





# Tackling Economic Inequality, Boosting Opportunity: A Blueprint for Business

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## Executive Summary

This policy statement is a part of CED's ongoing project on "sustainable capitalism." In this project, we undertake research on a series of issues that are part of the controversy surrounding capitalism today, in the aftermath of the recent financial crisis. Many of these issues also echo the vigorous debate at the time of CED's founding — almost 75 years ago, in 1942, and in the aftermath of the Great Depression — when many contemporary commentators also spoke of a "crisis of capitalism."

We will complete and release this policy statement, and others, in the nature of working papers — to solicit and provoke comment and discussion. We will use that input to develop each policy statement into a chapter of our forthcoming book, *Sustainable Capitalism*, which will mark CED's coming diamond anniversary year of 2017.

We believe that capitalism — perhaps more accurately described as the free-market system — historically has been an enormous success. It has delivered worldwide progress against poverty and has been the foundation of the growth of the greatest nation ever known to man. But capitalism cannot stand totally immutable in a world of rapidly advancing technology and changing social institutions. Capitalism must evolve if it is to continue to serve the needs of the world's people and economies and if it is to remain "sustainable."

And perhaps one of the key challenges to capitalism's ability to sustain itself — one of the most powerful sources of the controversy surrounding capitalism today — has been the perception and the reality of the growth of inequality over recent decades, and especially since the financial crisis.

To some Americans, economic inequality has become a matter of intense concern. President

Obama has called it "the defining challenge of our time."<sup>1</sup> It has been the subject of numerous books, articles, and symposia.

There has been an equally impassioned pushback to this concern — not so much on the recent growth of inequality as on its significance, potential ill effects, and possible remedies.<sup>2</sup>

And with the rising intensity of the debate, the noise has tended to overwhelm the information on a topic that was already highly complex. Different measures of economic well-being — income versus wealth, and numerous variations of each — have been confused and conflated. Weaknesses in the available data often have been ignored.

Inequality touches on so much of our nation's economic policy that decisions in this space can have a profound impact on our collective well-being. So our nation needs a meeting of the minds, thoughtfully but urgently. We need to establish the facts, consider our options in an accurate and dispassionate way, and decide on a course of action.

True business statesmen are uniquely situated to begin such a national conversation. Government is paralyzed by partisanship, and most outside advocacy groups are guided by political orientation. CED has a history of almost three-quarters of a century of pursuing the public interest rather than trying to score partisan or ideological points. We call issues as we see them. We understand that all of society is in the same boat and that our nation can prosper best if we prosper together. We seek to communicate why business must be a key part of a resumption of growth of economic prosperity for all Americans, just as business has been a driver throughout the history of our nation's rising prosperity, including the immediate post-World War II era that many remember and wish to re-create today.

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The inequality debate thus far has been highly polarized and polarizing. Although we come from a perspective that emphasizes the historical achievements of free markets, we see merit on both sides of the debate. We believe that our society will advance when each side recognizes the wisdom in the other's position and joins an open dialogue to find the common ground that holds the principles and concerns that we all share. We counsel patience as we hear each other out,

in full. We believe that our discussion below is a sound first attempt at a synthesis of what each competing perspective on this issue has to offer — ideally, a presentation of what every responsible voice both already believes and can learn from others.

That was the motivation behind our investigation of economic inequality, and this policy statement shares our findings, which we summarize here.

## A Note About The Color Coding

This summary, and the policy statement that follows, present a nonpartisan consensus among our members, who individually come from diverse partisan backgrounds. In producing these documents, our members sought to understand each other's differing points of view and to find and recognize the value that each brought to the table. They agreed in this summary to try to communicate where they could agree on arguments and recommendations that came from each of the two main partisan perspectives, and where they found ways to combine those perspectives in honorable and productive compromise. Toward that end, some of the text of this summary is printed in color and formatted to convey the balance of the consensus among our members of different persuasions.

- Views and recommendations that might be seen as more characteristic of the conservative point of view are slightly offset to the right and are printed in RED.
- Views and recommendations that might be seen as more characteristic of the liberal point of view are slightly offset to the left and are printed in BLUE.
- Findings and recommendations that might be seen to meld those partisan perspectives are centered and are printed in PURPLE.

***Our economy always has generated some measure of inequality — although no more than, and quite possibly less than, historical alternatives.*** That is not surprising. Individuals inevitably differ in their innate skills and their other endowments. And free enterprise encourages people to take risks to innovate and invest. Investments that are successful generate the jobs and incomes that the American people need and can earn substantial incomes for the innovators and investors. But investments can meet with less success — for their initiators, investors, and employees (who often invest through stock options and pension plans). The American people at large would not have it any other way; they want innovation and investment, and if they succeed they want to be rewarded. Thus, economic systems that are most conducive to economic growth because they allow market forces to reward success tend to have some measure of inequality. And on the other hand, trying to enforce equality of outcomes can be expected to reduce economic growth and incomes because it will deter investments that will not seem worth the risk and the effort without a reward for success. That is why many alternative economic systems, including socialism and communism, have failed: they have not produced growth and widespread prosperity, and as much as they have promised utopian equality, they have generated their own inequality and waste through economic manipulation and corruption as well.

There are many reasons to choose to do business in the United States, the world's largest market. For Americans, patriotism is among them; for non-Americans, it is often our open free-enterprise system as well as our robust consumer market. But if innovators and investors conclude that too much of the return to their efforts will be denied to them in a search for equality of outcomes, they will not pursue their ideas, concluding that it is not worth the hard work and risk. Or, in today's open global economy — and especially if the innovators are non-American — they will pursue their ideas elsewhere.

***But over the past several decades in the United States, inequality (by any measure) has been increasing significantly.*** After the transformative events of World War II, our economy enjoyed more than two decades of extraordinary growth and a general narrowing of inequality. Since the early 1970s, however, growth has generally been slower, and inequality has generally grown. This has been true of all measures of economic well-being: market incomes, after-tax, after-transfer incomes, and wealth. And this finding is consistent across most developed countries in multiple databases constructed by multiple researchers, even though they disagree on many narrower details and on their policy conclusions. Although there are numerous sources of data and analysis, we see as particularly persuasive the findings of the Congressional Budget Office, which has focused on a consistent methodology using the same data sources since 1979, under organizational leadership appointed by both political parties. Their findings show consistent increases in inequality using several alter-

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native measures of income. Some analyses suggest that the current degree of inequality is at or near its level of 1930, which was the highest in modern times. This raises concerns about economic stability and popular reactions that might lead to hasty and counterproductive policy making.

The finding that there has been a consistent trend toward both income and wealth inequality over the last several decades provides definitive conclusions about neither causation nor what policy steps, if any, should be taken in response. Answering those questions requires deeper analysis.

***Some, but not all, of the increasing inequality of the last four decades has resulted from spectacular returns to highly successful innovations and investments. We are not troubled by this phenomenon.*** The highly successful enterprises of recent years by definition provided substantial value to a large number of people; had they not, they would not have been so successful. Many of the individuals who profited so spectacularly from those innovations were line employees with stock options, not executive decision makers. Such rewards were examples of the opportunity made possible by free enterprise.

Thus, we see no ground to attempt to undo such success. At the most important level, every American wants access to the American dream, which is driven by innovation. Innovation provides us with new and better products and services at lower prices. It raises our standards of living and provides prosperity, even as it sometimes provides large returns that can expand measured inequality. We must take care that in pursuing other goals we do not pay a disproportionate price in terms of innovation, growth, and living standards.

***Some, but not all, of the greater inequality that we observe has resulted from lagging real income growth for a large number of working Americans. We find that reduced income growth exceedingly troubling.*** CED's mission has always included income growth broadly shared among the American people. This is the essence of the promise of the free-enterprise system that we have supported from our founding. Any erosion of that American dream is unacceptable and will reduce the quality of life for even the successful.

Some have alleged that the loss of income growth is a sign of a loss of ambition or will on the part of the American people. This is false. The enormous drop in employment since 2007 was not caused by a synchronized collapse of interest in prosperity on the part of vast numbers of American workers. We owe our fellow citizens more respect than to suggest as much.



Some also have alleged that the spectacular returns enjoyed by some have come directly and causally at the expense of those who have suffered lower income growth. We find this belief to be unfounded. Many of the conspicuous innovations that have been richly rewarded have no possible connection to broad wage trends. They have come from the development of new products and services that have been built from the ground up, with newly employed labor and new resources.

Thus, again, we see no reason and much risk in seeking policies that would choke innovation, or risk its relocation overseas, in the cause of reducing inequality. In contrast, our economic system must be geared to increase broadly based income growth to reduce inequality. Increasing growth — really, increasing productivity and innovation — is a monumental task. It is the mystery behind all of economic progress. It is, in essence, seeing into the future. CED's central mission here is to call business leaders and Americans of all perspectives to unite in the task of seeking prosperity and equality of opportunity to raise all, but not by repressing some.

***Our society's objective should be equality of opportunity that reduces inequality, not forced equality of outcomes.*** It follows from our reasoning above that the economy must lift the bottom, not compress the top. Equality achieved by curtailing opportunity or demonizing success is at best a temporary remedy for any pains of inequality. Forced equality does not raise, and has no prospect of raising, productivity and innovation. It does not raise the achievement of the labor force that it is intended to help. It is a remedy for inequality in only the most superficial, ephemeral sense. In contrast, expanding opportunity will end today's waste of resources. Expanded opportunity will utilize people's skills more fully and open up investment opportunities. That is why we must set our economy back on track.

We believe that equality of opportunity is the only ultimate remedy to inequality. Only through raising the capacity of the full US labor force can productivity and incomes be raised on a sustained basis, to the benefit of all of society. We have every confidence that as we approach the goal of equality of opportunity, the resulting rising prosperity will lessen inequality of outcomes, as the incomes of our population rise closer to their potential. As the old saying holds, a truly rising tide will lift all boats.

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*Although each alternative statistical measure of economic inequality has a valid purpose, we believe that our society's success should be defined by the growth and distribution of market incomes.* We do not believe that our society can target equality of outcomes, nor should it try to force equality of outcomes. But we do believe that from equality of opportunity will follow greater incomes, broadly shared, and with that a lessening of inequality. And in that respect we refer to market income, which we believe is the most meaningful standard.

Dollars of income from different sources are not the same. Dollars earned through labor or as returns on the individual's own savings represent production, self-sufficiency, and security, in a sense not matched by public transfer payments. If opportunity yields productivity and incomes, individuals achieve greater equality in a more meaningful sense. It is their own stake in the ownership of the economic system. It is that meaning of equality to which our society should aspire, more than some numerical equality that is dependent upon a constancy of future public policy.

***Our nation, at this time, does not have equality of opportunity, and past attempts to achieve it, however well-meaning and energetic, have fallen short.*** Some might take the mere establishment of a goal of equality of opportunity to be an absolution of any and all societal or economic reality. They would say that if one individual has overcome adversity to succeed in our free-market economy, then anyone can. We are free to go on our way.

The sad reality is that too many Americans reach the starting line of a career in the labor force with no realistic chance of success. If we want our nation to remain exceptional, to remain the world's leader, then we must set opportunity as our primary objective.

***In the interim, in the absence of equality of opportunity, we must take responsibility for policies to ease the current inequality of outcomes.*** What do we do as a society until we have equality of opportunity? Pursuing a long-term goal of equality of opportunity will not directly ease the dislocations caused by recent lagging incomes. The stated intent of current public policy is to assess the cost of government according to ability to pay, and to provide a safety net for those who fail in competition in the free market. However, policy is not fully successful in the pursuit of those objectives. As CED has noted elsewhere, our federal income tax is neither efficient with respect to its effect on the allocation of resources and the maximization of incentives for productive activity, nor fully equitable in terms of the assessment of liabilities. Nor are our cash and in-kind assistance programs on the outlay side of the budget fully effective in achieving their objectives. Improvement of these policies must be a part of our national agenda as well. With efficient policies — policies that do not waste

resources on their own inefficiencies or inequities — we can achieve more of all of our multiple, competing policy objectives.

***Businesses themselves can ease the hostility in the inequality debate.*** In our experience, US firms seek to provide rewarding employment for their workers. Businesses see that as in their own and their shareholders' interests, as well as in the interests of their employees. Loyalty and a strong sense of shared purpose yield the best business results. In our work on “sustainable capitalism,” we begin with the perspective of a “multi-stakeholder model” of business — in which lasting value generation is recognized to follow from a cooperative relationship among the management and the board of the firm and their community, employees, customers, owners, and the environment. A mindset that is limited to near-term results at the expense of these stakeholders might lead to temporarily pleasing reported numbers, but not long-term sustainable performance.

However, businesses, like all other institutions, periodically need to reexamine their relationships with their many stakeholders. And in this day of system-wide economic challenges, that reassessment must encompass inequality and a lack of opportunity, to refresh the “social contract” and restore a broad consensus about the value of our free-enterprise system. For too long, it has been common for business leaders to “keep their heads down in the foxhole” and avoid debate on public issues. That might avoid controversy in the near term, but over time it has cost both trust in business and a full debate on vital public policy.

***In addition, business should advocate sound public policy to enhance and equalize opportunity.*** True equality of opportunity for the entire American population and economy will require collective action. Business statesmen can foster a more civil debate and strengthen our economy by advocating sound and thoughtful public policy:

- ***Expand access to quality preschool education and child care.*** The best evidence indicates that early childhood education has the greatest, surest return among alternative investments in our future workforce. At-risk children, at the very least, need access to high-quality early childhood education if they are to enter the world of work with a solid opportunity for success. Some businesses conceivably can provide their workers' children with adequate day care and early education, but there is little doubt that eventually public and private sources must provide additional financial support for early education for the bulk of the at-risk population. Success requires quality-focused accreditation, qualified teachers, performance measurement, and accountability for results.<sup>3</sup> Much of the return to early education will come far in the future, but that only emphasizes the necessity of early action.

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- ***Enhance the K-12 performance with states' and unions' cooperation.*** Business leaders should work nationally, at the state level, and in their home communities to implement standards for educational achievement that support college and career readiness. Local, hands-on business involvement could help to dispel the fears of supposed outside interference in the setting of standards for the benefit of future workers. CED has researched this issue extensively.<sup>4</sup> Accountability for student success in the classroom is critical. Business should reexamine the potential for partnering with schools in offering job-specific training alongside general academics, and in communicating their skill needs to wide-access, low-cost educational institutions in their areas. Innovations along these lines would help students who enter the workforce out of high school, not only those who plan to move on to college.
- ***Broaden postsecondary access and improve performance.*** As CED has reported elsewhere, US postsecondary educational attainment is lagging behind our competitor nations around the world. Well-to-do US youth are attending college; our weakness lies among students and families of modest means — even those who are well prepared academically — many of whom have no experience of postsecondary attendance or success.<sup>5</sup> Increasing enrollment and completion by highly qualified students from low-income families could be enormously productive in reducing inequality, and certainly in expanding opportunity. And much can be done. College costs are rising much faster than prices generally — even faster than the widely recognized cost of health care. Our nation must devote its energy and creativity to innovation in postsecondary education. That includes finding less-expensive alternatives to “seat time” while maintaining the verifiable value of a college degree. Business leaders should lend their time and expertise to the wide-access, low-cost undergraduate institutions, as well as to the more prominent, elite graduate and research institutions; it is the wide-access schools that must bear the brunt of extending education to the less affluent underserved segments of our population. At the same time, more scholarships for low-income households and incentives for high-prestige universities to prepare and admit low-income students could help. Businesses should specify and explain the skills that they need, so that postsecondary institutions can develop curricula that impart those skills. Government aid should be tied to defined student outcomes and preset cost-containment goals. And we should improve both secondary education and community college training for those students for whom a four-year degree is not the best choice.
- ***And finally, business should develop and advocate public policies to compensate for the current inequality of opportunity.*** There are other policy imperatives whose primary effect would be to ease some of the ill effects of the current limited opportunity for many millions of Americans, although these ideas would also enhance incomes and economic growth in the long run:

- **Reform the US health care system.** The cost of providing quality health care to any family or individual does not vary with household income. However, the cost of health care is much higher as a percentage of income for lower-wage workers. Even after the Patient Protection and Affordable Care Act (ACA), however, our nation still reflexively conceives of health care as a financial obligation of the employer. For that reason, employers must think of the cost of health care as a part of the cost of hiring a low-wage worker. Over time, that crowds out cash wages, and may have contributed substantially to slow wage growth for many workers, and to a perception of growing inequality.<sup>6</sup> CED has recommended substantial changes to US health care finance and delivery that would both reduce the impact of the inverse linkage between the cost of care and employee cash wages, and in the long term slow the rate of growth of health care costs while improving the quality of care.<sup>7</sup> Health care system reform would therefore be one of the most important steps that the nation could take to reduce income inequality.

- **Reform the US tax system.** The US tax system should also be an important part of attaining equal opportunity, by encouraging growth and assuring that tax liabilities are distributed fairly. Instead, it falls far short. Polling suggests that the American people support a progressive income tax but that they are sensitive to the level of the highest tax rates imposed.<sup>8</sup> This is broadly in keeping with John Rawls' *A Theory of Justice*, in which he posits that people should choose public systems that they would want whether their life outcomes ultimately proved either favorable or unfavorable. Rawls' philosophical expression was that the public should judge policy as if they saw their futures through a "veil of ignorance"; a more common expression would be that citizens should be objective in choosing policies that will apply to them however their lives evolve as well as to others in different circumstances. This would suggest a tax law that would provide the relief that people would want if their incomes turned out to be low, and higher but not excessive tax rates that they would be willing to pay if their incomes turned out to be high. This consensus of the American people offers sound guidance. Tax policy requires balance that is fair to everyone — that follows Rawls' dictum such that people would accept it not knowing what their life outcomes will be, such that they would consider it fair whether their incomes were high or low. This will necessarily be a compromise between the political extremes, but that is what democratic policy making for all of the people is about. An ironic ray of hope is that our nation's tax system today is grossly inefficient. This is to say that it achieves less of all of our objectives — fairness, economic growth, simplicity, and revenue sufficiency — than we could expect. The shinier side of this coin is that an improved income tax can deliver far better outcomes in every respect. A reformed income tax would avoid preferential tax law provisions that can directly cause inequality by favoring politically influential groups. And it could much better encourage new and innovative

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investments by allowing profitability in the marketplace, rather than favors in the tax law, to allocate resources. It also could have a broader tax base, such that overall tax rates could be lower — not higher — than today, but with a fair distribution of the burden. The Tax Reform Act of 1986 is a good model of what could be accomplished, and how.

- **The Earned Income Tax Credit** (EITC) is in effect a federal government wage supplement for low-wage workers, increasing at a fixed percentage of wages from the first dollars earned and then later phasing out as earnings increase further. It explicitly supports working families (and at a lesser rate, single workers). It supplements modest wages, which makes work more attractive for those whose hourly reward is the least. It does not add to employer costs, as does the minimum wage, and thus does not deter hiring or fuel inflation. On the other hand, it is administratively challenging, and it can discourage work for some by increasing implicit tax rates over the income ranges where it is phased out. The EITC could be restructured to make it easier to administer effectively, especially if undertaken at the same time as fundamental tax reform.

- The **corporate income tax** is highly controversial and often misunderstood. Some believe that the amount of tax paid by corporations is an important and independent contributor to tax fairness. We would emphasize that the true determinant of fairness is the total amount of tax paid either directly by (in the individual income tax) or indirectly on behalf of (through the corporate income tax) **people**. One could imagine tax systems in which the total tax for particular taxpayers would be the same, but relatively more might be paid directly through the individual income tax, and relatively less might be paid indirectly through the corporate income tax — or vice versa. It is not clear that one alternative combination is inherently more or less “fair” than the other. However, one combination might prove to be far preferable in terms of its implications for economic growth and opportunity. We need a constructive public dialogue to reform our tax system to achieve all of our objectives, including fairness and economic growth and opportunity.

Many corporations argue that the convoluted US tax system (including the preferential provisions referenced above) and its relatively high statutory rates inhibit R&D and capital investment here. On the other hand, many critics argue that traditional US corporations should be “patriotic,” remain and invest in the United States, and pay higher taxes if that should result. We ask those critics to look at the bigger picture. The world economy is constantly changing. Many flagship US corporations of 50 years ago no longer exist, including some because they succumbed to international competition. And every day, new firms enter onto the world stage, often with no particular national identity — or at least much less so than was

the case in the more insular economy of the years just after World War II. The United States is the largest market in the world, and as such, there is good reason for many firms all around the world to consider investing here to serve our consumers — even if their traditional identity is not American. However, just as traditionally US firms might lose competitive ground or even fail if faced with an uncompetitive US corporate tax system, so firms from other nations might pass up the opportunity to invest here for the same reason. American workers would lose jobs and opportunity under either contingency. We need a competitive corporate tax system to give American workers jobs and rising incomes.

Clearly, tax reform is a massive undertaking, and will be highly contentious, but along with systemic health care reform, it is one of the most valuable possible steps toward greater equality of opportunity and reduced economic inequality. Our nation will not provide opportunity and rising incomes unless we pursue a competitive tax system.

