Our Perspectives: Commentary on the economy & regulatory policies affecting financial companies
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The Longbrake Letter
Special Edition — Income Inequality*

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I. America's Crumbling Social System

There is ample evidence that all is not well in the United States — America's social system is crumbling. In a landslide, New York City recently elected Bill de Blasio to be its next mayor. Growing income inequality and the widening gap between rich and poor was the central theme in de Blasio's successful dark-horse candidacy. In his election night victory speech, de Blasio described income inequality as "...that feeling of doing well, while so many slip further behind" and identified it as "the defining challenge of our time."

Thinkers from across the political spectrum increasingly are talking and writing about evolving trends in America's economic and social system. Overall, there is worry and concern, although there is substantial difference of opinion about the significance of these trends and how America's economy and society might be affected. Thus, not all would agree with the title of this Section — "America's Crumbling Social System."

This month's letter explores trends in income, wealth, and cultural inequality. While I attempt to present the various viewpoints in a balanced fashion, my own viewpoint is manifest and it is one of deep concern, but it is also one of hopefulness that some favorable counter developments are already underway and potential solutions exist, which policymakers could adopt and implement.

Discussion begins by defining the elements of an ideal social system and then documents how America's social system has steadily moved farther

*The information contained in this newsletter does not constitute legal advice. This newsletter is intended for educational and informational purposes only.

away from the ideal in recent decades. Trends in income, wealth, and cultural inequality are indicia of the decline. The ascendancy of shareholder wealth maximization, efficient markets theory, and the operation of free markets as the dominant economic model has been coincident with these trends and has amplified them. Concurrently, America's social contract has shifted from a high-wage to a low-wage orientation. Collectively, the American social system has become less inclusive and more extractive — increasingly serving the interests of the few at the top of the income and wealth pyramids.

Decline in America's social system can be arrested through transformative change of the dominant cultural and ideological hegemony. Transformative change will not come easily because those who benefit from the current system are invested in preserving it and they command great economic and political power.

Nonetheless, initiatives are already underway which are setting the stage for potential transformative change. Foremost is the emergence of business organizations with governance structures that are alternatives to the predominant shareholder wealth maximization corporate form. These business alternatives include traditional non-profit service providers but increasingly extend to social enterprises. Changes in laws and the development of broad-based networks of supporting intermediaries, including faith-based organizations, which build relationships, provide skills training, and enable access to low-cost financing are essential for successful growth of these alternative businesses. Successful transformative change is not guaranteed. It will take a long time to evolve and will need to be nurtured in many ways. But, successful implementation of these kinds of changes will result in a strong, inclusive social system that benefits all Americans.

II. Ideal Social System

Before exploring the issue of income inequality and its impacts on the economy and America's social system, it will be useful to do some stage setting by describing the parameters of an "Ideal Social System." This relies to a large extent on the work of Daron Acemoglu and James Robinson[1] and

[1]Acemoglu, Daron and Robinson, James (2012). *Why Nations Fail: the Origins of Power, Prosperity and Poverty.*

Woody Brock.[2]

Based on Acemoglu and Robinson's extensive case studies, we learn from history that nations that have and sustain inclusive economic and political systems create more income and wealth for their citizens over time and that income and wealth is distributed more evenly. Woody Brock specifies the necessary components for an ideal social system, which also has the virtue of being inclusive.

Brock posits that an ideal social system has three components: (1) a constitution, (2) the economy, and (3) the political system. The constitution is an essential component of the ideal social system because it contains enforceable rules that govern behavior in the economy and the political system. Religion plays a companion role in establishing values, beliefs, and norms that frequently complement the rule of law in guiding desirable behaviors.

1. Norms for an Ideal Constitution

Constitutional norms provide for the rule of law and equal protections and treatment of citizens. The U.S. constitution, the first ten amendments (Bill of Rights), and subsequent amendments meet the norms for an ideal constitution. In state capitalism, such as practiced in China, there is no meaningful constitution. The party and the state are the constitution. This means that the interests of the power elite, rather than society as a whole, govern outcomes.

Religious and faith traditions lay out behavioral and ethical expectations, especially as they define how individuals should behave in transactions with others. They are a powerful complement to a constitution, a body of written laws, and judicial decisions.

Faith traditions and written constitutions are necessary conditions for achievement of an ideal social system, but to be sufficient to assure achievement of an ideal social system, society must embrace them and believe without question that all will be held to account. Human beings are motivated by self-interest and the pursuit of self-interest, left unchecked, will block achievement of an ideal social system.

[2] Brock, H. Woody (2012). *American Gridlock: Why the **Right** and **Left** are Both Wrong.* Hoboken, N.J.: John Wiley & Sons, Inc.

2. Norms for an Ideal Economy

According to Brock there are six norms necessary to achieve an ideal economy:

- Efficiency (non-wastefulness)
- Stability
- Freedom (actions and decisions occur without the necessity to secure permission)
- Privacy
- Distributive justice ("fairness" — the glue that keeps society working)
- Incentive structure compatibility

The sixth norm of "incentive structure compatibility" must permeate the five other norms.

Faith traditions complement the functioning of economic institutions. This is true for all six norms but the linkage is particularly important for "distributive justice."

3. Norms for an Ideal Government

According to Brock, "politics is about eyeball-to-eyeball bargaining between interest groups." An ideal government is one in which multi-lateral bargaining achieves "good" compromises that serve the collective interests of society well. An ideal government is efficient (same norm as in the ideal economy), fair (embodies notion of distributive justice), and unbiased.

4. Interaction between the Three Components

The economic and political systems overlap. The extent of the overlap is determined by how much economic activity the political system seeks to control. The constitution and the political system also overlap. The constitution constrains the power of government and establishes rules for balancing the needs of society and the rights of individuals.

Achieving the optimal overlaps is crucial to optimizing social welfare over the long run. Conceptually, this appears to be straightforward. But, in practice there is wide disparity in political beliefs about the extent to which the political system should exercise control over the economic system. Too much political control can stifle innovation, impede efficiency, and threaten freedom; too little political control can lead to instability and impinge upon distributive justice.

5. Comparing Liberal Democratic Capitalism and State Capitalism

Brock believes that the troubles afflicting developed countries which have liberal democratic capitalism models stem primarily from flaws in the government component. Politicians seize on voter insecurities to promise more and more benefits which cannot be paid for in the long run. The underfunding of U.S. entitlement programs is a case in point.

In the case of state capitalism, the government directly controls too large a part of the economy through government-owned and government-regulated companies. These companies have enormous incentive to maintain and grow the extent of their control. This frustrates competition and over time economic efficiency and growth suffer. The absence of any meaningful constitution assures that dominance and oppression by such companies will serve the narrow interests of their elites rather than society as a whole.

China's economic and political system is an example of state capitalism. China's economic success to date has benefited from its ability to mandate an investment/trade based strategy through state-controlled enterprises. However, this strategy is fast approaching a dead end, which China's current leadership acknowledges. Significant reforms in China's economic and political institutions that move in the direction of greater inclusiveness will be necessary to sustain China's rapid growth. Such reforms are not in the interests of many of the beneficiaries of the existing economic model. This is not to say that China's leadership will fail to implement the necessary reforms, but it is clear that implementation will be resisted and ultimate success is not assured.

6. Causes of the 2008 Financial Meltdown

But, the virulence of the 2008 financial markets panic and the lethargic economic recovery in its aftermath have spawned debate about the virtues and shortcomings of liberal democratic capitalism.

Woody Brock cites four causes of the 2008 global financial meltdown.

First, the Efficient Market Theory, which the political and financial elite came to rely upon, is deeply flawed — the reasons are discussed in Section III below. According to Brock, this theory is "poor" because "...it neither explains nor predicts real-world data and ...at a deeper level its Basic Assumptions are indefensible. The Basic Assumptions of the Efficient Market Theory include: (1) participants do not make mistakes, (2) all risks can be hedged (when (1) and (2) are combined, they imply that leverage does not matter), and (3) everyone possesses all relevant information and knows how to price correctly. Models based on this theory grossly underestimated volatility and derivative instruments designed in reliance on the theory did not perform as expected.

Second, theories of the efficacy and benefits of market deregulation were misguided. Blind adherence to "the market knows best" belief leads to disastrous outcomes.

Adherence to "the market knows best" belief diminishes or limits the legitimate role of government in assuring outcomes that serve the collective interests of society well and opens the way for narrowly-based financial and political elites to rig the system to serve their interests.

Third, according to Brock, the emergence of a "pathological" incentive structure contributed significantly. The hallmark of the incentive structure involved de-linking performance and risk. This outcome was at the root of the breakdown in underwriting in the securitization market. But it also was reflected in adoption of governance structures such as limited liability corporations and the substitution of corporate governance for partnership governance in investment banking companies.

Fourth, and most important of all, was the runaway use of excessive amounts of leverage, which, as Hyman Minsky postulated, migrated from hedge to speculative to Ponzi financing.[3]

Most unfortunately, these four causes interacted and reinforced each other to create an unprecedented Ponzi-financed global boom. The magnitude was huge and so, too, was the damage caused by collapse of the boom.

7. Inclusive Versus Extractive Societies

Acemoglu and Robinson's historical case histories demonstrate that the success or failure of a nation is directly linked to whether its political and economic institutions are "extractive" or "inclusive". Extractive institutions are structured to serve the interests of elites and to extract income and wealth from the masses. Inclusive institutions are distinguished by broad participation of all segments of a nation in ways that prevent entrenchment of elites.

Inclusive institutions embrace the rule of law and individual rights. They enable free entry of new businesses. This encourages investment and innovation which eventually create great wealth.

