A special report on the rich

After decades of prospering mightily, the wealthy may now be in for an extended period of austerity, says Philip Coggan.

Illustration by Alex Nabaun

Even the wealthy burghers of Monaco are feeling the pinch. At the principality's Le Metropole shopping mall the winter sales were still in full swing in early February. Upmarket retailers such as Lacoste and Christian Lacroix felt obliged to offer 50% reductions.

The rich will get little sympathy, but they have taken a big hit from the financial crisis. After all, they own a disproportionately large share of the equity and property markets. Many of them derive their wealth directly from the financial sector, working for hedge funds, private-equity firms or investment banks. A survey by Oliver Wyman, a consultancy, estimates that the financial crisis has caused high-net-worth individuals (as the banking industry calls the rich) to lose $10 trillion, or a quarter of their wealth. The annual Forbes list found that the global number of billionaires last year fell to 793 from 1,125, and a report by Spectrem Group, a research company, saw a drop in the number of American millionaires from 9.2m to 6.7m between 2007 and 2008.

A few businessmen who borrowed money against the security of their assets have seen their fortunes almost disappear. In Russia the number of billionaire oligarchs has halved, according to Finans magazine, and the assets of the ten richest tycoons have lost two-thirds of their value. Most spectacularly, one Russian businessman who had reportedly agreed to buy a villa in the south of France for €400m is in danger of losing a €39m deposit after backing out of the deal.

To many people this come-uppance of the rich will seem to be a good thing. The extremes of wealth in "Anglo-Saxon" America and Britain had reached levels not seen since the 1920s. The gains from recent economic growth flowed disproportionately to the wealthy. According to one study by Robert Gordon of Northwestern University and Ian Dew-Becker of Harvard, the top 10% of earners received the vast majority of the benefits of the "productivity miracle" of 1996-2005. Another international study found that only Mexico and Russia had more unequal income distributions than America.

Ajay Kapur, a strategist at Mirae Asset Management, dubbed this state of affairs a "plutonomy", an economy dominated by the spending of the rich. It was a world where the

wealthy might be born in France, work in London, park their money in Switzerland and have their business headquarters in the Cayman Islands. Such people seemed to inhabit a different country from other people, which Robert Frank, a writer, called “Richistan”.

That world of the wealthy emerged from economic and political changes in the early 1970s. Fixed exchange rates were abandoned, financial systems were liberalised, trade unions were confronted and taxes were cut, all of which helped usher in the asset-price booms of the 1980s and 1990s. Some of those who played the markets with borrowed money—the founders of hedge-fund and private-equity firms—became billionaires.

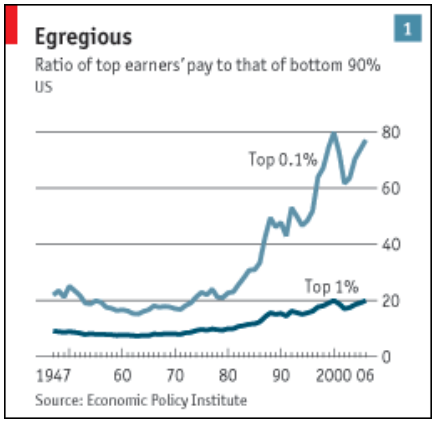
A rebound in profits from the low levels of the 1970s, combined with the use of share options as incentives, allowed chief executives to make fortunes. The opening up of the Russian, Indian and Chinese economies, allied to a boom in commodity prices, created a whole new batch of emerging-market plutocrats.

The size of the accumulated wealth was stupendous. The Forbes 400 richest people in 1982 had a combined net worth of $92 billion; by 2006 they owned $1.25 trillion. To make it onto the first list in 1982, you needed a net worth of $75m; by 2006 you had to be a billionaire. A lot more of this money was self-made; inherited wealth made up over 21% of the first list and under 2% of the 2006 roster. And almost a quarter of the 2006 rich owed their fortunes to the finance sector, compared with less than a tenth back in 1982.

The rich man in his castle

It would have been easy to conclude that the tide of history was simply resuming its usual flow towards greater inequality. For much of the time since records began the normal state of affairs has been extremes of wealth, whether in the hands of aristocratic landowners or industrial entrepreneurs. The period after the second world war, labelled by economists as the “great compression”, when wage differentials narrowed and taxes went up, looked like an historical anomaly.

But now the tide is turning again, reflecting widespread resentment of the mess in which the financial sector has landed the economy. The public may have been willing to tolerate extremes of wealth and pay when the economy was producing growth and jobs, but now it has become more suspicious. Why did bankers enjoy bonuses during the boom years but leave taxpayers to foot the bill during the bust? Why should companies be allowed to dodge taxes and sack workers by shifting operations overseas?



What is happening now could mark one of those sea changes in public policy that seem to come along once in every generation. In the late 19th and early 20th century a decline in American farm incomes prompted a rise of populism and progressivism that led to attacks on corporate trusts in America under Theodore Roosevelt. In the 1930s the Depression led to the

New Deal and the re-regulation of the financial sector in America, and the rise of fascism in Europe. Reaction to the economic crisis of the 1970s ushered in the Thatcher and Reagan reforms.

Governments are already trying to deal with public anger about manifestly unfair gains by capping bankers' bonuses. The level of regulation will increase, and taxes will inevitably rise as governments struggle to contain their bulging budget deficits. As President Obama's budget proposal showed, the rich will be tempting targets for those tax hikes.

It is also possible that globalisation may come under threat as governments seek to placate their voters by protecting local jobs and industries. Already banks are being urged to lend money to domestic rather than foreign businesses. The German and American governments are leading an attack on bank-secrecy laws in tax havens. The elite may no longer find it so easy to move itself and its capital from country to country, depending on where the returns are highest and the taxes lowest.

All this may bring a reduction in inequality, especially in the Anglo-Saxon economies where it seemed to have increased most. The big question is whether this will be short-lived, linked solely to the crisis, or turn out to be something more structural. Social safety nets are much better developed than they were in the 1930s, which may make the poor less desperate and constrain their anger at the rich. But the search for scapegoats will be on.

For the moment the pressure is being felt by businesses that service the rich. Ferretti, a top-of-the-range yacht manufacturer, has defaulted on part of its debt; creditors are set to get just 11 cents on the dollar. The decision by Saks, an exclusive retailer, to slash prices during the 2008 holiday season caused consternation among some luxury-goods groups. Sales at Tiffany's American jewellery stores have plunged. De Beers has suspended production at one of its biggest diamond mines.

And even wealthy people who are not feeling the pinch may have become more cautious about spending ostentatiously. Net-a-Porter, an upmarket fashion website, now offers the option of having designer outfits delivered in a brown paper bag.

Fee for no service

Those who look after rich clients' wealth are already in trouble. Surveys indicate that the better-off are highly dissatisfied with the service provided by their private banks, which failed to protect them from the market falls of the past 18 months. The fraud that caused investors who handed their money to Bernard Madoff to lose tens of billions of dollars has raised new doubts about the safety of portfolios and about the due diligence undertaken by wealth managers.

All that said, there are still plenty of rich people around. Someone was confident enough to pay $20m for a Degas bronze at an auction at Sotheby's in February. Diners at the Hotel Metropole in Monaco are still willing to shell out €137 for a grand dish of rock lobster.

But the outlook for the rich is no longer the "glad, confident morning" that it seemed just two years ago. In a survey of high-net-worth Americans by Harrison Group in January, 78% said their sense of financial security had been undermined by the crisis; only 46% were optimistic about their own future, against 93% in 2005.

This special report will explain how disparities in wealth and income became so wide in the first place and ask whether that process will now go into reverse. And it will examine how well the rich are coping with the crisis—because that will matter for everyone else too.

