polish 2(198)'17
sociological
review
ISSN 1231 – 1413

JACEK TOMKIEWICZ
Kozminski University

The Social Consequences of Income Distribution—Are Increasing Company Profits a Threat to Economic and Social Stability?

Abstract: The aim of this text is to show that unusually high levels of company profit should not be treated as a sign of a healthy economic situation but rather of a growing socio-economic imbalance. Huge profits are caused by the structure of many global markets—multinational companies often dominate markets and depress local competitors. The decline in household revenues and public budgets has led to ever larger public and private debts. At the same time, economic policy, which is determined by current politics, has contributed to a growth in income inequalities and social imbalances. The tax system has become ever less progressive and the structure of the financial market has become highly procyclical. The data analyzed in this text comes mainly from advanced economies, but it is clear that income distribution is one of the most important challenges facing the entire global economy.

Keywords: corporate profit, socio-economic equilibrium, income inequalities.

JEL codes: D31, D43, D63, E62, F61

Introduction

In every economic system, income flow is divided into labor and capital remuneration. Production and remuneration factors compete with each other. A relative increase in wages, understood as a percentage of GDP, means a decrease in capital revenue and vice versa—increased profits are necessarily a consequence of lower remuneration for labor.

Entrepreneurship is the market economy's basis for functioning and that means the economic situation of companies determines the state of the whole economic system. For companies, the basic aim of functioning is to maximize profit, so it might be hypothesized that the high profitability of the entrepreneurial sector is proof of the good state of the economy. Thus when company profits are increasing, it might not be thought a matter of concern. Yet the tendencies we have been observing for several years in the majority of the world's economies allow us to state that the increasing remuneration of capital owners has led to increasing economic and social inequality.

The aim of this paper is to argue that the changing distribution of income in an economy is not a sign of its stability and dynamics but rather a result of basic changes in the functioning of markets. The dominance of financial markets, the increasingly stronger position of international corporations, and the weakened bargaining power of average employees,

has resulted in decreased remunerations in favor of increasing profits, which has negative consequences for the dynamics and structure of the economy.

The scope of this analysis is limited to the advanced economies—data from the US economy is used to show the most important phenomena. This does not mean that the problem of income distribution is not a "hot topic" in other parts of the world as well. The "Arab Spring" or rising social tensions in China could be mentioned. The post-communist transformation and its impact on income and wealth inequalities would be another area worth studying. I am not going to analyze in detail the links between income distribution and the current financial crisis. There is ever more proof that the structural cause of the financial crisis of 2008 was deep change in the distribution of national income. A similar change can be observed in most economies worldwide within the last 30 years (Rajan 2010, Kumhof, Rancičre, Winant 2015) and there can be no doubt that the crisis has had a huge impact on social cohesion in many economies (Ötker-Robe, Podpiera 2013). We have to remember, though, that there is no consensus among social scholars over how income distribution affects societies' quality of life. On the one hand, Wilkinson and Pickett (2010) provide many arguments and data to show that greater equality equates with better functioning societies. On the other hand, an interesting study by Zagórski, Evans, Kelley, and Piotrowska (2014) shows that the quality of life in different countries is determined more by the general level of income (GDP per capita) than by its distribution.

Corporate Revenues and other Economic Parameters

In 2014, the highest level of corporate profits in the history of the USA was reported: their share of GDP was 10.4% (FED data). This is surprising as the world economy and its center—that is, the USA—is still coping with the consequences of the financial crisis, which began with the bankruptcy of the Lehman Brothers bank in September 2008. The Federal Reserve has been maintaining its interest rates at the level of 0 and still uses so-called non-standard instruments of financial policy. The budget is far from stable; public debt exceeds 100% of GDP; and a relatively low unemployment rate does not reflect the social situation of many Americans—the poverty rate is 14.5%, which is more than before the crisis, while the remuneration level has remained the same. How is it possible that companies are making record-breaking profits while the economy is in such a poor state? On what does the profitability of companies depend, if such a concurrence of high profits and the poor economic state of other sectors is possible?

The above data provides a lot of food for thought. Above all, it clearly shows that company profits do not reflect the real state of the economy, as can be proven by the negative correlation[1] between profit and GDP dynamics (Table 2) and the negative relation between level of profits and material investments (Table 1). This is because the structure of capital expenditure has changed significantly in recent years. An increasingly large part of the surplus earned is not invested in the development of production capacities, but is instead placed on the financial market. It is very common for companies to buy their own shares

[1] This is just a simple correlation, so there is no level of significance.

Table 1

Corporate Profits and Investments (gross fixed capital formation) in the USA

Year	Profit share in GDP (%)	Investments (% of GDP)
2000	4.7	23.6
2001	4.6	22.1
2002	5.4	21.6
2003	6.3	21.7
2004	7.7	22.5
2005	9.5	23.2
2006	9.9	23.3
2007	9.0	22.4
2008	7.3	20.8
2009	8.3	17.5
2010	9.8	18.4
2011	9.2	18.5
2012	10.4	19.2
2013	10.5	19.3
2014	10.5	19.8

Source: FED (Link: http://research.stlouisfed.org/fred2) and IMF World Economic Outlook Database.

