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ROCKEFELLER INSIGHTS

RISING TIDES

COULD THE CONFLUENCE OF LOW UNEMPLOYMENT
AND ABUNDANT CORPORATE CASH FLOWS LIFT
LOW WAGES?



INCOME INEQUALITY IN THE UNITED STATES IS AMONG THE HIGHEST OF ALL DEVELOPED COUNTRIES AND, IN A REVERSAL OF PRIOR PATTERNS, HAS RISEN DRAMATICALLY OVER THE LAST FOUR DECADES. A CENTRAL ISSUE FOR INVESTORS IS THE ROLE OF THE CORPORATION IN ADDRESSING THIS DIVIDE.



HOW DEEP IS THE DIVIDE?

According to the *Harvard Business Review*, hourly inflation-adjusted wages received by a majority of working people in the United States have risen about 0.2% per year since the 1970s.² During the same period, the share of income that lower-paid workers receive has declined from 65% to 57%. The distribution of income has also become more unequal, with most wage gains going to the highest paid workers. Data from the 2018 World Inequality Report (“WIR”) show that in 2014, the top 1% of Americans earned 20.25% of national income, while the bottom 50% of the population earned just 12.5%. Exacerbating these trends, the bottom half of earners have seen stagnation and in some cases a decline of their income on an inflation-adjusted basis. The WIR analysis found that nearly all growth in after-tax incomes for the bottom 50% has come from Medicaid and Medicare. When controlling for those factors, the data suggest that incomes for the bottom 50% of earners have stagnated since the 1970s.³ So while the bottom 50% of pre-tax incomes grew by only 1%, pre-tax income for the top 1% grew by 204%; for the top 0.01% by 453%; and for the top 0.001% by 636%. Further, wages in the lower half of the distribution have not kept pace with housing, education, childcare or medical inflation. As a result of this divergence, income inequality has contributed to wealth inequality in the United States.

From the end of WWII to the 1970s, incomes grew rapidly and doubled in inflation-adjusted terms at every level of work and income. Data from the Center on Budget and Policy Priorities (“CBPP”) echo the analysis from the *Harvard Business Review*, showing that from the beginning of the 1970s, income growth at the top continued to increase strongly while low and middle income growth slowed significantly.⁴

Looking at the distribution of wealth (household assets, minus debts), the spread increases and becomes much more highly concentrated at either end. According to CBPP, “the share of wealth held by the top 1% rose from just under 30% in 1989 to nearly 49% in 2016, while the share held by the bottom 90% fell from just over 33% to less than 23% over the same period.” When inflation for essential goods and services outpaces wage growth, the effects are felt much more significantly by those with low and middle incomes, and may have long term negative consequences for national economies.⁵

¹ Alvaredo, Facundo, et al. World Inequality Report 2018, pp. 78–80.

² Nunn, Jay and Shambaugh, Ryan. “Why Wages Aren’t Growing in America.” Harvard

Business Review, 24 Oct. 2017, hbr.org/2017/10/why-wages-arent-growing-in-america.

³ Alvaredo, Facundo, et al. World Inequality Report 2018, pp. 78–85.