Bling on a budget

Designer belts are being tightened

A WEALTHY Mexican walked into an exclusive shop in Vail, Colorado, late last year and picked out $11,000-worth of clothes to lay on the counter. He perused them for a minute, then offered the sales assistant $6,000 for the lot. The shop countered with an offer of $6,800.

The rich are economising, and the businesses that deal with them are having to cope. In a survey of wealthy individuals conducted by Harrison Group, 80% said they were looking at each spending category to see what they could save, 77% were buying fewer big-ticket items and 78% were waiting for the sales before buying such items. Across the board, Harrison's Jim Taylor reckons the wealthy are spending 30% less than before, the sole exception being items for their children.

Claudia d'Arpizio of Bain Consulting reckons that the luxury-goods market probably grew by only 1% last year, having suffered heavily in the fourth quarter. A dramatic estimate of the decline during the holiday season was made by SpendingPulse, part of the MasterCard credit group, which calculated that luxury-goods spending between November 1st and December 24th 2008 was down 34% year-on-year. Bain thinks the first half of this year will also look grim.

The effects are showing up across the industry. Bulgari of Italy reported a 17% drop in jewellery sales and a 28% decline in watches in the fourth quarter; Tiffany's said sales in its American stores dropped 35% in November and December; Richemont, a Geneva-based group with brands such as Cartier, saw its sales fall by 12% in the three months to December. LVMH did rather better than the rest, reporting revenue growth of 4% in the fourth quarter, although the watches and wine divisions suffered small drops year-on-year.

Moreover, shoppers for luxury goods can be frustratingly inconsistent. Although the overall trend is down, demand in one shop can be up 50% one day and down 50% the next. Manufacturers and retailers find it hard to budget or plan stock levels.

The wealthy are cutting back on leisure spending as well. According to Smith Travel Research, in the week ending February 21st occupancy rates in luxury hotels were 17.5% down on the same period in 2008, and revenue per room was 27.5% lower. That has caught out some hotel owners who took on too much debt; in Colorado, the owner of the Vail Plaza Hotel & Club filed for Chapter 11 bankruptcy in October.

Vivian Deuschl of the Ritz-Carlton hotel group says corporate bookings have been particularly badly hit. This has become known as the “AIG effect”, after the insurance group that was rescued by the American government last autumn and several times more since. Shortly after the first bail-out it emerged that the group had spent $440,000 on a spa retreat for salesmen. Political outrage at the junket led other companies to rethink their plans. “Even if businesses have money,” says Ms Deuschl, “they are very skittish about spending it at luxury hotels.”

In addition, the conference market is taking a hit because of the business downturn. The Fairmont hotel in Monte Carlo, which is close to the Grimaldi conference centre, says events are being booked at much shorter notice. Some hotels are reacting to this by trimming non-essential spending; using potted plants as decorations, for example, instead of fresh flowers that have to be replaced every day.

Just like flowers, servants are being pruned. David Gonzales of the Domestic Placement Network in southern California says that a number of chefs have lost their jobs. Live-in chefs are very expensive to maintain and their employers can economise by eating out more, entertaining less and using contract caterers when they have dinner parties at home.

Nor has the crisis driven the wealthy to drink. Champagne exports fell by 4.8% last year. An index of fine-wine prices dropped by 18% after the Lehman Brothers collapse; Simon Staples of Berry Bros & Rudd, a London-based fine-wine merchant, says that some prices have dropped by 40%. But that still leaves the prices of some vintages, such as the sought-after 2005s, well above their initial levels.

Flash fatigue

There seem to be two main reasons why the wealthy are tightening their purse strings. The obvious one is the hit to their portfolios from the equity and property markets. “It’s not just that they’ve lost money,” says Russ Prince of Prince & Associates. “They’re not sure how much more they’re going to lose.”

The second reason is a feeling that it is wrong to show off at a time when the economy is in recession and people are feeling poor. Conspicuous consumption is out. The top end of the watch market is suffering, not least because such watches are often bought out of bonuses in the financial sector, which have largely dried up.

Mr Taylor of Harrison Research points to a boom in sales of used luxury cars. “You don’t want to pull up in your driveway with a new Mercedes when you know your neighbour is suffering.” Tastes may shift from the flashy to the practical; cashmere knitwear may still be acceptable whereas extreme fashion is not.

All this comes after many boom years in the luxury sector. An indication of the demand for top-of-the-range goods can be found in Forbes magazine’s “cost of living extremely well” index which includes items such as facelifts, fur coats and Gucci loafers. It almost quadrupled between 1982 and 2006, whereas the broadly based consumer-price index merely doubled.

Stephen Abery of the broker Fraser Yachts says that roughly half of the world’s 100 biggest yachts have been built since 2000. Some are more than 150 metres long, half as much again as a football pitch. Even a 70-metre version could cost €100m to build. And what with a dedicated crew, mooring, fuel and insurance, the annual running costs will be in the millions.

The cost of finding trained crew has gone up sharply in recent years, says Mr Abery, although the trend has softened recently. Wages for domestic servants have also shot up: Mr Gonzales says demand has tripled in recent years. Steven Ferry of the International Institute of Modern

Butlers says there has been a big jump in the use of butlers in hotels, where they serve the occupant of a suite or a range of suites.

It is not quite a return to the world of P.G. Wodehouse's Jeeves (a valet, not a butler), who looked after Bertie Wooster. Modern butlers often act as household managers rather than serving up drinks on silver trays. Their employers tend to be asset-rich and time-poor and need staff to maintain a range of properties.

The market for luxury goods and services is highly stratified. There is a big gap between those who can afford a butler and those whose only foray into the market is to buy a Gucci handbag. Marc Cohen of Ledbury Research points out that the high-profile wealthy make up only 0.1% of consumers; luxury-goods groups have to aim a bit wider to do well. But expansion can create a dilemma. If it is overdone, a brand can lose its cachet.

Guy Salter of Walpole, a British luxury-goods association, says the industry has done so well for so long that it lost sight of some of the issues. "A hundred years ago luxury-goods manufacturers were small family-owned businesses who knew their customer base very well. By the 1970s and 1980s there were lots of people flocking to buy luxury goods who were happy to pay for the flash and the logo. The companies stretched the elastic too far," he argues.

Crafting a new strategy

The recession may cause manufacturers to rethink their strategy. Ledbury's Mr Cohen says the wealthy may decide they will buy fewer things but will go for higher quality: less bling and more craftsmanship. This may favour a group such as Bottega Veneta which produces handbags without a logo but with a distinctive stitching pattern.

Another group that thinks it can benefit from the change in mood is NetJets, which allows both the rich and the corporate elite to fly privately without the expense of owning their planes. The company says the average corporate client spends €700,000-800,000 a year, compared with the €17m-18m it would cost to buy a mid-size jet. NetJets is hiring 12 new salespeople in a bid to capture market share; it may be helped by the fact that owning a jet has come to symbolise corporate excess.

Most companies associated with the luxury-goods market, however, will have to adjust to a decline in demand. Mr Salter says that manufacturers cannot react to the squeeze by cutting costs unless they can maintain quality. "Integrity comes from having craftsmen," he says. "The wealthy are not going to economise on good taste."

Luca Virgilio, who runs the Hotel Metropole in Monaco, says it would be a mistake for him to compromise on quality; clients visit the hotel precisely because it is luxurious. Rather than cutting prices, the hotel is offering more services for the same price in an effort to keep clients loyal.

It is a tough call to make. Keeping standards and prices high maintains elite appeal but risks losing some customers to lower-cost alternatives. What makes the call even more difficult is that the ranks of the rich have changed over the past 20 years; old money has become less important. "A lot of the wealth of the past 20-30 years is self-made and they are looking for value," says Walpole's Mr Salter. "Most of even the super-rich were middle-class 20 years ago."

