The Self-Destruction of the 1 Percent

By CHRYSTIA FREELAND

IN the early 14th century, Venice was one of the richest cities in Europe. At the heart of its economy was the colleganza, a basic form of joint-stock company created to finance a single trade expedition. The brilliance of the colleganza was that it opened the economy to new entrants, allowing risk-taking entrepreneurs to share in the financial upside with the established businessmen who financed their merchant voyages.

Venice’s elites were the chief beneficiaries. Like all open economies, theirs was turbulent. Today, we think of social mobility as a good thing. But if you are on top, mobility also means competition. In 1315, when the Venetian city-state was at the height of its economic powers, the upper class acted to lock in its privileges, putting a formal stop to social mobility with the publication of the Libro d’Oro, or Book of Gold, an official register of the nobility. If you weren’t on it, you couldn’t join the ruling oligarchy.

The political shift, which had begun nearly two decades earlier, was so striking a change that the Venetians gave it a name: La Serrata, or the closure. It wasn’t long before the political Serrata became an economic one, too. Under the control of the oligarchs, Venice gradually cut off commercial opportunities for new entrants. Eventually, the colleganza was banned. The reigning elites were acting in their immediate self-interest, but in the longer term, La Serrata was the beginning of the end for them, and for Venetian prosperity more generally. By 1500, Venice’s population was smaller than it had been in 1330. In the 17th and 18th centuries, as the rest of Europe grew, the city continued to shrink.

The story of Venice’s rise and fall is told by the scholars Daron Acemoglu and James A. Robinson, in their book “Why Nations Fail: The Origins of Power, Prosperity, and Poverty,” as an illustration of their thesis that what separates successful states from failed ones is whether their governing institutions are inclusive or extractive. Extractive states are controlled by ruling elites whose objective is to extract as much wealth as they can from the rest of society. Inclusive states give everyone access to economic opportunity; often, greater inclusiveness creates more prosperity, which creates an incentive for ever greater inclusiveness.

The history of the United States can be read as one such virtuous circle. But as the story of Venice shows, virtuous circles can be broken. Elites that have prospered from inclusive systems can be tempted to pull up the ladder they climbed to the top. Eventually, their societies become extractive and their economies languish.

That was the future predicted by Karl Marx, who wrote that capitalism contained the seeds of its own destruction. And it is the danger America faces today, as the 1 percent pulls away from everyone else and pursues an economic, political and social agenda that will increase that gap even further — ultimately destroying the open system that made America rich and allowed its 1 percent to thrive in the first place.
You can see America’s creeping Serrata in the growing social and, especially, educational chasm between those at the top and everyone else. At the bottom and in the middle, American society is fraying, and the children of these struggling families are lagging the rest of the world at school.

Economists point out that the woes of the middle class are in large part a consequence of globalization and technological change. Culture may also play a role. In his recent book on the white working class, the libertarian writer Charles Murray blames the hollowed-out middle for straying from the traditional family values and old-fashioned work ethic that he says prevail among the rich (whom he castigates, but only for allowing cultural relativism to prevail).

There is some truth in both arguments. But the 1 percent cannot evade its share of responsibility for the growing gulf in American society. Economic forces may be behind the rising inequality, but as Peter R. Orszag, President Obama’s former budget chief, told me, public policy has exacerbated rather than mitigated these trends.

Even as the winner-take-all economy has enriched those at the very top, their tax burden has lightened. Tolerance for high executive compensation has increased, even as the legal powers of unions have been weakened and an intellectual case against them has been relentlessly advanced by plutocrat-financed think tanks. In the 1950s, the marginal income tax rate for those at the top of the distribution soared above 90 percent, a figure that today makes even Democrats flinch. Meanwhile, of the 400 richest taxpayers in 2009, 6 paid no federal income tax at all, and 27 paid 10 percent or less. None paid more than 35 percent.

Historically, the United States has enjoyed higher social mobility than Europe, and both left and right have identified this economic openness as an essential source of the nation’s economic vigor. But several recent studies have shown that in America today it is harder to escape the social class of your birth than it is in Europe. The Canadian economist Miles Corak has found that as income inequality increases, social mobility falls — a phenomenon Alan B. Krueger, the chairman of the White House Council of Economic Advisers, has called the Great Gatsby Curve.