Table 2

Dynamics of Investments and the State of the Capital Market (Dow Jones Index) in the USA

Year	Dynamics of profits (%)	DJ Index dynamics (%)	GDP dynamics	Correlation between profits and DJ	Correlation between profits and GDP
2000	−12.0	−6.18	4.092	0.36494823	−0.3747489
2001	−0.3	−0.07	0.976		
2002	51.5	−16.76	1.786		
2003	13.3	25.32	2.807		
2004	23.7	3.15	3.785		
2005	35.6	−0.61	3.345		
2006	2.9	16.29	2.666		
2007	−3.3	6.43	1.779		
2008	−48.9	−33.84	−0.292		
2009	104.7	18.82	−2.776		
2010	8.7	11.02	2.532		
2011	0.8	5.53	1.602		
2012	12.4	7.26	2.321		
2013	5.4	26.50	2.219		
2014	2.9	7.52	2.389		

Source: FED and IMF data (as in Table 1) and author’s calculations.

from the market—the so-called stock repurchase scheme. Such behavior seems to be rational at first glance: we assume that our shares are undervalued, so we treat them as an important capital investment. Tax basis management is also very important due to the tax shield mechanism—the tax basis decreases with the increase of the share of debt in the company’s liabilities, which happens when borrowed capital is used to buy a company’s

own shares. It is worth noticing that if a company has information that is unavailable on the market, and from which the assumption of the undervaluation of shares results, the situation itself is pathological as it means that the rules governing the public shares market are being infringed. A company's motivation to buy its own shares should rather be based on a desire to increase their price by increasing demand and decreasing the scale of capital dispersal. A justification for such behavior can be found. Stockholders are satisfied because the estimated value of their assets increases and they can expect to be paid dividends as the number of shares in public circulation is decreasing. In the long term, however, the situation of stockholders, especially minor ones, is worsened. A higher concentration of ownership shares means easier decision-making for the management board, which usually cooperates closely with the supervisory board, and this may mean, for example, higher remuneration for the members of those boards. Such a situation is evidently contrary to the interests of minor stockholders as it means a decrease in profit and dividends. It is worth noting that the fact that a company is buying its own shares means there will be no development projects, which would increase its value in the long term.

The scale of the phenomenon of companies buying their own shares on the open market is very large and has only been possible since the prohibition against such purchases was waived in 1982. Between 2003 and 2012 corporations included in the S&P 500 index bought their own shares to a value of 2.4 billion dollars, which constitutes as much as 54% of the profits gained during this period. 37% was spent on paying dividends and not much was left to invest in the real development of the companies. It is hard not to notice a relation between such behavior and the manner of rewarding management boards—in 2012, the remuneration of 500 of the most well-paid managers in the USA depended in as many as 83% of cases on the current valuation of shares (share options constituted 42% of bonuses, while 41% of bonuses depended on the share price) (Lazonick 2014).

The financial activity of non-financial companies has been gaining importance due to both expenditure and revenue. Between 1980 and 2007, the share of profit from financial activities in the total profits of American non-funded companies increased from about 20% to 35% (Lin, Tomaskovic-Devey 2013), which explains the positive relation between the state of capital markets and the profitability of companies (see Table 2).

There is a relatively new phenomenon in the economy: very high corporate savings, which are not invested in production activities but are placed on the financial market. This produces a situation where the traditional source of demand for money on the financial market, that is, companies looking for capital to finance investments in the real economy, significantly contributes to the increased supply of funds in the financial sector. Since the 1980s, the savings structure has changed radically—households save less, while company funds have greater significance. In the USA, the share of corporate savings increased from about 50% to almost 80% between 1980 and 2007 (FED data).

It was not until the 1990s that the balances of companies in the G7 countries changed in settlements with the financial market. From being a net debtor at the level of about 3% of GDP in the 1980s to being the supplier of capital for the financial market at the level of 2.5% of GDP in 2004—this is the difference between undivided profits (ones not paid in dividends) and intangible investments (IMF 2006).

Similar processes as those occurring in the USA can be observed in the majority of international economies. Company profits, understood as percent of GDP, are increasing—McKinsey (2015) calculates that between 1980 and 2013 the share of profits increased from 7.6% to 9.8% at the world level. This had to have an effect on the remuneration of employees, whose share in national income in OECD countries decreased from 66% in 1990 to 61.7% in 2012 (OECD data).

The Social Consequences of Falling Wages

The aforementioned changes in the division of income have numerous social consequences.

Above all, there is a visible worsening of the bargaining position of employees in comparison to capital owners. Work productivity is growing faster than remuneration, as is reflected by the decreasing wage share in GDP, so the growth of corporate profit must simultaneously be higher than GDP growth. This feature of the market system (capital income is rising faster than wages) is the most important message of Piketty's famous book (2014), in which he indicates that the progressing concentration of income and possessions are an inherent quality of the capitalist economy.

Aside from well-known factors such as the competition of so-called low-cost countries and widespread outsourcing and offshoring (IMF 2007, ILO 2008), additional processes currently occurring in the global economy should be mentioned.

