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The Rich-Poor Gap: A Synopsis

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Abstract: The most intractable disparities prevail in rewards garnered by individuals whether for their personal efforts, inheritance, or just good luck. A dramatic concentration of income and wealth, disproportionally rewarding relatively small elites in society, has become evident especially in the last four decades in the United States, but similar disparities also exist worldwide. The phenomenon has become perhaps the most glaring deficiency in the functioning of modern capitalism. Economists address this issue in terms of free-market and non-market (government policy) solutions or approaches; but government interventions have not worked and even free trade has rewarded owners of corporations rather than workers, including in the foreign countries where investment has migrated. The strong rationale for rewarding capitalists is still lauded as the source of entrepreneurialism and innovation, but rising inequality and decreasing social mobility have discredited "trickle-down" theories and foment social discord. The most intractable disparities prevail in rewards garnered by individuals whether for their personal efforts, inheritance, or just good luck. Corporate payroll systems are clearly out of balance, which indicates that shareholder capitalism has not been functioning properly. Few governments believe that regulation and taxation of higher income and wealth are the best or only recourse. Resolution must revolve ultimately around notions of social control, especially realistic shareholder control over managers. However, getting rich as an executive in a top-tier corporation indeed seems appropriate, perhaps as much as for talent in professional sports or Hollywood. Of course, the issue may largely disappear in a growing economy.

Keywords: Rich-Poor Gap, Middle Class, Globalization, Technological Unemployment, Utility Maximization, Protectionism, Trickledown Effect, Ultra-High Net Worth Individuals, Shareholder Capitalism, Integrity Of The Market, Incentive Pay, Minimum Wage Law, Redistribution

Introduction

President Obama's pro- Middle Class campaign commencing in late 2013 was inspired by a debate that has special salience recently, though it is an ancient conundrum: wealth and income inequality. A dramatic concentration of income and capital, disproportionately rewarding a relatively small elite in society, has become manifest especially during the last four decades in the United States. Compensation to top earners has sky rocketed while inflation-adjusted earnings of the median American household have been essentially unchanged. Widening income and wealth disparities are increasingly evident in almost every country in the world, becoming perhaps the most glaring issue in modern capitalism.

A variety of figures supporting this trend are commonly cited, for example by Business Week. According to *The Economist* 2/1/14:23, overall income going to the top 1% soared from 10% in 1980 to 22% in 2012. Graphics in Domhoff(2012) showed that compensation for top executives increased from less than 50x workers' pay until around 1980 to 400x currently; the same ratio is about 25:1 in Europe. Meanwhile, from 1990 to 2005 CEOs' pay increased almost 300% (adjusted for inflation) while production workers gained a scant 4.3%.Since 1973, the share of GDP garnered by the wealthiest 1% of Americans has risen from less than 8% to more than 19% (Piketty 2014).The share of American employment in manufacturing has declined from nearly 30% in the 1950s to under 10%, such that even drudgery gives way to unemployment.

Piketty argues that America may be pioneering a hyper-unequal economic model in which a top tier of capital-owners and "super managers" grab a growing share of national income and accumulate more and more of the national wealth. The figures show that income and wealth gains in the last 4 decades have gone to a tiny percent of the rich, while real wages to labor have been stagnant. Both economic and political forces allow and even favor the concentration of wealth into the hands of the very top elites, which is manifest in and also attributable to this worldwide trend toward higher returns from economic growth going to capital than to labor. The steady elimination of jobs and squeezing out an entire economic middle class could generate more antagonistic, unstable and potentially dangerous politics.

The Role of Free Trade

Largely explained in terms of technological change and globalization, American middle class jobs have been turned over to machines or migrated overseas. Yet even overseas average job holders have benefitted less than investors. Worldwide since the 1980s, owners of capital and top managers have captured an increasing share of the world's income from production while the share going to labor has fallen. The realization that both globalization and technological progress have rewarded the owners of capital rather than their workers is not a new phenomenon: John Milton Keynes lamented a "new disease ...technological unemployment. …due to our discovery of means of economizing the use of labour outrunning the pace at which we can find new uses of labour." [in *The Economist* 1-18-2014 p24] Substituting capital for labor, or cheaper foreign labor for domestic, is increasingly attractive in the modern era. Most American jobs created in the post-recession years have been in low-wage industries such as retailing and food service.

