

Does inequality cause crises?

by Michael Roberts

“Inequality is the defining challenge of our time”

President Barack Obama.

It has become a popular view among many economists that rising inequality of wealth and income in the major economies over the last 40 years or so is a major cause of crises (slumps) under capitalism and is certainly the underlying cause of the Great Recession.

Those who support this position include mainstream Nobel prize winners like Joseph Stiglitz, the current Reserve Bank of India governor, Raghuram Rajan and various leftist economists including Marxists.¹ Even the economists of the leading investment banks and financial institutions have warmed to the idea.²

That Wall Street should take up this theme shows that the near-record levels of inequality of income in the major economies is becoming a serious worry for the strategists of capital. They fear a social backlash and/or a breakdown of economic harmony unless this is reversed or at least ameliorated.³

But the argument of many is that inequality is not just a threat to social harmony, but actually damages the capitalist economy and is the main cause of crises.

“Our review of the data, as well as a wealth of research on this matter, leads us to conclude that the current level of income inequality in the US is dampening GDP.” (S&P). Beth Ann Bovino, the chief economist at S&P, commented: “What disturbs me about this recovery — which has been the weakest in 50 years — is how feeble it has been, and we’ve been asking what are the reasons behind it.” She added: “One of the reasons that could explain this pace of very slow growth is higher income inequality. And that also might also explain what happened that led up to the great recession.”

But is this assertion correct? Is (rising?) inequality the main cause of crises and in particular, the Great Recession? More specifically, are we talking about the level of inequality or the change in inequality, are we talking about inequality of wealth or income; and how are we measuring it?

¹ Many economists view not only of left economists of the Keynesian or post-Keynesian variety (too many to mention), but also of Marxists like Richard Wolf or Costas Lapavistas and even some mainstream Nobel prize winners like Joseph Stiglitz (in his book *The price of inequality*) or the current head of the Indian central bank, Raghuram Rajan (as in his book, *Faultlines*). <http://www.chicagobooth.edu/faculty/directory/r/raghuram-g-rajan>. And there have been a host of books arguing that inequality is the cause of all our problems — *The Spirit Level* by Kate Pickett and Richard Wilkinson being one that’s very popular. The varied views on this issue were summed up in a compendium, *Income inequality as a cause of the Great Recession* (<http://gesd.free.fr/treeck12.pdf>).

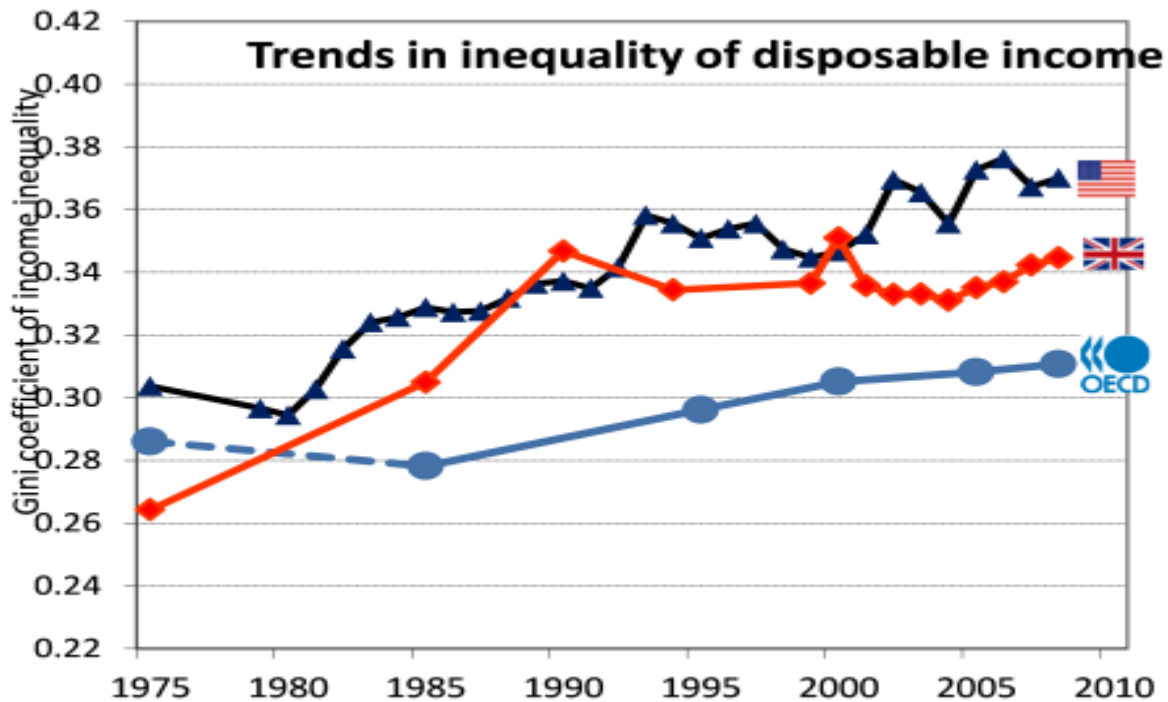
² Now even mainstream economics and financial institutions have taken up the idea. In a new report, economists at Standard & Poor’s, the US credit agency, reckon that unequal distribution in incomes (they don’t refer to wealth as Piketty does) is making it harder for the nation to recover from the recession. (“[How Increasing Inequality is Dampening U.S. Economic Growth, and Possible Ways to Change the Tide.](#)”)

³ Indeed, Piketty’s main worry about his forecast of rising inequality in wealth was the social consequences

WHAT HAS HAPPENED TO INEQUALITY?

It is almost universally accepted across the political spectrum that inequality in America has widened substantially in recent decades.⁴

Two French economists have pioneered the collection of data on top incomes: Emmanuel Saez of the University of California, Berkeley and Thomas Piketty of the Paris School of Economics.⁵



The father of inequality studies, Sir Anthony Atkinson, who should have got the Nobel prize in economics last month, in my opinion, has provided the bulk of the evidence in a judicious way.

In a working paper from the OECD, Kaja Bonesmo Frederiksen (*Income inequality in the European Union*, OECD Working paper 952, 16 April 2012), found that inequality had risen quite substantially since the mid 1980s and that the large gain accruing to the top 10% of earners was the main driver of this inequality. The reason that the top 10% did better was down to a decline in progressive taxation, rising capital gains from property and share ownership, so-called performance related pay, weaker trade unions and globalisation – indeed all the elements of the neo-liberal era.

I did some analysis of the OECD paper and found that the ratio of the share of real disposable income growth going to top 10% over growth in income going to the bottom 10% averaged 2.6 times for the European Union, 9.1 times for the UK and a staggering 21.9 times for the US. That means the top 10% of income earners in the US got 22 times more growth in income than the bottom 10% between the mid-1980s and 2008. Only in France and Greece was income growth for the bottom 10% faster than for the top 10%. The most 'neo-liberal' capitalist economies saw the most unequal

⁴ For instance, a 2011 study by the Organisation for Economic Cooperation and Development (OECD), *Divided We Stand: Why Inequality Keeps Rising*, noted that inequality in America started to increase in the late 1970s and has continued to widen since.

⁵ Their data on many countries is freely available to examine and download on the [World Top Incomes Database](#).

expansion in incomes. While the bottom 10% of income earners in Europe managed just 0.87% annual increase in real disposable income from the mid-1980s to 2008, the top 10% got 2.23% a year. And the top 10% of British income earners did best in the whole of the OECD, experiencing 4.2% average annual growth in real disposable income, while the bottom 10% got only 0.5% annual increase a year over the last 30 years.

In recent years there has been a particular focus on what is sometimes called 'top inequality'. In more colloquial terms, this means focusing on, say, the growing wealth of the top one per cent, or even the top 0.1 per cent, rather than merely the richest 10 per cent.



THE THEORY

But what's the theory behind the idea that (rising) inequality causes crises? Well, at the most abstract, it is a theory of crisis in the distribution of income/value rather than any flaws or contradictions in the production of value.

The most straightforward (crudest?) explanation for the link between inequality and the crisis is what could be called 'the demand gap'. There are many variations of this idea, but at its core is the argument that most households (or perhaps just Americans), suffering from stagnating incomes, could not afford to buy everything they needed. This shortfall in consumption hit corporations, as their markets were limited, and ultimately the economy as a whole⁶.

This is nothing more than the old 'underconsumption' theory of crisis first promoted by Sismondi and continued by Proudhon, Keynes and by the majority of Marxist analysis.⁷

According to this view, most of the increase in wealth in society was going to those at the very top. Yet there is a limit to how much the super-rich can consume. There are only so many yachts they can sail in, or private jets with which they can fly around the world. For this reason, the top 1% or 10% tend to save a high proportion of their money rather than spend it all. It's the argument presented by Obama's advisers.⁸

Robert Reich, who has acted as an adviser to Obama and was secretary of labour under Bill Clinton, has promoted this crude version of the inequality thesis. In his 2012 book *Beyond Outrage*, which is dedicated 'to the Occupiers', he blames the lack of purchasing power for the anemic recovery. 'Because so much income and wealth have gone to the top, America's vast middle class no longer has the purchasing power to keep the economy going – not, at least, without getting deeper and deeper into debt.'

The next stage in the argument is typically that stagnant wage incomes and potential lack of consumer demand led to a massive increase in household debt so that households could sustain spending while financial institutions were encouraged to lend more by the authorities. Although this approach worked well in the short term, over the longer term it led to the inflation of a household over-leverage, a financial bubble and subsequent bust.⁹

⁶ Inequality did not cause the crisis. <http://danielbenami.com/>

⁷ See Bleaney, Shaikh. And of course, see Marx's refutation of this theory of crisis here.

⁸ Obama: 'Now, this kind of inequality – a level that we haven't seen since the Great Depression – hurts us all. When middle-class families can no longer afford to buy the goods and services that businesses are selling, when people are slipping out of the middle class, it drags down the entire economy from top to bottom. America was built on the idea of broad-based prosperity, of strong consumers all across the country. That's why a CEO [chief executive officer] like Henry Ford made it his mission to pay his workers enough so that they could buy the cars he made. It's also why a recent study showed that countries with less inequality tend to have stronger and steadier economic growth over the long run.'

