MEMORANDUM

To: Commission on Poverty and Inequality
From: Matthew Samach
Subject: Inequality in the U.S. – Analysis and Policy Recommendations
Date: October 7, 2018

Abstract

This memo will analyze the accelerating growth of wealth inequality in the developed world and examine four potential drivers of this trend: globalization, technological advancement, changing dynamics between investors, employers and employees, and deregulation. Next, it will give two policy recommendations the U.S. federal government could implement to reverse this trend: a system of employee co-determination on corporate boards and the establishment of a national social wealth fund.

Overview of Inequality

The United States has returned to a level of social and economic inequality that it has not seen in a century. Both the Gini coefficient on gross income per person and income captured by the top 10% of households demonstrate this point.[1] Wealth inequality is even more startling. The richest 10% receive 40% of total income, but they have 71% of the nation's total wealth.[2] Although not as acutely felt as in the U.S., similar trends are developing across the rest of the developed world. In Europe, barring the United Kingdom (which has shown equally drastic trends as the U.S.), the ratio of wealth to income has increased from around 3 or 4-to-1 to a ratio of 6:1. Continental Europe has not seen a wealth-to-income ratio this high since the 19th century, before the first world war upended the global economy.[3]

Analysis

Globalization

Market globalization, the process of opening up trade and capital mobility between nations, has yielded an incredible result – starting in the 1990s, global inequality began to shrink after two centuries of a widening disparity.[4] On the other hand, intranational inequality in the United States and most other developed nations has accelerated since the 1980s.

A major factor in globalization is the flood of cheap, primarily unskilled labor that emerged with the entry of China, India, and the former Soviet Bloc onto global markets.[5] A large bulk of low-skill, labor intensive economic sectors such as manufacturing moved to these geographies, leaving many low-skilled laborers in the developed world either unemployed or with deflated salaries.

Opposite of low-skilled labor, capital was perhaps the biggest beneficiary of globalization.[6] Access to new markets, the aforementioned glut of cheap labor, and international value chains allowed multinational corporations to grow and optimize profits at levels previously unheard of. As firms grew enormous, the executives' compensation grew proportionally. Returns on investment were astronomical as well.

Elite professionals whose pay is tied to the size of firms' dealings, such as lawyers specializing in mergers and acquisitions or hedge fund managers, saw their income balloon in line with the increase in size of deals and profits.[7] Other highly skilled laborers benefited because firms around the world competed over them, driving up high-end salaries.[8]

Technology

The breakneck advancement of communication and information technology has worked hand-in-hand with the forces of globalization to reshape the global economy. For instance, it has allowed for some elite economic actors to amass sensational wealth. Through the internet, artists and athletes can develop global reach; Justin Bieber was a YouTube sensation before he became one of the biggest stars in the world. In the financial sector, where bonuses are often rewarded relative to the profits an employee brings in, technology allows a single operator to manage huge portfolios with assets in the billions.[9] In these technologically enabled winner-take-all sectors, the majority of competitors gain a miniscule fraction of what the break-through stars do.

For more stable jobs in medium skilled areas, those jobs that might require a college degree and involve moderately complex office tasks, technology enabled globalization has had a harmful effect in the developed world. Globally integrated information systems mean that these types of tasks can be easily outsourced to emerging economies such as India.[10] This dynamic helps explain why median earnings in the U.S. and U.K. are declining, furthering inequality.

Changing Dynamics between Capital, Management, and Labor

The philosophy of "Shareholder Primacy," posited by Milton Friedman in 1970, declared that a corporation's only ethical obligation is to maximize its profits on behalf of its shareholders.[11] Around this time, the makeup of shareholders began to change as well. The bulk of shareholders transformed from individual households and pension funds, happy to passively collect dividends from companies, into activist institutional investors like hedge funds. Because these investors compete to raise massive quarterly profits and attract wealthy clients, they exert pressure on management to cut labor expenses, buy back stocks instead of reinvesting in jobs and human capital, and merge with other companies, decreasing labor market competitiveness.[12] To appease financial backers, management became stingier with wage hikes and benefits such as healthcare and pensions.[13]

While this shift in managerial priorities was taking place, organized labor's power in the workplace was being rapidly degraded. Increased global competition, shareholder primacy, economic restructuring, disinflation, and hostility from the Reagan administration all diluted union power.[14]