Extractive institutions control economic and political processes to serve the interests of the elite. They often are distinguished by open corruption of those in power or accomplish similar outcomes through laws and regulations which protect the interests of the elite. Societies with extractive political and economic institutions discourage investment and innovation. Laws, rules, and practices block and the ever-present threat of confiscation

[3]Minsky defines three levels of credit creation. The first, called "***hedge financing***", occurs when borrowers have the ability to meet their contractual debt payments of interest and principal through cash flows generated by activities financed by the loan. The second, called "***speculative financing***", occurs when cash flows are sufficient to cover interest on the debt but insufficient to repay principal, thus requiring repeated refinancing of the debt. The third, called "***Ponzi financing***", occurs when cash flows are insufficient to cover either interest or principal payments on the debt so that debt and interest must be refinanced and the amount of the debt constantly grows. Unless regulation intervenes there is a natural tendency for credit creation to progress over time from hedge to speculative to Ponzi. This progression unfolded during the housing bubble. Economies and financial systems are stable when credit creation is limited to hedge financing. However, fragility builds as speculative financing takes hold. And, when Ponzi financing emerges it is only a matter of time before a Minsky moment arrives when forced selling of overvalued assets causes the financial system to implode.

inhibits attempts by non-elites or outsiders to establish new businesses.

Acemoglu and Robinson argue that political and economic institutions, whether they collectively are extractive or inclusive, are self-perpetuating. This results either in a virtuous circle of economic development and wealth creation in the case of inclusive institutions or a vicious circle that discourages economic development and wealth creation in the case of extractive institutions. Unfortunately, history indicates that extractive institutions are the rule and inclusive institutions are the exception.

Success of the U.S. economy and political system since the founding of the republic in 1776 has rightfully been attributed to the inclusive underpinnings of the U.S. constitution and system of government. It has also benefited historically from the role religious institutions have played both in guiding behaviors consistent with inclusiveness but also in partnering with government in founding and operating a variety of public educational, medical and charitable organizations.

Many, including Acemoglu and Robinson, now question whether corporate and political elites are inexorably accumulating power as they pursue an agenda of self-interest. Recent economic and political events in the U.S. suggest that that the U.S. economic and political system is drifting away from inclusiveness and toward extractiveness.

Why did the housing bubble and financial asset speculation using extensive leverage careen out of control before the inevitable financial crash occurred in 2008? Many, such as Henry Kaufman, foresaw the debilitating consequences of the crash for millions of Americans. Why did our business and political leaders do next to nothing and why have so few been held accountable in the aftermath? And, why did the values, beliefs, and norms of our faith traditions have little apparent impact? The answer would appear to be that increasingly America's leaders, believing in the efficacy of shareholder value maximization and in the ability of free markets to regulate outcomes in the overall collective interest, permitted power to accumulate in the hands of those bent upon serving their own interests in extracting wealth and maximizing their incomes. The effectiveness of traditional governance, including religious values, beliefs, and norms, eroded as the new ideology of shareholder value maximization and free markets gained ascendancy.

8. What Can Be Done To Change Societies?

There is no natural process to create inclusive institutions. Elites cede power only if threatened with loss of power. Often this requires revolution. But, revolution does not necessarily change the outcome. Extractive institutions remain entrenched and the only change is that one power elite is substituted for another. Change comes about when there are nascent inclusive institutions with strong leadership which is able to capture the support of the masses to effect significant and lasting change in a nation's political and economic institutions. This happened in many parts of Europe following the discovery of the Americas by Christopher Columbus. Once established, the economic success of inclusive societies in Europe created pressure for change in extractive societies. Some migrated over time to predominantly inclusive political and social institutions; others, such as Russia, have never changed.

But, can inclusive institutions be so weakened that power elites' natural extractive tendencies gain the upper hand? Acemoglu and Robinson do not address this question. However, it is an important one because some believe that the U.S. is straying from a predominantly inclusive society toward an extractive one. For example, the apparent capture of the political elite by the financial elite in the U.S. is an example of how powerful the extractive tendencies of elites can be. It is possible that Acemoglu and Robinson might argue that the ascendency of Wall Street cannot long continue because of the deep entrenchment and power of America's inclusive institutions.

Culture and social norms are important. Acemoglu and Robinson do not give much credit to culture in establishing and perpetuating inclusive political and economic institutions. However, culture in terms of social norms and values plays an important role. But, having said this, and reflecting on Charles Murray's book *Coming Apart*,[4] there is some question as to whether America's culture is changing in ways that are facilitating the emergence of the extractive power of America's financial elite. If this is so, it is not absolutely certain that the tradition of the dominance of U.S. inclusive political and economic institutions will continue to drive economic development and wealth creation.

[4]Murray, Charles (2012). *Coming Apart: the state of white America, 1960-2010. New York: Crown Forum.*

III. Shareholder Wealth Maximization and Free Markets

Over the last 50 years finance theorists extended the neo-classical economic theory of competition to financial instruments and markets. The neo-classical economic theory of competition is highly idealized and is based on rigid simplifying assumptions that are not consistent with observed behaviors. Financial economics theory is subject to the same limitations. However, the elegance of mathematical models that flowed directly from the assumptions and the utilization of these models in designing and pricing a plethora of financial instruments coupled with the fact that the models appeared to be reasonable in "normal" times, led many theorists and practitioners alike to blindly embrace the theory and models as accurate and complete. The theory dictates that market participants should seek to maximize value and based upon the theory's assumptions, the operation of the market will assure that no participant benefits at the expense of another participant — the optimal collective outcome will always be achieved. In time this mantra of "the market knows best" came to dominate beliefs and behavior. Regulation was judged to be intrusive and unnecessary. In effect, Brock's third pillar — the constitution/rule of law — was replaced with assumption that the market would do the job. Obviously, we know from hard experience that it did not.

1. Neo-Classical Economic Theory

Neo-classical economic theory was developed in the late 1800s and early 1900s. It is based on the theory of perfect competition, which results in the maximization of aggregate economic welfare. The theory is based on simplifying assumptions of human behavior that describe in broad general and ideal terms behaviors of participants in the economy.

Neo-classical economists understood that the real world is far more complex than the world assumed under the tenets of perfect competition. They realized that the actions of individuals do not adhere strictly to the simplifying assumptions. Nonetheless, the theory of perfect competition is a useful construct for understanding how an economy functions. By comparing the idealized assumptions to actual behaviors, economists and policymakers can better understand how to govern the economy to maximize aggregate public welfare, given the inherent self-interested and sometimes irrational behaviors of individuals.

2. Rise of Financial Economics and the Efficient Markets Hypothesis

Modern finance had its genesis in the 1950s. The defining event was Harry Markowitz's doctoral dissertation on portfolio theory. Development of modern financial theory proceeded rapidly during the 1960s and 1970s and keyed off of the neo-classical theory of perfect competition.

3. Assumptions of the Financial Economics Theory

- All participants are rational
- All participants have access to complete information
- All participants share the same decision-making framework for using information to make decisions
- The decision-making framework is accurate and complete

All of these assumptions are oversimplifications of observed real world behaviors. The fourth assumption, if accepted uncritically, is especially problematic. What the term "accurate and complete" means is that the decision-making framework is stable and does not change over time. But that assumption is patently inconsistent with the rapid development of new financial technologies and the constantly evolving structure of the global economy and financial markets.

Financial economics theory posits that if all of these assumptions hold (which they do not), the collection of all individual decisions, which is "The Market", will assure optimal outcomes both for individuals and the community as a whole. Thus, any form of intervention will lead to a suboptimal outcome.

4. Operationalization of Financial Economics Theory

Had financial economists been content to stay in the world of theory as had neo-classical economists financial economics theory would have remained a useful device for understanding the imperfect working of financial markets.

However, the theory, which assumes that financial events (phenomena) are random and normally distributed — both simplifying theoretical assumptions — , was operationalized through the development of market-traded financial instruments. The assumptions of randomness and normal distribution are a simplification of the fourth assumption that the decision-making framework is stable over time.

The famous Black-Scholes option-pricing model embedded the assumptions of randomness and normal distribution. This model was relied upon to develop pricing methodologies for a plethora of financial derivatives using historical data. The historical data were presumed to be normally distributed and to be stable over time. In other words, the pricing algorithms assumed that future price variability could be defined by and explained by past price variability.

These pricing models appeared to work well over a variety of market circumstances. As a consequence, the mathematical elegance of the model and the apparent accuracy of how it explained financial market behaviors strengthened the political movement toward deregulation and embracement of "The Market" as an effective and efficient market governance mechanism.

5. Failure of the Theory of Financial Economics

But, people lost sight of the reality that financial phenomena are neither random nor normally distributed. They lost sight of the reality that the model is not stable but ever changing as technological innovation and global competitiveness has evolved.

The macroeconomic consequences of growing income/wealth inequality had no place in the theory of financial economics.

Myopia and faith in the efficacy of micro financial theory blinded people to the building macroeconomic fragility.

There were warnings along the way that the assumptions underlying the construction and pricing of financial derivatives were deeply flawed. The collapse of Long Term Credit Capital, a mathematically-based arbitrage operation, in 1998 exposed the limitations of the assumption of normally distributed events. The reality was that the distribution had large fat tails in times of extreme duress. This hardly was a startling revelation. The centuries-long history of booms and busts and of speculation indicates that extreme events and fat tails are a natural occurrence in human existence.

Yet, the elegance of the theory and its operationalization led to uncritical belief in its efficacy. As financial markets embraced the theory and developed lucrative financial instruments based on it, self-interest entrenched commitment to its tenets and led to the capture of government policy and regulatory processes.

Thus, in this way modern finance theory contributed to rising income inequality and was a significant contributor to the escalation of unchecked market euphoria during the bubble years.

Perhaps disturbingly, in spite of the failure of the application of modern finance theory in recent years in governing market processes, the pricing of financial derivatives continues to be based on the simplified theory. Moreover, the beliefs, vested interests and political influence of the financial elite remain relatively unchanged.

