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For richer, for poorer

For richer, for poorer

Growing inequality is one of the biggest social, economic and political challenges of our time. But it is not inevitable, says Zanny Minton Beddoes

IN 1889, AT the height of America's first Gilded Age, George Vanderbilt II, grandson of the original railway magnate, set out to build a country estate in the Blue Ridge mountains of North Carolina. He hired the most prominent architect of the time, toured the chateaux of the Loire for inspiration, laid a railway to bring in limestone from Indiana and employed more than 1,000 labourers. Six years later "Biltmore" was completed. With 250 rooms spread over 175,000 square feet (16,000 square metres), the mansion was 300 times bigger than the average dwelling of its day. It had central heating, an indoor swimming pool, a bowling alley, lifts and an intercom system at a time when most American homes had neither electricity nor indoor plumbing.

A bit over a century later, America's second Gilded Age has nothing quite like the Vanderbilt extravaganza. Bill Gates's home near Seattle is full of high-tech gizmos, but, at 66,000 square feet, it is a mere 30 times bigger than the average modern American home. Disparities in wealth are less visible in Americans' everyday lives today than they were a century ago. Even poor people have televisions, air conditioners and cars.

But appearances deceive. The democratisation of living standards has masked a dramatic concentration of incomes over the past 30 years, on a scale that matches, or even exceeds, the first Gilded Age. Including capital gains, the share of national income going to the richest 1% of Americans has doubled since 1980, from 10% to 20%, roughly where it was a century ago. Even more striking, the share going to the top 0.01%—some 16,000 families with an average income of $24m—has quadrupled, from just over 1% to almost 5%. That is a bigger slice of the national pie than the top 0.01% received 100 years ago.

This is an extraordinary development, and it is not confined to America. Many countries, including Britain, Canada, China, India and even egalitarian Sweden, have seen a rise in the share of national income taken by the top 1%. The numbers of the ultra-wealthy have soared around the globe. According to *Forbes* magazine's rich list, America has some 421 billionaires, Russia 96, China 95 and India 48. The world's richest man is a Mexican (Carlos Slim, worth some $69 billion). The world's largest new house belongs to an Indian. Mukesh Ambani's 27-storey skyscraper in Mumbai occupies 400,000 square feet, making it 1,300 times bigger than the average shack in the slums that surround it. ▸▸

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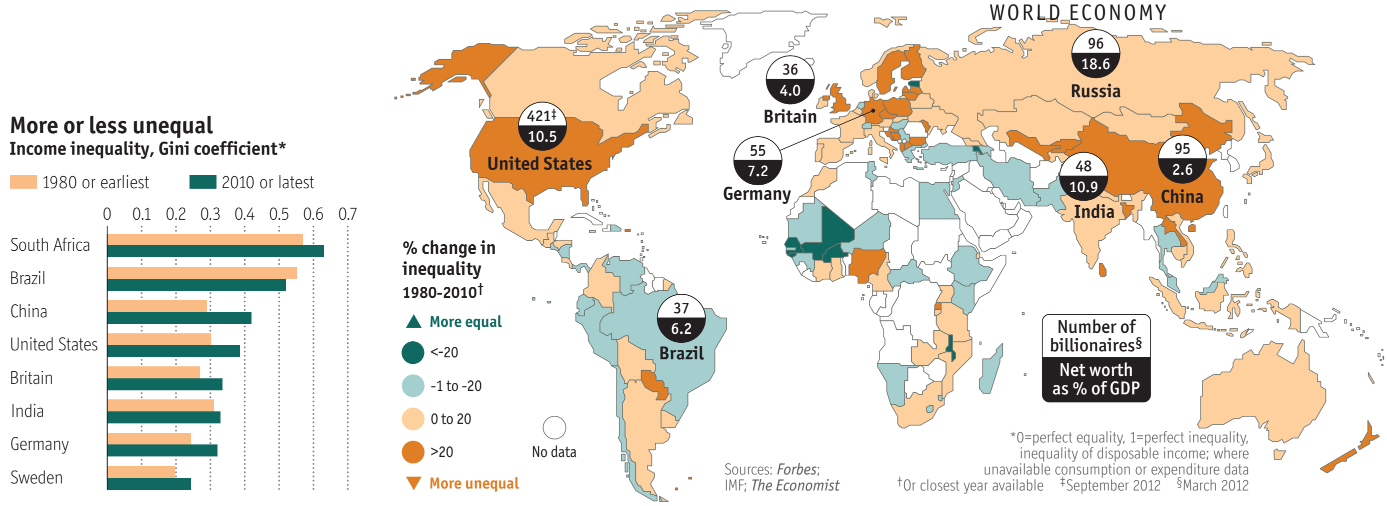


The concentration of wealth at the very top is part of a much broader rise in disparities all along the income distribution. The best-known way of measuring inequality is the Gini coefficient, named after an Italian statistician called Corrado Gini. It aggregates the gaps between people's incomes into a single measure. If everyone in a group has the same income, the Gini coefficient is 0; if all income goes to one person, it is 1.

The level of inequality differs widely around the world. Emerging economies are more unequal than rich ones. Scandinavian countries have the smallest income disparities, with a Gini coefficient for disposable income of around 0.25. At the other end of the spectrum the world's most unequal, such as South Africa, register Ginis of around 0.6. (Because of the way the scale is constructed, a modest-sounding difference in the Gini ratio implies a big difference in inequality.)

Income gaps have also changed to varying degrees. America's Gini for disposable income is up by almost 30% since 1980, to 0.39. Sweden's is up by a quarter, to 0.24. China's has risen by around 50% to 0.42 (and by some measures to 0.48). The biggest exception to the general upward trend is Latin America, long the world's most unequal continent, where Gini coefficients have fallen sharply over the past ten years. But the majority of the people on the planet live in countries where income disparities are bigger than they were a generation ago.

That does not mean the world as a whole has become more unequal. Global inequality—the income gaps between all people on the planet—has begun to fall as poorer countries catch up with richer ones. Two French economists, François Bourguignon and Christian Morrisson, have calculated a "global Gini" that measures the scale of income disparities among everyone in the world. Their index shows that global inequality rose in the 19th and 20th centuries because richer economies, on average, grew faster than poorer ones. Recently that pattern has reversed and global inequality has started to fall even as inequality within many countries has risen. By that measure, the planet as a whole is becoming a fairer place. But in a world of nation states it is inequality within countries that has political salience, and this special report will focus on that.

From U to N

The widening of income gaps is a reversal of the pattern in much of the 20th century, when inequality narrowed in many countries. That narrowing seemed so inevitable that Simon Kuznets, a Belarusian-born Harvard economist, in 1955 famously described the relationship between inequality and prosperity as an upside-down U. According to the "Kuznets curve", inequality rises in the early stages of industrialisation as people leave the land, become more productive and earn more in factories. Once industrialisation is complete and better-educated citizens demand redistribution from their government, it declines again.

Until 1980 this prediction appeared to have been vindicated. But the past 30 years have put paid to the Kuznets curve, at least in advanced economies. These days the inverted U has turned into something closer to an italicised N, with the final stroke pointing menacingly upwards.

Although inequality has been on the rise for three decades, its political prominence is newer. During the go-go years before the financial crisis, growing disparities were hardly at the top of politicians' to-do list. One reason was that asset bubbles and cheap credit eased life for everyone. Financiers were growing fabulously wealthy in the early 2000s, but others could also borrow ever more against the value of their home.

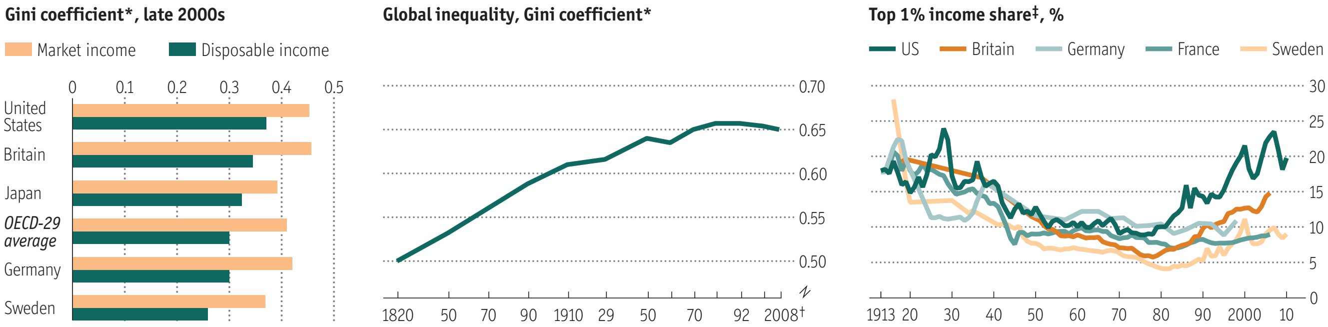
That changed after the crash. The bank rescues shone a spotlight on the unfairness of a system in which affluent bankers were bailed out whereas ordinary folk lost their houses and jobs. And in today's sluggish economies, more inequality often means that people at the bottom and even in the middle of the income distribution are falling behind not just in relative but also in absolute terms.

The Occupy Wall Street campaign proved incoherent and ephemeral, but inequality and fairness have moved right up the political agenda. America's presidential election is largely being fought over questions such as whether taxes should rise at the top, and how big a role government should play in helping the rest. In Europe France's new president, François Hollande, wants a top income-tax rate of 75%. New surcharges on the richest are part of austerity programmes in Portugal and Spain.

Even in more buoyant emerging economies, inequality is a growing worry. India's government is under fire for the lack of "inclusive growth" and for cronyism that has enriched insiders, evident from dubious mobile-phone-spectrum auctions and dodgy mining deals. China's leaders fear that growing disparities will cause social unrest. Wen Jiabao, the outgoing prime minister, has long pushed for a "harmonious society".

Many economists, too, now worry that widening income disparities may have damaging side-effects. In theory, inequality has an ambiguous relationship with prosperity. It can boost growth, because richer folk save and invest more and because people work harder in response to incentives. But big income gaps can also be inefficient, because they can bar talented poor people from access to education or feed resentment that results in growth-destroying populist policies.

The mainstream consensus has long been that a growing economy raises all boats, to much better effect than incentive-dulling redistribution. Robert Lucas, a Nobel prize-winner, epitomised the orthodoxy when he wrote in 2003 that "of the tendencies that are harmful to sound economics, the most seductive and…poisonous is to focus on questions of distribution."



Sources: The World Top Incomes Database; IMF; OECD; World Bank; "Inequality among World Citizens: 1820-1992", by Bourguignon & Morrisson, *The American Economic Review*, 2002; "A short history of global inequality: The past two centuries", by Branko Milanovic, *Explorations in Economic History*, May 2011

*0=perfect equality, 1=perfect inequality †Estimate ‡Includes capital gains, except Britain and France

But now the economics establishment has become concerned about who gets what. Research by economists at the IMF suggests that income inequality slows growth, causes financial crises and weakens demand. In a recent report the Asian Development Bank argued that if emerging Asia's income distribution had not worsened over the past 20 years, the region's rapid growth would have lifted an extra 240m people out of extreme poverty. More controversial studies purport to link widening income gaps with all manner of ills, from obesity to suicide.

The widening gaps within many countries are beginning to worry even the plutocrats. A survey for the World Economic Forum meeting at Davos pointed to inequality as the most pressing problem of the coming decade (alongside fiscal imbalances). In all sections of society, there is growing agreement that the world is becoming more unequal, and that today's disparities and their likely trajectory are dangerous.

