TOUCH STONE

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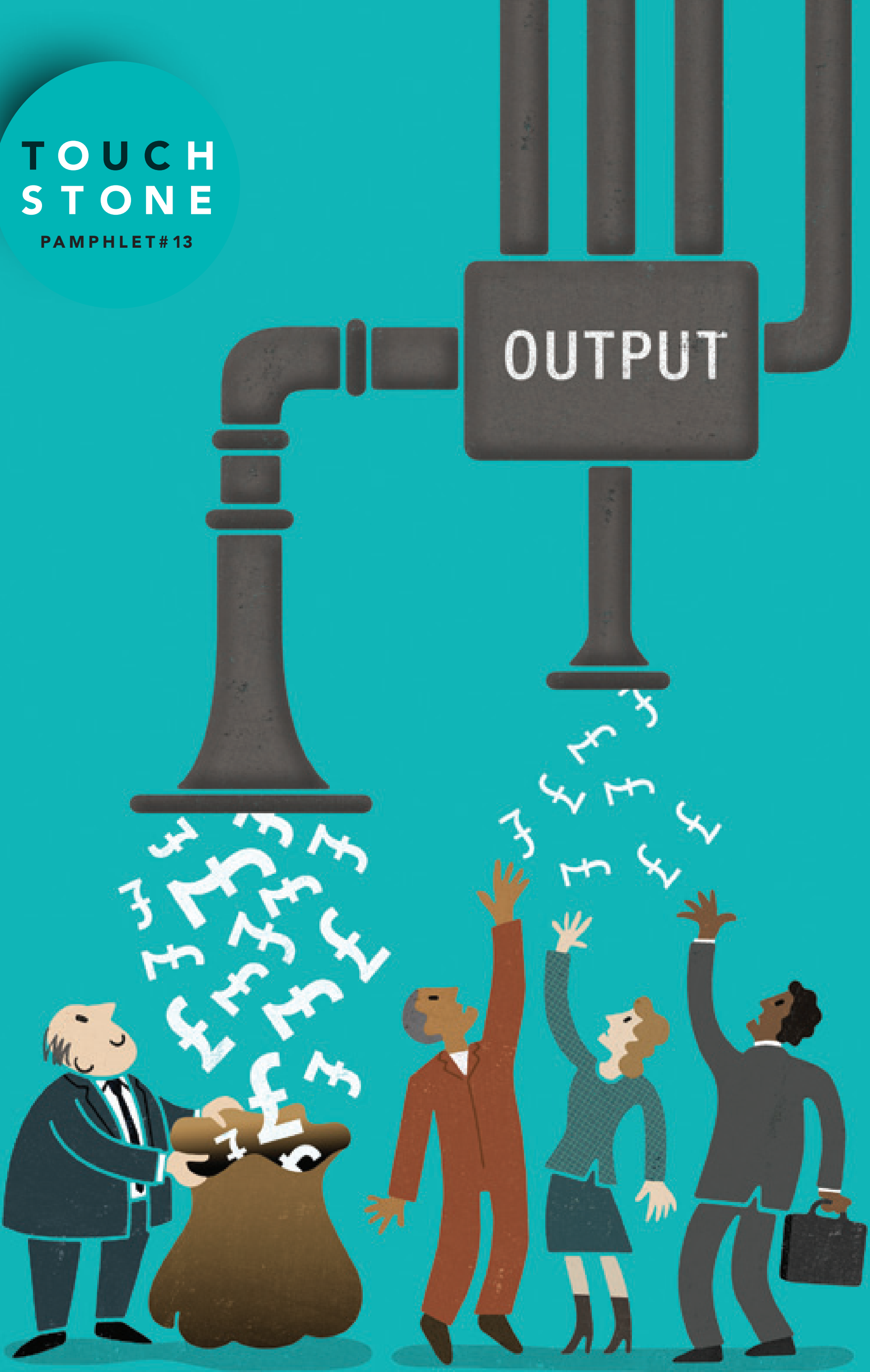

How to Boost the Wage Share

"Capitalism may not have it quite so easy in the next phase of capitalism. Going forward … labour will fight back to take its proper (normal) share of the national cake, squeezing profits on a secular basis."

Albert Edwards, Société Générale, 2011 (quoted in Pollack, 2011).

"I believe that the economics profession and the policy community have downplayed inequality for too long … Now all of us have a better understanding that a more equal distribution of income allows for more economic stability, more sustained economic growth, and healthier societies."

Christine Lagarde, Head of IMF, 25 January, 2013

Increasing the wage share is one of the key economic policy challenges for the next decade. A rising wage share will underpin higher living standards and allow growth that is more sustainable and not reliant on consumer debt. This study looks at what practical steps policy makers could take from raising the minimum wage through to an active industrial policy in order to boost wages.

About the authors

Stewart Lansley is a visiting fellow at Bristol University and has published widely on the issue of the relationship between inequality and economic performance. His recent books include *The Cost of Inequality*, Gibson Square, 2011, and *Rich Britain*, Politico's, 2006. He has also written several TUC Touchstone Pamphlets and Extras including *All In This Together* and *Unfair to Middling*.

Howard Reed is Director of the economic research consultancy Landman Economics, which specialises in complex econometric modelling work and policy analysis. His recent projects include *Where the Money Goes* (with Tim Horton of the Fabian Society), funded by the TUC and UNISON, which looked at the distributional impacts of the spending cuts announced by the coalition government in the 2010 spending review, and a previous Touchstone report *Fairness and Prosperity*, which looked at the potential for a more equal distribution of income to improve the UK's economic performance.

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Contents

Foreword

by Frances O'Grady, TUC General Secretary

British workers are experiencing the longest fall in real wages since the 1870s. Prices have been rising faster than earnings since 2010. People in work are thousands of pounds a year worse off as a result. Whatever statistic is seized on to tell us the recovery has begun, this does not feel like an economic recovery. Rather we seem stuck in a prolonged living standards crisis.

But the great wage squeeze is nothing new. It began well before the crash. Wages for average workers stagnated between 2003 and 2008 – and that was when the economy grew by more than ten per cent. The share of national income paid out as wages has been falling for three decades. And we should never forget that in the years before the crash, households were encouraged to borrow to keep up their living standards. This not only contributed to a big build up in household debt that helped cause the crash, but has also made recovery so difficult ever since.

It is good to see that politicians of all parties are now talking about the need to relieve the squeeze on living standards.This pamphlet provides an outline of the policies needed to do that. It may not work as a phrase on the doorstep but 'practical predistribution' is what we need. And to make it work collective bargaining must be at its core.

Stewart Lansley and Howard Reed show how a number of medium term policies can start to deliver. A more generous minimum wage, an increase in the coverage of the living wage, an extension of collective bargaining through new modern wages councils and a reduction in unemployment can all boost the wage share. But they are right to say that reversing a three decade trend cannot be done overnight. Paying many people more to do the jobs that they currently do can make a start, but we also need to rebuild and rebalance our economy to create many more high skill, high wage jobs using all the tools of industrial policy and active government.

A minimum wage was a major advance for the UK. But while we certainly need to do more to boost the wage floor, we also need to secure fairer and better pay for those in the middle. For too many years public policy has only been concerned about those at the bottom, with an unspoken assumption that keeping wages down for everyone else was almost always a good idea. But while employers might want to strike a tough bargain with their own workforce, it is just as much in their interests to have customers with money to spend. Wage led growth is central to a long-term recovery.

Britain needs a pay rise, and this pamphlet starts an important discussion about it can be delivered.

Executive summary

For the last 30 years the British economy has seen a steady shift in the way national income has been distributed, away from wages and in favour of profits. Most of the resulting fall in the 'wage share' has been borne by those in the bottom half of the wage distribution. Although there have been similar falls in the 'lower half wage share' in a majority of rich nations, this has not been universal and has been especially sharp in the UK.

Although external factors, such as globalisation and technological change, have played a part, the sustained fall in the wage share is mainly the result of a series of domestic policies, notably the weakening bargaining power of labour and the increasing role played by the finance sector in the economy resulting from the de-regulation of this sector in the 1980s.

This fall has fitted the pro-market economic orthodoxy of the last three decades and has been justified across the political spectrum as necessary to increase profitability, investment and innovation and thereby improve Britain's economic performance. This pamphlet produces new evidence that the orthodoxy is wrong, that in fact, the falling wage and rising profit share has been associated with a weaker economic performance: notably, declining investment and innovation, and lower growth. Indeed, the evidence suggests that maintaining the wage share at the level of the late 1970s would have been associated with a higher growth rate.

The pamphlet also draws on a growing body of evidence to show that the growing imbalance in the distribution of output was a significant contributory factor in the 2008 Crash and the subsequent prolonged and increasingly intractable crisis.

The evidence is growing that reversing the downward trend of the past 30 years and securing a higher wage share is a necessary condition for sustainable recovery. The pamphlet examines a number of medium- to long-term measures – a slightly more generous minimum wage, an increase in the number being paid the living wage, an extension of collective bargaining, and a reduction in unemployment – for how this could be achieved. As well as closing the pay gap between top and bottom, we show that these measures would also close around a quarter of the 'wage gap'- the difference between the current 2011 wage share (53.7 per cent) and the 1980 share (59.2 per cent) – which currently stands at around 5.5 per cent.

A further closing of the gap would require a more active industrial strategy aimed at rebalancing the economy towards sectors that can support higher-waged employment.

Introduction: the long squeeze on living standards

Over the last six decades, the course of living standards for those of working age in the UK has gone through two contrasting phases. In the first, from the end of the Second World War to the mid-1970s, real living standards across society rose broadly in line with rising prosperity. Indeed, with low and middle income households gaining slightly more from growth than high income households, inequality fell (Atkinson, 1983, ch 4; Alvaredo, et al, 2012).

During the second phase, from the early 1980s to today, living standards for most of the workforce became progressively detached from growth and inequality rose. This is because the gains from a growing economy became increasingly unevenly divided in favour of a small group at the top, leaving significant sections of the population (roughly the bottom three-fifths) lagging behind the average rise in prosperity, and at an accelerating rate.

Between the mid-1980s and the early 2000s, living standards for those in the middle of the income distribution (the median) were rising at about 70 per cent of the rate of growth. From 2003 to 2008, despite GDP growth of 11 per cent, median incomes stagnated (Resolution Foundation, 2012). Then from 2009, median household incomes began to decline in real terms. The Office for National Statistics (ONS) has shown that between the first quarter of 2009 and the second quarter of 2012 net national income per head – 'the preferred measure of income in terms of economic well-being' – fell by 13.1 per cent (Carolan et al, 2012).[1]

These typical trends from the early 1980s hide wide variations across the income distribution. Living standards amongst lower income households have lagged even further behind the median while households in the top one per cent have seen their incomes rise much more quickly. It is this uneven division of the gains from growth that has driven the growing divide of the last 30 years.

The downward trend in real household incomes for most – but especially those on low incomes – is also predicted to continue until at least the end of 2013 before they begin a slow recovery. The Resolution Foundation (2012) forecasts "A typical low income household in 2020 is set to have an income 15 per cent lower than an equivalent household in 2008".

A number of factors affect the course of living standards. They include changes in the pattern and level of employment, state benefits and taxes, the rate of inflation and changing pay levels. Although each of these is important, this pamphlet will concentrate on what has been happening to market incomes, before the application of taxes and benefits, and more specifically, the role of wages and salaries. In the UK, these account for almost four-fifths of gross household income for those of working age. Moreover, wage levels – and their distribution across the population – are not just a vital determinant of living standards; they also have a big impact on the way the economy functions. It is this latter effect that this pamphlet examines.

Two main factors determine the level of wages received by individual members of the workforce. First, the way the output of the economy is distributed – between wages on the one hand and profits on the other. Secondly the way the total wage pool is divided between individuals – the distribution of earnings. Both factors – the division and trends in what economists call 'factor shares' *and* the way wages are divided – not only help to determine the level and course of living standards; they also have a critical, but often ignored, impact on economic health.

The structure of this report is as follows.

- Chapter 1 examines the course of the wage share since the Second World War and looks at changes in the distribution of pay over the same period, both for the UK and other rich nations.
- Chapter 2 summarises the main evidence on the causes of these shifts.
- Chapter 3 looks at the evidence on the impact of the falling wage share (and rising inequality) on economic performance, including investment and productivity and growth.
- Chapter 4 examines the relationship between a falling wage share, growth and economic stability.
- Chapter 5 looks at the extent to which a new social contract with labour, including higher wages, stronger bargaining power and lower unemployment, could raise the wage share and narrow the dispersion of earnings.

1. What has been happening to wages?

This section charts what has been happening to wages – both the wage share and its distribution – in the UK and across the rich world over the last 30–40 years.

Trends in the wage share

The decoupling of earnings from output is not a phenomenon unique to the UK but has occurred in a majority of rich nations, though to varying degrees. From 1990 to 2009, the median wage share across all OECD nations (the 34 member club of the world's most economically advanced countries) fell from 66.1 per cent to 61.7 per cent (OECD, 2012a, p 113; Bassanini and Manfredi, 2012) though there were large variations across countries. Table 1, for example, shows large falls in Australia, the UK and Sweden. Nevertheless, some countries, notably Denmark and Japan, were able to buck the trend, showing that wage falls have not been inevitable.

Table 1: The wage share in ten advanced economies, 1970–2007

	Wage share (% of GDP)		Change
Country	1970	2007	
Australia	60	53	-7.1
UK	65	60	-5.3
Sweden	66	61	-4.9
Canada	59	55	-3.8
Germany	59	55	-3.7
USA	64	60	-3.1
France	56	57	+0.9
Finland	55	56	+1.0
Denmark	59	65	+6.1
Japan	41	49	+8.2

Source: Reed and Mohun Himmelweit, 2012; based on OECD data as presented by Bailey et al (2011)

Measuring changes in the wage share is not in fact straightforward and there are a number of conceptual issues which require clarification. Researchers have made adjustments to the base figures shown in table 1 for several factors, some of which have led to a sharper drop in the wage share and some a shallower drop, while slightly changing the pattern across countries.[2]

Take the case of the impact of the increasing share of wages going to top corporate executives and financiers. If these were, more accurately, attributed to profits, and excluded from the base 'wage share' figures, there would be a sharper fall in the wage share (Lansley, 2011, p 52). The OECD (2012a, Box 3.1, p 115) has made a calculation of the size of the wage share accruing to the bottom 99 per cent of earners (after deducting the top one per cent). Because the share accruing to the very top earners has been rising in most countries since the 1970s, mostly sharply, these adjustments show a larger drop in the wage share especially in countries like the US and Canada where the rise in the top one per cent has been especially sharp. The OECD has not made this calculation for the UK, but it would follow a similar pattern.

Figure 1 shows that the wage share in the UK averaged 59 per cent of Gross Domestic Product in the 1950s and 1960s.[3] It then peaked (at 65.5 per cent) in 1975 during the era of 'the profits squeeze' before falling to 53 per cent by 2007. The share rose slightly during the height of the downturn to stand at 55 per cent in 2009. There were similar small rises in several other countries following the Crash. This is because at least initially, the response of employment to GDP contraction in several countries was moderate with many firms opting to retain staff, thereby temporarily raising the wage share. However, this small rise has proved a temporary phenomenon with the wage share shrinking again in 2010 and 2011. At 53.7 per cent in 2011 it is now back to where it was before the Crash. As the OECD (2012a) has predicted, given the weakness of current real earnings growth, it is likely that there will be further slippage in 2012 and 2013.

