TOUCH STONE

PAMPHLET#4

Do the Super-Rich Matter?

It's the controversy that is becoming symbolic of a wider debate about the future direction of the UK. Should we be "intensely relaxed" about the super-rich, as Peter Mandelson claimed? Or are they symptomatic of something fundamentally wrong with Britain? *Do the Super-Rich Matter?* forensically analyses the impact the wealthiest are having on our wellbeing. It reveals an economy increasingly skewed to serve the interests of a tiny minority and a society losing touch with a basic sense of fairness. Uniquely, *Do the Super-Rich Matter?* proposes a bold programme to address these worrying trends.

Stewart Lansley

Stewart Lansley is the author of *Rich Britain, The Rise and Rise of the Super-Wealthy*, Politico's, 2006, and joint author of *Top Man, How Philip Green Built His High Street Empire*, Aurum, 2006. His book *Londongrad*, on the story of the UK-based Russian oligarchs, will be published in 2009.

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TUC

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Do the Super-Rich Matter?

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Foreword

by Brendan Barber, TUC General Secretary

With the exception of football, politics may be the sphere of life more prone to cliché than any other. Politicians, eager to climb the greasy pole, will always be about to deliver the most important speech of their career at the end of that week, which is a very long time.

Weary journalists may be forgiven for resorting to these elderly clauses as deadlines approach. But there is one overworn phrase which has proved more malign. It is a term thrown at those who question the influence of the very wealthy: 'the politics of envy'. More a personal putdown than a serious point, those four words are used repeatedly to shut down debate about the super-rich. Strangely, they are often used by the same people who complain loudly about political correctness (the cliché in permanent need of therapy) preventing open discussion.

So Stewart Lansley is to be congratulated for breaking the taboo in such a readable and enlightening fashion. Stewart shows that a debate about the super-rich is much needed. His analysis reveals that, whatever one might think about a life of Lear jets and superyachts, the rise of this new class in the UK marks a break with a long trend towards a more egalitarian society. This is important: it poses risks to social cohesion – especially as tough times beckon – and it has skewed our economy towards the generation of vast wealth for a tiny minority.

It is regrettable, therefore, that for fear of being labelled envious, many have shied away from this debate – all the more so as our attitude to the super-rich has implications far wider than the bank balances of a few thousand individuals. A more sceptical view of the City super-bonus culture of recent years, for example, may have prevented much of the uncertainty now stalking the UK economy.

I hope this pamphlet can kick-start an open debate. Such discussion will help clarify the type of economy we want as we emerge from the current troubled climate.

Executive summary

The last two decades have seen the rise of a new super-rich class in the UK. It is a process that has reversed the previous long-term trend toward a more equal Britain and is taking us back to levels of income inequality last seen before the Second World War.

Today's super-rich lists are dominated by those making money in land, property and finance. Despite the presence of a significant minority of people from disadvantaged backgrounds among the rich, birth remains the most powerful indicator of who ends up at the top of the wealth tables.

The rise of today's super-rich is a product of the juxtaposition of economic globalisation, a dramatic shift in the wider political culture in the UK and the erosion of the social norms that used to keep greed and excess in check. The effect has been the rise of fortunes that equal or surpass those of the 19th century.

The evidence does not support the broad political consensus that the rise of the super-rich has been wholly good for Britain.

While the City has emerged as the leading global financial centre, the growing reliance on finance has crowded out other industries and made the economy excessively dependent on short-term, fast-buck-making deals that are rarely in the interest of sustainable business or improved long-term growth.

Today's economic convulsions have exposed the reality behind the City's claims to have increased world liquidity and reduced investment risk. They reveal how much City decision-making has been geared to the process of personal enrichment, with damaging consequences for the wider economy. In effect, the City operates as a giant informal cartel, charging excessive fees for activity that is as likely to transfer as create wealth. While the world's financial systems have been unravelling, most of those responsible have ensured that they will not be the ones to suffer the consequences.

Although personal fortunes would be justified if they were the product of wealth creation with wider benefits, the evidence is that the escalating fortunes enjoyed by company executives, investment bankers and hedge fund and private equity partners are not linked to record levels of company or economic performance. Far from expanding the cake, Britain's business leaders have mostly taken advantage of today's pro-rich culture to grab a larger share of it for themselves.

Although it may be statistically possible to reduce poverty when inequality is rising, in practise it is very hard to do so. The evidence is that rather than being a 'positive sum game' with no losers, much wealth accumulation is the product of carefully manipulated transfers that harm others, from ordinary taxpayers and shareholders to customers. The much trumpeted 'trickle-down' effect peters out quickly as you descend the income ladder, with gains spreading little further than to the already affluent.

The hands-off policies of recent times are becoming increasingly difficult to justify. The present system of self-regulation has been too lax, while the current system of corporate remuneration remains deeply flawed. There are clear signs that we have reached the limit of public tolerance of a society skewed so heavily in favour of the rich, irrespective of the impact on others. Even pro-market experts are expressing concerns about the decline in ethical standards in boardrooms.

Despite claims from Business Minister John Hutton that the Government is powerless to close the widening wealth gap, this report lays out a range of economically and politically feasible measures that could cap unjustifiable fortune building at the expense of others and secure a fairer distribution of rewards:

- Banks should run higher levels of capital requirements to improve counter-cyclical policy.
- Greater transparency is needed in the extent of risk inherent in financial products.
- Private equity companies should have the same disclosure requirements as public companies.
- International controls need to be strengthened.
- Bonus payments should be deferred until the performances of those receiving bonuses become clear.
- Institutional investors need to take a greater role on pay, while remuneration committees need to be strengthened.
- The Competition Commission should launch an inquiry into the fees charged by investment banks.
- The Government needs to reassert a commitment to the principle of progressive taxation.
- New rules should limit the tax relief available on leveraged loans.
- Inheritance tax should be replaced with a lifetime receipts tax.
- Capital gains should be treated as income.
- A much more concerted attack is needed on tax avoidance by, for example, introducing a minimum tax rate for those earning over £100,000 and taking a tougher stance on the non-domiciliary rule.
- The Government should finance either a regular independent social audit that analyses the impact of increasing wealth concentration on wider life chances or establish a permanent Wealth Commission parallel to the Low Pay Commission.

When it comes to top salaries, dividends and bonuses, the last decade has seen one record tumbling after another… In the last few years those at the top of the income and wealth ladder have been getting richer at a much faster pace than the population as a whole.

Section 1 – A golden age for the rich

In July 2005, Richard Desmond, the proprietor of the Express newspaper titles, announced that he was paying himself a 'chairman's remuneration' of some £52m, the equivalent of £1m a week. Although it was hefty by historic standards it was not by contemporary ones. Just nine months earlier the Indian-born British resident Lakshmi Mittal paid himself a £1.1bn dividend. At the time it was the highest private dividend on record, although it did not last for long. A year later, the swashbuckling and controversial high street retailer Philip Green topped it with a dividend of £1.2bn from his Arcadia group of shops, which he had acquired just three years before. This was the equivalent of the annual pay of 54,000 people on average earnings.

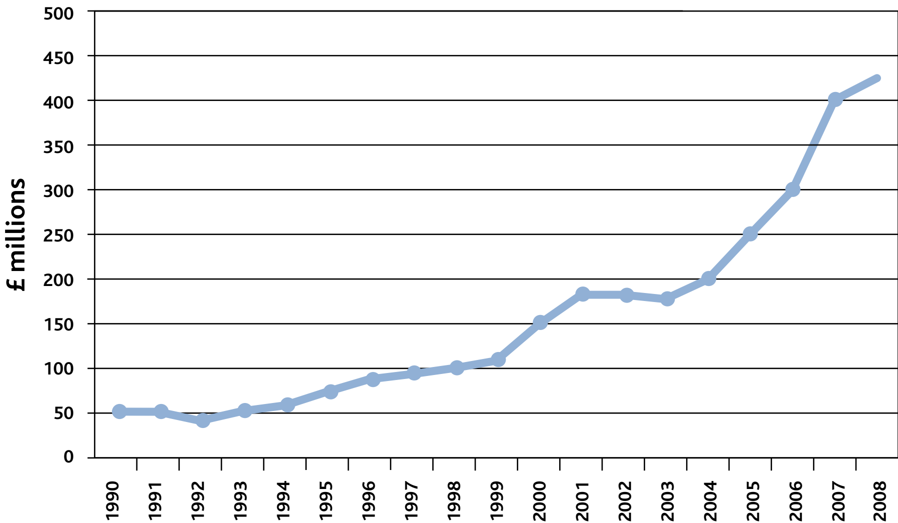
When it comes to top salaries, dividends and bonuses, the last decade has seen one record tumble after another. Take boardroom pay; the average total earnings (comprising pay and bonuses) of the chief executives of FTSE 100 companies have doubled over the last five years to stand at £3.2m in 2007.[1] Since average earnings have risen by only a fifth over the same period, the pay of Britain's top company bosses has been rising at five times the rate of employees'. Whether we take the company boardroom, the deal-making entrepreneur, the hedge fund partner or the investment banker, the story is the same. In the last few years those at the top of the income and wealth ladder have been getting richer at a much faster pace than the population as a whole.

In the financial year 2006/7, a record total of £9bn was paid out in bonuses to City of London staff, beating the figure of £7bn paid out the year before. As many as 4,200 people received at least £1m. A few hundred received over £5m, while around 20 top executives received over £10m.

In the last 20 years Britain has experienced a remarkable social and political revolution: a great surge in both the numbers of the super-rich – a mix of City financiers, entrepreneurs, aristocrats and foreign tax exiles – and in the level of their wealth. According to the *Sunday Times*: "The past decade of Labour government has proved a golden age for the rich."[2] As shown in Figure 1, the level of income needed to join the ranks of Britain's richest 200 residents (as recorded by the *Sunday Times*) has risen more than eightfold, from £50m in 1990 to £430m today.

5

Figure 1: Level of wealth required to reach the richest 200 in Britain 1990–2008



Source: *Sunday Times* Rich Lists 1990-2008

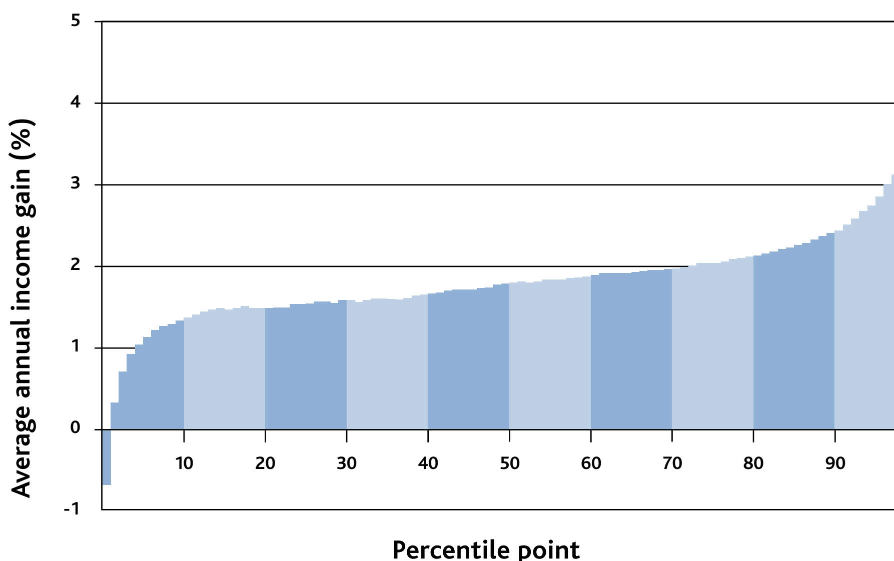
For most of the last century Britain experienced a steady narrowing of the gap between rich and poor. Historians dubbed it the era of the 'great levelling'. The trend started before the First World War and continued at a slower pace in the two decades after the Second World War.

This process of equalisation eventually petered out in the mid to late 1970s before plunging sharply into reverse. Figure 2 divides the population into 100 equal groups ranked by income, from the poorest one per cent on the left through to the richest one per cent on the right. It also shows the average annual income rises for each group over the period 1979 to 2005/6. The figure shows that top earners have enjoyed increases that have greatly outstripped those of all other groups, thereby fuelling the rising gap between rich and poor.

Most of this rise in income inequality took place in the 1980s. It steadied off in the first half of the 1990s, rose again from the mid-1990s to 2001 and then levelled off again before rising slightly in 2005/6.[3] Over the period since 1996-7, when Labour came to power, incomes of the top one per cent have risen by an average real rate of 3.1 per cent, well above an average increase of 2.3 per cent.[4]

The same historical pattern is also true of wealth levels. The share of wealth enjoyed by the top one per cent fell consistently over the course of the 20th century to reach a low of 17 per cent in 1991. It then started climbing again to reach 23 per cent in 2002. While the share of the nation's wealth at the top has been rising, that of the poorest half of the population has been shrinking, falling from a high of 10 per cent in 1986 to a mere six per cent in 2002.[5]

Figure 2: How the rich have got richer, 1979–2005/6.



