Income Inequality and the Limits to Capitalism: The Haves and Have-Nots

By Brian Fabbri (October 2012)[1]

As the world becomes increasingly interdependent it is rapidly migrating toward a very bipolar universe. This is becoming very evident in the US where numerous new academic studies have detailed with an abundance of data that the US is rapidly becoming a nation of Haves and Have-nots. Over the past 30 years, wealth increasingly became concentrated in the top 1% of the population. In 2007 just before the great recession, 23.5% of wealth in America was owned by the top 1%, the highest percentage since the peak in 1928, 23.9%. The net result has been the disenfranchisement of the middle class in America. A recent Pew Research center study revealed that median household income fell 5% over the last decade, household net worth dropped 28%, standards of living deteriorated, and household attitudes toward government, banks, and big business soured.

The Eurozone is similarly manifesting itself to be an economic zone of a few relatively healthy economies and several others bordering upon default and depression. The European Commission's forced austerity requirements on the countries with slumping economies will only exacerbate an already worsening trend of income inequality. These countries, in desperate need for cheap liquidity to help finance massive budget deficits, are being forced to submit to the demands of the richer Eurozone countries in order to postpone bankruptcy. The net result of the austerity measures agreed to will propel these slumping economies into deeper recessions and greater unemployment. As unemployment rises it exaggerates the income disparity between the haves and have-nots.

Problems of increasing income inequality are not confined to the West, or to only advanced economies. They are also present right here in Asia. For example, Singapore's Deputy Prime Minister Tharman Shanmugaratnam said in a recent speech that market forces will only widen disparities in income and wealth. 'Economic growth itself does not lift all boats and certainly not equally'. He pointed out that the bottom fifth of workers in Singapore have not seen any increase in real incomes in the last decade, and in Singapore's case it was a decade of robust economic growth. It also was a period of earnest competition. The World Economic Forum in their latest Global Competitiveness Report ranked Singapore the second most competitive economy in the world after

[1] The views and opinions expressed herein are those of the author, and do not necessarily represent those of the National University of Singapore (NUS), the NUS Business School or CAMRI.

Switzerland. Therefore, according to Mr. Shanmugaratnam, Singapore 'needs careful sustained government intervention and a good dose of compassion' to counter this inevitable trend. Other major Asian economies are also experiencing rising income inequality; however, they are further behind Singapore in their economic development and are at a stage in development when inequality is typically experienced. As these emerging economies, like China's, continue to advance into more mature phases of development, the initial income disparity associated with emerging growth will transition into a broader economic issue for their governments to control.

Unequal Distribution of Success Attributes

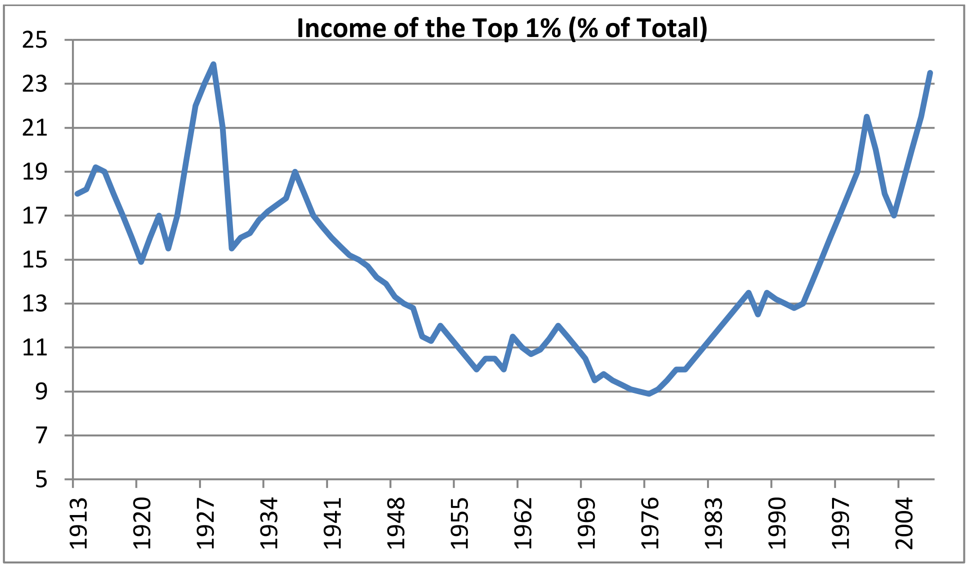
Governments and social engineers, whenever they have had the opportunity, have been plagued by the difficult tradeoff between promoting a society based upon meritocracy and providing an adequate lifestyle for the underclass. Nearly all of the most economically successful countries in the past century have benefitted tremendously from adopting and promoting a meritocracy. A society that richly rewards achievement raises the standard of living for all members of society. The evidence from a diverse group of countries across the universe overwhelmingly supports this concept and equally condemns claims from alternative regimes such as communism, dictatorships and fascism. However, unfettered capital markets and meritocracies may create income inequality.

