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Andrew Watt*

# Distributional Issues in the Context of the Economic Crisis in Europe

*This article takes a step back from the debate on the precise causes of the crisis and the detailed steps needed to resolve it. It focuses on distributional issues and discusses the ways in which widening income inequality in most European countries has been linked to factors that lie behind the crisis. It then considers distributional effects of current efforts to resolve the crisis and explains why crisis-resolution policies need to address distributional concerns. Finally it proposes measures, many of which require coordination at least at the European level, to address the distributional crisis that otherwise awaits us in coming years and that will ultimately help to establish a new, more economically and socially balanced growth model.*

The economic forecasts for Europe are still being revised down. It is already clear that the recession will be deeper than that of the early 1990s; the only comparison is with the Great Depression of the 1930s and the main question whether a prolonged slowdown can be avoided. It is still not certain that the mainstream view – that the European economy will bounce back in 2010 – will prove correct. In any case the scourge of unemployment is set to return to blight European labour markets: in a number of countries the unemployment rate has already more than doubled, and it is certain to head back to double figures, wiping out the gains painfully achieved since the mid-1990s.

An earlier contribution by the present author[1] looked in some detail at the causes of the crisis: why did problems in part of the US financial market and the subsequent downturn in the seriously imbalanced US economy have such an unexpectedly severe impact on a European economy that, as a whole, was seemingly free of such tensions?

This analysis is briefly reviewed below. I then recall some stylised facts about income distribution and reflect briefly on the link between inequality and the factors that led to the crisis. The two subsequent parts set out the main argument of this contribution: that present policies to address the crisis are likely to worsen an already bad distributinal situation. To remedy this a number of proposals for national and European policymakers are then made.

### A Systemic Crisis with Multiple Roots

In contrast to a widely held view that the crisis is best understood as resulting from misbehaviour by (or perverse incentive structures for) a small but powerful cabal of Wall Street and City of London bankers, I have previously argued that the recession resulted from a combination of diverse "proximate" and "fundamental" factors.[2] It is important to recognise that a series of quite traditional negative demand shocks ("proximate factors") had hit the European economy in the months prior to the crisis: a sharp rise in commodity, and especially energy, prices; a serious appreciation of the euro (by one third against the US dollar since the start of 2006); the lagged effects of eight interest-rate hikes by the ECB. In some countries only (notably UK, Ireland, Spain) these factors were exacerbated by bubble-like phenomena familiar from the USA.

What made the downturn so unexpectedly swift and caused it to affect countries that appeared to have avoided the excesses of the USA and a small number of European countries were a series of more fundamental factors which made the economy particularly vulnerable to shocks, clogged up the key credit channels on which the real economy depends, or curtailed the implementation, or reduced the effectiveness of, the usual demand-stimulation mechanisms.

These "fundamental" factors included massive global current account imbalances (especially the trade surpluses of China, until recently Japan and also Germany, with the USA, but to a lesser extent also the UK and Spain). The willingness of the surplus countries to lend to the deficit countries kept interest rates low which led both domestic and foreign investors to seek higher return from risky assets; this was one reason why so many toxic US assets were held by German banks.

* European Trade Union Institute (ETUI), Brussels, Belgium.

[1] A. Watt: The economic and financial crisis in Europe: addressing the causes and the repercussions, European Economic and Employment Policy Brief, No. 3, 2008; http://www.etui.org/research/Media/Files/EEEPB/2008/3-2008.

[2] Ibid.

A second feature has been the rapid internationalisation of production, investment and financial linkages without a corresponding development of supervisory and other forms of regulation at an appropriate (global, European) level. Amongst other things, this prevented coordinated mechanisms to manage exchange rates and induce both deficit and surplus countries to change policies to reduce global imbalances and also led to a competition between countries to offer lowest levels of regulation and taxation on mobile factors of production. Partly as a result of these shortcomings, but partly also in the wake of a major political shift in advanced capitalist economies since the early 1980s, we have seen, thirdly, a sustained and far-reaching process of state withdrawal from involvement in the economy. Amongst other things, state ownership (not least of financial institutions) has been reduced, labour market and welfare state institutions have been weakened, commercialised, or privatised, while enforced (or at least enforceable) legal regulation has been dropped in favour of codes of conduct and so-called self-regulation.

These trends, perhaps enhanced by technological developments, have led, fourthly, to very substantial shifts in income distribution in most advanced capitalist countries. This is discussed more fully below.