Source: Institute of Fiscal Studies

As a result of this new era of 'widening', Britain has been slowly reverting to levels of income inequality that prevailed before the Second World War, and to levels of wealth concentration of at least a generation ago. The driving force behind this remarkable historical shift has been the surge in income and wealth levels at the very top. This 'top level' wealth explosion has been largely an Anglo-Saxon phenomenon – one that has been even more pronounced in the United States. There are no real parallels in continental Europe.

Moreover, these official statistics are likely to understate the true levels of wealth among the mega-rich. If more accurate information were available it would show that the distribution of income and wealth is even more concentrated at the top while the trends would take us back even further into the past. The main reason for this is that although the rich have always been able to hide their true wealth from the prying eyes of the revenue the evidence is that, despite falls in the marginal rates of tax imposed on the rich in recent times, they have become even more adept at doing so.

Section 2 – Who are the super-rich?

Unlike poverty, there is no official wealth line that distinguishes the rich or the super-rich; the location of the 'super-rich line' is subjective. There are also no official figures of the number of people in Britain worth more than £50m, £10m or even £1m. Figures produced by independent organisations show a steep hierarchy of wealth. According to the *Sunday Times*, you need assets of £80m to join the wealthiest 1,000 – a group that could be described as the premier division of the super-rich – and between around £10m and £79m to join the next 4,000 richest – the first division. There is then a steep rise in the number with assets of more than £1m, a group that constitutes between 100,000 and 150,000 individuals. This booklet describes the 'super-rich' as those with assets of over £10m; that is, some 5,000 individuals.[6]

Wherever we draw the line, the rich and super-rich are predominantly male. In 2008, only 9.6 per cent of the *Sunday Times*' 1,000th richest were female. By far the biggest group – 23 per cent – obtained their wealth from land and property. The next largest group – 17 per cent – was from banking, finance and insurance, with many working as hedge fund operators and financial speculators or in private equity. A mere 11 per cent made their money from industry and engineering, with five per cent in construction and housebuilding.

Not so long ago Britain's land-owning aristocracy was seen as a spent force. Yet many of them have seen their wealth soar, the product of rising land and property values. As a result, they made up 13 per cent of the top 1,000 in 2008. Others in the list include descendants of the commercial and industrial barons of the 19th century – names like Sainsbury, Vestey, Guinness, Rothermere and Rothschild – some of whom are richer than their forebears. Several are the offspring of the richest businessmen in the 1960s and 1970s such as George Weston, son of Canadian-born Garfield, the food and restaurant king behind Associated British Foods.

The *Sunday Times* claims that the proportion of those in its list who have 'inherited' their wealth has steadily fallen from some 40 per cent in 1990 to 24 per cent in 2008, while the proportion that is 'self-made' has risen from 60 to 76 per cent over the same period. This trend has been used to claim that the rich have been becoming 'increasingly meritocratic'. But the newspaper defines the 'self-made' in a very specific way – as people without an inheritance. This is a very broad definition which says little about background. Many of the 762 defined as self-made by the *Sunday Times* will not be so by the definition used in academic studies, which have typically examined parental background and wealth.

Many of those in the list do come from humble beginnings. The billionaire Barclay brothers were born to a poor family in Glasgow in 1934. Brian Souter, who set up the Scottish bus company Stagecoach is a former bus conductor. Damon Buffini, one of the richest men in the City, grew up on a council estate.

While some of the super-rich have overcome disadvantaged upbringings, most of those defined as 'self-made' come from relatively wealthy backgrounds, even if they have not inherited, or not yet inherited, a business or a large financial sum. Examples include James Dyson, born to middle-class academic parents and educated at Gresham's School, and Lord Lloyd Webber, the son of a composer, who was educated at Westminster School. These men may be self-made in the sense that they have not inherited a business, but they still come from relatively privileged backgrounds. The likelihood is that most of the 762 will have been born to families towards the top end of the income distribution, making the 76 per cent figure a significant overstatement of the proportion who are self-made in the sense of rising from the bottom of the pile.

There is another factor at work in the apparent rise in the number of 'self-made' millionaires in the *Sunday Times* list. Over the last 15 years the proportion of rich celebrities, rock musicians and television stars in the list – names like David Beckham, Sir Elton John and Simon Cowell – has been rising, the direct result of staggering increases in fees and in some cases lucrative sponsorship deals. Celebrities typically, though not always, come from more modest backgrounds. If the list of the rich was confined to business (that is, excluding celebrities, musicians and sports stars), the proportion of the 'self-made', as defined by the *Sunday Times*, would be lower.

In addition, if there had been a noticeable increase in the rate at which new wealth was emerging and replacing past wealth, one would expect a regular churning across the lists. In fact, the movement in and out of the *Sunday Times* list over the last 18 years has been somewhat limited, with a substantial overlap between the 1990 and 2008 lists. Of the top 50 in 1990, 39 of them or their families were still in the top 1,000 in 2008. Of the 11 who had dropped out, one had given his money away and three had died. Of the top 100 in 1990, 71 of them or their offspring are still in the top 1,000 today.[7]

There is certainly no strong reason to believe that the wealthy is a significantly more meritocratic group than in the past or that it is the product of rising levels of social mobility. On the contrary, a century and more of economic and social upheaval in the UK has had, at best, a marginal impact on the chances of those from lower income groups making it to the top.

The best evidence is that although there is fluidity, with some from poor backgrounds making it to the top as they always have done, and some descendants of the rich dissipating their inheritance, birth remains the most powerful indicator of where you are likely to end up in the wealth stakes. The rise of 'new money' is not, in general, a sign of a more opportunistic culture. According to a detailed study by historian Tom Nicholas: "Becoming a business leader in Britain is still largely determined by the interconnected characteristics of a wealthy family and a prestige education… there has been no democratisation of British business over the last century and a half."[8]

Section 3 – Why have the rich been getting richer?

The fluctuating fortunes of the rich and the poor, and the gap between them, can be traced to the way in which the political and public climate interacts with the wider economic backdrop. Over time, the state has adopted different strategies, from leaving the issue of distribution alone, to intervention designed to raise the floor and/or limit the ceiling of personal wealth through taxation. It is possible to distinguish three broad modern periods in the undulating fortunes of the rich, each characterised by both different economic and technological circumstances and different roles played by government.

The 19th century

The first period covers the Industrial Revolution – an era that stretched roughly 100 years until the end of the 19th century. It saw the first great wealth explosion in Britain, a period when vast fortunes were made in manufacturing and transport, but especially in commerce and finance. The acceleration in the pace at which large and unprecedented fortunes were being made, especially in the two to three decades from the 1850s, can be traced to the combination of new industrial and economic opportunities and the dominant ideology of laissez faire. Taxes were low, trades unions were in their infancy and there was little public regulation of industrial activity.

1900 to the mid-1970s

The second period spans the era from 1900 to the 1970s. In the opening years of the new century, the first brakes were applied. The state intervened to limit and reduce the intense inequality of the previous decades. This brought some protection for the poorest, but did little initially to thwart the progress of the very rich. The first great reckoning for the rich came with the 1929 Crash and the deep global recession that followed.

The impact of 1929 on the rich was dramatic. In the two decades after the Crash, top personal fortunes shrank, the brakes were applied much more firmly and the wealth gap narrowed. In 1953 one Inland Revenue official claimed there were only 36 millionaires left, down from over 1,000 before the Second World War. According to wealth historian WD Rubinstein, by the early 1960s, "large fortunes were extremely rare".[9] Even allowing for the rise of tax evasion designed to hide the true levels of wealth, the richest businessmen dying in the period from 1950 to the mid-1970s left estates that were generally far smaller than those who died in the previous 50 years.[10]

The mid-1970s to the pesent day

The 1970s brought another dramatic turning point – one that has seen the rich steadily return to the levels of wealth and privilege they enjoyed in the pre-war era. The change has been brought about by the combination of the rise of globalisation and a dramatic political and cultural shift. With the spread of globalisation, markets have extended beyond the confines of national and continental boundaries. Bill Gates is super-rich partly because he invented a new computer operating system, but also because worldwide sales of Microsoft Windows brings a staggering billion dollars per month in profit.

But the emergence of global markets is only part of the story behind the current wealth boom. Even more important has been the dramatic shift in the political climate. As political and public support for 'welfarism' cooled with the emergence of economic difficulties in the 1970s, Mrs Thatcher came to power with a belief that post-war Britain suffered from a lack of entrepreneurial drive and there was a need to remove what she saw as the brakes on wealth creation.

During the 1980s state regulations were axed, controls on banks and their lending and investment practices were lifted, most state-owned monopolies were privatised and corporate and top income tax rates were cut. Following the so-called 'Big-Bang' reform of city trading regulations British merchant banks lost their hold on the City to be displaced by giant American investment banks with more cut-throat values and methods. The result: a huge and sustained bonanza for those working in the City. Successive Prime Ministers from Mrs Thatcher onwards have all taken the view that Britain's economic dynamism needs more wealth-creating tycoons to drive rising prosperity.

This shift from a broadly anti- to strongly pro-rich stance can be traced to the development of the pro-market and anti-state ideology of neo-liberalism that began in the 1960s and by the middle of the 1980s had eclipsed the ruling social democratic orthodoxy of the post-war era.[11] The link to the return of the super-rich is no accident. In his study of the rise of neo-liberalism and its adherence to free markets, the distinguished American Professor David Harvey has argued that one of the key purposes of those working to displace social democracy has been the "restoration of the power of an economic elite".[12]

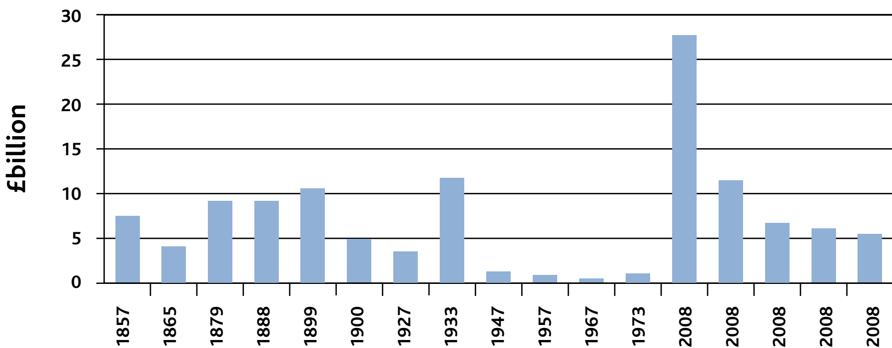
Integral to this shift in the ideological landscape has been the emergence of what the American economist Paul Krugman has called a "new social norm".[13] The 1929 Crash ushered in a new and more egalitarian political and social culture. In both Britain and the US, new norms emerged about an acceptable degree of pay differential. According to Krugman, top executives behaved "more like public-spirited bureaucrats than like captains of industry".[14] In his 1967 book, *The New Industrial State*, JK Galbraith gave a description of typical executive behaviour at the time: "Management does not go out ruthlessly to reward itself – a sound management is one expected to exercise restraint." He went on: "With the power of decision goes opportunity for making money... Were everyone to seek to do so ... the corporation would be a chaos of competitive avarice." At the time the cultural climate operated to prevent such 'chaos', a kind of hidden and accepted code that was generally effectively abided by, partly through fear of public outrage of overt excess. It was a code that emerged out of what came to be seen as the costs of the extravagant behaviour and damaging inequality of the pre-1929 era, and endured for several decades, capping the degree of inequality in the process.

It is a code that has long gone. The staggering increase in rewards that has occurred in recent years would not have been acceptable to public and political opinion even two decades ago. Today's rich are not just wealthier, but much less embarrassed by their wealth and much happier to flaunt it. Greed has become acceptable, indeed imperative. Modern capitalism has taken the architect of market fundamentalism, Milton Friedman, at his word: "Few trends could so thoroughly undermine the very foundations or our free society as the acceptance by corporate officials of a social responsibility other than to make as much money for their stockholders as possible."[15] The 'stealth wealth' culture and 'conspicuous abstention' that characterised the post-war decades has been replaced by a voracious consumerism. The public look on with a mix of awe and distaste while Britain's political leaders across the spectrum have allowed themselves to idolise the super-rich.

Such are the runaway fortunes now being acquired that those at the top of the league are not just outclassing their predecessors in the post-war era but are now accumulating fortunes that exceed some of the great fortunes of the 19th century. Figure 3 provides comparisons of the highest levels of wealth recorded in Britain in each decade from the 1850s to the 1970s and compares these with the top five in the 2008 *Sunday Times* Rich List. All figures have been adjusted to their 2008 equivalents by upgrading for the growth in national income over time.[16]

The figure shows that in 2008 Britain's richest person, Lakshmi Mittal, the Indian steel magnate, is more than twice as rich as any other person in the last 150 years. Mittal is foreign born, but even the richest Briton – the Duke of Westminster – has a fortune that exceeds many, if not all, of the richest of the 19th and early 20th centuries. The figure also confirms the historical pattern, with the rich enjoying rising fortunes from the second half of the 19th century, losing ground sharply from the 1930s and bouncing back in recent years.