Not so fast

That is too simplistic. Inequality, as measured by Gini coefficients, is simply a snapshot of outcomes. It does not tell you why those gaps have opened up or what the trend is over time. And like any snapshot, the picture can be misleading. Income gaps can arise for good reasons (such as when people are rewarded for productive work) or for bad ones (if poorer children do not get the same opportunities as richer ones). Equally, inequality of outcomes might be acceptable if the gaps are between young people and older folk, so may shrink over time. But in societies without this sort of mobility a high Gini is troubling.

Some societies are more concerned about equality of opportunity, others more about equality of outcome. Europeans tend to be more egalitarian, believing that in a fair society there should be no big income gaps. Americans and Chinese put more emphasis on equality of opportunity. Provided people can move up the social ladder, they believe a society with wide income gaps can still be fair. Whatever people's preferences, static measures of income gaps tell only half the story.

Despite the lack of nuance, today's debate over inequality will have important consequences. The unstable history of Latin America, long the continent with the biggest income gaps, suggests that countries run by entrenched wealthy elites do not do very well. Yet the 20th century's focus on redistribution brought its own problems. Too often high-tax welfare states turned out to be inefficient and unsustainable. Government cures for inequality have sometimes been worse than the disease itself.

This special report will explore how 21st-century capitalism should respond to the present challenge; it will examine the recent history of both inequality and social mobility; and it will offer four contemporary case studies: the United States, emerging Asia, Latin America and Sweden. Based on this evidence it will make three arguments. First, although the modern global economy is leading to wider gaps between the more and the less educated, a big driver of today's income distributions is government policy. Second, a lot of today's inequality is inefficient, particularly in the most unequal countries. It reflects market and government failures that also reduce growth. And where this is happening, bigger income gaps themselves are likely to reduce both social mobility and future prosperity.

Third, there is a reform agenda to reduce income disparities that makes sense whatever your attitude towards fairness. It is not about higher taxes and more handouts. Both in rich and emerging economies, it is about attacking cronyism and investing in the young. You could call it a "True Progressivism". ■

History

As you were

After a period on the wane, inequality is waxing again

JANE AUSTEN'S "PRIDE AND PREJUDICE" is a story about love. It is also about inheritance and income gaps. The heroine, Elizabeth Bennet, comes from a well-off family, the second of five daughters. But her financial future is dark because, in the absence of sons, her father's estate will pass to a cousin. Elizabeth's suitor, the brooding Mr Darcy, is fabulously wealthy. To her mother's horror, Elizabeth at first rebuffs him.

All ends happily when Elizabeth decides that Darcy is ravishing after all. But her mother's reaction is a rational response to the realities of income distribution and social mobility in Austen's time. In an entertaining analysis of inequality, "The Haves and the Have Nots", Branko Milanovic works out that by marrying Mr Darcy, Elizabeth would increase her income 100-fold. Without him, she would have the same income as a merchant seaman. With him she would be catapulted into the top 0.1%.

Before the industrial revolution, wealth gaps between countries were modest: income per person in the world's ten richest countries was only six times higher than that in the ten poorest. But within each country the distribution of income was skewed. In most places a small elite lorded it over a mass of peasants. There was little social mobility except, as Elizabeth found, through marriage. Colonial America was an exception to this feudal sclerosis. Research by Peter Lindert and Jeffrey Williamson shows that on the eve of the American revolution incomes in the 13 colonies that formed the United States were more equal than in virtually "any other place on the planet".

The industrial revolution widened the gaps both between countries and within them. As incomes accelerated in western Europe and then America, the distance between these countries and others grew. So, too, did internal income disparities. One study suggests that England's Gini coefficient shot up from 0.4 in 1823 to 0.63 in 1871. Mill workers were more productive and earned more than rural labourers. The great industrialists reaped the rewards of building railways, steel mills and other transformative technologies. Their fortunes were also boosted by monopolistic power and crony capitalism.

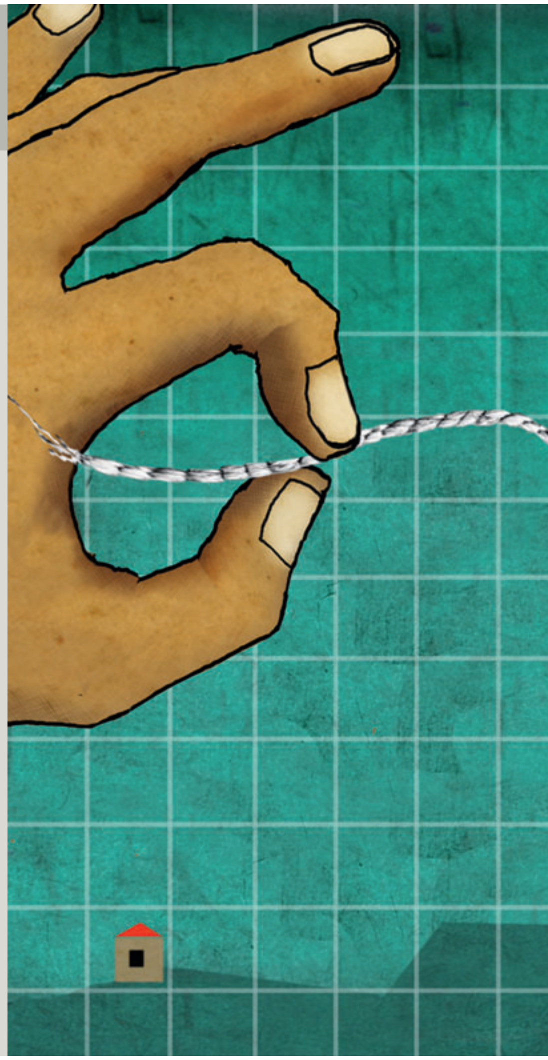
The growth of the industrial workforce brought increasing political pressure for redistribution. Communism was the most dramatic result. But capitalist economies changed profoundly too. In response first to the formation of workers' unions and the rise of socialist parties and then to the Depression, politicians on both sides of the Atlantic introduced progressive taxes, government regulation and social protection. In Germany Bismarck pioneered pensions and unemployment insurance in the 1880s. In America Theodore Roosevelt's Square Deal broke up monopolies ("trusts") in the first decade of the 20th century. In the 1930s the New Deal introduced Social Security (pensions), disability and unemployment insurance. In Britain Lloyd George's People's Budget of 1909 raised income taxes and inheritance taxes at the top to fund basic pensions as well as unemployment and health insurance for workers. This spartan social safety net was transformed by the Labour government after 1945 with a National Health Service and a system of cradle-to-grave benefits.

Of the three levers used to narrow inequality—taxation, government spending and regulation—the tax system changed the fastest. Until the late 19th century tariffs and excise taxes were the main source of revenue. By the 1930s governments relied heavily on progressive income taxes to fund their (much larger) spending. Britain's tax take in 1860 was some 8% of GDP; by 1927 it had risen to almost 20%. America changed its constitution to introduce an income tax in 1913. In 1944 the top rate reached a peak of 94%.

Punitive rates of taxation did not, by themselves, transform the income distribution. Many fortunes in the early 20th century were destroyed by wars, hyperinflation and the Depression; France, for instance, lost a third of its capital stock in the first world war and two-thirds in the second. But high tax rates made it much harder for fortunes to be built up again. In most countries the share of the top 1% fell persistently from the 1920s until the late 1970s.

Like a piece of string

Sizing the gap



ECONOMIC INEQUALITY CAN be measured in many ways—by the distribution of wealth, income or consumption, or between races, sexes, regions or individuals. The resulting picture can vary a lot. In America, for instance, the income gap between blacks and whites, and men and women, has narrowed over the past 30 years, even as that between individuals has widened. Disparities in consumption are always smaller than those in income because people save and borrow to smooth their living standards. The distribution of wealth is usually less equal than that of annual incomes. Gaps in pre-tax income are larger than those in disposable income after taxes and government transfers.

The main measures of economic inequality used in this special report are the Gini coefficients for disposable income and consumption derived from household surveys. These surveys are now conducted in almost all countries. In the rich world and in Latin America, official Gini coefficients are usually based on income. In Asia and Africa consumption-based figures are more common.

Cross-country comparisons can be tricky. Inequality in India, for instance, is often said to be lower than in China. But China's Gini coefficient of 0.48 measures inequality of income, whereas India's official Gini of 0.33 measures consumption. Peter Lanjouw and Rinku Murgai of the World Bank calculated an income Gini for India which, at 0.54, is much higher than China's and close to Brazil's.

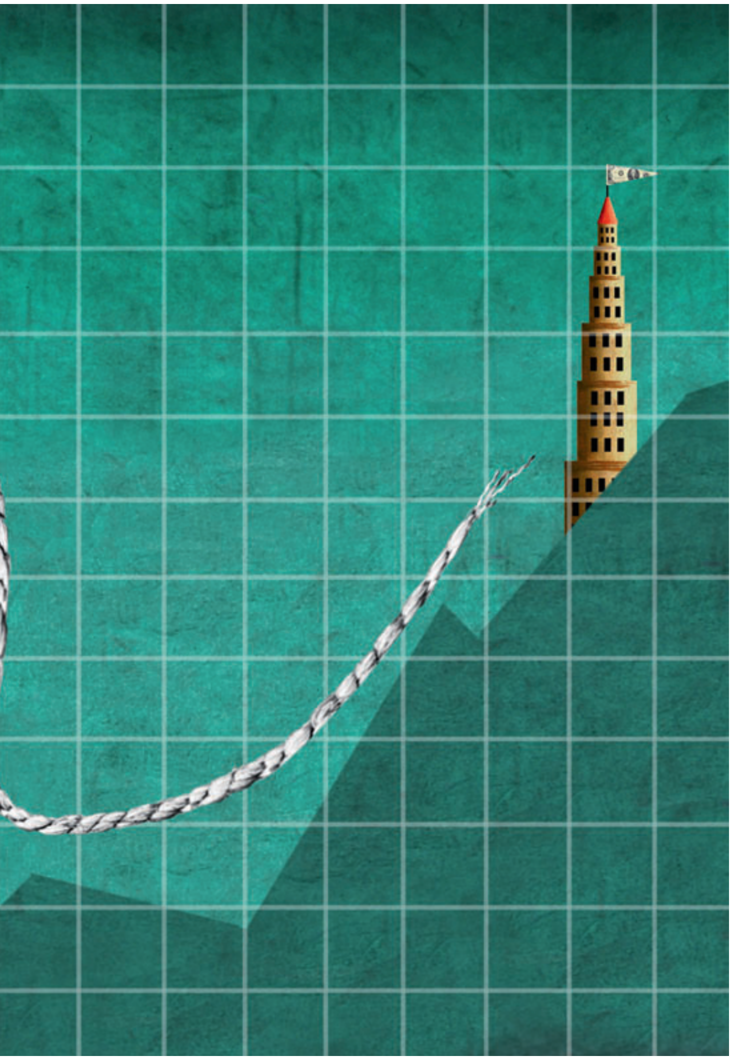
Another problem is that there are several international databases, all slightly different. Nor are household surveys good at capturing inequality at the very top, not least because it is all but impossible to get the ultra-rich to take part in them. The best information on the highest incomes comes from tax returns, thanks to work pioneered by two French economists, Emmanuel Saez and Thomas Piketty, together with a Briton, Anthony Atkinson, and an Argentine, Facundo Alvaredo. These four have built a huge database of top incomes which now includes 26 countries. Their statistics go back much further than household surveys (in America's case, to 1913).

Gini coefficients and the top income share can paint different pictures. Argentina's Gini, for instance, has fallen sharply over the past decade even as the share of income going to the top 1% has risen. Germany's Gini has risen by 32% since the early 1980s, but the share of income going to the very top has barely budged. One reason is that the statistics cover different people; another is arithmetic. The Gini aggregates all disparities, so it is a better summary measure, but it does not tell you where the gaps are growing.

