Inequality, austerity and the crash

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The global meltdown that began in 2007 has been widely blamed on a mix of excessive profiteering, reckless financial risk-taking and blind-eye supervision by the regulatory authorities. These were all central factors that helped trigger economic implosion. But despite their importance, they are merely the headline explanations, secondary, not primary causes. They are, in reality, symptoms of a much more-deep seated social and economic trend – the soaring income and wealth gulf of the last three decades.

The root causes of the growing economic turbulence of recent years are to be found in a combination of the mass personal fortunes accumulated across the globe in the last thirty years and the erosion of ordinary living standards to which they gave rise. Without the creation and empowerment of an international financial elite, able to control the destiny of mass global flows of capital, and holding more economic muscle than even the largest nation states, economic forces would have played out very differently. The financial institutions would have had had much less cash to be reckless with, governments would have been more hands-on and debt levels would have been much more sustainable. The natural economic cycle would have been much more muted.

From the early 1980s the central social and economic trends of the previous three decades – falling poverty, reduced inequality and spreading opportunities – were set on a reverse course in both the UK and the United States, the nations that most embraced the new economic ideology of market capitalism. Over the next 25 years, in both countries, the proceeds of rising prosperity were much less equally shared than they had been in the post-war era. Poverty and inequality rose sharply.[5]

Middle income groups were also left increasingly behind in the battle for the spoils of rising prosperity.[6] In contrast, the period saw the re-emergence of a domestic and global super-rich, suddenly free to accumulate fortunes at levels not seen since the 1920s.

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[5] John Hills et al (eds), *Towards a More Equal Society*, Joseph Rowntree Foundation, 2009, ch 2

[6] S Lansley, *Life in the Middle*, TUC Touchstone Pamphlet, 2009

These trends not only ushered in increasingly divided societies, they also proved to be an economic time-bomb. Widening inequality became a key – if largely unrecognised - ingredient in the growing fragility of the economy and played a central role in the build-up to the credit crunch and the subsequent recession.

The single most important driver of soaring inequality has been the shrinking of national wage pools. For half a century until the late 1970s, wage-earners – in nearly all rich nations – shared more or less equally in the increases in national economic output being achieved. It was this stability in the level of 'wage-shares` that helped to bring greater equality and sustained the demand that fuelled the long period of post-war economic prosperity. But it was a trend that was not to be maintained. From the late 1970s, for the first time for decades, the critical balance of power between employers and the workforce shifted sharply in favour of the former. As business gained the upper hand, the bargaining power of labour slumped.

For the next thirty years, real wages for most began to fall behind the growth in productive capacity. In the UK, two-thirds of the workforce found their wages being squeezed. In the United Stares, it was as high as 90 per cent. While wage growth stagnated, profits boomed. Personal fortunes at the top soared to new heights as a small business and financial plutocracy - corporate executives, investment bankers and new financial deal-makers - found ways of capturing the lion's share of the growth being generated by rising productivity. One sixth of national wealth was transferred from the pockets of wage-earners into the bank accounts – mostly salted away in the growing number of offshore tax havens – of the richest.

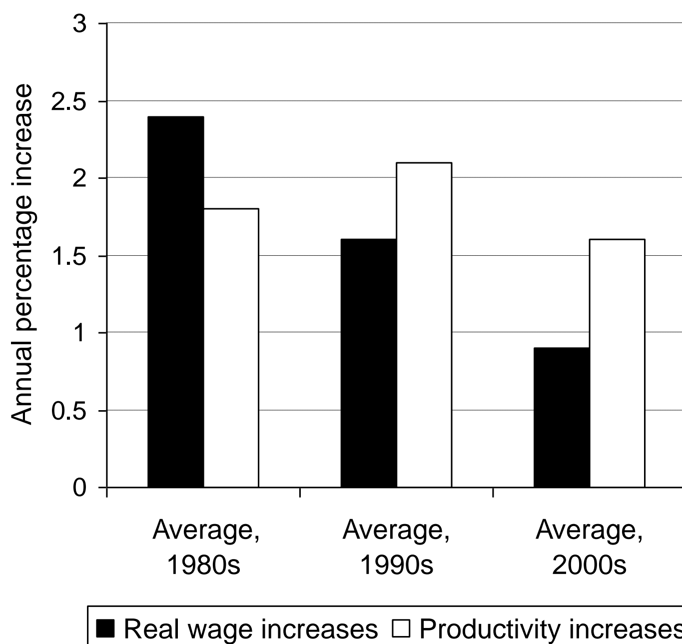
Figure 1, for the UK, shows that the share of national output going to wages held its post-war level at between 58-60 per cent until the early 1970s and then reached a high of 64.5 per cent in 1975 – the era of the 'profits squeeze - before going into freefall. In 2008 it stood at 53.2 per cent – close to its post-war low in 1996. As a result, the share of national output being taken up by profits reached close to a post-war high just before the onset of the recession.

