“Fairness as an Economic Force”
Alan B. Krueger, Chairman, Council of Economic Advisers
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Remarks as prepared for delivery

I’m honored that Ed [McKelvey] invited me to be the keynote speaker at Oberlin College’s conference on “Learning and Labor Economics,” honoring 100 years of Economics majors at Oberlin, as well as Al Rees Class ’43 – you started the major just in time for Al – and Hirsch Kasper’s 50 years of service at Oberlin. I was also pleased to learn that “Learning and Labor” is Oberlin’s motto. I have observed this up close: the CEA regularly accepts interns from Oberlin, and they have done an outstanding job for us. Princeton’s motto, you may know, is “In the Nation’s service.” These mottos matter. Princeton was much more likely to grant me public service leave to serve in my current job because of our motto. In a modern economy, continuous learning and work go hand in hand, so Oberlin’s motto is even more appropriate today than 100 years ago when the Economics major got going.

I also want to mention on a personal note that Al Rees was a close friend and colleague of mine. I remember when Al returned to Princeton from heading the Sloan Foundation in 1989. We faced the problem of which office to give Al at the time. I recall that Orley Ashenfelter firmly decided that we should give Al an office that was identical to Richard Lester’s office. It still rings in my ear like it was yesterday when Orley bellowed, “We don’t want *orbits of coercive comparison* between our emeritus faculty.” That equilibrium held until Hank Farber negotiated to take both of their offices – a theme I will return to later on in my talk.

In preparation for this event I reviewed some of Al and Hirsch’s research. In looking at their work, it is striking how relevant it is for today.

One area I want to single out is Hirsch’s work on unemployment. Hirsch’s 1967 *Review of Economics and Statistics* paper, “The Asking Price of Labor and the Duration of Unemployment,” is a classic. This was the first paper I am aware of to study how the reservation wage (the lowest wage an unemployed worker will accept) varies with the length of unemployment. Other economists had speculated that unemployment is a result of high and rigid reservation wages. Hirsch looked at data. With data on a cross section of unemployment insurance (UI) recipients in Minnesota, he found that, relative to their previous wage, the average reservation wage was about 3 percent lower for those who were unemployed for a full year. He also found suggestive evidence that small declines in the reservation wage were associated with a higher likelihood of accepting a job. The paper is a model for transparency and hands-above-the-table econometrics. Interestingly, using longitudinal data for 6,000 UI recipients in New Jersey, Andi Mueller and I found very similar estimate. Following the same workers over time, we estimated that the reservation wage declined by 3 to 7 percent over the course of a year, driven principally by older workers and those who started with personal savings and were drawing them down.

Hirsch could not have known that decades later the Displaced Worker Survey would show that unemployed workers suffer around a 20 percent loss in wages once they regain employment. In comparison to this wage loss, I've always considered the decline in the reservation wage to be quite modest, and evidence that unemployed workers' previous wages serve as an important reference point for the wage that they are willing to accept.

Given that long-term unemployment is now one of our Nation's most pressing problems, the line of research that Hirsch started is critical for designing policies and strategies to help the long-term unemployed return to work. One such strategy that I wanted to highlight is from the $12.5 billion Pathways Back to Work fund to make it easier for workers to remain connected to the workforce and gain new skills for long-term employment. This initiative, which is in the President's latest Budget, will support summer and year round jobs for low-income youth, subsidized employment and job training opportunities for unemployed and low income adults, and provide search assistance for the long-term unemployed. The Budget also includes $4 billion of funding for the Reemployment NOW program, which helps States fund innovative strategies (e.g., wage subsidies) to connect long-term unemployed individuals with job opportunities. The extension of Emergency Unemployment Compensation (EUC) last year included a requirement that long-term unemployed workers need to have an in-person meeting with the Reemployment Services office in order to receive EUC, in light of the fact that Job Search Assistance has been found to be effective for virtually every population to which it has been applied.

I also wanted to highlight one of Al Rees's papers, which, I believe, was his last. The paper is titled, "The Role of Fairness in Wage Determination" published in the *Journal of Labor Economics* in 1993. I know this paper well because after Al passed away, Marianne Rees told me that Al left instructions for me to proofread the galleys. The paper has some wonderful insights. As you know, in addition to his distinguished career at the University of Chicago and Princeton, Al directed the Council on Wage and Price Stability during the 1970s, was a director of Nabisco, provost of Princeton and president of the Sloan Foundation. Rees wrote, "In none of those roles did I find the theory I had been teaching for so long to be the slightest help. The factors involved in setting wages and salaries in the real world seemed to be very different than those specified in the neoclassical theory. The one factor that seemed to be of overwhelming importance in all these real-world situations was fairness…." He went on, echoing Richard Lester, "Labor markets are always more or less imperfect and leave a *zone of indeterminacy* within which there is room for bargaining, both collective and individual, and for discretion on the part of wage setters."

