

THE EMPIRICAL FAILURES OF NEOLIBERALISM

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INTRODUCTION

Over the past several decades, an empirical revolution in economics has undermined many of the assumptions of the reigning approach to economic policy, which we refer to here as “neoliberalism.” This issue brief elevates five of the leading arguments made by advocates of neoliberalism and explores their theoretical claims. It then tracks these arguments against recent research by leading scholars of economic inequality to show how neoliberalism has failed to deliver increased growth, equality, or mobility.

There has been a significant amount of empirical work done since the financial crisis and Great Recession that pushes back on ideas that were, just 15 years ago, seen as common-sense among economic policymakers. This shift is important, and this paper looks to document some of the high-level changes in economic thinking, along with the work that best covers it. By elevating the leading empirics that turn neoliberalism’s theoretical claims on their head, we aim to energize a thoughtful reevaluation of the arguments and lay a foundation for a new set of economic policies that are capable of building a stronger, more inclusive economy and democracy by curbing the concentrated power in our economy and political system while also building on the strengths of government to directly address both the individual and collective challenges facing our nation (see Abernathy, Hamilton, and Morgan 2019).

In analyzing each argument, we focus on three elements. First, we explore how the data challenge neoliberal arguments. Next, we examine causation: to what extent can we assume that inequality slows growth, or that increased concentration leads to higher corporate profits, even if we know the trends are real? Finally, we begin to explore solutions, assessing how clear a path forward is and whether the contours of solutions are known and thought through.

We take the term “neoliberalism” for granted here, as it has been defined and debated at large in other forums. Though we try not to tie each argument to specific people, we believe that each of these ideas, in some form, has been hegemonic over the past several



decades. We also don't try to ascribe motivations or histories for why each became a central feature of economic decision-making. Whether it was a response to the 1970s, the influence of corporate decision-making and abstract economics, or simply the best way people could understand the world they were facing, doesn't matter here for evaluating their history against the record. Each of these theories has been brought into question not just by research but also by the lived experience of Americans.

GROWTH, INEQUALITY, AND MOBILITY

Advocates of deregulation promised both more efficient markets and economic growth (as measured by gross domestic product) that would “trickle down” to benefit the economy as a whole. Such an approach, they promised, would be like a rising tide that lifts all boats. Contrary to the theory, however, regressive policies, including lower tax rates for corporations and the already wealthy, deregulation, and privatization, have resulted in slower growth, greater income inequality, wage stagnation, and decreased labor market mobility.

A central argument among policymakers for nearly 50 years is that neoliberal policies, such as lower taxes on income and capital, deregulation of markets, and privatization of publicly provided services, would lead to greater growth (as measured by GDP). Further, policymakers have simultaneously argued the inverse: that government intervention in the economy will hold growth back. The overall idea was that even if benefits of light-touch policies accrued largely to the rich, the overall growth would benefit all workers and the economy at large through wage growth and increased mobility.

There were many foundations for these arguments. Conservative economists look to supply-side economics, which suggests that reducing taxes on capital and the rich lead to increased investment and growth. Others on the center-left were more concerned about increases in inequality while arguing that efforts to curb inequality reduce growth and inadvertently hurt the people that government seeks to help.

Rising inequality, however, has not created positive benefits—at least not for the majority of Americans. Leading research and analyses show that, while neoliberal policy increased inequality as expected, it also resulted in slower growth, greater income inequality, stagnant wage growth, and decreased labor market mobility.

Though supporters of neoliberalism tout stronger economic growth and greater efficiency, the US economy has not grown faster as promised. Starting in 1980—when neoliberal ideology was gaining momentum—the growth rate of the economy slowed. While the economy grew on average by 3.9 percent a year from 1950 to 1980, it has slowed to an average annual rate of 2.6 percent since 1980.



