FINANCIAL SECTOR PAY FUELS INCOME INEQUALITY

Disproportionately high pay and bonuses in the financial sector is making the industry less stable and worsening income inequality. That is the central finding of research by OECD economist **Oliver Denk**, to be presented at the annual congress of the European Economic Association in Mannheim in August 2015. His analysis of a big new dataset covering a range of European countries shows that:

- Finance workers make up 20% of the top 1% of earners, despite making up only 4% of the entire workforce.
- About half of the top earners in Luxembourg work in finance; in the UK, they account for 40%.
- Financial institutions pay wages well above their employees' productivity. This 'wage premium' is 28% of an average person's earnings.
- The wage premium is larger the further up a financial employee is in the income distribution and reaches 40% for the top earners.
- The situation is most extreme in the UK where the pay of a top income earner in finance is nearly twice their productivity.

The study finds that this wage premium happens because the banking sector is concentrated, uncompetitive and guaranteed bailouts by being 'too big to fail'. Splitting the sector into lots of smaller firms would help solve this, as would putting caps on bonuses for short-term success. The author comments:

> 'Finance jobs pay so much not because people in finance are any more useful for society than doctors, journalists or engineers. They pay so much because the financial industry is averse to competition and benefits from public bailout guarantees.'
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> 'Banking reform that aligns pay in finance with comparable industries would reduce income inequality in Europe by the same amount as it has increased since the mid-1990s.'

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Rising inequality has become a major concern to politicians and people around the globe. This new OECD research by Oliver Denk shows how excessive pay in the financial sector raises income inequality, using a vast and unique European micro dataset.

'Finance jobs pay so much not because people in finance are any more useful for society than doctors, journalists or engineers', says the author who is to present the study at the European Economic Association's annual congress in Mannheim.

'They pay so much because the financial industry is averse to competition and benefits from public bailout guarantees. Banking reform that aligns pay in finance with comparable industries would reduce income inequality in Europe by the same amount as it has increased since the mid-1990s.'

Protest movements against bankers in the wake of the global financial crisis are emblematic of the popular perception that pay in finance is an important factor behind high and rising inequalities. The report is the first of its kind to confront this perception with hard data for a large set of European countries.

Financial sector employees make up 20% of the top 1% earners but only 4% of overall employment. The two countries with the largest concentration are Luxembourg and the UK. About half of the top earners in Luxembourg work in finance; in the UK they account for 40%.

High pay in finance is not necessarily an economic or even social concern. Financial sector workers may, in principle, produce more than workers elsewhere. But the empirical analysis in this report finds that financial institutions pay wages well above their employees' productivity. This so-called wage premium is 28% of an average person's earnings. It is larger the further up a financial employee is in the income distribution and reaches 40% for the top earners. The situation is most extreme in the UK where the pay of a top income earner in finance is nearly twice their productivity.

Excessive remuneration of people in finance widens income inequality, slows economic growth and threatens financial stability. This raises two important questions: What are the sources of this wage premium? And how can policy-makers reduce it?

Banking is a very concentrated industry with a small number of big banks in most countries. These big banks command large market power. Jobs in finance are extremely competitive, with the lucky applicants who get one making large amounts of money. The concentration of the financial industry and the barriers to entry allow bankers to secure very high pay levels.

Another source of the wage premium is public guarantees to too-big-to-fail banks, which effectively subsidise banks and bankers. Germany is the country where bailout guarantees are largest. Compared with other countries, German banks have high leverage ratios and a governance structure with unusually close ties to the public sector.

What to do about it? Splitting too-big-to-fail banks would create smaller entities that could go bankrupt without creating systemic risk. This would be one way to increase competition in the financial industry and the chance of a bail-in of banks' share and bondholders.

Alternatives can be considered, but they should also raise competition in the banking sector and reduce the probability of a bank bailout. Restricting compensation practices that reward short-term success with no clawback provisions would cap very high financial sector pay when it is the most unjustified.

These policy initiatives for a sounder financial system would make it less attractive, and more difficult, for banks to pay excessive salaries and bonuses. The beneficiaries of such a new financial architecture would be the ordinary taxpayers and especially the socially vulnerable.

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‘Financial Sector Pay and Labour Income Inequality: Evidence from Europe’ is to be presented at the annual congress of the European Economic Association (11am, 25 August 2015, Mannheim).

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