In sum, we see our goal of equality of opportunity not as an absolute, or even mere aspiration. It is rather an obligation and a commitment. Without true opportunity, all of our societal objectives — prosperity, productivity, and innovation — are out of reach. The ills of irremediable inequality and economic stagnation — cynicism and despair — remain. The society that is left is unsatisfying even to those who succeed. And success itself is in jeopardy, as the creative workforce atrophies and the markets for products and services slowly migrate elsewhere.

The debate over inequality should bring the nation together, not tear it apart. Our goal should be greater and equal opportunity, which we believe would raise every member of our society; we should not rest until we achieve that goal.

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## Notes to the Executive Summary

- 1 Barack Obama, “Remarks by the President on Economic Mobility,” Speech, THEARC, Washington, D.C., December 4, 2013 (<https://www.whitehouse.gov/the-press-office/2013/12/04/remarks-president-economic-mobility>).
- 2 David Brooks, “The Inequality Problem,” *New York Times*, January 17, 2014 ([http://www.nytimes.com/2014/01/17/opinion/brooks-the-inequality-problem.html?\\_r=0](http://www.nytimes.com/2014/01/17/opinion/brooks-the-inequality-problem.html?_r=0)); Scott Winship, “Overstating the Costs of Inequality,” *National Affairs*, no. 15, Spring 2013, pp. 33-49 ([http://www.nationalaffairs.com/doclib/20130322\\_Winship.pdf](http://www.nationalaffairs.com/doclib/20130322_Winship.pdf)); Philip Armour, Gerald Auten, Edward Conard, Diana Furchtgott-Roth, Bruce Meyer, James Sherk and Scott Winship, *Income Inequality in America: Fact and Fiction*, Manhattan Institute, May 1, 2014 ([http://www.economics21.org/files/e21ib\\_1.pdf](http://www.economics21.org/files/e21ib_1.pdf)).
- 3 *Investing in Children: Business Leadership in Early Care and Education*, Committee for Economic Development, September 23, 2014 ([https://www.ced.org/pdf/CED\\_Early\\_Childhood\\_Web.pdf](https://www.ced.org/pdf/CED_Early_Childhood_Web.pdf)).
- 4 *How Business Leaders Can Support College- and Career-Readiness: Staying the Course on Common Core*, Committee for Economic Development, November 12, 2014 ([https://www.ced.org/pdf/White\\_Paper.pdf](https://www.ced.org/pdf/White_Paper.pdf)).
- 5 Anthony P. Carnevale and Jeff Strohl, “How Increasing College Access Is Increasing Inequality, and What to Do about It,” *Rewarding Strivers: Helping Low-income Students Succeed in College*, Richard D. Kahlenberg (ed.) (New York: Century Foundation Press, 2010), p. 158. For example, one study found that students from the highest quartile of SAT-equivalent scorers, but the lowest socioeconomic quartile, were less likely to graduate from college than students from the highest socioeconomic quartile but the second lowest SAT-equivalent quartile.
- 6 Mark J. Warshawsky, “Can the Rapid Growth in the Cost of Employer-Provided Health Benefits Explain the Observed Increase in Earnings Inequality?” *The Bureau of National Affairs, Inc.*, 2012 (<http://mercatus.org/sites/default/files/Can-Rapid-Growth-Cost-Employer-Provided-Health-Benefits-Explain-Observed-Increase-Earnings-Inequality.pdf>).
- 7 *Adjusting the Prescription: CED Recommendations for Health Care Reform*, Committee for Economic Development, April 23, 2015 (<https://www.ced.org/healthcare>).
- 8 “Taxes,” Gallup, 2015 (<http://www.gallup.com/poll/1714/taxes.aspx>); “Polls,” *The Hill*, February 27, 2012 (<http://thehill.com/polls/212643-hill-poll-likely-voters-prefer-lower-tax-rates-for-individuals-business>).



## Part One:

# *Income and Wealth Inequality: Trends and Potential Issues*

### **Why Should Businesspeople Care about Income and Wealth Inequality?**

This policy statement is a part of CED's ongoing project on "sustainable capitalism." In this project, we undertake research on a series of issues that are part of the controversy surrounding capitalism today, in the aftermath of the recent financial crisis. Many of these issues also echo the vigorous debate at the time of CED's founding — almost 75 years ago, in 1942, in the aftermath of the Great Depression, when many contemporary commentators also spoke of a "crisis of capitalism."

We will complete and release this policy statement, and others, in the nature of working papers — to solicit and provoke comment and discussion. We will use that input to develop each policy statement into a chapter of our forthcoming book, *Sustainable Capitalism*, which will mark CED's coming diamond anniversary year of 2017.

We believe that capitalism — perhaps more accurately described as the free-market system — historically has been an enormous success. It has delivered worldwide progress against poverty and has been the foundation of the growth of the greatest nation ever known to man.<sup>1</sup> But capitalism cannot stand totally immutable in a world of rapidly advancing technology and changing social institutions. Capitalism must evolve if it is to continue to serve the needs of the world's people and economies — if it is to remain "sustainable."

And perhaps one of the key challenges to capitalism's ability to sustain itself — one of the most powerful sources of the controversy surrounding capitalism today — has been the perception and the reality of the growth of inequality and the erosion of economic mobility over recent decades, and especially since the financial crisis.

To some Americans, economic inequality has become a matter of intense concern. President Obama has called it "the defining challenge of our time."<sup>2</sup> It has been the subject of numerous books, articles, and symposia. America has been known as the "land of opportunity," where "all men are created equal." The prospect of the loss of opportunity and some measure of our individual economic standing thus tears directly at our nation's self-image, as well as the hopes of many individuals for themselves and their families.

There has been an equally impassioned pushback to this concern — not so much on the recent growth of inequality as on its significance, potential ill effects, and possible remedies.<sup>3</sup> And with the rising intensity of the debate, the noise has tended to overwhelm the information on a topic that was already highly complex. Different measures of economic well-being — income versus wealth and numerous variations of each — have been confused and conflated. Weaknesses in the available data often have been ignored.

Inequality touches on so much of our nation's economic policy that decisions in this space can have a profound impact on our collective well-being. So our nation needs a meeting of the minds, thoughtfully but urgently. We need to establish the facts, consider our options in an accurate and dispassionate way, and decide on a course of action.

True business statesmen are uniquely situated to begin such a national conversation. Government is paralyzed by partisanship, and most outside advocacy groups are guided by political orientation. CED has a history of almost three-quarters of a century of pursuing the public interest rather than trying to score partisan or ideological points. We call issues as we see them.

# Tackling Economic Inequality, Boosting Opportunity: A Blueprint for Business

We understand that all of society is in the same boat and that our nation can prosper best if we prosper together. We seek to communicate why business must be a key part of a resumption of growth of economic prosperity for all Americans, just as business has been a driver throughout the history of our nation's rising prosperity — including the immediate post-World War II era that many remember and wish to re-create today.

The inequality debate thus far has been highly polarized and polarizing.<sup>4</sup> Although we come from a perspective that emphasizes the historical achievements of free markets, we see merit on both sides of the debate. We believe that our society will advance when each side recognizes the wisdom in the other's position and joins an open dialogue to find the common ground that holds the principles and concerns that we all share. We counsel patience as we hear each other out, in full. We believe that our discussion below is a sound first attempt at a synthesis of what each competing perspective on this issue has to offer — ideally a presentation of what every responsible voice both already believes and can learn from others.

It is impossible to have a rational and focused conversation without a careful definition of terms.

**Equality** has several definitions, and it is not the same as fairness, though the two concepts overlap. Inequality and unfairness are easier to recognize than equality and fairness. Other than strict mathematical equality, all of these concepts are subjective. We present five of the different concepts of equality below.

- **Normative equality** is the notion that all people are entitled to certain things, such as life, liberty, and the pursuit of happiness, regardless of their relative degrees of personal achievement.
- **Formal equality** is the establishment of a basis of equality that applies to everyone, such as the right to vote, free speech, and privacy. These rights are basic, but they are also conditional insofar as they can be taken away on the basis of reprehensible behavior, unlike normative rights.

- **Substantive inequality** arises if A is born tall and B is born short. But is this something society can correct? Does this inequality deserve social attention? Resolution of these questions requires a standard to uphold, such as equal opportunity or a balance of advantages and disadvantages.
- **Equality of opportunity** Given an individual's circumstances, does the system allow him or her to reach full economic potential? If any individual devotes hard work to the task, does he or she have a fair chance to achieve a good standard of living?
- **Material equality** refers to measurable characteristics, such as total wealth, annual salary, or amount of physical property. Henceforth, this policy statement will use the generic terms “equality” and “inequality” to refer to material equality and inequality, and will focus on the concepts of material equality and equality of opportunity.

**Income** is the flow of purchasing power (that is, money, usually measured annually) to an individual or household. Perhaps two concepts of income are most useful: *market income*, which includes wages, business income, investment income, and pension income on a pretax basis; and *after-tax after-transfer income*, which is market income minus tax liabilities plus government benefit payments. There are numerous variations on both of these concepts, with respect to the inclusion or exclusion of particular items in income or taxes, and the definition of the individual or household unit of measurement. Although some commentators express intense preferences between these two major concepts of income, we believe that each serves a particular valid purpose and answers some meaningful questions. We see neither concept as inherently “right” or inherently “wrong.”

**Wealth** is the accumulation of net assets over the lifetime to date, through either earnings or inheritance. As in the instance of income, there are variations in the inclusion or exclusion of

particular assets in the measurement of wealth, in methods used to value different types of assets, and in the definition of the measurement unit to which those assets are attributed.

**Opportunity** is less precisely measurable, but it generally refers to the ability of either an individual or a child of that individual to better his or her lot — measured in terms of income or wealth — either within one lifetime or across generations. Opportunity is perhaps the essence of our national identity — more so than income or wealth — given that over our national lifetime, so many generations have endured hardship so that their children and grandchildren could enjoy that better life. The importance of opportunity is reflected in many aspects of our national life. For example, in professional sports, the losing teams in each season get the highest player draft choices for the next season — because we collectively believe that the least well-off deserve a boost so that they will have a chance to advance.

So why should business leaders care about economic inequality? As we noted earlier, economic policy to influence inequality can have a profound impact on our nation. But beyond that broad, general point, there are four more-focused areas of concern.

**Values and Fairness Principles** Our economy has always generated some measure of inequality — although no more than, and quite possibly less than, historical alternatives. The presence of some inequality is not surprising. Individuals inevitably differ in their innate skills and their other endowments. And free enterprise encourages people to take risks to innovate and invest. Investments that are successful generate the jobs and incomes that the American people need, and can earn substantial incomes for the innovators and investors. But investments can meet with less success — for their initiators, investors, and employees (who often invest through stock options and pension plans). The American people at large would not have it any other way; they want innovation and investment, and if they succeed they want to be rewarded.<sup>5</sup> Thus, economic systems that

are most conducive to economic growth because they allow market forces to reward success tend to have some measure of inequality. And on the other hand, trying to enforce equality of outcomes can be expected to reduce economic growth and incomes because it will deter investments that will not seem worth the risk and the effort without a reward for success. That is why many alternative economic systems, including socialism and communism, have failed: They have not produced growth and widespread prosperity, and as much as they have promised utopian equality, they have generated their own inequality and waste through economic manipulation and corruption as well.<sup>6</sup>

For this reason — perhaps more by instinct than economic analysis — Americans have never desired or sought near-equality of income and wealth.<sup>7</sup> Enforced equality would run counter to the US tradition of free-market rewards for hard work. Instead, Americans have espoused equality of opportunity, and flowing from it, self-sufficiency and responsibility, rather than equalizing outcomes. All of this might strike many as access to the American dream.

Thus, the equality of opportunity for which the American system strives is not the same as equality of outcomes. Some individuals will work harder than others, and some will have more God-given talent and intelligence, or luck and family wealth. For those less fortunate, society provides some level of a social safety net, including educational support and other remedies.

CED believes that equality of opportunity should be our society's paramount objective. But we recognize that different forms of inequality can become locked in a vicious and deteriorating cycle — significant material inequality can constrain future equality of opportunity, even across generations. Furthermore, inequality can cause societal stress and division.<sup>8</sup> Therefore, we believe that business leaders must be attentive to these issues and seek workable and publicly acceptable solutions, as well as a civil dialogue that heals the current public stress.

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**Economic Growth** Excessive inequality can degrade the overall performance of the economy. Many economists believe that a relatively more even distribution of income and wealth — given a freely functioning market economy — can in some respects (but not all) be more conducive to a higher rate and greater stability of economic growth. For one thing, persons with lower incomes tend to spend more of their income than those with higher incomes, so if typical incomes rise more, it gives a boost to economic activity in the short run. Furthermore, if income is concentrated in just a few hands, then overall economic activity is more subject to a small number of spending decisions and might therefore be more volatile. A broader and deeper base of consumer demand can lead to steadier and more reliable growth. That is because domestic producers have a larger and more stable home market that will not fluctuate with relative currency values (as do foreign markets). Furthermore, in the US market, where the purchasers share the same culture and changes in preferences are felt directly and almost immediately, sellers can adjust to changes in demand more quickly. But finally, and perhaps most importantly, a more even distribution of income and wealth provides more opportunities for a broader segment of the population to achieve greater educational and financial opportunity. Thus, more individuals participate fully in the economy, and economic activity rises and is more stable in the long run. As one reflection of this line of thought, Standard & Poor's issued a report on August 1, 2014, concluding that income inequality hurts US growth.<sup>9</sup>

**Social Instability** The social instability argument holds that rising income and wealth inequality could spark opposition to the US free-enterprise system. Excessive inequality could have effects ranging from mildly divisive to catastrophic.

Risks would begin as some small highest quantile (the “top 1 percent” has become a common though quite likely misleading metaphor) would enjoy a much greater rise in living standards, proportionately, than others. The growing

difference would spawn resentment by the worse-off majority. At its mildest, this ill will could worsen our already polarized politics and erode public consensus about our national values, make the political dialogue harsher, and delay or even prevent the achievement of compromise and agreement on important issues. At a more corrosive level, this resentment could even break the current gridlock and lead the disaffected majority to use its power at the ballot box to redress the perceived imbalance. Ill-considered policy changes could make everyone worse off in comparison to the “old” system. In the most extreme scenario, a plutocracy of the most well-off would take over more of the economy and use its wealth to dominate the political discourse. As the status of the less well-off collapses, they could recoil against their diminished economic circumstances by upending the status quo, going beyond the ballot box to nonpolitical, even anarchical means. More conventional economic thinking would hold that the “new” system would be likely to generate less innovation, growth, and advancement of well-being, and everyone would suffer.

Some might argue that on the political front, a small number of well-to-do persons could at least in theory exert undue influence on the political process for their own ends. Indeed, according to the Sunlight Foundation, in the 2014 election campaign just 31,976 individuals, or roughly 0.01 percent of the population, were responsible for 29 percent of all political contributions and related PAC donations — roughly \$37,000 per person.<sup>10</sup> Undue influence could be achieved through the tacit acquiescence of elected officials who think they need more contributions for the ever-increasing cost of political campaigning, which has far outpaced inflation.<sup>11</sup>

Some who argue to reduce inequality in order to maintain social stability might point to the French Revolution (1789), the Russian Revolution (1917), and the Chinese communist takeover (1949) as dramatic upheavals caused by high levels of income and wealth inequality. The causal role of inequality in these events can easily be exaggerated, yet

inequality certainly did contribute to some extent. Today's US society is a far cry from these historical episodes; one economist estimates that 60 percent of the wealth was concentrated in the hands of the top 1 percent in prerevolutionary France.<sup>12</sup> And it is of course uncertain that these upheavals actually remedied the inequality that may have caused them; China and Russia may have greater inequality today than they did before their revolutions; at the very least, their inequality is high by the scale of other developed nations today.<sup>13</sup> The conventional wisdom prior to each of these upheavals was that "it can't happen here." And though we might believe that the United States would be immune from such strife, by some measures our nation is highly violent by developed-world standards.<sup>14</sup> In any event, the most basic objective of US policy makers should be that we never come close to such disorders.

**Social Mobility** Social mobility — the ability of a person to move over time from one income or wealth ranking to another — is perhaps the core of the American dream. Social mobility can be up or down and can be either intergenerational (occurring between generations, such as when a child attains a different income or wealth ranking than his or her parents) or intragenerational (occurring within a generation, such as when an individual's income rises markedly because of business success). Societies differ in the extent to which social mobility is possible. Under a caste system based on the circumstances of birth, movement from one class to another may even be prohibited. At the other extreme would be a true meritocracy in which placement is based on individual achievement regardless of birth.<sup>15</sup>

The premise of the American dream is that our country has substantial social mobility — that anyone, including the poorest of the poor, can rise to the top by dint of hard work. This belief is deeply ingrained in the national psyche. Such advances do occur. For example, the probability that a child whose parents are in the bottom fifth of the income distribution reaches the top fifth has been estimated at 8.4 percent for children

born in 1971, and 9.0 percent for children born in 1986. For those in the second lowest quintile, the chances of moving up to the top were 17.7 percent and 13.8 percent, respectively. Thus, the chance of such a child truly "making it" is around 1 in 10 and has been rising slightly. (Note that this statistic reflects annual income rather than wealth).<sup>16</sup> In a somewhat different finding, researchers from Harvard, Berkeley, and the Office of Tax Analysis of the US Treasury, using a long series of IRS tax records up to 2012, found that social mobility in the United States has stayed more or less constant over the last 50 years.<sup>17</sup>

But consider that if income outcomes were truly a random draw, then the chance of any child reaching the top 20 percent of the income distribution would be 20 percent. So upward mobility is possible, but outcomes in our society are by no means random with respect to upbringing. One international comparison found that mobility so measured is less in the United States than in the United Kingdom, Denmark, or Canada (and is barely half as great as in Canada).<sup>18</sup> Consider also that measurement of mobility, either intergenerational or intragenerational, can be highly complex. An individual or a young parent raised in an affluent family and attending an elite professional school may have a low income in that current year and a much higher income in a later year, but that person's or family's progress might not be considered a demonstration of the existence of social mobility.

And on the heels of an economic downturn of epic proportions, many American parents may fear the utter loss of opportunity for their children — not just a lack of progress, but an actual decline of living standards for graduates unable to find good jobs. For them, the opposite of opportunity is insecurity.

Social mobility in the United States is lower than in most Western European countries that have a similar GDP per capita,<sup>19</sup> but this fact must be tempered with the realization that America's looser immigration regulations have many new participants starting near the bottom. With the

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considerable income inequality in the United States, the reward for those climbing to the top is greater here. According to the Organisation for Economic Co-operation and Development (OECD), the average income of the top OECD decile is 10 times the lowest, whereas in the United States the ratio is 19 times.

Excessive inequality can reduce social mobility. Education is considered a key to successful social mobility, and children from the highest-income families have a higher probability of undertaking advanced education — even relative to lower-income children with superior secondary school achievement.<sup>20</sup> For example, the OECD study noted that “children born to the highest-income families...in 1993 were 69.2 percentage points more likely to attend college than those from the lowest income families.”<sup>21</sup> For people born in 1984 (nine years prior), the percentage difference was higher, 74.5 percent. This suggests that the message of education is getting through, and that greater student loan-grant assistance is increasing attainment for children of families with modest means. Similarly, “social movements have delivered better career opportunities for women and minorities.”<sup>22</sup> Given these positive developments, however, one might wonder why apparent social mobility has not increased even more. As one possible explanation, many students and families of modest means — even those who are well prepared academically — have no experience of postsecondary attendance or success to guide them, and if they attend poor schools, they may receive little guidance toward advanced education.<sup>23</sup> Striking evidence has been uncovered

that third-grade children with high math scores are significantly more likely to register patents in their adult years — but that this effect applies far more strongly to children whose parents’ incomes are above the median.<sup>24</sup> Also, the cost of higher education may be escalating out of reach; see CED’s policy statements on that subject.<sup>25</sup>

Thus, if severe inequality persists over years, extending into generations, it is possible or even likely that some people and their children could endure an essentially indefinite period of an absence of opportunity. Ultimately, if social mobility decreases because persons from lower-income households do not or cannot take advantage of education, then those individuals may become frustrated and eventually disengage from the economy and the democratic process. Supreme Court Justice Louis Brandeis put it succinctly nearly a century ago: “We may have democracy or we may have wealth concentrated in the hands of a few, but we can’t have both.”<sup>26</sup> Viable US free enterprise depends on the majority “buying into the system,” and the system’s sustainability is in danger if frustration becomes despair and participation declines sharply. Everyone must believe we are in the same boat and rowing in the same direction if we are to reach our greatest collective potential.

In sum, our free-enterprise system has prospered in the past with relatively high levels of inequality, but today’s levels are extreme. Continuation of the current trend raises concerns for business leaders, who should be prepared to engage on this issue to keep our economic system strong and sustainable.

## Current State of US Income and Wealth Inequality

This section will discuss inequality of incomes, and then inequality of wealth.

