Inclusive Capitalism for the American Workforce

Reaping the Rewards of Economic Growth through Broad-based Employee Ownership and Profit Sharing

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Introduction and summary

The American model of capitalism needs major institutional reforms to regain its economic health and do what it has failed to do for the past three to four decades—ensure that the benefits of economic progress reach the bulk of our citizens. Well before the recent housing and financial crises, the Great Recession of 2007-2009, and the ensuing jobless recovery, the U.S. economy was not delivering the benefits of sustained economic growth to the vast bulk of workers.

From the mid-1970s through the 2000s the earnings of most American workers increased more slowly than the rate of productivity growth. Real median earnings barely rose even as gross domestic product per employed worker grew substantially.[1] This contrasts with the nearly equal rates of real earnings growth and productivity growth from the turn of the 20th century through the early 1970s, which created a large prosperous middle class.

The disconnect between economic growth and earnings growth over the past four decades results today in the United States having an extremely high level of economic disparity. In 2008 the level of income inequality was higher in our nation than in any other advanced industrial democracy in the Organisation for Economic Cooperation and Development. Among the 135 countries with measured levels of inequality, our nation ranks 41st highest in inequality, with greater inequality than in over half of low-income developing countries, including China, where a large part of the population remain poor peasant farmers.[2]

The recent housing and financial crises, the ensuing recession, and the current jobless economic recovery exacerbate these long-term trends. Indeed, despair about the direction of the economy is overwhelming earlier hopes that the recent economic turmoil was a temporary breakdown from which our country would rapidly recover. The reason why most Americans have a pessimistic view about our economic future is clear. High unemployment will likely last through the end of the decade, which will depress wage growth for most workers and together with unemployment add to economic disparity.[3]

Even if U.S. macroeconomic policies somehow restore employment and economic growth in the next few years to the rates that preceded the implosion of Wall Street, few Americans would find satisfactory another decade in which economic growth benefited only a small proportion of Americans. But it is hard to envisage the economy attaining a sustainable growth path if most workers continue to be excluded from the benefits of growth as they have been in recent years. Flat to falling wages in real terms means less money spent in our economy by the vast majority of our workers.

So what can be done to reverse the economic disparity in our nation and restore prosperity for all? This paper lays out a policy reform that will help restore the link between economic growth and the earnings of workers so that the recovery re-establishes a prosperous middle class. The reform encourages firms to develop broad-based incentive compensation systems that link employee earnings to the performance of the firm. This reform would give employees access to the capital-related earnings of their companies comparable to that of the senior executives who run these firms.

Some of the country's leading firms, such as Wegmans Food Markets, Inc., one of the nation's top grocery chains, and technology giants Cisco Systems Inc. and Google Inc., among others, boast incentive compensation systems that our policy seeks to encourage alongside a track record of successful business performance that benefits both workers and firms. For these and other firms that practice an inclusive form of capitalism, broad-based wealth creation and business success go hand in hand, but most firms limit pay for performance to a small number of high earners or have no access to meaningful incentive pay systems at all.

Our proposal is designed to encourage the senior executives and board members of firms that do not have inclusive incentive compensation systems to adopt such systems for the good of their employees, their companies, and the broader economy. To the extent that broad-based incentive compensation systems affect these firms as they do the firms that already use such systems, it is likely that productivity will rise as well, increasing output as well as spreading the rewards of growth to more workers.

In the pages that follow, we first lay out the deep-seated problem facing our nation—the stagnation of wages for most workers over the past 30 or so years despite increases in output per worker, and the substantial growth in capital-based earnings that went to a small group at the top of the earnings distribution. We

then present our proposed reform. This is to allow firms to deduct incentive-based pay as a business cost only in incentive programs that are sufficiently broad-based to cover most workers. Currently, companies can deduct incentive compensation costs from their corporate taxes no matter how few employees benefit and no matter how large the compensation.

This reform builds on longstanding regulations governing pension and health care systems, which allow tax deductions for those forms of compensation beyond regular wages and salaries only if the plan covers most workers. Specifically, our plan would give favorable tax treatment to compensation systems that link incentive pay to company performance if all of the company's full-time employees participated in them and if the value expended on the top 5 percent of employees by salary was also expended on the bottom 80 percent of employees by salary.

By offering tax deductions to plans that cover all workers, this reform should induce firms to adopt such plans. By linking the earnings of all workers to company performance, our reform will help re-establish the historic relation in which the earnings of all workers increase with economic growth.

We next review the evidence on the economic performance of firms with broad-based incentive systems and on the performance of firms with incentive systems limited to few top earners. There are over one hundred studies that compare firms with and without broad-based incentive systems and/or compare firms before and after they introduce such systems. And there are a small number of field or laboratory experiments on broad-based incentive systems. These studies find that broad-based incentive compensation systems are generally associated with higher economic performance for firms and better labor market outcomes for workers. This evidence contrasts with growing evidence that incentive systems that allocate incentive pay to only a few workers do not work well for the firms or the economy.

Since our proposal calls for a change in tax policy, we examine the magnitude of tax deductions that currently go to equity compensation plans and profit-sharing plans under current U.S. tax law. The law does not allow firms to deduct as a cost of business salaries for executives beyond $1 million, but allows tax deductibility of incentive pay of any amount regardless of how many persons are covered by the plan. Recently-released data from the U.S. Internal Revenue Service show the deduction for stock options alone amounted to $86 billion from July 2007 to June 2008. The tax deduction effectively subsidizes the incentive pay of a few top executives and other high paid employees.

Finally, we consider how firms and workers might respond to our reform. We examine the impact of our proposal on a few Fortune 500 firms. Our analysis shows that firms with current broad-based systems will likely not be meaningfully affected by the change since they already practice the brand of inclusive capitalism that the policy seeks to encourage. Firms with narrowly-defined compensation systems will, however, have to re-evaluate their plans and either expand them to cover more workers or pay taxes on their narrowly based plans. Firms without any incentive pay plans will hopefully be spurred by the reform to examine the potential that such forms of broad-based compensation have for improving their economic performance and the well-being of their workers.

On the workers' side we examine ways in which firms can give workers incentive pay while keeping the risk manageable and consistent with diversification of employee assets. It is important that our reform does not place employee pay and wealth unduly at risk due to the vagaries of the performance of their firm, as has happened to many workers in their 401k retirement plans. This problem can be addressed by limiting the amount of company stock in a company or individual employee's 401k plan financed by that worker's savings to 10 percent.

The net outcome of our proposed reform should be that more firms will adopt broad-based incentive systems that will spread and deepen incentive pay systems to their workers, which should improve economic performance and help restore the relation between worker incomes and economic growth. Such inclusive capitalism would do wonders to restore faith in the American Dream.

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