The role of trade unions, which are a form of collective representation of employees in contacts with capital owners, is decreasing, as is the frequency with which countries conduct specific economic policies.

To a large extent, this is the result of objective processes occurring in the economy. The role of large economic units bringing employees together is constantly decreasing and this does not favor the forming of trade unions. Today, production is frequently of a dispersed nature, and the operation of companies is largely based on design activity, which makes the size and structure of employment change dynamically. At the same time, companies have become international—the employees of the same company in various countries regard their colleagues from other countries mainly as competition for their own positions, and thus it is hard to imagine transnational trade unions functioning as a part of international corporations.

The well-organized representation of employees can affect the distribution of income in an economy, although there are different views on the direction of the relationship, i.e., whether a large role for trade unions increases or decreases income inequality in the economy. Friedman's famous notion (1996) is that trade unions, by forcing a particular industry or company to pay higher wages, reduce the demand for labor, causing some job-seekers to be unemployed or to have to settle for jobs outside their specialty (a situation that is associated with low pay), and thus increase the overall rates of income inequality. This view has not been empirically confirmed. All the empirical studies cited by the ILO (ILO 2008) show a weaker or stronger, but always negative, correlation between the strength of trade unions, measured by the "unionization" of labor, and income inequality indicators. Labor organizations influence income structure in the economy by three main channels:

Table 3

Participation in Trade Unions in OECD Countries—% of Workers Who are Members of a Trade Union

Country	Time										
	1999	2002	2005	2006	2007	2008	2009	2010	2011	2012	2013
Australia	25,4	23,2	22,3	20,2	18,5	18,6	19,3	18,4	18,5	18,2	17,0
Austria	38,2	35,7	33,9	31,6	30,5	29,7	29,4	29,0	28,4	28,0	27,8
Belgium	54,3	55,6	53,7	54,8	54,7	54,4	54,9	53,8	55,1	55,0	55,1
Canada	28,0	28,3	27,7	27,4	27,3	27,0	27,3	27,2	26,9	27,2	27,1
Chile	12,7	12,8	13,3	13,0	13,1	14,1	15,0	15,0	14,9	15,3	15,0
Czech Republic	30,0	22,2	19,7	18,7	17,9	17,4	17,2	16,6	15,8	14,3	12,7
Denmark	74,0	71,6	70,7	68,4	67,9	66,3	67,7	67,0	66,4	67,2	66,8
Estonia	16,3	13,5	9,7	8,4	7,6	6,2	7,6	8,2	7,0	6,1	5,7
Finland	76,3	73,5	70,6	70,4	70,5	69,8	69,2	68,6	69,6	69,8	69,0
France	8,1	8,1	7,7	7,6	7,5	7,6	7,7	7,7	7,7	7,7	7,7
Germany	25,3	23,5	21,7	20,7	19,9	19,1	18,9	18,6	18,5	18,3	18,1
Greece	26,8	24,8	24,1	24,1	24,0	23,5	22,6	22,1	22,7	22,8	21,5
Hungary	24,5	19,0	17,5	16,1	15,1	14,6	13,9	12,9	11,8	10,7	10,5
Iceland	87,4	92,5	84,0	85,1	84,8	84,6	85,1	85,4	85,2	85,2	85,5
Ireland	38,7	36,1	34,0	32,4	31,5	31,9	33,1	32,7	32,6	31,2	29,6
Israel	41,3	36,5	33,1	32,0	30,5	28,6	27,3	25,7	24,2	22,8	
Italy	35,4	33,8	33,8	33,6	34,0	33,9	35,2	36,0	36,3	36,9	37,3
Japan	22,2	20,3	18,8	18,3	18,3	18,2	18,5	18,4	19,0	18,0	17,8
Korea	11,7	10,8	9,9	10,0	10,6	10,3	10,0	9,7	9,9	10,1	
Luxembourg	43,3	42,1	41,4	40,1	38,7	36,5	35,9	35,1	33,9	32,8	
Mexico	15,8	15,9	16,9	16,3	16,8	15,7	15,3	14,4	14,5	13,6	13,6
Netherlands	24,7	21,0	20,6	20,0	19,3	18,8	19,1	18,6	18,4	17,9	17,8
New Zealand	21,7	22,3	20,9	21,3	21,4	20,8	21,6	21,0	21,1	20,9	19,8
Norway	54,8	54,5	54,9	54,2	53,0	52,6	53,6	53,7	53,5	53,3	52,1
Poland	20,5	14,1	18,1	16,3	15,6	15,1	14,6	14,6	13,6	12,7	
Portugal	22,4	20,7	21,6	21,2	21,2	20,9	20,6	19,8	18,8	18,9	
Slovak Republic	34,2	27,4	22,8	20,6	18,8	17,2	16,0	15,2	14,1	13,6	13,3
Slovenia	40,4	44,7	37,1	31,4	29,0	26,6	26,3	25,0	23,1	22,0	21,2
Spain	16,8	16,1	14,6	14,3	15,5	17,2	17,6	17,3	16,9	17,1	16,9
Sweden	80,6	78,0	76,5	75,1	70,8	68,3	68,4	68,2	67,5	67,5	67,7
Switzerland	20,9	19,9	19,3	18,9	18,5	17,5	17,3	17,1	16,7	16,2	16,2
Turkey	29,3	25,1	16,8	14,3	12,3	10,7	10,2	8,9	7,8	7,0	6,3
United Kingdom	30,1	29,3	28,6	28,2	28,1	27,3	27,3	26,6	25,8	26,0	25,8
United States	13,4	12,6	12,0	11,5	11,6	11,9	11,8	11,4	11,3	10,8	10,8
OECD countries	21,0	19,7	18,9	18,3	18,1	18,0	18,1	17,7	17,6	17,2	17,0

Source: OECD (https://stats.oecd.org/Index.aspx?DataSetCode=UN_DEN).

