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# Economic recovery requires a better deal for labour

By Simon Tilford

CENTRE FOR EUROPEAN REFORM

# Economic recovery requires a better deal for labour

**By Simon Tilford**


- ★ If market capitalism is to retain its appeal, the living standards of the broad mass of the population must rise, and vested interests must not be allowed to abuse the system. But the benefits of economic growth are increasingly accruing to capital and to a tiny minority at the top of the income scale. This has serious implications for Europe's economic prospects and political stability.
- ★ Economic recovery in Europe is being held back by the weakness of business investment. Despite a secular rise in corporate profits, investment has fallen steadily for 30 years. This is not the result of waning competitiveness brought on by onerous labour regulation or excessive business taxes, but weak consumption. Businesses will not invest unless they are confident about the outlook for demand.
- ★ The weakness of consumer demand can be traced to two things. First, a steady fall in labour income (wages, salaries and other employee benefits) as a proportion of national income. This is the flipside of the rise in corporate profits. Second, a sharp rise in income inequality. The wealthy consume a lower proportion of their income than the less well-off.
- ★ In an effort to improve competitiveness, EU countries are trying to cut their labour costs relative to one another, shift the burden of taxation from capital to labour and consumption, weaken workers' bargaining power, and curtail social transfers. This promises to aggravate Europe's core problem – a structural shortage of demand – by bringing about a further decline of labour income and a rise in inequality.
- ★ European governments must not weaken the competitive pressures that contribute to productivity growth. But they need to combine supply-side reforms with policies to prevent a further rise in inequality and continued decline in labour's share of the pie. If they fail to do this, recovery will prove elusive, undermining social cohesion and opening the way for populism and a backlash against markets.


Economic recovery in Europe is being held back by the unprecedented weakness of business investment. Despite a secular decline in business taxation and labour market reforms that have boosted the power of capital relative to labour, the ratio of investment-to-GDP across the EU has been falling for decades and has now stagnated at 60 year lows. Rather than investing their profits, firms are sitting on cash. This is depressing economic activity, employment and wage growth and forcing governments to run big budget deficits.

Europe's austerity-minded politicians and policy-makers argue that business investment will recover once governments have pushed through supply-side reforms and put public finances on a sound footing. Companies will then feel confident about investing for the future. According to this argument, investment is weak because countries have lost competitiveness and because firms are worried about the weakness of public finances. There is no doubting the needs for supply-side reforms of one kind and another, but the dominant narrative does not bear scrutiny.

This paper will argue that the origins of the weakness of business investment lie in a severe structural shortage of consumer demand. This can be traced to a steady fall over a 30 year period in the proportion of national income (or GDP) accounted for by wages, salaries and other employee benefits (the so-called 'labour share') and to rising inequality. Weak demand is not the result of a lack of competitiveness brought on by onerous labour regulation or excessive business taxes. Businesses will not invest unless they are confident that there will be demand for whatever it is they produce.

Rather than boosting investment, Europe's current economic growth strategy will weaken it further by further eroding labour share and aggravating inequality. Aside from holding back economic recovery, this threatens popular confidence in markets and ultimately, social cohesion. Economic recovery in Europe will require European governments to challenge some of the assumptions that have guided policy over the last three decades.

## What has happened?

**The decline of labour income**

Labour shares differ between countries for a variety of reasons, including a country's industrial structure. For example, countries with large mining and oil and gases industries tend to have low labour shares because these industries generate very large revenues while employing few people. The labour share in any economy also tends to be cyclical – it rises in a recession or period of weak economic growth as companies hold on to workers and accept lower profits, and falls in times of rapid growth as revenues and labour productivity rise. The division of income between workers and capital has swung decisively in favour of capital since the early 1980s: the labour share has fallen steadily across all the major industrialised countries over this period (see Chart 1).

The reason is that wages have risen by less than the rate of growth in labour productivity (and this despite a steady decline in the rate of productivity growth in most developed countries over this period). The decline in labour's share of national income has been biggest in continental European countries that are widely seen as having 'social market' economies, in particular Germany and Italy, and smaller in economies which are generally considered more economically-liberal and where capital is thought to be dominant, such as the UK and the US. Contrary to popular perceptions, workers have not captured an unsustainably high proportion of national income in struggling eurozone economies such as Italy and Spain; in both cases labour income (as a proportion of the total) is lower than in Germany.

> *"The division of income between workers and capital has swung decisively in favour of the latter since the early 1980s."*

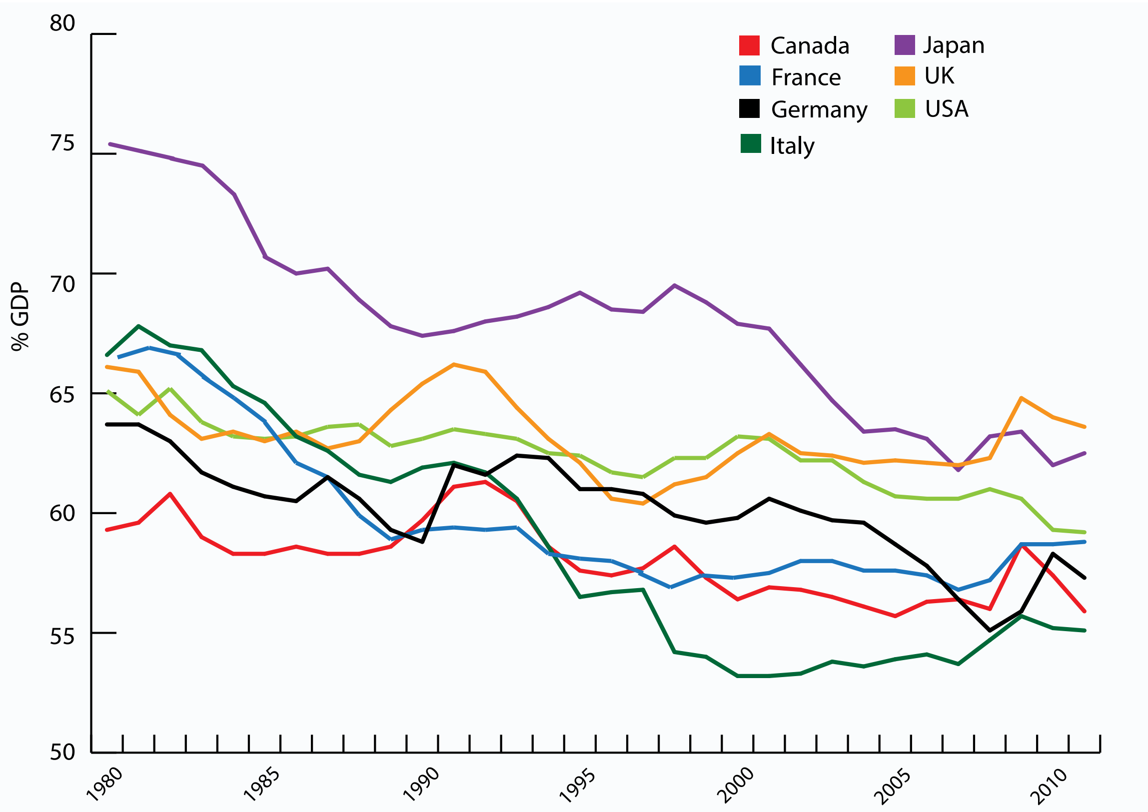


Chart 1: Labour share of national income (including from self-employment)

