

Inequality: How It's Fuelling The Crisis

by

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At the depth of the downturn in October 2009, St Paul's Cathedral hosted a spirited debate on the role of the growing income gap in market-led economies. Sharing a platform with Nicholas Sagovsky, a canon theologian at Westminster Abbey and Vince Cable, then deputy leader of the Liberal Democrats, Brian Griffiths, the Vice-Chair of Goldman Sachs and a former adviser to Mrs Thatcher, defended higher inequality 'as the way to achieve greater prosperity for all.'

Lord Griffiths was espousing one of the central claims of the still dominant free-market school: that the post-war shift towards more equal societies had killed incentives and stifled enterprise. Higher rewards and the accumulation of large fortunes might bring a bigger divide, they claim, but, by encouraging business, job and wealth creation, they raise growth rates and make everybody better off. It is a creed that was largely embraced by New Labour in power and remains embedded in mainstream economic thinking.

As a result, the gains from growth in a number of rich countries over the last three decades have been heavily colonised by big business and a small group of financiers, bankers and business executives. This has set the workforce adrift from economic progress and left ordinary citizens across much of the globe with an increasingly smaller share of the economic cake.

Between 1980 and 2007, average real wages in the UK rose by only a little over half the rate of growth, a process of decoupling that accelerated from the late 1990s. In the United States, living standards for four-fifths of the workforce have been little better than stagnant over the last three decades. In Germany, real wages started flat-lining from the millennium. It is these trends that fuelled the towering personal fortunes of the modern age and the rise in inequality to levels not seen for three generations.

While recent years have seen several hard-hitting, and hotly debated, critiques of this sharp increase in the concentration of wealth, these have concentrated on issues of injustice and proportionality. One of the most influential of these critiques, *The Spirit Level*, has shown that highly unequal societies are much more likely to impose widespread social damage.

But another equally important, but largely ignored, issue is the impact of deepening inequality on the way economies function. Are Lord Griffiths and his co-believers right in claiming superior economic benefits from higher levels of inequality? Has the deepening income and wealth gulf of the last three decades delivered the promises of the architects of 'market capitalism'? The evidence points in only one direction. The wealth gap has soared, but without the promised pay-off of wider economic progress. On all measures of economic performance bar inflation, the post-1980 era of rising inequality has a much poorer record than the egalitarian post-war decades.

IN the UK, while inflation has been largely tamed, the economy since 1980 has been expanding at two-thirds of the rate achieved in the post-war era of 'regulated capitalism'. Productivity growth averaged 1.9 per cent a year from 1980 to 2008 compared with an annual average rise of 3 per cent in the more regulated era. The average level of unemployment since 1980 is close to five times that of the two post-war decades. This is despite a steady fall in the share of national output accruing to wage-earners, from around 60 per cent at the end

of the 1970s to 53 per cent by 2008, a trend that was meant to unleash a new era of record job creation.

Most important, in part because of the weaker performance on growth and productivity, financial crises have become much more frequent and more damaging culminating in the crisis of the last four years. The main outcome of the post-1980 experiment has been an economy that is both much more polarised *and* much more fragile and prone to crisis. So what does this tell us about cause and effect? Is it the rise in inequality itself that has contributed to more fragile and unstable economies, making it a key factor in the cause of the 2008 crash?

According to the only official account of the 2008-9 crash, the answer is no. The report of the bipartisan US Financial Crisis Inquiry Commission into its causes, published in January 2011, blamed pretty well everybody and everything for the meltdown but failed to mention 'inequality' once in its mammoth 662 page report.

Yet, the historical evidence provides strong evidence of a link *from* inequality to instability. The two most damaging recessions of the last century – the Great Depression of the 1930s and the Great Crash of 2008 – were both *preceded* by sharp rises in inequality. In the United States, for example, there have been only two occasions over the last 100 years when the richest one per cent of Americans have held more than a fifth of the country's income pool. The first came in the 1920s, when in the eight years to 1928 the year before the great crash, the share of income taken by the top one per cent increased from 14 to 24 per cent. The second came in the build-up to 2008 which witnessed a similar rise from 14.3 per cent in 1990 to 22.8 per cent by 2006.