FIGURE 1
Annual GDP Growth

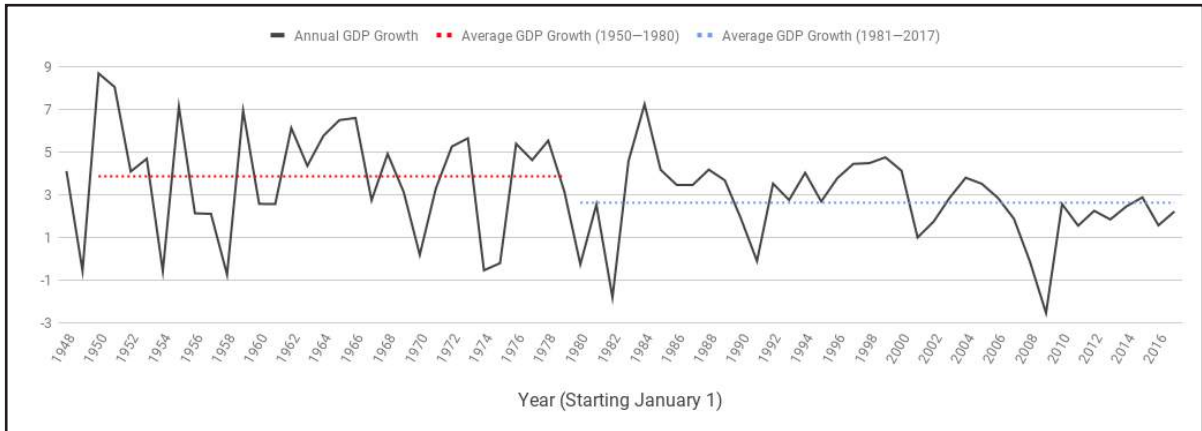


Figure 1 Source: BEA, Author's calculation.

Recent empirical analysis undermines the decades-old idea that there is a strict tradeoff between equality through redistribution and the efficiency of the economy as measured by GDP growth. The International Monetary Fund (IMF) finds not only that this tradeoff doesn't exist in practice, but that, if anything, the relationship is the opposite (Berg et al. 2014). In a cross-sectional analysis of countries over the past several decades, the IMF found that lower inequality (as measured after taxes and transfer of incomes) is correlated with faster and more durable growth. Higher levels of redistribution don't change growth, at least beyond the most extreme cases. There are many debates over these results, and cross-sectional aggregate data—as opposed to tougher controls and experiments—can only tell us so much. It is significant, though, that researchers are not finding proof that redistribution hurts growth—which goes against the neoliberal case.

FIGURE 2
Top 1% Income Share

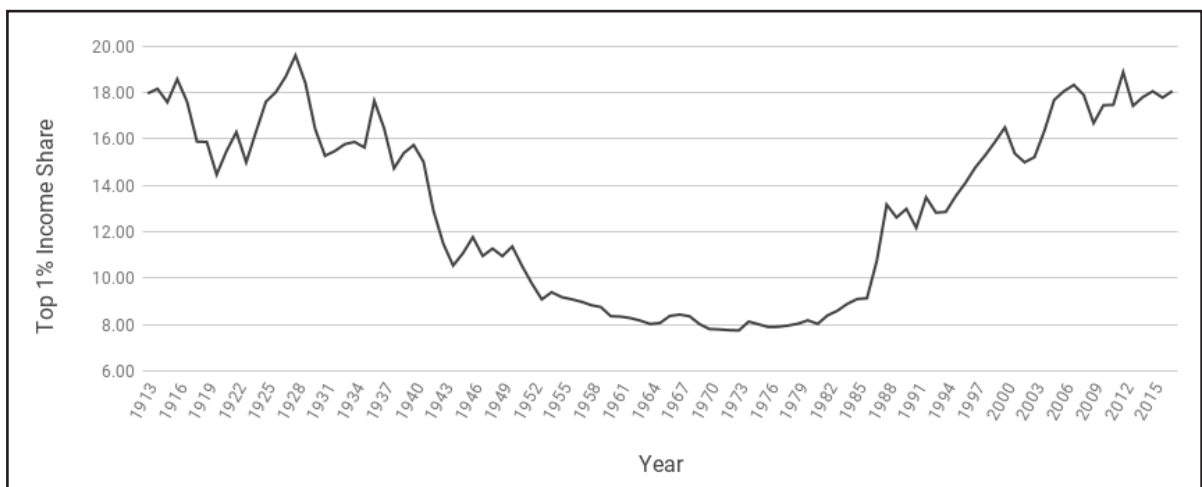


Figure 2 Source: Saez/Piketty.



The deregulatory agenda failed to spur economic growth, but it did grow inequality. Notably, income inequality has risen since the introduction of neoliberal economic policies. Research from Emmanuel Saez and Thomas Piketty shows that the top 1 percent's share of income went from 8 percent of total income in 1979 to 18 percent in 2017.