Taxes rose across the advanced world, but the ways that governments spent them varied greatly. In America, whose government was more interested in equality of opportunity than of income, the most transformative shift was to bring in mass education. Starting around 1910, America made huge investments in public high schools in pursuit of universal secondary education. After the second world war the GI bill offered all returning soldiers the chance of higher education.

Claudia Goldin and Larry Katz, two economists at Harvard, see this dramatic boost to education as the main cause of the narrowing of inequality in America in the mid-20th century. It also boosted social mobility. Daniel Aaronson and Bhashkar Mazumder of the Federal Reserve Bank of Chicago found that as college enrolment surged in the 1940s, the relationship between parents' and their children's relative earnings notably weakened.

In Europe the emphasis was on ensuring egalitarian outcomes with big government transfers, particularly after the second world war. Governments in Europe were slower than in America to invest in mass education, but many continental countries built even bigger welfare states than Britain, with generous jobless benefits, child subsidies and income support. In virtually all rich countries other than America such benefits (rather than progressive tax systems) became the most important instruments for reducing inequality.



The third leg of the state's response to inequality was regulation. Roosevelt's trustbusting weakened America's robber barons, and other legal changes protected workers' rights to organise and, especially in Europe, to conclude binding national pay agreements. Union power soared and minimum wages enshrined in law narrowed the gap between workers and managers. Banking, a big source of wealth in the early 20th century, was heavily regulated after the Depression.

The Great Compression

All this meant that for decades incomes at the bottom and in the middle of the distribution grew faster than those at the top. The exact timing and scale differed. In America disparities declined fastest in the 1930s and 1940s, in Europe after the second world war. America's Gini coefficient reached a low of around 0.3 in the mid-1970s, and Sweden's hit 0.2 at about the same time. In most advanced economies the gap between rich and poor in the 1970s was a lot narrower than it had been in the 1920s. This was the era now widely known as the "Great Compression".

Income gaps between countries, however, continued to widen as the advanced industrial economies pulled ever farther ahead of less developed ones (with a few notable exceptions such as post-war Japan and then Taiwan and South Korea). By the 1970s average income per person in the ten richest countries was around 40 times higher than that in the ten poorest. This divergence among countries outweighed the compression within them. As a result, the "global Gini", as measured by Messrs Bourguignon and Morrisson, rose.

But around 1980 both these trends went into reverse. Globally, poorer countries began to catch up with richer ones, and within countries richer people began to pull ahead. The surge in emerging markets began with Deng Xiaoping's 1978 reforms in China. By the 2000s the large majority of emerging economies were growing consistently faster than rich countries, so much so that global inequality at last started to fall even as the gaps within many countries increased.

The coincidence of timing suggests that the reversals are related. The huge changes that have swept the world economy since 1980—globalisation, deregulation, the information-technology revolution and the associated expansion of trade, capital flows and global supply chains—narrowed income gaps between countries and widened them within them at the same time. The modern economy's global reach hugely increased the size of markets and the rewards to the most successful. New technologies pushed up demand for the brainy and well-educated, boosting the incomes of elite workers. The integration of some 1.5 billion emerging-country workers into the global market economy boosted returns to capital, ensuring that the "haves" would have more. It also hit the rich world's less educated folk with unaccustomed competition.

Politicians in search of a scapegoat find it easier to blame globalisation than technology for the widening wage gaps in rich countries, and some studies of America's wage dispersion conclude that around 10-15% of the widening wage gap can be explained by trade. One analysis, by David Autor at MIT and colleagues, suggests that in manufacturing the impact of trade with China could be much bigger. But most economists reckon that technological change plays a far bigger role. The OECD, in a big cross-country analysis, concludes that "skill-biased technological change" is one of the main determinants of the rich world's wage inequality. On average, it finds, globalisation—as measured by a country's trade exposure and financial openness—has no significant impact.

Whatever the exact breakdown, these two factors are in-

Like father, not like son

Measuring social mobility

IN HORATIO ALGER'S famous story, "Ragged Dick", a plucky boot shiner improves his lot through hard work, honesty and learning his "three RS" (reading, 'riting and 'rithmetic). The marks of his success are a suit, an office job and a new name, "Richard Hunter, Esq".

These days economists use more sophisticated gauges. They measure mobility over a lifetime (rags to riches, or the reverse), between generations (how children do relative to their parents), in absolute terms (whether children are richer or poorer than their parents) or in relative ones (whether children are higher or lower on the income ladder than their parents).

When countries are growing fast there is a lot of absolute upward economic mobility. In most emerging economies children almost invariably earn more than their parents. Even in America, despite slow growth and widening income gaps, most people do better than the generation above them: a recent study by the Pew Charitable Trusts found that 84% of adult Americans had higher real incomes than their parents.

The more important gauge of a meritocracy, however, is relative mobility, particularly between generations. In a society with broad equality of opportunity, the parents' position on the income ladder should have little impact on that of their children. Economic historians use clever techniques to measure this. Gregory Clark at the University of California, Davis, and Neil Cummins of City University of New York, for instance, have tracked families with rare surnames. Looking at English census records since 1800, they picked out names such as Bazalgette and Leschallas and compared them with records of students at elite institutions such as Oxford and Cambridge universities. Their results show that even over 200 years social mobility has been rather limited. The wealth and social status of people with rare surnames in 1800 is strongly correlated with that of their descendants today.

Individual families' fortunes over time can now be tracked by statistical surveys. This allows economists to measure how much parents' position has influenced their adult children's relative income or education. The resulting coefficient, the inelegantly named "inter-generational elasticity of income", is today's main measure of social mobility. The higher the coefficient, the less mobility there has been.

This technique shows Scandinavian societies to be very mobile. Only around 20% of parents' relative wealth (or poverty) is passed on to their kids. China, in contrast, is fairly immobile: 60% of income differences persist between generations. The big surprise is the United States, where parental income explains around half of the differences in adult children's income, much more than in Canada, and more than in any European country except Italy and Britain. According to this measure, social mobility in America now is lower than in most of Europe.

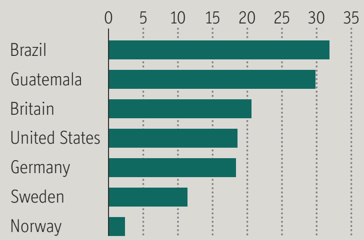
Another way to measure economic opportunity is to tease out what share of inequality can be explained by factors over which people have no control: race, gender, birthplace, parents' education and occupation. The smaller that fraction, the greater a country's equality of opportunity.

Such an "Inequality of Opportunity Index" was pioneered by Francisco Ferreira of the World Bank and now exists for 40 countries. At one extreme lies Norway, where only 2% of the—already low—inequality can be explained by accidents of birth. At the other extreme, in Brazil a third of the high income inequality is due to people's background. America is closer to Brazil than to Norway (see chart 1).

Economists also gauge equality of opportunity by measuring disparities in children's access to basic services that will influence their prospects, such as education or running water. The World Bank is developing indices which adjust overall access to such services by a measure of the inequality in that access. South Africa, for instance, has the same overall rate of access to sanitation as Nicaragua. But once you adjust for race disparities, its "Human Opportunity Index" for sanitation is much lower.

Give me a chance 1

Inequality of opportunity as % of total inequality
Latest available*



Source: World Bank *From period 1996-2010

creasingly hard to separate. The IT revolution has allowed more goods and services to be traded across borders, and it has fuelled the integration of the global capital market. At the same time emerging economies are now often the source of innovation. Technology accelerates globalisation, and globalisation accelerates technological progress.

At the same time technology is undermining some of the 20th century's equalising institutions. Assembly-line manufacturing, for instance, was conducive to union organisation. That is much less true of many of the cognitive jobs of the digital era. Many social transformations are also making inequality worse, particularly the rise of single parenthood and "assortative mating" (the tendency of educated people to marry each other).

Does all this mean that ever widening inequality is inevitable? The history of inequality suggests it need not be, and offers two lessons. The first is that market and social forces do not operate in a vacuum. For good or ill, the mix of tax reforms, welfare programmes and regulatory interventions pursued in the 20th century combined to reduce inequality. Those policy choices matter just as much today. If they did not, changes in income distribution would have been much more uniform across countries. Instead, much like a century ago, sweeping global forces have been muted, or exacerbated, by government policies and social institutions.

The second lesson is that governments can narrow inequality without large-scale redistribution or an ever growing state. The 20th century's most dramatic reductions in income gaps took place when governments, by and large, were smaller than they are today. Large, rigid welfare states proved unsustainable. But there was also a successful progressive prescription for reducing income gaps and boosting mobility by attacking crony capitalism, investing in the young (especially by broadening access to education) and creating a safety net for the poorest (particularly through unemployment insurance and pension schemes). Worryingly, governments in some of the countries where inequality has risen most seem to have forgotten that. ■

The United States

The rich and the rest

American inequality is a tale of two countries

THE HAMPTONS, A string of small towns on the south shore of Long Island, have long been a playground for America's affluent. Nowadays the merely rich are being crimped by the ultra-wealthy. In August it can cost $400,000 to rent a fancy house there. The din of helicopters and private jets is omnipresent. The "Quiet Skies Coalition", formed by a group of angry residents, protests against the noise, particularly of one billionaire's military-size Chinook. "You can't even play tennis," moans an old-timer who stays near the East Hampton airport. "It's like the third world war with GIV and GV jets."

Thirty years ago, Loudoun County, just outside Washington, DC, in Northern Virginia, was a rural backwater with a rich history. During the war of 1812 federal documents were kept safe there from the English. Today it is the wealthiest county in America. Rolling pastures have given way to technology firms, swathes of companies that thrive on government contracts and pristine neighbourhoods with large houses. The average household income, at over $130,000, is twice the national level. The county also marks the western tip of the biggest cluster of affluence in the country. Between Loudoun County and north-west Washington, DC, there are over 800,000 people in exclusive postcodes that are home to the best-educated and wealthiest 5% of the population, dubbed "superzips" by Charles Murray, a libertarian social scientist.

The Hamptons and Washington's chic suburbs offer two snapshots of the most striking characteristic of American inequality: the surge in wealth at the top. Washington's superzips are full of the rich: people in the top 5% of the income distribution (which means an annual income of at least $150,000) and the top 1% (those earning more than $340,000 a year). The helicopter passengers in the Hamptons epitomise America's ultra-wealthy, the 0.1% of the population whose annual household income is at least $1.5m, and the top 0.01%, with an annual income of $8m or more. Over the past 30 years incomes have soared both among the wealthy and the ultra-wealthy. The higher up the income ladder, the bigger the rise has been. The result has been a huge, and widening, gap—financially, socially and geographically—between America's elite and the rest of the country.

How this happened is a story in three acts. During the 1980s the least-educated Americans fell behind those in the middle. As the computer revolution increased the demand for skilled workers and old manufacturing industries crumbled, those with just a high-school degree or less saw their relative earnings sink. Over the past decade the squeeze moved to the middle of the income distribution, to those who attended college but did not earn a degree. Incomes at the top, meanwhile, rose smartly during the whole period.

The result was a dramatic divergence in fortunes. Between 1979 and 2007 (just before the financial crisis) the real disposable income after taxes and transfers of the top 1% of Americans more than quadrupled, a cumulative rise of over 300%. Over the same period the bottom fifth's income rose by only 40%. The middle class shrank, both as a share of the population and geographically. Only 40% of American neighbourhoods now have an average income within 20% of the national median, compared with 60% in the 1970s.

