Institut für Makroökonomie
und Konjunkturforschung
Macroeconomic Policy Institute

Policy Brief

October 2009

From the financial crisis to the world economic crisis

The role of inequality *

Gustav Horn, Katharina Dröge, Simon Sturn,
Till van Treeck, Rudolf Zwiener

* English version of IMK Report No. 41,
translated from German into English by Katja Rietzler

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A central cause of the crisis, which the public debate has taken little notice of so far, is the rapid increase of income inequality in many industrialised countries, but also in some emerging economies (IMK 2009). In the USA many private households have reacted to stagnating real incomes by increasingly extending their borrowing. This was facilitated by a deregulated financial system. Only thus could private consumption become the main pillar of economic growth in the USA for years. The opposite holds for Germany: here the weak wage dynamics and social spending cuts have induced consumption restraint rather than higher debt, thus causing an extended period of weak domestic growth. High capital exports and a strong (and risky) foreign market involvement of the banking sector (cf. also Horn et al. 2009 for an analysis of the relationship between the economic crisis and global imbalances) were the flip side of the extreme export hikes of the German economy, which were enhanced by weak wage increases. In the current financial crisis the limits of these opposite growth models become evident: both are based on the necessity to compensate the sluggish trend resulting from an increasing income inequality with other sources of demand. These consisted either in increased household borrowing (USA, UK, Spain) or in export-led growth (Germany, Japan, China).

The importance of a growing income inequality for the explanation of the global economic crisis is increasingly emphasised by internationally renowned economists (cf. Fitoussi/Stiglitz 2009). At the same time the growing economic disparity is interpreted as the result of a shift in the political power structure, which has to be reversed in favour of lower income groups (cf. Krugman 2008). The German debate, by contrast, is still characterised by demands for further wage restraint, social spending cuts and increases of the international competitiveness (cf. Sinn 2009a, Schmidt 2009, Dreger 2009), which would signify merely a continuation of the pre-crisis strategy. In the light of the current crisis better-founded research on the potentially negative repercussions of an unequal income distribution on the economy as a whole is an important challenge in macroeconomics. This IMK Report sketches some hypotheses on this issue; it is the third in a series on the causes of and remedies for the economic crisis (IMK 2009, Horn et al. 2009).

The following section begins with an empirical appraisal of the development of economic inequality in selected industrialised countries. Despite some national idiosyncrasies it can be shown that since the early 1980s there has been a general shift in the income distribution at the expense of employees and low-income groups. In a second step the determinants of the income distribution which are typically referred to in the literature

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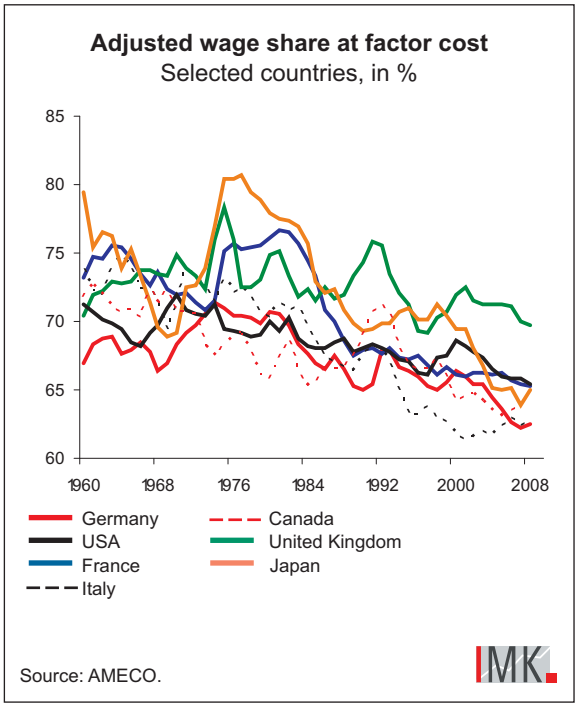
are discussed. This is followed by a digression of the relationship between the income distribution and unemployment. The publications which dominate the theoretical and political debate have long assumed a positive relationship between income inequality and growth dynamics. Political interference with the income distribution, especially in favour of lower incomes, has generally been considered harmful and responsible for higher unemployment. Empirically this relationship is far from unequivocal, both from a historical and from an international perspective. In fact, there seems to be a wide choice of political approaches to income distribution.

The following sections focus on the most recent trends of distribution and growth in the USA and in Germany as two key examples. A special focus of the analysis is the extent to which the deregulation of the financial system in the USA has offered new borrowing possibilities for low-income households, which temporarily propped up private consumption expenditure. For Germany, by contrast, statistical analyses show that the increasing inequality in the distribution of primary incomes[1] as well as social spending cuts during recent years have contributed significantly to an increase in the household savings ratio. As simulations with the IMK's macro-econometric model have shown, higher wage increases – in line with productivity growth and the ECB's inflation target – and lower savings would, on balance, have resulted in a better growth performance during recent years despite losses in net exports. Thus, Germany would also have contributed to a reduction of global trade imbalances (cf. Horn et al. 2009). Whereas the consumption boom in the USA was facilitated by tremendous private household borrowing and substantial capital imports from abroad, while the income inequality was rising, Germany (similarly to Japan and, to some extent, China) confirmed its role as a "free rider": among others by extreme wage restraint it neglected domestic growth and consequently depended on the willingness of the "deficit countries" to borrow. At the same time German banks – despite their rather conservative domestic lending practices – temporarily reaped high returns on speculative foreign financial products. As the current world economic crisis drastically illustrates, both growth strategies are unsustainable in the long run.

Figure 1



Redistribution in favour of profits and high incomes

Since the 1980s slower trend growth, rising unemployment, declining wage shares and an increasing income polarisation have been observed in most OECD countries (cf. Glyn 2005).

Figure 1 shows the wage share for the G7 countries – Germany, France, the UK, Italy, Japan, Canada and the USA -, which jointly produce more than 50 % of global GDP. For all countries in the analysis it is shown that after the peak in the 1970s the wage share has followed a declining trend in the last three decades, a development which can be observed in almost all OECD countries (cf. Glyn 2009). This means that real wage increases have remained below productivity growth for more than three decades and that profits account for an increasingly high share of national income.

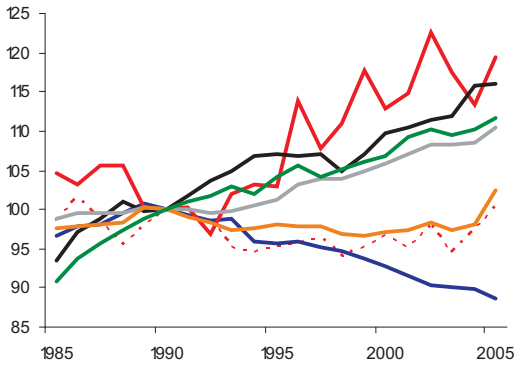
Equally the personal income distribution has become increasingly polarised in many countries since the 1980s (cf. Kenworthy/Pontusson 2005, Alvared/Piketty 2008; OECD 2008a; Brandolini/Smeeding 2009). Figure 2a shows the dispersion of men's gross wages as a measure of personal income distribution. It is defined as the ratio of the top level income of the 9th decile and the top level income of the 1st decile. The larger this ratio, the more wages drift apart. In most OECD countries for which data is available wage dispersion has increased significantly since the mid-1980s. This general trend conceals very different developments. Especially in Germany, New Zealand, the Netherlands, Sweden and the USA the increase in wage dispersion has been very pronounced. Figure 2b shows the development of the lower half of the wage

[1] Incomes before taxes, social contributions and transfers.

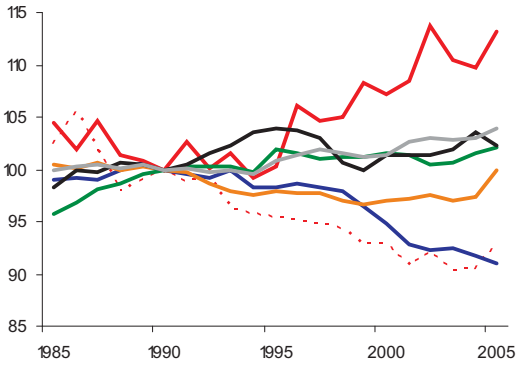
Figure 2

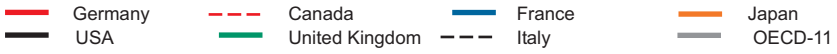
Wage dispersion
Selected countries

(a) Decile ratio 9/1 of gross full-time wages for men, index: 1990=100



(b) Decile ratio 5/1 of gross full-time wages for men, index: 1990=100





Annotation: Ratio of the top level incomes of the 9th over 1st decile Fig. (a) and of the 5th over the 1st decile Fig. (b).
OECD-11: Canada, Finland, France, Germany, Japan, Netherlands, New Zealand, Sweden, United Kingdom, USA.
Source: OECD 2008a.

distribution in selected countries. Whereas the wage dispersion at the bottom has declined in Canada, Finland, France and Japan, it has increased strongly in Sweden, the Netherlands and Germany (cf. OECD 2008a).

