The Global Financial Crisis Discloses Dysfunctional Distribution of Income in Developed Economies. Where Do Central and Eastern Europe Stand?

Simona MARINESCU[1]
Cezar Radu COJOCARIU

Abstract

Born in 2008 in one of the most dynamic economies of the world as a massive financial crush and spilled over developed countries threatening growth and social stability, the global financial crisis unveiled structural problems in mitigating global risks associated with the integration of markets.

While the financial crisis received a strong response from the governments facing declining aggregate demand and recession, a sovereign debt crisis to follow the banking crisis was imminent, but its likely proportion was hard to estimate.

The paper approaches in a systemic way the distribution of income in developed economies, the issues associated to this process and the specific situation in CEE countries.

Keywords: *financial crisis, wages, labor, capital shares*

JEL classification: M10.

1. The European Union context

The ongoing third stage of the Economic and Monetary Union plan of Jacques Delors, aimed at converging the economies forming the Eurozone, is undergoing a massive financial tsunami with Greece, Portugal, Spain and Italy on the front line, raising questions as to where the implementation of the Stability and Growth Pact, proposed by German Finance Minister, Theo Waigel in 1990 and adopted by 17 member states in 1997, went wrong. Obviously, the countries facing prospects of defaulting today have operated for years outside the safety blanket set out by the two fiscal stability criteria of budget deficits lower than 3% of GDP and total national debt not higher than 60% of the GDP, without the European Central Bank to detect the noncompliance early enough.

Coming under criticism from the outset because of its alleged rigidity, the EU Stability and Growth Pact and its needed reform have been high on the agenda of the European Council of Economic and Financial Affairs since March 2011 for imposition of penalties and close oversight, but the damage is already in the financial system and in the confidence of European citizens across member states.

[1] **Simona MARINESCU,** UNDP Istanbul International Center for Private Sector in Development Director, Turky
Cezar Radu COJOCARIU, Bucharest Academy of Economic Studies, Romania

Before governments, central banks, politicians and the world at large draw conclusions and test long-term solutions, there is some merit focusing on root causes that have generated the crisis within the US financial market.

The debt-led consumption growth that has been extensively indulged in and that has destabilized mortgage industries, banks and insurance companies and, through collateralized debt obligations, banks and other businesses around the world, must be seen in the context of a demand and supply driven market economy. It may have had deep roots in the gradual decline of labor's share of national incomes that the US and the world have witnessed over the last three decades.

The capital-biased distribution of national incomes has led to a decrease of labor's share by 10% in the US alone during the last thirty years whereas in Greece the percentage of GNI going to labor dropped by over 31%, by almost 19% in Ireland and at a two digit- figure in Portugal, Austria, Finland and Japan for the same period. In 1961, economist Nicholas Kaldor included amongst his 6 "stylized factors", the constancy of factor shares demonstrating with the use of analytical tools that labor's and capital's shares do not change over time.

The Cobb-Douglas production function, widely used by central banks around the world to calculate potential GDPs and inflation rates based on which short-term interest rates are being set, considers labor being compensated at the 70% level of output whereas capital get the remaining 30% with the assumption that the factor shares remain constant over years as Kaldor predicted. But that has never been the case. Some constancy of the factor shares has been randomly observed, but the reality is that structural changes in national economies that have been transferred through globalization in the marketplace have triggered declining labor shares.

As a result, households making less money would have consumed less if easy access to loans had not been extensively promoted by the US Federal Reserve and other central banks in the developed economy in years preceding the crisis. The debt-led consumption growth of the last decades seems to have been behind the financial crisis of 2008 and at the core of the globalization consequences that have not been enough evaluated by the policy makers of developed countries. Wages as a variable component of marginal costs have been affected by the global competition, and unions – the traditional defenders – have lost strength against the mobility of capital that has relocated in markets more conducive to higher profits.
Studies conducted by the International Monetary Fund and famous economists including Prof. Joseph Stieglitz of Columbia University and Prof. Jean Paul Fitoussi in the Institute of Political Studies in Paris, have concluded that technological progress, the liberalization of trade in a very competitive global market as well as the diminishing power of unions that economies have witnessed over the last three decades, have contributed to the decline of labor's shares. Real wages have grown at a slower pace than has productivity, while capital's shares directed to shareholders have taken a larger portion of the income.