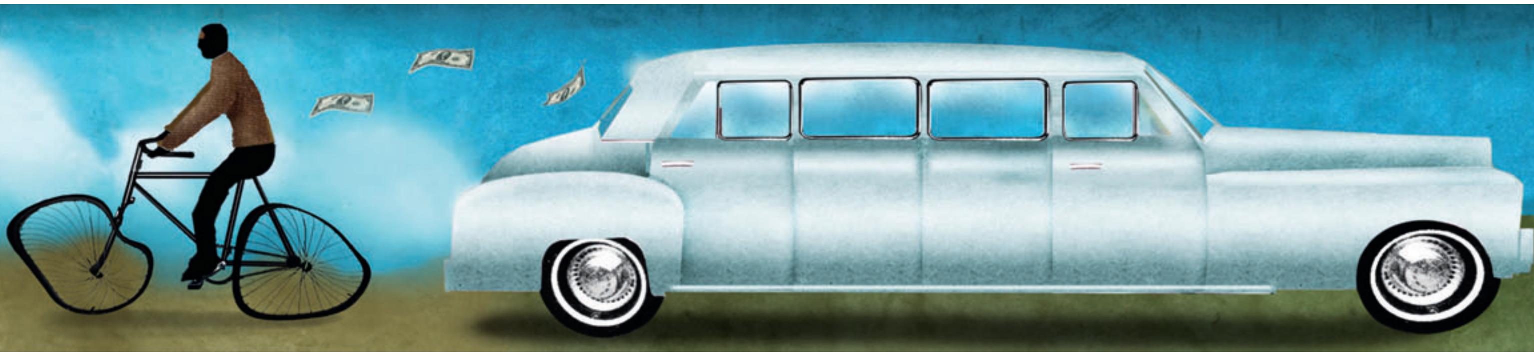
The recession temporarily upended this trend. America's wealthiest fared poorly in 2008 and 2009, largely because the tanking stockmarket ravaged their bonuses and share options. The government safety net prevented a collapse at the bottom. But the sluggish recovery has brought back the old pattern. More than 90% of all income gains since the recession ended have gone to the top 1%.

What lies behind these widening gaps? A big reason, particularly in the bottom half, is education, or rather the lack of it. Just as the information-technology revolution demanded more skilled workers, the continuous improvement in Americans' education stalled. High-school graduation rates stopped climbing in the 1970s, for the first time since 1890. College completion rates also slowed. Many Americans were failing to match the new technologies with better skills. According to Harvard's Ms Goldin and Mr Katz, this explains 60% of America's widening wage inequality between 1973 and 2005.

College and/or bust

Both the soaring cost of a college education and the shortcomings of America's schools system played a part. In the 1970s a year's tuition at a public university cost 4% of a typical household's annual income; at a private university it took about 20%. By 2009 tuition fees had jumped to over 10% of median income for a public university and around 45% for a private one. Even with the surge in subsidised student loans, many potential graduates were priced out or dropped out early without a degree.

In primary and secondary schools the problems are partly financial but mainly organisational. America spends a lot on its schools, but that funding comes largely from state and local governments. Richer neighbourhoods can afford better schools, which reinforces the growing geographical gap between different social groups. According to the OECD, America is one of only three advanced countries which spends less on the education of ▸▸



poorer children than richer ones. And unlike most OECD countries, America does not put better teachers in poorly performing schools, where teachers' unions often obstruct reform efforts.

Not everything can be pinned on schooling. American women (like women almost everywhere) are better educated and earn more than they did 30 years ago. It is less skilled men who have fallen behind. Almost uniquely among rich countries, American men now aged between 25 and 34 are less likely than their fathers to have a college degree. The damage from this has been compounded by institutional changes, such as the weakening of unions and, particularly, the erosion of the minimum wage. But the main culprit is educational slippage.

This poor performance has a racial tinge. High-school dropouts are disproportionately black or Hispanic. America's habit of locking up large numbers of young black men does not help their employability. But the decline increasingly affects the white working class too. Ever more low-skilled white American men have left the labour force, many moving onto disability rolls. Even before the recession, only around two-thirds of white men with nothing more than a high-school diploma were working.

This decline of work among less skilled white men has had profound social consequences, which in turn have exacerbated income inequality. Marriage rates have fallen, divorce has increased and the share of children born to single mothers has

Makers and takers

America's government redistributes, but not well

AMERICANS ARE ENGAGED in a furious argument about redistribution. In now infamous comments at a fund-raiser in May, Mitt Romney, the Republican presidential candidate, wrote off the 47% of Americans who pay no income tax as people who consider themselves "victims", entitled to government handouts. Conservatives like to point out that 40% of all income taxes come from 1% of taxpayers. America's government, they argue, redistributes far too much from a shrinking pool of "makers" to a vast number of loafers. Those on the left peddle the opposite view: that the government redistributes far too little because the tax system is skewed to benefit the rich and America's welfare state is the skimpiest in the developed world.

Both sides are wrong. Because America relies mainly on (progressive) income taxes, whereas other rich countries raise a bigger share of their revenue from (regressive) consumption taxes, its tax system is, in fact, one of the most progressive in the rich world. But it is riddled with deductions and loopholes, most of which favour the wealthy, so it is both less progressive and much less efficient than it could be. On the spending side of the budget, America allocates far less than other rich countries to cash transfers, such as unemployment insurance or income support. But it does spend a large and growing share of its budget on social services, particularly health care for the poor and the old. The result is a welfare state that is skewed rather than skimpy. America's government raises revenues inefficiently and redistributes them oddly: too much from young to old, too much in the form of health care, and ever less from rich to poor.

Start with taxes. It is true that in 2011 only 54% of Americans paid federal income taxes. That is partly because, since Ronald Reagan, the government's main form of assistance for the working poor has been the Earned Income Tax Credit, a kind of negative income tax. It is also the consequence of America's high jobless rate and temporary tax credits to boost the economy. In more normal times around 40% of Americans pay no federal income tax. But more than 60% of those who don't pay federal income taxes do pay payroll taxes. And if you include taxes raised at state and local level, such as on property and sales, virtually all Americans pay some tax.

One study suggests that when you consider all taxes, the share paid by the wealthiest 1% falls to 21.6%, close to their share of pre-tax income, whereas the poorest quintile pay 2.1%, not much below their share of pre-tax income. In other words, America's Byzantine tax system does hardly anything to redistribute income. It looks progressive relative to other rich countries only because consumption taxes elsewhere are regressive.

America's system could be more progressive and much more efficient if its politicians were less wedded to "tax preferences". These exemptions, which include interest paid on mortgages up to $1m and contributions to gold-plated health insurance, are now worth some $1.3 trillion, or 8% of GDP. Most are hoovered up by the wealthy and the upper middle class. More than 60% of all tax preferences flow to the wealthiest 20% of Americans, with only 3% going to the bottom quintile. Successful professionals do not see themselves as beneficiaries of government largesse, but the government in effect subsidises their big houses, expensive health care and retirement savings.

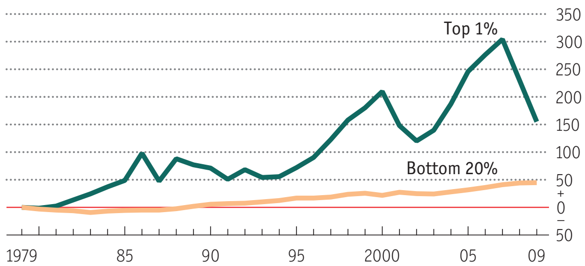
If America's tax system represents a missed opportunity to redistribute income while improving efficiency, it is its spending system that makes its overall policy far less progressive than that of other rich countries. Its cash transfers are stingy. For all the conservatives' insinuations of loafers living on handouts, America spends less than half as much as the average OECD country on cash transfers for people of working age. At the same time benefits in kind, such as state provision of education, health care and housing, gobble up a large and growing share of America's budget. But according to the Centre on Budget and Policy Priorities, over half of all entitlement spending flows to the elderly and around 40% is spent on health care. The poor do not get much of a look-in. Around 10% of the total goes to the richest fifth of Americans, almost 60% to the middle three-fifths and only 30% to the poorest fifth.

If you combine tax expenditures and entitlements, America's efforts at redistribution look even more perverse. The government lavishes more dollars overall on the top fifth of the income distribution than the bottom fifth. As Irwin Garfinkel, Lee Rainwater and Timothy Smeeding point out in "Wealth and Welfare States", a book comparing America's safety net with those of other countries, the federal government "spends" four times as much on subsidising housing for the richest 20% of Americans (via the mortgage-interest deduction) than it spends on public housing for the poorest fifth. It also short-changes the young by spending far less on pre-school education and far more on old people's health care than other rich countries.

Some of this is unavoidable. Governments are bound to spend more on the old as societies age. But America takes this to extremes, propelled by an inefficient tax code and the rapid rise in health-care costs. The combination is fiscally unsustainable, bad for growth and not very equitable.

The rich get richer 2

US, average real income after taxes and transfers
% change since 1979



Source: Congressional Budget Office

soared. Mr Murray calculates that fewer than 30% of children in the poorest third of white America live with both parents by the time their mother turns 40. Among the most affluent fifth, around 90% of children live in a household with both parents. Marriage has become a fault-line dividing American classes.

Tax and benefit changes have also had an effect, but a subtle one. Most Americans below the median income level pay no federal income tax (and, thanks to the Earned Income Tax Credit, the working poor get substantial rebates). Poorer Americans are hit disproportionately by payroll taxes, which are regressive and have grown in importance. But the biggest hit is on the benefit side. Although America's social spending has rocketed (it is now worth some 16% of GDP), it is becoming less redistributive as Medicare, the universal health plan for the elderly, swallows up ever more (see box, previous page). According to the Congressional Budget Office, in 1979 over half of all federal social spending went to the poorest fifth of households. Now it is only 36%.

Part of the trend at the top of America's income ladder is simply the mirror image of that at the bottom. The rising skill premium has rewarded those with lots of education, and social shifts have reinforced the income concentration. Not only are the well-off and well-educated far more likely to marry and stay married than poorer folk, they tend to marry each other. In 1960 American couples with two college-educated partners accounted for only 3% of the total. Today that figure is 25% and in the top 5% of the income distribution it is 75%. Apart from the cleaning lady, it is hard to find an adult without a degree (or two or three) in super-zip households.

But if educational differentials and assortative mating lie behind much of the gap between those in Loudoun County and poorer Americans, they do not explain the Hamptons phenomenon. America's top 0.1% are no better educated than the top 1%. Income gaps at this level have less to do with the skills-bias of the modern economy and more to do with its global reach.

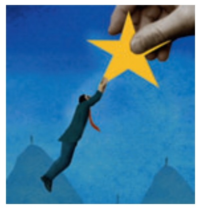
In a classic paper published in 1981, the late Sherwin Rosen of the University of Chicago pointed out that the very best in a field, be they entertainers or textbook authors, earned vastly more than the next best. Modern communications, he mused, would transform the market for superstars. And so they have, as Chrystia Freeland, a journalist, points out in her new book, "Plutocrats". Moreover, in the past three decades the potential market has become dramatically bigger, whether for Hollywood blockbusters or celebrity dentists.

Celebrities do not account for a large share of America's ultra-rich. But the same factors—winner-takes-all economics coupled with an incomparably bigger global economy—explain part of the rise in the incomes of the chief executives who make up a bigger share of the very wealthy. During the 1980s CEO pay surged more in America than anywhere else. Until the early 1980s American chief executives, on average, earned 40% more than their next two lieutenants. By 2000 they earned two-and-a-half times as much.

This rise is widely put down to failures of corporate governance and a collapse in social norms which once set an informal limit on the earnings gap between bosses and workers. There is truth to both explanations, and it is not hard to find chief executives earning tens of millions of dollars despite lacklustre performance. But these effects should not be exaggerated. In a recent paper Steven Kaplan, of the University of Chicago, finds that CEO pay has fallen in recent years and that, contrary to myth, CEOs who perform badly get paid less and are fired more often than successful ones.

There is also a less bothersome explanation for CEO pay that is based on superstar economics. America is home to a lot of the world's biggest companies, and globalisation has made many of them a lot bigger. In a global market for the best CEO talent where winner-takes-all economics prevails, the gap between the top and the rest is bound to be vast.