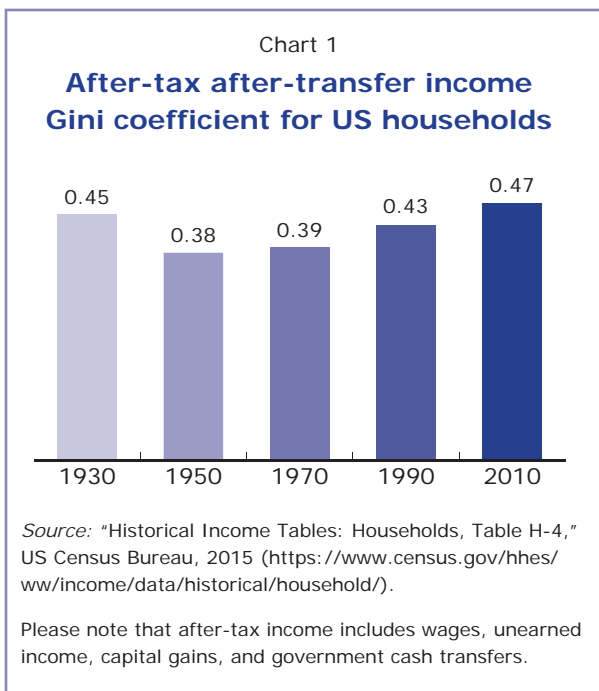
### Income inequality: statistical measurements

Over the last 40 years, economic inequality has increased in the United States. Perhaps the most common measure is the share of market income (which, again, includes wages, business income, investment income, and pension income on a pretax basis). There are reasonably good historical data and comparable country data on market income because it must be reported (with some penalty for misrepresentation) on tax returns in virtually all developed countries. The other prominent income definition is “after-tax after-transfer income” (again, market income minus tax liabilities plus government transfers).

The most common single-number measure of inequality (of income, wealth, or any other quantity) is the Gini coefficient. The Gini coefficient, conceptually, is the difference between a perfectly equal distribution and the actual distribution, expressed as a percentage. If the actual distribution is precisely equal — all persons have the same identical income — then there is no difference between the actual and equality, and the Gini coefficient is zero. If one person receives all of the income, then the distribution is totally unequal, and the Gini coefficient is 100 percent, or 1.0.

With the rapid economic growth and rising wages from the end of World War II through the early 1970s, inequality (measured by the Gini coefficient) fell. But since the oil crisis and the recession of the mid-1970s, inequality has generally increased and now is slightly in excess of its historical peak level of 1930.

Chart 1 uses “after-tax after-transfer income.” Using market income as a definition would show more inequality (i.e., a higher Gini coefficient) in each individual year (because that measure would not include the equalizing effect of government transfer payments and progressive taxes), but with a similar upward trend over the last 40 years. Note that the increase in measured inequality does not indicate that middle- and lower-income households in the United States have become worse off over time. They have not, on average, because aggregate income has grown sufficiently to prevent that (see Charts 13 and 14, pages 43 and 44).<sup>27</sup> However, we will argue later that the rate of growth of the incomes of those households in recent decades has been disappointingly slow.



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The US income distribution is more unequal than comparable industrialized nations, but less than many emerging markets. Chart 2 lists selected developed economies, ranked by their Gini coefficients and ordered from most unequal to most equal. These OECD data are several years old and reflect after-tax after-transfer income.<sup>28</sup>

As an alternative to the Gini coefficient (which has both the advantage and the disadvantage of being a one-number summary of complex information — so although Gini coefficients are easy to compare, an infinite number of alternative distributions, which potentially would not be equally preferred by analysts, can yield the same Gini coefficient<sup>29</sup>), researchers and readers often prefer to assess the degree of income inequality through the income shares received by each

decile (10 percent) or quintile (20 percent) of the population ranked by income. In 2010, for example, the top 10 percent in the United States received 48 percent of total market income, versus 35 percent in 1980. That statistic's previous peak was 44 percent in 1930, after which it hit a low of 33 percent in 1970 (see Chart 3). Again, a declining share of income for any population quantile during a period of healthy growth in total income does not necessarily mean that the actual level of purchasing power is declining.

To give a sense of scale, the average household market income for the top 10 percent in 2010 was \$348,000. For the bottom 40 percent, it was \$34,000. Using after-tax after-transfer income, those two figures would be \$259,000 and \$32,000.<sup>30</sup>

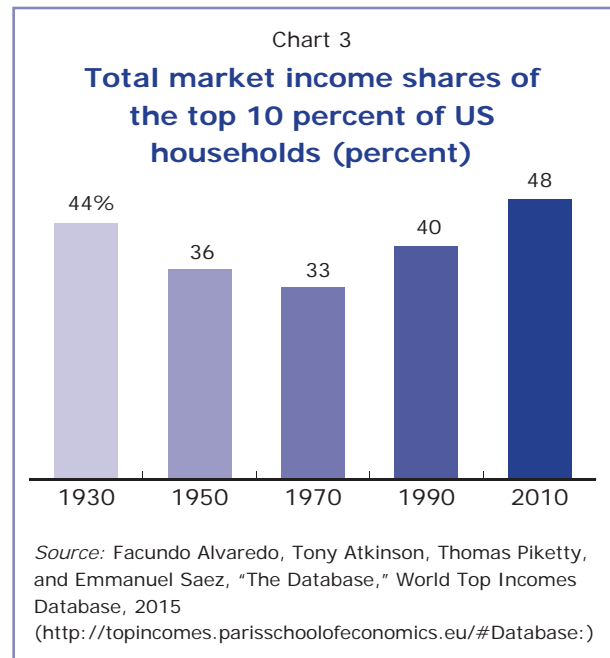
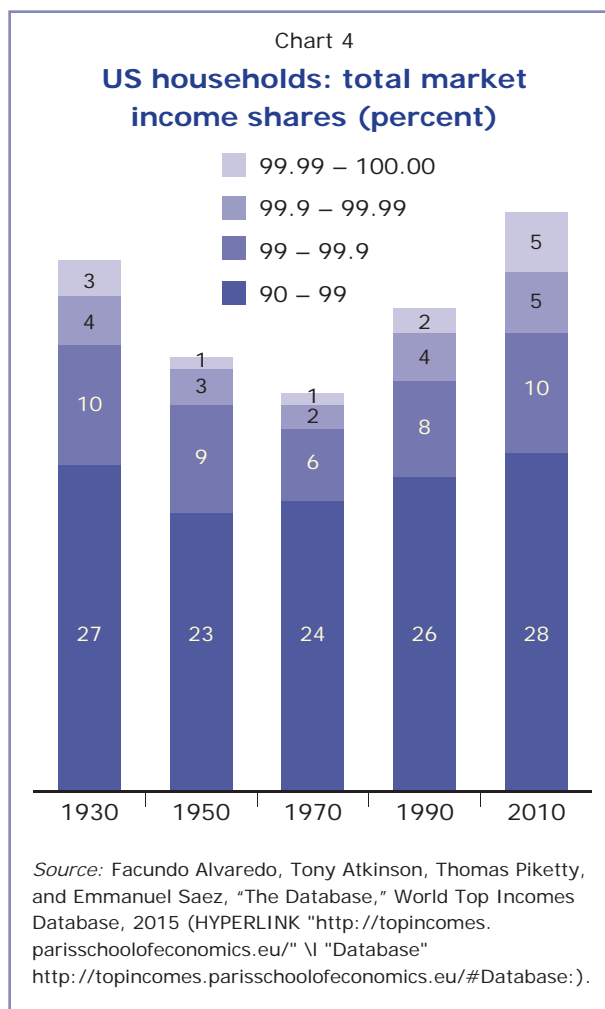




Chart 4 helps to illustrate that since 1970, the greatest growth in market incomes has occurred at the very top of the income distribution — the highest 0.1 percent (or more detailed data might even suggest the top 0.01 percent) of the income scale, rather than the entire highest 10 percent or even 1 percent of the population.

Of the 15 percentage-point gain in the top 10 percent’s income share since 1970 (from 33 percent to 48 percent), about half, or 7 percent (out of 15 percent), went to the top 0.1 percent — the highest 1 in 100 among the top 10 percent. And more than half of that increase, 4 percent, went to the top 0.01 percent of households.

Different income measures serve different purposes; no income measure is always “right” or “wrong.”

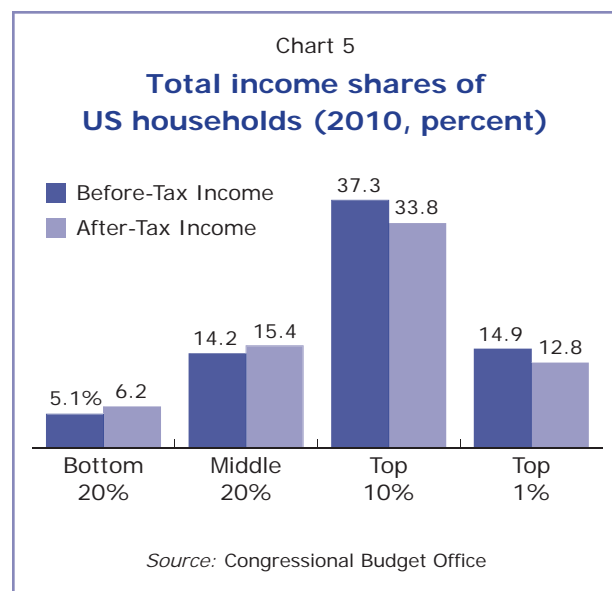


So, for example, market income shows the recipient’s own command over resources in the marketplace, while after-tax after-transfer income shows the recipient’s capacity to consume or save. At different times and under different circumstances, researchers and policy makers will want to know each of those measures.

The concentration of income differs under different measures in a fairly predictable way, as seen in Chart 5.

We present these data to allow comparable measures of market income and after-tax income. These data are not comparable with other data presented earlier in this policy statement because the Congressional Budget Office includes employer health insurance and pension contributions in income.

Thus, in 2010, the after-tax income share for the bottom 20 percent of households was 6.2 percent, while the bottom 20 percent on a market income basis (not identically the same households) received 5.1 percent of the total of that income. Thus, taxes on net increased the bottom 20 percent share by one-fifth (i.e., 6.2 percent / 5.1 percent = 1.22). Because the US tax system is generally progressive, the distribution of after-tax income is relatively closer to equal than is that of market income.



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## Wealth inequality: statistical measurements

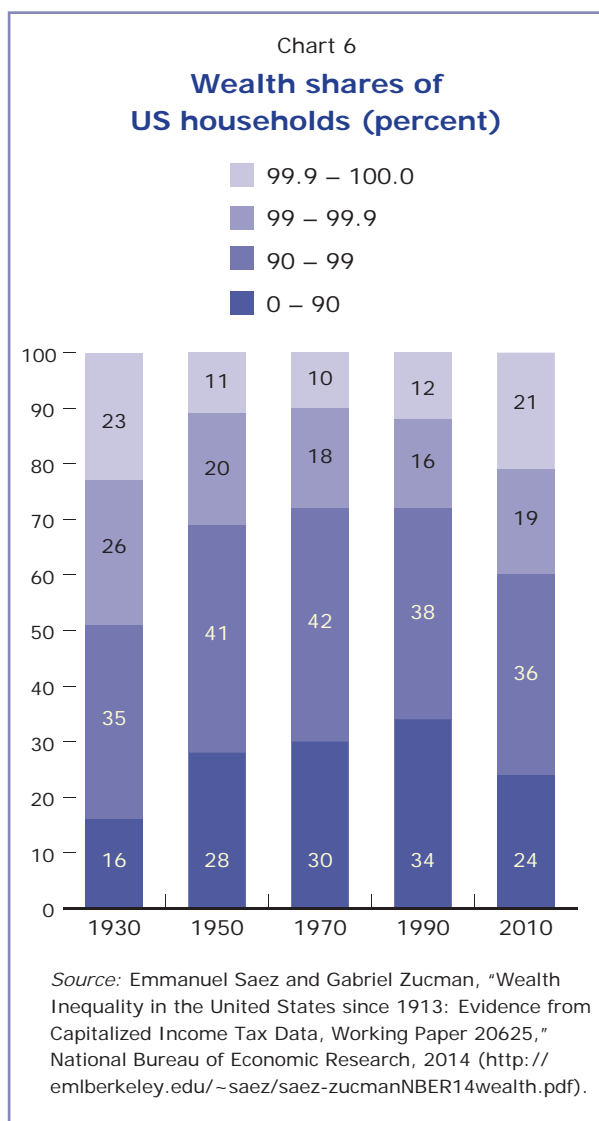
Again, income and wealth are often confused or even conflated in popular discussion, but they are different things. Income is the money earned in a given year through wages, self-employment profits, retirement payments, and investment income. Wealth is the accumulation of assets over the lifetime to date, through either earnings or inheritance. The top 10 percent of households ranked by income and the top 10 percent of households ranked by wealth include some of the same households, but the two groups are not identical.

Wealth inequality is greater than income inequality in the United States, as it is in other developed economies. Economist Edward Wolff of New York University estimates in a 2012 paper that the 2010 Gini coefficient for US household wealth was 0.87, versus the 0.47 for after-tax after-transfer income shown in Chart 1 (page 21).<sup>31</sup> The rather extreme Gini coefficient for wealth — substantially closer to the theoretical maximum of 1.0 than we have seen for any concept of income — arises in part because 23 percent of all households in Wolff's data have zero net wealth.<sup>32</sup> (In contrast, when both market incomes and government transfers are included, virtually all US households have at least some income.) In addition, the more wealthy households appear to be the most sophisticated investors — although perhaps those with less wealth are highly risk averse because they do not want to lose what little they have. Furthermore, lower-income households have far less-diversified wealth portfolios, with most of their net worth in their home equity. They suffered more during the financial crisis and have earned much lower returns on their net wealth since.<sup>33</sup>

The bottom half of households have just 5 percent of all wealth. In contrast, the top 10 percent of wealth holders own 76 percent of all wealth (while the top 10 percent ranked by market income receive 48 percent of market income). The average household net worth of the top 10 percent of wealth holders was \$3.6 million in 2010.<sup>34</sup> The wealth distribution is even more top-heavy than that statistic would

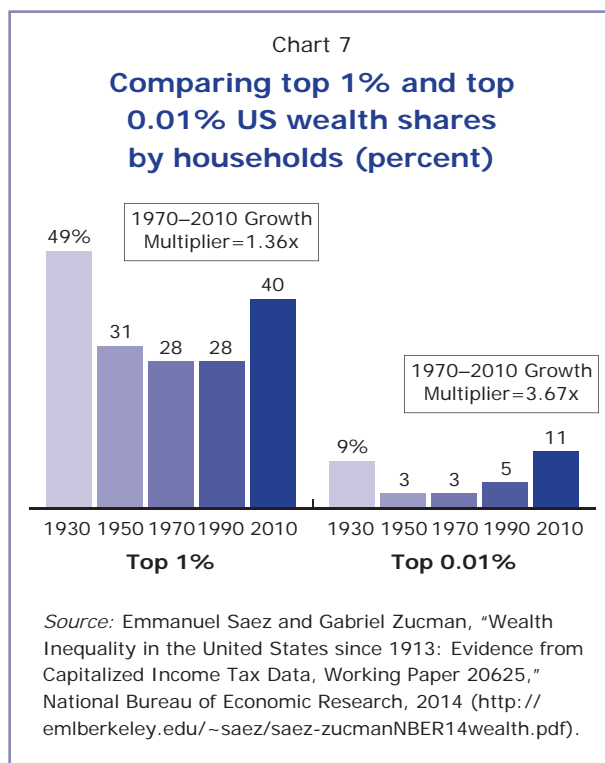
suggest, however, with a considerable amount of wealth in the hands of a very few households.

As Chart 6 shows, the 90 to 99.9 percent share has fallen from 60 percent to 55 percent since 1970, while the share of the bottom 90 percent fell from 30 percent to 24 percent. Thus, the highest 0.1 percent gained in terms of its share of total wealth relative to the entire remaining 99.9 percent of the population. This does not mean, of course, that the rest of the population lost wealth in absolute terms; there was a substantial increase in aggregate wealth in the United States over those 40 years.<sup>35</sup>



But in purely distributional terms, wealth has become far more concentrated in the very top of the pyramid. The situation in Western Europe is similar, but less pronounced than in the United States.

As a measure of the growing concentration of wealth, the share of the top 0.01 percent of households ranked by wealth has more than tripled since 1970, as shown in Chart 7. The top 0.01 percent represents just 15,600 households out of 156 million.<sup>36</sup> As these figures indicate, the increase in the share of wealth of the entire highest 1 percent was 12 percentage points (40 percent minus 28 percent), but the increase of the top 0.01 percent — the highest 1 percent of the highest 1 percent — was 67 percent of that (8 percentage points — 11 percent minus 3 percent — of the 12 percentage-point increase for the entire top 1 percent). Thus, the growth in the share of wealth is reflective mostly of a group far more concentrated even than popular rhetoric about the “1 percent” would suggest. Note also that the wealth share of the highest 0.01 percent is larger than it was in 1930.



The average market income of the top 1 percent and the top 0.01 percent in 2010 was \$1.1 million and \$26.7 million, respectively.<sup>37</sup> The average wealth was \$12.6 million and \$343 million, respectively.<sup>38</sup>

Although there are knotty conceptual issues in the definition and measurement of market income — the inclusion or exclusion of employer contributions for health insurance plans and the treatment of realized capital gains is discussed in Appendix 1 — there are probably even more measurement issues with respect to statistics on wealth.

The definition of the household unit can have an impact on the measured distribution of wealth even if total wealth remains unchanged. As just one example, a divorce in a high-wealth household will turn that one household into two, each potentially with approximately half of the original amount of wealth. But if that wealth was large enough, having one more wealthy household might increase the measured concentration of wealth.

A second conceptual issue that could have a potential quantum effect on the measured wealth statistics is the treatment of Social Security (and Medicare) and other retirement plans.<sup>39</sup> Social Security is far more important to people with low (or even no) wealth than to those with significant amounts of marketable wealth, including defined contribution retirement plans like 401(k) plans. So counting a present value of expected future Social Security benefits can increase the measured wealth of many households by orders of magnitude (although the degree to which this is true is less today than it was a few decades ago because of differential changes of expected mortality among people with different levels of income).<sup>40</sup> Of course, expected future Social Security benefits are not marketable, transferable, or even bequeathable to heirs. Given the “insurance” nature of Social Security, if two spouses should die prior to claiming benefits, then neither would recover any part of what they contributed during their working lives. The program is fair actuarially, however, and so others of modest means might receive a substantial return on their contributions.

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Likewise, Medicare benefits cannot be redeemed in cash, but they do protect other wealth from dissipation for medical services.

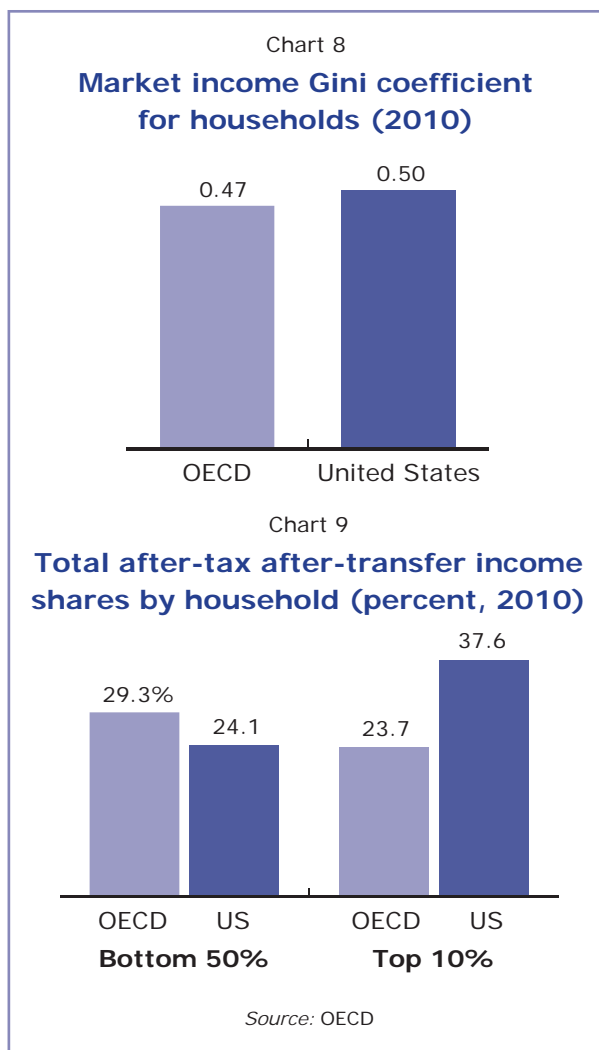
Finally, analysts might quarrel over the types of assets that could be included in measures of wealth, and those decisions could well have consequences for measurements of wealth inequality over time. For example, people of considerable wealth might purchase and bid up the prices of rare or non-reproducible “trophy assets” such as luxurious homes or boats. Such assets, certainly housing, have the advantage of very long expected lives. And in one respect, those assets certainly do add to the owners’ command over future consumption or saving; they could be sold for cash and their market values redeployed. Such assets also do produce output in some ways; for example, the rental value of owner-occupied homes is included in the GDP. However, those assets do not produce output in the same sense as would alternative investments in machines, factories, or commercial real estate. Thus, the distinction between such trophy assets and pure consumption — which is not added to measures of wealth — is probably less sharp than economic science would prefer. A related generic measurement issue is the assignment of values to any assets that are not regularly traded in open markets, such as unique pieces of business real estate.