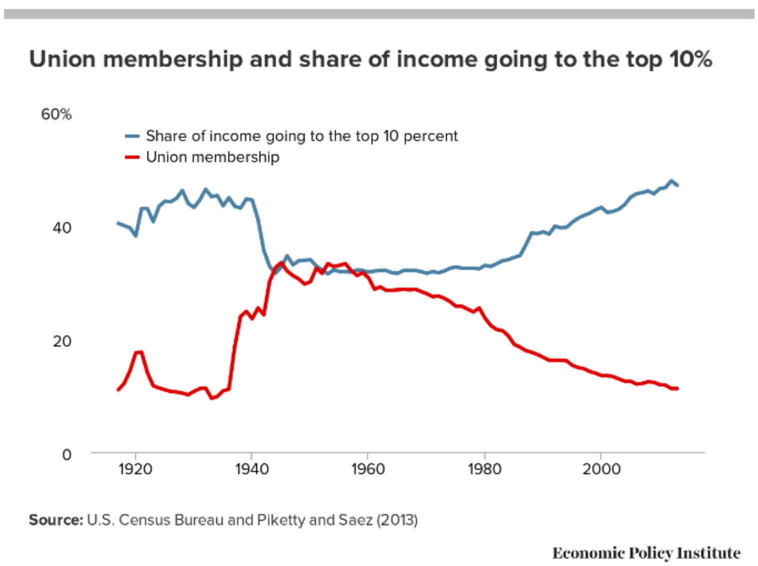

Fig 1. Union membership rates and top 10% share of income in the U.S. (Graph by Economic Policy Institute.[15])

Figure 1 shows the correlation between the continuous drop in union density and the increase in share of income claimed by the top 10% over the latter half of the 20th century. It's estimated that from 1973 to 1993, decline in unionization rates accounted for 15-20% of the rise in male wage inequality.[16]

Deregulation and Policy Changes

The era of neoliberalism has been marked by policies of tax cuts, deregulation, and market-based solutions. Under Reagan, the highest marginal tax rate fell from 70% to 40%. Similar cuts were instituted in the U.K. under Thatcher, with less severe cuts passing in continental Europe.[17] An even more impactful tax reform was changing taxes on income from savings into a flat tax; because people high on the economic ladder own a large majority of income generating capital, this was effectively an immense regressive tax.[18]

Profitability in the financial sector skyrocketed as a result of deregulation and expansion into new capital markets through globalization. The small number of people who controlled these financial innovations and expansions reaped enormous profits.[19]

Labor markets were deregulated throughout most of the developed world, giving employers more flexibility to hire and fire while increasing worker precarity even further. According to the OCED employee protection policy metric, 14 of 20 member-countries have relaxed labor regulations over the past 20 years.[20] Looser labor laws make it easier for employers to cut employment and exert control on labor markets to depress wages.

Finally, the implicit threat generated by capital mobility has made most world governments reluctant to raise taxes.[21] After all, when a firm or individual can easily relocate to more "business friendly" countries, governments are reluctant to scare away valuable employers for their nation. This has meant that redistributive, tax-heavy policies like generous welfare states have degraded since the neoliberal turn.

Policy Recommendations for Poverty and Inequality Commission

Analysis of the factors that have driven inequality over the past fifty years – from globalization and accelerated technological progress to deregulation - point to two general themes: increased leverage of businesses against workers and increased leverage of businesses against governments. To reverse these trends, this paper recommends two policy propositions: the federal government should mandate a German style system of co-determination for corporations and establish a Norway style social wealth fund.

Recommendation 1: A German style system of corporate governance that mandates employee co-determination. Under this system, boards of sufficiently large corporations must have a set percentage of employee representation on corporate boards of directors. Germany built its co-determination system to create a democratic decision-making process at the workplace, equalizing the power imbalance between investors and workers.[22] This system's effect on curbing both pay disparity and shareholder primacy has been very successful. German CEOs typically make about 1/3 as much as their U.S. equivalents despite running world-class multinationals.[23] Executive stock options, one of the principal tools for enforcing shareholder supremacy in the U.S., are much less common in Germany than the U.S. Stock options represent 63% of total compensation for executives in the U.S. but only 24% in Germany.[24]

One might assume that this system inhibited German firms' competitiveness and innovation; however, a German commission tasked with determining the efficacy of co-determination found that the system promoted "cooperative modernization" of industry and increased trust between employees and management, improving information flow in the enterprise.[25] It also rewards employee loyalty and encourages companies to invest in their human capital over the longer term.[26] Germany to this day boasts competitive firms like BMW and Siemens and is the economic backbone of the European Union.

