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Equity: a key to macroeconomic stability

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'Equity supports strong institutions that create, regulate, stabilise and legitimise markets and, in turn, build resilience to shock'

It was easy to blame the 2008 global financial crisis on greedy bankers, irresponsible regulators and lackadaisical government officials. These convenient scapegoats were obvious targets and politicians could take popular measures to punish the 'villains'. However, the true source of the crisis lay beyond these individuals, for all their faults. An important part of the story was widespread and systemic inequity.

In a paper for the 2010 Poverty, Equity and Growth Network (PEGNet) Conference, I argue that equity, policy space and institutional capacity are the foundations for a resilient economy (Vandemoortele, 2010). This is demonstrated by the very different experiences of two countries during the 2008 financial crisis: the US and Mauritius. In the US, high and rising inequities contributed to macroeconomic instability. In Mauritius, mutually reinforcing reductions in inequity, combined with the strengthening of institutions and the widening of policy space resulted in macroeconomic resilience. Income distribution in the US is now far more inequitable than it is in Mauritius, as seen in their respective Gini coefficients, with higher scores showing greater inequity. The US had a Gini coefficient of 47 in 2009 (DeNavas-Walt et al., 2010) compared with 39 for Mauritius (CSO, 2009).

Indirect impacts of inequity

The indirect impacts of inequity include its effect on policy space and institutions.

Policy space is the set of instruments used by policy-makers to achieve a set of targets, and include monetary, fiscal, trade and social policy. High inequities embed special interests, limit policy space and delay reforms, thereby undermining resilience. Although vested interests are inevitable, they tend to be more entrenched in highly inequitable countries.

In the US, rising inequity, manifest in the form of vested interests, shapes policy and gives policy-makers less space in which to implement counter-cyclical policy that protects against economic shocks. For example, US politicians who empathised with voters' falling incomes and relied on their votes for re-election failed to address the poor quality and rising costs of education, as 'improvement requires real and effective policy change in an area where too many vested interests favour the status quo' (Rajan, 2010: 8).

Mauritius, however, has avoided the entrenchment of vested interests in policy processes, resulting in a development strategy that aimed to shift political and economic power away from the wealthy minority and towards the whole population. The separation of economic and political power, along with close collaboration between state and business, has contributed to the country's macroeconomic resilience.

Institutions include the behavioural norms and organisations that create incentives for desirable development outcomes. Again, inequity can undermine their quality and their ability to build macroeconomic resilience. For example, growing disparities between groups increase the risk of fiscal instability. When politicians compete for government funds, they have an incentive to overexploit the common pool of resources, with negative effects on fiscal balance and the 'national development project'.

Take the Federal Reserve in the US. Here, a market stabilising institution that was supposed to minimise macroeconomic volatility and avert financial crisis actually encouraged subprime mortgage lending. When Americans defaulted on their debts, and the financial sector began to crumble, the Nobel laureate Joseph Stiglitz said '[t]he problem is that before the crisis, the Fed didn't even use the power it already had'.[1]

In Mauritius, a concerted 'nation-building' strategy by the state in its early years created the foundations for strong institutions. This strategy involved a partnership between major ethnic groups, a space for negotiation among those groups, a better balance of economic and political power and the building of strong institutions to ensure economic redistribution and political representation. The African Peer Review Mechanism report highlights that, '[t]he country has gradually, but rapidly, acquired

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human and institutional capacities, … promoting its autonomy and instituting a resilient economy' (APRM, 2009: 20).

Direct impacts of inequity

Inequity undermines macroeconomic resilience in four direct ways. First, it leads to **aspirational consumption** and increasing personal debt. Middle-income earners, seeing their wages fall, aspire to maintain or achieve a standard of living similar to their wealthier counterparts (who are seeing their incomes rise). Middle-income earners in turn take on more debt, facilitated by weak market institutions. Taking this to scale can, and has, undermined macroeconomic resilience.

In the past three decades, middle-income Americans have seen their real incomes decline. The provision of cheap credit, which permitted their sustained consumption and investment, led to higher levels of household and business debt. The stock of debt as a percentage of personal disposable income rose from approximately 80% to 120% between 1991 and 2005.

Second, inequity leads to **risky investment**. Deep-rooted financial instability is more likely in a situation of rising inequity, where borrowers have to take on more debt simply to cope with the debt they already have. Borrowers and lenders both speculate that it will be possible to refinance the debt in the future. In a growing economy, their behaviour seems 'rational' as their expectations keep being fulfilled and asset prices continue to rise. Financial agents looking for larger profits will, therefore, take greater risks for as long as this prosperity continues, thereby generating financial instability in the market – as happened in the US.

Third, inequity increases **household exposure to risk**. The liberalisation of financial instruments has shifted the burden of risk to households in ways that are not always obvious to those with limited expertise in assessing their own exposure. These groups are most vulnerable to shocks when their pensions, investments and insurance are affected. US workers, for example, have relied increasingly on capital markets to finance basic services such as housing, pensions, education and health care. Privatisation of these services, without a publicly provided safety net, has shifted the financial risk of ill health and unemployment to individual workers. In the past, wage earners paid financial firms to manage these risks and ensure that they had access to basic services, such as health. In the face of the financial crisis, the millions of people who lost their homes, their retirement savings and their jobs found that there were no quality public services in place to help them.

Fourth, inequity provides incentives for **crime and tax evasion**. Alesina and Perotti (1996) argue that high inequity creates incentives for people to engage in illegal, non-market activities, such as drug trafficking and other crimes, which contribute to political and social instability. Research also indicates that rising income inequity makes it easier to avoid taxes and fines, undercutting government revenue and reducing its fiscal space. Bloomquist's (2003) analysis of US data between 1947 and 2000, for example, finds a link between the wage share of those in the top 10% of income, and the under-reporting of their wages and salaries.

Key lessons

- Inequity undermines macroeconomic resilience because it depresses aggregate demand, stimulates conspicuous consumption that generates few jobs, leads to excessive risk-taking in financial markets, entrenches vested interests that delay policy reforms and impedes counter-cyclical measures – as in the US.
- While inequity undermines the effectiveness of institutions, equity supports strong institutions that create, regulate, stabilise and legitimise markets and, in turn, build resilience to shock.
- High levels of inequity constrain the policy space for the design and implementation of counter-cyclical policies – a space that is supported by equity.
- Strong institutions can act as effective constraints on the abuse of political and economic power, foster state-business relations and bolster macroeconomic resilience, election cycle after election cycle – as we have seen in Mauritius.

Equity, policy space and strong institutions contribute to macroeconomic resilience, and the strengthening of these three key ingredients for economic health should be tailored to a nation's specific political, economic and social context.

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