Inequality and instability: why more equal societies have more stable economies

According to the economic orthodoxy of the last thirty years, a stiff dose of inequality is a necessary condition for economic progress. Higher rewards and lower taxes at the top, it is claimed, boost enterprise and deliver a larger economic pie. The income gap might get wider, but eventually everybody, including those on the lowest incomes, will become better off. Here, Stewart Lansley **puts the theory to the test.**

THE THEORY – for theory it is – first emerged in the post-war teachings of a small group of pro-market thinkers. They argued that greater post-war equality had been a serious drag on prosperity and needed to be reversed. As the Austrian-American economist, Ludwig von Mises, a leading prophet of the superiority of markets, put it in 1955: 'Inequality of wealth and incomes is the cause of the masses' wellbeing, not the cause of anybody's distress.'[1] In 1975, the highly influential *Equality and Efficiency: the big tradeoff* provided further backing for this thesis.[2] It argued that redistribution from rich to poor reduces incentives and leads to a smaller economic pie.

This theory has been put to the test over the last thirty years in both the UK and the US. Both countries have allowed the concentration of income and wealth to return to levels last seen in the inter-war years. Moreover, although it was a theory that originated with the new right, it came to be embraced across most of the political spectrum, including by New Labour in the UK and the Democratic Party in the US.

So has the experiment in 'unequal market capitalism' worked in the way predicted by the theory? The answer appears to be no. The income gap has surged, but without the promised pay-off of wider economic progress.

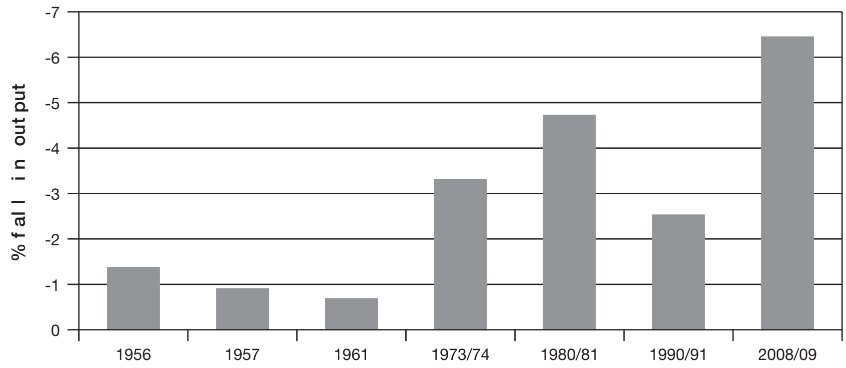
On all measures of economic success bar inflation, the post-1980 era of rising inequality has a much poorer record than the egalitarian post-war decades. One study has found that the UK's growth and productivity rates have been about a third lower since 1980 than in the post-war era, while unemployment has averaged five times the level of the 1950s and 1960s.[3] Since 1979, as shown in Figure 1, there have been three deep-seated recessions compared with three shallow and short-lived ones in the first two post-war decades. The main outcome for the countries that have embraced the post-1980 model of market capitalism most fully has been economies that are both much more polarised and much more fragile.

Not only has inequality failed to deliver faster growth, there is growing evidence that it is also associated with greater instability and played a critical role in both the 2008 Crash and the persistence of the current slump. Unsurprisingly, this is a view that has yet to penetrate official explanations of the crisis. The report of the bipartisan US Financial Crisis Inquiry Commission into the causes of the 2008/09 Crash, for example, fails to mention 'inequality' once in its 662 pages.[4]

Yet history shows a strong association between rising inequality and economic breakdown. The Great Depression of the 1930s and the Great Crash of 2008 were both preceded by sharp rises in inequality. In contrast, the most prolonged period of economic success and stability – from 1950 to the early 1970s – was one in which inequality fell and the proceeds of growth were evenly shared between wages and profits, and across earnings groups.