⁹ The credit crunch, the banking collapse and the Great Recession had nothing to do with the classic Marxist explanation of the downward pressure on profitability. It was down to the rapacious speculative lending of the too-big-to-fail banks – the explanation that Marxist Costas Lapavistas has expounded in his new book (*Profiting without producing*) – see my post (<https://thenextrecession.wordpress.com/2013/11/12/the-informal-empire-finance-and-the-mono-cause-of-the-anglo-saxons/>) and Tony Norfield's devastating review of Lapavistas' book (<http://economicsofimperalism.blogspot.co.uk/2014/01/capitalist-production-good-capitalist.html>).

Behind this conclusion is a theoretical analysis that the Great Recession was ultimately the result of rising inequality in the US and elsewhere. The argument goes that the great financial crisis was caused by debt – mostly in the private sector. **As wages were held down in the US, households were forced to borrow more to get mortgages to buy homes or loans to buy cars and maintain their standard of living. They were encouraged to do so by reckless lending from banks even to ‘sub-prime’ borrowers. And as we know, eventually the sheer weight of this debt could not be supported by rising home prices or by the chicken legs of average incomes and the whole house of cards eventually came tumbling down.**

The argument presented by Joseph Stiglitz, Paul Krugman, and now by the S&P, is that the US is a ‘consumer economy’, with 70% of spending by households. So if the rich have most of the money, then spending will slow or fall and we get a crisis through a ‘lack of effective demand’. Well, the actual evidence for a causal connection between rising inequality and consumer spending is very weak. In the period leading up to the Great Recession, consumer spending raced along and so did rising inequality.

This was the message of the best-selling book after Piketty’s *Capital* in the 21st century, that of Atif Mian and Amir Sufi, two leading mainstream economists at Princeton and Chicago universities in their book, *House of Debt*,. “Recessions are not inevitable – they are not mysterious acts of nature that we must accept. Instead recessions are a product of a financial system that fosters too much household debt”.¹⁰ Instead, they reckon they have discovered the secret of the cause of the Great Recession and the Great Depression on the 1930s: “One important fact jumps out: the dramatic rise in household debt. Both the Great Recession and Great Depression were preceded by a large run-up in household debt... And these depressions both started with a large drop in household spending.”

James Galbraith presents a similar argument in his book *Inequality and Instability*. “As Wall Street rose to dominate the U.S. economy, income and pay inequalities in America came to dance to the tune of the credit cycle.” Galbraith argues that the rise of the finance sector was the driveshaft that linked inequality to economic instability. And Nouriel Roubini argues that the instability of the financial sector arose from inequality and caused the crisis.¹¹

And the ex-chief economist of the World Bank, Nobel prize winner and now scourge of mainstream economics, **Joseph Stiglitz, takes the same position**. Why might widening inequality lead to a banking crisis? Stiglitz’s theory is that “growing inequality in most countries of the world has meant that money has gone from those who would spend it to those who are so well off that, try as they might, they can’t spend it all.” This flood of liquidity then “contributed to the reckless leverage and risk-taking that underlay this crisis,” he asserts.

In a related view, called the Stiglitz hypothesis, Sir Anthony Atkinson and Salvatore Morelli propose that “in the face of stagnating real incomes, households in the lower part of the distribution borrowed to maintain a rising standard of living,” and “this borrowing later proved unsustainable, leading to default and pressure on over-extended financial institutions.”

¹⁰ recently described by the ‘official’ proponent of Keynesian policies, Larry Summers, as the best book this century! See my post (<https://thenextrecession.wordpress.com/2014/06/14/doctors-without-diagnoses/>).

¹¹ Roubini’s, *The instability of inequality*, <http://www.economonitor.com/nouriel/2011/10/17/fu>).

The IMF is right there too. Michael Dumhoff and Romain Ranciere from the IMF argue that “*long periods of unequal incomes spur borrowing from the rich, increasing the risk of major economic crises*”¹²). According to Dumhoff and Ranciere, something happens to lead to income stagnation for middle and low-income workers, while high-income households acquire more capital assets. This increases the savings of wealthy households relative to lower-income households. In order to keep their living standards from declining, the middle class borrows more. Financial innovations, including new types of securitization, increase the liquidity and lower the cost of loanable funds available to the borrowers. So the “*bottom group’s greater reliance on debt— and the top group’s increase in wealth — generated a higher demand for financial intermediation and the financial sector thus grows rapidly as do the debt-to-income ratios of the middle class relative to the wealthy. The combination of rising middle class debt and stagnant middle class incomes increases instability in financial markets, and the system eventually crashes.*”

And former World Bank economist, expert on global inequality and closet Marxist, Branco Milanovic joins the pack.¹³: “*The root cause of the crisis is not to be found in hedge funds and bankers who simply behaved with the greed to which they are accustomed (and for which economists used to praise them). The real cause of the crisis lies in huge inequalities in income distribution that generated much larger investable funds than could be profitably employed*”.

The most sophisticated explanation of the inequality thesis comes from the post-Keynesian wing of macroeconomics¹⁴. Openly based on a distribution theory of crises, Engelbert Stockhammer argues that the economic imbalances that caused the present crisis should be thought of as the outcome of the interaction of the effects of financial deregulation with the macroeconomic effects of rising inequality. In this sense, rising inequality should be regarded as a root cause of the present crisis. Rising inequality creates a downwards pressure on aggregate demand since poorer income groups have high marginal propensities to consume. Higher inequality has led to higher household debt as working-class families have tried to keep up with social consumption norms despite stagnating or falling real wages, while rising inequality has increased the propensity to speculate as richer households tend to hold riskier financial assets than other groups.

For Stockhammer, capitalist economies are either ‘wage-led’ or ‘profit-led’. A wage-led demand regime is one where an increase in the wage share leads to higher aggregate demand, which will occur if the positive consumption effect is larger than the negative investment effect. A profit-led demand regime is one where an increase the wage share has a negative effect on aggregate demand. The post-Keynesians reckon that capitalist economies are wage-led. So when there is a decline in the wage share as there has been since the 1980s, it reduces aggregate demand in a capitalist economy and thus eventually causes a slump. The banking sector increases the risk of this with its speculative activities

¹² (<http://www.imf.org/external/pubs/ft/fandd/2010/12/pdf/kumhof.pdf>)

¹³ ‘In the US, the top 1% of the population doubled its share in national income from around 8% in the mid-1970s to almost 16% in the early 2000s. That eerily replicated the situation that existed just prior to the crash of 1929, when the top 1% share reached its previous high-water mark. American inequality over the past hundred years thus basically charted a gigantic U, going down from its 1929 peak all the way to the late 1970s, and then rising again for 30 years.

¹⁴ Cambridge Journal of Economics entitled *Rising inequality as a cause of the present crisis (Stockhammer on inequality)*. “My hypothesis is that the crisis should be understood as the interaction of the deregulation of the financial sector (or financialisation, more generally) with the effects of rising inequality”.

The problem I have with this post-Keynesian hypothesis is manifold. First, surely, no one is claiming the simultaneous international slump of 1974-5 was due to a lack of wages or rising debt or banking speculation? Or that the deep global slump of 1980-2 can be laid at the door of low wages or household debt? Every Marxist economist reckons that the cause of those slumps can be found in the dramatic decline in the profitability of capital from the heights of the mid-1960s; and even mainstream economists look for explanations in rising oil prices or technological slowdown. Nobody reckons the cause was low wages or rising inequality.

I suppose Stockhammer would say that in the 1970s, capitalist economies were 'profit-led' but now they are 'wage-led'; so each crisis has a different cause. As the title of his paper says "inequality as the cause of the present crisis".

But how did a profit-led capitalist economy become a 'wage-led' one? Yes, wages were held down and profits rose. But why?

Surely the answer lies in the attempts of the strategists of capital to raise the rate of exploitation as a counteracting factor to the fall in profitability – the classic Marxist explanation. Rising inequality is really the product of the successful attempt to raise profitability during the 1980s and 1990s by raising the rate of surplus value through unemployment, demolishing labour rights, shackling the trade unions, privatising state assets, 'freeing' up product markets, deregulating industry, reducing corporate tax etc – in other words, the neo-liberal agenda. As Maria Ivanova has pointed out, rising inequality was really a side effect of financialisation¹⁵

Stewart Lansley argues that there is a strong link between rising inequality and instability in capitalism, citing the examples of rising inequality just before the Great Depression of the 1930s and now before the Great Recession¹⁶. But Lansley admits, the crisis of the 1970s was not due to a lack of wages, but in that case because "wages have grown too quickly". This neo-Ricardian view of crises revolves round the idea that it is the wage/profit share that matters: so some crises are caused by workers having 'too high' wages.

The 'wage-led' distribution theory leads to what Lansley concludes: that if we get the 'right' level of wage share, then capitalism will be fine. As he puts it: "the great concentrations of income and wealth need to be broken up and the wage share restored to the post-war levels that brought equilibrium and stability". Apparently, British capitalism was fine just after the war due to the right 'wage share' and level of inequality – ah, those golden years of enforced 1940s austerity!

Capitalist booms and slumps and ensuing financial crashes have taken place even when inequality was much lower than now. Surely, no one is claiming the simultaneous international slump of 1974-5 was due to a lack of wages or rising debt or banking speculation? Or that the deep global slump of 1980-2 can be laid at the door of low wages or household debt?

Marxist economist Gerard Duménil argues that each crisis has a different cause: sometimes it is inequality and sometimes it is profitability – not dissimilar then from the post-Keynesian view. In the

¹⁵ CONF_2011_Maria_Ivanova on Marx, Minsky and the GR).