Figure 1: The falling wage share, UK, 1948–2011

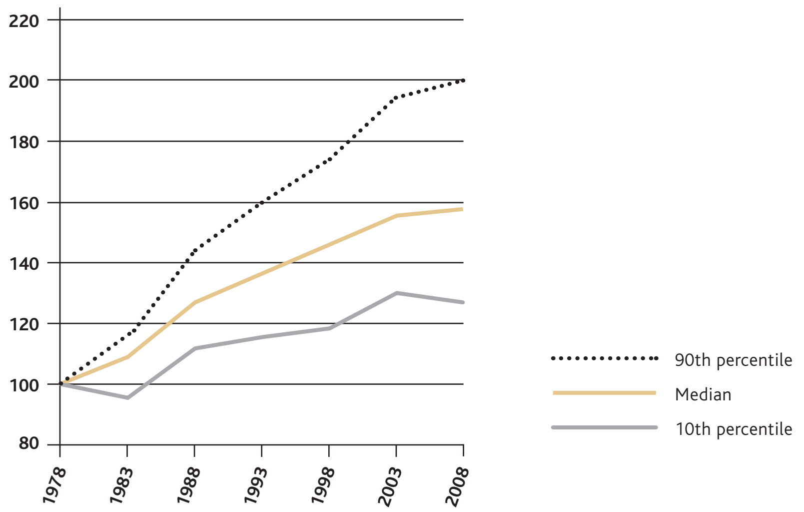
Note: This graph is based on Office for National Statistics national accounting data and gives a slightly different result than the trend shown in table 1 based on OECD data, although the broad trend is the same.

Trends in the wage share

The falling wage share only tells part of the story about wages and understates the full scale of the wage squeeze faced by the bulk of the workforce since the 1970s. This is because the decline in the overall wage share hides significant differences across earning groups, with the wage distribution since the early 1980s becoming much more unequal.

Figure 2 shows how earnings (for full-time males) have become increasingly concentrated at the top in the last thirty years with *real* gross earnings rising much more quickly at the top than in the middle and at the bottom.

Figure 2: How earnings have become more unequal over the last 30 years: UK index of gross weekly real earnings, full-time males, 1978 to 2008 (1978 = 100)

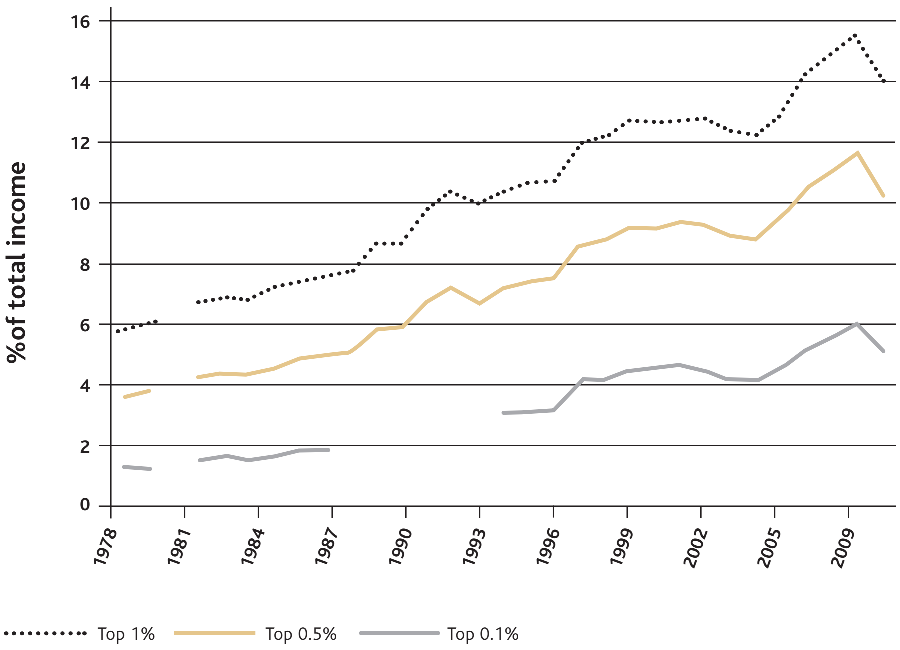


Source: Lansley, 2011, p 53.

Notes: Annual Survey of Hours and Earnings (for 1997–2008) and New Earnings Survey (for 1978 to 1996). The earnings figures have been adjusted for changes in the retail price index. The NES covers GB and ASHE covers the UK. There has been a similar, though less extreme, rise in the dispersion of wages over the period among women.

The economic policies of the last three decades have led to the emergence of a broadly three-speed wage economy in the UK. Leading the race in the super-track of earnings growth has been a small group of financiers, bankers and company executives – a small subgroup of the top one per cent – with pay rising more sharply than the top decile and the economy itself (see figure 3). earning below the median wage) own their home with a mortgage. Mortgagees also comprise 9 per cent of those who are classified as benefit-dependent by the Resolution Foundation (this definition encompasses all households with an income below £11,650). With 7.2 million households classified by the Foundation as low-earner households, this implies that there are just over two million low-earner, owner-occupied households.

Figure 3: Share of income accruing to top 1, top 0.5 and top 0.1%, UK, 1978 – 2009



Source: Lansley, 2011, p 53.

Secondly, a broad and expanding group of professionals outside of the corporate and City super-elite working in areas such as the law, accountancy and medicine. Below these two groups sits the rest of the working population which has ended up in the slow lane of earnings growth, with earnings that have fallen increasingly behind the growth of the economy.

Similar trends have occurred in most – though not all – developed nations. The distribution of market incomes (gross wages, income from self-employment, capital income, and returns from savings taken together) widened in almost all OECD countries between the mid-1980s and mid-2000s, though again to varying degrees, with some countries showing only minor change (OECD, 2008).

As a result, the falling wage share has not been evenly distributed across the earnings range but has been borne almost entirely by middle and lower paid employees. The bottom 60 per cent of earners in the UK – and in a number of other rich nations – have therefore been experiencing a sustained double-edged squeeze, a shrinking share of a diminishing relative wage pool. As the Resolution Foundation (2012, p16) has found, 'Only 12p of every pound of UK GDP goes to wages in the bottom half, down 25 per cent in the last three decades'. Throughout, we refer to the proportion of national output accruing to the lower half of the distribution as the 'lower half wage share'. It is the widening dispersion that is the primary explanation for the falling 'lower half wage share' in the UK. Just over a third of the decline in average wages relative to GDP is accounted for by the overall fall in the wage share, with the rest being accounted for by the growing pay gap (Reed and Mohun Hemmelweit, 2012, p 11).

There are two main explanations for the overall fall in wage shares. First, because of industrial change leading to a long-term shift in the type of jobs available. Second, because of a slowing down in the rate of growth of wages in many occupations compared with the economy. As shown in the final section, both factors have been at work over the last thirty years. There has been both a shift away from sectors with a higher wage share and a stretching of the pay gap within industries and occupations. One study, for example, has found that earnings in a range of low-paid manual and unskilled jobs in 1978 – from heavy goods vehicle drivers to factory packers and bottlers – rose much

2. What accounts for these trends?

Economists have attributed the falling 'lower half wage share' to a number of factors. The most important of these are:

- technological change
- globalisation (increased liberalisation of product markets and increased mobility of capital across national boundaries)
- financialisation (the increased role of financial activity and rising prominence of financial institutions in national economies)
- reductions in the bargaining power of labour
- the rising level of unemployment.

Academic economists (at least those working in the orthodox, neoclassical tradition), and those working for the IMF and the OECD, have attributed the rising earnings gap and the falling wage share mostly to a mix of globalisation and technological change. The opening of borders, it is argued, has led to a shift of jobs from mature to developing economies and brought downward pressure on wages in developed economies. The emergence of global markets has made labour much more plentiful internationally, strengthening the bargaining power of domestic employers. By increasing the demand for skilled workers and depressing it for those without, technological progress will also have fuelled a rising gap.

Several studies (IMF, 2007, chapter 4; European Commission, 2007; van Reenen, 2011) have claimed that technological change has been a key cause of changes in functional income distribution and the prolonged wage squeeze and that globalisation (of trade and production) has also played an important role. In *Divided We Stand*, the OECD (2011) found that globalisation had little impact on wage inequality, while technological change was the principal explanation.

Other studies have questioned the importance played by globalisation and technological change (Reed and Mohun Hemmelweit, 2012). Indeed, all advanced economies have faced these external pressures but their impact has been very different across countries, suggesting that other institutional and political factors have been at work.

The Washington-based Centre for Economic and Policy Research (Rosnick and Baker, 2012) argues that the OECD has overstated the role of technology in driving the growth of inequality. Instead, CEPR finds 'the impact of technology to be negligible'. This is because the OECD analysis only examined trends across countries in the gap between the 90th and the 10th percentile, thus 'overlooking the fact that the vast majority of the gains from rising inequality went to workers at the 99th and 99.9th percentiles.' In contrast, the CEPR study found that when the top of the distribution is included, the key explanation for the growing gap has been the growth of the financial sector in recent decades, with 'earnings in the sector coming at the expense of the rest of the economy, contributing to the relative decline in income for less highly paid workers.'

This finding is supported by other independent studies which pinpoint *financialisation* – an increased role of financial activity and rising prominence of financial institutions in national economies – as a key driver of the upward concentration of income and thus of falling wage shares at the bottom (Ertürk et al , 2008; Stockhammer, 2010 and 2012; Lansley, 2011). As shown in the next section, most of the increase in the concentration of income at the top is explained by rising incomes in finance.

Changes in the role of labour market institutions – through a sharp decline in the level of trade union membership and the extent of collective bargaining – have also played an important role. Over the last 30 years, trade union membership has fallen much more steeply in some countries than others. In the US it fell from 26.7 per cent in 1978 to 13.1 per cent by 2011, with a more significant fall amongst blue-collar and high-school educated workers (Mishel et al p 267). The UK, where membership has also halved over the last thirty years, now stands in 21st place out of 27 countries in the European Union in terms of workplace employee representation. In 2009, only 18 per cent of private sector employees were members of a union (Bryson et al, 2012).

While the OECD has found no correlation between the wage share and collective bargaining coverage, other studies have concluded that trade union membership has been an important determinant of both wage levels and wage inequality, especially in explaining a widening gap in the bottom half of the wage distribution.

These have found that unionised workers enjoyed a wage premium (defined as the percentage difference in average hourly earnings of union members compared with non-members) of the order of 10 per cent in the UK in the 1980s and 1990s. That figure has been falling since the 1990s as it has in other countries, and in 2009 has been estimated at 5 to 6 per cent. While the advantages of unions in raising the overall rate of pay has been declining, the evidence is that unions continue to have a 'sword of justice' effect in compressing pay differentials (Bryson and Forth, 2012). The UK's Department for Business, Information and Skills confirms that the union wage premium is significant but has been declining and finds that it is twice as high in the public as the private sector (Brownlie, 2012).

In the United States, the union premium has been estimated at 13.6 per cent overall. In addition unions reduce wage inequality because they raise wages more at the bottom and in the middle than at the top. The halving of unionisation levels has resulted in a rise in the gap between more lowly and more highly educated workers. In 1978 unionisation narrowed the pay gap between blue-collar and white-collar workers by 11.3 percentage points, a figure that had fallen to 3.6 points by 2010 (Mishel et al, 2012, p 267–271). Unions also improve pay and working conditions for the broader workforce as union compensation norms and workplace practices become more generalised. The same study found that 'declining unionization accounted for about a third of the growth of male wage inequality and a fifth of the growth of female wage inequality between 1973 and 2007. Further, unions provide a political check on excessive managerial pay' (Mishel et al , 2012 p 44).

Establishing causation is vital to the correct policy response. Each of the various explanations for the falling wage share have very different policy implications. Some, especially largely external, factors – such as globalisation and technological advance – are much less susceptible to policy change, at least at a national level, than others.

Indeed, in emphasising the role of technological change, the OECD comes to an important policy conclusion: 'While a weakening of workers' bargaining power may be partly responsible, new analysis by the OECD indicates that the main factors that are causing the broad trend towards a declining wage share, such as globalisation and ICT-driven technological change, are also important drivers of overall economic growth.' For this reason, the OECD goes on to argue that 'It is not clear that governments should try to reverse the decline in the labour share.' Instead they argue that 'Well-designed tax-transfer policies and especially policies to promote human capital and employability of the low-skilled can go a long way to ensure that the benefits of growth are more widely shared' (OECD, 2012c).

This is in line with the OECD's long-held support – expressed most strongly in its influential 1994 Jobs Study (1994) – for the deregulation of labour markets. The organisation has long been extolling the virtues of flexible labour markets (code for weakening rights and enfeebling trade unions) on its member states, thus contributing to the process of poorer labour protection followed in many rich countries (though it has in fact toned down – though not abandoned – its support for labour deregulation in most of its recent work, as summarised in Reed, 2010).

However, since labour market deregulation has been one of the key causes of the rise of inequality, it is a line of argument increasingly at odds with more recent output by the OECD. Indeed, the organisation has produced two influential reports on the problems associated with rising inequality – *Growing Unequal* and *Divided We Stand* (OECD, 2008, 2011). In addition its latest *Employment Outlook* warns not only that 'the unequal distribution of both labour and capital income growth that went hand-in-hand with the decline of the labour share might endanger social cohesion', but that 'the shift of income away from labour (and, in particular, away from low-wage workers) towards capital (and top earners) might also have a negative impact on aggregate demand, to the extent that workers with below average pay tend to have a higher consumption propensity than do top earners and capitalists' (OECD, 2012, p110).

The organisation attempts to square this circle by arguing that the solution to the declining wage share lies in a mix of better education (as a means to enable more workers to move into better jobs) and the use of the tax/benefit system (as a means to offset the unequal distribution of wages). While these are both important, the evidence is that they are only a partial solution. They fail to recognise that the very labour market reforms promoted by the OECD have been a major contributing factor to the rising income gap. They also only partially embrace the emerging debate about the role to be played by 'predistribution' – the attempt to reduce the gross wage gap before the application of taxes and benefits.

The overall weight of evidence suggests that the OECD and other global institutions have overstated the role of factors like technology and understated the importance of other factors such as the level of financialisation and collective bargaining. If this evidence is correct, the policy response needs to concentrate on raising the level of collective bargaining and limiting the role played by financial institutions, as well as wider measures to raise the wage share and reduce rates of pay inequality.

3. The economic impact of the long wage squeeze

While part of the long wage squeeze since the early 1980s can be attributed to global and national economic changes that have been independent of government, the overriding explanation is to be found in the shift during the 1980s away from the dominant post-war model of managed capitalism to a much more deregulated model. This shift – one that had its roots in the severe global stagflation crisis of the 1970s – aimed to reduce the role of state intervention and give more freedom for markets, a change that fuelled many of the wider economic changes – from financialisation to the weakening of collective bargaining – of the next 30 years.

Central to the ideas that underpinned this shift, one that started in the UK and the US, was the belief that the egalitarian drive of the 1950s and 1960s had gone too far and had become a drag on economic dynamism. Wages in industrialised countries, it was claimed, were too high, driven upwards by over-powerful unions, and had led to a dangerous squeeze on profits and corporate investment. According to this theory – for theory it was – the rich should also be allowed to get richer: improved rewards at the top would correct for the failings of post-war welfare capitalism, lift Britain out of its tepid entrepreneurial culture and bring renewed economic dynamism. Increasing the share of output going to profits would lead to a rising level of investment (and exports), a more dynamic and faster growing economy and higher levels of employment.

This argument drew on several quite separate, but influential strands of thought. First, a group of New Right thinkers wedded to the virtues of free markets. As the Austrian-born but New York-based economist, Ludwig von Mises, wrote in 1955: 'Inequality of wealth and incomes is the cause of the masses' well being, not the cause of anybody's distress.... Where there is a lower degree of inequality, there is necessarily a lower standard of living of the masses' (von Mises, 1955). Although greater reliance on markets would mean the wealth gap might grow, all citizens would still be better off through an expanded economic cake.

Similar arguments were later employed by the leading economist of the 'Chicago school' of neoclassical economics, Milton Friedman (1982, p 133), though he expressed it slightly differently. "Few trends could so thoroughly undermine the very foundations of 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." These ideas gelled with the thinking of Mrs Thatcher's closest advisers, among them Sir Keith Joseph, her Education Secretary and founder in 1974 of the Centre for Policy Studies, committed to free-market Conservatism. As he wrote in one of the Centre's first pamphlets, *Stranded in the Middle Ground?*, published in 1976: "Making the rich poorer does not make the poor richer, but it does make the state stronger … The pursuit of income equality will turn this country into a totalitarian slum."