So why do excessive concentrations lead to economic turmoil? The principal explanation can be found in the impact of the growing gap between pay and economic output. First, a rising earnings-output gap sucks demand out of the economy. In most rich economies, wage-enabled consumption accounts for

around two-thirds of economic demand. If wages fall substantially below this level, as they did in both the 1920s and the two decades to 2008, purchasing power does not keep pace with the extra output being produced. Consumer societies suddenly find they lack the capacity to consume.

Without counteracting policies that lift demand, economies would eventually grind to a halt. In both the 1920s and the 2000s, the demand gap was filled by an explosion in private debt. In 1920s America, the ratio of household debt to national income rose by 70 per cent in less than a decade. In the UK, levels of personal debt rose from 45 per cent of incomes in 1981 to 157 per cent in 2008, a three-and-a-half fold increase. Without this stimulus to demand, a deep-seated recession would have occurred much earlier.

Secondly, high levels of inequality eventually lead to asset bubbles. In 1920s America, a rapid process of enrichment at the top merely fed years of speculative activity in property and the stock market. The build-up to 2008 followed a near identical pattern. From the early 1990s, rising corporate surpluses, uncontrolled bank lending and burgeoning personal wealth led to a giant mountain of global footloose capital. By 2008, the assets – loans, credit advances and derivatives - held by the ten largest UK banks had grown to nearly five times the size of the UK economy. The cash sums held by the world's global rich (those with cash holdings of more than one million dollars) doubled in the decade to 2008 to a massive \$39 trillion, a sum equivalent to slightly more than three times the size of the annual output of the American economy.

Only a tiny proportion of this surplus ended up in productive investment and the creation of new wealth. Instead, a tsunami of hot money raced around the world at speed in search of faster and faster returns, creating the bubbles – in property, commodities and business - that eventually brought the British and global economies to their knees.

How to divide the spoils of the economy – between employees (through wages) and the owners of business (through profits) – is one of the oldest issues of political economy. As one of the founding fathers of classical economics, David Ricardo – who made his own personal fortune from speculation – wrote in 1821, ‘The principal problem in Political Economy` is to determine how ‘the produce of the earth ... is divided among ... the proprietor of the land, the owner of the stock or capital necessary for its cultivation and the labourers by whose industry it is cultivated`.

The division of the national wealth is in part an issue of social balance. But this balance is also a key factor in ensuring that economies work. If aggregate wages and output get too out of line, in either direction, the implications for the economy can be highly damaging. In the post-war decades up to the end of the 1960s, wages and profits moved roughly in line with growing output, a period that coincided with relative economic stability.

In contrast, economic crises have occurred when wages have grown too quickly or too slowly in relation to output. During the 1970s, the wage share soared in the UK (and in most other rich nations) from its post-war average of 59 per cent to peak at 65 per cent, a record level that created a profits squeeze that threatened the long run sustainability of the capitalist model.

The 1920s and the post-1980s, in contrast, brought a falling wage and rising profits share, bringing a sustained wage-squeeze that destroyed the natural process of economic equilibrium essential to stability. On both occasions, allowing the richest members of society to accumulate a larger and larger share of the cake merely brought a dangerous mix of demand deflation and asset appreciation which ended in prolonged economic turmoil for most of the world.

These lessons have yet to be learnt. 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. Across the globe, the great wealth divide has continued to grow. This year in the UK, seven out of ten employees have been forced to take a pay freeze or a pay cut. Yet while real wages are continuing to fall, executive pay and City bonuses have been rising. The American business magazine, *Forbes*, counted a record number of 1210 billionaires across the world in 2011, up 28 per cent over 2007. Their combined wealth has risen from \$3.5 trillion in 2007 to \$4.5 trillion in 2010. Little more than a thousand individuals command a sum equivalent to a third of the output of the American economy, even higher than in the year the crisis broke.

Vast income gaps are still present in the global economy. The proceeds of growth, when it returns, are likely to continue to be very unequally shared. If we are to avoid the risk of near-permanent recession, this fundamental imbalance needs to be restored. The great concentrations of income and wealth need to be broken up – as they were from the 1930s - and the wage share restored to the post-war levels that brought equilibrium and sustained stability.