¹⁶ (<http://classonline.org.uk/pubs/item/rising-inequality-and-financial-crises>). Called Rising inequality and financial crises: why greater equality is essential for recovery.

neoliberal period, we have a new exploitation of the poor through deregulation of mortgages, the expansion of derivatives, leading to the super bonuses of the top executives. In Dumenil's view, the neoliberal crisis comes about when this crazy venture can no longer be sustained. So the neoliberal crisis and that of the Great Depression in the 1930s were really ones of greed and class exploitation and had nothing to do with falling profitability, which was rising not falling.

THE EVIDENCE

What are we measuring?

- Inequality of wealth or income?
- The level of inequality or the first derivative, the change in inequality, or the second derivative, the rate of change

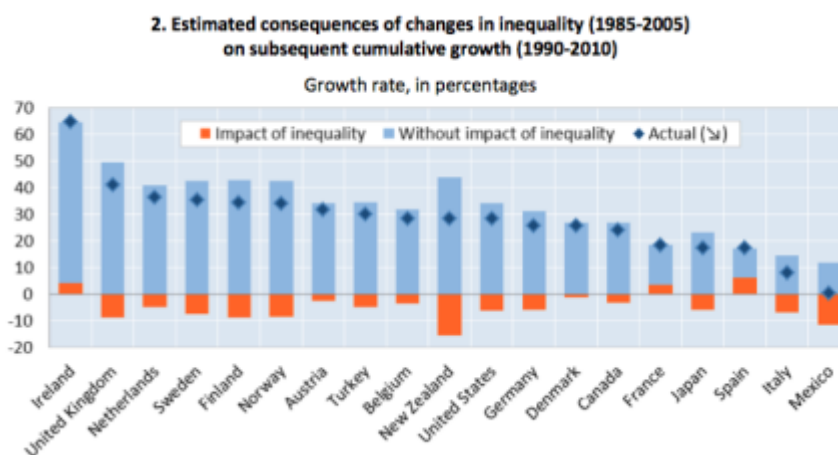
How do we gauge correlation and/or causation?

- It could simply be a coincidence that inequality rose sharply for many years preceding the crisis.
- There could be actual causation. High inequality could somehow create economic vulnerabilities.
- There could be a 'common causation'. In other words, both widening inequality and the crisis could be caused by a common factor

Wealth or income? Thomas Piketty's opus is almost totally about the changes in inequality of wealth over the last two hundred years. And in his book, there is little or nothing in 685 pages about booms and slumps, or about the Great Depression, the Great Recession, or other recessions, except to say that the Great Recession was a 'financial panic' (as claimed by Ben Bernanke) and was not as bad as the Great Depression because of the intervention of the central banks and the state. Piketty adopts the usual neoclassical explanation that these events, like wars, were exogenous 'shocks' to the long-term expansion of productivity and economic growth under capitalism¹⁷. Crises are just short-term shocks and we can revert to his fundamental law instead "as it allows us to understand the potential equilibrium level toward which the capital income ratio tend in the long run when the effects of shocks and crises have dissipated".

But most evidence supporting inequality as a cause of crises relies on the level or change in inequality of incomes.

The OECD argues that rising inequality has damaged economic growth¹⁸.



¹⁷ Piketty op cit p 170

¹⁸ <http://www.oecd.org/social/reducing-gender-gaps-and-poor-job-quality-essential-to-tackle-growing-inequality.htm>

The OECD sifted through 30 years of data and found that, when the gini coefficient, a popular measure of inequality (a gini of 0 means everyone has exactly the same income; a gini of 1 means one person gets all the income) goes up, growth declines. But is that because inequality hurts growth, or vice versa?

The OECD uses a statistical test to conclude it's the former. The OECD finds that higher inequality has a significant impact on relative educational attainment among different income classes. As inequality goes up, the poorest 40% of the population get fewer skills and lower quality education. The OECD then estimates how much more education the poor may have had if inequality had not increased and plug that into a growth model that includes components such as human capital. From this, the study concludes cumulative economic growth was 4.7 percentage points lower for the average OECD country between 1990 and 2010 (that's about \$2,500 for the average American).

So the OECD suggests that rising inequality causes slower growth because the poor get worse education for better skills at work. But there is no backing in the OECD study for a causal sequence from stagnant incomes to higher debt or reckless financial institutions as argued earlier.

The IMF also considers the issue.¹⁹ Using a cross-country dataset that distinguishes market (before taxes and transfers) inequality from net (after taxes and transfers), the authors find that lower net inequality is robustly correlated with faster and more durable growth, for a given level of redistribution. The combined direct and indirect effects of redistribution—including the growth effects of the resulting lower inequality—are on average pro-growth. But this study simply suggests that if governments reduce inequality, they may deliver faster economic growth and the authors add cryptically that “we should be careful not to assume that there is a big trade-off between redistribution and growth.” Again there is nothing about crises as such, or the arguments of low incomes, high debt, financial instability etc.

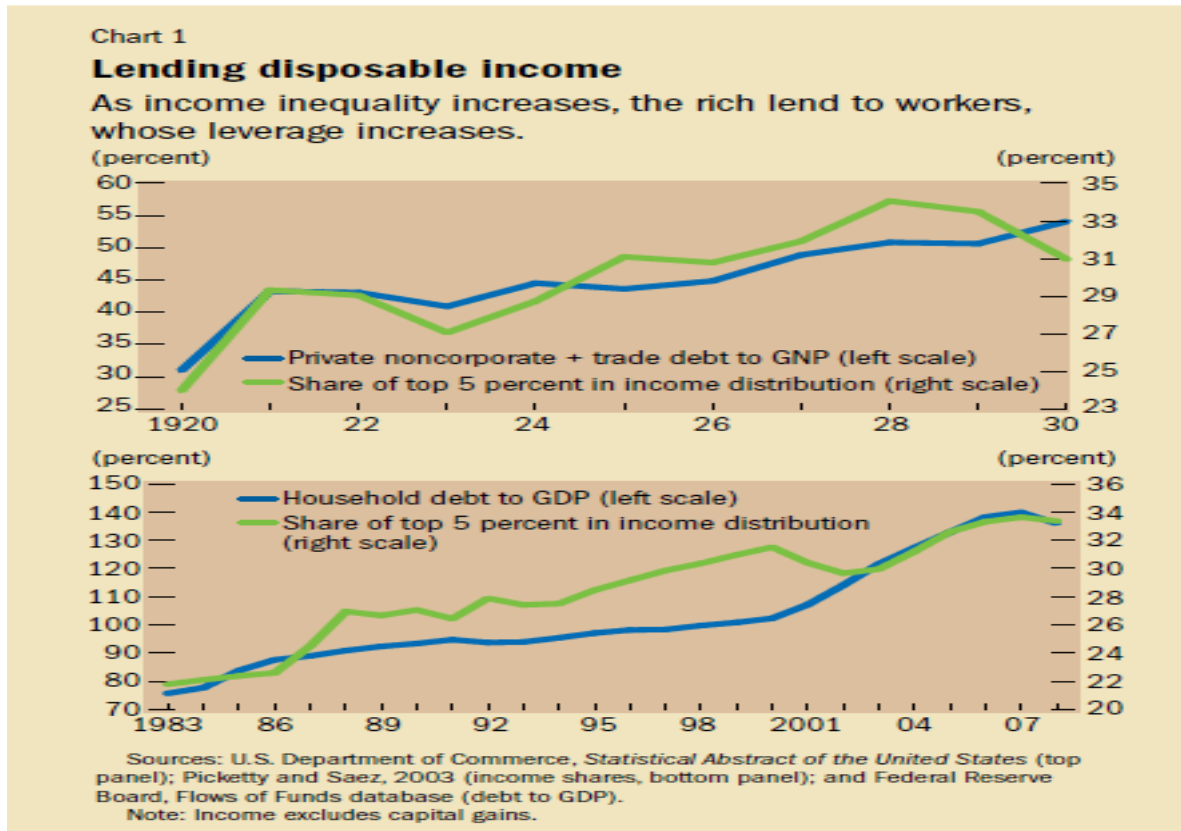
What is the evidence supporting the view that average incomes were stagnant in real terms in the US or elsewhere?

There is broad acceptance that inequality has widened since the 1970s still leaves much open for debate. For instance, there are disagreements on the extent to which average incomes in America have foundered over the same period²⁰

In the US, wage share relative to GDP has declined, while personal consumption has increased since the early 1980s. This would suggest that consumption has been sustained because of increased debt, as has been argued above. **It's true that US aggregate debt-to-income across all income groups grew consistently with the income share of the top 5% both before the Great Depression and Great Recession. This increase was considerably sharper in recent years for the bottom 95% than the top 5%.**