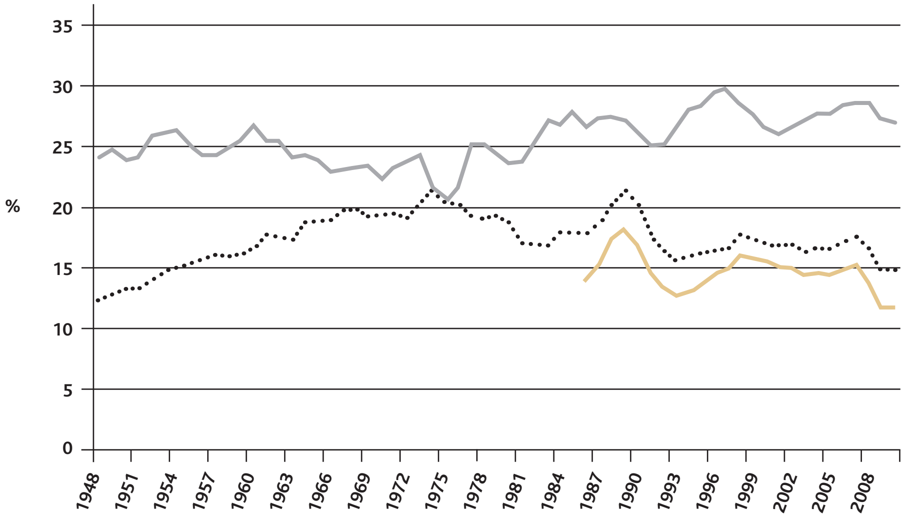
A further strand of thought came from mainstream economists associated with the centre-left rather than the right of the political spectrum. In 1975, in *Equality and Efficiency: the Big Trade Off*, the influential American economist Arthur Okun argued that you could have more equal or more efficient economies but not both. This was because the social welfare costs of redistribution would lead to reduced efficiency, and allowing inequality to rise was thus a necessary condition for economic success. This became the standard 'equity-efficiency trade-off' theory which is still taught to undergraduate economics students today.

These views were embraced by both Margaret Thatcher and Ronald Reagan in their attempts to remodel the British and American economies throughout the 1980s. During this decade both countries embarked on a process of deregulation, the downgrading of the role of collective bargaining and the empowering of the financial sector. Parallel to the building of a quite different model of capitalism – one which began in the US and the UK, but eventually spread, if in mostly weaker forms, to a number of other countries – was the development of a new system of economic thought built around the idea of efficient and self-regulating markets that required minimal state involvement to work properly.

So, just how effective has this strategy been? Has the new model of de-regulated capitalism delivered its promise of higher achieving economies? Has the falling wage-share helped boost growth and productivity, investment, enterprise and employment? Is the cake bigger than it would otherwise have been?

In one sense, the strategy has been highly successful. The counterpart of these downward trends in the wage share has been a steady rise in the profit share in most countries. As shown in figure 4 for the UK, the profit share ('operating surplus') was higher in the post-1980 than the pre-1970 period.

Figure 4: Profit share and investment, UK, 1948–2010



Note: The red line from 1948 shows total investment (public and private). The blue line shows private sector investment (this is not broken down before 1985) which closely tracks the total figure.

Source: Reed and Mohun Himmelweit, 2012.

This rise in the profit share, however, has not been evenly spread across different business sectors. The whole of the upward trend in the profit share over the last thirty years is attributable to the increased profitability of the financial sector. Thus the share of total UK profits accounted for by financial sector firms increased dramatically from around one per cent in the 1950s and 1960s to around 15 per cent in the years 2008 to 2010. There has been a similar pattern in several other countries, notably the US (Reed and Mohun Himmelweit , 2012; Lansley, 2011).

However, the rise in the profit share has not been associated with an improved economic performance in the UK. A study of the comparative economic record of the post-war era and the post-1980s shows that on all counts bar one – that of reducing inflation – the post-war period was superior. Growth and productivity rates have been growing at two-thirds of the average rate achieved in the 1950s and 1960s. Unemployment has been consistently higher. Recessions have become deeper and longer (Lansley, 2011, ch 6).

Moreover, the fall in the wage share since the early 1980s has been associated with a slowing of the global growth rate over the last 30 years compared with the post-war decade, across most of the developed world. In contrast, large parts of the developing world, notably China and India, have experienced faster growth (Onaran and Galanis, 2012, Appendix, tables 1a and 1b).

Part of the reason for the weakening growth in the UK is that the corporate sector has not responded in the way predicted by the theory. Both investment levels –

gross fixed capital formation (the standard measure of company investment in the national accounts) – and R&D spending have been lower, on average, since 1980 than in the immediate post-war decades. As figure 4 shows, the rise in the profit share since the mid-1970s has been associated with a fall in the level of investment. While the profit share increased from around 25 per cent in the 1950s and 1960s to around 30 per cent of GDP from 1980, gross fixed capital formation fell from around 20 per cent to 15 per cent over the same period. There is a similar negative relationship when it comes to business spending on R & D which has been falling as a proportion of GDP since the 1980s while the wage share has been rising.

This raises a key issue: if increased profits have not been funneled into increased investment or research and development, where have they been going? The explanation lies in the rising importance of the financial services sector – a mix of investment banks, private equity houses, hedge funds and wealth management companies – in the economy, and where nearly all of the increase in the profit share has been captured. Here, growing profits have been used in two main ways.

First, to source the growth of remuneration packages for directors, financiers and executives in finance and parts of the corporate sector. Most of the increase in the concentration of income over the last 30 years is accounted for by the pay explosion amongst a small group of financiers, bankers and corporate executives (Bell and van Reenen, 2010). In the decade to 2008, three-quarters of the increase in income concentration amongst the top one per cent went to finance workers, virtually all of it in bonuses.

This is also true of the United States where it was Wall Street that drove the growing income concentration at the top. In 2004, for instance, non-financial executives of publicly traded companies accounted for less than 6 per cent of the top 0.01 percent income bracket. In that same year, the top 25 hedge fund managers combined appear to have earned more than all of the CEOs from the entire S&P 500. The number of Wall Street investors earning more than $100 million a year was nine times higher than the public company executives earning that amount' (Cowen, 2010; see also Kaplin and Rauh, 2010).

Secondly, growing profits came to be increasingly used to help fuel a boom in corporate and financial restructuring, notably through a surge in mergers and acquisitions and private equity activity and an avalanche of lucrative financial deal-making. It was this activity that became the principal route to the accumulation of mass personal fortunes on both sides of the Atlantic (Lansley, 2011, chapters 9–10).

In the US, the total value of acquisition activity had reached over $2 trillion by 2000, more than 40 times its 1980 value. These deals included the acquisition of Warner Lambert by Pfizer in 1999 to form the world's fastest growing drug company and the $180 billion takeover of Time Warner, the world's top media conglomerate, by the US's largest internet service provider, AOL, a year later.

The total value of UK merger and acquisitions deals rose sharply in the opening years of the twenty first century, most of them hostile (ONS, 2012). Some of the largest deals include the bitterly fought and titanic £112 billion Vodafone takeover of Mannesman in 2000, the Glaxo Wellcome takeover of SmithKline

Beecham in the same year and the equally controversial RBS $100 billion takeover of the Dutch bank, ABM Amro, in 2007. It is a similar story with private equity, with more than a fifth of the UK workforce now employed by companies owned by private equity houses, a sharp increase over the 1970s.

The evidence is that while the architects of these schemes walked away with huge fees and bonuses, the impact on the productive base of the surge in financial engineering has often been negative. Many private equity and merger deals have proved to be very bad news for the companies concerned as well as the staff. Accumulated surpluses that might have financed a rise of spending on infrastructure and new enterprise has instead been used to finance the post-millennium property and takeover boom along with the purchase of financial instruments and a very mixed bag of financial activity, much of which increased the fragility of the financial system. From the 1990s, such short-term deal-making activity delivered much higher cash returns for much lower immediate risk than could be obtained by providing long-term capital for new plants, business development or designing new products (CRESC, 2009; NEF, 2010).

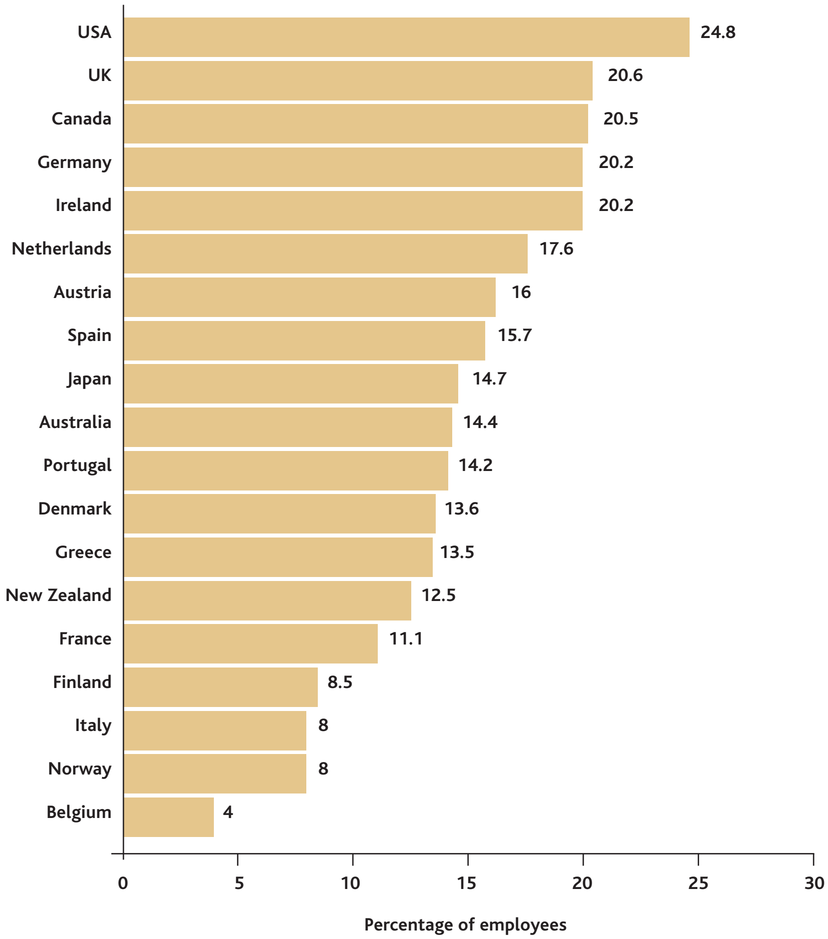
Here there has been another factor at work preventing rising profits from feeding an improvement in the rate of investment and innovation. The American political scientist, Jacob Hacker, has argued that there is what he calls an 'upside-down U-shaped relationship' between inequality and positive outcomes. 'A certain level of inequality, a certain level of risk, can have positive effects, motivating people. But at a certain point it becomes counterproductive.' Above a certain level of inequality, 'a lot of people do not have the resources necessary to really break into the upper tier and fund new ideas. You also might worry that when inequality is too great, you're getting hoarding of resources at the top, and credit markets perhaps aren't working to make sure that the finances are available for the broad economy' (Shiller and Hacker, 2011).

Other studies have also found a clear positive correlation between the extent of equality and the degree of *innovation* (as measured by the number of patents per head of population) (Wilkinson and Pickett, 2010). As innovation is seen as a key determinant of the rate of economic growth by most economists, a higher level of innovation in more equal countries would fly in the face of the conventional orthodoxy. Recent work (Lundvall, 2006; Arundel *et al* 2007) suggests that the 'social distance' between workers in different professions and disciplines and at different levels of the company hierarchy in workplaces may be an important determinant of the capacity of firms to innovate. Economies with larger degrees of 'social distance' between different sections of the workforce may find it hard to be innovative because the complementarities between people in the workplace with different skills and knowledge bases are not fully exploited.

If these findings are correct, then a move towards greater equality which puts workers and managers in UK workplaces on a more equal footing – for example, greater participation by the workforce in decision-making processes – could facilitate more innovation and higher growth. 'Furthermore, to the extent that inequalities of pay and status between managers and workers in firms increase, this could actually have a negative impact on firm performance because it creates greater social distance between different parts of the workforce, and hence less innovation' (Reed, 2011, p15).

While the rising profit-share has not been associated with investment-boosting activity, its counterpart, the falling wage share, has been associated with two highly negative consequences for the wider economy. First, with a near-doubling of the proportion of the UK workforce on low pay (those below two-thirds of median earnings), figure 5 shows that the UK now has the second highest level of low pay (20.6 per cent) amongst leading economies, behind the US (24.8 per cent) and close to Canada (20.5 per cent) and Germany (20.2 per cent).

Figure 5: Share of employees in low-wage work, 2009



Source: Schmidt, 2012

Note: Low pay is defined as those below two-thirds of the median

Second, the spread of low pay has led to an increase in public spending to pay for a rise in in-work benefit and tax credit payments for the low paid, without which there would have been an even bigger hike in poverty.

4. The falling wage share, instability and the question of distribution

One of the most important – and controversial – issues arising out of the falling wage and rising profit share has been its impact, if any, on growth, stability and the current crisis. For the last 30 years the issue of 'factor shares' has been largely ignored in the management of most major economies and in the macro-economic literature explaining longer term economic trends and has not been used as a critical variable in economic modelling.

The implicit argument of the dominant neo-classical school is that the higher the profit share and the lower the wage share the better, and issues of distribution and redistribution have been treated largely as a dangerous irrelevance when it comes to growth, efficiency and the boom bust cycle. As the Chicago economist Robert E Lucas, Nobel prizewinner and one of the principal architects of the pro-market, self-regulating school that dominates economic strategy in the Anglo-Saxon world, put it in 2003: 'Of the tendencies that are harmful to sound economics, the most poisonous is to focus on questions of distribution' (Lucas, 2004).

The main 'freshwater' view associated with neoclassical economics is the 'real business cycle' model promoted by macroeconomists like Edward Prescott (Kydland and Prescott, 1982). This extreme version of neoclassical theory sees factor shares as an irrelevance largely because of its assumption that economic growth is determined by technological considerations, with markets (including the labour market) always 'clearing' (in the sense that there is neither excess supply nor demand in the labour market and the economy is always in equilibrium at full employment, provided wages are allowed to be freely determined in the market). Proponents of this view do not regard the level of wages relative to profits, and the distribution of wages, as factors relevant to macroeconomic modelling.

Other neoclassical economists operating in the tradition of older 'New Right' theorists like Milton Friedman have tended to view a high wage share as actively bad rather than irrelevant because high wages are seen as 'crowding out' profits – and (the argument goes), since investment is financed from profits, investment must go down if wages go up. But this is only true in an extremely simplistic model with a single time period, and no borrowing or stock markets. In reality there is no strict identity between profits and investment even in the short run, because firms can secure funds for investment through borrowing or issuing equity.

In the long run, it is entirely possible that higher wages can drive higher profits rather than crowding them out. Over time, the capacity of the economy can expand through economic growth, which is driven by investment and innovation. If higher wages lead to an increase in demand for goods and services it is entirely plausible that this can lead to an increase in investment which helps drive growth, which in turn leads to higher wages – in other words, a 'virtuous circle' rather than a trade-off. Below we present some evidence that this effect may have been operating to boost growth in the early post-war decades when the wage share was higher than it is now.

Since the 2008 crash, however, both of these neoclassical positions have run into trouble. As in the 1930s, persistent economic stagnation and high unemployment mean that the 'real business cycle' perspective is increasingly out of favour as it seems unable to explain the slump. At the same time, a growing number of economists – in both the US and the UK – have come to question the conventional view, arguing that getting the distribution question right is critical to both growth and economic harmony. An excessive imbalance in wage and profit shares – and in the distribution of those shares – it is argued, can have highly negative macro-economic consequences. In particular, a falling wage share, especially amongst low and middle income groups, and excessive levels of inequality to which it gives rise, can make economies less resilient and more unstable.