The classical economists' argument is that free trade is a win-win arrangement because the generally lower consumer prices that may arise from imports will exceed the wage losses in the home market. Thus, despite so many middle-class jobs lost as a result of out-sourcing production (and contributing to the ever rising trade imbalance), the overall home economy is supposed to be better off because of lower prices for consumers – a utility-maximizing outcome. Obviously, our longstanding adherence to this theory has its victims– the American economy has suffered a persistent deficit and American workers are not better off. The proportion of American adults participating in the work force recently hits its lowest level since 1978. The gains that have been achieved through free trade have gone to the richest percent of the population.

The Peterson Institute of International Economics estimates that 39% of the increase in income inequality in America is caused by its trade deficits – we have moved so much middle-class manufacturing overseas. While in theory the gain to American consumers from cheaper imports offsets the loss of income to American workers, the gain from cheaper costs is garnered increasingly by capital, not labor. Since labor's share of economic growth has been declining worldwide, the relatively higher return on capital becomes part of the inequality debate. Though foreign labor has been grabbing American jobs, those foreign workers are robbing us to reward plutocrats, just as our labor has been doing.

Opponents of free trade argue that many trade deals (such as Nafta and lately the Asian Free Trade negotiations) have not been totally in our direct interest. Classical economics would hold that free trade is in the global interest, and global benefit is what free trade is supposed to accomplish. But protectionism has had strong support from economists ever since the argument of the "free trade fallacy" by Paul Krugman and others in the 1980s. Krugman argued that trade relationships are disadvantageous for some traders because of oligopolistic advantage. Now it can be further argued that it is the corporate owners of these companies that benefit from free trade agreements, not the workers nor even the countries.

Economic Rationale for Rewarding the Capitalists

The United States has become the most unequal advanced country in terms of income differentials between rich and poor. This circumstance is lauded by many as a source of American dynamism – for driving wealth creation, hence thrift, innovation, enterprise. Thus, inequality in theory should boost economic growth through the implicit incentive for seizing opportunity and for hard work, and because riches are saved and invested to "trickle down" to the rest of society. Inefficiencies arise today due to ebbing trickle-down effects and even barring talented poor people from education or other opportunities that money can buy. Today's dual circumstance of rising inequality and inadequate social mobility feeds social dissension and promotes ill-conceived populist policies. To the extent public policy does address these issues rationally, the power of money interests can tilt policy in favor of even more concentration of wealth and influence.

Despite the accepted wisdom that rising income incentivizes free enterprise —*i.e.,* entrepreneurism, innovation, etc— rising inequality has immense political salience within countries because it is regarded as unfair and detrimental to the vast majority of citizens. The perceived unfairness has become more controversial since recessionary times have deprived broader society the benefits of asset bubbles, cheaper credit, etc. Rich bankers were bailed out, while many others lost homes and jobs. Without equal opportunity, income inequality might only be resolved by resorting to wealth redistribution as in the old communist societies or democratic-socialist states of 20th century Europe, which formulae failed. Ever since, neither market enterprises nor governments have found satisfactory solutions.

Nobel-laureate Joseph Stiglitz (2013) cited Singapore as providing lessons for the United States. Very high saving is driven by government policy – 36% of income for young workers goes into self-funded nest eggs to pay for healthcare, housing, and pensions. Ninety percent of Singaporeans are homeowners. The government also invests heavily in education, R&D, science and technology. Since 1980 Singapore's economy has grown 5.5 times faster than the US.

Robert Reich's 2013 documentary "Inequality for All" showed how the United States, while not the richest society, is more unequal in wealth than any other advanced country, and the problem is not abating. A report by Credit Suisse Research Institute (2013) cited the number of "ultra-high net worth" individuals, with personal assets exceeding $50 million; and the United States accounted for 46% of them with China in second place with 6% of them. US chief executives still are making it big, with an average of $12.3 million in 2012, which was 354 times the average worker, up from 195 to 1 in 1993. Three decades ago (1980) the ratio was 42 to 1.

