Fact Sheet

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Executive Compensation and Income Inequality

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Contention: *A mounting body of economic research indicates that the rise in pay for company executives is a critical feature in the widening income gap.*

Peter Whoriskey, June 19, 2011

Fact: Skill-Biased Technology Is Primarily Responsible for Widening Wage Disparities. According to the Organization for Economic Co-operation and Development (OECD), since 1985, the main reason for widening wage disparities in industrialized countries was the large shift in demand for high-skilled employees and away from low-skilled labor that resulted from technological progress, innovation, and global competition.[1] The trend was also linked to changes in working hours. While average annual hours worked fell a little on average, the hours of lower-paid employees declined far more than those for the higher-paid. Moreover, the OECD found that wage disparities are widening not only in the United States, but also in Sweden, Germany, Italy, Norway and Denmark; countries that have much higher tax rates, stronger unions, and more generous social welfare programs. In fact, during the past decade, inequality grew faster in Denmark, Germany, and Sweden than anywhere else.

According to the Congressional Budget Office, "the most important source of widening dispersion in the top half of the wage distribution between 1979 and 2009 was growth in the wages of college graduates compared with those of high school graduates."[2] Technological innovations and related organizational changes (skill-biased technological change) are responsible for most of the increased demand for workers with more education and skills. Most importantly, these technologies decreased the relative demand for workers doing routine cognitive work typical of "middle-skilled" jobs and increased the relative demand for highly skilled workers doing more complex analysis.

Studies on the significance of shifts in international trade and the rising number of foreign-born people in the workforce are inconclusive or appear to have had only a modest effect on the distribution of wages.[3] Moreover, while changes in the real (inflation-adjusted) value of the federal minimum wage and declining unionization rates may have contributed to changes in the wage distribution during the 1980s, neither of those factors is a plausible explanation for the changes during the 1990s and 2000s.[4]

The factors that contribute to rising wage disparities are complex, varied, and interrelated. For example, one study found that up to one-third of the growth in the wage gap between the rich and the poor is driven by city size independent of workers' skills.[5] Prior to 1979, wage inequality was roughly equal regardless of where workers resided; now the size of the metropolitan area predicts wage inequality. According to one author of the study "if we want to understand what's causing the wage gap, we now know we need to look at the unique economies of our larger cities."[6]

Another economic study that looked at the top 1 percent of individual tax returns noted that theories about executive compensation, financial market asset prices, corporate governance, social norms, and institutions are hard to prove because the effects are so interrelated.[7] However, the study found the incomes of executives, managers, financial professionals, and technology professionals are very sensitive to stock prices and the business cycle. Another study concluded that "poor corporate governance or managerial power over shareholders cannot be more than a small part of the picture of increasing income inequality," and that "CEO pay is highly related to firm industry-adjusted stock performance."[8]

Conclusion: A variety of interrelated factors have contributed to rising income disparities over the past 30 years. Economic research shows that widening income disparities have come from skill-biased technological change and the large shift in demand for high-skilled employees and away from low-skilled labor; and the growth in the wages of college graduates compared with those of high school graduates. Other research on the significance of international trade, immigration, unions, and executive compensation are inconclusive and these factors appear to have had only a modest, if any, effect on the distribution of wages.

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[1] Organization for Economic Co-operation and Development, *Growing Income Inequality In OECD Countries: What Drives It and How Can Policy Tackle It?*, May 2, 2011, available at: http://www.oecd.org/dataoecd/32/20/47723414.pdf.

[2] Congressional Budget Office, *Changes in the Distribution of Workers' Hourly Wages Between 1979 and 2009*, February 16, 2011, available at: http://www.cbo.gov/ftpdocs/120xx/doc12051/02-16-WageDispersion.pdf

[3] *Id.*

[4] *Id.*

[5] Nathaniel Baum-Snow and Ronni Pavan, *Understanding the City Size Wage Gap*, The Review of Economic Studies, February 2011, available at: http://www.restud.com/wp-content/uploads/2011/02/14277.pdf.

[6] Science Daily, *Larger Cities Drive Growing Wage Gap Between the Rich and the Poor, Study Shows,* February 11, 2011, available at: http://www.sciencedaily.com/releases/2011/02/110207103607.htm.

[7] Jon Bakija, Adam Cole, and Bradley T. Heim, *Jobs and Income Growth of Top Earners and the Causes of Changing Income Inequality: Evidence from U.S. Tax Return Data,* Williams College, Department of Economics Working Papers, No. 2010-24, November 2010, available at: http://web.williams.edu/Economics/wp/BakijaColeHeimJobsIncomeGrowthTopEarners.pdf.

[8] Joshua D. Rauh and Steven N. Kaplan, *Wall Street and Main Street: What Contributes to the Rise in the Highest Incomes?* CRSP Working Paper No. 615; AFA 2008 New Orleans Meetings Paper, July 2007, available at SSRN: http://ssrn.com/abstract=931280.