The Economist

A special report on the rich

More or less equal?

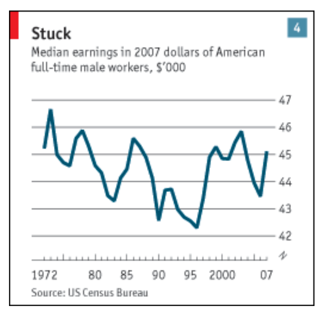
The gap between rich and poor has been widening for 30 years. It has started narrowing again

Apr 2nd 2009 | from the print edition

Illustration by Alex Nabaun

THE past 30 years have been a great time for the wealthy. Their businesses became more profitable; their equities and properties increased in value; for those who worked in investment banking or hedge funds, bonuses rose steeply. And the further up the income scale you went, the better the rich did. Just as the bottom 90% of the population have lagged far behind the top 10%, most of those in the top 10% have trailed the elite 1%. And that select 1% has looked in envy at the Croesus-like 0.1% at the very top of the tree.

Any explanation for this rise in inequality needs to account for several different trends. In the 1980s the poor fell further behind the middle classes, but since the 1990s those middle classes have been squeezed. Both groups have lost ground to the elite. Between 1947 and 1979 the top 0.1% of American earners were, on average, paid 20 times as much as the bottom 90%, according to the Economic Policy Institute, a think-tank in Washington, DC; by 2006 the ratio had grown to 77. In 1979, 34.2% of all capital gains went to the top 1% of recipients; by 2005 the figure was 65.3%.



All this happened during a period when American workers' median real incomes stagnated (though the notional value of any health insurance would have risen steeply). In 2007, according to the Census Bureau, the median income of American male workers was $45,113, less than the $45,879 (in 2007 money) that they earned back in 1978 (see chart 4). At no point over that 29-year period did median incomes pass the $46,000 mark. Families made ends meet because more women worked (and their real incomes did rise) and because they were able to borrow money to maintain their spending.

The classic tool for measuring inequality is the Gini coefficient. The higher it is, the less equal the society. In America the coefficient climbed steadily from 0.395 in 1974 to 0.47 in 2006 before dipping slightly to 0.463 in 2007. In Britain, according to the Institute for Fiscal Studies, the Gini has risen from 0.25 in 1979 to 0.35 in 2006. Figures from the United Nations suggest that America's Gini coefficient is lower than that of many developing countries but well above the levels recorded by egalitarian Denmark, Finland and Sweden, where it does not seem to have risen much.

The recent widening of inequalities marked a complete reversal of the previous trend. From the 1930s to the late 1970s wealth disparities in developed countries declined sharply. But which is the anomaly: the earlier period of high tax rates and rapidly growing state involvement in the economy, or the rising inequality of the past 30 years?

The norm and the exception

Historically, it seems that the rich, like the poor, have always been with us. Even so, the change of course in the 1980s calls for an explanation, as does the fact that inequality has risen far more in some countries than in others. There is a clear gap between America's and Britain's "Anglo-Saxon" model and the rest.

That makes some explanations for the widening disparities look suspect. One is the widespread use of technology, which might be expected to favour those workers who are able to exploit it. But the Nordic economies are well up on technology; Finland, for instance, is home to Nokia, a huge mobile-telecoms group. Technological change may explain why unskilled workers have lost ground to graduates. But it does not explain why such a wide gap has emerged at the very top of the income scale, with the top 0.1% outpacing other professional workers.

The disappearance of the ultra-high tax rates that were prevalent in the 1970s helped the rich hang on to their gains. But work by two academics, Thomas Piketty and Emmanuel Saez, shows that inequality has been just as marked in pre-tax as in post-tax incomes. And why did governments propose (and voters approve) such tax cuts in the first place? There was a feeling in the 1970s that the post-war economic model had been corroded by rising inflation and a series of oil shocks. That helped prepare the ground for the Reagan and Thatcher reforms.

As for inequality lower down the scale, a study of the literature by Robert Gordon and Ian Dew-Becker cites the decline in trade unionism as a big factor, at least for men. In 2005 only 14% of American workers were union members, compared with 27% in 1979. The decline in unionisation may also help to explain the political acceptance of the low-tax, low-regulation regime. Political parties are no longer as dependent as they were on union donations. Instead, they have had to cultivate the rich, who have gained greatly in lobbying power. A study in the late 1990s of congressional elections found that 81% of political donors earned more than $100,000 a year and only 5% earned less than $50,000.

The free-market consensus among parties in Western countries increased disillusionment among the poor, who felt they lacked any real choice between economic policies. That, in turn, made them less likely to cast their vote.

Domestic politics is clearly not the only factor. Many people would point to globalisation, in particular the opening up of the Indian and Chinese markets that vastly increased the global labour force, putting downward pressure on unskilled wages. But academic studies have not found this to be a big factor in explaining the level of wages for the unskilled in recent years.

Globalisation may, however, explain some of the changes at the very top of the scale. The emergence of a global market for talent in areas such as banking, the law and investment may explain why the top 0.1% have been so well rewarded.