This inequality has proceeded along two lines. From the 1980s to the late 1990s, this was primarily driven by inequality within labor income (i.e., income from wages). One can picture a superstar CEO as an example of this. But from 2000 to now, this happened along capital income (i.e., income generated from assets); the share of income paid to labor fell from 85.3 percent in 1980 to 78.5 percent in 2011. These findings show that inequality has not only persisted but has spread across the types of income that people receive, be it wages or capital earnings (Piketty, Saez, and Gabriel Zucman 2017).

The Neoliberal era has also seen slower wage growth, which diverged from overall economic growth and productivity growth since 1980. A widely circulated graphic, most prominently put forward by the Economic Policy Institute, captures that broken link between wages and productivity. Three wedges have fueled this divergence: inequality within labor income, increases in the capital share, and the inflation measure between the prices that workers face and the prices that businesses face (Bivens and Mishel 2015). Though the economy has grown since 1980, hourly wages for most workers have increased a mere 0.6 percent per year on average after adjusting for inflation. Between 2000 and 2017, the median family income increased by just under 5 percent.

Little to no improvement in relative mobility—the ability of people to rise up and down the economic ladder at a faster clip—may be the most important indictment of the deregulatory agenda. Using the ladder as analogy, if the distance between the rungs of a ladder are increasing, the ability of people to climb the ladder needs to increase. In a dynamic economy, the rich could more easily see their incomes fall, and the poor and middle class could more easily climb up the economic ladder. Today, however, the US ranks poorly on economic mobility among advanced economy countries. Over 10 years, starting in 1994, more than 93 percent of people starting out at the bottom 20 percent of income did not rise to more than the middle-income group. In comparison, 80 percent of those starting out in the top income group remained in the top or second to top after 10 years (Stiglitz 2015).

Rates of relative mobility have gotten worse. Research shows that the rate of mobility has declined from the mid-century period, and unsurprisingly, the greater inequality experienced in the US since 1980 seems to have decreased economic opportunity. What progress America achieved in improving income mobility has stopped, and the country has become more socially rigid. Economist Nathaniel Hilger found sizable improvements in intergenerational mobility in cohorts born between 1940 and 1980—a period of significant



gains for social justice, including the expansion of education and important civil rights victories. This is also the period that saw the strongest declines in inequality. Since then, the rate of relative mobility has flattened, exacerbating negative economic consequences in a period of higher inequality (Hilger 2015).

Even worse, *absolute* income mobility has also fallen. Closely tied to ideas of “the American Dream,” this data point measures whether children are better off than their parents were. According to research led by Raj Chetty, 90 percent of children born in 1940 would go on to earn more than their parents. This number falls to 50 percent for children born in the 1980s. This decline in upwardly mobility is not simply a byproduct of declining growth; even if GDP growth rates increased to mid-century levels, this would still not restore former rates of absolute mobility. Shifting the *distribution* of growth, however, would increase absolute mobility. The researchers find that if you saw growth along the more broadly distributed prosperity of the mid-century period, you would stop more than 70 percent of the decline in absolute mobility (Chetty et al. 2017).

WAGES AND HUMAN CAPITAL

A marketized approach to labor policy argues that investment in human capital—i.e., education and “upskilling”—is the solution for economic inequality. In other words, if workers want higher wages, they can increase and adapt their skills, education, and ability to work in the marketplace. Therefore, the theory views inequality as an individual problem best solved by individualized solutions rather than as a structural problem to be solved by policies that redefine economic outcomes. It is clear that skill and education gaps do not sufficiently explain economic inequality—nor do more skills and education solve for it. Notably, research shows that unequal access to education is a result of inequality as much as a driver of it.

A common argument among policymakers over the last 50 years has been that individuals must invest in their own education and skills development to earn higher wages. Proponents argue that workers facing stagnating wages must have inadequate skills and education for the job market. Few would disagree with the idea that education is important. Recent research, however, challenges this human capital argument. More and more analyses point to structural reasons for how wages are determined, which runs counter to the story of individual failures.

First, the US education system reproduces inequality just as much, if not more, than it corrects it. The quality of education one receives is closely tied to the socioeconomic status and education of their parents. The development that occurs during the early stages



of life is much more unequal and has lifelong consequences for an individual's cognitive development and economic success. Beyond this, the wage premium for having a college education, though significant, stalled in the early 2000s and has not increased since. Moreover, the premium comes largely from high-end degrees and graduate education, which are farther out of reach for those with no college degree.