It is in this vein that a debate about the future of capitalism is just beginning to emerge. The risk is that the debate will not develop into a substantive and critical evaluation of the causes of income inequality and the shortcomings of the application of simplified financial theory to the operation of financial markets. Without such an in depth assessment solutions, which have broad-based consensus, will not emerge. We have already witnessed the consequences of the current paradigm. So, clearly the status quo is not an optimal outcome. Indeed, adherence to the status quo could either lead eventually to social unrest and political reform under duress or alternatively it could foster the gradual decline in America's economic, financial and political ascendancy.

6. Asset Price Bubbles

Asset pricing theory, which was developed by Myron Gordon,[5] is based on the same general assumptions of financial economics theory. It posits that the price of an asset is determined by the discounted expected return of holding an asset for one time period. This price depends upon three factors: any cash payment received during the period, the expected price at the end of the period and the discount rate. However, numerous studies have found that actual fluctuations in asset prices do not conform to the dictates of theory.

In a recent article, John Williams,[6] president of the Federal Reserve Bank of San Francisco, quipped: "*We economists like to explain things using highly stylized models. We build make-believe worlds, populate them with creatures that act according to strictly prescribed rules, and analyze what happens. ... Often the simplest model — with patently unrealistic assumptions — yields the keenest insights into how a market or an economy works. ... Much of the research on asset prices continues to rely on highly stylized models with identical agents, rational expectations, and optimizing behavior.*"

If the assumptions of the theory held without exception, asset prices would never lead to price bubbles. In fact asset price bubbles form rather frequently. Williams states that the actual behavior of asset prices can be explained by replacing the assumption of rational expectations with people's perceptions of what they believe will happen in the future. The record clearly shows that people's expectations of the future depend on what has happened in the recent past. Thus, if prices have risen, the collective expectation is that they will continue to rise. This introduces a positive feedback loop that propels asset prices into bubble territory.

Williams concludes that asset price models need to incorporate an assumption of procyclical investor optimism and cites Charles Kindleberger's seminal work: "*The lesson of history is clear: asset price bubbles are here to stay. They appear to be a consequence of human nature.*"[7]

[5] Gordon, Myron J. (1959). *Dividends, Earnings, and Stock Prices.* Review of Economics and Statistics 41(2), pp. 99-105.

[6] Williams, John C. *Bubbles Tomorrow, Yesterday, but Never Today?* Federal Reserve Bank of San Francisco Economic Letter 2013-27.

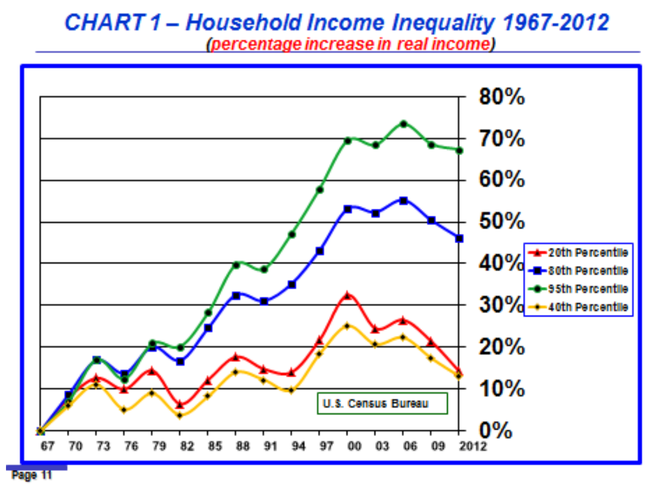
[7] Kindleberger, Charles P. (1978). *Manias, Panics, and Crashes: A History of Finan-*

IV. Income Inequality

This section documents changes in income inequality in the U.S. over time.

1. Widening Income Inequality

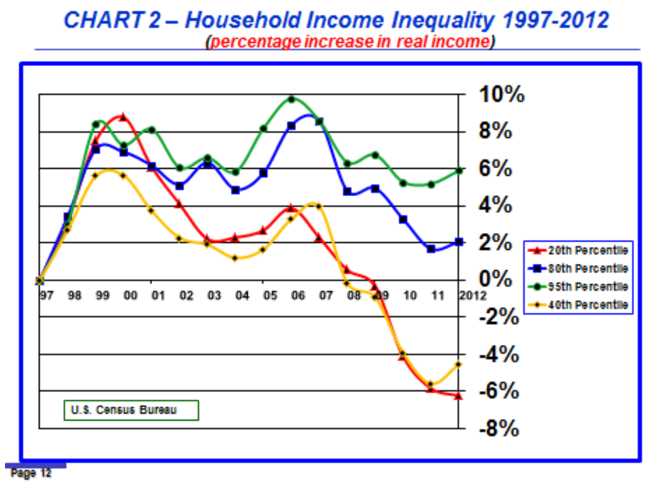
Income inequality has been worsening steadily for 45 years. **Chart 1** shows



that real spending power for the lowest 20% of the U.S. population has increased just 15% over the last 45 years while real income has increased nearly 70% for the top 5%. The skew is even more dramatic for the top 1%.

Chart 2 shows that real incomes have declined 6% for the lowest 20% of the population over the last 15 years while rising 6% for the top 5%. The small increase for the top 5% isn't a good result, but decline for the bottom 40% is a disaster.

cial Crises. New York: Basic Books.



2. Income Inequality — What the Data Say

Two papers, one a theoretical economic analysis prepared by two International Monetary Fund economists, Michael Kumhof and Romain Ranciere,[8] and the other a white paper authored by Anant Thaker of the Boston Consulting Group and Elizabeth Williamson of the Frontenac Company,[9] assert that the 2007-09 financial and economic crises were a direct outcome of income and wealth inequality that built up over 40 years.

Kumhof and Ranciere provide time series data for the share of income received by the top 5%.

These data indicate the following for share of income earned by the top 5%:

- 1920 — 24%
- 1929 — 34%
- 1983 — 22%

[8]Kumhof, Michael and Ranciere, Romain (November 2010). *Inequality, Leverage and Crises*. International Monetary Fund Working Paper.

[9]Thaker, Anant A. and Williamson, Elizabeth C. (January 2012). *Unequal and Unstable: The Relationship Between Inequality and Financial Crises*. New America Foundation.

- 2007 — 34%

During the same two periods (1920 to 1932 and 1983 to 2007) Kumhof and Ranciere found that the ratio of household debt to GDP nearly doubled in the earlier period and more than doubled in the latter period and reached a higher level in 2007 than in 1932.

Thaker and Williamson report share of income data for the top 1%, which was originally compiled by Piketty and Saez,[10] updated by Thaker and Williamson for 2008, and further updated by Piketty and Saez for 2011 and 2012:

- 1920 — 16%
- 1929 — 24%
- 1968 — 8%
- 2007 — 24%
- 2011 — 20%
- 2012 — 23%

The Great Recession resulted in a temporary setback for the top 1 percent, but most of the lost ground had been recovered by 2012. According to a news report by Annie Lowrey,[11] Saez and Piketty also reported that incomes for the 99 percent grew 1 percent in 2012, but incomes for the top 1 percent grew 20 percent, and incomes for the top 0.1 percent grew 32 percent.

Piketty and Saez use two different data series to track the debt to GDP ratio. The earlier series is individual and non-corporate private debt to GDP and the recent series is the more common ratio of household debt to GDP:

[10]Piketty, T. and Saez, E. (2008). *Income Inequality in the United States, 1913-1998.* Quarterly Journal of Economics, 118(1), 2003, pp. 1-23, with updated data to 2008: U.S. Census Bureau; U.S. Federal Reserve Flow of Funds; National Bureau of Economic Research.

[11]Lowrey, Annie. *The Rich Get Richer Through the Recovery.* The New York Times, September 10, 2013.

- 1920 — 60% (individual and non-corporate private debt to GDP)
- 1932 — 95% (individual and non-corporate private debt to GDP)
- 1968 — 60% (individual and non-corporate private debt to GDP)
- 1968 — 40% (household debt to GDP)
- 2007 — 95% (household debt to GDP)

The pattern in both measures in the years preceding the 2008 crisis is clear and eerily similar.

3. Mechanism Through Which Growing Income Inequality Leads to Financial Crisis

According to Kumhof and Ranciere, the triggering event causing income inequality to widen and reliance on debt to grow was a shift in relative income bargaining power in favor of the top 5% relative to the bottom 95%. Once this shift in bargaining power commenced it set in motion a series of events that over several decades inexorably led to rising inequality and debt burdens.

First, as the share of income of the bottom 95% shrank, that group attempted to maintain consumption through borrowing. Second, as the top 5% gained income, and thus wealth, that group needed to find ways to invest its accumulating wealth. Accordingly, it provided the funds that the bottom 95% borrowed.

Borrowing was enabled by financial innovation, such as subprime mortgages and home equity loans. All of this activity facilitated tremendous growth in the financial sector of the economy.

As the financial sector grew relative to the rest of the economy its political power grew as well. This led to adoption of policies that promoted and protected the interests of the financial elite, which in turn reinforced the building inequality. One can place deregulation, reduced capital requirements and other "free market" elements into this basket. And, as described in the next section, the evolution of the social contract between employers and employees from a high-wage to a low-wage paradigm, coupled with the ascendency of shareholder wealth maximization in driving corporate behavior, reinforced the shift in bargaining power.

However, the trends in widening income inequality and growing debt burdens, according to Kumhof and Ranciere, cannot continue indefinitely. A financial crisis eventually erupts because there is an ultimate limit to how much debt households can support. Increases in debt and decreases in savings reduce a household's ability to manage through a life crisis — illness, loss of job, divorce and so forth.