Figure 3: Top wealth levels by decade since 1850 compared with the five richest in 2008



Source: Drawn from dataset in Appendix 1

That today's wealthiest citizens enjoy shares of the national wealth that compare and sometimes surpass the richest Victorian and Edwardian industrialists and financiers is all the more remarkable given the changing economic and political climate in which these past and present fortunes have been acquired. In the late 19th century, the constraints on fortune-making were much weaker, monopolies could operate largely unchecked, the tax authorities were in their infancy, unions were few and regulations minimal. It was a society in the process of transition and the sorts of fortunes being accumulated at the time were to prove unsustainable. What is extraordinary is how in today's much more mature democracy and regulated economy, the top few thousand individuals are able to win such large shares of the economic wealth of the country.

Section 4 – Are the super-rich good for Britain?

The consensus, at least until recently, has been that the contemporary personal wealth boom has been good for Britain, even if it has meant a widening gap between rich and poor. Both Tony Blair and Gordon Brown have gone out of their way to applaud the rise of the super-rich. In the last 20 years, Britain's financial institutions, many of them concentrated in the City, have achieved a remarkable level of political backing that comes close to canonisation. Until the current deep-seated economic crisis that began in August 2007, the prevailing political and economic view in Britain was that 'the City' has been what Professor Doreen Massey of the Open University describes as "the untouchable golden goose of the economy". So does the UK's finance industry and its leaders deserve their lauded reputation?

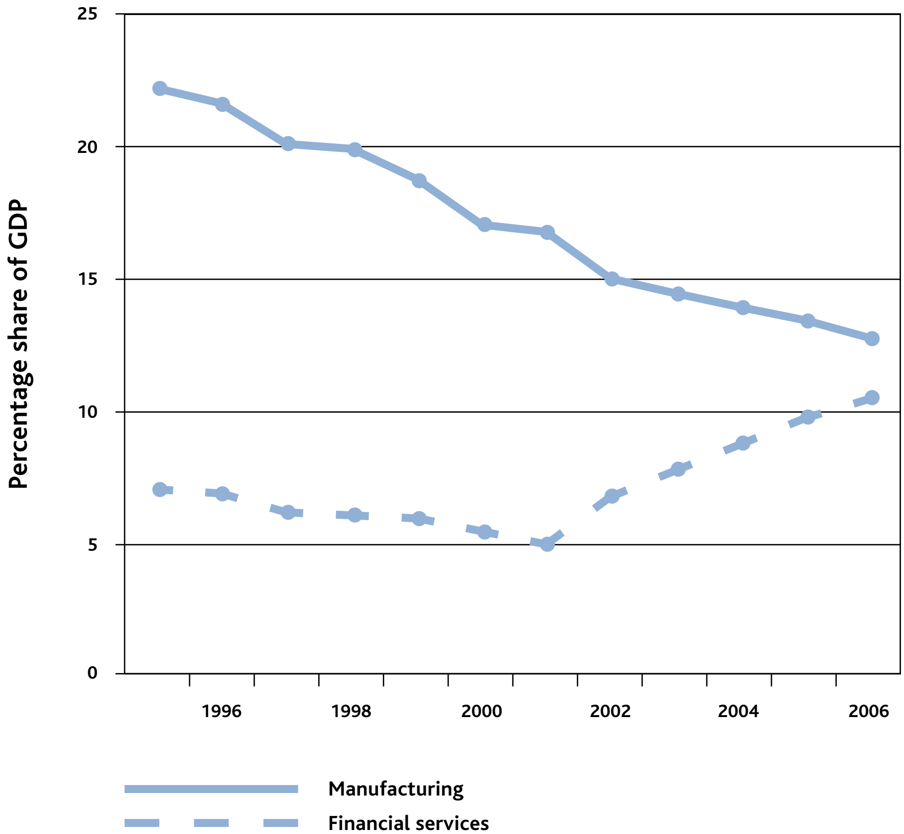
Is the City 'the golden goose of the economy'?

It is certainly the case that the national financial services industry has become an increasingly important engine room of the economy. As Figure 4 shows, while the importance of manufacturing has been falling, financial services have been growing their share of national economic activity, from 6.6 per cent in 1996 to 9.4 per cent in 2006 and an estimated 10.1 per cent in 2007.[17] Indeed, over the last three years the financial services sector has accounted for a remarkable third of overall GDP growth. (Another third has come from residential and commercial property). It made a net contribution to the UK's export earnings of £24bn in 2006.

Over the last 20 years, the City has greatly enhanced its world reputation as a centre of financial excellence. In February 2007, a McKinsey Report commissioned by New York's mayor, Michael Bloomberg, started a few pulses racing by arguing that London may have replaced New York as the world's principal financial centre. Then in March 2008, research house Z/Yen declared that London sat at the top though New York had been closing the gap over the previous year.[18]

According to the McKinsey Report, London's strength is heavily down to a 'lighter touch' when it comes to regulation. New York has been losing business to London, which now leads the world in several complex financial areas, holds the global crown in international share issues, and has proved highly successful in wooing the world's mega-rich. As Forbes describes it: "London attracts the elite of the world's rich and successful. It can lay claim unchallenged to one title: it is the magnet

Figure 4: The relative importance of manufacturing and financial services in the UK economy



Source: ONS National Accounts Yearbook

for the world's billionaires."[19] Indeed, of the country's 75 resident billionaires, 40 are foreign born, lured here mainly by the country's generous tax breaks. Not that long ago, one of Britain's great preoccupations was the inexorable outward brain drain. Today the UK is attracting some of the world's leading talent into the financial services industry.

But although the international business that the City attracts has proved vital to Britain's economic success in recent times, there remain important questions over the City's role and the way it sometimes operates.

Some analysts have warned that the growing power of the City has been damaging to other industries. Consultants Ernst & Young claim that it has become "the cuckoo in the nest", crowding out industries that would otherwise have flourished. The share of domestic lending by the British banking sector going to manufacturing fell from 5.2 per cent in 1999 to an even lower figure of 2.3 per cent in 2007 while the share going to other financial intermediaries rose from 25 to 31 per cent.

In addition, the City has sucked in the pick of Britain's brightest graduates, with some of the best young PhD mathematicians and physicists behind the fiendishly complex mathematical formulae used to run hedge funds. The Governor of the Bank of England has also spoken out about the way City salaries distort the economy by skewing the pattern of rewards for talent.[20] The concentration on finance capital in recent times has almost certainly been to the detriment of other parts of the economy, including small businesses, advanced manufacturing and parts of the regions.

Short-termism

While the banks are continuing to lend on a medium to long-term basis to some industries – such as pharmaceuticals, where the fruits of investment take years to deliver a return – there has been a steady increase in emphasis on short-term 'fast-buck' deals, which move money around at speed in search for the quickest return. Once one of the City's main roles was to provide medium- and long-term capital for business development, contributing to the patient organisation-building on which enduring companies and long-term wealth creation are founded. This is the way many large and successful companies were originally built. Today investing in companies of the future is an increasingly fringe activity compared with speculating on share prices, interest rates and currency movements.

The rise of short-termism is revealed in part by the falling length of time shares are now held, the increasing use of selling short and the increasing volatility in share price movements with churning, rather than long-term holding, now the norm. It has been estimated that up to 45 per cent of traded shares is accounted for by hedge funds engaging in predominantly short-term speculation.

Many commentators believe that such short-termism has contributed to the destabilisation of some companies, which, rather than getting the committed long-term investment they need to build for the future, have had to increasingly concentrate on satisfying the demands of their financial masters. Some believe that this has also been damaging to overall economic performance. According to the Nobel Prize-winner and former World Bank chief economist, Joseph Stiglitz, writing about the long bull run of the 1990s: "Financial markets are more interested in the short run than the long. They pushed policies that may have made the accounts look better in the short run, but which often weakened the economy in the long-run. They pushed policies that served their own interests more than the general interest; in some cases these policies increased instability and actually decreased long-term growth."[21]

Indeed one of the most important effects of the 'Big Bang' has been the growing influence, some would say dominance, of financial markets in the boardroom, a process academics call 'financialisation'.[22] It is claimed that this pressure from the finance industry has led to a dramatic change in the role and values of company managers and boards, which have become more distant from their businesses and much less focused on long-term strategy and much more on delivering improvements in the short-term share price. This is well expressed in an interview with a City analyst in a study by Manchester Business School: "When I talk to the corporate managers of large German and Japanese companies, they speak of products, quality, customers and costs. They assume that if they produce innovative, attractive high quality products at a competitive cost, they will do

well and be profitable. With UK and US managers, the opposite applies... Many of them seem to be a million miles away from the real business."[23]

Today's chief executives have been nurtured in a business culture that values buying and selling companies above the organic growth that can be too slow to bring success in today's frenetic climate. This "incessant pressure to transact"[24], as one insider has described it, explains the increasing emphasis on merger and acquisition activity, financial engineering and big top-down cost reduction strategies that may have limited benefit for long-term performance. Commentators such as Don Young, a former Redland director and now a business consultant, claim that the growing influence of finance over big companies is noticeable in "the balance of the British economy, in the lack of innovation by many British companies and in the rates of company decline and failure."[25]

It is notable that among Britain's largest companies, the nation is strong in only two sectors of advanced technology – aerospace and pharmaceuticals – and these make up only nine per cent of FTSE 100 companies. In other key high-technology areas like electronics, computer software and telecommunications the UK is very weak. It is arguable that the growing power of finance and its interest in quick hits has contributed to the lack of large-scale investment in technology and the industries of the future. Marconi, which finally collapsed in 2005, is one high profile victim of this process. The exceptions to this pattern – pharmaceuticals and aerospace – are both special cases, protected by a mix of regulation, patent protection and government support.

Although the growth of the City has helped spearhead a London boom, it has also made Britain more dependent on the whims of global wealth, the rising volume of footloose capital looking for a home, and on activities that feed off the world's nomadic super-rich. The global talent may prove fickle in its choice of home. Another consequence of 'financialisation' has been the way Britain's economy has become heavily reliant on a series of corporate, government and personal debt binges, making it especially vulnerable in today's world of contracting credit. The expansion of credit may have helped to maintain economic growth but as we now know, it has been a mirage – nothing more than a temporary boost to the economy. As Anthony Hilton, City columnist on the *Evening Standard,* has warned: "The entire UK economy has become in effect, a giant hedge fund with a massive one-way bet on financial services – and no Plan B for the day when the City goes off the boil."[26] Today the City has not just gone off the boil. The lending and borrowing excesses of the last few years have unleashed a gale force economic storm with repercussions yet to be fully felt.

The credit crunch

Until late summer 2007, the City (and Wall Street) made two big claims in its defence, firstly, that it had vastly increased the liquidity of financial markets – thereby enabling a higher level of national and worldwide economic activity – and secondly that it had created new instruments that reduced and controlled the level of risk, thus improving the efficiency with which resources are allocated.

Today's market convulsions have exposed the reality behind these claims. Far from managing risk more effectively, what has emerged is a pattern of reckless and self-serving lending that has led to the drying up of liquidity as one international bank after another has battoned down the lending hatches.

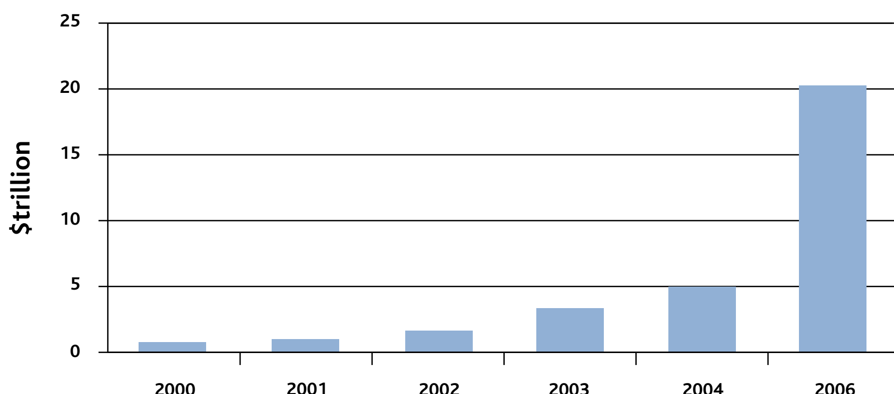
The current economic turbulence has its roots in the way America's biggest banks, awash with cash, embarked on a large-scale lending spree to the nation's sub-prime borrowers. Because they could charge higher interest rates to those with poor credit records, this was initially easy money. Much of the lending was also 'predatory' – aggressively sold with hot commissions and sometimes designed to trap borrowers into a lucrative debt spiral. But aware of the risks to themselves of lending to marginal, higher risk buyers, the mortgages were bundled up into packages with other less risky ones and sold off to financial houses around the world. In this way much, if not all, of the risk was passed on to others. It is these packages of debt, called collateralised loan obligations (CLOs), that have wrought devastation not merely in America's heartland, but around the globe.

When US interest rates were pushed up – in part as a response to the over-heating bubble in the housing market, aided by high levels of sub-prime lending – more borrowers started to default than predicted, and the banks found themselves with mounting losses. It was the subsequent liquidity crisis, when banks stopped lending to those who had built up large debts, that led to the crisis at Northern Rock and the first major run on a bank since the fringe bank crisis of the 1970s.