Figures 3a and 3b show an additional measure of the personal income distribution, the Gini coefficient based on primary income and disposable income[2] of private households, respectively. The more unequal the distribution of incomes the further the Gini coefficient moves from 0 towards 1. With the exception of France the analysed countries exhibit a trend increase of the Gini coefficient since the mid-1980s. This trend increase can also be observed for the average of the OECD-countries. If transfers are taken into account the increase is slightly dampened, but even disposable income is distributed more and more unequally.

What are the reasons for these feeble wage increases and for the polarisation of the income distribution in recent decades?

Causes of the re-distribution processes

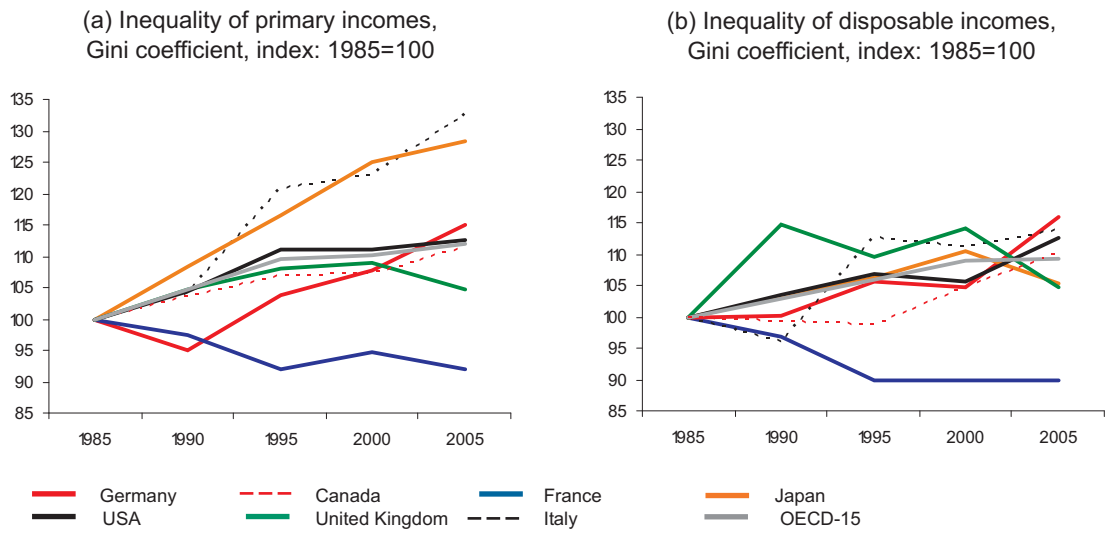
Scientific literature offers no unequivocal answer to these questions. Important determinants of functional and personal income distribution found in the literature are globalisation, technological change and labour market institutions – such as the level and duration of unemployment benefits, employment protection laws, minimum wages, taxes and social contributions on wages (tax wedge), unions and collective bargaining systems. Globalisation – or, more precisely, a type of globalisation favouring mobile production factors, i.e. capital – is said to increase the pressure on wages, especially for low-skilled employees, and to lead to a declining wage share as well as a more unequal personal income distribution. Equally the technological change of the most recent decades is said to have lead to a devaluation of the work of the low-skilled. Coordinated wage-bargaining, strong unions and other labour market institutions might counteract this trend under certain circumstances. In the literature measures of the personal income distribution are partly explained by political variables – such as the political orientation of the governing parties. In addition, the secondary distribution – that is the distribution of incomes after redistribution by the state – is affected by tax policies and the supply of public goods.

From their econometric analyses the IMF (2007) and the EU Commission (2007) draw the conclusion that technological change is the most important varia-

[2] Income after taxes, social contributions and transfers.

Figure 3

Income inequality
Selected countries



Annotation: The more unequal the distribution, the higher the Gini coefficient.
OECD-15: Canada, Denmark, Finland, France, Germany, Greece, Italy, Japan, Luxembourg, Netherlands, New Zealand, Norway, Sweden, United Kingdom, USA.
Source: OECD 2008a.

ble explaining the decline of the wage shares during the most recent two and a half decades. But globalisation is also found to play a vital role, whereas labour market institutions contributed little to an explanation. In addition Guscina (2006) finds a positive influence of employment protection laws on the wage share. Stockhammer (2009) identifies a strongly negative effect of trade and financial globalisation, and a positive effect of union density – that is the share of workers who are organised in a trade union – on the wage share. Nunziata (2005) explains the evolution of real unit labour cost and finds, that productivity, unemployment and labour market institutions are the most important independent variables.

Rueda and Pontusson (2000) estimate the causes of the increasing wage dispersion. Acording to their study, high union density, centralised wage-bargaining, high employment in the public sector and leftist governments significantly reduce the inequality of wage incomes. Pontusson et al. (2002), too, obtain similar results. Königer, Leonardi and Nunziata (2004) investigate the causes of wage inequality among men and find an equalising effect of employment protection laws, the level and duration of unemployment benefits, union density and minimum wages. Baccaro (2008) explains the determinants of the Gini coefficient. In the time dimension key independent variables include in particular the demand for qualified labour, foreign direct investment (FDI) and trade liberalisation. Union density and coordinated or centralised wage-bargaining play a particular role in explaining differences in the income inequality between countries.

Kenworthy and Pontusson (2005) and Brandolini and Smeeding (2009) show that redistribution by the government leads to a reduction of income inequality. The OECD (2008a) points out, that public goods (such as the education system, infrastructure and health care) have to be taken into account when measuring the distribution of secondary incomes. And in their analysis Alvaredo and Piketty (2008) point to the key role of tax policies and partly of social norms for the evolution of secondary incomes of the top strata.

All in all the empirical literature partly provides very different results concerning the main causes of the declining wage share und the rising income inequality. However, there is a consensus that globalisation, technological progress and labour market institutions are among the most important determinants.[3] Furthermore, recent political science literature increasingly provides evidence that the political orientation of the government is also an important explanation (see box: “Paul

[3] Numerous microeconomic studies also confirm the influence of labour market institutions – especially trade unions – on wages (c.f. e.g. Kahn 2000; Bentolila/Saint-Paul 2003; Card et al. 2004, Blanchflower/Bryson 2004; Dustman et al. 2009) Azmat et al. (2007) find a negative effect of privatisation on the wage shares in network industries.

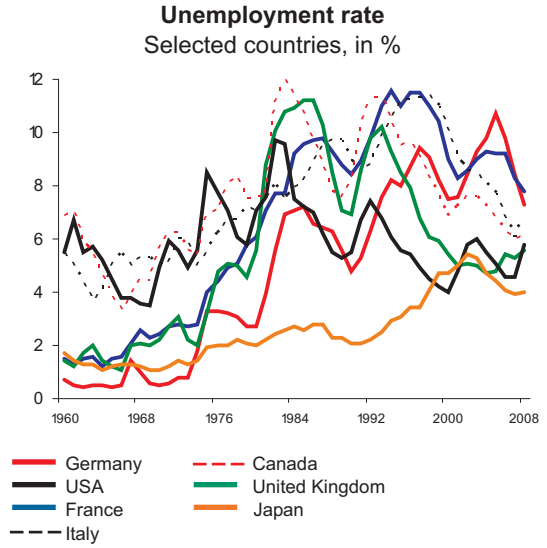
Krugman on the extreme increase in income inequality in the USA"). To a large extent there seems to be a consensus that stronger unions, coordinated wage-bargaining, minimum wages and other institutions, which strengthen the bargaining power of employees, contribute to a more egalitarian distribution of wage and household incomes.[4] In addition the bias in the income distribution can partly be corrected via tax policies and the provision of public goods. Thus the income distribution is not a purely exogenous variable, but can – at least in part – be influenced by policy.

Trade-off between unemployment and inequality?