*Source: European Commission*

The flipside of the fall in the proportion of national income accounted for by wages and other benefits has been a rise in the proportion accounted for by corporate income, the so-called gross operating surplus (see Chart 2). Put another way, the return on capital employed has increased very significantly over this period. The corporate sector has also benefited from changes to the tax system. The data is patchy, but it is clear that corporate income net of tax has risen by even more than the rise in gross operating surplus. Personal income taxes as a share of GDP have risen across the industrialised world and consumption taxes have jumped, but taxes on corporate income have fallen steadily (see Table 1). In short, despite capturing a bigger share of national income, firms are paying less tax on it because the burden of taxation has shifted from capital to labour.

> *"Despite capturing a bigger share of the pie, firms are paying less tax because the burden of taxation has shifted from capital to labour."*

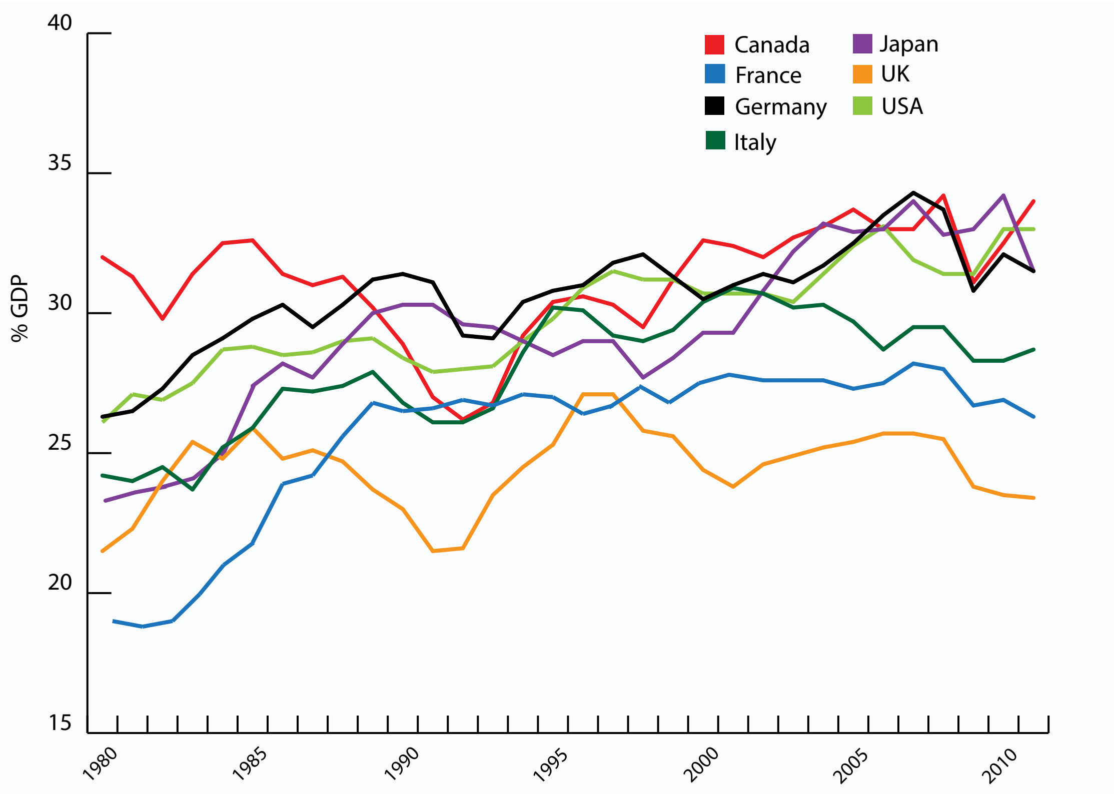


Chart 2: Gross corporate operating surplus (per cent, national income)

*Source: European Commission*

| | 1980 | 1990 | 2000 | 2012 |
|---|---|---|---|---|
| France | 50.0 | 42.0 | 37.8 | 34.4 |
| Germany | 60.0 | 54.5 | 52.0 | 30.2 |
| Italy | 36.3 | 46.4 | 37.0 | 27.5 |
| UK | 52.0 | 34.0 | 30.0 | 24.0 |
| Canada | 50.9 | 41.5 | 42.4 | 26.1 |
| Japan | 50.0 | 50.0 | 40.9 | 39.5 |
| US | 49.7 | 38.7 | 39.3 | 39.1 |

Table 1: Combined corporate tax rates (per cent, GDP)

*Source: OECD Tax Statistics*

| | Total population | Bottom ten per cent | Top ten per cent |
|---|---|---|---|
| France | 1.2 | 1.6 | 1.3 |
| Germany | 0.9 | 0.1 | 1.6 |
| Italy | 0.8 | 0.2 | 1.2 |
| UK | 2.1 | 0.9 | 2.5 |
| Canada | 1.1 | 0.9 | 1.6 |
| Japan | 0.3 | -0.5 | 0.3 |
| US | 0.9 | 0.1 | 1.6 |

Table 2: Trends in household income (average annual change mid-1980s to late 2000s)

*Source: OECD*

## Rising inequality

Stripping out the top 1 per cent of income earners reveals that labour share of national income has fallen even more steeply. The reason for this is that the decline in the ratio of labour compensation to GDP has gone hand in hand with an increasingly unequal distribution of that income.[1] The labour compensation of the top 1 per cent of income earners, measured as a fraction of national income, has increased substantially in nearly all countries (France is a partial exception). Put another way, a hugely disproportionate share of the rewards from economic growth has accrued to those at the top, led by boardroom executives and senior bankers. The top 10 per cent of income earners has also done very well relative to the workforce as a whole, with France again being an outlier (see Table 2, page 3). By contrast, median incomes have risen more slowly, and actually fell between 1990 and 2009 in Germany and Japan.[2]

The result of these differing wage trends has been a rise in inequality. The Gini coefficient is a standard measure of inequality, where zero means everybody has the same income and 1 means that the richest person has all the income: the lower the number, the more equal the country.