The subsequent meltdown has led to Britain's major banks writing off billions in bad debts while the International Money Fund (IMF) predicts that the global losses will eventually reach $1tr.[27] In the US, the nation's fifth largest investment bank, Bear Stearns, was first bailed out by the Federal Reserve and then taken over by JP Morgan to prevent it from collapsing. The Wall Street bank – a specialist in trading mortgages – was found to have some $11.8bn of capital but $395bn of debt. Its entire business was supported by little more than a two per cent capital base. Other institutions had even higher asset to borrowing ratios. While such 'leverage' is one of the oldest tricks in the banker's book, what has emerged is a form of 'super-leverage' with loan to deposit ratios at unprecedented highs. The reliance on super-leverage – permitted by the regulatory authorities on both sides of the Atlantic – has been a key source of the rising profits and bonuses across financial services since 2000, but is also at the root of the current economic fall-out.

Collateralised loan obligations are just one example of the highly complex and impenetrable structured investment vehicles that earn big fees and that have proliferated in the last decade. Most have been devised and issued by the investment banks whose bosses have been climbing up the rich lists in recent years. In the second half of 2007 the value of these contracts and financial obligations – nearly half of them issued or acquired in London – stood at some $454tr, close to double the value of the world's output. In the same period, the largely unregulated market for credit default swaps – corporate insurance that pays up in the event of losses to banks from the non-payment of debt, in essence another form of gambling – stood at more than $62tr, roughly twice the size of the entire US stock market and a rise of 37 per cent compared with the first half of the year .[28] Figure 5 shows the explosive growth in the global derivatives market. These devices enable traders to hedge their bets or gamble on the movement of exchange rates, share prices and interest rates. They were once presciently described by Warren Buffet as "financial weapons of mass destruction".

Figure 5: Global credit derivatives market 2000–2006



Source: British Bankers' Association

What has been created in the last decade is in essence a hidden financial world which some specialists have likened to a 'shadow banking system' that is largely untouched and little understood by regulators. In this new world, many investment instruments have been taken off the balance sheets of those issuing them, enabling issuing banks to up their lending even further, while the credit risks themselves have been sold on to other investment groups, either directly or repackaged, and the banks have run down the capital held against the risk of default.

For a while the rapid growth in this market seemed to serve the global economy well, undoubtedly contributing to sustained economic growth. As a result nobody questioned the personal fortunes being accumulated. Essentially a huge punt by the world's leading financial players, it paid off as long as the economy kept on booming. But what was being played out was a dangerous game of pass the parcel that ended when the music finally stopped in the late summer of 2007. Those left holding the parcel – much of it a massive bundle of 'toxic debt' – were mostly a mix of American and European banks and institutional investors, including pension funds and insurance companies. The ultimate losers from the game have been a mix of smaller investors, pension fund holders, shareholders, bank staff, including 2,000 Northern Rock staff, and mortgage borrowers along with the broad body of taxpayers.

Now the game is up, growth has slowed sharply while the super-leveraging of the last few years has given way to an equally dangerous reverse process of 'de-leveraging', with banks and financial institutions asking for their loans back and pushing up the cost of new lending, adding to the likelihood of a serious downturn. This has long been a characteristic of global finance – over-optimistic during the feast years and over-cautious during the famine.

There is nothing especially new about financiers inventing fancy and complex products mainly designed to enrich themselves while others take the real risks. Similar instruments were issued in the run-up to the 1929 Crash. Derivatives have been at the heart of many historical speculative bubbles and their misuse has been central to a number of major recent corporate scandals, from Enron to Parmalet.[29] The last UK example of such leverage being used to promote financial products that subsequently turned out to be more or less worthless was the split-capital investment trust. Again, it was mostly ordinary investors that paid the price.

What has been exposed by the 'credit crunch' today is a failure of much of the lauded financial industry – players and regulators alike – with the European banks and pension funds buying the CLOs and the regulators apparently unaware of the full risks involved. One senior business academic has described investment bankers as behaving like "pyromaniac firemen... increasing volatility and risk through their support of speculative behaviour".[30] According to Joseph Stiglitz: "This is the third crisis for American financial markets in 20 years... The sub-prime issue is about predatory lending, but it has gone badly wrong. The situation has been created by financial institutions that have run amok... We thought these structures were about maximizing corporate profits, but it seems they are more about maximizing the profits of senior bankers and chief executives."[31]

City pay regimes

Top City salaries greatly exceed those of FTSE 100 chief executives – part of the explanation for the leap-frogging of business pay. The average pay in the City of London is more than double the UK average and 60 per cent more than the London average. While financial intermediaries account for some five per cent of full-time male employees, they swallow up 40 per cent of the national bonus pool with the top fifth of this group – some 86,000 individuals – receiving an average payment of £117,000.[32] According to the Institute of Fiscal Studies, almost 30 per cent of the best paid 0.1 per cent of the population work in financial intermediaries.[33]

The City argues that this disparity reflects their greater contribution to economic performance. An alternative explanation is that, although there is fierce competition for business, some parts of the City in effect operate as a giant, informal cartel, charging what most independent observers believe to be excessive fees. Known as 'the croupier's take' these fees are charged for activities that often involves the transfer – rather than the creation – of wealth towards themselves and their clients.[34] The investment banks constitute what one writer has described as an 'oligopoly' and as a result enjoy high margins on acquisitions and new share offerings.[35] Take the fees charged for merger advice. In 2007, for example, Merrill Lynch pocketed the lion's share of the estimated $400m fees paid out by the consortium led by The Royal Bank of Scotland for its successful bid for ABN Amro, a deal that turned out to be ill-advised, with the Bank greatly overpaying for its rival. The investment bank has recently picked up more fees for advice on the £12bn rescue rights issue forced on the Bank.

Although individual deals are negotiated, in general finance directors in Britain's biggest companies rarely question the overall scale of fees charged for services from underwriting and organising IPOs to managing mergers and acquisitions. This is largely because of the cosy relationship between the executives of investment banks and the companies they advise, which arises mainly because big business has become increasingly dependent on the banks. One insider called the money earned by the banks "supernatural".[36] Anthony Hilton of the *Evening Standard* has described what he calls the 'gargantuan' profits made by investment banks as "perhaps the biggest case of market failure the world has ever seen".[37]

Following his inquiry into the Great Crash of 1929, Judge Ferdinand Pecora described the investment bankers of the time as having "heads I win, tails you lose ethics".[38] Seventy-five years on, not that much has changed. Financial speculation, the source of many modern fortunes, is rarely associated with creating value. As one leading figure in the hedge fund industry has admitted, "when I first went into the City, I could not believe that anyone would want to pay me so much for creating nothing".

One former banker has called today's finance industry "bloated and parasitic".[39] Another former top executive has described brokers' pay as "a social and moral disgrace".[40] In 1998, the chief executive of the giant investment bank Credit Suisse First Boston admitted: "OK. If I am being honest with you then yes, let's whisper it, but the truth of the matter is that all of us are overpaid. There is nothing magical about what we do. Anybody can do it."[41] One senior investment bank trader, who prefers to remain anonymous, told me: "What the vast majority of people in the City get paid is much too high. I have no issue with a genius trader making £100m. But most people, whilst talented, are doing roughly the same kind of job that they could do in any other industry yet they seem to get paid two to three times as much." Part of the reason is that City clients – who mostly handle other people's money and whose own salaries are high by the standards of other professionals – have no incentive to query the fees being charged, while the regulators feel powerless to intervene.

Raghuram Rajan, professor of finance at the University of Chicago and former chief economist at the IMF, has divided gains in the financial market between what he calls 'alpha gains' generated by astute investment, which add real value by beating the market without taking excess risk, and 'beta gains', which accrue from taking extra risk. Rajan concludes that it is very difficult to create alpha gains and argues that much of the excess pay received in the financial industry really comes from 'fake alpha' – high short-term returns that are undermined later by hidden risks that are revealed only in the medium or longer term. Investment managers who bought complex financial instruments such as CLOs, for example, generated higher initial returns than investing in corporate bonds as did the Northern Rock managers by taking on such 'tail risk'. As Rajan argues, both strategies brought "the manager a premium in normal times for taking on beta risk that materialises only infrequently. These premiums are not alpha since they are wiped out when the risk materialises."[42]

There is nothing wrong with risk in itself. Taking risks in the hope of economic growth is the route by which societies prosper – even if some schemes fall by the way en route. The problem with the kind of risk being taken in recent years is that those taking the risks have been playing with other people's money, not their own, using the financial system to place near one-way bets favouring the financiers.

At a gathering of G7 finance ministers in February 2008, a report from the Financial Stability Forum, made up of central bankers and regulators from around the world and created by the G8 in the wake of the Asian crisis of the mid-1990s, was damning in its criticism of "feckless investors and irresponsible bankers" alike. Among the culprits identified were "the lavish performance-pay regimes on Wall Street and the City which encouraged disproportionate risk-taking with insufficient regard to longer term risks". Also culpable were the credit rating agencies, including Moore's and Standard and Poor's, which awarded some of the financial instruments that have triggered the credit crunch with the coveted triple A rating – a ranking normally reserved for central banks – despite subsequently being revealed to be close to worthless.

What is now being faced is not just another twist of the economic cycle, but a much more extreme version that could arguably have been avoided with more effective, anti-cyclical regulation. Gordon Brown's claim to have ended boom and bust now looks hollow. While the world's leading financial deal-makers have gained during the feast years, much of the rest of the world is now bracing itself for the famine. How prolonged and how deep it will be nobody knows.

What we do know is that the creators of the toxic sub-prime repackaged loans are mostly continuing to live it up. One of the remarkable characteristics of the wealth boom of recent times has been the way the new super-rich have not only been the main winners from the boom, but have also been able to protect themselves from the consequences of their own actions. As economists like to put it, the finance industry has found clever ways of socialising losses while privatising profits.

In the 1929 Crash many of those who lost out badly were the rich themselves. Not only did many lose their fortunes, but the super-rich as a group were to face a long period of decline that lasted close to two generations. The periodic stock market crises of the last 20 years, though much less severe than in 1929, have resulted in many fewer casualties among the rich. Apart from a few hundred young and mostly naïve dot-com entrepreneurs who saw their paper fortunes vanish, the super-rich as a class not only survived the puncturing of the post-millennium technological bubble but actually thrived (see Figure 1, p 6).

Of course some of the losers from the reckless behaviour behind today's global turmoil are the financiers themselves. The British Bahamas-based multi-billionaire Joe Lewis lost a third of his fortune in a speculative bet on Bear Sterns. Commercial property baron Robert Tchenguiz has lost heavily with the fall in property prices. Executives with salaries linked to share values will have lost out from falling share values. Thousands of middle-players in the City will lose their jobs. Many financial deal-makers will have a quieter time for a while with falling fee income, though with substantial sums already stashed away, while new fortunes will be harder to come by.

Nevertheless, while the world's financial systems have been unravelling, most of the architects of the financial failure have quietly ensured that they would not be the ones paying the price. In the United States, the bosses of giant investment banks Merrill Lynch and Citigroup who presided over multi-billion write-downs because of the gung-ho way they expanded into sub-prime lending walked away with pay-offs of $161m and $93m respectively, figures that some have described as excessive even if they had been successful.

As Jon Moulton of Venture Capitalists Alchemy Partners put it: "The bankers have gone home. They have got their big bonuses. It's the ordinary people who are left with the damage and the debt."[43] In his blog, BBC business editor Robert Peston has written: "In crude terms bankers have been given the bank's capital to gamble in a game of global roulette. Before the wheel stopped turning, they were rewarded as though their bet on red had come good. But when the ball finally kerplunked in a black slot – well they and the moolah were long gone."[44]

Keeping your own fortunes intact is all about timing. To most financiers the present crisis has hardly come out of the blue. The City knew it was coming, while the regulators warned of the mounting risks. Some of the wealthiest made their exits before the full horror had been revealed. Some hedge funds took positions that anticipated the bubble was about to burst, generating large profits in the wake. City bonuses in 2008 are down overall but only one per cent compared with 2007, though 2009 is likely to see a much sharper fall. Although a number of Mayfair-based multi-billion pound hedge funds have already folded, wiping out investors' money, the partners will mostly have walked away with big gains from the feast years, though some are facing legal battles with investors.[45] According to *The Sunday Times*, the richest 1,000 increased their wealth by nearly 15 per cent between the 2007 and 2008 lists while the richest 50 in the world increased their wealth by nearly 23 per cent.[46]

Do the super-rich create new wealth or redistribute existing wealth?

A second important question in judging the role played by the super-rich is whether escalating rewards are the product of exceptional levels of new wealth creation or the result of the diversion of existing wealth.

Few could quibble with contemporary levels of personal enrichment if they reflected successful business and wealth creation and added value at historic levels in a way which benefited society as a whole. So is this what has been driving runaway executive pay, soaring City fees and record bonuses? Has Britain bred a new generation of business leaders, financiers and entrepreneurs with exceptional levels of skill, talent and drive who have uncovered new secrets of business success? Regrettably, the answer to these questions is mostly no.

Exceptional merit and dynamism undoubtedly deserve generous reward. Successful entrepreneurs who can build a fortune from scratch or turn a poorly performing company around have been the backbone of rising prosperity, driving job creation and economic growth. But there are no strong reasons to believe that today's escalating rewards are linked to historically and internationally

exceptional levels of skill, risk-taking and effort. If that was so we would be witnessing a historic rise in the rate of economic progress as well.