Whereas income inequality is considered unfair by most citizens in industrialised countries (cf. Gatti/Glyn 2006), many economists, especially in Germany, have warned against higher wages and a smaller dispersion of (at least primary) incomes. To fight unemployment, which – particularly in Europe – has risen sharply since the 1970s (cf. Figure 4) they demanded that wage increases remain below productivity growth (implying a declining wage share) and additionally that the wage structure be further widened (implying a higher wage dispersion), for "wage restraint creates jobs" (IW 2009, translated from German into English by the IMK).[5] According to this view labour market institutions such as trade unions, ("implicit") minimum wages and other state social security institutions, which enable employees to demand "excessive" wages, are the cause of the high unemployment.

In many countries economic policies have followed these views, which began to establish themselves in the early 1980s. In the Anglo-Saxon countries the emphasis on increasing the flexibility of labour markets and the renunciation of Keynesian-inspired demand management is closely linked to the change of the ruling political parties in the early 1980s (cf. Eggert/Krieger 2009; Krugman 2008; Freeman/Pelletier 1991; Glyn 2005). In other industrialised countries the OECD – and later also the IMF and the EU Commission – equally played an important role propagating such economic policies (cf. Howell 2005). Despite weak empirical evidence these multinational organisations advised their member states to carry out far-reaching measures of labour market flexibilisation (cf. OECD 1994, 1997, 1999; IMF 1999), which were to decrease wage pressure and to raise wage dispersion. For this, they argued, was the only way to fight unemployment.

Figure 4



Initially economic policy conclusions were based on the concept of a "natural rate of unemployment", which emerges under given market institutions. Since the late 1980s the natural rate has been derived from a one-sided interpretation of a New Keynesian equilibrium model of the labour market, the NAIRU model, as well as a one-sided interpretation of the empirical literature. In fact the NAIRU model is largely undetermined in terms of economic policy conclusions (cf. Carlin/Soskice 1990, 2006; Hein 2004; Stockhammer 2008). However, many empirical studies reduce the issue to labour market institutions allegedly impeding employment (cf. e.g. OECD 1994; Siebert 1997; Nickell et al. 2005).

This explicit attribution of equilibrium unemployment to labour marked institutions is controversial in the international literature. Thus e.g. Blanchard and Katz (1997, p. 67f) argue as follows concerning the role of labour market institutions in the determination of unemployment: "Despite the OECD endorsement, this approach faces conceptual and empirical problems. At the theoretical level, [...] while rigidities can indeed increase cost and lead to labor market sclerosis, it is not clear that they lead to high unemployment. At the empirical level, [...] the cross-country evidence on the relation of unemployment to rigidities is less than fully

[4] In many of these studies the influence of unemployment is controlled for. Labour market institutions generally have an equalising effect on incomes and tend to raise the wage share. Unemployment has the opposite effect. Thus, in the second round the question arises whether labour market institutions affect unemployment.

[5] Sometimes it is argued that wage restraint can go hand in hand with a stable or even increasing wage share, if there is a corresponding increase in employment. This would require very restrictive assumptions about the elasticity of substitution of the production factor labour, which are dubious from a theoretical point of view and cannot convincingly be supported by empirical evidence (Felipe/McCombie 2001; Acemoglu 2003).

supportive." And Fitoussi, Jestaz, Phelps and Zoega (2000, p. 257) find "that the institutional reforms in the OECD proposal can only be a small part of the story."

Some authors detect a better explanation of the evolution of unemployment over decades in the combined effects of labour market institutions and exogenous macroeconomic shocks (cf. Blanchard/Wolfers 2000; IMF 2003; Bassanini/Duval 2006). According to the prevailing interpretation of this approach negative macroeconomic shocks lead to an increase in inequality in countries with flexible wages, because of inadequate social security systems and weak unions, whereas these shocks resulted in higher unemployment, especially among low-skilled workers, in countries with rigid wages.[6] In this context a frequently voiced hypothesis was: "[G]rowing U.S. inequality and growing European unemployment are different sides of the same coin" (Krugman 1994, p. 62).[7]

Although these shocks were taken into account, macroeconomic stabilisation policies were considered only for the short term, for due to strong theoretical prejudice any influence of monetary or fiscal policy on the equilibrium long-term unemployment was ruled out a priori. Policy advice remained largely unchanged. The empirical literature – especially that of the influential policy-relevant institutions such as the OECD, the IMF and the EU Commission – paid little attention to the possibility that in the long run unemployment is much rather affected by the price-setting behaviour of the business sector, changes of behaviour and preferences of individuals or demand components as well as macroeconomic policies. Overall, however, different empirical studies yield a surprisingly diversified picture. Yet the public debate in Germany has so far taken little notice of it.[8]

In this context e.g. the studies of Baker et al. (2004, 2005) and of Baccaro and Rei (2007) are worth mentioning. Based on extensive literature studies and estimations of their own Baker et al. (2004, 2005) reach the conclusion: "While it is possible to construct multivariate regressions that find significant relationships between various labour market institutions and the unemployment rate, it is also easy to construct equally plausible regressions that do not. In short, the econometric evidence on this issue is at best inconclusive. It is certainly not the sort of evidence that governments should use for making public policy." (2004, p. 15) After numerous verifying estimations and tests for robustness Baccaro and Rei (2007) find that "the impact of labor market institutions is, for the most part, not robust and that unemployment is mostly increased by high real interest rates and independent central banks" (p. 563).[9]

Meanwhile even the OECD, which was a driving force in the liberalisation of labour markets for a decade, is no longer certain about the effects of the welfare state and trade unions on unemployment. In its Employment Outlook 2006 it points out that with respect to the design of labour market institutions there are several ways of achieving low unemployment:

- Firstly, the Anglo-Saxon way, characterised by low product market regulation, a small tax wedge, low unemployment benefits, limited employment protection, weak trade unions and decentralised wage-bargaining.
- And Secondly, the Nordic way, characterised by wage-bargaining between social partners, a good social safety net, high unemployment benefits, strict product market regulation, an average tax wedge and moderately strict employment protection laws.

"This suggests that there is not a single road for achieving good employment performance." (OECD 2006, p. 192) According to the OECD the two successful models differ in that the group of Nordic countries spends substantially more on labour market policies, but also exhibits significantly higher income equality and substantially lower relative poverty (cf. OECD 2006, p. 190ff, esp. Table 6.3, p. 191).

Richard Freeman (2007, p. 19f) summarises the current results of the scientific debate on the empirical effects of labour market institutions as follows: "For all of the difficulties in pinning down the impact of institutions on aggregate economic performance across countries, analyses have found that institutions have a major impact on one important outcome: the distribution of income. [...] By contrast, despite the considerable effort, researchers have not pinned down the effects, if any, of institutions on other aggregate economic outcomes, such as unemployment and employment."

In a nutshell we can conclude: For decades the cutback of social benefits and partly even the weakening

[6] In international comparative studies this potential cause of different trends of unemployment in the USA and in European countries, especially Germany, has repeatedly been questioned (c.f. Nickell/Bell 1996; Card et al. 1999; Freeman/Schettkat 2001; Howell/Huebler 2005; Möller 2008).

[7] Meanwhile Paul Krugman has revised this hypothesis and now favours a political explanation of the increasing income inequality in the USA (see box: "Paul Krugman on the extreme increase in income inequality in the USA" as well as Krugman 1999 on a macroeconomic and philosophical explanation of sluggish growth in Germany).

[8] This is also astonishing, because, especially for Germany, a number of well-known studies on unemployment reach the conclusion that labour market institutions cannot contribute to a satisfactory explanation of German unemployment (c.f. Bassanini/Duval 2006, p. 13; Nickell et al. 2005, p. 20).

[9] Similar results – though interpreted differently – are found by the IMF (2003).

of trade unions have been promoted by economists, several international organisations and individual governments in most OECD countries. This – there is a broad consensus in the scientific literature – has led to a weakened bargaining power of employees and to an increased economic inequality. According to the view of the labour market dominating in the public debate there has been a wide-spread conviction that this would help to reduce unemployment in return. However, there is no agreement on the latter in the scientific literature and numerous empirical research findings challenge this argumentation.

For a long time, the Anglo-Saxon model of deregulated labour markets and a relatively weak welfare state has been preached as a role model. This model was indeed said to coincide with higher income inequality, but it was assumed to produce higher employment as a reward. However, as is now becoming obvious, the apparent success of the Anglo-Saxon model rested to a very significant extent on the compensation of the weak income dynamics of a large part of the population by extended borrowing as a source of strong consumer demand. Or, in other words: If there is a connection between income inequality and the financial market bubble – which is very plausible in our view – the success of this model proves largely illusionary with hindsight. The following section further explores the potential connection between increasing inequality and the economic crisis.