Still poorly understood is the way in which, fifthly, this has interacted with the "financialisation" of the economy.[3] This umbrella term covers diverse trends such as the increasing size of the financial sector, the massively expanded volume of financial transactions and products, changes in corporate governance towards "shareholder value", the increased use of stock options and other forms of (short-term) incentive payments to senior managers, the growing role of Chief Financial Officers within large corporations. One key aspect of financialisation has had such importance for the crisis that it can be considered separately: securitisation – the rendering tradable of formerly untraded contractual relationships, such as mortgages and other loans, and thus the diffusion of risk exposure.[4] It is only against this background that a seventh feature, to which many commentators have, in my view incorrectly, ascribed central importance in explaining the crisis, should be mentioned: a period of historically low real interest rates. Low real interest rates certainly increased the appetite for risk ("search for yield") and were a proximate cause of inflating asset prices. Yet the appropriate level of interest rates must be judged against the performance of the economy (the "supply side"). In the case of Europe, which recovered painfully slowly from the 2001 downturn, it seems hard to argue that interest rates were set too low. A more plausible argument can be made that both economic policy and theory have relied too heavily on interest-rate setting, and ignored other demand-management instruments (notably fiscal policy) and other central bank instruments (such as minimum reserve requirements and other supervisory measures).[5] Attention to these matters would have permitted low interest rates to stimulate activity without endangering aims such as financial stability.

In retrospect this constellation of very diverse factors constituted a perfect storm of complex interacting forces. The combination of the deflation of prior asset price bubbles, especially the US housing market, with the above-mentioned proximate causes of slowing demand and output growth led to a severe economic downturn in Europe, which gathered pace from negative feedback effects between the "real" economy and the financial sector and contagion across national borders. In the following I focus on the interaction between the crisis and the fourth factor mentioned: inequality and income distribution.

### Income Inequality – a Driver of the Crisis

An increase in income inequality in countries since around 1980, following an extended period that began in 1945 during which income differentials had been steadily compressed, is a stylised fact of advanced capitalist societies.

Much discussed has been the extent to which the top ten per cent (and especially the top 1%) of US citizens have expanded their share of national income, virtually monopolising the entire productivity gains of the US economy.[6] But in Europe, too, the trends have been marked.

According to a detailed study by the OECD:[7]

- The increase in the Gini coefficient (the most basic measure of income inequality) between the mid-1980s and the mid-2000s was actually greater than in the USA in Portugal, Norway and Finland, and similarly

[3] Contributions that have begun to tease out some of the implications of "financialisation" include: E. Hein, T. van Treeck: Financialisation in Post-Keynesian models of distribution and growth - a systematic review, IMK Working Paper, No. 10, 2008; T. Palley: Financialisation: What it is and Why it Matters, IMK Working Paper, No. 4, 2008. For an analysis of the role of private equity within this complex see A. Watt: The impact of private equity on European companies and workers: key issues and a review of the evidence, in: Industrial Relations Journal, Vol. 39, No. 6, 2008, pp.548–568.

[4] Günter Franke, Jan P. Krahnen: The Future of Securitization, CFS Working paper, No. 31, 2008, Centre for Financial Studies, Frankfurt am Main 2008, http://www.ifkcfs.de/fileadmin/downloads/publications/wp/08_31.pdf.

[5] On this see also T. Palley, op.cit.

[6] For a survey: R. Gordon, I. Dew-Becker: Controversies about the Rise of American Inequality: A Survey, NBER Working Paper, No. 13982, May 2008.

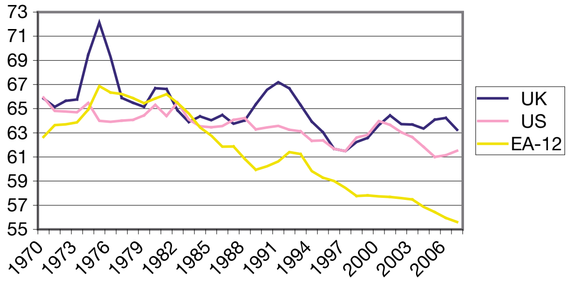
[7] OECD: Growing unequal? Income distribution and poverty in OECD countries, Paris 2009.

strong in Germany, Italy and Sweden. All the other EU members of the OECD, except Spain, Ireland, Greece and France experienced widening inequality over this period.