— by maintaining the relationship between increased productivity and increased remuneration,
— by making it difficult for an employer to pay different wages to people holding similar jobs, due to having all the workers in a business entity enrolled in a union,[2]

[2] This pattern was confirmed, for example, in the UK, where in the eighties the rates of trade union membership were falling relatively rapidly (Gosling, Machin 1994).

— by providing employees with well-organized representation, in order to have a real impact on economic policy, which through tax regulations and social transfers affects the redistribution of income in the economy.

The relation between the financial situation of companies and the state of financial markets is dual in nature. On the one hand, the fact that a major part of the assets of economic units is invested in the financial market means that a given company depends less on such variables as sales dynamics or the costs of its activity (profit versus loss), but more on the current state of indicators on the financial market. On the other hand, financial institutions play a more important role as company shareholders; as investors, they are characterized by a more short-term attitude toward returns from the capital invested. Both factors make the bargaining power of employees decrease in relation to capital owners. Decreases on financial markets immediately result in companies' having negative results, which makes their management boards look for savings in the costs of labor. At the same time, when valuations of financial instruments are growing fast, tangible investments of the kind that increase employment are not chosen because it is possible to obtain high profits from financial investments. The dominance of financial investors among shareholders demands higher fluctuations in employment, which decreases the negotiating position of employees. This is the case, for example, during a slowdown or recession. When it is possible that a transitional period of decreased production will occur, current financial indicators demand a decrease in employment, while from the long-term perspective it would be rational for the good of the company to maintain the same level of employment in order not to lose valuable human resources and to lower the costs of obtaining new employees in the future, when the economic situation is better.

Table 4

Share of Capital Income (of companies and households) in the Total Income of Selected Economies Between 1970 and 2010

Year	Country				
	USA	Japan	France	United Kingdom	Italy
1985	24%	28%	18%	23%	28%
1990	23%	30%	25%	23%	29%
1995	25%	24%	24%	26%	33%
2000	24%	25%	25%	26%	34%
2005	26%	29%	23%	29%	33%
2006	27%	29%	24%	29%	32%
2007	26%	30%	25%	29%	32%
2008	24%	28%	25%	30%	30%
2009	26%	26%	24%	30%	28%
2010	29%	27%	25%	27%	29%

Source: Author's calculation based on The World Wealth and Income Database (http://www.wid.world/).

The most important social consequences of changes in income structure are growing economic and financial inequalities. The rising share of capital income visibly increases the scale of inequality in the whole economy. According to the data, capital income is much more concentrated than labor income. For example, the Gini coefficient for capital

Table 5

Share of 1% of Wealthiest Households in Total Income

Year	Country				
	France	Italy	Japan	United Kingdom	USA
1985	7.2	6.81	7.03	7.4	12.67
1990	8.23	7.78	8.05	9.8	14.33
1995	7.7	8.13	7.3	10.75	15.23
2000	8.29	9.09	8.22	12,67	21.52
2005	8.73	9.35	9.42	14.25	21.92
2006	8.94	9.72	9.62	14.82	22.82
2007	9.25	9.86	9.64	15.44	23.5
2008	8.8	9.66	9.71	no data	20.95
2009	8.08	9.38	9.56	15.42	18.12
2010	no data	no data	9.51	12.55	19.86

Source: Author's calculation based on The World Wealth and Income Database (http://www.wid.world/).

income among EU countries is lowest in Germany, with a value of 0.82 (the Gini for the entire economy was 29 in 2011), and highest in Portugal—0.96 (general Gini 34.2) in the 2005–2011 period, so the higher the share of capital income, the higher the total level of income inequality (Schlenker, Schmid 2014). There are a number of reasons for a high concentration of capital revenues.

The majority of the capital held by the poor part of society is so-called dead capital (generally because it is not legally recognized), which means it does not bring any profit (interests, rents, dividends, etc.) and is not used for development, e.g., as collateral for a loan (De Soto 2000). This pattern applies also to financial capital, as is mainly visible in the current very low interest rates. Low savings are usually kept in non-interest current accounts, with the result that when bank fees are calculated in a great amount of capital bears negative interest.

Small amounts are usually deposited for short periods of time, which decreases the interest rate (usually, the longer the period of time for which funds are deposited, the higher the interest rate), harms the bargaining position, and prevents waiting for an unfavorable situation on the financial market to pass.