Worldwide increase in inequality as structural cause of global imbalances and financial market instability

An international team of experts under the leadership of Jean-Paul Fitoussi and Nobel laureate Joseph Stiglitz has recently presented a report on the background of the global financial crisis and the resulting policy recommendations (Fitoussi/Stiglitz 2009). The increasing income inequality observed in most countries since the early 1980s is identified as the key structural cause of the crisis. According to this report it has given rise to weak demand, because the lower income groups tended to have a higher propensity to consume than rich households.

In the USA, however, the stagnant trend caused by the increasing inequality had been offset by increased household borrowing: “In the US the compression of low incomes was compensated by the reduction of household savings and by mounting indebtedness that allowed spending patterns to be kept virtually unchanged” (p. 4).

In most European countries, by contrast, the increasing inequality is found to have led to completely different macroeconomic effects. Here the redistribution is found to have caused increased savings and slower growth. A less innovative financial sector as well as institutional restrictions, such as the European Stability and Growth Pact, are found to have limited the borrowing potential of private households as well as the governments.

According to Fitoussi and Stiglitz, the differing reactions of individual countries to the increasing inequality had mutually reinforced each other. For the USA’s and other countries’ inequality-induced borrowing requirements had been matched by excessive savings in some European and other countries, which had equally been due to the income distribution. This had continued until the resulting instability had erupted into the current crisis: “Thus, the combination of structural disequilibria that goes by the name of global imbalances resulted in a fragile equilibrium that temporarily solved the aggregate demand problem on a global scale at the expense of future growth” (p. 4).

The IMK has presented an essentially identical analysis of the undesirable macroeconomic trends that led to the global financial crisis (van Treeck et al. 2007; Hein/van Treeck 2008; IMK 2009). In the following the relationship between income distribution, growth dynamics and financial market stability is to be illustrated in more detail using the USA and Germany as examples.

USA: Instability due to credit-based growth and increasing inequality

Figure 5 shows the share of the richest households in the USA’s total private household income before tax. This measure of income inequality is frequently used for long-term comparisons due to the good data availability in the tax statistics. It becomes obvious that – after a process of redistribution from the bottom to the top, which continued roughly three decades – income inequality is again as high as it was in the 1920s (cf. Piketty/Saez 2003).

Currently there is a growing awareness that the unequal income distribution is largely the result of political decision-making and not exclusively due to technological change or globalisation (cf. box: “Paul Krugman on the extreme increase in inequality in the USA”). After the Great Depression of the 1930s and the Second World War, too, the substantial income inequality was identified as a key cause of the crisis (Eccles 1951; Galbraith 1954). With Franklin Delano Roosevelt’s New Deal the lessons had been learnt and targeted political measures were taken in favour of the

Figure 5

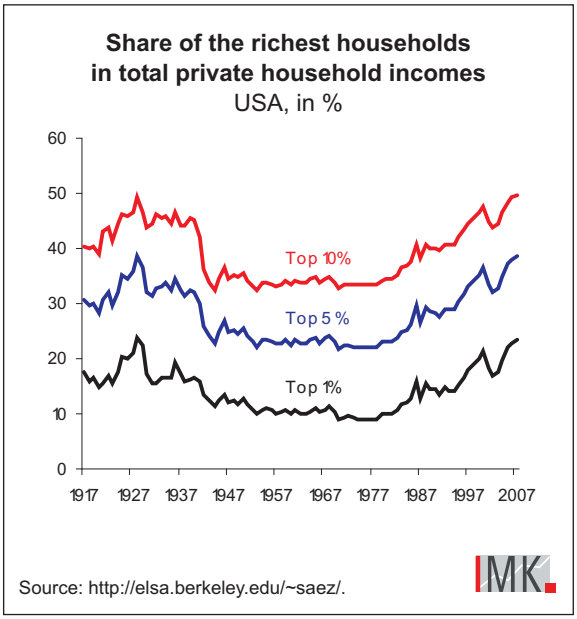
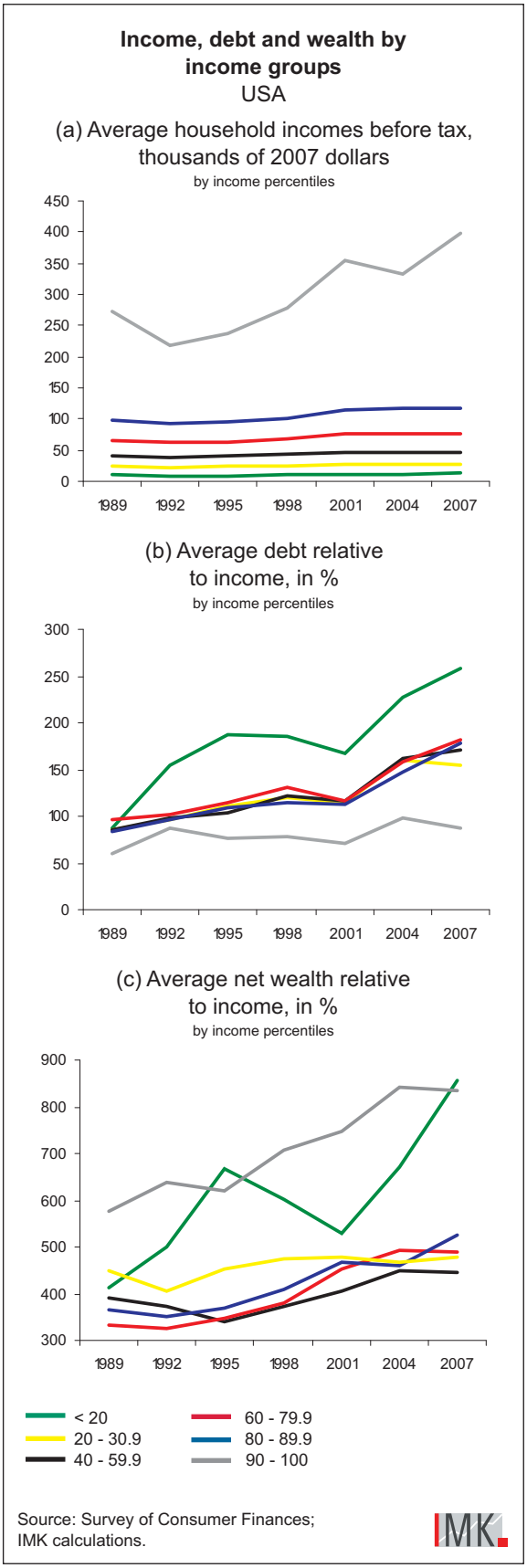


Figure 6



lower and medium income groups (Krugman 2008; Goldin/Margo 1992). Since the "neo-conservative Revolution" and the weakening of the trade unions in the 1980s income inequality has surged once more.

As Figure 6a shows for the period since the late 1980s, the richest 10 % of private households managed to achieve by far the sharpest increase in their pre-tax incomes. According to the statistics of the Survey of Consumer Finances the annual median real pre-tax income per household has not even risen half as fast between 1989 and 2007 as the average income. Since the beginning of this decade the median income has hardly risen at all. This development coincides with the decline of the wage share (cf. Figure 1) and above all with a strongly increasing wage dispersion: For decades the real wage increases of the bottom 90 % of households have remained below the average productivity growth (cf. Dew-Becker/Gordon 2005). Obviously the inequality of disposable incomes has been enhanced by the diminishing progressivity of the tax system (cf. e.g. Piketty/Saez 2003).