- Similarly, of the 16 European countries covered by the OECD data for both the 1980s and 1990s the rate of income growth was faster in the top than in the bottom quintile in all but three.[8]
- The OECD presents data on the share of *pre-tax* income of the top 1% of taxpayers for eight European countries (p. 32).[9] In the UK and Ireland this small group has, since the mid-1980s, increased its income share by around 4 and 5 percentage points respectively, comparable with other English-speaking OECD countries, albeit less than the massive c. 8 percentage point rise in the USA. Significant increases were also recorded in Germany and Sweden, and smaller ones in Spain and France. Given the reduced tax rates that have resulted from tax competition and the increased scope for the wealthy to declare their income in tax havens, these figures substantially understate the extent to which the very top of the income distribution has enjoyed a huge rise in its control over total spending power in European economies.

Meanwhile the share of labour compensation in national income has fallen across the advanced capitalist countries, although to considerably different extents. From levels oscillating around 65-67% of GDP until around 1980, the wage share trended gradually down, with cyclical fluctuations, in the USA and the UK. In the euro area, however, the decline was dramatic. Labour has "lost" around 10% of GDP to capital according to these figures. In practice because of the imprecision in allotting income between labour and capital, these figures probably overstate the European/Anglo-Saxon divide: in particular it seems likely that elements of executive remuneration are classified as labour income in the latter but as capital income in the former. At least this – tentative and partial – explanation helps account for the seeming paradox that the rise in inequality in household income, especially at the top, has been much greater in the English-speaking countries, while the decline in the labour share has been less pronounced.[10]

**Figure 1**
**The Wage Share in USA, UK and Euro Area**




Source: AMECO database, DG Ecfin: Compensation per employee as percentage of GDP at market prices per person employed.

While a controversial debate rages on the weighting of the different factors,[11] there is broad agreement that some combination of the following trends is at the heart of the rise in inequality and the shift in the functional distribution of income to the detriment of workers: globalisation that pitched low-skilled workers into competition with those in emerging economies while increasing the returns to the highly skilled; associated with that, regulatory and tax competition; so-called "skill-biased" technological changes that raised the returns to the highly skilled, reducing demand for the low skilled, while rendering work increasingly "tradable" across national borders; the weakening of trade unions and welfare states; high unemployment and more generally the reduced commitment of governments to maintaining full employment, and to regulating labour and other markets.

It is noticeable that many of these trends were those that were identified earlier as leading to the increased fragility of the global economic system. Rising personal and functional inequality is intricately linked with drivers such as globalisation and financialisation. The crisis has marked the point at which the capacity of this economic and political system to reproduce itself has broken down: the various imbalances in the world and in domestic economies, not least among them those in the functional and personal distribution of income identified here, are no longer sustainable. Growing inequality has contributed to asset price inflation, increasing debt burdens, and it interacts in complex ways with savings-investment (current account) imbalances. This has placed an increased share of resources in the hands of those who, rather than consume it in the form of real goods and services, have used it to speculate on financial markets. Meanwhile, at the other end of the income scale, the poor have been forced to expand borrowing

[8] Own calculations based on the OECD data in Table 2.1, p. 29; it is also the case in the Czech Republic and (just) Hungary, for which data are only available for the mid-1990s to mid-2000s.

[9] Survey data is well-known to poorly capture incomes at the top, and researchers have to rely on administrative (tax authority) data, which has its own problems, and limits country coverage.

[10] Other factors, including household composition effects, may also play a role. Especially in the first half of the period the stronger employment growth in the UK and USA than in Europe also had the effect of stabilising the wage share there.

[11] See for instance OECD: Employment Outlook, Paris 2007, ch. 3.