Recommendation 2: The U.S. government should establish a publicly held financial assets fund (social wealth fund), found a public corporation to manage the fund, and develop a program to pay out a universal-basic-dividend to U.S. citizens on an annual basis. A program that uses this exact model already exists in the United States. The Alaska Permanent Fund (APF) has been successfully managing financial assets and paying its citizens dividends since 1977.[27] In 2017 the APF paid out a dividend of $1,100 to its over 600,000 citizens, an equivalent payout of $4,400 to a family of four.[28] Although not entirely attributable to the APF, Alaska was the most equal state in the nation in 2016.[29]

The standard bearer of social wealth funds in the world today is Norway. Publicly owned Norwegian funds control 59% of the country's wealth and amount to around 250% of its GDP.[30] The Norwegian government uses these funds to support its generous social welfare programs. Using the Gini index for income and World Bank data, Norway is ranked as the third most equal country in the world.[31]

A social wealth fund helps to solve inequality in two ways. First, it distributes the wealth generated from returns on corporate equity more broadly. Corporate profit will no longer exclusively benefit those at the top, but also average citizens whose livelihoods were harmed by globalization and technological advances. Second, partial government ownership of corporations could act as "patient capital", dulling the influence of short-term thinking, hyper extractive activist investors.[32] Such a relationship, where public banks or entities own corporate equity, already exists in many other developed countries.

Conclusion

Since the 1970s, a variety of factors came together to create enormous economic growth and innovation. These developments, including globalized markets, deregulation in the developed world, and innovation in information technology, disproportionately allocated income growth to corporations and their wealthy investors. These forces were harnessed by corporate interests to increase their own leverage against laborers and governments' ability to tax or otherwise regulate them. To create a country where growth works for everyone, the U.S. government should institute a system of employee co-determination for corporate boards and establish a national social wealth fund that pays a universal basic dividend to all U.S. citizens. The former policy proposal allows the voices and interests of employees to be felt in the corporate decision-making process, while the latter creates a system of equitable growth that also dilutes the influence of aggressive institutional investors.

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[1] Bourguignon, François. *The Globalization of Inequality*. Princeton: Princeton University Press, 2012, 48.
[2] Ibid, 58.
[3] Ibid, 60.
[4] Ibid, 28.
[5] Ibid, 76.
[6] Ibid, 84.
[7] Ibid, 90.
[8] Ibid, 90.
[9] Ibid, 86.
[10] Ibid, 78.
[11] Holmberg, Susan R. *Fighting Short-Termism with Worker Power: Can Germany's Co-Determination System Fix American Corporate Governance?* New York City: Roosevelt Institute, 2017. Accessed September 29, 2018. http://rooseveltinstitute.org/fighting-worker-power-short-termism-can-germanys-co-determination-system-fix-american-corporate-governance/, 4.
[12] Ibid, 10.
[13] Ibid, 12.
[14] Bourguignon, François. *The Globalization of Inequality*. Princeton: Princeton University Press, 2012, 101.
[15] Sommeiller, Estelle, Mark Price, and Ellis Wazeter. "Income Inequality in the U.S. by State, Metropolitan Area, and County." Economic Policy Institute. June 16, 2016. Accessed October 07, 2018. https://www.epi.org/publication/income-inequality-in-the-us/.
[16] Bourguignon, François. *The Globalization of Inequality*. Princeton: Princeton University Press, 2012, 106.
[17] Ibid, 92.
[18] Ibid, 93.

[19] Ibid, 98.
[20] Ibid, 99.
[21] Ibid, 115.
[22] Holmberg, Susan R. *Fighting Short-Termism with Worker Power: Can Germany's Co-Determination System Fix American Corporate Governance?* New York City: Roosevelt Institute, 2017. Accessed September 29, 2018. http://rooseveltinstitute.org/fighting-worker-power-short-termism-can-germanys-co-determination-system-fix-american-corporate-governance/, 13.
[23] Ibid, 17.
[24] Ibid, 17.
[25] Ibid, 19.
[26] Ibid, 13.
[27] Bruenig, Matt. *Social Wealth Fund for America*. People's Policy Project, 2018. Accessed September 29, 2018. https://www.peoplespolicyproject.org/projects/social-wealth-fund/, 27.
[28] Ibid, 29
[29] Ibid, 30.
[30] Ibid, 16.
[31] Barr, Caelainn. "Inequality Index: Where Are the World's Most Unequal Countries?" The Guardian. April 26, 2017. Accessed October 07, 2018. https://www.theguardian.com/inequality/datablog/2017/apr/26/inequality-index-where-are-the-worlds-most-unequal-countries.
[32] Holmberg, Susan R. *Fighting Short-Termism with Worker Power: Can Germany's Co-Determination System Fix American Corporate Governance?* New York City: Roosevelt Institute, 2017. Accessed September 29, 2018. http://rooseveltinstitute.org/fighting-worker-power-short-termism-can-germanys-co-determination-system-fix-american-corporate-governance/, 16.