As the 'profits squeeze` of the 1970s gave way to the much more sustained 'wage squeeze` of the last three decades, real wages in the UK rose much more slowly than productivity. From 1980 to 2007, real wages – rising at 1.6 per cent per annum – fell behind productivity, rising 1.9 per cent pa. Since 2000, the gap – as shown in figure 2 - has opened further with real wages rising by a mere 0.9 per cent per annum while productivity has averaged 1.6 per cent.

Figure 1: How the profits squeeze gave way to the wage squeeze

Source: Office for National Statistics

Figure 2: How real wages have lagged productivity, 1980 to 2008, UK



Source: Author's calculations

The declining wage and rising profits share were driven by the deregulation of the financial services industry, the boosting of market forces, the steady erosion in the power of labour and a growing emphasis on cost-cutting in the pursuit of 'shareholder value' – maximising short term share price. These were the outcome of the wider shift in economic philosophy from one of managed global capitalism to what became known as the 'Washington consensus' – the belief in efficient and self-regulating markets.

It was the application of this belief that led to the new emphasis on flexible labour markets, new constraints on collective bargaining and the new macro-economic priorities. The trends were fuelled (though not caused) by a reduction in the

demand for unskilled labour resulting from technical change and the global transfer of jobs triggered by globalisation, factors that have added to the growing bargaining advantage of employers.[7]

The wage squeeze has been compounded in its impact by another long term economic trend: the increasing concentration of earnings at the top. During the period from 1978 to 2008, *real* earnings at the 90th percentile doubled. In contrast, real median earnings rose by a little over half this rate - 56 per cent – while those at the 10th percentile increased by only 27 per cent.[8] The earnings structure has thus become increasingly skewed towards the top end, with the gap widening sharply between the middle and the top.

As a result, the falling wage share has not been evenly distributed across the earnings range but has been borne almost entirely by middle and lower paid employees. Thus the bottom 60 per cent of earners has faced a shrinking share of a diminishing pool.

These trends have been at their strongest in Anglo-Saxon economies. The US has experienced an even steeper fall in the wage share, while even more of the gains from growth have gone to the richest one per cent. Real incomes for the bulk of middle America remained static over the last two decades. The Walton family who own Wal-Mart have a combined wealth in excess of $90bn, roughly equal to that of the poorest third of the US population - some 100 million people.[9] The fall in the wage share in Europe has been shallower, while most countries on the continent have experienced a lesser rise in inequality and nothing like the personal wealth boom of the UK and the US.

The new market theories predicted that as long as wages and prices were flexible, growth and full employment would follow while the business cycle would be much more muted. According to this theory, the 2008-9 recession should not have happened in countries like the US and the UK that fully embraced the new ideology. Wages and labour markets in Anglo-Saxon and even several more regulated European economies have become a good deal more flexible than in the 1970s which means that economic downturns should have been avoided. As the American economist Robert Lucas, Nobel Laureate and one of the high priests of the new philosophy, declared in 2003, 'the

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[7] See e.g. 'The Globalisation of Labour`, *World Economic Report,* IMF, 2007

[8] S Lansley, *Unfair to Middling,* TUC Touchstone Extra, 2010; the figures are for full time males and have been adjusted by the RPI

[9] T Judt, *New York Review of Books,* 6 December, 2007

central problem of depression-prevention has been solved, for all practical purposes.'