Sum this increase in financial vulnerability across millions of households and in the aggregate the economy's ability to withstand a shock, such as a sudden and sharp increase in oil prices, steadily erodes. Also, as we now know, runaway speculation in housing propelled a bubble in prices which was aided and abetted by abundant and cheap debt, steadily diminishing credit underwriting standards, and a laissez-faire attitude on the part of government regulators perhaps swayed by the belief in "The Market" as an efficient regulator or perhaps inhibited by the political power of the financial elite.

And, the greater are the excesses during the bubble period, the harder will be the crash when it eventually unfolds.

While the 2008 financial crisis apparently marked the limit for accumulation of household debt relative to income, the forces driving ever increasing income inequality still appear to be in play. But, there is also probably a limit to the extent of income inequality. As income inequality escalates, the macro economy becomes increasingly fragile. This already appears to be manifested in the stubbornly high rate of unemployment, low productivity and anemic GDP growth. The crash, when it finally arrives, could be horrific and the convalescence period would likely be painful and extended.

4. Kumhof and Ranciere's Theoretical Economic Bargaining Power Model and Income Inequality

Kumhof and Ranciere constructed a simple theoretical model which describes almost exactly the sequence of events summarized above. The benefit of a simple model, which explains real world phenomena well, is that it can be used to test how events might continue to unfold given different policy interventions.

Kumhof and Ranciere's simple model consists of two groups of households — investors who comprise the top 5% of the population and workers who comprise the remaining 95%. Investors derive utility from consumption and wealth. Workers derive utility only from consumption. In addition to the utility functions for investors and workers, the model includes an aggregate production function for the economy in which returns to factors of production incorporate a variable for workers' bargaining power. Capital and loans are also included in the model.

A change in relative bargaining power is introduced to the model and imbalances build over successive iterations. A crisis event can be introduced to the model at any iteration.

The performance of the model can be tested through simulated scenarios.

5. Policy Reponses to Financial Crisis

Once the crisis unfolds, the impact of policy responses can be tested. There are two types of solutions.

One solution is to restructure debt by moving it from creditors to taxpayers — the socialization of debt. This is what Ireland did with its banks. This solution also is being applied in part to the Greek sovereign debt problem and more generally is the approach in principle that the European Financial Stability Facility and European Stabilization Mechanism incorporate. The model reveals that this solution buys time but ultimately is relatively ineffective in curing the problem of overleverage because individuals, not directly but as taxpayers, ultimately are still saddled with excessive debt.

An alternative solution is to grow out of the problem. This involves increasing economic growth so that the debt burden, which remains unchanged in nominal terms, shrinks in relative terms as income increases. The challenge, of course, is to devise a policy that stimulates growth without creating additional leverage.

Austerity, which focuses on reducing debt, is a counterproductive policy because it results in depressing income and in so doing increases the burden of debt relative to income. This wrongheaded policy has driven the collapse in the Greek economy (GDP has declined by about 25%) and is damaging other European economies including Portugal, Spain and Italy in particular.

Kumhof and Ranciere use the model to demonstrate that the only way to grow earnings of workers successfully over time and reduce the debt burden is to restore the original income bargaining power balance. This solution results gradually over time in a reversal of income inequality. But, it takes a very long time to unfold. They do not explain how this might be accomplished but it would appear to require changing the now dominant low wage social contract.

There is a third solution, of course, and that is to tinker a bit with policy but do little of substance. The initial U.S. response was socialization of debt through tax cuts and a significant increase in debt-financed spending. That policy shifted the debt problem from households to taxpayers. But, what is the real difference between households and taxpayers? However, the rapid escalation in the public debt led to policy reversal, which has stabilized the public debt-to-GDP ratio at a much higher level but at the apparent cost of stubbornly high levels of unemployment and slow growth in incomes.

With weak income growth overleverage and the accumulated debt burden has been an ongoing drag on economic recovery. It will take a very long time to return to a more normal economic environment and unresolved income inequality will remain an ever present threat both to the economy and to social/political stability.

6. Reducing Income Inequality Is the Only Effective Long-Term Solution to Reduce Potential for Financial Crisis

If one accepts Kumhof and Ranciere's model at face value, the only effective long-term solution is to alter relative income bargaining power between investors and workers. If this can be done, over time the distribution of income would shift back toward workers and debt burdens would shrink. That is what the model shows and that is what happened between 1932 and 1968.

But powerful forces stand in the way of implementing such a solution. First and foremost is the absence of a political consensus that purposeful intervention is required to alter the balance of income bargaining power between workers and investors. Part and parcel to this is the entrenchment of vested interests (economists call them rent seekers) in the status quo which have nothing to gain personally by permitting a change in relative bargaining power. These vested interests generally are the same people that Kumhof and Ranciere define as investors. Their entrenchment is supported by U.S. political campaign financing, which was exacerbated by the Supreme Court's Citizens United decision permitting individuals to establish "super PACs". It is hard to alter or break entrenched power alliances between the political and financial elite.

There are other obstacles which may be subject even less to successful intervention. An example is competition in a globally-integrated communications and technology era, which has rendered geographic and political boundaries meaningless. How does America grow income when competitive pressures from other countries constantly limit the ability of workers to negotiate?

7. What Prompted the Shift in Relative Bargaining Power Between Workers and Investors Beginning in 1967?

There were many contributing factors but no apparent single catalyst:

- Federal tax rates have become less progressive over time as the composition of taxes has shifted toward payroll taxes. This phenomenon was documented recently by the Congressional Budget Office.[12]
- The Congressional Budget Office documented that changing transfer payments programs, particularly Social Security and Medicare, are contributing to growing income inequality.
- Wall Street, which is a collective term for large po1werful corporations, seems increasingly to have inordinate sway in guiding policies in both the Democratic and Republican parties. Some believe this is a direct result of political campaign finance. For example, why is the House Financial Services Committee the largest in the House of Representatives

[12] Congressional Budget Office (October 2011). *Trends in the Distribution of Household Income Between 1979 and 2007.*

with nearly 15% of the members serving on it? Others, disparagingly, have referred to this development as "crony capitalism". Crony capitalism involves interest groups successfully using their financial power to lobby for legislative and regulatory outcomes that serve their narrow economic interests. In extractive societies, the financial elite capture the political elite.

- The amount of sales and employment accounted for by larger businesses is growing, which Nouriel Roubini suggests is contributing to the growth of less competitive and margin-increasing oligopolies. This appears to be the case particularly in banking.

- Union membership has declined precipitously partly as the consequence of the shift toward a service-based economy. Labor unions during much of the 20$^{\text{th}}$ century helped assure that the benefits of technical change were spread broadly. But the changing composition of the economy from manufacturing to services and the political ascendancy of deregulation after the mid-1970s contributed to rapid decline in the influence of labor unions. This tilted the balance of power toward management and investors, with the effect that more of the benefits of productivity flowed to management and investors and less flowed to labor. These developments have negated John Kenneth Galbraith's principle of "countervailing power" in which big labor, big business and big government struck a balance of power.

- The addition of 3.5 billion people to a more integrated global workforce has reduced demand for lower skilled jobs in the U.S. When demand declines relative to supply, wages fall. The opposite impact has occurred for higher skilled jobs — demand has increased relative to supply. The combination of these naturally leads to a widening of income inequality.

- The explosion in communications technology has reduced the importance of geographic boundaries in constraining economic activity.

- Benefits of increasing productivity do not automatically flow to all participants in the labor force. In the first order they go to those with greater skills. The benefits of productivity can be spread across the entirety of the population, but this requires affirmative government policies. Until recently this was enabled by a broad political consensus to build a combination of safety net and social welfare programs.

- Financial liberalization, as statutory and regulatory limits to competition were modified or discarded, has contributed significant gains in the share of income garnered by people employed in financial services.
- The belief in "The Market" as an effective and efficient regulator of financial and economic activity has decreased support for raising the minimum wage.

Most of these causes would be hard to remediate and may even be irreversible. Going forward it is not clear exactly what political and policy changes would restore relative income bargaining power between workers and investors. But the status quo and benign neglect are clearly not answers.

8. Does Growing Income Inequality Matter?

Intuitively speaking, the answer to the question of whether income inequality matters is "Yes". History tells us that when the divide between the "haves" and the "have nots" becomes extended, at some point the masses rise up against the privileged few. This is a fairness/economic justice issue.

Branko Milanovic[13] reported that between 1988 and 2008, incomes of the world's top 1 percent rose 60 percent while there was no change in incomes for the bottom 5 percent. Milanovic provides evidence that inequality results in lower economic growth. This finding has to do with the increasing scarcity of human capital with respect to physical capital. Scarcity puts a premium on developing a high skill level which depends on education and training. Milanovic argues that widespread education is difficult to establish in societies with widely disparate income distribution. In this regard, it is both interesting and worrisome to note that except for higher education, the quality of education in the U.S. has fallen considerably in recent years compared to other nations. This implies, at least circumstantially, that growing income inequality and declining educational opportunity and quality in the U.S. are linked.

[13] Milanovic, Branko (2011). ***International Monetary Fund.***

V. Evolution from High-Wage to Low-Wage Social Contract

Embedded in American society is an implied social contract which specifies the roles and behavioral expectations of each segment of society with respect to each other. While the social contract is shaped by the constitution, it is not static. It evolves over time as beliefs, values, and norms change. The contract is impacted by technological change. But, it is also influenced by power structures and whether those structures are predominantly inclusive or extractive. Thus, it is entirely possible that the social contract that prevails at a particular moment in time may not conform to the norms of an ideal social system.

The U.S. social contract has changed dramatically over the last several decades from one characterized by high wages to today's focus on low wages.

1. High-Wage Social Contract

In a recent study prepared for the New American Foundation, Freedman and Lind[14] describe how the U.S. has migrated over time from a high-wage social contract to a low-wage social contract. They conclude that the low-wage social contract has failed.