There are additional reasons to believe that the story of human capital doesn't explain inequality. First, as David Card and others found, much of the economic inequality we see today is not between skilled and unskilled workers but instead from those who work at very profitable firms versus less profitable ones. These "superfirms" point to a serious problem in viewing wages as a market of workers selling their skills into a wide market of indistinguishable employers buying them—a key component of human capital theory. If labor markets are characterized less by premiums commanded for skills and more by premiums attached to profitable firms, profits often generated by supra-market rents, more skills won't translate into higher wages (Card et al. 2018).

The skills story functions more as a sorting mechanism within the smaller pool of jobs that exist rather than realistically reflecting the productivity frontier at maximum output.

Second, the skills story is difficult to defend when the economy is operating below full employment. Individuals can't solve collective problems of decreased demand and the inability of the market to self-correct, especially in a period of very low interest rates. The overall share of the prime-age population at work—a broader measure of labor market activity than the unemployment rate—remains just below the pre-recession level and two points below the pre-2000 recession level. The skills story functions more as a sorting mechanism within the smaller pool of jobs that exist rather than realistically reflecting the productivity frontier at maximum output.

Third, where we have seen a reduction in poverty, it has come from government action, not from education. The earned income tax credit (EITC) and minimum wage, for example, are the systematic levers that raised wages for lower-wage workers—not skills. In 1967, the poverty rate was 27 percent without tax credits and benefits. That number is 29 percent now, but it is 16 percent when tax credits and benefits are applied. The EITC has pulled many people out of poverty. Yet, by only helping people working at any point, the structure of the EITC has exacerbated deep poverty. Just as inequality has increased between the



rich and the poor, it has increased between the very poor and slightly poor; though overall poverty has decreased, deep poverty—measured by those below 50 percent of the poverty line—rose from 4.5 percent in 1984 and 1993 to 6.6 percent in 2004 (Ben-Shalom, Moffitt and Scholz 2011). At the same time, more research has shown that the minimum wage is an important determinant of inequality between the 10th and 50th percentile, particularly among men. The fact that the bottom of the income distribution, where the most vulnerable Americans reside, is so sensitive to government policy choices weakens the idea that human capital is the major determinant of the income distribution.

