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# HOW SOARING INEQUALITY CONTRIBUTED TO THE CRASH

**The economic meltdown has been widely attributed to a combination of global imbalances, excessive bank leveraging, reckless financial risk-taking and excessive personal debt. But these headline explanations are only part of the story. The immediate triggers of the current crisis have their roots in the much more deep-rooted economic, social and political upheavals of the last thirty years. Widening inequality became a key ingredient in the growing fragility of the British (and US) economy and played a central role in the build-up to the credit crunch and the subsequent recession.**

**Stewart Lansley***

By the late 1970s the post-war consensus that combined strong government and a commitment to social solidarity had broken down. Sustained economic success gave way to óstagflationôï a dangerous mix of rising unemployment and rising inflation. With increasing instability in the 1970s blamed on the failures of managed capitalism, a contrasting political and economic ideology emerged that saw a weakened role for the state and an enhanced role for markets. This shift quickly came to dominate policy making in the UK and the United States and while the belief in the ósocial market` continued for longer in most of continental Europe, the shifting Anglo-Saxon consensus came to have much wider global repercussions.

From the early 1980s the central social and economic trends of the previous three decades ï falling poverty, reduced inequality and spreading employment and social opportunities ï were set on a reverse course, most notably in the UK and the United States. Over the next 25-years, the proceeds of rising prosperity were much less equally shared than they had been in the post-war era. Poverty and inequality rose sharply in both nations. Along with the poor, middle income groups were also left increasingly behind in the battle for the spoils of rising prosperity. In contrast, the super-rich were suddenly free to accumulate fortunes at levels not seen since well before the Second World War.

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These trends proved to be an economic time-bomb. Widening inequality became a key ingredient in the growing fragility of the British (and US) economy and played a central role in the build-up to the credit crunch and the subsequent recession.

**How the ‘profits squeeze’ gave way to the ‘wage squeeze’**

The share of UK national output taken in wages held its post-war level at between 58-60 per cent until the early 1970s and then rose to a high of 64.5 per cent in 1975. The wage share then started drifting steadily downwards to as little as 53.2 per cent in 2007. As a result, by 2007, the share of national output being taken up by profits had reached close to a post-war high.

As the óprofits squeezeô of the 1970s gave way to the much more sustained ówage squeezeô of the last three decades, real wages in the UK lagged productivity. From 1980 to 2007, real wages rose at 1.6 per cent and productivity by 1.9 per cent pa. Since 2000, the gap has opened further with real wages rising by a mere 0.9 per cent per annum while productivity has averaged 1.6 per cent.

The declining wage and rising profits share were the product of new macro-economic priorities, the deregulation of the financial services industry, the boosting of market forces, a new emphasis on flexible labour markets and the steady erosion in the power of labour. They were fuelled by a reduction in the demand for unskilled labour resulting from technical change and the global transfer of jobs, factors that added to the bargaining advantage of employers.

**Rising wage inequality**

The wage squeeze has been compounded in its impact by another long term economic trend in the UK: the increasing concentration of the earnings pool at 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. Between 1978 and 2008, real earnings at the $90^{th}$ percentile doubled while real median earnings rose by 56 per cent and those at the $10^{th}$ percentile increased by only 27 per cent.

This rise in earnings inequality over the last 30 years ï with most of the rise taking place from the early 1980s to the mid-1990s - has been driven first by dramatic shifts in the structure of the workforce, notably a significant rise in the number working in well-paid professional and managerial jobs; a decline in the number of middle-skill jobs requiring moderate levels of education and paying moderate salaries; and a rise in the number of routine low paid jobs. There has been a steady polarisation of the jobs market with a óhollowing out of the middleô- the steady loss of jobs once paying middle levels of pay.

A second factor has been a sharp increase in earnings relativities between jobs. Earnings in high paying jobs have been creeping up over time more quickly than those in middle and low paying jobs. The most high profile examples are those at the very top with very sharp rises in the pay of financiers, bankers and company executives (roughly the top 0.1 per cent). Over the last decade, for example, remuneration packages for the chief executives of FTSE100 companies have risen nine times faster than those of the median earner.