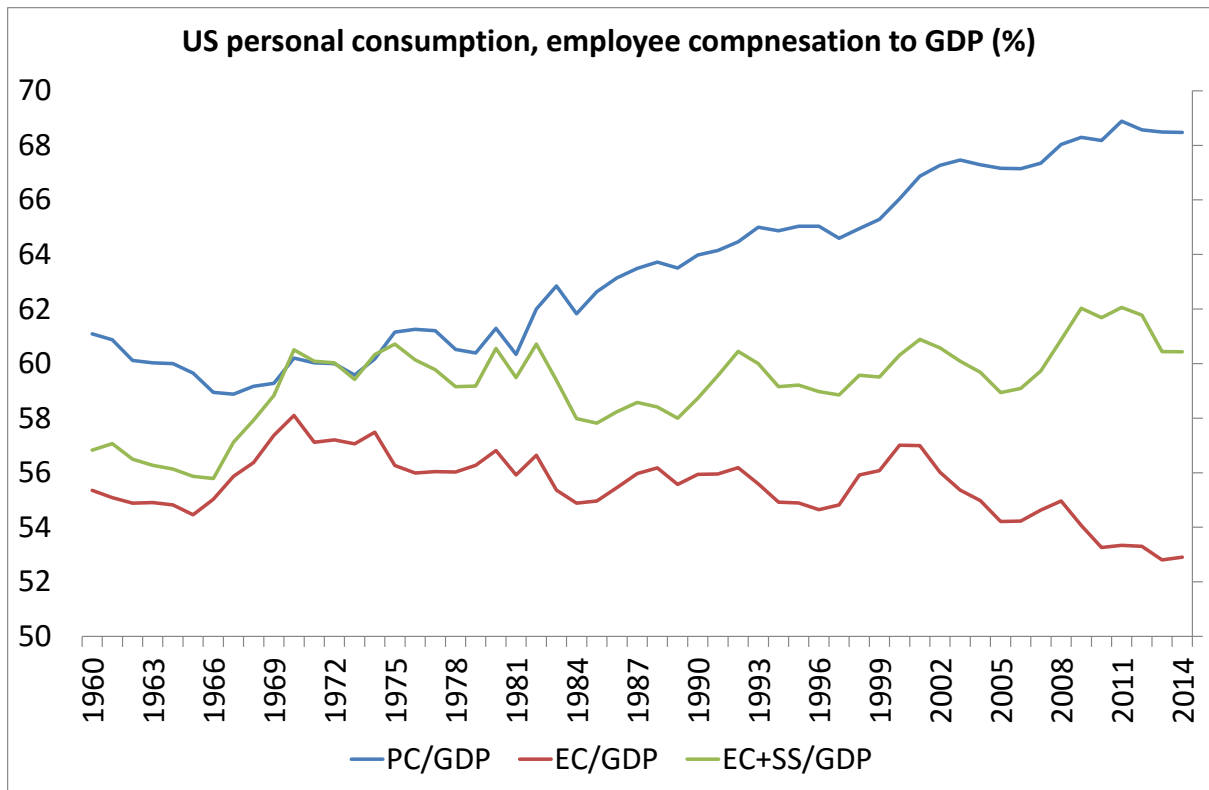
¹⁹ INTERNATIONAL MONETARY FUND Research Department Redistribution, Inequality, and Growth Prepared by Jonathan D. Ostry, Andrew Berg, Charalambos G. Tsangarides¹ Authorized for distribution by Olivier Blanchard April 2014

²⁰ see '[Average incomes "did not stagnate"](#)', *Fund Strategy*, 30 April 2012.

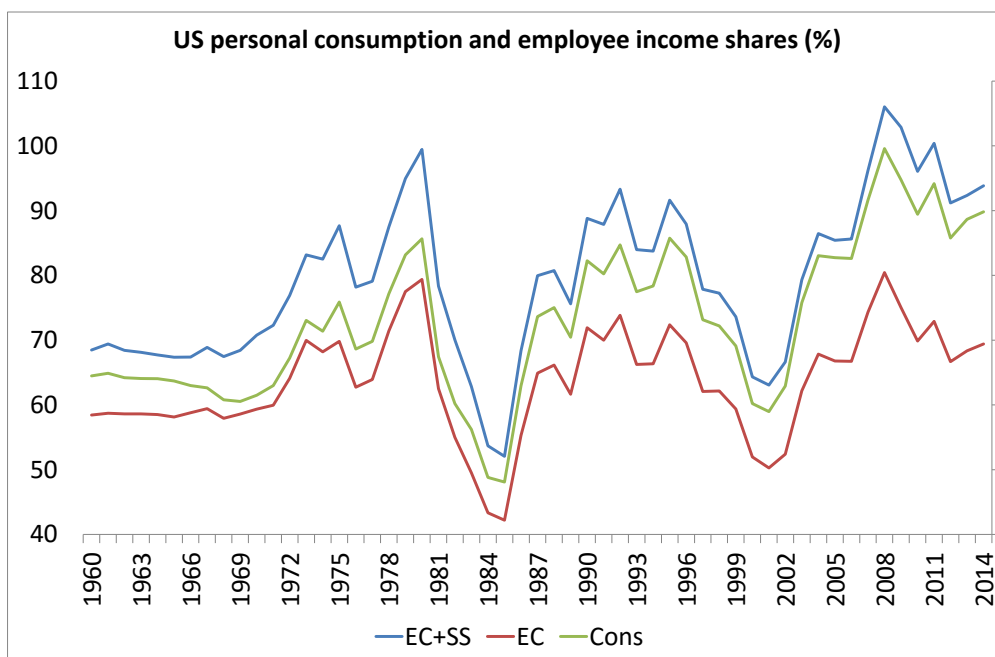


So QED? Well, maybe not. There could other reasons for the rise in personal consumption to GDP. If we measure employment compensation (which includes health benefits and employer payments for pensions etc), then the gap between income and consumption narrows. And if we also add in net government benefits (after tax) to employee compensation, the gap narrows further.²¹

²¹ See A Kliman *The failure of capitalist production*, chapter 8.

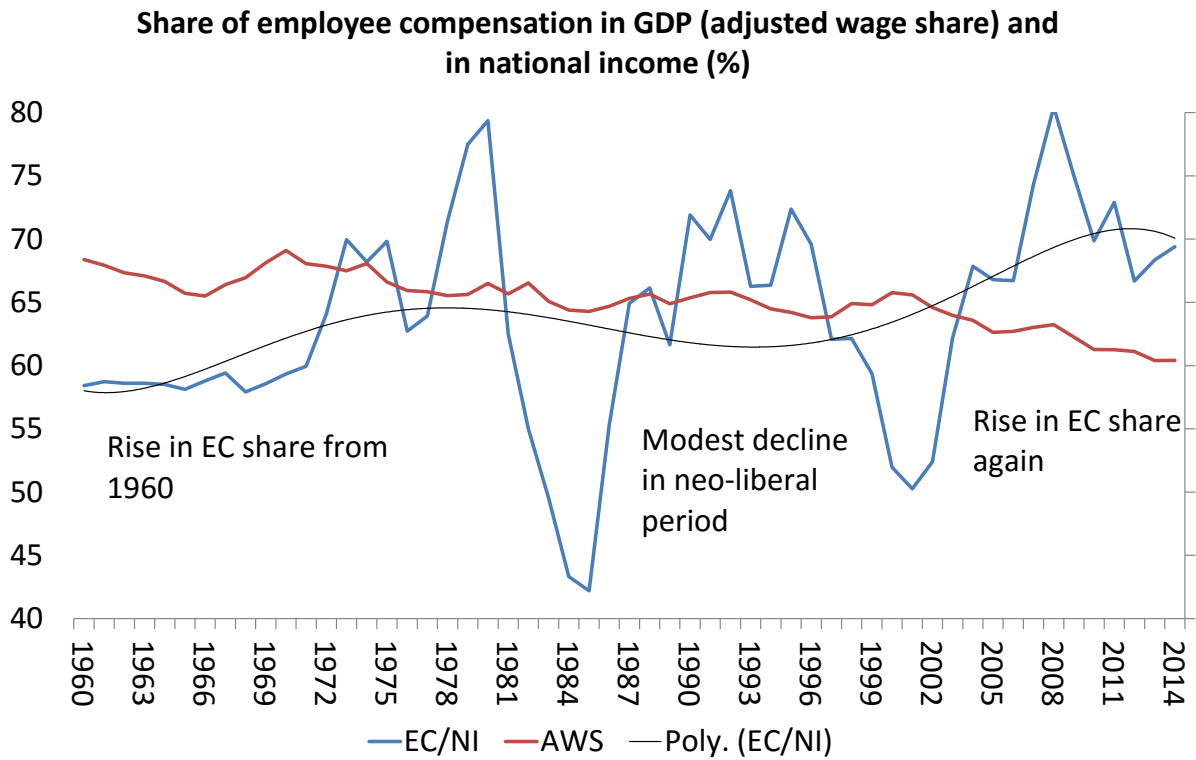


Moreover, it is comparing apples to pears to compare wage income to GDP as GDP does not account for depreciation. If we compare employee income to national income, we get a different story.

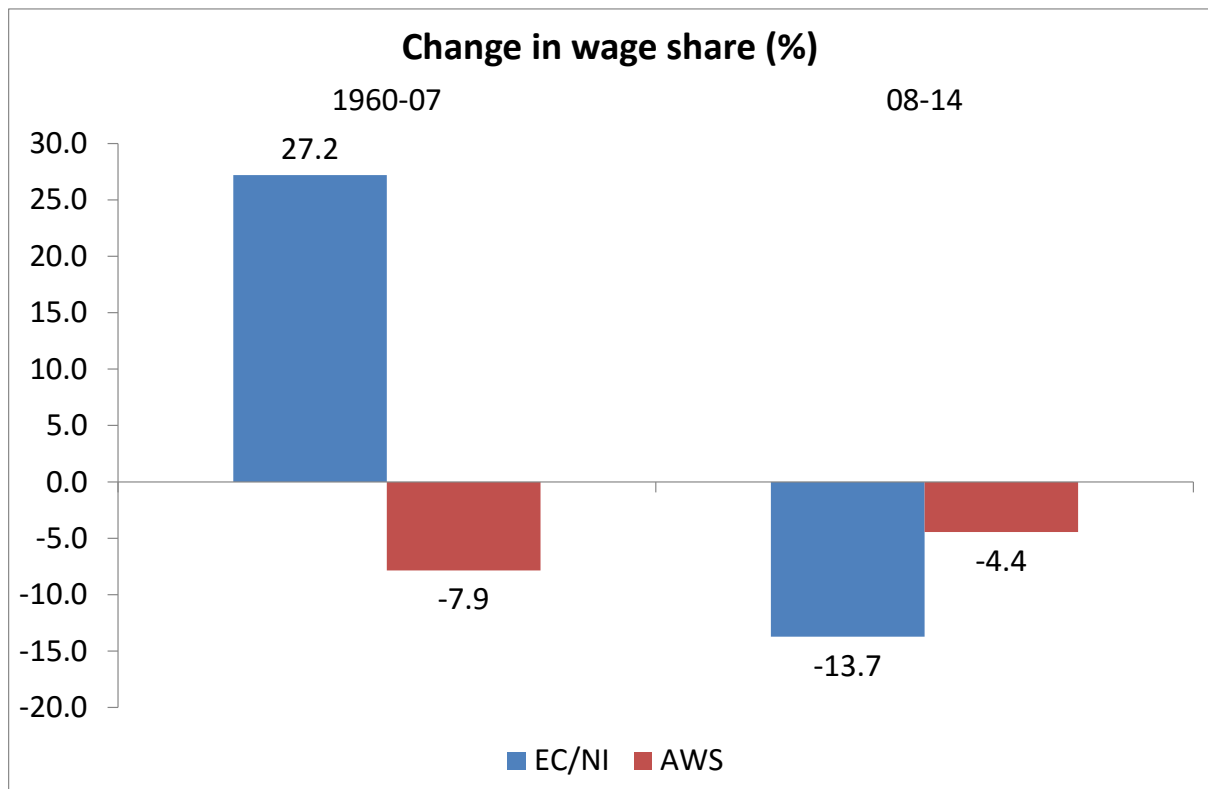


The rise in personal consumption to national income is now matched pretty closely by a rise in employee income and benefits to national income. **Yes, cash income from work has more or less stagnated since the 1990s BUT employee and state benefits have filled the gap with consumption, particularly from the 2000s. Debt does not have to fill the gap. Indeed, we know that most of the rise in household debt was mortgage debt to meet the cost of home prices, not to fill a 'demand gap' caused by low wage income. Indeed, the share of employee compensation to national income**