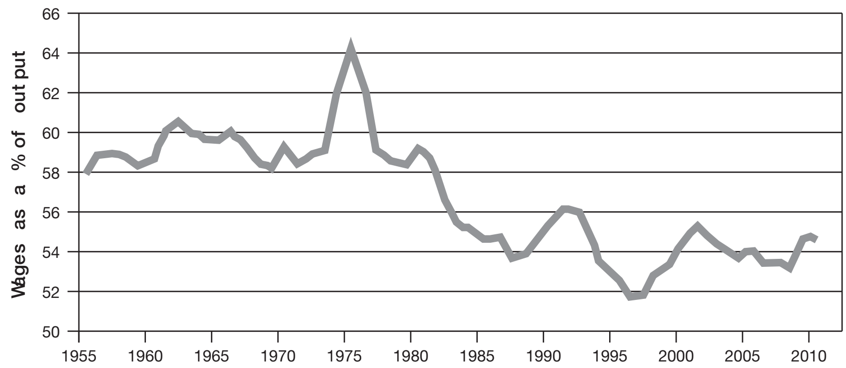
Association is one thing, causation is another. To establish cause and effect, we must consider the impact of changing 'factor shares' – the way the output of the economy is divided between wages and profits – on the way private enterprise economies work. As shown in Figure 2, throughout the 1950s and 1960s the division remained roughly constant, with wages in the UK settling at between 58 and 60 per cent of output, a higher rate than achieved in the pre-war era. It was this steady and elevated wage share that helped drive the 'great levelling' of the post-war decades. It then rose sharply to a historic peak of 64.5 per cent in 1975. By 1980 it had fallen back to 60 per cent, close to its post-war average. It then fell, reaching 53 per cent by 2007, a level last seen before World War One. The US has followed a very similar pattern, with its economy experiencing an even deeper fall in its wage share over this period.

Figure 1: **Post-war recessions, UK**



Source: S Lansley, *The Cost of Inequality: why greater equality is essential for recovery*, Gibson Square, 2012, p132

Figure 2: **The UK's long wage squeeze, 1955–2010**



Source: S Lansley, *The Cost of Inequality: why greater equality is essential for recovery*, Gibson Square, 2012, p40

In search of greater efficiency, successive UK and US governments from 1979 allowed, indeed encouraged, the fruits of growth to be colonised largely by a small business, financial and corporate elite, leaving the workforce with a continually shrinking share of the nation's output. According to market theorists, this shift in the division of output in favour of business and the very rich would trigger a sustained investment boom and deliver more robust economies. Instead, it appears, concentrating the gains of economic progress in this way has created a dangerous structural imbalance that has made nations much more prone to instability and crisis.

There are three main mechanisms that link growing inequality to economic crisis. First, reducing the relative incomes of large sections of the workforce stifles purchasing power and prevents economic output being sold. In the build-up to 2007, rising inequality set a number of economies on a sustained course of deflation. The political solution to this problem of shrinking consumer power was to pump economies full of private debt. This did not prevent recession, it just delayed it. The same factors were at work in the 1920s. The 1929 Crash was preceded by a sharp rise in inequality with the resulting demand gap filled by an explosion in private debt.

Secondly, the swollen corporate and personal wealth surpluses that were the flipside of these shrinking wage shares were used in ways which greatly damaged the real productive economy. Instead of boosting investment, these surpluses led to a giant mountain of footloose global capital that ended up fuelling commodity speculation, financial engineering and hostile corporate raids, activity geared to transferring existing, rather than creating new, wealth and reinforcing the shift towards greater inequality. By contributing to the creation of asset bubbles, the same process greatly amplified the risk of financial crisis. Again, there are striking parallels with the 1920s when swelling surpluses were poured into real estate and the stock market, creating the bubbles that triggered the 1929 Crash.

Thirdly, the effect of these trends has been to intensify the concentration of power. Both the UK and the US now exhibit the features of 'plutonomies' – societies in which wealth and economic decision making is heavily concentrated in the hands of a tiny minority. The UK has moved back in time to a model of political economy close to that of the Victorian gilded age. The US has returned to the pattern of the 1920s.

In the US, such is the concentration of income, 5 per cent of earners account for 35 per cent of all consumer spending. In addition, a new elite has been able to ensure economic policies work in their own interest. Hence the inaction on tax havens, the blind-eye approach to tax avoidance and the scaling back of regulations on the City and Wall Street, policies that have simultaneously accentuated the risk of economic failure.

