

## **The role of the widening gap between the rich and the poor in the recent financial crises**

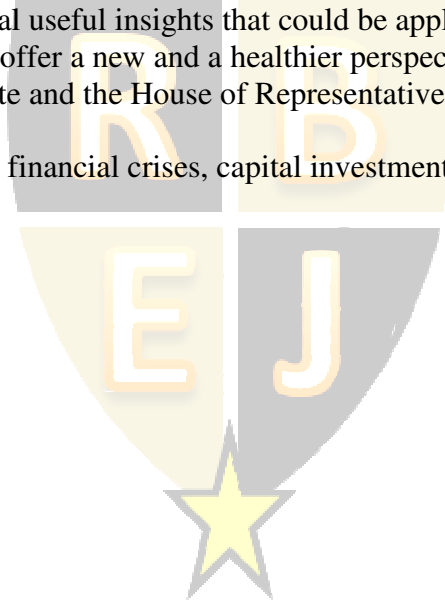
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### **ABSTRACT**

This paper proposes that the mainstream economists' view of the recent financial crises and economic collapse is limited in its explanation of causality. This is due to the self-adjusting properties of the economic models that are used, and as such, these models do not allow for any kind of economic crises (Asensio and Lang, 2010). Due to the narrow properties of these models, mainstream economists provide limited guidance on possible corrective actions in order to avoid or minimize the impact of future collapses.

It is argued in this paper that economic disparity and the widening gap between the rich and the poor played an important role in the recent financial and economic crises. Such an outlook would give us additional useful insights that could be applied to personal, national and international policies. It would offer a new and a healthier perspective in the most recent tax-cut policy debates in both the Senate and the House of Representatives.

Keywords: economic disparity, financial crises, capital investment, savings, loans, economic justice, progressive taxes



## INTRODUCTION

In recent years, a number of papers have been published concerning the reasons for the most recent economic collapse. From Minsky's theory of financial instability (Davidson, 2008) to the theory of structural instability (Tropeano, 2010) classical as well as modern theories have been used to try to explain the collapse. Mainstream economists failed to predict the recent collapse due to the self-adjusting models used that did not allow for any kind of economic crises.

At the macro level three factors are blamed to have influenced the crises: expansive monetary policy; flawed financial innovations; and the collapse of trading (Schwartz, 2009). At the micro level the blame is attached to the housing bubble and credit default swaps. If one carefully studies the recent literature on the crises, as stated by Jamie Dimon, Chairman and CEO of JPMorgan, the over arching driver was "excessive greed". Unfortunately, the lesson of not being overly greedy does not provide any practical insight for individuals and institutions. A useful and practical lesson needs to fall between the grand moral virtue of a greedless society and specific macro and micro economic principles.

## A HEALTHY MARKET ECONOMY

In the United States, it is rarely challenged that economic disparity is morally wrong, but such a disparity is not usually blamed for an economic collapse. To examine the possible causality, it is important to first understand how a healthy market economy ideally functions.

In the simplest model of a healthy market economy, people produce goods and services; they are paid for producing these goods and services; and they will in turn spend their profit in purchasing other goods and services. In this model growth is possible without generating excess profits (Shipman, 2001). Thus, if the need of the community can be met in a 20-hour work week, then in this most simple model, production is either slowed down or stopped entirely. In other words, "overproduction" is not practiced.

In a healthy economy, unlike the theories of economic determinism as understood by Marxism, it is neither necessary, nor desirable, for people to earn equal wages, or earn according to their needs. The problems arise when a small percentage of the population accumulates excess wealth to a point that a large portion of their wealth is saved and not spent. This diversion of resources disrupts the natural flow of money through the system and wealth that should have been spent in purchase of goods and services is now saved and invested. And, as the wealthy continue to invest their excess wealth, their excess wealth continues to grow (Taylor, Harrison, and Kraus, 2008).