Another keen observation in his article is, "Fairness primarily affects the supply of work from experienced, long-service workers, either because a sense of grievance will increase turnover or because workers who feel unfairly treated will withhold effort." In addition to market power which creates rents to be divided, Rees noted that fairness could matter because of disputes about the division of rents from specific training.

The implication of fairness is that utility functions are interdependent, involving the wages of other people as well as one's own wage.

This is the main theme that I want to emphasize tonight – despite much research showing the importance of fairness for labor market outcomes, economists have devoted too little attention to the profound role that considerations of fairness have on the distribution of pay. In addition, I will argue that over the past three decades there has been an erosion of the norms, institutions and practices that maintain fairness in the U.S. job market – that occurred on top of market forces – that has exacerbated income inequality and made it harder for families to make it into the middle class in America. The zone of indeterminacy that Rees and Lester referred to still exists, but the bargain that working Americans have been able to strike within in this zone has shifted to their disadvantage, and to the detriment of our Nation. The erosion of traditional wage contours that have enabled the top earners to take home an ever larger share of the income distribution has not, in the end, served to raise productivity or improve incentives, and it is hindering intergenerational mobility. Instead of "you're own your own economics" we need, as President Obama has stressed, a return to growing the economy from the middle out, and a recognition of the reciprocal responsibilities of citizenship.

The shift in norms and practices concerning fairness was partly spurred on by market forces, but government policy and shifting attitudes of scholars and opinion leaders also exacerbated the breakdown in norms that previously supported a growing middle class in the post-war period. For example, at a time when we saw rapidly rising before-tax income inequality, the previous administration cut taxes disproportionately for high-income earners. At the other end of the distribution, in the 1980s the nominal value of the minimum wage was unchanged from 1981 to 1989, causing a 26 percent decline in the value of the minimum wage after accounting for inflation. In a job market characterized by imperfect information, search frictions and varying degrees of bargaining power, the minimum wage serves an anchor for other wages that provides a reference point for wage setting.

An astonishing 84 percent of total market-based income growth from 1979 to 2011 went to the top 1 percent of families, and more than 100 percent of it from 2000 to 2007 went to the top 1 percent. This shifted the equivalent of over $1 trillion in annual income to the top 1 percent.

I'm told by Sue Helper, an Oberlin alumna now at the CEA, that Hirsch Kasper taught her in 1976 about "the rule of 5 and 20" – that the top 5 percent of households took in 20 percent of total income. That rule held for quite some time, but in 2011 the top 1 percent of families took in 20 percent of national income, up from 10 percent in 1979, according to Thomas Piketty and Emmanuel Saez.[1] Perhaps the rule should be renamed "1 and 20". The top 5 percent took home 36 percent of market income in 2011. When Sue was at Oberlin, the top 5 percent took home took home 22 percent, consistent with Kasper's rule.

Evidence on Fairness

Now let me turn to the role of fairness. There is overwhelming evidence that concerns about fairness and relative pay enter into wage setting, and that it is in employers' interests to take perceptions of fairness into account.

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[1] Saez, Emmanuel and Thomas Piketty. 2011 update to figures from "Income Inequality in the United States, 1913-1998." *Quarterly Journal of Economics* 118, no. 1: 1-39.

David Card, Alex Mas and coauthors conducted an experiment in which they disclosed information to workers about their coworkers' pay for a randomly chosen subset of employees of the University of California.[2] All employees were then surveyed about their job satisfaction. They found an asymmetric response to providing this information: workers who were paid in the bottom half of their pay unit and occupation reported lower satisfaction, while those in the top half were unaffected. Likewise, those who learned they were in the bottom of the distribution were more likely to look for a new job and more likely to leave, while the disclosure of pay information had no effect on the turnover of higher earners. Clearly, discovering one's place in the pay hierarchy had an impact on morale and satisfaction for those in the bottom. Card et al. concluded, "These patterns are consistent with a utility function that imposes a negative cost for having wages below the reference-point, but little or no reward for having wages above the reference point."

In a related randomized field experiment, Ernst Fehr and his coauthors varied the pay for workers who were hired to distribute free newspapers. They found that raising pay for workers who felt that they were underpaid substantially increased their productivity, but raising pay for those who did not feel underpaid had no effect on productivity.[3] Again, payment relative to a reference wage seemed to influence performance.