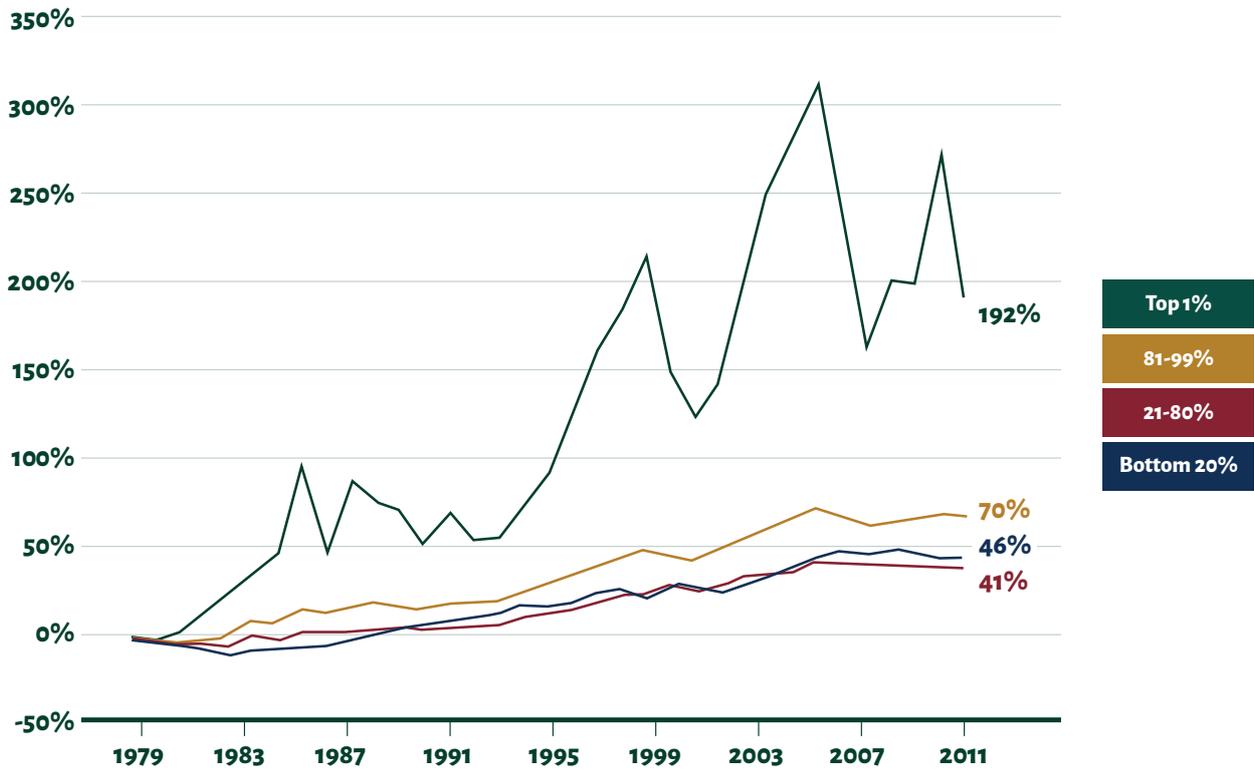
⁴ Stone, Chad, et al. “A Guide to Statistics on Historical Trends in Income Inequality.” Center on Budget and Policy Priorities, 15 May 2018, [www.cbpp.org/research/poverty-and-](http://www.cbpp.org/research/poverty-and-inequality/a-guide-to-statistics-on-historical-trends-in-income-inequality)

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⁵ “Inequality Hurts Economic Growth, Finds OECD Research.” Stu-

dents, Computers and Learning - Making the Connection - En - OECD, 12 Sept. 2014, www.oecd.org/newsroom/inequality-hurts-economic-growth.htm.

Growth in U.S. After-Tax Income



Source: Congressional Budget Office, *Cumulative Growth in Average Inflation-Adjusted After-Tax Income, by Before-Tax Income Group, 1979 to 2013

When wages fail to rise proportionately, the government may need to increase its spending on supplemental assistance programs. The UC Berkeley Labor Center found that low-wages cost U.S. taxpayers approximately \$152.8 billion per year in public funding. Further, their data suggest that 73% of public assistance recipients nationwide are members of working families.⁶

Housing Inflation, as an Example

The online real estate company Zillow, conducted an analysis of its United States data from 2011-2016 and found that rents outpaced income growth in every market.^{7,8} Even in cities where low-wage workers saw the biggest increases, Zillow found inordinate increases in rental costs. As an extreme, but important example, San Francisco's lowest earners increased their wages by an average of \$485 over a five-year period, while rents rose an average of \$1,145. Zillow found that in the largest 25 metropolitan areas of the United States, 69% of low-wage earners have not saved enough to cover three months' living expenses. A CareerBuilders Survey conducted in summer 2017 among 2,000 hiring and HR managers and 3,000 full-time employees found the following:⁹

- **78% of full-time workers polled live paycheck-to-paycheck**
- **71% are in debt, with 56% saying their debt is unmanageable**
- **56% save less than \$100/month, including 10% of those making more than \$100,000/year**

⁶ Jacobs, Ken. "The High Public Cost of Low Wages." Center for Labor Research and Education, 23 May 2018, laborcenter.berkeley.edu/the-high-public-cost-of-low-wages/.