The high-wage social contract evolved in the early twentieth century, came of age during the New Deal, and lasted until the 1970s when it was gradually replaced with today's low-wage social contract. Its development was driven by rapid transformation of the U.S. economy from agriculture to manufacturing and by the evolution of large corporations and burgeoning unions.

Henry Ford is often cited as the trailblazer of the high wage social contract. In early 1914 he raised the minimum daily wage for male factory workers from $2.34 for a nine-hour day to $5.00 for an eight-hour day. The policy was extended to female workers in 1916. In instituting this policy, Ford was not necessarily a benevolent capitalist; his objective was to pay his workers enough so they could afford to buy the cars he manufactured. Not

[14] Freedman, Joshua and Lind, Michael (2013). *Beyond the Low Wage Social Contract. New American Foundation.*

only did he accomplish that objective, Ford workers became more productive and they had an elevated loyalty and sense of pride in the company.

High wages spurred consumption and fostered rapid growth in the economy. And the benefits trickled down to the masses resulting in rapid growth in the numbers of people who were able to achieve a middle class standard of living. This virtuous development was sustained by growth in unions which used their growing economic and political power to sustain the high-wage social contract. The ability of unions to negotiate high wages and benefits for their members set the standard overall which also benefited nonunionized workers.

Government did its part as well by providing programs such as the GI bill, which subsidized education and housing for veterans, a variety of safety net programs, such as unemployment insurance, and public works programs, such as the building of the interstate highway network. These initiatives were paid for through high taxes, but in a high-wage, rapidly growing economy, the burden of high taxes was tolerable.

John Kenneth Galbraith[15] captured the essence of the high-wage social contract in his seminal book, *The Affluent Society.* In an earlier book, he introduced the concept of "countervailing power" to describe the balance of power among big business, big government, and big labor (unions) in fostering and sustaining the affluent society. Unfortunately, prior to his death Galbraith acknowledged that countervailing power no longer described the functioning of the U.S. economic and political system.[16]

2. Stakeholder Capitalism

One of the defining features of the high-wage social contract was stakeholder capitalism. Stakeholder capitalism involved corporations and businesses acting in ways that benefited all of their stakeholders rather than exclusively focusing on shareholders. Henry Ford clearly was a practitioner of stakeholder capitalism. Lou Pepper,[17] CEO of Washington Mutual Savings Bank from

[15]Galbraith, John Kenneth (1958). *The Affluent Society.*

[16]Galbraith, John Kenneth (1956). *American Capitalism: The Theory of Countervailing Power.* Cambridge, MA: Riverside Press.

[17]Pepper, Louis H. (2005). *If You Get a Moment would you Please.* LaConner, WA: University Publishing, Washington State University.

1981 to 1990, embraced the efficacy of stakeholder capitalism and referred to stakeholders as the four C's — capital markets (shareholders-investors), crew (employees), community and customers. To Pepper all four constituencies were of equal importance. No one constituency's interests could be fully satisfied without harming another constituency. This required balancing. Pepper's insight was that by focusing in a balanced fashion on all four constituencies shareholders would be well rewarded in the long run.

3. Benefit Corporations and Non-Profit Social Venture Corporations

Stakeholder capitalism among publicly owned companies has largely been replaced by shareholder capitalism. But some companies, usually privately held ones, still practice stakeholder capitalism.

According to Gar Alperovitz,[18] an obstacle to businesses including a social benefit mission is the legal requirement that decisions of corporations financially benefit shareholders.

Angus Loten[19] reported that Blak Jones, who is an entrepreneur in Boulder, Colorado, donates 20 percent of his after tax profits to local projects devoted to activities such as reducing child poverty and protecting the environment. But, Jones worries that this could open him to shareholder lawsuits that he is not acting in the best interests of his shareholders.

Twelve states (California, Hawaii, Illinois, Louisiana, Maryland, Massachusetts, New Jersey, New York, Pennsylvania, South Carolina, Vermont, and Virginia) have enacted statutes creating a benefit corporation (B Corp), which permits businesses to use profits for social purposes.

Increasingly, non-profit organizations and cooperatives are competing alongside for-profit organizations to provide similar or the same goods and services to the public. Such organizations are required by law to provide benefits to the constituencies they serve. Direct competition with for-profit businesses often leads to accusations of unfair competition. Competition is

[18] Alperovitz, Gar (2013). *What Then Must We Do: Straight Talk About the Next American Revolution.* White River Junction, VT: Chelsea Green Publishing.

[19] Loten, Angus. *Can Firms Aim to Do Good if It Hurts Profit?* The Wall Street Journal, April 10, 2013.

unfair, it is argued, because the for-profit organizations are unable to charge prices sufficient to generate an adequate amount of profits to compensate shareholders. For example, credit unions are cooperatives that provide financial services primarily to consumers. They are largely exempt from taxation. This is seen by their for-profit shareholder-owned competitors, who provide the same kinds of financial services to the same customers, as providing an unfair advantage.

4. Low-Wage Social Contract

Globalization, deregulation, the increasing role of services employment and the decline in manufacturing, the decrease in union membership, and more generally the ascendancy of financial economics theory with its singular focus on maximizing shareholder value all contributed to the replacement of the high-wage social contract with the low-wage social contract.

According to Freedman and Lind, an economic system defined by a low-wage social contract is one in which many jobs pay poorly. Rather than attempt to raise wages, public policy focuses on helping low wage earners through lower taxes, tax credits, and various types of cash and in kind subsidies. While Democrats and Republicans differ on program details, just as was the case when the high-wage social contract predominated, both political parties accept the reality of the low-wage social contract. Neither party has attempted to alter the foundational drivers of the low-wage social contract but instead has focused on ameliorating the consequences. For example, statutorily-mandated minimum wage rates have not kept up with inflation. While Democrats favor raising the minimum wage and Republicans generally do not because they see it as government intrusion into the operation of the free market, Democrats have not chosen to make raising the minimum wage rate a high policy priority.

Wal-Mart epitomizes how the low-wage social contract has come to dominate American business. Wal-Mart thrives by selling merchandise to consumers at low prices. It is able to do so partly through employment of technology to increase productivity, through large scale operations, and by importing goods from low production cost countries. But, the primary driver of its low-price strategy is low wages and benefits to employees. It is argued that low prices benefits consumers and is a direct outcome of efficiency gains driven by free market competition.

Low wages, however, by themselves depress consumer demand. The low-wage social contract in theory replaces spending power by reducing taxes, providing tax credits (Earned Income Tax Credit and Child Tax Credit), and extending subsidies, such as food stamps and child care.

Critics of income inequality analysis, such as Aparna Mathur,[20] argue that income is a poor measure of the standard of living; consumption is a better measure of well-being. Income transfers and subsidies support consumption. Freedman and Lind agree that in theory reduced taxes, tax credits and welfare programs can supplement low wages and maintain the standard of living. However, they argue that adjustments to income data to accommodate these factors do not close the gap for low wage earners. Various studies, such as one by Perry and Boudreaux,[21] reach contradictory conclusions, which reflect the difficulty of constructing a statistical measure for the standard of living and well-being. Also, Mark Thoma[22] summarizes studies that critique the argument that consumption inequality has not worsened.

The debate over how to measure well-being skirts the issue of power relationships. Income and political power are correlated. Transfers and subsidies to low-income wage earners may support consumption but they tend to breed dependency relationships. Krugman[23] asserted in an opinion editorial in the The New York Times: "*The gap between the society's meritocratic ideology and its increasingly oligarchic reality is having a deeply demoralizing effect.*" Krugman argues that the concentration of income among a few at the top is undermining the values that define America.

Freedman and Lind argue that after-tax income is too low and inhibits consumption demand. That depresses overall economic growth. Prior to 2008, the shortfall in spendable income was offset in part by easy access to credit. But the credit binge had an unhappy ending which predominantly fell on those with the lowest incomes.

Freedman and Lind state that for the low-wage social contract to work the gains from productivity need to be shared with workers in the form of

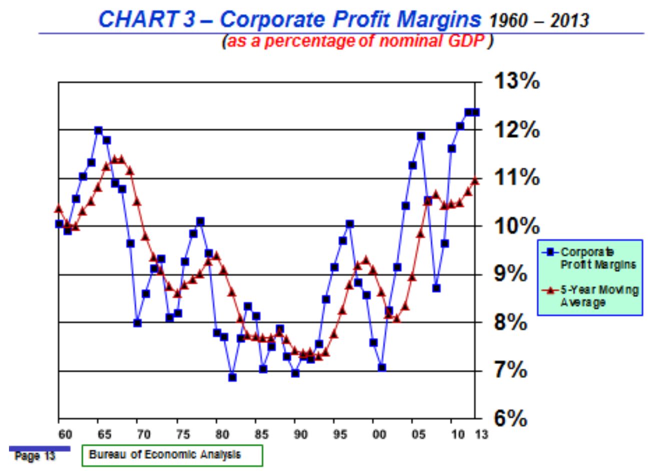
[20] Mathur, Aparna. *The Inequality Illusion.* American Enterprise Institute blog, September 27, 2013.

[21] Perry, Mark J. and Boudreaux, Donald J. *The Myth of the Stagnant Middle Class.* The Wall Street Journal, January 23, 2013.

[22] Thoma, Mark. *The Myth that Growing Consumption Inequality is a Myth.* EconoMonitor, October 25, 2012.

[23] Krugman, Paul. *Rich Man's Recovery.* The New York Times, September 12, 2013.

