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How Income Inequality Inhibits Economic Growth

By Raghuram Rajan

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To understand how to achieve a sustained recovery from the Great Recession, we need to understand its causes. And identifying causes means starting with the evidence.

Two facts stand out.

First, overall demand for goods and services is much weaker, both in Europe and the United States, than it was in the go-go years before the recession.

Second, most of the economic gains in the United States in recent years have gone to the rich, while the middle class has fallen behind in relative terms. In Europe, concerns about domestic income inequality, though more muted, are compounded by angst about inequality between countries as Germany roars ahead while the southern periphery stalls.

Persuasive explanations of the crisis point to linkages between today's tepid demand

and rising income inequality. Progressive economists argue that the weakening of unions in the United States, together with tax policies favoring the rich, slowed middle-class income growth, while traditional transfer programs were cut back. With incomes stagnant, households were encouraged to borrow, especially against home equity, to maintain consumption.

Rising house prices gave people the illusion that increasing wealth backed their borrowing. But now that house prices have collapsed and credit is unavailable to underwater households, demand has plummeted. The key to recovery, then, is to tax the rich, increase transfers and restore worker incomes by enhancing union bargaining power and raising minimum wages.

This emphasis on anti-worker, pro-rich policies as the recession's primary cause fits less well with events in the European Union. Take, for example, Germany. It reformed labor laws to create more flexibility for employers and did not raise wages rapidly. As a result, Germany seems to be in better economic shape than countries like France and Spain, where labor was better protected.

So consider an alternative explanation. Starting in the early 1970s, advanced economies found it increasingly difficult to grow. Countries like the United States and Britain eventually responded by deregulating their economies.

Greater competition and the adoption of new technologies increased the demand for highly skilled, talented and educated workers doing nonroutine jobs like consulting, and their salaries have increased accordingly.

More routine, formerly well-paying jobs done by the unskilled or the moderately educated were automated or outsourced. So income inequality emerged — not primarily because of policies favoring the rich, but because the liberalized economy favored those equipped to take advantage of it.

The short-sighted political response to the anxieties of those falling behind was to ease their access to credit. Faced with little regulatory restraint, banks overdosed on risky loans. Thus, while differing on the root causes of inequality (at least in the United States), the progressive and alternative narratives agree about its consequences.

The alternative narrative has more to say. Continental Europe did not deregulate as much, and preferred to seek growth in greater economic integration. But the price for protecting workers and firms was slower growth and higher unemployment. And while inequality did not increase as much as in the United States, job prospects were terrible for the young and unemployed, who were left out of the protected system.

The advent of the euro was a seeming boon, because it reduced borrowing costs and allowed countries to create jobs through debt-financed spending. The crisis ended that spending, whether by national governments (Greece), local governments (Spain), the construction sector (Ireland and Spain) or the financial sector (Ireland). Unfortunately, past spending pushed up wages without a commensurate increase in productivity, leaving the heavy spenders indebted and uncompetitive.

The important exception to this pattern is Germany, which was accustomed to low borrowing costs even before it entered the euro zone. Germany had to contend with historically high unemployment stemming from reunification with a sick East Germany. In the euro's initial years, Germany had no option but to reduce worker protections, limit wage increases and reduce pensions as it tried to increase employment. Germany's labor costs fell relative to the rest of the euro zone, and its exports and gross domestic product growth exploded.

The alternative view suggests different remedies. The United States should focus on helping to tailor the education and skills of the people being left behind to the available jobs. This will not be easy or quick, but it beats having corrosively high levels of inequality of opportunity, as well as a large segment of the population dependent on transfers. Rather than paying for any necessary spending by raising tax rates on the rich sky high, which would hurt entrepreneurship, more thoughtful across-the-board tax reform is needed.

For the uncompetitive parts of the euro zone, structural reforms can no longer be postponed. But given the large adjustment needs, it is not politically feasible to do everything, including painful fiscal tightening immediately. Less austerity, while not a sustainable growth strategy, may ease the pain of adjustment.

That, in a nutshell, is the fundamental euro-zone dilemma. The periphery needs financing as it adjusts, while Germany, pointing to the post-euro experience, says that it cannot trust countries to reform once they get the money.

The Germans have been insisting on institutional change — more centralized euro-zone control over periphery banks and government budgets in exchange for expanded access to financing for the periphery. Yet institutional change, despite the euphoria that greeted the latest EU summit, will take time because it requires careful structuring and broader public support.

Europe may be better off with stop-gap measures. If confidence in Italy or Spain deteriorates again, the euro zone may have to resort to the traditional bridge between weak credibility and low-cost financing: a temporary International Monetary Fund-style monitored reform program.

Such programs cannot dispense with the need for government resolve, as Greece's travails demonstrate, and governments hate the implied loss of sovereignty and face. But determined governments, like those of Brazil and India, have negotiated programs in the past that set them on the path to sustained growth.

As a reformed Europe starts growing, parts of it may experience U.S.-style inequality. But growth can provide the resources to address that. Far worse for Europe would be to avoid serious reform and lapse into egalitarian and genteel decline. Japan, not the United States, is the example to avoid.

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