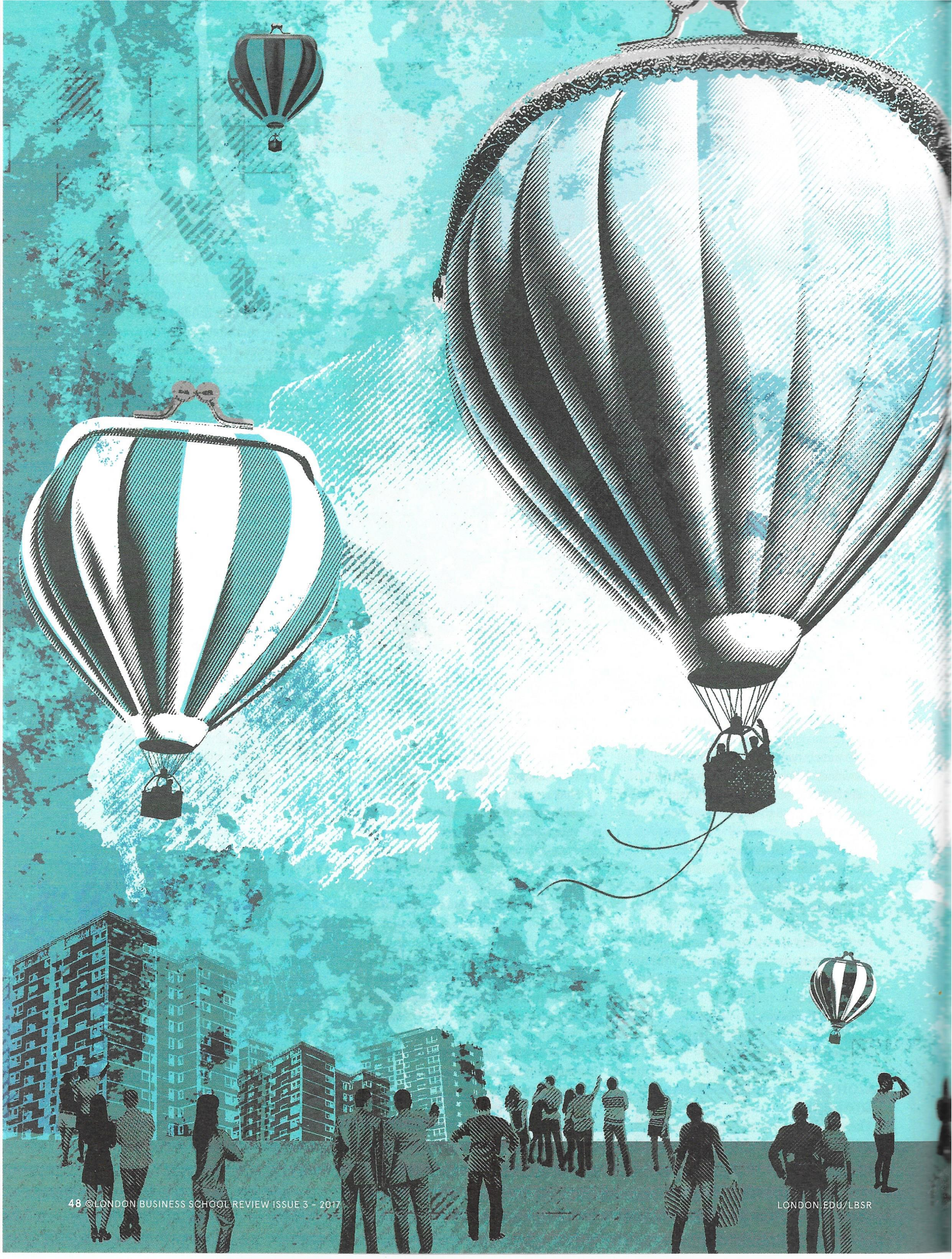


Polarising prosperity

The rich have done well in recent decades. The ultra-rich have done even better. **Elias Papaioannou** explains

Illustration/Gary Neill

Income inequality has become a hot topic. Scarcely a day goes by without a commentator pointing out that, since the 1970s, the fruits of economic growth in many developed countries have accrued to a relatively small fraction of the population.