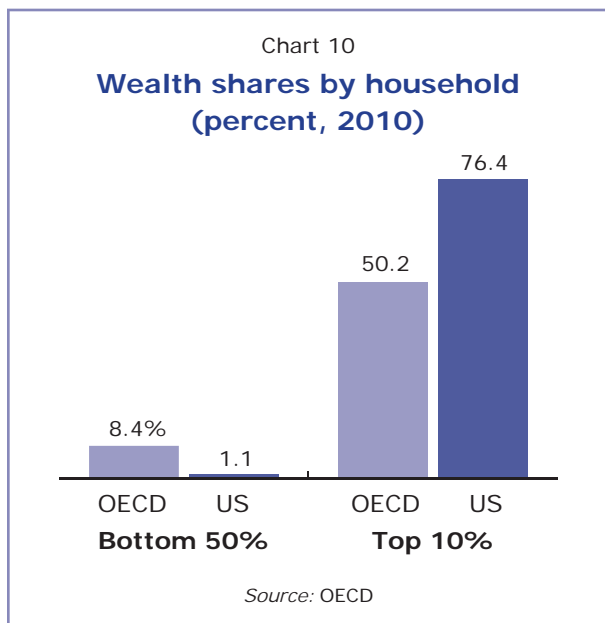
Thus, like the choice between an analysis of market income versus one of after-tax after-transfer income, wealth investigators need to choose whether to include some insurance value for future Social Security benefits, among other issues. For example, if the purpose is to consider the household’s immediate potential control of resources out of accumulated wealth, then Social Security would have no effect. But if it is, rather, to estimate the future spendable income of the household assuming a normal life span into retirement, then Social Security should be a part of the picture. And intuition has been confirmed by analysis to show that including an insurance value for future Social Security disproportionately increases the measured wealth of low-wealth households, especially those who otherwise have no net worth at all. This has a significant effect on

the measured Gini coefficient for the distribution of wealth. (See Chart 15, page 62, and its discussion in Appendix 2.)

## Income and wealth inequality: OECD comparisons

For international perspective, economic inequality is present elsewhere in the developed world. Gini coefficients are generally smaller in other OECD member nations than in the United States, as shown in Chart 8 (which uses market incomes) and Chart 9 (which shows shares of after-tax after-transfer incomes). (Two likely reasons are more progressive taxes and less salary differential between top and bottom earners.)





As Chart 10 shows, the OECD nations, like the United States, have a greater wealth concentration than income concentration. The top 10 percent of wealth holders in the OECD control 50 percent of total wealth, versus the top 10 percent of income earners — again, not precisely the same people — who receive 24 percent of all disposable income. In the United States, wealth concentration is greater than in the OECD at large, as shown in the same chart.

### Inequality and the lower-income population

In the broadest sense, incomes can become more unequally distributed either because incomes below the mean (or median, depending on the measure) increase more slowly (or even decrease), or because incomes above the mean (or median) increase more rapidly, or both. And the slower growth of incomes below the mean can arise because of an increase in the population at income levels below the mean, which can result from an increase in the adult native-born population of individuals or families, or because of immigration.

Thus, increasing inequality does not necessarily mean that the living standards of lower-income households are falling. From 1970 to 2010, pretax

income (adjusted for inflation) for the bottom 40 percent increased by a cumulative 6.7 percent.<sup>41</sup> However, that rate of growth over 40 years was extremely low by previous standards — and far lower than the rate of labor productivity growth.<sup>42</sup> Meanwhile, the real incomes of the top 10 percent, 1 percent, and 0.1 percent, respectively, were up 75 percent, 166 percent, and 361 percent, with each of these figures obviously heavily driven by that last highest income category.<sup>43</sup> The economic “pie” is growing bigger, but the best-off minority is getting a far larger share of the growth. Some believe that these outcomes are fair because those who are most rewarded have been judged to have produced value through business enterprises in the marketplace, through hard work, personal investment, or skill (or all three). But others question whether this trend, especially given the degree of difference of rates of income growth, is good for American free enterprise over the long run.

A first cousin of this fact is the argument that the American middle class is shrinking. The Pew Research Center defines the middle class as those with incomes (adjusted for family size) between 67 percent and 200 percent of the overall median. (Any definition is arbitrary, of course.) Pew finds that the proportion of households fitting that definition in 2014 is only 43 percent, down from 62 percent in 1970.<sup>44</sup> The proportion of households below that income level actually fell from 10 percent in 1970 to 9 percent in 2014. Thus, apparently, the “decline of the middle class” has occurred solely because households have exited up — the “upper class” has grown from 29 percent to 49 percent of the population by this definition from 1970 to 2014. That is a good sign, but we would not consider it in isolation from the fact that real wage growth has slowed over the same period. Membership in the upper class in 2014 is identified based on the median income in 2014. Therefore, households in the talented upper-middle class in 1970 might have ascended to the upper class in 2014 not because their income growth was extraordinarily rapid, but rather because the income growth of the median household below them was extraordinarily slow.

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Between 1970 and 2014, the median inflation-adjusted household income (not adjusted for family size) increased by only 0.5 percent per year. Just for perspective, if 1970 median income had grown instead at 2.0 percent per year, it would have been almost twice as large as the actual median income by 2014 — not far short of what Pew considers to be the border of the upper class in that year.

As an economic issue, inequality is a minor concern of Americans at large. It consistently polls well behind (i) jobs and (ii) government spending and the budget deficit, despite President Obama’s statement that inequality is “a fundamental threat to the American Dream, our way of life and what we stand for around the globe.”<sup>45</sup> However, for a significant minority of Americans, inequality is a matter of such intense concern that it shows the potential to be profoundly divisive. And among the media and across the political aisle, the issue of inequality receives significant attention, as prestigious newspapers and magazines run many articles and opinion columns on the subject, and a book by French economist Thomas Piketty, titled *Capital in the Twenty-First Century*, reached the *New York Times* bestseller list.

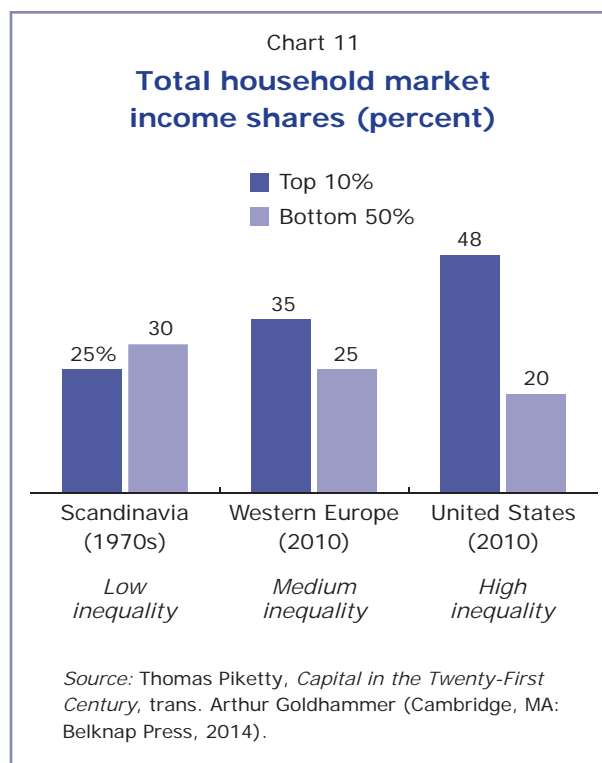
## Is There a Counterproductive Level of Inequality?

If people have the incentive to pursue education, to work hard, to invest, and to take the risk to innovate, and if natural aptitudes and other endowments differ from person to person, some inequality is unavoidable. If people are rewarded for success in a free enterprise economy, the incomes and wealth of those who succeed will be greater than others’. In short, without the freedom to fail, there can be no freedom to succeed. But is there some standard for what is an acceptable amount of inequality — or conversely, is there some level of inequality that becomes excessive and counterproductive? What balances society’s standard of fairness and adequacy against the incentives needed to motivate effort in a capitalist system? Some might hold up other economic systems as potential models, and we consider that intellectual approach here.

## Scandinavian countries as an ideal?

A few commentators have suggested that the Scandinavian economies in the 1970s are the modern ideal.<sup>46</sup> These economies have had high standards of living, boosted in part by oil discoveries in the waters of Norway and Denmark. They had a more moderate degree of inequality than today’s Western Europe and the United States, driven in part by state ownership of these natural resources and their use in providing social benefits for all (see Chart 11).

Choosing Scandinavia as the ideal — which might be taken to imply that the US level of inequality is unreasonable — is a matter of subjective judgment. No two economies or societies are necessarily similar enough that one attribute, like the degree of inequality of income or wealth, would be directly transferable from one to another. The Scandinavian countries are small, highly homogeneous in terms of population, and relatively economically specialized — producing for “niche” markets.



The United States, in contrast, is extremely large, ethnically diverse, and engaged in virtually every market for consumer and capital goods and services. Even if we were to decide that the greater equality of the Scandinavian countries was highly admirable, we would not necessarily be able to achieve that attribute without changes to our institutions that would take decades and would be so radical that they might be destabilizing, leading to undesirable and unintended consequences.

Some have argued that inequality itself is good in that it motivates hard work and innovation — with the implication that in some instances the nation might conclude that it has too little inequality and that more would be better.<sup>47</sup>

The problem is that this logic is fundamentally antieconomic. Economists believe that the market measures rewards — and therefore incentives — accurately. If the market is allowed to work and to set the prices of products and services, there will be winners and losers in the economy, and there will be some resulting degree of inequality. But that degree of inequality will be determined by the prices set by the free market, based on the value of all activities relative to one another. Thus, *inequality* is not per se “good”; *opportunity* and *free markets* are. To suggest that more inequality would be better, and that it would somehow yield better outcomes, is to deny the primacy of the free market. We should not imagine that more inequality than is yielded by the free market would be somehow “better.”

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## *Part Two: Possible Causes of Growing Income and Wealth Inequality*

### **Introduction**

There is considerable controversy about economic forces and policy choices that surround the growth of inequality. Discussion of the numerous extant hypotheses could go on at extreme length. We will seek to identify briefly three broad classes of possible causes: market forces; social change; and federal, state, and local government policy. The lines that divide these categories are less than sharp, but we find them to be useful as we consider how business and society should respond to growing concern about inequality.

Not all of these causes have direct remedies. For example, some adverse demographic forces are “baked in the cake” and cannot be reversed. However, where possible, we will recommend policy responses in a later section of this statement.

### **Market Forces**

One alleged and potentially demoralizing cause, discussed by Thomas Piketty in his 2014 book,<sup>48</sup> is a **natural and inevitable tendency of capitalism** to generate ever-increasing inequality of wealth and income. According to this theory, the rate of return ( $r$ ) on capital in a capitalist system exceeds the rate of productivity growth ( $g$ ) over time. Thus, accumulated wealth appreciates faster than employee compensation grows, on average. The rising wealth inequality leads to greater income inequality through the same mechanism as income from capital grows faster than wages. Rising wealth inequality is thus inevitable, absent a shock to the system. These relative rates of growth have been discussed in theory for some time, but the phenomenon has not been emphasized as a potential source of ever-rising inequality.

This phenomenon would doom the US system to an inevitable plutocracy, although, interestingly,

this result has not yet materialized in America’s history — according to adherents of the theory, because of wars or other disasters that destroy wealth and interrupt the process. But inequality has moderated in the past without a system shock like a depression or a revolution. And note that a depression would devalue the holdings of the wealthiest persons more than others, thus promoting equality (while harming everyone — even those who have no wealth to devalue). One of the basic critiques to this theory is that the rate of return on capital could be expected to decline as the supply of capital grows.

To confirm this argument of a natural and irreversible tendency of capitalism, some would argue that inequality is destined to increase because the federal government will not allow the stock, bond, or real estate markets to decline for substantial periods — either because of concern for wealth holders or because of the possible consequences for all households. This argument would hold that the shock that the theory claims is necessary to reverse the march toward greater inequality will never actually occur.

As vividly demonstrated in the 2008 crisis, the US federal government will go to extraordinary lengths to forestall a financial panic that would lead to an economic depression. In 2008, the government essentially guaranteed (i) all bank, S&L, and credit union deposits, (ii) the entire commercial paper market, (iii) the entire money market fund industry, and (iv) the senior unsecured creditors of a broad range of financial institutions (and through its support of Fannie Mae and Freddie Mac, most of the nation’s housing finance as well.) In some cases, the equity holders of these corporate beneficiaries paid little or no compensation to the government. By way of example, several large financial firms could have failed in 2008, absent a government guarantee of their obligations.



The federal government received no ownership stake in many of these businesses, and the firms' shareholders (including their top managers) eventually enjoyed substantial increases in their share prices. (In the case of activities of the Troubled Asset Relief Program, or TARP, the federal government did receive compensation, and in fact made money in the end.)

In recent decades, government actions intended to "prop up" the capital markets have become so expected that Wall Street traders gave them a nickname: "the Greenspan Put." The "invisible hand" that governs asset prices is thus muted by government action, reversing the self-correcting mechanisms. Few would argue that financial panics and depressions are good for society as a whole, but their mediation arguably tends to preserve an upward spiral of wealth inequality to the extent that those who already own wealth are protected from failure.

A second development in markets that is alleged to contribute to US inequality is **globalization**. In the immediate post-World War II years, US firms were less global than they are today.<sup>49</sup> US consumer demand was much more dominant in the world picture. Quite naturally, therefore, US firms' revenues, employment, and profits were heavily concentrated in the United States, and some experts believe that owners and top managers perceived a greater responsibility toward their US employee base. As economies around the world developed (in a phenomenon that was both inevitable and in many ways beneficial to US living standards), US-based firms put more effort into pursuing foreign sales, and they pursued foreign production for those other markets — and in some instances built foreign links in the supply chain for the US market as well. For large US firms in the S&P 500 index, foreign sales as a percentage of total revenue have climbed from 42 percent in 2003 to 47 percent in 2012.<sup>50</sup> The share of foreign profits in the total has also risen, although that trend is difficult to assess due to tax strategies and differences in accounting conventions in the United States and abroad. Globalization tended

to weaken the demand for US labor in lines of production that were most easily located overseas, in turn weakening the bargaining position and reducing the wages of some low- and middle-skilled US workers.

The low cost base in developing economies can result from lower wages and costs of land and construction of factory facilities, fewer protections and fewer benefits for workers, and loose environmental regulations and undervalued currency regimes. These attributes offset a risk premium relative to the more stable and reliable US economic system, as well as transport expense to the United States.

Americans should want foreign economies to develop and grow, just as we want economic and wage growth for all Americans. This is especially true of the developing nations, where wages are the lowest and human need is the greatest. Growth overseas reduces the most offensive poverty and also gives the United States better customers and suppliers.<sup>51</sup> Our nation is not better off because other nations — especially the poorest — are worse off. And it is in the natural course of economic development for developing countries to grow faster than developed countries. That is because to grow, the United States and other developed economies must innovate to improve their already state-of-the-art technology — which is most difficult — whereas developing countries need only copy even generations-old technology to take quantum leaps in their lagging productivity levels.

And we should want US firms to compete successfully in those markets, even if it means that some of their incremental employment is added in those markets overseas. If US production is not competitive for some low-technology products that can be produced by low-skilled labor, requiring US production would amount to ceding those markets to foreign producers — losing all US jobs, not just the production jobs that would be associated with those markets. The prosperity of all Americans depends upon our firms remaining competitive in every possible market.

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Closely associated with increasing globalization is the **advance of technology**. Manufacturing and some other jobs have become much more demanding in terms of training and skill. And at the same time, many low-skill, low-education-oriented US manufacturing jobs (such as in textiles and other apparel or even automobiles) that have not been moved to developing economies with lower costs of doing business have been replaced by sophisticated machines.<sup>52</sup>

Beginning almost 50 years ago, manufacturing employment, which had been growing in absolute numbers, became roughly steady; and then, about 15 years ago, it began to decline. Thus, over that period, manufacturing employment fell steadily and then more rapidly as a share of total employment. However, although the US economy shifted gradually toward consumption of services rather than manufactured goods, manufacturing production fell in much smaller proportion than did employment. (Imported manufactured products filled the gap left by declining domestic production — as did increased consumer demand for services.)<sup>53</sup> This was made possible by all manner of sophisticated machinery often with computer control, which can produce growing volumes of output with less human intervention. This development has occurred at breakneck speed on the scale of past transitions through agriculture and industrialization, and has therefore demanded massive and rapid adjustment on the part of many American workers.<sup>54</sup>

From this perspective, highly skilled and educated Americans, those in the upper segments of the income distribution, hold jobs requiring skills that poor countries and machinery cannot deliver. Whenever skills are made obsolete by trade or technical change — usually affecting middle-range workers — those persons fall further behind in wages and incomes.<sup>55</sup>

This shift in the worker profile has been reflected by company practice, in that the percentage of training staffers in the workforces of US manufacturers has “fallen by about half from 2006 to 2013,” suggesting that industry may pay

less attention to worker training.<sup>56</sup> If firms are finding workplace training to be less productive in developing the workforce, it could cut off one avenue through which line employees have advanced their careers. Or there could be a chicken-and-egg conundrum in which firms may be reluctant to train employees for fear that those employees will leave for other companies, or that more rapid worker turnover for other reasons deters firms from paying for training; or employers may be pressed by financial markets to deliver short-term profits, which dictates economizing on training (and other investments in long-term value).

Another factor was the **increase in the domestic supply of labor caused by the maturation of the baby boom**. The oldest members of that generation — born beginning in 1946 — were in the labor force in full numbers by 1970. The subsequent entry of the younger members of that generation into the labor force caused competition among workers, holding down wages — even as the growth of the labor force increased aggregate output.

Yet another market force that has driven rising inequality has been the emergence of a “**winner-take-all**” economy.<sup>57</sup> More so than in past decades, success — often on the part of innovators and first movers of new ideas — has begun to yield extreme rewards, allowing the successful to move straight to, and beyond, the existing upper tail of the income distribution.

The winner-take-all phenomenon has appeared in numerous situations in numerous markets. Successful individuals in sports and the performing arts have earned enormous rewards. The availability of the internet for mass instantaneous promotion and sales has facilitated this process. First movers in internet technology itself have been among the biggest winners (while other, similar new firms have failed).

Corporate executive compensation has been widely cited as a source of inequality, and as a manifestation of this winner-take-all phenomenon. Due to governance-related compensation changes in the 1990s, top managers in public firms began

to receive more stock options as a substitute for or in addition to cash compensation. This was intended to align managers' interests with owners.<sup>58</sup> Executives at publicly traded companies can reap larger compensation packages if stock prices rise in a particular year when the options are exercised. Meanwhile, the growth of large firms has made them more complex and more difficult to manage well, which is reflected in the higher compensation of their managers. Widely publicized large compensation packages considered out of context can give the general public an unfavorable view of capitalism, with the appearance that the rewards of work go to only a few. However, there remains the serious challenge of truly aligning the incentives of managers with the firm's long-term value, rather than its share price at one arbitrarily chosen moment in time.

With somewhat less fanfare, a small grouping of hedge fund and private equity fund managers make enormous annual compensation, sometimes approaching \$1 billion or more per individual manager, often hundreds of times higher than corporate CEOs.<sup>59</sup> And meanwhile, those fund managers sometimes demand greater short-term reported profits from executives of nonfinancial firms, which can require downsizing of employment — with its own consequences for inequality. Such financial-manager compensation has been negotiated with sophisticated investors — such as state pension funds, university endowments, and sovereign wealth funds — on an arm's-length basis. Nonetheless, there is at least an appearance of unfairness to citizens who pay attention to such matters, and such compensation does push the prominent statistical measures visibly toward greater inequality. The incomes of hedge fund managers reported in the press are so large as to be highly material to the published income distribution statistics.<sup>60</sup>

The US financial sector as a whole has expanded dramatically in size, rising from 4.5 percent to 8.4 percent of GDP between 1980 and 2010.<sup>61</sup> Financial sector managers (and those reliant on the sector) are disproportionately at the top segments of the distributions of income and wealth. The United

States has continued to enjoy capital markets that are the model for many countries around the world and that have the function of allocating capital to its most productive uses. That being said, the growth of especially those segments of the sector that have yielded spectacular incomes has led some to question whether the legitimate intermediation function of routing savings into efficient investment is (or at least was, prior to the financial crisis) being eclipsed by speculation — a “slicing and dicing” and selling and reselling of shares of real economic activity — that could hinder real growth by crowding out other uses of capital such as physical or research and development (R&D) investment that can accelerate technical innovation and create jobs.