In particular, the financial sector contributed an increasing proportion of stockmarket profits from the early 1980s to 2006. The greater acceptance of debt allowed private-equity firms and hedge funds to bet on rising asset prices with borrowed money, which is a quick route to riches when all goes well. There were plenty of incentives to take risk, in the expectation that someone else would pick up the tab when things went wrong. The willingness of central banks to use interest-rate cuts to bail out financial markets only added to the speculative enthusiasm.

Illustration by Alex Nabaun

Messrs Gordon and Dew-Becker point to the rise of "superstar" labour markets in which the best talent commands a huge premium. The clearest examples are found in entertainment and sport. Name recognition gives an exponential kick to the incomes of celebrities like Madonna or David Beckham who can attract endorsements, souvenir sales and the rest. In financial markets, those who mastered the sophisticated instruments (such as derivatives) that emerged in the era of liberalisation were also able to cash in.

The halo effect

Another group of beneficiaries, chief executives, may be in a different category. They benefited from the early use of share options in America, which gave managers a geared play on the 1980s and 1990s bull market. Messrs Gordon and Dew-Becker are not sure whether the resulting wealth was due to their executive skill or to their ability to control boards and thus the amount they got paid. Some executives enjoy a "halo of reputation", the academics suggest, that causes directors to shower them with vast rewards when an equally capable but less famous alternative might have been willing to do the job at a small fraction of the price.

One thing holding back such executives was "outrage constraint", a fear that massive pay packages might attract unwelcome attention in the media. That may have led to an attempt to disguise executive pay, with the really big increases being awarded in the form of option grants and deferred compensation and benefits.

Spurs to effort

Leaving aside the moral issues, does inequality have any economic benefits? In the 1970s it was argued that high taxes had reduced incentives and thus economic growth. Entrepreneurs had to be motivated to build businesses and create jobs. But extensive study by economists has found little correlation, in either direction, between inequality and economic growth rates across countries.

One argument advanced in America is that wide income disparities might encourage more people to want to go to college, thus creating a better-educated workforce. But Lawrence Mishel of the Economic Policy Institute points out that several societies that are more egalitarian than America have higher college enrolment rates.

There might also be an argument in favour of wealth disparities if social mobility was high and the sons and daughters of office cleaners could fairly easily rise to become chief executives. But America and Britain, which follow the Anglo-Saxon model, have the highest intergenerational correlations between the social status of fathers and sons; the lowest are found in egalitarian Norway and Denmark. Things are even worse for ethnic minorities; a black American born in the bottom quintile of the population (by income) has a 42% chance of staying there as an adult, compared with 17% for a white person.

As a result, talent is being neglected. Of American children with the highest test scores in eighth grade, only 29% of those from low-income families ended up going to college, compared with 74% of those from high-income families. Since the better-off can afford to keep their children in higher education and the poor cannot, breaking out of the cycle is hard.

Perhaps Americans put up with this system because they have unrealistic expectations of their chances of success. One study found that 2% of Americans described themselves as currently rich but 31% thought that they would become rich at some stage. In fact only 2-3% of those in the bottom half of the income distribution have a chance of becoming very well off (defined as having an annual income of more than $340,000). Just over half of those earning $75,000 a year think they will become very well off, but experience suggests that only 12-17% will make it.

Health outcomes too are decidedly unequal; the gap between the life expectancy of the top and bottom 10% respectively rose from 2.8 years to 4.5 between 1980 and 2000. That does not meet the definition of a fair society by John Rawls, a 20th-century philosopher, who described it as one in which a new entrant would be happy to be born even though he did not know his social position ahead of time.

However, these inequalities are likely to lessen now. For a start, this decade has so far seen a dismal performance by the stockmarket, which plays a crucial role in creating and maintaining wealth. Real annual returns from American stocks averaged -4.1% in the decade to the end of 2008.

The pendulum swings back

Property prices are already falling sharply, as noted earlier in this special report. Investment bankers are losing their jobs or at least seeing their bonuses cut, and hedge-fund managers are going out of business. As long as the credit crunch continues, it will be more difficult to use borrowed money to boost incomes. And corporate profits, which usually make a handsome contribution to the incomes of the rich, are declining steeply.

Much of this is what you would expect in a recession, and the poor will be suffering along with the rich. But although they may lose their jobs and default on their loans, they will not be troubled by collapsing asset prices because they do not own assets. Edward Wolff of New York University points out that the proportion of American households owning some stocks (including mutual funds and 401k pension plans) went up from 32% in 1983 to 51% in 2001. But only 32% of the population owned more than $10,000-worth of stock, and many middle-class people are only modestly affected by falling asset prices. The richest 10% of the American population owned 85% of all stocks.

Ajay Kapur, the strategist at Mirae Asset Management who coined the term “plutonomy”, identifies six factors that helped to create the phenomenon; the existence of capitalist-friendly governments and tax regimes; the development of financial complexity, innovation and deregulation; the paramount rule of law; globalisation; technology changes; and patent protection. Some of these are already being affected by the recession. Governments have become less friendly towards capitalists and regulations are being tightened. The rule of law is being replaced by what Mr Kapur dubs the rule of man: politicians and central bankers are changing the system on the hoof. “It is hard for investors to know the rules of the game because they keep changing,” he says.

With plutocrats now causing widespread anger, and with public-sector deficits widening, governments will be tempted to target the tax privileges of the wealthy. But how easy will it be to get hold of their money?

from the print edition | Special reports