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Catch me, if you can. International Financial Markets and the Political Economy of Inequality

Cédric Maxime Koch

Abstract

Inequality in terms of income and wealth is rising across the developed world, as confirmed, for instance, by recent publications by Thomas Piketty. This article takes a political economy approach to explain this phenomenon and argues that the modus of international market integration since at least the 1970s is indispensable to understand the dynamics contributing to rising inequality. In particular, Fritz Scharpf's theory of positive and negative integration as well as Susan Strange's concept of structural power are applied to discern the modus of international economic integration. Two sources of rising inequality are found: (1) higher and increasing returns on capital compared to income from labour due to public entities' inability to effectively perform taxation policy in the current system, and (2) states' declining ability to sustain an inequality-reducing welfare state due to the structural power that firms and individuals derive from the modus of financial globalisation. Combining these findings and their implications for policy, the article concludes that inequality will continue to grow until positive integration in the form of substantial international regulation and coordination of taxation is achieved.

Keywords: financial globalisation, structural power, positive integration, income inequality, taxation

Introduction: An Increasingly Unequal World

In some ways, Thomas Piketty was preaching to the converted when he published his analysis of inequality, "Capital in the 21st Century" (2014), in English language. He instantaneously rose to prominence and toured media

outlets and centres of power alike, particularly in the United States (Schuessler 2014). His analysis seemed to confirm the suspicions of many: Both the unequal distribution of income and wealth had reached historically high levels over the last decades and these disparities were, if anything, poised to exacerbate further.

Social demand for a better understanding of the dynamics of inequality is apparently strong, reflecting the neglect of distributional aspects in large swathes of mainstream economic analysis (Atkinson & Bourguignon 2000). Piketty (2014) rationalised growing economic disparities by pointing to the larger and increasing return on capital in contrast to lower returns from wage income (Piketty 2014: 571). While this conclusion and the reasons provided in support of it in Piketty’s book are powerful by themselves, the following article will aim to put Piketty's findings in a larger analytical context and thereby illustrate some additional explanatory factors underlying inequality.

This article starts from the following research question: How is financial globalisation since the 1970s related to the trends of growing inequality? Based on various theories of political economy, this question will be answered affirmatively in the article, arguing that the modus of international financial integration has been a driver of rising inequality. It will be shown that financial globalisation since that time is characterised by what Fritz Scharpf (1999) termed negative integration – reducing and abolishing barriers to market exchange across borders – instead of what he labelled positive integration, namely the creation of international markets through common institutional regulation and coordination. Employing Susan Strange´s (1996) concept of 'structural power', the dynamics of such an international market are then explained and two sources of rising inequality are identified: First, higher and increasing returns on capital compared to labour income due to public entities' inability to effectively perform taxation policy in the same system; and second, states' declining ability to sustain an inequality-reducing welfare state due to the structural power firms and individuals derive from the modus of financial globalisation. Combining these findings and their implications for policy, this article will conclude that until positive integration in the form of substantial international regulation and coordination of taxation is achieved, inequality will continue to grow.

Analysis

Financial Globalisation since the 1970s

Since the 1970s, the global economy has seen an astonishing increase in the level of economic integration through vastly expanded trade in goods, services, capital, and international migration. While volumes of trade in goods roughly doubled during that period (World Bank 2014), the explosion of

international capital flows appears even more stunning: As described in more detail by Alfaro, Kalemli-Ozcan, and Volosovych (2007: 28-33) based on data by the International Monetary Fund (IMF), average inflows of capital per capita grew by 4.8 percent on average between 1970 and 2000, with Foreign Direct Investment (FDI) and portfolio investment (equity) flows as the strongest-growing components ahead of debt. Global FDI flows, for example, have increased from 1972 by a staggering factor of 133 to a value of more than two trillion dollars in 2007 (UNCTAD 2016) and annual international financial transactions stood at around 6.5 trillion dollars in 2003 (IMF 2016).