Politicians like to talk about their desire to promote policies that benefit the many, not the few. But in truth, it is the few – often the very few – who have done extraordinarily well over the past few decades.

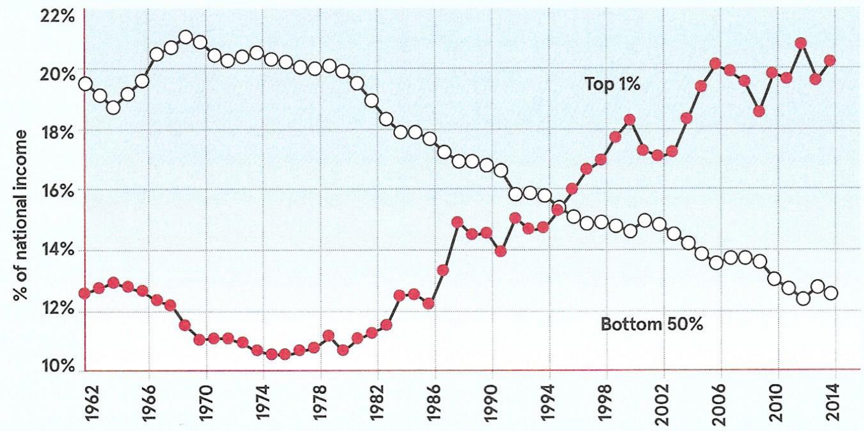
Little wonder that mainstream politicians are so desperate to show – in their rhetoric, if not by their deeds – that they sincerely care about the many. After all, it is the many – those who feel left behind while the rich have become ever richer – who have provided the mainspring for anti-establishment movements on both sides of the Atlantic. Donald Trump's populist agenda struck a chord with Americans who felt impoverished and excluded: the American dream for them was no longer achievable. Bernie Sanders tapped into a similar sentiment. In Europe, Marine Le Pen in France and leaders of the Brexit movement also exploited the widespread sense of resentment.

It is entirely understandable. Whether measured by wealth or by income, it is indisputable that those at the top have captured a far larger share of the economic cake than those further down the scale.

Look at the figures for the US. There are various ways of cutting the data, but they all tell the same story.

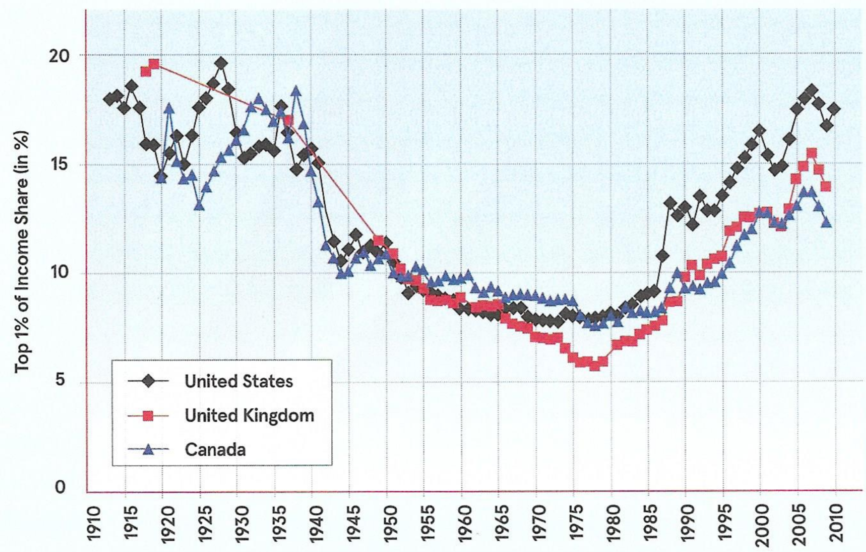
National Income Share before Taxes USA:

Rich Americans are taking a bigger slice of the pie



A Global Phenomenon?

The pattern extends beyond the US: people at the top have seen their share of national incomes increase



The rich get richer

Take average pre-tax incomes adjusted for inflation, for example. In 1980 the annual average of the bottom 50 per cent of households was $16,000. By 2014 that had increased – but only marginally, to $16,200.

In 1980 the average income of the top one per cent was $428,000 – a huge sum even then, but by 2014 it had more than trebled to $1.3 million. The gap between the lower half of the population and those at the top of the income scale had become a yawning chasm.

