Confluence Investment Management

Weekly Geopolitical Report
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## The Four Horsemen of Leveling: A Book Review

Occasionally, we find a book that has such an interesting message that we dedicate a Weekly Geopolitical Report to reviewing it. This week, we will look at *The Great Leveler* by Walter Scheidel.[1] The book is an extensive historical analysis of inequality and the factors that reduce it.

In this report, we will discuss the premise of the book, the "four horsemen" of income leveling and the future it portends. As always, we will conclude with potential market ramifications.

**The Basic Premise**

Inequality has become a critical issue. In 2013, President Obama said the following about inequality:

*And that is a dangerous and growing inequality and lack of upward mobility that has jeopardized middle-class America's basic bargain—that if you work hard, you have a chance to get ahead. I believe this is the defining challenge of our time: Making sure our economy works for every working American.*[2]

Interestingly enough, Scheidel's historical analysis makes it clear that the current level of inequality is hardly unique. And, a certain degree of inequality has been with us since the early stages of human existence. Archeologists note that even early gravesites of hunters and gatherers show distinctions of wealth and status. These differences steadily became more widespread as civilization developed.

In theory, society could take steps to prevent or reduce inequality. However, history suggests the opposite usually occurs. As agriculture developed, Scheidel's analysis shows that wealth became increasingly concentrated. ***Scheidel's key insight is that civilization and peace tend to bring rising income and wealth inequality.***

However, a casual observation of history also suggests that wealth and income distributions are not permanent. Sadly, Scheidel's conclusion is that massive societal disruption reduces inequality. He refers to these as the four horsemen of equality.

**The Four Horsemen**

The "Four Horsemen of the Apocalypse" comes from scripture.[3] The biblical reference is widely debated but, in general, it refers to tribulations. Scheidel suggests that his four horsemen refer to events that cause inequality to decline. Here is his list:

**Mass Mobilization War:** Warfare has been part of human history for thousands of years. Small wars didn't seem to cause widespread changes in inequality. That isn't to say that anything short of mass mobilization war had no effect; clearly, in ancient times, being invaded usually led the vanquished nation to

[1] Scheidel, W. (2017). *The Great Leveler: Violence and the History of Inequality from the Stone Age to the Twenty-First Century*. Princeton, NJ: Princeton University Press.

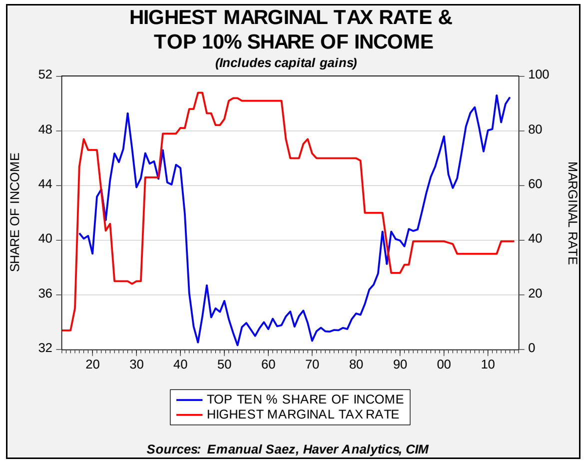
[2] Ibid, page 2.

[3] Rev. 6:1-8

lose its material wealth and its citizens who survived usually ended up in slavery. On the other hand, mass mobilization war, the kind seen in the last century, have caused jarring changes in wealth and income distribution, regardless of the outcome. Clearly, the losers fare worse but the wealthy in winning nations tend to see their holdings reduced as well. Mass mobilization warfare adversely affects the wealthy in three ways.

1. During war, fixed assets are often destroyed. One of the goals of mass mobilization war is to undermine the enemy's economy. Thus, it is common to bomb infrastructure and industry. Destroying these assets reduces the wealth of the capital holding class.
2. Mass mobilization wars don't end quickly and require massive resources to execute. Governments tend to appropriate assets of the private sector and, since the wealthy have the greater share, this class pays a larger share to fund the war effort.
3. This sort of warfare requires the full mobilization of the labor force to produce the goods and services necessary to support the military. Low unemployment gives labor power over capital and reduces the income to capital.