Then why is there a dilemma, why indeed is there a trade-off? The trade-off comes as a result of the unequal distribution of personal attributes. The distribution of personal attributes that drive a meritocracy: skills, intelligence, ambition, desire, and work discipline are not distributed evenly across the population, or in any political state. Thus, some individuals succeed and amass enormous wealth and power and some languish at the bottom of society. The dilemma for society is how to provide enough social services to those that have not achieved much from the spoils amassed by the ultra-achievers. If the gifted and dedicated achievers keep all that they have earned, leaving only crumbs for the not so gifted, they will need to hire many not so gifted to keep the remaining not so gifted from their doorstep. Because the modern era of interconnectedness has given all income classes access to information about necessities: education and health care, and some of the nicer things in life: entertainment and material items, all classes build similar expectations.

Income inequality is rising in nearly all relatively free market economies. It appears to be the hallmark of successful market activity. A market economy is based upon incentives and reward for achievement. The most successful economies reward achievement the most. History has produced enumerable examples across many different societies and eras that have demonstrated how reward for achievement promotes economic growth and propels innovation. However, the problem for political leaders is personal attributes such as skill, ambition, desire for achievement, dedication, and work effort are not distributed evenly throughout the population. Therefore, the rewards for achievement are not distributed uniformly either.

The phenomena of the top 1% in the US

Income inequality in the US has grown significantly since the late 1970s, after several decades of stability. While inequality has risen among most developed countries, and especially English-speaking ones, it is highest in the United States. From the 1940s to the 1980s, the income gap in the US remained fairly consistent. In the 1990s, however, while those in the bottom 90th percentile have seen stagnation in their income levels, incomes in the top 10th percentile have doubled. The increase in income for the top 1% and more evidently the top 0.1% is attributed to several developments: first, from the extraordinary growth in salaries, second, from the expansion in financial sector workers, and third, from the progressively higher salaries of the CEOs. This is drastically different from the beginning of the 20th century, when income disparity was last this great. Then wealth was measured by ownership of capital, or land.[2]



The post 1970s increase in inequality in the US has been caused by a widening gap between the middle class and top earners, rather than between the poor and middle class. The disparity becomes more extreme the further one goes up in the income

[2] Note: The source for the first chart: "The State of Working America" by Robert Reich, University of California. The source for the last 4 charts: Federal Reserve Flow of Funds and Brian Fabbri.

distribution. A 2011 study by the US Congressional Budget Office (CBO)[3] found that the top earning 1 percent of households gained about 275% after federal taxes and income transfers over a period between 1979 and 2007. The top 1% possesses more wealth than the entire bottom 90%. Other sources find this trend continuing since then. In addition inequality is also on the rise at the state level. The report showed that 27 states had median incomes lower than the national average of US$50,502.

In the words of Nobel laureate economist Paul Krugman there has been a "great economic arc" from high inequality "to relative equality and back again".[4] In 1915, an era in which the Rockefellers and Carnegies dominated American industry, the richest 1% of Americans earned roughly 18% of all income. By 2007, the top 1 percent account for 24% of all income. In between, their share fell below 10% for three decades.