One manifestation of the winner-take-all phenomenon, however, may be more benign than the most adverse interpretations of growing inequality. Some research indicates that much of the growth of income inequality that we have observed occurs not *within* firms, such as between line workers and executives in the same firm. Rather, inequality has grown because of an increasing dispersion *between* firms — between the incomes of employees (at every level) of *one* firm and employees (at every level) of *another* firm.<sup>62</sup> The root of this development is a *larger dispersion in the returns of different firms* themselves, with an increasing number of firms — a minority, but a growing minority — earning spectacular returns. So, for example, from 1965 to 1967, only 1 percent of nonfinancial firms earned returns of 50 percent or more. In contrast, 40 years later, from 2005 to 2007, 14 percent did. As these firms earned spectacular returns, some of their employees earned substantial incomes that added significantly to the upper reaches of the income distribution and increased measured inequality. And some of these individuals are not the small numbers of creators of new, highly successful firms. Even line employees who participated in stock option programs of new firms could earn substantial incomes and amass considerable wealth. Microsoft, for example, created more than 10,000 millionaires from among its early employees.<sup>63</sup>

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If this interpretation is borne out by further research, it raises questions about the nature of inequality and our collective reaction to it. If inequality is solely or primarily about a few high-level employees in each of many firms obtaining enormous success while (or by) leaving their own colleagues behind, that is a clearly hostile environment. But it is very different from another in which *all* of the participants in a highly successful venture do very well relative to others who work for firms that earn merely normal returns. It is the difference between inequality because of winners and inequality because of losers. However, one dissonant note in this story is that typical employee wages have lagged in recent years; many wage earners have had pay that has barely kept pace with inflation, even as other workers at highly successful firms have done very well. It would be far better if wages in general had grown more rapidly while employees at every level of successful enterprises had profited still more.

Another entire family of market-driven issues is the **harsh cyclicality of the economy** over recent years. Economic troughs have been deep and long-lasting during the last five recessions, with higher unemployment, and the most recent cycle — the financial crisis that arose in the late 2000s — has arguably been the worst since the Great Depression itself. Perhaps the unemployment episodes have become less responsive to policy, or employers have become more determined to restrain rehiring to avoid finding themselves overstaffed, and have reengineered work to that effect. Workers lose jobs and have less bargaining power with employers because of these slack labor market conditions. Meanwhile, some investors lose money in the downturns, but sophisticated investors try to sell before the downturns and profit in the rebounds. Thus, economic downturns could worsen inequality; they certainly harm the prospects of typical working families.

So, for example, in the aftermath of the financial crisis, the real (i.e., inflation-adjusted) prices of such assets have increased at rates exceeding productivity gains and wage increases for most households.<sup>64</sup>

This has happened in part because of the extremely stimulative monetary policy that the Federal Reserve deemed necessary to try to stem the downturn, and which had the effect of driving financial demand to risky assets. Wealth holders store their value in the form of publicly traded equities, privately held equities, real estate, commodities, and various other assets. Thus, households that held substantial amounts of assets before the run-up in values began caught the wave and consolidated their positions at the highest point in the wealth curve — especially considering that many retirees with modest wealth at the onset of the financial crisis lost much of the value of their portfolios and will have great difficulty replacing it while dissipating their holdings at low interest rates to maintain their day-to-day living standards. Note, however, that the degree of inequality is lower if the net present value of Social Security payments, Medicare benefits, and employer-based defined-benefit pension plans (which are made more secure by stock market gains) is included in the measure of wealth.

Several economists have noted that **US corporations are devoting declining percentages of their profits to R&D and capital equipment.**<sup>65</sup> This may be because of the extremely adverse economic cycles of late. At least in theory, this trend could stifle US business innovation and productivity gains, which, in turn, could restrict wider economic growth, reduce income growth, and increase inequality.

By way of illustration, for publicly traded companies, there has been real growth in the corporate dollars dedicated to share buybacks, compared to R&D and capital investments. Stock buybacks benefit all shareholders, either by giving those who choose to sell a price they are willing to accept, or by raising the price of remaining outstanding shares. Thus, “...the 449 companies in the S&P 500 index that were publicly listed from 2003 through 2012 used 54 percent of their earnings — a total of \$2.4 trillion — to buy back their own stock.” Dividends accounted for an additional 37 percent of earnings, meaning these two items represented 91 percent of net income.<sup>66</sup>

These two items as a percentage of net income have been rising for the last 20 years; this trend, according to some observers, leaves fewer dollars available for the corporate R&D that leads to innovation. One institutional investor, Laurence Fink of BlackRock, said, “It concerns us that in the wake of the financial crisis, many companies have shied away from investing in the future growth of their companies.”<sup>67</sup>

Investment in new capital could increase capacity in the most efficient technology, and investment in R&D can develop still better technology. The trend toward greater use of corporate funds for stock buybacks may be the result of “short-termism” driven by institutional investors who demand immediate returns on their investments. Firms engaging in stock buybacks would contend that they do not have sufficient demand to invest in greater capacity in the tepid recovery from the financial crisis, or that they do not see opportunities for profitable investments in R&D, or that R&D investment is highly risky and hence potential returns must be discounted for that risk. These points may well be true. Still, such a perspective does not send an encouraging message about the future of the firm or about the economy broadly. It will be particularly troubling if investment does not pick up as the economic recovery strengthens.

Economists would note that there is some difference in the importance of sheer size between investments in physical capital and investments in R&D. Physical capital generally is required in some scale to the amount of production undertaken by the firm — because one machine, for example, likely is needed for every several units of output. By contrast, one innovation funded by one R&D project might apply to and improve every product made by the firm in equal measure (or in other words, R&D produces knowledge, which is what economists call a “public good”). Thus, a large firm might not need to have an R&D budget that is the same percentage of its size as would a smaller firm to obtain the same (or even a greater) amount of value (and the same is true of comparisons of the United States and other

countries with smaller economies). This is one reason not to overinterpret statistics about lower R&D spending as a percentage of entity size.

The end result of all of these market factors has been that **wage growth has lagged productivity growth**. From 1973 to 2011, US labor productivity has grown by approximately 1.6 percent per year. In contrast, the real median hourly wage has grown by an average of only 0.1 percent per year.<sup>68</sup> (Including the real increase in employer-paid health insurance premiums would increase this real median average wage growth percentage, possibly to very nearly the rate of productivity growth.<sup>69</sup>)

A key question going forward is whether a principal reason for this productivity-wage divergence is slow economic growth restrained by tepid demand. During the 1950-1980 period, when inequality generally lessened, the US economy had an average real GDP growth rate of 3.9 percent per year.<sup>70</sup> Labor was in demand, and workers were rewarded in the marketplace. From 1980 to 2010, real annual GDP gains were only 2.7 percent.<sup>71</sup> This lower growth rate resulted in a slack labor market where workers faced worsened prospects for obtaining employment and less negotiating power, and so relatively more of the fruits of productivity growth accrued to owners and top managers. If the economy rebounds significantly and a strong labor market returns, real wage gains should be expected to recover; a failure to see renewed wage growth with renewed strong economic growth would be most troubling and would demand careful rethinking of economic policy regarding wages and inequality.

## Social Change

Several factors in recent American social life have influenced the degree of US economic inequality.

A McKinsey study reports that “**Migration and deunionization** exerted downward pressure on compensation levels for workers in repetitive manual labor occupations and administrative support roles.”<sup>72</sup>

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Among workers performing the same tasks, unionized employees tend to earn higher compensation than nonunion employees. American union workers were 27.8 percent of the total workforce in 1970, but only 11.3 percent in 2013.<sup>73</sup> This decline likely slowed wage growth relative to productivity gains, according to many economists.

Likewise, unrestricted immigration can create an oversupply of employees in low-skill occupations, depressing wages. Over many years, the US government has been ineffective in restricting the flow of illegal immigrants. As of 2014, approximately 12 million illegal immigrants resided in the United States.<sup>74</sup> To some, these immigrants tend to compete with less-educated, low-income American citizens, dragging down their wages and limiting their opportunity to advance economically.<sup>75</sup> Others contend that native-born Americans do not aspire to the jobs typically held by immigrants (including agricultural and construction labor), and that immigration feeds an otherwise detrimentally slow-growing labor force. From that perspective, immigrants might complement rather than substitute for domestic workers and might result in higher output, for the benefit of all. The debate extends to our treatment of highly skilled foreign labor. Some argue that educated foreign workers — including those who attend postsecondary institutions here in the United States — should be welcomed into this country to expand the workforce and bring their risk-taking, entrepreneurial spirit. Others respond that US employers make that case only to expand the supply of talent and therefore to hold down wages. This issue is among the most controversial confronting the United States today.

A contrary view is that jobs filled by unionized workers are precisely those where technology was most able to replace labor — and where foreign competitors were most able to exploit lower costs and other advantages to erode the United States' competitive edge. Thus, maintaining higher wage rates likely would have accelerated even faster the replacement of labor with capital. Likewise, much

of the work performed by migrant labor, such as in agriculture, is not sought after by domestic labor.

Over the last few decades, the United States has experienced a sizable increase in the **prevalence of one-parent families**, from 13 percent of families with children in 1970 to 30 percent in 2015.<sup>76</sup> This trend follows not only from high rates of divorce and incarceration of fathers, but also from out-of-wedlock births, which currently are over half of the total in the United States.<sup>77</sup> One-parent households are proportionately overrepresented in the lower part of the income distribution,<sup>78</sup> and so this trend increases measured inequality in the current generation. Furthermore, studies show that having two parents advances a child's progress, meaning that the ill effects of out-of-wedlock births and marriage dissolution can extend to future generations as well.<sup>79</sup> It can be difficult to assign causation, given that people at risk of low-income careers would tend to be involved in out-of-wedlock births or divorce for that reason. However, there is sufficient evidence at least of association between household marital status and economic prospects that reducing single parenthood should be considered as part of an anti-inequality strategy.

Furthermore, in addition to the growing prevalence of one-parent households, it is increasingly common for both parents of two-parent families to work full time. Many married women find work to be satisfying, and others find work necessary to achieve what they believe to be an acceptable standard of living. With the growing prevalence of market work on the part of women has come the phenomenon of marriages of high-achieving women with high-achieving men — meaning that high-income families now often have not one high salary, as they did perhaps 50 years ago, but two.<sup>80</sup>

This phenomenon is compounded further because of the challenges facing working parents. Those families need high-quality **child care** so that they can work. But beyond mere safe child care, **quality early childhood education** can enhance the life chances of young children, especially those from challenged backgrounds.

However, even merely safe child care is beyond the means of many two-worker couples, and certainly of many single-parent families.<sup>81</sup> It seems a vain sentiment to demand work effort on the part of parents with low potential wages — especially single parents — when the child care that they need (much less the early education that will advance their children) is not available. Thus, the very acceptability of work on the part of women may have been unequalizing, because low-wage parents have less opportunity to work. There is evidence that inequality of labor income among women has been growing faster as a result.<sup>82</sup>

## Government Policies

Many aspects of public policy — at the federal, state, and local levels — have also been associated with the growth of economic inequality.

One prominent interpretation is that the changes in technology and the global marketplace have been tidal in their power, and therefore are beyond the influence of any economic actors, public or private. However, this perspective continues, the nation's prerequisites for economic growth — the “commons,” as it were — have been allowed to deteriorate, to the detriment of all, but especially the most vulnerable.<sup>83</sup> These preconditions — the knowledge and skills of our population, the infrastructure that serves businesses and individuals, so-called neighborhood effects that can render entire communities economically strong or weak — are historically considered the responsibility of government. However, government is all of us; we must choose not only the steps for government to take, but also collective initiatives — especially those that require the input of business — that can begin a process of renewal of the “commons.”

Looking first at essential government policy steps, governments at all levels invest substantial sums in public education, which is a major component of budgets for local governments (elementary and secondary) and for states (at all levels). The federal government's financial contribution is mostly related to postsecondary student financial aid and grants to local governments for K-12 education.

The United States is renowned worldwide for the quality of its elite postsecondary and postgraduate / research educational institutions. One problem today is getting our students to that stage of education. Public policy is heavily implicated in our nation's lagging educational performance at both levels.

**K-12 public schools** have received more funding (on an inflation-adjusted basis) in the last few decades, but the added investment has not “moved the needle” on widely recognized standardized test results. In fact, some studies show the United States lagging its developed country counterparts in this regard. Lower-income students need quality education to increase their chances of climbing the income ladder, but they have less likelihood, relative to high-income students, of receiving a quality education.

For example, the chances of a lowest-income quartile individual graduating from college are 8 percent, versus 54 percent for the top quartile.<sup>84</sup> High-performing low-income students are significantly less likely to attend or complete college than high-income students who have the same level of academic preparation.<sup>85</sup> At the most selective universities, students from the highest income quartile and the lowest represent 70 percent and 5 percent, respectively, of the enrollment.<sup>86</sup>

For the population as a whole, the United States still leads the world in postsecondary educational attainment. But that is because of higher relative attainment levels for our older generations, who went to school decades ago, relative to their overseas contemporaries. Attainment by younger US generations significantly trails that of our competitor nations, including the leaders of Korea, Canada, Japan, Ireland, Norway, and New Zealand.<sup>87</sup> For further example, according to the OECD's widely cited Program for International Student Assessment (PISA), for 15-year-olds among the 34 OECD countries, the United States ranked 27th in math (below average), 17th in reading (average), and 20th in science (average). Our nation ranks 5th in spending.<sup>88</sup> Improving K-12 public education has been a long-term challenge in the United States.

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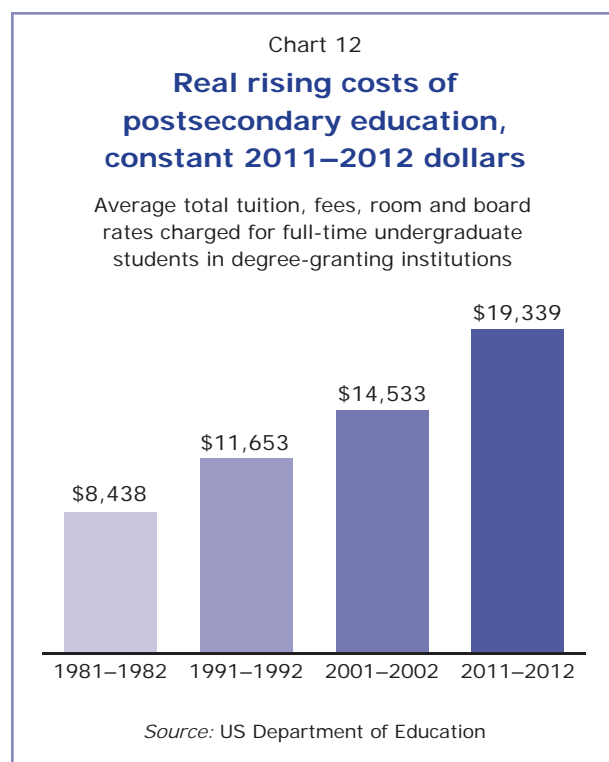
In addition, however, broad-based economic growth is needed to put those who achieve a quality education to work. In 2012, 44 percent of college graduates (the highest level in two decades) aged 22 to 27 were working in jobs that were deemed not to require a bachelor's degree.<sup>89</sup>

But even for those who obtain an adequate elementary and secondary education, college education costs have grown far in excess of inflation over the last 30 years — in excess even of the notorious pace of the cost of health care (see Chart 12).<sup>90</sup> Federal government direct subsidies have increased as well, but such support is a double-edged sword because educational institutions that face cost pressures can seek to increase tuitions and thus capture that additional public funding for themselves. This cycle can be particularly vicious if public subsidies are funneled at least indirectly into amenities rather than either access to or the quality of higher education. Furthermore, much of the federal support for education is in the form of loans that must be repaid. The higher costs and the prospect of substantial debt likely deters a greater proportion

of low-income than higher-income young adults from attending college, given that families with limited or no experience of higher education typically have the least information about how to finance an education (such as how to obtain financial aid) and what the benefits of education might be. Education correlates well with earned income and wealth, so to the extent that higher costs do deter those from low-income families, the increased college costs contribute potentially to more intragenerational inequality and to reduced economic and social mobility as well.

Yet another powerful driver of inequality is the **fast-rising cost of health insurance**. This is in some degree a measurement phenomenon, but with an important element of substance. Employees with employer-sponsored health insurance probably judge their well-being to a first approximation by looking at their take-home pay after their and their employers' insurance premium payments are deducted. The pace of health insurance cost growth suggests that over time employers have had to limit cash wage increases or even hiring to sustain the health insurance benefit.<sup>91</sup> Because health insurance premiums are a greater share of employer compensation cost for low-wage than for higher-wage employees, rising health care costs have likely increased the inequality of market cash incomes (not including the insurance premium) and have reduced measured cash wage growth.

By way of illustration, assume that an employee making \$36,000 in cash per year has an employer health insurance benefit of \$12,000. Suppose that inflation runs at 2 percent per year, and the employer can afford to increase total compensation by 3 percent per year, but health care costs rise by 6 percent per year. After 10 years, even though the employer's combined wage and benefit bill (starting at \$48,000 — the \$36,000 in cash plus the \$12,000 in health insurance) has increased in inflation-adjusted terms by 1 percent per year, the employee's inflation-adjusted take-home pay will actually have to fall by almost 2 percent cumulatively to make room for the growth in cost of the health insurance premium.





However, the higher the total compensation, the lesser the percentage intrusion of rising health-insurance costs into cash compensation — meaning that health care cost inflation adds to the inequality of cash wages.

If public policy could ease this drain on employer costs (not to mention the out-of-pocket costs of all households, whether covered or not), it would help all households but also could have a powerful effect on income inequality. The Patient Protection and Affordable Care Act of 2010 was billed as an effort to control the cost of care, but its effect was primarily to increase coverage. If we cannot make care affordable, all of our past effort to increase coverage will be washed away by a tide of rising cost.

To some degree, this kind of comparison elevates measurement conventions over substance. If one employee has employer coverage and another with equal total compensation does not, and so must acquire coverage on his own out of after-tax wage income, then a comparison of take-home pay will mistakenly suggest that the latter employee is better off rather than equally well off. If the latter employee faces a more hostile market for individual health insurance coverage, in fact, that employee might be much worse off than the former.<sup>92</sup> But the core substantive point remains true: rapidly rising health care costs deplete household purchasing power and place a disproportionate burden on lower-income households. The fact that many but not all households receive health insurance from their employers alters our perception but not the reality of this phenomenon.

Other public policies more directly steer outcomes related to inequality. In our democracy, our public policies were approved by our elected representatives, though perhaps some years ago. Therefore, our system and its **tax and benefit programs** constitute at least an implicit rough consensus as to the people's desired post-tax post-transfer distribution of income and wealth. However, as in any collective decision process over multiple and widely varying public objectives and preferences, and multiple complex and interacting

policy systems in a changing environment, the result may never reflect, and can gradually depart from, what was intended. Policies can become highly inefficient, meaning that they do not achieve any of the voters' multiple objectives to the fullest possible extent. And the voters' objectives and preferences themselves can change.

Federal, state, and local governments provide a social safety net to support persons at the low end of the range of income and wealth. Some of the most important income support programs (notably the earned income tax credit) are conditional upon work. The combined tax system, federal, state, and local, is progressive — the degree to which is a subject of intense debate. (And the Social Security and Medicare payroll taxes, sometimes criticized as regressive, are linked to progressive benefit programs — albeit paying those benefits later in life.) Regardless, some government policies may have the consequence, perhaps unintended, of promoting inequality.

Tax policy in particular has been a matter of fierce debate on the broad topic of economic inequality. The role of taxation in inequality is both complex and controversial. Judgments about tax policy rest on perspectives on the nature of inequality itself.

The consistent data series on alternative measures of income since 1979, created by the Congressional Budget Office (CBO), shows that all measures have trended toward inequality (with some fluctuations from year to year, often following major economic events such as the business cycle or the financial crisis). But in any given year, after-tax after-transfer income is distributed more equally than is market income.

According to the CBO analysis, the most well-to-do fractions of the population — either the highest 10 percent or the highest 1 percent — pay a larger share of total taxes in the latest years than they did in 1979. (Again, the CBO does not present estimates for the very highest quantiles — the top 0.1 or 0.01 percent — where much of the growth of income has been concentrated.)

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Despite that trend, those upper-income quantiles also receive a higher share of the after-tax income now than they did in 1979. Thus, the increased concentration of market income has outweighed the increased concentration of tax liability. This result is possible in part because, measured according to the CBO's methodology, total tax liability as a percentage of market income has declined across the income scale — on average, from 22.0 percent in 1970 to 17.6 percent in 2011. Taxes have declined for all income groups. For the lowest 20 percent of the population ranked by market income, the tax burden has fallen by 5.6 percentage points (from 7.5 percent to 1.9 percent). At the same time, for the highest 1 percent of the population, the tax burden has fallen by 6.1 percentage points (from 35.1 percent to 29.0 percent); the market incomes of the top 1 percent of the population are of course much larger.<sup>93</sup>

Over the same period, partly as a simple arithmetic result, budget deficits have increased, and the public debt has grown markedly. The unified budget deficit in 1979, at 1.6 percent of GDP, is the eighth smallest of the 37 years including and since. The 1979 debt held by the public as a percentage of GDP, at 24.9 percent, is below every succeeding year, and about one-third of today's level. In 1979 the nation also had comparatively low spending; only 11 of the succeeding 36 years had lower spending as a percentage of the GDP.<sup>94</sup> So for those years since 1979, we have enjoyed either lower-than-sustainable taxes, or higher-than-sustainable spending, or both. The interpretation of this question will affect choices regarding the role of the tax burden in inequality.