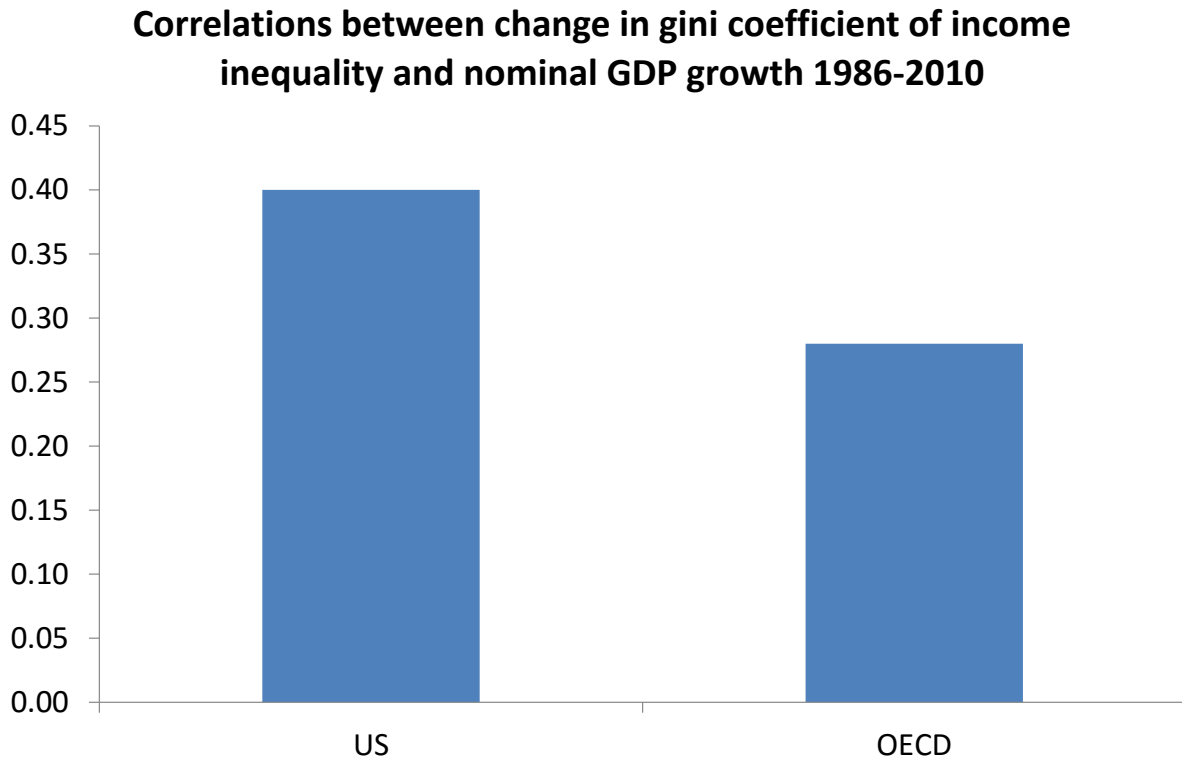
has risen in the 1990s while wage share has declined.



If we stick to wage share of GDP, then there was a 8% fall in the share from 1960 to 2007. But if we use employee income to national income, there has been a 27% rise!



Another exercise: what if we correlate the change in inequality of income against the rate of NOMINAL GDP growth? I did this for the OECD using the gini coefficients as the OECD paper did. I found that there was a POSITIVE correlation between the change in inequality and nominal GDP growth.



Correlation does deliver causation. But most likely this suggests that as growth accelerates, inequality rises under capitalism, not vice versa. And that does not seem unreasonable under capitalism, particularly in the neo-liberal period since the 1980s.

But let us look closer at the connection between inequality and crises or slumps, rather than just growth. A paper by Michael Bordo and Christopher Meissner from the Bank of International Settlements analysed the data and concluded that inequality does not seem to be the reason for a crisis. Credit booms mostly lead to financial crises, but inequality does not necessarily lead to credit booms. *“Our paper looks for empirical evidence for the recent Kumhof/Ranci re hypothesis attributing the US subprime mortgage crisis to rising inequality, redistributive government housing policy and a credit boom. Using data from a panel of 14 countries for over 120 years, we find strong evidence linking credit booms to banking crises, but no evidence that rising income concentration was a significant determinant of credit booms. Narrative evidence on the US experience in the 1920s, and that of other countries, casts further doubt on the role of rising inequality.”*

Edward Glaeser also points to research on the US economy that home prices in various parts of the US did not always increase where there was the most income inequality. That calls into question the claim that income inequality was inflating the housing bubble.

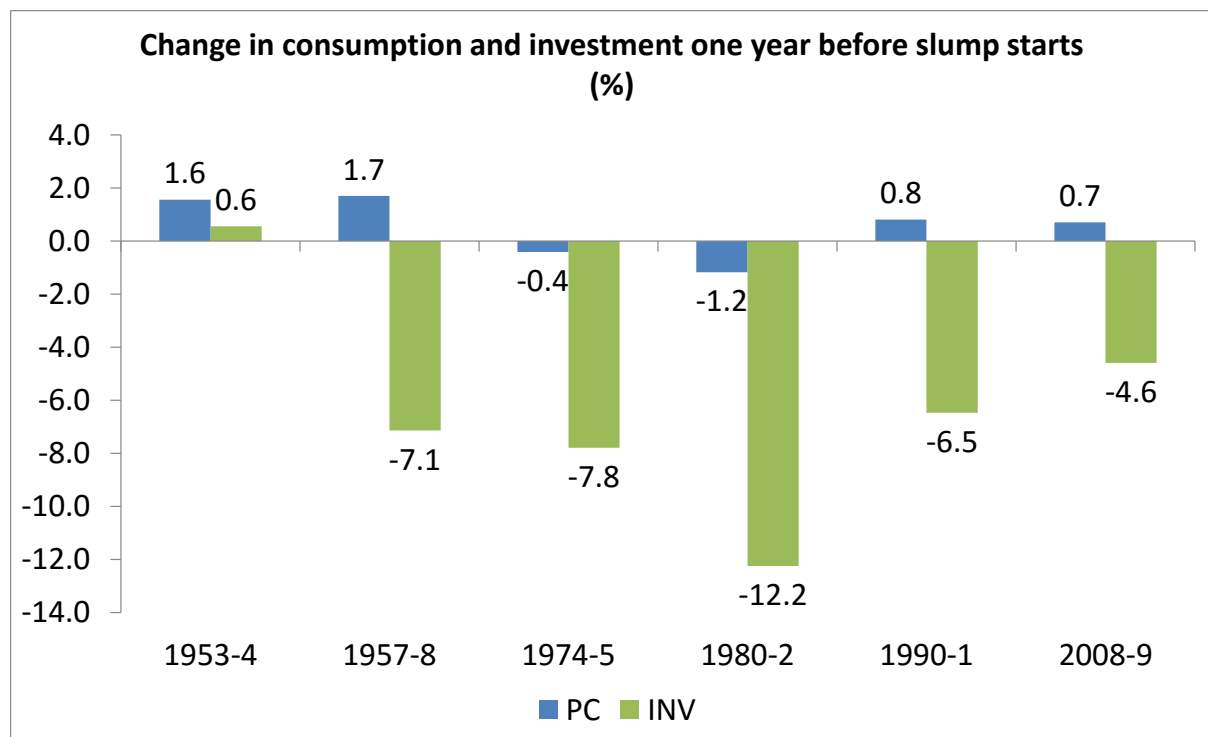
Inequality experts, Professors Atkinson and Morelli, found little regular connection between inequality and crises. Looking at 25 countries over a century, they find ten cases where crises were preceded by rising inequality and seven where crises were preceded by declining inequality.