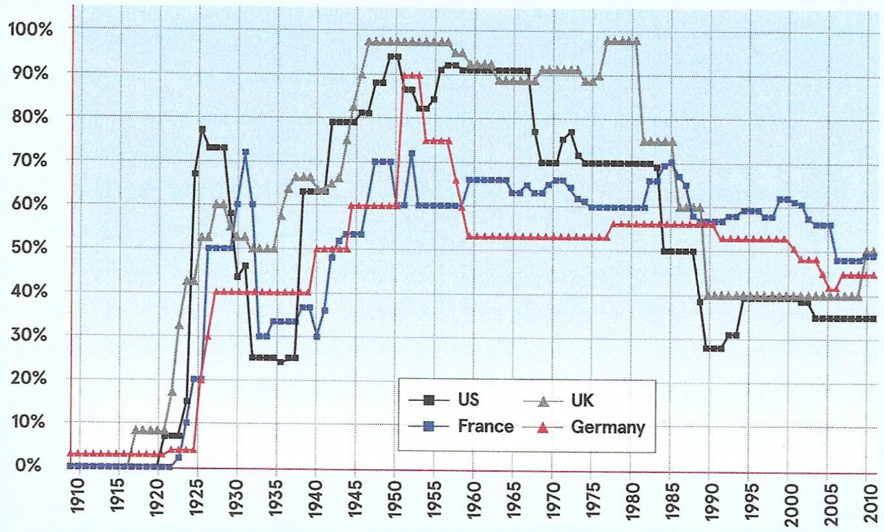
Now take a shorter time period, from 1993 to 2014. The US economy grew over that period and average wages went up by just over 25 per cent. But that average is almost meaningless: it conceals huge differences.

Of the aggregate increase in the incomes of US citizens, more than half accrued to the top one per cent. By 2014 the top one per cent of households were receiving around one fifth of the pre-tax incomes of the entire population. The bottom half were having to share less than 13 per cent. Even after taking taxes into account, the bottom half have still done badly in securing a decent slice of the economic pie: their share of total net incomes was less than 20 per cent in 2014.

All this is striking enough. But dig a little deeper and the picture is even more dramatic. Certainly, those in the top one per cent might consider themselves rich. But compared to those at the very pinnacle of the league table, they are little more than comfortably off. Look at the one per cent of the one per cent (those who comprise the

Evolution of Tax Marginal Tax Rates in Selected Countries

The best-paid people can keep more of their income than at the end of the Second World War



one in 10,000) at the top of the income ladder. Call them the ultra-rich, or the ultras for short.

From the end of the Second World War until the mid-Eighties, the incomes that went into the pockets of this small group ticked along below one per cent of the national whole. After that, the share of the total took off and has continued to do so. By the middle of the current decade this super-rich sliver of the population – just 16,500 families – was taking more than three per cent of the entire national pie. Taking capital gains into account, the share had grown to nearer five per cent.

Not just rich; ultra-rich

By 2015 a family would need to have annual income including capital gains of at least $11.27 million to make it into the one in 10,000 club. Even then, the family would scrape into the ultras category only by a whisker. The average income of this one per cent of the one per cent was far higher: $31.6 million.

Income equality in the US is not a new phenomenon. It was manifest in the 1920s but was dented by the Great Crash of 1929, declined during the New Deal in the 1930s, and remained low during and after the Second World War. Indeed, in the

> **'This super-rich sliver of the population is taking more than three per cent of the entire national pie'**

years from the end of the war to 1980, post-tax incomes for the top one per cent of the population actually grew more slowly than those of the remaining 99 per cent.

It is only since 1980 that the rich – particularly the ultras – have left everyone else behind. Between 1980 and 2014, post-tax incomes of the ultras' one per cent of one per cent club multiplied more than sevenfold.

This is not just a US phenomenon. Income distributions in Britain and Canada have shown a similar pattern: inequality showed a steady decline over the half century to the late Seventies, then reversed.

And even China, that country that still likes to call itself communist, has seen the same trend. Certainly, its growth over recent decades has benefited all groups from top to bottom: those in the poorer half of the population saw their real incomes multiply fivefold between 1978 and 2015. But that is eclipsed by the increase for the top one per cent: their incomes rose by nearly 1,900 per cent over the same period. Again, the increase is even higher among those at the very top.