Of the big developed economies, Italy, the UK and the US have the highest levels of inequality before the payment of taxes and the receipt of social transfers. Japan is the least unequal, followed by Canada and Germany, though all three have experienced large increases in inequality over the last 25 years. The level of inequality after the payment of tax and receipt of transfers is considerably lower in all developed economies, reflecting the redistributive character of their tax and social systems. However, as might be expected, the US tax and social systems are less redistributive than the European ones. Because of this, US levels of inequality are higher than European ones but the gap has narrowed substantially. For example, Italy and the UK are now as unequal as the US was as recently as 15 years ago (see Charts 3 and 4).

> *"A disproportionate share of the rewards from economic growth have accrued to those at the top."*

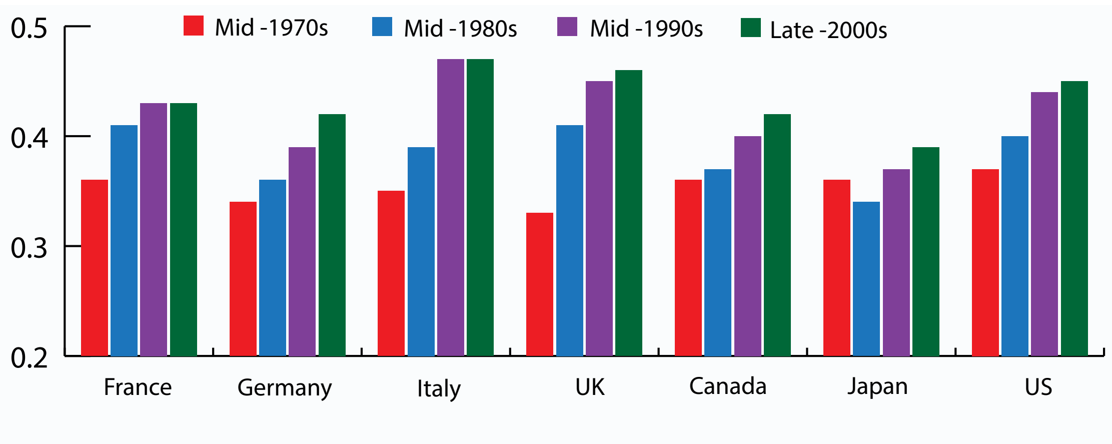


Chart 3: Income inequality before taxes and transfers as measured by Gini coefficients (Working age population 16-65)

*Source: OECD: Income Distribution and Poverty Database*

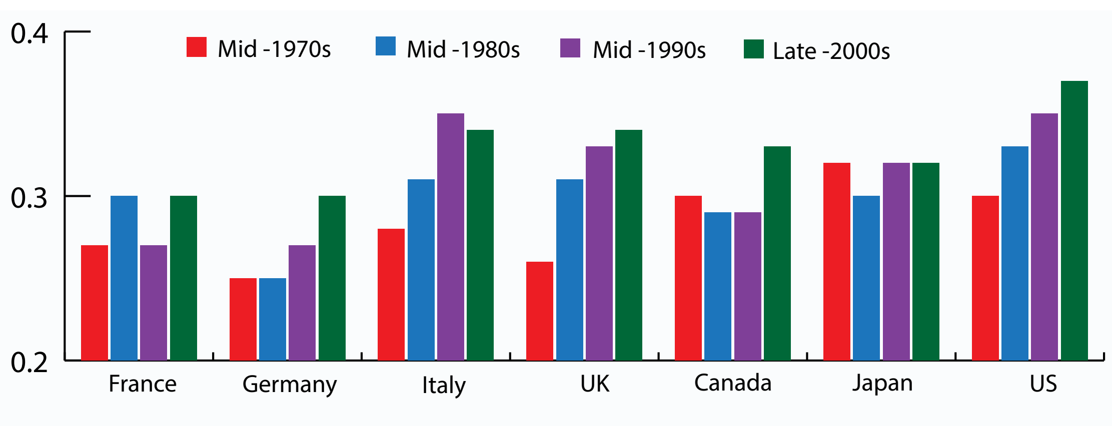


Chart 4: Income inequality after taxes and transfers as measured by Gini coefficients (Working age population 16-65)

*Source: OECD: Income Distribution and Poverty Database*

*1:* 'Divided we stand: Why inequality keeps rising', OECD, December 2011.
*2:* The 'median' is the 'middle' value in the list of numbers. It differs from the 'mean', which is the sum of a range of numbers divided by the amount of numbers.

## Why has this happened?

What explains the declining share of labour income and the accompanying rise in inequality? There is no single reason. Some of the drivers are to a large extent beyond governments' control, such as technological change, more capital-intensive forms of production, globalisation of trade and increased capital mobility. But government policy has also contributed to the trend. Financial liberalisation has led to major changes in corporate governance: firms now face huge pressures to put short-term profits ahead of long-term organic growth. Governments have done too little to address the rent-seeking that this financialisation has given rise to.[3] Tax and social systems have become less redistributive, as taxes on capital have fallen and those on labour and consumption have risen as governments have attempted to create a more attractive environment for business and for high earners. Labour market reforms and the erosion of unemployment benefits have weakened the bargaining power of labour. Governments – at least continental European ones – have also done too little to reduce persistently high unemployment, which has contributed to making labour (and the unions that represent it) more compliant.

**Capital accumulation**

The production of goods and services has become steadily more capital-intensive: that is, the amount of capital per worker has increased. One reason for this is the shift away from labour-intensive industries such as textiles in favour of sectors where the labour share of income generated is low. However, research from the OECD suggests that this structural shift accounts for only a small part of the decline in the proportion of national income paid to labour. Declining labour share within industries has been a much bigger factor.[4] Hourly productivity has increased by more than hourly wages and benefits in all sectors. The financial sector, network industries such as telecoms and energy, and medium and high tech manufacturing have experienced especially large falls in labour share as a proportion of the value they create.

