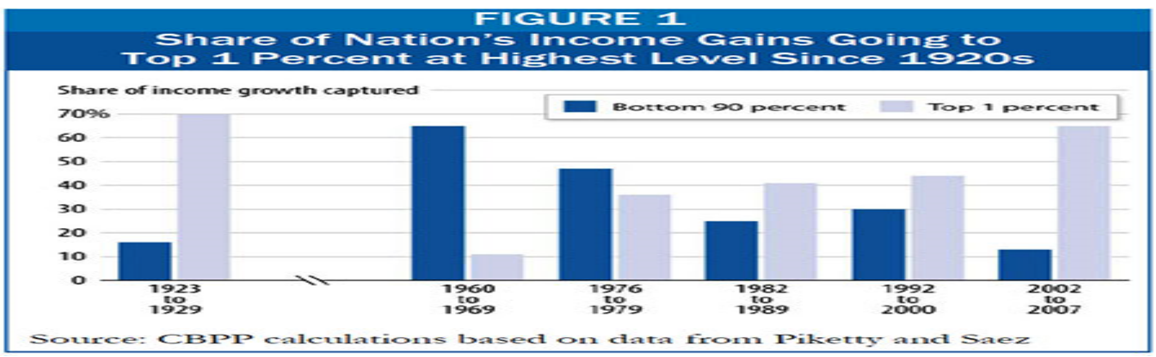
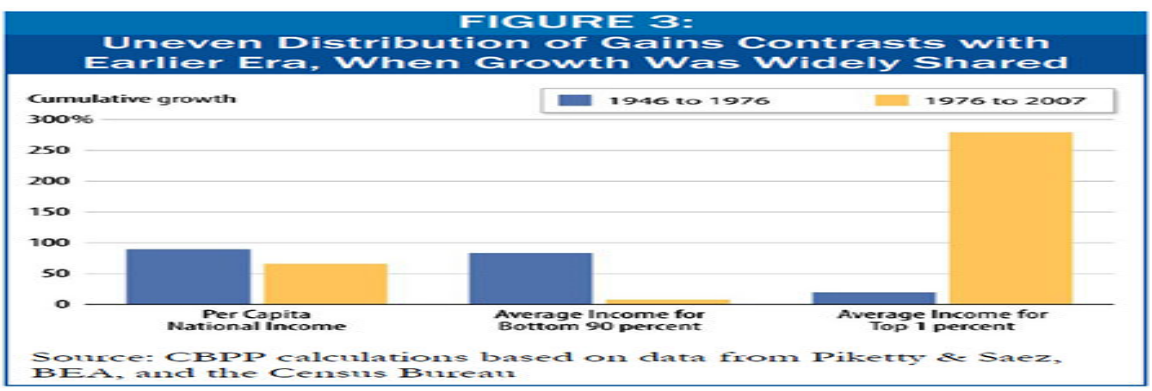
Financial FAQs

Great Inequality Causes Great Recessions

We are living in an era of the greatest income inequality since the Depression. So how do we cope with it? It is perhaps the major cause of our Great Recession, as it was the cause of the Great Depression.

Thomas Piketty and Emmanuel Saez among others have documented it (See Feb. 2003 Quarterly Journal of Economics). The Center for Budget and Policy Priorities (CBPP), a non-partisan think tank, using Piketty and Saez data, documents that income and asset inequality has risen to levels last seen in the 1920s (see graphs).





Income disparities before that crisis and the recent one were the greatest in approximately the last 100 years, according to Harvard Professor David Moss, who is among a small group of economists, sociologists and legal scholars trying to discover if income inequality contributes to financial crises. In 1928, the top 10 percent of earners received 49.29 percent of total income. In 2007, the top 10 percent earned a strikingly similar percentage: 49.74 percent. In 1928, the top 1 percent received 23.94 percent of income. In 2007, those earners received 23.5 percent.

Clinton Labor Secretary Robert Reich in a recent New York Times' op-ed has also been vocal about its dangers, as we said last week. "The national economy isn't escaping the gravitational pull of the Great Recession," he writes. "None of the standard booster rockets are working: near-zero short-term interest rates from the Fed, almost record-low borrowing costs in the bond market, a giant stimulus package and tax credits for small businesses that hire the long-term unemployed have all failed to do enough."

And, "It's no coincidence that the last time income was this concentrated was in 1928." Professor Reich hedges his bets, however. "I do not mean to suggest that such astonishing consolidations of income at the top directly cause sharp economics declines. The connection is more subtle."