**Table 1**
**Total Support for the Financial Sector and Upfront Financing Need**
(as of 18 February 2009, in % GDP)

| | Capital injection | Purchase of assets and loans | CB support (backed by treasury) | CB liquidity provision | Guarantees | Total | Upfront govt. financing |
|---|---|---|---|---|---|---|---|
| Austria | 5.3 | 0.0 | 0.0 | 0.0 | 30.0 | 35.3 | 5.3 |
| Belgium | 4.7 | 0.0 | 0.0 | 0.0 | 26.2 | 30.9 | 4.7 |
| France | 1.2 | 1.3 | 0.0 | 0.0 | 16.4 | 18.9 | 1.5 |
| Germany | 3.7 | 0.4 | 0.0 | 0.0 | 17.6 | 21.7 | 3.7 |
| Greece | 2.1 | 3.3 | 0.0 | 0.0 | 6.2 | 11.6 | 5.4 |
| Ireland | 5.3 | 0.0 | 0.0 | 0.0 | 257.0 | 262.3 | 5.3 |
| Italy | 1.3 | 0.0 | 0.0 | 2.5 | 0.0 | 3.8 | 1.3 |
| Netherlands | 3.4 | 2.8 | 0.0 | 0.0 | 33.7 | 39.9 | 6.2 |
| Norway | 0.0 | 13.8 | 0.0 | 0.0 | 0.0 | 13.8 | 13.8 |
| Portugal | 2.4 | 0.0 | 0.0 | 0.0 | 12.0 | 14.4 | 2.4 |
| Spain | 0.0 | 4.6 | 0.0 | 0.0 | 18.3 | 22.9 | 4.6 |
| Sweden | 2.1 | 5.3 | 0.0 | 15.3 | 47.3 | 70.0 | 5.8 |
| Switzerland | 1.1 | 0.0 | 0.0 | 10.9 | 0.0 | 12.0 | 1.1 |
| UK | 3.5 | 13.8 | 12.9 | 0.0 | 17.4 | 47.6 | 19.8 |
| Simple European average | 2.6 | 3.2 | 0.9 | 2.1 | 34.4 | 43.2 | 5.8 |
| USA | 4.0 | 6.0 | 1.1 | 31.1 | 31.1 | 73.7 | 6.7 |

Source: IMF: The state of public finances: outlook and medium-term policies after the 2008 crisis, IMF Board paper, 6 March 2009, http://www.imf.org/external/np/pp/eng/2009/030609.pdf, p. 7, Table 1.

in order to maintain living standards in the face of stagnating real wages in many countries.

The immediate question now, however, is how the crisis itself, and the steps being taken to resolve it, will feed back into distributional outcomes.

### The Distributional Implications of Policies to Resolve the Crisis

The initial impact of the crisis will, perhaps counter-intuitively, be to reduce inequalities. Profits and dividends will be hit. Investors will suffer major capital losses on a wide range of assets from housing to equities. Executive bonuses will be curtailed for both economic and political reasons. A number of high-paying jobs, especially in the financial sector, will simply disappear, and the former incumbents will have to make do with a wage closer to the average. Total wages will initially rise as a share of (a contracting) GDP, as it takes time for firms to reduce their payroll in response to falling revenues and output, depressing productivity, while wage rates are only renegotiated periodically.

This effect will quickly pass, however, to be replaced by more pernicious developments.[12] Rising unemployment will increase poverty and widen the income distribution at the bottom. Workers will be forced to make wage concessions to defend jobs, as firms struggle to rebuild their balance sheets. Public sector wage cuts and cutbacks in welfare provisions will be forced on governments in many countries either via the good offices of the IMF or because of a perceived need to calm "the markets" in the face of rising government deficits. Fiscal deficits will be higher (see below) and, in a globalised world, it will be the immobile factor labour that will disproportionately be called upon to foot the bill. Last but not least, retirees and older workers face substantial cuts in pension entitlements depressing the living standards of this group. In short, unless, counter-action is taken, the stage is set, as in the wake of previous recessions, for a return to the trend of widening inequality.

Critically, there are a number of specific features of the current economic crisis that suggest that the impact on distribution could be particularly negative this time. These features relate to the fact that the financial sector has been at the heart of the crisis. As a result policy attention has focussed on preventing a financial meltdown. This was in many cases justified and to this extent can be considered benign, even in terms of (longer-term) distributional concerns, if it prevents a Great Depression. However, there are also considerable signs that the financial sector has in effect held the state to ransom: being too big or systemically important to fail has, perversely, strengthened the hand of the sector vis-à-vis a terrified state that is systematically at an informational disadvantage. On top of this comes the po-

[12] It is of course a normative judgement that, from current levels, further increases in inequality are negative, a return to a more equal distribution positive. It is not entirely arbitrary, however. It can be justified on Rawlesian grounds up to the point at which the absolute welfare of the poorest would be negatively affected by any "efficiency" losses caused by higher equality.

litical power of the financial sector, especially evident in the USA, where key policymakers came from (and can expect to return to) the financial institutions that have failed so spectacularly, but also in Europe.