**Labour's declining bargaining power**

Another factor behind the decline in labour income is the weakened bargaining power of labour. This has come about for a number of reasons. The first is increased domestic competition brought about by the liberalisation of markets and the privatisation of state-owned firms. Whereas these moves led to big increases in productivity in some industries, wages lagged well behind productivity growth. The second is increased international competition and rising trade with emerging markets, which has forced businesses in developed countries to bear down on labour costs. The third is increased scope for off-shoring, which has made it possible to locate production of goods and services a long way from the markets for them. The fourth is labour market reform. Many labour market reforms have had positive economic effects by improving labour market flexibility and challenging vested interests. But they have also contributed to a reduction in labour's bargaining power. Labour reforms in many developed economies have undercut the power of trade unions, while the erosion of unemployment benefits, increased use of temporary and agency workers and persistently high unemployment have combined to make workers more acquiescent.

> *"Some of the drivers of declining labour share and rising inequality are to a large extent beyond governments' control."*

**Corporate governance**

Changing patterns of corporate governance have contributed to the decline in the share of national income accounted for by labour compensation. Over the last 30 years the principle of share-holder value has become central to corporate governance. Companies, especially in the UK and US, but increasingly in all industrialised countries, are now under strong pressure to engineer short-term profits for investors, even if these come at the expense of investment and hence organic growth. The drivers of this trend are the increased threat of takeover and changes to remuneration, which is increasingly driven by short-term share performance. Senior executives have little to gain personally by signing-off on investment, as most of it depresses profits over the time horizons which determine their financial rewards, with the result that companies now take a more short-term view. Growth has also increasingly come through mergers and acquisitions, often financed by debt, rather than through investment in capital and workforces. In a drive to meet share price targets and reduce debt levels, managers have a strong incentive to reduce short-term costs by outsourcing and bearing down on wage costs.

All these pressures on workers' bargaining power have shifted workers' expectations. They have also contributed to a decline in trade union membership as well as to the unions changing their role. Unions have internalised these competitive constraints – instead of negotiating wage increases in line with productivity trends, they have

*3:* Rent-seeking refers to the ability of groups to extract disproportionate rewards (or 'rents') for whatever it is they provide.

*4:* Andrea Bassanini and Thomas Manfredi, 'Capital's grabbing hand? A cross-country/cross industry analysis of the decline of the labour share', OECD 2012.

switched to trying to maintain employment levels. This has led to the emergence of so-called 'pattern bargaining' where wage restraint in collective bargaining agreements for export-orientated sectors has set the rule for the rest of the country. A graphic example of this phenomenon was Germany during the first decade of Economic and Monetary Union (EMU), when the unions across the country's export-driven manufacturing sector accepted year after year of unprecedented wage restraint, which set the benchmark for wage settlements across the rest of the economy.

**Drivers of inequality**

Many of the factors behind the decline of labour income also explain rising inequality. Increased competition in many sectors, combined with labour market reforms aimed at encouraging part-time work and other forms of casual employment, have depressed wages in lower-paid sectors. Labour markets reforms aimed at bringing more low-paid people into work, such as Germany's Hartz IV reforms of 2004, have also increased the income inequality of those in work. Technological change has tended to hit low skilled workers hardest, with demand for their labour weakening significantly. Tax and benefit systems have become less redistributive. Most developed countries have pushed through reforms to benefits of one kind or another and tightened up the eligibility for social protection. All have lowered their top rates of income tax and reduced taxes on wealth (or capital).

The rise in inequality is also undoubtedly partly down to rent-seeking. Markets have been progressively liberalised, but are not always being effectively regulated.[5] The financial services industry is perhaps the most egregious example. However, it is not the only one, suggesting a broader failure of corporate governance. Boardroom pay has ballooned, inflating wage differentials. The chief executives of the UK's 100 biggest companies earned 114 times the average pay of a full-time worker in 2011, up from 81 times in 2009 and 47 times in 2000. This trend is not confined to countries that are considered to be 'economically liberal' such as the UK and the US, but is happening across Europe. The dramatic rise in boardroom pay does not reflect share performance. Nor does it result from the fact that companies are competing for global talent: the overwhelming proportion of senior executives in all major industrialised countries are recruited nationally.

The exaggerated remuneration of top bankers and senior executives is no more acceptable than public sector unions securing pay increases in excess of productivity growth, or organised special interest groups defending social rights – unfunded pension liabilities, for example – that can only be exercised at the expense of others.

## What are the implications?

The falling labour share of national income combined with rising inequality has potentially far-reaching implications for economic growth. The European economy will not recover unless firms boost their investment, but there is little chance of this happening while median household incomes remain under such pressure. The increasingly unequal rewards from economic growth, and the growing power of capital over labour, risk eroding popular confidence in the market economy. And popular perception of business as a vehicle for 'rent extraction' rather than a source of employment, wealth and tax revenue would poison the climate for economic reform.

A decline in the proportion of national income accounted for by labour will, everything else being equal, lower household consumption's share of overall GDP. This, in turn, will hit investment, or at least investment made with the aim of meeting domestic (as opposed to export) demand. Widening inequality also has negative implications for private consumption and investment: high income earners save a much higher proportion of their incomes than less well-off ones, so the redistribution of income in favour of the wealthy tends to depress consumption. It will not necessarily lower overall demand in an economy if the wealthy invest their savings domestically. However, this is unlikely for the same reason that the decline in the labour share is negative for investment: rising inequality depresses consumption and with it limits profitable investment opportunties.

> *"Rising inequality and declining labour share have far-reaching implications for economic growth."*

For many years in the run-up to the financial crisis, increased household borrowing masked the impact of rising inequality and declining labour shares on consumption (see Table 4). In Canada, the UK and the US, consumer spending grew rapidly as households took on large amounts of debt and saved less of their incomes. France and Italy also experienced rapid growth of household indebtedness. It is even possible that rising inequality created political pressure to encourage easy credit in a drive to mitigate the impact of stagnating median incomes on domestic demand and employment.[6] In countries where wages stagnated but there was no credit boom – such as Germany – exports compensated for the weakness of private consumption, leading to

*5:* Joseph E. Stiglitz, 'The price of inequality', Allen Lane, 2012.

*6:* Michael Kumhof & Romain Ranciere, 'Inequality, leverage and crises', IMF, 2010.

vast trade surpluses. Private consumption fell steadily as a proportion of GDP, while net exports (exports minus imports) ballooned. Essentially, Germany – like Japan – was dependent on other countries running up high levels of household borrowing.

The boom in household borrowing proved unsustainable and has now gone into reverse, as households attempt to reduce their excessive debt burdens and repair their balance sheets. Household savings rates have returned to their long-term levels in the UK and the US. This process of household deleveraging is depressing private consumption. And even once it is complete, household borrowing is likely to be muted; governments have drawn lessons from the financial crisis and will no doubt intervene to prevent a repeat of the excessive credit growth in the run-up to the financial crisis. Export-driven economies such as Germany remain as dependent on external demand as ever, largely as a result of booming exports to non-European economies: Germany's current account surplus is on course to exceed 6 per cent of GDP 2012. This is below the record reached in 2007, but in absolute terms will be the biggest in the world after China. However, it is a wrong to believe that Europe as a whole could follow the German route as that would imply Europe running a huge trade surplus with the rest of the world, which is not in a position to absorb it.