Inequality and growth

Such a view represents a major challenge to the conventional wisdom and the idea of an 'equity-efficiency trade-off' as outlined by Okun, Lucas and others. According to the conventional view, high levels of equality would be associated with slower growth. Policy measures such as progressive taxation or means-tested welfare benefits, that reduced income inequality would, it is argued, have a negative impact on incentives and thus reduce labour supply, effort and ultimately economic growth.

Yet the evidence of the post-war era, at least for rich countries, is that the association between income inequality and growth is the other way round. As we saw in the last section, in the case of many nations, including the UK and the US, growth in the more unequal post-1980 era has been slower than in the earlier, more equal period.

There have now been a large number of mostly cross-sectional studies, using different data and methodologies, examining this relationship. These raise serious question marks over Okun's efficiency/inequality trade-off and Lucas's 'poisonous' theory (see, for example, Berg et al, 2012). While some of these studies support the notion that inequality leads to faster growth, a majority of them suggest that – contrary to the orthodoxy – greater equality can improve growth or at least not hinder it. As one study by the IMF of the Lucas assertion has concluded, 'Surprisingly, we find that the welfare costs of inequality outweigh the benefits of growth in most cases' (Cordoba and Verdier, 2007).

Another study by the American sociologist Lane Kenworthy (2008) looked at 12 developed countries and attempted to control for other key factors such as the degree of employment in each economy. Kenworthy's study finds no strong relationship between income inequality and economic growth, arguing that countries can achieve good performance on economic growth with either an

'Anglo-Saxon' model based on relatively unregulated labour markets and prioritizing growth in low-end service jobs (such as we see in the USA for example), or a 'Nordic' welfarist model based on high levels of redistribution and public sector employment. Both these models have achieved well in terms of growth and employment creation, while the latter also has better social outcomes.

A study of the efficiency/inequality trade-off by IMF economists A Berg and J Ostry (2011) also challenges the theory that inequality is a necessary condition for faster growth. They find that a higher wage share has historically been associated with faster and more stable growth. 'When growth is looked at over the long term, the *(efficiency/equality)* trade-off may not exist', they conclude. 'In fact equality appears to be an important ingredient in promoting and sustaining growth.'

In addition, research for the ILO has found that most nations have 'wage-led and not profit-led economies'. That is, they experience slower growth when wage-demand is suppressed and the profit share is boosted. This is because consumption falls more sharply than investment rises with an increase in the profit-share. Moreover, even though some countries are profit-led, the global economy treated as a whole is wage-led, as are some economic zones such as the eurozone. 'If a country is wage-led', the study concludes, 'policies that lead to a pro-capital redistribution of income are detrimental to growth' (Onaran and Galanis, 2012, p 3).

In an attempt to test this relationship further, we looked more closely at the extent to which a higher wage share might promote higher growth in the UK economy and whether there is any support for the 'wage-led growth' hypothesis in the empirical data for the UK alone. This is a difficult question to answer conclusively because of the multiplicity of factors operating in the UK economy at the same time.

We have used aggregate data on national output (Gross Domestic Product), wages, investment, employment and inflation for almost the whole of the post-war period (1948 to 2011) to construct a simple model of the determinants of real GDP growth which uses the wage share as an explanatory factor. The model also uses a number of other explanatory variables including the growth rate in average wages per employee (deflated using RPI), the level and growth rate of employment as a percentage of working age population and the RPI inflation rate (for details see the Appendix).

The results show that an increase of 1 percentage point in the wage share is associated with an increase of 0.55 per cent in the rate of growth of real GDP (Appendix table A1). This effect is relatively large – suggesting that (for example) the decrease in the wage share from 59.2% in 1980 to 53.7% in 2011 (5.5 percentage points) was associated with a decrease of around 3 percentage points in the growth rate (e.g. from 4% per year to 1% per year). Furthermore, this result (which is statistically significant at the 1% level) is in addition to significant correlations between growth in average wages and GDP growth, and between the employment rate and GDP growth.

This result seems to confirm that there is a strong positive relationship between the wage share and economic growth in the post-war period. The only other statistically significant (at the 5 per cent level) result in the regression is that high inflation is associated with reduced economic growth – an increase of 10 percentage points in the inflation rate (e.g. from 2 to 12 per cent per year) is associated with a reduction of just over 2 percentage points in the GDP growth rate.

It is important to be clear that although these results establish a statistically significant relationship between economic growth and the wage share, controlling for other economic variables, we cannot be certain which way the causality runs. It could be that increased economic growth raises the wage share (although the mechanism by which this process would occur is not clear), or alternatively that some external factor not included in the regression affects both the rate of GDP growth and the wage share. Nonetheless, the results presented here provide important new evidence that the distribution of national income between wages and profits matters for economic growth, despite being largely ignored in current macroeconomic models.[4]

Inequality, instability and the 2008 Crash

Along with the question of the relationship between inequality and growth, is there any evidence that excessive levels of inequality are associated with greater economic turbulence and contributed to the 2008 Crash? The most detailed investigations into the causes of the 2008 Crash have either ignored or dismissed the role of inequality. The findings of the bipartisan US Financial Crisis Inquiry Commission (2011) blamed pretty well everybody for what happened from politicians and regulators to Wall Street banks and credit rating agencies – 'a crisis of this magnitude cannot be the work of a few bad actors' – but failed to mention 'inequality' once in its mammoth 662 page report.

Although the question of the relationship between inequality and instability and the Crash remains controversial, and is one where there is far from a consensus, recent years have seen a growing body of academic evidence on the subject. Prior to the present crisis, it was an issue that was more or less totally ignored in economic research. Some recent studies have found little relationship between income inequality and financial crises (Atkinson and Morelli, 2011). Others have concluded that inequality played a central role in the 2008 Crash, largely by creating pressures that increased the risk of financial crisis (Kumhof and Ranciere, 2010; Fitoussi and Saraceno, 2010; Rajan, 2011; Lansley,2011; Livingston, 2012; Stiglitz, 2012 ; Galbraith, 2012).

These studies have suggested a number of different, but reinforcing mechanisms that link the falling wage share (and rising inequality) to the Crash and wider instability.

- The first mechanism relates to the effect on demand. A falling wage share, it is argued, creates a 'wage-output gap' with the workforce steadily losing the purchasing power necessary to buy the output being produced. Eventually economies experiencing such a growing gap would grind to a halt. This is because the marginal propensity to consume out of capital is lower than that from wage income (Dynan, et al, 2004). The outcome of this problem in the run-up to the 2008 Crash was an unprecedented rise in household debt, a response made possible by political sanction through the earlier de-regulation of financial markets. In the UK, levels of personal debt rose from 45 per cent of incomes in 1981 to 157 per cent in 2008. In the US, debt also rose sharply to reach a third more than national income by 2008. None of this prevented recession, it just delayed it. The same factors were at work in the 1920s, when the growing demand gap was filled by another explosion in private debt (Lansley, 2011, chapters 7–8; Lucchino and Morelli, 2012). Some have attributed this debt surge to 'demand-side' factors, with households turning to debt to maintain living standards in the face of first slow-rising and then stagnant real incomes. Others have attributed it to 'supply-side' factors. These include political pressure, especially in the US, on lenders to expand credit to lower income groups and monetary policy aimed at lowering interest rates, with both aimed at sustaining aggregate demand in the face of stagnant real wages. Cheap credit was being used to give families facing declining or stagnant living standards the illusion of rising prosperity. One IMF study (Kumhof and Rancière, 2010) has shown that a shock to the income distribution implies a simultaneous increase in both credit demand and credit supply, but with a more important role for credit supply, especially when the income shock is persistent. Another IMF study has shown that the increase in inequality accounts for a substantial proportion of the significant deterioration in current account deficits that took place in the UK and the US from the 1980s. 'When workers' income share declines at the expense of investors, investors respond by lending part of the income they gained back to workers. In addition, in an open economy they benefit from the ability to intermediate foreign savings to domestic workers. This lending stimulates aggregate demand to the point that, despite a significant drop in workers' consumption, the current account deteriorates' (Kumhof et al, 2010, p 28).

- Secondly, concentrating income in fewer and fewer hands at the top risks creating bubbles in a number of asset markets, notably in property and business valuations. The decade to 2008 saw a mix of growing corporate surpluses and private wealth that were the flipside of shrinking wage shares. Instead of being used to boost productive investment, these surpluses contributed to a giant mountain of footloose global capital that was used in ways – leveraged lending, financing the growth of hostile corporate raids and the financial engineering of existing companies – that contributed to soaring asset prices and greatly amplifying the risk of financial crisis. Again there are striking parallels with the 1920s when swelling surpluses were poured into real estate and the stock market fuelled the bubbles that helped trigger the 1929 Crash.

- Thirdly, the levels of inequality of recent times have simultaneously intensified the concentration of power, and helped to turn the US and the UK into what the giant American financial corporation, Citibank, has dubbed (in a series of classified but subsequently leaked memos) 'plutonomies', 'where economic growth is powered by and largely consumed by the wealthy few' (Kapur, 2005, 2006). One of the key effects of this development has been that the American economy now depends more on the sales of 'toys for the wealthy' than the needs of the 'non-rich' and their 'surprisingly small bites of the national pie'. Another effect has been a process of 'regulatory capture' in which the regulators have increasingly become controlled by those they are meant to be regulating. It is this process that has helped lead to inaction on tax havens, a blind-eye approach to tax avoidance and financial deregulation, policies that have benefitted the few while accentuating the risk of economic failure.

- Fourth, a number of academic studies – covering large and small firms in both North America and Europe – have shown a strong correlation between narrower pay dispersion within an organisation and improved organisational performance. This research suggests that wide gaps between top and bottom pay harm performance overall, and can also have particularly strong negative effects in certain circumstances. In firms with a high degree of interdependence in work tasks requiring a greater degree of interaction between employees, for example, pay compression is associated with improved performance. Large pay gaps are also especially detrimental in R&D-intensive firms (Cowherd & Levine, 1992; Bloom, 1999; Shaw et al 2002; Martins 2008; Faleye et al, 2010).

The growing global consensus against rising inequality and the falling wage share

Recently, the possible link between inequality and growth and instability has begun to gain currency beyond academic circles, even amongst those powerful global institutions that became leading advocates of market-led economies from the 1980s. 'Wages did not keep pace with rising productivity' declared the Director General of the International Labour Office, Juan Somavia, at the annual meeting of the IMF in October 2010: 'With household incomes squeezed for all but the very wealthy, growth became dependent on an unsustainable credit bubble in some countries and on exports in others' he continued. 'Minimum wage setting and collective bargaining systems should aim to ensure that wage increases do not lag behind productivity' (Somavia, 2010).

A few months later a detailed report on the crisis by the United Nations' Committee on Trade and Development went further against the grain of orthodox thinking. One of the causes of the 2008–9 crisis lay in 'the trend towards a finance-driven capitalism in many OECD countries, most pronounced in the United States, and the trend towards greater income inequality, which dampens aggregate demand and contributes to financial instability as well as global imbalances' (UNCTAD, 2010).

In March 2011, Steve Nickell, of the independent Office for Budget Responsibility, admitted to the House of Commons Treasury Select Committee that if wages failed to keep pace with inflation, real wages would fall, consumption would decline and growth would be weak. 'That, in some senses, is the worst of all possible worlds' (quoted in Parker and Pimlott, 2011).

In December 2011, President Obama attacked the long period of stagnant earnings facing most Americans, or what he called the erosion of the 'basic bargain that made this country great'. 'But this isn't just another political debate', he continued. 'This is the defining issue of our time' (Obama, 2011). A month later in January, 2012, the President's Chairman of the Council of Economic Advisers, Alan B. Krueger, declared that 'The rise in inequality in the United States over the last three decades has reached the point that… [it] is a threat to our economic growth' (Krueger, 2012).

In April 2012, the head of UNCTAD, Supachai Panitchpakdi – formerly a leading cheerleader of the 'Washington Consensus' and global economic liberalisation when head of the World Trade Organisation – said that the solution to the economic crisis depended on an urgent 'mixture of reflation, redistribution and regulatory measures … to achieve these goals is now the urgent task of policymakers, at the international as much as the national level' (UNCTAD, 2012).

Then at the annual meeting of the World Economic Forum at Davos in January 2013, Christine Lagarde, head of the IMF, told Davos delegates that 'I believe that the economics profession and the policy community have downplayed inequality for too long… Now all of us have a better understanding that a more equal distribution of income allows for more economic stability, more sustained economic growth, and healthier societies with stronger bonds of cohesion and trust'.

Even leading financiers are beginning to accept that the global billionaire class will now have more of a battle on their hands. As Albert Edwards, Société Générale's in-house über-bear, declared in November 2011: "Going forward… labour will fight back to take its proper (normal) share of the national cake" (quoted in Pollack, 2011). That the 'transfer of income to the rich' has gone too far is a view being more widely echoed through parts of the finance industry. As GMO's Jeremy Grantham has put it, "If we want to dig ourselves out of our current morass, don't we have to change this equation (of allowing excessive inequality) and isn't the most direct way of doing this to divide the pie more evenly?" (quoted in Hume, 2011). Or as the global economic commentator, Marc Faber, has argued, the share of GDP going to labour is too low and corporate profits are 'too high' (interviewed in Money Week, 2012).

5. A new social contract with labour

The above analysis has shown that:

- since the early 1980s, the share of output going to the bottom half of the workforce ('the lower half wage share') has been falling sharply in the UK
- around one third of this fall can be attributed to a fall in the share of output going to wages and about two-thirds to a rise in the dispersion of earnings
- this trend can be accounted for both by changes in the structure of the UK economy (with a shift away from sectors with a higher wage share to those where the profit share is proportionally higher) and by changes in the rate at which pay has risen across different parts of the earnings distribution (with those in the top decile seeing their pay rise far more quickly than those with lower earnings).
- similar trends have occurred in a number of rich nations, though not all and mostly not on the same scale as the UK
- this trend has been driven by a mix of factors, but most significantly, the financialisation of the economy (a process encouraged by the de-regulation of finance) and the weakening bargaining power of labour
- while this process of upward redistribution was in part a considered political strategy aimed at boosting innovation, investment and growth, it has in fact been associated with a weaker economic performance on each of these factors
- this process was a significant contributory factor in the 2008 Crash.

On the basis of this analysis, rebalancing the economy towards a higher overall and 'lower half wage share', a reduced dependence on low pay and a smaller pay gap would lead to stronger growth and less economic turbulence. While stemming and reversing the trends of the last 30 years will be far from easy, and will have to be secured gradually over time, the evidence is that doing so is a necessary step for achieving sustained economic health.

Achieving this rebalancing requires, above all, a new social contract with labour, or what President Obama has called a new 'basic bargain' – one underpinned by a new set of governing rules between the state, the workforce and business. In the UK, the current contract has broken down. Growth no longer automatically delivers improved living standards, while a large and growing proportion of the workforce is being denied secure work and decent pay.

The elements of this new social contract should be:

- measures aimed at raising the earnings floor for those currently in work
- measures aimed at capping excessive rewards at the top
- measures aimed at increasing the extent of collective bargaining and workplace participation
- a new central commitment to policies that create full employment
- longer term measures aimed at reversing the recent trends towards a low pay economy.

Rebalancing the economy in this way requires a mix of short-, medium- and longer-term measures. These would aim first to raise wages in the bottom half of the distribution and narrow the pay gap *among the existing workforce*. A second group of longer term and more fundamental measures would then aim to alter the structure of the workforce by reducing the economy's dependence on low-paid sectors.

Achieving these goals would require a much more active role for government (national and global) aimed at creating a more equal distribution of wages before taxes and benefits – essentially aimed at the root causes of rising inequality rather than concentrating on tackling the symptoms through redistribution. One of the important lessons of the last 30 years is that it was a mistake to allow the question of 'factor distribution' to be ignored by the policy-making machinery in the United Kingdom. That question needs to play a much bigger role in strategic economic planning, by, for example, the adoption of clear national targets for the wage share and pay gap. Achieving these targets and thus securing a more sustainable balance in the distribution of national income between wages and profits could also be used as an additional measure of economic success. (Lansley, 2012).