The evidence is that soaring corporate pay at the top has failed to engineer a significant improvement in the nation's productivity and innovation record. While the level of productivity in the UK has been rising slightly in recent years – especially in manufacturing – Britain has failed to close its longstanding productivity gap with its major competitors. Output per worker is almost 40 per cent below the level achieved in the US and around 20 per cent below France and Germany. There are many reasons for this, but the evidence is that part of the explanation lies in a lack of innovation within businesses.[47] Although its performance has been improving slightly, Britain also remains relatively low in the international entrepreneurial league.[48] Among the Organisation for Economic Co-operation and Development (OECD) countries only the UK had a lower share of GDP spent on R&D in 2000 than in 1981. Britain also has a poor international record on patent generation.

Of course, there are many examples of successful UK entrepreneurs, from James Dyson to John Caudwell, who have created wealth, jobs and opportunities, and whose fortunes are the direct result of successful business creation. Britain has thousands of successful small businesses that together employ a half of the private sector workforce and constitute the backbone of the British economy. The internet pioneers deserve to be seen as business giants who have presided over a profound business and social revolution. Few would begrudge the fund manager Warren Buffett his status as one of the richest men in the world, a position gained by his sustained skill and prescience in reading the movements of competitive markets, and by eschewing the short-termism characterising most fund management. He likes to describe his favourite holding period as 'forever'.

But founding entrepreneurs who painstakingly build companies from scratch, who put their livelihoods on the line by taking big business risks are not a dominant force in the modern rich list. Those who do make it there are generally not conspicuously more successful than earlier path-breaking business leaders and entrepreneurs from William Lever to Simon Marks. It is difficult to argue that we are living through a new entrepreneurial and economic renaissance in which the new rich are making society generally wealthier, dragging the rest of us upwards with them.

Moreover, the modern entrepreneur tends to play a very different role from the moguls of the past. Today they are more likely to have made their money not from building firms and products from scratch or adding value by introducing new processes. Rather, the ranks of the rich contain many tycoons, investment bankers and business executives who, far from promoting a new economic and entrepreneurial leap forward, have taken advantage of today's more pro-rich culture to grab a larger slice of the cake for themselves by simply taking giant risks with other people's money and ensuring someone else pays when they get it wrong.

Company chief executives

In 2000 a typical FTSE 100 chief executive was paid 39 times the national average. Today it is over 100 times. This dramatic surge in the pay of Britain's top business leaders might have been merited if it had been driven by a transformation in company business performance. But this is decidedly not the case. Rising pay has largely been the result of boards setting very specific targets for CEOs on share price and/or market shares. As one senior banker described the process: "These numbers get hit in a rising market, and all CEOs negotiate tough exit clauses for the possibility of falling markets. The real issue is that the targets don't achieve what we want – that is stable, well-managed and growing companies, because boards/shareholders cannot measure subjective targets."

A study by Manchester Business School shows that from 1983 to 2002 top company chief executives enjoyed pay increases that greatly outstripped a range of measures of business performance, from the rate of profit to the return on capital. Although the market valuation of these companies increased noticeably over the period, the reasons for this – irrational exuberance, declining interest rates and higher levels of saving in equities – had little to do with the management of the companies. The authors conclude: "Set against our evidence that giant firms grow no faster than GDP while CEO pay has risen much faster, top managers in giant firms appear to be an averagely ineffectual officer class who do, however, know how to look after themselves."[49]

Moreover, exit clauses mean that 'rewards for failure' are commonplace. Most chief executives have negotiated contracts that, even when pushed, guarantee them generous pay-offs known as 'golden parachutes'. Sir Peter Davies presided over a falling share price and plunging profits before he picked up a controversial £2.4m on being ousted by Sainsbury's in 2004. A few months later bonuses of £807,000 were paid to the executives of the Jarvis Group despite the company's share price crashing from 566p to 9.5p. In 2007, Bob Diamond, the American president of Barclays Capital earned £21m (some 30 times the pay of the Governor of the Bank of England) despite the huge problems at the bank, while Adam Applegarth, the chief executive of Northern Rock, walked away with £760,000 despite his failed stewardship. In America such payouts are known as 'golden condoms' because they 'protect the executive and screw the shareholder'.[50]

Mergers and acquisitions

Among the most lucrative rewards are those that follow mergers and acquisitions. Economists differ about the wider economic benefits of the merger boom of recent times, a boom stimulated particularly by the pressure from investment banks exploiting new business theories that urged managements to 'merge or die'. While the very threat of takeover keeps management on their toes and thereby helps to create more dynamic boardrooms, mergers and acquisitions have mostly been driven by the prospect of fat bonuses and fees for the 'marriage brokers' – the directors and their City banking and legal advisers who arrange and execute the deals – rather than the long-term interests of the company. This group nearly always walks away enriched and unharmed, whatever the outcome.[51]

The balance of the evidence is that the main effect of mergers has been to achieve wealth redistribution from the buying firm to the selling firm and has been as likely to destroy as create value. Marconi was created out of one of Britain's most

successful companies, GEC, built-up over a lifetime by Arnold Weinstock. Yet the electronics giant was sunk in the late 1990s by a City- and acquisition-led strategy which brought colossal fees for the investment banks advising the company, but which ultimately brought the company down – though not before its top directors had walked away with generous payoffs. The merger of AOL and Time Warner in 2001 led to some of the largest losses and capital destruction in corporate history. Although there was some logic to the deal – to create the world's largest mobile phone operator – Vodafone overpaid massively for its £112bn takeover of Mannesman in 2000, a move that led to a collapse in the company's share price and a huge squandering of existing wealth.[52] The effect of these failures has been a huge blow to pension funds, with millions of ordinary citizens losing out – along with the hundreds of employees who have lost their jobs in the process.

One study of the impact of recent mergers in the UK, US and continental Europe concluded that: "shareholders of acquirers experience wealth losses on average or, at best, break even... The odds of positive and significant value creation for acquirer shareholders may even be less than 50 per cent, which is what one would get with the toss of a fair coin."[53]

Hedge funds

Some of the biggest recent rewards – ones that often depend on 'hidden risks' – have been enjoyed by relative newcomers to the financial services industry: the hedge fund operators and private equity barons. Hedge funds – private pools of capital provided by a mix of wealthy individuals and institutional investors – now control huge sums of money, some $1.4tr globally across 11,000 funds. The funds are heterogeneous; some invest in a traditional manner and 'buy long', while many specialise in 'shorting' when they believe that a company's shares are overvalued. Shorting involves borrowing shares and then selling them in the hope that they will fall in value and can be bought back at a cheaper price when the time comes to return them. While some funds engage in little more than giant speculation using sophisticated mathematical formulae to bet on the movement of share prices, or spot a market in bonds or commodities that appear to be out of kilter, some have funded merger and acquisition activity and sometimes private equity takeovers. For the most part, their profits have come from correctly anticipating market movements rather than reshaping the fundamentals of the business world – as much redistributing as creating wealth.

Hedge funds are one of the most obscure parts of the finance industry, lacking in transparency and accountability and mostly weakly regulated. While some have achieved remarkable immediate returns – which explains their popularity among investors – their performance has weakened in recent times. The MSCI Hedge Fund Index rose 5.8 per cent in the year to October 2007, while the Dow Jones rose 8.6 per cent and the MSCI World Equity index 5.5 per cent. Hedge funds deliver big personal rewards to partners by charging much higher fees than those of other fund managers. They typically take two per cent of the total assets under management and also keep 20 per cent of the gains. In the good times managers make a killing, yet they suffer no penalties during the downside, which is borne entirely by the investors themselves.

While discussing whether a hedge fund should buy any of the packages associated with US sub-prime mortgages, one insider told a financial journalist: "If you are running a newish hedge fund which has persuaded £50m or so out of a few gullible investors and you want a chance of getting rich quick, buying all this stuff makes sense. Sure, everyone knows the sector is going to blow up, but no-one knows when, and in the meantime you can make excellent returns from fiddling around with mortgage-backed securities and their many derivative products. You can charge whopping performance fees until the crash comes, then when it comes you just shut up shop and go home. Your clients will have lost money but as long as you get a couple of years at the trough, or even just one good one, you'll be set up for life." [54] These comments came before the sub-prime crisis blew up and are a clear example of Rajan's 'fake alpha' – delivering huge but unjustified rewards by hiding risk.

This is not the only way some funds have destabilised the financial system using secretive dealings in search of higher personal gains. It is not uncommon for funds to buy shares in order to swing the vote on a merger or takeover proposal – not to further the interests of the company, but to manipulate the share price in the direction of an earlier bet. When Deutsche Borse, the German Stock Exchange, bid for the London Stock Exchange in December 2004, two hedge funds – the British Children's Investment Fund and New York-based Atticus Capital – led a high profile campaign against the takeover. According to two American-based academics who have studied the influence of hedge funds on takeovers this was because the two funds had taken a short position on the LSE, a bet that its shares would fall. [55]

Private equity

Another source of the modern fortune has been private equity – effectively a new name for the controversial leveraged buy-out firms of the 1980s, and an industry that has been slowly eating away at the edges of the dominant shareholding model. Sometimes private equity is confused with venture capital, that is private funding of new business start-ups. In fact the amount of actual venture capital – often the real seed-corn for future business – is small in the UK.

Former public companies that have been taken private since 2000 include Philip Green's BHS and Arcadia along with Boots, Debenhams, the AA, Harvey Nichols, Hamley's, Homebase and Halfords. Since private buyers finance their purchases by a very heavy dose of borrowing through leverage rather than issuing shares or using much of their own money, the private equity boom has been driven by the cheaper credit available from 2000 that has made public-to-private acquisitions much easier to finance.

What the private equity barons have done since 2000 is find a way of scooping a giant jackpot – 'life-changing amounts of money' according to corporate analysts[56] – by buying up great chunks of British business, loading them with tax-reducing debt, re-ordering their finances to extract as much cash and 'surplus' assets as possible and then selling them on at a profit. The biggest British names behind the private equity boom have been Permira (owners of the AA and Little Chef), Apax (Somerfield and Tommy Hilfiger) and CVC. The partners running the firms, such as Damon Buffini of Permira and Mike Smith of CVC, employ separate management teams to run the companies once acquired, and are lavishly paid – at a 'gravity-defying' rate, according to *The Economist*.[57] Those involved in the industry have amassed colossal fortunes in just a few years.

Whether the private equity boom has been in the longer-term interest of the companies is the subject of heated debate. The industry claims to have a good record on managing the companies it acquires, on investment, jobs and exports, and to have generated big alpha returns. It is too early to judge the overall economic impact of the industry, though early evidence suggests a very mixed impact. Some companies have been made leaner and fitter, adding value through better financial discipline and improved management – though sometimes by selling off and leasing back property and other assets – but others have not. In general, private equity is looking for a short-term hit, inviting criticism that it is not there for the long term and has little commitment to a company's staff and community, while exacerbating the short-termism that has long dogged the British economy. The current more difficult financial climate has resulted in a more level playing field without easy credit and rising asset prices and will provide a sterner test of private equity's claims to operate a superior business model.

The industry's own research shows that private equity has generated substantially greater returns than achieved by the FT all-share index. But the evidence is that the gains have come less from improved efficiency and management than from the multiplier effect on returns enabled by financial 'leverage'. Take, for example, a private equity firm that buys a company for £1bn and borrows 70 per cent of the cost – the average level of debt involved on recent deals. If it sells the company three years later for say £1.3bn, it will have made £300,000 merely by investing £300,000, a remarkable 100 per cent return. Since 2000, the combination of low interest rates and rising asset values has brought huge leverage-enhanced profits for the architects of public-to-private deals. Moreover, while financial engineering has delivered high returns in boom conditions, some of the companies taken over recently are in danger of drowning in a sea of debt in today's more turbulent waters.

The overall evidence is that the rewards earned by partners, mostly the product of financial engineering rather than value creation, are disproportionate. US studies have shown that private deals over the period from 1980 have "not so far generated superior average returns and that these returns come with health warnings about variability and risk".[58] A 'what if' study by Citigroup found that if US companies had enjoyed the benefits of leverage used by private equity firms they would have generated higher returns than those achieved by the buy-out companies just by buying European mid-cap companies with low levels of debt and good cash generation.[59] This means that the apparently higher returns achieved by private equity could be at least replicated and often exceeded in public companies if they were willing to take on the same degree of leverage. A British study has come to similar conclusions, showing that once the debt leveraging is stripped out, the returns achieved suggest "mixed and in some cases, even mediocre results". The study concluded that the main impact of private equity has been the use of financial engineering to "rearrange claims for the benefit of those who own equity, as well as how the private equity business model ensures value capture by a managerial elite of general partners who run funds and senior managers who run the operating businesses invested in."[60]

Section 5 – Does the rising wealth gap no longer matter?

Not so long ago, a soaring wealth gap would have proved politically unacceptable. But the climate has changed. New Labour's leaders have repeatedly argued that as long as we raise the floor and improve the lot of the poorest, the gap is no longer something to worry about. The latest expression of this view came from the business and enterprise minister John Hutton in March: "Rather than questioning whether huge salaries are morally justified, we should celebrate the fact that people can be enormously successful in this country. Rather than placing a cap on that success, we should be questioning why it is not available to more people." The political abandonment of the egalitarian objective is one of the defining characteristics of the shift away from the social-democratic values that dominated post-war politics and opinion.

