Part I

INTRODUCTION
I

WEALTH AND INEQUALITY

The love of wealth is therefore to be traced, as either a principal or accessory motive, at the bottom of all that the Americans do.

d(e Tocqueville 1841)

One of the most astute observers of American life, Alexis de Tocqueville noted that wealth accumulation is perhaps the fundamental motivator of American behavior. At the same time, wealth ownership is thought to be concentrated in the hands of a small minority of the population. It is no secret that wealth ownership has advantages and that these extend beyond the obvious economic benefits to such areas as general social standing and political power. Political influence, for example, is typically exercised indirectly, through lobbying, private funding of research and policy institutes, and campaign financing (Domhoff 1990; Dye 1995; Useem 1984). To the extent to which economic power can be converted into political power, those who own wealth also influence the making of important decisions. As Spencer pointed out more than a century ago, "Even before private land-owning begins, quantity of possessions aids in distinguishing the governing from the governed" (Spencer 1882:401). While the nature of the economic and political systems in which wealth is accumulated has changed dramatically since Spencer's time, there is still a strong association between control of material possessions and political influence. Thus those who have wealth have every incentive to maintain that wealth, while those who own little are motivated to acquire wealth. Moreover, the notion of the American dream suggests that such upward mobility is, indeed, possible. Researchers have long suspected, however, that in addition to motivating much of what Americans do wealth ownership is the single dimension on which American families are most persistently unequally distributed. While disparities in income and educational attainment are
Introduction

extreme, disparities in the ownership of wealth are likely worse and apparently more enduring across generations.

Yet information on the distribution of family wealth in the United States has been relatively scarce, and understanding of the processes that lead to wealth inequality has been even more elusive. As a result, knowledge of the role that wealth ownership plays in motivating and constraining behavior has remained relatively limited. Over the last decade, data improvements have allowed researchers to begin outlining a few of the more salient descriptive features of the distribution of wealth, and while the evidence is still preliminary, the picture that has emerged is disquieting. Wealth inequality, already highly concentrated in the early 1960s, became even more so during the 1980s and 1990s. Estimates indicate that the top 1 percent of wealth owners enjoyed two-thirds of all increases in household financial wealth during the 1980s, while the bottom 80 percent actually owned less real financial wealth in 1989 than in 1983 (Wolff 1995b). In the past, Americans smugly assumed that European societies were more stratified than their own, but it now appears that the United States has surpassed all industrial societies in the extent of its family wealth inequality (Wolff 1995b). Interpreting these reports, the press has realized that wealth inequality may be as harmful as income and educational inequality, which have attracted so much more attention. Pondering new wealth distribution estimates in its lead editorial, the New York Times worried that “Some inequality is necessary if society wants to reward investors for taking risks and individuals for working hard and well. But excessive inequality can break the spirit of those trapped in society’s cellar – and exacerbate social tensions” (4/18/95).

While improvements in wealth data began to cast new light on this fundamental social problem in the 1980s, understanding of both wealth inequality and its causes remains far from complete. Researchers have begun to create a picture of household wealth distribution, particularly for the years in which surveys were conducted (Wolff 1987b, 1995a, 1995b, 1998; Wolff and Marley 1989). Demographic, social, and financial characteristics of families in various portions of the distribution have also become increasingly clear, again particularly in the years for which survey data are available (Avery, Ellieżnau, Canner, and Gustaftson 1984b; Avery, Ellieżnau, Canner, Gustaftson, and Springert 1986; Avery, Ellieżnau, and Kennickell 1987; Avery and Kennickell 1990; Kennickell and Shack-Marquez 1992; Kennickell and Starr-McCluer 1994). Yet this research appears in disparate places and has seldom been
Wealth and Inequality

accumulated into a single story of wealth inequality in America. At the same time, and perhaps more importantly, our understanding of the processes that create these distributional outcomes is limited. Family-level demographics and processes, such as racial differences, aging, and inheritance, are likely to affect wealth accumulation and thus inequality (Ando and Modigliani 1963; Blau and Graham 1990; Danziger, VanDerGaag, Smolensky, and Taussig 1982; Oliver and Shapiro 1995). Likewise, social and economic trends, such as baby booms and stock market fluctuations, are likely to influence distributional outcomes (David and Menchik 1988; Goldsmith 1962; Wolff 1979). While researchers have certainly addressed these subjects, empirical support for arguments has been somewhat limited by the availability of longitudinal data with adequate coverage.

