Institute for governance
of private and public organizations

Inequality and executive compensation: Why Thomas Piketty is wrong?*

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*The opinions expressed in this text are the authors' alone.

Toward Value-Creating Governance™

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Executive summary

A group of economists, among whom the French economist Thomas Piketty, produced a massive amount of data and statistics documenting the level and rise of economic inequality over long periods of time and across several countries.

Making use of this information, Piketty wrote a book, which became the darling of the American, even global, left: ***Capital in the Twenty-First Century***. The book paints a vivid picture of rising inequalities and predicts the inevitable concentration of wealth if States do not adopt radical measures.

In particular, Piketty and his colleagues point to the growth in inequalities in "Anglo-Saxon" countries (especially the United States and Great Britain) due, according to them, to enormous increases in "salary" paid to executives of corporations listed on stock exchanges.

According to Mr. Piketty, this phenomenon stems from the fact that, given current governance practices, executives essentially set their own "salary". As result of the evolution in "social standards" since the Reagan and Thatcher era, American and British corporate executives, asserts Piketty, get lavish compensation without facing opprobrium and social push-back.

The corrective measures proposed by Thomas Piketty are dramatic but politically unrealistic: increase in the marginal tax rate to 80% and a global tax on capital.
Indeed, most of the executive compensation in the form of options or stocks is taxable at the rate applicable to capital gains (15% in the United States) and not at the rate applicable to employment income. As well, the humongous income of hedge fund managers and private equity fund managers, usually defined as «carried interest» is thus shielded from the personal income tax rates. A significant increase in the tax rate on capital gains (not proposed by Piketty) would have a negative effect on investments and economic growth.

Piketty also proposes a global tax on capital. This proposal, which entails an Orwellian process of disclosure and estimation of assets by all individuals, as well as a transnational sharing of the information thereby collected, has only an infinitesimal probability of being adopted.

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Piketty and his colleagues therefore propose two measures, one based on a poor understanding of the dynamics of executive compensation and of changes in the financial industry, and the other on a program that is doomed from the start. However, it is possible to take concrete and effective action to have a clear and significant impact on economic inequality.

Here are ten policy proposals that are within the reach of governments or corporate boards.

I. Introduction

In a position paper published in 2012, IGOPP asserted that the high levels of compensation paid to corporate executives could potentially create issues of social legitimacy for publicly listed corporations. *If boards of directors are to fully discharge their legal duty of acting in the long-term interest of the company, they must be concerned by the impact of large, controversial compensation on the social legitimacy of private business enterprises.* ("*Pay for Value*", IGOPP, 2012)

Now, the topic of executive compensation has become a recurring media «scandal» and a thorn for the board of directors of most corporations. Regardless of the arguments that are put forward to explain and justify the considerable sums paid to executives, the egregious disparity between the incomes in society and within the business firms makes this issue, at best, a rallying cry for those who want a fairer society and, at worst, a platform for demagogues.

True, disparities of income and wealth are inevitable in a meritocracy; true, the benefits of a market economy are indissociable from a certain degree of inequality in the sharing of the wealth, but this is not the issue.

The issue – the malaise – stems from the ***level*** of the inequalities and from the ***source*** of the wealth. Beyond a certain threshold, every society becomes uncomfortable with, and even hostile to, the fortune of a minority. This threshold tends to vary considerably across countries and across societies. This hostility is enhanced by the perception, the impression that such wealth has not been honestly earned, that it is not the result of an activity which benefits the whole society.

This is why the fortune of entrepreneurs, innovators, and the creators of large businesses arouses less hostility. The same is true of sports or film celebrities. On the

other hand, the lavish compensation reaped by financial speculators, traders and other financial magicians is viewed with great suspicion and animosity.

In fact, the financial crisis of 2008 revealed not only that the compensation of the people responsible for this fiasco was one of the causes thereof, but also that these people were paid enormous sums for activities of little social value. Despite its short lifespan, the *Occupy Wall Street* movement did raise awareness of the wealth of the privileged 1% of American society.

The issue had been framed; the passion was high for a while, but it then faded away, until recently.

A group of economists, among whom the French economist Thomas Piketty produced a massive amount of data and statistics documenting the level and rise of economic inequality over long periods of time and acros several countries.

Making use of this information, Piketty wrote a book, which became the darling of the American, even global, left: ***Capital in the Twenty-First Century.*** The book paints a vivid picture of rising inequalities and predicts the inevitable concentration of wealth if States do not adopt radical measures.

In particular, Piketty and his colleagues point to the strong growth in inequalities in "Anglo-Saxon" countries (especially the United States and Great Britain) due, according to them, to enormous increases in "salary" paid to executives of corporations listed on stock exchanges.

According to Mr. Piketty, this phenomenon stems from the fact that, given current governance practices, executives essentially set their own "salary". As result of the evolution in "social standards" since the Reagan and Thatcher era, American and

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British corporate executives get lavish compensation without facing opprobrium and social push-back.

Are Piketty *et al* right, and, if so, can the same be said of Canada and Quebec?

Three forms of economic inequality

To understand the phenomenon of economic inequality, one must distinguish between three forms of inequality:

1. Unequal distribution of income;
2. Unequal distribution of wealth (or patrimony);
3. Unequal intergenerational social mobility.

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II. Inequality of income

The calculation of income inequalities raises numerous definitional and measurement problems, particularly when one wishes to make comparisons between countries. (See the appendix to this text[1]).

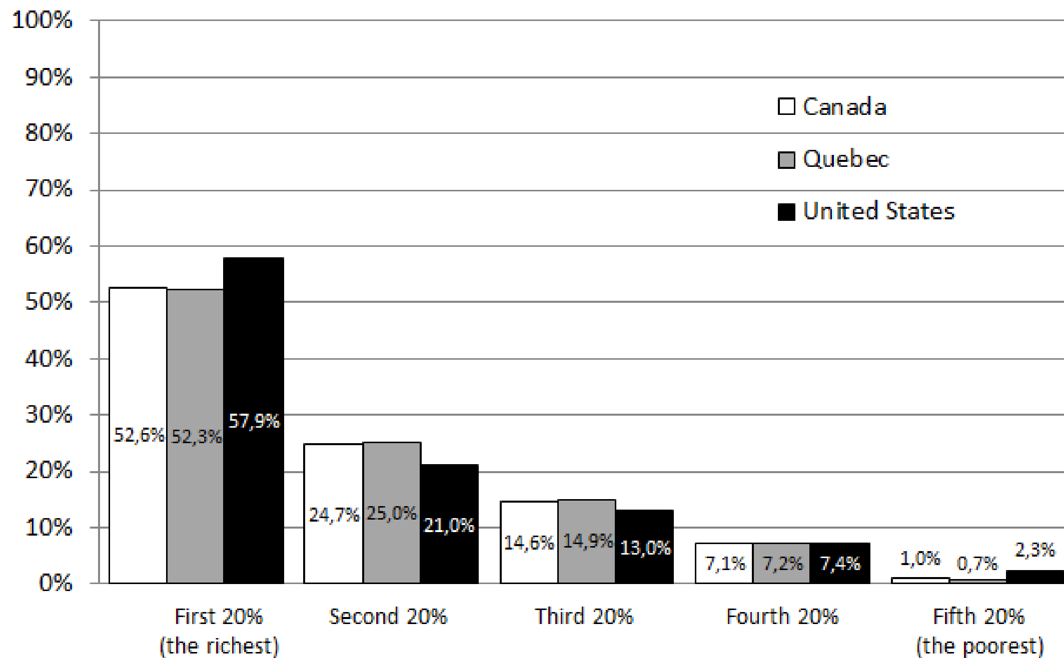
Thus, a comparison of the gross income (i.e. before taxes and government transfers) of families (Quebec, Canada) and households (United States) yields the following result (Table 1).

