Thank you for the invitation to speak tonight. It is both an honour and a privilege to be here. An honour, because the person for whom this evening is named is a legitimate Canadian labour hero. I never met Larry Sefton, but I have worked all my adult life in the movement that inspired him, 20 years of that in the Canadian institution that he played a major role in building, the Steelworkers. And during those years, Larry Sefton’s legacy rubbed off on me through the extraordinary experience of working with people who had been inspired by him to devote their lives to the Canadian labour movement – people like Lynn Williams, Stew Cooke, Homer Seguin, Gord Brigden, Bob Mackenzie, John Morgan and Leo Gerard.

It is a privilege as well, in that I get to share the platform with a comrade, Leo Gerard. In keeping with the academic environment, you could say we went to the same school, albeit a school unlike any other. A lot has changed since then. Leo has become a big fish in the biggest pond there is. And late in my career, I’ve found a niche in which I get to run around armed only with numbers, seeking out windmills at which to tilt. I have to note that some things don’t change, however. My role here requires that I actually do something; Leo just has to be Leo.
After some reflection, I decided to entitle this lecture “Roots of crisis: how growing inequality sowed the seeds of an economic collapse”. I had been tempted to call it “Roots of crisis: how conservatives got everything they wanted and wrecked the economy in the process”, but realized both that the title was so obvious that the lecture would be too short and that while blaming the right would be immensely satisfying, it doesn’t point towards a way out of the mess.

My point of departure here is that the roots of the current economic crisis go back a long way.

But I’m going to start with a now-familiar story set in the present, with a family in East Compton California – and before I go on I want to stress that this is a notional family, not a real family – not unlike much of the asset base of the world’s financial system.

The family is fighting its own small battle to hang onto its little piece of the American dream, and they grab for the ultimate symbol of that dream – the chance to own their own home. They’re amazed that when they go to see the mortgage broker, he doesn’t seem to care about the fact that they are struggling economically. He doesn’t seem to care that they can’t afford a down payment. He doesn’t seem to care that they can’t afford the mortgage payments. He even lets them start out with low payments, giving them a period of grace in which unpaid interest is added to the amount they owe. He tells him he’s confident that housing prices are going to continue to go up and the economy will keep growing, so none of this will be a problem.
What he doesn’t tell them is that the reason why he doesn’t care is because he’s not going to hang onto their mortgage. He’s going to sell it to his local bank, taking his profit off the top. And the local bank doesn’t care either even though it has never met our family and knows nothing about it, because it is going to sell the mortgage to a big bank in New York, taking its profit off the top.

Now the big bank in New York owns this mortgage, along with thousands of others. It doesn’t know anything about the family in East Compton either, or for that matter about any of the thousands of other families whose mortgages it now owns, because it doesn’t intend to hang onto the mortgages either.

So the bank packages these thousands of mortgages into what it calls a structured investment vehicle – actually a series of investment products all based on the same pool of mortgages. The SIV divides up the entitlement to a return from these mortgages into slices. There could be lots of slices, but we’re going to assume there are only three. The first slice – which cost its investors 50-60% of the value of the mortgages -- gets all of the income from the mortgages, until its owners have been paid the return they’ve been promised. Once the first slice has been paid, the second slice – which might have cost its investors 20-40% of the value of the mortgages – gets the remaining income, until its owners have been paid their promised return. The rest of the income goes to the owners of the bottom slice – usually called the equity slice.

Once it has set this structure up, the bank goes to an agency to get an investment rating on these slices. The rating agency looks at the pool, and it
concludes that, for the investors in the top slice to lose anything, 40-50% of the mortgages would have to default, which would be highly unlikely, so they rate it AAA – the same as government bonds – about as safe as you can get. Even the second slice gets a pretty good rating, because 10% to 20% of the mortgages would have to default in order for that slice not to be paid, and that’s well above normal default rates.