2. Analyses across the countries

In OECD countries, union coverage has shrunken significantly over the last two decades and, with it, the bargaining power over salaries and other work-related rights and benefits.

Analyses conducted across countries have shown that the marginal propensity of consumption is much higher amongst wage earners and their households, whereas owners of capital tend to save more.

In Central and European Countries, labor's shares have also declined. In Romania, the labor's share of income has dropped from over 79% in 1990 to an estimated 59% in 2011 [Figure 1] with a surge in value during 2000-2002.

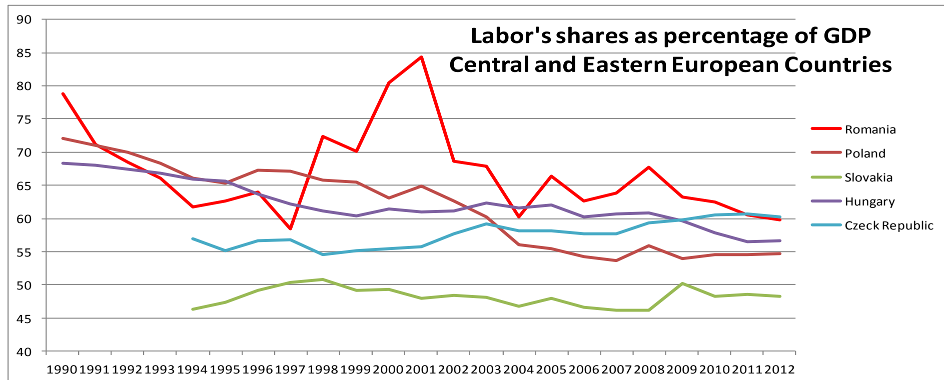

Figure 1. Employment compensation 1990-2011 as percentage of GDP at factor costs

Source: AMECO Database

One may wonder under such circumstances whether the Federal Reserve has set low interest rates to stimulate borrowing as a means to offset the deficit of demand resulting from declining labor's shares.

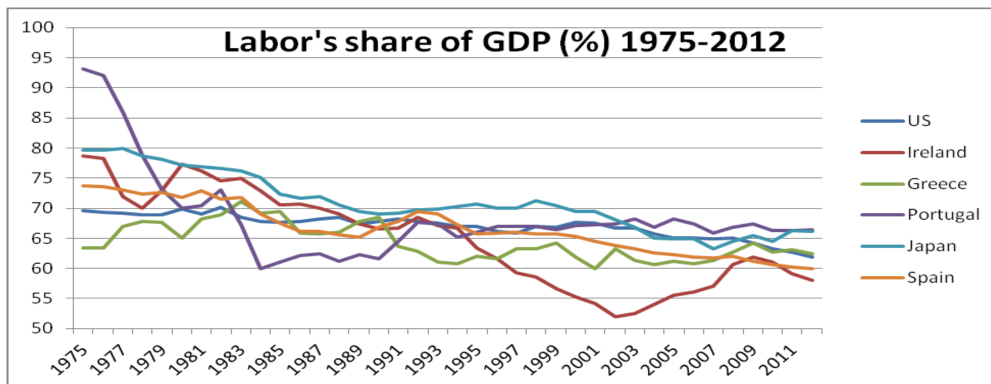

Figure 2. Employment compensation as percentage of GDP at factor costs in selected OECD countries

Source: AMECO Database

For the European countries affected by the US-born financial crisis of 2008, the question is what type of social policies should be adopted to prevent deflation, considering the downward trend of labor's shares and the high rates of unemployment that will further impact aggregate demand.