Inequality was higher in two of the six cases where a crisis is identified, which is exactly the same proportion as among the 15 cases where no crisis is identified. ²²

MOST IMPORTANT: IT IS NOT LACK OF CONSUMER DEMAND THAT CAUSES A CRISIS BUT A DROP IN INVESTMENT

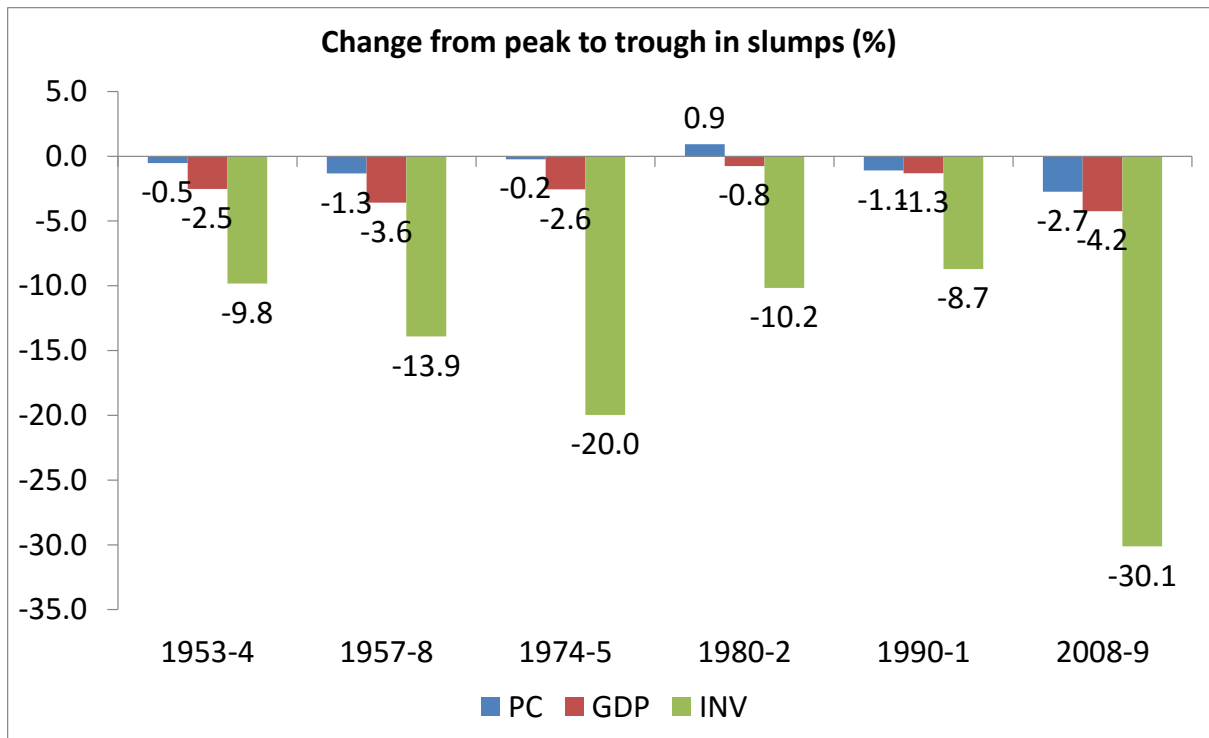
1. BEFORE CRISES THERE IS NOT A SHARP SLUMP IN CONSUMPTION BUT IN INVESTMENT.
2. CONSUMPTION FALLS LESS AND AFTER THE SLUMP IS UNDER WAY.
3. INVESTMENT FALLS MORE AND BEFORE A SLUMP.

Investment usually falls before a slump – it's a great indicator. Consumption seldom falls before. Investment fell one year before every post-war slump in the US except the mild 1953-4. Consumption fell in advance in only two occasions and then by tiny amounts.

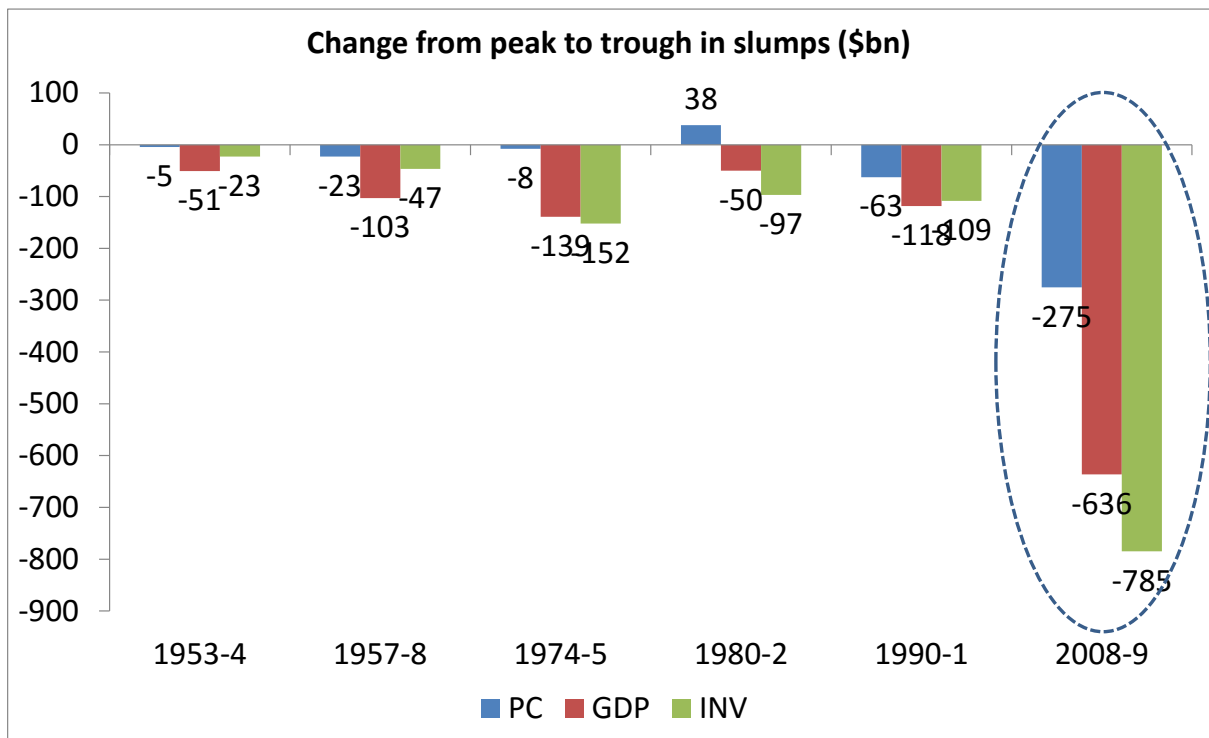


During slumps, consumption falls much less than investment.

²² <https://thenextrecession.wordpress.com/2014/03/18/inequality-and-britains-oligarchs/>



Consumption is a much larger proportion of GDP than investment but even so, the absolute contribution of investment to slumps is much larger.

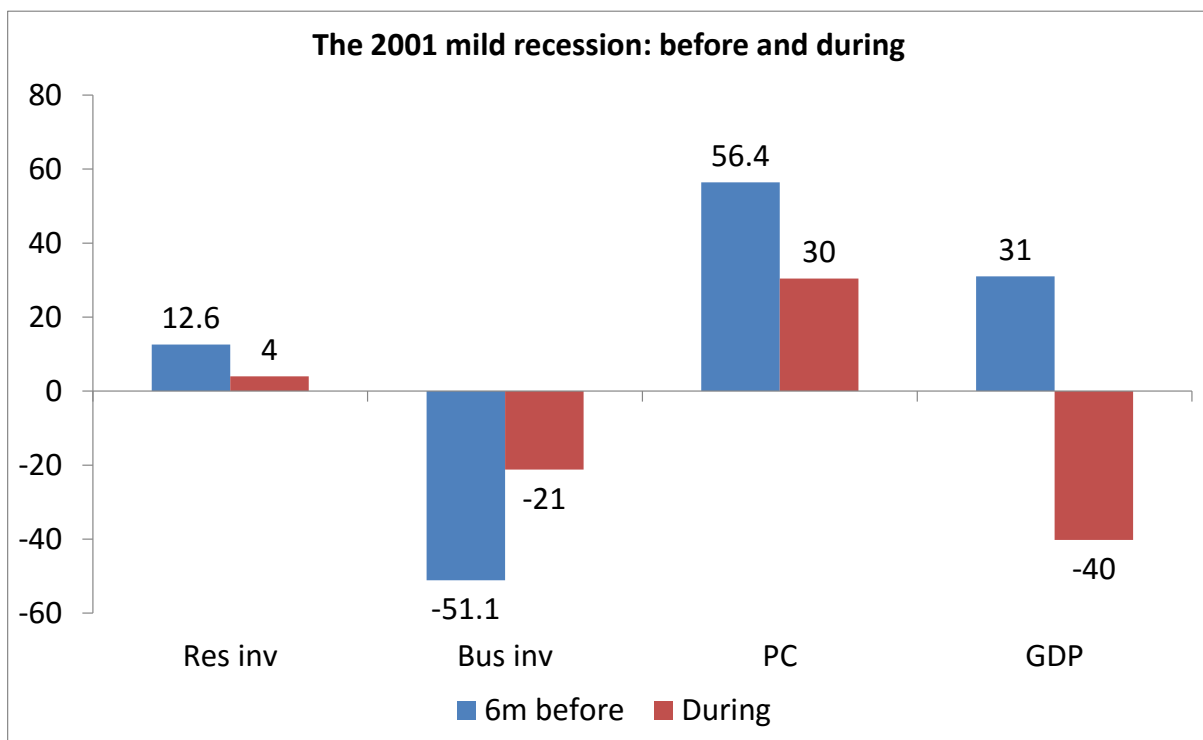


The contribution of a decline in consumption to a slump is tiny compared to that of investment. Indeed, in the three biggest post-war slumps, investment fell more in constant dollar terms than GDP (exports and government spending made up the difference). Consumption never fell more than GDP or investment even though investment is less than 25% of the size of consumption expenditure in GDP.

The data above covers all investment (residential housing and business investment). Maybe slumps were led by a collapse in the housing market (residential investment) due to mortgage debt over-leverage and not due to any collapse in business investment. If the former, this would provide some support to the inequality/stagnant incomes/mortgage debt thesis.