⁷ Huffman, Mark. "In Largest Cities, Low-Wage Workers Can't Afford the Rent." ConsumerAffairs, 5 Sept. 2017, www.consumeraffairs.com/news/in-largest-cities-low-wage-workers-cant-afford-the-rent-090517.html.

⁸ "Low-Income Renters Struggle to Afford the Least Expensive Apartments." PRNewswire, 29 Aug. 2017, www.prnewswire.com/news-releases/low-income-renters-struggle-to-afford-the-least-expensive-apartments-300510537.html.

⁹ "Living Paycheck to Paycheck Is a Way of Life for Majority of U.S. Workers, According to New CareerBuilder Survey." Press Room | Career Builder, 24 Aug. 2017, http://press.careerbuilder.com/2017-08-24-Living-Paycheck-to-Paycheck-

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**LOW-WAGES COST
U.S. TAXPAYERS
APPROXIMATELY \$152.8
BILLION PER YEAR IN
PUBLIC FUNDING, WITH
MEMBERS OF WORKING
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73% OF PUBLIC
ASSISTANCE RECIPIENTS.**

BERKELEY UNIVERSITY

<http://laborcenter.berkeley.edu/the-high-public-cost-of-low-wages>

AS OF 2012, THE TOP
0.1%, REPRESENTING
161,000 FAMILIES,
**COLLECTIVELY OWNED
AS MUCH WEALTH AS
THE BOTTOM 90% – OR
145 MILLION FAMILIES.**

NATIONAL BUREAU OF ECONOMIC RESEARCH, 2014

<http://www.nber.org/papers/w20625>

The Federal Reserve Board's 2016 Survey of Household Economics and Decision Making found that about 30% of households, representing 73 million adults, report they are struggling or just barely getting by; 51.3% do not have funds to cover three months of living expenses; and 52.5% of households earning less than \$40,000 are struggling to make ends meet.¹⁰ For those making less than \$40,000/year, the top concern is rent (as they likely receive Medicaid). For those making between \$40-100,000, the top concern is health insurance affordability, while the main concern for those making just over \$100,000 is education expenses for their children.

The implementation of President Roosevelt's New Deal marks the only time in U.S. history where the wealth inequality spread tightened, largely as a result of policy changes, which included both progressive taxation and stronger financial regulation.¹¹ Since the 1980s however, the middle class has struggled to maintain savings as housing inflation, access to consumer credit, and higher education costs have all seen substantial increases. At the same time, the rapid accumulation of financial assets by the top earners (and therefore, increases in their capital income) has sent those incomes surging. As a result of this driver, according to Saez and Zucman in their analysis from 2016, "Income inequality has a snowballing effect on wealth distribution."¹² Their analysis shows that, as of 2012, the top 0.1%, representing 161,000 families, collectively owned as much wealth as the bottom 90% percent – or 145 million families.

Reducing wealth inequality will likely require both public and corporate policies to be designed with the intention of closing this divide. A clear contribution that companies could make would be to address income inequality within their own organizations.