On this basis, income distribution in the U.S. is somewhat more unequal than that observed in Canada and Quebec.

[1] On reading the multiple differences between the U.S. and Canadian compilations for recent years, one easily understands the extent to which the undertaking by Piketty and his colleagues was hazardous and subject to caution. The debate sparked by errors in the figures and questionable assumptions that were identified by the ***Financial Times*** is hardly surprising, but does not ultimately call into question the general conclusions of Piketty and his colleagues.

TABLE 1

Income Distribution (Gross) per Population Quintile: Percentage of Total Income Received by each 20% Group (2010)



_Source of Canadian data: Statistics Canada, CANSIM Table 202-0701

_Source of U.S. data: Congressional Budget Office, The Distribution of Household Income and Federal Taxes, 2010. December 2013.

However, this distribution of gross (or market) income, which is often used to assess inequalities, gives a misleading impression, as is shown in Table 2 for the United States.

One notes in this table that the top quintile, before taxes and social transfers, has a share of income 25 times higher than the lowest quintile (57.9/2.3) whereas, after adjustments for taxes and social programs, this ratio falls to about 5:1 (47.2/9.3). From this point forward, we will often use statistics for income *after taxes and transfers*.

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TABLE 2
Share of Income, Transfers and Taxes per Income Quintile, United States (2010)

Income adjustments	Income Quintiles				
	Lowest	Second	Middle	Fourth	Highest
Market (or gross) income	2.3	7.4	13.0	21.0	57.9
Social Security and Medicare	36.2	22.1	16.7	11.7	11.4
Other Transfers	47.0	22.8	13.3	8.8	6.2
Federal Taxes	0	2.8	9.2	18.4	69.3
Income after taxes and transfers	9.3	11.0	14.3	19.8	47.2

_*Source: Congressional Budget Office, "The Distribution of Household Income and Federal Taxes", 2010. December 2013.*

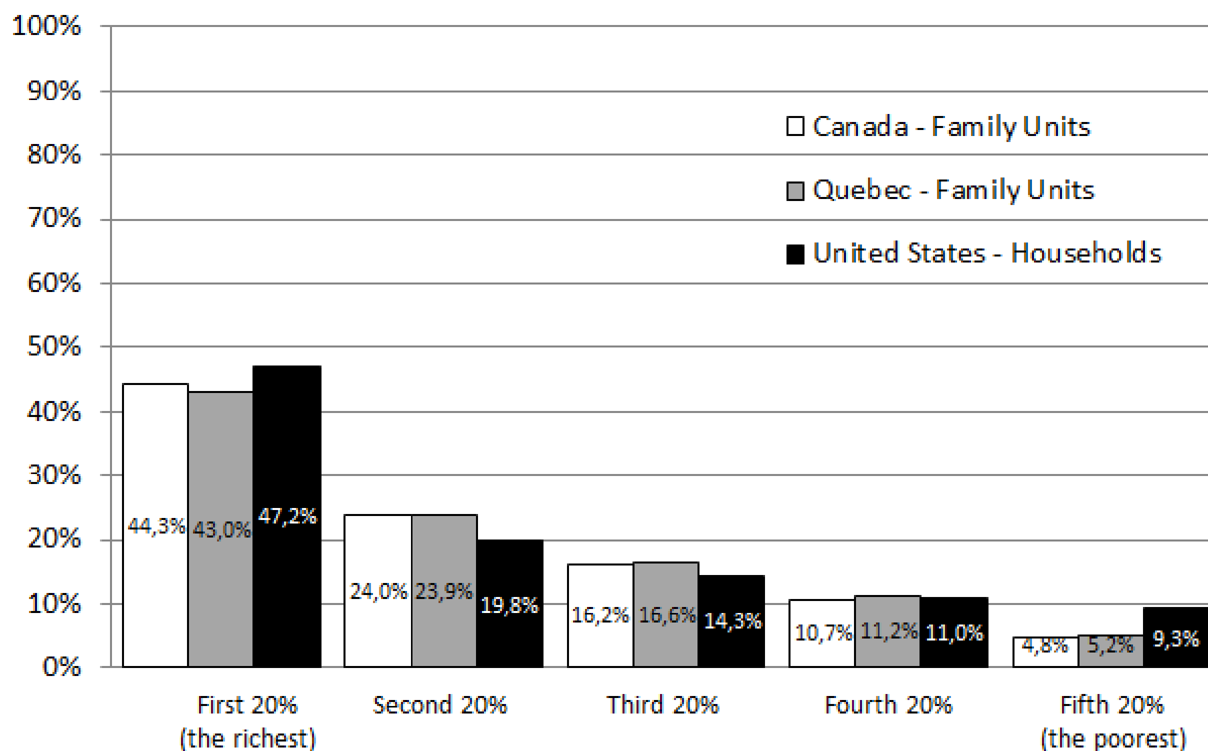
How, therefore, do the United States, Canada and Quebec compare in terms of the equalities of family and household incomes *after taxes and transfers.* Table 3 shows that the inequality is relatively higher in the United States, but lessened by the different manner of determining quintiles in the United States.[2]

One also notes that the income share of the first quintile, which was 52.3% in Quebec according to Table 1, becomes 43% when taxes and social transfers are taken into account.

[2] This inequality would be even more reduced if one could correct for the fact that the quintiles in the American distribution are determined on the basis of the distribution of income *before taxes and transfers* while the quintiles for the Canadian (and therefore Quebec) distribution are determined on the basis of the income *after taxes and transfers*.

TABLE 3

Distribution of Income Share after Taxes and Transfers (2010)



_ *Source of Canadian data: Statistics Canada, CANSIM Table 202-0703*

_ *Source of U.S. data: Congressional Budget Office: Congressional Budget Office, The Distribution of Household Income and Federal Taxes, 2010. December 2013.*

The relatively higher income share received by the fifth U.S. quintile is explained by the fact that the state-subsidized medical services (*Medicare* - elderly persons; *Medicaid* - people with low income) are accounted for as social transfers and added to the income of U.S. households. Since the Canadian/Quebecois health-care system is universal, the value of the medical services is not added to family incomes.

This table does certainly show an unequal distribution of net income, but the difference is less dramatic than shown by other ways of assessing these inequalities.

Top of the income pyramid

In fact, the greatest stakes in income inequality are played out at the top of the income pyramid, i.e. the top 1% or even 0.1%. Table 4 clearly reveals the scope of the phenomenon and shows the disparity at the top of the income pyramid in Canada and Quebec as compared with the United States.

