

## Is Market Failure Behind the Takeoff in Inequality?

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The growth in wage inequality within many late-industrial countries is one of the most spectacular and consequential developments of our time, spectacular because the turnaround was so sudden and undermined the conventional view that economic development would bring about widely diffused affluence, consequential because it is affecting the lives of so many people and in such profound ways. During the early stages of this takeoff in inequality, the dramatic changes in remuneration were happening under the radar, with the public not just unconcerned by the changes but also largely unaware of them (McCall and Kenworthy 2008). But that's no longer the case. We are now in the midst of a historic moment in which public debates about the legitimacy of extreme poverty and inequality have taken on a new prominence and urgency.

We don't harbor any illusions that a major change in poverty or inequality policy could easily be achieved. In any late-industrial country, one will find a well-developed and deeply institutionalized apparatus for ad-

ressing poverty and inequality, and any changes in that apparatus will at this point likely be glacial. It is nonetheless important to continue revisiting and redefining the rationale behind such an apparatus and thereby ensure that any further changes and elaborations are consistent with that rationale. We will attempt in this chapter to lay out what we think is a promising rationale and how existing policies might then be elaborated to better serve it.

This type of exercise is only infrequently attempted. In many countries, perhaps especially the United States, there's a rather strong strand of pragmatism underlying poverty and inequality policy. If an anti-poverty program can be shown to work at low cost, then that's enough for us and we will embrace it. This pragmatist movement to identify what works and what doesn't elevates to center stage the very simple empirical question of whether a given program has its intended effects. It's surely important to know whether a program works. But the typical evaluation exercises, almost by definition and certainly by convention,

don't ask whether the program under study resonates well with our larger ideals.

The United States would be well served by an ideology, a constitution of sorts, that underlies its reform apparatus, just as it has an ideology underlying its efforts to fashion a more productive economy. The latter type of economic reform is an ongoing process: There's endless discussion about trade alliances, tax reform, corporate regulation, and so forth. These debates are occasionally guided by explicit evidence of whether the proposed reforms will work, but it's also conventional to refer back to first principles by asking whether the proposed reform will allow the invisible hand to better operate and thus be competition enhancing. The United States is understood as a market economy precisely because of this a priori commitment. For a variety of reasons, debates about poverty and inequality reform are rather less tethered to any a priori commitments, and they become quite technical and pragmatic as a result. In the absence of principles, policy interventions tend to grow and accumulate into a sprawling array, one without any obviously unifying rhyme or reason. Although clearly it's crucial to know whether programs work as intended, our argument in this chapter is that there are also returns to building policy around principle.

What might that principle be? We did not by chance choose to contrast ideology-rich economic policy and ideology-poor inequality policy. The contrast is especially instructive, we argue, because poverty and inequality policy is best founded on the same market principles that now inform our economic policy. We make this argument in particular for countries, such as the United States, Germany, and the United Kingdom, in which market principles are

deeply written into the cultural DNA and hence have a special and abiding resonance. For other countries (e.g., Nordic countries), such principles are a less fundamental cultural commitment, and the rationale for building them into poverty and inequality policy is less compelling.

The reader may at this point be perplexed. How, it might be asked, could one possibly build anti-inequality interventions around market principles? Aren't profound poverty and inequality the main consequences of adopting market principles? Wouldn't labor-market institutions that adhere rigorously to market principles generate yet more poverty and inequality? These are important questions, and the rest of our chapter will be devoted principally to answering them. We will suggest that market principles, if the United States were truly to commit to them, might yield far less poverty and inequality than we now have.

We well realize that this is a radical view. The conventional wisdom is that poverty and inequality are straightforward consequences of market processes, that those with a promarket commitment must reconcile themselves to much market-generated inequality, and that insofar as less inequality is preferred, the only recourse is to take on such market-generated inequality with after-market redistribution. This conventional wisdom is so widely diffused and taken for granted that many people presume that progressive taxation and other redistributive after-market interventions are the *only* way to address poverty and inequality. The presumption, in other words, is that the market generates inequality and that after-market interventions are therefore the only way to undo inequality. We will argue that in fact nothing could be further from the truth.

We take the obverse position that *market failure* is a main source of poverty and inequality. Put simply: There would be less inequality in the United States if labor markets were more competitive, if our commitment to competition went beyond lip-service appeals, and if this commitment could be implemented even when the rich and powerful might be harmed by it. If, in other words, market failure is the cause of poverty and inequality, then the correct prescription is market repair. We argue that market economies can take on poverty and inequality by making their labor-market institutions more competitive and reducing the amount of illicit, noncompetitive inequality generated within the market. This approach reduces the pressure to take on poverty and inequality via redistributive approaches that are typically viewed as ideologically suspect.