Profits from capital, contrary to wages, are not usually subject to regulations aimed at flattening their distribution. I am thinking now about minimum wages or limitations on working hours. An example of such a regulation in the case of profits from property is the legal limitation on rent from tenants living in private rental property, but this is of very small importance to the whole economy—currently, the major part of capital income is obtained on the financial market.

It is worth noting that the remuneration for each job or position is usually publicly known (the majority of companies are listed companies, which are obliged to provide information on the salaries of their management boards), so persons obtaining high salaries are under social pressure and evaluation, even if only from shareholders or other employees in the company. Such a problem is non-existent in the case of capital income, due to the obligation of bank secrecy.

In the case of capital income, there is no margin of alternative costs, such as is the case when it comes to labor—I could have free time instead of working for another hour and earning money. Investing an additional million dollars, that is, for example, 4 million instead of 3, does not have an alternative cost in the form of free time.

Capital income is usually subject to flat-rate taxation, while salaries are usually subject to progressive taxation. One of the most basic changes in taxation policies in the 1980s was dividing labor income and capital at the household level, where before the total amount was the basis for progressive taxation (Tanzi 2014). Capital, especially today, is much more mobile than labor and thus it is relatively easy to conduct so-called fiscal optimization, that is, to maintain capital in the instruments and places that allow for its lowest possible taxation.

Active management of a portfolio of assets, for example, by its diversification, is a standard method of investing capital, allowing it to obtain high rates of return while minimizing the risk. However, it should be noted that only in the case of an appropriately high amount of investment is such a strategy profitable—in the case of small amounts, the costs of management and the transactional fees result in a decrease of profitability. In addition, there is also the capital barrier—a whole range of financial instruments are available only for investors with a suitably large amount of capital.

As in the case of every economic activity, investing capital also faces the returns-to-scale effect, which means a relative decrease in fixed costs. Even though in the case of standard financial instruments—for example, participation in investment funds—the management cost is described as a percent of the funds invested, in the case of large amounts the receivables for the persons managing the funds are subject to negotiation, that is, the costs are lower with the increase of invested funds.

There are also some serious arguments allowing us to believe that the level of capital income in national economies is underestimated in official statistics, and thus their real, higher, level means that real income inequalities are higher than is officially declared. This results from the following:

- capital incomes are relatively easy to hide from taxation and public statistics, for example, by keeping profitable assets abroad or by manipulating official ownership status.[3] Part of capital income will not appear in national reports or in surveys of households, as it is hard to imagine that assets and profits from properties kept in tax havens will be disclosed in surveys,
- cash flows of funds which have been disbursed are included in capital income. In the case of shareholders, profit will include only the dividend paid to them, while if the income of a joint-stock company is reinvested in the company, the cash flow for the benefit of the shareholder is not present. However, from the economic viewpoint, the reinvested (non-distributed) profit may also be treated as profit for the shareholder—the reinvested profit increases the value of assets, so it is a situation similar to the capitalization of interest in the case of a bank deposit. This means the capital income of share-

[3] It is estimated (Zuckman 2013) that there are funds in an amount equal to 8% of the global financial wealth in so-called tax havens, which means that if we took this amount into consideration, it would change the income and wealth distribution known to us.

holders should include the profit gained by the company that has not been distributed yet. This would result in even greater indicators of inequality.

Distribution of Profit in the Economy and the Shape of the Financial Market

Let us focus on the fact that the transition of the corporate sector from a position of borrowing funds from the capital market to one of placing cash in financial instruments entails a significant difference in the economic structure as well as in relations between economic units.

The shape of the financial sector, which is a consequence of profit distribution in the economy, has consequences for macroeconomic stability. The fact that today mainly households and governments are in debt and the company sector is the supplier of net funds makes debt instruments dominate the financial market (debt securities, money bills, credits, and derivative instruments based on the debt incurred) while equity securities, such as shares, start to play a less significant role. Such a structure results from the specificity of economic units, such as households and governments.[4] In contrast to a company, the public sector and a natural person cannot issue equities, which have two important characteristics:
— cash flows (dividends) depend on the current financial situation of the issuer,
— in case there is no profit, the dividend is not paid out,
— shares do not have a maturity date, which means there is no need for the issuer to buy them back in a given term.

The classic behavior of the financial sector in a business cycle is an increased demand for shares during the period of revitalization and growth (a good economic situation guarantees profits, which are the basis for paying dividends), while during a time of slowdown or stagnation, the demand for shares is lowered and interest in safe financial instruments guaranteeing stable return rates, such as bonds, is increased. Such a mechanism makes the financial sector operate in an anti-cyclical manner—during a period of fast development, low demand for bonds increases their profitability, which limits expenditure financed publicly with debt. However, the search for safe deposits during a depression makes it easy for the government to finance the budget deficit at a low expense, making it impossible to conduct anti-cyclical fiscal policy.