It is important to clarify the distinction between personal savings and excess wealth. In a typical household, savings represent deferred consumption, where as excess wealth is money that is either not spent and is passed on through inheritance, or is invested, grows, and then gets passed on through inheritance. Excess wealth is usually used for status or power, and as it gets passed on from generation to generation, it rarely reenters the normal flow of commerce. As this type of excess wealth continues to grow, it overwhelms the financial system.

Most people living in the United States are ignorant of the existence of this pool of excess money. This ignorance is reinforced by constant media coverage of the lack of savings in a typical American family. In reality, most Americans do not have sufficient disposable income to save significant amounts of money that can have an effect in the flow of the economy. But, excess wealth is not concentrated in the savings of most Americans. For example, before 2002,

in the United States over 17 trillion dollars of savings were spent to buy stocks (Kumar, 2009). Of this 17 trillion dollars of outstanding stocks, 85 percent was owned by only 10 percent of the investors. In addition to owning most of the stock market, this small and elite group of investors owned 90 percent of all business assets and 85 percent of all financial securities (Taylor, Harrison, and Kraus, 2008). Thus, it can be concluded that before the crash between 85 to 90 percent of the savings in the United States were accumulated by about 10 percent of the population.

This fact means that a significantly large portion of the total wealth in the United States is mostly controlled by a small and exclusive group of investors. One of the reasons for the struggling economy is the unavailability of this wealth for purchases of goods and services. It is impossible for the bottom 90 percent of the population to spend enough money to jump start a struggling economy, especially when 85 percent of the savings are pulled out of the system by the wealthiest 10 percent of the population. It could be argued that as long as most of this saved money is invested back into the system it could be considered as money spent. This argument is flawed.

## **INVESTMENT vs. SAVINGS**

Savings can be invested in three primary ways: Capital Investment; the Stock Market; and Loans. Under ideal conditions, each of these tools can contribute to economic development. However, practically, if there is over investment, then each of the above tools can potentially cause harm to the system.

### **Capital Investment**

Businessdictionary.com (2011) defines capital investment as “money invested in a business venture with an expectation of income, and recovered through earnings generated by the business over several years. It is generally understood to be used for capital expenditure than for day-to-day operations or other expenses”. In a healthy economy, as new products are developed and productivity increases, wages increase and/or more workers are hired. Unfortunately, historically wages have not increased in accordance to productivity. This is driven by investors’ feeling of entitlement toward the majority of the profits generated by the investment. As a result, coupled with overproduction strategy, fewer people are able to purchase goods that are produced in excess. This will eventually decrease the profitability of the company which will result in worker layoffs. For example, in the United States between 2001 and 2006 productivity increased by 16 percent per worker. In contrast, during the same period, real median wages dropped by 2.9 percent. Professor Lane Kenworthy from the University of Arizona charted inflation adjusted GDP from 1947 to 2007 vs. median family income during the same time frame, as indicated in Figure 1 (Appendix). He concluded that in 2007 had median family income increased in sync with per capita GDP, that income would have been \$91,000 rather than \$61,000, as indicated in Figure 2 (Appendix), a 33 percent deficiency.

Modern economists are aware of this discrepancy, but have not been able, or are not willing, to reformulate their theories accordingly. As the gap between the rich and the poor increases, savings have continued to be used for capital investments. One of the unfortunate results of such a practice is production of excess goods and services that are unaffordable for the majority of the people.

## **Stocks**

As new stocks are purchased, it is assumed that capital investments are taking place. In a healthy market economy, where gains of investments are equally distributed amongst all involved in the process, the stock market is an effective tool to encourage capital investments.

