

AN EQUALITARIAN RECOVERY FOR THE EUROPEAN UNION



Rémi BAZILLIER

Member of FEPS Next Left Focus Group, FEPS Scientific Council and Assistant Professor at the University of Orléans, France

CONTRIBUTIONS

We observed in the last years a renewed interest for income inequalities. Different reasons can explain this move. The long-term trend of declining inequalities observed after the Second World War has reversed since the beginning of the eighties. A debate in the 90's and the 2000's focused on the relative influence of globalization on such break in the long-term tendency. The boom of top incomes has been especially strong in the US and in some European countries. In the context of financial crisis, these high incomes have strongly criticized by an increasing share of public opinion, especially so in countries where they were concentrated in the financial sector. The *indignados* movement in Spain put a strong emphasis on this topic of inequalities. In France, the claim for "*Egalité*" was at the core of the Presidential campaign of François Hollande. In the US, the *99% movement* also directly focuses on the social consequence of this growing share of income hold by the top 1%. It indirectly influenced some political propositions such as the Buffet rule and the general priorities of the President Obama in the current negotiations about debt and fiscal policy.

But this topic of inequalities did not reach the front page of the newspaper only because inequalities are less bearable in times of crisis. It also follows recent advances in research showing a possible causal link from inequality to financial instability. Rajan (2010) in his influential book *Fault line* considered that these growing inequalities explained an increased political pressure to facilitate the access to credit: "*the political response to rising inequalities – whether carefully planned or an unpremeditated reaction*



to consistent demands – was to expand lending to households, especially low income ones. The benefits – growing consumption and more jobs – were immediate, whereas paying the inevitable bill could be postponed in the future” (p. 8). Kumhof and Ranciere (2011) supported this assumption by developing a model explaining an increase in leverage by the rising inequalities, and linking this increased leverage with the probability of a crisis. Acemoglu (2011) proposed an alternative hypothesis. The strong increase in credit supply was mainly explained by financial liberalization, which in turns, explained the growing level of inequalities. This topic is also explored by Atkinson and Morelli (2011) who highlighted the influence of the institutional context to explain such patterns.

The underlying logic is quite simple. **When wage compression is high, poorest households have two options.** They can adjust their living standards by contracting their level of consumptions. Or they can sustain their living standards by increasing their level of borrowing. This latter case was observed in most developed countries, especially in the US. It was facilitated by the deregulation of the financial system. Financial innovations were indeed largely used to lend to poor households who were traditionally excluded from the credit market (the famous *subprimes* in the US). The poorest therefore contributed to the increase of credit demand. And in the same time, the richest, whose income had exploded, were looking for new financial investment possibilities. It contributes to the increase of credit supply. This leads to a boom of private debt which was indeed not sustainable in the long run. In the international context, a similar logic can be applied to explain current account imbalances.

These researches mostly focus on the American case, with a strong focus on the explanation of the *subprimes* crisis which was the starting point of the Great Recession. But a quick look to European data shows that we also observed a boom of private debt in a significant number of European countries. For instance, in France, the households' debt has increased from 52.5% in 2002 to 82.5% of their disposable income in 2012. The huge impact of the crisis in Spain was not explained by a problem of public debt. This country had a budget surplus before the crisis and one of the lowest levels of debt in Europe. But private debt was huge, also in a context of growing inequalities. Current rise in inequalities and private debt is not a singularity of the US, neither of anglo-saxon countries. It may have increased the vulnerability of European countries also. The Spanish case is a typical example of a transfer from private debt to the public sector. The following figure shows the relation between the increase in deficit between 2007 and 2009 and the income distribution. In average, countries with higher levels of inequalities tend also to be the ones that have known the highest increase in public deficit.

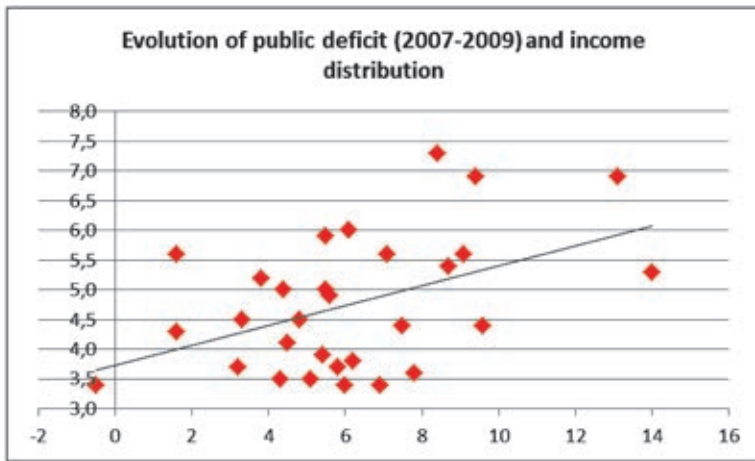


Figure 1 – Income distribution: income quintile share ratio (source Eurostat). Public deficit (source Eurostat)

Of course, other factors may have influenced such relation and this figure does not necessarily imply a causal relation from inequality to evolutions of public debt. But these exploratory statistics clearly show that this issue of inequalities may also bring an additional dimension to the current debt crisis in Europe.