For all the attention focused on CEO pay, the numbers of chief executives among America's ultra-rich are neither particularly big or growing. The very richest Americans—those who feature in the *Forbes* list of billionaires—tend to be entrepreneurs, from the icons of the tech era (Bill Gates, Mark Zuckerberg) to many whose money has more prosaic roots (Sara Blakely, America's youngest female billionaire, made her fortune from women's underwear).



A disproportionate, and growing, chunk of the very rich, however, have made their money in Wall Street rather than Main Street. An analysis by Mr Kaplan and Joshua Rauh, now of Stanford University, shows that the share of investment bankers among the top 0.1% is larger than the share of senior executives. America's top 25 hedge-fund managers make more than all the CEOs of the S&P 500 combined. The financial industry's outsize pay partly reflects its growth. For good or ill, finance's share of American GDP soared between 1980 and 2007. Capital markets have globalised faster and more comprehensively than any other part of the economy, enabling hedge funds and other asset managers to deploy ever bigger pools of funds. According to Thomas Philippon of New York University and Ariell Reshef of the University of Virginia, financiers also have higher skill levels than they did a generation ago.

These fundamental economic shifts explain part of the rise in Wall Street incomes, but not all of it. Messrs Philippon and Reshef argue that between a third and half of Wall Street's higher pay is unjustified, deriving from rents rather than productivity. But what explains these rents? Luigi Zingales of the University of Chicago points out that one source is the implicit subsidy (through lower borrowing costs) that banks enjoy by being too big to fail. He reckons this subsidy is worth some $30 billion a

In a global market for the best CEO talent where winner-takes-all economics prevails, the gap between the top and the rest is bound to be vast

year, enough to fund a fair few bonuses. Others point to a broader cronyism between Wall Street and Washington over the past 30 years which has allowed financiers to tilt rules in their favour. The finance industry (along with property and insurance) employs more lobbyists than virtually any other industry, around four per Congressman.

Financiers have also been among the biggest winners from changes to America's tax code. The country's top rate of income tax has been repeatedly slashed since 1980, from 70% to 35%. By itself, that reduction has not greatly affected average tax burdens at the top (since there have been enough loopholes to ensure that few people paid the top rate). America's richest have gained more from reductions in the capital-gains tax, which is now only 15%. Private-equity moguls have done particularly well, since the tax code allows them to classify their income as capital gains.

Scratching each other's backs

The combination of tax loopholes, bank bail-outs and massive lobbying has led many observers to conclude that America's growing inequality has political roots. The wealthy, in this logic, control the political system and rig it to their advantage. In an influential book, "Unequal Democracy: The Political Economy of the New Gilded Age", Larry Bartels of Vanderbilt University showed that senators' votes are influenced by the preferences of their rich citizens but not their poor ones. As money plays an ever bigger role in politics, goes the argument, so the clout of the ultra-wealthy grows, particularly to block things they don't like.

This claim is hard to prove, but circumstantial evidence for it seems to be mounting, particularly since the Supreme Court's 2010 "Citizens United" decision lifted any restrictions on political spending by individuals or firms. That opened the way for the rise of "super-PACs", privately funded organisations set up to influence election outcomes. These have now raised hundreds of millions of dollars. The sources of this money are highly concentrated: one analysis suggests that 80% of the total comes from fewer than 200 donors. America is still a long way from the first Gilded Age, when the robber barons openly bought unelected senators' loyalty by giving them shares in their companies. But it is hard to believe that this surge of cash from the richest will have no impact at all.

Whatever its causes, the stratification of American society is having profound consequences. A country that prides itself on its social mobility is already less mobile than most people think and is almost certainly becoming even less so. As the box with the previous article showed, standard measures of inter-generational mobility in America are lower than in Canada and much of Europe. Most of this has to do with the difficulty of escaping from the bottom rungs of America's income ladder. According to Markus Jantti, a Finnish economist who has studied mobility across countries, more than 40% of the sons of the poorest 20% of Americans stay in that quintile, compared with around 25% in Nordic countries. The evidence is mixed on whether social mobility has lessened or simply stayed the same over the past 30 years. But it is clear that there has been no improvement in mobility to compensate for widening inequality.

And even the most recent studies of social mobility look at the earnings of people who were children over two decades ago. Since disparities in income, education and social behaviour now strongly reinforce each other, future mobility might be a lot lower still. A study by Sean Reardon of Stanford University suggests that the gap in standardised test scores between schoolchildren from high- and low-income families is roughly 30-40% bigger today than it was 25 years ago. Bob Putnam, of Harvard University, puts it starkly. Put away the rear-view mirror and look at future social mobility, he says, and "we're about to go over a cliff." ■

Asia

Crony tigers, divided dragons

Why Asia, too, is becoming increasingly unequal

THE SUMMIT OF Songshan mountain, some 60 miles (100km) from China's capital, marks the boundary between Beijing municipality and the neighbouring province of Hebei. It is also a study in contrasts. On the Beijing side the mountain road is wide, freshly surfaced and flanked by a solid safety wall. A Lycra-clad cyclist sweats his way up on a fancy mountain bike. A large car park is under construction for visitors to hot springs in the nearby village of Bangongqu. Enterprising local families can make 100,000 yuan ($16,000) a year catering to Beijing tourists, not far off the city's average white-collar wage. The Beijing provincial government provides pensions and other social benefits.

Hebei is a much poorer province. On its side of the mountain the road narrows and the tarmac deteriorates. Half a mile from the summit is the village of Yanjiaping, where some 50 families scrape a living growing cabbages. No one has a car, no one gets a pension, and the nearest primary school is 12 miles away. Farmers are barred from grazing cows on the mountainside so that trees can grow to stem sand storms from Inner Mongolia. Shen Zhiyun, a gnarled man in fake US army fatigues, says a village family makes 4,000-5,000 yuan a year, nowhere near Indian levels of poverty, but a far cry from the living standards only a few miles away. "We live in a different country," he says.

The transformation of China's economy over the past 30 years is the most spectacular growth story in history. Less noticed, China has also seen the world's biggest and fastest rise in inequality. China has not officially published a Gini coefficient since 2000, but a study by the China Development Research Foundation suggests that it has surged from less than 0.3 in 1978 to more than 0.48. In little more than a generation Mao's egalitarian dystopia has become a country with an income distribution more skewed than America's. Asia's two other giants, India and Indonesia, have also seen disparities rise sharply, though less dramatically than China. Indonesia's Gini is up by an eighth, to 0.34.

Part of this rise was both inevitable and welcome, a natural consequence of the end of Maoist communism in China and Fabian socialism in India. The three economies, particularly China's, are far richer and more dynamic than they were 30 years ago. Just as Kuznets suggested, urbanisation and industrialisation have brought widening gaps. As people have left subsistence agriculture for more productive work in cities, inequality has risen along with prosperity.

But that cannot be the whole explanation, if only because the experience of today's Asian tigers is in striking contrast to that of an earlier pack. In Japan, Hong Kong, South Korea and Taiwan growth rates soared in the 1960s and 1970s and prosperity increased rapidly but income gaps shrank. Japan's Gini coefficient fell from 0.45 in the early 1960s to 0.34 in 1982; Taiwan's from 0.5 in 1961 to below 0.3 by the mid-1970s. That experience launched the idea of an "Asian growth model", one that combined prosperity with equity.

Education, again

Today's Asian growth model does the opposite. One explanation is that the big forces driving modern economies—technological innovation and globalisation—benefit the skilled and educated in emerging markets much as they do in the rich world. Narayana Murthy, the billionaire co-founder of Infosys, an Indian software giant, or Robin Li, the creator of Baidu, China's most popular search engine, have harnessed technology much like Bill Gates has done. Senior lawyers and bankers in Mumbai or Shanghai are part of a global winner-takes-all market, able to command salaries similar to those of their colleagues in New York or London. And as Ravi Kanbur of Cornell University points out, the offshoring of tasks that has hit mid-level workers in America and Europe often benefits people higher up the skills ladder in recipient countries. Call centres in Bangalore are manned by well-educated Indians.

As in the rich world, these fundamental economic forces are not the only drivers of income distribution. Government policy has also played a big role. One problem is cronyism. As in the Gilded Age in America, capitalism in today's emerging markets involves close links between politicians and plutocrats. India is a case in point. From spectrum licences to coal deposits, large assets have been transferred from the state to favoured insiders in the past few years. Many politicians have business em-

Lessons from Palanpur

More inequality in an Indian village is balanced by greater mobility

AT FIRST SIGHT Palanpur is a powerful reminder of the stubborn persistence of India's rural poverty. The village is not particularly remote. It is next to a railway line, only a few miles from a big highway, and less than 120 miles from Delhi. It is surrounded by some of India's most fertile agricultural land, well suited to the cultivation of sugar cane, groundnuts and menthol. Yet Palanpur's residents are crowded into sparse dwellings along mud paths, with no running water, no drains and only intermittent electricity.

Spend a day in the village, and the picture becomes more nuanced. You hear how life has improved. Even the poorest villagers now have brick rather than mud houses; only a couple of years ago many were still made of mud. From marble-polishing to brickmaking, more jobs outside agriculture are becoming available. The government's rural employment-guarantee scheme has put a floor under wages. The roads have got better. All children now attend the village school, when only a few years ago many children from the lowest castes were not in school.

There are obvious gaps between wealthier and poorer folk. Mahendra Morya, head of the richest family in the village, recently bought a second tractor. Some households now have pit latrines. A couple even have a television on which to watch DVDs. Many of the most visibly wealthy are members of the upper castes. Mr Morya is a Murao, a high caste of cultivators. But some further down the social pecking order seem to be doing well too. Nanhe, the head of a Muslim family, started out repairing bicycles in the 1990s. Now he has a menthol-processing facility and plans to branch out into mustard oil.

Most surprising is the success of Ramjimal, a Jatab, the group at the bottom of Palanpur society. He is a skilled bricklayer, travelling around neighbouring villages building houses. One of his brothers has become a lawyer and moved to Chandausi, the nearest town.

A long-running study at the London School of Economics provides statistics to confirm these impressions. Its researchers have spent over 50 years conducting detailed surveys to track the fortunes of Palanpur's residents. The most recent one, in 2008-09, shows considerable change from the previous one in 1983. Real incomes have doubled (which, over 25 years, translates into modest average annual growth of just under 3%), and income disparities have become much wider. Palanpur's Gini coefficient in 2009 was 0.4, 30% higher than in 1983. But social mobility has increased too, and a disproportionately large number of the winners came from the bottom of the social heap. Half of the families that climbed most were Jatabs.

A study by Viktoria Hnatkovska and colleagues of the University of British Columbia suggests that Palanpur is not an isolated case. It shows that the inter-generational mobility of India's Dalits (or Scheduled Castes, the most disadvantaged group) has improved and is now similar to that of other groups. Ms Hnatkovska's findings remain controversial, but most Indian academics agree that caste rigidities are loosening, mainly thanks to the growth of non-agricultural employment and improved access to basic education.

There is still a long way to go. Secondary-school attendance among the Scheduled Castes generally remains shockingly low. And with income gaps widening, there is a danger that those at the bottom will get stuck there. But in a country where for centuries the disadvantaged had no chance of improving their prospects, more social mobility, even amid wider inequality, is a big step forward.

pires of one kind or another. Rich businessmen often become politicians, particularly at the state level. Raghuram Rajan, an Indian-born economist at the University of Chicago who recently became chief economic adviser to India's government, has pointed out that India has the second-largest number of billionaires relative to the size of its economy after Russia, mainly thanks to insider access to land, natural resources and government contracts. He worries that India could be becoming "an unequal oligarchy or worse".