This debate goes back to the Great Depression, as we have also said in past columns, when Roosevelt's Federal Reserve Chairman Marriner Eccles maintained that income inequality was a major cause of the Great Depression:

> "… a giant suction pump had by 1929-30 drawn into a few hands an increasing portion of currently produced wealth. This served them as capital accumulations. But by taking purchasing power out of the hands of mass consumers, *the savers denied to themselves the kind of effective demand* (my italics) for their products that would justify a reinvestment of their capital accumulations in new plants. In consequence, as in a poker game where the chips were concentrated in fewer and fewer hands, the other fellows could stay in the game only by borrowing. When their credit ran out, the game stopped."

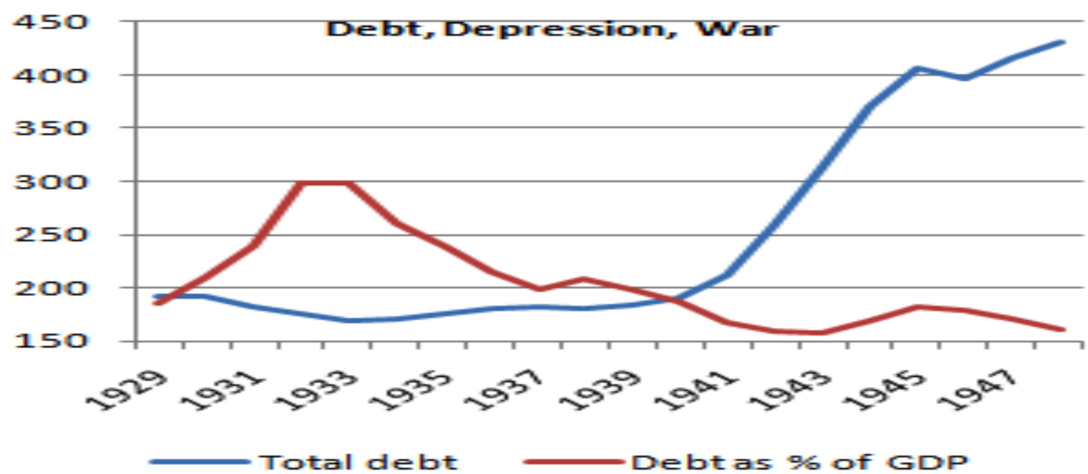
By effective demand, Eccles was referring to what economists today define as aggregate demand. Eccles was maintaining that the growth in income inequality created a credit bubble that burst and so led to an sharp diminishment in aggregate demand, which economists express as a formula.

The relationship is intuitively simple, yet was hard to verify before Piketty and Saez, et.al., did their research. As more income flowed to the top income brackets, middle and lower income classes had to borrow more to keep up their consumption patterns. And the easy credit available with the housing bubble accelerated that borrowing, to the tune of $2.3 trillion extracted from housing in the last decade. But then the excess of supply produced during the bubble caused housing values to crash, losing more than $4 trillion and counting of the $11 trillion in housing assets.

Professor Reich says we have to find ways to raise the wages of working people—the 90 percent who have suffered stagnant wages since the 1970s. Lowering payroll taxes for the lowest income earners who spend most of their incomes, while restoring the Clinton era taxes on those earning more than $250,000 is the most discussed remedy for such income disparity.

Another remedy is more stimulus spending. Nobelist Paul Krugman warns that without more stimulus we will have turned the clock back to 1938, when Roosevelt was faced with the same dilemma. He thought the economy had recovered sufficiently to cut deficit spending in order to balance the Federal budget. The country was against more stimulus spending then, as now, and Democrats lost 70 seats in the 1938 election. But that precipitated the second stage of the Great Depression, which was only cured by the tremendous deficit spending of WWII.

And deficit spending in fact works during extreme downturns. Because it stimulates economic growth and some inflation, which history documents is the only way to increase revenues enough to pay down such monumental debt. Krugman documents this with a graph of Depression-era debt compared to debt as a percentage of GDP. It shows that government deficit spending actually boosted economic growth (GDP) enough to lower total debt as percentage of GDP from 1933 to 1947, when the federal deficit grow to 150 percent of GDP. Why? Because it boosted revenues, whereas debt reduction measures during the Hoover Administration decreased revenues from 1929 to 1933.



Unfortunately, it does look like such 'structural' unemployment as we have—due to so many jobs going overseas—will keep unemployment high for years if not decades to come. And so a better social safety net similar to that of the rest of the industrialized world will have to be developed to even the playing field of rich vs. poor. Even Wall Street and Big Business will eventually recognize that it is good business to put more money into the pockets of those who spend it.

No country can care for its citizens without predictable financial markets, and a stable, growing economy.

Harlan Green © 2010