The Rise of Wealth Equality in the West

Daniel Waldenström joins Chelsea Follett to discuss the decline of wealth inequality in the Western world.

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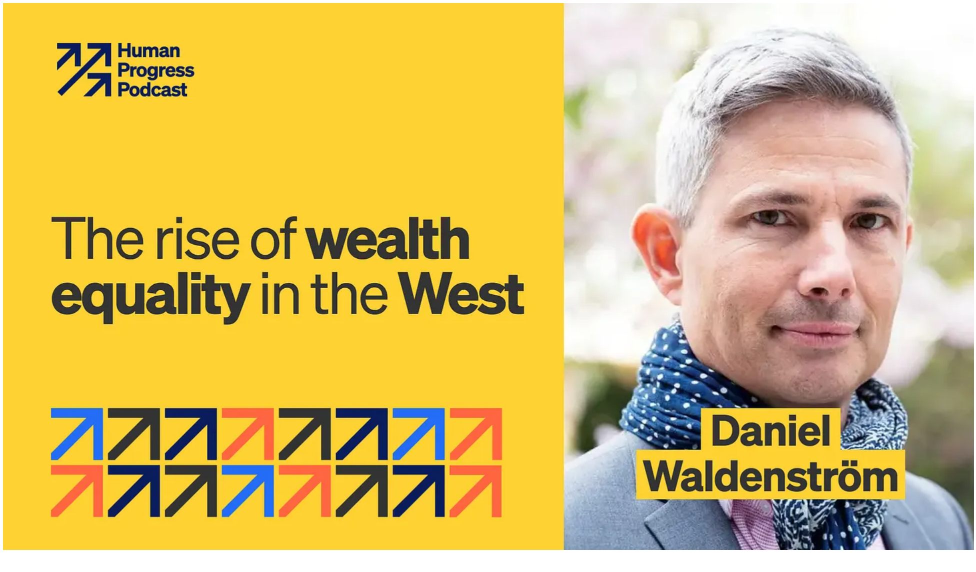

Free-market capitalism creates wealth, critics concede, but it also results in an ever-growing gap between the rich and the poor.

But is that really true?

In the latest episode of The Human Progress Podcast, Daniel Waldenström, a professor of economics at the Research Institute of Industrial Economics, joins Chelsea Follett to discuss new historical data showing a long term fall in wealth inequality in the West.

Listen to the interview

Below is an edited and abridged transcript featuring some highlights from the interview.

Your book, *Richer and More Equal: A New History of Wealth in the West*, reveals a surprisingly upbeat story: ordinary citizens in the Western world are now richer and more equal than before. Tell me about that and why the prevailing narrative of increasing inequality seems to be overstated or wrong.

One key aspect to this question is how we interpret economic outcomes in society. How do we interpret wealth creation? How do we interpret entrepreneurs creating new firms that make profits and build enormous fortunes? Is that something positive or a problem for society?

My view is that within a democratic market economy, I see very few problems with having such value-creating activities. Of course, that is different in autocratic countries. We have examples of oligarchs in Eastern Europe that have become rich through theft or dictatorships in developing countries where people gain wealth through political connections. But within democratic market economies, value-creating activities generally improve human well-being. Whether you're a worker or a tax collector, everything begins with value creation in the private sector. People start firms, hire people, and pay wages and taxes. So, when some people become very successful at this, I think that is inherently positive.

This view contrasts with that of some of my research colleagues, who see rich people as a problem.

I departed from that view, and I challenged that view using data. The previous narrative argued that equalization—the reduction in inequality during the 20th century—was mainly due to the destruction of the capital of the rich, either through war or taxes. My data show that the main force that has created equality over the 20th century is lifting the bottom, allowing normal people to save and build wealth. And that equalization goes hand in hand with value creation and capital accumulation. So, equalization doesn't rely on the destruction of capital but on the creation of capital.

You discuss the changing nature of wealth and how it has increasingly moved into housing and pension funds. Tell me about this shift.

So, there are different kinds of assets that we can own. We can own a house, stocks, bank deposits, bonds, land, or a summer cottage. This differs across households, but when we add up all the households in the economy and analyze the aggregate composition, we see that the wealth stock in all the rich nations has transformed profoundly.

One hundred years ago, most wealth was stuff that the rich people owned: things like industrial corporations and large agricultural domains. The stuff that the middle-class or workers owned, like houses and their long-term savings, composed just a fourth of all assets. But during the 20th century, we started establishing structures and institutions that made people more engaged in the economy. We saw educational reforms allowing more people to get better trained. We had better rules in the labor market with structures for working hours and so on. And all of that made workers more productive. So, they had a safer work environment, and they were better trained. And then, therefore, they got better paid. That allowed them to start saving privately. And the first thing they started saving in was housing.