In a situation where financial instruments are dominated by debt securities, which are a derivative of debt incurred mainly by households and governments, while the main suppliers of capital are companies recording surpluses on the financial market, the financial sector operates in a strongly procyclical manner. During a period of fast increase, company revenues flowing into the financial market lead to a decrease of interest rates and this encourages governments and households to finance their expenditure with debt, which boosts economic growth. When the economy slows down—for example, as a result of a negative shock in the form of a crisis on the financial markets—there is automatically a problem with funding for households and the public sector, because:

[4] For example: In the USA and UK, household debt amounted to, respectively, 114 and 156% of annual income in 2012, while in 2000, it amounted to 101 and 112%. At the same time, public debt increased in those countries from 55 and 41% of GDP, respectively, to 104 and 85% (OECD data).

— the unemployment rate grows, and, at the same time, the solvency of natural persons decreases,
— the budget deficit and public debt increase, especially in relation to GDP, which decreases as a result of recession,
— the need to cover losses as a result of the crash of the financial market limits access to resources on the debt market, and so-called risk aversion increases.

During a period of slowdown or recession, share issuers limit dividend payouts or suspend them completely when the company is incurring losses. The situation is different in the case of a debt issuer. Interest and capital installments must be paid regardless of the current situation of the debtor, so economic growth declines during a slowdown or crisis as a result of a decrease in demand from consumers and governments. This is because:
— the reduction of current expenditures (lower taxation income in the case of a country and smaller incomes for households due to the worsening labor market situation), with a stable encumbrance due to debt-servicing costs, decreases the funds that can be used for current consumption,
— there are problems with long-term debts, which in a situation of uncertainty on the financial markets may not be re-financed on terms profitable for the debtor,
— the increased risk aversion of financial institutions limits the possibilities of incurring new debts, which would be used to finance consumption.

This is the exact mechanism we observed before and during the last financial crisis. In the period preceding the crisis, consumption demand increased very fast thanks to the increasing debt of households and the public sector and then broke down in the face of the crash on the financial markets (Mian, Sufi 2012).

Income Structure and the Shape of the Public Finance Sector

It is worth noting that changes in income structure in the economy, that is, the increasing role of capital incomes and the decreasing role of salaries, is not reflected in the structure of tax incomes. The trend is quite the opposite. Labor and consumption taxation has an increasingly important role in budgets (in OECD countries, social security contributions and direct taxes constituted 46% of public income, compared to 38% in 1985—OECD data). Simultaneously, the importance of corporate taxation is generally the same as previously, even though the income of companies has increased, e.g., in the USA, corporate incomes increased from 3 to 10% of GDP while the share of corporate income tax in the country’s income remains at the level of about 10% (FED and OECD data). Such a fiscal policy results from factors called “fiscal termites” (Tanzi 2010). Under the conditions of free capital flows, the development of international financial markets and transnational corporations, it is relatively easy for companies and natural persons to avoid income tax. Governments that face increasing obligations (for example, from demographic changes) have two choices:
— to finance expenditure with public debt, which is even more tempting as there is a large amount of capital on the financial market (the stabilization funds of raw-material countries, pension funds, company deposits) searching for a safe deposit such as government bonds,

— to increase the significance of public income, that is, to tax whatever is less mobile than capital, such as labor and consumption.

An analysis of the state of public finances during the last few years indicates that fiscal policy in OECD countries reflects the aforementioned solutions. Even though the economic situation in the world was generally good from the mid-1980s to the financial crisis in 2008 (the time is frequently described as the big boom period), the majority of countries were not able to balance their public finance sector—there was a constant deficit, which meant that public debt increased. At the same time, labor and consumption taxation is growing significantly. The deepening fiscal inequality and the changing public income structure have negative consequences for the macroeconomic and social balance.

Public debt, which was at a high level even in the times of a beneficial economic situation, practically prevented the conduct of fiscal policy at the time it was needed, that is, during the recession caused by the financial crisis. Even though the post-crisis revitalization is still very fragile, which should call for a loose fiscal policy, the majority of governments are required to conduct a fiscal adjustment, which, under current macroeconomic conditions, will have pro-recessive consequences (Perotti 2011). This problem is most visible in the south of Europe: the subsequent phases of limiting public expenditure and increasing taxes have deepened the recession in Greece; Spain and Portugal are facing similar problems.

The increasing taxation of consumption and labor has negative social consequences. Indirect taxes and social security contributions are of a degressive character, which means that as a salary increases, the relative encumbrance of consumption taxes and contributions decreases.[5] Factors resulting from the current phase of globalization, such as technological development or increased capital, and product and service flows, weaken the bargaining power of the average worker and increase income inequalities (Bourguignon 2015). At the same time, the taxation policies being conducted result in greater inequality—the role of indirect taxes of a partially progressive character is decreasing, while the significance of fiscal instruments, which are degressive, is increasing.

It is justifiable to ask why, considering the great increase of income equality in the majority of economies since the 1980s, an economic policy that would decrease the scale of disparities has not been implemented? If a few persons are living at the expense of the rest of the society, the democratic system should elect those who would combat the situation, for example, through taxation policy, social transfers, market regulations, or by providing public goods that would increase social cohesion. In accordance with the well-known median voter theory (Meltzer, Richard 1981), a change in income structure that increases income inequality results in higher support for greater redistribution.