As Hutton added: "Child poverty can be abolished while people at the top are very wealthy. It is not only statistically possible – it is positively a good thing." It may be statistically possible, but it is a lot harder to achieve with the rich pulling away. There is strong evidence that the level of social mobility falls as inequality rises and that a growing concentration of wealth inhibits the life-chances of the poor, affecting access to education, health and housing.[61] Those countries that have the lowest levels of relative poverty are also those which have the highest levels of income equality.[62]

One of the key arguments used to defend the growing wealth gap is that personal wealth accumulation is said not to hurt anyone else. As one strong critic of egalitarianism has argued: "There is not a shred of evidence that wealth in itself harms those without it… Nor does it harm me that Sir Elton John and the Duke of Westminster are hugely better off than me, even if the work of one is embarrassingly vulgar, and the wealth of the other due to birth. To resent their good fortune would be to succumb to the nasty, small-minded vice of envy."[63]

This may be true of some wealth, but not all. While some personal fortunes are the result of real wealth creation that harms nobody, others, as we have seen above, are largely the product of carefully manipulated transfers from one group in society to another. Much of the activity of the investment banks has been shown to be less about 'risk-reduction' than 'risk-passing'.[64] It cannot therefore be claimed that today's rich are never or even rarely hurting others. Far from being what some pro-wealth supporters claim is a 'positive sum-game ' with no losers, the growing concentration of wealth is the outcome of a complex process of transfers affecting ordinary taxpayers, shareholders and customers with losers as

well as winners. Nowhere is this better illustrated than in the deepening current financial crisis, where the losers are, as we have seen, rarely those responsible for economic mayhem. Instead they are ordinary people – shareholders, small business owners facing bankruptcy, pension-fund holders, staff losing their jobs, those facing higher mortgage payments and taxpayers forced to bail out some of those who created the mess.

Defenders of the widening gap say that the extra wealth at the top will eventually 'trickle-down' to benefit the rest of society. There are occasions when this trickle-down does occur; the City's contribution to Britain's trade balance, for example, will have benefited society as a whole. Successful company creation that introduces jobs and wealth has wider benefits. Such a gain does not occur when economic activity simply diverts wealth from others. This serves only to change the pattern of demand away from the choices of the losers to those of the winners. Even where there is a trickle-down effect from new wealth – from successful business creation or that brought in by super-rich foreigners choosing to reside in the UK – the likelihood is that the much-trumpeted effect peters out as it descends the income ladder with, in most cases, the bulk of the gain spreading little further than among the affluent.

There is certainly a substantial body of winners from the increased concentration at the top. The big-spending rich have created boom conditions in the markets for exclusive holidays, top designer clothes and restaurants. Other winners include those selling bespoke jewellery and luxury yachts and those running the new concierge agencies like Quintessential that sell 'lifestyle management' to the super-wealthy. What Britain has become increasingly adept at is 'financial bag-carrying' – the creation of an army of legal and financial advisers, personal buyers and fixers providing services to the world's super-rich.

For the most part, the gainers from the expansion of wealth at the top have been those already in or near to the top income brackets – City bankers, luxury goods entrepreneurs and the new financial bag-carriers. But the gains have barely stretched beyond these groups. Why?

Firstly, although new jobs have been created, many have gone to foreign labour, including top paying jobs. One senior wealth adviser claims that foreign non-doms account for 40 per cent of the senior management posts in the City. A fair proportion of the spin-off work – in services, security and restaurants – has been low paid and often exploitative, more likely to be filled by migrant workers than the indigenous population.

Secondly, some of the extra demand at the top has led to inflationary pressures rather than increases in productive capacity. Rising corporate pay scales have created recruitment difficulties for other industries critical to economic success – media, advertising and publishing – while fuelling a sharp rise in salaries among top managers in the public sector and opening up new pay gaps between the top, middle management and basic grades. This is more 'trickle up' than trickle-down.

The growth of higher fortunes has led to a surge in inflation in a number of markets that supply exclusive and rare commodities. Contemporary art prices have quadrupled in the decade to 2007, leading to record profits for Bond Street auction houses but hitting the budgets of public art galleries and museums in the process.

Some of the extra demand is being translated into the growth of 'grey markets' in areas such as private jets and premium cars. Private jet order books are full for years ahead, with buyers paying premiums of up to £5m to jump the queue for the top of the range £22m Gulfstream G550. The new Rolls Royce Phantom Drophead Coupe, retailing at £325,000, has a two year waiting list at least. To secure early delivery costs an extra £75,000.

Much of the boom in property prices from 2005 was driven by a combination of expanding City bonuses and the arrival of super-rich foreigners, taking advantage not only of their tax-free status, but able to pay much lower stamp duty by placing homes in offshore companies. While the sustained property boom increased the notional wealth of existing home owners, it had a number of significant downsides. By encouraging speculation in the property market, it sharply increased the number of empty homes, especially in London and the South-East. The inflation in house prices made it much more difficult for the Government to manage the economy, forcing it to impose higher interest rates than would otherwise have been the case. Most significantly, it created a crisis for young first-time buyers, a group which slumped to a 27 year low in 2007. In the five years to mid-2007 the average price paid by first time buyers rose four to five times faster than wages.[65]

The wealth boom has not just strangled housing choices for ordinary people. It has also impacted on what is being built, with most new-build being at the middle, higher and top end of the market, with prestigious executive apartments replacing schools, pubs and petrol stations. Since the late 1990s, the north and south sides of the Thames has seen the erection of walls of luxury housing developments at prices only the rich can afford.

If the trickle-down effect was working, even with a lag, one would expect the growing wealth gap to begin closing. But not only have the super-rich continued to pull away from others, new patterns of inequality have opened up. Commenting on the poor trading suffered by M&S over Christmas, the company's chief executive Sir Stuart Rose highlighted the growing gulf between rich and poor. "I have never seen such a polarised UK economy. The rich are so very, very rich. The West End can't get enough diamonds. But the poor are getting poorer."

Rising inequality is reflected first in the apparently growing regional gap between London and the rest of Britain.[66] In Victorian times the industrial north, with its concentration of successful industrialists, acted as a partial counter to the power of the London-based financiers. As a result wealth was spread more evenly across the country, and between finance and industry. But from the early 1900s London, the financial centre of gravity, started pulling away from the rest of the country, a process that is being repeated again now with the rising power of the City.

Most of the benefits of the current wealth boom have accrued in London, with some studies claiming the wider gains have been spread thinly beyond the M25 and the Home Counties.[67] The effect, according to one study by Sheffield University is that "the country is being split in half... To the south is the metropolis of Greater London. To the north and west is the archipelago of the provinces – city islands that are slowly sinking demographically, socially and economically."[68] Geographers have also found that neighbourhoods in Britain are now less socially integrated than at any time since the Second World War, leading to a new form of economic and geographical apartheid.[69]

London in turn is slowly transforming into a city for the rich, just as it was in the 1920s before the impact of the Great Crash. Although London has became in many ways a more exciting place to live, the ability to access its new pleasures has become increasingly dependent on wealth. Although London has always been a divided city geographically – between the well and poorly paid, between the employed and unemployed, between professional and industrial workers – those divisions narrowed in the decades after the war. Today we are returning to the much greater divisions of the past.[70] According to *Prospect* magazine, London has been turned into "a hyper-capitalist, deregulated, very unequal, financial services-driven, mass-immigration-driven city state."[71] In a survey published in July 2007, four out of ten Londoners thought the capital had become "just a city for the rich".[72]

Having such large concentrations of wealth in such small areas carries a high risk of social disintegration, from rising crime rates to poorer health, as was shown in the Edwardian era and during the 'roaring twenties'. There is strong evidence that only when wealth is spread around more evenly are harmful social consequences minimised.[73]

Section 6 – The way forward

In many ways the current financial crisis is a classic case of 'elite over-reach', perhaps on a scale not seen since 1929. Back then, the world's financial elite were undone by their own excess and blindness. Although many of the claims about the benefits of today's wealth explosion have been exposed in the unfolding economic crisis of the last six months, the position of today's new rich 'super-class' looks much more secure.

In general, the British Government has shown a marked reluctance to intervene to challenge the growing power and fortunes of the super-rich, with the result that there has been little, if any, real political counterweight to the growing power of money. There are several reasons for this. Firstly, the Government has largely embraced trickle-down theory – the belief that allowing the rich to significantly increase their wealth would make us all better off. Indeed, by opting for relatively weak regulation by international standards the Government has set out to encourage the creation of large personal fortunes. Secondly, the Labour Party itself has become increasingly dependent on the financial support of rich individuals; Tony Blair has a highly paid part-time post with Wall Street bank JP Morgan while Gordon Brown has appointed a coterie of City advisers. Thirdly, by courting the City and its financial institutions and setting out to woo the domestic- and foreign-rich with generous tax breaks, the Government has allowed the economy to become so dependent on these groups it cannot introduce policies that threaten that dependence. In doing so it has created a policy trap that has proved difficult to spring.

On those occasions when the Government has attempted to rein in the financial industry's more unacceptable practices, clean up corporate pay excesses or close super-rich tax loopholes, the City has used its financial muscle and lobbying power to force the government into a retreat. In February 2008, for example, *The Guardian* newspaper published Downing Street documents which revealed how, in 2003, a small group of the UK's top businessmen forced Tony Blair to back down over plans to impose higher taxes on pension fund pots over £1.4m.

However, the hands-off policies of recent times are increasingly difficult to defend. Trickle-down theories have been found wanting while the credit crisis has exposed the intellectual thinness of neoliberalism. There is growing concern about the way political parties have become increasingly reliant on rich individuals for funding. Allowing, indeed encouraging, the economy to become increasingly dependent on the City has proved to be a high-risk strategy.

Speaking on Radio 4's *Today* programme on 26 April 2008, John Hutton claimed that governments do not have the power to close the gap – even if they wanted to. That is not the case. The role of government should be to act in the following four areas:

1. to build a system of regulation that encourages genuine wealth creation and prevents unjustified wealth diversion;
2. to ensure that rewards are linked to performance;
3. to construct a tax system that treats all citizens equitably;
4. to help fashion a political and cultural climate that prevents reckless personal abuse of the financial and business system.

The present system fails to pass any of these four tests. As argued above, a considerable volume of financial activity is geared to redistributing rather than creating wealth; rewards are only loosely linked to real performance; and the tax system is rigged in favour of the rich.

Regulation

The regulatory authorities in the UK and the US must take some of the responsibility for the current crisis. In the UK, the light touch policy has been revealed to have permitted too much irresponsible lending while giving too much leeway on banks' reserve requirements and on the flow of complex financial instruments. The regulators should have acted to prevent the build up of the asset price bubble by, for example, preventing the housing boom getting out of control. They could have helped to smooth the house price cycle by limiting the excessive generosity of mortgage packages – sometimes in excess of 100 per cent – which helped to fuel price rises. And while market abuse is believed to be widespread – the FSA claims a third of takeover announcements are accompanied by insider dealing – there have been very few successful prosecutions, while fines have rarely been punitive.

In recent times the business community has been given what it has repeatedly lobbied for – a hands-off system of regulation during the years of feast and big state handouts during the famine. It is now time to even up the balance sheet. Today there is much talk of the end of aggressive investment banking and a new sobriety. Even some pro-market experts are starting to question the Friedmanite dictum that greed is good for the economy, citing the erosion of ethical constraints in boardrooms. According to Martin Wolf, the pro-market *Financial Times* commentator: "I now fear that the fragility of the financial system with the huge rewards that it generates for insiders will destroy the political legitimacy of the market economy itself. So it is time to start thinking radical thoughts about how to fix the problems."[74]

But although it is now widely accepted that the current system of self-regulation with only limited rules has been far too lax – allowing bankers to enrich themselves through the diversion of existing wealth while increasing rather than spreading risk in the system – no alternative blueprint has yet emerged. Such an alternative would need to ensure better accounting standards, the strengthening of risk-management procedures and a review of the role of credit rating agencies. It should be tough enough to prevent another destabilising debt binge with a stricter system of regulation that increased transparency and disclosure and ensured that risk is spread in a more even-handed way. The powerful anti-regulation lobby will seethe

at any toughening, claiming that greater intervention will make things worse and stifle innovation. But given that more effective regulation could have limited the current level of economic instability, now is the time to shift the balance from excessively risky financial innovation to preventing reckless practices.

Remuneration

Despite the voluntary measures introduced in recent years to restrain the abuse of executive power, the system of corporate remuneration remains deeply flawed. Self-regulation has failed to work, with non-executive directors and institutional shareholders proving mostly spineless in acting to prevent boardroom excess. The boardroom culture can be described as being about 'grabbing as much as you can while you can'. John Plender of the *Financial Times* claims that the remuneration system has "greatly increased the temptation to cook the books in order to bump up bonuses and other incentive rewards… there has been a real decline in ethical standards".