Keynes's advice that "in an economic crisis, print, lend, borrow and spend" seems to be excessively exercised by all of the central banks of the countries affected nowadays, but the velocity of money has decreased over the last year, signaling that the perception of recession has gained ground, making uncertain the return of economies to the upward track.

In response to the grim financial and economic reality of the Eurozone, the Europe 2020 Strategy adopted by the European Commission in March 2010 has set out three key priorities in an attempt to rebuild the viability of markets from within, but large fiscal imbalances combined with declining demand may not be conducive to notable results anytime soon. Development can be sustained through investment and growing exports, but there is much more to be done on the reform agenda to leverage policy and programmatic interventions in countries at the verge of defaulting to secure positive results towards the ambitious goals of the European strategy.

Concluding:

- Smart growth: developing an economy based on knowledge and innovation
- Sustainable growth: promoting a more resource efficient, greener and more competitive economy
- Inclusive growth: fostering a high-employment economy delivering social and territorial cohesion

These may sound relevant on paper, but challenges remain big and the lack of confidence that pervades all nations may be difficult to overcome.

European countries struggle with high youth unemployment rates for which the very generous social model of the last decades has not provided solutions. There might be a need for more flexible employment policies for new comers in the labor market to maximize their success in finding jobs.

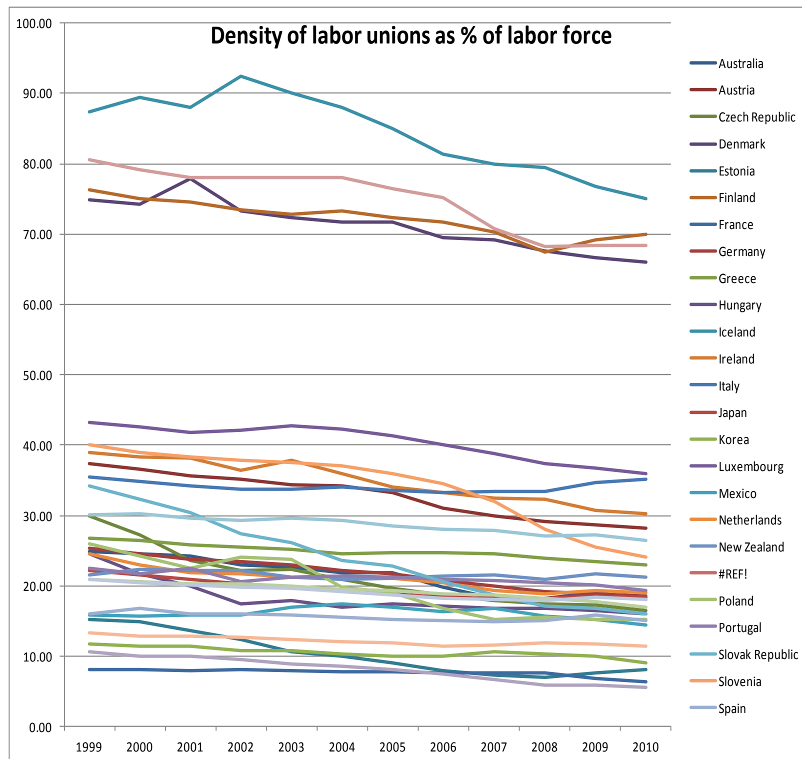

Figure 3. **Declining bargaining power in selected OECD countries**

Source: AMECO Database

The major risk that labor's declining shares may pose in the long run is the deepening inequality that may result between workers and owners of capital. Also, lower salaries mean lower social contributions to pension schemes that may fuel old age poverty and massive intergenerational discrepancies.