Now, they’re ready to put these products to investors. The investors look at the top slice. It pays a decent interest rate, but not great. But it’s rated AAA, and that’s good enough for people who lend money in the short-term money market, so the investors borrow money at relatively low interest rates to buy a product that pays a higher interest rate, pushing up the return on their own money.

A quick example shows how this works. I’m looking at an investment of $100 that pays 8% a year. Not bad, but not great. But I can borrow money short term at 4%, and because the investment I want to buy is AAA rated, the lender will let me borrow 80% of the value of the investment. So I pay 4% on 80% of $100, or $3.20, in interest and I get a return of $4.80 on my investment of $20, or 24%.

So like magic, I’ve managed to turn an 8% investment into a 24% investment. Isn’t capitalism wonderful.

And everybody does this, because everybody convinces themselves that they’ve managed to make the risk of these mortgages disappear. Remember, none of these heavily-levered investors, and none of the people who provided the
leverage has a clue who this family in East Compton is, or whether or not they are going to be able to make their payments.

For a while, everybody is happy. The family in East Compton has a house, and they can see that it is increasing in value. The people in the middle have already been paid. The leveraged investors are raking in their big returns. And the short-term lenders are getting a bit better return than the treasury bill interest rates they would normally get.

Then it starts to fall apart. The housing market starts to slow down. The homeowners move into the full-interest payment phase of their mortgages. They can't pay. So they go into default. Payments to the investors slow down, and bad things start to happen. The bottom slice is wiped out completely, and the second slice is starting to lose money. That makes people who might buy the top slice nervous. The return demanded by potential buyers goes up. The value of the existing investments goes down – in some cases to an amount less than the amount borrowed, wiping out the investment completely. And just as important, it makes the people who lend money to these investors really nervous. They start demanding more collateral for the loans, and refuse to lend as much as 80% of the (reduced) value of the mortgages. They have to raise cash quickly to replace the lost loans. That drives asset prices down. And so the cascade goes. Eventually, the investors can't pay back their short-term lenders, and the whole thing freezes up. The lenders can't get their money back. And nobody will lend money to anybody.
The financial mess spreads quickly to the real economy. The short-term lenders can't get their money back – money they had set aside to pay wages, build inventories, make new investments. And the family in East Compton no longer has any disposable income, and drops off the consumer bandwagon.

So what does this have to do with inequality? For that answer, we have to go back to our family in East Compton. Like the typical middle-income family in the United States and Canada, their real income has remained unchanged in over 30 years, while the economies of both countries have been growing consistently at 3-4% a year, in real terms. They’re struggling to keep up, and they’re using all of the resources at their disposal to do so. They are working longer hours. They are maxing out their credit cards. Their consumption was underwritten in part by the downward pressure on prices created by imports from China and that country’s undervalued currency. (In the United States, thanks to mortgage interest deductibility, they’ve got a powerful incentive to max out their borrowing on the equity in their homes.) And particularly in the United States, but in Canada as well, governments are anxious to help people acquire the trappings of a middle-class life even if they can’t afford it by making it easier to buy and finance a house.

Remarkably, the willingness of middle-income families in the United States and Canada to make sacrifices and go into debt to sustain their living standards was enough to drive mass-consumption led economic growth at a time when middle-incomes were not growing at all.
The credit crunch may have been the catalyst for the downturn, but the party was coming to an end anyway.

Let’s look at the evidence, for Canada.

The period from the end of the 2nd World War to 1975 was a period of unprecedented growth in mass living standards in Canada. Real incomes of middle-income families grew rapidly. Income inequality declined markedly. Collective consumption – the consumption of public services – increased substantially as a share of total consumption. The share of wages and salaries in national income increased as the bargaining power of workers relative to owners of capital increased, as reflected in the growing share of the workforce that was protected by unions, the emergence of stronger employment standards, the introduction of public pension plans and the strengthening of unemployment insurance. Of the eight decades between 1920 and 2000, the sixties and the seventies produced the most rapid increases in personal income per capita.

We can see that pattern in the data on average wages and salaries in Canada.

[chart on average industrial wages]

That pattern began to change in the late 1970s.