Cheap thrills

Retailers' plans were thrown into disarray when Saks Fifth Avenue decided to cut prices on designer clothes by up to 70% even before the start of the holiday season (defined as Thanksgiving to Christmas). The strategy helped Saks avoid being burdened with excess stock in January, but rival shops were made to look very expensive and felt they had to follow suit.

Nordstrom, a department-store group, reported a 68% fall in fourth-quarter net profit, thanks to a decline in margins prompted by price cuts. The markdowns solved the immediate problem of excess stock but did nothing to solve the medium-term issue of slumping demand; the Seattle-based retailer is forecasting a 10-15% decline in same-store sales this year. There is also the longer-term question of whether consumers might get hooked on price cuts. "The very big discounts by department stores may have created a dangerous attitude in shoppers, that it is a little bit irrational to pay the full price," says Bain's Ms d'Arpizio.

Many of the wealthy may be migrating to the internet. Mr Salter cites a survey showing that they are happy to buy online; some 40% said they preferred net-based shopping because they felt uncomfortable going into luxury-goods stores. But online shopping holds its own dangers. Last year a French court fined eBay €40m for allowing auctions of fake luxury items on its site. The problem of counterfeiting may get worse as wallets get squeezed.

Senior people in the industry admit this is going to be a very difficult year. The best they can hope for is that the rich will concentrate their spending on the highest-quality stuff. Cutting corners can be a false economy; a cheap handbag, one expert argues, can drag down the rest of a woman's outfit. Manufacturers think it is better to accept lower sales than lower margins. They worry that just by trying to get through 12-18 months of crisis, they might be ruining their brands. But it is a big bet, and some of those brands will not survive.

A thing of beauty

The best works of art still command fancy prices.

IN CHRISTIE'S Paris auction room on the evening of February 23rd it was as though the financial crisis had never happened. A sale of works of art collected by the late designer Yves Saint Laurent brought in $264m, well ahead of the estimate of $232m (though a Chinese buyer refused to pay for some bronzes as a nationalist protest). Records were set for works by Piet Mondrian and Marcel Duchamp, although a Picasso failed to meet its reserve price and was withdrawn.

At Sotheby's, meanwhile, sales of Impressionist, modern and contemporary art in February raised $100m, including a record £13.3m ($20m) for a Degas sculpture. The same piece had been bought for $9.1m in 2004.

But the art market has hardly come through the crisis unscathed. Ian Peck of the Art Capital group reckons that prices have dropped by 20-30%, with the contemporary market particularly badly hit. His group, which lends money to art buyers, has reduced estimated values of collateral by up to 50%.

What the February auctions showed was that there is still money around to bid for exceptional pieces. But the auctioneers are being much more selective about the works they are offering for sale and have abandoned the boomtime practice of guaranteeing prices. These attracted buyers and allowed auctioneers to take part in the upside, but carried a big risk when the market turned.

That risk has duly surfaced. Sotheby's reported a 52% decline in revenue in the fourth quarter of 2008, with a 46% fall in auction sales. The company reported "significant auction-guarantee losses and inventory writedowns" and is cutting its staff by 15%. "We are forecasting lower sales volumes for 2009," says Ed Dolman, chief executive of Christie's. "But there have been seen some very high prices paid for individual items, including the highest price ever paid for a diamond."

Some buyers, such as the hedge-fund titans, may have been hit by the financial crisis, but the art world has yet to see a lot of forced sales. "The market is driven by the Ds, death, debt and divorce," says Mr Dolman. "There is a fourth D, discretionary selling, but there has not been much of that so far."

The previous art-market downturn was 20 years ago, after record prices were paid for Impressionist works, including $54m for "Irises" by Vincent van Gogh. The buyer of that work, Alan Bond, an Australian tycoon, turned out to have borrowed part of the purchase price, and struggled to repay the loan after his business empire collapsed. At the time he was competing for the paintings with a group of Japanese buyers whose fortunes had been boosted by the boom in their country's land and share prices in the late 1980s. When the Japanese economy slumped in the early 1990s, the art market fell back sharply.

Art-buying during the recent boom has been far more broadly based, taking in Asia, Russia and the Middle East. The Russians may now have receded again, but art experts hope that the rest of the market will prove more resilient this time.

Show them the money

The rich have become disillusioned with the people who look after their fortunes.

ONE of the problems with being rich is that you cannot just leave your money to sit there: you have to do something with it. Few people feel confident enough to throw themselves into the hurly-burly of financial markets on their own. The wealth-management industry exists to take that problem off their hands, for a pretty hefty fee.

Unfortunately for all concerned, the industry tends to promise more than it can deliver. Last year was disastrous for financial markets, with the MSCI World index of equities falling 42%. Moreover, many clients, having been persuaded of the benefits of diversification in recent years, had bought alternative assets, such as hedge funds and private equity, which supposedly offered absolute (positive) returns uncorrelated with the stockmarket. But when the crisis came, those assets turned out to be highly correlated to the mainstream and lost value as well.

The final straw came at the end of last year when the extent of the Madoff scandal was revealed. Bernard Madoff pleaded guilty to running a Ponzi scheme in which he was paying early investors consistent returns by taking the money from later ones, with potential losses in the tens of billions of dollars. Just what were wealth managers doing to earn their fees if they could not spot the scam?

So there is now fairly widespread dissatisfaction with the industry. “The old wealth-management universe is not just broken, it’s been broken and tossed away,” says Russ Prince of Prince & Associates, a market-research firm. “Nobody believes anything anybody is saying any more.” A survey by his company showed that 15% of the wealthy had left their main adviser last year and a further 70% had pulled some of their money away.

A survey of rich Americans by Harrison Group found that 63% had lost faith in financial institutions. And Caroline Garnham of Lawrence Graham, a London law firm, says that half of her clients do not use private wealth management at all, and half of the remainder are dissatisfied with the advice they received.

The private wealth-management business has always been rather murky. Ask for performance figures, and the best you will get is the record of some model portfolio; clients are all different, managers say, and have different attitudes to risk. Besides, they argue, looking after a client is not just about performance, it is also about tax management, family structures and all manner of other things. Some clients have strong opinions and will want a say in how the portfolio is run; others will have long-standing positions in particular businesses or properties that they may be unwilling or unable to sell. So a private-client portfolio will normally look quite different from a pension-fund version with its careful mix of equities, bonds and property.

These constraints are real enough, but they make it very hard to measure the “success” of a private-client manager. A lot may depend on the trust between the individual client and the relationship manager at the bank; if the bond is strong, then a bad year such as 2008 can be explained away. This can be an advantage to private banks once clients are on the books; inertia may keep them there, if only because clients can rarely be sure that they would be better off elsewhere.

Who rates as rich?

How much money do you need to count as wealthy in the first place? For a wealth manager, it depends on how big a portfolio you can give him to manage. For example, Merrill Lynch’s wealth-management report starts counting at $1m in “investible assets”. That excludes

people's main homes, which may seem reasonable. But it means that a Londoner who sells his home and decides to rent can suddenly find himself "rich".

In fact, a lot of wealth managers will not bother with anyone who has less than about $10m in assets. After all, a portfolio of $1m these days would generate an income of only $30,000 if invested in Treasury bonds, which does not leave much scope for the playboy lifestyle.

Putting performance to one side, another big issue for the industry is the quality of advice on offer, and whether it is sufficiently impartial. In many cases private banks may be part of larger groups that see an advantage in having a captive client base for their other activities. This link is made explicit in a recent report on the wealth-management industry by Boston Consulting Group (BCG). "Some players position their private banks within their corporate or investment banks," the report says. "This approach aims to keep the client's wealth in a single institution and tap product-development synergies."

