount of taxes (on labour) necessary to reimburse the creditors must guarantee (at least) that wages do not persistently fall below their subsistence level.</u>

4 – Concluding remarks

This paper dealt with the links between increasing income inequality and the growth of public debt on the global scale. It has been shown, based on evidence, that the increase in income inequality reduces the rate of growth, both because of the reduction of aggregate demand and the reduction of the rate of growth of labour productivity. Moreover, the increase in public debt involves a redistribution of taxation at the expense of workers, fostering income inequality, and income inequality, in turn, is associated with a rising crime-rate and the consequent necessity, for the government, to increase public spending on the maintenance of social order.

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