- THE WALL STREET JOURNAL.
  WSJ.com
- SEPTEMBER 10, 2009

Income Gap Shrinks in Slump at the Expense of the Wealthy

By BOB DAVIS and ROBERT FRANK

The deepest downturn in the U.S. economy since the Great Depression may finally shrink the gap between the very best-off Americans and everyone else.

If so, it won't be by lifting up the bottom. It will be by pulling down the top.

Over the past 30 years, chief executives, Wall Street bankers and traders, law-firm partners and such amassed ever-greater incomes, while the incomes of factory workers, teachers, office managers and others in the middle grew much more slowly. In 2007, the top 1% of U.S. families accounted for 23.5% of all personal income in the U.S., according to economists Emmanuel Saez of the University of California at Berkeley and Thomas Piketty of the Paris School of Economics. That was a level not seen since the Roaring Twenties.

Beyond
The Bubble
America's New Economy

The top 1%'s share appears to be falling fast. Mr. Saez and other economists expect income going to the top 1% of taxpayers -- currently, those with about $400,000 a year -- will drop to somewhere between 15% and 19% of all income by 2010. That still would leave income distribution more top-heavy in the U.S. than in many other countries.

One early indication: Median chief-executive pay at companies in the S&P 500 fell 15% in 2008 (to $7.3 million), according to University of Southern California pay expert Kevin Murphy.

"Based on past experience, it looks like inequality will go down and change the long-term trend of America becoming a less egalitarian society," says Ariell Reshef, a University of Virginia economist and another student of the equality issue.

This is among several potentially far-reaching changes wrought by the bursting of the housing and credit bubbles and the deep recession that ensued. Finance is likely to claim a smaller share of the nation's talent and make up a smaller part of the economy. The relationship between employers and employees may shift, and some workers will never fully recover from the blows they have suffered. Borrowing will be harder for many, and in any case, reducing debt instead of increasing it will hold new priority, possibly for a long while. In time, the past two years may be seen as a watershed in Americans' behavior and the nation's economic life.

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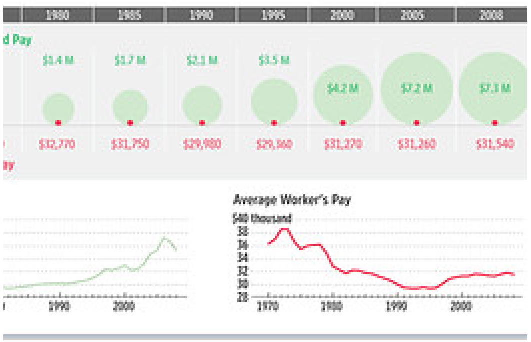

See figures on income gap.

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At the same time, the income gap, after narrowing during the 1991 and 2001 recessions, quickly widened again later. That could happen again. New York University economist Edward Wolff says that if efforts in Washington to rein in executive pay, impose new regulations and raise tax rates on capital gains don't succeed, investment and CEO riches could snap back.

Still, the recession that began in December 2007 has been of a different animal from those of 1991 and 2001, in that it followed a credit bubble that had sent incomes of finance executives soaring far above those of other engineers and other highly skilled people. The finance and insurance industries, which accounted for 5.9% of gross domestic product in 1990, rose to 8.1% in 2006, according to Moody's Economy.com. That fell to about 7.5% of the economy in 2008, the firm says; it estimates the figure will slip to 7.2% this year.

New York University economist Thomas Philippon and Virginia's Mr. Reshef estimate 30% to 50% of the extra pay received by finance-industry workers reflected a bubble in the sector.

Less income flowing to the top could have broad effects, from the amount of revenue the government collects to the kinds of cars piling up on dealers' lots. For instance, the top 1% of earners will pay 36% of all federal individual income taxes this year, according to an estimate from the Tax Policy Center, a Washington think tank. If their income softens, so will federal revenue, making budgets harder to meet.

Less income for the wealthy could lead to a reshaping of the luxury-goods economy, what some call the plutonomy. Half of U.S. consumer spending came from the top 20% of earners in 2000, according to economists Dean Maki and Michael Palumbo. Sales of all luxury goods are expected to decline 15% this year, according to consulting firm Bain & Co.

Among big-ticket items, U.S. sales of Bentleys, Maseratis, Maybachs and Lamborghinis have fallen over 50% this year, much worse than the 26% drop for the broader car market, according to Autodata Corp.