THE OUTLOOK FOR RISING WAGES

Although the call for a living wage has been sounded for decades, market forces may be aligning to realize meaningful wage gains. The confluence of low unemployment, labor shortages in certain markets and record liquidity across many sectors could mark an inflection point for rising wages as companies look for ways to retain employees or attract new talent.¹³

Low Unemployment as a Factor

Jobless claims recently fell to a 45-year low. As labor nears full employment, certain jurisdictions and industries are already seeing wage pressure. According to *The Wall Street Journal*, cities in the United States with unemployment rates near or below 3% are starting to see wage increases that surpass national averages. In Minneapolis – where the unemployment rate is the lowest in the country at 2.3%, weekly wages for workers have risen by more than 4% from about a year earlier. In Denver, San Jose and Austin – all with unemployment rates below 4%, the Journal reports wage growth of a minimum of double the national average of 2%.¹⁴ Competition for skilled labor has been echoed by companies throughout the country in industries such as construction management, information technology, and manufacturing. Low unemployment and immigration constraints have also contributed to increased demand for unskilled labor in construction, agriculture, food services and hospitality, as those sectors continue to grow.

¹⁰ Larrimore, Jeff, et al. Report on the Economic Well-Being of U.S. Households in 2016, the Federal Reserve Board, www.federalreserve.gov/publications/files/2016-report-economic-well-being-us-households-201705.pdf.

¹¹ Alvaredo, Facundo,

et al. World Inequality Report 2018, p. 2.

¹² Saez, Emmanuel, and Gabriel Zucman. Wealth Inequality in the United States since 1913: Evidence from Capitalized Income Tax Data. National Bureau of Economic Research, 2014,

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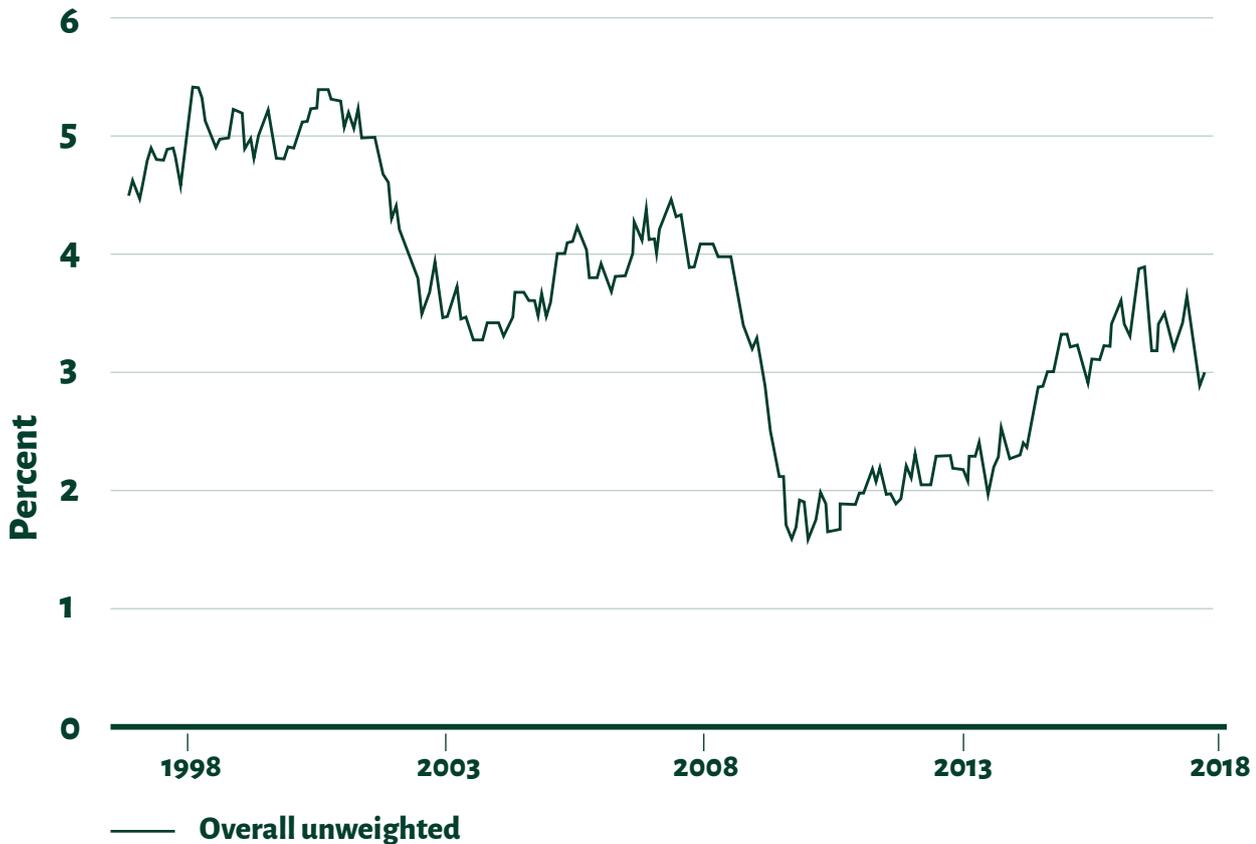
¹³ Chang, Andrew, et al. "U.S. Corporate Cash Reaches \$1.9 Trillion But Rising Debt and Tax Reform Pose Risk." S&P Global Market Intelligence, 25 May 2017, www.spglobal.com/our-