These synergies often turn out to benefit the banks a lot more than the clients. As Stefan Jaecklin of Oliver Wyman puts it, "in the integrated banking model there are limited benefits for the private bank from having an investment bank attached; the benefits mainly flow the other way round. A lot of private banking has not been about advice but about pushing products. Often bankers will be rewarded not just on the basis of assets under management but on product sales."

Jacques de Saussure of Pictet, a Swiss wealth-management group, agrees. "We have avoided having an investment bank within the Pictet group because it creates lots of conflicts of interest," he explains. "The wealth-management business can become a distribution channel."

An important development in recent years has been the use of so-called structured products. Like the toxic versions that were undone by the collapse in the American housing market, these products involve the use of derivatives. That makes them a tempting sales opportunity for investment banks with derivative expertise. An enthusiast would say that these products often have tax advantages and can be used to manage an investor's risk profile; a cynic would say that the structures can disguise a lot of fees and charges.

A gamble by another name

Some structured products may be a reasonable way of enticing investors to take a bit more risk; for example, with an investment that offers 90% of the growth in an equity index but with a guaranteed return of capital if the market falls. But others, particularly those involving commodities, may be a vehicle for gambling. "A lot of structured products were speculative in nature, with questionable purpose in a private-banking context," says Mr Jaecklin.

These structured products can quickly turn into dead money if markets move against them, with clients locked in for years or able to redeem only at fire-sale prices. "Structured products can become illiquid and pricing can be at the mercy of the issuer," says Pictet's Mr de Saussure.

Another issue emerged from the collapse of Lehman Brothers. In some cases the guarantee on a structured product was provided by the failed investment bank; this meant that clients did not get their promised money back after all.

But the bigger problem has been investment losses. During the boom years some Asian private-banking clients were sold a toxic product known as an accumulator. The structure sounded simple. If shares in a company, say General Electric, stayed above a given level, investors received a high yield; if the shares dropped below that level, they ended up owning the stock. In effect, the clients had written a put option on the share price. That was fine in

rising markets but proved to be a disaster in 2008 when clients ended up owning shares that were falling rapidly.

Asian clients may have been sold more of these products because they were generally seen as being willing to take rather more risk. As one observer remarks, many of these clients were people who were earning 25% a year from their own businesses; they found it hard to understand why private banks were offering much lower returns. Raj Parmar of HSBC Wealth Management says there was “little doubt that the Asian wealthy did exceptionally well in the past five to seven years and better than their counterparts around the world. However, a lot of institutions were knocking on their door and outbidding each other on returns, often using leverage. By late 2008 many Asian investors gave away a substantial proportion of the profits they made in those five to seven years.”

Many Asian clients will have been caught out by the sharp falls in local markets last year, with the Shanghai A share market dropping by 65%. Even so, the industry sees the region as a promising area for expansion. According to BCG, assets under management in China grew at a compound annual rate of 25% between 2002 and 2007, though the figure will have taken a big hit in 2008. Another growth area was central and eastern Europe, which had four of the ten fastest-growing wealth markets in 2002-07: Poland, Slovakia, Hungary and the Czech Republic.

Wherever the clients are based, they are likely to have been chastened by the experience of the past 18 months. Like everyone else, rich people want the impossible: high returns with no risk. But their biggest fear, naturally enough, is losing a chunk of their wealth so large that they would have to adjust their lifestyles to live on a smaller income. So at times of trouble they will retreat from risky assets such as hedge funds and into cash and government bonds. Some have called it the “back to basics” market. “For the next 18 months to two years, investors will be a little cautious,” says HSBC’s Mr Parmar. “They are going to demand more explanation of what is in their portfolios. It is hard to sell a black-box product today.”

Golden glow

Indeed, there is considerable demand for that most ancient of financial products, gold. According to the World Gold Council, investment demand for bullion between 2007 and 2008 rose by 64%. Pictet, the wealth-management group, decided some time ago to take physical delivery of gold (rather than get exposure via the derivatives market), and has had to find extra space in its vaults.

This change in behaviour is, in itself, a challenge for the private-banking sector. Oliver Wyman suggests that the shift from equities and structured products into cash and fixed income will reduce private-bank revenues by around 20%.

Moreover, the Madoff scandal and the controversy surrounding Sir Allen Stanford, a rich Texan accused of an $8 billion investment fraud, raises a lot of questions about what private wealth managers actually do with their clients' money. How could such groups pass due-diligence tests when they used obscure auditing firms and kept their investment processes so secret? According to Jérôme de Lavenère Lussan of Laven Partners, a company that specialises in due diligence, "there has been a degree of complacency and laxness about how people choose investments."

There may well be some consolidation in the fund-of-hedge-funds industry, where many people have been amazed to find that managers charged 1% or 1.5% of the sums invested a year for their supposed skill in scanning the industry, only to send clients' money to Mr Madoff. With the sector already losing money after suffering unexpected losses in 2008, many funds-of-funds may be forced to close. "We expect that firms which suffered from exposure to Madoff (almost regardless of the scale) will see material redemptions as investors react to perceived lapses in the due-diligence process," says Huw van Steenis, a finance-sector analyst at Morgan Stanley.

The rest of the wealth-management industry may also have to change. Fees have not been transparent, with clients getting charged for a whole range of services and some managers taking "retrocessions" or kickbacks from outside funds with which they place money. "The industry needs to move to a model where advice is being charged for and money flows are transparent," says Mr Jaecklin.

Downward pressure on fees seems inevitable. In the 1990s, when investors were earning 20% a year, fees seemed a trivial issue; but when cash is yielding 1-2% and government bonds 3-4%, they take a much bigger chunk of total return.

Given their losses in 2008, clients may also be attracted to banks which they believe to have weathered the crisis better than others; Credit Suisse and JPMorgan are both reporting significant inflows. Another section of the market that may do well is private family offices, which deal with the wealth of a single dynasty or a small group. Their main drawback is that they require considerable resources to set up, so may not be worthwhile unless a family has around $1 billion. Multi-family offices, such as the London-based Fleming Family & Partners, are another option.

There is a natural inertia about wealth management. Clients may want to believe that they made the right choice of adviser in the first place, or will "cling to nurse, for fear of finding something worse". They may also feel they lack the expertise to evaluate the service they are getting. "Private clients don't know enough about the industry to be able to demand what they need," says Ms Garnham. But the financial crisis will have shaken many clients out of their lethargy. The next few years will see big changes in the wealth-management industry. In future, firms will have to deliver as well as promise.

Dropping bricks

A runaway boom in property prices has gone into reverse.

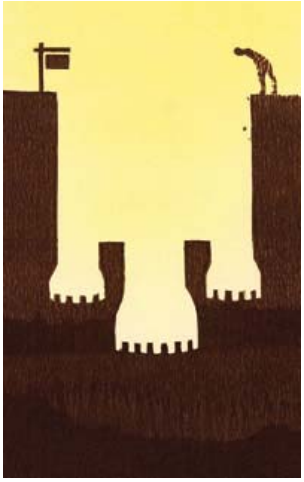


Illustration by Alex Nabaun

IF ANY market has been distorted by the activities of the rich over the past decade, it must surely have been property. For a while it seemed as if the plutocrats were competing against each other to pay the silliest prices for the smartest locations.

Even though prices are now retreating, in some areas they still seem over the top. A two-bedroom apartment in Monaco shown to The Economist did have a view of the bay, but it was not helped by an elevated highway bang in front and a noisy building site next door, and the kitchen was tiny. The price was a staggering €8m, enough to buy three or four substantial houses in, say, west London.