Despite the shift in the distribution of income in favour of business, lower corporate taxes and the decline in labour's bargaining power, business investment has fallen. Indeed, the relative decline of labour income has coincided with a parallel decline in business investment (see Chart 3). There are cyclical peaks and troughs in business investment spending, but even allowing for this, the trend has been downward. One reason advanced for this decline is that capital (or investment) goods have got cheaper, so that firms do not need to invest as much as they did in the past. Certain investment goods have no doubt fallen in price, but this alone cannot explain the phenomenon of declining investment. If it were simply a case of firms getting more bang for their buck, the rate of productivity growth would presumably not have fallen as far as it has.

> *"The shift in the distribution of income in favour of business, has coincided with a decline in investment."*

| | 1988 | 1995 | 2000 | 2005 | 2011 |
|---|---|---|---|---|---|
| France | n/a | 57.4 | 66.0 | 78.6 | 97.3 |
| Germany | n/a | 91.1 | 108.9 | 101.5 | 88.5 |
| Italy | n/a | 37.5 | 52.8 | 68.4 | 85.6 |
| UK | 110.6 | 105.7 | 111.7 | 153.9 | 157.0 |
| Canada | 88.7 | 100.7 | 109.8 | 125.9 | 146.5 |
| Japan | 112.2 | 137.6 | 130.5 | 128.2 | 121.3 |
| US | 84.2 | 91.5 | 100.5 | 129.9 | 117.3 |

Table 4: Household indebtedness, including mortgages (per cent, household gross disposable income)

*Source: OECD*

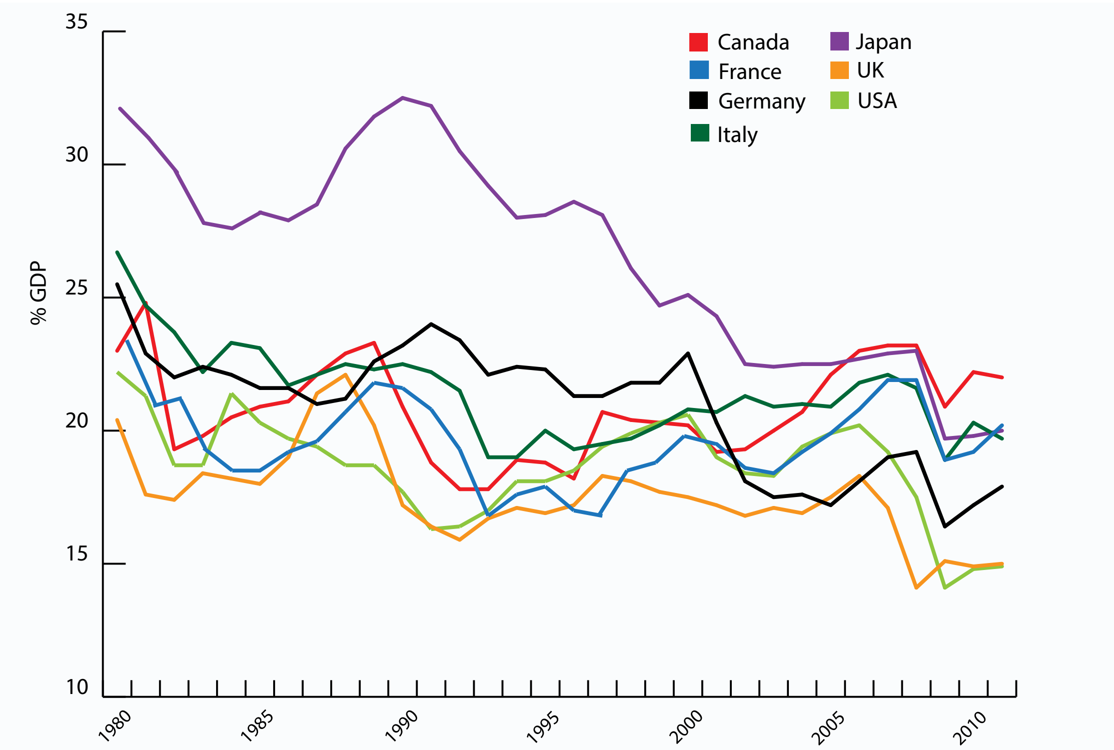


Chart 3: Annual investment spending (per cent, GDP)

*Source: OECD*

There are some short-term reasons for the weakness of business investment. One is corporate deleveraging. Firms built up high levels of debt in the run-up to the financial crisis, largely as a result of activity such as mergers and acquisitions rather than investment in organic growth, and are trying to reduce their debt to more manageable levels. Another reason is that many banks have stopped providing revolving credit lines, forcing firms to build up bigger cash cushions. But the most important factor holding back business investment across Europe is weak demand. Firms will not invest unless they are confident about the outlook for demand for whatever it is they produce. And here two factors are crucial. One is excessive fiscal austerity, which has snuffed out Europe's tentative economic recovery and threatens much of the eurozone with slump. The other is the decline in consumer purchasing power relative to GDP. One company's wages are another's revenue. Boosting profits by paying workers less may make sense for individual firms, but it weakens consumer demand and with it firms' incentives to invest.

Companies are repaying debt or simply sitting on this cash, as there are no compelling reasons to invest. Eurozone firms have around €2.5 trillion in cash reserves, American ones $2 trillion and their UK counterparts an astonishing £750 billion. Business leaders are quick to demand that governments "learn from business and live within their means". But big government deficits are simply the flipside of these corporate savings. While companies continue to save much more than they invest, either households or governments will have to spend more than their incomes, or countries will have to export more than they import.

**Popular confidence in capitalism**

The promise of capitalism is that wages rise in line with productivity growth, and that vested interests will be unable to extract disproportionate rewards for whatever it is they do. Both promises have been broken. Not only has the rate of economic growth declined steadily, but the benefits of that economic growth are increasingly accruing to a small minority at the top of the income scale (see Chart 5). And far from preventing groups within society from extracting undue rewards, markets appear to be abetting them in their drive to do so.

