The Rich Can’t Get Richer Forever, Can They?

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Talk of waves or cycles produces a false sense of predictability.

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In 1831, Alexis de Tocqueville, at the age of twenty-five, was sent by France's Ministry of Justice to study the American penal system. He spent ten months in the United States, dutifully visiting prisons and meeting hundreds of people, including President Andrew Jackson and his predecessor, John Quincy Adams. On his return to France, he wrote a book about his observations, "Democracy in America," the first volume of which was published in 1835. Many of the observations have weathered well (he noted, for instance, how American individualism coexisted with conformism). Others have not. For example, Tocqueville, who was the youngest son of a count, was deeply impressed by how equal the economic conditions in the United States were.

It was, at the time, an accurate assessment. The United States was the world's most egalitarian society. Wages in the young nation were higher than in Europe, and land in the West was abundant and cheap. There were rich people, but they weren't super-rich, like European aristocrats. According to "Unequal Gains: American Growth and Inequality Since 1700," by the economic historians Peter H. Lindert and Jeffrey G. Williamson, the share of national income going to the richest one per cent of the population was more than twenty per cent in Britain but below ten per cent in America. The prevailing ideology of the country favored equality (though, to be sure, only for whites); Americans were proud that there was a relatively small gap between rich and poor. "Can any condition of society be more desirable than this?" Thomas Jefferson bragged to a friend.

Today, the top one per cent in this country gets about twenty per cent of the income, similar to the distribution found across the Atlantic in Tocqueville's day. How did the United States go from being the most egalitarian country in the West to being one of the most unequal? The course from there to here, it turns out, isn't a straight line. During the past two centuries, inequality in America has been on something of a roller-coaster ride.

An early systematic attempt to chart the evolution of inequality in this country was undertaken by Simon Kuznets, at that time a professor at Johns Hopkins, who, in 1955, published what turned out to be a seminal paper, "Economic Growth and Income Inequality." Drawing on years of assiduously collected data—for which he later won a Nobel Prize—he reached a surprising conclusion. Like most economists, he had assumed that the general trend, in a capitalist economy governed by private property, would be for the rich to get richer—for inequality to increase steadily over time. That had been true in the initial stages of industrialization, he found, but since then the United States, England, and Germany had experienced a narrowing of economic disparity. And, as more data about more countries became available, Kuznets found that in most advanced economies the poor were catching up with the rich. It was, he said, "a puzzle."

The explanation appeared to involve two factors. First, there was the rise of mass education. Once countries had reached a certain level of industrialization, skills—human capital—became as important as physical capital in determining productivity, and a greater economic share accrued to those with more education, not just to those with money to invest. Second, politics took over from economics. The poor, with the weight of numbers on their side, realized that they could vote in favor of taxing the rich more heavily, redistributing the money to themselves in various ways.

Kuznets's own life seemed to illustrate how education could raise the income of the poor. He was born in 1901, into a Jewish family, grew up in eastern Ukraine, and at the age of twenty-one, during the Russian civil war, fled to the United States. There he obtained a doctorate in economics from Columbia, and became the preëminent economic statistician in the country. The inverted-U-shaped relationship that he found between income and inequality—inequality rising in the early stages of development and then falling afterward—came to be called the Kuznets curve. As Kuznets determined, it was after the American Civil War that the gap between the rich and the poor began to widen. The concentration of incomes grew during the Gilded Age and eventually peaked during the Jazz Age, when the share of income going to the top one per cent reached twenty per cent. Then, during the next twenty-five years, inequality began to decline, until, by the time Kuznets was writing, it was back to the low levels of the early Republic.

Kuznets's article came out at the height of the Cold War. The U.S. economy was booming. More and more people were going to college. White-collar work was taking over from blue-collar work, and, during the Great Depression, the government had introduced programs such as Social Security and unemployment insurance. Americans took comfort in the fact that their version of capitalism was not only the most dynamic and productive economic system in the world but one that was steadily becoming more equitable and fair. It seemed as if they had the problem of inequality licked; it was the era of what came to be called the Great Compression. By the seventies, America was as equal as any of the Scandinavian countries are today.

