The stickiness of finance-related income inequality

When the economy is strong, financial-sector salaries soar. They don’t come down when times are hard.



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What goes up must come down, or so the aphorism goes. That may be true in many cases, but when it comes to income inequalities exacerbated by high financial-sector salaries, once the inequality goes up, it almost never comes down.

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That's the conclusion of multi-country research into income inequality which looked at how financiers' salaries widened the income gap during boom years, and then asked what happens during a downturn. Do inequalities then narrow? Do higher capital requirements for financial institutions — which presumably drain the pool of funds that banks can pay their executives — result in lower salaries? Do efforts to cap bonuses for executives translate into less pay?

No, on all counts, the research shows.

IESE's Marta Elvira, together with leading academics from around the world, looked at a roughly 30-year period during which income inequality generally worsened and then, in the wake of the 2008-09 financial crisis, stabilized or declined. Not coincidentally, they represented boom years and bust years for finance. The research covers more than a dozen countries in Europe, North America and Asia.

Quantifying the asymmetry, the research finds that finance contributed, on average, 45% to salary gains by top earners in the 12 years leading up to 2008. In the seven years post-crisis, finance contributed 29% to narrowing inequality.

"Neither the post-financial crisis downswing in financial activity nor financial regulation contributed to a significant reduction in inequality to the extent that the 1990–2007 financial upswing contributed to its increase," the study concludes. "The contribution of finance to inequality in times of upswing thus has long-term and hardly reversible effects."

The same pattern emerges despite the varied economic models of the countries under study: from liberal North America (Canada, the U.S.), to the social democracies of Scandinavia (Sweden, Norway, Denmark), to corporatist western Europe (France, Germany, the Netherlands), to eastern European transitioning economies (Czechia, Hungary), to southern Europe (Spain).

How finance exacerbates income inequality during boom years

The outsized contribution of finance-sector salaries to general income disparity during upswings is well documented, and this research corroborates that. The sector has been found to widen the earnings gap in a number of ways: during boom years, even non-financial companies may prioritize financial earnings over other more productive types of investment.

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Companies also tend to favor shareholders and dividends over employees, workforce flexibility over labor unions, during upswings.

Add to that performance-based executive compensation, and you end up with all top managers earning magnitudes more than normal employees. Financiers, in particular, enjoy disproportionately large salaries during growth years, research shows.

Even among top earners, financiers consume a disproportionate piece of the income pie, the research finds. Finance earnings in 1992 were 2.8 times more represented, on average, in the top 1% than non-financial earnings in the countries studied. That peaks at 4.9 times in 2008, dips to 4 in 2009, but then heads back up to between 4.1 and 4.5.

The numbers show that when inequalities arise, it's difficult to reverse them — even if the financial sector is plunged into crisis like it was in 2008. When finance salaries do drop, it is often only temporary, lasting one or two years.

There were substantial variations among countries, however, the research found. In France and Japan, for example, finance continued to widen inequalities even when inequality was narrowing on a national level. In Canada, Denmark, Hungary and the Netherlands, finance pay declined when income inequality did — but at a slower pace than how much it contributed to the gap. And in countries such as Norway, Sweden, Germany and South Korea, the finance sector's post-crisis contribution to a bit more equality was equal or greater than its pre-crisis contribution to inequality.

Capital requirements & bonus caps don't help

Given this situation, what policy responses are possible or effective?

After the crisis, regulators attempted to tackle systemic risk, introducing higher capital requirements for banks, which could be expected to reduce bank leverage, dilute the profitability of higher-risk activities and further depress bonus pools.

But the research finds that post-crisis increases in capital requirements at best yielded very modest reductions in the contribution of finance to inequality.

The European Union, meanwhile, introduced a cap on bonuses in 2013 in an effort to limit excessive risk-taking by executives, which it felt that bonuses incentivized. But the limit merely generated a long-run increase in fixed remuneration and a short-run decline in

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variable remuneration.

Fixed wages increased by 20% over the 2014-17 regulatory period — by 15% in 2014 and by an additional 12% in 2015, not decreasing after that. Variable income, or bonuses, were somewhat trickier to evaluate: given their volatile nature, much depends on the base year of comparison. Compared with 2012-13, bonuses dropped immediately after the new cap; compared with 2009-13, no clear decline can be seen.

“In sum, apart from the modest restructuring of the remuneration practices of European banks by reducing variable remuneration and increasing fixed remuneration, a real reduction in top earnings in banks cannot be observed,” the study finds.

Why are finance salaries so resilient?

The researchers argue that the underlying reason financiers’ salaries are so impervious is that, during upswings, financiers are rewarded for their perceived contribution to the success of the firm. But those same executives may be able to negotiate continued high wages during downswings because banks fear losing top performers and suffering even greater losses.

That conclusion speaks to what may and may not work in reducing inequalities. Rather than government policy or business cycles, it’s organizational processes that keep salaries high — and make them resistant to both market shocks and regulatory pressure.

About the research

This research analyzed administrative, employer- and employee-linked data on earnings from 1990 to 2019 for 12 countries (Canada, Czechia, Denmark, France, Germany, Hungary, Japan, the Netherlands, Norway, South Korea, Spain and Sweden), complemented with World Bank indicators and earnings share estimates for the U.S. To analyze the impact of the European bonus cap, data came from bank reports, from 2009 to 2017, in 13 European countries (Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, the Netherlands, Spain, Sweden and the U.K.) complemented with balance sheet indicators from Compustat data.

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