Rising inequality threatens legitimacy of growth path

Nouriel Roubini

THIS year has witnessed a global wave of social and political turmoil and instability, with masses of people pouring into the streets: the Arab Spring; riots in London; Israel’s middle-class protests against high housing prices and an inflationary squeeze on living standards; protesting Chilean students; the destruction in Germany of the expensive cars of fat cats; India’s movement against corruption; and now the Occupy Wall Street movement in New York and across the United States.

While these protests have no unified theme, they express in different ways the serious concerns of the world’s working and middle classes about their prospects in the face of the growing concentration of power among economic, financial, and political elites. The causes of their concern are clear enough: high unemployment and underemployment in advanced and emerging economies; inadequate skills and education for young people and workers to compete in a globalized world; resentment against corruption, including legalized forms like lobbying; and a sharp rise in income and wealth inequality in advanced and fast-growing emerging-market economies.

Of course, the malaise that so many people feel cannot be reduced to one factor. For example, the rise in inequality has many causes: the addition of billions of people in emerging economies to the global labor force, which is reducing the jobs and wages of unskilled blue-collar, and off-shorable white-collar workers in advanced economies; skill-biased technological change; winner-take-all effects; early emergence of income and wealth disparities in rapidly growing low-income economies; and less progressive taxation.

The increase in private- and public-sector leverage and the related asset and credit bubbles are partly the result of inequality. Middle-class income growth for everyone but the rich in the last few decades opened a gap between incomes and spending aspirations. In Anglo-Saxon countries, the response was to democratize credit — via financial liberalization — thereby fueling a surge in private debt as households borrowed to make up the difference. In Europe, the gap was filled by public services — free education, health care, and so on — that are now under pressure as fiscal constraints, fueling public deficits and debt. In both cases, debt levels eventually became unsustainable.

Firms in advanced economies are now cutting jobs, owing to inadequate final demand, which has led to excess capacity, and to uncertainty about future demand. But cutting jobs weakens final demand further, because it reduces labor income and increases inequality. Because a firm’s labor costs are someone else’s labor income and demand, what is individually rational for one firm is destructive in the aggregate.

The result is that free markets don’t generate enough final demand. In the United States, for example, slashing labor costs has sharply reduced the share of labor income in GDP. With credit exhausted, the effects on aggregate demand of decades of redistribution of income and wealth — from labor to capital, from wages to profits, from poor to rich, and from households to corporate firms — has become severe, owing to the low marginal propensity of firms/capital owners/rich households to spend.

The problem is not new. Karl Marx oversold socialism, but he was right in claiming that global inequality, unfettered financial capitalism, and redistribution of income and wealth from labor to capital could lead capitalism to self-destruct. As he argued, unregulated capitalism can lead to regular bouts of over-capacity, under-consumption, and the recurrence of destructive financial crises, fueled by credit bubbles and asset-price booms and busts.

Any economic model that does not properly address inequality will eventually face a crisis of legitimacy. Unless the relative economic roles of the market and the state are rebalanced, the protests of 2011 will become more severe, with social and political instability eventually harming long-term economic growth and welfare.

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Elusive alternatives

Thus, the rise of the social-welfare state was a response (often of market-oriented liberal democracies) to the threat of popular revolutions, socialism, and Communism. As the frequency and severity of economic and financial crises increased. Three decades of relative social and economic stability then ensued, from the late 1940’s until the mid-1970’s, a period when inequality fell sharply and median incomes grew rapidly.

Some of the lessons about the need for prudential regulation of the financial system were lost in the Reagan-Thatcher era, when the appetite for massive deregulation was created in part by the flaws in Europe’s social-welfare model.

Those flaws were reflected in yawning fiscal deficits, regulatory overkill, and a lack of economic dynamism that led to sclerotic growth then and the eurozone’s sovereign-debt crisis now. But the laissez-faire Anglo-Saxon model has also now failed miserably. To stabilize market-oriented economies requires a return to the right balance between markets and provision of public goods. That means moving away from both the Anglo-Saxon model of unregulated markets and the continental European model of deficit-driven welfare states. Does an alternative Asian growth model — if there really is one — has not prevented a rise in inequality in China, India, and elsewhere?

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