> *"Far from preventing vested interests from extracting undue rewards, markets appear to be abetting them in their drive to do so."*

These trends are likely to worsen because governments are pursuing policies that will inevitably further shift the balance from labour to capital. This is especially the case in Europe, where countries' growth strategies are strongly focused on boosting the price competitiveness of their exports and where little is being done to boost domestic demand. Wage restraint, or even wage cuts, are the order of the day as all countries attempt to reduce their labour costs relative to others, while governments try to make their countries more attractive to business by shifting the burden of taxation from capital to labour. At the same time, unprecedented fiscal austerity is forcing governments to cut social transfers. The result will be further declines in labour share coupled with further rises in inequality.

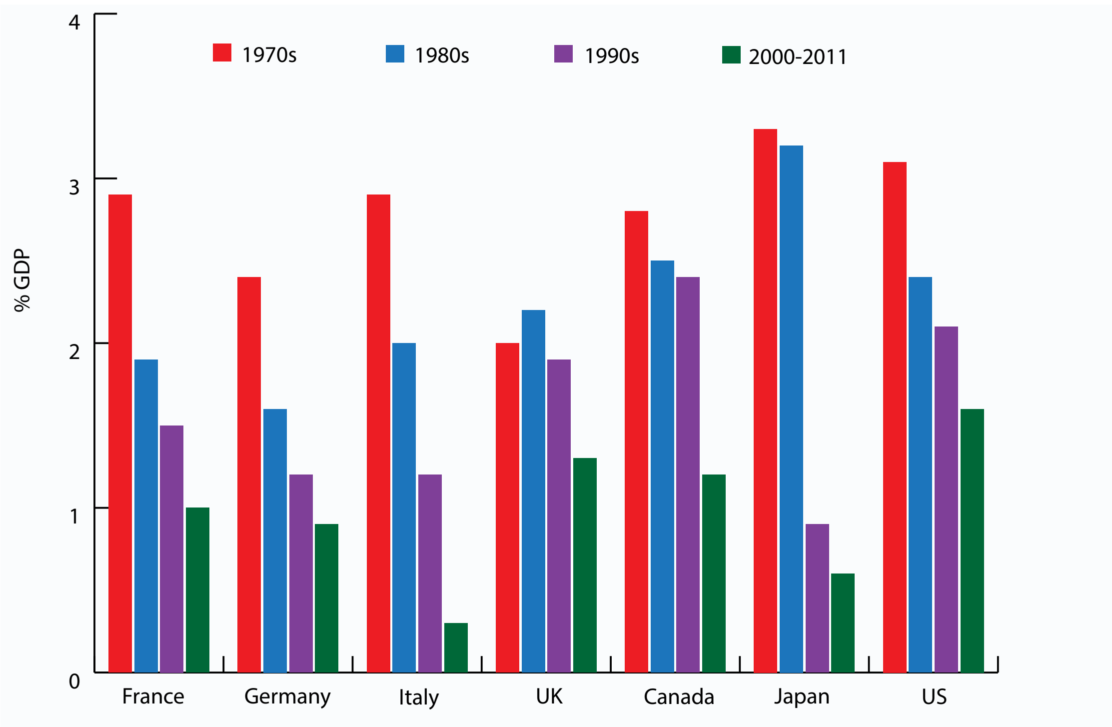


Chart 5: Annual economic growth (per cent)

*Source: European Commission*

Far from laying the groundwork for a recovery, these trends pose a further obstacle to one. Cutting the proportion of national income accounted for by wages, accepting a steady rise in inequality and boosting the proportion accounted for by corporate profits will not lead to sustainable growth in private consumption and investment across Europe. Such a strategy only worked for Germany – the model for the eurozone's growth strategy – because it could rely on buoyant external demand. What might appear to make sense in individual cases is proving very damaging when pursued by all. With every country trying to do the same thing, export-led growth will prove elusive, even for the most ruthless cost-cutters. Put another way, focusing on things that might make sense for exporters will weaken the European economy as a whole. Economic growth will stagnate and living standards fall, leaving public finances chronically weak and debt burdens unsustainable (see the next section).

This will exacerbate the legitimacy problems of markets, weaken social cohesion and undermine political effectiveness. The full brunt of these policies will be felt in countries where faith in markets and confidence in governments are already running at low levels, such as Italy and Spain. Governments risk discrediting structural reforms by associating them in voters' minds with declining living standards and increased inequality. The consequences are likely to be far-reaching. Not only will governments struggle to push through the needed reforms, but there is a risk of a broader backlash against the market economy and the EU. Governments will struggle to sell market-led reforms to increasingly (and understandably) cynical electorates. Mainstream political parties are likely to lose much of their credibility, and euroscepticism is likely to take hold as more populist politicians respond to mounting popular anger by becoming increasingly hostile to the EU. Support for state control over capital is likely to rise, as are demands for greater trade protectionism and tougher curbs on immigration.

*"Governments risk discrediting reforms by associating them in voters' minds with declining living standards."*

## What can European governments do

What can governments do to arrest the decline in labour share and reverse the rise in inequality? It would make no sense to attempt to slow the pace of technological change or weaken the competitive pressures that contribute to productivity growth. Without stronger productivity growth, there can be no sustainable rise in private consumption, without which Europe's economic prospects will remain bleak. There is no doubt that European economies, especially those across the south of the eurozone, need to push through supply-side reforms of their labour and product markets. The tricky part is preventing liberalisation and the adoption of new technology from further depressing labour share and exacerbating already very high levels of inequality. Governments are not impotent. Indeed, government policy is exacerbating these disadvantageous trends, as discussed in the previous section. There are several things governments can do, but many of the crucial things will require them to work more closely together and to distance themselves from special pleading by business. It will also require policy-makers to stop thinking of their economies as Deutschland AG or UK plc: what might work for individual firms will not work for whole countries, let alone an economic region.

**Education**

When governments are asked what they intend to do about rising inequality (they never acknowledge the issue of falling labour share) they almost always cite education. There is little doubt that improved skills foster greater social mobility and help to prevent workers from getting left behind. Countries where large numbers of people leave school before completing secondary education and fail to enter vocational training – such as Italy and UK – can certainly help fight inequality by raising skills levels. But the contribution that improved skills can make to arresting the rise in inequality should not be exaggerated. After all, even countries with impressively skilled workforces have seen pronounced increases in inequality. Moreover, although there is a relationship between rising inequality and declining labour share – lots of people getting left behind will lower labour share – the two trends are distinct. It is not simply the labour share of unskilled workers which has fallen; the labour share of all but the top few per cent of the workforce has also fallen.