The first era of inequality lasted roughly from the post-civil war era to sometime around 1937. But from about 1937 to 1947 income inequality in America fell dramatically. Highly progressive New Deal taxation, the strengthening of unions, and regulation of the National War Labor Board during World War II raised the income of the poor and working class and lowered that of top earners. This "middle class society" of relatively low level of inequality remained fairly steady for about three decades ending in late 1970s. It was the product of relatively high wages for the US working class, and political support for income-leveling government policies.

Wages remained relatively high for several reasons: one, because of low foreign competition for American manufacturing, two, because of a lack of low skilled immigrant workers, three, high competition for US workers in general, and four, strong trade unions. By 1947 more than a third of non-farm workers were union members, and unions both raised average wages for their membership, and indirectly (though to a lesser extent) raised wages for workers in similar occupations not represented by unions. Scholars believe political support for equalizing government policies was provided by high voter turnout coming from several important trends: from union voting drives, from the support of the otherwise conservative South for the New Deal, and from the prestige that the massive mobilization and victory of World War II had given the government.

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[3] Trends in the Distribution of Household Income, 1979-2009, Congressional Budget Office, 8 August 2012.

[4] Paul Krugman, "The Conscience of a Liberal", The Opinion Pages, New York Times, 29 September 2012, and "The Rich, the Right and the Facts", from the American Prospect: http://www.pkarchive.org/economy/therich.html.

The return to high inequality began in the late 1970s. Studies have found that income grew more unequal almost continuously since then except during the economic recessions in 1990-91, 2001, and 2007 sub-prime bust. The present inequality differs in some ways from the pre-Depression era inequality. Before 1937 a larger share of top earners' income came from capital (interest, dividends, income from rent, capital gains). Post 1970, the income of high-bracket taxpayers comes predominantly from "labor", i.e., employment compensation. Economist Timothy Smeeding summed up the current trend.[5] Americans have the highest income inequality in the rich world, and over the past 20–30 years Americans have also experienced the greatest increase in income inequality among rich nations. The more detailed the data we can use to observe this change, the more skewed the change appears to be. The majority of large gains are indeed at the top of the distribution.

According to CBO the major reason for the observed rise in the unequal distribution of after-tax income was an increase in market income that is household income before taxes and transfers. Market income for a household is a combination of labor income (such as cash wages, employer-paid benefits, employer-paid payroll taxes), business income (such as income from businesses and farms operated solely by their owners), capital gains (profits realized from the sale of assets, stock options), capital income (such as interest from deposits, dividends, rental income), and other income. Of these, capital gains accounted for 80% of the increase in market income for the households in the top 20%, in the 2000-2007 periods. Even over the 1991-2000 periods, according to the CBO, capital gains accounted for 45% of the market income for the top 20% of households.

The U.S. is not alone among developed nations in facing rising income inequality. The rich are getting richer and the poor are getting poorer in all the Anglo-Saxon countries (UK and Canada), while in contrast, there has been stability in the income distribution in many other developed countries such as France, Japan and Sweden. The pre-tax income inequality in France is significantly reduced by its tax system where the tax code is more progressive than in the U.S, similarly in Sweden.

Keeping the Spoils

Income inequalities' pernicious effects manifest itself in two vital areas: political power and education. Both enable the wealthy to perpetuate and preserve their privileged status. The adage that *money is power* is played out with increasing visibility in each US

[5] Timothy Smeeding, "Public Policy, Economic Inequality, and Poverty: The United States in Comparative Perspective", Social Science Quarterly, Volume 86, Issue Supplement s1, pages 955 – 983, December 2005.

national election as wealthy corporations and individuals contribute outrageous amounts of money to political campaigns to protect their interests. Politicians use the vast sums of money to purchase expensive media advertising campaigns to successfully grasp election victories. Once seated in power they are morally obligated to promote legislation that protects or enhances their benefactors' economic and social interests.
The complexity of the U.S. tax code creates a disconnect between the tax rates on the books and what people and corporations pay. Whoever has the best accountant pays the lowest tax rate. This exacerbates and creates the weird scenario where the rich are taxed at a lower rate. They also have the best lobbies for tax reduction and the best accountants who can provide the best strategies to avoid (not evade) taxes. Buttressing this point is the declaration from the most esteemed investor in America, Warren Buffet, a billionaire himself, who admitted that his income is taxed at a rate that is well below that of his secretary.