In another experiment, Fehr and coauthors randomly adjusted the pay of members of a pair of workers who sold membership cards to specific nightclubs in Germany. They found that increasing the disparity in pay between pairs of workers *decreased* the productivity of the two workers combined.[4] These studies suggest that a more equal distribution of wages would be good for business because it would raise morale and productivity. Other evidence suggests that a more equal wage distribution and rising middle class strengthens consumption and macroeconomic performance.

In an *American Economic Review* paper that is typical of much Industrial Relations research carried out by Lester, John Dunlop and Lloyd Reynolds, David Levine conducted a survey of 139 companies' compensation managers.[5] He asked them a series of hypothetical questions about what would influence their pay recommendations, such as a firm's profitability and wage changes for related occupations. He concluded that, "It appears that wage recommendations respond to changes in the market, but considerations of equity are also of considerable importance in tempering the responses of compensation executives." For example, he found that the executives tended to maintain relative wage differentials for close occupation groups (e.g., carpenters and electricians), even if market forces were pushing to expand them.

There is much other evidence that fairness matters in actual labor market settings, but I'll conclude this part of my discussion by citing three strands of evidence on how the minimum

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[2] Card, David, Alexandre Mas, Enrico Moretti and Emmanuel Saez. 2012. "Inequality at Work: The Effect of Peer Salaries on Job Satisfaction." *American Economic Review* 102, no. 6: 2981-3003.
[3] Alain Cohn, Ernst Fehr and Lorenz Goette, "Fairness and Effort - Evidence from a Field Experiment," October 2008.
[4] Alain Cohn, Ernst Fehr, Benedikt Herrmann, and Frederic Schneider, "Social Comparison in the Workplace: Evidence from a Field Experiment," IZA Working Paper 5550, March 2011.
[5] Levine, David. 1993. "Fairness, Markets and Ability to Pay: Evidence from Compensation Executives." *American Economic Review* 83, no. 5: 1241-1259.

wage serves as an anchor for other wages and a benchmark for fair pay. First, research has found that there is a spike in the distribution of wages at the minimum wage for workers in jobs that are *not covered* by the minimum wage. This finding suggests that the minimum wage becomes a focal point for wage setting.[6] Second, a minimum wage increase often leads to a ripple effect in the wage structure, lifting the wages of workers above the new minimum wage. Larry Katz and I surveyed fast food restaurants before and after the minimum wage increased from $3.80 to $4.25 an hour in April 1991, and found that when the minimum wage rose, a significant number of firms increased wages for workers who were making $4.50 an hour before the minimum wage increased, and were not bound by the increase.[7] We found that the minimum wage had a ripple effect on wages above the minimum, even at firms that already paid above the minimum wage. This point was made by the head of the New Jersey Business & Industry Association, who said, "People earning above minimum expect more once the [minimum wage] goes up because they are upset if someone just starting earns more or as much as they do." And third, we and others have found that employers rarely used the subminimum wage, which enabled them to pay teenagers the old minimum wage even after the minimum wage rose. Evidently, employers were reluctant to pay workers doing the same work a different wage.

Perhaps the area where norms of fair behavior matter most – and have changed the most – concerns executive compensation. As Rees noted, "The contribution of an executive to the output of the firm is extremely hard to measure, so that equity considerations, except in the case of conspicuously outstanding or poor performance, will loom large."

Rees went on, "if the power of equity considerations is constrained by demand in the case of low-level employees and not for those at the top, the result will be a widening gap in compensation between the top and the bottom. This seems to me to be what has been happening during the 1980s, although I cannot explain why it did not happen sooner."

The rapid rise of executive compensation, particular in the finance industry, has contributed mightily to the rise in income inequality. The proportion of people in the top 1 percent who were from the finance and real estate industry nearly doubled from 1979 to 2005. And in 2005, executives from the finance and real estate sector received one quarter of the income in the top 0.1 percent.

You even see this in universities. Ronald Ehrenberg, John Cheslock and Julia Epifantseva of Cornell found that the average pay of presidents at research universities increased 35 percent from 1992 to 1998, when endowments soared.[8] Yet they found that presidents' pay increases were unrelated to their job performance, at least as measured by improvement in their universities' academic standing.

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[6] Falk, Fehr and Zehnder (2006) present results of a laboratory experiment which finds that the minimum wage shapes workers' reservation wages. ("Fairness Perceptions and Reservation Wages – The Behavioral Effects of Minimum Wage Laws." *Quarterly Journal of Economics* 121, no. 4: 1347-1381.)

[7] See Card, David and Alan B. Krueger. 1995. Myth and Measurement: The New Economics of the Minimum Wage. Princeton University Press, Chapter 5.

[8] Ehrenberg, Ronald G., John J. Cheslock and Julia Epifantseva. 2001. "Paying our Presidents: What do Trustees Value?" *Review of Higher Education* 25, vol. 1: 15-38.