Despite the weak trend of real mass incomes private consumption was the driving force of economic growth in the USA for an extended period. On the one hand high income households in the USA seemed to exhibit a lower savings ratio than those in most other rich industrialised countries – at least temporarily. Particularly during the "new economy" boom of the 1990s the share price-based increase in equity, which was spread very unevenly across households, seems to have contributed to a declining savings ratio of the private household sector as a whole (Maki/Palumbo 2001). On the other hand, financial innovations and de-

Paul Krugman on the extreme increase in income inequality in the USA

Paul Krugman – Laureate of the Nobel Prize in Economics in 2008 – argued in the mid-1990s that income inequality and unemployment are two aspects of the same process in different countries. Meanwhile he has thoroughly revised this position and justified his reorientation at length in his book "The Conscience of a Liberal: Reclaiming America from the Right", which was first published in 2007.
The fact that income inequality is "as high as it was in the 1920s" (Krugman 2008; pp. 4-5), is not primarily the result of market forces according to Krugman:

"[...] I've become increasingly convinced [...] that political change in the form of rising polarization has been a major cause of rising inequality. That is, I'd suggest an alternative story for the last thirty years that runs like this: Over the course of the 1970s, radicals of the right determined to roll back the achievements of the New Deal took over the Republican Party, opening a partisan gap with the Democrats, who became the true conservatives, defenders of the long-standing institutions of equality. The empowerment of the hard right emboldened business to launch an all-out attack on the union movement, drastically reducing workers' bargaining power; freed business executives from the political and social constraints that had previously placed limits on runaway executive paychecks; sharply reduced tax rates on high incomes; and in a variety of other ways promoted rising inequality." (Krugman 2008; p. 7)

In reaction to the world economic crisis in the 1930s and the massive economic inequality President Franklin D. Roosevelt's "New Deal" laid the foundation for an egalitarian distribution of incomes - by means of an employee-friendly labour market and social legislation and an increased taxation of profits and high incomes. Gradually this new social and economic consensus was also accepted by the Republicans, because of its popularity and success, and served as the basis of the after-war boom. "[T]he Great Compression was, in fact, followed by the greatest sustained economic boom in U.S. history." (Krugman 2008, p. 62)

In the 1970s the new political right, known as "movement conservatism" succeeded in occupying key positions of power in the Republican Party. "It's a network of people and institutions that extends far beyond what is normally considered political life: In addition to the Republican Party and Republican politicians, movement conservatism includes media organizations, think tanks, publishing houses and more. [...] Money is the glue of movement conservatism, which is largely financed by a handful of extremely wealthy individuals and a number of major corporations, all of whom stand to gain from increased inequality, an end to progressive taxation, and a rollback of the welfare state – in short, from a reversal of the New Deal." (Krugman 2008; p. 10) Ronald Reagan is considered the first representative of "movement conservatism" in the White House. According to Krugman Reagan's economic policies were characterised by the weakening of trade unions and the welfare state and a tax policy in favour of high income earners. The political and institutional transformation of society, which was started in those days, is still effective today.

According to Krugman the hypothesis of politically induced redistribution is particularly supported by the following findings of the scientific literature:

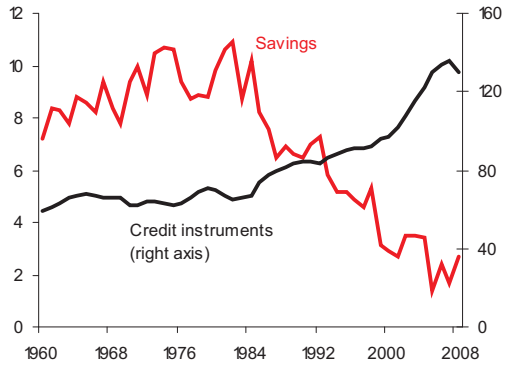
- An examination of the roots of the American middle-class yielded the result that it did not emerge gradually: "Instead, America's postwar middle-class society was created, in just the space of a few years, by the policies of the Roosevelt administration – especially through wartime wage controls." (Krugman 2008; p. 7). After these measures had been phased out, the relatively egalitarian income distribution persisted for three decades. "This strongly suggests that institutions, norms, and the political environment matter a lot more for the distribution of income – and that impersonal market forces matter less – than Economics 101 might lead you to believe." (Krugman 2008; p. 8)
- The temporal coincidence of the political and the economic change suggests a causal relationship: "[...] the timing strongly suggests that polarizing political change came first, and that rising economic inequality followed." (Krugman 2008, p. 8)
- Looking at the winners and losers of income trends during the last three decades, it becomes obvious that even highly qualified employees could achieve only moderate increases of their incomes. "The big winners, instead, have been members of a very narrow elite: the top 1 percent or less of the population. As a result there is a growing sense among researchers that technology isn't the main story." (Krugman 2008, p. 8)

- Technological change and globalisation can be assumed to affect all countries in a similar way. However, an international comparison reveals that the increase of income inequality in the USA has been particularly pronounced since the 1980s, whereas other countries observed a comparatively moderate rise in inequality.

Reference:
Krugman, P. (2008): The Conscience of a Liberal: Reclaiming America from the Right, Allen Lane, London.

Figure 7

Savings and debt of private households relative to disposable income
USA, in %



Source: NIPA tables, flow of funds; IMK calculations.

liberate measures of financial market deregulation have facilitated an ever rising indebtedness also of the bottom income strata (cf. box: "On the political economy of deregulated lending in the USA and in Germany"). According to Sapir (2009) the growth dynamics of the recent past can be interpreted as follows: "The US economy maintained a high rate of growth by substituting credit – mostly mortgage credit and the now notorious home equity extraction mechanism – for labor income. This was helped by a highly pro-active monetary policy but also by securitization. In a largely deregulated financial environment securitization helped banks and mortgage brokers to lower interest rates on high-risk mortgages. The cut-throat competition in the mortgage industry was a strong impetus to extend the securitization process to the mortgage industry (with mortgage-backed securities)."

As a result these developments have lead to a downright fall of the savings ratio and a simultaneous surge of debt relative to the disposable income of the private household sector (Figure 7). Indeed, the debt of the lower income strata has risen much more sharply relative to their income during the last 20 years than that of the richest households (Figure 6b). This is due, in particular, to the increase in mortgages. Admittedly the poorest fifth of households also recorded a higher than proportional increase of its net wealth, especially during the housing boom since the beginning of the 2000s (Figure 6c). However, this resulted mainly from rising property prices rather than additional savings. When the housing bubble burst, the over-indebtedness of a large part of the American population became evident.

With the financial crisis the growth and social model of the USA has reached its obvious limits (Palley 2009). For decades insufficient increases of real incomes and inadequate social security were supposed to be compensated by the promotion of home ownership and easy access to credit (cf. box: "On the political economy of deregulated lending in the USA and in Germany"). This model was complemented by permanently expansionary monetary and fiscal policies, which kept unemployment low and thus limited the social consequences of the increasing inequality.

The macroeconomic implications of this growth model consisted in systematic and high financial deficits in both domestic sectors – the private and the government sectors – of the US economy. This could not lead to anything but a high trade deficit and the necessity of massive capital imports from abroad, which reached about six percent of GDP just before the onset of the crisis. Thus, a number of difficult macroeconomic challenges emerge for the future. Although they were identified by some authors a long time ago (e.g. Godley 1999; Papadimitriou et al. 2002), they had not entered common consciousness before the global economic crisis (cf. e.g. Sinn 2009b).

A stricter regulation of the financial system will be necessary to prevent tendencies of over-indebtedness in the private household sector. However, if consequently the channel of a steady credit growth as a basis for strong private consumption is blocked, new sources of a strong and dynamic consumer spending will have to be found. In other words: Private consumption will have to be fed to a larger extent by current incomes rather than by new borrowing.

To enable the USA (and other current deficit countries) to rebalance their growth pattern towards stron-

On the political economy of deregulated lending in the USA and in Germany

USA: "Home ownership as substitute for social policies"?[10]

There is evidence that across countries there is a negative relationship between home ownership and the welfare state (Eggert/Krieger 2009, p. 391). In the USA the promotion of home ownership especially for lower income strata has traditionally played an important role.

In reaction to the world economic crisis government influence on the promotion of homeownership increased tremendously in the 1930s. During this period the foundation of the – at that time still state-owned – Federal National Mortgage Association, better known as Fannie Mae was decided. The Glass-Steagall-Act of 1933 aimed at a privileged position of the Savings & Loans Institutions in mortgage finance. For instance the savings banks were exempted from the interest ceilings introduced by the "Regulation Q". At the same time the Glass-Steagall-Act introduced a strictly separate banking system, where commercial banks could not speculate in the stock markets and investment banks were excluded from retail banking. These measures strengthened the competitive positions of the savings banks, which were thus able to expand their mortgage lending at low interest rates.

