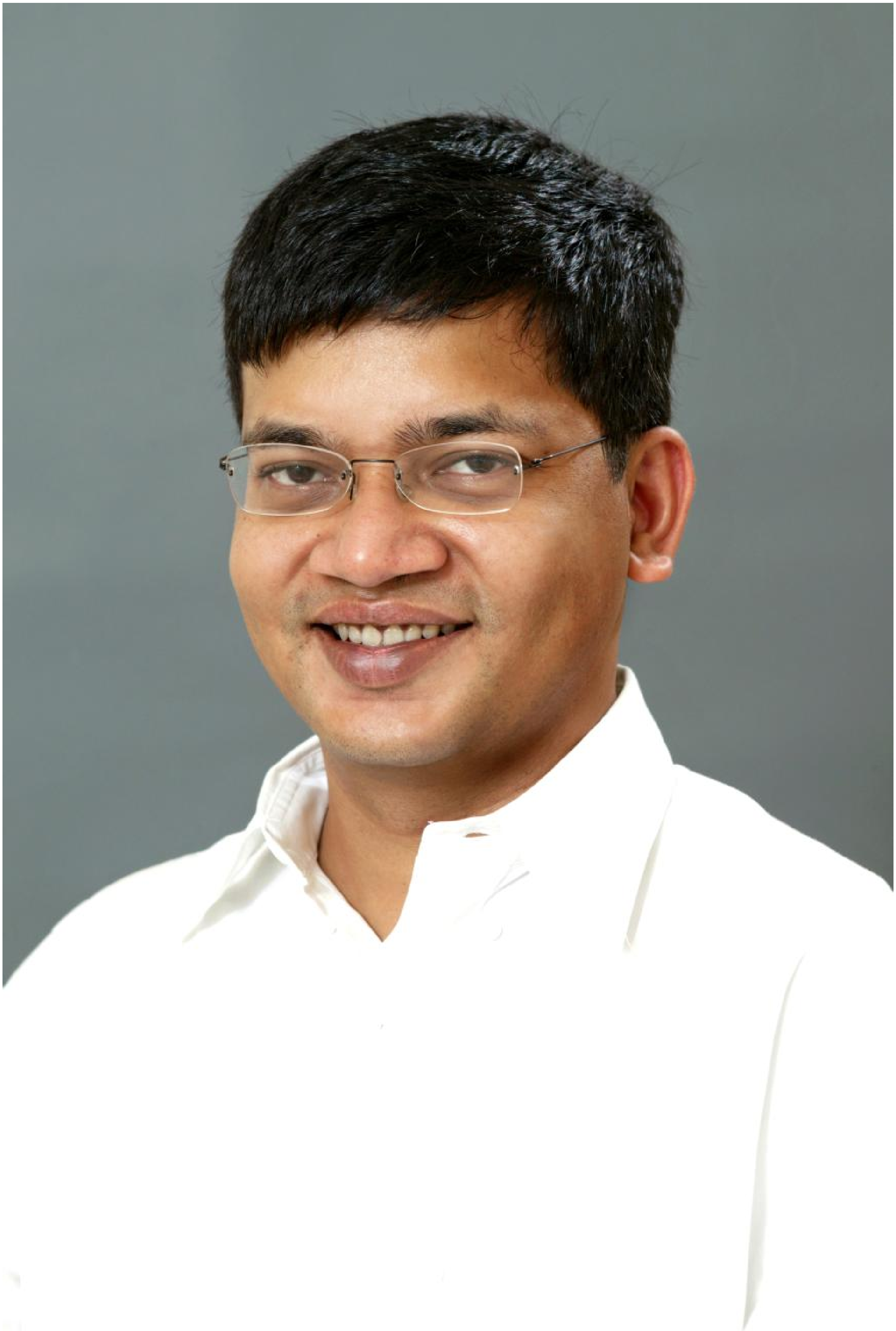
How the rich got richer

By Grace Segran

The gap between the rich and poor used to be the province of third world countries. Why is it an issue in developed countries these days?

Gaping disparity between the rich and the poor used to be the hallmark of third world or developing countries – places without a “middle class” or an equitable and sustainable tax code or developed agencies of social support and education. Today, however, income disparity is an issue in developed countries… and there is hard data to support the claims of inequality.



“From the 1940s to the 1980s, the income gap in the US remained fairly consistent,” points out **Pushan Dutt** INSEAD Associate Professor of Economics, citing United States government statistics. “In the 1990s, however, while those in the bottom 90th percentile have seen stagnation in their income levels, the top 10th percentile has seen their incomes double.” Dutt spoke to INSEAD Knowledge on the sidelines of a student discussion on income equality held at INSEAD’s Asia Campus in Singapore recently.