Not only did the growing income divide help to drive the global economy over the cliff in 1929 and 2008, it is now helping to prolong the crisis. UK wage earners today have around £100 billion less in their pockets (roughly equivalent to the size of the nation's health budget) than if the cake was shared as it was in the late 1970s. In the bigger economy of the US, the sum stands at £500 billion. In contrast, the winners from the process of upward redistribution – big business and the top 1 per cent – are sitting on growing corporate surpluses and soaring private fortunes that are mostly sitting idle. This imbalance is a central explanation of the lack of recovery.

The key lesson of the last thirty years is that economies that allow the richest members of society to accumulate a larger and larger share of the cake merely bring a dangerous mix of demand deflation, asset appreciation and a long squeeze on the productive economy that will end in economic turmoil.

For the last thirty years we have been operating an economic model set on a course to self-destruction. Yet the same model has survived the second deepest recession of the last hundred years largely intact. In contrast, the economic crisis of the 1930s was to give way to a very different model of political economy, one that proved a decisive turning point in the fortunes of both the rich and the poor. From that point, the extremes of wealth that had helped create the crisis were steadily eroded.

Today, it is largely business as usual. As a result, the world's rich have ensured that they have been the main winners from the global recession. In the US, profits and dividends have risen since 2008, while real wages have plunged. Indeed, average real family income declined by a remarkable 17.4 per cent between 2007 and 2009.[5] Profits and dividends are up largely *because* wages are down. As JP Morgan Chase chief investment officer, Michael Cembalest, has documented: 'US labor compensation is now at a 50-year low relative to both company sales and US GDP.'[6]

As the American economist Emmanuel Saez has shown, the key consequence of this is that all income growth in the US in 2010 went to the wealthiest 10 per cent of households, and 93 per cent to the wealthiest 1 per cent.[7]

In the UK, there has been a similar, if less extreme, pattern. Real wages have fallen on average by 7 per cent in the last two years – and are set to continue to fall – while the income gap between top and bottom has continued to widen through the slump. Figure 3 compares the course of top executive (for FTSE 100 companies) remuneration with median full-time earnings since 2000. Not only did executive pay greatly outstrip average earnings growth up to 2007, apart from a slight blip in 2009, it has continued to do so.

Both the US and UK economies – and many other rich nations – are moving in the wrong direction. To escape today's era of slow and intermittent growth and prolonged instability, the great concentrations of income and wealth need to be broken up – just as they were in the 1930s.

This requires a fundamental shift in our approach to political governance. There needs to be wider recognition that we have been backing the wrong theory on the impact of inequality. A model of capitalism that fails to share the proceeds of growth more proportionately is not sustainable. The traditional case against the growing income gap, based on social justice and fairness, needs to be extended to embrace the evidence about the damaging economic impact of more polarised economies.

The pursuit of more equal societies needs to be elevated to a primary goal of domestic and global economic policy. In the UK since the 1980s, the impact of inequality has played, at best, a marginal role in state decision making. This has been true under governments of all political colours. Although there were plenty of debates at the highest levels about social mobility and tackling poverty during the post-1997 Labour years, the wider question of the division of factor shares and the macro-economic impact of changes in the concentration of income were more or less completely ignored.

No single economic forecasting model in the

UK – from those constructed by independent institutions as well as the Treasury and the Office for Budget Responsibility (OBR) – incorporates the impact of changes in the distribution of income on vital outcomes like private investment, consumption, living standards, overall demand in the economy and key asset prices. This is all the more significant in that the OBR has predicted that labour's share of output will fall by more than a further three percentage points between 2009 and 2015.[8] Yet the repercussions of this trend have now been ignored.

The question of 'factor distribution' ought to be a key issue in strategic economic thinking. This determines the course of average living standards and has a major impact on economic stability and durability. Yet it slips through the net of current policy-making machinery.