TABLE 4
Share of Total Income after Taxes and Transfers (2010)

	Top 1% income group	Top 5% income group	Top 10% income group
Quebec	7.2%	18.4%	28.6%
Canada	8.6%	20.5%	31.3%
United States	14.9%	27.4%	37.3%

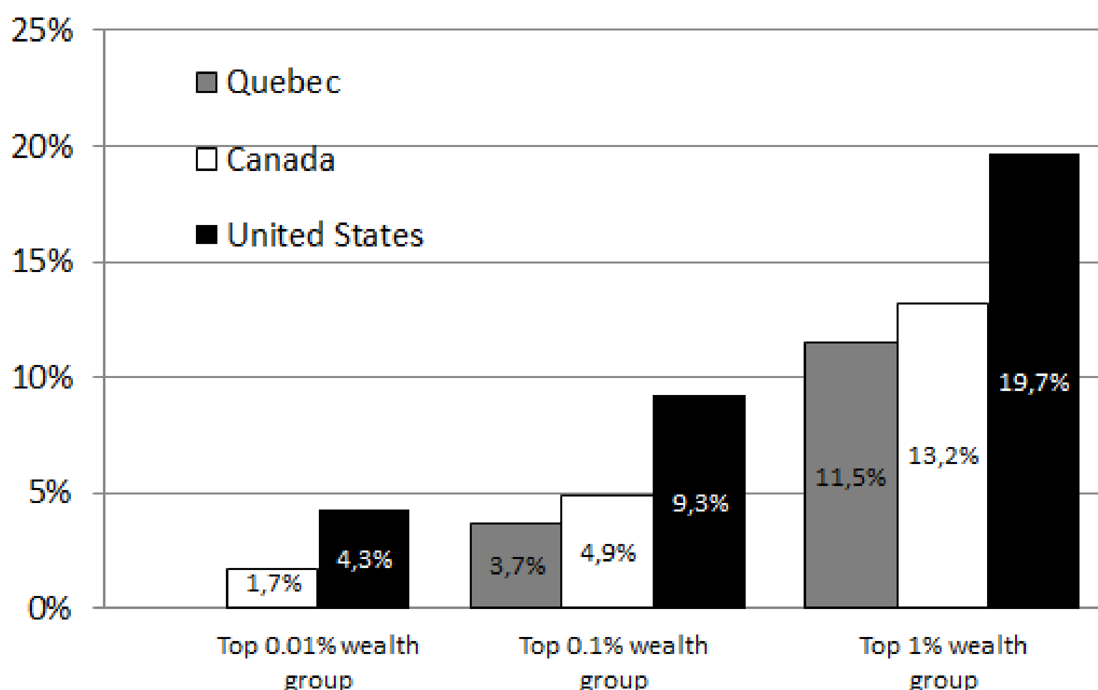
_Sources: Statistics Canada, CANSIM Tables 204-0001 and 204-0002; Congressional Budget Office, *The Distribution of Household Income and Federal Taxes, 2010*. December 2013.

Thus, the total income share captured by the top 1% in the U.S. is more than twice that of the top 1% in Quebec.

If one considers the distribution of gross income more finely by adding capital gains, the result is shown in Table 5.

TABLE 5

Share of Gross Income *including Capital Gains*, by Group (2011)



_Sources: Statistics Canada, CANSIM Tables 204-0001 and 204-0002; Saez & Piketty, The World Top Incomes Database

Here again, Quebec is clearly different from Canada and very strongly different from the United States. The group representing the top 0.1% of incomes captures only 3.7% of total income in Quebec, while this group represents 4.9% in Canada and 9.3% in the United States.

It should be noted that the income threshold for inclusion in the 1% or 0.1% group strongly varies by province, as shown in Table 6. Thus, in 2011, a net income of $133,300 was sufficient to join the top 1% in Quebec, while the income threshold for the same group was $229,400 in Alberta.

For the 0.01% group, the difference in the threshold is even greater: $416,200 in Quebec compared to $933,500 in Alberta and $617,100 in Ontario.

TABLE 6

Income Threshold (after Taxes, Transfers and Capital Gains) for Inclusion in Top Income Groups (2011)

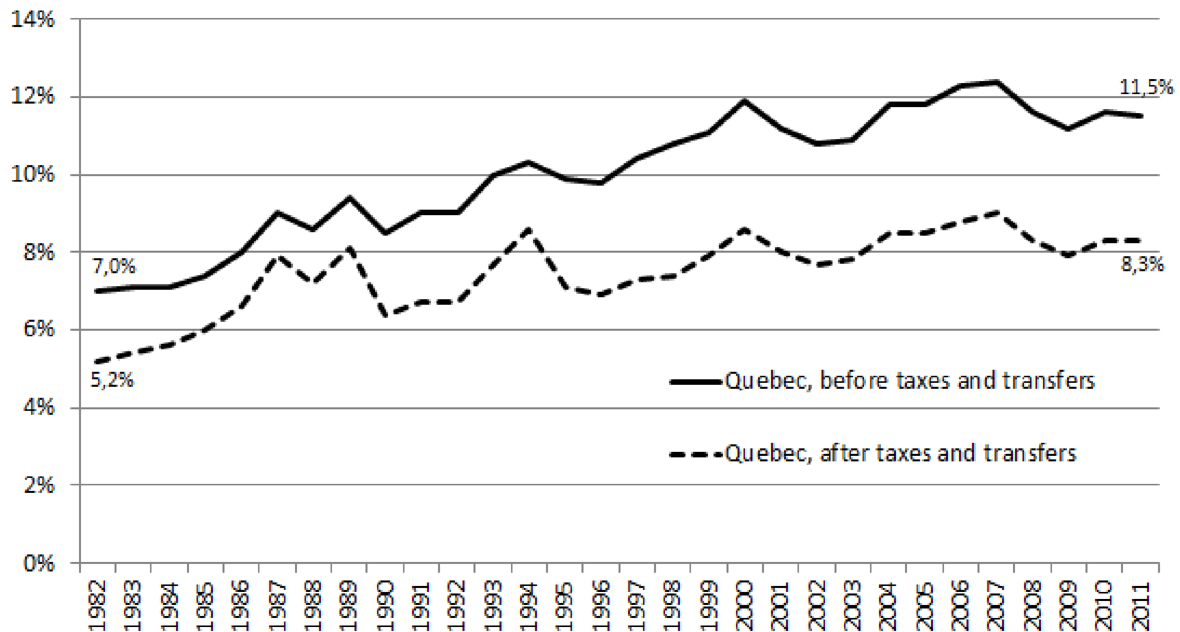
	Alberta	Ontario	Quebec	Canada
Top 0.1% income group	$933,500	$617,100	$416,200	$577,000
Top 1% income group	$229,400$	$169,400	$133,400	$163,400

Source: Statistics Canada, CANSIM Table 204-0002

Figure 1 shows the change in the share of total incomes in Quebec obtained by the top 1% since 1982. In 30 years, this share of net incomes has increased from 5.2% to 8.3%, but has remained stable since the start of the 2000s.