**Corporate governance**

Governments rarely talk about inequality (let alone declining labour shares) in connection with corporate governance. But a change in corporate governance could help combat these trends. Governments could take a number of steps to challenge the short-termism that encourages an excessive focus on labour costs and deters investment in their employees. The first is to reform the structure of executive remuneration. Excessive executive pay captures most of the headlines, and is undoubtedly socially corrosive, but a perhaps even more serious problem is the perverse incentives facing chief executives. Remuneration is closely tied to short-term share performance, which leads to an excessive emphasis on short-term profitability. Executive pay needs to be more closely linked to long-term performance, and not just to the share price; a range of metrics is needed. Executives' duty should be to the company and its long-term health and those that work for it, not simply its share price.[7] This would encourage a focus on long-term organic growth. Too many firms are being run for cash rather than growth, with damaging implications for economic activity.[8]

To facilitate this trend, quarterly reporting of financial performance could be scrapped. Such reports encourage short-termism and reveal very little about a firm's long-term prospects. Governments should explore ways of encouraging investors to hold bigger stakes in companies and to hold on to them for longer, becoming more actively involved in businesses. Asset managers' own remuneration structures also make them biased towards short-term profits: asset managers often face the same short-term performance targets as executives. Much as with improved labour skills, reforms of corporate governance would be no panacea and would affect some countries more than others: the so-called 'financialisation' of corporate governance and the short-termism this has spawned is present across the industrialised world, but is most pronounced in the UK and the US.

**Redistributive tax and social systems**

Governments need to reverse the trend away from redistributive tax and social systems, if they are to succeed in boosting domestic demand and hence economic growth. First, they should refrain from cutting social transfers as this will aggravate inequality and depress consumption. Second, income tax should become more progressive, with those on low incomes (who have a low propensity to save) paying less tax and those on higher incomes (who have a higher propensity to save) being more heavily taxed. There is no empirical evidence that higher taxes for the wealthy would discourage risk-taking or undermine work incentives.[9] Third, the burden of taxation needs to shift from income and consumption taxes such as VAT (which hit those on low and average incomes hardest and are thus highly regressive) to capital and wealth.

The decline in business taxation and the rise in corporate income over the last 20 years has not encouraged higher investment, since the flipside has been a slump in household income (and with it consumer demand). If businesses are unwilling to invest their cash holdings, governments need to tax them and redistribute the incomes to those that will spend; namely workers on low to medium incomes. In order to address the beggar-thy-neighbour competition that seeks to attract capital by reducing corporate taxes, the EU should harmonise corporate tax bases and (ultimately) rates. Higher taxes on capital across Europe would not lead to capital flight from the region, as there would be more demand in Europe and hence investment to meet it. Indeed, the current policies – by depressing demand – are more likely to lead to capital flight.

*"If governments are to boost demand, they need to make their tax and social systems more redistributive."*

**End the obsession with 'competitiveness'**

Rebalancing national income away from capital in favour of labour means ending the destructive focus on trade competitiveness. Many European policy-makers and politicians attribute Europe's poor performance and the crisis across the south of the eurozone to a lack of 'competitiveness'. According to this way of thinking, countries compete with one another, much as firms do. This misunderstanding of what drives sustainable economic growth is leading to policies that will depress labour share further and worsen inequality. In an effort to improve their competitiveness, countries are trying to reduce their costs relative to their trade partners by cutting wages, making their business environments more attractive to capital by cutting corporate tax rates, pushing through labour reforms aimed at reducing workers' bargaining power, and curtailing social rights and transfers. The result will be to further worsen Europe's growth prospects by depressing private consumption and with it investment.

A falling labour share might boost investment in export-orientated sectors of an economy – so long as there is foreign demand from somewhere – but not across the economy as a whole. In anything other than the short-term, economic growth, even in small, highly trade dependent economies, is determined by the rate of growth in private consumption, not competition for world markets. In the case of the Europe, a large and largely closed continental economy, the correlation between economic growth and the expansion of private consumption is a very tight one. Even those countries that do succeed in running big trade surpluses only manage to do so because others run trade deficits (and hence accumulate debt). That is the problem of growing through unbalanced trade: a country's trade partners need something to pay with. The country with the huge

*7:* John Kay, 'The Kay review of UK equity markets and long-term decision-making', July 2012, UK Department for Business, Innovation and Skills.

*8:* Andrew Smithers, 'The change in corporate behaviour', Smithers & Co, April 2012.

*9:* 'The Mirrlees review: Reforming the tax system for the 21st century', Oxford University Press, 2010.

trade surplus tends to get worthless IOUs in return for its goods and services. Not every country can grow by becoming more competitive, and it is often a poor economic strategy for those that do manage to pull it off.

Rather than engaging in a fruitless battle to become more competitive than each other, European governments should be focused on boosting domestic demand. The paper has already argued for a reform of corporate governance and for more redistributive tax and social security systems. Another crucial element in any drive to revive demand across Europe and boost the bargaining power of labour should be an expansionary macroeconomic policy, at least until the crisis is overcome. Unfortunately, ECB attempts to loosen monetary conditions are hamstrung by disagreements among eurozone governments and by the bank's excessively low inflation target. And fiscal policies across Europe are destructively pro-cyclical.

For governments to tighten fiscal policy following a financial crisis and when economies were still very weak was always risky. Quite how risky has been brought into sharp relief over the last three years. The European Commission had assumed that a fiscal tightening of 1 per cent of GDP would knock just 0.5 per cent off GDP. In reality, the so-called multipliers have been much bigger. According to the IMF, fiscal tightening of 1 per cent has depressed GDP by between 0.9 and 1.7 per cent, and by even more than this in some of the hardest-hit southern members of the eurozone. With demand chronically weak, the EU currently needs an expansionary fiscal policy. This means countries that can boost demand should do so. And it means dealing with the institutional flaws in the eurozone which force counties in deep recessions to pursue self-defeating fiscal austerity.

Officials from the ECB never tire of saying that low inflation is the best contribution that the bank can make to economic growth. Price stability is important, but a reference value of under 2 per cent and no accompanying mandate to ensure an adequate level of economic activity (such as that applying to the US Federal Reserve) is too restrictive for the eurozone. The currency union is a largely closed economy (exports account for a similar proportion of GDP as they do in US) and hence cannot rely on exports to drive economic growth – it needs robust growth in domestic demand. If the ECB had to take economic activity into account, not only would eurozone interest rates be lower, but the central bank would also be pumping money directly into the eurozone economy. Much like the US Fed, the Bank of Japan and the Bank of England, the ECB would be engaged in quantitative easing (QE), the unsterilised purchasing of government debt and other assets.[10] By bringing down public and private borrowing costs and boosting the volume of credit, QE could strengthen economic activity. Unfortunately, reforms of eurozone governance have hitherto not included reform of the ECB.