FIGURE 3

Top Rates vs. Top Share Across Countries

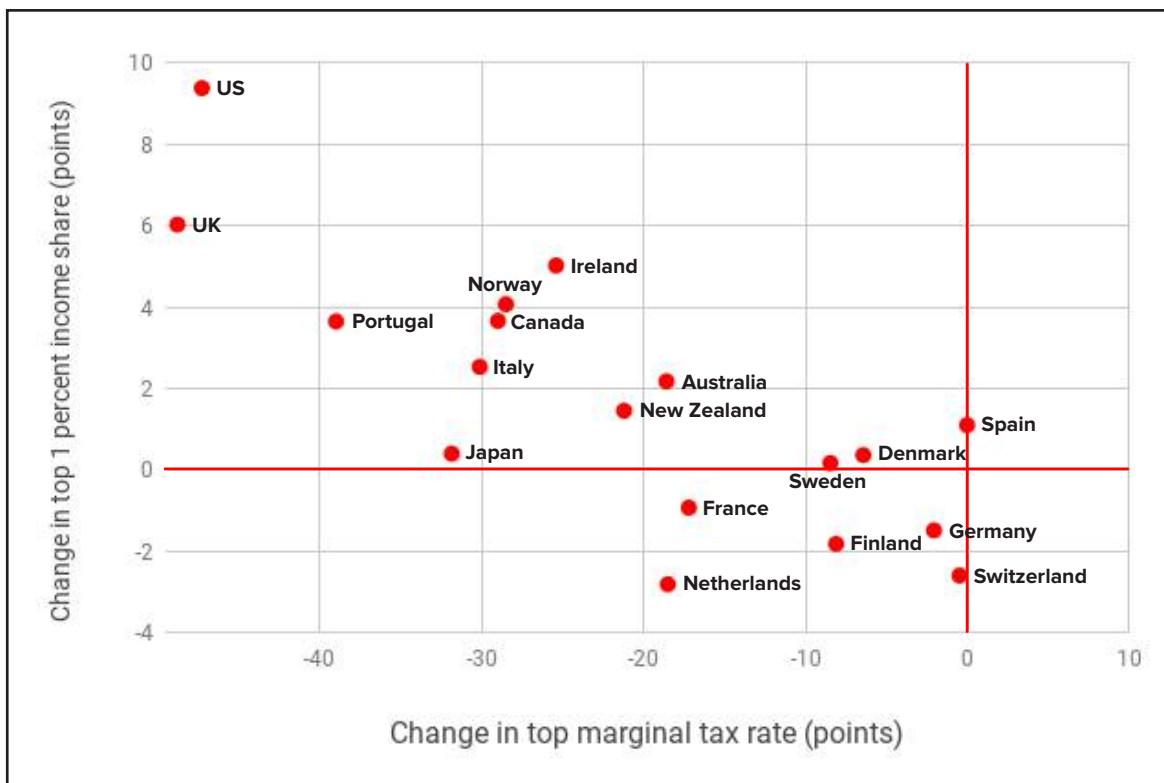


Figure 3 Source: Thomas Piketty, Emmanuel Saez and Stefanie Stantcheva | *Optimal Taxation of Top Labor Incomes: A Tale of Three Elasticities*.

Fourth, we see evidence that institutional rules and structural conditions (e.g., taxes and labor conditions) increasingly determine wage levels—not individual efforts such as skill investment, as human capital theory posits. According to research from Emmanuel Saez, Thomas Piketty, and Stefanie Stantcheva, high marginal tax rates are negatively related to top income shares, with countries that saw larger declines in top marginal income tax rates having a larger increase in top incomes. As the most extreme example, the US saw around



a 45 percent decline in the top marginal tax rate since 1960 and around a 10 percent gain in the top 1 percent income share over that period. Most other developed nations fall along this line. It was always a stretch to say that the top 1 percent simply had better skills than those in the bottom 2 percent, who saw no such gains in incomes. In reality, high marginal tax rates help prevent the looting of businesses and other extractive activities that are largely designed to benefit those at the top (Piketty, Saez, and Stantcheva 2014).

New research by Henry Farber, Daniel Herbst, Ilyana Kuziemko, and Suresh Naidu also quantifies the importance of unionization to the wage growth of the mid-century period. Surprisingly, many economists had doubts about unionization and wages, assuming that unionization largely benefited workers already likely to make more money. Using new data, the researchers find that people of color benefited the most from unionization in the 1960s, with the union-wage premium being five times larger for workers of color than white workers. The researchers argue that if we had the 30 percent unionization rate from 1955, the growth in the top 10 percent income share would have been reduced by 50 percent (Farber, Herbst, Kuziemko and Naidu 2018).

MARKETS AND RACIAL INEQUALITY

Advocates of deregulation promised that markets—unconstrained by government—would reduce discrimination and racism. As the theory goes, in free, competitive labor markets, discrimination would be competed away. Therefore, any racialized inequality is the result of individual choices and a lack of personal ambition, which can be solved by taking more “personal responsibility” for individual economic status and well-being.

According to a theory promoted by Gary Becker, unbiased employers, consumers, and/or producers would have a competitive advantage by employing, buying from, or selling to people of color and women. Eventually, market competition would close the wage and wealth gaps. This assumption, along with the assumption that wages represent human capital, implies that any racial inequality persists due to individual choices: individual failings like lack of skill, education, or effort, or individual discrimination on the part of an employer or consumer. Recent research by leading thinkers studying racial inequality has exposed the shortcomings of this theory by analyzing data on employment, income, and wealth disparities for people of color. At every level of education, people of color experience higher rates of unemployment, are paid less than their white counterparts, have fewer assets than their white counterparts, and accrue less wealth.

The myth is debunked particularly by examining one metric of inequality: wealth. At every level of income and educational attainment, white households have more wealth than



Black and Latinx households (Darity et al. 2015). Additionally, Black households headed by someone with a full-time job have less wealth than white households headed by an unemployed person, and Black households headed by a college graduate have less wealth than white households headed by someone without a high school degree.

Hard work and skills have proven insufficient to close this gap. A study by Prosperity Now and the Institute for Policy Studies found that white middle-income households own nearly eight times as much wealth as Black middle-income earners and 10 times as much as Latinx earners (Collins et al. 2017). If these trends continue, it would take 228 years for the average Black family to reach the same level of wealth that white families have today, and it would take 84 years for a Latinx family. The study also found that Black and Latinx families have seen their wealth fall considerably from \$6,800 and \$4,000, respectively, in 1983 to \$1,700 and \$2,000 in 2013.