FIGURE 1

Change in Share of Income in Quebec (*including Capital Gains*) obtained by the Top 1% in Quebec between 1982 and 2011



_ *Source: Statistics Canada, CANSIM Table 204-0001*

Professor Veall, of the University of Ottawa, was curious enough to calculate income statistics for Quebec based on the language of the form used for the tax return. Figure 2 is instructive on the income differences and growth in these differences between "Anglophones" and "Francophones" for the period from 1982 to 2010. One notes that the growth in the share of total income earned by the 1% or 0.1% group is much lower among "Francophones" than "Anglophones".

The share of total incomes represented by the top 1% and 0.1% in Quebec has not materially increased since the start of the 2000s.

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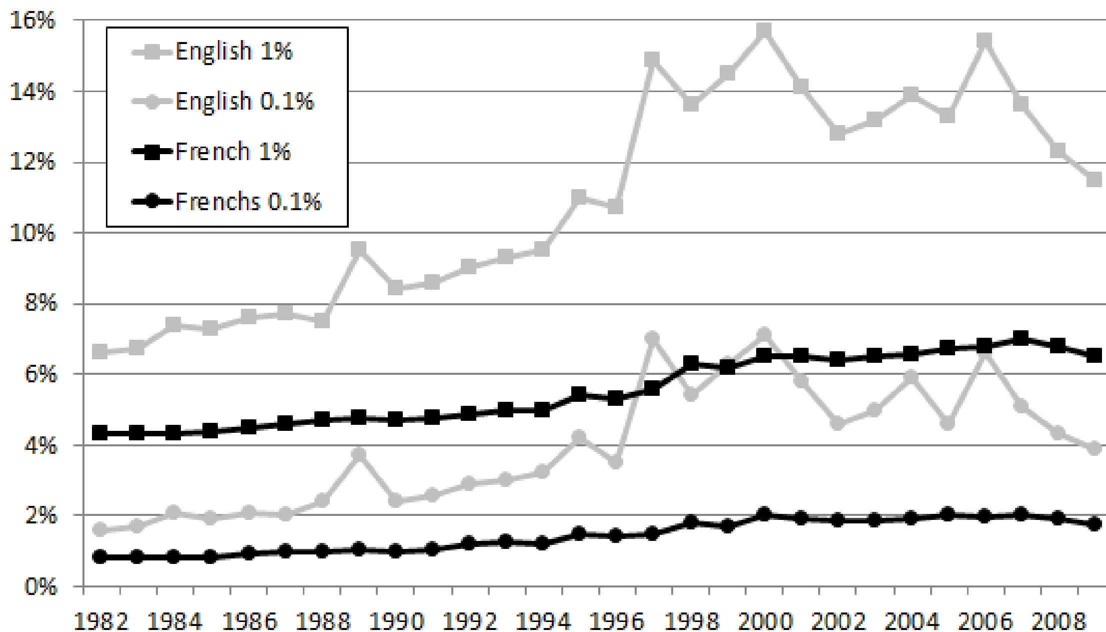
FIGURE 2

Share of Gross Income in Quebec Based on Language used in Tax Return



_Source: Veall, Michael R. (2012) "Top income shares in Canada: recent trends and policy implications". Canadian Journal of Economics, Vol. 45, No. 4, pp.1247-1272.

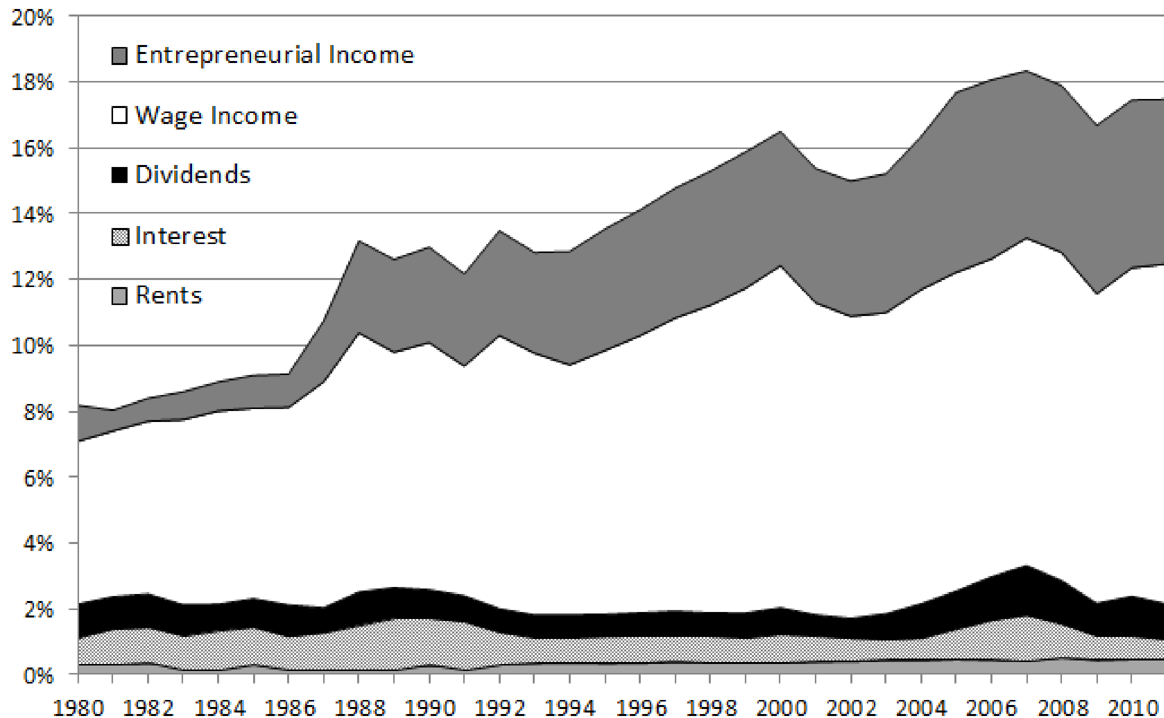
A correction in the U.S. data

Clearly, income inequalities in the U.S. seem to be large and growing. However, the U.S. result is skewed by a very particular phenomenon: since the 1980s, many owners of corporations (of a specific type known as S-corporations) have chosen to report the corporation's net profits as personal income, thereby avoiding the double taxation characteristic of ordinary corporations (taxes both on profits and on dividends). Figure 3 below shows the scope of the phenomenon.

At the top of the pyramid (1.0%), "entrepreneurial income", which was negligible until 1985, now represents close to 30% of the total share of income received by this group.

FIGURE 3

Share of Total Income Received by Top 1% and Composition, United States, 1980-2011



_Source: Piketty and Saez, The World Top Incomes Database

During another time period or under different tax rules, such as in Canada, for example, this income and the taxes paid on it would be classed as "corporate taxes".

In 2010, there were 2.6 million such corporations in the United States from all sectors of industry with some 4.4 million shareholders, who reported net earnings of $419 billion as income for tax purposes. Thus, the 31,000 S-corporations from the "financial activities, securities, commodities, contracts and other financial investments" sector reported average net earnings of more than $400,000.

Figure 3 also reveals the increase in and contribution of "salaries" in the composition of the incomes of the top 1%.

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The effect is even more noticeable if one refers to the very top of the income pyramid, the top 0.01%, as shown in Table 7. Whereas "entrepreneurial income" (essentially the famous S-corporations) only represented some 10% to 12% of the very high incomes in 1980, they accounted for *more than a third of the very high incomes* in 2011.

