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Don't waste the crisis: The case for sustained public investment and wage-led recovery policies

by Frank Hoffer

Returning to the pre-crisis world after timely, targeted and temporary government interventions as advocated by the OECD and others is risky and a waste of public funds. Structural changes in income distribution, taxation and capital markets are needed to address the fundamental causes of the crisis and put social justice and decent work at the centre of a crisis response.

Root Causes of the Global Economic Crisis

In recent decades, wages and transfer incomes have not grown in line with productivity in most countries. In fact, institutional and legal capital and labour market changes, combined with aggressive, short-term profit-maximisation strategies enabled the owners of private enterprises and financial capital to appropriate most of society's productivity gains. Moreover, threats of relocation or disinvestment resulted in labour market deregulation and casualisation of employment. Such global capital mobility led to the rise of tax havens, transfer pricing and tax competition, reducing the ability of governments to tax capital, thus driving down tax rates and regulation levels. Meanwhile, the high profit rate in the financial industry put pressure on the real economy to produce similar results for shareholders. Thus, the profits of the financial bubble economy became the benchmark for the real economy.

In sum, while income differentials have widened, the tax burden has shifted to employees and consumers, further reducing purchasing power of the people. Throughout the world indecent, precarious and informal employment is increasing.

In many countries, open capital markets overly constrain government's ability to pursue expansionary fiscal policy, as any increase in inflation would trigger capital outflows and ultimately risk a currency crisis. These capital market constraints, combined with the declining ability to tax, reduced governments' space for public expenditure, while low wages limited private consumer demand. Nevertheless, overall demand stayed high as rapidly growing private deficit spending backed by asset bubbles disguised the long-term unsustainability of growing imbalances in distribution and trade. It created the illusion that consumption can rise despite a declining wage share, and that wage increases below productivity growth are "only" a problem of social justice, not an economic policy issue.

As long as asset prices go up, a bubble seems to be a free lunch where everybody gains. However, the bubble, like any pyramid scheme, can only continue if more and more people join. The bubble itself creates a need to loosen credit criteria further: as the ratio between actual income and asset prices grows, credit conditions need to be softened to draw new entrees in the (real estate) market. Financial irresponsibility has to grow.

When the bubble burst, it did not just hit the bubble economies; countries with an export surplus-led strategy, priding themselves on their solid financial policies, also saw their "beggar thy neighbour" policies collapsing. They could no longer offset their lack of internal demand through ever-growing export surpluses. The export machines came to a standstill. The export champions realised that they had exchanged real goods against fancy but toxic pieces of paper. Instead of sharing productivity gains fairly in society, they were wasted.

Saving the financial system by bailing out the irresponsible banks is insufficient to address the underlying imbalances and to increase aggregate demand. During the economic downturn, private investment will remain sluggish. Over-indebted consumers cannot continue to spend beyond their means. There is no alternative to continued substantial counter-cyclical monetary and fiscal state intervention.

But state intervention can only be lastingly successful if accompanied by policy measures to correct the dysfunctional wage developments of the past decades, to build a genuinely fair and progressive tax base and change the dysfunctional global capital markets.

A Decent Work Response

In a global economy, coordinated global responses are the optimal solution. This requires national and international rules for capital and labour markets. The ILO's Global Jobs Pact offers a policy framework to meet these needs.

Investing in the Future, Creating Employment and Increasing the Social Wage

Under the conditions of a slump, public investment has a higher employment intensity than tax cuts. The provision of universal quality public services and infrastructure is key to reducing inequality, building inclusive societies and increasing opportunities for the poor. Universal quality education, health service, affordable housing, and other freely accessible public services reduce the need for individual savings and increase the proportion of people's disposable income.

Preventing Wage Deflation and Promoting Wage-led Recovery

Increased public investment must be complemented by institutional measures to avoid wage deflation, reduce wage inequality, ensure that productivity gains translate to higher wages, and thus to ensure a sustainable consumption pattern. Combining centralised or coordinated collective bargaining with minimum wage legislation is most suitable to establish a wage floor and compress wage differentials. Increasing the wage share and strengthening the wages of low-income workers in particular leads to an increase of overall consumption, as poor households spend a higher share of their income. Simultaneously, precarious employment relationships must be limited as they have been used to circumvent labour rights and collective bargaining agreements. Labour clauses in public contracts must require contractors and sub-contractors to pay the prevailing collective bargaining wage rate. Moreover, public sector employment must be increased and public sector wage levels must be maintained to serve as an additional wage anchor.

The state has to combat employer's aggression against the desire of workers to form or join a trade union. It needs to level the playing field through legal mechanisms of extending collective bargaining coverage and worker representation at the workplace. Any bailout or state subsidies must hinge on worker participation in the restructuring through collective bargaining processes and agreements.

Maintaining and Extending Social Protection

Social security systems are the fastest and most efficient way to provide income replacement for workers in a crisis situation. Comprehensive social security systems act as automatic stabilisers and must be extended during an economic downturn to stabilise income levels and overall consumer demand.

In developing countries without comprehensive social security systems, a social floor that includes a basic pension, child benefits, access to healthcare and temporary employment guarantee schemes or cash transfers for the under- and unemployed is urgently needed to lift millions of people out of poverty. It contributes to increasing demand and is a necessary complement to any effective minimum wage legislation.

Finally, governments must protect retirement savings. Pay as you go systems are clearly less vulnerable through capital market volatility. Any pension scheme - private or public - must be legally obliged to guarantee at least a minimum rate of return equivalent to government bonds.

Making the Necessary Global Structural Changes

The suggested measures will be difficult to implement and impossible to sustain without restructuring the global financial system that has propelled the failed economic regime.

Regaining the ability to tax capital

Tax havens must be closed. To solve this issue, banks that work in tax havens, either directly or through subsidiaries, or that engage in other tax theft operations, should be barred from major US or EU financial centres. Requiring multinationals to report their global profits and pay a unitary tax; treating as a unit all the business that is done under one ownership, then estimate what proportion of its income was earned in a specific country and apply its national tax to that income. Transfer pricing and financial dislocation would become rather unattractive. Wealth and heritage taxes and marginal tax rates on high income must be increased to rebalance the tax burden in society and increase the purchasing power of ordinary citizens. Property taxes on high value real estate would be a first step that could be introduced relatively easily even at the national level.

Downsizing speculative and high risk activities of the financial industry

A small tax on stock market transactions would abolish unproductive financial market speculation based on minimal margins and high leverage. A high capital gains tax on short-term profits would reduce incentives for speculative trade in financial markets. Higher reserve requirements for banks and more conservative rules for mortgages reduce the probability of asset bubbles. Banks can only be allowed to operate as private enterprises if they bear the risks of their investment and never become too big to fail. A diverse banking system - incorporating state-guaranteed savings banks, clearly mandated public development banks and private banks - is needed to reduce the institutional lobby and blackmail power of the financial industry. Rating agencies that are fully independent from the financial industry has to ensure better risk assessment. Investor protection against toxic products must be provided through compulsory state certification of all financial products. Risk-taking by pension funds needs to be limited by insisting on a guaranteed minimum rate of return.

Conclusion

Without structural changes as proposed above, we risk wasting today's crisis. The unconditional promise of governments for universal bailouts after the collapse of Lehman Brothers has indeed increased the moral hazard problem. Pumping money into the system without addressing the causes of global imbalances is dangerous and unsustainable, and may soon lead us into another financial crisis. However, governments will have much less financial firepower, then, because the ammunition was used for another Wall Street firework display instead of closing the casino.

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