Beginning in the mid-1970s, the steady growth in middle-income living standards that began at the end of WWII came to an end. Since then, median family incomes have stagnated, in real terms.

[chart on median incomes of families with children]
Significantly, annual hours worked by the median family increased. In other words, despite steady growth in national income, average families were only able to maintain a static real income level by working longer hours. Much of that growth in employment hours was attributable to increasing participation in the labour force by women with children.

The share of wages and salaries in national income, after decades of increases, began a decline that continued right through to the mid 2000s.

[chart]

Within that declining share of wages and salaries, employment incomes became polarized as for the first time, employment income became a major driver of increasing inequality. The most obvious symbol of that change was the extent to which salaries for corporate executives became disconnected from the wages and salaries of the people whose labour made those salaries possible. As recently as the late 1970s, American Motors’ CEO George Romney famously turned down a $100,000 bonus offered by his board, on the grounds that his $225,000 salary – at about 25 times the salary of the assembly line worker – was about right.

By 1995, the average of the 50 highest paid CEOs in Canada was about 80 times the average worker’s pay.
In 2007, the average of the best-paid 50 was 394 times the average workers’ pay.

[chart on ratio of CEO to average, 1995 and 2007]

As the business community succeeded in convincing the public that it was a bad thing for workers to be paid well, and that it was a good thing to undermine their bargaining power, the proportion of the workforce represented by unions declined, and more than all of that decline was in the private sector.

Along with that decline, there was a decline in what I call “upper working class jobs” – working class jobs that paid middle-class wages – and a decline in the proportion of the workforce covered by a pension plan.

Tax policy helped to drive the growth in inequality as well. Top marginal tax rates were reduced. The rate of tax on capital gains was reduced by 1/3. And those CEOs were allowed to report and pay tax on their income from stock options and share grants as if they were capital gains. That is, at half the rate of tax paid on the incomes of their employees.

A recent comprehensive study of tax incidence in Canada conducted by Marc Lee of the Canadian Centre for Policy Alternatives makes it clear that, taken together, tax changes at all levels of government in Canada since the early-1990s have delivered virtually no benefit to most Canadians. They have delivered substantial benefits to those Canadians at the top of the income scale. And they have transformed a mildly progressive tax system into a regressive one. Thanks to the tax cuts of the 1990s, the tax system is now no longer
alleviating relative market income inequality in Canada -- it is exacerbating inequality.¹

The extent to which this growth in inequality is concentrated in the top end of the income scale is remarkable. A study by Saez and Veall based on income tax data in Canada going back decades shows a remarkable pattern. As one might expect, given the other data we’ve looked at, income inequality went down during and after WWII and the concentration of income at the top of the income scale continued to decline until 1990. Then in 1990, it took a sharp turn up.

[Saez & Veall]

A significant study from Statistics Canada that focused on income growth at the top end of the income scale in Canada between 1982 and 1992 and between 1992 and 2004 adds considerable detail to the picture. It finds that the income distribution was relatively stable between 1982 and 1992 but that income inequality exploded between 1992 and 2004. It shows that gains in individual real incomes since the early-1990s have gone entirely to Canadians in the top 10% of the income scale and that the resulting increase in the share of total income going to the richest 10% of Canadians has in fact gone predominantly to the richest 1% of Canadians.²

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² “High-income Canadians”, Brian Murphy, Paul Roberts and Michael Wolfson in Perspectives on Labour and Income, Statistics Canada, September 2007. The study found that all of the share increase attributable to the top 10% of the income scale went to the top 5% (i.e. the bottom half of the top 10% simply kept pace with overall income growth); that 90% of the share increase for the top 10% actually went to the top 1%; that 50% of the top 10%’s share increase went to the
Looking at income taxes and CPP premiums, the Statistics Canada study found that while effective tax rates for most Canadians had been relatively stable between 1992 and 2004, effective tax rates on Canadians at the very top of the income scale had come down dramatically.\textsuperscript{3} Effective tax rates dropped by three percentage points for the richest 1%; five percentage points for the richest 0.1%; and eleven percentage points for the richest 0.01%.