We saw during the middle of the 20th century a virtual explosion in homeownership, going from 20 to 30 percent of the population to maybe 60 to 70 percent. Alongside this development, people started living longer—way past retirement age. And what did that imply? Well, they started to save for retirement.

These two kinds of assets, housing wealth and pension funds, have grown in importance and value over time. Today, they have become the most important part of total private wealth in all Western societies. Maybe 75 to 80 percent of all wealth is in housing or long-term savings. Wealth has transformed from being mainly composed of the stuff that the elite own to being mainly composed of stuff that regular people own, and that explains why we have a much more equal society in terms of wealth ownership today.

Part two of the book shifts the focus to the distribution of wealth over the past 130 years or so in various Western nations. What did you find?

So, over the last 20 years, we've built comparable, longitudinal wealth inequality series for several countries. How do you do this? How do we measure wealth inequality? It's difficult. But mainly, we use data on the holdings of those with wealth, the rich people. We rank all households from the poorest to the richest and then look at the richest ten percent. Then, we divide the sum of their wealth by the total wealth in the economy. And we can also do this for the top 1 percent. So, we have data on the top wealth shares over the entire 20th century up to today: around 130 years of comparable wealth inequality trends.

And what they say is quite clear: we are much more equal today than in the past. In the European countries, the richest tenth of society once held around 90 percent of all wealth. That share has been halved over the 20th century. The first fascinating thing is that this great wealth equalization occurred in all Western countries, even the US, over the 20th century up to the 1970s and '80s. That kind of consistency is very interesting.

Then, in recent decades, if you continue from 1980 onwards, one of the most surprising facts is that in the European countries, wealth inequality has not increased since the 1980s. It's been hovering around the same historically low level that they landed on in the 1970s. And this is in spite of the fact that wealth values have increased tremendously around the Western world. Housing has become more expensive; stock markets have boomed. We are richer today than we were in 1980, and yet, in Europe, wealth inequality has not increased. The reason is that most of the wealth that has increased in value is held by the middle class or the ordinary people. So, they've been lifted up by these asset price increases and the positive economic developments.

In the US, there has been an increase in wealth concentration. In the US, the wealth holdings of middle-class households have increased in value a lot, but the wealth of the top groups has increased even faster. Mind you, even in the US, there hasn't been much of a wealth concentration increase since 2010. Over the last 10 to 15 years, US wealth concentration has been relatively stable.

Yet, even in the US, you note that inequality is lower than pre-war levels. What explains this pattern of inequality?

We can see that mechanically, the main explanation for the long equalization during the 20th century is that we've been lifting the bottom. We've been expanding wealth ownership and wealth growth in the lower parts of the wealth distribution, and the lower parts have experienced higher wealth growth than the top.

The reasons why we've seen this are, to a large extent, institutional. Political and economic institutions expanded opportunities, allowing people to get educated, gain access to the labor market, and take loans for starting enterprises. Basically, entering the economic market and possibly succeeding. So, as I said before, capital destruction or taxing the rich has been relatively unimportant to wealth inequality change.

Then, of course, taxes matter, and they can prevent people from wanting to invest and so on. We've seen examples of that in the economic histories of all of these Western countries. But, mind you, much of the growth of government that we've seen over the 20th century has actually been built by increasing labor taxes. So workers have borne the biggest burden of increased taxation, meaning that their opportunity to save privately is what has been prevented the most by tax increases.

You go into greater detail in the book about the different kinds of wealth, including offshore wealth, to public sector wealth, and inheritance. Tell me about all of these things.

The concept of wealth is a little bit complicated if we compare it to, for example, income. So, income from labor is quite clear in its definition, whereas wealth is the stock value of assets that need to be defined and valued. One complication is that some wealth is held offshore. Of course, this wealth should be part of people's portfolios and the standard wealth measurement. The problem is that some offshore wealth is hidden for tax reasons. There is research trying to measure the size of those hidden assets, and the main conclusion is it doesn't change much. On the aggregate, when it comes to measuring wealth inequality, it doesn't change a lot. And it does not change the historical developments at all.

You also mentioned social security wealth. When we get sick, we get an income, or when we retire, we have a pension. Some of that is then based on our savings, but some is also based on promises from employers or, most of the time, from the state. You can think about those future pension incomes as wealth because you would need to save more money privately in the absence of a pension system. These wealth amounts are huge, and they are much more evenly distributed than other types of wealth. So, whereas many workers don't own much property or have a lot of private savings, they have a lot of expectations of future pension incomes. So, when we add the present value of future pensions, we see that the equalization of wealth inequality over the 20th century is much larger. This is true for both the US, which is one of the lowest-taxing market economies, and for Sweden, which was, during parts of the 20th century, close to a socialist command economy.