As can be seen from the above discussion, the direction of economic policy is just the opposite. Everything that is part of the neoliberal approach to the economy (Harvey 2005)—lower marginal tax rates, decreased capital income taxation, privatization, a not

[5] The marginal consumption tendency decreases together with the increase of income, so the higher the income, the smaller the part of it that is consumed and subject to VAT or excise taxation, which means that the relation between indirect taxes and revenue obtained decreases. On the other hand, among households with high incomes, salary is becoming less important as it is supplemented by capital income, which does not constitute pensionable pay. This means that the relation between income/social contributions and taxes paid is decreasing.

very active labor policy, a combination of market regulation and deregulation, and the liberalization of turnovers abroad—has contributed to an increase of income inequality in the majority of market economies (Żyżyński 2009).

One of the reasons for the situation is a change in the scope of political discussions—the current debate has an increasingly post-materialist character, so voters are affected by issues other than income level (Inglehart 2016). Studies by political scientists (Bonica, McCarty, Poole, Rosenthal 2013) indicate five main reasons for voters' passivity in regard to the imposition of conditions that would increase social equality. Stiglitz (2012) reaches similar conclusions in his book on the causes and consequences of income inequality in the USA.

First of all, the economic agendas of political parties in almost every developed country have become similar in the past year: no one questions that the aim of economic policy should be to maximize GDP growth. At the same time, agenda issues are of less importance in public debates, and voters' decisions depend on the media efficiency of political leaders (Brett, Gamble, Tomkiewicz 2014). Geopolitical factors are also of great importance. The downfall of the planned-economy model made politicians and voters feel that there is no alternative to liberal capitalism (Szymański 2015). Simultaneously, the consequences are that:

— politicians are more influenced by the lobbying of capital owners, who demand lower taxes and the deregulation of specific markets (as the failure of communist economies was unambiguous proof that only liberal capitalism can provide high rates of economic growth),
— employees and voters in highly developed countries see the low standards of living in post-communist countries and do not support solutions reminiscent of a centrally planned economic system,
— the fall of the so-called Eastern bloc countries has meant there is no help from communist countries for left-wing parties in Western countries.

In public discourse, a kind of political correctness in regard to the above can be noted; it can be shortened to the statement that "what is good for business is good for the economy." As such an approach is not surprising in the case of organizations uniting entrepreneurs, let us focus on the fact that the World Bank,[6] the leading world institution established to promote social development, has made its Doing Business rating—which is limited to evaluating specific economies in terms of their facilitation of the entrepreneurial sector—its most important project. The aforementioned political correctness is blurring the differences in approach of the left and right wings concerning economic policy. Almost no serious political group in the world's leading countries questions the need to improve conditions for business, even if it means worsening the situation of employees or consumers, as such an approach is seen as the only way to guarantee economic growth and improve the quality of life. Such postulates as making the labor market more flexible, lowering taxes, having less supervision of public institutions, and limiting bureaucracy are elements of the political agenda of all parties from left to right.

[6] The World Bank's official motto is "Working for a World Free of Poverty."

Second, the demographic structure of voters is changing. The general voting turnout is lower and in particular among poorer people who would be the most interested in policies to redistribute income.

Third, even though we have shown how the structure of income distribution has quickly come to favor the wealthiest, it is undeniable that there has been an increase in the general income of the majority of society, which has been reflected in a significant improvement in quality of life, as measured, for example, by access to goods and services. As real income is growing and it is possible to borrow, consumption is rising and interest in public policy is decreasing.

Fourth, the richest part of society makes a relatively higher contribution to politics in relation to its percentage share in society, thanks to mechanisms of financing political parties and direct participation in exercising authority. In many countries it is common for business managers to take over public positions and, vice versa, for politicians, after ending their political careers, to take management positions in corporations. At the same time, as the commercialization of politics makes electoral success depend on financial efforts, the rule of "one man, one vote" has largely been replaced by "one dollar, one vote."

Finally, the structure of modern countries is so complicated that the voter has difficulty in connecting his or her decision with the policies that are really implemented. I have in mind such issues as the voting system (proportional or majority); the functioning of technocratic institutions such as the central bank (which are not subject to direct democracy); and the dependence of national politics on transnational regulations (which can best be illustrated by the example of membership in the EU).

Summary

Even though the good financial situation of companies might seem to indicate a good economic situation, it has become visible in recent years that the growing profitability of capital poses a threat to socio-economic stability. Above all, it should be noted that a change in the income structure of the economy does not equate to a general increase in the tempo of economic growth, and that increased company profits result from companies taking over a larger part of the income generated. At the same time, the financial market is profiting. Companies' disposable funds are more and more frequently invested in financial instruments, with the result that the state of economic entities has come to be determined by the state of the financial market rather than by the real sphere described by such indicators as GDP dynamics, the employment rate, or the tangible investments scale.

The decrease of salaries in the GDP and simultaneous increase of profits and capital income requires a modification of fiscal policy. The difficulty of taxing mobile capital, the growing encumbrances on labor and consumption, and rising public debt, pose a threat to macroeconomic and social stability. A further threat to economic stability is the shape of the financial market as an outcome of income distribution. The dominance of debt instruments (bonds and derivatives) over equities (shares) makes the financial system highly procyclical because both households and governments rely to a large extent on debt-financed consumption.