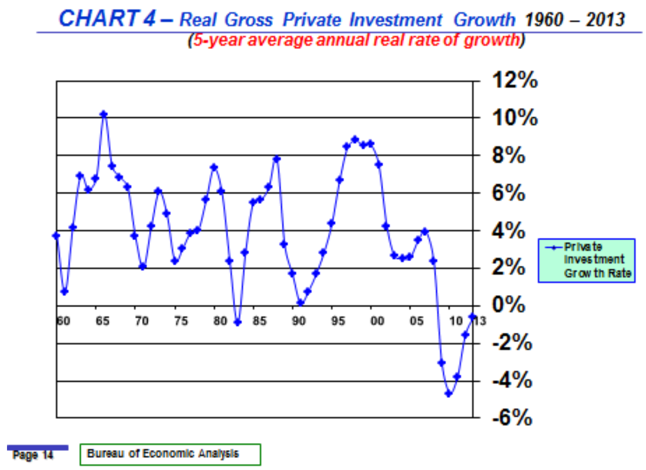
higher wages or passed on to consumers via lower prices. But, as shown in **Chart 3**, the share of income going to corporate profits has risen from



7 percent in 1990 to 12.5 percent in the second quarter of 2013. Between 1990 and 2012 real income declined 3.2 percent for the bottom 20 percent of households and 1.3 percent for those at the 40$^{\text{th}}$ percentile of the income distribution. Real household income rose 18.5 percent for the highest 5 percent of the income distribution. These data indicate that most all of the benefits of improving corporate profits are flowing to a small segment of the population.

Thus, growth in the share of income going to corporate profits is an indicator of growing income inequality. Since 1960, that share of income going to corporate profits has averaged 9.3 percent, but the share has fluctuated over time. **Chart 3** shows the annual share of corporate profits as a percentage of nominal GDP and a five-year moving average to make trends clearer. Corporations' share of income today is slightly higher than it was in the 1960s, but after falling to a low point in the early 1990s it is has been rising ever since.

Defenders of the upward trend in the share of corporate profits argue that profits will be invested in plant, equipment and new innovations, which will boost productivity and GDP growth. This will raise income and presumably benefit all households. First, as **Chart 4** shows, the growth rate in real private investment has been declining, even as corporate profit margins



have been rising. In fact, growth has been negative over the past five years. Second, productivity is not rising and real GDP growth is disappointingly low. So, it would appear that we have the worst possible outcome. GDP and income growth are well below historical trends and the gains that are occurring are going to corporate executives, traders, investors and the wealthy.

Productivity depends on investment, which depends on demand. If demand is anemic, the incentive to invest is limited. It's hard to hard to see how a low wage social contract can stimulate economic growth in the way that history clearly shows the high wage social contract did.

VI. Wealth Inequality

There exists far less commentary about wealth inequality, primarily because of the scarcity of data and abundant measurement challenges.

Wealth and income inequality are presumed to have similar consequences. However, wealth and political power are highly correlated. Because wealth inequality is even more skewed than income inequality this implies that wealth matters more in determining who wields political power.

The Gini coefficient, which has a value bounded by 0 and 100, measures the degree of concentration. A value of 0 means that everyone has the same wealth or the same income; a value of 100 means that all income or wealth is held by a single household. Thus, the higher the value of the Gini coefficient is, the great is the concentration of income and wealth. According to Daniel Altman,[24] the Gini income inequality coefficient, based on U.S. Census Bureau data, was in the low 40s in the early 1990s, but the Gini wealth coefficient was in the mid-70s at that time. By 2010 the Gini wealth coefficient had risen to 80. In 2010, the top 10 percent of households controlled 20 times the amount of wealth as the bottom 50 percent. Thus, wealth is far more concentrated than income and the level of concentration is rising.

According to a recent Pew Research Center Report, mean net worth of the top 7 percent in the wealth distribution increased 28 percent during 2010 and 2011 while mean net worth decreased 4 percent for the remaining 93 percent.[25]

Many have pointed out that younger workers have not been accumulating wealth and many older workers have not accumulated sufficient wealth to provide for adequate income in retirement. Annie Lowrey[26] reported that an Urban Institute study found that people under the age of 40 have accumulated less wealth than their parents had at the same age, even though average household wealth has doubled over the last 25 years. There are many reasons including low-wage jobs, and rising reliance on debt, especially student loans. A Pew Charitable Trust study, "Retirement Security Across Generations," found that between 2007 and 2010 those born between 1966 and 1975 (aged 35 to 44) lost half of their net worth and had higher levels of debt than previous generations at the same stage in life.[27]

[24] Altman, Daniel. *To Reduce Inequality, Tax Wealth, Not Income.* The New York Times, November 18, 2012.

[25] Blow, Charles M. *Billionaires' Row and Welfare Lines.* The New York Times, October 25, 2013.

[26] Lowrey, Annie. *Younger Generations Lag Parents in Wealth-Building.* The New York Times, March 14, 2013.

[27] Ellin, Abby. *Generation X Fares Poorly During Recession, Study Finds.* ABC News blog, May 31, 2013.

1. Wealth Concentration Threatens Inclusive Economic and Political Systems

Trends in wealth concentration and the high level of concentration is important given Acemoglu and Robinson's findings about the linkage between the financial elite and the political elite and the tendency of nation's economic and political systems to be extractive.

One of Acemoglu and Robinson's case studies concerns the rise of Venice in the early 14th century. The foundation of Venice's rise to an economic and political power was the colleganza, which was an organization that financed trade expeditions. Initially the colleganza was open to anyone which enabled entrepreneurs to participate in financing merchant voyages alongside established businessmen. In other words, the colleganza initially permitted social mobility which enabled lower classes the opportunity to move into the upper classes. But, as time passed, the upper class felt increasingly threatened and moved politically to preserve their interests and status by blocking new participants in the colleganza. This political shift was called La Serrata, meaning "the closure". Eventually the colleganza was abolished and the political/economic elite assumed full power. This marked the transformation of Venice from a vibrant inclusive economic and political system into an extractive one. As this transition took root, the decline in Venice's economic and political power followed inexorably over several decades.

According to Chrystia Freeland,[28] America is following in the steps of Venice "*. . . as the 1 percent pulls away from everyone else and pursues an economic, political and social agenda that will increase that gap even further — ultimately destroying the open system that made America rich and allowed its 1 percent to thrive in the first place.*" America's creeping Serrata is manifesting itself in the evolving division into upper and lower classes based on social and educational status.

[28]Freeland, Chrystia. *The Self-Destruction of the 1 Percent.* The New York Times, October 12, 2012.

2. Stagnation of Social Mobility

Richard Reeves[29] argues that the stagnation of social mobility is a bigger problem than the widening of income inequality: "*When the income gap of one generation becomes an opportunity gap for the next, inequality hardens into social stratification.*" The loss of social mobility is correlated with increasing wealth concentration because control of wealth tends to pass from one generation to the next. Some move up and some move down, but it is better to be born of wealthy parents.

Social stratification — the division of Americans into classes — is supported by the higher education system and labor market practices which result in a process labeled "opportunity hoarding" by sociologist Charles Tilly. An example of opportunity hoarding is that the children of wealthy parents, who are less talented than those of poor parents, are more likely to get into a good college and to have the kinds of connections that lead to high paying jobs.

VII. Evolution of American Culture and the Social Fabric

There are other forces at work besides those which have impacted income and wealth inequality and the functioning of financial markets that are affecting American society. Cultural changes are also important drivers and regulators of individual and community well-being.

Even if solutions to the economic and financial causes of income and wealth inequality were found and implemented and were able to put the economy on a course to resolve the current economic imbalances and inequities, cultural change might limit or even block success.

Culture is shaped by many factors. Economic phenomena and financial markets are important influencers, but they are not the only important drivers of culture.

[29] Reeves, Richard V. *The Glass-Floor Problem.* The New York Times, September 29, 2013.

1. "The American Way of Life" — The Death of the Expectation of Upward Mobility

We used to hear mentioned frequently and believe in "The American Way of Life" and "The American Dream". Nowadays we hear less about these aspirations. Why has that occurred? Perhaps it is because, unlike times past, these aspirations no longer seem to be true for a large portion of America's population.

Charles Blow[30] summarized findings of an Allstate/National Journal Hartland Monitor poll that documents the decline in the belief in "The American Dream". While 56 percent expressed hope that their living standards would improve in the future, 59 percent were worried that their standard of living could decline and 85 percent said that it is harder to maintain a middle class standard of living than it was ten years ago. But when asked what they think has happened to others, over 80 percent responded that more Americans have fallen out of the middle class in recent years. The poll also indicated that Americans see less opportunity to "get ahead", less job security, and less disposable income than prevailed for persons in the middle class in the past. Respondents expressed the view that getting a good education is key to staying in the middle class, but they worry about its cost and availability. And, when asked who is to blame for the decline in opportunity, respondents named Congress, chief executives of major corporations and large financial institutions.

But what did the concept of "The American Way of Life" embody? According to Charles Murray, it involved a civic culture that swept an extremely large portion of Americans of <u>all classes</u> into its embrace. This civic culture muted the importance of differences in income and wealth inequality. Even though there were broad income and wealth differences Americans engaged in an extremely broad middle-class dominated American life and that this was a good thing.

Or, as Friedman[31] puts it, Americans believed that "a rising tide lifts all ships" and <u>all</u> would benefit from high productivity and greater economic efficiency. Friedman believes that the "social fabric" is at risk because so many Americans are "losing ground."

[30] Blow, Charles M. *The Morose Middle Class.* <u>The New York Times</u>, April 26, 2013.

[31] Friedman, George (2013). *The Crisis of the Middle Class and American Power.* Stratfor.

Friedman asserts that liberals would remedy this by transferring wealth through taxes and income transfers; conservatives would rely on the free market to resolve the problem. But, as Friedman notes, the free market drives economic outcomes, not social ones. And, as discussed in this paper, the free market's economic outcomes may well exacerbate social relationships by permitting an ever increasing skew in wealth distribution.

Robert Putnam[32] doesn't pull punches: "*The American dream has morphed into a split-screen nightmare.*" He laments that the social fabric of the 1950s and 1960s, which was the basis of the American dream gradually disappeared and has been replaced by a new upper class that reaps most of the benefits.