But so much for preliminaries. The principal type of market failure that generates inequality is, we contend, the growing extraction of rent at the top of the class structure, where “rent” refers in this context to wages or returns in excess of what a fully competitive market would pay. The most common examples of rent include the minimum wage, the so-called union wage, excessive returns to schooling (occasioned by restrictions on access to schooling), and the wage premiums that accrue to certification, licensing, and related forms of occupational closure. Among countries with increasing inequality (e.g., the United States), rents that formerly accrued to workers in the lower half of the income distribution have been reduced by the decline of unionization, the decline in the real value of the minimum wage, and by other institutional reforms that reduce the bargaining power of labor. This rent destruction at the bot-

tom of the income distribution is well known and doesn’t require further study. The standard literature on rent destruction has, however, shown a perplexing tendency to assume that rents are being destroyed at the top of the class structure as much as at the bottom. The evidence of the past thirty years suggests, to the contrary, that rent destruction and rent creation are deeply asymmetric, with fundamental forces at work creating new potential for rent at the top of the class structure just as rent is being eliminated at the bottom. It’s precisely such asymmetry that has generated much inequality of late.

This new capacity for rent creation at the top of the class structure takes the form of rent that accrues to (1) occupations that create artificial scarcity by controlling who is qualified to enter the occupation (i.e., occupation rent), (2) capitalists who, by virtue of operating in increasingly concentrated and union-free industries, can use their newfound leverage to more effectively squeeze labor (i.e., capital rent), (3) educated workers who benefit from a reduced supply of competitors by virtue of substandard precollege schooling and rationed college slots (i.e., education rent), and (4) CEOs who secure sweetheart deals because the members of governing boards have no incentive to tie CEO pay to performance.

Although much has been written about these sources of rent at the top of the class structure, they haven’t been incorporated into testable models of inequality or used to understand trends and cross-national differences in inequality. We think it’s high time to build a comprehensive theory of the rent-based takeoff that may then be tested against more conventional theories that stress technological rather than sociopolitical sources of the takeoff. In the present chapter, we will

focus on just two of the four types of rent, as doing so will serve to illustrate the type of analysis that could be developed more generally. We begin by arguing that rising returns to schooling, well appreciated as a main cause of rising inequality, are attributable to market failure in the form of barriers to free and open competition for higher education. We then argue that excessive executive compensation is likewise rooted in noncompetitive practices and that a market wage might be inequality reducing. Because of space limitations, we can’t render the arguments in any comprehensive way, and instead we refer the reader elsewhere for a related and more sustained treatment (Weeden and Grusky 2010). The two examples laid out here should be taken as mere illustrations of the larger claim that market failure is a principal cause of inequality. We can use these two examples to show that, insofar as market failure is indeed a driving force behind the rise of inequality, one can reduce inequality not just by shifts from postmarket redistribution but also by market repair.

### Education and Market Failure

The takeoff in inequality is typically understood as the consequence of technological changes (e.g., increasing computerization) that increase the demand for educated labor. Because this demand can’t be immediately met, the payoff to educated labor increases as employers compete with one another and bid up its price, and the earnings gap between educated and uneducated labor accordingly widens. This account, which treats such skill-biased technological change (i.e., SBTC) as the smoking gun behind the takeoff in inequality, remains exceedingly popular. Although anti-SBTC carping is growing more common, a com-

prehensive alternative to SBTC hasn’t yet been developed.

The SBTC story thus stresses that rising returns to education arise from the increase in demand for skilled labor. We might reasonably ask why workers don’t simply go ahead and pursue a college education when they well know that there’s a high payoff to college. Are there real structural impediments that prevent workers from realizing their hopes and aspirations for a credential? Or are there instead cognitive impediments that prevent them from formulating such aspirations in the first place? The cognitive impediments story, stated baldly, is that workers are either stupid or lazy: That is, they either don’t understand that college yields a high payoff or understand that it yields a high payoff but even so just can’t be bothered to pursue a college degree. We will suggest here that the cognitive-impediments story is less plausible than an account that recognizes that workers may simply not be in a position to secure a degree even though they appreciate its benefits.