My aim in this book is to begin to fill some of these gaps. I synthesize theory and data from various sources to present a detailed picture of household wealth distribution from 1962 to 1995. Furthermore, I isolate and examine some of the aggregate and family-level processes that create this distribution. I examine trends in the overall distribution of wealth among families, the movement of families among segments of the wealth distribution over time, and the distribution of the components of wealth (i.e., specific financial assets and real assets versus debts). To identify trends in wealth distribution even more clearly, I isolate and examine specific segments of the wealth distribution. I pay particular attention to top wealth holders, those who control the bulk of household wealth. I also identify trends in wealth ownership among both the middle class and the poor. Finally, in an effort to create a more unified picture of the processes that underlie trends in wealth ownership than has been available in the past, I explore the factors that have contributed to changes in wealth distribution, including both macroeconomic influences and microlevel influences.

To accomplish this, I synthesize data from various sources. I use basic data sources, including survey data (the 1962 Survey of the Financial Characteristics of Consumers, and the Surveys of Consumer Finances for more recent years), estate tax data on top wealth holders, and aggregate flow of funds data on household wealth holdings (e.g., the total amount of stocks, bonds, and housing assets owned by households in a given year). I also use a simulation model to literally synthesize these data sources into a single model of household wealth ownership. I draw on existing theory and research to identify potential sources of wealth inequality, and I use the simulation model to examine the feasibility of these ideas. The simu-
Introduction

ulation model allows me, for example, to ask questions about the distributional outcomes of stock market booms and busts. It also allows me to ask family-level questions such as whether the distribution of wealth would be different today if middle-class families had begun investing in the stock market decades ago. In addition to investigating the basic processes that lead to inequality, the simulation model allows me to address the implications of policies designed to lessen inequality. We know historically that the distribution of wealth has fluctuated dramatically with economic trends and changes in demographics. This might suggest that, in time, current levels of wealth inequality are likely to be lessened without intervention. Previous research cannot address this question, but it is one for which a simulation model is a highly useful tool.

What Is Wealth and Why Should We Study It?

When social scientists discuss financial well-being, they usually refer to income. However, I want to make a clear distinction between income and wealth. Wealth is property; it is the value of the things people own. Wealth is measured as net worth, defined as total assets (such as stocks, bonds, checking and savings accounts, the value of the family home, vacation homes, and other real estate) minus total liabilities (such as mortgage debt, the balance on credit cards, student loans, and car loans). Income is a flow of financial resources, such as wages or a salary received for work, interest and dividends from investments such as pensions, or transfer payments from the government. In contrast, wealth refers to the stock of resources owned at a particular point in time.

Income can, of course, be saved to produce wealth, but the two are not equivalent. Unlike income, wealth is not used directly to buy necessities such as food and clothing, but it can be used to generate income for these purposes. Assets such as stocks and bonds and, to a lesser degree, checking and savings accounts can produce interest and dividend income that can be used to satisfy either short- or long-term consumption needs. In the short term, wealth can be converted wholly or in part to produce income to meet consumption needs or to reduce liabilities. Similarly, wealth can satisfy long-term consumption desires through investment for long-term income streams, as in the accumulation of pension wealth to meet consumption needs after retirement. While there is a clear relationship between wealth and income, having one does not necessarily imply having the other.
Wealth and Inequality

In addition to producing income, wealth generates more wealth, allowing the rich to get richer. Because wealth appreciates, saving and reinvesting interest and dividends allows wealth to grow. Wealth can also be used as collateral to secure loans for further investment; many of the wealthiest people leverage their assets this way to produce even greater wealth. Wealth also allows its owner to combine consumption with investment, as in the purchase of houses and other real estate, land, vehicles, paintings, thoroughbred horses, or jewels. Frank (1999) used the term “luxury fever” to highlight the extravagant consumption that is possible, and that was increasingly obvious in the 1980s and 1990s, with great wealth. One of the most famous rich people of the 1990s, Bill Gates, Chairman of the Microsoft Corporation, built a 45,000-square-foot house on the shores of Lake Washington that cost more than $100 million and included a $6.5-million swimming pool. When new construction is considered “luxury” at $200 per square foot in many regions, the Gates mansion seems even more extravagant given that it cost more than $2,000 per square foot to build. Equally extravagant were the homes of Microsoft cofounder Paul Allen and Oracle CEO Laurence Ellison. Allen’s 74,000-square-foot house and Ellison’s $40-million, 23-acre complex have drawn nearly as much attention as Gates’s new home (Frank 1999:21–22).