But the same has not been true everywhere. France, Japan and (most strikingly) Sweden saw inequality lessen between the mid-Thirties and the end of the last war. But since then – even since the end of the Seventies – inequality has remained fairly constrained. Indeed, in France the bottom 50 per cent of the population take roughly the same share of total national income as they did four decades ago.

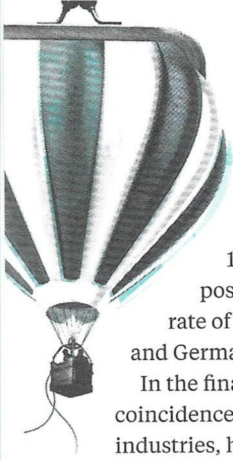
France, however, is an exception. The general point stands: in most developed economies the distribution of incomes has become more and more stretched. Why?

An international market

Globalisation provides a partial explanation. Less skilled workers are more likely to see their work outsourced to low-wage countries than was the case a few decades ago.

And plenty of evidence suggests that, since the 1970s, technology has been skill-biased, favouring those workers with high levels of education, while low-skill workers have been hit by automation, robots and communications technology.

At the top end of the spectrum, individuals with a specific and highly valued talent operate in an international market: corporations around the world can bid for their skills. With globalisation, markets for both goods and services have become larger: someone who can invent or develop a successful new product is going to be worth more to a company selling that product if it can be marketed worldwide rather than in a single country or region. »



Tax rates for high earners have tumbled since the 1970s. (At various times in the post-war period, the top marginal rate of tax in the US, Britain, France and Germany topped 70 per cent.)

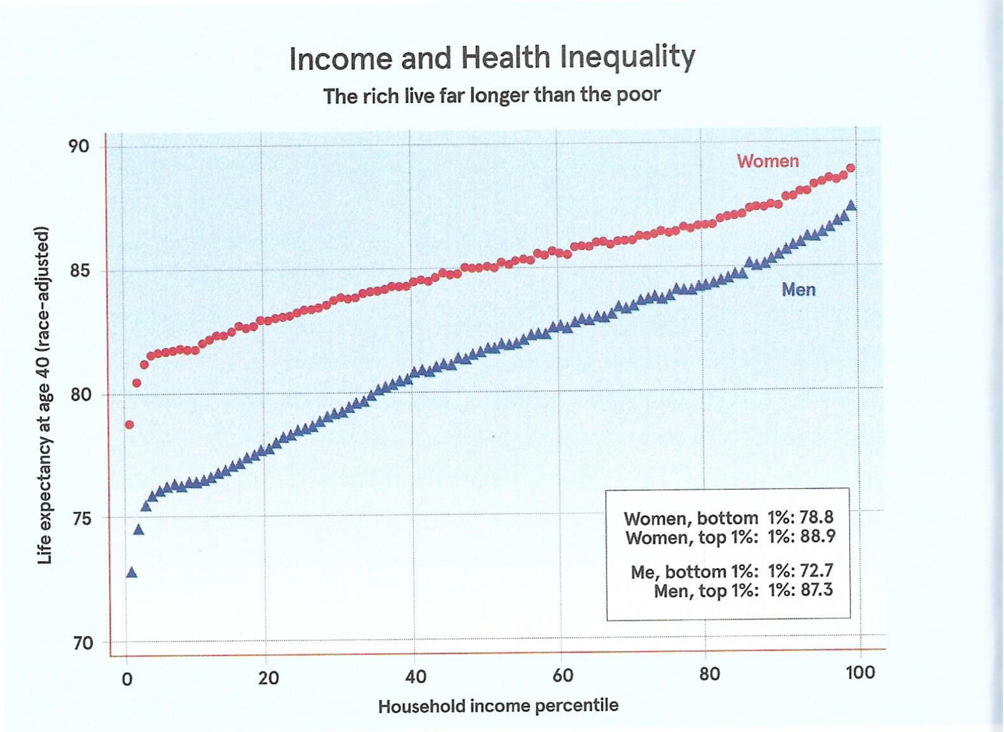
In the financial sector, it is probably no coincidence that pay, relative to other industries, has been highest during periods of deregulation. From the mid-Forties to the early Eighties, regulation was tight and financial sector wages were only modestly higher than elsewhere in the economy. In the years before that period and after it, regulation was lighter touch and wages were higher.