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¹⁴ Raice, Shayndi, and Eric Morath. "In Cities With Low Unemployment, Wages Finally Start to Get Bigger." *The Wall Street Journal*, Dow Jones

& Company, 2 Jan. 2018, www.wsj.com/articles/in-cities-with-low-unemployment-wages-finally-start-to-get-bigger-1514808001.

Wage Growth Tracker | Three-month moving average of median wage growth



Sources: Current Population Survey, Bureau of Labor Statistics, and Federal Reserve Bank of Atlanta Calculations. Data updates can be found at <https://www.frbatlanta.org/chcs/wage-growth-tracker?panel=1>.

Immigration as a Factor

Undocumented immigration has been on the decline since the George W. Bush administration.¹⁵ Steady enforcement by the Obama administration, combined with current aggressive deportation targets, have limited the population of people willing to work jobs that are physically demanding, potentially unpleasant and not well paid.¹⁶ Decades of deportations have put pressure on businesses typically tied to low paid, unskilled labor – particularly in the agricultural sector. According to the U.S. Department of Agriculture, approximately half of farm laborers are undocumented. *The Los Angeles Times* reported in March 2017 that wages for farm workers have risen nearly 50% since 1996, and that farmers have become so desperate for labor that many are offering benefits such as healthcare, housing subsidies, and profit sharing.¹⁷ According to a federal survey, nine out of 10 field laborers are foreign-born, with over half being undocumented. Farm Credit East – a lender to the agricultural sector, estimates that New York State alone could be facing economic losses of up to \$8.57 billion, if deportations continue and labor is simply not available.¹⁸ There are so few domestic-born farm workers, that most farmers rely on H-2A temporary foreign worker visas. The current administration has proposed further cuts to documented immigration programs and steeper enforcement of deportation orders to undocumented immigrants, which could present even more labor shortages in the short term.¹⁹

¹⁵ Smith, Noah. "Immigrants Haven't Hurt Pay for Americans." Bloomberg.com, Bloomberg, 14 Feb. 2018, www.bloomberg.com/view/articles/2018-02-14/immigrants-haven-t-hurt-pay-for-americans.

¹⁶ Palma, Bethiana, and David Mikkelson. "Were More People Deported Under the Obama Administration Than Any Other?" Snopes.com, 13 Feb. 2017, www.snopes.com/obama-deported-more-people.

¹⁷ Kitroeff, Natalie, and Geoffrey Mohan. "Wages Rise on California Farms. Americans Still Don't Want the Job." Los Angeles Times, Los Angeles Times, 17 Mar. 2017, www.latimes.com/projects/la-fi-farms-immigration.

¹⁸ Frank, Michael. "Can America's Farms Survive the Threat of Deportations?" The Atlantic, Atlantic Media Company, 6 June 2017, www.theatlantic.com/business/archive/2017/06/can-americas-farms-survive-the-threat-of-deportations/529008.