Prominent among the controversial issues in tax policy are the taxes on wealth and on income from capital. Compared to 40 years ago, **tax rates on capital gains and inheritances** have declined. The theoretical capital gains tax rate reached 49.125 percent in the middle 1970s, and the highest inheritance tax rate was as much as 77 percent at about that time.<sup>95</sup> Some who focus on the distribution of after-tax incomes or wealth would argue that reductions in these tax rates, which apply disproportionately or exclusively

to those who have greater wealth, would tend to promote inequality, whereas others believe that higher rates for these taxes are uniquely inimical to incentives to invest and save, and hence to economic growth.

**Globalization** has exposed all of the US economy to competition, but the effects vary widely. Generally, we expect that highly skilled workers benefit from the access to cheaper foreign products, but workers with lesser skills, though they benefit from access to the same products, are more exposed to competition from workers from poorer countries who are paid much less. Some allege that several of the largest US trade partners, Mexico and China among them, have trade regimes (or currency policies) that appear to block US exports, and therefore that US workers unfairly lose jobs to (or face undue wage pressure from) Mexican and Chinese workers. These critics believe that the US federal government has been reluctant to enforce policies against such consistent trade violations. Other economists (and CED) argue that much of the US trade imbalance is self-inflicted, because US national saving is less than our investment — which forces our nation to borrow and to import — and that our economy cannot hide from international competition without eventually ceding our global leadership.

Federal law sets a **minimum wage** that applies nationally, but states and local governments can set higher floors. The federal minimum wage has not kept pace with inflation. As a result, making reference only to the federal minimum, some allege that those earning the minimum wage fall behind, and that wages slightly above the minimum are held back as well. The status in any given geographic area depends on action taken (or not) by lower levels of government.

Some economists are concerned that under a significantly higher minimum wage, current jobs and future job opportunities would be lost to technology, foreign labor, and employer cost-cutting, curtailing stepping-stone jobs for young workers just finding their feet in the labor force.

They would add that a period of weak job and wage growth would be precisely the wrong time to increase the minimum wage. They also argue that a higher national minimum wage might be especially excessive in some low-living-cost parts of the country, and that high-income states and localities could be expected to act on their own.

Some would argue that social norms should dictate the payment of higher wages in scale with a more generous standard of living. A transition

to such a standard of behavior would entail temporarily higher inflation and a permanently higher price level, and it would reduce US international competitiveness if employers in other nations did not follow suit.

Drawing sensible conclusions and recommendations from this complex of forces requires systematic analysis. Following is CED's interpretation of changes in inequality, their significance, and the appropriate public policy responses.

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## *Part Three:*

### *Possible Business and Government Policies That Might Moderate the Rise in Income and Wealth Inequality*

#### **The Policy Goal of the Committee for Economic Development regarding Economic Inequality**

As is apparent from the analysis above, economic inequality is multidimensional and complex. It involves labor and capital income, taxes, government transfer payments, and accumulated wealth. Data on all of these elements are imperfect in terms of their representation of both the population and the relevant aggregates themselves. Inequality differs from country to country, and it varies over time within each.

Thomas Piketty has attracted much attention of late with his construction of a long-term multinational database and his attempt to formulate a unifying theory across all of those data. Piketty concluded that income-and-wealth inequality has increased; this trend is inherent in the nature of capitalism and presents a danger to democracy; only state intervention on a global basis — in the form of higher taxes on the wealthy, which are then redistributed to the poor across national borders — can reverse this trend and save capitalism from self-destruction. The very sweep of that exercise has aroused controversy over some of his precise findings. And Piketty's recommendations of policy responses to his own most troubling factual findings have in our view overreached practicality and public acceptance, as well as the findings themselves (leading Piketty himself to back away from his own line of argument to some degree). In that way, the policy recommendations have diverted what could have been an important and productive discussion into rancorous conflict.

We choose instead to focus on a more focused diagnosis and to draw our own policy conclusions. We believe that business can contribute to the

important and productive discussion that our nation so badly needs.

We would summarize our findings and recommendations as follows:

**Over the last 40 years, inequality (by any measure) has been increasing.** After the transformative events of World War II, our economy enjoyed more than two decades of extraordinary growth and a general narrowing of inequality. Since the early 1970s, however, growth generally has been slower, and inequality has generally grown. This has been true of all measures of economic well-being: market incomes, after-tax after-transfer incomes, and wealth. And this finding is consistent across multiple databases constructed by multiple researchers, even though they disagree on many narrower details and on their policy conclusions.

We see as particularly persuasive the findings of the Congressional Budget Office, which has focused on a consistent methodology using the same data sources since 1979, under organizational leadership appointed by both political parties. (Note that the CBO data measure all concepts of income but do not measure wealth in any form.) Chart 13 (page 43), taken from the CBO analysis, shows that market incomes of any higher income group have grown markedly faster relative to any lower income group in almost all years since 1979. Cumulatively over that period, the inflation-adjusted market income of the top 1 percent of households (the highest-income group analyzed separately) increased by 174 percent; that for the middle 60 percent and the lowest 20 percent (separately) increased by 16 percent, or less than one-tenth as much.

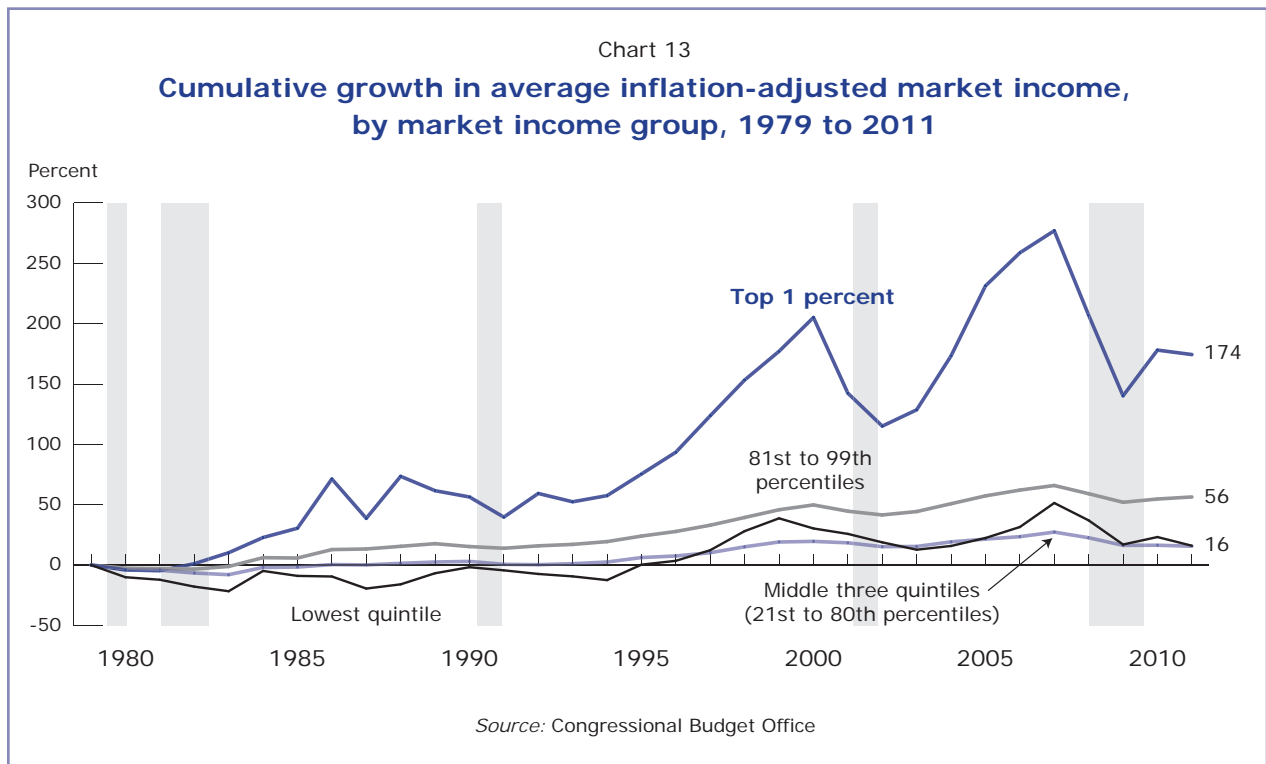


Chart 14 (page 44) shows the same measurements for after-tax after-transfer income. The same broad pattern holds. The inflation-adjusted income of the top 1 percent grew cumulatively by 200 percent, that of the middle 60 percent grew by 40 percent, and that of the lowest 20 percent grew by 48 percent. (The faster cumulative growth of after-tax after-transfer income than market income reflects the general reduction of tax collections over time. The faster growth of after-tax after-transfer income for the lowest 20 percent than the middle 60 percent reflects both increased low-income tax relief and more generous transfer payments.) Thus, regardless of the chosen definition of income, inequality has increased relatively consistently since at least 1979. As was noted earlier, inequality was less using after-tax after-transfer income than market income in each year, although the trend toward increased inequality holds under either measure.

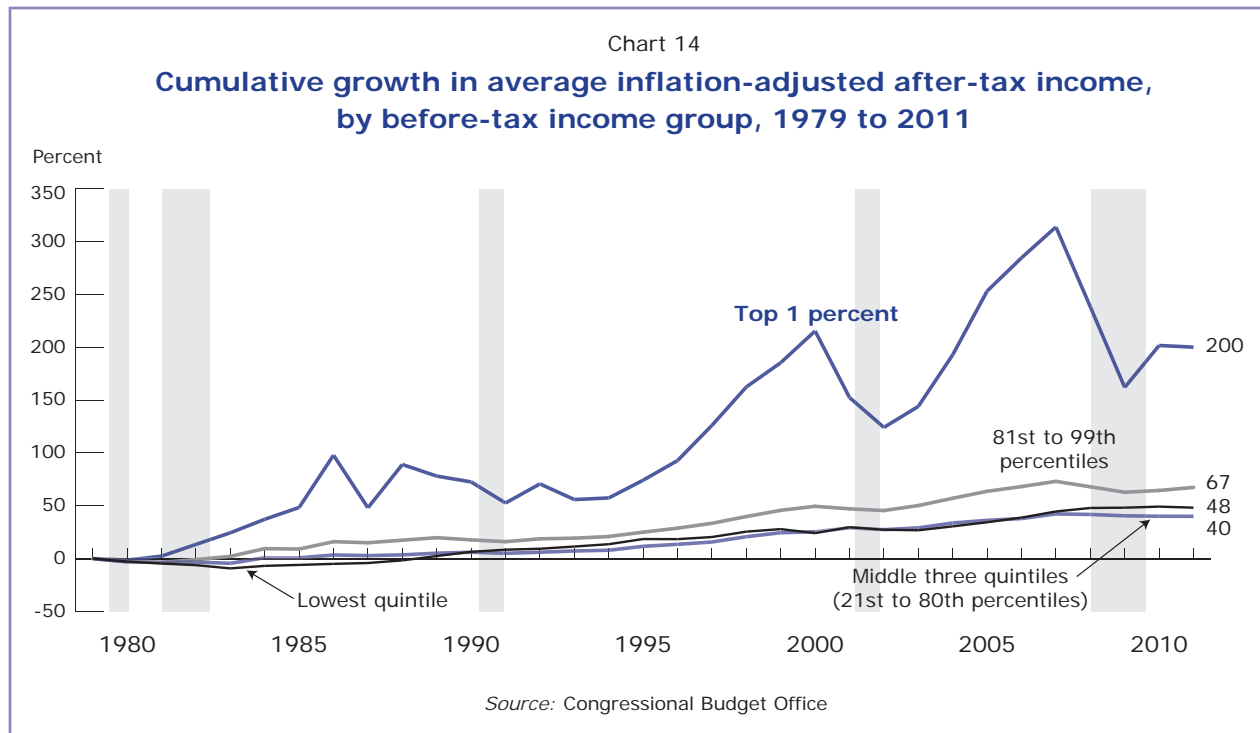
Some may interpret the broad trend toward inequality over the last four decades as part of a historical regularity, with the immediate post-World War II

quarter century as a predictable exception because of that upheaval. We do not believe that such historical regularity is certain, and we would not choose to make highly consequential policy decisions on the basis of such an unproven theory. We prefer to act on the reality that we observe over the postwar era, which we believe is sufficient history for practical purposes.

The finding that there has been a consistent trend toward inequality over the last several decades provides definitive conclusions about neither causation nor what policy steps — if any — should be taken in response. Answering those questions requires deeper analysis.

**Some, but not all, of the increasing inequality of the last four decades has resulted from spectacular returns to highly successful innovations and investments. We are not troubled by this phenomenon.** The highly successful enterprises of recent years by *definition* provided substantial value to a large number of consumers; had they not, they would not have been so successful.

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Many of the individuals who profited so spectacularly from those innovations were line employees with stock options, not executive decision makers who conceivably could be alleged to have manipulated market outcomes in some nefarious way. Such rewards were examples of the opportunity made possible by free enterprise.

To decry such rewards because they led to spectacular returns and therefore to some increased measure of inequality is to be willing to forgo the benefits of those innovations to large numbers of consumers, and to lose the employment opportunities that follow from those innovations. It is irrational on its face. One might question on the basis of personal taste whether one particular innovation is of a value equal to the rewards that were earned. That is every individual consumer's right, and each consumer is free not to buy any particular product or service. But to deny the market value of any highly successful product or service, in our economic democracy in which every consumer votes with his or her dollars, would be the logical equivalent of denying the *validity* of an

election on the basis of one's personal preferences even though more voters chose the other candidate.

Thus, we see no ground to attempt to undo success. At the most important level, every American wants innovation. It provides us with new and better products and services at lower prices. It raises our standards of living. It provides prosperity. We must take care that in pursuing other goals we do not pay a disproportionate price in terms of innovation, growth, and living standards.

**However, some, but not all, of the greater inequality that we observe has resulted from lagging income growth for a large number of working Americans. We find lagging real incomes on the part of so many middle-income Americans exceedingly troubling.** CED's mission has always included income growth broadly shared among the American people. This is the essence of the promise of the free-enterprise system that we have supported from our founding. It is unacceptable that many Americans have come to doubt that this promise will be kept.

Broadly lagging income growth is a sign of wasted resources. People's skills are not being fully used. Opportunities for investment are being missed. These losses cannot be made up. Therefore, we must set our economy back on track to prevent the continuation of such losses in the future.

Some have alleged that the loss of income growth is a sign of a loss of ambition or will on the part of the American people. This is not true. As the most elementary evidence, we would note that there were almost 10 million fewer Americans employed at the beginning of 2010 than there had been at the beginning of 2008.<sup>96</sup> Some might infer that over those two years, 10 million Americans, or more than 6 percent of our labor force, had totally lost their ambition. We do not believe that. We strongly suspect, rather, that the lagging income growth over the last several decades, including the financial crisis, has been caused by forces far beyond most workers' control.

Some also have alleged that the spectacular returns enjoyed by some have come directly and causally at the expense of those who have suffered lower income growth. We find this belief to be unfounded. Many of the conspicuous innovations that have been richly rewarded have no possible connection to broad wage trends. They have come from the development of new products and services that have been built from the ground up, with newly employed labor and new resources. They have not exploited other resources — except to the extent that consumers have chosen to spend their dollars on those new products and services instead of older ones. Rather, we see the slowdown in broadly based income growth to follow from multiple forces rooted in national macroeconomic policy weaknesses, technology, and globalization.

Thus, again, we see no reason and much risk in policies that might choke innovation in the cause of reducing inequality. In contrast, we feel every motivation to increase broadly based income growth to reduce inequality. Increasing growth — really, increasing productivity and innovation — is a monumental task. It is the mystery behind

all of economic progress. It is, in essence, seeing into the future. It is our highest purpose in all of CED's work, and in writing this policy statement. Our central mission here is to call business leaders and all Americans of vastly different perspectives to unite in the task of seeking prosperity and real equality by raising all, not by repressing some. We will put forward our reasoning as to how to conceive of this task, and what policy steps might achieve it.

**Our society's objective should be equality of opportunity, not forced equality of outcomes.**

It follows from our reasoning above that the economy must lift the bottom, not compress the top. Equality achieved by curtailing opportunity for success is at best a temporary remedy for any pains of inequality. It does not raise, and has no prospect of raising, productivity and innovation. It does not raise the achievement of the labor force that it is intended to help. It is a remedy for inequality in only the most superficial, ephemeral sense. Resorting to forced equality of outcomes is capitulation. It is surrender.

We believe, rather, that equality of opportunity is the only ultimate remedy to inequality. Only through raising the capacity of the full US labor force can productivity and incomes be raised on a sustained basis, to the benefit of all of society. We have every confidence that from equality of opportunity *will follow* a lessening of inequality of outcomes, as the incomes of our population rise closer to their potential.

**Although each alternative measure of economic inequality has a valid purpose, we believe that our society's success should be defined by the growth and distribution of market incomes.**

We do not believe that our society can target equality of outcomes, nor should it try to force equality of outcomes. But we do believe that from equality of opportunity will follow greater incomes, broadly shared, and with that a lessening of inequality. And in that respect we refer to market income, which we believe is the most meaningful standard.

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Dollars of income from different sources are not the same. Dollars earned through labor or as returns on the individual's own savings represent production, self-sufficiency, and security, in a sense not matched by public transfer payments. If opportunity yields productivity and incomes, individuals achieve greater equality in a more meaningful sense. It is their own stake in the ownership of the economic system. It is that meaning of equality to which our society should aspire, more than some numerical equality that is dependent upon a constancy of future public policy.

**Our nation, at this time, does not have full equality of opportunity, and past attempts to achieve it, however well-meaning and energetic, have fallen short.** Some might take the mere establishment of a goal of equality of opportunity to be an absolution of any and all societal or economic reality. They would say that if one individual has overcome adversity to succeed in our free-market economy, then anyone can. We are free to go on our way.

We see a goal of equality of opportunity not as an absolution, or even mere aspiration. It is rather an obligation and a commitment. Without true opportunity, all of our societal objectives — prosperity, productivity, and innovation — are out of reach. The ills of irremediable intergenerational inequality and economic stagnation — cynicism and despair — remain. The society that is left is unsatisfying even to those who succeed. And success itself is in jeopardy, as the creative workforce atrophies and the markets for products and services slowly migrate overseas.

The sad reality is that too many Americans reach the starting line of a career in the labor force with no realistic chance of success. If we want our nation to remain exceptional, to remain the world's leader, then we must set opportunity as our primary objective.

**In the interim, in the absence of equality of opportunity, we must take responsibility for policies to ease the current inequality of outcomes.** What do we do as a society *until* we have equality of opportunity? Pursuing a long-term goal of equality

of opportunity will not directly ease the dislocations caused by recent lagging incomes. The stated intent of current public policy is to assess the cost of government according to ability to pay, to provide a safety net for those who fail in competition in the free market, and to facilitate strong economic growth. However, policy is not fully successful in the pursuit of any of those objectives. As CED has noted elsewhere, our federal income tax is neither efficient with respect to its effect on the allocation of resources and the maximization of incentives for productive activity, nor fully equitable in terms of the assessment of liabilities.<sup>97</sup> Nor are our cash and in-kind assistance programs on the outlay side of the budget fully effective in creating an equitable safety net with fair work incentives. Improvement of these policies must be a part of our national agenda as well. Moving from inefficient to efficient policies — policies that do not waste resources on their own inefficiencies or inequities — we can outperform the usual trade-offs of one objective versus another and more fully achieve *all* of our multiple policy objectives. We discuss our assessment of and recommendations for national policy below.

## Should Business Take Action Regarding Inequality?

### Business statesmanship

The American people for all of our history have rejected constraints on rewards to those who work hard and succeed. However, they have demanded fairness in economic competition — that is, equality of opportunity. The willingness to accept market outcomes is the reason for the long-term resilience of the free-enterprise system. Perhaps not surprisingly, the periods of greatest challenge for free enterprise have been the periods of our worst economic performance: the Great Depression of the 1930s and the financial crisis since 2008. When so many Americans are disappointed by their own economic outcomes, and when they perceive diminished prospects for their children, they will begin to question whether the free-enterprise system has failed — or even been manipulated to their disadvantage.



Our system recovered from the Great Depression in part by the tragic accident of the economic necessity of World War II. The challenge that free enterprise faces today is to achieve the same kind of recovery in a purposeful way — through voluntary cooperation rather than such monumental forced sacrifice. The danger is that the building cynicism based on lagging incomes and perceived inequality of opportunity could lead to a corrosion of civility in public life, and extreme and ill-considered public-policy decisions — to the detriment of all. The cost in US world leadership, in particular, could be felt painfully in a deterioration of international standards of behavior in trade and diplomacy. The stakes are frighteningly high. If we believe in what our nation stands for, we must work together at all costs.