Estimating the amount of support offered to the financial sector is a tricky task, not least because many forms of support do not show up, or not immediately, in the normal measures of fiscal policy, the government deficit and debt. This is notably the case with guarantees, which initially "cost nothing", but pose a serious fiscal risk for the future, and equity purchases, which increase the debt, but not the deficit. Bearing these caveats in mind, a recent overview by the International Monetary Fund[13] gives an idea of the order of magnitude involved.

Table 1, based on IMF data,[14] shows substantial fiscal resources already and irrevocably committed to the financial sector (last column). The simple average of the European countries covered by the analysis is a hefty 5.8% of GDP, only slightly lower than for the USA. For the UK the figure is virtually one fifth of annual GDP! What is particularly worrying is that many of the measures do not cause upfront costs, but nevertheless pose budgetary risks. This is indicated in the second-to-last column ("total"). The European average approaches half of annual GDP (42.3%) – in America it is three-quarters. Ireland's blanket issuing of government guarantees implies a total exposure of two-and-a-half times its GDP. Iceland is not covered.

Of course, the guarantees are unlikely to be called in full.[15] Possibly some of the assets purchased can later be sold at a profit. Yet it is safe to conclude that the funds already definitively committed to the sector imply by themselves a substantial increase in deficits and/or debts that will have to be serviced in coming years. There is a serious risk that the cost to the exchequer could run into double-digits as a percentage of GDP; blowing such a hole in government finances would constrain fiscal policy (and other) decisions for years to come.

It is important to set this public support for the financial sector in context by comparing it with the size of other discretionary fiscal policy measures taken by governments. A recent survey of the stimulus packages for most EU countries has been collated by the BRUEGEL institute.[16] The BRUEGEL figures explicitly exclude the measures directed towards the financial sector just discussed (p. 7). Overall, the analysis suggests that, in 2009, genuine discretionary tax cuts and expenditure increases amount to just 0.8% of GDP. (On top of this comes 0.07% from the EU Commission.) This figure does not include "extra credit and similar measures", which are calculated to be a more substantial 2.1%. However, in some ways mirroring the guarantees, this is not actual additional spending, but merely a government subsidy to enable producers and consumers to take out additional loans of that magnitude.

These figures relate just to 2009, whereas the above figures for financial sector support can be expected to be disbursed over the next two or three years. Given this and the uncertainties about the data, any comparisons must be cautious. Yet it is clear that, especially in the short term, but probably also in a more medium-term perspective, fiscal measures by European countries in support of the financial sector will almost certainly be larger than all other genuine discretionary fiscal measures combined. They could well prove to be two or three times as important. Even allowing for the automatic stabilisers – which according to the OECD[17] are somewhat more than half as large again as the discretionary measures – one is forced to the conclusion that the financial sector has absorbed a huge proportion of the total fiscal resources deployed by governments in their attempts to resolve the crisis.

The point here is not to call into question the wisdom, in principle, of directing fiscal firepower in this way. There is a wide consensus that stabilising the financial system is vital, specifically that it is a precondition for the success of other fiscal and monetary policy measures to stimulate demand and output. Nor do I wish to lend support to those sowing panic regarding the "burden on future generations" of rising deficits. History has shown that even large deficits can be swiftly reduced, provided economic growth is successfully re-ignited; this is confirmed by the cited IMF study[18] At the same time it is legitimate, and I would argue essential, also to consider the distributional, not to say, ethical, implications of this approach, and draw appropriate policy conclusions. To do this it is necessary to consider quali-

[13] International Monetary Fund: The state of public finances: outlook and medium-term policies after the 2008 crisis, IMF Board paper, 6 March 2009; http://www.imf.org/external/np/pp/eng/2009/030609.pdf.

[14] The IMF table from which these data are taken contains 14 detailed footnotes, not reproduced here. The point of this exercise is to gain an idea of the order of magnitude. The figures given here are as of 18 February 2008.

[15] The IMF's best guess of the likely actual cost of the guarantees is 2-6% of GDP, but it notes that the "margin of uncertainty is large" (p. 9).

[16] D. Saha, J. von Weizsäcker: Estimating the size of the European stimulus packages for 2009: An Update, BRUEGEL Policy Contribution, 2009, http://www.bruegel.org/Public/PublicationPage.php?ID=1174#14541. This assessment is also fraught with difficulty and should taken as indicative only. The cut-off date is virtually the same as for the IMF study, 20th February.