A similar serious effect that results from high concentrations of wealth is the perpetuation of income inequality across generations through education. In highly developed meritocracies, income and wealth is highly positively correlated with education. University selection in the US is primarily driven by academic achievement and family affiliation. Academic success is often achieved through expensive and intense tutoring to supplement private school education. The more educated children gain access to the best universities, often the most expensive. These universities not only provide a relatively more celebrated education, but equally important access to mingle and befriend the next generation of successful individuals. Moreover, those with the least education are the most likely to be hurt by disruptions and changes in the economy caused by international trade or by technological changes.

"Also, when you have a degree, you are much more likely to be insured against the fluctuations of the business cycle," states Peter Orszag, former director of the US Congressional Budget Office (cbo). He adds that in the US, immigration, the decline in unions, and the decline of the minimum wage in real terms - conditions which largely affect those with less education – may also have an effect on rising inequality. Technology increases the demand for skilled workers, which raises their wages relative to unskilled workers. Education raises the supply of skilled workers, bringing relative wage differentials down and therefore reducing inequality. However, the problem is that the US has not responded to the technological revolution by becoming more educated. Indeed, Orszag points out that the demand for skills has far outstripped their supply, which suggests that income inequality will exist as long as the skills gap remains.

Finally, a new social psychology is gaining more notoriety: *last place aversion*. As the middle class continues to decline in number and importance, experimental economists have discovered that people losing status become much less generous to those below them when they feel they are in second to last place. They would rather distribute money upward than help those on the bottom to surpass them. The lack of growth tends to breed xenophobia, intolerance, and a negative feeling towards the poor. This complicates the political process and helps explain the sometimes confusing and economically perverse claims by new political parties (example, the Tea Party in the US) voicing populist outcries.[6]

So What?

If the myriad of economic factors and developmental trends have combined to produce a less equal distribution of income in the Anglo countries, all of whom have been operating under a meritocracy system, should politicians worry, or equally, should investors worry? Are the recent fledgling *Occupy Wall Street* movements just a tiny hint of a more serious social rebelliousness to come?

In the late 1920s when the income disparity was at its widest the prevailing boom morphed into the great depression. It is true that millions of dollars in financial assets were lost, but the social losses emanating from a 25% unemployment rate were graver. Today's dilemma is equally serious. After 3 years of insipid economic recovery the unemployment rate remains above 8%, household liabilities, while lower than at their peak, remain uncomfortably high from a historical perspective, and household real estate values have not recovered. In fact, after years of extracting equity from their households and the recent plunge in equity values, households own just 43% of their real estate compared with 72% fifty years ago.