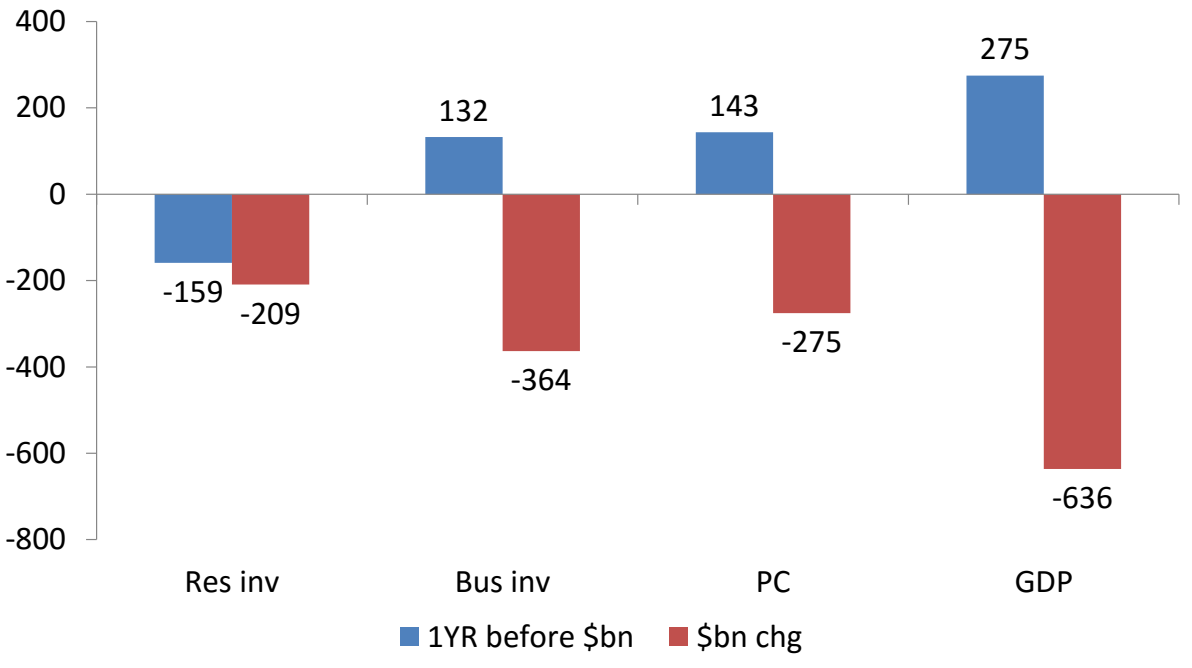
The official data for the US only give breakdown between residential and business investment since 1999. None of the post-war recessions prior to 1999 could be considered as a product of a US housing market collapse. But what about the mild recession of 2001 and the Great Recession of 2008-9?

Well, the evidence is clear on the mild recession of 2001. Six months before the slump began in Q2 2001, GDP rose \$31bn, while consumption rose \$56bn and residential investment rose \$13bn. But business investment FELL \$51bn. It led the recession. By the end of the slump, at end-2001, GDP had fallen \$40bn, consumption and residential investment did not fall at all, BUT business investment dropped \$21bn.



The story of the Great Recession is different. In the year before the slump began at the beginning of 2008, residential investment fell by \$160bn while business investment and consumption, along with GDP continued to rise. So in the GR, it seems that the housing slump was the trigger. During the slump that lasted until mid-2009, GDP fell \$636bn, but the biggest fall came in business investment, even larger than the much larger consumption component. In all cases, private consumption was not the leader into a slump and did not collapse the most. The fall in residential investment helped drag the US economy into the 2008 recession but business investment was the main driver of the slump.

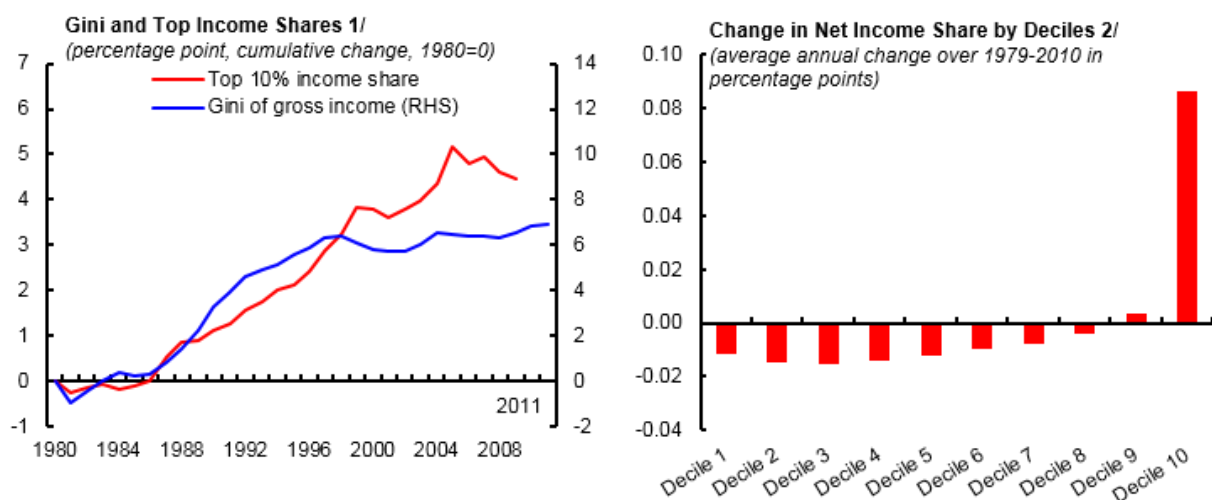
The Great Recession: before and during



THE ALTERNATIVE PROFITABILITY THEORY

Krugman has argued that there is common causation between economic crisis and widening inequality. It is true that both have the same roots, but it is wrong to argue that one has caused the other. If there is dubious and contradictory theoretical and empirical support for backing the theory that capitalist crises are the result of rising inequality of incomes in economies, can we find an alternative explanation?

If we start with a Marxist perspective, we could argue that the rising inequality of income since the 1980s in most capitalist economies is more to do with the balance of forces in the class struggle between capital and labour. The stronger capital is, the more it can get the rate of surplus value up. And that is what has happened in many countries since the 1980s.



Recent research has shown that the class struggle weakened union power²³ Piketty also shows that the main reason for the huge increase in the incomes and wealth of the top 1% was not higher incomes going to more skilled workers in wages, but huge increases in capital income, namely rising dividends from shares, capital gains from buying and selling shares, rents from property and capital gains from buying and selling property and interest from loans and bond holdings etc. In other words, rising inequality is the result of the appropriation of new value by top bankers, corporate chief executives and the shareholders of capital. Rising inequality is a product of capitalist exploitation.

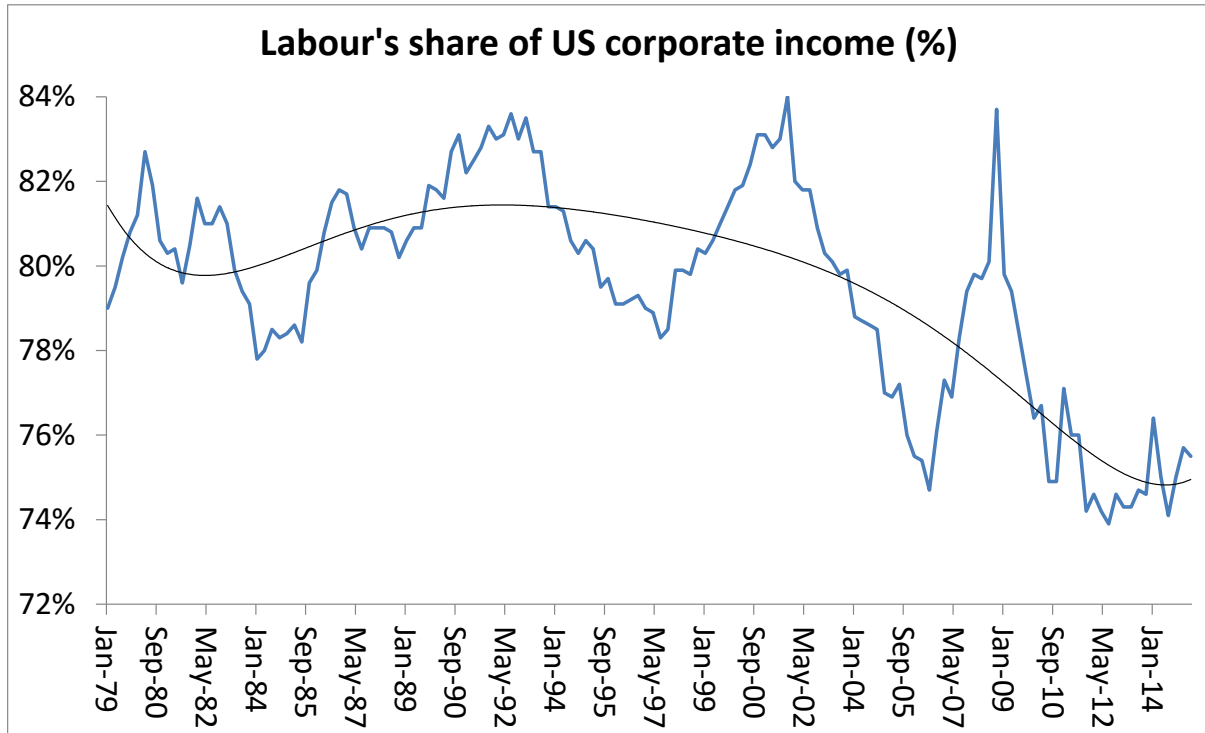
Emmanuel Saez has pointed out that the incomes of the wealthy are closely tied to share options and realised capital gains²⁴. It is also true that a high proportion of the best-paid come from within the financial sector itself.

²³ etc <http://www.voxeu.org/article/union-power-and-inequality> Jaumotte, F and C Osorio Buitron (2015), "Inequality and Labour Market Institutions" IMF Staff Discussion Note No. 15/14 (Washington: International Monetary Fund).

²⁴ [Striking it richer: the evolution of top incomes in the United States](#)

And in a recent excellent paper, Simon Mohun shows identifies the largest increase in incomes going to just the top 2% who live entirely off income from capital in the form of rent, interest and profit, and not wages.²⁵

And the real increase in profit share in US corporate income took place after 2002.