Business leaders can address issues of equality of opportunity through their own enterprises and through advocacy of sound public policy. We at CED have our own perspectives on these issues, and we set forth some of our ideas below. But surely more important would be to begin a creative dialogue with the entire US business community. Engagement in such a public conversation could yield valuable ideas. But it could also be highly constructive in its own right. As we said earlier, true business statesmen are uniquely situated to begin such a national conversation and to demonstrate that the US free-enterprise system can work for all of us. That conversation itself can smooth the rough edges in the current all-too-prevalent public incivility. The very attempt to solve that problem may be the most important first step toward the goal of sustaining capitalism.

### Industry or firm-specific remedies

**Restore the US business social contract.** In our experience, US firms seek to provide rewarding employment for their workers. Businesses see that as in their own interests, as well as in the interests of their employees. Loyalty and a strong sense of shared purpose yield the best business results. In our work on “sustainable capitalism,” we begin with the perspective of a “multistakeholder

model” of business — in which lasting results are recognized to follow from a cooperative relationship among the management and the board of the firm and their community, employees, customers, owners, and the environment. A mindset that is limited to near-term results at the expense of these stakeholders might lead to temporarily pleasing reported numbers, but not to long-term sustainable performance.

However, businesses — like all other institutions — periodically need to refresh their relationships with their many stakeholders. And in this day of system-wide economic challenges, that reassessment must encompass inequality and any absence of genuine opportunity.

We offer just a few examples, of which there surely are many more.

The financial crisis struck some localities extraordinarily hard. So while the economic indicators on average across the country were troubling, some localities were still harder hit. Particularly in those pockets of the country, people who lost their jobs could be unemployed for substantial lengths of time. A public-private partnership sought to call businesses’ attention to the plight of the long-term unemployed. In CED’s experience, the initial reaction of at least one firm was that its hiring policies surely were neutral and equitable with respect to persons with recent long spells of unemployment.<sup>98</sup> But upon closer examination, it became clear that this was not so. For example, a customary practice from normal times was to subject job applicants to a credit check. But upon consideration, the firm realized that persons who had suffered extended spells of unemployment quite understandably were likely to have credit issues. As a result of such self-examination, many firms signed on to a list of “best practices” from the public-private informational campaign, which included setting credit reports aside in the cases of long-term-unemployed job seekers. Clearly, business leaders cannot call on the unemployed to seek work, and then reject them out of hand on the ground of fully understandable consequences of being unemployed.

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Improving hiring practices cannot create new job openings, but it can give hard-hit workers a chance to qualify for what jobs there are.

A second practice that firms could undertake deals with contracting. Larger firms often purchase goods and services from smaller contractors. However, the smallest potential contractors, including minority-owned firms, can have difficulty establishing the necessary credentials to qualify for serious consideration. This can be a matter of one-time documentation rather than any lack of the ability to perform, and once such firms have established their credibility and track records, they can often expand and offer their employees better jobs with more security. One firm associated with CED tasked its executives to reach out to potential contractors, and rewarded those executives for successfully bringing such firms up to speed and scale to become suppliers. Several small firms were able to grow as a result.

Corporations should support more worker training, both vocational and higher education. To obviate the risk that well-trained employees will be poached by competitors, businesses could consider a medium-term employee contract or employment commitment to ensure that training costs are recouped — to the ultimate mutual benefit of employer and employee.

Emphasis on short-term reported earnings can lead firms to cut back on future-focused expenditures, such as research and development and physical investment. Financial market players who demand quarterly earnings performance can so distort the incentives of firms. Stock options for corporate executive compensation can have similar unintended consequences. Executives whose options are about to mature can have strong incentives to take actions to boost short-term stock prices, sometimes by cutting research and investment expenditures or other investments. Boards should consider remuneration according to performance indicators that could be formulated to eliminate such perverse incentives.

Finally, as we noted earlier, many worker-parents are constrained by a need for child care, and their

children's prospects are constrained by a need for quality early childhood education. Some firms, particularly larger firms, could capitalize on their space and economies of scale to facilitate care and quality education either on-site or in cooperation with outside facilities.

And broadly speaking, firms can follow variations on two basic models of workforce development. A firm can pursue a low-wage, low-worker-investment, high-turnover model, through which it tries to minimize its wage bill and manage its way through the lower employee performance that results. Alternatively, it can pursue a higher-wage, high-worker-investment, low-turnover model, through which it pays more in wages per worker, but tries to recoup that cost through higher productivity, greater employee loyalty and initiative, and reduced costs in hiring, waste, and errors of execution.

All markets are different. There are markets where labor is a high percentage of cost, competition is fierce, and margins are narrow, and there is little scope for improvement of employee productivity through greater training and longer tenure and experience. But employers should at least investigate the opportunities for a win-win of improved firm performance through upgraded employee skills with correspondingly higher wages.

**Refrain from “crony capitalism.”** A recent CED policy statement explained that private-sector involvement with government is increasingly “bilateral” or “transactional:” What does a corporation get “money-wise” from interacting with federal, state, and local government?<sup>99</sup> If abused, such behavior can deteriorate to “rent seeking” and can reduce economic growth and distort the allocation of society's scarce resources. Such manipulation of public-private relationships is by no means restricted to business, and can even be antibusiness. It can even involve elected policy makers using their power to demand campaign contributions from business leaders, implicitly threatening retribution through public policy. But business leaders should encourage both their colleagues and policy makers to refrain voluntarily

from crony capitalism and to recognize the damage it does to capitalism's credibility and innovative ability. A level playing field that welcomes innovators and new businesses expands opportunity.

### Community-based actions

As was noted above, restoration of an eroded "commons" of prerequisites for growth and prosperity can be an essential first step toward equality of true opportunity in some communities. All segments of our communities have something to contribute, and business can be an essential contributor and can energize the process.

Achievement of quality pre-K-12 education, developing skills in non-college-bound youth, helping postsecondary students to degree completion and matching their skills to jobs, building and maintaining essential infrastructure, and facilitating and mentoring entrepreneurs and entrepreneurship are all functions that community coalitions of business, educators, government, and others can fulfill. Efforts in Minneapolis-St. Paul, Minnesota, and Columbus, Ohio, are held up as models.<sup>100</sup>

For business leaders to step forward to build and drive such multiconstituency coalitions is, to be sure, risky. In the best of times, resolving differences of perspectives and interests across those several constituencies requires time, patience, and effort. But today, when some in our society view all business leaders with suspicion, attempts at such cooperation might seem quixotic or even dangerous. However, we believe that the potential reward more than justifies the risk. The benefit to the community of cooperative action to identify and implement skill- and infrastructure-building projects can be considerable.

But beyond the tangible benefits, creating channels of communication and establishing relationships of trust can be their own reward. With civility and cooperation, all members of our society can enjoy a greater quality of life well beyond the tangible improvements from a strengthened economic "commons."

We encourage business leaders to look for opportunities to assemble constituencies in their communities to pursue the common good. This has been a part of CED's role and message since our founding.

These ideas are far from exhaustive of the potential for a constructive "social contract." But they do illustrate that awareness and creativity can enhance equality of opportunity, and quite likely even reduce the inequality of outcomes. But awareness and creativity are not automatic. They require effort. Business needs to exert the effort needed to refresh its relationships — its "social contract" — with its employees and other stakeholders, just as it needs periodically to review and renew its core business strategies. So, for example, US firms should search thoroughly in hiring to consider disadvantaged and minority groups. Prestige companies should recruit at lower-rated colleges to spread opportunity beyond the elite universities and to locate unrecognized talent. And employers should share their expertise — and insight as to their recruitment needs — with the "wide-access" postsecondary educational institutions that must be the leaders in educating the large, currently underserved populations, including ethnic minorities and lower-income groups.<sup>101</sup>

### Potential Government Remedies

As we noted earlier, the issue of inequality has the potential to become so divisive among the body politic as to be debilitating to our political and policy-making systems. Our nation faces enormous challenges that will require cooperation across the political aisle. But political differences today seem to be more of an ideological gulf. Bridging that gulf in the nation's interest is essential.

And again, our recommendations for public policy rest on our concern about lagging wage growth for millions of Americans. Some interpret the worst side of inequality as the achievement of the highest incomes, and the resulting accumulated wealth. We disagree. In a healthy economy with innovation and robust productivity and wage growth, there

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will be large incomes but also strong income growth for all. The United States has had the former but not the latter. Decrying the former will get us nowhere in achieving the latter.

The focus between compressing the top versus raising the middle and the bottom is not mere semantics. One philosophical approach versus the other will lead to a different tone of public dialogue, and different policy choices as well. A philosophy that “rewards to innovations are offensive because they yield large returns” will lead to a contentious debate that could, in a globally open economy, convince innovators and employers that they would be better off investing and hiring elsewhere. It also would devalue in the public debate the vital task of upgrading the education and skills of millions of lower- and middle-income Americans and their children. If policy’s primary objective is to flatten the top of the income distribution, it follows that the truly vital task of raising the incomes of working Americans is secondary. These are not our priorities.

So we will focus instead on a public policy agenda to increase the skills and incomes for the vast majority of Americans — to achieve equality of opportunity. This is clearly a difficult, long-term challenge. Much of what policy can accomplish will be aimed at young people, which means that its payoff will come many years in the future. And so we also consider the proper role of public policy until we achieve true equality of opportunity.

## Policies to enhance skills, productivity, and opportunity

An attack on the fundamental and detrimental problem of inequality of opportunity would focus on the skills and productivity of the American workforce.

There is resistance to our premise. Some would flatten the income distribution from above; that, we believe, would treat only the symptoms and not achieve the true objective of higher living standards. Others believe that a dedication to skill building and workforce development would be ineffectual.

Often those arguments boil down to the same dead-end philosophy that the problem is success for the few rather than lagging incomes for the many. But the central theme of our argument is that the workplace is ever changing, driven by technology. Routinized, purely physical work without creativity and judgment is increasingly subject to automation — if it is not moved overseas.<sup>102</sup> But on the other side of the coin, creativity in any stage of the production process can lead to innovation and competitive advantage. The entire US workforce — not just those who fill jobs for college-educated workers — must be attuned not to the last job, but to the next one. With that kind of workforce development, the United States stands the best chance to be the most attractive home for investment from new as well as existing firms. By contrast, if we fail to develop our workforce, not only will we have workers who are less capable of succeeding on the cutting edge, but also we will have less investment and fewer job opportunities even for those of our workers who have succeeded in their training.

In sum, we see a view of a “new world of work” where education is powerless to advance opportunity as preemptive surrender. It assures that our nation and its workforce will not be ready for the next wave of technology. In contrast, we see opportunity on the cutting edge of skills for all US workers.

Our recommendations for public policy to create and equalize opportunity are:

- **Expand Access to Quality Early Childhood Education and Child Care** The best evidence indicates that early childhood education has the greatest, surest return among alternative investments in our future workforce. At-risk children, at the very least, need access to high-quality early childhood education if they are to enter the world of work with a solid opportunity for success. Some businesses conceivably can provide their workers’ children with adequate day care and early education, or facilitate their early education elsewhere. This can be a win-win in also helping parents to find the quality child care that they need so that they can work.

But there is little doubt that eventually public and private sources must provide additional financial support for day care and early education for the bulk of the at-risk population. Success requires quality-focused accreditation, qualified teachers, performance measurement, and accountability for results.

CED has produced a substantial body of research on the benefits of quality early childhood education.<sup>103</sup>

- **Enhance K-12 Performance with States' and Unions' Cooperation** Business leaders should work at the state level and in their home communities to implement standards for educational achievement that support college and career readiness. Local, hands-on business involvement could help to dispel the fears of supposed outside interference in the setting of standards for the benefit of future workers. CED has researched this issue extensively.<sup>104</sup> Accountability for student success in the classroom is critical. Business should reexamine the potential for partnering with schools in offering job-specific training alongside general academics, and in communicating their skill needs to wide-access public and low-cost educational institutions in their areas. Innovations along these lines would help students who enter the workforce out of high school, not only those who plan to move on to college. Experimental incentive programs to encourage low-income students to stay in school, including personal intervention and mentoring, as well as cash, SNAP cards, and tax credits, are worth investigation. Businesses could be involved in experimentation along these lines.
- **Broaden Postsecondary Access and Improve Performance and Completion** As CED has reported elsewhere, US postsecondary educational attainment is lagging behind our competitor nations around the world.<sup>105</sup> Well-to-do US youth are attending college; our weakness lies among students and families of modest means — even those who are well prepared academically — many of whom have

no experience of postsecondary attendance or success.<sup>106</sup> Increasing enrollment and completion by highly qualified students from low-income families could be enormously productive in reducing inequality, and certainly in expanding opportunity. And much can be done. College costs are rising much faster than prices generally — even faster than the more often cited cost of health care. Our nation must devote its energy and creativity to innovation in postsecondary education. That includes finding less-expensive alternatives to “seat time” while maintaining the verifiable value of a college degree. Business leaders should lend their time and expertise to the “wide-access” undergraduate institutions, as well as to the more prominent elite graduate and research institutions; it is the wide-access schools that must bear the brunt of extending education to the large less-affluent underserved segments of our population. At the same time, more scholarships for low-income households and incentives for high-prestige universities to prepare and admit low-income students could help. Businesses should specify and explain the skills that they need so that postsecondary institutions can develop curricula that develop those skills. We should improve both secondary education and community college training for those students for whom a four-year degree is not the best choice. “Competency-based” education is a promising approach.<sup>107</sup> And we should support innovative methods of assisting students to completion of their degrees or certificates.<sup>108</sup>

### Policies to compensate for the current inequality of opportunity

Pending stronger opportunity for many American workers and youth, we need to pursue fairness in economic outcomes. Several key areas of US economic policy are highly inefficient and fail to encourage economic activity while also leading to inequitable outcomes. We can do much better.

- **Reform the US Health Care System** The cost of providing quality health care to any family or individual does not vary with household income.<sup>109</sup>

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However, the cost of health care is much higher *as a percentage of compensation* for lower-wage workers. Even after the passage of the Patient Protection and Affordable Care Act (ACA), however, our nation still reflexively conceives of health care as a financial obligation of the employer. For that reason, employers must think of the cost of health care as a part of the cost of hiring a low-wage worker. That drives down cash wages, and may have contributed substantially to lower employment of low-wage and entry-level workers, slow after-tax wage growth for many workers, and to a perception of growing inequality.<sup>110</sup> But beyond issues of perception based on our society's convention of employer coverage is the reality of unsustainably rising costs for society as a whole, disproportionately weighing on low-income households. CED has recommended substantial changes to US health care finance and delivery that would both reduce the inverse linkage between the cost of care and employee cash wages, and in the long term slow the rate of growth of health care costs while improving the quality of care.<sup>111</sup> Health care system reform would therefore be one of the most important steps that the nation could take to reduce income inequality.

- **Reform the US Tax System** The US tax system also could be an important part of attaining equal opportunity, by encouraging growth and assuring that tax liabilities are distributed fairly. Instead, as Senator Ron Wyden (D, Oregon) puts it, the tax code is a “rotting economic carcass, infested with chronic diseases like loopholes and inefficiencies.”<sup>112</sup>

Polling suggests that the American people support a progressive income tax, but that they are sensitive to the level of the highest tax rates imposed.<sup>113</sup> This is broadly in keeping with John Rawls' *A Theory of Justice*, in which he posits that people should choose public systems that they would want whether their life outcomes ultimately proved either favorable or unfavorable. Rawls' philosophical expression was that the public should judge policy as if they saw their futures through a “veil of ignorance”; a more common

expression would be that citizens should be objective in choosing policies that would apply to them however their lives evolve, and to others in different circumstances. This would suggest a tax law that would provide the relief that people would want if their incomes turned out to be low, with higher but not excessive tax rates that they would be willing to pay if their incomes turned out to be high. (Of course, this kind of focus-group experiment becomes far more complex when the nation's precise revenue needs are factored in, but the principle is unimpeachable.) However, our current tax system, with preferential outcomes for some and therefore excessive burdens for everyone else, fails Rawls' test.

Tax progressivity is appropriate in our free-market system in which some enjoy success but others, often for no want of trying, do not. All Americans benefit from the opportunity that our nation gives us (though we maintain that this opportunity must be shared more broadly), and we need to meet the cost of maintaining that system. The tax system should not penalize those who achieve success, or deter others from trying. The American people's sense of fairness dictates their preference that maximum tax rates be limited; every American wants and hopes someday to be successful, and so they want skill and hard work to be rewarded.<sup>114</sup> But the American people also realize that some of the conspicuous success comes because our system itself uniquely facilitates it, and some can come from good fortune. For example, the 10,000 millionaires among the early employees at Microsoft surely worked hard and well.<sup>115</sup> But many others — many times over — with the same skills worked equally hard and well for other firms that were not so successful. Their efforts should be respected, too.

The consensus of the American people offers sound guidance. Tax policy requires balance that is fair to everyone — that follows Rawls' dictum such that people would accept it not knowing what their life outcomes will be, such that they would consider it fair whether their incomes were high or low. This will necessarily

be a compromise between the political extremes — but that is what democratic policy making for all of the people is about.

An ironic ray of hope is that our nation’s tax system today is grossly inefficient. This is to say that it achieves less of all of our objectives — fairness, economic growth, simplicity, and revenue sufficiency — than we could expect. The shinier side of this coin is that an improved income tax can deliver far better outcomes in every respect.

Today’s numerous preferential provisions, each well intended, combine to allow favored interests to pay less than others. Collectively, those preferences reduce the amount of income subject to tax, which leaves us short of revenue for all manner of public purposes and requires higher tax rates that in turn blunt incentives to work, save, and invest. Perhaps even more importantly, preferences for yesterday’s favored economic activities disadvantage tomorrow’s innovations. In the end, we have slower economic growth and reduced innovation and dynamism, plus inequality through lower taxes for favored persons and businesses. A reformed income tax could much better encourage new and innovative investments. It also could have a broader tax base, such that overall tax rates could be lower, not higher, but with a fair distribution of the burden. The Tax Reform Act of 1986 is a good model of what could be accomplished and how.<sup>116</sup> The tax reform proposal of the Debt Reduction Task Force (the “Domenici-Rivlin Commission”) of the Bipartisan Policy Center (BPC), which follows the broad outlines of CED’s own previous policy statement, shows the policy possibilities.<sup>117</sup>

Although the Tax Reform Act of 1986 passed the Democratic House and the Republican Senate by relatively wide and bipartisan margins (the Senate Finance Committee vote was unanimous), it was controversial before the national audience. In particular, some considered it to unfairly favor upper-income taxpayers because it reduced the top-bracket individual income tax rate

from 50 percent to 28 percent. But this criticism misses the reality that a higher tax rate on a smaller portion of income not only raises less revenue, but also unfairly favors those who obtain preferential treatment over those who do not. (In addition, of course, tax preferences that direct investment toward favored activities rather than unfavored activities that have greater value in the marketplace reduce economic growth.) Even with the much lower 28 percent rate, the 1986 tax system collected virtually identical revenue as had the earlier tax system from the highest-income households.<sup>118</sup> One subsequent research study found that the 1986 system actually raised more revenue, at least in part because upper-income households decided that it was not worth the trouble and expense (and the legal risk) to spend money on various tax-reduction schemes given that that top-bracket tax rate was so much lower.<sup>119</sup> We urge policy makers and the public not to confuse higher *statutory tax rates* (as opposed to *actual tax liabilities*) with fairness — especially given that lower tax rates are conducive to greater economic incentives to work and invest.

The corporate income tax is highly controversial and often misunderstood. Some believe that the amount of tax paid by corporations is an important and independent contributor to tax fairness. This common misunderstanding is almost analogous to the confusion between stated individual income tax rates and the amount of tax actually paid. We would emphasize that the determinant of fairness is rather the total amount of tax paid either directly by (in the individual income tax) or indirectly on behalf of (through the corporate income tax) *people*. One could imagine tax systems in which the total tax for particular taxpayers would be the same, but relatively more might be paid directly through the individual income tax, and relatively less might be paid indirectly through the corporate income tax — or vice versa. It is not clear that one alternative combination is inherently more or less “fair” than the other. However, one combination might prove to be far preferable in terms of its implications for economic growth and opportunity.

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We need a constructive public dialogue to reform our tax system to achieve *all* of our objectives, including fairness and economic growth *and* opportunity.

Many corporations argue that the convoluted US tax system and its relatively high rates inhibit R&D and capital investment here.<sup>120</sup> The \$2 trillion of offshore cash held by the Fortune 500 and the mergers and acquisitions tax inversion craze are two recent symptoms of the problem.<sup>121</sup> On the other hand, many critics argue that traditional US corporations should be patriotic, remain and invest in the United States, and pay higher taxes if that should result. We ask those critics to look at the bigger picture. The world economy is constantly changing. Many flagship US corporations of 50 years ago no longer exist, in some instances because they succumbed to international competition.<sup>122</sup> And every day, new firms enter onto the world stage, often with no particular national identity — or at least much less so than was the case in the more insular economy of the years just after World War II. The United States is the largest market in the world, and as such, there is good reason for many firms all around the world to consider investing here to serve our consumers — even if the firms' traditional identity is not American. However, just as traditionally US firms might lose competitive ground or even fail if faced with an uncompetitive US corporate tax system, so firms from other nations might pass up the opportunity to invest here for the same reason. American workers would lose jobs and opportunity under either contingency. And opportunities with foreign firms investing here will be a continuing and even growing phenomenon for the indefinite future. As we noted earlier, it is easier for foreign firms behind the competitive frontier to catch up than it is for US firms on the frontier to innovate and move forward. We can expect more competition, and we ignore it at our peril. And we want those new firms to invest and hire in the United States. Therefore, we need a competitive corporate tax system to give American workers jobs and rising incomes.