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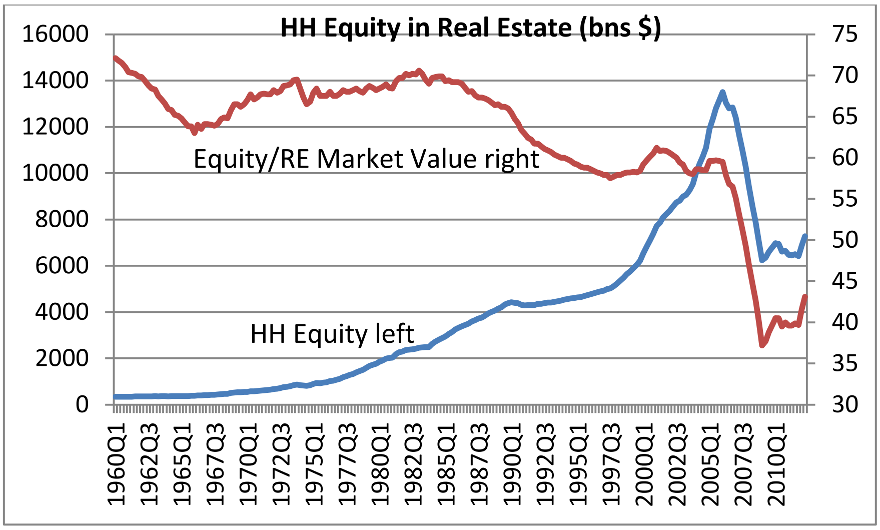
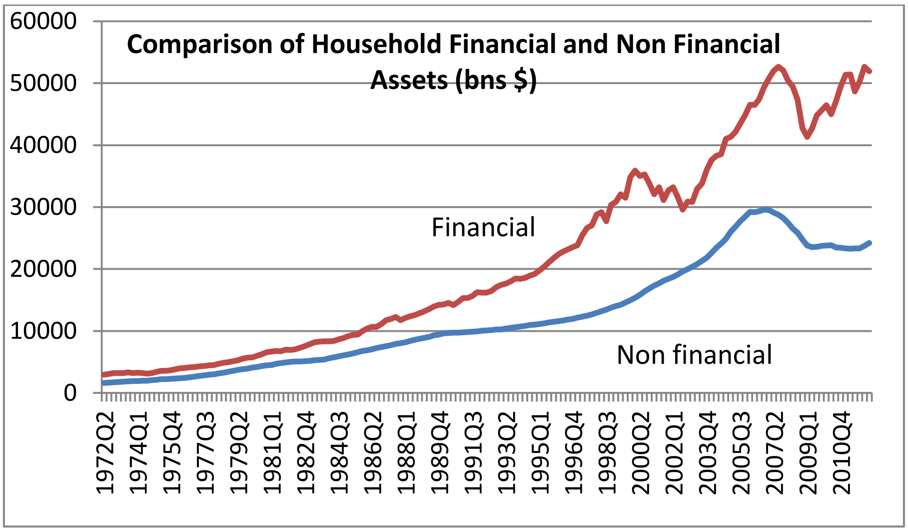
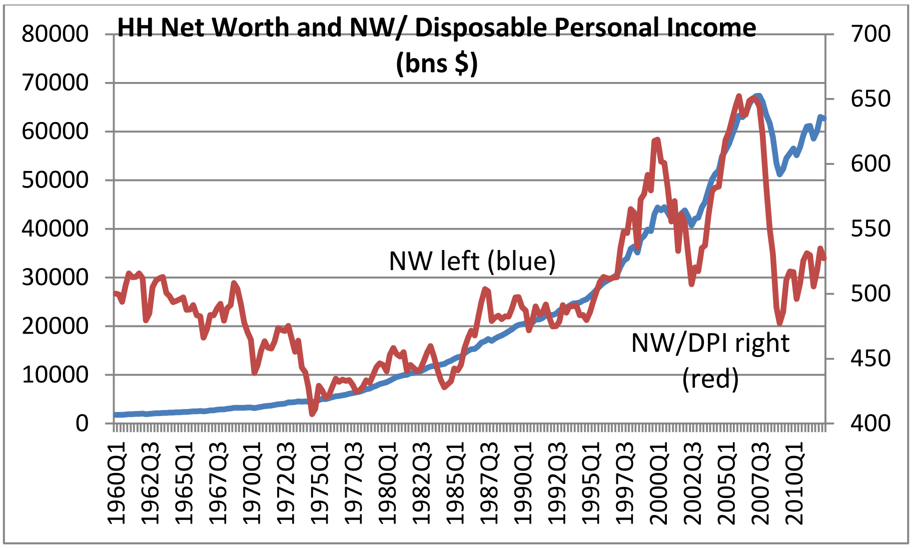
[6] Editor's Note: The New York Magazine article, "The Money-Empathy Gap" reports that "the affluent value individuality — uniqueness, differentiation, achievement — whereas people lower down on the ladder tend to stress homogeneity, harmonious interpersonal relationships, and group affiliation."
http://nymag.com/news/features/money-brain-2012-7/index5.html
In a related article in FT Wealth's Autumn 2012 issue on the Politics of Greed, UC Berkeley psychologist, Paul Piff, and his colleagues are reported to have (controversially) documented that "wealth and higher education are associated with higher levels of independence, freedom and self-esteem" and that "the 'upper classes' are less cognizant of others, less empathetic and easily distracted."