The policy regime of the last 50 years had similarly ineffective results in reducing unequal outcomes in labor markets. Contradicting Becker's theory, people of color still experience starkly higher unemployment rates than white Americans. Historically, Black and Latinx unemployment rates have been, and remain, about twice as high as those for white Americans. Black unemployment today averages 6 percent, compared to an average of 3 percent for white Americans (Pettit 2013).

Studies show that these racial disparities also show up in wages. Black men earn 73 cents on the dollar compared to white men (Miller, Vagins, Hedgepeth, and Nielson 2018). Women of color face layered levels of economic obstacles, including gender pay gaps. When compared with white men, white women earn 76 cents on the dollar, but Black women earn 62 cents on the dollar, Latinx women earn 54 percent, and Native American women earn 58 percent (Flynn 2017).

Furthermore, researchers have identified a number of mechanisms that perpetuate these gaps. Studies show that employers discriminate by not interviewing workers with nonwhite-sounding names and by channeling people of color and women into lower-wage jobs (Bertrand, Mullainathan 2004; Pager, Western and Bonikowski 2009). Researchers have also documented the link between industry-level compensation and employment levels of white men. In "feminized" industries like nursing or care work, for example, even white men earn less than similarly skilled white men in other fields.

Notably, most researchers identify a web of structures—not individual choices—as the primary drivers of labor market inequality. Such structural factors include geographic segregation, wealth inequality, unequal access to justice and public services including schools, along with historical inequalities compounded over generations (Flynn, Warren,



Wong and Holmberg 2017).

In the context of structural racism, the human capital story and push toward upskilling as a path to prosperity has actually increased inequality. As a discriminatory labor market requires workers of color to have more education for the same pay as white workers, the burden of student debt is compounded for borrowers of color (Margetta Morgan and Steinbaum 2018). Black and Latinx borrowers, for instance, are far more likely to fall behind on their loan payments (Board of Governors of the Federal Reserve System 2018). In fact, within 12 years of entering school, half of Black students default on a student loan, and Black borrowers on average owe 113 percent of their original balance at the 12-year mark.

THE FINANCIAL SECTOR AND ECONOMIC GROWTH

For nearly half a century, neoliberals have argued that deregulation of the financial sector would lead to a more efficient—i.e., less rent-seeking—and resilient financial sector. Instead, we got higher financial profits, more extraction, and the 2008 financial crisis.

One substantial policy agenda of the last several decades has been the “freeing” of the financial sector. Neoliberals have argued that releasing the financial sector from regulatory constraints would lead to lower capital costs, increased access to financial services, and a more resilient system. They claimed that outdated regulations were no longer necessary except in extreme cases, and that one-size-fits-all regulations held back the financial sector’s ability to invest in productive enterprises. They also promoted the story that the industry was best suited to regulate its activities, as opposed to a government agency, which was subject to regulatory capture and ill-equipped to predict and oversee the financial sector’s operations.

As a result, starting in the early 1980s and through the 2008 financial crisis, financial regulations were scaled back, repealed outright, or otherwise not extended or even enforced. It’s easy to look at the financial crisis and conclude that this process went too far, created too much room for instability, and needs reform. But the problems are actually broader and more interesting than that.