TABLE 7
Proportion of Composition of Gross Income Attributable to "Entrepreneurial Income", United States

Group	1980	1987	2011
Top 0.01%	10.70%	31.26%	35.67%
Top 0.1%	10.37%	22.05%	36.01%
Top 0.5%	12.50%	17.78%	32.44%
Top 1%	13.34%	17.23%	28.60%

_Source: data obtained from The World Top Incomes Database

Thus, either the U.S. data overestimates the income share of the top 1% and 0.01% by including the shareholders of S-corporations, or this manner of compiling data provides a more accurate picture of the reality, and one should therefore add to the Canadian data the large number of small businesses having one or two shareholders with a high net income, which are currently included in the statistics for businesses.

But even if the U.S. data were corrected for this, the strong and growing income inequality in the United States would remain, as shown in Figure 3.

III. Inequality of wealth

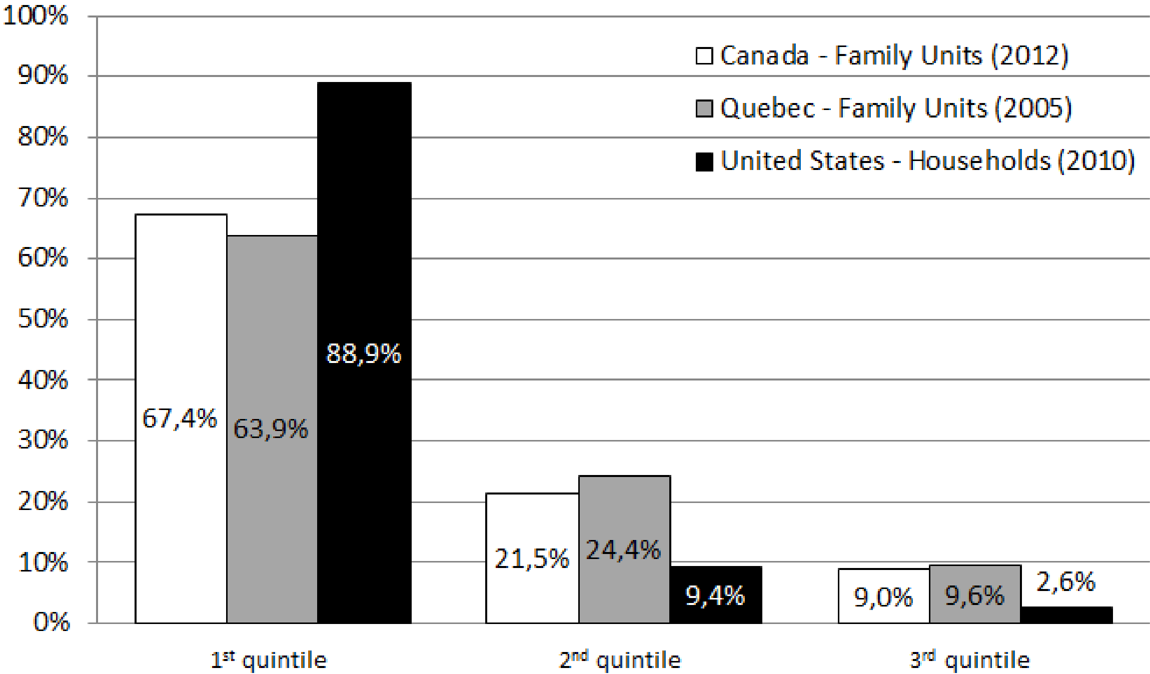
It is generally and universally the case that the distribution of wealth is more unequal than the distribution of income. Assets are accumulated by those who have the means to add to them every year, and wealth also accumulates through inheritances, the appreciation of financial assets, etc.

The unequal distribution of wealth (or assets), even more so than income inequality, fans the flames of resentment and raises social fairness issues. It has been shown that strong inequalities in wealth also lead to a reduction in social mobility. (See Corak (2012), among others).

While the data on assets is of much lower quality than the data on income, it seems clear that this inequality of wealth has grown nearly everywhere over the past 30 years, as shown by numerous research studies and publications. (See, in particular, Alvaredo, Atkinson, Piketty and Saez, ***Journal of Economic Perspectives***, Volume 27, No. 3, 2013.)

This development has resulted in historically high levels of inequality in wealth distribution in the United States. Table 8 shows a comparison between the situations in the U.S., Canada and Quebec.

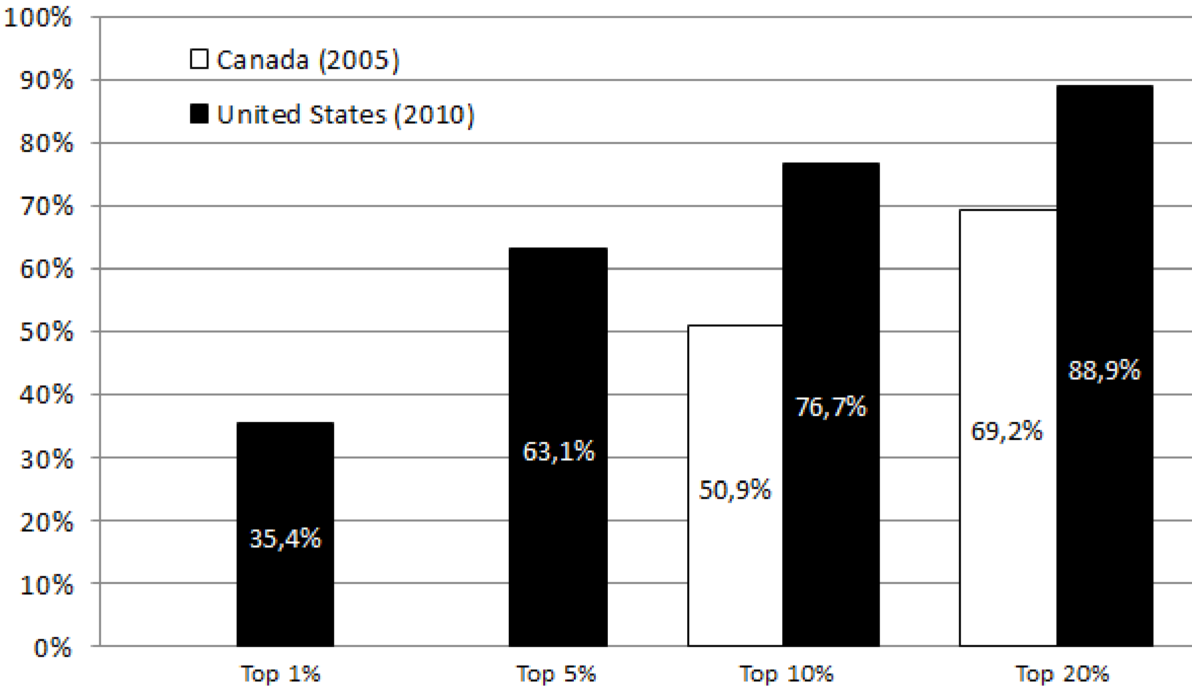
TABLE 8
Share of Total Wealth by Quintile



Sources: Statistics Canada, “Survey of Financial Security 2012”, The Daily, February 25, 2014; ISQ, Avoirs et dettes de l'ensemble des unités familiales, selon le quintile de patrimoine, montants médians, Québec, 2005; Wolff, E. N. “The Asset Price Meltdown and the Wealth of the Middle Class”, New York University, August 26, 2012.