This has already been acknowledged by the European Union. On February 1 2013, László Andor, European Commissioner for Employment, Social Affairs and Inclusion welcomed the first ever meeting at EU level of representatives of national trade unions and business organisations to exchange views on wage developments. Held in Brussels, the 'tripartite' meeting, organised by the EU's Employment Committee, discussed how wages have evolved in recent years in relation to productivity and what this has meant for domestic demand and employment in individual countries and the EU as a whole. The meeting also discussed inequalities in wage distribution across income groups.

The meeting arose out of an earlier commitment by the European Commission made in response to the problems posed by the financial and economic crisis. The Commission put forward a series of new policies better known as 'European economic governance' in which 'wages and collective bargaining systems are seen as one of the main instruments for the European coordination of economic policy and wage developments should be in line with developments in labour productivity' (Eurofound, 2012) .

A new focus on 'pre-distribution' aimed at reducing the weight borne by the tax and benefit system through 'redistribution' would need to reform the current labour market model which offers one of the weakest systems of workforce protection among the OECD nations. This is because institutional structures in the labour market

– from the role of unions and collective bargaining to corporate governance and the power of public contracts – are critical to achieving a narrowing of the pay gap.

Each of the measures discussed in this chapter would have a positive impact on both the wage share and the dispersion of pay. At the end of the discussion of several possible policy measures (raising the wage floor, widening the extent of collective bargaining and reducing the level of unemployment) we make an estimate of their individual and combined impact on the wage share and the 'wage gap'. We calculate the wage gap – the difference between the current 2011 wage share (53.72 per cent) and the 1980 share (59.19 per cent) – as 5.47 per cent of GDP. This latter figure is close to the average of the 1950s and 1960s.

This analysis shows that pre-distribution measures can have a notable impact on the wage share.

Raising the wage floor for those currently in work

Today, around a million workers (some 4 per cent of the workforce) are paid the minimum wage, while a fifth of the UK workforce – some 4.8 million – earns less than the 'living wage'. This is the minimum pay level calculated to be needed to provide an adequate standard of living for an average household when transfer payments including tax credits and benefits are also taking into account. While the minimum wage for adults aged 21 or over currently stands at £6.19 (and will rise to £6.31 in October 2013) , the living wage stands at £7.45 per hour outside of London and £8.55 in London.

The incidence of low pay varies considerably by industry. Minimum wage jobs are concentrated in low pay occupations like retail, hospitality, social care, food processing and security while the highest proportions of below living wage earners are found amongst bar staff (an estimated 90 per cent of all workers in this category), waiters & waitresses (85 per cent), kitchen & catering assistants, elementary personal services occupations & launders, dry cleaners & pressers (all 75 per cent) and sales & retail assistants (65 per cent) (Markit, 2012).

There is certainly scope for raising wage levels above the current minimum, though more so in some industries than in others. The introduction of the minimum wage in 2000, which came with dire warnings of negative effects on employment, has proved a great success story. The policy has had the effect of raising and strengthening the wage floor while reducing earnings inequality in the bottom half with little or no recognisable negative effect on employment (Butcher et al, 2012). Its value has risen faster than both the median wage and prices, though this rate of increase has slowed sharply in recent years. Indeed, from 2010 onwards the minimum wage has been reduced in real terms (relative to the Retail Price Index), taking its real value back to its 2004 level. If the minimum wage had been held constant in real terms from 2009 onwards, the adult rate would now be £6.60 rather than £6.19 – just under 7 percent higher.

There is some, if limited, scope for a further narrowing of the minimum wage rate in relation to the median, without affecting the level of employment. While workers in small firms are more likely than those in larger companies to be paid at the national minimum wage, around 51 per cent of minimum wage workers are employed by large firms. To help pinpoint the sectors where there is greater scope for raising pay levels without damaging jobs, the Low Pay Commission, the independent body which sets the level of the minimum wage, could be tasked with helping to research sectors where a higher minimum wage would be affordable.

In addition there is a case for increasing the wage floor in sectors where firms have an ability to pay more on a sectoral basis. This would involve the rebuilding of tripartite institutions involving unions, business and government in certain sectors. Agreements on wage rates could be reached that would then be enforced by law.

Such an approach would stand in stark contrast to that of the current government, which seems to be determined to abolish part of the last surviving Wages Council, namely the Agricultural Wages Board for England and Wales. The other Wages Councils were abolished in 1993 by the Conservative government of the time. Abolition resulted in both wages and employment levels falling in a number of sectors, thus providing part of the intellectual rationale for the establishment of the National Minimum Wage.

Joint Industrial Councils, which brought together unions and business, where established in the UK throughout the 1920s and 1930s and strengthened by the post-war Attlee government. By the late 1940s such Councils covered around 85 per cent of the economy. They played an important role in supporting pay and terms and conditions in the 1950s and 1960s.

The criteria in choosing such sectors would be likely to include both the incidence of low pay and the absolute numbers of low-paid workers.

One potential idea would be to work within the new sector councils established by the BIS department. These councils could provide a forum for talks between employers and unions, facilitated by the government, on terms, conditions and pay across the sector.

What about the scope for an increase in the numbers receiving the living wage? One key advantage is that any wage rise among the low paid would lead to a simultaneous increase in tax revenue and some reduction in the public expenditure cost of wage-related benefits, including tax credit and housing benefit.

A good rule of thumb is that the government gets back about 45 per cent of any addition to low pay rates. One study (Lawton and Pennycock, 2013) has estimated that the government could receive £2.2 billion in the form of higher tax, NI and lower tax credit spending if the living wage was implemented in full (although as this would also involve, in an extreme scenario, up to 160,000 job losses, and some displacement of young people from the jobs market, this effect is only illustrative).

While the report by Lawton and Pennycook acknowledges that it would be difficult to raise all wages to the level of the living wage, without some loss of jobs, they propose 'the creation of "living wage" zones' in which a proportion of savings that accrue to the Treasury as a result of the living wage being paid by local public sector employers would be fed back to those local authorities to encourage spreading the living wage into the private sector. Companies could use the money to help them cushion the impact of raising wages or to fund training. The report also calls for all listed companies to make public how many of their staff are paid below the living wage. If they fail to do so, transparency should be made a legal obligation.

Although it would be unrealistic to be able to raise the pay of the whole of this group to this level without risks to jobs and competitiveness, more could be done and the government should set a clear timetable – say five years – for doing so. Despite the momentum created by an effective national campaign, only around 40,000 extra workers won a living wage in London in the six years to 2012 (Queen Mary College, 2012). The number of accredited living wage employers – mainly public sector bodies and a number of high-profile financial and legal firms such as KPMG, Barclays, PwC, Clifford Chance and Deloitte – remains small.[5] Aside from a handful of notable exceptions (such as the cosmetics retailer Lush) relatively few companies in retail, food service or the travel and tourism sectors, which account for a substantial share of low-wage jobs, have become living wage employers.

How could the number receiving the living wage be raised?

First, by all public sector organisations setting the standard by ensuring that all their employees are paid the living wage. To date, although an increasing number of organisations in central and local government, the health service and some universities have become living wage employers, a large number have not.

Secondly, public employers should do far more to ensure that businesses with whom they contract are paid at living wage rates through the greater use of social clauses in procurement processes. This is beginning to happen. Several Whitehall departments have declared a commitment to the living wage, including the DWP and Cabinet Office. In December 2012 the firm supplying cleaning services to the DWP (Telereal Trillium) announced it was to pay all its 500 Whitehall staff the living wage – an increase of more than £2 an hour – from April 2014.

In 2012 the London borough of Southwark agreed to implement a living wage for all directly employed and contracted out staff. The cost of funding the introduction of the living wage for contracted-out staff, including care providers, was estimated to be £1 million. A living wage was also negotiated for all workers providing support services to the London 2012 Olympic Games. Glasgow City Council has introduced a living wage for all council employees, increasing the basic salary of the lowest paid Council workers by over £1100 a year. In addition, the Council is aiming to encourage its suppliers to pay a living wage to staff working on Council business and has also developed a Glasgow Living Wage Employer Award to encourage wider uptake.

Another possible measure would be the restoration of the Fair Wages Resolution which was abolished in 1983. This was an instrument that required all government departments to procure goods and services only from those businesses that observed the prevailing wage rate in a particular industry. The Resolution's aim was both to protect pay and conditions and to improve performance in low wage labour markets, ruling out the 'low paid road' to competitiveness. 'No governmental measure had over the last three quarters of a century done more', according to the leading labour lawyer, Otto Kahn-Freund, 'to spread the habit of observing collective agreements than these Fair wages resolutions, covering as they did a very wide sector of the economy, especially through the inclusion of sub-contractors' (Davies and Freedland, 1983). Prior to the introduction of the national minimum wage, it had thus been a significant factor in establishing effective wage floors and its abolition will certainly have contributed to the slipping of that floor from the mid-1980s.

The success of the Resolution was also in large part down to the greater role then played by trade unions in negotiating wage rates. 'It was an approach that recognised collective bargaining as a collective good, with widespread social benefits (the establishment of effective wage floors, the elimination of unfair competition)… Action by the state (the Fair Wage Resolution) was an important auxiliary support both to collective bargaining and the role of trade unions as agents of pre-distribution' (Coats, 2012).

Although such measures would raise public procurement costs and might be more difficult to apply in a period of austerity, they could be more easily implemented in more normal economic circumstances. Fair wage clauses are not a panacea for tackling low pay but they would make a noticeable difference.

Both the present and last governments have claimed that European procurement law restricts the use of social clauses, yet TUC research shows that the barriers from EU Directives can be exaggerated and that there is much greater scope for their implementation than critics suggest. As long as contracts are non-discriminatory (i.e. open to companies from all EU member states) and are transparent (so the terms of the contract are clear to all bidders at the outset), much more can be done. Moreover, EU law allows contract decisions to be based on 'the most economically advantageous tender, from the point of view of the contracting authority'. If an authority decides that contractors paying the living wage would boost demand in the local area, thereby strengthening the economy in the process, that authority should be free (and, indeed, encouraged) to require contractors to pay it.

The new Social Value Act, 2012, may also offer further leverage for encouraging the greater use of living wage agreements. Passed with cross-party support and government backing, this Act requires public authorities to ensure that they procure services in a way that provides 'social value' – meaning that local authorities will need to have regard to the wider consequences of their procurement decisions, including the impact on jobs, communities and the environment, as they commission services.

Most living wage employers are found in the public and voluntary sectors and only a tiny proportion of private sector organisations have become accredited. Yet while the private sector will argue that they can't afford to raise wages, the evidence is that a significant proportion of the low paid work for large and profitable companies.

Although the cost of implementing the living wage will vary between organisations and could be more easily absorbed by some than others, the bill for a number of firms would be marginal especially in relation to the benefits. One study of the impact on the wage bill for a number of FTSE 100 companies found that the potential costs of a living wage for many large companies across key sectors of the economy are surprisingly low. "For many, especially in banking, IT and construction, the average upfront wage costs are affordable, representing less than a 1 per cent increase". "In other industries, such as retail and hospitality, where the proportion of lower-paid jobs is higher, the upfront costs would be higher, at between 4.7 and 6.2 per cent. So for these firms the report recommends a phased introduction, starting with a move to pay 90 per cent of the living wage" (Pennycook, 2012).

A similar finding applies in the United States, the country sitting at the top of the global low pay league. A study by the National Employment Law Project (2012) shows that most low-wage workers aren't employed at struggling start-ups or local businesses trying to expand. Instead, NELP has found that the majority of such workers are employed by large corporations enjoying healthy profits, sometimes more than before the recession: of the top 50 low-wage employers in America: 92 per cent were profitable last year; 63 per cent are earning higher profits now than before the recession; and 73 percent have higher cash holdings now than before the recession.

There is also evidence that the introduction of the living wage has had a number of positive benefits for companies. These include improved retention, and thus lower recruitment costs, and lower absenteeism rates.

Evidence from the United States, which pioneered the idea of the living wage in the 1990s, suggests that a living wage can boost productivity, not by the firms substituting higher-skilled for lower-skilled employees, but by raising work effort following higher wages (Brenner, 2005; Chapman and Thompson, 2006). A study by the Greater London Authority found that more than 80 per cent of employers believe that the living wage had enhanced the quality of the work of their staff, while absenteeism had fallen by a quarter. Two thirds of employers reported a significant impact on recruitment and retention (GLA, 2012).

According to the consultancy firm, KPMG, adopting the living wage for all its staff, including its 700 in-house and outsourced facilities staff has been very successful: 'turnover amongst our cleaning staff has more than halved; morale has been raised; despite improved sick pay potential abuse has not materialized; productivity has improved; attitudes are more flexible and positive.' (Stallard, 2010, p 14)

The consultants, Price Waterhouse Coopers, adopted the living wage for their 260 low-paid staff in 2006: "Although our wage bill has increased by £100,000 a year as a result, we've noticed staff turnover drop from 4 per cent to 1 per cent and absenteeism reduce as well" according to Steve Sherwood, director of infrastructure. "The improvements are noticeable: we have a more stable and happier workforce, and we attract better people."

Wendy Cuthbert, head of UK corporate real estate services for Barclays Group, which employs around 1,500 catering, cleaning and security staff within the M25, says that since adopting the London Living Wage in 2007 her company has seen catering staff retention rates increase to 77 per cent compared to an industry norm of 54 per cent and cleaning staff retention rates climb to 92 per cent compared to the industry norm of 35 per cent. "Now when we train our staff we know that the money isn't being wasted", she says. "They don't want to leave and they no longer have to do two jobs just to survive." As a result Barclays has found that savings made on recruitment and training has offset the increase in the wage bill. "Overall it's been cost neutral for us", she says, while, "most of all, our workforce is now stable and reliable. We don't understand why more companies don't do this" (quoted in Unison, 2012).

City law firm Linklaters have been paying the London living wage to their 230 catering, cleaning and security staff for the past four years, although they only signed up officially in 2011. Bob Jones, head of UK operations, says: "It made good business sense. Having a large attrition rate on staff is not good for a business like ours. We need to have staff that are loyal and trustworthy. As a result of offering the London living wage we've seen more motivated individuals doing their jobs better. Absenteeism and illness has reduced as has the staff attrition rate. People feel more valued." (Unison, 2012).

Capping / restraining pay at the top

Narrowing the pay gap also requires reducing pay levels at the top. This is mainly an issue in the private sector where the gap between the highest and lowest paid is much greater than in the public sector. One study (One Society, 2011a) has shown that while the average top-bottom pay gap in the public sector was 15:1 in 2010, it stood at 262:1 amongst FTSE 100 companies. These ratios ranged from 48:1 (Capital Shopping Centres) to 656:1 (Marks and Spencer).

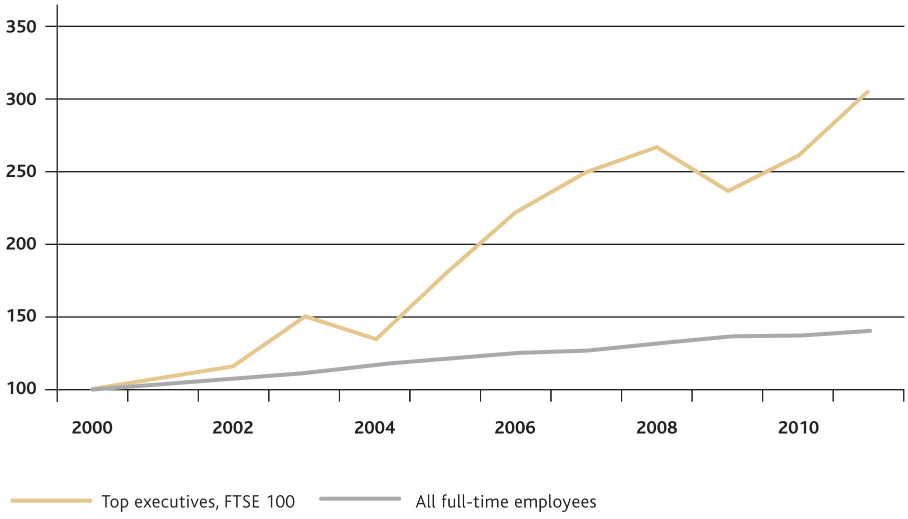
Companies with large public sector contracts also typically pay their executives much more than the highest-paid public sector employee. Serco, which receives over 90 per cent of its business from the public sector, paid its CEO some £3.2 million in 2010, 6 times more than the highest-paid UK public servant and 11 times more than the highest-paid UK local authority chief executive.