The main structural impediments at stake here are supply-side and demand-side barriers that prevent sufficient numbers of workers (relative to demand) from securing a college education. The *supply* of potential college students is artificially lowered because children born into poor families and neighborhoods don’t have the training (in primary and secondary schools) that qualifies them for entry into college (Goldin and Katz 2008). The *demand* for college students is kept artificially low because, in at least some countries, elite private and public schools engage in explicit rationing of their available slots. It’s not as if Stanford University, for example, is meeting the rising interest in its degrees by selling some profit-maximizing number of them. If top

universities did meet the demand in this way, the excessive returns to a high-prestige education would disappear, as indeed happened in the 1970s in the United States. We haven't, however, witnessed an analogous takeoff in higher education in recent decades. Instead, elite private universities have evidently decided to ration their slots, while public universities have been prevented from expanding because of declining state subsidies (and other forces).

This failure of educational institutions to expand in the face of rising demand stands in direct contrast to the expected response in competitive markets. When demand for hybrid cars, for example, increased dramatically in the United States, car manufacturers responded by ramping up production to a profit-maximizing level. They didn't typically respond by setting up hybrid-car admissions committees, by rigorously interviewing and testing prospective buyers, or by asking them to submit detailed résumés and statements about how the hybrid-owning experience will change their lives. Why did education and automobile manufacturers respond so differently to increased demand? The answer is simple: The market for cars more closely approximates a competitive market, whereas the market for education is anything but. We have become so accustomed to the contemporary practice of rationing higher education that we no longer appreciate what a profound form of market failure it is.

These bottlenecks on the supply and demand sides mean that those lucky enough to have a college education are artificially protected from competition and reap excessive pay as a result. If all children, even those born into poor families, had fair and open access to higher education, these excessive returns would disappear under the force of competition. It's in this very im-

portant sense that market failure is generating inequality. The prescription is likewise clear: If market failure is the cause of inequality, the proper response is market repair. We can straightforwardly repair the market by addressing the supply-side and demand-side bottlenecks that now prevent workers from acquiring college degrees.

Who would win and who would lose under such market repair? We have already noted that the losers would be those who are now artificially protected from competition and are therefore reaping excessive returns. The winners are those who are currently locked out of higher education, but would gain access once markets were repaired. But these are not the only winners. The other main winners would be the businesses that currently pay inflated prices for high-skill employees, but will no longer have to do so once higher education is opened up fully to competition. It's surely not in the interest of businesses to pay excessive returns to rationed secondary education, nor is it in the wider interest of any country to settle for the lower GDP that such restrictions on competition imply. The upshot is that market repair yields many winners.

It's high time, then, to move beyond the usual lip-service appeals to educational reform and appreciate that the current system makes a mockery of our ostensible commitment to markets. To be sure, the rise of for-profit educational institutions is often championed (and perhaps more often derided) as some nascent implementation of market principles, but such for-profits remain a small fraction of the higher-education sector, enrolling fewer than 4 percent of students in two-year programs and fewer than 2 percent of students in four-year programs (Bailey, Badway, and Gumport 2001). Moreover, it's altogether unclear whether there is

a payoff to a for-profit credential, let alone whether that payoff equals the payoff to a traditional credential. If the payoff is indeed as small as some research suggests, then even a substantial increase in the number of for-profit credentials won't necessarily reduce inequality by much (Chung 2009; Grubb 1993).

### Executive Pay and Market Failure

If one next considers CEO and executive pay, one again can't be all that impressed by our commitment to market principles. The main and well-known problem is that board members, sitting at the behest of the CEO, make decisions about that CEO's pay (Bebchuk and Fried 2004). This setup lends itself to board members favoring ample compensation packages because their own interests are best served by attending to the CEO's interests. It should come as no surprise, for example, that CEO pay is higher when many of the outside directors have been appointed under the CEO.<sup>1</sup> It becomes difficult with such pay-setting practices to represent the resulting pay in market terms. It's rather like asking a professor's students to decide on the professor's pay in advance of receiving their grades. When the fox is guarding the henhouse, one has to believe the fox's interests are better served than those of the hens.

The board's particularism is, however, nicely camouflaged by the practice of hiring outside consultants to examine the pay of peer firms and to make a recommendation accordingly, with that recommendation then typically represented as the pay level set by a competitive market (DiPrete, Eirich, and Pittinsky 2010). It's indeed the case that one can't expect CEOs to accept compensation below the prevailing compensation and

that an individual firm may therefore have no reasonable alternative but to compensate at the prevailing level. It shouldn't, however, be concluded that this package reflects the marginal product of the CEO. Rather, it's nothing more or less than the prevailing package, and the prevailing package simply reflects the prevailing practice of allowing CEOs to appoint board members who are then beholden to them. The resulting "market pay" is simply the pay that's generated when nonmarket forces are allowed to affect the board's compensation decisions.

