# Business leaders risk discrediting markets

**by Simon Tilford, 13 May 2010**

Despite their battered reputation, markets remain the best way of generating economic growth. But the market economy faces a crisis of legitimacy brought about by rising inequality and a breakdown of the relationship between risk and reward. The promise of capitalism is that wages rise in line with productivity growth. But over the last 15 years a hugely disproportionate share of the rewards from economic growth has accrued to those at the top, led by boardroom executives and senior bankers. By contrast, median incomes have stagnated. As a result, governments will struggle to convince electorates of the case for markets and free enterprise, and will have a tough time slimming down bloated public sectors.

One reason for the rise in inequality is falling demand for unskilled labour. Technological change and growing trade with emerging economies means that there is little demand for poorly-skilled workers. It is no surprise that the widening of wage differentials has been most pronounced in those European countries with large numbers of poorly-skilled workers. However, the rise in inequality also reflects a surge in what economists call 'rent-seeking': the ability of certain groups within society to extract disproportionate rewards (or 'rents') for their work.

Boardroom pay has ballooned across Europe, inflating wage differentials. According to Income Data Services, the executives of the UK's 100 biggest companies earned 84 times the average pay of a full-time worker in 2009, up from 47 times in 2000. This trend is not confined to countries that are considered to be 'economically-liberal' such as the UK. It 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 European countries are recruited nationally.

Another group to have attracted outsized rewards is employed in the financial services industry. Pay in the financial sector has risen far more rapidly than across the economy as a whole. But as Andrew Haldane of the Bank of England has convincingly demonstrated, the huge rise in the sector's profitability and the subsequent growth in remuneration was the product of leverage – increased borrowing – and not an improved return on assets. The latter requires skill, the former does not. To make matter worse, the losses incurred by the banks when their excessive leverage provoked the financial crisis were covered by the taxpayer. In short, the banks were able to privatise the rewards while socialising the losses. Their subsequent return to profitability owes much to intervention of governments.

The exaggerated remuneration of top bankers and senior executives is essentially a form of rent-

seeking. In essence, it is little different from 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. The popular perception of business as a vehicle for 'rent extraction' rather than a source of employment, wealth and tax revenue is poisonous for the political economy of reform.

Rising inequality did not matter so much when economies were growing and public finances were manageable. But it does now. European governments face mighty challenges. They have to persuade sceptical electorates of the need for more flexible labour markets; the curtailment of social rights; a greater role for the private sector in areas currently dominated by the state; and even cuts in public services. But how can governments succeed in doing this if such reforms are blamed for rising inequality and for allowing unwarranted personal enrichment? Put another way, how can governments address rent-seeking by other powerful groups in society, such as the public sector unions, in the face of rent-seeking by those in the financial sector and on company boards?

The rise in income inequality needs to be reversed and the relationship between risk and reward restored if governments are to be able to sell market-led reforms to increasingly (and understandably) cynical electorates. Governments have to be able to demonstrate how people benefit from markets. They have to be able to show that markets prevent groups within society from extracting undue rewards, not abet them in their drive to do so. 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 they themselves advocate and which are needed to boost economic performance.

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