Market Response for Top-Tier Wages: Executive Compensation

Corporate payroll systems are clearly out of balance, increasingly since the 1970s favoring the very top income earners. Economists can address this phenomenon in terms of market and non-market (regulatory) approaches, but practice does not conform to theoretical idealism.

Managers and unions, as well as policy makers, simply resort to collective bargaining, ad hoc pay negotiations, or political activism. Yet there seems little prospect of robust systemic reform. In 2013 bankers' bonuses were at their highest since 2008 – their financial crisis is not changing mindsets.

Notions of "shareholder capitalism" underpin business logic, and these views are widely understood and accepted: Owners of any enterprise are depended upon to compel managers to maximize long-term profitability, certainly net of the payroll burden. However, application of this theory is very imprecise in practice. Stockholders cannot exactly determine value added by particular managers or company departments in isolation. Value added by managers may be calculated simply in terms of profits or losses, but obviously there cannot be accurate knowledge of alternative performance; and what the financial crisis clearly demonstrated was that risk was not properly calculated.

In practice, executives at the very top of enterprises can reward themselves at a level that often seems out of proportion with actual performance: bonuses, golden parachutes, and a winner-take-all division of rewards while losers take the dire burden of losses in terms of workforce reductions or firings among those with less power to influence such decisions. This tendency is indeed predominant. According to Schwarz (2013), despite productivity being up by 80% since the 1970s the average worker's pay has been essentially flat.

Nothing depicts this rich-poor gap, and payroll discrimination, better than Wall Street. No one doubts that banking and finance in America should evoke shame in someone, be it private bankers or the government. Despite the Dodd-Frank Act and volumes of other new laws, the regulatory system remains in a mess; and if free-market competition instead would work its magic, why has the integrity of Wall Street not been secured? In theory financial institutions exist to provide trust in the provision of capital because their reputation and the integrity of the market is valued above all else by the financial intermediaries themselves. Yet, Goldman Sachs profited from the financial crisis in 2008 by selling mortgages to its clients that were allegedly designed to fail. Bank of America was found liable for fraud in the sale of faulty loans (through its acquisition of Countrywide Financial Corp). Morgan Stanley offered inside information about Facebook's initial public offering to selected customers only. International banks rigged LIBOR, an interest rate used to peg contracts worth trillions; and the "London fix" which is a benchmark for global currency markets, where turnover is $5 trillion daily, is suspected to be manipulated through a practice called "banging the close" whereby banks submit a succession of orders just as the benchmark is set at 4 pm.

The biggest penalties were assessed against JP Morgan Chase, which was fined a record $13 billion for its involvement in faulty mortgages, having already lost $6 billion in its "London whale" trades. The bank's 2012 annual report revealed legal exposure in numerous other cases – facing investigations into alleged manipulation of international interest rates and also the California electricity market, bond dealing involving the city of Milan, its energy trading business, its collections litigation practices, and its role in Bernard Madoff's Ponzi scheme. All the while, ratings agencies published opinions about banks' financial health that were completely wrong, seemingly oblivious to their own malfunction. Clearly, all this indicates "market failure" (and non-market – government— failure to intervene). What illustrates this best is the fact that throughout the banking crisis and the aftermath, bankers continued to reward themselves with generosity unmatched in history.

Many recent studies are charting alleged abuses in executive pay. One study (2013)by the Institute for Policy Studies in Washington revealed "widespread poor performance within America's elite CEO circles. Chief executives performing poorly –and blatantly so— have consistently populated the ranks of our nation's top-paid CEOs over the last two decades." Taking a sample group of the nation's best-paid chief executives over the last two decades, nearly 40% of the CEOs were either fired, their firms either collapsed or took a bailout (22%), or the CEOs' firms paid major fraud claims (8%). Only 8% were given the ax, but they exited with an average $48-million golden parachute.

Public disapproval of "golden parachutes" rarely has much impact, since the deal was contracted in advance. Similarly, "say on pay" votes only curb some of the most egregious excesses. Company boards facing such votes can manage to win them by dropping particular overgenerous perks. Some practices have been curtailed, such as big severance awards vested simply by quitting or retiring, or topping up pensions when bosses retire earlier than planned. Boards have been compelled to more carefully cost out and justify perks that may have previously been regarded as practically free.