Whereas the government-controlled promotion of home ownership was accompanied by an expansion of the welfare state and a decline in economic inequality, privatisation and deregulation of mortgage finance was enhanced in the 1980s and increasingly understood as a "substitute for social policies": As "rational politicians were clearly aware of the socially disruptive force of a growing income disparity, [...] [and] the increases of wage income in the USA had remained substantially below that of capital and profit incomes, the promotion of home ownership in favour of the middle class played a politically important role." (Eggert/Krieger 2009, p. 392 f, translated from German into English by the IMK). In this context the deregulation of the financial system was pushed deliberately by policymakers in order to meet the rising demand of mortgage loans: "[T]he genius of the market economy, freed from the distortions forced by government housing policies and regulations [...] can provide for housing far better than Federal programs. [...] [T]he Nation can no longer rely so completely on a system of highly regulated and specialized mortgage investors and a single type of mortgage instrument if the strong underlying demand for housing credit is to be met." (President's Commission on Housing 1982 as quoted by Eggert/Krieger 2009, p. 393)

Particularly the following concrete steps towards deregulation and a government promotion of home ownership are worth mentioning:

1968 and 1970: Partial privatisation of Fannie Mae and Freddy Mac
Parallel to privatisation the idea of securitisation emerged. Fannie Mae and Freddie Mac bought mortgages and emitted so-called mortgage-backed securities (MBS).

Promotion of home ownership as "Affirmative Action" since the 1970s
The Community Reinvestment Act (CRA) of 1977 and the Home Mortgage Disclosure Act (HMDA) of 1975 aimed to encourage banks to expand loans to minorities. This policy was continued under George W. H. Bush within the framework of the HOPE-programme (Homeownership and Opportunity for People Everywhere), under Bill Clinton (relaunch of the CRA in 1995) as well as under George W. Bush (Objective of creating 5.5 million properties for minorities from 2002 onwards). Obviously such policies were also seen as a measure to alleviate social conflicts and especially to reduce the number of violent assaults in residential areas.

Deregulation of the savings banks in the early 1980s
The Depository Institutions Deregulation and Monetary Control Act (DIDMCA) of 1980 and the Depository Institutions Act (Garn-St.Germain-Act) of 1982 deregulated the savings bank sector. The DIDMCA lifted the ceilings for interest on deposits. This put savings banks under pressure to generate higher yields on their assets. In addition the savings banks began to provide adjustable rate mortgages to an increasing extent.

1988: Basel I and the securitisation boom
According to the Basel Agreement of 1988 Banks had to hold capital equivalent to at least 8% of their assets. One possibility for banks to evade this regulation was to sell existing loans to third parties. Thus, the respective loan no longer burdened the balance sheet. The sale also freed liquidity for the extension of new loans.

Commercial banks have increasingly entered the securities business since the 1980s
In the 1980s the commercial banks have increasingly entered the trade with securities[KR1]. At the same time they were allowed to merge with companies that earn less than 10 % of their gross turnover in the securities business. By the mid-1990s this ceiling had been raised to 25 %.

1992-1996: Fannie Mae and Freddy Mac expand their support in the low-income sector
In 1992 the Federal Housing Enterprises Financial Safety and Soundness Act ruled that the mortgage finance companies Fannie Mae and Freddy Mac should use part of their funds for facilitating affordable home ownership for individuals with low incomes. In 1996 the American Ministry of Housing and Urban Development instructed Fannie Mae and Freddy Mac to carry out 42 % of their mortgage financing in the low income sector (incomes below the median income). This objective was met in 1998.

1997: Invention of credit default swaps
In 1997 the so-called credit default swap (CDS) was invented. A CDS is a security supposed to serve as an insurance against financial market risks such as the collapse of asset prices. The security is the promise of its issuer to refund a potential loss. From the perspective of a single bank the default risks are reduced by a credit insurance, which increases the incentives for increased lending, because the credit does not have to be backed with equity. As the CDS were not subject to any regulation, nobody examined whether the insurer had sufficient funds to be able to compensate for any damage at all.

1999: Gramm-Leach-Bliley-Act
The requirement of a separate banking system is lifted: commercial banks may engage in security transactions without limit.

2000: The Bush Administration and the American Dream
In June 2000 President George W. Bush declared that he wanted to raise the number of home owners from difficult social backgrounds substantially. For this purpose he promised tax relief and support from Fannie Mae. At the end of the same year he signed the American Dream Downpayment Act, which envisaged supporting the downpayment by a loan of 10,000 dollars or 6 % of the house price.

2001: The boom of the Ninja loans
In the USA it is possible to raise a mortgage loan without downpayment. The[KR2] borrower's liability is limited to the value of the property, excluding all his other assets. The banks deliberately failed to verify whether the borrowers had sufficient financial means. They even tempted low income household with so-called Ninja loans (no income, no job, no assets). These Ninja loans offered the possibility of completely deferring the payment of principal during the first five years. In addition a "teaser rate" which was often below the market rate was agreed initially. However, it was replaced by an adjustable rate after some years. Banks sold their loans off to so-called "special purpose vehicles" (SPV), which repackaged and resold the loans. In contrast to banks these SPV are not subject to any regulation or capital requirements.

Germany: "Porsches versus Lehman-Brothers Certificates"?

In contrast to the USA no domestic credit bubble has built up in Germany in the recent past. On the one hand this may be due to the differing social norms and the stronger welfare state. On the other hand banks' lending has traditionally been more cautious and conservative. At the same time it could be observed that German banks were engaged in the international mortgage-backed securities trade with substantial capital and

thus got into distress during the financial crisis. Thus, along with the one-sided orientation towards exports the strong international involvement of the banking system is equally called into question: “It should by now be sufficiently clear that it did not make any sense to sell Porsches for Lehman-Brothers Certificates and then boast about being the world export champion.” (Sinn 2009a, translated from German into English by the IMK) However, the question is why German banks were so cautious and risk-averse when extending domestic loans and at the same time ran high risks in the international financial markets.[11]

Traditionally conservative lending

For a long time risk protection had been the primary objective of German regulators (the Bundesbank and until 2002 the Federal Banking Supervisory Office). As far as possible the regulators prohibited the trade with new financial products, which were classified as risky, in the German markets. Until the late 1980s avoiding bankruptcies of German financial intermediaries was given priority over the promotion of competition.

Despite Germany’s strong export orientation the German financial markets have long been largely isolated from international competition. Due to the high capital gains tax (40 % to 50 %) hostile takeovers of German banks and companies were virtually impossible. Thus, the German universal banks were able to earn adequate yields at a relatively low risk, while the investment business remained unattractive for an extended period.

Liberalisation tendencies after the mid-1980s

Since the mid-1980s the German regulatory authorities were increasingly forced to give up their resistance to innovative financial products, among others by pressure from the European Community. Since 1993 all investment funds which were licensed in one EC-country had to be licensed in all other countries, too, irrespective of the local minimum reserve requirements.

The four financial market promotion laws from 1990 (inter alia: abolition of the stock exchange tax, limited admission of options trade), 1994 (inter alia: admission of money market funds), 1998 (inter alia: admission of trade in interest rate and foreign exchange swaps, improved possibility to trade in futures and options) and in 2001 (inter alia: liberalisation of stock exchange legislation and revision of the law on securities trade) lead to a significant liberalisation of the German financial market. The Law on Control and Transparency in the Business Sector (Gesetz zur Kontrolle und Transparenz im Unternehmensbereich, KonTraG) passed in 1998 introduced new forms of risk management (Ratings to assess the profitability of investments). This law was an important step for banks to develop indicators of their investment strategies.

The tax reform of the year 2000

A radical reorientation of the German financial system took place after the tax reform of the year 2000. Due to the abolition of the capital gains tax for corporations – which was unusual by international standards – German banks now faced significantly increased competition. For fear of hostile takeovers many banks aimed at higher returns on equity.

Weak domestic lending and risky foreign focus of the German banking system

In recent years credit demand of the domestic sectors has been rather weak (Sachverständigenrat 2007). However, lax lending practices similar to those in the USA were prohibited by regulations. The main refinancing instrument of German mortgage loans is the mortgage bond (Pfandbrief), which can only be issued for up to 60 % of the loan value according the mortgage bond law (Pfandbriefgesetz). In addition, the determination of the loan value has to follow “conservative” standards. The market for securitised debt only slowly got under way, although vested interest groups such as the “True Sale Initiative” succeeded bringing about changes in the legislation. Nevertheless, it seems that the traditionally close relationship between banks and clients as well as fears that the clients would not tolerate the sale of their loans stopped banks from expanding their securitisation business.

At the same time, however, German banks hardly hesitated to get engaged in securitised foreign mortgage debt, which had long been awarded top grades by international rating agencies. Here, the banks, under pressure for high returns, were offered seemingly safe investments with high yields, which in addi-

tion required little capital if bought by special purpose vehicles located abroad.