FIGURE 4

Growth of the Financial Sector

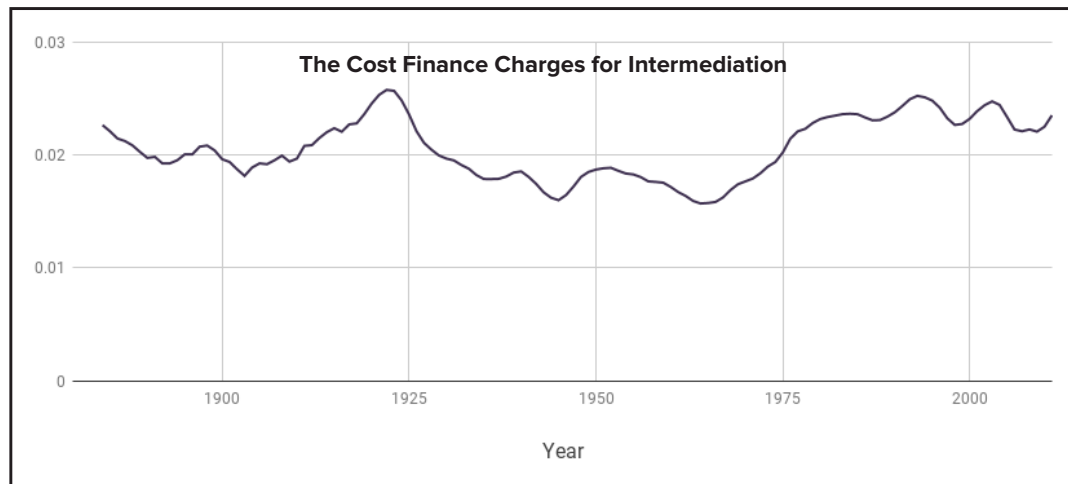


Figure 4 Source: Thomas Philippon.

Since 1980, the financial sector has become larger and more profitable. The size of the financial sector peaked around 7.6 percent of GDP at the height of the housing bubble and, after a brief decline, returned to 7.3 percent in 2014. In addition to becoming larger, the sector has also become more profitable, as evidenced by an increased contribution to total corporate profits. Financial sector profits grew from less than 10 percent of total corporate profits in 1950 to nearly 30 percent of total corporate profits in 2013. Much of this growth is from activities that should concern us all: increased trading activities rife with conflicts of interest and risky bets, unregulated shadow banking, and an explosion of household credit from 48 percent of GDP in 1980 to 99 percent of GDP in 2007.

Despite these profit gains, however, the financial sector also grew less efficient over the past 40 years. Reduced financial regulation, improved information technology, innovative financial securities, and hedging products have failed to lower the per-unit cost of financial intermediation (the total income of finance divided by the amount of financial assets). According to analysis by economist Thomas Philippon, the unit cost of finance has fluctuated between 1.5 percent and 2 percent throughout the past 130 years, and it has actually increased since the 1970s. Even with technical adjustments for the quality of the loans, the unit cost of finance is about as high as it was in 1900, which means that there have been no efficiency gains in the financial sector. If anything, there have been efficiency losses since the 1970s (Philippon 2015).

Another important aspect of the growth of the financial sector has been the growth of shareholder primacy as a guiding view and practice for corporate America (Palladino 2018). This ideology isn't just reflected in boardrooms and business schools; it guides

the law, courts, and regulatory environment as well. Many are concerned about the rise of shareholder primacy. One body of work focuses on the idea that shareholder pressure may reduce investment below a socially optimal level, as shareholders have too high of a risk premium (or, alternatively, demand too much in returns), and this in turn hampers investment and growth. This “short-termism” has become a concern for American businesses. An alternative worry is that asset-management firms are too large and concentrated. By consolidating shareholder ownership among a handful of firms, there’s an oligopolistic pressure to reduce investment and de facto collude.

A functioning financial sector is essential to economic development and growth. However, a new line of research argues that beyond a certain size, the financial markets don’t help, and perhaps even hurt, economic growth. Stephen Cecchetti and Enisse Kharroubi of the Bank for International Settlement analyzed 50 countries from 1980 to 2007 and concluded that a financial sector sized up to about 90 percent of GDP is associated with positive productivity growth. Beyond that level, they identify a causal relationship between financial sector employment and slower growth. They also argue that finance disproportionately benefits projects with low productivity and takes skilled workers away from other industries. The prestige and profitability of Wall Street may be attracting talent and skills better suited for research and entrepreneurship (Cecchetti and Kharroubi 2012).

ANTITRUST AND GROWTH

Neoliberal doctrine led policymakers, regulators, and courts to believe that the relaxation of antitrust enforcement increases competition and innovation within and across markets. Any possible rents, the theory went, would be competed away by new businesses. As researchers have shown, though, the evidence proves otherwise.

During the 1970s and ‘80s, antitrust regulators adopted a set of economic assumptions suggesting that the exercise of unfair advantage in markets was rarely profitable over the long term and that new entrants would identify inefficiencies and outcompete incumbents. The assumptions narrowed the scope of antitrust enforcement for both regulators and courts, reducing scrutiny for mergers, permitting previously highly scrutinized tactics like vertical integration. Not only did this ideological shift narrow the scope of enforcement, but it was also during this time that the burden of proof was placed onto the aggrieved parties who came before the courts.