But growing pay inequality is not just a product of runaway pay amongst a few thousand top executives and financiers. The best paid employees in September 2009 were those working for City-based firms. The average pay at money broker ICAP, which employs 4,330 staff, was more than £200,000, double the average of five years earlier.

Earnings amongst those working in well paid white collar professions outside of the corporate super-elite and City financiers have also been rising faster than non-professional salaries. Corporate lawyers, accountants, medical practitioners, senior civil servants and top local government officials have all been able to command salaries that are much higher in relation to the median than their counterparts 30 years ago.

Although real living standards in the UK have nearly doubled over the last 30 years, some groups of workers, especially those just above the minimum wage have enjoyed little increase at all in real earnings over the period. Most middle and low income workers have enjoyed only small rises in real wages. Mostly it is only top executives and financiers and the best paid professionals who have enjoyed wage rises in excess of wider rises in prosperity.

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 with real incomes for the bulk of middle America remaining 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.  On average the trends in continental Europe have been much weaker. The fall in the wage share in Europe has been shallower, while most countries on the continent have not experienced a noticeable rise in inequality or a personal wealth boom on anything like the scale of the UK or the US.

**The new economic imbalance**

These trends have had a profound impact on the way the economy functions. In the 1970s, Britainôs economic problems ï its inflationary spiral, low investment and weak productivity growth ï were exacerbated by the óprofits squeezeô of the time. Yet this squeeze turned out to be temporary.

Today the imbalance of the 1970s has been reversed. Britain has built an economy increasingly dependent on financial services, the spending power of the super-rich and in which the gains from economic growth have gone disproportionately to profits. Moreover, unlike the short lived profits squeeze of the 1970s, the subsequent wage squeeze has proved much more enduring. As a result Britain has been transformed from a relatively high wage, low debt, equal society to a low wage, high debt and much more unequal society.

Within this imbalance, rising inequality has played a major role in todayôs financial turbulence. This is for three main reasons.

First, because of the negative effect of greater inequality on spending power. To maintain rising living standards, ordinary families, faced with a declining wage share, became increasingly indebted. The debt/income ratio rose from 45 per cent in 1980 to 157.4 in 2007. It was this borrowing that propped up the sustained boom of the post-millennium years. Moreover because lending was extended to groups with few if any tangible assets, the level of default risk in the economy rose along with the fragility of the banking system.

Secondly, this increase in risk was multiplied because rising inequality boosted financial speculation at the top. Some of the swelling profitsô pool funded higher levels of business investment which would have helped to boost demand. But the shift to profits also drove the personal wealth boom of the last twenty years, a boom which concentrated wealth in fewer and fewer hands. Higher profits were used to justify the explosion of corporate, executive and financial remuneration.

So what did the rich do with their rising wealth portfolios? They went in search of quick profits. In doing so, they aped financial institutions, leveraging their wealth ï sometimes by huge amounts - by borrowing. Record returns together with cheap credit encouraged the wealthy to borrow not to finance consumption but to take large speculative bets on assets that offered, at the time, big potential returns. Money poured into hedge funds, private equity, takeovers, commodities, rare art, commercial property and luxury housing. Speculative frenzy created grey markets, fed rising, if illusory, business and asset values and created the multiple bubbles that triggered the credit crunch and the subsequent recession. In his book, *The Great Depression of 1990,* the American economist Ravi Batra has written: ówealth inequality is a prerequisite for manias and bubbles. The greater the inequity, the bigger the bubble and the more painful its eventual bursting.ô

A similar mechanism was at work in the build-up to the great recession with, in the United States, a great surge in the distribution of wealth and in the volume of speculative loans during the 1920s. During that decade, the poor and the middle stagnated while the rich prospered and soaring profits poured into real estate and stock markets, leading to the 1929 crash.

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. In his book *The Great Crash* JK Galbraith identified óthe bad distribution of incomeô and its impact on the pattern of demand as the first of five factors causing the crash and the great depression.