Finally, you asked about inheritance. When we look at the aggregate picture, looking at the aggregate flows of inheritance compared to GDP, and how has that changed over time, we see that over the last 120 years, the relative importance of inheritance was the largest at the beginning of the 20th century and has since become less and less important. We don't have that much data for many countries, but data for the UK, France, Sweden, and the US show basically the same picture. We see that even though richer heirs receive larger inheritances, the relative importance of inheritance is larger for less wealthy heirs. So, in fact, inheritance has an equalizing effect.

Another section of the book discusses how many of the super-rich are self-made and how many are rich heirs. And I have data there for the US and Sweden showing clearly decreasing trends in the relative importance of inheritance. So, there have been more and more self-made billionaires in our economies over the last 30 and 40 years. This is a signal that the book's overall message that we are getting richer and more equal is not changed when we also account for inheritance.

Fascinating. You mentioned globalization. Your book focuses on the West, but how generalizable are your results to the rest of the world?

So, yes, I have some discussion about this in the book. If we start with the global level, looking at all the wealth in the world and how it is distributed, we can see that it's very unequally distributed, more unequally distributed in the world than in any country. However, we also see that the measures of wealth inequality have decreased every year from the year 2000 up until the 2020s. So, the world is much more equal today than it was 20 years ago. The equalization has been much faster for poverty and for incomes than for wealth.

Given these trends toward more equality, why do you think there is this prevailing narrative to the contrary?

It's a difficult question. One reason is that the discussion has been quite narrowly focused on certain years, especially comparing outcomes to the early 1980s. So, the early 1980s were a turning point in the global economy, especially in the Western world, where we started leaving a very bad period of stagnation. Our production systems became less productive, and manufacturing industries were evaporating. They left the rich world because we were outcompeted by upcoming countries, especially in Asia.

But we learned our lessons. Our economic struggles were explained by regulations and high taxation. In Sweden, for example, the top marginal tax rate on labor income was above 90 percent. So, we started deregulating and lowering taxes and developed a better understanding of the role of technological change and economic incentives.

That, of course, lead to growth and also greater income inequality. But much of that was a normalization. Most Western countries went from historically low levels of income inequality, which resulted from extremely high taxes on productive people, to higher levels of income inequality as economic growth led to higher incomes. People interpret this fact negatively, but this normalization improved general welfare through things like better medical care and technology. So that's a kind of a misinformed narrative, but it's based on observations of increasing inequality since the 1980s.

Let me also say this. People on the right side of the political spectrum are generally less interested in discussing and understanding inequality, what is happening to it, and how it is measured. And in many cases, they basically left a vacuum in these discussions. People on the left have an interest in inequality, but their problem is that they already know the answers. They don't care about data or measurement; they take for granted that inequality is high and increasing. So, it's a very strange debate with many strong but misinformed statements.

What insights can we learn from this new history of wealth?

One very important lesson is that we can build wealth broadly in the population by enabling more people to become owners. We have seen that home ownership has been the main pillar of household wealth. I cite a research paper in the book showing that the long-term returns in home ownership have been almost as high as the long-term returns in the stock market, but at half the risk. I think another pillar is mutual funds. Mutual funds have democratized the stock market, allowing people to own shares that give high returns but with a low level of risk. Luckily, we understood this and guided many of our pension savings or investments into mutual funds.

There is also a lesson when it comes to the taxation of capital. There's one big group of capital taxes that work well. These are capital income taxes, so capital taxes on flows of returns. The biggest one is the corporate tax. So, the profit tax of corporations. Corporate taxes amount to around half of all capital taxes in total. Then, we have taxes on dividend income. We have taxes on rental income. We have taxes on realized capital gains. Whenever you, as an owner, take out cash from your company, we tax that as income, just like any labor earner.

The other kind of capital taxes, which are much more problematic, are the taxes on wealth and stocks of capital. Maybe there is a stock market valuation, and you pay taxes based on your company's value. The problem is that if you make little profit, you won't have any money to pay the tax with. What should you do then? Should you sell parts of the firm? That's going to create corporate governance problems. It's very clear from economic research that we don't want those kinds of effects of taxation. It's a very negative outcome of taxation. Another problem with wealth taxes is that we don't know exactly how to value assets that are not actively traded. Many companies are not on a stock exchange that lists how much they're worth. We could guess, but I would suppose we would have maybe 50 percent error margins. A 50 percent error margin on your tax bill is not so fun and could be very costly.

These problems are why very few countries today still have wealth taxes. These taxes also haven't worked historically. The revenues that they have generated are also very small compared to capital income taxes. So, I recommend not taxing wealth or "unrealized capital gains." I think those proposing these kinds of taxes lack a basic understanding of entrepreneurship and the economy.

Read the full transcript