And, as is common knowledge, the remuneration of people at the very top outside the financial sector – be it in law, sport or large corporations – has grown sharply over the past three decades.

All this concerns incomes. But what about wealth? While getting wealth estimates is tricky, recent research by Gabriel Zucman and Emmanuel Saez yields a broadly similar picture. Over the past 40 years, the richest people in the US have seen their share of the country's total household wealth increase sharply. In the late 1970s, the top 0.1 per cent – the richest one-thousandth of the population – was reckoned to control roughly seven per cent of total household wealth. By 2013, that had grown to more than 20 per cent.

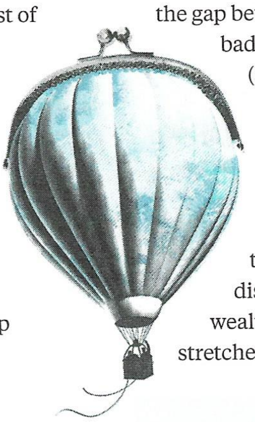
And strikingly, the sources of wealth of the very richest in the US have changed significantly. Look at the individuals who make it onto the Forbes 400, the list of America's wealthiest individuals. Back in 1982, the majority came from "old money": they were born rich and they stayed that way. Fast forward three decades to 2011. It was individuals who had come from only modestly wealthy backgrounds, or indeed who had started with nothing, who made up the majority of the list of elite billionaires.

Isn't this something to be celebrated? Doesn't it indicate that the American dream is in fact still very much alive and well – that someone can start with nothing and by their own efforts become rich?



Born rich, stay rich

International comparisons are instructive here, although it is always tricky to compare nations that differ across many dimensions. Return to incomes and look at the countries where inequality is greatest – Britain and the US. In these nations, there is actually *less* mobility between generations than elsewhere. People with rich parents are likely to stay rich and people from poor backgrounds are likely to remain poor. It is in those countries where the gap between the well paid and the badly paid is relatively small (such as Norway, Denmark and Finland) that people are most likely to move into a different income bracket from that of their parents.



Put this all together. Over the past few decades the distribution of both incomes and wealth has become increasingly stretched. On the one hand, we have the rich, the very rich and the ultra-rich: they have done exceptionally well. The remainder – particularly those in the less well-off half of the population – have not.

If we think this is a problem that should be addressed, how to do so?

Executive pay could be capped. Controls could be imposed on devices such as incentive schemes and share option schemes that have made a few people very wealthy. Company boards and regulators could be given more powers to curb what they perceive to be excess.

All that may sound appealing – but such measures would be effective only if applied everywhere. Otherwise, countries could compete to make their regulatory regimes lighter than those of their rivals – and thus more attractive to internationally mobile capital and individuals.

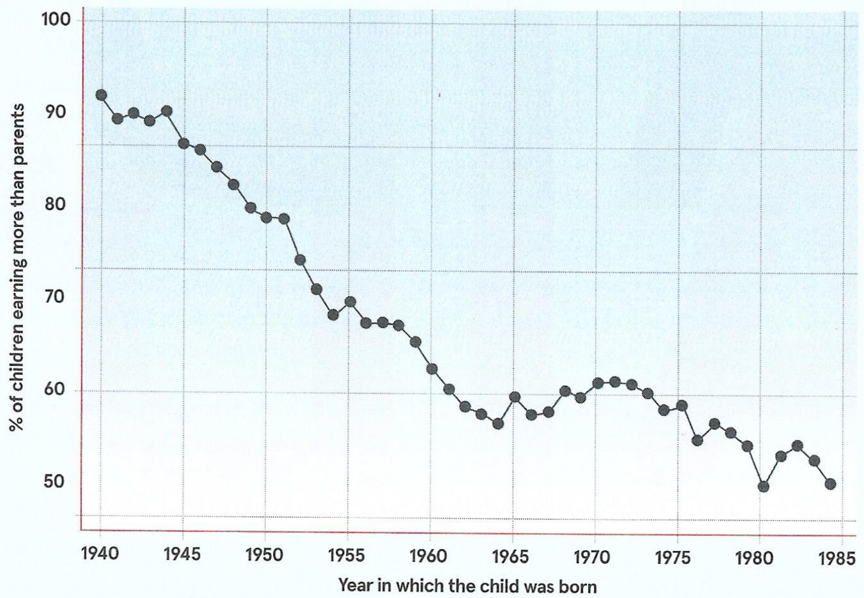
What about higher taxes? Again, the mobility of capital and people across borders is an issue: the lowest-tax environments will be the most attractive. If very talented people leave a country because they feel too highly taxed, productivity in that country may suffer. The temptation to use tax havens and straightforward evasion becomes greater.