These drastic developments were a result of the collapse of the Bretton Woods system of fixed but adjustable exchange rates coupled with tightly restricted international capital transactions in 1972 (Helleiner 2005). Following the suspension of the U.S. dollar's convertibility to gold at the fixed parity rate, almost all countries reverted to flexible exchange rates between each other, thereby allowing for international currency trading. As captured by the concept of the 'policy trilemma' of international monetary relations, such a flexible system is incompatible with controls on capital flows and monetary policy autonomy (see Aizenman 2010). In consequence, by 1979 most Western states had abolished controls and restrictions on international capital flows with many other (developing) countries following suit in the 1980s and 1990s (Fischer 1997), creating an integrated global financial market (Helleiner 2005).[1]

The Modus of Financial Globalisation

Undoubtedly, international markets have integrated strongly since the 1970s. But what kind of integration has this been? A helpful way of analysing market integration was proposed by Fritz Scharpf (1999) in the context of European integration and distinguishes between negative integration on the one hand and positive integration on the other.

Negative integration, Scharpf argues, is characterised by the facilitation of international trade by reducing state capacities for intervention against market activity at its borders (1999: 17). All sorts of quantitative and qualitative restrictions of market activity between states and infringements on free competition across borders, such as taxes, regulation or standards fall under this category. Reducing these will naturally make it easier for firms to conduct business internationally and thereby lead to economic integration (Scharpf 1999: 23).

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[1] Some important exceptions exist, notably China. Similarly, this process of liberalisation has been carried out with different degrees of deliberation across countries, with some states being pressured to abolish capital regulations, for example in the context of the IMF's structural adjustment programmes.

On the other hand, however, Scharpf (1999) argues that economic integration can also be achieved by negotiating commonly agreed rules and regulations of market activity beyond the national level – such as harmonisation of production standards or tax regimes to a new common level. Doing so would essentially expand the framework of a publicly regulated market to newly negotiated borders and is termed by him as 'positive integration'. Thereby, international trade and economic activity would be incentivised as well, since operating in either of the participating countries would take place in the same business environment for firms, allowing them to take advantage of larger markets without the frictions inherent in differing regulatory settings (Scharpf 1999: 26).

A crucial point observed by Scharpf (1999) is that political dynamics make negative integration much more likely than positive integration, given a general desire to reap the benefits of increased integration: It is considerably more difficult to find consensus on joint regulation of market activities between sovereign states due to disparate national electorates and interests than it is to agree on reducing barriers to market activity between each other (Scharpf 1999: 6).[2]

Applying this framework to financial globalisation, a striking similarity becomes apparent. According to economic theory, countries share a desire for increased financial integration because of the expected efficiency gains, consumption smoothing and risk hedging through a market-guided international allocation of capital (Kose et al. 2006). However, just like in other fields of integration beyond national borders, consensus on joint institutions upholding agreed regulations and binding standards for all participants is extremely difficult to achieve. As a result, states have proceeded to instead mutually reduce rules which inhibit international financial flows between them – the abolition of capital controls (Helleiner 1994). However, they were unable to agree on joint guidelines on how to treat the capital now able to freely flow between firms and individuals across their respective borders. This is exemplified by the absence of international institutions regulating global financial markets in the field of taxation (see also Gill 1992).[3]

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[2] Until today, common production standards could not be negotiated in most areas, even between EU states. However, EU law guarded by the powerful European Court of Justice created a common market by upholding rules of 'mutual recognition' of production standards – essentially a ban on EU-internal discrimination of products based on national production standards.