The foregoing story about CEO pay is not universally accepted. Indeed, a large contingent of scholars view executive-pay arrangements as the product of arm's-length contracting between boards and executives, with the resulting compensation package indeed reflecting the marginal product of CEOs (Murphy and Zabojnik 2007; Gabaix and Landier 2008). If existing corporate practices deliver compensation that simply equals the value of the decisions the executive is making, then there's no market failure. The debate between scholars who hold this view (i.e., the optimal contracting view) and those who reject it (i.e., the managerial power view) is long, acrimonious, and far from resolved.

Although we are skeptical that existing governance practices can successfully deliver market pay, it goes well beyond our charge to review the relevant literature here and attempt to make that case. We instead make the fallback point that one should at least avoid compensation practices that create the strong *appearance* of impropriety. It's possible that economists working within the optimal contracting view are entirely right that, at the end of the day, contemporary compensation levels are efficient and only appear improper. But here's the rub: Even if this were true, the

legitimacy of compensation practices is still everywhere doubted and called into question, and much corporate energy must accordingly be devoted to concealing, justifying, or explaining packages that the public and stockholders treat with much understandable suspicion. Because these packages are so public, the mere appearance of impropriety can lead to widespread cynicism about how fair our system is, with resulting costs in the form of increased disaffection and reduced initiative. If the optimal contracting view is on the mark, then CEOs will continue to be paid at the same high level even after the appearance of impropriety is removed. The best way to test this view thus involves doing away with the smoking gun practices that suggest wholesale corruption.

The upshot is that even those who hold to the optimal contracting view should have an interest in setting up compensation practices that eliminate the appearance of corruption. It's useful in this regard to contrast two rather different approaches to reining in compensation. The institutionalist approach, which we have been advocating here, requires that we reform pay-setting institutions that make boards beholden to CEOs, thereby eliminating at least the appearance of impropriety. This institutionalist approach differs from a reformist approach that instead takes the existing corporate pay-setting institutions as given and layers various pay-governing controls on top of them. These secondary controls may take the form, for example, of (1) internalized moral restraints on the amount of pay that executives should accept or be offered, (2) government regulations capping total compensation, (3) corporate pay scales constituting voluntary caps on compensation, or (4) government taxation of excessive compensation.

The foregoing reformist approaches operate, it would seem, from the premise that two wrongs make a right. That is, instead of repairing institutions that are susceptible to nonmarket influence, they instead take deeply flawed institutions and layer on top of them additional nonmarket correctives (e.g., pay caps). The evident premise is either that two layers of nonmarket practices will, in conjunction, magically hit upon the true market wage or that the main objective shouldn't be to capture that elusive competitive market wage but instead just limit compensation any way possible.

We think such cynicism underestimates the public and, in particular, its commitment to competitive markets. As we see it, the informed public wants nothing more or less than competitive market wages, and high levels of compensation are quite unproblematic in market-focused societies (e.g., the United States) when they're justifiable in market terms. There's much empirical evidence suggesting, for example, that the U.S. population is prepared to accept quite extreme inequality insofar as it's fairly generated under competitive market rules (Hochschild 1995). It's accordingly wrong to interpret the current public outrage about CEO pay as some mass protest against high compensation. Rather, it's a mass protest against corruption, against sweetheart deals, against foxes guarding the henhouse. If we're right on this point, the institutionalist approach is clearly preferred, and we should accordingly turn to developing corporate practices that will plausibly yield market pay.

### Conclusion

We've argued here that there is much market failure in late-industrial societies, that

such failure generates high inequality, and that market repair is our best bet for reducing inequality in a way that resonates well with our core commitments. The conventional wisdom, by contrast, is that competitive markets are inequality-generating machines and that perhaps the worst-possible principle around which to build a commitment to equality is the market principle. This conventional formula confuses markets as they are with markets as they should be. In their current form, markets are indeed inequality-generating machines, but that's partly because they encompass various forms of closure, corruption, and supply bottlenecks that are inconsistent with a purely competitive market. If such market failure could be taken on, and we think it can, we might end up with strikingly less inequality. We have focused here on two especially important examples of this argument but suspect that it applies more widely.

We don't want to press our argument too far by suggesting that inequality should exclusively be addressed via market repair. To the contrary, after-market redistribution clearly is an important tool for inequality reduction, and our objective here has simply been to remind that it's not the *only* tool. The obvious problem with focusing exclusively on after-market intervention is that in some countries it's ideologically suspect and doesn't garner enough support to reduce inequality appreciably or permanently. The market principle is, by contrast, one of the core commitments of most late-industrial countries and hence a promising base upon which to build anti-inequality initiatives that deliver over the long run.

### NOTE

1. For a review of relevant evidence, see Bebchuk and Wiesbach 2009.

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