And then, starting sometime in the early eighties, inequality started to rise. The shape of the curve went from an inverted U to something more like an N: up, down, and up. Nor was this shift a temporary aberration. It has continued for nearly four decades. The jump in inequality has been most dramatic in the United States, where the share of income going to the top one per cent has soared from eight per cent in the early eighties to almost twenty per cent today. But inequality has also increased in Britain, Australia, Canada, large parts of Europe, and even Japan, suggesting that there is something systemic at work across the world. (At the same time, there have been some affluent countries—notably France and the Netherlands—where inequality has barely budged.)

Economists are still arguing about the reasons for this reversal. One important factor, they mainly agree, was the opening up of China, Eastern Europe, and other less advanced regions to world trade; another was the liberalization of capital markets. Rising import competition hurt employment in domestic manufacturing and held down wages. Most economists also agree that changes in technology have put unskilled workers at a stark disadvantage.

What they disagree about is the role of government policy. Rising inequality coincided with a profound shift in economic policy throughout much of the advanced world. In the nineteen-seventies, productivity growth in advanced economies stalled, unemployment rates jumped, and inflation rose and remained obstinately high. And so, in one country after another, political parties got elected by promising to cut tax rates, free up markets, and reduce government intervention in the economy. The change was most pronounced in Great Britain and the United States, after Margaret Thatcher and Ronald Reagan took office. But it also occurred to varying degrees in Continental Europe, Canada, Australia, and Japan.

The story of this transformation is the subject of Binyamin Appelbaum's "The Economists' Hour: False Prophets, Free Markets, and the Fracture of Society." It is a tale that has been told before, but Appelbaum adds flesh to the narrative by recounting it through the lives and careers of a small group of economists associated with the University of Chicago—including the Nobel Prize winners Milton Friedman, George Stigler, Gary Becker, and Robert Mundell—who were behind the shift.

At the center of Appelbaum's lively and entertaining chronicle is the towering figure of Friedman. (Well, figuratively speaking; he was a diminutive five feet two.) He loved nothing more than an argument, and, unlike many of his colleagues, he was a brilliant communicator, able to convey his points in plain English. He published a best-seller, "Capitalism and Freedom," in 1962; created, with his wife, Rose, the PBS television series "Free to Choose," in 1980; and had a column in *Newsweek* for nearly two decades.

When Friedman joined the economics department of the University of Chicago, in 1946, it already had a distinctive philosophy, going back to its founding in the previous decade, which involved a belief in the efficacy of free markets and skepticism about the benefits of most government intervention. This orientation had initially put the department outside the mainstream, but under Friedman's intellectual leadership it went on to become the most powerful economics department in the country, shaping monetary policy, the calibration of exchange rates, the enforcement of antitrust rules, and the setting of tax rates. Thirty Nobel Prizes have been awarded to people who taught or were taught in the department. Today, Friedman is acknowledged as the most influential economist of the second half of the twentieth century.

An old joke has it that an economist is someone who wanted to be an actuary but lacked the charisma. "The Economists' Hour" should help to dispel the myth that economists are invariably dull—although, as it happens, Friedman did intend to become an actuary when he graduated from Rutgers, in 1932. A live wire from the start, he conformed to another, more accurate professional stereotype, namely, that economists are know-it-alls. It's something to do with the analytical prism through which the discipline views the world. Friedman advocated freely floating exchange rates, because he thought that no policymaker would know better than the market where to set the right rate—yet he himself could not resist the temptation to second-guess the market. At one point in the seventies, he grew convinced that the liberal profligacy of Pierre Trudeau, Canada's Prime Minister, would cause the Canadian dollar to fall, and sold the currency short. When the Canadian dollar instead rose by thirteen per cent, Friedman was forced to admit he had been wrong and cut his losses.