Shifting Ground

In considering reasons for the growing wage gap between the top and everyone else, economists have tended to shy away from considerations of fairness and instead focus on market forces, mainly technological change and globalization. But given the compelling evidence that considerations of fairness matter for wage setting, I would argue that we need to devote more attention to the erosion of the norms, institutions and practices that maintain fairness in the job market. We also need to focus on the policies that can lead to more widely shared – and stronger – economic growth. It is natural to expect that market forces such as globalization would weaken norms and institutions that support fairness in wage setting. Yet I would argue that the erosion of the institutions and practices that support fairness has gone beyond market forces.

For example, policies and tactics that undermine the ability of workers' to join unions and exercise their right to collectively bargain, erode a critical institution that has long fought for fairness in the labor market, and served to strengthen the middle class, both for union members and nonmembers.

An alternative argument, however, is that the zone of indeterminacy has shrunk due to market forces, and some might even argue that this is a good thing. At first blush, I see little support for either of these propositions. Corporate profits as a share of the economy are near their all-time high, so it is hard to argue that companies do not have the ability to support higher wages. Second, the workforce is older and less mobile, which should increase the rents from specific training and other sources that are available to be divided between workers and firms. Third, productivity growth has not accelerated over the past 30 years; in fact, except for the late 1990s (when inequality narrowed) productivity growth has slowed. If the rise in inequality had improved incentives, one would have expected productivity growth to rise even more quickly, not slow down. Indeed, it is hard to see what the macroeconomy has gained from the enormous shift in the income distribution.

I already mentioned that the decline in the real value of the minimum wage and tax cuts tilted to the top have eroded norms of fairness. But these policies can be reversed.

Another policy I want to highlight concerning executive pay is "Say on Pay." The Dodd-Frank Wall Street Reform Act requires companies to hold a non-binding vote on the compensation of the CEO, CFO and at least the three other highest compensated executives. This went into effect in January 2011, and Treasury had required it of TARP recipients even before Dodd-Frank. I am not aware of any academic study on "Say on Pay" yet, but about 3 percent of companies lost Say-on-Pay votes in 2012. Although this may seem small, there were some very consequential negative votes, including at Citigroup and Hewlett-Packard. According to reporting in the *Wall Street Journal*, executive turnover at companies that failed Say-on-Pay votes last year was about twice as high as overall turnover, and about one in four of the companies that lost Say-on-Pay votes in 2011 replaced their CEO after the vote.[9] Moreover, as in final arbitration cases, the fact that pay packages need to be aired in front of shareholders should provide some discipline on compensation committees' proposals, and provoke boards to explain their compensation practices. Indeed, the general counsel at TIAA-CREF said that Say-on-Pay votes are "creating

[9] "'Say on Pay' Changes Ways." *Wall Street Journal*. February 21, 2012.

an environment in which management and directors are becoming more willing to speak to shareholders."[10]

Say-on-Pay and other actions can introduce more fairness into the job market, and help narrow the growing wage gap. Given the strong human desire for fair treatment, the bully pulpit and well-targeted public policies provide an opportunity to strengthen the norms, institutions and practices that enforce fairness in the economy. I mentioned earlier that mottos matter. In this regard, President Obama's focus on "growing the economy from the middle out" is an appropriate motto, and one that should focus our attention on making choices that strengthen the middle class and provide more support for people struggling to get into the middle class.

I want to emphasize that much is at stake in this debate. Just about any way you measure it, the share of middle class jobs has been declining in the U.S. for the past three decades. This trend has deeply worrisome consequences for the future our economy and our country. Rising inequality is very likely reducing intergenerational mobility and restraining economic growth. This is one of the reasons why President Obama has proposed new Ladders of Opportunity to distressed communities and those struggling to get by, including his new proposal for universal preschool education.

A commitment to restoring more fairness to the U.S. job market would also help to offset the middle class jobs deficit. It would also help our companies. As President Obama has said, "We believe that when a CEO pays his autoworkers enough to buy the cars that they build, the whole company does better."

But I want to conclude by giving Al Rees the last word. Al ended his 1993 article by saying, "I do not want to be misinterpreted as saying that I now think that neoclassical theory is wrong. It is not, but it is incomplete. The most it can do is to set the stage for players such as personnel directors, union officers, and individual workers. It cannot write their lines. … [G]iven any configuration of [market] forces, the individual players usually still have substantial room for maneuver. In their maneuvering, they constantly struggle to preserve fairness as they see it." I think we owe it to Al Rees and our country to reset the stage so that considerations of fairness are allowed to play a more central role.

Thank you very much.

[10] "Boards Court Shareholders." *Wall Street Journal*. August 21, 2012.