As a result the German banks were severely shaken by the American real estate crisis, although the domestic lending practice has long remained rather conservative by international standards. For, supported by the deregulation measures in the German financial system, American banks found keen buyers for their highly speculative securities.

[10] For a detailed description of the regulations discussed in this section see Eggert/Krieger (2009); Markham (2002); Isenberg (2007).

[11] For a detailed description of the developments discussed in the following cf. Franke (2001); Flach (2005); KFW Bankengruppe (2009); Verband Deutscher Pfandbriefbanken (2009).

ger export growth and thus reduce their trade deficits, those countries which have exhibited substantial trade surpluses are required to allow for higher domestic growth (cf. Horn et al. 2009). For a long time, these countries have benefitted from the USA's readiness to incur new foreign debt and thus been able to cushion the stagnant trend resulting from growing inequality by export-led growth. As Fitoussi and Stiglitz (2009) point out the global external imbalances are caused not least by the rising income inequality in individual countries. In the following this is analysed in greater depth for Germany.[12]

Germany: Instability through export-dependent growth combined with a weak domestic economy and rising inequality

The increase in economic inequality in Germany during the last decade, which was exceptionally strong by international standards, is well-documented by now. Traditionally Germany was less affected by income inequality and poverty than the average OECD country. However, there has been a drastic increase of inequality in the last ten years. Recently the OECD (2008b) has even observed: "Since 2000, income inequality and poverty have grown faster in Germany than in any other OECD country." This becomes particularly obvious in the very weak income trend of the lower income groups (cf. Kalina/Weinkopf 2009). Between the mid-1990s and the mid-2000s the real disposable income of the bottom fifth of private households has fallen even in absolute terms, which has only been the case in Belgium, Japan, Turkey and – to a lesser extent – in Mexico and in the USA (OECD 2008a). Meanwhile Germany is slightly above the OECD average of relative income poverty according to the OECD definition (households with less than 50 % of the median income are considered poor). In the mid-1980s the poverty risk in Germany was still about a third lower than on average of the 19 OECD countries, for which data is available.[13] The causes can be found both in the more unequal distribution of primary incomes and in social and tax policy decisions, which affect the secondary distribution of incomes.[14]

With respect to the primary distribution we can observe both a rapid decline of the share of wages in national income and a growing inequality of wage income ("wage dispersion"; cf. Figures 1, 2a, 2b). Both forms of redistribution had long been called for by many economists and government advisors (e.g. Sachverständigenrat 1992, paragraph 371; 1999, paragraphs 340ff. ; 2000, paragraphs 416ff.).[15] At the same time the labour market reforms of recent years corresponded to this logic: As the OECD 2008a observes, wage inequality is usually linked strongly with atypical employment. In Germany such employment was actively promoted (marginal employment such as "Minijobs" and "Midijobs"; temporary work and so-called "One-Euro-Jobs"),

[12] Some authors see the strong export-orientation of China and Japan in context with the rising income inequality there (cf. He/Kuijs 2007; Rogoff 2007; Economist 2009).

[13] Although a slight decrease of income inequality – as measured by the Gini coefficient – and of the poverty risk could be recorded in 2006 due to the economic upswing and the decline of unemployment (Frick/Grabka 2008), the distribution of disposable income remained more unequal than at the beginning of the decade. In 2007 people even perceived the income distribution as more unfair than in 2005 (Liebig/Schupp 2008). Recent data which fully reflects the effects of the latest upswing is not yet available. In the course of the current financial crisis and the resulting rise of unemployment income inequality is likely to increase again.

[14] In addition the German reunification has led to some shifts in the income distribution. In 1991 the Gini coefficient in the new "Länder" was still significantly lower than in West-Germany. By 2004 it had risen above the West-German level. This is not true for the secondary incomes: Here the increase in inequality was equally much stronger in the new "Länder" than in West-Germany, but the level of the Gini coefficient still remained below the West-German level in 2004 (cf. Sachverständigenrat 2006; Table 51).

[15] For instance the German Council of Economic Experts (Sachverständigenrat) states in the discussion of minimum wages: "A rising dispersion by qualification in the wage structure is an essential element of the therapy rather than some unwelcome side-effect." (Sachverständigenrat 2006, p. 402, translated from German into English by the IMK)

and the eligibility criteria for unemployment benefits were tightened (Logeay/Zwiener 2008).

Although data of the European Commission shows that the share of employees in the German low-pay-sector was already above the EU average (EU Commission 2004), the wage dispersion, especially in the bottom segment of the wage structure, has continued to increase significantly (Brenke 2007). There is hardly any other EU member state, where the full-time labour income of the poorest 10 percent – compared to the median decile – has shown a performance as bad as in Germany between the mid-1990s and the middle of this decade (OECE 2008a, p. 80). According to calculations of the European Commission (2004) there are now very few countries in the EU where the wage dispersion between the bottom and the median decile is as pronounced as in Germany (see Aust et al. 2007 and Dustmann et al. 2009 for a detailed analysis of the low-pay-sector and wage dispersion in Germany).

Furthermore, the increasingly unequal distribution has been fostered by a number of tax and social policy reforms. These include cuts in unemployment benefits and in the state health care and pension systems as well as tax relief especially for high incomes and wealth as well as burdens on private consumption (see Vogt/van Treeck 2009 for a survey). If measured by the Gini coefficient the inequality of disposable income has risen as much as that of primary incomes (cf. Figures 3a and 3b).

Just as Krugman (2008) has shown for the USA, the drastic increase of economic inequality is not only the result of technological change and market forces, but also a trend, which has deliberately been brought about by policy makers. Moreover, it can be doubted, whether the trend of unemployment, which is unsatisfactory from a longer-term perspective, is indeed due to excessive wages or an insufficient wage dispersion and low incentives to work owing to a high burden of taxes and social contributions.

For instance Brenke (2009, p. 559) rejects sectoral change as an explanation of the weak trend of employees' compensation during the latest decade: "Much rather there have been real wage losses for employees in general during the last decade, although their qualification levels had increased on average. It seems rather that the particular employment problems of low-skilled persons are adduced to contain demands for higher wages in general" (translated from German into English by the IMK). This explanation is supported by the fact that Germany also exhibits unemployment above the EU average for medium-skilled persons (Brenke 2007, p. 73). By contrast, according to the OECD's statistics the share of low-skilled workers in the labour force (employees, self-employed persons and unemployed persons) between 25 and 64 years is extremely low in Germany by international standards at only 13 % (Deutsche Bundesbank 2007a, p. 45). Thus, the Bundesbank concludes "that there is no clear empirical evidence for the statement that the employment situation of individuals commonly classified as low-skilled is exceptionally bad" (p. 45, translated from German into English by the IMK). Thus, the broad consensus of the political elites that the main reason for unemployment could be found in excessive wage cost seems doubtful (Logeay/Zwiener 2008).

Equally, the statement that a generous welfare state and a progressive tax system (and the resulting redistribution) exert negative effects on growth and employment lacks any convincing empirical foundation (cf. Truger 1999; Corneo 2006; Gatti/Glyn 2006).

On the contrary there are strong arguments for the view of Fitoussi/Stiglitz (2009), which interprets unemployment in Germany primarily as a demand problem and concludes that the weak development of real mass income has been a major cause of the largely stagnant growth trend.

This argumentation has repeatedly been put forward by the IMK, too (e.g. Logeay/Zwiener 2008; Horn et al. 2008; Hein/van Treeck 2008; Joebges et al. 2009). It can be illustrated by an analysis of the composition of Germany's latest upswing between 2004 and 2007 (Logeay/Zwiener 2008) and by means of a simulation with the IMK's macro-econometric model of the German economy (cf. Joebges et a. 2009, Meinhardt et al. 2009).