The evidence from several reports has shown that Britain's rising gap has not been justified by improved company performance at the top. In the ten years to 2011, the average annual bonus for FTSE 350 directors went up by 187 per cent while the average year-end share price fell by 71 per cent (Tatton et al, 2011).

Since the crisis, attitudes towards soaring executive pay have been hardening among the public, within government and among shareholder groups. This has led to several shareholder revolts at company AGMs and a number of majority votes (which are advisory only) against recommended pay packages. In 2012, there was an unusually high level of shareholder opposition to executive remuneration policies at UK companies. Six remuneration reports were rejected by shareholders – among them some high-profile companies including Aviva and WPP – more than in any other year since the introduction of a mandatory shareholder vote on executive pay in 2002.

Despite growing opposition, the executive pay gap has continued to rise through the crisis. Figure 6 shows that after narrowing slightly in 2009, the gap between top executive and median pay returned to its long-term upwards trend.

Figure 6: Index of top executive v median employee pay, 2000–2011



Source: Lansley, 2012

Curbing excessive pay at the top requires policy shifts on several fronts. First, there need to be tougher rules on corporate governance. These should include (The High Pay Commission, November 2011):

- Greater simplification of pay along with greater transparency. All directors' pay packages should be published in the annual reports of listed companies, along with top-to-bottom and top-to-median pay ratios and company policies on low-paid staff and contractors. In addition, the annual report should record the distribution of pay across different levels of earnings and the number of workers in receipt of the National Minimum Wage and Living Wage.
- Widening the composition of remuneration committees (by, for example, including employees) along with attempts to changes the culture and expectations on remuneration.
- Reviewing the role of remuneration consultants.
- Measures to encourage investor assertiveness, by making investors and companies more transparent and remuneration votes binding.

The government has committed itself in principle to the need for change. The Business and Regulatory Reform Bill includes a number of new measures aimed at constraining top levels of pay. While critics have welcomed the extension of shareholder power, however, they claim that the new measures are limited and 'will do little to reverse the growth of inequality in Britain' (One Society, 2012, p 15). The Bill, for example, will make shareholder votes binding (they are purely advisory at the moment). But, rather than take place every year, this binding vote will happen only every three years.

While tougher reforms of corporate governance would help, wider measures are needed, including the greater use of non-statutory pay ratios. In the public sector the vast majority of pay ratios fall well within a 20:1 band and there is now considerable transparency in pay levels and rates (Hutton, 2011).

The New Economics Foundation has argued that companies should be required, by law, to publish pay ratios of the highest to the median and the lowest paid employee (Simms and Boyle, 2011). Under its proposals, all public companies (and companies seeking government contracts which are over a certain size) operating a ratio above 1:20 'would need to show how the economic and social benefits of doing so outweighed the costs.... While disclosure of size of CEO salaries, as happens now, may simply tempt remuneration committees into greater levels of excess, disclosure of the ratio can potentially shame or guide the corporate world into more equitable arrangements – or to explain why they are genuine exceptions.'

They go on to argue that this ratio should be included in a Charter of Responsible Pay which would need to be endorsed by investors and employers organisations, and which companies would be encouraged to sign. Companies that fail to do so could then be asked difficult questions by investors about why they have not. The charter could include a maximum acceptable bottom-to-top pay, aware that there may be reasonable exceptions to this.

Although such an idea would provoke a good deal of corporate hostility, there is a long history of the corporate use of such ratios (Lansley, 2006, ch 11). As JK Galbraith argued, "The most effective way of enhancing equality within the firm would be to specify the maximum range between average and maximum compensation"

(Galbraith, 1973, p260). There are examples of companies – across the world – that follow this practice. The American supermarket chain Whole Foods is perhaps the most prominent company to organize its executive pay according to a bottom-to-top ratio. The ratio was originally set at 1:8 but has more recently been shifted up to 1:19. That means that nobody at Whole Foods is allowed to earn more than $650,000. "Is this cash compensation too low to retain top executives?" asks Whole Foods co-founder and CEO John Mackey. "Apparently not, because Whole Foods has never lost to a competitor a top executive that we wanted to keep since the company began more than thirty years ago" (Mackey, 2009).

In the UK, the ethical investor research service EIRIS registers whether companies have large gaps between directors' and employees' pay. They also ask whether the highest paid in the company are paid more than 25 times UK average earnings (Eiris/Eurosif, 2010).

The Mondragon network of more than 200 linked co-operatives in the Basque region of Spain also has an explicit ratio between bottom and top. Originally set at 1:6, as a deliberate way of forcing managers to raise pay if they needed a pay rise themselves, it has since grown to about 1:15 as a means of tackling the problem that too many managers were being lured away from co-ops by higher pay elsewhere.

In 2012, France imposed a maximum 20:1 ratio on pay in public sector organisations (all those with a majority public shareholding). Because this affects a large number of corporations it has meant a sharp fall in pay for a number of chief executives – including at EDF – without leading to any resignations.

Although there has been growing public and political hostility to excessive pay at the top in the UK, there is yet to be a clear mechanism for translating that public disquiet into policy action. One of the factors that helped keep pay in check throughout the first three post-war decades was a system of social norms that were intolerant of corporate excess. A kind of unofficial 'shame gene' operated across the City and in boardrooms that kept pay ratios at much lower levels than those operating today. We need something similar – a cultural shift generated by the reversal of the political license given from the 1980s that make pay ratios at current levels socially acceptable.

Ultimately creating a lower gap will depend on a fundamental shift in the balance of economic and social power and influence away from the dominance currently enjoyed by boardrooms, big business, and especially the City. More power needs to be shifted from boardrooms to the workforce through the empowering of employees and the spreading of collective bargaining.

Extending the role of collective bargaining

The economic orthodoxy of the last 30 years has been that high levels of employment regulation (of which collective bargaining is one part) are detrimental to economic outcomes, creating distortions and bringing lower employment levels. It is a view that, as we have seen, has long been promoted by international organisations such as the OECD (1994) and has led to a process of labour market de-regulation notably in the US and the UK, and more latterly in some European countries.

One of the effects has been a rolling back of labour rights in the UK while the extent of unionisation and collective bargaining has halved: only 18 per cent of employees in the private sector are covered by a collective agreement (down from 23 per cent in 1996) and only 31 per cent of all employees are covered by collective bargaining arrangements (down from 36 per cent in 1996) (OECD, 2012b). 'The coverage of collective agreements has diminished significantly. In most workplaces in the UK today employers are free to determine terms and conditions of employment without any negotiation or consultation with representatives of their employees… one can only conclude that the possibilities for democratic participation in the workplace have diminished over time too' (Coats, 2012, p 12).

This has not been a universal trend. While Britain now sits near the bottom of the global league table on employment rights (it used to be nearer the top), collective bargaining coverage is much higher in other rich nations like Austria, Belgium, Denmark, France and Sweden. Denmark has a national commitment that 'no Dane should suffer economic hardship' and a high degree of inclusiveness and a relatively narrow pay gap.

As a result of these trends there is now a strong body of empirical evidence – across time and countries – on the effect of de-regulation (Reed and Lansley, 2010). Here the collective evidence goes against the grain of orthodox economic thinking. It shows that, contrary to the arguments used to justify more liberalised employment laws, high levels of collective bargaining and employee engagement have a range of positive economic benefits, at both the micro and macro level. At the level of the firm, they are associated with better conditions of work and a boost to skills, innovation and productivity. Where a workplace has union representatives and union recognition, employees are 15 per cent more likely to report receiving training (Bryson and Forth, 2010).

Organisations whose employees are fully engaged have been found to be more than 40 per cent more productive while those with the most engaged employees benefit from higher customer advocacy, a lower employee turnover and stronger financial performance (Hay Group, 2001; Towers Perrin, 2006). In the US, some of the improvement in US productivity ascribed to the diffusion of information and communication technology has been found to be the result of innovations in workplace organisation – including the use of self-managed teams, profit-sharing and employee voice (Black and Lynch, 2003).

At a macro-economic level, the evidence is that countries with a more structured national tripartite dialogue – between unions, government and employers – have been highly successful in wider economic management. In Germany, for example, the involvement of the union movement was critical to the adoption of a number of labour market measures – including a new programme of wage subsidies to support short-time working – that have helped stem rises in unemployment during the crisis.

High levels of collective bargaining are also strongly associated with low levels of low pay, narrower pay gaps and a higher overall wage share. The international evidence is that the 'most important influence on the observed differences in low-wage work is the inclusiveness of a country's labour market institutions' (Gautie and Shmitt, 2010, p 7). Countries with 'inclusive pay-setting systems' and strong levels of workforce bargaining power (such as Denmark and France where collective bargaining agreements cover around 90 per cent of all workers) have a lower incidence of low pay.

Also important is the extent to which there is a tradition of 'solidaristic' attitudes towards wage determination with a general acceptance of the merits of relatively narrow earnings dispersions and a commitment among players to reducing inequality. What is clear from this evidence is that 'countries have a choice as to how they treat workers at the lower end of their labour markets' (Salverda and Mayhew, 2009). Over the last 30 years, countries exposed to the same processes of globalisation, technological innovation and growing product competition have had very different experiences when it comes to changes in the extent of low pay and pay dispersion.

This also holds when it comes to jobs in identical industries. A study of six countries (US, UK, Germany, France, Netherlands and Denmark) has found that the share of retail jobs (traditionally low paid) that are low paid varies from a high of 49 per cent in the UK to a low of 23 per cent in Denmark and 18 per cent in France.[6] The main explanation for these differences lies in the differences in labour market institutions. In Denmark, for example, 'high union density and unions' commitment to wage compression lift most jobs above the low-wage threshold' (Gautie and Shmitt, 2010, p 28).

Global comparisons also raise question marks about the scale and nature of a trade-off between the number of jobs and the level of pay. It is the existence of this trade-off – again promoted strongly by the OECD (1994) – that has been used to justify the jettisoning of jobs protection and the weakening of unions in the belief that liberalising labour markets would produce more jobs and thus be the cure for the higher levels of unemployment occurring across much of Europe in the 1990s.

While some trade-off undoubtedly exists, the evidence shows that it is relatively weak: high wages can in fact be associated with high levels of employment. A 2005 review of the cross-country evidence (Baker, Glyn, Howell and Schmitt, 2005) found that high union density and collective bargaining is consistent with a strong record on employment generation and growth. For example, the Scandinavian/flexicurity model (including Denmark, the Netherlands, Norway, Finland and Sweden) embraces strong collective bargaining, high levels of employment protection, generous welfare benefits and stringent job search requirements with time limits on the durations of contributory benefits. Moreover, while the Anglo-Saxon model is characterised by high earnings inequality and high levels of in-work poverty, the flexicurity countries have combined high employment and good growth rates with much lower levels of wage inequality and in-work poverty.

Both Denmark and the Netherlands, for example, have a better record on low pay than the UK and the US, but have at least as good a record on employment and a better record on the employment of the young and the least-educated. The reason seems to lie in the way the former countries adopted 'high-road' labour market strategies (with an emphasis on higher quality and more rapid innovation) as opposed to the 'low-road' (aimed at price competition) market strategies more commonly adopted in the US and the UK. Only France – with a small share of low-wage workers and a high unemployment rate, fits the standard inequality-unemployment trade-off (Gautie and Shmitt, 2010).

While some economists dismiss the flexicurity countries' experience as a special case, other cross-country studies have come to a similar conclusion: 'The data on the shares of low-wage work provide only weak support for the view that European labour market institutions lead inevitably to fewer employment opportunities for entry-level workers' (Gautie and Shmitt, 2010, p 18–19).

In a study of the relationship between inequality and instability, the American economist, James K Galbraith, found that higher wages can be associated with higher employment: "… measures to *reduce* the inequality of European wages,' he concludes, 'would help reduce chronic unemployment on average among Europeans. This is quite the opposite of the common view that Europe needs *more* pay inequality ('flexibility') rather than less." The implications of this set of findings for economic policy are profound. Labour market deregulation may actually *increase* unemployment and make Europe's current depression *worse* (Galbraith, 2012, p 182).

There is also evidence that more can be done to raise wages even in traditionally low paid work in areas like call centres, big-box food retailing and hotel work. There are big cross-country variations in pay rates for these less-skilled jobs, depending on whether firms have chosen 'high road' or 'low road' workplace practices.

Again, the determining factor has often been the role of labour market institutions. In the UK and US, for example, basic supermarket work is associated with low skill and minimal training, with firms competing on pay rates. Stocking shelves, for example, requires little skill and individual workers work in isolation on simple, repetitive, fully specified tasks that are easily monitored and easily shifted. In similar stores in Germany, in contrast, frontline workers have had some vocational training and are able to be given greater responsibility and discretion for several stages of supermarket work from ordering to stocking and merchandising (Gautie and Schmitt , 2010).

In Denmark, many employers in food processing have responded to competitive pressures from globalisation by increasing the capital intensity of production, raising productivity sufficiently to pay above the low-wage threshold. In Germany, the apprenticeship system trains many retail sales clerks in electronics to a level that improves sales and wages. In contrast with the US, "in many European industries, employers have learned to live with legislated and negotiated costs that many US firms would find prohibitive" (Gautie and Schmitt, 2010 p 19).

That the orthodoxy may be wrong, or certainly more complex, on these issues is now beginning to get wider acceptance, at least when it comes to the question of the macro-economic implications of an imbalance in bargaining power. As two senior IMF economists put it in 2012: "The crisis is the ultimate result, after a period of decades, of a shock to the relative bargaining powers over income of two groups of households, investors who account for 5 per cent of the population, and whose bargaining power increases, and workers who account for 95 per cent of the population [and whose bargaining power has fallen]" (Kumhof and Ranciere, 2010, p 3).

The UK fits this description like a glove. It is a country with non-inclusive pay-setting institutions and weak collective bargaining. Any strategy to raise the wage share and reduce the extent of low pay needs to start with extending the role played by unions, bargaining and employee participation. Increasing union density and involvement will not be easy, especially as most rich nations have experienced a similar, if shallower, downward trend in umion membership. This trend has been driven by a mix of hostile public policy, deindustrialisation, the growth of employment in private services, the outsourcing of support functions and employer mistrust. From 1997, Labour allowed a modest re-regulation of the labour market – through the introduction of the national minimum wage, the right to ballot for trade union recognition and improved maternity and paternity leave – without detriment to employment creation or any evidence of serious additional rigidities, but were reluctant to go further.

Yet there is certainly considerable scope for raising union membership in the private sector. Union density (and consequently bargaining coverage) varies significantly by sector. Public administration and education have the highest rates (at over 50 per cent) and 'accommodation and food services' the lowest (at 3.6 per cent). While union density fell across most industries between 1995 and 2011, it increased in 'wholesale, retail trade and motor repair' (Brownlie, 2012).

The union movement itself could become more pro-active in recruitment, for example, by pledging to undertake well-resourced national organising campaigns to increase membership among vulnerable workers, in particular in workplaces where there are already recognition agreements and in sectors where vulnerable employment is common.