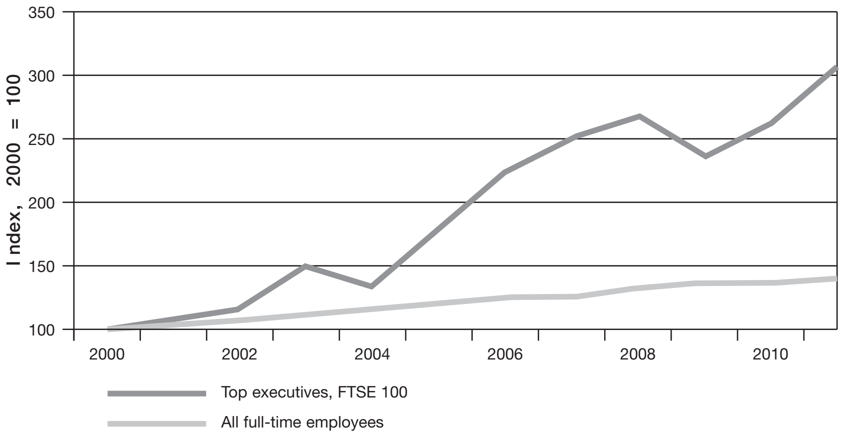
As Gavin Kelly, a former senior adviser to Number 10 under both Tony Blair and Gordon Brown, told a recent *Analysis* programme on Radio 4: 'The truth is that no department in Whitehall really sees it as their job to worry about big trends in living standards facing the working population of this country. Obviously everyone has an interest in it but no one really owns it.'[9]

This hands-off approach needs to change. Government needs to identify a new set of economic indicators to those such as inflation, productivity, growth and unemployment. These should include pay ratios, the wage share, the concentration of income among the top 1 per cent and the pattern of average tax rates. To date, analysis of the implications of this data has mostly been left to independent researchers.

Each indicator should be given a target that is compatible with economic stability. Thus the wage share target should be set at the average of the two post-war decades – 59 per cent – a level that brought equilibrium and sustained stability. At 53 per cent – and heading lower – it is currently well below target. Average tax rates should rise by income decile. At the moment, they are higher among lower than among higher income households. The share of income enjoyed by the top 1 per cent currently stands at above 15 per cent, well above the level consistent with stability. The ratio of pay between the top and the bottom stands at well above 100:1, more than double the typical pattern of the 1950s and 1960s.

Alongside these new indicators, government should identify the most effective policy instruments for reaching these targets. These need to be designed to restrict the level of economic inequality to within the limits that prevent instability. They would range from tax and industrial policy to the role of collective bargaining and corporate governance. When the targets are breached – as they clearly are at the moment – then policy needs to be adjusted accordingly.

Figure 3: **Index of top executive and employee pay, 2000–2011**



Source: S Lansley, *All In This Together*, TUC Touchstone Extra, 2012, p26

Extending the role of government in this way would no doubt lead to cries of outrage from those likely to be most affected. There remains, for example, a concerted campaign in defence of big City pay-outs, as Michael Spencer, the chief executive of the interdealer broker, ICAP, and with a fortune worth half a billion pounds, wrote in the *Independent* on 10 March: 'High pay is good for Britain. In fact it is vital.'

Yet until we wake up to the failings of the current orthodoxy, and acknowledge the real causes of the crisis, the world is likely to be locked into an era of instability and stagnation with, at best, short-lived periods of debt-fuelled growth. ■

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1 L von Mises, *Ideas on Liberty*, Irvington, 1955, chapter 9
2 A Okun, *Equality and Efficiency: the big tradeoff*, Brookings Institute Press,1975
3 S Lansley, *The Cost of Inequality: why greater equality is essential for recovery*, Gibson Square, 2012, chapter 6
4 http://c0182732.cdn1.cloudfiles.rackspacecloud.com/fcic_final_report_full.pdf
5 E Saez, *Striking it Richer: the evolution of top incomes in the United States (updated with 2009 and 2010 estimates)*, 2012
6 H Meyerson, 'An economic recovery that leaves workers further behind', *Washington Post*, 11 April 2012
7 See note 5
8 http://budgetresponsibility.independent.gov.uk/economic-and-fiscal-outlook-november-2010/
9 *Analysis*, BBC Radio 4, February 2012,