

Income Inequality and Financial Fragility

*Robert Hockett**

A distinct strand of thought found in some works of nineteenth century political economy gives reason to think income and wealth concentration not only unjust in some circumstances, but also inefficient. The source of the inefficiency lies in gross inequality's capacity to introduce systemic fragility to a market economy. The guiding idea is that relative losses below the top of the income or wealth distribution can prevent goods markets from clearing. That deprives the macroeconomy of consumer demand, thereby diminishing productive activity, lowering employment and spending, and thus feeding back into the goods-clearing problem itself. This is the core of the classical theory of feedback-fed "crisis."¹

A later, twentieth century line of thought associated with Keynes and Kalecki identifies two additional elements in the crisis dynamic: the marginal propensity to consume's inverse relation to wealth, and the recursive structure of decentralized investment behavior.² The first factor leaves stable aggregate demand ever more dependent on investment. The second factor leaves investment markets themselves prone to feedback dynamics and consequent underemployment equilibria. This is effectively the Keynes-Kalecki

* Edward Cornell Professor of Law, Cornell Law School. Thanks to participants in the "New Directions in Financial Regulation" conference held at Vanderbilt Law School in April of 2017. Thanks especially to Yesha Yadav and Morgan Ricks, who planned and orchestrated this extraordinary gathering in addition to presenting at it.

1. The first several paragraphs of this brief piece summarize a model developed in, and empirical findings reported in, Robert Hockett & Daniel Dillon, *Income Inequality and Market Fragility: Some Empirics in the Political Economy of Finance* (Jan. 21, 2013), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2204710 [<https://perma.cc/AR7C-NKEQ>].

2. The latter is my term, but what it names is implicit in Keynes and Kalecki. See Robert Hockett, *Recursive Collective Action Problems: The Structure of Procyclicality in Financial and Monetary Markets, Macroeconomies, and Formally Similar Contexts*, 3 J. FIN. PERSP. 1, 20–28 (2015), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2239849 [<https://perma.cc/2GLE-923M>].

account of crash and depression.³

In a decentralized modern market economy with a developed financial sector, one would expect the Keynes-Kalecki update of the political economists' crisis dynamic to work through the medium of ever more sophisticated consumer- and mortgage-debt products and associated derivative contracts and other financial instruments. These would respond to both heightened demand for investment yield at the top of the increasingly skewed distribution, and heightened borrowing needs below the top of the distribution. In such an economy, one would also expect leverage-fueled asset price bubbles and busts and their Fisher-style debt-deflationary sequels to be larger and longer, respectively, than in times past, owing to mortgage debt's tendency to lengthen the leverage cycle. We can think of this as a case of the aforementioned Keynes-Kalecki dynamic, with an additional Fisher-Minsky wrinkle.⁴

Using autoregressive filtering, time-lagged cross-correlations, and cognate statistical methods on large sets of data that include income inequality, debt and investment trends, consumption and price indices, current account balances, and other indicators of macroeconomic performance, a colleague and I have found strong support for the proposition that a "financialized" Fisher-Minsky rendition of the Keynes-Kalecki-supplemented political economists' crisis dynamic links significant income and wealth inequality to market fragility.⁵ This goes a long way toward explaining, among other things, a remarkably rich set of parallels that can be drawn between the paired inequality and market calamity of 1928–29 on the one hand and that of 2008–09 on the other hand. It also sheds light on other such parallels between these calamities on the one hand and formally analogous episodes in other, non-U.S. jurisdictions.

These results bear implications not only for tax, education, and trade policy, but also for the project of financial regulation. While gathering income and wealth inequality do not render that project futile, they do seem, ironically, to render it simultaneously more urgent and more difficult. There is significant evidence, for example, that U.S. financial regulators found it difficult to buffer the destabilizing effects of capital glut via traditional means—e.g., leverage limits and interest

3. Hockett & Dillon, *supra* note 1; Hockett, *supra* note 2.
4. Hockett & Dillon, *supra* note 1; Hockett, *supra* note 2.
5. Hockett & Dillon, *supra* note 1; Hockett, *supra* note 2.

rate policy—once that glut had grown “tidal.”⁶ There also is evidence that U.S. legislators and regulators actually welcomed, or at the very least looked more favorably upon, new mortgage- and consumer-debt products as substitutes for aggregate-demand-reducing real income stagnation among Americans with incomes below the very top of the distribution.⁷ Both this “purchasing power effect” and the “wealth effect” wrought by resultant housing price rises became the principal guarantors of continued macroeconomic growth and employment from the early 1980s through the crash of 2008.

These results bear at least two important lessons for finance-regulatory policy. The first is that financial regulation should attend at least as much to household debt growth as to fraud, regulatory arbitrage, and other forms of opportunistic behavior. This should be the focus of macroprudential finance-regulatory policy in particular—which, as the prefix “macro” itself suggests, is more a matter of aggregates than of individual delicts.⁸ That is not to say that traditional “microprudential” regulatory aims and methods are not important; indeed, quite the contrary. It is simply to say that microprudential tools must be used in pursuit of macroprudential goals—to render no longer individually rational such market behaviors which, when aggregated, result in collectively calamitous outcomes.⁹

The second finance-regulatory upshot of the results I allude to here is that tax policy, trade policy, and financial regulation are not pragmatically “orthogonal” to one another, and accordingly must not be “siloed” from one another. Macroprudential finance-regulatory considerations must be included in tax, trade, and other spaces of policymaking, as financial system effects will bear crucially on such policies’ efficacy and sustainability. By the same token, financial regulators must make a point of becoming and remaining cognizant of the ways in which alternative tax, trade, and other policies will affect the feasibility of their stability-maintenance efforts.

6. See, e.g., Robert Hockett, *A Fixer-Upper for Finance*, 87 WASH. U. L. REV. 1213, 1251 (2010) [hereinafter Hockett, *Fixer-Upper*]; Robert Hockett, *Bretton Woods 1.0: A Constructive Retrieval for Sustainable Finance*, 16 N.Y.U. J. LEGIS. & PUB. POL’Y 401, 451 (2013) [hereinafter Hockett, *Bretton Woods*].

7. See Hockett, *Fixer-Upper*, *supra* note 6, at 1236–38; Hockett, *Bretton Woods*, *supra* note 6, at 449–50; Hockett & Dillon, *supra* note 1, at 2–3.

8. See Robert Hockett, *The Macroprudential Turn: From Institutional ‘Safety and Soundness’ to Systematic ‘Financial Stability’ in Financial Supervision*, 9 VA. L. & BUS. REV. 201, 208 (2015).

9. Hockett, *supra* note 8, at 206–09; see also Hockett, *supra* note 2.