Golden goodbyes are more difficult to change for various reasons. Pay consultants use more generous existing pay packages as basis for negotiating with a new boss, to attract the desired talent. Contesting a past pay package can easily dissuade new candidates. Often candidates for the top jobs also employ law offices specializing in pay negotiations, and PR firms to sell their talents; and by the time the chosen candidate fails to perform it is too late. Public outcry tends to be after-the-fact, rather than in the optimism of a new hiring. Lawsuits only can "claw back" mistakenly generous pay packages if there is firm evidence of, say, financial misstatement.

Shareholder capitalism assumes effective monitoring by owners, as represented by the Board of Directors. However, corporate boardrooms have historically been largely ceremonial, often just friends of the boss, who might not contribute much in terms of oversight and expertise. The Sarbanes-Oxley Act of 2002 and new rules at the New York Stock Exchange in 2003 have obliged boards of directors to take more responsibility for preventing fraud and self-dealing by corporate executives. Arguably there have been ill-effects such as more paperwork, but in "Boards that Lead" (2013) the authors argue that boards of directors are in a "third revolution" as strategic partners with management. The authors depict better relationships between company directors and executives where directors act proactively in recruiting top talents and also preparing for their departure.

Legal structure of enterprises also has changed the degree of control of owners over managers. The conventionally-structured corporation is ostensibly required to be mindful of the wishes of stockholders in such matters as compensation, but diverse other structures have evolved that allow more freedom from owners and regulators, more akin to partnerships. The essence is a move towards types of firms which pay out more of their earnings rather than accumulating reserves. Examples emerging since the mid-1970s include Real-estate Investment Trusts, Energy Master Limited Partnerships, and Business Development Companies. Compensation in these special entities can amount to a distribution of profits, which are not kept as Retained Earnings.

Non-Market Response: Regulatory Approaches

An indicated course of action is for governments to impose binding measures on firm directors, payroll committees, etc, or else raise taxes on exorbitant incomes. However, empirical evidence is ambiguous on prospects for success of government policies to regulate business. The bailout agreements reached by the Bush and Obama administrations, though attempting to curtail excessive bonuses, did not immediately restrain executive self-aggrandizement. Existing pay contracts protected prevailing compensation levels, and when those contracts ran out new contracts did not seem to change things. The Pay Czar appointed by President Obama was quick to observe that he had no intention, nor sufficient power, to actually dictate payroll decisions; and it seems doubtful the existence of such an office had any real effect.

The Securities and Exchange Commission proposed a new rule regarding CEO pay in compliance with a mandate in the Dodd-Frank Act. The SEC voted in September 2013 to open its proposed version to comments for 60 days, but what it finally approved goes into effect only in 2015. The rule requires most large corporations to calculate the ratio of the pay of their CEO to the median pay of all their employees. It was designed to provide transparency on the diversion of corporate resources from workers to top management. By extension, wealth goes to shareholders because stock-related bonuses provide executives the incentive to boost share prices. The implication is that managers will direct corporate capital towards dividends for stockholders, rather than investment which might set up their companies for future profit and benefits to all stakeholders but not typically reflected in near-term stock price. One mitigating factor, whether imposed by market or regulatory forces, might be lesser risks and returns. Probably the most important international non-governmental institution regulating global finance is the Bank for International Settlements in Basel, Switzerland, which has an historically conservative reputation. BIS primarily affects European banking, where higher capital ratios under Basel 3 are imposing limits on risk, and thereby windfall profits and the associated pay bonuses. Basel 3 (the Third Basel Accord, devised under the auspices of the BIS) is a global, voluntary regulatory standard on bank capital adequacy.

During February and March 2013 various measures were initiated in Europe to limit bonuses for high-income earners, with indefinite prospects for success. The logic of controlling payroll decisions with administered caps on bonuses, mandatory director votes or employee "say on pay", etc appeals to liberal governments. Pre-crisis evidence indicated that lavish bonuses rewarded big, risky gambles that seemed to pay off; but when everything went wrong starting in around 2008, few top bankers seemed to be fairly penalized. We can theorize that risk favors asymmetric bets, with large gains more likely to be identified and rewarded than indefinite losses. Big cash bonuses then encourage further risk taking.