[3] This article covers only aspects directly relating to trends in inequality. However, important exceptions to the configuration described here exist. Most notably, states agreed to let their financial systems be regulated by the recommendations of the Basel Committee on Banking Supervision, a sub-group of the Bank for International Settlements. This body issues proposed rules on capital requirements and other broad-based regulations for banks, which most states implement in response. However, this regulation regards only one aspect of intervention, namely macro-stabilisation and prudential regulation. While such policy may be indirectly related to trends in inequality, it is

Negative Integration and Structural Power of Private Capital

Financial Globalisation characterised by negative integration has given both individual and firm actors important power over public authorities. This reconfiguration can usefully be analysed by drawing on Susan Strange´s (1996) notion of 'structural power'. In her definition, power is "the ability of a person or a group […] to affect outcomes [in a way] that their preferences take precedence over the preferences of others" (Strange 1996: 17). Thus, a state's power must be judged on its ability to create outcomes in line with its preferences, even at the expense of other actors' preferences. Equally, other entities such as individuals and firms may well hold such power if they are able (possibly only through their existence within a given structure) to exercise control over outcomes (Strange 1996: 60). Applied to financial globalisation, this broader and less capability-centred definition allows to discern the considerable power of corporations and individuals vis-à-vis public authorities in an integrated global financial market – and, ultimately, to discern the contribution of this configuration to increasing inequality.

Two characteristics jointly yield structural power to private actors in the negatively integrated global financial market: (1) capital mobility and (2) international competition. Firstly, both individuals and firms are in principle able to transfer liquid assets such as cash in a bank account to another country at very little cost. This implies that, if national policy relating to such capital does not – to refer back to Strange´s definition of power – correspond to the 'preferences' of these agents, funds can be removed from the reach of this policy by moving them abroad. In the case of individuals, such potentially undesired policy includes capital and investment regulation and taxation as well as inheritance laws and taxation.[4] Investing or depositing money abroad, where these policies are more in line with individuals' 'preferences', is both legal and a very viable part of the business model of many banks and asset and wealth management firms. In a similar vein, firms are largely able to determine in which country their capital is to be invested or held based on their preferences. Given that profit-maximisation is a firm's primary interest, every tax policy is in principle against that interest and companies will, all else being equal, choose to employ capital where taxes are lower. Furthermore, firms have found ways to avoid taxation even in countries they operate in, since international taxation law is governed by a highly complex and

much less so than other parts of the financial system such as taxation policy, which will mainly be dealt with in this article. Therefore, it appears appropriate for the purposes of this analysis to omit the Basel Committee from scrutiny. Similar reasoning applies to other policy bodies in the international financial system, for instance the International Monetary Fund.

[4] The focus here is exclusively on legal actions. Naturally, evasion from state intervention also (significantly) takes place in illegal contexts such as money-laundering and trafficking, and various illegal ways of avoiding taxes exist, against which criminal and tax authorities try to act.

equally porous web of over 3000 bilateral treaties (Bowers 2014; Strange 1996: 62). A range of legal vehicles and approaches to tax-minimisation within this system exist (Christensen & Murphy 2004; Lisowsky 2010), including setting up subsidiaries and legal structures in tax-favourable jurisdictions and transferring profits there as payments within the same firm (Shay 2014).

The second characteristic of contemporary global financial markets of matter here is international competition over tax policy and the absence of cooperation or policy coordination, which would correspond to Scharpf´s positive integration. To date, no supranational agreement on taxation exists aside from non-binding guidelines and codes of conduct (despite attempts by, for instance, the OECD to achieve a firmer international regime (Strange 1996: 62)). Due to this, states compete with each other for the desired presence of both individuals' and firms' internationally mobile capital. Certain countries such as Luxembourg or Ireland and jurisdictions such as the Jersey Islands specialise in attracting such capital and undercut taxation rates which larger and economically more diverse countries with higher required public expenditures (for example on poverty reduction) must charge (Slemrod & Wilson 2009). While not all states engage in such low taxation (Plümper et al. 2009), the existence of a few so-called 'tax havens' as a consequence of international competition suffices to allow internationally mobile capital to ‘seek shelter’ in them, given individuals' and firms' ability to move capital across borders. For instance, recent revelations have documented how Luxembourg and other EU states offered large firms operating in the European market corporate taxation levels of around one percent through complex but legal mechanisms, substantially below corporate taxation levels of other EU states (see Bowers 2014).