It turns out that Canada, and Quebec in particular, are more egalitarian than the United States and several other countries. The differences between Canada and the United States are accentuated when one compares the most well-off groups in these societies, as shown out in Table 9.

TABLE 9
Share of Total Wealth Held, by Group



_Source for Canada: Statistics Canada, Perspectives on labour and income, Catalogue no. 75-001-XIE, December 2006, Vol. 7, No. 12; Wolff, E. N. "The Asset Price Meltdown and the Wealth of the Middle Class", New York University, August 26, 2012.

Those who believe that inequalities in income and wealth must be reduced and that they are a socially explosive phenomenon at their current levels in the United States must ensure they have a good understanding of the causes before proposing public policies to address this issue.

IV. Causes of observed inequalities

Piketty and his colleagues conclude that this inequality of income and wealth, observed especially in the "Anglo-Saxon" countries (United States, United Kingdom, Canada and Australia) is primarily the result of huge "salary" increases paid to corporate executives of stock-exchange listed corporations.

This "explanation" does not take into account the important phenomenon of S-corporations (or "entrepreneurial income") that we described above.

And, in actual fact, the salaries and bonuses of U.S. corporate executives did not substantially increase, in constant dollars, between the 1950s and 2000s! (Frydman and Jenter, 2010)

Compensation linked to stock price

The staggering increases in the compensation of corporate executives of U.S. Stock-exchange listed companies stems particularly from stock options and other forms of compensation that are linked to the value of the corporate stock.

In a stock market that has been fueled on earnings per share for some 30 years, stock- and stock option-based compensation has become appealing and nearly irresistible to corporate boards in the United States for four reasons:
1. The proceeds of the exercise by corporate executives of these options and stocks are taxed at the substantially lower rate applicable to capital gains (in Canada except in Quebec); however, in the U.S. gains on stock options are taxed as regular incomes; **2.** Until 2004, corporations did not incur any accounting cost from this type of compensation; after 2004, a relatively modest accounting charge was imposed for the granting of options to corporate executives; **3.** In the US, because (!) the profits from executives exercising stock options are taxed as regular incomes, the corporations

obtain a tax credit equivalent to the difference between the exercise price and the market price for the stock; the effect of this simple tax loophole is that hugely profitable corporations, such as Microsoft, paid little or no tax on their profits in certain years in which there was a massive exercise of options; **4.** This form of compensation caused executives to become ferociously focused on maximizing share value, to the great pleasure of the investment funds that are now the majority shareholders of U.S. companies.

The arguments supporting this form of compensation, particularly in the United States, seem irrefutable and difficult for a board member to dispute.

The granting of compensation to executives in the form of stocks and stock options started on a small scale in the United States during the 1970s and grew, during the 1980s, to 26% of the total compensation granted by the 50 largest U.S. corporations. During the 1990s, this percentage rose to 47% and then to 60% during the period from 2000 to 2005. (Frydman and Jenter, 2010)

In 2010, compensation linked to the value of the stock represented 62% of the total compensation of the CEOs of the 500 largest U.S. corporations and 55% for the CEOs of the 60 largest Canadian corporations. (Allaire, IGOPP, 2012)

This type of compensation was practically non-existent in Europe until the 1990s (except in the United Kingdom). Even in 2008, only 19% of the compensation of European corporate executives was in the form of stock options and stock-related incentives. (Conyon et al., 2010)

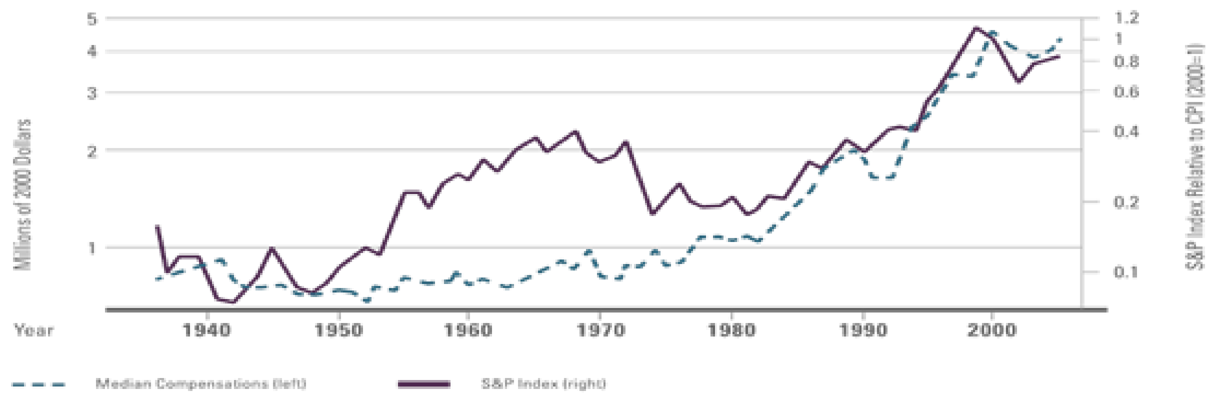
Thus, since this compensation in the form of options creates a direct link between the compensation of U.S. corporate executives and the performance of the U.S. stock

markets, it is easy to understand how and why there has been a quantum leap in this compensation, and in the unequal distribution of wealth, over the past 30 years.

Figure 4 shows that there was no correlation, before 1980, between the total compensation of corporate executives and the stock markets. Then, beginning in the 1980s, we observe that there is a nearly perfect correlation between the total compensation of U.S. corporate executives and the stock markets.

FIGURE 4

Total Compensation of the Three Highest Paid Executives of the 50 Largest U.S. Firms Compared to the S&P Index



_ Source: Frydman and Saks, 2007

Given the performance of the U.S. stock markets over the past 30 years (*the value of stocks on the S&P 500 has increased tenfold during that time*), and given that the term of stock options is usually 10 years and that stocks and stock options are generally, but not always, granted every year, the compensation and wealth of U.S. corporate executives is such that most of them found themselves in the group of 1%, and even 0.1%, of the richest persons during that 30-year period.

The "financialization" of the economy

The quantum leap in inequalities of wealth in the United States is also explained by the particular evolution in the U.S. (and British) financial sector. The phenomenon of the *financialization* of the U.S. economy, which also seems to have escaped Piketty and his colleagues, has exacerbated the unequal distribution of assets and strongly contributed to the unprecedented level of concentration of wealth held by the 1%, and especially 0.1%, of the richest Americans.

Thus, discreetly, and unnoticed by the general public, there has been a proliferation over the past 30 years in the number of specialized firms, held by private interests, engaging in financial, stock-market and speculative transactions of all kinds, generating immense wealth for their partners and managers.

Hedge funds (which would be more appropriately called "speculative funds") are included among these specialized, and largely invisible, firms that often have a primary role, sometimes a supporting role, in most financial scandals. Managing other people's money, they generally collect management fees of 2%, plus 20% of the realized profits. When these hedge funds, numbering some 5,300 in the United States, make a successful bet, they win the lottery.