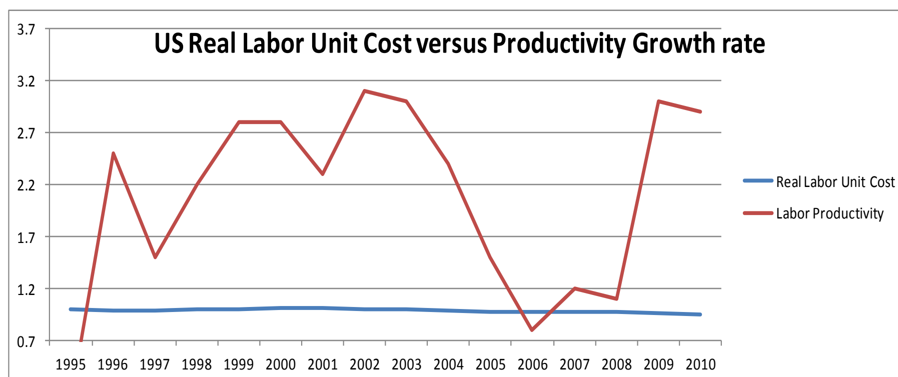

Figure 4. Labor compensation versus Labor productivity

To begin the process of restoring parameters of consumption and saving, central banks may need to factor in their forecasts of growth the dynamic of labor's shares so as to ensure that through monetary policies investment is encouraged. High productivity private sector jobs are needed to allow for a gradual reduction of public deficits and for sustainable, inclusive growth.

While for the US, the change in income distribution between labor and capital was the root cause of extensive debt-led consumption growth, for the entire developed world, restoring income distribution might be an important step forward towards post-crisis recovery.

References

[1] Mankiw, Gregory N: *Macroeconomics Sixth Edition*, 2007

[2] Hazlitt, Henry*: Economics in One Lesson*, 1946

[3] Hazlitt, Henry: *The Failure of the New Economics – An Analysis of Keynesian Fallacies*, 1959

[4] Stiglitz, Joseph E.: *Freefall, Free Markets and The Sinking of the Global Economy*, 2010

[5] Lewis, Hunter: Where *Keynes Went Wrong and Why World Governments Keep Creating Inflation, Bubbles and Busts*, 2009

[6] Krugman, Paul: *The Return of Depression Economics and the Crisis of 2008*, 2008

[7] United Nations *World Economic and Social Survey 2011*

[8] Blanchard, Olivier *Monetary Policy and Unemployment*, 2003

[9] Heise, Arne and Lierse, Hanna: *The Effects of European Austerity Programmes on Social Security Systems*, 2011

[10] Lee, Kang-kook and Jayadev, Arjun: *Capital Account Liberalization, Growth and the Labor Share of Income: Reviewing and Extending the Cross-country Evidence*

[11] Foley, Duncan K. *Unholy Trinity: Labor, Capital, and Land in the New Economy*,

[12] Zaman, Gh., Goschin, Zizi, Herþeliu, C.: *Analysis of the Correlation between the GDP Evolutions and the Capital and Labour Factors in Romania*, Romanian Journal of Economic Forecasting, 2005, pp. 5-21

[13] Atkinson A.B.: *Factor shares: the principal problem of political economy?,* 2009

[14] Felipe, Jesus Felipe and Kumar, Utsav: *Unit Labor Costs in the Eurozone: The Competitiveness Debate Again*, 2011

[15] Santos, Tano and Veronesi, Pietro: *Labor Income and Predictable Stock Returns*, 2005

[16] Hall, Robert E.: *The Rigidity of Wages and the Persistence of Unemployment*, 1975

[17] Ricardo Hausmann, Bailey Klinger, Rodrigo Wagner: *Doing Growth Diagnostics in Practice: A 'Mindbook'*, 2008

[18] Dumitru Miron; Cristian Păun: *Financial and monetary features of the international Business*, ASE Publishing House; Bucharest, 2001

[19] Nuti, Mario: *The European Social Model: Is There a Third Way?*, PECOB 2011

[20] Brian Hodgkinson: *A NEW MODEL OF THE ECONOMY*, 2007

[21] Alfonso Arpaia, Esther Perez and Karl Pichelman: *Understanding Labor Income Share Dynamics in Europe*, 2009

[22] International Labor Organization: *Global Wage Report 2010/11 – Wage policies in times of crisis*