In fact, contrary to orthodox market theories, the compression of wages became a key determinant of the 2008-9 crash. The squeeze on wages, the boost to profits and the mass upward transfer of wealth meant that market power became increasingly concentrated. A supra-elite of global and domestic financiers, richer and more powerful than many nations and governments, used its growing economic and political muscle to ensure weak financial regulation by the state, lower taxes on the wealthy and inaction on tax havens. City and Wall Street lobbying ensured the birth of finance-driven economies as the new power-brokers built support for the idea that financial innovation was good for the economy, a key generator of social value and should be the central engine of economic growth. In the US, former Wall Street bosses took top jobs in government. In the UK, the Treasury became little more than an outpost of the City.

The shrinking of national wage-pools greatly upset the natural equilibrium essential to economic stability. As wage rises fell behind productivity increases, they led to an increasing shortfall in the purchasing power needed to buy the extra output being produced. A dangerous gap opened up between demand and supply. If this slump in consumer demand had been allowed to continue, economies would have ground slowly to a halt.

The political solution to this problem - one acknowledged by successive governments, especially in the US and the UK where the wage squeeze was greatest – was to license huge increases in lending to private individuals. People borrowed not just to finance house purchase but a wider range of consumer spending and every day living expenses, accelerating the profit flow in financial services. From the mid-1990s, rising economic prosperity was being secured only by an unprecedented explosion of private debt on both sides of the Atlantic. The personal debt/income ratio in the UK rose from 91.1 in 1997 to 157.4 in 2007. In 1980 it stood at 45 per cent.[10] It was this borrowing that propped up the sustained boom of the post-millennium years.

While ordinary consumer purchasing power was slipping and private debt exploding, giant private sector surpluses were being created off the back of soaring profits. These brought an additional set of economic imbalances. As the financial elite captured an increasing share of the world's productive output, and the concentration of wealth intensified, a giant mountain of global footloose capital – a mix

[10] Lansley, *Unfair to Middling*, op cit

of corporate surpluses and hoards of personal wealth – began to emerge.

Some of it – a mix of private and corporate cash – was used to finance tycoon lifestyles. Long waiting lists grew for the world's fastest private jets and sleek mega-yachts. Destabilising grey markets emerged as the richest and most impatient offered huge cash sums to jump the queue. Premiership football clubs were snapped up by foreign billionaires. Prices at London and New York auctions for French impressionists and the most-sought after contemporary artists boomed to new heights.

But despite the mass flaunting of wealth, most of these cash surpluses re-emerged back in the finance sector. A tidal wave of surplus money careered around the world in search of the fastest returns, most of it landing in London and New York. In the City and Wall Street, the giant money flows powered a cash merry-go-round as the world's mega-rich sought new ways of building even bigger fortunes. As the search for quick profits exploded, the punts became riskier and riskier.

Little of this circulating pool of hot money ended up in sustainable, wealth and job-creating investment that could have strengthened the real productive base of the economy. Instead, the 'real` economy – where new products are created and new industries built - became increasingly starved of cash. While banks invested some £50 billion in manufacturing in 2007, close to £800 billion went on a mixed variety of property and financial deals. Finance, driven by these ever larger surpluses of cash, became the economic cuckoo in the nest.

Money poured into hedge funds, private equity houses, takeovers, commodities and commercial property. These mass financial spending sprees by the world's richest mostly added up to large speculative bets that offered, at the time, spectacular returns. Asset prices and business values began to soar, fuelling a sustained speculative frenzy from the immediate post-millennium years.

Far from creating new wealth that would have grown the size of the economic pie, the City and Wall Street used the new pro-rich culture to grab a bigger slice of the cake for themselves and their clients. Deal-making and corporate restructuring became mechanisms, often highly complex and little understood, for transferring existing rather than creating new wealth.

Speculative frenzy triggered staggering returns and rising business and asset values. It was these illusory returns that created the multiple bubbles that brought the credit crunch and the subsequent recession. A similar mechanism was at work in the build-up to the

great recession with, in the United States, a great surge in the concentration of wealth and in the volume of speculative loans during the 1920s. The global distribution of wealth today is almost as uneven as it was in the 1920s. The combined wealth of the world's richest 1000 people is almost twice as much as the world's poorest 2.5 billion.[11]

The role of inequality in fuelling financial instability has long been recognised. Keynes made it clear that because of the lower marginal propensity to consume of the rich, and their propensity for speculation, wealth inequality increases the risk of financial instability and economic collapse. It is no accident that the reduced inequalities of the post-war decades coincided with sustained growth and a much more subdued if crisis-punctuated economic cycle. While there have been three deep recessions under 'market capitalism` – in 1980-81, 1990-91 and 2008-9 - there was only one shallow and short-lived recession ( in 1961 when output fell by 0.2 per cent in two successive quarters ) in the 25 years of 'welfare capitalism`.

