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How the Mighty Have Fallen

The rich really aren't like you and me: They're historically recession-proof. But this time they've been hit hard—and we may all be the poorer for it.

Robert J. Samuelson

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Just who is "rich" in America is a matter of considerable disagreement. No one disputes that Bill Gates (No. 1 on last year's *Forbes* 400 list with a net worth of \$57 billion) and Warren Buffett (No. 2 at \$50 billion) are wealthy or, indeed, that everyone on the *Forbes* list qualifies (the poorest had a net worth of \$1.3 billion). But as you move from billions in net worth to the mere hundreds or many tens of millions, and then to annual incomes of the mere hundreds of thousands, the arguing begins.

In April, *The Wall Street Journal* ran an article sympathetically portraying families with incomes around \$250,000, the level that President Obama has targeted for tax increases. By most measures, these families rank in the top 2 percent to 4 percent of the income spectrum. But many—possibly most—see themselves as "upper middle class" and not "rich," the paper reported.

"I'm not after sympathy," said the wife of a surgeon who makes about \$260,000. "What I want is a reality check on what rich means. I can pay my mortgage and can buy some clothes. I'm not going without, but I'm not living a life of luxury." The mayor of San Jose scoffed at \$250,000. That's what a two-engineer couple might make, he said. It put them in "the upper working class" and wasn't enough to "buy a home in Silicon Valley."

The article triggered an outpouring of e-mails—many applauding that someone had finally described their harried plight; others sarcastically wondering what planet the whiners lived on. But so much angst among the affluent—however defined—attests to something else: the present recession, unlike any other since World War II, has deeply shaken the nation's economic elite.

With secure jobs and ample incomes, the rich and the near rich are supposed to be insulated from economic slumps. Well, not this time. Many feel fearful, threatened, and impoverished. In a recent Unity Marketing survey of consumers with incomes exceeding \$250,000, 60 percent said their financial situation had deteriorated; 39 percent said bonuses or commissions had been cut; 29 percent said their regular income had been reduced; 8 percent said they'd lost their jobs; and 4 percent said their hours had been reduced. Even with a partial stock-market rebound, many of America's most affluent feel vulnerable to layoffs and lost income, just like other Americans. "This has been an equal-opportunity recession," argues Pam Danziger of Unity Marketing.

Collateral damage is widespread. Sales at luxury chains have fallen sharply; same-store revenues for Saks Fifth Avenue and Neiman Marcus dropped about 25 percent in recent quarters. Many country clubs are struggling to hold members. In New York's Hamptons, unsold homes reached a 34-month supply early this year at the prevailing sales pace; buyers had hibernated. Economist Susan Sterne, a specialist in consumer spending, calls it "the demise of luxury... the people who buy \$3,000 Gucci handbags. You see it in the luxury-car market and housing."

Some causes are obvious. With the recession's epicenter on Wall Street, layoffs and bonus

reductions among highly paid investment bankers, traders, and money managers have thinned the ranks of the rich. The plunge in share prices has especially hurt the wealthy, because they disproportionately own stocks.

But something bigger may also be happening. In a new study, economists Jonathan Parker and Annette Vissing-Jorgensen of Northwestern University find that—contrary to conventional wisdom—income losses in recessions are proportionately greater for the well-to-do than for middle-income households. By their estimates, the relative income loss for the top 10 percent of the population is 26 percent larger than for the average household. For the top 1 percent, the contrast is even starker. Their proportionate loss is more than double—that is, if the average household had an income loss of 10 percent, the top 1 percent would lose more than 20 percent.

That doesn't mean they suffer more hardship. It's almost certainly tougher for a family with an income of \$50,000 to adjust to a \$5,000 loss (10 percent) than it is for a family with \$1 million to compensate for a \$200,000 drop (20 percent). And the poor experience the highest joblessness. Still, the increased economic vulnerability of the upper classes is a change from the past. Before the 1980s, the conventional wisdom was true, Parker and Vissing-Jorgensen say. Higher income conferred more stability.

It's not entirely clear what changed. Parker thinks that "one cause is the dramatic increase in pay for performance." In the past quarter century, salaries for top executives and managers have increasingly consisted of stock options, year-end bonuses, and sales incentives, he says. When the economy thrives, pay rises; when it sours, pay falls. Parker also cites the growth of professionals (lawyers, doctors, accountants, consultants) among the economic elite. "When the demand for elective surgery or legal services or consulting services goes down, so do their incomes," he says. Even among the top one tenth of 1 percent, wages represent half their income, and "proprietors' income" (essentially profits from a business or partnership) accounts for another quarter. The stereo-type of the rich living mainly off dividends and interest income is increasingly outdated. Many of the wealthy are owners of small businesses whose well-being is—to some extent—hostage to the business cycle.

It will strike many, no doubt, that the setbacks and anxieties for the country-club set are just deserts. Some will correctly note that well-paid CEOs and investment bankers helped bring about the economic crisis. They're just getting their comeuppance—and it's about time. Others will point out that countless studies have shown that, in recent decades, the gap between the rich and the rest has widened. From 1990 to 2006, for instance, the share of pretax income received by the top 1 percent grew from 12 percent to 19 percent, says the Congressional Budget Office. The present reverses are a healthy correction. So goes the argument.