Even the U.S., which suffered significantly less domestic damage from the war than Asia or Europe, saw a massive drop in inequality. The chart below shows the share of income of the top 10% of households and the highest marginal tax rate. Note that even though the highest marginal tax rate was raised to 80% by 1936, the top 10% of households were still capturing over 45% of total income. It wasn't until WWII began that the share of income fell sharply.




The author details many more examples but it is safe to say that war has been effective in reducing wealth and income inequality.

**Transformative Revolution:** Scheidel shows that civil war has an ambiguous effect on income and wealth distribution but revolution is very effective in changing these arrangements. The classic example is the Communist Revolution in Russia. The author notes that mere revolts that affect a localized area do not lead to large or lasting changes in income and wealth distributions. On the other hand, transformative revolution is extremely effective in changing the patterns of wealth and income.

Shortly after the Bolshevik Revolution, Lenin and his cohorts implemented land reform, expropriating the landed estates of the nobility and the Russian Orthodox Church without compensation. This action eliminated the landed aristocracy. In addition, the Bolsheviks nationalized the banks and took over the Russian industrial base. By 1919, about 97% of arable land was owned by peasants. However, the communists were concerned that another set of landlords would emerge. Thus, they began the process of collectivizing farmland, putting it all under state control.

Initially, collectivization failed. The *kulaks*, who were the more successful farmers, came under persecution by Lenin. Unfortunately, agricultural production collapsed; although farmers were now more equal, they were equal with less resources, and incentives to work hard evaporated. Lenin was forced to retreat from his communist ideals with the New Economic Policy which allowed limited markets to develop. Although agricultural production rebounded, some differentiation in incomes did as well. Stalin solidified his control by the late 1920s and within a decade farm collectivization was complete. The costs were astounding. Up to 1.8 million *kulaks* were arrested and it is estimated that six million peasants starved to death.[4]

In the cities, the secret police[5] arrested 1.5 mm Russians in 1937-38, and nearly half died. From 1934 to 1941, it is estimated that seven million people entered the gulag. The incarcerated were put to work, further pressuring wages.[6] There is clear evidence that inequality fell in the Soviet Union; Gini ratios from the late 1960s into the fall of the Soviet Union were around 0.28.[7] Similar outcomes were observed in China as well.

Transformative revolutions lower income inequality by taking income and wealth from those who have it; there wasn't much evidence that it was shifted to the poor. In general, wealth was destroyed as communism proved to be profoundly inefficient. Thus, equality was achieved by leveling down.

[4] Op cit., page 219.
[5] The NKVD, the forerunner of the KGB.
[6] Op cit., page 220.
[7] Ibid, page 221. For reference, the U.S. Gini ratio during the mid-1970s was around 0.36.

**Societal Collapse:** The third cause of income leveling is societal collapse. In this situation, a government collapses, leading to a breakdown of civil order. As civil order collapses, the ability of the wealthy to hold onto their assets is compromised. Most of the examples come from ancient history—the fall of Rome, the collapse of the Tang Dynasty in China and the end of some of the kingdoms in the Andes. However, Scheidel does include Somalia in the list of collapsed states.

Societal collapse brings incomes downward by destroying the wealth of the upper classes. Wealth accumulation depends on social and legal stability. If these are lost in political chaos, downward income leveling occurs.

**Plague:** The classic example of this scourge was the bubonic plague which was mostly the cause of the Black Death. It was a flea-borne bacteria carried by rats. The rats were ubiquitous and were often carried on cargo ships, spreading the disease. The fatality rates were stunning, running around 50% of those affected. The Black Death appeared in Europe around 1347 and reduced the European population over the next four years by 45% to 50%. The world population is estimated to have fallen by nearly 25%, although estimates are imprecise due to spotty record-keeping during this era.

The sharp drop in population dramatically reduced available labor. Real wages in England jumped 3.5x from 1310 to 1450.[8] The author cites numerous comments from capital owners in this era, complaining about the scarcity of workers. In England, King Richard II tried to legislate away the rise in wages.[9] He was unsuccessful in this endeavor.

