Income Inequality and Winner Take All Tournaments

85 people with as much wealth as the poorest 3.5 billion. A pope warning about “unbridled capitalism”? Is the market system fatally flawed?

The simple answer is no, it’s not. After all, in the last 30 years, capitalism has lifted over a billion of those poorest 3.5 billion out of abject poverty. During that time, capitalism has made the world’s income distribution less uneven, even as it made America’s income distribution more uneven. But capitalism does have a problem – a tendency for what economists call “winner take all tournaments”. Let me give you a sports example, from my own family.

Two of my nephews, Nate and Pat Holland, are professional athletes who compete in snowboard cross. Both are among the best in the world in their event, good enough to be on the American World Cup team. Both were invited to compete in this January’s X games.

But Nate is better, one of the top boarder crossers in the world, and one of the 4 American men on the Olympics team. How much better? In some recent X games races, Pat took on average 1.7% more time to complete the course, about one extra second for every minute of racing. That time difference on the 40 yard dash would mean a 24” difference at the tape. 1.7% was the difference between Usain Bolt and the best (3rd place) American in the 2012 Olympics 100 meter dash.

So how has that difference affected them financially? Pat has earned enough to get by; Nate perhaps 10 times as much. Pat has no gold metals, Nate has 8 from the X games alone. Pat has one corporate sponsor, Nate over half a dozen. But that’s the nature of winner-take-all competitions: a small difference in performance results in a huge difference in payout.

We see these winner-take-all tournaments in sports, in entertainment, and in big business. The players who make the NFL are a bit better than the ones who don’t, the one’s who start a bit better still. But the earnings differences are enormous. There are hundreds of professional comics almost as funny as the ones who get their own TV shows. But a handful make more money than all the rest combined. And there are millions of highly qualified corporate executives, but only a very few get the enormous payoffs granted to CEOs.

Is this a problem we need to eliminate? No. These winner-take-all tournaments create great incentives, to race faster, sing better, work harder, perform better. Knowing that one more sack every other game, 8 more per season, will get you a million dollar contract and your own soup commercial is an enormous incentive to up your performance.

But the payoffs to these tournaments are well beyond what’s needed to create the proper incentives. Wouldn’t you rush the passer just as hard, if the payoff were a half million dollar contract? Would you strive less hard to host the Tonight Show if it only paid three million per year? Would you have refused to create Facebook if it had merely turned you into a quarter billionaire?

Most of the wealthiest 1% got that way by winning a winner-take-all tournament. So fine, let them enjoy their wealth. But taxing them 30%, 40%, or even 50% of their winnings should be considered fair game. Capitalism will continue bring its prosperity benefits, even if we bridle its upper end payoff a little bit. And it’s only right for the winners in the economic contest to help open the doors of opportunity to those who are a lot less ... fortunate.