All this is understandable, but incomplete. The criticism usually presumes that if the rich and near rich get less, someone else will get more. Redistribution achieves a better social balance. Sometimes that happens. But sometimes when the rich get less, no one else gets more. Regardless of how the rich earned their money—trading bonds, performing surgery, starting new companies, providing legal work—it's no longer so lucrative. The rich get poorer, but no one else gets richer. Society is worse off.

"Trickle-down economics" is a despised phrase and concept to many, but it also embodies a harsh reality. The rich often play a pivotal role in U.S. economic growth, and if they are enfeebled, then the consequences are widespread. Consider:

??Consumption spending, the economy's main engine, is skewed toward the upper classes, because they have most of the income. In 2009, households with more than \$200,000 in income account for 3.4 percent of the total but will generate almost 14 percent of consumer spending, estimates economist Sterne. Households with incomes between \$100,000 and \$200,000 represent about 14 percent of the population and 34 percent of spending. Together, these groups generate nearly half of U.S. consumption, although they're only a sixth of the population.

??Similarly, the rich pay most of the taxes. In 2006, the richest 1 percent paid 28 percent of all federal taxes, estimates the CBO. The richest 10 percent (including the top 1 percent) paid 55 percent. The system is progressive—that is, the richer people get, the more of their income they pay in taxes. In 2006, the effective rate for the top 1 percent was 31 percent, reflecting all federal taxes. By contrast, the poorest fifth paid an effective rate of 4 percent. (State and local taxes are

less progressive, because they rely more heavily on regressive sales taxes.)

??The wealthy dominate charitable giving. In 2004, families with a net worth exceeding \$5 million made up about 1.5 percent of all U.S. families but accounted for 27 percent of contributions, according to the Center on Wealth and Philanthropy at Boston College. Those with a net worth between \$1 million and \$5 million, about 7 percent of all families, represented another 20 percent of contributions. So, a tenth of American families made nearly half of all gifts.

??Wealthy individuals are an important source of money for venture capital—funds invested in startup companies. Individuals and families represent about 10 percent of VC money (most of the rest comes from pension funds, college endowments, and insurance companies).

When the affluent retrench, they drag a lot with them. For example, the financial crisis led to a 44 percent fall in year-end bonuses at Wall Street firms, to \$18.4 billion in 2008 from \$32.9 billion in 2007, according to the New York state comptroller. No doubt that struck many as overdue and insufficient. Bankers were overpaid, and huge year-end bonuses encouraged excessive risk-taking. The trouble is that the loss of taxes on the bonuses blew a \$1 billion hole in the state's budget and made it harder to pay for schools, health care, and prisons.

It's the same story with consumption. In late 2008, spending declined at about a 4 percent annual rate, and, in the first quarter of this year, rose slightly. But Danziger's surveys show steeper cutbacks at the top. From 2007 to 2008, consumers with incomes from \$150,000 to \$249,000 reduced spending by about 8 percent, while those above \$250,000 cut almost 15 percent. Similarly, charitable giving decreased to \$308 billion in 2008, a drop of 5.7 percent after adjustment for inflation, says the Giving USA Foundation, a nonprofit group. Donations may fall further this year. The stock market is a strong predictor of giving. A 100-point rise in the S&P 500 stock index increases charitable contributions by \$1.7 billion, says the Center on Philanthropy at Indiana University.

Not all charities have suffered. "Our funding is up 42 percent over last year," says Ross Fraser of Feeding America, an umbrella group that channels cash and groceries to 206 food banks around the country. "Charities such as ours do well when times are hard. If you have to choose between giving to the ballet and feeding a hungry child, who's going to win?" But that compounds the pressure on other nonprofits: colleges, hospitals, and environmental groups.

It's probably true that being rich is more a state of mind than an explicit level of income or wealth. It's feeling of having enough money so that money is no longer a worry. For many, that sense of security is gone. Michael Silverstein of the Boston Consulting Group reckons there are about 100,000 households with a net worth—counting their homes, stocks, bonds, and businesses—of at least \$20 million. Even at these rarefied levels, he thinks, many are rattled. "They've seen up to a 30 to 40 percent drop in their net worth from peak to trough. Some have friends at blue-chip companies like General Electric, AIG, or Citigroup who have lost fortunes invested in company stock," he says.

What's unclear is whether the trauma will permanently change behavior. Silverstein is skeptical. "The nice thing about Americans is that they have short-term memories," he says. "We'll get out of this—and then the rich will realize they're rich again and start to spend." But Danziger, the marketing researcher, thinks the shopping culture has taken heavy hits. Americans have "been on an extended buying spree for the past 20 years. They've got stuff—and they don't need a lot of it," she says. There's a growing realization "that material wealth doesn't make people happy." Striving to replenish their savings, Americans—even the rich—will skimp on spending.

One way or another, it's doubtful that trickle-down economics will soon regain the power of recent decades, when exploding stock and real-estate values and rising salaries were compounded by George W. Bush's favorable tax changes. But cheering at its eclipse may be premature and misguided. The contradiction is that many of the large gains at the top that are routinely deplored also provide the economic fuel for desired spending at the bottom. If the rich—however defined—remain stuck in neutral, the overall economy may not do much better.

With Baobao Zhang in Washington

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