Another loser: philanthropy. In the brutal second half of last year, the number of charitable gifts of $1 million or more from individuals fell by more than a third from a year earlier, according to the Center on Philanthropy at Indiana University.

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Attorney Darren Tucker, shown with his wife and two sons, took a big pay cut to move from a law firm to the Federal Trade Commission when business slowed.

Outsized pay will surely live on for some -- in sports, in entertainment and on Wall Street. But there are reasons to believe that on the whole there will be less for people at the very top, not only in this feeble economy but for some time after the financial system heals.

For one thing, the Obama administration and the Democrats who control Congress are pressing for regulatory changes and tax increases that target the wealthiest and eyeing restraints on corporate compensation.

In addition, the scaling back in the size of the finance sector, at least in the near term, puts a damper on the kind of riches the industry created over the past decade. Mr. Reshef estimates that 21% of the increase in overall income inequality from 1980 to 2005 was attributable to rising compensation in the finance industry. Generally lower leverage and risk-taking on Wall Street serve to shrink the pot of gold from finance.

All this would be welcomed by some, particularly on the left. But reduced rewards at the top also "could diminish incentives for talented people and stifle a certain kind of innovation," says Michael Spence, a Stanford economist and Nobel laureate.

One member of the top 1%, Charles McDaniel, CEO of a Virginia moving company called Hilldrup Cos., is blunter. "When high-wage earners make less, at some point they'll say all the policies are stacked against them," he says. "They won't take risks [and] you won't have jobs created or new opportunities."

The leveling of incomes is no abstraction to people like Anthony Carmenate, a son of Cuban immigrants who worked his way from a boyhood job at a Chinese laundry in Hoboken, N.J., to the top ranks of Bank of America's asset-management business.

After graduating from Montclair State University in New Jersey, where he paid his way by tending bar, Mr. Carmenate got a job at a call center for Alliance Capital, a predecessor of AllianceBernstein. He sold mutual funds to brokers and rose to become head of U.S. product management. In 2003, Bank of America recruited him to help manage a new unit called Banc of America Capital Management.

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Erik Jacobs for the Wall St. Journal

Anthony Carmenate, in his home near Boston, has struggled since losing his $500,000-a-year job in asset management.

He bought a five-bedroom colonial home in the Boston suburb of Natick. His wife, Angela, managed the home and raised the couple's three children. The Carmenates didn't consider themselves big spenders, but, with an income of more than $500,000 a year, they began to splurge. She bought Coach handbags and designer shoes. He bought a BMW and Land Rover. When they took their kids to Disneyland or the Jersey shore, they sometimes paid to bring along a baby sitter.

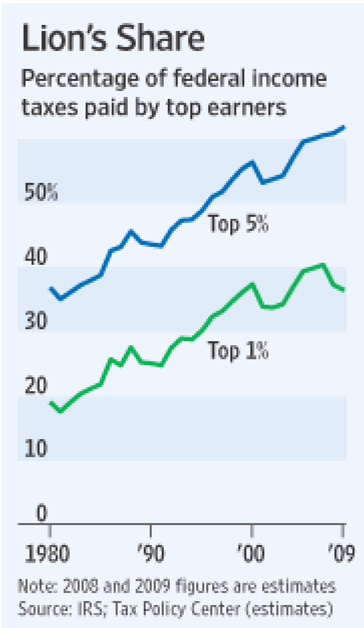
This spring, the 42-year-old Mr. Carmenate was laid off, and he has struggled to find a job at anywhere near his former pay. He meets with ex-colleagues, calls headhunters and taps his personal network, but, with banks wiping out layers of management, he says, "whenever I get a lead, I find that there is a sea of people like me applying for the same one." He has started to do some consulting work.

"I'm an optimistic guy," he says. "But salaries like mine aren't likely to come back anytime soon. It's simple: Wall Street doesn't need as many people as it used to."

Although nine large banks gave million-dollar bonuses to nearly 5,000 individuals last year, according to a July report by New York's attorney general, the report also showed that the banks' total pay and benefits declined nearly 11% from 2007.

The country has seen large shifts in income distribution before. In the 1930s, top earners were battered by the bursting of the financial markets, and New Deal regulation and taxes helped narrow the gap further. The top 1% of U.S. families had 23.9% of pretax income the year before the crash of 1929. By the time World War II ended, their share was less than 13%, where it stayed for some 35 years, professors Saez and Piketty calculate.