**Be sceptical of special pleading by business**

The influence of business on economic policy across Europe has never been greater. Sometimes this can be positive: governments can learn from the corporate sector and business leaders are often right to warn of the damage done by excessive and ill-thought out regulation. But the macroeconomic effects of business influence on policy are often pernicious. The erosion of the bargaining power of labour has been welcomed by business, as has the lowering of the rate of corporate tax. Yet these measures have not boosted investment or economic growth. The reason is simple: the interests of individual businesses are not the same as the interests of an entire economy, let along an entire region. One business's wage costs are another's revenue. A business can save more (for example, by cutting wages) without undermining demand for its products. Countries can only behave like firms if they are able to rely on exports to close the gap between what they produce and what they consume, which they cannot all do simultaneously.

> *"The interests of individual businesses are not the same as the interests of an entire economy, let alone an entire region."*

As this paper has argued, governments need to strike a more appropriate balance between the 'interests' of capital and those of labour if the European economy is to recover. A cursory look at the advice that business leaders have given during the crisis illustrates why. Most business leaders across Europe have championed fiscal austerity, arguing that countries must learn from businesses to live within their means. But at the same time business lobbies are exhorting governments to 'do something' about weak consumer demand. By 'doing something' they typically mean lowering business taxes and pushing through reforms aimed at further eroding the bargaining power of labour. Yet it makes no sense to argue that economies are depressed because of the burden of business taxation and onerous regulation when corporate profits have hit an all-time high. All that a lowering of business taxation will achieve is a further boost to corporate savings, while a further erosion of labour rights will depress consumption further (and with it business investment.) Governments should listen to business leaders, but treat their advice with the same healthy scepticism with which they treat lobbying from organised labour or any other interest group.

*10:* Unsterilised means that the central bank does not offset its purchases of government bonds by selling other assets.

## Conclusion

Economic growth in Europe depends on a recovery in private consumption, which in turn requires a rethinking of the balance between capital and labour. Over the last 30 years real wages have decoupled from productivity growth, leading to a steep fall in the proportion of national income (or GDP) accounted for by wages, salaries and other benefits. Simultaneously, there has been a big rise in inequality as the benefits of economic growth have accrued to those at the top of the income scale. The flipside to the fall in the proportion of national income accounted for by employee income has been a steady rise in the proportion accounted for by corporate income and profits. These trends have gone hand in hand with a steady decline in business investment. Europe's strategy for dealing with the eurozone crisis is exacerbating these trends and is therefore a further obstacle to the economic recovery the currency union so urgently needs.

European countries are relying on two things to boost investment and hence employment. First, they are trying to lower labour costs, make their business environments more attractive by switching the burden of taxation from the corporate sector to the consumer, push through labour reforms aimed at reducing workers' bargaining power, and curtail social rights and transfers. Second, they are attempting to boost business confidence by consolidating their public finances. They hope that these measures will improve their competitiveness and with it enable them to capture a larger share of export markets. Such a strategy might make sense for individual countries, so long as they can rely on exports, but not for the European economy as a whole. This strategy promises to further aggravate Europe's core problem – a structural shortage of demand – by bringing about a further decline of labour income and a further rise in inequality.

There is no doubting the need for reforms aimed at increasing competition and opening the way for the adoption of new technologies. Governments must not attempt to slow the pace of technological change or weaken the competitive pressures that contribute to productivity growth. But they need to combine market-led reforms with measures aimed at preventing a further decline in labour's share of the pie and a rise in inequality. Indeed, with households now highly indebted across the industrialised world, a sustained recovery in private consumption will require a rise in the share of national incomes accounted for by wages and salaries. There are a number of things governments can do, but some will require them to challenge firmly held assumptions, to work more closely together and to distance themselves from special pleading by business:

- **Improving educational standards.** There is some evidence that raising skills levels can combat inequality. Governments should certainly redouble their efforts to reduce the number of people who leave school early and do not enter vocational training. But improving educational standards will only do so much to address inequality and prevent a further decline in labour share: even countries that have enviously well-trained workforces have experienced sharp falls in labour share and rising inequality.

> *"Economic growth depends on a recovery in consumption, which requires a new balance between capital and labour."*

- **Reform corporate governance.** Executive remuneration needs to be linked to long-term performance, and not just to the share price; a range of metrics is needed. Executives' duty should be to the company, its long-term health and those that work for it, rather than simply its share price. This would encourage a greater emphasis on long-term organic growth (as opposed to expansion through mergers and acquisitions), and reduce the excessive focus on reducing labour costs. The relationship between risk and reward must be rebuilt by reducing executive remuneration.

- **Redistribute income and wealth.** Tax systems need to be more redistributive. The better-off need to pay more tax, whereas those on lower incomes need to pay less. In tandem, governments should switch the burden of taxation from consumption to capital by reducing value-added taxes and increasing taxes on capital and wealth. There is no empirical evidence that this would hit investment or work incentives. In an effort to address beggar-thy-neighbour tax competition, the EU should move to harmonise corporate tax bases and rates.

- **End obsession with 'competitiveness'.** Competitiveness is relative; countries cannot all return to growth by becoming more competitive relative to one another. The policies employed to boost competitiveness threaten a further decline in labour share and rising inequality, which will leave everyone poorer. Rather than engaging in a fruitless battle to become more competitive than each other, European governments should be focused on boosting domestic demand. This will require expansionary macroeconomic policies. Monetary policy should be loosened further, and the EU as a whole needs to put an end to fiscal austerity.

- **Distance themselves from business.** Governments need to adopt a more sceptical ear when confronted with business lobbying. Running a country is very different from running a firm. What might work for individual firms is at best zero-sum when adopted by countries. For their part, the leaders of finance and business need to recognise that their remuneration is an obstacle to the kinds of market-led reforms that they themselves advocate and which are needed to boost economic performance.

What will happen if governments fail to change track? Economic recovery will prove elusive and public finances will remain chronically weak. This will exacerbate the legitimacy problems of markets, weaken social cohesion and undermine political effectiveness. Voters will associate structural reforms with declining living standards, increased insecurity and inequality. Not only will governments struggle to push through the needed reforms, but there will also be a risk of a broader backlash against the market economy and the EU. Mainstream political parties are likely to lose much of their credibility, and euroscepticism is likely to take hold as more populist politicians respond to mounting popular anger by becoming increasingly hostile to the EU. Support for state control over capital is likely to rise as are demands for greater trade protectionism and tougher curbs on immigration. These are unlikely to prove transient trends: events of this kind tend to influence attitudes for decades.

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