These features of the current international financial system yield 'structural power' to firms and individuals vis-à-vis public authorities. Both individuals and firms are able to hinder public authorities from exercising a desired level of taxation and thereby wield precisely the control over outcomes that is characteristic of Strange´s (1996) definition of 'structural power'. (Individual) States, even if they wanted to, cannot perform tax policy in the way they could in the absence of international capital mobility. Furthermore, this does not only entail a weakening of *current* policy effectiveness but also a strong disincentive for states for higher taxation on private capital, given that this may lead to offshoring of production, reduced foreign investment, and expatriation of wealthy individuals. Holders of private capital therefore wield another important source of structural power over states, namely the threat of moving funds beyond the reach of the state. Since states are therefore very likely to resist temptations of higher taxation, even when in need for funds due to other reasons (for instance war or recession), this yields power over outcomes – and thus structural power – to holders of mobile private capital.

Structural Power and the Increasingly Unequal World

How do this modus of financial market integration and its structural power relations contribute to growing inequality?

On the one hand, this negative integration of global financial markets is inherent in Piketty's (2014) analysis. Based on an unprecedented wealth of compiled statistical data, he argues that returns on capital historically exceed returns on income, creating a dynamic of growing inequality between capital owners and the rest of society (Piketty 2014: 571). While this development also held in long periods preceding financial globalisation (notably prior to World War I), financial globalisation and the implied capital mobility have made it more difficult for states to counteract this fact by taxing capital gains more strongly that income. In the absence of international capital mobility, governments maybe would have chosen to reduce this unequal trend to the benefit of non-capital owners – whereas they were discouraged to do so given international tax competition. Furthermore, financial globalisation contributed to a second source of growing inequality demonstrated in Piketty's book, namely the increasing returns on capital. Piketty shows that even between the (generally benefiting) group of capital owners inequality is growing, due to the tendency that gains resulting from capital increase as a function of initial capital stock (Piketty 2014: 451). This is explained by the fact that with growing funds, capital owners can pay more expensive expertise in asset management (for example professional wealth managers). Thereby, they have access to higher-yielding portfolios and 'alternative investment strategies', in contrast to common small investors relying on low-yielding savings accounts or relatively simple stock portfolios (Piketty 2014: 452). These increasing returns on capital have probably been exacerbated by financial globalisation, since capital owners with access to expert asset management may now invest in a globally diversified portfolio with even higher yields than nationally-limited investment.

On the other hand, financial markets' negative integration implies a second source of growing inequality beyond Piketty's analysis: As shown above, states' ability to effectively tax at current levels and to increase taxes to desired levels has declined markedly in the face of increased structural power of both wealthy individuals and firms. As a consequence, countries' capacity to counteract trends of growing inequality through other means than taxation has been reduced as well. More precisely, the reduced ability to fill governments' fiscal coffers due to financial globalisation impeded their ability to finance inequality-reducing expenditures such as education or social spending. While these sectors enable wider shares of society to participate in a country's economic success and thereby lower inequality, a limited ability to increase public revenue through taxes has led to their systematic under-financing by governments (see Gilbert 2002).

Hence, the particular configuration of financial market integration has likely exacerbated inherent trends in growing inequality uncovered by Piket-

ty, both by allowing for more strongly increasing returns on capital and by impeding states' ability to finance inequality-reducing expenditures.[5]

Policy against an Increasingly Unequal World

As was shown, the modus of financial market integration contributes to growing inequality. Crucially, however, this analysis has shown that the current setup is by no means unavoidable. It is rather a direct consequence of the political choices underpinning the negative integration of global financial markets, which removed obstacles to market activity yet failed to provide enforceable common rules for this market activity. If this is the case, essentially two remedies to the problem emerge: (1) an unwinding of international financial market integration; or (2) positive market integration at the international level.

The first solution does not seem likely, given the stunning amount of contemporary international capital flows and economies' general dependence on them. Individuals, firms, and states all rely (until now) on financing through ever-more integrated international capital markets, be it through international bank loans, foreign equity, or issuance of government bonds to global capital markets. Given the enormous cost of foregoing such financing and adjusting to exclusively national sources of financing, a policy of financial disintegration does not seem likely in the short or medium term.