Another of the colorful characters who populate "The Economists' Hour" is Robert Mundell. Appelbaum credits him with providing the theoretical underpinnings of the idea of a single currency—making him in effect the intellectual father of the euro—and of supply-side economics. In the late sixties, convinced that inflation was heading upward, Mundell bought a run-down fifteenth-century palazzo in the Tuscan countryside for ten thousand dollars. He turned out to be right about inflation, and later claimed to have multiplied his investment a hundredfold. Yet, three decades later, when he won the Nobel Prize in Economics, he was still shovelling cash into his Italian money pit.

"The Economists' Hour" is a reminder of the power of ideas to shape the course of history, a heartening thought for those of us in the ideas business. But why did the free-market policies promoted by Appelbaum's principals spread across the world? One reason was that they led to improved economic growth for a while. Yet international competitive pressures played a role, too. As the world economy opened up in the nineteen-eighties, newly mobile capital tended to flow to places that offered the highest return, and very often these were countries with the lowest taxes and the least onerous regulation. To hold on to capital, countries found themselves forced to match the free-market policies of their trading partners.

There is ample evidence that this shift, in turn, led to more uneven income distributions. Countries with larger tax cuts experienced bigger increases in inequality. Appelbaum's book—focussing on the who, rather than the how—does not delve deeply into these consequences. But they are richly detailed in "Capitalism, Alone: The Future of the System That Rules the World," by Branko Milanovic.

Even though inequality began to rise after 1980, it took economists a couple of decades to really notice. Among those who turned their attention to the fallout was Milanovic, who grew up in Communist Yugoslavia, spent a couple of decades in the research department of the World Bank, and now teaches economics at the City University of New York. Milanovic originally built his reputation in the late nineties, when, using a giant World Bank database of household incomes, he was able to demonstrate how the benefits of globalization had been distributed among different classes across various groups of countries. The big winners were the "global plutocrats," whose returns on capital shot up, and the new mass middle class of the emerging world, mainly in East Asia and India, who benefitted from the spectacular growth of their regions. The big losers were Western middle-class workers whose incomes stagnated as the industries they worked in were hollowed out by foreign competition. Hence the visceral appeal of Donald Trump's protectionist measures against China.

Milanovic isn't just a whiz at number crunching; he has a whimsical, wide-ranging appreciation for history and culture. He has written about income distribution in the early Roman Empire (inequality during the Augustan age was roughly comparable to that of the United States today), the effects on European soccer when limits on the number of foreign players allowed in club teams were lifted (the richest clubs became even more dominant in their leagues), and the financial implications of Elizabeth Bennet's decisions in "Pride and Prejudice" (marrying Mr. Darcy would put her in the top tenth of one per cent, while, as a spinster, she would have fallen from the top percentile to about the fiftieth percentile). "Capitalism, Alone" builds on Milanovic's previous book, "Global Inequality," which came out in 2016. Indeed, so many of the themes and ideas in the new book were prefigured in the last one that ideally the two should be read together.

In "Global Inequality," Milanovic traced the fluctuations of inequality back to the Middle Ages in Holland, Spain, and Italy, and showed that inequality has been going up and down in long and unpredictable waves ever since, responding to various contending forces. In the fourteenth century, for instance, the Black Death led to shortages of labor, which drove up wages in Italy; in the twentieth century, two world wars and the Great Depression destroyed a generation's worth of capital, causing the incomes of the rich to plunge. Surveying all the data, Milanovic concludes that there seems to have been some sort of cap on inequality—a limit to the economic divisions a country can ultimately cope with. The rise of inequality in the United States during the nineteenth century, its subsequent fall during the middle decades of the twentieth century, and its resurgence in the past four decades provide an example of the wave at work. Kuznets had come up with his inverted-U-shaped curve only because he had focussed on too small a slice of history.

In "Capitalism, Alone," Milanovic turns from the past to the future. With the rise of the emerging economies of Asia, he says, we now have two alternative forms of capitalism operating side by side. One is the "liberal meritocratic" version found in the West, and championed by the United States. The other is "political capitalism," the less democratic and more authoritarian variant, which has taken shape, most notably, in China. Like all schematics, this one elides a lot of details, but it provides a useful conceptual frame.

