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ECONOMIC NEWS UPDATE

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Market Forces and Trends in Inequality

Sometimes, you can have too much of a good thing. That's what the new mega-rich, the private equity entrepreneurs, are finding out. It doesn't matter that there might be sound economic reasons for allowing these risk-takers to pay taxes on their interests in the ventures they put together at low capital-gains rates -- 10% in the UK, 15% in the US. Politicians are not guided by economic considerations alone. They have to respond to their constituents' notions of fairness. And they sense that Americans' toleration of large income inequalities, on the assumption that everyone has an opportunity to grasp the golden ring, or at least a silver one, might be waning.

So on both sides of the Atlantic the enormous incomes garnered by private equity entrepreneurs have attracted attention to the tax advantages accorded this very small, very, very rich group of people. It is one thing when the trade unions attack private equity firms, complaining that they destroy jobs in their pursuit of the greater efficiencies needed to generate enough cash to service their enormous debt burdens. It is quite another thing when Nicholas

Ferguson, a leading member of the private equity fraternity for the past 25 years, and chairman of SVG Capital, says there is something wrong when buyout executives are "paying less tax than a cleaning lady. I have never heard anyone give a clear explanation of why it is justified." And when Stephen Schwarzman, the billionaire co-founder of the Blackstone [private equity] Group, worries because "The middle class ... hasn't done as well over the past 20 years as people at the high end...".

Ferguson's charge and Schwarzman's worry have resonated because they come at a time when politicians see an opportunity to attract votes by exploiting discontent with increasing inequality.

Start in a place where you wouldn't ordinarily expect to hear whining about relative incomes: the executive suites of major corporations. CEOs are turning green, not because they worry about global warming, but because they are envious of the size of the payouts to private equity operators. Not that CEOs are suffering. Professor Xavier Gabaix of MIT and Professor Augustin Landier of New York University

estimate that average CEO incomes increased sixfold between 1980 and 2003. Other studies record increases of 18 percent last year, and an expected average rise of about 15 percent this year. But even the most handsomely remunerated corporate chieftain is a pauper compared with the moguls who run Blackstone, KKR, and the other buy-out shops. The average CEO can afford to join a country club, either with his own money or by having the corporation pick up the tab; a private-equity operator can build his own golf course. A corporate jet is fine, but using it for private travel is likely to raise howls of protest from shareholders and, in some cases, attract the attention of federal prosecutors. Leaders in the private equity sector have their own jets, and no need to apologies or explain if they flit to the south of France for a weekend in the sun.

It is not only the CEOs who are feeling relatively poor. So, too, are their seconds-in-command. The gap between the compensation of the men at the top of America's corporation and those executives who report to them is growing. A study by finance professor Carola Frydman of MIT and Raven Saks at the Federal Reserve Board found that in the 1960s and 1970s chief executives at the largest companies earned 80 per cent more than the third-highest paid executive; that gap is now 260 percent. At Wal-Mart, the CEO earned 40 percent more than his top lieutenant ten years ago, and now earns twice as much.

Income envy is not confined to the board rooms: the gaps between executive compensation and shop-floor pay, and between this generation and its parents, are becoming a political hot-

button issue. Political heat throws little light, so here are a few facts.

The share of national income going to profits has risen, while the share going to workers has declined, and the incomes of high earners have risen faster than those of average workers. Also, a study by the Pew Charitable Trusts found that "American men have less income than their fathers' generation at the same age."

But before signing on to presidential wannabe John Edwards' "Two Americas" thesis, consider a new study by Barry Bluestone, professor of political science at Northeastern University and the late Bennett Harrison, at the time a professor at Harvard's Kennedy School. They concentrate on the "typical American family", the 29-to-59 year-old group that is in its prime working years, and adjust for household size. That eliminates the distortion created by students and retirees, whose earnings are not representative of their lifetime experience, and by the lowering of family size that makes a given family income go further. The median income of this typical family is \$63,000 (£32,000), which buys a reasonable standard of living in most parts of the United States. The portion of families in the "middle class", those with incomes of between \$30,000 and \$90,000 fell from 47 percent to 39 percent between 1974 and 2004, which sounds ominous, until we note that the portion with incomes above \$90,000 rose by nine percentage points, and the percentage of households that are poor has not increased.

Rather than bewilder you with more statistics, let me do something more useful, and describe the underlying forces at work.

- Private equity firms are making large fortunes because they increase the operating and financial efficiency of the companies they take over, and can claim a portion of the increased profits for themselves.
- CEOs are earning more because they manage larger companies -- the sixfold increase in CEO compensation about keeps pace with the sixfold increase in the market value of big companies -- and, it must be said, because friendly boards of directors have been more generous with shareholders' money than is warranted by executive performance.
- Highly skilled workers are earning more than their less skilled counterparts because the premium paid by employers for education and skills is rising, and because globalization has brought over one billion unskilled, low-paid workers in developing countries into the labor market, depressing wages at the low end. College graduates now can look forward to salaries 75% above those of high-school graduates; 25 years ago the gap was 40%.

All of these developments add to inequality. But none of these developments should have you reaching

for your handy copy of the Communist Manifesto and the Marx-Engels forecast, "Society as a whole is more and more splitting into two great hostile camps, into two great classes directly facing each other."

Market forces are already in motion to change some of these trends. As more and more imitators follow the path of the original private equity players, those profits are being competed down -- which is what happens to all builders of better mousetraps in the long run. CEO compensation is now under greater scrutiny than ever, as increasingly active shareholders and corporate boards, awakened to their fiduciary responsibilities by Sarbanes-Oxley, become less generous. More and more workers are enrolling in community (two-year) colleges to upgrade their skills. Wages in China and India are rising, easing some of the pressure on wages of unskilled workers in developed countries.

Throw in a bit of political pressure -- easy to deride, but sometimes useful in injecting equity considerations into policy debates -- and the prospect is that grumbling might produce some jiggling of the tax system, but no sustained assault on market capitalism - - at least, not in America where we still believe that although academics Marx and Engels had it wrong, Deng Xiaoping, one of the founders of Communist China for the last eighteen years of its life its "paramount leader", had it right, "To be rich is glorious."



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