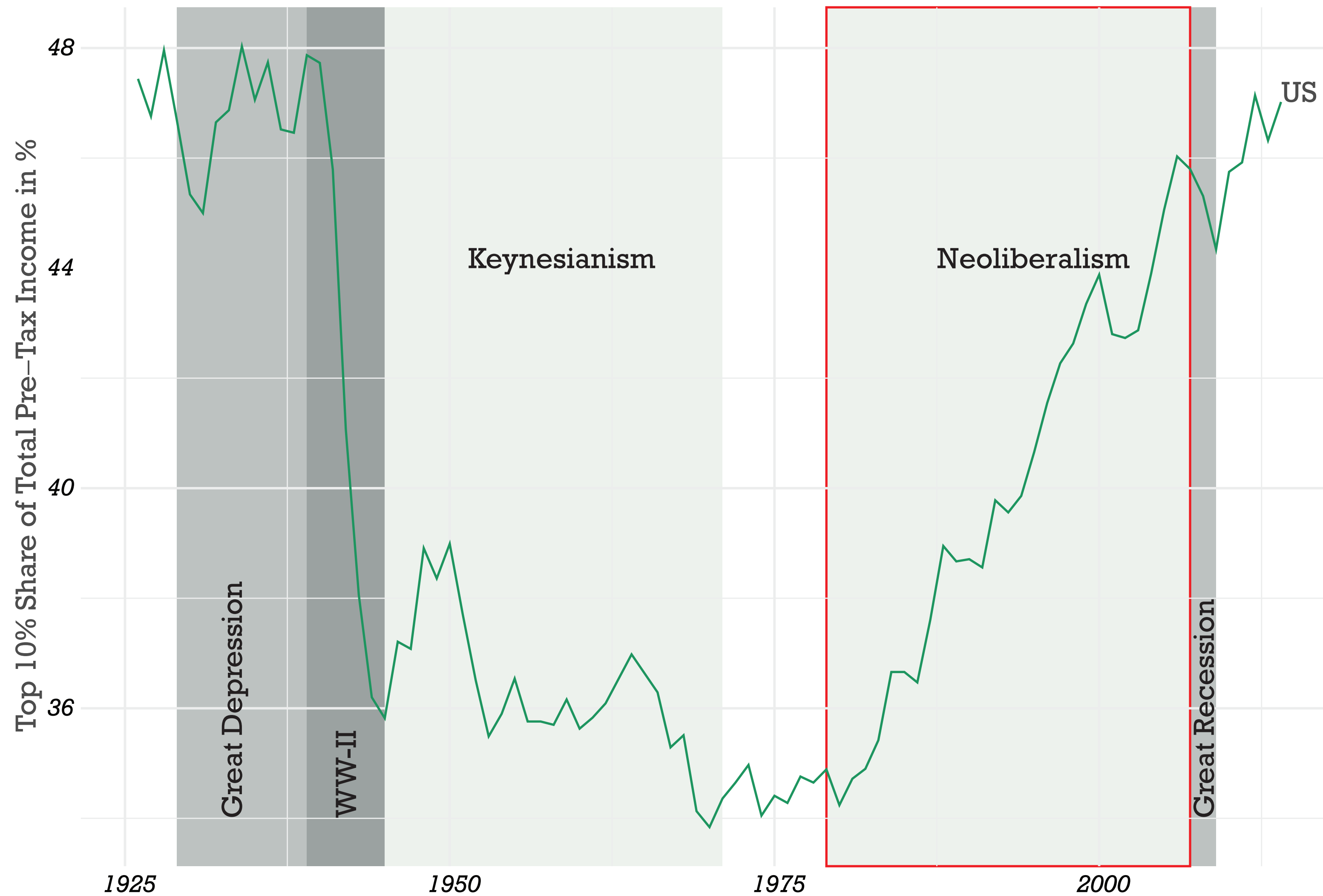
The Issue With Economic Policy and Inequality

Neoliberal Economic Policy Creates Income Inequality

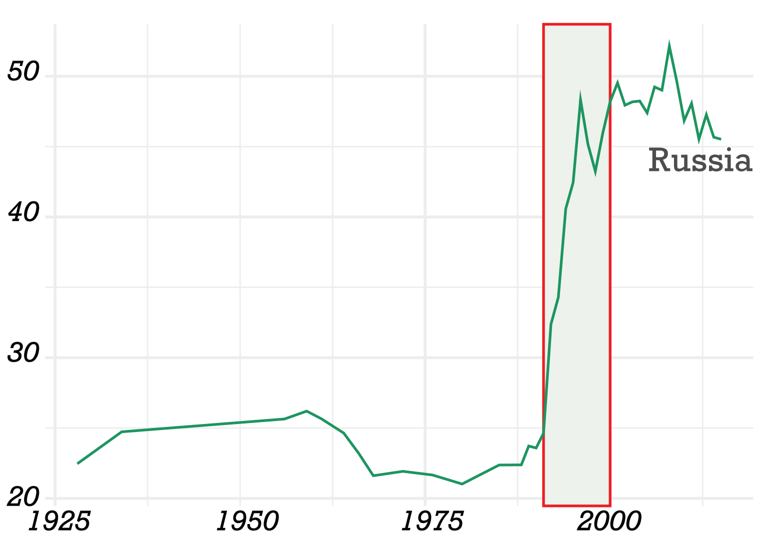


The Great Depression was a demand driven crisis, at least according to John M. Keynes. He argued that in an economic downturn the state should offset a decrease in investment in the private sector by heavily increasing government spending. This policy was implemented, although before Keynes had written down his theory: the second world war increased government spending. After the war Keynes published an economic justification for the policy which was very influential among western countries, including the United States.