In Keynesian economics, it is assumed that when there is an excess of money in the system, the demand for new capital investments decrease. This means that if stocks are purchased, it is of existing stocks (seasoned issues), rather than newly issued stocks (unseasoned issues). As a result, one persons' savings is exchanged for another's, without any consumption. The ability of the investor to consume goods and services is not affected by the rise and the fall of the market if these stocks are not sold and the money not pulled off the stock exchange. Unfortunately, very few people actually take money out of the stock market (Ferri, 2010), which contributes to a false perception of the investors' ability to consume goods, and increases their willingness to borrow against their perceived wealth.

## **Loans**

The third way to invest savings is through making loans, which potentially may be the most harmful way to use excess savings. As the amount of money that comes out of the excess savings of the wealthiest top 10 percent increases, the amount that the bottom 90 percent have at their disposal to pay off those loans decreases. The compounded effect will result in the bottom 90 percent continuing to borrow money in order to repay already borrowed money, and this will tip the equilibrium of the economy into an unintended cascading avalanche of bankruptcies, defaults, and foreclosures.

It is widely believed that when excess savings are used to give loans, the borrowers will use these loans to buy goods and services, and this will help the economy to grow. Unfortunately, the assumption that loans and paychecks have the same effect on the health of an economy is incorrect. A loan allows for purchases today with tomorrow's income. But, when tomorrow arrives the loan must be paid back with interest. In the long run, the ability of the borrower to purchase goods and services decreases. A healthier way to increase consumption is to increase wages and not loans, and this cannot be done unless the gap between wages and productivity decreases. Over the past 30 years, as this gap increased in size, people made up the difference by borrowing. What the right hand took away in wages, the left hand returned in loans, and the long-term consequences of this charade were catastrophic. Although seemingly the market had a limitless amount of money to lend, there was an upper limit to the amount of viable loans which the borrower was able to pay back. As a result, the borrowers began to walk away from the loans and instruments such as sub-prime mortgages collapsed.

## **NETWORKS OF WEALTH**

How wealth gets distributed is an extremely complex concept. Most people attribute only the most basic reasons for such a distribution. Reasons such as: inheritance; education; talents and skills; the desire to make money; circumstances; luck; connections; tolerance for taking risks; etc., are used to justify the large gap between the wealthy and the poor. Jean-Philippe Bouchaud and Marc Mezard of the University of Paris took a different approach in trying to

investigate this gap. Bouchaud and Mezard formulated a set of comprehensive equations that followed wealth as it shifted from person to person in a computer simulated world. They linked people together into a network of transactions and ran various alternatives in their formulas trying to manipulate the gap. In one of the alternatives everyone in the network started with the same amount of initial capital and identical money-making skills. Regardless of their attempts in trying to manipulate the formulas and control the gap, the model always produced the same basic shape of wealth distribution. That is, a large portion of the total wealth distributed itself into a small portion of the population. Bouchaud and Mezard concluded that the disparity in wealth distribution that is seen today has very little to do with the talents and the backgrounds of the rich and the poor in society, but rather it is an organizational feature of the system that emerges naturally from the networks of the economy (Bouchaud and Mezard, 2000).

It is clear that for an individual to generate a large sum of wealth the entire economic network is needed to function. An infrastructure is needed to bring ideas and transactions into existence. Thus, the entire network deserves a share of the wealth as part of economic justice.

## **ECONOMIC JUSTICE**

An effective tool to moderate the extremes in income is progressive taxation. There is a current debate in the US Senate and the House of Representatives that taxing the ultra rich will have a negative impact on the US economy. The rationale for this argument is based on the ideology that by taxing the ultra rich the amount of money for investment will be limited. Unfortunately, this assumption is not valid and historical data does not support it. In 2010, the top tax bracket in the US was capped at 35 percent. In the 1950s, during the Eisenhower's administration, it was capped at 91 percent. During that period, investments did not decrease due to taxes. David Johnson, a senior fellow at the Commonweal Institute, has outlined 14 points on how Eisenhower's 91 percent top tax bracket fixed an ailing economy. In his report, he demonstrates a positive correlation between top tax rate and GDP, as indicated in Figure 3 (Appendix), and an inverse correlation between top tax rate and the federal debt, as indicated in Figure 4 (Appendix). The argument that increasing taxes during a recession will hurt the economy is based on an ideology that is more political than economical and it is not supported by historical data. In fact, there is more historical evidence supporting the contrary.