[8] Ibid, page 303.
[9] Ibid, page 311.

The issue was simple supply and demand. In other areas of Europe, especially in what is now Eastern Europe, nobles were able to enforce restrictions that tied workers to the land, reducing their bargaining power. But, for the most part, wages rose. Although the demand for labor likely declined due to a smaller population, the collapse in the supply of labor led to higher wages.

There were other events cited by the author. In the new world, smallpox decimated the native population. In the mid-14th century, a pandemic raged and real wages rose in the aftermath.[10] Widespread plague is the only one of the horsemen that led to leveling through the improvement of living conditions of the less affluent.

**The Key Lessons**
Here are the key conclusions:

**Peace and prosperity seem to lead to income inequality.** Wealth formation requires political and social stability. Maintaining wealth requires the rule of law and the political protection of property. Without these factors in place, people will tend not to invest and the scale of production will remain small. Thus, in stable political systems, history indicates that income and wealth distributions will become increasingly wide.

**Reducing income inequality seems like a worthy goal but history suggests the costs are extraordinarily high**. In three of the four horsemen cited by Scheidel, income was leveled by reducing wealth of the upper tiers. Only the fourth, plague, lifted incomes from the lower tiers. The author's analysis leads one to conclude that the only way to reduce inequality is through a cataclysm.

**It appears that the odds of occurrence of any of the four horsemen have changed relative to history.** The advent of nuclear weapons probably reduces the likelihood of mass mobilization warfare. That's because no enemy in possession of a nuclear weapon can suffer unconditional surrender. If an enemy cannot be completely defeated in a conventional mass mobilization war, it seems rather pointless to even engage. Instead, since WWII, we have seen a series of limited wars; that is a more likely outcome. Of course, a full-scale nuclear war would probably have a dramatic leveling effect, but it appears that such a conflict isn't likely. On the other hand, the other three may be more likely. Social media may make revolution easier. The fraying of the social fabric in the West, observed by the political turmoil seen recently, could portend a breakdown of social order. And, bioengineering may inadvertently raise the odds of a plague-like event.

**Although governments may try to reduce inequality without a crisis, the historical record isn't encouraging.** Those with wealth build political power, regardless of government structure. In the U.S., political campaigns rely heavily on wealthy donors. In China, it is apparent that the economy needs to restructure toward consumption and away from investment. These changes would have a dramatic impact on wealth distribution, taking away from those who have benefited and giving to those who have not. So far, Chinese leadership has been unable to change its policies. We do not expect significant changes in income and wealth distribution to occur without a crisis.

**Ramifications**
Historical analysis can suffer from the problem of induction. Inductive reasoning assumes the future will resemble the past. The problem with projecting the future from

[10] Ibid, page 317.

past experience is that something new might occur. Nicholas Taleb's famous book on this issue, *The Black Swan*,[11] examined the problems of reasoning through induction.

Just because major reductions in inequality in the past have only occurred due to one of the four horsemen, it doesn't mean it can't happen in the future in a less onerous way. However, holding out hope for such an outcome does require one to bet against thousands of years of history.

For investors, conditions of inequality will likely remain in place. The lack of war, the avoidance of revolution, the maintenance of civil society and the containment of pandemics all suggest that current conditions will continue. We would expect attempts to dampen the negative effects of inequality but these will likely be muted by the political power held by the wealthy.

The current bout of sluggish economic growth appears to be due to tepid aggregate demand. Persistent low inflation and interest rates would be expected in an economy with excess capacity. Redistribution policies are probably the most effective way to boost aggregate demand in the short run; however, these are usually accompanied by progressive tax structures and higher marginal rates, neither of which seem likely in the current political environment. Scheidel's work suggests that inequality will probably continue until (a) a historical anomalous event takes place where income and wealth distributions adjust without a cataclysm, or (b) a calamity occurs. For the time being, it appears the prudent course is to expect neither but pay close attention.

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[11] Taleb, N. N. (2007). *The Black Swan: The Impact of the Highly Improbable*. New York, NY: Random House.