[17] Using the weighted average of the OECD countries. The underlying figures refer to the years 2008-2010. OECD Economic Outlook, Spring 2009.

[18] Cf. International Monetary Fund, op.cit., pp. 31 ff.

tative aspects of the support given to the financial sector and those of other fiscal measures. How the money has been and will be spent is as important as how much has been provided.

**The Nature of the Support Offered to Financial Institutions**

This crucial issue deserves a much fuller analysis, one that also does justice to differences between countries. Yet, it is already evident that concerns voiced *ex ante* by critics[19] of the various bailout schemes are now proving amply justified. Recently evidence emerged about the spending of US public money provided to rescue AIG, formerly the largest insurer in the world.[20] Most of the press comment centred on the around US$ 165 million that this failed company, rescued by the American taxpayer, paid out in bonuses to its top staff.[21] Quantitatively and systemically much more important, however, was the fact that the US Treasury has effectively written a cheque to the value of more than US$ 43 billion to an assortment of leading US and European banks. They were counterparties in AIG's speculative trades (especially credit default swaps) and had been left holding essentially worthless toxic paper.

This means that ordinary taxpayers have transferred billions to institutions (their employees and shareholders) who for years have made huge profits (and their staff derived bonuses) from speculative trades that have been shown to be hugely risky. That downside risk has now been assumed in full by the taxpayer. Many people earning US$ 50,000 a year have, unwittingly, shown "solidarity" with a much smaller number earning US$ 50 million, a group that in previous years, as we have seen, derived a wholly disproportionate share of the increase in overall national income, and one intimately linked with the administration that designed the rescue package. Goldman Sachs, the firm formerly run by Hank Paulson, until recently Treasury Secretary, received almost US$ 5 billion. That they had during the glory days also systematically disparaged and actively promoted the dismantling of government and other institutions that offer security to ordinary workers rubs salt into the wound.

In terms of volume this is an arguably extreme illustration, and one from the USA. Yet in Europe, too, bank bailouts were flawed. In many countries the rescue packages contained one or more of the following elements. Capital was frequently injected without the government taking an equity stake. This bailed out existing shareholders who, according to the rules of "the market", should have received nothing for having invested in worthless institutions. Various schemes to take private assets off the hands of the banks ("bad banks") mean that the public assumes massive risk, by definition "overpaying" – in terms of current market value – for the assets. As the AIG example shows, those that had lent to troubled banks (in many cases themselves troubled institutions) have seen or can expect to see, their claims honoured in full. Again, a "market" solution would have called for them to take severe losses for having lent so recklessly. Last, but in the public perception by no means least, banks receiving public funds have continued to pay out dividends to shareholders and bonuses to staff. The latter has happened even in those cases where the bank has been wholly nationalised, as the new owner, the state, was forced to honour existing employment contracts which had been so astutely drafted that large bonuses were offered as the reward for massive failure.[22] Top executives forced to resign benefited from generous "golden parachutes" and pension entitlements at a time when ordinary workers face redundancy and are concerned about retirement income.

What can be said about qualitative aspects of the fiscal packages outside of the support measures for the financial sector? Many institutions (such as the IMF, OECD, European Commission) and economists emphasised that it made sense to put additional spending power in the hands of those least likely to save it. Following this principle should on balance have a progressive effect on income distribution, as it implies cutting taxes and other charges on low income groups and/or providing them with additional transfers in various forms. Note, however, that much depends on the design of the measures. Income tax cuts, notably, will not benefit those with earned income below the tax threshold. Similarly, additional public spending might be expected to be generally positive in distributional terms, given the larger reliance of low and middle income groups on public infrastructure. This is generally harder to measure, though, and will obviously depend on the actual projects supported.

To what extent this principle has actually been followed, requires further study. I am not aware of any

[19] Among many others see Willem Buiter's Maverecon blog: http://blogs.ft.com/maverecon/.

[20] The disclosure document is available at: http://media.ft.com/cms/22704bc0-11a7-11de-87b1-0000779fd2ac.pdf.

[21] Public outrage led to some of this being paid back.