Educational attainment, which created the American middle class, is no longer rising. The super-elite lavishes unlimited resources on its children, while public schools are starved of funding. This is the new Serrata. An elite education is increasingly available only to those already at the top. Bill Clinton and Barack Obama enrolled their daughters in an exclusive private school; I’ve done the same with mine.

At the World Economic Forum in Davos, Switzerland, earlier this year, I interviewed Ruth Simmons, then the president of Brown. She was the first African-American to lead an Ivy League university and has served on the board of Goldman Sachs. Dr. Simmons, a Harvard-trained literature scholar, worked hard to make Brown more accessible to poor students, but when I asked whether it was time to abolish legacy admissions, the Ivy League’s own Book of Gold, she shrugged me off with a laugh: “No, I have a granddaughter. It’s not time yet.”

America’s Serrata also takes a more explicit form: the tilting of the economic rules in favor of those at the top. The crony capitalism of today’s oligarchs is far subtler than Venice’s. It works in two main ways.
The first is to channel the state’s scarce resources in their own direction. This is the absurdity of Mitt Romney’s comment about the “47 percent” who are “dependent upon government.” The reality is that it is those at the top, particularly the tippy-top, of the economic pyramid who have been most effective at capturing government support — and at getting others to pay for it.

Exhibit A is the bipartisan, $700 billion rescue of Wall Street in 2008. Exhibit B is the crony recovery. The economists Emmanuel Saez and Thomas Piketty found that 93 percent of the income gains from the 2009-10 recovery went to the top 1 percent of taxpayers. The top 0.01 percent captured 37 percent of these additional earnings, gaining an average of $4.2 million per household.

The second manifestation of crony capitalism is more direct: the tax perks, trade protections and government subsidies that companies and sectors secure for themselves. Corporate pork is a truly bipartisan dish: green energy companies and the health insurers have been winners in this administration, as oil and steel companies were under George W. Bush’s.

The impulse of the powerful to make themselves even more so should come as no surprise. Competition and a level playing field are good for us collectively, but they are a hardship for individual businesses. Warren E. Buffett knows this. “A truly great business must have an enduring ‘moat’ that protects excellent returns on invested capital,” he explained in his 2007 annual letter to investors. “Though capitalism’s ‘creative destruction’ is highly beneficial for society, it precludes investment certainty.” Microsoft attempted to dig its own moat by simply shutting out its competitors, until it was stopped by the courts. Even Apple, a huge beneficiary of the open-platform economy, couldn’t resist trying to impose its own inferior map app on buyers of the iPhone 5.

Businessmen like to style themselves as the defenders of the free market economy, but as Luigi Zingales, an economist at the University of Chicago Booth School of Business, argued, “Most lobbying is pro-business, in the sense that it promotes the interests of existing businesses, not pro-market in the sense of fostering truly free and open competition.”

IN the early 19th century, the United States was one of the most egalitarian societies on the planet. “We have no paupers,” Thomas Jefferson boasted in an 1814 letter. “The great mass of our population is of laborers; our rich, who can live without labor, either manual or professional, being few, and of moderate wealth. Most of the laboring class possess property, cultivate their own lands, have families, and from the demand for their labor are enabled to exact from the rich and the competent such prices as enable them to be fed abundantly, clothed above mere decency, to labor moderately and raise their families.”

For Jefferson, this equality was at the heart of American exceptionalism: “Can any condition of society be more desirable than this?”

That all changed with industrialization. As Franklin D. Roosevelt argued in a 1932 address to the Commonwealth Club, the industrial revolution was accomplished thanks to “a group of financial titans, whose methods were not scrutinized with too much care, and who were honored in proportion as they produced the results, irrespective of the means they used.” America may have
needed its robber barons; Roosevelt said the United States was right to accept “the bitter with the sweet.”

But as these titans amassed wealth and power, and as America ran out of free land on its frontier, the country faced the threat of a Serrata. As Roosevelt put it, “equality of opportunity as we have known it no longer exists.” Instead, “we are steering a steady course toward economic oligarchy, if we are not there already.”

It is no accident that in America today the gap between the very rich and everyone else is wider than at any time since the Gilded Age. Now, as then, the titans are seeking an even greater political voice to match their economic power. Now, as then, the inevitable danger is that they will confuse their own self-interest with the common good. The irony of the political rise of the plutocrats is that, like Venice’s oligarchs, they threaten the system that created them.

*The editor of Thomson Reuters Digital and the author of “Plutocrats: The Rise of the New Global Super-Rich and the Fall of Everyone Else,” from which this essay is adapted.*