This is difficult to swallow in the U.S. where achieving “The American dream” of house, car, job and happy family is considered a birthright. In the U.S., research shows that the shift in the top 1 percent and the top 0. 1 percent today comes from the rise in salaries and numbers of financial sector workers, and the increasingly higher salaries of the CEOs – people with in-demand skills and expertise – according to Dutt. That’s drastically different from the beginning of the 20th century, when wealth was measured by ownership of capital or land – real assets. “Very pertinent questions can be raised about whether the levels of compensation of CEOs reflect productivity or not,” adds Dutt. “I don’t know the answer to that but I think it is a valid question.”

An Anglo-Saxon Problem?

As it turns out, the U.S. is not alone among developed nations in facing rising income inequality. Its cultural brethren are also suffering. Dutt claims rising income inequality is not a global phenomenon; it is “mainly an Anglo- Saxon phenomenon,” mimicked in the U.K. and Canada. This widening income gap, however, is not happening in France, Japan and Sweden. In other words, while the rich are getting richer and the poor are getting poorer in Anglo-Saxon countries, there has been stability in the income distribution in many other developed countries.

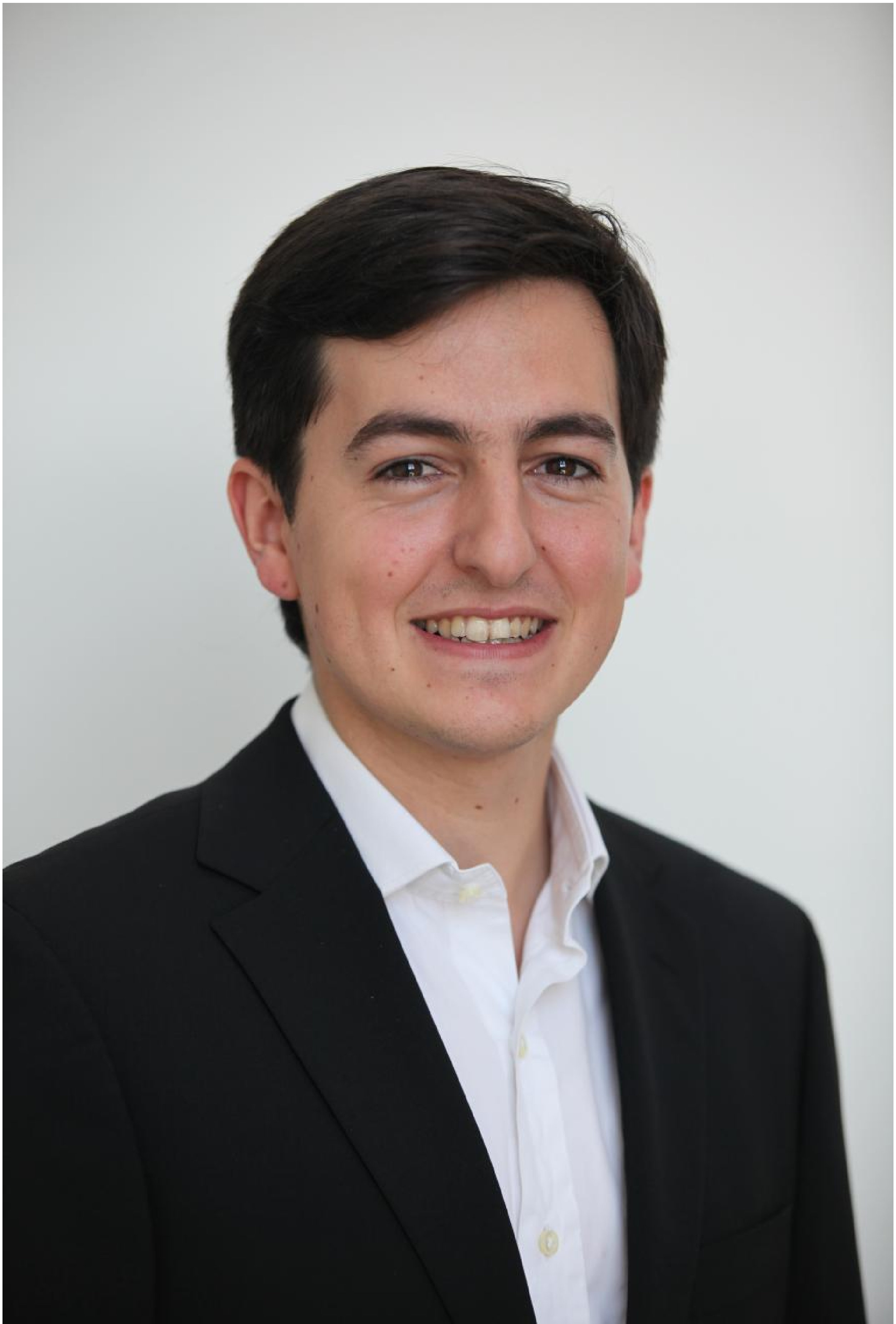
But while the S&P downgrade may have been expected, the breakdown of Greek restructuring talks was a bad surprise to markets unprepared for a disorderly default of an industrialised country.