To look at it another way, roughly 70% of the gains of the richest 10% of tax filers went to the richest 5%; more than 70% of the gain made by the richest 5% went to the richest 1%; nearly 65% of the gains of the richest 1% went to the richest 0.1%; and 80% of the gains of the richest 0.1% went to the top 0.01%.

More than 25% of the tax savings realized by the richest 10% of Canadian tax filers actually went to the richest 1/100 of 1% of tax filers.

We don’t survey wealth that often in Canada. Perhaps that has something to do with political leaders not wanting us to know. But those rare surveys are extremely revealing. Statistics Canada studied the distribution of wealth in 1984; again in 1999; and again in 2005.

The Statistics Canada study that accompanied the release of the 2005 data shows that wealth inequality has been growing even more rapidly than income

\begin{itemize}
\item highest income 0.1%; and that 20% of the share increase that went to the top 10% actually went to the top 0.01% of tax filers.
\end{itemize}

\textsuperscript{3} The effective tax rate for the bottom 95% of the income distribution dropped by about one percentage point. The effective tax rate for the top 5% dropped by about three percentage points, but most of the gain was right at the top of the scale. The effective tax rate on the top 0.1% of tax filers dropped by about 5 percentage points; the effective tax rate on the top 0.01% dropped by 10 percentage points.
inequality. In 1984, the richest 10% of households accounted for 52% of the wealth; the bottom 50% held only 5%. By 1999, the share of the top 10% had increased to 56%; by 2005, to 58%. Between 1984 and 2005 only the top 10% saw their share of wealth increase.

By contrast, the bottom 50% of the wealth distribution held 5.3% of the wealth in 1984; 3.9% in 1999; and 3.2% in 2005.

In 2005, 24% of families had no net financial wealth; that compares with 17.7% in 1984.

Consistent with the data for income inequality, the Statistics Canada data show that wealth inequality had been going down for nearly two decades prior to 1984 and then increased sharply. The wealth of the middle-income families (the middle 20% of households) dropped from 9.1% of total wealth in 1984 to 7.7% in 1999 and 6.9% in 2005. Significantly, all of the increase in wealth of middle- and upper-middle income households is accounted for by increasing equity in the family’s principal residence. For the middle 20% of households, the value of the principal residence was about 1/3 higher than the household’s net worth, with most of the difference accounted for by mortgage debt. What this means is that, for middle-income families, a decline in the value of their home of 20% actually reduces their net wealth by 26%.

Canadians aren’t all that different from Americans. Their perceptions of their wealth have a significant influence on their current consumption. And if the labour
market isn’t giving them the income growth they need to sustain their living standard, they go into debt.

From the Statistics Canada release

Between 1999 and 2005, total debt in Canada increased by 47.5%. This was largely due to two factors: the increase in the cost of purchasing a home and the increase in the proportion of families who owned a home with a mortgage.

The median value of mortgages on the principal residence amounted to $90,000 in 2005, up 17.5% from $76,600 in 1999. Just over one-third (34%) of all family units reported having this type of mortgage debt.

The second largest contributor to the increase in debt load was lines of credit, which more than doubled during the six-year period to roughly $68 billion. About 3.3 million families, one-quarter (24.9%) of the total, reported having a line of credit debt in 2005, up from only 15.4% in 1999.

The median line-of-credit debt surged from $5,800 to $9,000. Much of the increase was secured by residential assets in the form of home equity.

Families reported holding about $46 billion in loans on owned vehicles, a 41.3% increase, and $25.8 billion in outstanding credit card and installment debt, up 58.4%. Student loans approached $20 billion, a 15.8% increase.

Almost 11 million families reported owning at least one credit card last year. The median credit card and installment debt rose to $2,400 from $2,100.

And it turns out that, when it comes to personal debt, Canadians are actually not all that different from Americans.