¹⁹ Mohan, Geoffrey. "To Keep Crops from Rotting in the Field, Farmers Say They Need Trump to Let in More Temporary Workers." Los Angeles Times, Los Angeles Times, 25 May 2017, www.latimes.com/projects/la-fi-farm-labor-guestworkers.

THERE ARE SO FEW
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LA TIMES

<http://www.latimes.com/projects/la-fi-farm-labor-guestworkers/>

Tax Changes as a Factor

While 2017 saw record profitability and high liquidity for many sectors, companies overall made modest incremental investments in their workforces.²⁰ However, labor shortages across sectors last year led many to predict that wages should be rising.²¹ ***With even more cash on hand from the corporate tax cut, could companies now be even better positioned to make significant labor investments? If so, will wages rise enough to impact income inequality?***

Following the passage of the tax bill – which was widely criticized as mostly benefiting corporations, a handful of large companies were quick to announce they would be using part of their tax savings for the benefit of their workforce. Bank of America, American Airlines, Walt Disney Company, Lowe's, Comcast and Southwest, among others, announced a one-time bonus of up to \$1,000 for all employees. While these were encouraging announcements, it is important to consider whether these decisions are impactful investments in the workforce.^{22,23}

While a one-time bonus is clearly positive for the recipients, an increase in base pay would show a more meaningful investment in employees and actually work toward reducing income inequality within any individual company. Comerica Bank, Fifth Third Bancorp, Marsh & McLennan, PNC Financial Services, The Travelers Companies and CVS Health all raised their base pay for their lowest paid workers in addition to offering a one-time bonus of \$1,000 or more. CVS also committed to absorbing the increases to healthcare premiums in 2018/2019 as well as offering 100% paid parental leave for its 100,000 employees.

However, raising base pay alone will not indicate whether a company is actually improving the pay gap within its ranks. If share buybacks are also planned, an outsized increase in executive variable pay could widen the gap even more. Some recent company declarations mask other actions that further enshrine the wealth divide. For example, Walmart announced base pay raises, bonuses and expanded benefits to hourly workers, but at the same time began closing 10% of its Sam's Club stores and moving ahead with its \$20-billion share buyback over the next two years. This type of policy does little to close the income gap for Walmart internally or society at large. Some companies, such as Envoy Air, announced one-time bonuses for employees, but lobbied against base pay raises in contract negotiations with their employee unions. *The New York Times* recently found that the frequency of companies issuing one-time bonuses instead of growing base pay has been increasing for nearly two decades. The Times suggests that because employers are cautious of permanent increases to labor costs, variable pay has increased as a percent of overall compensation as stocks continue to rally.²⁴

The labor shortage for both skilled and unskilled workers is likely to continue to drive average wage increases across most sectors. The convergence of low unemployment and the corporate tax cut makes 2018 an opportune time to engage portfolio holdings on the importance of permanent increases to base pay. While the tax change will result in many income groups getting a short-term reduction of their tax rate, it may further increase wealth inequality in the United States. As a result of this broadly regressive tax policy, after-tax incomes are set to increase by a greater percentage for those at the top of the distribution than for those at the lower end of the distribution. Further exacerbating this divide, the repeal of the Affordable Care Act's individual mandate will likely create disruptions in the healthcare system that could increase this country's wealth gap even more.

The Congressional Budget Office estimates that as a result of this change we could see an additional four million people without insurance by 2019, climbing to 13 million by 2025 if another healthcare solution is not implemented. Additionally, while the effects of substantially increasing the deficit remain to be seen, history suggests that we predict calls to reduce spending for public assistance programs that benefit low income and marginalized populations such as the disabled and veterans.

²⁰ "Wage Growth Tracker." Federal Reserve Bank of Atlanta, www.frbatlanta.org/chcs/wage-growth-tracker.aspx?panel=1.