Where company payroll policies are inclined to reward exceptional performance highly, the unintended consequence of government-administered caps on variable pay such as bonuses is to drive up fixed pay. A higher fixed-cost base limits ability to cut costs in a downturn and also to build incentives into pay structures.

Private firms have adapted by deferring all or part of bonuses, to enable firms to "claw back" bonuses that led to some long-term detriment. A simpler approach is the awarding of bonuses in the firm's equity or subordinated debt, meaning the bonus will be directly impacted by poor firm performance.

Toward Resolution

As noted earlier, the issue revolves around the notion of realistic stockholder control over managers. If disgruntled stockholders adopt the "Wall Street walk" by simply selling stock when managers engage in too much risk, this might be less constructive than trying to improve management. It is assumed that hedge funds for example are too short-term oriented, quick to buy or sell stock rather than engage management directly through ownership control. However, probably disengaged stockholders are worse than hedge funds. At least, the behavior of bankers, CEOs etc that was uncovered as a result of the financial crisis is a wake-up call to stockholders, who recognize either they must be more vigilant or governments will be more inclined to step in.

Trends in compensation policy in the banking industry are slowly turning course from the halcyon days prior to the 2008 financial crisis. However, political efforts are less the reason than the mechanisms of shareholder capitalism. In fact industry reform often runs counter to lawmakers' intentions. For example, legislative limits on bonuses have made banks rely more on basic pay awards; but this makes incentivizing pay more difficult –basic pay cannot be tied to performance, and remuneration cannot be deferred to a future point where performance becomes more manifest.

Pay and employment for bankers has been declining after peaking in 2010, as the investment-banking industry is facing a structural downturn. A new environment is emerging with higher capital standards and tougher regulations, for example forcing derivative trading onto exchanges where fees are less exorbitant than in negotiated "over-the-counter" transactions. Revenues and profitability fall faster than costs as pay and employment adjustments lag. Bonuses are finally limited by regulations for example Europe beginning in 2014 prevented bonuses bigger than annual salaries. Also stockholders may rise to the occasion and become more careful, after watching their top employees pocket large bonuses while stockholders (and taxpayers) suffered the industry's losses. Still, many banking subsidiaries have only the parent bank as stockholder, and that type of ownership may be more amenable to management decisions on pay.
Bankers' pay may illustrate the social consensus on the compensation issue best. "Few issues rile the public, and politicians, as much as bankers' pay, for obvious reasons. Investment banking is an industry that in the past seems to have been run mainly for the benefit of its employees rather than its shareholders or its customers." (*The Economist* May 11th 2013:15) However, since the crisis shareholders are finally "exerting a downward push on pay". "Both the number of people employed in banking and the amount they are paid are falling fast… Average pay has probably fallen by about 20% since the crisis". (16) The causes and direction of this trend are complex, and as argued at the outset excessive pay still prevails. Managing the banking business manifests a need for reform in the cost and pay structures despite strong profitability among the biggest players.

Ad hoc evidence indicates that management is indeed pursuing reform at banks. Goldman Sachs was holding training programs for top management, adjusting its approach to disclosure and transparency, pulling back on its world-beating (but of course controversial) proprietary-trading business, realigning internal incentives, for pay and promotion for example, all in a mood of post-2008 introspection. However, "it [Goldman Sachs] remains committed to a business model that is designed to put it in difficult situations." (*The Economist*, Oct 5th 2013 p74) Stephen Mandis (2013)charts the journey of the bank from partnership to public company, from trusted advisor to amoral trader, listing conflicts that arise when you underwrite debt, advise on deals and take your own proprietary positions.

Should CEOs Really Be Paid Less?