Starting around 1980, a mix of deregulation, technological change and globalization produced larger markets and fatter payouts at the top. Median CEO pay at large companies rose by a factor of six between 1980 and 2005, after accounting for inflation, say economists Carola Frydman of Massachusetts Institute of Technology and Raven Saks of the Federal Reserve. By 2007, the top 1%'s share of income had swollen to about as high as it was before the 1929 crash.



The gains at the top didn't necessarily come at the expense of others, because the economy expanded greatly after 1980, letting incomes grow across the spectrum. But those at the top end rose more rapidly. In 1980, for instance, the income of the top 5% of households was 2.86 times median incomes; by 2007, it was 3.52 times the median. In other words, the gap widened by 23%, Census data show.

At the same time, the amount of mobility up and down the American income ladder has remained largely unchanged over the years, according to most academics who have studied the issue. The rate has been relatively unchanged since 1969, says the Pew Charitable Trust.

Among the factors putting pressure on incomes at the top now is a shift in the political winds in Washington. Tax changes pushed by President George W. Bush after the 2001 recession reduced income taxes disproportionately on wealthier Americans. President Barack Obama, by contrast, campaigned on a pledge to use the tax code to reduce inequality, and he hopes to limit the Wall Street risk-taking that fed huge paydays. The White House and Congress are taking aim at executive compensation, with a federal pay czar scrutinizing compensation at some companies in which the government invested.

White House economist Austan Goolsbee says that "this isn't Robin Hood. The president's policy is not about trying to prevent incomes from growing in the top 1%," The administration argues that higher tax rates on wealthier Americans would pay for needed investments.

Pressure on pay at the top extends well beyond finance. At law firms, billings ballooned earlier this decade, and law-firm salaries accounted for 1.5% of all U.S. salaries in 2007, twice the share in 1980, according to Economy.com. The firm expects this to fall to 1% in 2018.

Darren Tucker, a 36-year-old antitrust attorney in Washington, was rising at O'Melveny & Myers, earning about $400,000 last year as a "counsel." That was one rung below partner, where annual payouts average about $1.5 million. But earlier this year, his boss told him he shouldn't expect to make partner anytime soon, in part because business was slowing.

Having already seen a round of layoffs, he leapt at a chance for a job at the Federal Trade Commission paying $153,000. "What was keeping me at O'Melveny & Myers was the big salary to come," Mr. Tucker says. His former boss at the firm, Richard Parker, says he helped Mr. Tucker land the FTC job and praises his legal skills.

Mr. Tucker and his wife have been spending $100,000 a year for treatment for their two children, who he says were diagnosed as autistic. With the job shift, says his wife, Anne, they have moved one child, who has greatly improved, into public school. For the first time in years, she is looking for a job, as a substitute teacher.

The wealth boom of the past decade was also fueled by entrepreneurs and family companies -- beneficiaries of easy credit, economic growth and rising asset values. Many of them, too, are taking a hit.

A world away from Wall Street, Mr. McDaniel, whose family owns the Hilldrup moving-and-storage firm in Stafford, Va., is used to luxuries. "I like to be well treated," he says. He has hopscotched to high-priced vacations in five-star hotels: skiing in Colorado in winter, snorkeling in the Caribbean in the spring and fly-fishing in Wyoming or Montana in the summer. The burly Mr. McDaniel, a 45-year-old former University of Virginia star linebacker, is also a regular, with his teenage son, at Super Bowls, and sometimes charters planes for East Coast trips. He drives an Audi A8 L, a model that starts at about $75,000.

When the economy is humming, "psychologically you're on a high, and the business supports that high," he says.

This year, Mr. McDaniel worries that the family company's revenue of about $100 million may drop by 20%. To cut costs, he is turning salaried drivers and packers into independent contractors, paid by the move. For those still on salary, he is freezing pay and suspending 401(k) contributions.

This summer he rented a house on a North Carolina beach rather than jetting to Jackson Hole, Wyo.

Among those sharing in the income setback at the top will be the charities to which Mr. McDaniel commonly gives. "If my business is off 20%, my salary may be off 20%, so my charitable giving should be off 20% too," he says.

Write to Bob Davis at bob.davis@wsj.com and Robert Frank at robert.frank@wsj.com

Printed in The Wall Street Journal, page A1