In addition to the material luxuries it can buy, there are other more basic advantages of wealth ownership. Wealth not only allows the direct purchase of a home, but it also allows its owner to purchase advantages such as physical protection and a safe and pleasant living environment. Wealth can buy leisure, that is, it can allow its owner to decide whether to work or not. While there may be pressures associated with wealth ownership, it certainly removes the stresses associated with meeting very basic needs. In the words of Rebecca Jacobs, a woman who became rich as an entrepreneur, “Money can’t give you health, friends, love. But it can give you peace of mind” (Schervish, Coutsoukis, and Lewis 1994:47). Because assets can be used to lessen the impact of a financial emergency, wealth also provides economic security to its owners. Wealth can be used to indirectly gain advantages such as political influence, social prestige, flexibility, leisure, and improved educational and occupational advantages for oneself and one’s children.

Naturally there are also potential disadvantages associated with the ownership of wealth. Excess wealth can attract unwanted media attention and solicitations of various kinds. In some cases, wealth can invite secu-
Introduction

Inequality threats and may produce social isolation. Moreover, wealth ownership may dampen achievement motivation and performance in both those who have created wealth and those who stand to inherit it. A recent investigation provides detailed qualitative accounts of the privileged lives of the American super-rich as well as insights into how the wealthy portray themselves (Schervish, Coutsoukis, and Lewis 1994). The authors attempt to depict both the advantages and disadvantages of wealth ownership. The people they interview do seem to encounter various inconveniences associated with owning great amounts of wealth. However, the authors only succeed in demonstrating that, on balance, the advantages of having wealth far outweigh the potential disadvantages. In the words of Sophie Tucker, a famous entertainer who lived from 1884 to 1996, “I’ve been rich and I’ve been poor. Believe me, rich is better.”

In the context of these advantages, it seems even more remarkable that the majority of wealth is owned by less than 10 percent of the population. In recent decades, most people have not owned stocks, mutual funds, bonds, or even less-risky assets such as certificates of deposit. Most American families own checking and savings accounts, a vehicle or two, and tend to keep most of their assets in owner-occupied housing. In a common scenario, many middle-class Americans first use their income to make payments on a house to take advantage of tax breaks and the combination of consuming and investing that is available in homeownership.

After a mortgage payment, however, there is often little left over to save in other forms. Americans do tend to buy their homes and vehicles with credit, and they finance other expenditures with debt as well. In recent years, in fact, Americans have been willing to accumulate tremendous amounts of such debt, including large amounts of mortgage debt, car loans, loans for vacations, and home improvement loans. While such liabilities may ease short-term financial woes, their long-term effect is to diminish overall wealth along with the advantages associated with wealth.

In many cases, debt accumulation is unavoidable. Many middle-class and poor families are forced to take loans for daily survival and thus erode the small amount of wealth they may have accumulated. In their study of racial inequality in wealth ownership, Oliver and Shapiro interviewed a rather typical American couple. Albert and Robyn are both college graduates and Albert also has a master’s degree. They have been married five and a half years, have a two-year-old daughter, and both are currently employed. They bought a house when their daughter was born to make sure they had a suitable place to raise their child and also to take advan-
Wealth and Inequality

tage of tax credits for homeowners. Since the birth of their daughter and
the purchase of their home, however, they have been unable to save money.
They regularly borrow money at very high interest rates to pay short-term
bills. As a result, they have diminished their small savings and have accu-
mulated more debt than they feel comfortable with owning (Oliver and
Shapiro 1995:71–72). Like many Americans, Albert and Robyn are at high
risk of financial disaster as U.S. society virtually requires two incomes
to meet even modest financial obligations. Unlike the wealthy, most
Americans could not rely on their assets to replace lost earnings if they
were suddenly unemployed. Likewise, most Americans, like Albert and
Robyn, are not accumulating assets to pay for potential future expenses
such as college educations for their children and a comfortable retirement
for themselves.

Wealth, Income, and Inequality

In this book, I treat wealth as an intrinsically important indicator of family
well-being and one quite different from income. When wealth (rather than
income) is used as an indicator of family economic well-being, a different
picture of advantage and disadvantage emerges; this suggests that our
understanding of social inequality and social mobility has been limited by
our nearly total focus on income. Moreover, because of the financial secu-
rity and other advantages associated with wealth ownership, the control
of wealth has been an important determinant of well-being throughout
history, and the truly advantaged are still signaled by high net worth.
Despite the important role wealth plays in stratifying society, however,
existing studies of financial well-being generally use income to indicate
the relative status of families. Advantage and disadvantage are usually
measured in terms of current earned or total income or, less commonly,
the present value of potential future income. The recent emphasis on
income as an indicator of financial well-being has been the result of em-
pirical convenience because, in the words of one economist, “with the
advent of the income tax and the ever widening scope of census question-
ing, the government began to accumulate vast stores of data concerning
the incomes of individuals and families in America” (Winnick 1989:160).
Information regarding wealth holdings, in contrast, has not been investi-
gated as successfully by the government, in part because the wealthy have
strong incentives to conceal the details of their holdings from such aген-
cies as the Internal Revenue Service.
Introduction