Since 1980, the debt:income ratio of Americans has increased from about 65% to about 120%; for Canadians, the change has been from about 65% to about 110%.
So far, we’ve talked only about private income and private consumption. That’s a big omission, because in Canada, an upcoming CCPA study shows that for families well into the upper-middle income range, their social wage – the value they receive from public services – is well over half the income they receive from private sources. To put it bluntly, public services make a significant contribution to the living standards of all but a small extremely wealthy group of Canadians.

From 1961 to the mid-1990s, program spending in Canada increased fairly steadily as a share of GDP, reaching a peak of about 41%. By 2005, it was down to less than 33% -- a huge drop in collective consumption.

[chart]

So when you add it all up, we were heading into the downturn in what amounted to a perfect storm for middle-income families, and what is a perfect storm for middle-income families is a perfect storm for the economy.

There is good news amongst all the bad. A year ago, the default response to the downturn would have been to repeat all the policy prescriptions that got us into the mess in the first place. We would have heard calls for reduced public spending, lower taxes – especially on wealthy individuals and businesses, less regulation of business and … well, you can repeat the list.

But all of that was before what may well be the happiest week of my life so far. On the front page of my Globe and Mail there was a picture of former US Federal Reserve Board Chairman Allan Greenspan, looking like a stand-in for Mr. Burns from the Simpsons, having declared that he had no idea what was happening or
why, and that he had been fundamentally wrong in assuming that the greed of
the financial services industry would be self-correcting. And later that same
week, there was a story to the effect that the University of Chicago, after
considerable controversy, had decided not to name a building after Milton
Friedman, on the grounds that his ideas had been discredited and it would
therefore be an embarrassment to the university to name a building after him.

In short, the conservative ideas that got us into this mess -- ideas that created
the steady drift towards greater inequality, that celebrated greed and excess and
denigrated hard work and moderation, that celebrated the deterioration in the
bargaining power of employees relative to their employers, that ripped up the
regulations that restricted corporate behaviour, that conned us into a trade-off of
public services for tax cuts that mostly benefited a small minority at the top of the
income and wealth scale – have been exposed for the servants of privilege that
they are.

This presents a risk and a challenge. The risk is that in our desire to put the
economy back on the rails will lead us to put it right back onto the same track it
was on before the collapse. It is certainly not hard to figure out what
conservatives want to do. They are going to support an expanded role for
government just as long as it takes to extract the billions of dollars from all of us
that are needed to pay off all the bad bets that were made in the decade of
excess. And then, having given governments around the world no choice but to
run up huge debts to bail them out, they’ll revert to stoking hysteria about
government debt and deficits and calling for more “incentives” in the tax system.
There are two challenges. One is to keep from being drawn totally into the symptoms of the problems we currently face, as compelling as they are. The other is to frame and deal with the issues pragmatically rather than nostalgically.

I’m going to divide the issues here into two categories: those that have to do with the public economy; and those that have to do with the functioning of the market economy.

First, the public economy. To put it bluntly, we need more government. A shift in consumption away from private consumption towards public or collective consumption will make the economy more stable, more equitable and more environmentally sustainable. That is one of the issues under the surface in the current debate about stimulus. It is what made the Harper government so reluctant to acknowledge what was required. It is what led the Harper government to do as little in their budget as they thought they could get away with politically. And it is what explains the Conservatives’ lack of interest in what the stimulus spending actually accomplishes.

Perhaps characteristically, the debate is framed much more clearly and sharply in the United States. The New York Times’ commentary on President Obama’s budget plan named it – approvingly – as a blueprint for larger government.

I hasten to add that this isn’t about picking a number for how big government should be and then getting there. It is about how much more we need to do in the public economy to meet clearly-defined needs. We need to work down the huge backlog in infrastructure investment – the unanswered question in all of this
enthusiasm for fiscal stimulus is why these things had to wait for a full-blown economic crisis to get anywhere near the top of the political agenda.

With no apology at all to the green shifters, who believe that we can transform our energy economy for free, building a sustainable economy is going to require massive investments of public money, for reasons that should be obvious. The benefits from a more sustainable environment are not private, they are collective. And that means private decisionmakers will never invest enough in measures to reduce our ecological footprint.