[22] The 70% government-owned Royal Bank of Scotland paid almost £1 billion in bonuses (cash and "deferred" payments in own stock) to staff for 2008 having received a £20 billion bailout. Astonishingly this was presented by the British government as representing a positive "cultural change" (finance minister Darling), because the bonus was 90% down on the previous year and was the "absolute legal minimum". See "RBS to pay bonuses worth up to £950m", Financial Times, 17 February 2009, http://www.ft.com/cms/s/0/81d2f4b8-fd08-11dd-a103-000077b07658.html.

published analyses. I have made a very provisional assessment on the basis of the BRUEGEL overview cited earlier, which provides only limited information on specific measures. A first point that can be made unequivocally is that additional labour market policy measures, i.e. direct assistance to what might be termed "deserving victims" of the crisis, those that have lost or are at risk of losing their jobs as a result of the overall economic downturn, account for just a tiny fraction of the overall volume.[23] Assessing the groups most likely to benefit from the other measures is not always easy. There are certainly examples of "positive" redistribution measures: various lump-sum transfers per child (Germany) or per household (Belgium); cuts in VAT and income tax play a significant role in some countries, and these will tend to be broadly progressive, although this depends on the details. However, it should be noted that a number of measures – which may be justified on other, for instance ecological, grounds – will tend to benefit middle and higher income groups: many countries are supporting homeowners in various ways, while measures supposed to support the car industry and environmental modernisation of buildings give a subsidy to those in a financial position to purchase these goods and services (at a discount). A considerable proportion of the measures targets business. France is an interesting case. The initial package proposed by President Sarkozy was largely business-oriented. Only after massive street protests were – substantial – "social" elements introduced.

Let us sum up. There has been and will be a massive transfer of public resources to the financial sector, also in relation to the size of more general fiscal measures. Moreover, in many cases taxpayers have given money to what can only be described as the "undeserving rich": wealthy individuals who have pocketed high incomes in past years, and who have been at best negligent about the risks they were incurring, more generally cynical, because they were aware that they were too important or well connected (in both economic and political terms) to fail, and, in some cases, actually criminal. It is clear that one of the key outcomes of the crisis will be very substantially higher government deficits and debt which will have to be shouldered by the taxpayer. The way in which this fiscal largesse has been distributed which, to phrase it slightly polemically seems to privilege the "undeserving rich" over the "deserving poor", will tend to exacerbate the already serious trend towards greater inequality in European countries. This is not only socially unjust: to the extent that rising inequality has been one of the factors behind the crisis and the unsustainability of the growth model, it is vital not just for ethical, but also for economic reasons, to take steps to address and reverse these trends.

### A Socially Just and Politically Feasible Exit Strategy Needs To Be Set Out Now

The crisis, the discrediting of social actors who have decried government attempts at redistribution, and public outrage over some of the trends described in this paper all create a window of opportunity for policymakers. Popular anger with the crisis and the response to it has already manifested itself on the streets of European cities from Dublin to Riga. This will intensify as the pace of job losses accelerates in the coming months. Once recovery sets in there will be a huge pressure to let bygones be bygones. The struggle over income distribution, pre and post tax, will resume. But the forces arguing for a reversal of past trends towards greater inequality will be weaker, economically and politically.

It is therefore vital to act now. An "exit strategy" should be drawn up to ensure a fair burden-sharing of the costs of the crisis, and more generally to put our economies and societies back on a road of balanced participation in the fruits of increased output. This will require coordination. For many of the measures needed to mitigate the situation call on the actually or potentially mobile to make a larger contribution and/or to target government support at sections of the population that are not so mobile, nor so well-connected. Ideally, agreement should be reached at international or at least European level on the basic thrust of such a programme, details of which would then be left to individual countries.

Below I sketch out possible contours of such a package. The focus is on the distributional issues discussed here.

Governments should agree on the following:

1. Basic principles of any continued support for the financial sector.[24] Public support comes at a price. Most basically, governments must take an equity stake, up to and including full public ownership in supported financial institutions to ensure the public interest and benefit from any possible future "upside". Existing shareholders and bondholders must take (partial) losses on their investments.[25] More importantly, going forward, the new owners must en-

[23] Based on Figure 1, which shows a breakdown for nine countries. Of these in three cases the BRUEGEL authors did not identify any additional labour market measures at all.

[24] It is true that this has increasingly been recognised by European governments. The recent Geithner plan in the USA, however, raises major concerns in this regard.

[25] This is also vital to avoid future crises ("moral hazard"). Of course the decision on the extent of such enforced losses is a tricky one in any given instance, given the possibility of systemic repercussions.

sure sensible limitations on both employee bonuses and dividend payments.