2. Hollowing Out of the Middle Class

Murray asserts that a new upper class and a new lower class are evolving, which in effect is hollowing out the old broad-based middle class.

- Key attributes of members of the new upper class include:
- College bachelor or advanced degrees
- Shared tastes and preferences that set members apart from mainstream America
- Live increasingly in geographically separate markets (super-zips)

Key attributes of members of the new lower class include:

- High school education or less
- Defining cultural characteristic is withdrawal from America's traditional core cultural institutions such as fraternal societies and churches
- Poverty (income) is <u>not</u> a key defining characteristic

[32] Putnam, Robert D. *Crumbling American Dreams.* <u>The New York Times</u>, August 3, 2013.

3. Murray's Data Analysis

Murray compared key data for white-only members of the new upper and lower classes as he defined them. The focus on whites only is intended to eliminate confusion and debate about the effects of race and ethnicity on changes in the data over time. Specifically, Murray compared data for 1960 to data for 2010 wherever possible for white males between the ages of 30 and 49. He intentionally omitted consideration of income differences.

As Murray defines it, the new upper class (college degrees) embraces 20 percent of white males between the ages of 30 and 49 and the new lower class (high school degree or less) includes 30 percent of white males between the ages of 30 and 49. The remaining 50 percent are in the middle class and have some education beyond high school.

Marriage

	Upper Class	Lower Class
1960	94%	84%
2010	83%	48%

The sharp decline in marriage among members of the lower class is a significant negative cultural development. Unattached males tend to be less responsible. Revealing perhaps his personal biases, Murray argues that unattached males are less industrious.

Single-Parent Births

	Upper Class	Lower Class
1970	1%	6%
2010	6%	44%

According to a Pew Center research study,[33] single moms make up 25 percent of households and single dads make up 6 percent. The total of 31 percent is three times the level that existed in 1960.

[33]Mathur, Aparna, Hansen, Peter and Fu, Hao. *The Mysterious and Alarming Rise of Single Parenthood in America.* American Enterprise Institute blog, September 3, 2013.

Incidence of Criminal Behavior

Upper Class	no change in incidence
Lower Class	incidence has risen 4.7 times but has declined in recent years

Religiosity (defined in reverse as secular orientation)

	Upper Class	Lower Class
1972—1976	29%	38%
2010	40%	59%

According to Murray the importance of religiosity is involvement in community-based social value creation initiatives. Thus, a decline in religiosity, particularly among members of the lower class, reflects an increasing shift toward focus on self rather than on community. Religiosity is important because historically about half of American philanthropy and community volunteerism has been church related. Furthermore, religious organizations account for much more non-religious social capital creation than that which flows from Americans with a secular-only orientation.

4. Causes of Cultural Inequality

Based on Murray's assessment of data trends, he believes that significant cultural inequality has evolved in America. Further, he believes that resolving income and wealth inequality issues will not by themselves cure the deleterious impacts of cultural inequality.

- **Great Society and Substitution of the State for Non-Government Organizations.** Murray speculates about why the new upper and lower classes emerged and permitted cultural inequality to assume such a significant and negative role. One source was the social reforms of the 1960s embodied in Lyndon Johnson's Great Society. The broadening of the social safety net and expansion of social welfare programs made it more feasible to have a child out of wedlock. The responsibility of the individual male to care for the child shifted to the state. There is ample evidence that children of single parents are less successful and create a variety of criminal and non-criminal societal costs much greater than occurs for children of dual-parent households.

In addition, the state increasingly deals with social problems which churches, fraternal organizations and community organizations used to deal with. It can be argued that while the delivery of programs by the state from a process standpoint is more comprehensive and fairer, this gain is more than offset by the loss of flexibility and human empathy that typically accompanies delivery of social services through non-governmental organizations.

- **Tilting the Balance from Community to Individual Rights.** For all the evils that the civil rights movement addressed in the 1960s and 1970s, it did result in strengthening the emphasis on individual rights. While not challenging the importance of this development, it is reasonable to question whether balance has been maintained between individual rights and overall community welfare.

- **Technology.** Technological innovation has increased the returns to education and may be contributing unintentionally to the separation between the new upper and lower classes.

- **Shift from a Manufacturing to a Services-Focused Economy.** Services focus less on groups and more on individuals. Developments in the workplace may in unintended ways be diminishing the strength of non-work place organizations. In so doing, the shift toward services may be reinforcing the shift toward individual rights and away from community.

- **Internet and Social Networks.** At first glance the internet is a powerful vehicle for individual expression. However, social networks, such as Facebook, may be in the early stages of creating the infrastructure for a new set of non-governmental organizations. However, a further question is one of whether the evolution of social networks will reverse or simply reinforce growing cultural inequality.

5. Consequences of Cultural Inequality

Emerging cultural inequality is defined by a breakdown in the old social norms which governed behaviors deleterious to overall community welfare. According to Murray, the old social norms began to unravel as government programs diminished the importance of non-governmental organizations, such as religious denominations and churches. And the weakening of these institutions led to a weakening in the role of these institutions as enforcers of the social norms. Feedback loops kicked in and the decline in non-governmental organizations and the breakdown in social norms evolved over time and the negative consequences of growing cultural inequality grew.

The new upper and low classes are pulling apart and the middle class is shrinking. Michael Austin[34] puts it starkly: "*We are indeed splitting into tribes in the country, but the pie is almost certain to continue shrinking rapidly for the vast majority of us.*" Charles Blow[35] voices similar sentiments: "*America is quickly dividing itself into two separate nations, regional enclaves of rigid politics, as the idea of common priorities fades further into a distant past.*"

6. What Is To Be Done?

Murray's analysis has been attacked, particularly from those of more liberal persuasion. His data, flawed as they may be, still point out substantive changes in America's culture which are troublesome. He is better at providing analysis than he is at providing solutions.

The value of Murray's book is that it challenges the prevailing view that increasing income inequality is the source of what ails America and all we need do is find solutions to reverse income inequality. Murray correctly argues that the challenges America faces go beyond pure economic considerations and include cultural phenomena, social norms, and societal values as well. In short, we need to rethink not just the role of capitalism in our economy and society, we also need to rethink the balance between individual rights and community welfare and the roles of government and non-governmental organizations.

[34] Austin, Michael. *Re: The Glue Holding America Together.* American Enterprise Institute blog, June 28, 2013.

[35] Blow, Charles M. A *Nation Divided Against Itself.* The New York Times, June 19, 2013.

VIII. Can U.S. Economic and Social Decline Be Reversed?

Is the U.S. destined to continue declining as has happened to many once powerful nations throughout history? Understanding the causes is a necessary first step to identifying possible strategies to address the causes and implement initiatives that move society back toward an inclusive ideal social system. Necessary strategies exist, but knowing what they are does not mean they will be implemented. Human beings tend to be self-centered and have difficulty acting in ways that benefit the collective interest, especially when doing so might involve some personal cost or loss. Human beings are protective of what is close to and important to them. They tend to be risk averse and distrustful. History shows that the human condition in the absence of strong and enforced laws and norms of conduct and behavior tends toward the evolution of power elites and subjugation of the many by the few.

Elites find it difficult to cede power once they have accumulated it, especially if the elites believe that they know best and are acting in ways that they expect will serve the masses well. What today's elites believe is best is embedded in the theory of financial economics and its components of shareholder wealth maximization, the efficient markets hypothesis, the asset pricing model, and operation of free markets. Although many have pointed out the flaws in the theory of financial economics, nonetheless its fundamental assumptions have become embedded in the economic, political, and legal systems. In this respect the theory of financial economics has assumed the status of an ideology in governing economic, social, and political activity. Thought of in that way, it is not much different than the theocratic governments of some nations.

It is in our long-term interests to find and implement solutions that move the U.S. back in the direction of the ideal inclusive social system. There are three possible sets of solutions.[36]

[36] A much more detailed description of the three possible sets of solutions is contained in: William A. Longbrake. "*America's Crumbling Social System: Potential Solutions Involving Religious and Non-Profit Leadership and Organizations*." Draft paper prepared for "The Henry Kaufman Forum on Religious Traditions and Business Behavior" held at the Robert H. Smith School of Business, University of Maryland on October 31 and November 1, 2013.

1. Social Movements and Societal Change

The first involves social movements intended to address economic, social, and political grievances in ways that assure ethical practices and improve distributive justice. Religious and non-profit organizations already are engaged in building and supporting social movements and can do much more. However, if the fundamental business governance structure, which is based on the theoretical dictum to maximizing shareholder wealth, remains in place replete with the interlocks between the financial and political elite, social movements at best will win small victories on specific issues, but the system will remain much as it is.

2. Democratization of Wealth

Transformative change in the system requires diminishing the sway of the current corporate business structure, or even replacing it, with organizations and governance structures that are compatible with the norms of an ideal inclusive social system. That involves democratization of wealth.

3. Investment in Infrastructure

The third set of solutions should be the easiest to implement, but will require a sea-change in current political thinking. It involves disciplined use of public funds to invest in infrastructure initiatives that the private sector either cannot or will not invest in. Such initiatives include education, research, transportation systems, and the environment. Such investments will have the dual benefit of creating new jobs immediately but also in galvanizing productivity gains that will lead to more jobs and a higher standard of living in the longer run. Government can greatly amplify such an investment program through partnerships with private and non-profit organizations.

As I described in the ***September Longbrake Letter***, there are many reasons for the decline in actual and potential real GDP growth in the U.S. These include natural phenomena, such as slowing population and workforce growth and labor market demographics. But other factors have contributed. These include the low-wage social contract, which has led to a rising portion of low-paying jobs; increases in income and wealth inequality, which have concentrated economic and political power; shifts in cultural factors, which have hollowed out the middle class and led increasingly to segregated upper and lower classes and reduced social mobility; the ideology of shareholder wealth maximization and its companion "the free market knows best;" and weakened religious and fraternal organizations, which has diminished the ability of these institutions to serve as knowledge exchanges and relationship builders. Collectively, these trends have contributed to weakening GDP growth and aided the migration of the U.S. economic and political system toward a more extractive state.