Using income alone as an indicator of the financial well-being of families would be adequate if income and wealth were highly correlated. In reality, however, the correlation between the two indicators is relatively low. One study found that the correlation coefficient between income and wealth was 0.49 in 1983; while this correlation is already low, much of it is attributable to the inclusion of asset income (income generated by wealth) in the definition of total income. When asset income is removed from total income, the correlation between income and net worth dropped to 0.26 (Lerman and Mikesell 1988:779)! This suggests that the wealthy have rather low earnings, probably because they are able to support current consumption with income derived from assets. It also suggests that studies that focus solely on income miss a large part of the story of advantage and disadvantage in America.

Not only is the correlation between wealth and income low, but there is also substantial dispersion of wealth within income categories (Radner 1989). At all income levels, some families have acquired substantial wealth and own asset and debt portfolios that will maximize future wealth accumulation. Likewise at all income levels, there are those whose wealth is meager and whose portfolios indicate minimal potential for future wealth accumulation. In fact, many families, particularly nonwhite families, with both relatively low and relatively high incomes, have zero or negative net worth (Radner 1989; Winnick 1989). In contrast, many elderly households have low incomes but substantial net worth because they have had years to accumulate assets but no longer have earned income. For these reasons, many families found to be below the poverty line based solely on current income may be living quite comfortably on assets acquired during more prosperous years (Wolff 1990).

Moreover, wealth is even more unequally distributed than income. In 1989, the share of wealth of the top 1 percent of wealth owners was estimated to be 38.9 percent, while the share of the top 1 percent of income recipients was estimated to be 16.4 percent. The top quintile of wealth holders owned almost 85 percent of total household wealth, and the top quintile of income recipients received just over 50 percent of total family income. Another report (based on the Survey of Consumer Finances) found that wealth is more highly concentrated than income (Avery, Ellruthausen, Canner, and Gustafson 1984b). This report demonstrated that the top 2 percent of wealth owners owned 28 percent of total wealth in 1983, and the top 10 percent owned 57 percent of wealth. In contrast, in the same year, families with the highest incomes earned 14 percent of total income, and
Wealth and Inequality

those in the top 10 percent earned 33 percent. Moreover, the Gini coefficient for wealth increased from 0.80 in 1983 to 0.84 in 1989 (Wolff 1994). In contrast, the Gini coefficient for income in 1989 was 0.52. This evidence clearly illustrates that income tells only part of the financial story.¹

When wealth is used as an indicator of family well-being, a new picture of advantage and disadvantage emerges. For example, studies of income inequality suggest that a black middle class is emerging, and that the gap between the races is closing. Others, however, have argued that when family wealth is included, the existence of a black middle class is highly questionable (Oliver and Shapiro 1995). Oliver and Shapiro’s studies of racial differences in wealth ownership, in particular, provided strong evidence that black families have considerably less net worth than white families even when income is controlled. Similar differences are evident when wealth is included in other studies of wealth inequality, including those that focus on such indicators as age and cohort differences in well-being.

In addition to telling a different story about advantage and disadvantage, wealth comes closer both theoretically and empirically to our general understanding of well-being. When we talk about economic well-being, we are referring to how prosperous people are, to how financially secure they are. Income is an indicator of short-term security, a type of security that may be lost if markets change abruptly, if the income earner becomes ill or dies, or if one relocate with a spouse. Wealth implies a more permanent notion of security and an ability to secure advantages in both the short and long terms. It is this latter concept that likely fits our shared conception of well-being. This is also perhaps why most people, including social scientists, use the terms income and wealth interchangeably. It is the latter concept, however, that we should probably understand if we are to understand how well people are doing and what it really means to be disadvantaged.

How much wealth are we talking about when we refer to family wealth? Table 1–1 provides some indication of the total amount of family wealth outstanding in the United States. The first column in this table indicates

¹ The Gini coefficient is an indicator of inequality that is commonly used to indicate levels of income inequality. The Gini coefficient ranges from 0 to 1, with 0 indicating perfect equality and 1 indicating perfect inequality. Conceptually, if a single household were to own all wealth, the Gini coefficient would equal unity. Avery, Ellieshausen, Canner, and Gustafson (1984a) compare the Gini coefficient for income to the Gini for wealth ownership. I discuss the Gini coefficient more in Chapter 3.