Much more could also be done by government to encourage the greater use of collective bargaining and improved workforce participation. The trade union movement needs to play a more central role in the workplace and should have much wider representation on committees of enquiry and official organisations such as the Takeover Panel. The government has ratified ILO Convention 98 which requires them to promote free collective bargaining, but is taking few positive steps to honour this responsibility. One such step would be to restore to ACAS a positive duty to promote collective bargaining as the most appropriate means of determining working conditions where a union is recognised (or partially recognised). Restoring the duty, which was removed in 1993, would not mean that ACAS would have to advise all employers to recognise unions; it would simply allow them to do so where they judged that it would be the best solution.

The government could also explore using the tax system to incentivise employers to develop fairer pay solutions. This could include: providing tax relief for companies and organisations that reach collective agreements which raise the incomes of low earners; ensuring gender pay equality; giving staff access to education and training and/or committing the organisation to taking on apprentices. More also needs to be done on improving union recognition and for reforming the legislation on industrial action, as a means to boost union bargaining power. It is very difficult in practice for a union to run a wholly compliant ballot because of the complex technical requirements, mostly dating back to 1992. This means that the ultimate weapon for unions to use in the case of an intractable dispute over wages and conditions is much weaker than it should be. This reduces the impact of unions in negotiations on wages and conditions.

The role of full employment

Another key determinant of both the level and growth of wages is the level of employment. The evidence is that tight labour markets with low levels of unemployment are associated with higher wage growth. In the US the one period that breaks the 30-40 years of near median wage stagnation was the relative boom from 1995–2000. This period saw both falling unemployment to historically low levels *and* faster and more broad-based wage growth. This helped drive higher incomes for typical American households and came close to tracking the rise in output. 'Median household incomes rose by 1.9 per cent annually from 1995–2000, a rate more than six times as fast as the 0.3 per cent average annual growth rate between 1979 and 1995' (L Mishel et al, p 31). There was a similar pattern in the UK during the boom of the late 1990s. From 1997–2002, falling unemployment helped to boost wage growth with the result that the wage share actually recovered some of its lost ground (see figure 1).

The impact of unemployment on real wages is especially pronounced for low to middle earners (in the 20th to 50th percentiles of the distribution) compared with those in the top half of the distribution (Gregg and Machin, 2012). It also appears that the sensitivity of wage growth to unemployment has increased since 2003. Indeed, there may have been a shift in the relationship between unemployment and real wage growth over the last decade.

In the period from 1986 to 2002, a doubling of unemployment would have lowered median real wages by 7 per cent. In the later period 2003 to 2010, a doubling of unemployment would have pushed typical pay down by 12 per cent. Real wages are now significantly more sensitive to unemployment than in previous decades, meaning that unemployment may have to fall to very low levels before we can expect sustained pay rises. Although the study did not examine the potential drivers for this increase in real wage-unemployment sensitivity, the authors suggest 'it may, at least in part, be a consequence of the weakening of labour market institutions such as the coverage of trade unions. It may also reflect the impact of active welfare policies which have made the unemployed a closer substitute for those in work' (Gregg and Machin, 2012, p 4).

This points to an important policy conclusion. The experience of the US and the UK suggests that reinstating the goal of full or near-full employment (a goal effectively abandoned in the 1980s in favour of lowering inflation and never re-instated) would not just help to create more jobs but would be an important instrument in securing decent wage growth, reducing wage dispersion and closing the wage-output gap.

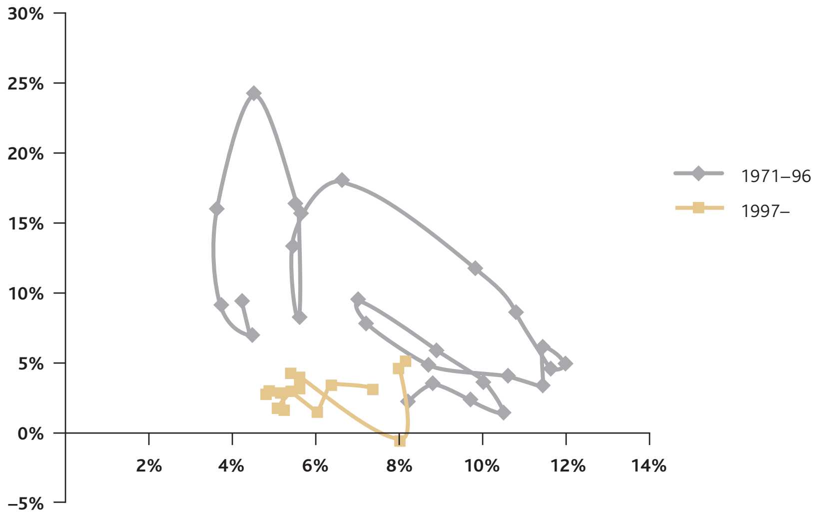
The experience of the late 1990s demonstrates the importance of the right blend of policy instruments. In the US, the policy authorities broke with economic orthodoxy, especially on the relationship between employment and inflation. Attempts to boost economic activity during this period by keeping interest rates low reduced unemployment significantly while having little impact on inflation (although it did contribute to asset bubbles). Although this was not the Federal Reserve's primary purpose, the same policy mix also proved to be highly effective in narrowing the wage-output gap. This raises a further question mark over the traditional explanations for the long wage squeeze. As the American Economic Policy Institute has put it, "The most fundamental lesson is that the generally dismal performance of wages and incomes of low-to-middle income workers cannot be chalked up to disembodied forces like 'technical change'" (Mishel, 2012 p 44).

Recent months have seen signs of a shift in direction on macro-economic priorities, with growth and cutting unemployment emerging as new priorities over capping inflation. In December, 2012, the Federal Reserve announced that the US would add a new economic target aimed at keeping unemployment below 6.5 per cent, and would need to keep interest rates low until that level is achieved. This was a significant economic and political step that puts the goal of reducing unemployment back at the heart of US economic policy. The move was followed by a suggestion from the new Bank of England Governor designate, Mark Carney, that central banks might need to consider moving from the current single inflation target to one of targeting 'nominal GDP growth' (that is, growth plus inflation rather than inflation alone).

In January, 2013, the Ernst and Young Item forecasting group joined those calling for the 2 per cent inflation target to be relaxed in favour of measures aimed at stimulating the economy. These developments are clear signs of a new recognition of the need for a shift away from the single inflation goal that has steered monetary policy in recent times towards a greater emphasis on growth and employment.

There is also some evidence that the traditional trade-off between inflation and unemployment may have eased in the last 10–15 years, in part down to more active labour market policies for the unemployed, but also in part down to the weakening impact of collective bargaining. If so, there is more potential for lowering unemployment – within current levels of labour market regulation – without generating inflation than there was in the 25–30 years before that, and this chimes with US experience. In the UK, as figure 7 shows, plotting the inflation rate against the unemployment rate from 1997 until 2012 shows a rough inverse 'Phillips curve' type relationship, but in recent years the curve appears to have moved 'inwards' slightly – meaning that moderate rates of unemployment (of between 5 and 8 per cent) have been compatible with relatively low inflation (less than 5 per cent), which was not the case for most of the 1970s, 1980s and early 1990s.

Figure 7: Inflation-unemployment trade-offs: pre- and post-1997



Source: authors' own analysis of unemployment and RPI inflation data from ONS

How much of the 'wage gap' might these policy measures close?

This chapter has examined a range of policies aimed at increasing wages, particularly for the lower-paid. So what contribution might these policies make to reversing the decline in the wage share over the last 30 years and to closing the 'wage gap'?

This section presents some results from empirical modelling of a selection of these policies: increasing the level of the minimum wage, raising a half of all employees paid below it up to the living wage, extending collective bargaining coverage and reducing the level of unemployment.[7] This is an exercise aimed at assessing the likely impact of policy changes and should not be read as an endorsement of the policies in full.

As we saw in section 4, the current 'wage gap' – the difference between the wage share in 1980 (59.19 per cent) and the wage share in 2011 (53.72 per cent), the most recent year for which finalised statistics exist, stands at 5.47 per cent as a percentage of GDP at 2011 levels. In money terms, this is £82.9bn (5.47 per cent of £1,516.2bn).

The policies below are evaluated according to how much of this gap they can close.

Increasing the minimum wage

Currently around 1 million people earn the adult minimum wage of £6.19 per hour (or less)[8]. As discussed earlier, if the minimum wage had been maintained in real terms at its 2009 level (the highest level in real terms since the minimum wage was introduced in 1999), it would have been set at £6.60 in October 2012. Analysis of the Labour Force Survey suggests that around 1.2 million employees earn between £6.19 and £6.60 per hour. Calculations using the Labour Force Survey suggest that if the minimum wage were raised from £6.19 to £6.60, the resulting increase in the gross wage bill would be around £1 billion.[9] This would increase the wage share by around 0.07 percentage points, and would close about 1.2 percent of the wage gap.

Introducing a living wage

Research done by Landman Economics in conjunction with the Institute for Public Policy Research and the Resolution Foundation for the report *Beyond the Bottom Line: The Challenges and Opportunities of a Living Wage* (Pennycook and Lawton, 2013) calculates the overall impact of the gross wage bill if all employees currently on hourly rates between the minimum wage and the living wage (just over five million employees) were moved up to living wage rates of £8.55 per hour in London and £7.45 per hour in the rest of the UK.

Extending the living wage to all employees seems unrealistic – at least in the short-to-medium term. This is because not all employers could afford to pay the living wage if it were simply imposed across the board, and there would most likely be employment losses from such a policy. Instead therefore, we have modelled a scenario where a randomly chosen 50 percent of employees currently paid at hourly rates between the minimum wage and the living wage are moved up to the living wage. This seems like an achievable aim across the UK economy for the medium term – say, in the next five to ten years. If the coverage of the living wage were extended in this fashion, the total gross wage bill would increase by £3.2 billion, increasing the wage share by 0.21 percentage points and closing 3.9 per cent of the wage gap.

Increased trade union representation / collective workplace bargaining

Recent research (referred to earlier) suggests that the current wage premium for union members compared with non-members is fairly small in the UK, at around 5 per cent. Data from the Labour Force Survey (autumn 2011) suggests that around 31 per cent of employees in the UK have pay and conditions which are affected by union agreements, and we take this as a proxy for the current coverage of collective bargaining in the UK.

If (for example) half of the workers who are currently not covered by union agreements became covered by such agreements (either via an increase in union membership or via an extension of collective bargaining at the industry or sector level), applying the union wage premium to those employees who are newly included in the bargaining process would we calculate increase the overall wage bill by approximately £13bn. This would increase the wage share by around 0.86 percentage points (closing some 15.7 per cent of the total wage gap.)

Impact of reduced unemployment

The extent to which unemployment affects wage levels is a key question in macroeconomics. Recently, unemployment has fallen slightly from its post-2008 high of 8.4 per cent, but still remains high compared to the rates in the late 1990s and early 2000s, let alone the rates in the 1950s and 1960s – when claimant count unemployment was often less than 3 per cent of the labour force.[10]

Gregg and Machin (2012) analyse the relationship between unemployment and real wages and find that a fall of 1 percentage point in the unemployment rate is associated with a 0.119% increase in median real wages (in the period 2003–2010). Currently the unemployment rate is around 7.7 per cent. We can test the impact of a fall in unemployment of 4.2 percentage points, to 3.5 per cent – a best case (and ambitious) scenario (below the level achieved in the late 1990s and early 2000s boom, but above the level achieved in the 'full employment' era of the 1950s and 1960s). Using the linear relationship identified by Gregg and Machin this would lead to an increase in median wages of 0.5 per cent. If this were replicated across the wage distribution the total wage bill would increase by around £4.1 billion, which would increase the wage share by 0.27 percentage points (closing around 4.9 percent of the total wage gap).[11]

The combined impact of all policies

Table 2 below shows the combined impact of these policies – increasing the National Minimum Wage, moving towards a Living Wage, increasing the coverage of collective bargaining and reducing unemployment – taking account of the interactions between the four policies. Overall, we estimate that these policies would eliminate 25 per cent of the 'wage gap' – returning the wage share to around 55.1 per cent of GDP.

Each of these policies would impact at different points of the wage distribution, but would be concentrated in the bottom half of the distribution. The raising of the minimum wage and the introduction of the living wage would benefit those at the lower end of the wage distribution. The other policies – the extension of collective bargaining and the reduction in unemployment – would particularly benefit lower paid workers but would also raise pay for those further up the wage distribution.

Table 2: The combined impact of these four policy measures

	Gross increase in wage bill for each item	Percentage of wage gap closed for each item alone	Cumulative effect of combining the policies
National Minimum Wage increased to £6.60 per hour	£1.0bn	1.2%	1.2%
Living Wage introduced for 50 percent of employees currently paid below it	£3.2bn	3.9%	4.5%
Extension of trade union membership and collective bargaining coverage	£13.0bn	15.7%	20.2%
Reduced unemployment	£4.1bn	4.9%	25.1%

Notes on calculating the combined impact – of 25.1 per cent – in the table, which assumes:

- that half of the impact of increasing the National Minimum Wage from £6.19 to £6.60 per hour is subsumed under the impact of introducing the Living Wage for half of employees (because the living wage rates are higher than the £7.19 per hour rate which would arise from increase in the National Minimum Wage
- that the impact of increased collective bargaining is additive, on top of the impact of the living wage
- that the impact of reduced unemployment is additive.

Of course, this is a partial analysis and does not include the impact of all possible measures that could be deployed. It ignores, for example, the possible impact of reducing the gender pay gap. As women represent close to half the labour force, any move towards closing the pay gap with men (average hourly earnings for men in July 2012 were £13.70 compared to £11.12 for women – a gap of around 18.8 per cent[12]) would have a significant impact on the total wage bill, though it is also likely that some of the impact would be offset by some reduction in male wages.

Although these measures would make a significant dent in the 'wage gap' of around a quarter, much more would need to be done to close it further. This is perhaps not surprising as ths gap has built up over 30 years of significant economic change, and could, inevitably, not be reversed quickly. The measures also apply to the current workforce. Further reductions in the gap would depend on the success of policies aimed at a fundamental rebalancing of the UK's industrial structure and changing the shape of the workforce in favour of more middle and higher paid work.

Rebalancing the economy away from low paid work

The policy measures discussed earlier in this section aim to tackle existing inequalities in wages regardless of industrial structure. But for a high-wage policy to be sustainable it has to operate in tandem with policies to alter the industrial structure of the economy in favour of the types of jobs that are more likely to support high-wage employment. In other words the UK needs an industrial policy to support high-wage employment.

There is clear empirical evidence that the changing industrial structure in the UK economy over the last 35 years – in particular, the sustained shift from industrial sectors (with a higher wage share) towards service industries (with lower wage shares) – has been an important contributory factor to the falling share of wages in national income, and the growing incidence of low pay. As one study of the period 1977–2009 has concluded: 'Overall, the findings show that the decline in overall labour share was largely a function of the changing industrial structure of the UK rather than of trends within sectors… the dramatic shift in the industrial structure of the UK from industry, where a relatively large proportion of value generated flows to labour, to finance, where a much higher proportion of value is retained as profits, produced a strong negative effect [on the wage share]' Whitaker and Savage, 2011).

The fall in the wage share has thus not been driven by a similar fall across all industries but by the growth of sectors with a lower wage and higher profit share. "The overall fall in the wage share… has largely been driven by a contraction of industries where the wage share is relatively high, and expansion of industries where the wage share is relatively low, rather than falls in the wage share in individual industries." (Reed and Mohun Himmelweit, 2012).

However, the fall in the wage share is not *entirely* due to sectoral shifts: there is also evidence of some stretching of pay within occupations. Take the growth area of managerial jobs, for example, an occupational group which has seen a widening pay gap. 'In the retail and wholesale sector, where managerial jobs increased between 2000 and 2008, the proportion of these jobs earning below £400 per week – adjusting for inflation – increased from 37 per cent to 58 per cent in this time period. In financial intermediation, a sector which has performed relatively well over this time period, there has clearly been a growth in high wage managerial jobs in this sector – those earning over £1,500 per week increased from just a couple of percent in 1993 and 2000, to 10 per cent in 2008. However, between 2000 and 2008, there was also a growth in the proportion of managers in this sector earning less than £400 (from 24 per cent to 30 per cent)' (Holmes and Mayhew, 2012).