Nearly 50 years later, consolidation across industries has burgeoned. Additionally, several indicators suggest that increased market power is reducing productive economic activity. From 1985 to 2017, the number of mergers completed annually rose from 2,308 to 15,361,



as summarized by economist Marshall Steinbaum. Concentration has increased in an estimated 75 percent of industries from 1997 to 2012, and the rate of new business startups has fallen. In turn, this has shifted the age curve of businesses further out, with firms over 11 years old accounting for 70 percent of workers in 2000 raising to 75 percent of workers in 2014. At the same time, labor market dynamism has fallen, with workers less likely—or able—to quit and relocate to a new job over the past two decades (Abdela and Steinbaum 2018).

FIGURE 5

Tobin’s Q for the S&P 500

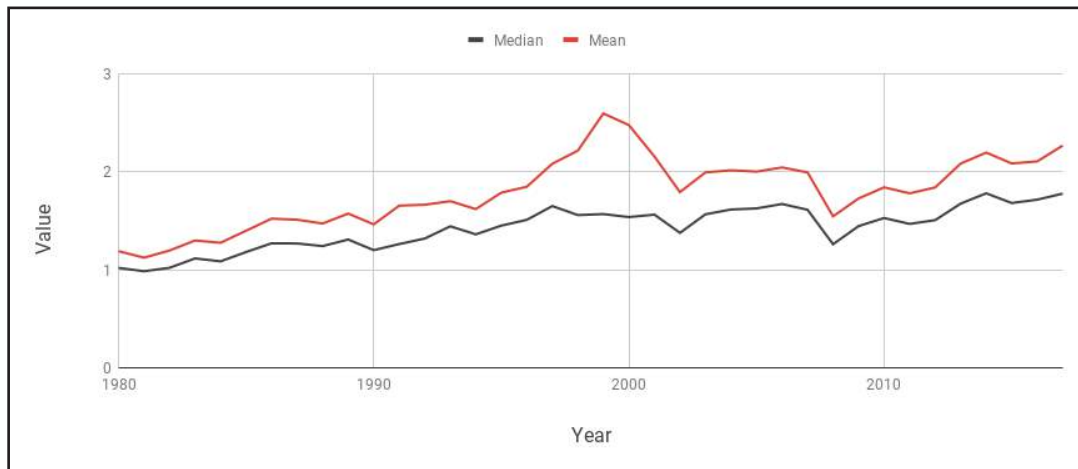


Figure 5 Source: Compustat, Author’s Calculations.

A growing body of work identifies the links between concentration or market power and declining capital investment. The valuation of equity over the book value of the firm itself, known as “Tobin’s Q” in financial literature, has doubled since 1980. If Tobin’s Q gets too high, competition and investment should bring it down. A Tobin’s Q greater than one implies that a firm is more profitable than its investment and assets and should therefore invest more. If it doesn’t, someone else should come in and invest in a similar way to drive down those profits. This hasn’t happened, which is shown by the fact that this value has consistently increased in recent decades.

Even as real interest rates have fallen dramatically, firms remain profitable. The rates of return for firms should be a combination of interest rates and risk factors specific to their business. So, if interest rates fall, rates of return should fall as well. Yet this hasn’t happened. As Gauti Eggertsson has found, there’s been a decrease in the real rate of interest, which has fallen by roughly half since 1980. During this time, however, the measured average return on capital has remained relatively constant. Normally, investments would pick up to make up the difference; firms would expand their businesses to take advantage of the high

profits, and other firms would rush in to compete away those rents. Yet here too, investment remains low as a percentage of profitability. Together, all of these factors—high profits, low interest rates, and weak investment—point to a significant market power problem that jeopardizes the macroeconomy (Eggertsson, Robbins, and Wold 2018).

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CONCLUSION

Over the past decade, significant research has been done on the state of the economy. The boldest and most important work, grounded in strong empirical evidence, shows that many of the guiding assumptions underlying economic policymaking for the last five decades no longer speak to what is going on in the economy or our country more broadly. This disconnect extends across a wide range of policy domains—from regulation of finance to higher education. The task now is to flesh out policy alternatives and examine how these new, bold policies would be best carried out—an endeavor that requires a new framework for how we examine the economy. Though this will be difficult, we can move forward knowing that the status quo is not working and that we have the best available evidence to support this fact.



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