In China cronyism is even more ingrained. The state still has huge control over resources, whether directly through state-owned enterprises, monopoly control of industries from railways to mining or the distorted financial system, where interest rates are artificially depressed and access to credit is influenced by politics. The importance of the state means that the beneficiaries tend to be close to state power.

Moreover, inequality in China could be higher than the official statistics suggest because rich people often understate their income and hide it from the taxman. A lot of money is invested in property, where soaring prices have reinforced inequality. Wang Xiaolu, of the China Reform Foundation, caused a stir a couple of years ago with a study that tried to measure this "grey" income. His results suggest that the income of the richest 10% of urban Chinese is some 23 times that of the poorest 10%. Official statistics say the multiple is nine.

Cronyism is the most obvious way in which Asian governments make inequality worse, but it is not the only one. Broader government strategies have distorted countries' growth paths in a manner that increased income gaps. In India a big problem is the lack of job creation. Unlike China, where the surge in factories assembling goods for export brought millions of migrant workers into the formal urban labour force, India's formal workforce has barely grown since 1991. More than 90% of Indians are still employed in the informal sector. Even in manufacturing, most people toil in one-room workshops rather than big factories. Productivity is lower, workers find it hard to improve their skills and their incomes rise more slowly.

India's failure to become a powerhouse of labour-intensive manufacturing owes much to its appalling infrastructure. Just-in-time delivery is hard to achieve when power supplies are so precarious. Another reason is the country's rigid labour laws, which discourage the formation of big firms. Between the federal government and the states, India has around 200 different laws, all setting detailed rules and making it virtually impossible to fire people. That deters employers from hiring workers and widens the gap between the lucky educated few and the rest.

We know where you live

In China the regulations that contribute most to inequality are the remnants of the country's *hukou* system of household registration. This hails from Mao's era, when China's rural sector was punitively taxed to finance the development of heavy industry. To ensure a stable supply of workers in agriculture despite the appalling conditions, people were barred from leaving their province of origin. The restrictions on mobility were dismantled in the 1980s, permitting millions to become migrant workers. But they still retain the rural *hukou* of their birth, as do their children. From housing to schooling, this puts them at a big disadvantage compared with holders of urban *hukou*.

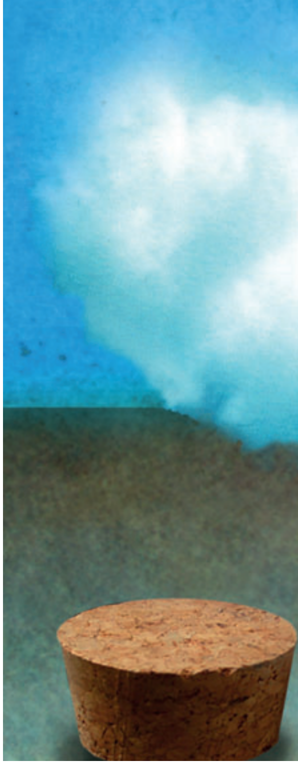
Migrants' children must take the *gaokao* (the all-important state college-entrance exam) in their place of origin, not where they and their parents might be living at the time, so lots of migrants send their children home for schooling. Since education is financed largely by local governments, these schools tend to be less well-funded and of lower quality. Hebei has far worse schools than Beijing. In Shanghai municipality, spending per student in rural areas is only 50-60% that of urban areas. As a result, the education system reinforces income disparities rather than mitigating them.

Along with disparities in infrastructure, the *hukou* system is a big reason for China's vast urban-rural gaps, which explain about 45% of the country's overall inequality. Other Asian economies do not suffer from a *hukou* problem, but there, too, government social policies have often made inequality worse because most social spending, from public housing to health insurance, has traditionally been confined to the formal, urban workforce. Moreover, many Asian governments spend a lot on universal subsidies, especially for energy. These are highly regressive. Indonesia, for instance, lavished 3.4% of GDP on fuel and electricity subsidies last year, more than it spent on infrastructure. According to the Asian Development Bank, 40% of that largesse flowed to the richest 10% of Indonesian households and as much as 84% to the top half.

Across emerging Asia political concerns about rising inequality are prompting reform

Things are beginning to change. Across emerging Asia political concerns about rising inequality are prompting reform, often in ways that echo the changes of the Progressive Era a century ago. In China the "Great Western Development Strategy" has poured vast sums into infrastructure in the western provinces. More recently the government has made a big effort to improve rural social services. Almost 100% of China's rural population now have basic health insurance (including the villagers of Yianjiaping), and a majority have basic pensions. Inequality between urban and rural areas has recently stabilised and that between regions has begun to fall slightly, but from an extraordinarily high level.

In the past couple of years several Asian economies, from Thailand to Vietnam, have introduced, or expanded the reach of, minimum wages. China's minimum wage, which is set at the provincial level, rose by an average of 17% last year. Some countries have introduced public-work schemes for the poorest. India's NREGA scheme, for instance, guarantees 100 days' work a year to the country's rural households and now covers 41m people. Others have experimented with targeted subsidies to the very poorest that have helped reduce inequality in Latin America (see next article).



By introducing a more efficient, and progressive, social safety net, Asia's governments will go some way towards mitigating their growing income gaps. But there will be no big breakthroughs until the bigger problems of informality (in India), discrimination against migrants (China) and cronyism (everywhere) are dealt with. And the longer that takes, the greater the danger that today's disparities will become entrenched.

Thanks to remarkable economic growth, almost all Asians are rapidly becoming better off. In India, old caste rigidities are being broken down (see box earlier in this article). But widening income gaps threaten to harm future social mobility. Using a methodology developed at the World Bank, a study by Zhang Yingqiang and Tor Eriksson found that the rise in China's income inequality is mirrored by a rise in its inequality of opportunity. Parents' income and their type of employer explain about two-thirds of China's inequality of opportunity, a much bigger share than is explained by parental education.

The stakes are high. Yu Jiantuo of the China Development Research Foundation argues that China's inequality is now hurting its growth prospects. Sustained cronyism could turn Asia's big economies into entrenched oligarchies rather than dynamic meritocracies. Ironically, in that sense they might become more like Latin America just as that continent appears to be moving in the opposite direction. ■

Latin America

Gini back in the bottle

An unequal continent is becoming less so

MICHAEL JACKSON BROUGHT Santa Marta a moment of fame. In February 1996 the King of Pop landed by helicopter at the top of one of Rio de Janeiro's most notorious *favelas*. Politicians tried to stop him, but Mr Jackson had permission from the drug barons who ruled the slum. He danced down the steep paths between shacks clinging precariously to the mountainside, surrounded by a cheering crowd of Rio's poorest citizens, and belted out his hit single "They don't care about us". The music video was played around the world. It trained a spotlight on Rio's poverty and inequality.

Sixteen years later Santa Marta is once again a showcase, but of a better sort. It was the first *favela* to be "pacified" under a government plan to wrest control of Rio's slums from the drug lords. The place was stormed by the army in 2008. It now has a police station, and is peaceful. It is a thriving example of the boom at the bottom of Brazilian society.

Meet Salete Martins, a bubbly 42-year-old, whose family moved to Santa Marta from Brazil's north-east when she was eight. By day she works as a trainee tour guide, showing visitors around her neighbourhood for a city-financed non-profit group called Rio Top Tours. At night she studies tourism at a local college. At weekends she sells Bahian food from a bustling stall near the *favela*'s entrance. And in between she flogs a popular line of beauty products. Her monthly income is around 2,000 reais ($985), four times as much as she made selling sandwiches three years ago and more than three times the minimum wage. She plans to launch her own tour-guide company before the end of this year.

Ms Martins's success is striking, even in Santa Marta. But it mirrors a trend that has swept the whole of Latin America. Poor people's incomes have surged over the past decade, leading to a big drop in inequality. In most Latin American countries the Gini coefficient in 2010 was lower than in 2000. The region's average, at 0.5, is down from almost 0.54 a decade ago, and lower than at any time in the past 30 years (see chart 3), though still high relative to other regions. Judging by evidence from Argentina, the only country in Latin America to publish statistics on tax returns of top earners, the richest 1% are still pulling ahead of the rest. But that concentration is more than made up for by the narrowing of gaps further down the income scale.

Both shifts are reflected in popular culture. "Mulheres ricas" ("Rich women") is a new reality-TV show about Brazil's ultra-wealthy ("I bathe in mineral water every day," said one woman in an early episode). But the country's most popular prime-time soap is "Avenida Brasil", which documents life among the newly minted middle classes. Although Latin America saw only half the average GDP growth of emerging Asia over the past ten years, its poverty rate fell by 30%. Around a third of the decline is due to improvements in income distribution.

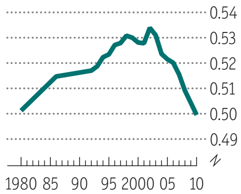
How did a continent that had been egregiously unequal since the *conquistadores*' land grab suddenly change course? Not because of radical nationalisation and redistribution. Latin America has a few asset-seizing hard-left governments, notably Argentina and Venezuela, but inequality has also fallen in countries following a more orthodox economic course, such as Chile and Colombia. Nor is the turnaround just a side-effect of the commodities boom. Inequality has fallen in countries that rely heavily on exports of commodities, such as Peru, but also in those where manufacturing plays a bigger role, such as Mexico. Nor can demography be the main cause. Poorer Latin American families have become smaller, which reduces inequality, but these changes were well under way in the 1980s and 1990s.

According to Nora Lustig, an economist at the University of Tulane and one of the first to document the narrowing of the region's income gaps, two things have made a big difference. First, the premium for skilled workers has been falling: a surge in secondary education has increased the supply of literate, reasonably well-schooled workers, and years of steady growth have raised relative demand for the less skilled in the formal workforce, whether as construction workers or cleaners. Second, governments around Latin America have reinforced the narrowing of wage gaps with social spending targeted at people with the lowest incomes. These include more generous pensions and conditional cash transfers—schemes that offer payment to the poorest families in return for meeting specific conditions, such as making sure their children go to school.

The most striking change has been in education. In the past Latin American governments lavished cash on univer-

That's better 3

Latin America's income inequality
Gini coefficient*



*0=perfect equality, 1=perfect inequality

Sources: Gasparini et al (2012) based on SEDLAC (CEDLAS and the World Bank)

sities. State primary and secondary schools were underfunded and of appalling quality. That bias in favour of tertiary education, perversely, most benefited the children of the rich, who had attended private primary and secondary schools. But since the early 1990s education spending has become much more progressive, with a huge expansion in public secondary education among the poor. According to Karla Breceda, Jamele Rigolini and Jaime Saavedra, three economists at the World Bank, Latin American governments, on average, now spend a larger share of GDP on education for the poorest 20% of children than does the United States.

More progressive spending has produced results. Some countries have seen an increase of 20 percentage points in the share of children finishing secondary school. Another study for the World Institute for Development Economics Research in Helsinki by Guillermo Cruces, Carolina García Domench and Leonardo Gasparini showed that the gap between rich and poor in secondary-school enrolment has fallen in all countries except El Salvador, Honduras, Guatemala and Nicaragua.

Many Latin countries are also championing pre-school education. Rio's city government, for instance, has dramatically increased its network of nursery schools since 2009, building 74 new ones in the past three years. Any child from a family below the poverty line is guaranteed a free place in a nursery from the age of six months.

A nudge in the right direction

Conditional cash transfers (CCTs) reinforce this focus on schooling. These stipends cost relatively little (typically 0.2-0.8% of GDP) but influence the priorities of many. About a quarter of Brazil's population now gets some money from Bolsa Família, the country's CCT scheme. State and local governments piggyback on top. In Rio, for instance, the city supplements Bolsa Família payments for 700,000 of its poorer families. If children do exceptionally well in exams, a bonus is paid. If they miss school, the payment stops. Ms Martins realised her 14-year-old was skipping school only when her monthly stipend was docked. Several academic studies in Mexico show that kids in CCT schemes stay at school longer.