In the "liberal meritocratic" world, inequality arises from the way capital is accumulated. The rich are able to save more than the poor, and thus come to own a disproportionate share of the capital and the wealth in the economy. Since the return on capital, a major source of income for the rich, tends to be higher than the growth of wages, the rich become richer. Almost as potent is the way the benefits of education are distributed: rich people tend to be more highly trained, and can earn higher salaries; they are also able to earn higher returns on their capital, since their wealth gives them greater tolerance for illiquidity and risk. In addition, they tend to marry other rich, educated people and are able to pass on more capital to their children, thereby perpetuating inequalities from one generation to the next.

The “political capitalism” of China has its own inequality-generating dynamics. Although China has become capitalist to the core—almost eighty per cent of the country’s industrial output is produced in the private sector—the commercial classes are under the thumb of a highly disciplined, autocratic bureaucracy. The rule of law is attenuated, decision-making can be arbitrary, property rights are not fully secure, and corruption is endemic. China is essentially going through a hugely accelerated version of the industrial revolution and the Gilded Age rolled into one. Add in the insidious impact of cronyism, and a very unequal society results. Income distribution in China, it turns out, is even more skewed than in the United States, approaching the sort of levels one finds in the plutocratic republics of Latin America.

What does all this mean for the future of global capitalism? Milanovic finds little on the horizon within either system that would curb the trend toward greater inequality, let alone reverse it. Despite the subtitle of his new book, though, Milanovic wisely trains his attention on the past and the present, steering clear of grand predictions. As he has pointed out, the economics profession has an abysmal track record when it comes to seeing into the future. Attempts to make predictions about societies are, in his view, inherently doomed, because of the contingencies of human events. To have predicted that a decline in inequality was going to happen in the first part of the twentieth century, one would have had to foresee (among other things) the onset of a global conflagration in 1914—and even as late as 1913 almost nobody did.

The problem with thinking in terms of waves or cycles is that doing so creates a false promise of predictability. Take the stock market. People often characterize it as something pulled between bull markets and bear markets; but, as anyone who has tried to time the market knows, it’s almost impossible to predict how high a wave might go or how long it could last. The contours of stock-market cycles become discernible only once they are over. The same seems to be true of inequality waves. That’s why Milanovic pointedly ended one of his earlier books with a quote by the poet Constantine Cavafy:

> Men have knowledge of the present.
> As for the future, the gods know it,
> alone and fully enlightened.

The enormous influence of the Chicago School helps explain why research into inequality and income distribution was long sidelined in this country. As Appelbaum shows in “The Economists’ Hour,” the Chicagoans concentrated on understanding how to make markets function more efficiently, and scanted distributional issues (even though, ironically, Milton Friedman’s thesis adviser was Simon Kuznets, and his first job after graduate school was doing research for Kuznets on income distribution). At Chicago, the prevailing view of inequality was that it wasn’t a bad thing—it spurred people to work harder and become more self-reliant and self-disciplined.

Milanovic, by contrast, belongs to a new generation of data-driven economists who have helped track what has happened to income distribution in recent years. They happen to include an unusually large band of French economists, among them François Bourguignon, Thomas Philippon, Thomas Piketty, Emmanuel Saez, and Gabriel Zucman —it's not for nothing that they come from the land of *égalité* and *fraternité*.

The cohort of European economists, including Milanovic and the French brigade, are following in the footsteps of Tocqueville. They have been able to hold up a mirror so that we Americans can better see ourselves. They've also succeeded in focussing public attention on the issue of inequality. They consciously moved away from quantifying inequality with opaque statistics such as the Gini coefficient, and instead popularized more readily understandable measures, like the share of income going to the very, very rich. The phrases "the top one per cent" and its obverse, "the ninety-nine per cent," became potent political rallying cries during the Occupy Wall Street movement in 2011, and concern for the problem hasn't dissipated. Inequality is a major political issue in the lead-up to the 2020 Presidential election; Democratic candidates are airing proposals for wealth taxes, steeper income taxes, more biting inheritance taxes, and a better social safety net. That's another heartening reminder of the power of ideas to shape the course of history. ♦