CLSRN

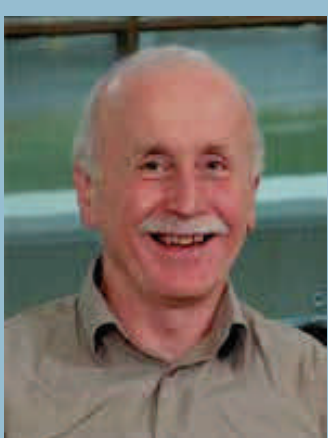
Labour Market Matters

Volume 5, Issue 3 March 2013

Special points of interest:

- Study finds that unbalanced economic growth and income inequality are drivers of volatility and crisis in the global financial markets.
- Three key policy options to combat growing income inequality including: widening of tax base, promoting better corporate governance and ensuring access to health and educational programs explored in new study.

"Osberg argues that when income growth rates are unbalanced, one instability leads to another. Unbalanced growth in incomes means that financial assets are accumulated at the top of the income distribution while liabilities accumulate at the bottom"



Lars Osberg (Dalhousie University)

Unbalanced Growth drives Income Inequality, Volatility and Economic Crisis

When the Dow Jones stock index hit an all-time high on March 5, 2013, some commentators said that this surge in share prices indicated a breaking of the psychological barrier faced by markets since the Great Recession. But others noted just how volatile financial markets have been – the Dow Jones index fell by half during 2008-2009, before starting its recent upward run. What happens on Wall Street, does not necessarily reflect what is happening on Main Street, and a study entitled ***"Increasing Inequality is Unbalanced Growth: Evidence from North America"*** (CLSRN Working Paper no. 102) by CLSRN affiliate Lars Osberg (Dalhousie University) may have an explanation.

Since the 1980s, in both Canada and the U.S., the rising share of the top 1% has been driven by the fact that their incomes have grown strongly, but the real incomes of most other people have stagnated. Osberg argues that when income growth rates are unbalanced, one instability leads to another. Unbalanced growth in incomes means that financial assets are accumulated at the top of the income distribution while liabilities accumulate at the bottom – but rising household debts and stagnant incomes for the middle class produce a financial house of cards. When the inevitable crisis occurs, rising unemployment then swells government deficits, creating new instabilities of public debt.

Osberg finds that while the income of the top 1% grew at a compound real rate of 4.03% annually between 1980 and 2007 in the U.S., the real incomes of the bottom of the income distribution have stayed virtually constant. Indeed, expressed in inflation-adjusted year 2010 dollars, the 20th percentile of the U.S. household income distribution received $20,000 in 2010 compared to $20,215 in 1990 and $19,593 in 1979. The 40th percentile got $38,043 in 2010 and $38,226 in 1990. Median household income in the U.S. was virtually unchanged – rising only 2%, from $48, 423 to $49,445 in the twenty years from 1990 to 2010. By contrast, the top 1/10th of 1% had average incomes of $6.3 Million in 2005, $6.8M in 2006 and $7.5M in 2007.

The income gains of affluent households have to be either consumed or saved. Osberg notes that the rapid growth of the financial sector in the last few decades is partly fuelled by a "recycling" of the additional savings of upper income households back to the rest of the population through financial markets. Ever growing incomes at the top produce ever increasing flows of loanable funds which (after complex financial intermediation) are ultimately borrowed by middle income households. But although the middle class can borrow to keep up with escalating consumption norms for a while, papering over stagnant incomes with greater and greater debt-loads to maintain an illusory lifestyle can only work for so long. Eventually there is a crisis in financial markets and a recession in the real economy. The two major economic crises over the past century—the Great Depression of the 1930s and the Great Recession of 2008 – were both preceded by a sharp increase in wealth and income inequality, and a similarly unsustainable sharp increase in debt-to-income ratios among lower- and middle-income households.

Osberg argues that if the large expenditure cuts to social welfare programs that are currently on the table in U.S. budget discussions are not averted, the long-term relative impoverishment of middle and lower classes in the U.S. will be accentuated, and this would slow even more the growth of their real incomes. Slower real income growth at the bottom of the income distribution, and continued increases at the top, will then accentuate rising income inequality, thereby reinforcing the imbalances which initially helped create financial instability and crisis in the first place.