What is now clear is that there is a natural economic limit to the degree of inequality that is sustainable, and that once that limit is reached, economies implode. That limit has been severely breached in the last fifteen years, creating the tensions that gave rise the destabilisation that brought the latest meltdown.

Yet despite the repeat of the conditions that created the 1929 Crash, the key lesson of the broken global economy has yet to be learned. The dominant business model of shareholder value remains intact. Power continues to reside with a super-wealthy financial oligarchy, able to deliver what Citigroup global strategist Ajay Kapur has called 'favourable treatment by market-friendly governments`.[12]

Today's most urgent task beyond recovery is a coherent strategy to rebalance the real economy. This means plans which halt and reverse the sliding wage share, reduce the gap between rich and poor, shrink the size of the financial sector and increase the flow of funds into productive and sustainable economic activity. Real living standards should rise in line with productive capacity while rising prosperity should be evenly shared across all groups in society.

Far from pursuing such a strategy, the government is fixated on the issue of the fiscal deficit with an £83 billion package of public

[11] D Rothkopf, *Superclass,* Little Brown, 2008 p xv

[12] Ajay Kapur et al, 'The Global Investigator: Plutonomy: Buying Luxury, Explaining Global Imbalances`, *Citigroup Equity Research*, October 14, 2005

spending cuts announced in the October Comprehensive Spending Review. As the Institute of Fiscal Studies and the chapter by Tim Horton and Howard Reed have shown, these cuts will be most heavily born by those on the lowest incomes, especially the low paid in work. By accentuating inequality in this way, the Government's strategy will be to aggravate the problem that gave rise to the crisis in the first place.

Moreover, the Government's emphasis on fiscal austerity means that the gains from post-recessionary growth, when it comes, are likely to continue to be very unevenly shared. Unemployment is likely to stay well above its post-millennium rate, while the wealth and income gap is set to persist at a level which threatens economic as well as social stability.

Although the meltdown of 2008-9 has led to some re-evaluation of the role played by a small group of elite financiers, no effective measures have been taken to limit the rising concentration of wealth at the top. While many of the world's mega-rich suffered a severe dent in their fortunes at the height of the bust, most have bounced back from the nadir of 2008. Throughout much of the turmoil of the time, many bankers and financiers, on both sides of the pond, continued with their gilded lives as if nothing had happened.

According to the annual report by the economic consultants, Merrill Lynch and Cap Gemini, the combined wealth of the world's richest 10 million individuals – each with at least $30 million in the bank – increased by a fifth between 2008 and 2009. Their wealth is back to the levels recorded in the year of the crash. Despite universal calls for restraint, the average Wall Street bonus in 2009 was the fourth highest in history. The City bonus pool in 2010 is heading towards pre-credit crunch levels while the lion's share of the £7 billion pay-out will, again, go to a few hundred top executives.

Today, the income gaps and financial imbalances that caused the debt surge and the multiple asset bubbles are still present in the global economy. Real wage levels in the biggest economies are static. The austerity measures being applied across the developed world are likely to intensify existing levels of inequality.

The world's mega-wealthy now look set to be the main beneficiaries of the recovery when it comes. The signs are that the post-recessionary era, one of jobless growth and fiscal austerity, will intensify economic divisions still further. Those jobs that are created in the private sector are likely to be low paid, insecure, and mostly part-time. The gains from productivity rises are likely to continue to be very unevenly shared. Current policies are thus simply sowing the seeds for a

continuation of the economic instability that has dogged the UK, US and global economy over the last three decades.

The 1929 Crash not only brought the Great Depression, it led to the wholesale reinvention of economics. Today, in contrast, it is largely business as usual. Yet without drastic action to reverse these inegalitarian trends, and ensure that the proceeds of economic progress are more evenly shared, the next meltdown will be deeper and even more intractable than that of 2008-9.

Stewart Lansley is the author of *Rich Britain,* Politico's, 2006. His book, *The Limits to Inequality* will be published in 2011.