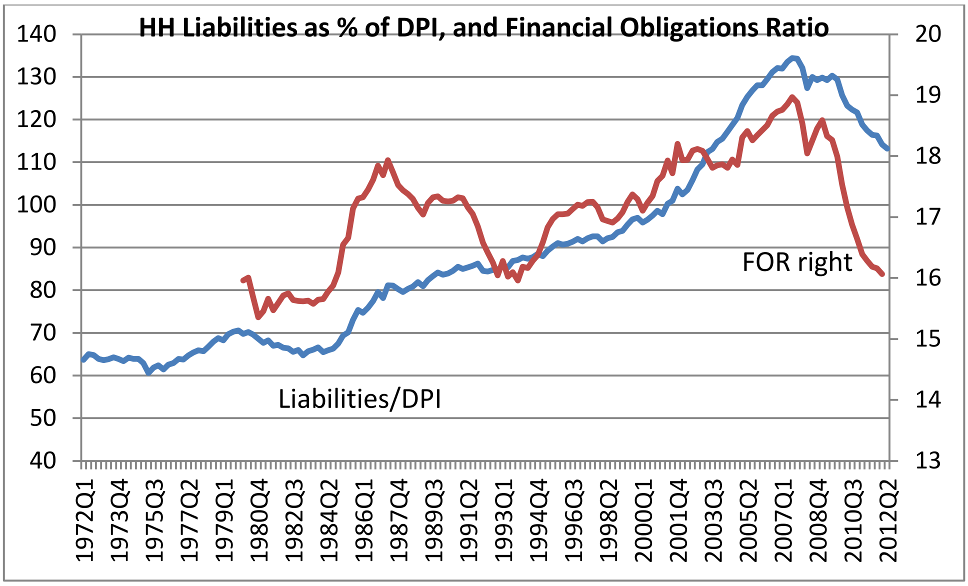
Ironically, it is financial assets whose values have recovered during the current business cycle expansion boosted by the massive injection of monetary liquidity. Stimulative monetary policy has resurrected depressed financial asset prices, but unfortunately not real estate prices. At mid-year 2012, non-financial asset prices are 18% below their 2007 peak. Since most families in the US own their own homes, and according to a recent Federal Reserve survey of households, 90% of financial assets (mainly stocks) are owned by just 10% of the population, it must have been the wealthy who derived all of the benefit from loose monetary policy. Indeed, in the post great recession period, the wealth gap became wider.



Another result is that the value of household financial assets has risen to double that of non-financial assets over the past 40 years. In 1972 household assets were roughly evenly divided between tangible and financial assets, a time marked by a much more even income and wealth distribution. One final aspect of the uneven accumulation of wealth is that household net wealth increased much faster than disposable personal income up to the recession in 2008. This implies that there was significant asset price inflation over this period. It was underpinned by a liberal application of leverage which was used to boost returns on financial assets.



The wealthy weren't the only ones to take advantage of leverage. Evidence shows that the run-up in consumption inequality has been considerably less dramatic than the rise in income inequality. The CBO found that household consumption numbers show more equal distribution than household income. Consumption in excess of income usually means a reduction in savings and increased use of debt. Savings rates did fall from an average of around 8% two decades ago to 2% just prior to the recession. However, it was the enormous unprecedented build up in debt that supported consumption growth. US household debt soared from the mid-1980s on to the onset of the great recession rising far faster than disposable income. By 2008 households had built up debt levels to an unsustainable record of 134% of disposable income.



The debt to income ratio has fallen to 113% in mid-2012 after several years in which households paid down debt and banks became more restrictive with lending terms. Several years of debt destruction has stifled consumption and therefore economic growth. Nevertheless, debt to income levels remain too high, and therefore slow economic growth will persist for more years into the future. It is the masses that must spend for the nation's economy to grow faster. The wealthy have a much lower propensity to spend than the masses and therefore cannot carry the economy any more than they can correct the massive federal fiscal deficit the country now faces.