2. A further expansion of European fiscal packages which in most countries should be of the order of 2% of GDP a year in genuine additional stimulus. The Stability and Growth Pact (SGP) should be put into abeyance until 2011; fiscal oversight should be about ensuring stimulus, not consolidation. At the same time a substantial increase is needed in the importance within the packages of labour market policy measures (extension of benefit duration, support for short-time working schemes, subsidies for training etc.) and a greater targeting towards low-income groups. IMF-backed contractionary measures in EU countries are to be rejected as long as output is falling (see also point 5).

3. Governments should agree now on a substantial rise in the top rate of income tax to be introduced by countries once their cyclical situation permits a tightening of fiscal policy. As a point of departure I propose an increase of 10 percentage points.[26] Agreement on this principle could be reached by a European summit and, conceivably, by a wider forum such as the G20. It could be considered within the framework of the SGP when it is taken out of its mothballs. This measure should be maintained until fiscal deficits return to a "normal" level (for instance the Maastricht ceiling of 3%). Having got used to the idea, it may well be that voters will prevent this measure being reversed. In countries where the top-rate band starts rather low on the income scale, capturing a large share of middle-income earners, it may make sense to raise this when the rate is increased.

4. Introduce a Financial Transactions Tax. Blueprints for such a tax have already been developed.[27] Even if one is sceptical about their value in reducing market volatility, there is little doubt that they would generate substantial public revenues.[28] Such a tax is particularly attractive given that it would be, and be seen to be, a direct response to the fiscal burdens imposed on the public by the excesses of the financial sector.

5. Possibly using the proceeds from an FTT (or a carbon tax), increase the budget of the European Union in order to finance both the required financial supervisory institutions at European level and to boost the EU's capacity to provide financial support to national governments encountering financial difficulties and currently being forced into perverse contractionary policies.

6. Recommendations consisting of broad principles should be drawn up for all large companies with respect to remuneration schemes and profit-distribution policies. These should be designed to prevent excessive risk-taking and short-termism. All companies receiving public money will be required to adhere to these principles. They could also be made mandatory for firms bidding for public contracts. If the principles are sound, reputational concerns should take care of most other firms.

7. Avoid beggar-thy-neighbour policies of real devaluation by promoting wage-setting in line with medium-term productivity trends. Depending on the national context, this can involve appropriate increases in statutory minimum wages, public sector wages or support for collective bargaining institutions. Appropriate EU-level institutions such as the Macroeconomic Dialogue should be strengthened to help ensure consistency of wage setting, especially within the euro area. Correction of past competitive imbalances must be symmetrical (i.e. also imply faster wage increases in countries running surpluses).

### Concluding Remarks

Distributional concerns are only a part of the crisis. Governments and other actors need to take a wide range of measures to address a number of concerns (financial stability, ecological sustainability) not discussed here. This may involve policy trade-offs. Yet the public debate about income distribution, about a fair sharing of burdens, while at times shrill, and indeed violent on the streets of some European cities, has so far not had a discernible impact on the debate over and choice of actual policies. It deserves a higher profile. Fiscal stimulus is needed and should be expanded, not curtailed. The financial sector must be rescued. But, although preliminary in nature, this article has shown that, unless counter-action is taken, current crisis-resolution policies may well have lasting and severe negative implications for income distribution. There is a political opportunity to address this, but that opportunity needs to be seized now and it needs to be done in a coordinated way. This in turn suggests a need to strengthen, and reorient, European-level policymaking.

[26] This would be only a small part of the decline in the top rate of income tax which is typically around 40% in European countries, whereas it was often 60% or more in the 1970s. Exceptions might be needed in Denmark and Sweden, countries where the rate has been stable in recent years at 59% and 55% respectively, http://www.kpmg.ch/docs/MM_Individual_Tax_Rate_081110_ENS.pdf.

[27] E.g. S. Schulmeister, M. Schratzenstaller, O. Picek: A General Financial Transaction Tax. Motives, Revenues, Feasibility and Effects, Österreichisches Institut für Wirtschaftsforschung, 2008, http://www.wifo.ac.at/wwa/jsp/index.jsp?fid=23923&id=31819&typeid=8&display_mode=2.

[28] Depending on coverage and the rate chosen, revenues of the order of 0.5-1% of GDP could be realised in Europe, S. Schulmeister et al., op.cit., pp. 46ff.