²¹ Cohen, Patricia. "U.S. Job Growth Picks Up the Pace, but Wages Lag Behind." *The New York Times*, The New

York Times, 7 July 2017, www.nytimes.com/2017/07/07/business/economy/jobs-report-june-unemployment.html?_r=0.

²² Collins, Keith, and Stephen Grocer. "What Companies Are Doing With Their Savings From the Tax Law." *The New*

York Times, *The New York Times*, 31 Jan. 2018, www.nytimes.com/interactive/2018/business/dealbook/tax-savings-benefits.html.

²³ Cohen, Patricia. "Where Did Your Pay Raise Go? It May Have Become a Bonus." *The New York Times*, The

New York Times, 10 Feb. 2018, www.nytimes.com/2018/02/10/business/economy/bonus-pay.html.

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Investing in the Workforce

While the tax change will increase the amount of capital companies could and should invest in their workforce, they are not mandated to do so. But perhaps companies should consider increases to wages and benefits before economic pressures absolutely force their hand. There is ample evidence that high levels of income inequality hurt economic growth.²⁵ A one percentage point increase in the income share of the top 20% reduces growth by 0.08 percentage points over five years, while a rise in the income share of the bottom 20% boosts growth.²⁶ Better-paid workers are better consumers of products and services. In addition, academic research has shown that providing living wages, benefits such as family leave and healthcare can lead to more loyal and satisfied employees, boosting productivity and lowering attrition. The costs of high turnover directly affect net income, while also affecting morale and productivity. According to the Work Institute's 2017 *Retention Report*, replacement costs are about 33% of an employees' annual salary, not to mention indirect productivity costs such as the skills/knowledge lost when an employee leaves or the time it takes for new hires to be fully functional. The study also highlighted that approximately 75% of employee turnover could be prevented by factors such as increasing career development opportunities, better work-life balance, as well as adjustments to benefits and compensation.²⁷ While wage increases are a critical part of labor retention, investments into employee benefits could also lower high attrition rates while simultaneously addressing some aspects of income or wealth inequality. For example, Amazon.com announced it would be investing in a program to reduce healthcare costs of its almost 900,000 employees. This program will not only save money for both the company and its employees, but is expected to improve retention rates. *The Harvard Business Review* cites numerous studies that have found positive correlations between employee engagement and customer satisfaction, and that "inspired" employees are more than three times as productive as dissatisfied employees.^{28,29} Taking this research into consideration, it seems that productivity gains could offset and perhaps even exceed additions to the cost curve from workforce investments.

Shareholder Influence and Engagement

Labor markets are anticipated to continue tightening as we head toward full employment and the economy continues its rapid expansion. Incorporating demographic shifts into this prediction, we could see a potential labor shortage of nearly 8.5 million people over the next decade.³⁰ How will companies retain talent in an increasingly competitive landscape? As shareholder representatives, we often speak with our portfolio companies on their approaches to building a productive and committed workforce for both skilled and unskilled labor. We can encourage companies to address income inequality within their own organizations, through the lens of also maintaining a competitive edge. The scramble to find workers, combined with the cost of high turnover can increase overhead and lead to productivity setbacks that perhaps a bit of foresight could have prevented. In other words, why should companies wait until the stakes are quite so high? What are companies across sectors doing to maintain and grow a competitive workforce? Asking companies to explain their employee turnover ratios, their occupational health and safety statistics, their policies regarding paid family leave or even their Glassdoor ratings can provide valuable insight into management quality. These discussions help analysts assess management foresight, resilience during a labor shortage or perhaps even indicate if a company is better positioned for fostering innovation compared to peers. As long-term investors, we view these as critical conversations to have with our portfolio companies. Asking these questions elevates the importance of worker retention as central to company outlook, and should therefore raise its significance internally. Although a company's products or services might not directly address wealth inequality, management should view their companies as a microcosm for how a productive and equitable society could function, while still keeping an eye on the balance sheet. In doing so, companies may just end up rewarding their employees, their bottom line and their investors.

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