Better education is boosting social mobility. Historically, the link between parents' and children's education has been closer in Latin America than anywhere else. In Peru, for instance, almost 70% of a child's educational achievement can be predicted from its father's schooling. But a forthcoming report from the World Bank suggests that the current generation of Latin American children are both better educated than their parents and moving relatively faster up the education ladder. And, like India's poorest castes, disadvantaged indigenous people have made big gains.

These newly educated workers enjoy far better prospects in the formal workforce than their parents did. State pensions have become more generous. Countries from Argentina to Bolivia have introduced non-contributory pension schemes—in effect, a promise of government support for the elderly. Minimum wages across the continent have soared. Brazil's has risen by more than 50% in real terms since 2003. And since pension benefits are linked to the minimum wage, the two trends reinforce each other.

The precise contribution of better education, better opportunities for less skilled workers and bigger social spending differs by country. An analysis by Ms Lustig, Luis López-Calva of the World Bank and Eduardo Ortiz-Juarez of the United Nations Development Programme suggests that narrower wage gaps explain most of the reduction in inequality throughout the region. According to calculations by Marcelo Neri, of the Institute for Applied Economic Research, government transfers explain about one-third of the drop in inequality in Brazil.

So far, so good. But will these gains last? In education, the big challenge is to complement quantity with quality. Latin America has now reaped the benefits that come from simply getting more children into school for longer. But most of the state schools are still much less good than their private equivalents. Virtually all middle- and upper-class children still go to private primary and secondary schools. Until those gaps in quality have been eliminated, educational inequities will persist. They are behind the recent wave of protests over education in Chile.

The more immediate challenge is how to pay for all this. Latin American states have traditionally not been progressive in outlook. Put crudely, governments raised revenue from the more affluent, then spent it on generous public pensions for those same people. Even now, 60% of transfer spending in Bolivia, for example, goes to people who are not poor. Mr Saavedra calls it a "fragmentary social contract". Governments fail to provide good public services, and middle-class people rely on private education and health care. But they do get generous pensions in return for their taxes.

The long boom of the 2000s allowed a painless change to this social contract. Sustained growth brought in enough tax revenue to boost both education spending and transfers at the bottom without pushing up tax rates. The boom also allowed huge increases in minimum wages without apparent damage to employment. But as growth slows and the real value of minimum wages rises, that combination is becoming unviable.

If the improvements in inequality are to be maintained, let alone continued, tough choices will have to be made. Middle-class entitlements will need to be squeezed. Much like the United States, many Latin countries will have to decide whether to invest in poorer kids or continue to pay generous pensions to richer old people. In both places the social contract needs to be remade. For evidence that this is possible, turn to Sweden. ■

Sweden

The new model

A bit more unequal, a lot more efficient

SALTSJÖBADEN, A CHARMING seaside town on the outskirts of Stockholm, has an iconic place in Swedish economic history. The "Saltsjöbaden Accord", signed there between unions and employers in 1938, ushered in the consensus system of labour relations that remains a pillar of Sweden's economic model. Nowadays the town is famous for a different reason. It is one of Stockholm's fanciest suburbs, and the setting for "Sunny Side", a popular television comedy that pokes fun at the country's new rich. In the show, Saltsjöbaden's yuppy residents fret over how to get their babies into the best nursery. A badly behaved child is threatened with banishment to Fisksätra, a poor enclave a few train stops away, where immigrants from 100 countries cram into dilapidated blocks of flats.

The most equal country in the world is becoming less so. Sweden's Gini coefficient for disposable income is now 0.24, still a lot lower than the rich-world average of 0.31 but around 25% higher than it was a generation ago. That rise is causing considerable angst in a nation whose self-image is staunchly egalitarian. A leftist group caused a media hubbub earlier this year by organising a "class safari" bus tour of Saltsjöbaden and Fisksätra. Opposition leaders insist that the ruling centre-right party is turning Sweden into America.

Anders Borg, the finance minister, vehemently disagrees. Sweden, he argues, has gone from being a stagnant benefit-based society to a vibrant modern economy with a remarkably small rise in inequality. Its experience, he says, shows that dynamism and egalitarianism do not need to be at odds.

The facts bear him out. Thanks to deregulation, budget discipline and an extensive overhaul of the welfare state, Sweden's economy has been transformed in the two decades since its banking crisis. The new Swedish model is quite different from the leftist stereotype.

Capitalism in Sweden is not inherently a lot more egalitarian than in other countries. Before the government steps in, the country's Gini coefficient for the working-age population is 0.37, close to the OECD average and higher than Switzerland's. Wage disparities are narrower than in Anglo-Saxon countries, thanks to centralised bargaining between unions and employers that sets minimum wages in different sectors. Top CEO pay has not risen nearly as dramatically as in America. But in other ways Sweden has been in the vanguard of many of the social changes that have boosted inequality in other countries, such as the decline of marriage.

The main source of egalitarianism in Sweden (and elsewhere in Scandinavia) is redistribution by the state. Under the old welfare model people paid high tax rates and got lots of social services and big transfers in return. The new model, broadly, retains most of the services but has cut the taxes and transfers.

Thanks to deregulation, budget discipline and an extensive overhaul of the welfare state, Sweden's economy has been transformed in the two decades since its banking crisis

In the early 1990s Sweden introduced a "dual income tax" system, which combined a flat tax on capital with a higher, progressive income tax. More recent reforms went further. The inheritance tax was eliminated in 2005, the wealth tax in 2007 and taxes on residential property in 2008. Thanks, in part, to these tax changes, capital income has soared, particularly at the top of Sweden's income scale. That has not always improved efficiency. For instance, Sweden's tax code now favours residential property over more productive investment.

More recently, and more sensibly, Sweden has cut taxes on labour, especially for the low-skilled. The Earned Income Tax Credit, which offers strong incentives for lower-skilled people to work, marks the biggest change. Other innovations, such as a credit for hiring household help, are designed to spur demand for low-wage workers. Union membership dues, in contrast, no longer qualify for tax relief. Benefits have been reformed at the same time as taxes. All handouts, from jobless aid to disability benefits, have become less generous, more short-lived and harder to qualify for.

All this has brought about palpable changes. Notice boards at Stockholm's suburban railway stations are filled with advertisements for cleaners, once an unheard-of luxury. The Iraqis, Somalis and other low-skilled foreigners in Fisksätra, unlike migrants a generation ago, can no longer count on a drip-feed of government support. The combination of lower taxes and fewer benefits is intended to encourage people to work. And getting more of them to take jobs, argues Mr Borg, is the key not only to faster growth but also to keeping inequality low. His ministry reck- ▸▸

ons that in the long term Sweden's reforms will raise the country's employment rate by 5%.

Critics on the left fear that inequality will surge, for at least two reasons. Trade unionists worry that the reforms will reduce union membership, undermining the consensual system of labour relations. Ola Pettersson, chief economist of Sweden's Trade Union Confederation, says the government is "undercutting" the Swedish labour model. That seems an exaggeration. With more than seven out of ten workers still members of unions, Sweden's collective bargaining model looks safe for now.

Others suspect a poverty trap in the making, with people stuck with low skills in low-wage jobs. That seems a more serious risk, particularly for Sweden's recent migrants who, by and large, are poorly educated and speak little Swedish. Pernilla Landin, a social worker who runs a multi-faith community centre in Fisksätra, already sees dangerous signs of social exclusion. "People don't have enough money to buy a train card," she says, "so they can't get out to look for work."

But the danger is vastly reduced by Sweden's all-enveloping public services. Although government spending has shrunk in recent years, the Swedish state is still large (51% of GDP last year), and it spends much more than Anglo-Saxon countries do on everything from early-childhood education to job search and training. According to the OECD, more than 70% of the children of the poorest fifth of Swedes are in state-financed child-care and education schemes, compared with fewer than 30% in America.

Sweden's government has also experimented more boldly than others with boosting public-service efficiency. Many schools are now independently run, and in health care private management is a growing trend. Public services have not entirely escaped cuts, but they started high and were designed to protect the poor. Once you allow for the progressivity of public services, the OECD reckons, Sweden's Gini drops to 0.18. That still leaves it as the world's most equal place, as well as one of the fastest-growing and fiscally stable countries in the rich world.

It would be naive to think that its model can simply be copied elsewhere. Sweden's citizens are strikingly committed to social cohesion, and willing to pay for a large state. A revival of America's union movement would be likely to lead to growth-destroying rigidities. Equally, it is hard to see Americans accepting the taxes that would go with government spending of more than 50% of GDP. Sweden's remake of the welfare state is most relevant in Europe, where in the aftermath of the financial crisis many countries are now struggling with unsustainable public finances, as Sweden did 20 years ago.

A place to look for ideas

Nonetheless, there are broader lessons. Sweden's experience suggests that the welfare state can be trimmed by cutting transfers and maintaining progressive investment in social services, without allowing inequality to surge. And a revamp of the welfare state that encourages employment can boost growth while keeping income gaps to a minimum.

The most important conclusion, however, comes from considering Sweden's experience alongside the recent record of the United States, emerging Asia and Latin America. All these case studies indicate that the geography of contemporary inequality has as much to do with government policy as with underlying economic forces. But it has not been a simple tale of tax and redistribution, nor is there a simple trade-off between efficiency and inequality. Sweden's economy has become much more efficient while still keeping inequality low. America's system of taxes and transfers is less progressive than it was in the 1970s, yet the state is no smaller. That suggests there is room for reforms that both counter inequality and improve economies' efficiency. ■

Trade-offs

Having your cake

Less inequality does not need to mean less efficiency

MITT ROMNEY, AMERICA'S Republican presidential candidate, caused a kerfuffle earlier this year when he dismissed concerns about inequality as the result of "class warfare" that had no place in America's public discourse. Rather than an "envy-oriented" debate about distribution, he argued in favour of creating a "merit-based" America, with policies that focus on economic growth.

Mr Romney's nonchalance about income gaps is controversial, even in America. But he is not alone in assuming that distribution and dynamism do not go together. The predominant view among economists has long been that there is a trade-off between prosperity and income equality.

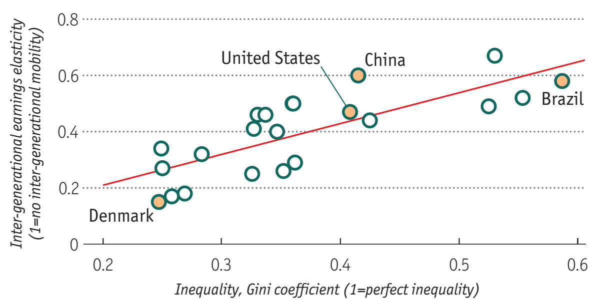
A century ago inequality was deemed an essential condition for investment and growth because rich people save more. Keynes wrote in 1919 that it was "precisely the inequality of the distribution of wealth which made possible those vast accumulations of fixed wealth and of capital improvements which distinguished [the Gilded Age] from all others". More recently the focus has been on its incentive effect. Milton Friedman argued that greater inequality would spur people to work harder and boost productivity. Gary Becker, of the University of Chicago, thinks that inequality encourages people to invest in their education. Redistribution, in contrast, brings inefficiencies as higher taxes and government handouts deter hard work. The bigger the state, the greater the distortion of private incentives.

That logic remains as powerful as ever. Economic freedom and better incentives boosted growth in China, India and elsewhere. Sweden's experience shows that deregulation, lower taxes and fewer benefits increase economic dynamism even as they reduce equality. Yet the analysis in this special report suggests that logic is incomplete. Some of today's inequality may be inefficient rather than growth-promoting, for several reasons.