In addition, these trends have been accompanied by changes in the government's role in regulating behaviors, perhaps too little prior to the 2008 financial crisis and now too much or not of the right sort, and a substantially reduced involvement in public infrastructure investment. The latter trend is particularly troublesome because historically the right kinds of government infrastructure investment have contributed positively and substantially to productivity and higher rates of real GDP growth.

In an era of high unemployment and low real GDP growth there has been only limited discussion and debate in academic and policy circles about how to use fiscal policy to boost the structural potential rate of real GDP growth. Government policies can have an impact on productivity growth, either for better or for worse, and therefore on real GDP growth over time. Recent policy has focused on across-the-board spending cuts (the sequestration) to bring government spending into better alignment with revenues. Another agenda is to reduce the size of government and the potential for government to interfere with the efficient operation of private markets. But, recent government policy is not optimal and is contributing to slow actual and potential real GDP growth.

Woody Brock provides a very cogent discussion of the how an optimal government fiscal policy should be crafted. Brock carefully explains that government fiscal deficits can be "good" *or* "bad". And, some good deficits are better than others. The pertinent part of the book is Chapter 2 entitled: "*Must There Be a Lost Decade? — A Socratic Dialogue with the President Explains Why Not*".

Real Economic Growth — Spending and Income Measurement Approaches

There are two ways of measuring the size and growth in the economy. One way is to add up all spending to determine gross domestic product — GDP. This is the method most are familiar with. The other alternative is to add up all sources of income to determine gross domestic income — GDI. Everyone's spending is someone else's income. This means that total spending, GDP, always equals total income, GDI.

Brock examines each of the components of GDP — consumption, business investment, government spending and net exports — and concludes that under the current policy regime maximum GDP growth over the next ten years will range between 1.5 and 3.0 percent with a median of 2.25 percent, which, incidentally, is almost exactly the average value derived by the Congressional Budget Office in its ten-year forecast.

It is instructive, according to Brock, to focus on the components of income. If policies can be crafted to drive up the rate of growth in income, growth in spending will automatically follow due to the identity that spending must equal income. The question is one of how to accomplish that objective.

Investment — Flawed Government Accounting

Brock argues that the answer to the question of how to boost income growth lies in increasing investment.

Investment spending in a business consumes cash immediately but the benefits of the investment yield cash inflows over an extended period of time. This is recognized in accounting terms by capitalizing the investment and then amortizing its value over its expected useful life. This is a fundamental and noncontroversial principle of accounting — matching revenues and expenditures.

For some reason, government accounting has never accepted this fundamental principle. All government spending, regardless of its nature, is treated as current expenditures. Clearly, this is a fair characterization of much of government spending but it is not a fair characterization of spending on public infrastructure that is identical in nature and impact to business capital investment spending.

This failure by the government to recognize the difference between current expenditures and long-term capital investments means that there is no understanding of the difference between a deficit that results from a boost in current spending and one that results from long-term investments in public infrastructure and capital projects. As the recent congressional and public debate exemplifies, the public has been taught to fear all deficits, regardless of source. Thus, it is not surprising that policy has focused exclusively on reducing the deficit and primarily through cuts in spending.

What If Government Deficits Are Adjusted to Separately Distinguish the Value of Long-Term Capital Projects?

If the government divided cash expenditures into current expenses and capital investments, the government would have a different income statement and balance sheet from the ones that exist today. The amount of Treasury debt financing would not change, but the government balance sheet would show a larger amount of capitalized assets. More importantly, the government's income statement would no longer be based on current cash flows. Expenditures on capital projects would be capitalized and amortized over their anticipated useful lives. Over an extended period of time these changes in accounting would not change the reality of long-term accumulation of public debt. However, it would focus attention in the shorter run on types of expenditures, as well as on their short-term and long-term benefits and costs.

For example, if $1 trillion in current spending were proposed on long-term capital projects which thorough analysis revealed would boost the structural potential real rate of GDP growth on a sustained basis, under the current accounting regime serious discussion would terminate quickly because the proposal would simply be viewed as inflating the current deficit. But, if business accounting principles were applied, capital expenditures would be capitalized and would not count against the current reported deficit. Of course, these capitalized amounts would be amortized over their useful lives and could contribute to future deficits. However, and ***this is a very important point***, if these capital expenditures are successful in boosting the structural potential real rate of GDP growth, they will end up paying for themselves through increased tax revenues. This is exactly the principle involved in making investments in private business and in capitalizing them and amortizing the upfront cash outlays over time as the investments produce revenues and positive net cash flows.

Government vs. Private Sector Role in Financing Investment

There is clearly a role for the government in investing in public infrastructure projects which would probably not occur if left to the discretion of the private sector. Obvious examples include the federal highway building and space programs where public investment had long-term benefits which were substantial and clearly fulfilled the objective of boosting the structural potential real rate of GDP growth.

But there are also investment projects that could be done by either the private or public sectors. The question then becomes one of how to decide which sector should assume responsibility. There are ***two pertinent criteria*** which can be used to make a determination. The ***first criterion*** is the measurement analysis used in standard business capital budgeting decisions. Does the risk-adjusted expected rate of return on the project have a high probability of exceeding the cost of capital? Typically, the government has a cheaper cost of capital than the private sector, but the private sector should be able to boost expected returns because it is not subject to the kinds of bureaucracy and obstacles to risk taking that exist in the public sector.

At first glance, it might seem almost automatic that rate of return analysis should always favor the private sector. However, Brock (2012) points out that the derivative beneficial effects of public investment spending that occur well beyond the confines of the immediate project should be considered in the overall assessment. Economists refer to such extended benefits as "positive externalities". Inclusion of such benefits would frequently boost the benefit of public sector stewardship relative to the private sector. That is because there is no incentive for private capital decisions to be based upon benefits to others that have no direct bearing upon the return to the company's owners. Maximization of shareholder wealth does not acknowledge the existence of positive externalities. There are many examples of the legitimacy of including externalities in the analysis. One recent extraordinarily compelling example is DARPA's investment in developing the prototype of the internet system which today is radically transforming just about every aspect of business and economic activity. When externalities are included in the analysis the focus will not be on the cost of the project but on the comprehensive expected benefits to society as a whole.

Then there is the ***second criterion***. There are times when the private sector has limited incentive to undertake significant investment activities. A business enterprise invests when it has high certainty that the project will be successful. When the economy is performing substantially below potential, as it is today, uncertainty about realization of future returns escalates and potential projects tend to be deferred or downsized. In addition, private sector businesses may have greater difficulty securing funding necessary to finance such projects. That also seems to be the case currently, particularly for small and startup businesses.

Public-Private Partnerships

Government tends to be highly risk averse and process bogs down decision making. There is an additional problem of inappropriate political influence. These are not easy obstacles to overcome but these issues are not new. There are many examples of public-private partnerships which have worked quite well. For example, consider the Federal Home Loan Bank System which provides liquidity and other services to member financial institutions and enables small community banks to compete effectively with giant behemoths. Or, consider the Export-Import Bank.

President Obama has proposed a national infrastructure bank which would be capitalized by the federal government. However, governance, financing and project selection, and management would be driven through a public-private partnership. The concept makes sense and there are plenty of precedents to provide guidance on how to structure such a bank. The proposed size at $10 billion in capital, however, would not make much of a difference in the larger scheme of things.

President Obama's proposal is only a token beginning. But it would be a worthy experiment. It could amplify and accelerate the democratization of wealth that Gar Alperovitz believes could be the kind of game changer that would lead to higher growth and a reversal of the extractive tendencies of recent economic, social and political developments. However, neither political party has shown any real serious interest in doing anything.

David Brooks[37] in reflecting about President Obama's second term, said that his "dream Obama" would nurture investment by redirecting spending from affluent older people to those who are young and those in need. An example would be to do means-testing of Medicare benefits. Obama could also use the bully pulpit to talk "obsessively" about how social and income inequality is dividing the nation and promote America's historic values of

[37] Brooks, David. *Our Second Adolescence.* The New York Times, February 25, 2013.

investing in the young and supporting programs to "restitch the social fabric."

President Obama appears to be listening to people like David Brooks. In an interview with The New York Times, President Obama talked about widening income inequality, the fraying of America's social fabric and how this is undermining Americans' belief in opportunity. He said that government spending priorities need to be for infrastructure, education, clean energy, science and research. "*If we don't do anything, then growth will be slower than it should be. Unemployment will not go down as fast as it should. Income inequality will continue to rise. That's not a future that we should accept.*"[38]

Unfortunately, the political agenda in Congress has been consumed with cutting spending and corralling the deficit. The issues that David Brooks and President Obama raise are critical to America's future but they are not yet on the main agenda.

4. Substantial Cause for Optimism

Businesses have the ability to play a significant role in all three of these solutions. However, other than the commitment of a few individuals and a handful of businesses, it is difficult to visualize that businesses collectively will step up and lead the way. Values, beliefs, and norms, including the imperative of maximizing shareholder value, will need to change first. Such change, if it occurs at all, is more likely to come from outside the established business community and through new business governance structures.

Transformation of the dominant cultural and ideological hegemony is essential to put the United States social system back on a path that celebrates inclusiveness and limits natural extractive tendencies of elites. Such transformation will not come easily because those who benefit from the current dominant cultural and ideological hegemony are invested deeply in its preservation and they command great power.

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[38]Calmes, Jackie and Shear, Michael D. (2013). *Obama Says Income Gap Is Fraying U.S. Social Fabric.* The New York Times, July 27, 2013.