The Polarization of the Political Process

As wealth increases it crowds populations into similar-minded living localities. The rich migrate to places populated by other wealthy and the poor and less wealthy remain concentrated in their neighborhoods. A study conducted at Stanford University showed that in 1970 almost 66% of American families lived in middle class neighborhoods, and by 2007 only 44% did. Research has shown that like-minded groups become more extreme in their views than they were before as their views are amplified and reinforced by one another. This causes more extremes in voting and in political candidate selection and eventually the polarization of the political process. It frustrates the need for compromise in political decisions, especially about the distribution of income and public services.

Disenchantment with the present political system is increasing everywhere. Such dissatisfaction breeds populist movements such as the recent *Occupy Wall Street* demonstration. However, this example of public rejection of the prevailing political system in the US is a benign response. Moreover, the spark that ignited this protest was not the growth in income inequality; rather it was a vigorous response to the *crony capitalism* that used public funds to bail out companies and individual managers of failing institutions. The government underwrote the banks who wound up privatizing profits and socializing risks. It was as if the public's embrace of meritocracy was dashed into the ground when the government decided to reject the market's natural discipline to punish failure, and instead chose to reward failure with public funds. The US public is growing suspicious that the elite in charge of government regulation are placing their own interests above shared social values. The business and government interaction witnessed in the past few years creates public outrage, and the ensuing populism generates dangerous politics, which left uncontested will cause a vicious cycle.

In Europe disenchantment is rising especially among the young. Twenty percent of those under 25 years old have no jobs. The youth unemployment situation is worse in Greece and Spain where 25% and close to 50%, respectively, is unemployed. Consequently, Europe is much closer to a tipping point than the US. The more sinister examples of disenchantment are the growth of extremist political parties that are mushrooming throughout Europe, like those that destroyed the continent in the previous century.

Preventing a tipping point – some suggestions

Are there solutions to prevent bigger, broader and more dangerous popular responses? Some suggestions are obvious and should prove effective, albeit they are not universally popular. First, increase the national tax rates' progressivity back to the levels that prevailed several decades ago. Second, remove tax deductions that render the present degree of progressivity ineffective. Return to promoting social goals directly through expenditures not indirectly through revenue reductions. Third, enforce the present monopoly and anti-trust legislation vigorously with an objective to improve competition, and to eliminate all ***too big to fail*** institutions, which have shackled governments. It is robust forms of competition that makes capitalism work. Enhanced competition will return power back to governments so they won't be forced to support companies that are too big to fail. Fourth, ensure that the public strongly believes that the system is fair — eliminate any suggestion of *crony capitalism* that has crept into view recently. Fifth, simplify and minimize government regulations, and shift the execution of the regulations from the lawyers, lobbyists, and entrenched parties back to the people. This would reduce the inherent corruption associated with excess complicated regulation.

Some suggestions are more dubious in terms of their timely effectiveness such as: creating a corporate climate of social responsibility, one that goes beyond that of maximizing shareholder value. It is a noble suggestion, but it would take years of education before it would become a guiding corporate principle. Finally, ensure that public goods are accessible to everyone in society equally, such as education and health care. Of course in a competitive, free market society private institutions will arise offering perceived better values that only the wealthy will be able to afford. It was Adam Smith who warned long ago that capitalism was the best system but an inherently flawed one that requires careful government regulation and supervision.

Dr Brian Fabbri is Managing Director of FABBRI Global Economics. He was formerly the Chief US Economist for North America at BNP Paribas, and was based in New York. Dr Fabbri also worked as Chief International Economist for Midland Bank Plc, as senior vice president, chief economist and director of institutional research at Thomson McKinnon, as vice president & senior economist at Salomon Brothers, and as head of the capital markets unit at the Federal Reserve Bank of New York. He appears regularly on CNBC and other business networks and radio shows, and is a member of the National Association of Business Economists, the New York Association of Business Economists, the Downtown Economists Club and the Money Marketers. Dr Fabbri earned a Ph.D. at New York University.

For more information, please contact camri@nus.edu.sg