Clearly, tax reform is a massive undertaking and will be highly contentious, but along with systemic health care reform, it is one of the most valuable possible steps toward greater equality of opportunity and reduced economic inequality. Our nation will not provide opportunity and rising incomes unless we achieve a competitive tax system.

- **Broader Use of the Earned Income Tax Credit (EITC)** The EITC is in effect a federal government wage supplement for low-wage workers, increasing at a fixed percentage of wages from the first dollars earned and then later phasing out as earnings increase further.

An implicit principle of the American dream is that you will live decently if you play by the rules and work hard. Some express concern that US public policy is excessively generous to those who do not work hard (breeding dependency) and to those who choose leisure (which some economists would count as an alternative to cash income in evaluating inequality).<sup>123</sup> The EITC was designed to answer that criticism.

The EITC explicitly supports *working* families (and at a lesser rate, single workers). It supplements modest wages, which makes work more attractive for those whose hourly reward is the least. It does not add to employer costs, as does the minimum wage, and thus does not deter hiring or fuel inflation. On the other hand, it is administratively challenging. It provides a cash payment to persons who claim to have worked, which does entail the potential for fraud. Its once-per-year payment is not well timed to help families who are challenged to make ends meet week by week. And phasing out the EITC imposes a very high tax rate on workers at still-modest wage levels, which is both burdensome and an incentive to cut back on work as income rises.

The EITC could be restructured to make it easier to administer effectively — especially in the context of fundamental tax reform, when other parts of the tax system could be changed



at the same time to make the entire system work in harmony. For example, the BPC tax reform recommendation included using the EITC to replace the personal exemptions and standard deduction for all taxpayers, which means that it would not need to be phased out — reducing complexity and maintaining work incentives. It also might make it safer and easier to deliver the EITC in installments in real time, rather than only as a “Christmas Club” at the end of the tax year. Improvement of the EITC would be more difficult outside of fundamental tax reform, but still would be highly desirable.

- **Fair Trade Enforcement** As noted, the US has consistent large trade deficits with China and Mexico. This long-term sizable disparity leads some to believe that our trade relationships are one-sided and reduce employment for American workers. Others, including many economists, emphasize the role of reduced US savings, including the federal budget deficit, in dictating borrowing abroad to import the consumer and investment goods that we demand in excess of our own production. They point out that the manufacturing share of US employment has declined for virtually the entire post-World War II period — beginning well before the recent rise in inequality. They might also point out that the Chinese currency has fallen in value in recent months not because of manipulation, but rather because of market-driven downward pressure — indicating concern about a weakening economy. The federal government should step up enforcement of any confirmed unfair trade practices. Any US jobs that result will benefit rank-and-file domestic workers. International trade is still a small part of US GDP, so this tactic will have a modest overall impact on incomes.
- **Immigration Reform** Immigration is among the most controversial issues in US politics. Separate debates rage over unskilled immigrant labor in often difficult work environments such as in agriculture, and smaller numbers of highly skilled workers in technology fields.

Outright restriction and even deportation of large numbers of illegal immigrants working in unattractive jobs has proven difficult. Apart from border control, the federal government should consider policies that require, at a minimum, that immigrants work “above the table” and pay appropriate taxes (many already do) and are not subject to exploitation at such low wages that they present totally unfair labor competition for native-born citizens.

- **Encourage Two-Parent Households** Single-parent households face greater challenges in supporting themselves and in providing lifetime opportunity for their children. Especially troubling is the danger that the lack of opportunity for one generation will pass on inevitably to the next. The percentage of children being raised in such households has increased dramatically, as noted earlier in this statement. Changing behavior in such issues is exceedingly difficult — given the complex economic and social forces behind historically high (but recently declining) rates of out-of-wedlock births and divorce.<sup>124</sup> However, government policy makers, and perhaps business leaders, should encourage two-parent households as a sound foundation for economic opportunity for children.<sup>125</sup>
- **Outdated and Intrusive Regulation** Many US firms, small and large, are subject to regulatory overload, which can provide little societal benefit while stifling investment. Regulation is not solely a federal issue; regulation at the state and local level also can be inefficient and costly. “A clear trend in the world is toward larger government and more regulation,” says Gary Wingens, Lowenstein Sandler law firm chairman, “We’re seeing more of our clients who are subject to regulations that didn’t exist a few years ago.”<sup>126</sup> Regulations that suppress wider economic growth increase inequality. New regulations should be tested with rigorous cost-benefit analysis; existing regulations should be reviewed to ensure their continued value and relevance.<sup>127</sup>

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- **Financial Sector Guarantees** The financial sector's government backstop is underpriced; large firms benefit from the implicit guarantee of government intervention should they find themselves at risk of failure. This guarantee benefits those financial players who already own the most wealth. One important goal of financial system reform should be to avoid incentives for large firms in distress to engage in risky behavior on the assumption that they will have a public backstop should they fail. The benefits of necessary government steps to prevent systemic damage through asset price declines and financial crises should be spread out among society at large, rather than being concentrated on a small segment of the well-to-do population.
- **Auto-Savings Enrollment** Persons with limited incomes and wealth have trouble setting aside money for retirement. Many employers of low-wage workers do not offer pension plans or 401(k) accounts.<sup>128</sup> But retirement savings vehicles would enable employees to participate in the capital-raising function of corporations and to gain financial market knowledge so that the free-market system would not remain just an abstract notion. Government and business should consider giving workers the option of a payroll deduction to be deposited into a government-administered 401(k) fund that would complement Social Security. The account options could be kept simple to hold administrative costs down. The worker would then be able to “graduate” to a full-featured private 401(k) account when the balance was large enough to make that administratively feasible. Similarly, nonworking individuals should have the option to open automatic savings plans through regular contributions.

## Conclusion

In sum, we see our goal of equality of opportunity not as an absolute, or even mere aspiration. It is rather an obligation and a commitment. Without true opportunity, all of our societal objectives — prosperity, productivity, and innovation — are out of reach. The ills of irremediable inequality and economic stagnation — cynicism and despair — remain. The society that is left is unsatisfying even to those who succeed. And success itself is in jeopardy, as the creative workforce atrophies and the markets for products and services slowly migrate elsewhere.

The debate over inequality should bring the nation together, not tear it apart. Our goal should be greater and equal opportunity, which we believe would raise every member of our society; we should not rest until we achieve that goal.

## Appendix 1: *The Income Inequality Databases*

### Introduction

In his book, Thomas Piketty uses databases that he created with his longtime collaborator, economist Emmanuel Saez (University of California, Berkeley). The authors assessed and cataloged information from a variety of publicly available sources located in different countries. The data compilation (as distinguished from Piketty's analysis of those data and his policy recommendations, which we critique elsewhere) was generally admired by economists and book reviewers. Many other economists and social scientists have studied income and wealth distribution, and we cite portions of their work here as well.

Data on the distribution of income are far from perfect. Tax return information, the source of much of the income data, is the best source available here in the United States and probably elsewhere. But tax returns still are not perfectly accurate, and many low-income people are not legally obligated to file; those who do are generally not required to report receipt of government transfer payments. Unknown numbers of other income earners do not file in an attempt to evade tax liability. Not all income is taxed, and individuals can sell businesses built over generations in one year and have high incomes that are not reflective of their ongoing command over resources. Because income tax returns generally do not include information on government transfer payments, and because some who live on support from transfer payments are not required to file, analysis requires the imputation of both transfer income and transfer recipients into the basic tax return data to investigate the entire population and after-tax after-transfer income.

This section reports a number of third-party critiques of essentially all income and wealth data, including the Piketty book, similar works, and original data sources. We begin with those critiques that suggest that measured inequality is exaggerated.

### Income Data Critiques That Suggest Less Inequality

- **Market Income vs. After-tax Income** Many income inequality analysts emphasize market income differences. Market income analyses for the United States rely most heavily on income data from Internal Revenue Service (IRS) information, using the Annual Social and Economic Supplement to the Current Population Survey (CPS) only to represent the population with incomes too low to be required to file tax returns. The IRS and CPS sources include households' labor and investment income before income taxes. The IRS data, but not the Census data, also report income tax liability. Neither source reports liability for other taxes (although payroll tax liability can be estimated from labor income on the tax return), and the IRS data do not include many low-income households who rely on government transfer payments. Because the US tax system (and especially the income tax) is generally progressive, some would argue that measurements of market income inherently overstate the degree of inequality. We believe that either measure can provide important insights into particular questions, and so neither is inherently superior or inferior.
- **Government Transfer Payments Not Included** As noted, certain government transfer payments and/or subsidies for low-income individuals are not included in the IRS data, so certain data compilations do not show the true spending power available to such low-income individuals. Furthermore, some transfer programs (such as Medicaid and the Supplemental Nutrition Assistance Program or SNAP, formerly known as Food Stamps) deliver aid in-kind and are often omitted even from measures of transfer income.

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Some observers would argue against the use of market income on the ground that after-tax income plus government cash transfers is a better measurement of spending potential. In particular, government transfer payments and low-income subsidies are directed more to poor people than wealthy people, and so such critics contend that use of market income for analysis exaggerates the level of inequality. We believe that each measure, market income and after-tax after-transfer income, provides valid answers to different questions. Neither is either inherently right or inherently wrong.

- **IRS Data Exclude Employer-Provided Health Insurance** The cost of employer-provided health insurance has risen significantly over the last 30 years. Higher-wage employees are more likely to have employer coverage, but the cost of coverage is more nearly equal from employee to employee than is the amount of cash compensation. (High-salary employees might have plans with more luxurious features, but the amount eligible for the tax exclusion is limited by nondiscrimination rules.) Thus, to the extent employers have shouldered this burden, compensation has risen more than the IRS data on cash wages would indicate, and measured inequality has risen less than it would have if employer health-insurance premiums had been routinely included in income. Again, though, many low-income individuals do not receive health insurance on their jobs, and the Affordable Care Act (ACA) will affect both perceptions and the reality of inequality in this respect. The significance of this phenomenon is a matter of subjective judgment. Low-wage recipients of employer health insurance do not need to pay all or part of the out-of-pocket costs of their care, and so are unquestionably better off after the ACA. However, personal judgments of well-being very often seem to be based on cash income, with health coverage taken for granted.
- **Changes in the Tax Law Alter the Measurement of Income over Time** Changes in the tax law can affect the measurement of income from one year to the next. A prominent example is

the liberalization of eligibility of corporations for “pass-through treatment” (that is, to be treated as subchapter S or limited liability corporations) and therefore to have all income reported on individual income tax returns and not be subject to the separate corporate income tax. As corporate income has migrated gradually to individual income tax returns, that has increased the measured incomes of the generally more affluent minority as represented on their individual income tax returns.

Depending upon the research technique, that may or may not affect the measured income distribution in any given study. Some research has measured income and tax liability only with respect to the individual income tax. But other research for some years has attempted to attribute the full corporate income tax liability to individual shareholders, and to do so it has attributed all of corporate income, whether earned by public companies or “pass-through entities,” to individuals. Under the latter methodology, the trend toward conversion to pass-through entities has not affected income and tax distribution statistics.<sup>129</sup> Note also that the measured income of corporations (and other businesses) can include what is sometimes called “phantom income,” which is taxable but does not represent new cash in the hands of the owners. Phantom income can arise because of the timing of depreciation, expensing, or amortization of assets, or because of repayment of debt. Some might argue that the attribution to individuals of phantom corporate income, which might appear at the highest levels of the income distribution, overstates their income in the commonly understood sense of the term.

- **Households Are Smaller Today Than 40 Years Ago** In 2010, households (most economists use households as the unit of analysis) are slightly smaller than they were 40 years ago (2.59 people vs. 3.14).<sup>130</sup> The available market income in each household is thus spread out over fewer people on average. Some analysts have chosen to measure market income per person in each household as a more accurate depiction of the

household's economic well-being. Others might agree in general but contend that economies of scale in household consumption would mean that a per-capita adjustment overstates the effect of falling family size.

- **One-Time Sales of Assets** The considerable concentration of income among a very small number of very high-income persons may in some individual instances be the result of one-time sales of assets — some of which, in the vernacular, might be called “deals” — involving the sales of farms or family businesses, or initial public offerings or mergers of businesses. (Another class of recipients of very high incomes is private equity and hedge fund managers and other well-placed persons in the financial industry.) Such deals may occur year after year across the economy, but involve different businesses and different owners in each year. If that should be so, then the top 0.01 percent of the income distribution would include a significant number of different people in each year, which might strike some observers as a lesser degree of inequality than if that same top quantile included only the same people year after year. It would imply less accumulation of concentrated wealth than if the same households benefited from big-dollar “deals” year after year. Still, in all likelihood, those who benefited from such deals in any given year would move well up the wealth ladder on a more enduring basis, and would have considerable (but substantially lower) incomes in succeeding years, as their savings of the proceeds from their one-time deals would yield interest or dividend income on an ongoing basis.<sup>131</sup> Note that some would question the inclusion of asset sales in income at all, on the ground that they are merely changes in the form in which assets are held, and do not constitute “income” strictly defined as the earnings from new production. (See also the discussion of accrued as opposed to realized capital gains in the next section.)
- **Summarizing** In 2014, the Congressional Budget Office (CBO) published a report that examined

“after-tax, after-transfer, size-adjusted household income” over the 1979-2011 period. It thus took account of the above critiques to the extent possible. The report estimated that inflation-adjusted average household income increased across the distribution. However, because the rate of increase was much greater among the highest-income households (a 200 percent income increase for top 1 percent — CBO does not provide information on subsegments of the highest 1 percent — 40 percent for middle 60 percent, and 48 percent for bottom 20 percent of households ranked by income), measured inequality increased at the least after 1979.<sup>132</sup> Other data suggest a turn toward greater inequality beginning in the early 1970s.<sup>133</sup>

### Income Data Critiques That Suggest More Inequality

Other observers contend that the available data may on balance be biased toward understating income inequality. Consider the following:

- **Data Exclude Accrued, but Unrealized, Capital Gains** As Chart 6 (page 24) demonstrates, 76 percent of capital assets (real estate, stocks, bonds, etc.) are owned by the top 10 percent of wealth owners. (There is a substantial overlap between the top 10 percent of the wealth owners and the top 10 percent of income earners, but those groups are not identical.) The income data can include realized capital gains (because they are reported on tax returns), but they exclude the year-to-year increases or decreases in the values of assets that households do not sell (because those values are not reported on tax returns, or in any other available statistical source). Because the real estate and equity markets have trended upward over the 1970-2010 time period, but the appreciation in values in unsold assets is always excluded, one could argue that income has been understated; and because holdings of wealth are highly concentrated, this omission probably leads to an understatement of inequality. In any given year, however, asset values could go down as well as up.

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- **Tax Shelters Reduce Income** An indeterminate number of wealthy Americans utilize tax shelters (investments that generate artificial losses to “shelter” positive income from other sources), which enable them to defer income taxes. Accordingly, measured market income

(and other income concepts) of the higher-income groups may be understated. But, at some point, the understated or deferred income may be realized as current income or capital gain, so this may understate or overstate income in any particular time period.

## Appendix 2: The Wealth Inequality Databases

In both the United States and Western Europe, household wealth statistics are less accurate than income data, as we discuss below.

### US Wealth Data

The United States requires that citizens report annual income (earned income and income from property, including realized capital gains) on their income tax returns. However, there is no similar reporting mechanism for household wealth. What household wealth data we have are derived from estate tax filings (annually, also from the IRS) and the Federal Reserve's Survey of Consumer Finances (every three years). Clearly, these sources do not have the accuracy (or near completeness) of IRS income tax information. Estate tax returns cover only those who die in a given year and also have considerable wealth — there is a high wealth threshold for the requirement to file. Surveys (of income as well as wealth) must be used to represent those who are not required to file, and surveys — as opposed to tax returns with accuracy compelled by force of law — are inherently less reliable; people simply have less reason to devote time to their accuracy, or to participate at all. Therefore, conclusions of all analyses must be evaluated critically — even more so than for studies of income.

### Pensions and Social Security Payments

In the United States, virtually the entire wage-and-salary-earning population (except government employees in a few grandfathered states) is enrolled in the Social Security program, which provides a monthly payment when an enrollee reaches retirement age.<sup>134</sup> A smaller portion of this population is covered by a public or private employer-sponsored defined-benefit pension plan upon retirement.<sup>135</sup> Such annuities and pensions do not appear in US wealth statistics because such plans

do not have well-defined and precise face values, are not convertible into cash, are not bequeathable, and in the case of Social Security may never be received if the worker were to die before collecting benefits and without a dependent eligible for survivor's benefits. However, if one were to include the "present value" of the expected cash flow of benefits, the household wealth of the lower-income quintiles would show a meaningful increase because (in simple arithmetic terms) their net worths measured without those values are either zero or small in size.

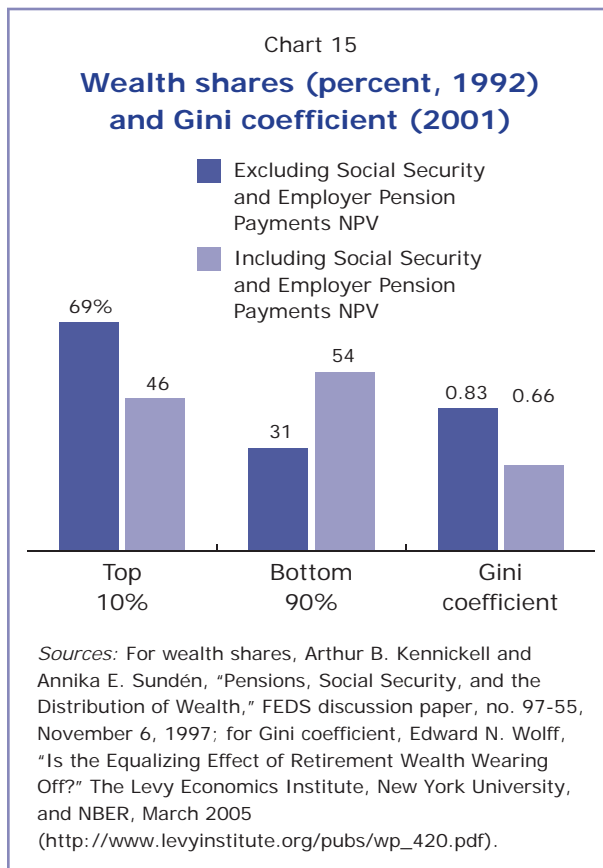
Correspondingly, the measured wealth of the household owners of greater amounts of marketable wealth would also expand with the inclusion of Social Security and employer pensions. These households may be expected to receive slightly higher Social Security amounts (due to larger lifetime earnings), and they have more access to employer-sponsored pensions. However, because those households are already counted as owning significant amounts of marketable wealth, Social Security and other defined-benefit pension values would constitute a smaller proportionate increase in their total holdings of measured assets.

Including the net present value (NPV) of Social Security payments and employer-sponsored pensions in household wealth lessens the measured level of wealth inequality, and for the bottom 40 percent of households ranked by wealth, such pension values would constitute the majority of adjusted household wealth (although the two latest studies documenting this notion are somewhat dated, having been published in 1997 and 2005).

Including a capitalized value of Social Security and defined-benefit pensions will reduce measured US wealth inequality in any given year. However, US wealth inequality, by either measure consistently applied, has increased steadily over the last 40 years.

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A 2008 National Bureau of Economic Research paper (using 2000 data) found the United States to have a 0.80 Gini wealth index, with over 90 percent of countries surveyed having a lower index. The 0.66 index (which uses the NPV of expected future Social Security and pension payments) places the United States close to the middle of all countries, but the other countries' indices do not correct for this same issue of defined-benefit public and private pension values.<sup>136</sup>



## Western Europe Wealth Data

Researchers have compiled household wealth data for Western Europe from several sources, including estate tax filings, probate statistics, gift tax filings, and individual declarations. As in the United States, Western Europe household income information is more plentiful (and more accurate) than the wealth statistics. As a result, one should consider the comparisons in Chart 10 (page 27) as general indicators rather than precise numbers.

## Wealth Data Completeness

It is unclear if and when the analysis of the distribution of wealth in the United States or elsewhere will benefit from more accurate and current data. In virtually all countries, taxation of wealth occurs only on the occasion of death, and accurate reporting of information so complex as holdings of wealth is likely only when it is required by law. No survey will have either the power to command accuracy or the reach across the population as would the annual, universal wealth tax return that likely never will be required in the United States or almost anywhere else. Accordingly, analysts can only make do with far less precise survey responses, and must convey appropriate uncertainty when reporting results of their work.



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