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Think Piece

Rising inequality and financial crises:
Why greater equality is essential for recovery

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Executive Summary

The UK economy has now entered its first double-dip recession in a generation and growth continues to stagnate. If we are to avoid the risk of near-permanent stagnation, the fundamental imbalances in our economy need to be addressed. If not, growth will continue to evade us.

The aftermath of the greatest economic crisis since the Depression of the 1930s has seen the wealth divide between the richest and the rest continue to grow. In the UK, real wages have fallen by seven per cent in the last two years – and are still falling – while personal fortunes at the top are continuing to rise. Vast income gaps remain.

Historical evidence suggests a strong link between inequality and 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.

This Think Piece argues that if the UK is to achieve a sustainable recovery from the current financial crisis, the wage share needs to be restored to post-war levels and the great concentrations of income and wealth broken up.

Introduction

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. One of the speakers, 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.

The economic impact of inequality

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. 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? 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, 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.

The growing gap between wages and economic output

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.

With most countries experiencing a fall in wage share in recent times, the global economy has been subjected to a sustained dose of mass deflation. Without counteracting policies to 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. The table below shows what has been

happening to this relationship in different periods over the last 100 years. In the post-war decades up 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, giving rise to 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.

The impact of a growing wage-productivity gap

Period	Relationship between wages and productivity	Impact
1950 - 1970	**WAGE BOYANCY** Wages rose in line with productivity	Stability
1920s and post -1980s	**THE WAGE SQUEEZE** In both periods, wages fell sharply behind rises in productivity	Recession
1970 - 1975	**THE PROFITS SQUEEZE** Wages rose more quickly than productivity	Stagflation

Conclusion

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. In the UK, real wages have fallen by seven per cent in the last two years – and are still falling – while personal fortunes at the top are continuing to rise. In the United States, 93 per cent of the growth achieved in 2010 went to boost incomes amongst the top one per cent. Today, some 1200 global billionaires command a sum equivalent to a third of the output of the American economy, 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 stagnation, 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.

The Centre for Labour and Social Studies (Class) is a new think tank established in 2012 to act as a centre for left debate and discussion. Originating in the labour movement, Class works with a broad coalition of supporters, academics and experts to develop and advance alternative policies for today.

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