In the graph to the right it is clear that the second world war changed the income distribution quite a lot. The share of the top 10% highest earners of total income dropped by almost 25%, not only for the period of the war but also after, when Keynesian policies were used.

Only in the 1980s, when the free-market policies advocated by neoliberalism took over, did inequality return to previous levels. As is a common problem in economics, this could totally be coincidental. There may be another factor influencing inequality that just happened to coincide with neoliberlism. But there are other examples of this behaviour.

In 1991 the Soviet Union collapsed and Russia started introducing free-market policies. The trend in inequality shows an even stronger effect on inequality.

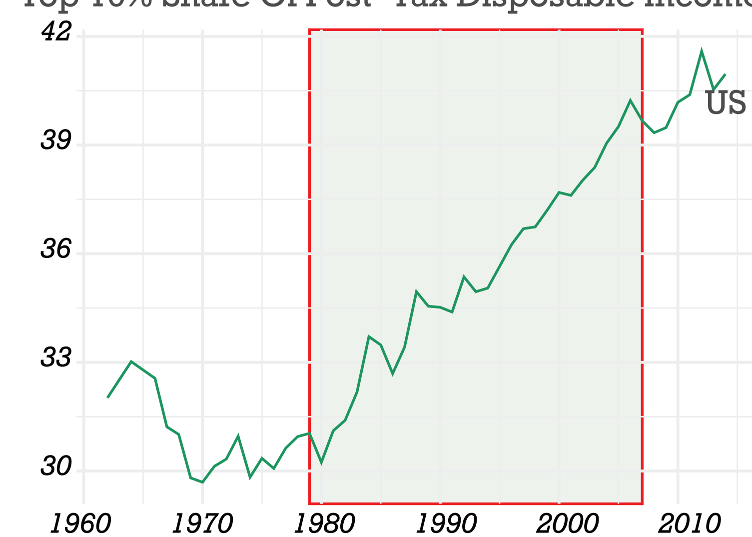


After opening up to the world economy, the share of total income going to the top 10% of the adult population almost doubled from below the level in the United States to significantly above.

In order to make a valid comparison, however, disposable income should be looked at, instead of pre-tax income. As Merryn Somerset Webb has recently argued in the Financial Times, inequality levels reduce drastically if tax rates and social benefits are taken into account.

The graph to the right shows that the level is, indeed, lower. But the trend of increasing inequality is still clear.

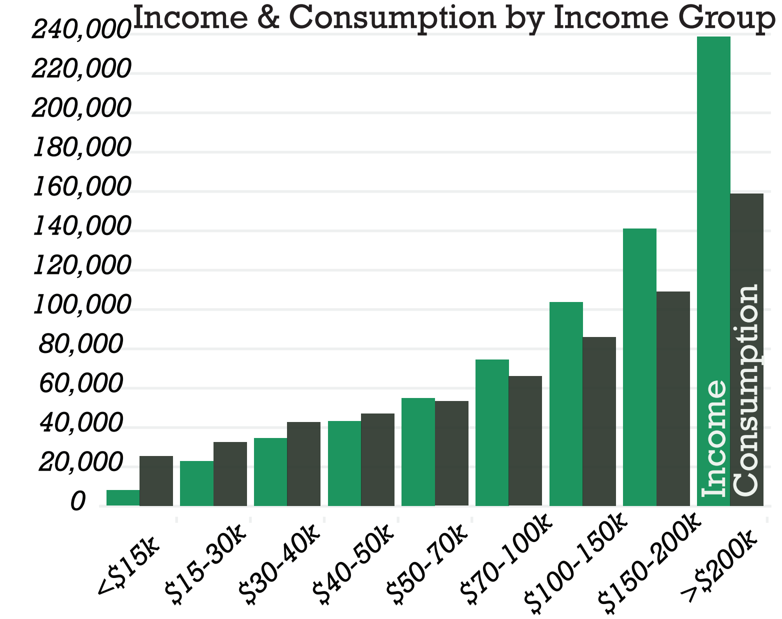
Top 10% Share Of Post–Tax Disposable Income



Neoliberlism is increasing inequality. But why should politicians care about it? After all, the goal of an equitable society in itself is subjective. One might think that a free-market is actually more fair than redistributive policies.

Our economy is largely demand-driven, meaning that a slow-down can be countered by increased demand. This may be a Keynesian argument, but even free-market advocates make investment decisions according to their outlook of the future. If they believe that demand is going to be strong, they will continue to invest, raising incomes of their employees and thereby fueling economic growth. And the poor are most likely to spend extra income, while the rich will save a larger part.

Income & Consumption by Income Group



Both income and consumption show an exponential trend for annual salaries above $50,000 but income is clearly outpacing consumption. Looking at effects on the aggregate economy it is therefore not only in the interest of the poor to move towards a more equal income distribution but also of the high earners, as their absolute incomes will rise with the expansion of the economy.