Once per year, ***Alpha*** magazine compiles the data on the compensation earned by the best 25 gamblers. According to this magazine, in 2013, these 25 individuals collectively earned $21.15 billion, with compensation ranging from $300 million to $3.5 billion. In other words, these 25 *"managers" earned 3.5 times the total compensation of the CEOs of the 500 largest corporations in the U.S.* – the very same CEOs who are so strongly criticized for the extravagance of their compensation. Of course, hedge funds use ingenious organizational structures and other tax schemes so that their income is subject to a very low tax rate.

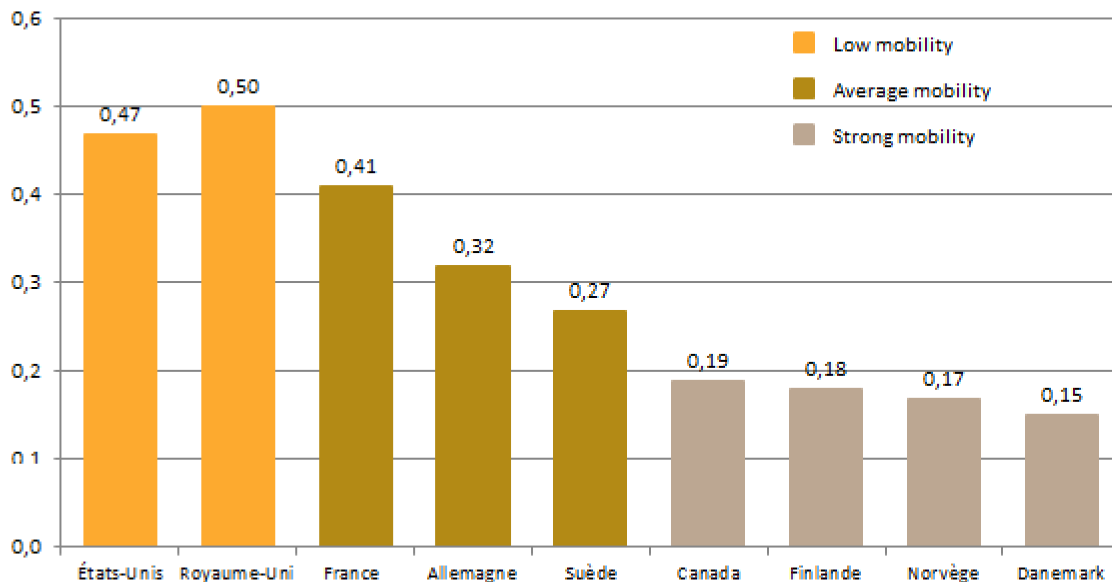
V. Inequality of social mobility

Inequality of social mobility – the fact that a child's economic fate is largely dependent on his family's economic situation – is the cruelest of inequalities. Inequality in the sharing of income and wealth appears as a transitory phenomenon of less importance if the movement of people between classes of income and wealth is large from one generation to the next.

However, as shown in Table 10 below, social mobility in the United States is rather low, especially compared with Canadian social mobility.

TABLE 10

Correlation between Intergenerational Income for a Set of Countries



_*Source: Corak, 2012*

The probability that a child of a poor American family will be in the poorest group upon reaching adulthood is nearly 50%. The probability that he will end up in the second poorest group stands at about 27%; then a child from a family in the lowest income quintile in the United States has three out of four chances (!) of ending up in either the poorest group, or the group of those who are just slightly less poor. Obviously, the phenomenon also plays a similar role for the children of rich families.

Worse yet, this low social mobility in the U.S. does not appear to be a recent phenomenon. According to an in-depth study, the probability that a child born in the U.S. in 1986 into a family in the lowest income quintile will reach the highest income quintile is **9%**, and this probability has not changed much in 40 years – a child born in the same circumstances in 1971 had a probability of **8.4%** of reaching the highest income quintile. This is a surprising result, suggesting that the American dream that

every citizen can become "rich and famous" seems to be more of an American myth. (Chetty, Hendren, Kline, Saez and Turner, Working Paper 19844, NBER, January 2014)

In this regard, the Crédit Suisse bank (***Global Wealth Report***, 2013) notes as follows: "*This [...] suggests that ten generations or more have to lapse before the wealth of an individual in North America* [read the United States] *is completely unrelated to the wealth of their ancestors.*"

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VI. Social mobility and fairness

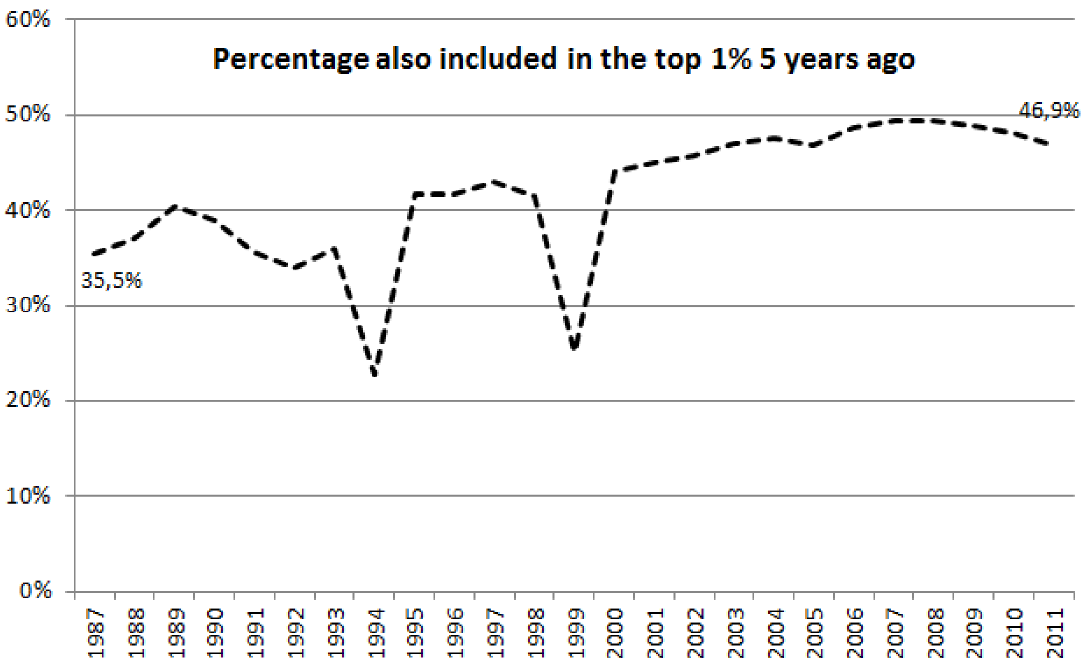
To the extent that the unequal distribution of wealth is perpetuated and passed on from generation to generation, the stakes are high and could carry political risks as the general population becomes aware of the mythical nature of the American dream.

Table 10 clearly indicates how Canada [and Quebec] shows strong mobility from one generation to the next, equivalent to that observed in some Scandinavian countries.