There is a growing consensus that by working to incentivise reckless behaviour the present system of remuneration in the financial industry has contributed greatly to the present economic crisis. That consensus embraces the Confederation of British Industry (CBI), the Bank of England and the Financial Services Authority (FSA), as well as leading economists such as Professor Rajan and Joseph Stiglitz. Hector Sands, the Chief Executive of the City watchdog, the FSA, has come perilously close to admitting that the economic mess Britain is now in is down to bankers' greed and the failures of those who negotiate their remuneration: "There is a risk that the remuneration systems are too short-term and that they do incentivise behaviour which is not helpful in terms of maintaining long-term financial stability." He criticised the lack of asymmetry between City bonuses and returns to shareholders, under which bankers get large pay packets for deal-making but hang on to them even if the deal turns sour leaving shareholders to pay the price.[75]

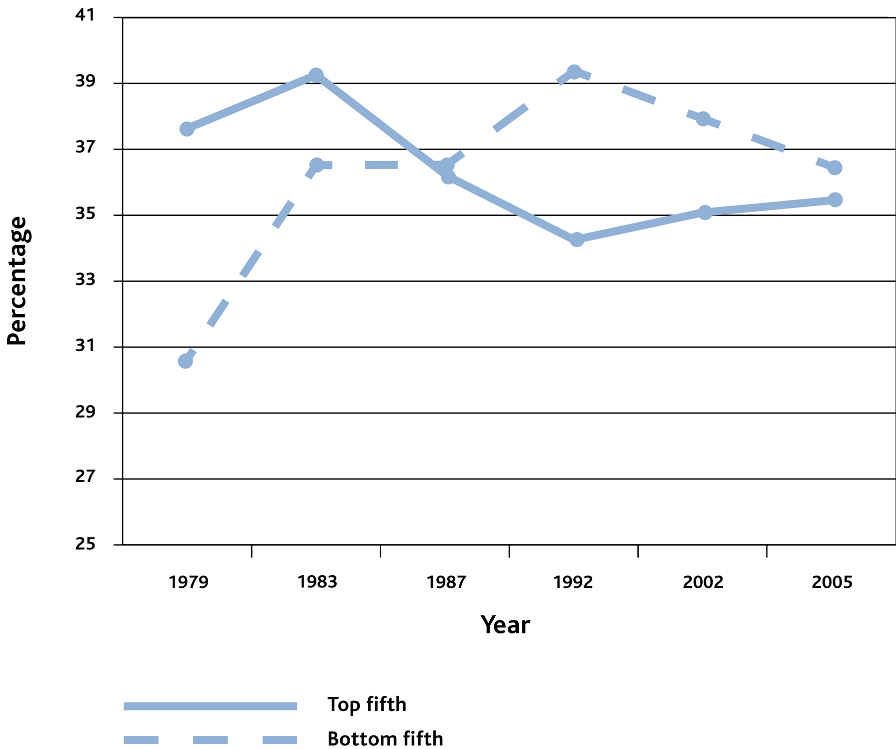
As Stiglitz has put it: "The system of compensation almost surely contributed in an important way to the crisis. The system was designed to encourage risk taking – but it encouraged excessive risk-taking. In effect it paid them to gamble. When things turned out well, they walked away with huge bonuses. When things turn out badly – as now – they do not share in the losses... It is one thing to gamble with one's own money – but these bankers were gambling with other people's money – with the Government (taxpayers) backstopping any losses. This is unconscionable."[76] Leading banks can now be added to that list. In April an internal report into massive losses at Zurich-based investment bank UBS revealed that a key cause of the record losses at the Bank was an "out of control" bonus scheme, one that rewarded traders for little more than betting huge sums whatever the outcome. One former trader has described his colleagues as "random gunslingers".[77]

If we are to avoid a repetition of the current financial turmoil the regulators need to ensure that those who create the mess are also those who pay for it. What is needed is a system of payments that rewards success but penalises failure, replacing the current asymmetrical system that offers unlimited upside with little – and often no – downside. A greater alignment of responsibility, risk and reward would eliminate some of the perverse incentives that have contributed to the personal wealth boom and fuelled the current crisis. Germany's Social Democrats have proposed a limit of €1m on the amount of top executives' pay that companies can deduct fully from their taxable profits.

Tax

One of the reasons for the growing inequality of recent times has been the increasingly regressive nature of the tax system which, as shown in Figure 6, moved from being broadly progressive to broadly regressive from the end of the 1980s. Increasingly the rich in the UK are treated as a special case when it comes to paying tax – the only group with the freedom to opt out of their tax obligations. In 2006, for example, the accountants Grant Thornton found that the 54 billionaires living in Britain paid £14.7m in tax on their £126bn combined fortunes – an average rate of a little over 0.1 per cent.

Figure 6: How Britain's tax system has increasingly favoured the rich
(Total taxes paid as a proportion of gross income by the poorest and richest fifth of the population)



Source: F Jones, 'The Effects of Taxes and Benefits on Household Incomes 2005–6, Table 3, Office for National Statistics, May 2007 and earlier versions of the same series

There are two main reasons for this regressive trend. First, there have been tax changes which have reduced the relative tax burden on top income groups. Take private equity, where personal fortunes have been greatly enhanced by Britain's tax laws. Following City pressure, in 1998 Gordon Brown broke the link between capital gains and income taxation established a decade earlier by Nigel Lawson by introducing a system of 'taper relief' on capital gains tax. This allowed businesses to pay as little as 10 per cent (rather than 40 per cent) on businesses held initially for 10 but then cut to two years or more. Despite an admirable goal of encouraging business start-ups its main impact has been to fire up the hedge fund and private equity revolution. Private equity partners operate a similar '2 + 20' fee policy to hedge funds. They charge an annual management fee of 1.5 to 2 per cent on the funds invested and an additional typically 20 per cent share of profits on the fund (known as 'the carry' – the difference between purchase and sale price). In most cases the 'carry' is taken not in the form of income (which would involve a marginal tax rate of 40 per cent) but of capital gains with its much lower rate. According to the *Financial Times*, the industry gossip is that private equity partners in fact often pay no more than 4–5 per cent on their multi-million pound annual incomes.[78]

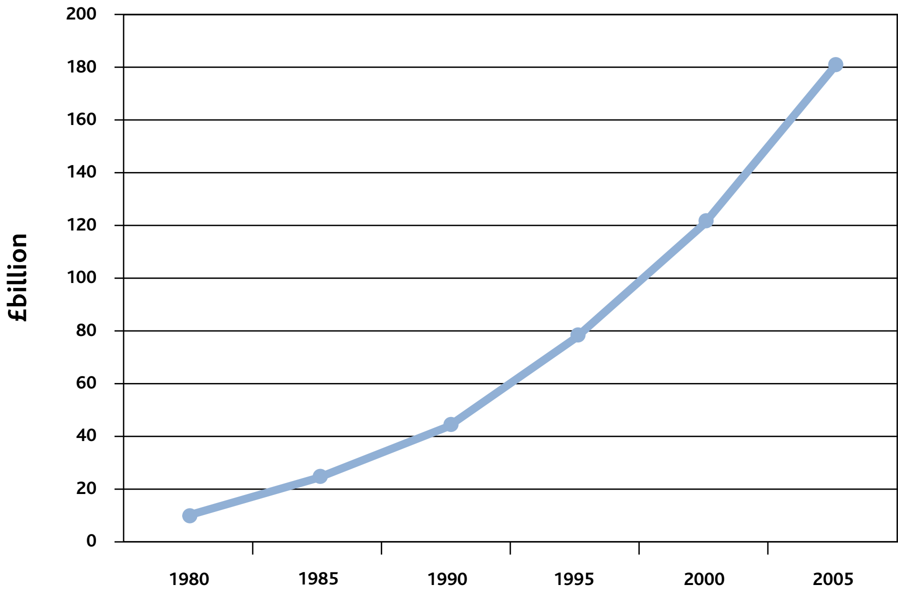
Moreover, as the interest on the debt can be offset against profits for tax purposes the high levels of borrowing in private equity have often reduced corporation tax payments to zero. Debenhams and the AA, for example, both stopped paying corporation tax after a private equity takeover. Since Boots was taken over in 2007, its tax bill has fallen sharply.

Nicholas Ferguson, one of the early founders of private equity, has said: "Any common sense person would say that a highly paid private equity executive paying less tax than a cleaning lady or other low paid workers can't be right." Labour liked to boast that it had created the most lenient tax system in the world for new business but was eventually forced to up the capital gains tax rate to 18 per cent because of the outcry over the way the rule was being exploited. Nevertheless, this change still means that income earned as a salary (which falls into the higher rate bad) is taxed at more than twice the rate of income resulting from investments – such as sales of buy-to-let properties – hardly a measure that will shift the tax balance towards the super-rich.

The second reason has been the rapid growth in the flow of individual wealth and corporate revenue diverted through secretive offshore tax havens. Figure 7 shows the rapid acceleration in capital flight over the 25 years to 2005 for Jersey alone after the removal of capital controls from the early 1980s.

The total value of assets held offshore, either tax-free or subject to minimal tax, is estimated to be over $11tr (a third of global GDP), much of it managed out of London by highly paid City accountants. Many of the 70 or so havens are British Crown Dependencies with close links to the City, such as Gibraltar and the Cayman Islands, as well as Jersey. This lucrative business is undermining public support for the tax system and the ability to fund public services. In 2007, the International Monetary Fund ranked London alongside Switzerland, Bermuda and the Cayman Islands as an 'offshore financial centre'. Richard Murphy has estimated the cost to the Exchequer of personal and business tax avoidance at £25bn.[79]

Figure 7: The growth of bank deposits in Jersey 1980–2005



Source: John Christensen, Tax Justice Network

Take the tax from financial services. Although this sector has enjoyed a rising share of GDP in the last few years, the total tax paid by financial services (corporation tax and income tax by employees combined) as a percentage of total UK tax receipts actually fell from 48.9 per cent in 2001 to 37.1 per cent in 2005.[80]

Ultimately, of course, the issue of the growing proportion of wealth stored offshore is one that can be tackled only by concerted international co-operation to force greater global transparency. Although effective action remains a long way off, the potential to crack down on tax havens has been shown by the way the German government paid whistleblowers for the records of 600 German tax evaders with accounts in Liechtenstein. Britain's HMRC also paid for the details of 100 accounts deposited by Britons. The German Chancellor, Angela Merkel, is spearheading a European campaign for a wider crackdown, forcing havens such as Monaco and Andorra (classed as 'unco-operative havens' by the OECD) to be more transparent and promise less secrecy to individual depositors.

As the economic crisis gathers pace and governments find themselves with limited fiscal options there will be a great political opportunity to tackle the growing problem. Tax experts, on the other hand, remain sceptical that such moves will do little more than scratch the surface, or that a much more concerted crack-down will ever be launched.

A change in Britain's 'social norms'

Ultimately, policies designed to create a fairer distribution of rewards, rein in the worst excesses of the financial and business community and cap and reduce inequality will not work without a fundamental change in the political and cultural climate that challenges the excessive secrecy, flawed incentive structures and deeply embedded culture of excess that apparently characterises much top business practice.

In the post-war era, the misuse of economic power was moderated by a series of implicit social norms about acceptable behaviour that worked to impose a natural limit at the top and as a check on abuse. The hidden 'shame gene' that ensured the economically powerful did not over-exploit their good fortune has been replaced by today's fawning and 'blind-eye' politics, while corporate Britain displays a minimal sense of self-restraint and wider social responsibility.

The policy response now depends on whether the bursting of the economic bubble will be followed by a bursting of the political bubble. There is some evidence that the tide of both popular and influential opinion is moving, even from within the financial industry itself. The public is increasingly uneasy about the rise of a super-rich elite powerful enough to pay themselves more or less what they like. There are enough signs – in growing shareholder impatience, in opposition to growing tax avoidance at the top, in rising concerns about the social impact of a deepening social divide – that we are reaching the limits of public tolerance of a society skewed so heavily in favour of the interests of one tiny group, irrespective of the impact on others.[81]

The public is only too aware of the special tax status enjoyed by the rich, which is one of the reasons behind middle class antipathy to inheritance tax. In tune with the views of their readers, a number of right-of-centre newspapers such as the *Evening Standard* and the *Daily Mail* have been running a string of articles that have questioned the Government's apparent love-affair with the super-rich.

Top professional opinion has also been declaring its hand. In the United States, as millions face repossession while financiers pocket record rewards, leading economists and commentators have started to debate the limits to markets. An apparent sense of shame has even spread among the super-rich themselves, with one US billionaire financier penning a blog entitled 'Enough is Enough'.[82] In continental Europe the political climate is increasingly intolerant of perceived business excess. The French have criticised soaring executive pay in poorly performing firms while the Luxembourg Prime Minister has called runaway executive pay a "scourge" and the German Social Democrats are pushing for tougher action on excessive rewards. In another sign that the pendulum is swinging, Josef Ackermann, head of Deutsche Bank, said in March: "I no longer believe in the market's self-healing power." [83]

In the UK, Sir Ronald Cohen, an adviser to Gordon Brown and one of the architects of the private equity revolution, has warned that the growing gap between the rich and the poor could lead to riots. A 2007 poll of pay experts by consultants Income Data Services found that over half thought that executive directors of public companies were overpaid while two-thirds thought that pay differentials between the executive board and the rest of the workforce were too wide.[84]

Section 7 – The policy response

Contrary to John Hutton's recent claims, there is a range of politically and economically feasible measures that would help to reduce economic instability caused by the reckless financing of recent years, cap unjustified fortune building at the expense of others and secure a fairer distribution of rewards without threatening the process of genuine wealth creation or requiring excessive interference in markets. Some of these proposals would work most effectively if embraced and enforced internationally at both EU and G8 levels. Measures are needed in the following areas: regulation of the City; remuneration; tax; and social audit.