INEQUALITIES CAN SLOW DOWN THE ECONOMIC RECOVERY

Joe Stiglitz, in a recent Op-Ed to the New York Times, argues that inequality is holding back the recovery. Inequalities can (i) be an (indirect) factor of crisis, (ii) be reinforced by the current crisis and also (iii) hold back the recovery. The first reason is that the middle class is too small to support enough consumers spending, which could drive a new dynamic of economic growth. The second reason is that stagnation of income for the majority of the population restricts the capacity to invest in the future, by educating themselves and their children or by starting new businesses. The third reason is that the weakness of the middle class holds back tax receipts. Due to the lack of progressivity in the fiscal system, they are the one that contributes the more to public budget. The fourth reason is that it creates the precondition of the next crisis as it is associated with more violent boom-and-bust cycles. The argument was made for the US but several dimensions can be also applied to European countries. The size of the middle class has squeezed in most European countries, and fiscal



progressivity is very low in numerous countries (in the South but also in France). A similar argument can therefore be made for the European Union. Tackling inequalities must be the core of a European strategy aiming at holding back the current crisis.

TACKLING INEQUALITIES THROUGH A “FISCAL REVOLUTION”

French economists Piketty, Saez and Landais called for a “fiscal revolution” in France to restore progressivity in the fiscal system. They show how the middle class assumed most of the fiscal charge mainly due to the capacity of the richest to reduce their tax payments through fiscal optimization. The specific structure of income taxation in France reinforces this unfair observation. They call for a complete change of the fiscal system in order to ensure both equality and progressivity in the taxation. Of course, each national case is different and this analysis cannot be extended globally to the European Union. But we observed a general trend of decline in the top income marginal rate all over Europe. The underlying fiscal competition between European countries explains part of this dynamic. As top income workers are also more mobile, States were more reluctant to tax them and transfer a significant part of this taxation to consumers mainly. The problem of consumption taxes is that the poorest pay a larger share of their income than the others and therefore they tend to reinforce income inequalities. The underlying idea was also that encouraging the wealthiest in the society it would enhance economic efficiency and therefore economic growth. Recent researches in economics tend to refute this idea, showing for instance how the development of the finance sector and the boom of wages in that sector may have adverse effects beyond a certain level. Taxing more the richest should not be seen as a leftist conservative policy but instead as a progressive modern policy in favor of efficiency, stability and development. Increasing the marginal level of taxation for the wealthiest will not weaken economic efficiency and can be promoted as a factor of both equality and efficiency. Piketty, Saez and Santcheva (2011) or Diamond and Saez (2011) calculated the optimal top marginal tax rates and found rates far higher than those which are currently practiced in all European countries. There is a space for more fiscal redistribution. And income inequality is not the only aspect. Wealth inequalities have also strongly increased in the last decades, calling for new taxes on capital.

CONTRIBUTIONS

NOTHING WILL BE POSSIBLE WITHOUT A EUROPEAN FISCAL HARMONIZATION

The declining of capital taxation and more generally of top income taxation can be explained by the strategy of countries trying to attract capital and top managers through a low taxation. It creates the condition of fiscal dumping which alienates every national effort to increase tax receipts. Despite strong national oppositions of some countries, it is

time to relaunch this debate of fiscal harmonization. It is not only a question of fairness, but also of efficiency. A more equal distribution of income is a factor of economic stability and development in the long run. Countries should be pushed to reduce income inequality through more redistributive fiscal policy. It implies to reverse this tendency of national policies aiming at increasing the level of price competitiveness through decreasing taxation at the expense of other European countries. In times where European Union is seeking for common policy goals, a coordinated strategy favoring income equality can be a mobilizing goal for European citizens.

CONTRIBUTIONS

RÉMI BAZILLIER

Is an assistant professor at the University of Orléans and a research affiliate at the Laboratoire d'Economie d'Orléans (LEO-CNRS). His research focuses on development and labour economics. He received his Ph.D. in Economics from the University of Paris I Panthéon-Sorbonne in 2007. He wrote several papers published in international peer-reviewed and recently published a book on the linkages between Labour and Sustainable development ("Le travail, grand oublié du développement durable", col. eDDen, ed. Le Cavalier Bleu, Sept. 2011, 224p).