But the rich do not want to live in the wilds of west London. Estate agents in that city say they balk at any property more than 800 yards from Hyde Park Corner. In New York the wealthy want to live either by Central Park or all the way out in the Hamptons; in Europe they aim for Monaco or the French Alps. Combine a limited number of preferred locations with the massive increase in wealth over the past 20 years and you get ridiculous prices.

Monaco's property market benefits from a shortage of space and tax advantages so persuasive that foreign residents far outnumber the locals. Last year it became the world's most expensive residential location measured by price per square metre, according to a survey by Knight Frank, a firm of estate agents (see chart 3). The prime areas of London slipped into second place because of the weakness of the pound. But even Monaco's market is suffering. Pascal Chaisaz of Savills, another estate agent, says that during the frenzy of 2006-07 prices reached €100,000 per square metre. They have now fallen back to €50,000, but that is still a lot more than the €15,000-20,000 at which they traded six or seven years ago.

The price of a smart address 3

Prime residential property, Q4 2008

	€ per sq m	$ per sq ft
Monaco	50,000	6,550
London	28,000	3,670
New York*	16,500	2,160
Moscow	16,200	2,120
Paris	16,000	2,100
Tokyo	15,850	2,080
Hong Kong	15,750	2,070
Rome	13,500	1,770
Singapore	11,850	1,550
Sydney	11,000	1,440

Source: Knight Frank Residential Pricing *Manhattan

The curse of Lehman

Agents generally agree that the top end of the market was doing very well until September 2008 when Lehman Brothers went to the wall. Liam Bailey of Knight Frank says that in the first half of 2008 the group sold twice as many houses in the £10m-plus category as it did in the first half of 2007. But the super-rich segment of the market has since dropped as steeply as anything else.

Knight Frank says that 37 of the 55 prime international locations it covers saw price falls in the last quarter of last year compared with a year earlier. Hong Kong, London, Singapore and Sydney all suffered double-digit declines over that period. The hardest-hit market may be Dubai, which indulged in a flurry of building in recent years in its bid to become a global financial centre. As speculators have fled the market, some prices have fallen by 50%.

Pamela Liebman of the Corcoran Group says the market in Manhattan has suffered as well. Bonuses in the financial sector have either fallen sharply or disappeared altogether, and hedge funds are struggling. Moreover, in a new spirit of discretion, buyers do not want to see their names publicly associated with a high-priced purchase; they are trying to do deals below the radar. Ms Liebman estimates that prices for the most expensive properties in New York have come down by 20-30%; in the Hamptons, where the rich have their summer homes, some buyers are making offers 40% below the peak. But, she adds, “there is a real disconnect between what buyers are willing to pay and what sellers will accept.” That has led to a big fall in transaction volumes.

Other smart addresses are also suffering. In Vail, Colorado, the number of transactions in December 2008 was the lowest for any month since the Land Title Guarantee Company began tracking deals in 1996; in nearby Aspen the local Sotheby’s International Realty office has closed. In California sales of million-dollar homes fell by 43% between 2007 and 2008, according to MDA Dataquick, with sales in Beverly Hills dropping by 30%. In February the Beverly Hills city manager was forecasting that the property downturn would cause an imminent 15% drop in tax revenues.

Manhattan and London are clearly affected by the downturn in the financial sector. But the uppermost end of the London market, argues Yolande Barnes of Savills, prospered until September last year because it was the preserve of the international wealthy. However, even the very rich now seem to be affected by the gloom. Russian buyers seem to have vanished altogether, whether in London, Manhattan or Monaco. There is now much scepticism about the plans of the Candy brothers, a firm of British developers who have been trying to create a new class of property with luxurious fittings and abundant services suitable for the global elite. Will the rich still be willing to pay a premium for such places?

Although the very wealthy can pay cash for their homes, they often do not want to tie up too much of their capital that way. But borrowing has become a lot more difficult. Simon Gammon of Knight Frank says that British banks now like to see a 60% loan-to-value ratio, rather than the 75% they would have accepted in the old days; and the spreads against LIBOR (the banks' benchmark rate) have risen. Some banks now try to use mortgages as quid pro quo for other business opportunities; for example, clients may be required to place money with their wealth-management arms before they are given a loan. Ms Liebman says American banks are also being more cautious, particularly about allowing for bonuses when calculating bankers' incomes.

Forecasting the bottom of the market is a tricky task, particularly at the prime end. For highly prestigious properties, valuation measures such as price per square metre are only an approximation. Paying $20m for an apartment might seem absurd to most people but would represent only a small part of a billionaire's portfolio.

Pride before the fall

Nevertheless, it was clear that the prices of the best properties became inflated. In 2007 Tim Blixseth, a luxury-resorts developer, advertised a 160-acre property near Bozeman, Montana, part of the Yellowstone Club, at a remarkable $155m. The resort has since gone into bankruptcy. The property was never built and the lot was sold for $10m.

Peter Mackie of Property Vision thinks that London prices could easily fall 50% from their peak. The market did very little in 2001-05, he says, and then took off with a whoosh because of bonus money. According to Savills' global residential review many markets have seen a decade of price rises of 10-20% a year. "Against such a backdrop, even today's largest falls of 50% in some cases will still leave a long-term legacy of substantial price growth," says Charles Weston-Baker, director of Savills' international residential department.

More or less equal?

The gap between rich and poor has been widening for 30 years. It has started narrowing again.

THE past 30 years have been a great time for the wealthy. Their businesses became more profitable; their equities and properties increased in value; for those who worked in investment banking or hedge funds, bonuses rose steeply. And the further up the income scale you went, the better the rich did. Just as the bottom 90% of the population have lagged far behind the top 10%, most of those in the top 10% have trailed the elite 1%. And that select 1% has looked in envy at the Croesus-like 0.1% at the very top of the tree.

Any explanation for this rise in inequality needs to account for several different trends. In the 1980s the poor fell further behind the middle classes, but since the 1990s those middle classes have been squeezed. Both groups have lost ground to the elite. Between 1947 and 1979 the top 0.1% of American earners were, on average, paid 20 times as much as the bottom 90%, according to the Economic Policy Institute, a think-tank in Washington, DC; by 2006 the ratio had grown to 77. In 1979, 34.2% of all capital gains went to the top 1% of recipients; by 2005 the figure was 65.3%.

All this happened during a period when American workers' median real incomes stagnated (though the notional value of any health insurance would have risen steeply). In 2007, according to the Census Bureau, the median income of American male workers was $45,113, less than the $45,879 (in 2007 money) that they earned back in 1978 (see chart 4). At no point over that 29-year period did median incomes pass the $46,000 mark. Families made ends meet because more women worked (and their real incomes did rise) and because they were able to borrow money to maintain their spending.

The classic tool for measuring inequality is the Gini coefficient. The higher it is, the less equal the society. In America the coefficient climbed steadily from 0.395 in 1974 to 0.47 in 2006 before dipping slightly to 0.463 in 2007. In Britain, according to the Institute for Fiscal Studies, the Gini has risen from 0.25 in 1979 to 0.35 in 2006. Figures from the United Nations suggest that America's Gini coefficient is lower than that of many developing countries but well above the levels recorded by egalitarian Denmark, Finland and Sweden, where it does not seem to have risen much.

The recent widening of inequalities marked a complete reversal of the previous trend. From the 1930s to the late 1970s wealth disparities in developed countries declined sharply. But which is the anomaly: the earlier period of high tax rates and rapidly growing state involvement in the economy, or the rising inequality of the past 30 years?

The norm and the exception

Historically, it seems that the rich, like the poor, have always been with us. Even so, the change of course in the 1980s calls for an explanation, as does the fact that inequality has risen far more in some countries than in others. There is a clear gap between America's and Britain's "Anglo-Saxon" model and the rest.