On regulation:

- Banks and all companies trading in financial markets need to run higher levels of reserve and capital requirements to ensure sufficient cushion to help smooth the cycle of returns, lowering them at the peak and reducing the risks of subsequent negative returns.[85] While the process of recapitalisation has started with, for example, some banks attempting to boost their capital position by record rights issues, it has not yet gone far enough. One option would be to enforce a doubling or even trebling of any set minimum ratio when regulators fear a boom is getting out of hand. This would not just be counter-cyclical but it would also "build up reserves and help to restrain bank lending during asset price booms, so as to release them during asset price depressions".[86]
- Much greater transparency over the extent of concealed risk in the system is needed by making the 'small print' much more explicit, for example, by developing a system of independent licensing of financial products to clarify what risks are involved and who bears them. This should not be done in a way which kills off the process of product innovation entirely. Such a system would help too to deal with the conflict of interest inherent in the decisions of the current credit-ratings agencies.
- Private equity companies should be subject to the same levels of disclosure as public companies. The lack of transparency in private equity not only encourages economic distortion, but it also prevents proper assessment of the industry's claims of a superior business model.

- There also needs to be a strengthening of international controls as well as greater harmonisation of the intervention of central banks. At the 2008 Davos forum, George Soros – the billionaire investor and philanthropist, and no stranger to working the markets himself – called for more stringent regulation and oversight of financial markets and for the appointment of a 'global sheriff' to patrol international markets. There are two possible organisations that might take on such a role. In January Sir Howard Davies, director of the London School of Economics and the first chairman of the FSA, called for the Financial Stability Forum (FSF) to take on the role of co-ordinating a global response to the current crisis. The FSF is already examining how banks assess credit risk, the accounting and valuation of derivatives and ways to supervise off-balance-sheet devices like structured investment vehicles and the role of debt rating agencies. Alternatively such a role might be taken by the IMF, which in April described the present crisis as the "largest financial shock since the Great Depression". Although the IMF has been a champion of deregulated markets in the past – and has thus, arguably, been part of the problem – there is no reason in principle why the Fund's role should not be recast to include global surveillance and stability, the encouragement of transparency and the monitoring of tax havens.

On remuneration:

- Remuneration schemes should be redesigned to prevent traders taking excessive and hidden risks with a higher proportion of pay, taking the form of pay-outs that are deferred until the final outcome of a financial strategy is clearer. Joseph Stiglitz has come up with one radical suggestion: "The solution is not so much to cap the bonuses, but to make sure that they share the losses as well as the gains – for instance, holding the bonuses in escrow for 10 years; if there are losses in the second or third years, the bonuses would be reduced appropriately."[87] Despite some acceptance of the need for change, including an admission by the director general of the CBI that the bonus culture had contributed to the financial crisis, the industry is likely to prove resistant to serious reform, claiming that weaker levels of remuneration would be difficult with such intense competition for top talent. Ideally bonus deferrals should be adopted internationally.
- Although there has been some flexing of shareholder muscle at AGMs in recent years, the pension funds and institutional investors which own great swathes of British companies have mostly proved toothless in the face of the excessive remuneration packages adopted by many boards. Remuneration committees, often dominated by non-executives with limited power, need to act in a much less spineless and more independent way. They could be strengthened by adding representatives of shareholders and staff and be chaired by independent professional remuneration managers with sufficient experience to know what best practice is across business.
- Despite the much higher levels of pay and bonuses in financial services compared with other sectors, the industry has never been the subject of an enquiry by the Competition Commission. In light of the current crisis, the Commission should initiate an enquiry into the fees charged in the investment banking industry.

On tax:

- The Government should reassert a commitment to the principle of progressive taxation – that tax should be related to ability to pay, with the rich paying a higher proportion of its income in tax than the poor – a fundamental principle of tax fairness long enshrined in most national tax systems. As Adam Smith wrote in the Wealth of Nations, published in 1776: "It is not unreasonable that the rich should contribute to public expense not only in proportion of their revenue but in something more than proportion."
- New rules are needed to limit the extent to which leveraged loans can be used to offset profits in the case of acquired companies, while allowing such relief for organic growth and investment that encourages real wealth creation. Both Germany and Denmark have introduced reforms in this area.
- Wealth transfers remain one of the main sources of continuing inequality in life chances and should be taxed more effectively. Such is the unpopularity of inheritance tax – easily avoided by the super-rich but not by asset-rich professionals – it should probably be replaced by a lifetime capital receipts tax on beneficiaries as proposed by the Fabian Society.[88] Under this scheme, gifts would be taxed over a lifetime instead of estates after death, with each taxpayer having a lifetime tax-free threshold and an annual tax-free amount. There is also a strong case for legitimising such a tax by hypothecating the income into a special fund to improve social mobility.
- Capital gains should be treated as income and taxed at the same rate with an adjustment to tax windfall gains more heavily than entrepreneurial success. This would prevent mega-earners disguising income as capital gain.
- Securing a more progressive system by shifting the tax balance towards richer taxpayers will require a much more concerted attack by the Government on tax avoidance by individuals and corporations:
  - The Government should introduce a minimum tax rate for earnings over £100,000, while still allowing the use of reliefs and allowances. Richard Murphy has estimated that a proposal to set a minimum average rate of 32 per cent on incomes over £100,000 rising to 37 per cent at £150,000 and 40 per cent on £200,000 and above would raise additional revenue of £5.7bn a year, enough to raise personal allowances by more than 10 per cent.[89]
  - The scope of the EU Savings Tax Directive – which requires those with offshore bank deposits to declare the interest – could be extended to cover companies and trusts as well as individuals. If the arrangement were extended to cover all forms of investment and international action was secured to include new tax havens such as Singapore, this could become a highly effective instrument in tackling illegal tax evasion.
  - The Government should grasp the nettle on non-domiciles, drop the new rule to charge a flat-rate of £30,000 – a crude and hastily implemented measure which will barely dent the fortunes of super-rich foreigners based here but may deter the non-super-rich working here in banking, medicine or academia – and replace the current regime with a temporary residence arrangement. Those resident for less than four years would pay tax on only

their UK income, while those resident for longer would pay tax on both UK and worldwide income as is the case for standard UK taxpayers. Claims by critics that this would drive the rich away are greatly exaggerated, as is the scale of the world's super-rich contribution to wealth creation in the UK. It is a risk worth taking to secure greater tax equity.

- The UK Government should take a much tougher line with its own Crown Dependencies and Protectorates such as Jersey, the Cayman Islands and British Virgin Islands, to lift the veil of secrecy in the way they conduct business by insisting on the same standards of disclosure and accountability as apply in the UK.

On social audit:

- While research into poverty is well-funded, there is little independent research on wealth. Yet the Government's claim that cutting poverty is not inconsistent with rising wealth at the top needs to be tested by independent analysis. The scale of the growing concentration of wealth and income over the last two decades means Government should either:
    - Finance a regular independent social audit that charts changes in the numbers of the rich and super-rich, which distinguishes between wealth creation and wealth diversion, and that analyses the impact of an increasing wealth concentration on wider social mobility and the distribution of life chances. This could parallel the annual reports by the Office for National Statistics on the impact of the tax/benefit system on changes in the distribution of income and on changes in the level of poverty; or
    - Establish a permanent Wealth Commission, parallel to the Low Pay Commission, including representatives from business and finance, that scrutinised top pay deals and assessed their wider impact.[90]

Despite the evidence that wild risk-taking by the super-rich is the main source of the deepening financial crisis, the British Government has shown little inclination to do more than tinker with the existing regulatory and tax system and issue entreaties to firms to 'behave responsibly'. It has yet to set out detailed proposals on tighter banking regulations. It has no plans to change the system of remuneration to limit corporate abuse. Its hurried reforms to capital gains and non-domiciles will have, at best, a marginal impact on the super-rich. Although the hands-off political and economic philosophy of the last two decades has been found wanting, there is little evidence of a substantial rethink taking place – one that would challenge the fundamental economic philosophy that has underpinned the crisis.

The Government has been handed a unique opportunity to take the lead on building a consensus for a new social and business deal that recognises the twin problems of market failure and inadequate regulation generated by the dogmatic belief in liberalisation and deregulation of the last two decades. It could, and should, have insisted that bankers sign up to a system of reciprocal obligations and commitments as required of the rest of the population in return for the billions of additional funds it has made available to ease liquidity. It could have publicly spelled out the wider social obligations that come with wealth – that those who want club membership have to pay the membership fee and abide by its rules.

Instead of a carefully constructed rethink, there remains a strong sense of ambiguity in Government statements. Alistair Darling's recent call – following the destabilising and illegal 'trash and cash' raid against HBOS in March – for new powers to clean up the City by encouraging a US-style whistleblower system contrasts with John Hutton's speech extolling the virtues of big fortunes.

The Government also seems increasingly out of step with wider opinion, yet the political constraints that may have limited its hand in the past have largely been removed with the evidence of malpractice revealed by the financial implosion and the growing clamour for reform.

The issue of the super-rich and inequality is rising up the political agenda. History has shown how the state can intervene to alter the distribution of wealth and income. Although globalisation and de-industrialisation have contributed to growing inequality, studies have shown that the main causes of the variations in inequality between nations are the policy attitudes and choices made by national governments.[91] International comparisons show that nearly all continental European nations have much lower levels of inequality without detriment to the wealth creating process.

The weak response to the crisis to date suggests that we are not yet at the kind of political and economic turning point such as that which occurred with the Great Crash of 1929 and the election of Mrs Thatcher in 1979 and Ronald Reagan a year later. There are no signs of a fundamental rethink that could bring a transition to a new phase in the undulating history of the rich – one marked by the emergence of a more gentle set of social mores and a changing political culture that would usher in a more egalitarian era.

Pumping in funds to prop up the ailing banking sector may help to get part of the financial system moving again but it will do little to stem the upward march of the super-rich. It would take much tougher measures and a more decisive political lead to halt and reverse the increasing concentration of wealth that has occurred in recent times. Without these, the likelihood is that some of the world's super-rich will take a back seat for a while, while quietly restructuring the system to suit their medium-term interests. If so, one of the best opportunities for decades to tackle the root causes of rising national inequality will probably have been lost.

Appendix – Top wealth levels since 1857 by decade

Year	Name	Wealth at the time £ million	Wealth adjusted to 2008 equivalent level £ billion
1857	James Morrison	4.0	**7.9**
1865	Richard Thornton	2.8	**4.4**
1879	Duke of Portland	8.5	**9.5**
1888	Viscount Portman	8.2	**9.3**
1899	Duke of Westminster	14.0	**10.6**
1900	Marquess of Bute	4.6	**5.1**
1927	Edward Guinness, Earl of Iveagh	13.4	**4.0**
1933	Sir John Ellerman	36.5	**12.0**
1946	11th Duke of Bedford	4.65	**1.3**
1957	James de Rothschild	11.6	**0.7**
1967	Guy Anthony Vandervelle	10.95	**0.4**
1973	Sir John Ellerman	52.5	**1.0**
2008	Lakshmi Mittel	–	**27.7**
2008	Roman Abramovich	–	**11.7**
2008	The Duke of Westminster	–	**7.0**
2008	Sri & Gopi Hinduja	–	**6.2**
2008	Alisher Usmanov	–	**5.7**

Notes: Based on largest estates left on death per decade from 1850 to 1979 taken from W Rubinstein and P Beresford, 'Richest by Century', *Sunday Times*, 26 March 2000 and from WD Rubinstein, *Men of Property*, The Social Affairs Unit, 2006. The figures for 2008 are from the *Sunday Times* Rich List. The figures in the first column are the levels of wealth recorded at the time. Those in the second column have been adjusted by the best estimate of the growth in national income over the period from their death to 2008. This column thus shows each person's level of wealth had they enjoyed the same share of national wealth in 2008 as they did at the time of their death. This provides a broad indication of their modern equivalent wealth. The historical comparisons are not strictly comparable as the 2008 figures are based on estimated wealth while still alive while all other figures are based on probate returns. These returns may understate the true worth of some of those listed, particularly since the 1930s. The comparisons are thus broad estimates only.

Notes

1 Incomes Data Services. *Directors' Pay Report*, 2007

2 *Sunday Times* Rich List, 2007

3 Because of this trend, over the two decades from 1979, the richest one per cent has seen its share of national income more than double. See AB Atkinson and W Salverda, 'Top Incomes in the Netherlands and the UK over the twentieth century', *Journal of the European Economic Association*, 2005, vol 3 no 4.

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6 As well as the *Sunday Times*, figures on levels of wealth at the top, all using slightly different definitions, are produced by Tulip Financial Research, by Datamonitor and by the annual World Wealth Reports produced by Merrill Lynch Capgemini. The figures produced by the *Sunday Times* are almost certainly an underestimate of levels of super-wealth.

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