Unlike in the USA there has not been any significant increase of the indebtedness of private household relative to their incomes in Germany in the recent past (van Treeck et al. 2007). Instead the majority of the population has reacted to declining real wages and social spending cuts (especially in the state pension system) in recent years by reduced consumer spending. As statistical analyses show a large part of the increase of the household savings ratio is due to changes in the distribution of income and increased old-age provisions in connection with the recent pension reforms. According to a single-equation estimation of Meinhardt et al. (2009, p. 63) almost half of the increase of the savings ratio between 2001 and 2008 can be attributed to the shift in the income distribution from wage to profit incomes. The other half seems to be due to the effects of the pension reform. In addition to the obviously very strong social norm of a cautious personal financial planning, which affects credit demand, German banks' lending practices have traditionally been rather conservative, too (see box: "On the political economy of dere-

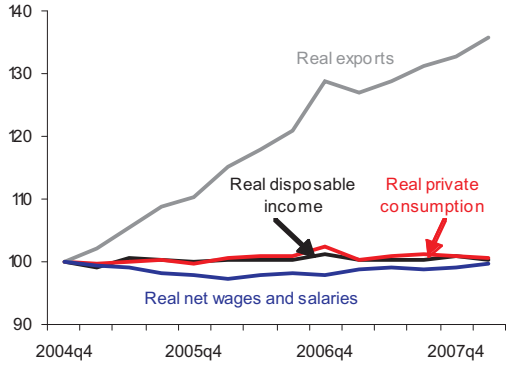
gulated lending in the USA and in Germany"). As a result unlike in the USA there has hardly been any significant wealth effect on private consumption expenditure in Germany. Instead, households predominantly finance their consumption through current income.

Real disposable income or net wages and salaries, respectively, did not even rise during the latest upswing (Figure 8). Real wages even fell in the upswing – an unprecedented development in German history (Logeay/Zwiener 2008; Brenke 2009). In general private consumption expenditure passively followed this stagnant income trend. Admittedly, the weak unit labour cost trend strengthened Germany's international competitiveness and, consequently, boosted exports. At the same time, however, the redistribution of incomes mechanically triggered an increase in the savings ratio of the private sector, as top income groups save more than the bottom income groups (Table 1, Deutsche Bundesbank 2007b). For the period from 2003 until 2007 alone about a third of the increase in the savings ratio could be explained by shifts in the income distribution (Meinhardt et al. 2009, p. 58).

The macroeconomic effects of wage restraint and the rising household savings ratio can be estimated by means of simulations with the IMK's macro-econometric model. If wage policy had followed the productivity trend since 1999, real wages would have risen 11 % faster than they actually did. This would have kept the wage share roughly unchanged. As in the IMK's model the wage trend also induces demand effects and unemployment is not primarily determined in the labour market through real wages, the consequences of higher real wages are theoretically undetermined. However, it turns out that the positive effects of a change in the distribution in favour of wage incomes on private consumption (and – via accelerator effects – on investment) dominate relatively to the negative effects on investment and exports in a relatively large economy like Germany. Thus, according to the model simulations a constant wage share since 1999 would have been accompanied by a higher real GDP and higher employment, whereas nominal net exports would have been 35 billion euro lower on balance after nine years (cf. Joebges et al. 2009, p. 22). Germany could thus have contributed to a decrease of global imbalances (Horn et al. 2009, p. 13). This would also have implied that the foreign orientation – which was not very helpful with hindsight – of the German financial systems would have been less extreme. A slower increase of the private savings ratio would have strengthened these effects (Meinhardt et al. 2009, p. 65ff.). In an optimal scenario the more favourable wage and consumption trends would have been supported by a more expansionary macroeconomic policy, which would have positive repercussions on the income distribution via lower unemployment.

Figure 8

Evolution of selected national accounts aggregates in the latest uspswing
Germany, index: 2004q4=100



Source: Logeay/Zwiener 2008, based on Destatis.

Increase of the dose or change of direction in distribution policy?

The strongly increased inequality is one of the roots of the current crisis. According to recent findings by the Nobel laureates Paul Krugman and Joseph Stiglitz and other renowned researchers the redistribution from the bottom to the top does not arise as the inevitable reaction to globalisation and technological change, but is above all a political and social process in favour of particular interest groups. At the same time, according to this view, the increase in inequality contributed decisively to the structurally weak demand in Germany as well as the macroeconomic instability which lead to the current world economic crisis.

The demand for a redistribution at the expense of the (bottom) wage incomes and in favour of profits and high incomes as well as a cutback of social spending combined with tax relief for "high performers" was also among the essential recommendations of influential economic policy advisors during the last ten years (e.g. Sachverständigenrat 1999, 2000; Sinn 2004). The German Council of Economic Experts (Sachverständigenrat) has seen this as part of the therapy and not as an unwanted side-effect or even the harbinger of the crisis.

It is remarkable that numerous economists in Germany seem to believe that the very distribution policy, which was used to exert pressure on wages and incomes before the crisis, could be continued unabated du-

Table 1

Savings ratio of private households by income quintiles
Germany 2003

Income group	Savings ratio in %
Total	11.6
Richest quintile	19.0
4th quintile	11.0
3rd quintile	6.0
2nd quintile	1.9
Poorest quintile	- 4.6

Source: Klär/Slacalek 2006 based on the Income and Consumption Survey (EVS) 2003.

ring and after the crisis. Thus, in reaction to the current world economic crisis and its strong effects on Germany there are demands for further wage restraint and further labour market deregulation, respectively, to achieve a successful growth performance (Schmidt 2009; Dreger 2009). This is said to be the only way to increase employment and Germany's attractiveness for foreign capital, which could eventually even reduce the export dependency of the German economy (cf. Sinn 2009a).

Ultimately it is argued that the German "World Championship in Exports" during recent years has not been fostered by strong wage restraint, but that it can be explained by the still excessively high (!) wage level, especially in the bottom segment: "For years Germany has ruined its domestic sectors via its egalitarian wage policy, which rendered it the World Champion of the unemployment rate of the low-skilled. The service sector has been decimated. [...] Capital and talents fled the labour-intensive domestic sectors, because they feared the fetters of an erroneous social policy, which countered the international low wage competition with high wage competition in the domestic labour markets. Part of the capital fled abroad; this explains the high export surplus. Instead of investing in Germany many businesses exported machines to foreign countries and there created the jobs whose loss is now deplored in Germany (Sinn 2009a, p. 38, translated from German into English by the IMK).

Although, logically, such an explanation of Germany's current account surplus cannot be ruled out, it is hardly falsifiable, because it ultimately reduces to the statement that, after the already strong redistribution from the bottom to the top during recent years has not produced the desired effects, the dose now simply has to be increased. Nevertheless, some doubts should emerge from the perspective of the advocates of this hypothesis, because with respect to the export dependency the opposite of the forecast effect has materialised, that is to say that the dependency on exports was rising continuously before the crisis.

Against the background of the theoretical and empirical relationships discussed above it is thus extremely doubtful whether Germany would be well-advised to continue the "experiment" of wage restraint and social spending cuts despite the associated social and macroeconomic risks.

For instance, according to all surveys one has to assume that the income inequality in Germany and in Europe is perceived as unfair by the population as a whole and is even disapproved of by the majority of individuals who are not directly affected by poverty (for a survey of international studies Gatti/Glyn 2006, S. 309-310; for empirical surveys for Germany Frick/Grabka 2008; Liebig/Schupp 2008). Against this background there should be at least very good, scientifically well-founded insights into important supply side growth effects to provide a rudimentary justification for the political promotion of income inequality – particularly in a deflationary international environment (cf. IMK 2009).[16]

By contrast if one adheres to the analysis of Fitoussi and Stiglitz (2009) and the IMK, there is a need for a fundamental change of direction in distribution policy to overcome the latent demand deficiency and the resulting susceptibility of the German economy to crises. The objectives and instruments are largely identical with those, recommended to resolve the global imbalances (Horn et al. 2009). This is no coincidence, because the global imbalances are closely linked to the redistribution of incomes.

A first step would be an economic policy which strengthens the unions' position in future collective bargaining, instead of weakening it as in the past. The introduction of a general statutory minimum wage and the extension of the general applicability of collective agreements are key elements of support. In addition new regulations are required for the applicability of temporary work, so that it will remain profitable in periods of above-average activity, but will no longer serve as a substitute for regular employment. All of this should cause wage formation to return to a trend, which is in line with productivity growth and does not – as in the past – remain below it. This would tend to stabilise the primary income distribution.

[16] "a neoclassical economist can hardly criticise a nation for having inadequate preferences" (Vartiainen 1998, p. 37 as quoted by Gatti/Glyn 2006, p. 310)

Additionally, economic policy should aim at a more even secondary distribution of incomes. This requires changes in taxes and social contributions, so that wealth and high incomes bear a larger burden and low income earners are somewhat relieved. The introduction of a wealth tax and a financial transactions tax as well as raising inheritance tax would be steps into this direction. At the same time the maximum income tax rate should be raised and the tax scale should be flattened, so that higher tax rates will be applicable only for higher incomes.

This package of measures should stop and possibly even reverse the trend of an ever rising inequality. As shown above, this is not just a demand resulting from deliberations on fairness, but also a prerequisite of future macroeconomic stability of the German and the global economy.

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