More is going to be required to address the poverty and inequality left behind by the market.

Health care is going to require more investment, to deliver on what Tommy Douglas called the second stage of medicare – a focus on health, and to meet the needs of an aging population.

We’re going to have to stop talking about how important education is to our economic future and actually do something. Our system of early learning is in the dark ages. The high-tuition model for postsecondary education is a dead end. Its advocates congratulate themselves at the fact that enrolment has not gone down; they ignore the mounting evidence that participation rates are not increasing and that advanced and professional education is increasingly becoming a preserve of the privileged.

And we’re going to have to pay for all of this – not with the kinds of taxes progressives love the most – taxes paid only by people we don’t know – but by
the value added and payroll taxes that are the foundation of public finance in every country in the world that has an advanced system of public services.

Turning to the market, the challenge is to alter the balance of power between workers and their employers. This is not a simple problem. It is not going to be sorted out by going back to card check certification and restrictions on employer free speech. Because the economic and labour market assumptions that underpinned the Wagner Act model for industrial relations no longer applies. The idea that an employee would have secure employment with the same employer for a career is no longer the reality for most workers. For a significant proportion of the workforce, in so-called non-standard work, there is no employment relationship that would be recognized in the Wagner Act model. For others, the insecurity reflects the changed environment in which employers operate.

Part of the answer is to modernize labour laws to take account the reality of insecure, non-standard employment to establish appropriate lines of responsibility and accountability. At issue is the entire labour framework, from employment standards to union organization to workers’ compensation and health and safety to retirement income. In the world of non-standard and insecure work, none of these structures works properly.

Part of the answer lies in addressing the increased bargaining power business has gained courtesy of the domination by business interests of international trade agreements and domestic regulatory reform. It is a truism in collective bargaining that flexibility and choice gives you power. And an international system in which a
business can choose -- whether or not it wants a unionized workforce; whether or not it wants to be subject to serious health and safety and environmental regulations; how much it wants to pay its workforce; and how much tax it wants to pay – gives business enormous power.

One of the encouraging developments in the current market meltdown is that governments seem finally to have realized that countries that act as tax and regulation-free havens destabilize the international economic system and threaten effectively to exempt income from capital from taxation.

The next step – an international financial regime that closes down the havens, imposes consistent systems of financial regulation and establishes common ground rules for corporate taxation – could be an important part of the new international financial regulatory regime.

Beyond that, some balance must be injected into international trade and investment agreements, to offset the incentives for lowest-common-denominator competition that are built into these agreements today. The one-sided investor rights built into international trade agreement templates are creatures of the laissez-faire business-oriented ethic that dominated public discourse for 30-years – an ethic that lies at the heart of the current financial crisis.

But the labour movement has a lot of work to do as well. History shows that every time there has been a fundamental structural shift in the organization of the economy, the labour movement has reinvented itself. Industrialization in the 19th century gave rise to trades-based unions. The emergence of mass production
and giant national manufacturing enterprises in the early part of the 20th century led to the establishment of employer / workplace based unions. In an environment in which everything is mobile except labour and in which the enduring economic relationship is not the relationship between a worker and an individual employer, the labour movement is being called upon to re-imagine itself and reorganize itself to contend with a very different kind of labour market.

While it is true that a new regulatory regime for labour relations is needed, the record shows that while legislation can institutionalize a system for workplace labour relations, legislation does not invent that system. Workers invent the system; they challenge the status quo; and when the status quo is no longer viable, a new paradigm is instituted in legislation.

We've ranged a long distance from the family in East Compton, so let's go back there to conclude. That family is a casualty of unchecked, growing inequality, of lax regulation, of a system that loads too much of what constitutes a good life onto the employment relationship. And as long as the United States is ten times Canada’s size; as long as we are located next door; and as long as the United States continues to be the dominant economy in the world, we all have a lot riding on the fate of that family in East Compton.