That makes some explanations for the widening disparities look suspect. One is the widespread use of technology, which might be expected to favour those workers who are able to exploit it. But the Nordic economies are well up on technology; Finland, for instance, is home to Nokia, a huge mobile-telecoms group. Technological change may explain why unskilled workers have lost ground to graduates. But it does not explain why such a wide gap has emerged at the very top of the income scale, with the top 0.1% outpacing other professional workers.

The disappearance of the ultra-high tax rates that were prevalent in the 1970s helped the rich hang on to their gains. But work by two academics, Thomas Piketty and Emmanuel Saez, shows that inequality has been just as marked in pre-tax as in post-tax incomes. And why did governments propose (and voters approve) such tax cuts in the first place? There was a feeling in the 1970s that the post-war economic model had been corroded by rising inflation and a series of oil shocks. That helped prepare the ground for the Reagan and Thatcher reforms.

As for inequality lower down the scale, a study of the literature by Robert Gordon and Ian Dew-Becker cites the decline in trade unionism as a big factor, at least for men. In 2005 only 14% of American workers were union members, compared with 27% in 1979. The decline in unionisation may also help to explain the political acceptance of the low-tax, low-regulation regime. Political parties are no longer as dependent as they were on union donations. Instead, they have had to cultivate the rich, who have gained greatly in lobbying power. A study in the late 1990s of congressional elections found that 81% of political donors earned more than $100,000 a year and only 5% earned less than $50,000.

The free-market consensus among parties in Western countries increased disillusionment among the poor, who felt they lacked any real choice between economic policies. That, in turn, made them less likely to cast their vote.

Domestic politics is clearly not the only factor. Many people would point to globalisation, in particular the opening up of the Indian and Chinese markets that vastly increased the global labour force, putting downward pressure on unskilled wages. But academic studies have not found this to be a big factor in explaining the level of wages for the unskilled in recent years.

Globalisation may, however, explain some of the changes at the very top of the scale. The emergence of a global market for talent in areas such as banking, the law and investment may explain why the top 0.1% have been so well rewarded.

In particular, the financial sector contributed an increasing proportion of stockmarket profits from the early 1980s to 2006. The greater acceptance of debt allowed private-equity firms and

hedge funds to bet on rising asset prices with borrowed money, which is a quick route to riches when all goes well. There were plenty of incentives to take risk, in the expectation that someone else would pick up the tab when things went wrong. The willingness of central banks to use interest-rate cuts to bail out financial markets only added to the speculative enthusiasm.

Messrs Gordon and Dew-Becker point to the rise of “superstar” labour markets in which the best talent commands a huge premium. The clearest examples are found in entertainment and sport. Name recognition gives an exponential kick to the incomes of celebrities like Madonna or David Beckham who can attract endorsements, souvenir sales and the rest. In financial markets, those who mastered the sophisticated instruments (such as derivatives) that emerged in the era of liberalisation were also able to cash in.

The halo effect

Another group of beneficiaries, chief executives, may be in a different category. They benefited from the early use of share options in America, which gave managers a geared play on the 1980s and 1990s bull market. Messrs Gordon and Dew-Becker are not sure whether the resulting wealth was due to their executive skill or to their ability to control boards and thus the amount they got paid. Some executives enjoy a “halo of reputation”, the academics suggest, that causes directors to shower them with vast rewards when an equally capable but less famous alternative might have been willing to do the job at a small fraction of the price.

One thing holding back such executives was “outrage constraint”, a fear that massive pay packages might attract unwelcome attention in the media. That may have led to an attempt to disguise executive pay, with the really big increases being awarded in the form of option grants and deferred compensation and benefits.

Spurs to effort

Leaving aside the moral issues, does inequality have any economic benefits? In the 1970s it was argued that high taxes had reduced incentives and thus economic growth. Entrepreneurs had to be motivated to build businesses and create jobs. But extensive study by economists has found little correlation, in either direction, between inequality and economic growth rates across countries.

One argument advanced in America is that wide income disparities might encourage more people to want to go to college, thus creating a better-educated workforce. But Lawrence Mishel of the Economic Policy Institute points out that several societies that are more egalitarian than America have higher college enrolment rates.

There might also be an argument in favour of wealth disparities if social mobility was high and the sons and daughters of office cleaners could fairly easily rise to become chief executives. But America and Britain, which follow the Anglo-Saxon model, have the highest intergenerational correlations between the social status of fathers and sons; the lowest are found in egalitarian Norway and Denmark. Things are even worse for ethnic minorities; a black American born in the bottom quintile of the population (by income) has a 42% chance of staying there as an adult, compared with 17% for a white person.

As a result, talent is being neglected. Of American children with the highest test scores in eighth grade, only 29% of those from low-income families ended up going to college, compared with 74% of those from high-income families. Since the better-off can afford to keep their children in higher education and the poor cannot, breaking out of the cycle is hard.

Perhaps Americans put up with this system because they have unrealistic expectations of their chances of success. One study found that 2% of Americans described themselves as currently rich but 31% thought that they would become rich at some stage. In fact only 2-3% of those in the bottom half of the income distribution have a chance of becoming very well off (defined as having an annual income of more than $340,000). Just over half of those earning $75,000 a year think they will become very well off, but experience suggests that only 12-17% will make it.

Health outcomes too are decidedly unequal; the gap between the life expectancy of the top and bottom 10% respectively rose from 2.8 years to 4.5 between 1980 and 2000. That does not meet the definition of a fair society by John Rawls, a 20th-century philosopher, who described it as one in which a new entrant would be happy to be born even though he did not know his social position ahead of time.

However, these inequalities are likely to lessen now. For a start, this decade has so far seen a dismal performance by the stockmarket, which plays a crucial role in creating and maintaining wealth. Real annual returns from American stocks averaged -4.1% in the decade to the end of 2008.

The pendulum swings back

Property prices are already falling sharply, as noted earlier in this special report. Investment bankers are losing their jobs or at least seeing their bonuses cut, and hedge-fund managers are going out of business. As long as the credit crunch continues, it will be more difficult to use borrowed money to boost incomes. And corporate profits, which usually make a handsome contribution to the incomes of the rich, are declining steeply.

Much of this is what you would expect in a recession, and the poor will be suffering along with the rich. But although they may lose their jobs and default on their loans, they will not be troubled by collapsing asset prices because they do not own assets. Edward Wolff of New York University points out that the proportion of American households owning some stocks (including mutual funds and 401k pension plans) went up from 32% in 1983 to 51% in 2001. But only 32% of the population owned more than $10,000-worth of stock, and many middle-class people are only modestly affected by falling asset prices. The richest 10% of the American population owned 85% of all stocks.

Ajay Kapur, the strategist at Mirae Asset Management who coined the term “plutonomy”, identifies six factors that helped to create the phenomenon; the existence of capitalist-friendly governments and tax regimes; the development of financial complexity, innovation and deregulation; the paramount rule of law; globalisation; technology changes; and patent protection. Some of these are already being affected by the recession. Governments have become less friendly towards capitalists and regulations are being tightened. The rule of law is being replaced by what Mr Kapur dubs the rule of man: politicians and central bankers are changing the system on the hoof. “It is hard for investors to know the rules of the game because they keep changing,” he says.

With plutocrats now causing widespread anger, and with public-sector deficits widening, governments will be tempted to target the tax privileges of the wealthy. But how easy will it be to get hold of their money?

Giving it away

Will the rich become less charitable?