The global distribution of wealth today is almost as uneven as it was in the 1920s. And its speculative element and impact has been accentuated by both greater leveraging and the rise of an avalanche of footloose capital owned by the worldös nomadic super-rich. The combined wealth of the worldös richest 1000 people is almost twice as much as the worldös poorest 2.5 billion.

The growing dependency of the global economy on the whims of a small global economic elite has fuelled the volatility arising from domestic concentrations of wealth. The latest global financial turbulence (following the Asian and dot-com crises of 1998 and 2000) adds weight to those such as Batra who have argued that the maldistribution of wealth has been associated with all the great speculative financial manias. Batra has argued that there is a natural economic limit to the degree of inequality that is sustainable, and that once they reach this limit they implode.

The third way high levels of inequality fuel instability is via shifts in the global and domestic power nexus. Over the last three decades, the rise of the global financial elite has shifted power from nations to a small coterie of individuals and corporations. Awe-struck political leaders stood on the sidelines as the new wealthy elite ensured what Citigroup global strategist Ajay Kapur has called ôfavourable treatment by market-friendly governmentsö Over the last decade this elite has used its growing political muscle to guarantee weak financial regulation by the state and lower taxes on the wealthy. According to Simon Johnson, former chief economist at the IMF, a dominant ôfinancial oligarchyöóplayed a central role in creating the crisis, making ever-larger gamblesé until the inevitable collapseö

**Rebalancing the economy**

It has taken a deeply damaging recession to expose the fragility of the UKõs recent market-driven growth strategy - historically low average real wages, a growing concentration of earnings at the top, a growing burden of private debt and an adherence to ôlight regulationö The debt binge on which the economy came to depend was never sustainable. Britain has also become much too reliant on rampant finance capitalism. According to the National Audit Office, bailing out the banking sector has cost £850bn, while the recession has blown a near-record peacetime hole in the UKõs public finances. Andrew Haldane, executive director at the Bank of England, has shown how bank assets ï loans, financial derivates and credit advances ï have soared from around 100 per cent of GDP in the late 1970s to five times output today. That is proportionately higher than any other country bar Switzerland and Iceland.

The fault lines of Britainõs low wage, high debt, finance-dependent economy are now only too evident. The ówage squeezeö and the growing gap between the top and the middle and the bottom contributed to the factors that led to the meltdown. Real wages were not growing fast enough to underpin final and stable demand without excessive borrowing by earners. By fuelling borrowing by households with a limited or zero asset base and encouraging rampant financial speculation, rising inequality brought unprecedented asset bubbles alongside an increasingly fragile banking system.

A growing number of leading economists have warned of the impact of the low wage model. In 2006, the Nobel-prize winning economist Robert Solow claimed that an economy that does not distribute its gains more widely is ópoorly performingö In the same year Ben Bernanke, Chairman of the US Federal Reserve, said that corporations should óuse some of those [higher] profit margins to meet demands for higher wages from workersö In 2007 Germanyõs finance minister called on European companies to ógive workers a fairer share of their soaring profitsö Writing in the journal *World Economics* in 2009, a similar argument was made by Tim Lankester, President of Corpus Christi College, Oxford University: ôIn capitalismõs last great crisis in the 1970s, the declining share of profits and the rising share of wages and salaries was the fundamental problem. In the latest crisis, the distribution problem ï in so far as it contributed to the crisis ï has been different: too large a share of national income has gone to high-income earners and not enough to the lower paid.ô

Today the recovery is threatened by the same factors that caused it: a lack of sustainable demand and a persistence of global and national inequality. The risk of a deflationary spiral will be accentuated if, as in previous downturns, the wage share begins to fall further as the economy picks up, aggravating the demand shortfall created by indebted consumers and the public spending black hole.

Todayôs 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.

Such a strategy would make the economy less dependent on debt for maintaining demand, limit the level of financial speculation, moderate the cycle of asset prices, reduce the degree of economic volatility and divert resources into more sustainable parts of the economy. Without such a strategy, the next crash will come sooner and could be even deeper.

**The views expressed in this article do not necessarily reflect those of the FES London.**

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