The combination of objective factors resulting from the current phase of globalization with an economic policy that visibly prefers capital owners has produced a significant change in the income structure and is causing financial inequalities to grow rapidly. The economic consequences of such a process can now be noticed—macroeconomic instability is increasing and is visible in the indebtedness of governments and households. At the same time, social cohesion has suffered too. Income inequalities have been rising fast as current political leaders are unable, or disinclined, to implement pro-egalitarian policies.

References

Bonica, A., McCarty, N., Poole, K., Rosenthal, H. 2013. Why Hasn't Democracy Slowed Rising Inequality? *Journal of Economic Perspectives* 27 (3): 103–124.

Bourguignon, F. 2015. *The Globalization of Inequality*. Princeton: Princeton University Press.

Brett, W., Gamble, A., Tomkiewicz, J. 2014. The Political Economy of Change at a time of Structural Crisis, in: J. Eatwell, T. McKinley, P. Petit, *Challenges for Europe in the World, 2030*. London: Ashgate, pp. 303–350.

De Soto, H. 2000. *The Mystery of Capital*. London: Black Swan.

Friedman, M., and Friedman, R. 1996. *Wolny wybór*. Sosnowiec: Wydawnictwo Panta.

Gosling, A., Machin, S. 1994. Trade Unions and the Dispersions of Earnings in British Establishments, 1980–90, NBER Working Paper Series No. 4732, Cambridge.

Harvey, D. 2007. *A Brief History of Neoliberalism*. Oxford: Oxford University Press.

Inglehart, R. 2016. Inequality and Modernization. Why Equality is Likely to Come Back, *Foreign Affairs*, January/February.

International Labour Organization. 2008. *Global Wage Report*, ILO.

Kumhof, M., Rancičre, R., Winant, P. 2015. Inequality, Leverage, and Crises, *American Economic Review* 105 (3): 1217–1245.

Lazonick, W. 2014. Profits Without Prosperity, *Harvard Business Review*, September.

Lin, F., Tomaskovic-Devey, D. 2013. Financialization and U.S. Income Inequality, 1970–2008, *American Journal of Sociology* 118 (5): 1284–1329.

Meltzer, A. H., Richard, S. F. 1981. A Rational Theory of the Size of Government, *Journal of Political Economy* 89 (5): 914—27.

McKinsey Global Institute. 2015. *Playing to Win: The New Global Competition for Corporate Profits*.

Mian, A. R., Sufi, A. 2012. What Explains High Unemployment? The Aggregate Demand Channel, NBER Working Paper No. 17830.

Otker-Robe, I., Podpiera, A. M. 2013. The Social Impact of Financial Crises: Evidence from the Global Financial Crisis. Policy Research Working Paper no. 6703, World Bank.

Perotti, R. 2011. The "Austerity Myth": Pain Without Gain. BIS Working Paper 362, Basel.

Piketty, T. 2014. *Capital in The Twenty—First Century*. Cambridge, Massachusetts, London: The Belknap Press of Harvard University Press.

Rajan, R. 2010. *Fault Lines: how Hidden Fractures still Threaten the World Economy*. Princeton: Princeton University Press.

Schlenker, E., Schmid, K. 2014. Capital Income Shares and Income Inequality in the European Union; ECINEQ Working Paper no. 329.

Stiglitz, J. 2012. *The Price of Inequality: How Today's Divided Society Endangers Our Future*. New York, London: W.W. Norton and Company.

Szymański, W. 2015. *Świat i Polska wobec wyzwań*. Warszawa: Difin.

Tanzi, V. 2000. Globalization, Technological Developments, and the Work of Fiscal Termites; IMF Working Paper no. 00/181, IMF.

Tanzi, V. 2014. The Challenges of Taxing the Big, *Revista de Economía Mundial* 37.

Wilkinson, R., Pickett, K. 2010. *The Spirit Level. Why Equality is Better for Everyone*. London: Penguin Books.

Word Economic Outlook. 2006. *Financial System and Economic Outlook*, IMF.

World Economic Outlook. 2006. *Globalization and Inflation*, IMF.

Word Economic Outlook. 2007. *Globalization and Inequality*, IMF.

Zagórski, K., Evans, M. D., Piotrowska, K. 2014. Does National Income Inequality Affect Individuals Quality of Life in Europe? Inequality, Happiness, Finances and Health, *Social Indicators Research* 117 (3): 1089–1110.

Zuckman, G. 2013. The Missing Wealth of Nations: Are Europe and the U.S. Net Debtors or Net Creditors, *The Quarterly Journal of Economics*: 1321–1364

Żyżyński, J. 2009. Neoliberalizm jako strukturalna przyczyna kryzysu a poszukiwanie dróg naprawy, *Ekonomista* 2.

Biographical Note: Jacek Tomkiewicz, (Ph.D.), Assistant Professor at the Department of Economics, Kozminski University. Author of studies and expert opinions for public institutions such as: Ministry of Finance, Chancellery of the Prime Minister or National Bank of Poland. The author of publications in macroeconomics, public finance and social policy.

E-mail: tomkiewj@kozminski.edu.pl