IN JUNE 2006 the then two richest men on the planet performed a remarkable ceremony. Warren Buffett, an eminent investor, agreed to hand over the bulk of his fortune to the foundation run by Bill Gates, the founder of Microsoft. It was a gesture that recalled the philanthropic heyday of Andrew Carnegie, the late-19th-century steel baron who became famous for funding public libraries.

How typical is such generosity of modern billionaires? Frustratingly, it is very hard to tell. The endowments of American foundations more than doubled between 1996 and 2006, but the increase only just kept pace with the rise in the total wealth of the Forbes 400 over that period. There is no evidence that the rich have been getting more, or less, generous.

What does seem to have changed is their attitude towards the way their money is used. They have become much more willing to get directly involved in the projects they fund. Mr Gates, for example, has left Microsoft to take charge of his foundation, including its work in fighting diseases such as malaria and AIDS. This increasingly businesslike approach of the new rich is reflected in an ugly new word, philanthrocapitalism (which is also the title of a book by an Economist journalist).

Again, it is hard to say whether Mr Gates's approach is typical. Charitable giving covers a wide range of activities, from fighting poverty in Africa to paying for a local concert hall. Local good deeds often owe as much to vanity as to genuine concern for others.

Will the financial crisis reduce charitable giving? According to the US Foundation Centre, which has figures going back to 1975, giving did not decrease, in real terms, during the recessions of the early 1980s and 1990s. American foundations can be flexible; tax rules require them to pay out 5% of their assets each year, but this can be calculated on a rolling average. In fact, the Gates Foundation says it has increased its payout ratio from 5% to 7% in response to the downturn.

But those measures involve spending money that has already been donated. It seems likely that the pace of new donations will slow down. For example, a big hedge-fund charity, Absolute Return for Kids, is planning a more modest annual dinner this year because the industry has shrunk. The Institute for Philanthropy sees something of a downturn in donations from corporations and from the "mass affluent"—the tier just below the wealthy. There is also some evidence that donors are spending their money closer to home, helping the poor in their own country rather than overseas.

But it is probably too early to tell what the rich will do when they have fully understood the massive hit to their wealth. The Obama administration is also proposing to reduce the tax break for charitable giving. The plutocrats may yet be tightening their purse strings.

Plucking the chickens

But taxes have their limits

THE rich are paying more tax; the rich aren't paying enough. Depending on which statistics you use, you can make a convincing case either way.

America's Internal Revenue Service publishes figures showing the proportion of income-tax receipts paid by different segments of the population. Back in 1986 the top 1% of taxpayers were responsible for 25.4% of all income tax paid; by 2005 their share had risen to 38.4%. The IRS also has figures for the top 400 American taxpayers. In 2006 their incomes averaged more than $263m, compared with $214m the year before. On those incomes they paid tax at an average rate of just 17.2%, well down from a peak of 29.9% in 1995; 31 of those 400 paid less than 10% in tax.

These figures are two sides of the same coin. The rich are paying a lot more tax in nominal terms because, as this special report has demonstrated, they have got a lot richer. But the rates of tax they pay have come down. Those on the political right can cite this as evidence that lower tax rates eventually increase tax receipts; those on the left, that the rich have been getting away with lower taxes at a time when median incomes have stagnated.

Governments around the world would like a bigger share of the pie as they seek to narrow deficits and placate angry electorates. One route they have been pursuing is to crack down on tax havens, those boltholes for the world's wealthy. Estimates of the amount held offshore range from $5 trillion to $7 trillion, so there is a strong incentive for governments to bring this money home.

In 2000 the Organisation for Economic Co-operation and Development identified over 40 tax havens; it has since persuaded 35 of them to commit themselves to a set of standards on transparency and information exchange. According to the OECD, some 49 agreements to exchange tax information have been signed since 2000 between countries ranging from Antigua to Sweden.

Countries that will not co-operate are named and shamed. Seven jurisdictions originally refused to make the commitment and were placed on a list of unco-operative tax havens; the blacklist has since shrunk to just three, Andorra, Liechtenstein and Monaco. In March Andorra and Liechtenstein pledged to weaken their secrecy laws. Switzerland, Austria and Luxembourg offerd to share information on savers with other governments on a case-by-case basis.

Individual countries are also taking action. In February UBS agreed to pay a $780m penalty to the American government and to disclose the names of some 250 customers to avoid

prosecution over having helped wealthy Americans avoid taxes. The American authorities promptly demanded that the Swiss bank hand over the names of a further 52,000 customers, which would require the bank to break Swiss law. (The Swiss have long made a distinction between tax evasion—not too serious—and tax fraud.) John Whiting of PricewaterhouseCoopers in London says the British authorities have been trying to get information about their own offshore-accountholders in a number of ways, including tapping the databases of high-street banks.

The German government used whistleblower laws to target citizens who had banked in Liechtenstein; some 900 suspects were pursued, including a former chief executive of Deutsche Post. The tiny principality was outraged, but its government fell in February and the new prime minister, Klaus Tschütscher, pledged to work with other countries and to get his country off the "unco-operative" list. A European Union meeting in Berlin in late February called for sanctions against states that do not play ball.

Countries such as Liechtenstein and Monaco are historical accidents, places that might easily have been tidied up by Napoleon or by the Treaty of Versailles after the first world war. They exist on the sufferance of larger states on whom they depend for defence and for transport links. But the EU finds it harder to put pressure on faraway countries.

Even so, with America and the EU both weighing in, there is some doubt about the long-term future of bank-secrecy laws. "The combination of whistleblower legislation and a lot of upset ex-employees in the financial-services industry may mean that in two or three years' time there will be no such thing as a secret account," says David Lesperance, a tax adviser. "Already, if you own any US securities, any bank you want to deal with is obliged to report the fact to the US authorities."

Philip Marcovici of the Zurich office of Baker & McKenzie, a law firm, says wealthy people can now do one of two things; play by the rules of their home country or get out. Staying in their country and breaking the law by hiding assets and income is not an option.

Want to know a secret?

But Mr Marcovici thinks governments are not approaching the issue of undisclosed income strategically. "They attack banks and jurisdictions and that forces them to get defensive. If they admit the problem, that will get them into legal trouble. Banks need to be part of the solution, and scaring wealth-owners into trying to hide the money better and farther is not in anyone's interest."

Banks may react by blaming a particular employee for aiding tax evaders when the problem is in fact endemic. Clients are free to leave Liechtenstein and move their money somewhere that is less susceptible to pressure from the European authorities.

One way of trying to deal with the problem of offshore tax evasion is a withholding tax that enables countries to deduct tax automatically and leave it up to the taxpayer to reclaim the money if he can. But this may not work. The EU savings directive, for example, says a withholding tax must be imposed on interest paid to an individual resident of an EU country or through a bank in the EU or an affiliated country. But it is easy to avoid the tax by turning the payment into something other than interest (such as capital gain), set up a company to receive it or have it made through a non-EU bank.

Such loopholes are common. One big controversy in recent years has been the tax treatment of "carried interest" in private-equity funds. This interest gives the fund managers the right to participate in future profits without putting up capital; in effect, it is a performance fee. In both

America and Britain it has been taxed as a capital gain rather than as income, substantially lowering the managers' tax bill. As one private-equity manager admitted, "any commonsense person would say that a highly paid private-equity executive paying less tax than a cleaning lady or other low-paid workers can't be right."

Another issue is the status of wealthy foreigners who usually enjoy tax privileges denied to domestic citizens. Voters in the Swiss canton that includes Zurich voted in February to end the practice of offering flat-rate deals for foreigners who choose to live in the area (the vote covered cantonal but not federal taxes). In Britain the political parties got into a brief bidding war over plans to tax the so-called "non-doms", people deemed to be resident in Britain but not domiciled for tax purposes. The idea was to impose a flat fee in return for ignoring their offshore earnings; previously foreigners were taxed only on such money as they brought into the country.