First, in countries with the biggest income gaps, increasing inequality is partly a function of rigidities and rent-seeking—be it labour laws in India, the *hukou* system and state monopolies in China or too-big-to-fail finance in America. Such distortions reduce economies' efficiency. Second, rising inequality has not, by ▸▸

The Great Gatsby curve 4

Late 1990s, early 2000s



Source: "Inequality from Generation to Generation: The United States in Comparison", by Miles Corak, 2012

and large, been accompanied by a smaller (and hence less distortive) state. In many rich countries government spending has risen since the 1970s. The composition has changed, with more money spent on the health care of older, richer folk, and relatively less invested in poorer kids. Modern transfers are both less progressive and less growth-promoting.

Third, recent experience from China to America suggests that high and growing levels of income inequality can translate into growing inequality of opportunity for the next generation and hence declining social mobility. That link seems strongest in countries with low levels of public services and decentralised funding of education. Bigger gaps in opportunity, in turn, mean fewer people with skills and hence slower growth in the future.

It is not easy to distinguish between efficient and inefficient types of inequality. The development of big cross-country statistical databases in the 1990s allowed economists to compare Gini coefficients and GDP growth in lots of countries over many years, but the results were mixed. Some studies found that wide income gaps were associated with slower growth. Others found the opposite. In a 2003 paper entitled "Inequality and Growth: What Can the Data Say?", Abhijit Banerjee and Esther Duflo of MIT concluded that the answer was "not very much".

More recent studies, however, support the idea that inequality can be inefficient. In an influential analysis in 2011 two IMF economists, Andrew Berg and Jonathan Ostry, looked at the length of "growth spells" rather than simply comparing growth rates. They found that growth was more persistent in more equal countries, and that income distribution mattered more for the length of growth spells than either the degree of trade liberalisation or the quality of a country's political institutions.

Other researchers have tried to isolate the "unhealthy" types of inequality using the two indices of inequality of opportunity first developed by the World Bank and described earlier in this special report. Two Spanish economists, Gustavo Marrero and Juan Gabriel Rodríguez, built an index of economic opportunity for individual American states. They found that states' GDP growth was inversely correlated with their inequality of opportunity, but not with overall inequality. In a forthcoming World Bank working paper, Ezequiel Molina, Jaime Saavedra and Ambar Narayan find that countries with lower educational equality, as measured by the Human Opportunity Index, grow more slowly.

This line of research is in its early stages, but a second strand of evidence, which examines the link between inequality and social mobility, is more developed. There are now plenty of studies which use the inter-generational elasticity of income to measure social mobility in different countries. Miles Corak, a Canadian economist, first plotted the results of these studies on a single graph. It is known as the "Great Gatsby Curve" (see chart 4, previous page), and suggests that countries with higher Gini coefficients tend to have lower inter-generational social mobility.

Perpetuating advantage

In some ways the link between wider income gaps and lower social mobility is unsurprising. From violin lessons to tutors for tests, richer parents can invest more in their children, improving their chances of getting into the best universities. The meritocratic assumption is that public provision of basic services, particularly education, does enough to counter this advantage to give everyone a reasonable start. That was never true in poor countries with rudimentary social services. Increasingly, it does not seem to be true in rich ones either, particularly America. But the link between inequality and declining mobility is not inevitable. Countries such as Sweden that invest heavily and progressively in public services are more likely to prevent widening income inequality from reducing opportunity. And Latin America shows that investing more in education at the bottom can improve social mobility even in the most stratified places.

Lower growth rates may not be the only symptom of economic damage from inequality. Another could be macroeconomic instability. In an influential recent book, "Fault Lines", Raghuram Rajan pointed to inequality as the underlying cause of America's 2008 crash. As less-educated Americans saw their incomes fall, he suggested, politicians encouraged reckless mortgage lending so that poorer folk could keep up their living standards by borrowing. This argument echoed John Kenneth Galbraith, who wrote in the 1950s that "bad distribution of income" was the main cause of the Depression.

The thesis seems plausible. There is evidence that widening income gaps in America pushed less affluent people to stretch their finances, particularly to buy pricier houses. Robert Frank, an economist at Cornell University, has documented "expenditure cascades" where rich people's spending patterns affect those of the near-rich. (One reason is that the less affluent want their children to go to the best schools, and house prices often reflect the quality of the local school.) Other scholars have spotted a link between inequality and financial distress. David Moss at Harvard Business School, for instance, found that the rate of American bank failures was highly correlated with the level of inequality.

But the link is not ubiquitous. In Germany and, especially, in China, higher inequality has encouraged saving rather than spending. Nor are financial crises always preceded by widening income gaps. Michael Bordo of Rutgers University and Christopher Meissner of the University of California, Davis, looked at 14 financial busts in rich countries between 1920 and 2008 and found that these crises were typically preceded by credit booms, but only occasionally by rising inequality. In the most compre-

hensive analysis Anthony Atkinson and Salvatore Morelli of Oxford University looked at financial crises in 25 countries over the past 100 years and concluded that there was no systematic relationship between inequality and macroeconomic disaster.

Since both the levels and the origins of inequality vary widely, it is hardly surprising that there is no established relationship between income gaps and financial crises. That does not mean inequality never aggravates macroeconomic instability, but unfortunately critics of inequality often exaggerate their claims. A case in point is "The Spirit Level", a book by two British epidemiologists, Richard Wilkinson and Kate Pickett, published in 2009. They claimed that higher levels of inequality were associated with higher murder rates, lower life expectancy, more obesity and all manner of other ills. Their explanation was a medical one. Inequality literally gets "under your skin" because the stress of keeping up with the Joneses raises cortisol levels.

"The Spirit Level" caused a sensation when it was first published in Britain, probably because it reflected the post-crash *Zeitgeist*. Its conclusions, however, have been largely debunked. In a devastating critique, published by the Democracy Institute, Christopher Snowdon showed that Mr Wilkinson and Ms Pickett made highly selective use of statistics. Other, more careful studies show that although there is a strong relationship between individual income and health (richer people tend to be healthier and live longer than poorer ones), the link between countries' income gaps and their citizens' health is weak.

Exaggerated claims of the damage from inequality have themselves done damage by reinforcing caricatures in an already highly charged debate. Quite legitimately, different people have different notions of what is fair, and what is the right balance between fairness and efficiency. But whatever their views, there is a reform agenda which both sides should embrace, one that both boosts efficiency and mitigates inequality. ■

Policy prescriptions

A True Progressivism

Bold moves are needed to tackle inequality and boost growth at the same time

ON AUGUST 31ST 1910 Theodore Roosevelt, by then America's ex-president, addressed a crowd of 30,000 at a civil-war commemoration in Osawatomie, Kansas. In one of America's most famous political speeches, he laid out his progressive philosophy. The federal government had a responsibility to promote equality of opportunity and attack special privilege and vested interests. "In every wise struggle for human betterment," he argued, "one of the main objects, and often the only object, has been to achieve in large measure equality of opportunity."

A century on, many emerging economies face circumstances not unlike those of Roosevelt's era. In the rich world government has become bigger than he ever imagined. But both rich and poor, in their efforts to boost growth and mitigate inequality, could draw inspiration from the spirit of the Osawatomie speech. Three broad reforms stand out.

One is to curb cronyism and enhance competition, particularly in emerging markets. Just as Roosevelt broke up America's trusts (monopolies) and cracked down on political corruption, China, India and many other emerging economies need to do some trustbusting and graft-attacking of their own. In China, freeing monopoly sectors, from mining to railways, would reorient the economy towards domestic consumption and reduce income gaps. A freer financial sector, with market-driven interest rates, would remove a potent source of income concentration and economic distortion.

In advanced countries, removing subsidies for too-big-to-fail financial institutions should also be high on the new progressive agenda. That, too, would result in more balanced economies and remove the rents that lie behind a lot of the surge in wealth at the top. Rich countries also need more competition in traditionally mollycoddled sectors such as education. Governments have a responsibility to invest in the young, but also to ensure that teachers have incentives to do their best.

The sooner the better

A second priority is to attack inequality with more targeted and progressive social spending. In emerging economies, especially in Asia, that means replacing expensive universal subsidies for energy with tailored social safety nets. It means wider use of conditional cash transfers. Latin America's models are gradually being copied elsewhere, but there is much farther to go: rich countries would do well to adopt the idea of tying social assistance to individuals' investment in skills and education.

Both rich and emerging economies must bring about a shift in government spending—from transfers to education, and from older and richer people to younger and poorer ones. Even if inequality were irrelevant, developed countries would need to reform their pension and health-care systems because today's promises are simply unaffordable. Concerns about distribution and its effect on future growth add impetus: the longer that governments prevaricate about reforming entitlements, the more will be squeezed from investment in the young and poor.

These days, public investment in education needs to go beyond primary and secondary school. Giving the less advantaged a leg up means beginning with pre-school and includes retrain-

ing for the less skilled. In both areas America, in particular, is found wanting. Its government spends barely more than 0.1% of GDP on "active labour-market policies" to get the less skilled back to work, one-fifth of the OECD average. Only half of American children attend pre-school. China plans to have 70% of its children in three years of pre-school by 2020.

The third priority is to reform taxes, to make them a lot more efficient and somewhat fairer. Critics of inequality often tout higher marginal taxes on the rich. Yet in most countries other than America, government spending is a much more important tool for combating inequality than the tax system. Tax revenue is better seen as a way to fund the state, not a tool to punish the rich. Economists argue about the disincentive effects of higher tax rates. (Messrs Piketty and Saez, the economists who have transformed analysis of income concentration at the top, reckon, controversially, that the optimal top income-tax rate could be as high as 80%.) But no one doubts that there are trade-offs.

In countries where the state is already large, rebalancing government spending should take precedence over raising more revenue. But given the mess that public finances in most countries are in, more tax revenue is likely to be necessary, particularly in less highly taxed countries such as America. Even there, though, higher marginal income-tax rates should not be the first choice. Instead, the focus should be on eliminating distortions that reduce both progressivity and the tax system's efficiency.

The "carried-interest" loophole, which allows private-equity managers to pay (low) capital-gains rather than (higher) income tax on their earnings, is one such sore. So are many tax deductions, from those for charitable contributions to mortgage interest, most of which disproportionately benefit the wealthy. An overhaul of the tax code to reduce corporate tax rates and narrow the gap between individuals' tax rates on capital and labour income would improve its efficiency and make richer people pay higher average tax rates. Higher property taxes would be an efficient and progressive source of revenue. Inheritance tax could be reformed so that it falls on individual beneficiaries rather than on the estate as a whole, as it does in Germany. That would encourage the wealthy to distribute their wealth widely, thereby making a hereditary elite less likely.

Parts of this agenda are taking shape, particularly in emerging economies. Brazil has begun a pension overhaul. China has boosted social services in rural areas. Indonesia and most recently India have cut fuel subsidies. But in the rich world the decibels of the inequality debate have been matched by the inadequacy of the reform effort. In continental Europe there is nothing much beyond a clamour to raise top tax rates. Britain's coalition government has taken on the welfare system but balks at getting rid of free bus passes for affluent old folk.

The most shocking shortcomings are in America, the rich country where income gaps are biggest and have increased fastest. The Republicans are right to say that Medicare, America's health-care system for the old, must be overhauled. But by slashing government spending on basic services such as education and advocating yet more tax cuts at the top, they undermine equality of opportunity.

The Democrats are little better. Barack Obama gave his own speech at Osawatomie last year, wrapping himself in Roosevelt's mantle. Inequality, he said, was the "defining issue of our time". But his response, from raising the top income-tax rate to increasing college-tuition subsidies, was just a laundry list of small initiatives. Roosevelt would have been appalled at the timidity. A subject of such importance requires something much bolder. ■

Offer to readers

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In most countries other than America, government spending is a much more important tool for combating inequality than the tax system