The rich are getting richer in Canada: what should government do?

A poll published by the National Post in 2012[1] found that more than three-quarters of Canadians think that Canada suffers from an income gap where the rich are getting too rich and the poor are getting too poor. In a paper entitled ***"Top Income Shares in Canada: Recent Trends and Policy Implications"*** (CLSRN Working Paper no. 103), CLSRN affiliate Michael R. Veall (McMaster University) confirms that the gap is growing. He finds that between 1986 and 2009, the average real income of the top 0.01% of all taxfilers in Canada increased by about 150%, in contrast to an increase of only 19% for those in the bottom nine-tenths of the income distribution.

Michael Veall (McMaster University)

Veall does not find a singular explanation for this income surge among the super-rich, but considers such possibilities as globalization and that technological change has favoured high-income individuals over those with low income. He also believes that that some of the surge is likely due to inappropriate corporate governance that has led to excessive executive compensation and the overuse of options.

Without being able to pinpoint the exact cause of the income surge, but still faced with clear evidence of growing income inequality in Canada, Veall outlines three policy priorities aimed to increase overall economic efficiency to benefit all Canadians.

First, with respect to taxation, Veall argues that changes must balance the possibility that a top-income surge is a requirement to retain talent or create economic incentives that can generate innovation with concerns that income inequality may promote social division and the concentration of political power. There is also the question as to which kind of tax changes on top-end incomes will generate more tax revenue. Based upon his review of the available evidence, he believes that there is some risk that increases in the top marginal tax rate may yield only small revenue gains or even revenue losses. Given that, he suggests that the most productive path may be to concentrate immediate efforts toward broadening the personal income tax base by eliminating or reforming those special tax preferences that tend to benefit those in the upper end of the income distribution, He mentions Registered Education Plans, the Labour Sponsored Venture Capital Corporation program and the Employee Stock Option Deduction as a few candidates for consideration.

> ***"[B]etween 1986 and 2009, the average real income of the top 0.01% of all taxfilers in Canada increased by about 150%, in contrast to an increase of only 19% for those in the bottom nine-tenths of the income distribution"***

A second policy priority should be corporate governance. There is evidence that Canadian corporations underperform across the board and that this is may be related to the problems associated with poor corporate governance. Indeed, he notes that shareholder democracy is weak in Canada, and notes related evidence that relative to other developed economies, Canada has a higher estimated rate of insider trading. Policies that limit the power of insiders can help promote a more vigorous market for corporate control and hence better management, capital allocation and growth.

Finally, the third policy priority concerns intergenerational immobility, which some evidence links to income inequality. When a high ability child born to lower socioeconomic status has little chance to advance and use her or his talents, or when someone of low ability becomes CEO simply by virtue of being born into the right family, it is not only be seen as unfair, it can lead to a less productive and dynamic economy. While income inequality is growing, Veall notes that estimated Canadian intergenerational mobility is very high by international standards, in particular much higher than that in the United States. He suggests that this high level of intergeneration mobility is linked to the accessibility of health and educational programs in Canada. Given the likely fiscal threats facing Canada in the upcoming years, maintaining accessibility to these programs in order to prevent a rise in inequality of opportunity will be a substantial policy challenge.

[1] Humphreys, Adrian, 'NDP making huge gains as Canada tilts leftward: poll,' *National Post*, May 28, 2012.

Endnotes

Labour Market Matters is a publication of the Canadian Labour Market and Skills Researcher Network (CLSRN). The CLSRN is supported by the Social Science and Humanities Research Council of Canada (SSHRC) under its Strategic Research Clusters program. Opinions expressed in this publication do not necessarily reflect the views of the SSHRC.

Articles in *Labour Market Matters* are written by Vivian Tran - Knowledge Transfer Officer, CLSRN, in collaboration with the researchers whose works are represented. For further inquiries about *Labour Market Matters* or the CLSRN, please visit the CLSRN Website at: http://www.clsrn.econ.ubc.ca or contact Vivian Tran at: Vivian.Tran@ubc.ca