The policy implications of these alternative factors are different. Narrowing pay gaps within industries depends to some extent on the reforms suggested earlier in this report – particularly reforms to increase collective bargaining in workplaces, but also upon the creation of more well-paid middle income jobs within particular industrial sectors. In addition, action is also needed to reverse the shift towards lower-wage, higher-profit sectors in the UK economy which has taken place since the late 1970s. Both require an industrial strategy to promote high-wage sectors and higher-skilled and higher-wage job roles. The final section of this report looks at what such an industrial strategy might entail, and what the prospects are for success.

Taking the 'high road'

Rebalancing the economy towards sectors that have a higher wage share is clearly a long-term goal. These would aim at rebalancing the economy towards an economic 'high road', an industrial strategy objective identified by the TUC over a decade ago (TUC, 2002). A 'high road' strategy for the UK economy would combine:

- high value-added product strategies
- high levels of training and investment
- high productivity and wages
- good workforce terms and conditions.

This would involve a much greater use of policy to promote production and service sectors based on a skilled labour force, higher investment and innovation. This would need a more pro-active industrial strategy and big policy changes on re-skilling. Of course, even success in such restructuring would not bring an end to low pay. Even those countries at the bottom of the low paid league have plenty of cleaners and waiters. But it would mean the measures aimed at paying more outlined above would have to do less of the heavy lifting.

Over the last 30 years, Britain has been moving in the direction of a 'low road' economy – one increasingly built around low value added, poor quality and low paid sectors. In contrast, those countries with lower levels of low pay have achieved a better balance with more 'high road' activity in high value added, high productivity sectors. The shift to a 'low road' economy is a trend driven in part by Britain's poor record on innovation and investment in both skills and physical capital. As a result, according to Professor Michael Porter, Britain has developed three central competitive disadvantages: 'insufficient investment in capital assets and innovation, positioning on low input cost rather than high value, and lagging adoption of modern management techniques' (Porter, p 38).

The danger with the current trajectory of falling real wages which the UK economy has recently slipped into is that, with labour becoming ever cheaper in real terms, the "low road" route becomes more and more attractive to employers as an alternative to capital investment. So in effect, falling real wages are a driver for reduced innovation and productivity. In this scenario the UK economy is likely to become increasingly stagnant and any growth that does take place is unlikely to show up in workers' living standards. This makes the case for an alternative approach to UK industrial policy – one which doesn't rely on falling real wages as the primary route to boost competitiveness – even more pressing.

The rebirth of industrial strategy

Industrial strategy was out of favour in the UK (and in many, though not all, other developed economies) in the 1980s, 1990s and 2000s as the neoliberal orthodoxy of the time was that the free market could be relied upon to grow industries that best exploited the UK's comparative advantages in production, provided the government got far enough out of the way (through deregulation) to allow the market to work properly. The main result of 30 years of deregulation and 'hands-off' industrial policy in the UK was the largest financial services sector (as a share of GDP) in the G7; this sector imploded spectacularly in 2008, when complete collapse of the UK banking system was only avoided through a multi-billion dollar bailout package and the part-nationalisation of RBS and Lloyds Group. The ensuing fiscal crisis which the UK has endured – and which frames the entire economic policy of the current government – is largely a consequence of the plight of the UK's financial services sector, which has severely diminished tax receipts for the last four years, as well as precipitating an economic depression worse in some ways than the 1930s (Portes, 2013).

The tragic economic consequences of *laissez-faire* in UK industrial policy have led to a reappraisal of the merits of industrial strategy, with economists along much of the political spectrum being far more willing to countenance some form of interventionist industrial policy than they would have been before 2008. Looking across the main arguments for some form of industrial strategy in the UK (a large and growing literature), the key messages seem to be the following.

Firstly, government needs to encourage innovation in innovative ways. Since the late 1990s, the main UK government policy initiative for encouraging innovation has been the R&D tax credit. A recent evaluation of the credit by HM Revenue and Customs suggests that it has been effective at encouraging R&D spending, but it has not been enough to reverse the long-term decline in R&D spending as a share of UK GDP (HMRC, 2011). Recent research on the determinants of innovation (Mazzucato, 2011) has suggested that well-structured industrial policy can address the current deficiencies in the UK business sector and boost investment and innovation. This should be done not by 'picking winners' but rather by using the state in a wider enabling role, to actively create markets for new technologies to come into being by bringing together the right networks of private and public sectors in order for radical innovation to occur. This approach is often associated with successful Asian economies such as South Korea and China, which helped drive their own growth miracles as part of their national development strategies. But an equally pertinent example is the USA, which has promoted successful innovations by private sector businesses backed with public funding, through initiatives such as the Small Business Innovation Research (SBIR) scheme, which channels a proportion of US government departments' research funding to a large number of highly innovative start-up firms.

Adequate levels of funding for business investment are crucial to provide the levels of capital investment which can support high-wage, high-value-added production. Currently in the UK economy there is a shortage of business lending to large sectors of the economy (Bank of England, 2012). Lack of bank lending is not the only reason why business investment is low – there are many firms who are accumulating 'cashpiles' of profits without reinvesting these funds in new plant and machinery – but it does explain part of the investment shortfall. Several policies are necessary to secure greater levels of bank funding for business investment, including a state investment bank to bankroll key infrastructure and low-carbon projects (Dolphin and Nash, 2012); full nationalisation and directed business lending targets for RBS, and perhaps Lloyds Group as well; and favourable tax treatment of new alternatives to traditional bank and venture capital finance such as 'crowdfunding' initiatives (e.g. Kickstarter). In the UK finance sector as a whole there needs to be a pivot away from what ex-Financial Services Authority head Adair Turner has called "socially useless activity" and towards increased bank lending for productive investment. Regulatory changes designed to discourage short-run speculative activities and encourage longer-term business lending have a key role to play here. Financial sector activities need to be refocused on value creation rather than value extraction and derstruction. This will make it more profitable to invest in the real economy than in financial trading around it (Perez, 2012).

An effective UK skills and education policy with increased levels of skills and a reduction in the number of school-leavers lacking basic skills is a necessary condition for a successful high-road economy, but is not (on its own) sufficient. This is because employers have to be prepared and willing to use well-qualified employees in jobs that make best use of their skills to produce high-value-added outputs. Otherwise, there is a risk that the UK economy will end up with a large proportion of employees who are overqualified for the jobs they do.

Measures to increase the bargaining power of workers would be helpful insofar as they reduce the likelihood that employers who want to pursue 'low road' strategies will be able to do so. Conversely, employers are more likely to pursue high road strategies if backed by an organised and empowered workforce. Increased trade union representation – both in terms of the percentage of employees belonging to a union, and the proportion of workplaces recognising trade unions for bargaining purposes – would be helpful in this regard. So would an increasing role for employee involvement in corporate governance – because when the workers have a stake in the business, management and worker incentives are much more likely to be aligned in favour of a 'high-road' strategy.

Encouraging the inward migration of high-skilled people is also a policy measure that can promote high-value-added industries because employers are then unable to claim that they cannot pursue a high-wage, high-skill approach to production because there is a shortage of jobseekers with the necessary skills to support this approach. Of course, inward migration should never be seen as an alternative to investing in training and education for UK-born employees. Rather, a flexible immigration policy needs to go hand-in-hand with well-funded training and education policies.

Overall, moving towards a more high road balance in the UK will require an active industrial strategy which focuses both on how existing businesses can become stronger, as well as growing new industries for the future. Such a strategy would include recognition of the need for the UK to specialise in a number of targeted, high skill, high value manufacturing and service sectors where we are or could become competitive in the age of globalisation. It would also need active government support for key industries, urgent action on skills and a government procurement policy that ensures every pound of public money spent contributes to sustainable economic growth. Such measures need to be supported by a wider economic policy that ensures our economy has the capacity to grow strongly in the future. That means investing in the recovery, and setting up new institutions such as a national investment bank, rather than continuing to inflict long-term economic damage through severe spending cuts. Success will also depend on creating a stronger role for unions and employer organisations in supporting such an industrial shift.

Appendix: The relationship between the wage share and growth, 1948–2011

To estimate the impact of a higher wage share on growth, we have used aggregate data on national output (Gross Domestic Product), wages, investment, employment and inflation for almost the whole of the post-war period (1948 to 2011) to construct a simple model of the determinants of GDP growth which uses the wage share as an explanatory factor. The model specification is as follows:

Dependent variable: growth rate in real GDP per head of population (deflated using Retail Price Index)

Explanatory variables:

- level of wage share (per cent) [insert actual definition]
- growth rate in average wages per employee (deflated using RPI)
- growth rate in investment per head of population (deflated using RPI)
- level and growth rate of employment as a percentage of working age population
- level and growth rate of unemployment (claimant count) as a percentage of working age population
- the RPI inflation rate
- a linear trend term (to capture structural factors affecting the overall capacity for economic growth in the economy over time).

The equation was estimated using an auto-regressive moving average (ARMA) specification which is a standard methodology for time-series modelling.[13] However, a simple OLS specification without the extra ARMA components produces very similar results.

Table A1: Results from time series model of determinants of UK GDP growth, 1948–2011

Explanatory variable	Coefficient	Standard error	|z-statistic|
Wage share (%)	0.5537	(0.1811)	3.06
Growth in average wages (%)	0.5468	(0.0827)	6.61
Growth in investment (%)	0.0308	(0.0205)	1.50
Growth in employment rate (% pts)	1.1409	(0.6151)	1.85
Level of employment rate (lagged 1 year)	-0.4258	(0.3672)	1.14
Growth in unemployment rate (% pts)	-1.2066	(0.7803)	1.55
Level of unemployment rate (lagged 1 year)	0.3044	(0.3482)	0.87
RPI inflation rate (% pts)	-0.2169	(0.0606)	3.58
Trend	0.0369	(0.0002)	1.44
Constant	-83.7467	(48.3968)	1.73
AR term (t-1)	0.2059	(0.6228)	0.33
MA term (t-1)	0.1695	(0.6428)	0.26
Number of observations	63		
Wald chi-squared (test for whole-regression significance)	260.59		
Prob > chi-squared	0.0000		

Data sources: employment and unemployment data taken from Bank of England, "Three Centuries of Economic Statistics". www.bankofengland.co.uk/publications/Documents/quarterlybulletin/threecenturiesofdata.xls
Other data taken from Office for National Statistics website.

The table shows that an increase of 1 percentage point in the wage share is associated with an increase of about 0.55 per cent in the rate of growth of real GDP. This result seems to confirm that there is a strong relationship between the wage share and economic growth in the post-war period. The only other statistically significant (at the 5 per cent level) result in the regression is that high inflation is associated with reduced economic growth – an increase of 10 percentage points in the inflation rate (e.g. from 2 to 12 per cent per year) is associated with a reduction of just over 2 percentage points in the GDP growth rate.

It is important to be clear that although these results establish a statistically significant relationship between economic growth and the wage share, controlling for other economic variables, we cannot be certain which way the causality runs. It could be that increased economic growth raises the wage share (although the mechanism by which this process would occur is not clear), or alternatively that some external factor not included in the regression affects both the rate of GDP growth and the wage share. Nonetheless, the results presented here are important evidence that the distribution of national income between wages and profits matters for economic growth, despite being largely ignored in current macroeconomic models.

We also estimated Vector Auto Regression (VAR) models using a system of four dependent variables (wage share, real wage growth, real GDP growth and real investment growth) in an attempt to model all possible directions of causality but the small number of annual observations available (63) coupled with the high number of parameters to be modelled meant that the results were not robust. This is a common problem with VAR modelling (Stock and Watson, 2001).

One of the reasons that we have used our own time-series modelling here to look at the impact of the wage share is that established economic models (e.g. the Treasury model, Oxford Economics etc.) incorporate the orthodox assumption that wage increases feed through to price inflation and hence reduce employment. This assumption is imposed by the neoclassical economic framework used in such models, rather than being a feature of the economic data themselves.

Notes

1 Of course, with a shrinking economy, some fall in real incomes and living standards since 2008/9 has been inevitable. Yet this fall is almost double the fall in GDP per head of 7 per cent. This is also a much more pronounced and longer lasting fall than in the recessions of the early 1990s and early 1980s. This is in part because while employment has fallen by less than expected given the scale of the contraction, real wage falls have been far more significant than in previous downturns.

2 Adjustments have been made for changes in the level of Employer National Insurance and Pension Contributions (these are included in the base figures), changes in the level of self-employment income (which are excluded – they are incorporated in profit figures), and changes in earnings amongst top income earners including executives (which are included in the base figures). In the case of employer national insurance and pension contributions and the effect of the growing concentration of earnings at the very top, these adjustments lead to a sharper drop in the wage share than shown by the aggregate figures. In the case of the rising level of self-employment, the impact is less clear-cut. (see for example, Bailey et al, 2011; Reed and Mohun Himmelweit, 2012 and OECD, 2012, Box 3.1 p115 and Box 3.2 p116).

3 This is higher than in the pre-war era (Glyn & Sutcliffe, 1972 p 16; Atkinson, 1983, ch 9).

4 One of the reasons that we have used our own time-series modelling here to look at the impact of the wage share is that established economic models (e.g. the Treasury model, Oxford Economics etc.) incorporate the orthodox assumption that wage increases feed through to price inflation and hence reduce employment. This assumption is imposed by the neoclassical economic framework used in such models, rather than being a feature of the economic data themselves.

5 Accreditation is awarded by the Living Wage Foundation:
http://www.citizensuk.org/campaigns/living-wage-campaign/the-living-wage-foundation/

6 Low pay is defined as below two-thirds of the median.

7 It should be noted that these results assume that the increases in wages do not produce any employment effects – either positive or negative. In reality, it is possible that employment effects could go in either direction. Higher wages could increase aggregate employment through stimulating demand; but on the other hand there could be increased unemployment if employers in some sectors are unable to afford the higher wages. A priori it is uncertain which effect – if either – would dominate.

8 Data from the Annual Survey of Hours and Earnings (ASHE) suggests that a small number of low-paid earners earn below the minimum wage rate; this is for two reasons. Firstly, minimum wage rates for workers aged under 21, and for certain types of trainees, are lower than £6.19 per hour. Secondly, it is likely that the minimum wage is not perfectly enforced in the UK and so some jobs paid at hourly rates below the minimum wage still exist, even for workers who are 21 or over and not trainees. […]

9 Note that this calculation includes people in the FRS data who are currently paid below the minimum wage. In some cases these people may not be eligible for the full minimum wage (for example because they are under 21 years old, and/or trainees). In other cases, we know that the FRS slightly overstates the extent of very low pay in the UK because the information collected on hours worked per week does not always relate to the same week worked by each person interviewed in the survey as the week which the earnings information comes from. This means that in some cases the estimated hourly wage from FRS data is misleadingly low. This means that the £3.8 billion figure given here should be seen as an upper bound estimate on the costs of increasing the minimum wage by £1 per hour.

10 The UK did not start collecting unemployment data using the ILO definition of unemployment until the 1980s, so the unemployment rates for the 1950s and 1960s are not strictly comparable with current levels. However, the claimant count in the 1980s was also much higher than in the 1950s and 1960s.

11 This assumes that the relationship between the unemployment rate and real wages is linear; it could be that the boost to wages from a lower unemployment rate is higher, the closer unemployment gets to a rate consistent with full employment.

12 Using a median measure of hourly wages instead of the mean, the corresponding figures are £10.40 for men and £8.66 for women – a gap of 16.7 per cent.

13 The auto-regressive (AR) component(s) in the ARMA specification (lags of the dependent variable) help to control for serial correlation in the dependent variable which can otherwise bias the estimated coefficients on explanatory variables. The moving average (MA) component(s) help control for serial correlation in random shocks which may affect the dependent variable. In this case, particular shocks which have affected post-war GDP growth include the 1973 and 1979 oil shocks and the financial crash of 2008.

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