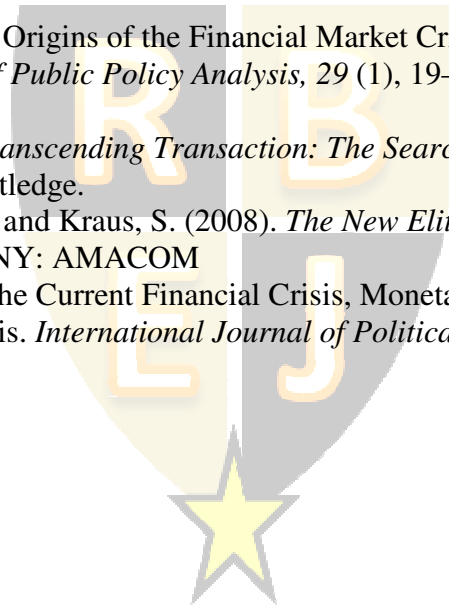
## **CONCLUSION**

Most of the solutions that are being offered in the past few years in regards to the most recent economic collapse are very limited in their scope. Even at the government level, policy discussion revolves around freeing up the credit market and getting credit flowing again. Unfortunately, such approaches will only push the problem further into the future. There already exists a large number of loans that present day wages are not able to pay back. The source of the problem that caused the collapse was not a lack of money to loan, but rather economic injustice that led to lack of proper circulation of savings.

Although total economic justice is an impossible utopian principle, it is possible and necessary to reduce the gap between the "haves" and the "have not's". In other words, it is not possible, nor desirable, to have equal distribution of wealth, but rather to eliminate the extremes of wealth and poverty.

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APPENDIX

Figure 1

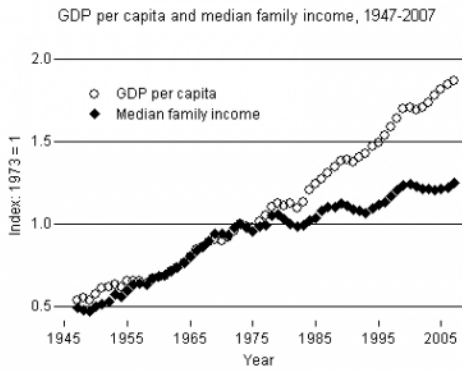


Figure 2

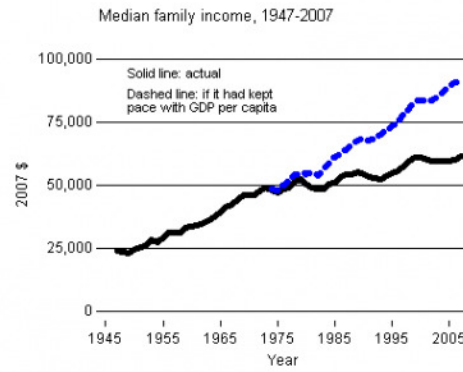


Figure 3

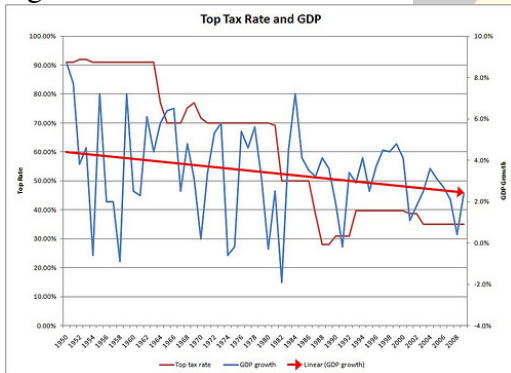


Figure 4