The irony of the tax code

How do these other countries manage to stave off inequality while the U.S./Anglo-Saxons have failed to do so? Dutt points to the tax system: “The pre-tax income inequality in France is significantly reduced by the tax system. If you don’t want to increase income inequality in your country, what you have to do is to subsidise some of the people who have low incomes. Bring them up to minimum wages.” Dutt adds that the tax code in France and Sweden is more progressive than in the U.S. Amongst OECD countries, apart from Turkey, Mexico and Chile, the U.S. tax code is listed as one of the least progressive.

Tax codes vary throughout the world. “Singapore, for example, has two or three tax brackets with very few deductions. This simplifies the tax structure considerably, making it easier to administer,” says Dutt. “You don’t run into the problem as in the U.S. where a myriad of deductions and exemptions means that the official tax rate can be rendered meaningless.”

Dutt says 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 best tax rate. Who has the best accountants? The rich have the best accountants. 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.”



There is also a lot of debate as to what has been the effect of technology on rising inequality - maybe up to 40 percent according to Alan Krueger, Chairman of the U.S. President's Council of Economic Advisors, says **Amine Ouazad**, Assistant Professor of Economics and Political Science who participated in the student discussion in Singapore. "Technology, for example, has rendered many mid-level professions redundant. Since the advent of the personal computer, many kinds of work performed by people, such as secretaries, have been replaced by machines."

Dutt describes a phenomenon which economists call "the race between technology and education". "Technology raises the demand for skilled workers, which raises the wages of skilled workers relative to unskilled workers. Education raises the supply of skilled workers, bringing relative wages down and therefore reducing inequality." However, the problem is that society has not responded to the technological revolution by becoming more educated. Indeed, Ouazad points out that the demand for skills has far outstripped their supply, which suggests income inequality will exist as long as the skills gap remains.

Is education then the key to narrowing the gap? Dutt argues that the benefits of education go beyond the level of individual satisfaction and achievement. "The best minds go to the most productive occupations," he says. "By increasing access to education, you not only create more economic equality, you also create greater equality of opportunity, leading to an efficient allocation of resources."

Yet Ouazad points out, "According to the latest estimates, there is an increasing fraction of people who are dropping out of high school, while at the same time, there is an increase in the college enrolment rate. In other words, there is an increase in the polarisation of education in the US." He says that the same phenomenon is true in the U.K., France and other developed countries.

Unfortunately 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," opines Ouazad. He adds that in the U.S., 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.

Politicians take aim

While education is an important tool in narrowing the income gap, it is one that can take 20 years to reap results, Dutt points out. The population is demanding a response to income inequality today, and politicians are responding. U.S. President Barak Obama's State of the Union address focused heavily on his proposals for greater economic fairness in America; his budget address took aim at tax cuts enacted by his predecessor, George W. Bush, for the rich – signalling his re-election strategy in the November elections. Politicians in debt-strapped Greece, Spain, Portugal and the U.K. have also been making income inequality a major talking point.

But is all this talk coming up with a sustainable plan for fiscal stability? Dutt says "No." "In no country in the world does a politician have a 20-year horizon. The best you can hope for is a 5-year horizon. So they look for quick fixes that will affect things now; but effective fixes require greater foresight and more patience."

How will rising inequalities impact the 2012 U.S. election? Dutt says that that the U.S. elections is not driven so much by inequality as whether voters believe that the U.S. economic conditions are getting better or not. Ouazad agrees that the economy is the major concern of U.S. voters, and the unemployment rate and job creations will have an impact on Barack Obama's chances of re-election. "Today the unemployment rate in the U.S. is falling (latest: 8.5 percent) but this is partly due to the fact that a fraction of active workers has decided to stop looking for jobs. In fact, in past elections, the incumbent has had a hard time when the country went through a crisis." For example, U.S. President Jimmy Carter was not re-elected in 1980 partly because interest rates at the time were nearly 20 percent.

Inequality and emerging economies

While both China and India are seeing increasing levels of inequality, they have not seen as much social unrest, observes Dutt. He told INSEAD Knowledge that while the income gap is widening in these countries, a degree of inequality is to be expected during periods of growth in emerging economies. "When countries grow, it takes people out of agricultural sectors and shifts them into manufacturing, in the case of China; and into services, in the case of India. It raises their salaries and wages in relation to those in agriculture. This is part of the growth process." However, he opines that governments still need to be concerned about the widening gap between rich and poor, because it may result in political instability which in the medium to long term can hinder growth.

What next?

The economic inequality issue has recently been very clearly framed by demonstrations around the world: the Arab Springs in Tahrir square and the streets of Moscow, and the Occupy Movement in the U.S., which found supporters in educations institutions, such as Harvard University, where students camped out on campus. The Harvard administration responded to the occupiers by shutting the gates to anybody who did not have a Harvard ID, making the protest "exclusive" and isolated. Meanwhile, outside the gates on Harvard Square, others were also camped out on the street: the homeless, on the sidewalk out of necessity, rather than ideology.

Of course, an admittedly cynical subtext of the demonstration at Harvard is that these wide-eyed, mostly well-off students were well on their way to becoming the 1 percent.

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