Soak the rich…

The British authorities are generally agreed to have made a mess of the proposals. According to Caroline Garnham of Lawrence Graham, a law firm, the big problem with the legislation was that the fee proposal was accompanied by 70 pages of anti-avoidance legislation. "Wealthy people don't want an investigation into their affairs by the British authorities because they don't know where the information will end up," she says. The predicted mass exodus of foreigners has not materialised so far, but then the new rules are only just about to kick in. Ms Garnham explains that "people haven't gone yet because they haven't had to file tax returns."

It is a sign of the political times that countries such as Switzerland and Britain, long seen as havens for the wealthy, are changing the rules. As the recession bites, voters are likely to become increasingly resentful towards those enjoying a free ride at the expense of other taxpayers.

In the long term it may not be politically sustainable to discriminate against the natives by giving special tax deals to foreigners. In Hong Kong and Singapore it makes no difference whether you are a foreigner or a local: you pay tax only on income from domestic sources. Those two countries may be the tax havens of the future.

Illustration by Alex Nabaun

But the tide is not running all one way. Just as some jurisdictions try to close tax loopholes, others will keep them open. In Sweden the authorities dropped a wealth tax in 2007 in part because some rich Swedes had been moving to London. Taiwan agreed to cut its inheritance

tax from a maximum of 50% to 10% in part because the wealthy had been moving money to Singapore and Hong Kong. In the Caribbean, St Kitts & Nevis offers citizenship in return for a property purchase of $350,000 plus government fees; citizens are able to enjoy foreign income, capital gains, gifts, wealth and inheritance free of tax.

What makes this tax competition even more acute is the mobility of money in a globalised world. Most developed countries abolished capital controls long ago. The very narrowness of the tax base, as illustrated by the numbers showing how much the top 1% contribute in America, highlights the danger of driving such people away.

In addition, political parties in many countries depend on wealthy individuals. Politicians have had to tread carefully for fear of giving offence to their paymasters.

Such pressures led to cuts in personal income-tax rates between 2002 and 2008 in 33 out of 87 countries surveyed by KPMG International, a firm of accountants, whereas only seven saw increases. The top rate fell from an average of 31.3% to 28.8%.

…but not too much

In Britain the Labour government has abandoned its long-standing pledge not to raise the top rate of income tax and imposed a 45% levy on those earning more than £150,000 a year. In America President Obama's first budget proposals included an increase in capital-gains tax and a rise in the highest rate of income tax back to levels last seen in the Clinton era. That trend is now likely to be reversed.

It seems unlikely that developed countries will ever go back to the income-tax rates of 90% or more seen in the 1970s, but some of the higher taxes recently introduced will surely stick, for three main reasons. First, most countries face big budget deficits, which makes it tempting to raise taxes to help fill the hole. Governments that ask middle- and working-class voters to shoulder the whole of the burden may quickly lose office.

Second, although in theory it is possible to move between countries to avoid tax, there are lots of practical difficulties. Family ties, business requirements and personal preferences are likely to persuade many people to pay somewhat higher taxes rather than uproot their lives. The recent crackdown on tax havens may also deter many investors from moving their capital.

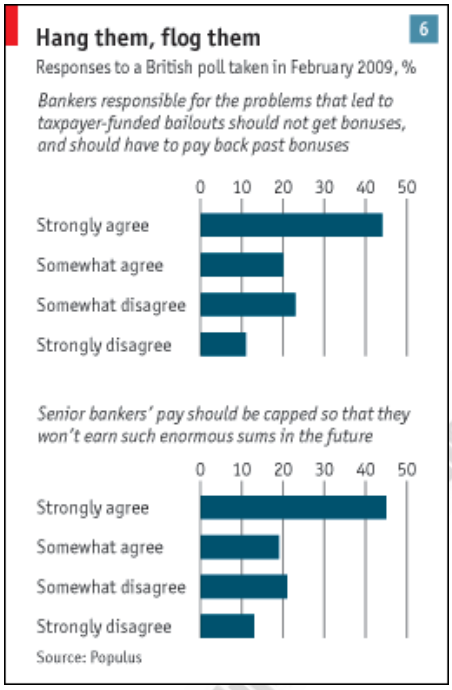
Third, there is the issue of security. The British government pointedly failed to help accountholders with the Guernsey branch of Landsbanki, a failed Icelandic bank. The Channel island, long seen as a tax haven for British investors, does not have a deposit-protection scheme.

"The tax authorities are trying to make it steadily more difficult to avoid tax," says Mr Whiting. The effect is to push evaders to the fringes of the system, where they may be more at threat from fraudsters than from the taxman. Rich people may feel it is better to pay some of their money in tax than to risk losing it all in a jurisdiction with lax rules.

Paying the bill

The rich will become a little poorer. That may be no bad thing, but beware a backlash

SOCIETIES have often distinguished between the deserving poor (afflicted by sickness or disability) and the undeserving sort (the feckless and workshy). These days they also seem to differentiate between the deserving and the undeserving rich.



Ordinary people do not seem to mind that sports stars or entertainers make millions; they also seem to respect genuine entrepreneurs who have built businesses that are obviously useful. But they have little time for bankers, hedge-fund managers and other financiers. Society as a whole may benefit from the efficient allocation of capital or the increased liquidity that financial markets provide, but the public cannot easily see the gains.

A Populus poll in February, for example, found that 64% of Britons thought that the staff of banks part-owned by the government should not get any bonuses at all; the same proportion thought that senior bankers who made mistakes should repay past bonuses. A remarkable 82% thought that pay for senior bank staff should be capped (see chart 6).

As governments are forced to step in to save other sectors of the economy, it seems plausible that the public will take a similar attitude towards executives of other failing businesses. The intellectual argument that high pay is needed to create incentives probably rings hollow with most people at the moment. What is clear to the public, though, is that bankers and businessmen earn fortunes in good times and shout for help from the taxpayer in bad times.

We've been here before

Revolts against the power of the rich have been a regular feature of American history, going all the way back to Thomas Jefferson. It was a Republican president, Theodore Roosevelt, who said that "every man holds his property subject to the general right of the community to regulate its use to whatever degree the public welfare may require it." His cousin, the Democrat Franklin Roosevelt, argued that "the transmission from generation to generation of vast fortunes by will, inheritance or gift is not consistent with the ideals and sentiments of the American people."

The era of progressivism embodied by Theodore Roosevelt led to the introduction of a federal income tax and the establishment of the Federal Reserve, which Woodrow Wilson saw as a counterweight to the power of financiers such as JPMorgan. Franklin Roosevelt eventually brought in a wartime top income-tax rate of 91%. Now Barack Obama has suggested raising the tax rates on high earners and closing loopholes such as the carried-interest privilege enjoyed by private-equity managers.

Such tax changes may suit the public mood. The danger is that popular anger, once released, can fasten on targets beyond the rich; immigrants, say, or foreigners generally. The 1930s Depression led to fascism in Germany and the second world war.

Even if such apocalypses are avoided, the anti-rich backlash can go too far. In the middle of a deep recession it is easy to forget that the previous 15 years had seen steady economic growth in the developed world, a remarkable growth surge in many emerging markets, low inflation and rapid technological development.

The trick will be to change regulation to reduce the risk of running up too much debt again but still allow new industries to be created and financed. If entrepreneurs can come up with cheap solar technology, say, or develop drugs to cure cancer, they will deserve all the money they can get.

The world is emerging from a long period of financial speculation. Some people got rich because they were talented, others because they were lucky. That luck ran out in 2007. The ranks of the rich are set to be thinned in coming years—but perhaps the wealth of those that remain will be more soundly based.

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