Atkinson makes the valuable point that what matters for inequality is who controls the levers of capital. *"In the old days, the mill owner owned the mill and decided what went on [there]. Today, you and I own the mill. But who decides what goes on? It's not us. That's the important difference. And it doesn't really appear in Piketty's book, which is actually more about wealth than it is about capital."*

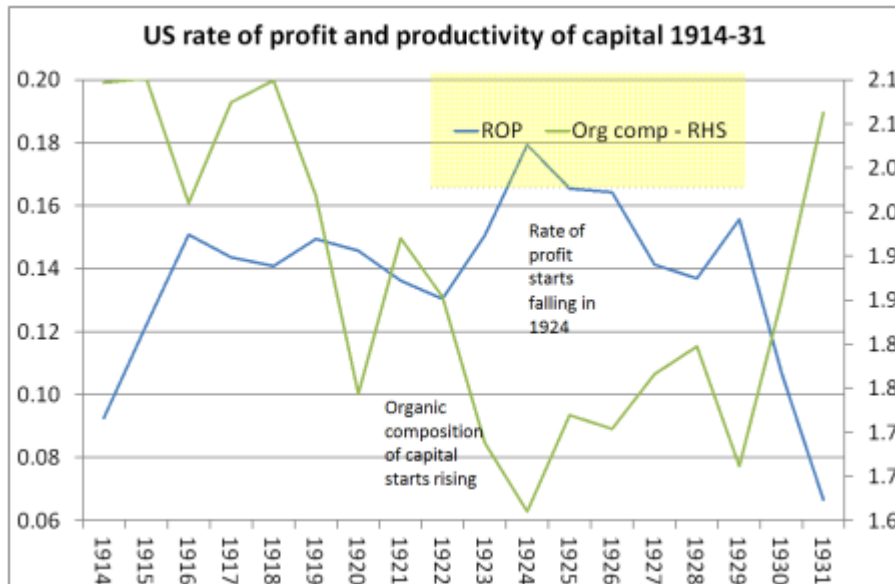
What is decisive for capitalism is surplus value (profit, interest and rent), not wage income or spending. Control of that surplus is key. The main feature of the last 100 years of capitalism has not been growing inequality of income – indeed, as Atkinson shows, inequality has not always risen. The main feature has been a growing concentration and centralisation of wealth, not income. And it has been in the wealth held in means of production and not just household wealth.

A new study shows how far that has gone in the recent period. Three systems theorists at the Swiss Federal Institute of Technology in Zurich have taken a database listing 37 million companies and investors worldwide and analyzed all 43,060 transnational corporations and share ownerships linking them²⁶. They have built a model of who owns what and what their revenues are, mapping out the whole edifice of economic power. They discovered that a dominant core of 147 firms through interlocking stakes in others together control 40% of the wealth in the network. A total of 737 companies control 80% of it all. This is the inequality that matters for the functioning of capitalism – the concentrated power of capital.

²⁵ <https://thenextrecession.files.wordpress.com/2015/09/classstructure1918to2011wmf.pdf>

²⁶ (147 control)

Indeed, I and others have presented more compelling evidence that capitalist crises are caused by lack of profitability, not a demand gap', caused by rising inequality. Dumenil claims that high inequality in late 1920s US caused the Great Depression of the 1930s and not by Marx's law of profitability, because there was no rising organic composition of capital before 1929. But if we consider Dumenil's own data, we find a rising organic composition from 1924 onwards and this also coincides with a peaking in the rate of profit. For five years before the start of the Great Depression the US rate of profit was falling.



Indeed, there is good empirical evidence that it is changes in profits that lead changes in investment and then to economic growth. Jose A Tapia Granados²⁷ shows that over 251 quarters of US economic activity from 1947, the movement in profits was much more volatile than movement in wages or even investment. Most important, "corporate profits stop growing, stagnate and then start falling a few quarters before a recession". Profits then lead investment and employment out of each recession. In the long expansion of the 1990s, profits started declining long before investment did (profits fell back in 1997 while investment went on growing until 2000, when a crisis ensued). "In all these cases, profits peaks several quarters before the recession, while investment peaks almost immediately before the recession." Using regression analysis, Tapia finds that pre-tax profits can explain 44% of all movement in investment, while there is no evidence that investment can explain any movement in profits. This confirms my own empirical analysis of the Great Recession where I show that profits fell for several quarters before the US economy went into a nose dive²⁸.

Guiglemo Carchedi recently presented a paper that showed post-war crises in the US occurred when there was a fall in new value created (profits and wages combined). This can happen even if the rate of profit had been rising before.

²⁷ Does investment call the tune? Empirical evidence and endogenous theories of the business cycle, to be found in Research in Political Economy, May 2012, http://sitemaker.umich.edu/tapia_granados/files/does_investment_call_the_tune_may_2012_forthcoming_rpe_.pdf.

²⁸ Carchedi and Roberts: The Long roots of the present crisis, <https://thenextrecession.files.wordpress.com/2013/12/the-long-roots-of-the-present-crisis.pdf>

More recently, I found that if I measured the correlations between the rate of profit, the mass of profit and investment using official US data for the years 2000 to 2013, that there were very high correlations between profitability, profits and investment. First, the correlation between changes in the rate of profit and investment was 64%; second, the correlation between the mass of profit and investment was 76%; and third, the correlation between the rate of profit (lagged one year) and the mass of profit was also 76%. It was necessary to lag the rate of profit as the data are annual for that not quarterly.

THE POLICY IMPLICATIONS OF THE INEQUALITY THESIS

If the cause of capitalist crises – or at least this particular crisis – is due to growing inequality of income and wealth, then it is easy to see what the policies are needed to correct this fault-line in capitalism: more equality. With higher wages, more progressive taxes and more regulation of bankers and their bonuses, the current depression could be overcome and future crises can be avoided. There is no need to replace the capitalist mode of production, just the current structure of distribution.

As Mian and Sufi put it in *House of Debt*: *“excessive reliance on debt is in fact our culprit... but it can potentially be fixed. We don’t need to view severe recessions and mass unemployment as an inevitable part of the business cycle. We can determine our own fate.”*

For Stiglitz, reducing inequality does not depend on controlling the levers of capital but on ‘more democracy’. Stiglitz notes: *“Inequality is a matter not so much of capitalism in the 20th century as of democracy in the 20th century.”* Whereas Piketty believes that extreme inequality is inherent to capitalism, Stiglitz argues that it’s a function of faulty rules and regulation. *“My argument is that these guys – the bankers and monopoly corporations – have destroyed capitalism in some sense, ...There are certain rules which are required to make a market economy work. And these guys are really undermining these rules. My book is really about trying to get markets to act like markets. That’s hardly radical, at one level. But at another level it is radical because the corporations don’t want markets to look like markets.”*

Robert Reich in his book arguing that inequality was the main cause of crisis²⁹ drew the following policy conclusions: *“Socialism isn’t the answer to the basic problem haunting all rich nations. The answer is to reform capitalism. The world’s productivity revolution is outpacing the political will of rich societies to fairly distribute its benefits. The result is widening inequality coupled with slow growth and stubbornly high unemployment. The problem is not that the productivity revolution has caused unemployment or under-employment. The problem comes in the distribution of the benefits of the productivity revolution. A large portion of the population no longer earns the money it needs to live nearly as well as the productivity revolution would otherwise allow. It can’t afford the “leisure” it’s now experiencing involuntarily. Not only is this a problem for them; it’s also a problem for the overall economy. It means that a growing portion of the population lacks the purchasing power to keep the economy going.... It doesn’t mean socialism. We don’t need socialism. We need a capitalism that works for the vast majority. The productivity revolution should be making our lives better — not poorer and more insecure. And it will do that when we have the political will to spread its benefit.”*

Stockhammer’s political conclusion from his claim that rising inequality has caused the ‘present crisis’ is *“that financial reform is necessary to avert similar crises in the future (even if little has yet changed in the regulation of financial markets). The analysis here highlights that income distribution will have to be a central consideration in policies dealing with domestic and international macroeconomic stabilisation. The avoidance of crises similar to the recent one and the generation of stable growth regimes will involve simultaneous consideration of income and wealth distribution, financial regulation and aggregate demand”*

²⁹ Aftershock, 2010).

But what political chance is there of that? Simon Wren-Lewis recognised on his blog: *“reversing inequality directly threatens the interests of most of those who wield political influence, so it is much less clear how you overcome this political hurdle to reverse the growth in inequality”*³⁰.

Radically different conclusions follow if the problem of crises is located on the supply side (with the cause to be found in profitability). From this perspective, falling profitability explains the sluggish character of the productive economy and is at the root of the crisis. If the economy had been more profitable, there would have been less need for such a rapid or ‘excessive’ expansion of credit. From this perspective the widening of inequality is more of a symptom than a cause of economic weakness. The rich became richer with the emergence of the asset bubble, but the underlying economy was far from healthy in the first place.

Inequality of wealth and income: the rich alongside a mass of poverty has always been a feature of class societies, including capitalism. As Marx said, all history is really the history of class struggle. What that means is the struggle to control the surplus created in any society. But inequality is not the cause of crises. Booms and slumps took place before inequality rose to current extremes. They can take place even when there is relative equality: indeed the drive for equality of income now would eat into profit shares and could exacerbate the crisis. And more equality will not stop slumps.

But it is not just the political obstacle that makes the inequality theory the wrong way to approach a critique of capitalism. It is not a coherent explanation. It appears to apply to just the current crisis and not to previous ones. It appears to apply to just some capitalist economies, like the US and the UK and not to Europe or Japan, where inequality is less but the global crisis is worse. So maybe the inequality theorists need to look elsewhere for the cause of capitalist crises – and look at the ownership of production, not the distribution of the value created.

I ask the question to the proponents of inequality: do they think that redistributing income or wealth would be sufficient to put capitalism on the road to growth without catastrophic slumps? Or do they agree that only replacing the capitalist mode of production through the expropriation of the owners of capital and the establishment of a planned economy based on ownership in common can do the trick?

³⁰ <http://mainlymacro.blogspot.co.uk/2013/12/inequality-and-left.html>)