In consequence, the only viable alternative appears to be a reorganisation of financial globalisation towards more positive integration. Indeed, an international tax regime would considerably reduce the structural power of holders of mobile capital and, at the same time, increase governments' fiscal ability to counter growing inequality. Such a system might for instance tackle the inequality-enhancing advantages of wealthy individuals through a common wealth tax or corporations' tax evasion through joint floors for corporate taxation. As of yet, such attempts have encountered strong political opposition by beneficiaries of the status quo and have repeatedly failed in the past. The absence to multilateral solutions has even driven the United States to announce legislation to unilaterally tax companies' profits globally (Harvey 2012).

Yet, however disappointing the historical record may be, reasons for optimism exist. Under ever-increasing financial strain due to the global financial crisis and the Euro crisis' fiscal austerity, governments' resolve appears to grow. In particular, the G-20's agreement of automatic tax information exchange as a first step of an intended crackdown on international tax avoid-

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[5] To be sure, not all potential sources of increased inequality resulting from financial globalisation were mentioned here. For instance, it might appear plausible that countries' growing reliance on debt as a replacement of tax revenue and the ensuing higher incidence of debt crises may have increased inequality, too. Similarly, regular financial crises and their often inequitable countering by policy might well play a role, too.

ance appears promising, though as of yet not all 'tax havens' are part of the process (Johannesen & Zucman 2014). Recent OECD reports on international tax legislation (2015) offer further reasons for optimism and will likely limit the structural power of capital and firms, if fully implemented. It remains to be seen whether public financial strain is large enough to force a truly international regime – the present analysis suggests it may well be the only hope cash-strapped governments and their electorates have, not least to combat trends in growing inequality.

Conclusion

This article has argued that the modus of financial globalisation since the 1970s has contributed to growing inequality. While negative integration of financial markets took place on an unprecedented scale over the last forty years, positive integration has been largely absent, particularly in the field of taxation. This configuration has yielded considerable structural power to both individuals and firms and has impeded states' ability to charge desired levels of taxes as well as their capacity to raise them. States' ability to redress rising inequality due to higher returns on capital than on incomes via higher capital taxation is obstructed by global tax competition. Furthermore, international capital markets exacerbated the tendency towards increasing returns on capital, heightening inequality. In addition, governments' lower revenue generation through taxes decreased their ability to counteract trends of growing inequality by increased spending on education or social programs.

Positive integration at international level through a common tax regime was presented as the only remedy to this problem yet has failed repeatedly in international negotiations. Recent G-20 agreements and OECD recommendations and the need for funds in fiscally austere times may, however, offer reasons for optimism in the future.

– I reflect –

Ich habe mich mit diesem Thema beschäftigt, da es eine aus meiner Sicht wichtige und oft übersehene Perspektive auf viele Phänomene der letzten Jahre wirft. So wird etwa der Alltag der politischen Verteilungskämpfe im ‚Westen' in den letzten Jahren immer mit der Legitimierung ausgetragen, der internationale Wettbewerb sowie die strukturell notwendige Konsolidierung erlaube nur noch eine schlankere Ausgestaltung gemeinschaftlicher Institutionen, bei der alle lernen müssten, mit weniger auszukommen. Dass dies nicht notwendigerweise so ist, sondern schlicht eine Konsequenz aus sinkender relativer Souveränität von national beschränkten Staaten gegenüber internationalen Prozessen und Akteuren, kann eine hilfreiche Einsicht sein. Bewegungen, welche die globale regelbasierte Institutionalisierung der Finanzglobalisierung sowie auf nationaler oder europäischer Ebene eine schrittweise Rückforderung legitimer staatlicher Besteuerungs- und Regulierungskapazitäten betreiben, scheinen daher unabdinglich, um die drastische und oft sozial ungerechte Kürzungspolitik und Hofierung einseitiger Interessen zu überwinden, welche zurzeit vielerorts die nationale Politik dominiert.

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