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<u>The economist</u>

The rise and fall of the wealthy

The rich under attack

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Going for the bankers is tempting for politicians—and dangerous for everybody else

The Bridgeman Art Library 

STONES thrown through a banker's windows in Edinburgh, workers "bossnapping" executives in France, retrospective 90% tax rates proposed in Washington, and now a riot in London as G20 leaders arrived for their summit (see article). A sea change in social attitudes that could have profound effects on politics and the world economy is under way.

The rich are certainly not the only targets in the current populist backlash. Frightened by the downturn, people are furious with politicians, central bankers and immigrants. But a rising wave of anger is directed against the new "malefactors of great wealth". Today's villains are a larger and more global bunch than the handful of American robber barons Teddy Roosevelt denounced a century ago; and most of them are bankers and fund managers, rather than owners of trusts and railroads. Yet the themes are similar to those at the end of that previous gilded age: rising inequality—the top 0.1% of Americans earned 20 times the income of the bottom 90% in 1979 and 77 times in 2006—and a sense that the greedy rich have cheated decent working people of their rightful share of the pie.

Some of this cheating has been of an old familiar sort: building Ponzi schemes and bribing politicians to secure favourable deals. There are greyer areas, in which the rich hide their cash in tax havens and get tax law written to their advantage—witness the indefensible treatment of private-equity profits. But what makes the rich's behaviour so galling for many critics is that their two greatest crimes were committed in broad daylight, as they were part of the system itself.

The two great cheats

The first charge is that the rich created a new form of heads-I-win-tails-you-lose capitalism. Traders and fund managers got huge rewards for speculating with other people's money, but when they failed the parent company, the client and ultimately the taxpayer had to pay the bill. Monetary policy contributed to this asymmetry of risk: when markets faltered central banks usually rescued them by cutting interest rates.

The second charge is that the bankers and fund managers were not doing anything useful. Unlike the "deserving" rich entrepreneurs who set up Microsoft and Google, the "undeserving" traders and brokers just shuffled money around the system to nobody's profit but their own. The faster the money went round, the larger the financial sector loomed in the rich countries' economies. At its peak it contributed 41% of domestic American corporate profits, more than double the rate two decades ago. As finance grew, the banks got ever bigger—too big to fail, eventually, so when they tottered taxpayers had to prop them up. Far from epitomising capitalism, the undeserving rich undermined it: it was socialism for the wealthy.

These two charges run together, but the second has much less justification. Enormous though the cost of bailing out the banks has been, there is nothing inherently undeserving about finance; even in their flawed state, more liquid markets have brought huge benefits to the rest of the economy. The lower cost of capital has made it easier for industry to invest, innovate and protect itself against interest and exchange-rate risk. Trying to single out financiers from entrepreneurs is a fool's errand: you will end up hurting both.

The heads-I-win charge is not entirely proven, either: some of the people who ran banks did lose when they went bust. Yet even a newspaper as inherently pro-business as this one has to admit that there was something rotten in finance: the basic capitalist bargain, under which genuine risktakers are allowed to garner huge rewards, seems a poor one if taxpayers are landed with a huge bill for it all. Hence the anger.

A time for correction and brown paper bags

Periods of excess, when inequality has grown, tend to be followed by eras of reform: Roosevelt bust the trusts and shortly afterwards Congress moved towards introducing a federal income tax. Part of the genius of capitalism is its ability to adjust to disruption from within and attacks from without.

Indeed, the system is already beginning to correct itself. As our special report this week points out, the rich are not as rich as they were: some $10 trillion, around a quarter of the wealthy's assets, has been lost. Inequality will decline. Investment banks and hedge funds are shrinking; private-equity groups are struggling to finance takeovers. Having discovered how volatile markets can be, banks will be less keen on trading in the future. There is even a correction going on in conspicuous consumption: Net-a-porter, a pricey website, offers to deliver designer outfits to its customers in brown paper bags.

The market's self-correction will not be enough, however. Higher taxes will eventually be inevitable, since so many governments have lurched heavily into deficit. But politicians must tread carefully. Tax rises right away would be a rotten idea, since for the moment fiscal stimulus is needed. And even when governments raise the money, they should first get rid of deductions and reverse unmeritocratic measures (such as George Bush's repeal of America's death tax) rather than jacking up income-tax rates to punitive levels. Squeeze the rich until the pips squeak, and the juice goes out of the economy.

As for heads-I-win capitalism, the problem of asymmetric risk should shrink, because the rule changes needed to make the financial system safer will also remove unwarranted profits. Contra-cyclical capital requirements, forcing banks to build more reserves during good times, will leave them less cash to splurge on bonuses. Many of the sweetest sources of profit sprang up in the cracks between regulatory systems; governments are now filling in these gaps. If central banks focus on asset markets when they rise as well as when they fall, they will remove much of the froth. Treat a bank that becomes too big to fail like a utility, and it will make less money.

Curbing the excesses of wealth, then, will be a side effect of regulations designed to make capitalism work better. Such measures will not provide the lyrics to revolutionary anthems, but they are going to be better than going after the wealthy. The rich are an easy target. But when you try to bash them, you usually end up punching yourself in the nose.