And conventional wisdom has it that high taxes discourage work and impede

ELIAS PAPAIOANNOU is Associate Professor of Economics at London Business School

The Fading American Dream

Recent generations are less likely to be better off than their parents



business creation. Well, maybe. But don't forget that in what are now thought of as the bad old days of the 1960s, when tax rates around the developed world were high, growth was generally stronger than it has been in the recent past.

The 99 per cent

Do not think that income inequality is just about the financial success of the top one per cent (or 0.1 per cent or 0.01 per cent) compared to others. It is not. Inequality outside these elite groups – within the remaining 99 per cent – has also increased markedly.

Between 1963 and 2012, pay for American men with a degree above bachelor level almost doubled in inflation-adjusted terms. In contrast, the incomes of men graduating from high school but with no further education increased by little more than 10 per cent. Average pay for high school drop-outs was actually lower at the end of the period than at the start. In other words, the premium put on skill went up. And the financial penalty for being badly educated became harsher. Those at or near the bottom of the pile have felt the effect of reductions in the real value of the minimum wage. Union power has declined. Tax changes have favoured those at the top: they no long face high marginal rates. Automation, global outsourcing and competition from developing countries (which has increased as tariffs and quotas have been dropped) have all combined to undermine the market for low-skill work at home. Excluding the agricultural sector, manufacturing accounted for almost one third of US jobs in the late 1940s. That share is now less than 10 per cent.

The impact of China joining the World Trade Organization in 2000 has been a huge factor. It has become the workshop of the world. At the start of the millennium its share of global manufactured exports was around five per cent. It is now nudging 20 per cent.

Beyond economics

This is about more than pure economics. In the US it has had profound political implications, too. This was shown in last year's presidential election. Donald Trump's anti-China rhetoric resonated most strongly in US states whose industries have been worst hit by Chinese competition. It was in these places that the Republicans did best.

And even in the years preceding the 2016 US presidential election, there was growing political polarisation, with congressmen taking more extreme positions on issues such as gun control, LGBT rights, immigration and abortion – and less willing to "cross the aisle" on political lines.

Income inequality also matters when it comes to a nation's health. In the US a child from a poor background is about twice as likely to die in its first year than in Finland, where health and welfare policies provide a far more comprehensive safety net.

As recent influential work by Anne Case and Nobel Laureate Angus Deaton shows, adults are impacted, too. On average, an American male in the bottom one per cent of the income distribution is likely to die before his 73rd birthday, whereas a man in the top one per cent can expect to live to 87. And the gap has been growing: it is the people at the top of the income scale who have seen their life expectancy increase; those at the bottom have not. One group has seen mortality in middle age actually increase: a poorly educated white American is now significantly more likely to die between the age of 50 and 54 than was the case at the turn of the millennium.

Furthermore, the US as a whole does badly when measured against life expectancy in other developed countries. And there are differences even within the US: states with welfare safety nets that are close to European standards show much better mortality rates than elsewhere, particularly among the very poor.

So inequality matters in politics. It matters in health. And because America's elite earners have taken such a huge share of the nation's increased income, there has been little left to share out among the remainder of the population. Of people born in 1940, more than 90 per cent would end up earning more than their parents. Of those born in the early 1980s – people now in their thirties – scarcely more than half are likely to be better off than the generation that preceded them.

So should we be surprised at the swelling up of populist movements that have challenged the decades-old political consensus? No. Should we be surprised that inequality has become a topic? No. Should we be concerned? Emphatically yes. o