The Economist, October 25th 2014, poses the above question. Certainly, the dramatic inflation in executive pay since the 1970s has contributed to the still-growing problem of inequality. The guiding principle of modern payroll systems at the top levels (as well as bottom levels traditionally) is that pay be performance-related. Managers ostensibly will work harder in the interests of owners (employers) if they become stockholders themselves, and the vehicle for this is stock "options" as part of their pay (usually bonuses). Typically, options are granted for achievement of particular performance targets. Executive pay during the 1990s and until the crisis especially benefited from a roaring stock market. Michael Dorff(2014) contends that performance-based executive pay should be scrapped in favor of the more sensible salary system that prevailed until the 1960s. He argued that a basic salary system would be good for companies by reducing the payroll burden, good for executives in terms of more stable, sufficient income; and certainly it would be good for countries and society to reduce the rich-poor gap.

However, many members of society make inordinate fortunes from their talents (market speculators, entrepreneurs, leading lawyers or consultants, superstars of sports and entertainment, etc); why shouldn't management talent? Rigid salary structures that ignore ways to reward superior performance may inevitably lose out to incentive-based payroll systems. Getting rich as an executive in a top-tier corporation indeed seems appropriate.

Non-Market Response for Wages at Bottom of the Ladder: The Minimum Wage Debate

It seems an absurdity that politicians, not business managers, should determine a fair floor level to compel employers to pay employees (alas, not just civil servants), especially because it is impossible to give accurate consideration to skill levels and job realities, market competition, economic disparities in different regions, etc. But that is the basis for the existence of minimum-wage laws, and even many economists feel this political intervention in the labor market is beneficial. Society generally feels a "living wage" to be a moral imperative.

The obvious argument against government-mandated pay levels is that such laws are effectively equivalent to an employment tax, and the question is who will pay this "tax". It might be offset by improvements in productivity and reduced turnover, but more likely employers avoid the tax by reducing employment, or they increase prices or move to a lower-wage location. The tax might also be offset by replacing workers with technology, or by dropping benefits to keep total compensation the same. The more direct response is that businesses simply curtail operations.

Today's technology is different from earlier technological waves that were "labor augmenting", rather it seems to reduce employment, particularly of workers without specialized skills. Technology in the current generation has destroyed large swathes of work in the middle of the wage and skill distribution. This has contributed to the hollowing out of labor markets –polarizing into high- and low-skill occupations with fewer jobs in the middle. Highly-skilled workers design and manage technology, but low-skilled workers who might have once been laborers in factories are displaced. Today there are too many such job seekers competing for low-wage positions. The simple reality is that the bottom tier of job markets can expect depressed wages. Indeed, the share of income going to labor worldwide has fallen in recent decades.

The counterpart of the declining remuneration of labor is the rising return on capital. (Labor would have lost out to capital even more dismally except for soaring pay awarded to a relatively small population of high earners according to Elsby andHobijn(2013) – so-called "labor-force polarization".) Economists such as Tomas Piketty argue that this disparity indicates a need to once again focus on distribution, as happened in the 19th and early 20th centuries, to allay the social strains that sometimes have threatened capitalist systems. Redistribution is most often addressed through taxation.

The "employment tax" of a Minimum Wage can be taken directly out of profits, reduced benefits to keep total compensation the same, or alternatively passed on to customers, shareholders, or providers of debt or capital assets by reducing their "rents" on the assets. It seems unlikely the "tax" can be assessed against the pay of higher-wage employees. To many, the wage gap between top and bottom earnings obviously warrants some redistribution, but we see little indication of that happening. The more ready recourse is usually to raise prices.
The direct cost of not mandating a "fair wage" might be more government welfare such as food stamps, inherently subsidizing employers.

There is also an indirect cost of having an increasingly unequal society, which is a national calamity and we have only begun to see the consequences. Human capital is being paid too little to generate wealth for employers, leading some to think in terms of social revolution.

The argument that better wages stimulate consumption is ambivalent. The counter-argument is that lost jobs due to minimum-wage increases will decrease demand in the economy. So any mandated wage increase is experimental –as were other government programs such as the Social Security system.

Some reforms that might be considered in the longer term include:

1. Minimum Wage law might include provision for compensatory reduction in top-level wages. How to administer this idea is problematic. We might concoct a mathematical formula, say, by calculating the added wage cost at the bottom and taking that amount from executive payrolls.
2. The earned income tax credit is available only to low-income working families, which more directly addresses the real problem of poverty instead of low individual wages.

Of course, the entire issue largely disappears in a growing, full-employment economy.

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