It is also noteworthy, as Figure 5 illustrates, that a large percentage of the people in the top 1% are replaced over a five-year period, in Quebec at least.For instance, more than half of the persons who were in the top 1% group in 2011 were not in this group in 2006.

FIGURE 5

Persistence of High Income* in Quebec (1987-2011)



*Income after taxes and transfers, including capital gains

_*Source: Statistics Canada, CANSIM Table 204-0002*

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This precious result for Canada and Quebec may be attributed to our universal health-care system and other social program, as well as the quality and accessibility of our educational systems.

The OECD's studies conducted through the ***PISA*** program provide illuminating data for assessing this phenomenon. This program consists of a triennial evaluation of the mathematics, sciences and reading skills of 15-year-old students throughout the world.

For example, in mathematics, of the 29 OECD member countries, Canada ranked 5th and Quebec 2nd (just behind Korea). The United States ranked 20th.

But even more significant, as noted by the OECD specialists, **Canada and Finland**, of all the OECD member countries, **are the only counties** to obtain a score that is clearly above average for the performance of their students, *and also an above-average score for the fairness of their educational systems*. The Canadian (and Quebecois) educational systems are designed so that the parents' socio-economic background has less influence on the quality of the schools and students' performance.

This fairness and social mobility, which is largely a result of our educational system, must be protected from the gradual erosion observed in a significant number of countries over the past 20 years.

Inequality of wealth and social justice

In a notable work entitled ***A Theory of Justice***, published in 1971, the American philosopher, John Rawls, proposed two tests for determining the distribution of wealth that would be compatible with a just society:

1. **Inequality in the division of wealth should not exceed the level for which it can be shown that *such inequality benefits the worst-off members of society*.**

Rawls thereby acknowledged that absolute equality would not be in the interests of the weakest members of society, because this would result in a decline in collective wealth and, consequently, a general impoverishment and a shrinking of social programs.

Economists endeavour to provide a partial response to this question of appropriate and just level of inequality by examining the impact of various marginal rates of income tax. Clearly, a high marginal rate reduces income inequalities between citizens, but if the marginal rate is such that it leads, paradoxically, to a reduction in the tax receipts of governments, then the State is compelled to reduce spending on social programs to the detriment of the most disadvantaged members of society.

2. **John Rawls also proposed the concept of the "*veil of ignorance*" to assess what level of inequality a particular society would judge acceptable or «optimal».**

Let us suppose that the citizens were unaware of what their position would be in the distribution of wealth since this position would be assigned to them at random. What level of inequality would these citizens choose as desirable or optimal in such circumstances? According to Rawls, such an (entirely conceptual) process would reveal the true tolerance of the citizens as a whole for economic inequalities.

While such considerations are certainly interesting from an intellectual perspective, they are difficult to apply in practice. However, recent American public opinion surveys give us an approximate response to this second question posed by Rawls, as shown in Table 11.

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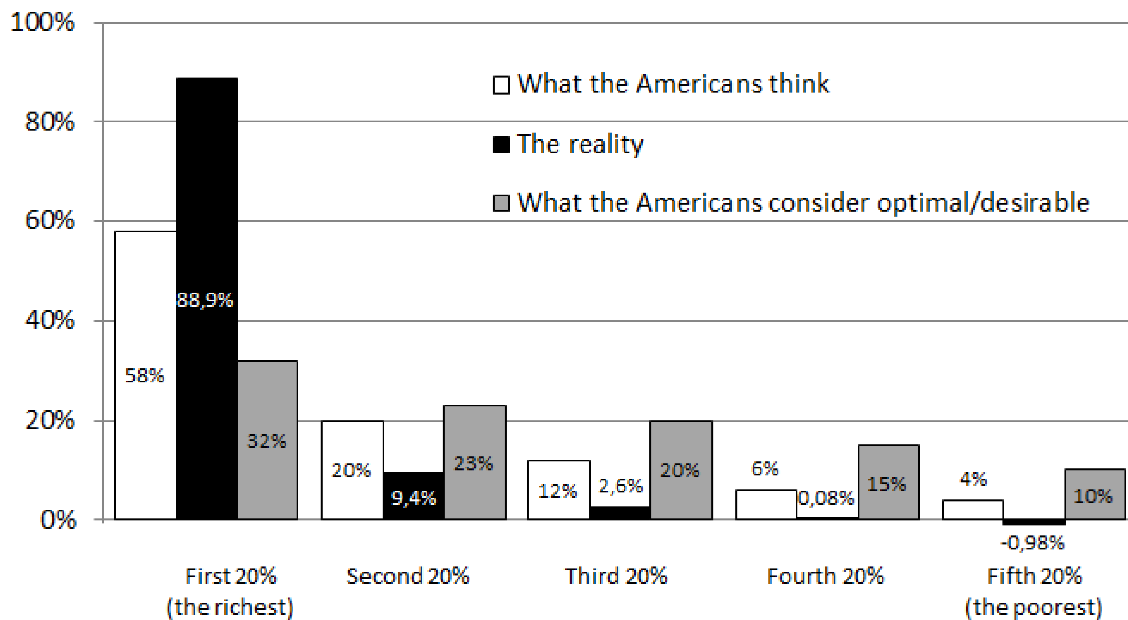
TABLE 11

Percentage of Total Wealth (or Assets) Held by each Quintile of the Population



_Sources: Pew Research 2010; Ariely and Norton, 2011; Wolff, 2012

First, it shows that Americans were not yet fully informed (in 2011) of the level of wealth disparity in their society.

The table also shows the huge gulf between the actual distribution of wealth and that which seems desirable to the American people. This gap is pregnant with social and political tensions.

VII. Conclusion and proposals

A reasonable sharing of wealth and income is not just an issue of social justice; it is a source of social peace as well as a driver of economic growth. Despite the sharp increase in the compensation of Canadian corporate executives (see Allaire, Y., IGOPP, "*Pay for Value*", 2012), Canada and Quebec in particular are still lands of moderate inequality of wealth and, in particular, of much greater social mobility than the U.S. These constitute precious social assets about which we must not be complacent.

In the United States, despite adjustments in the statistics that mitigate to some extent the income inequalities as first observed, inequalities in wealth are enormous and still growing fast. There is no doubt that the massive increase in executive compensation over the past 30 years, as well as the extensive financialization of the American economy, have contributed to this socially harmful result. Finally, the United States is suffering from low social mobility, which is aggravated by inequalities of wealth and sustained by some of the U.S. social policies.

As American citizens become better informed about the large disparity in income and wealth in their society as well as its perpetuation because of low social mobility, these issues will generate social resentment and lead to a relative loss of legitimacy for political leaders. These issues are now being addressed at the highest political level in the United States, but the counteroffensive is vigorous and well financed.

Social and tax policies

The corrective measures proposed by Thomas Piketty are dramatic but politically unrealistic: increase in the marginal tax rate to 80% and a global tax on capital.

Indeed, most of the executive compensation in the form of options or stocks can be deferred for many years before having to pay income taxes. In many countries, if not

in the U.S., the gains on stock options re taxed at the much lower rate applicable to capital gains. As well, the humongous income of hedge fund managers and private equity fund managers, usually defined as «carried interest» is thus shielded from the high tax rate applicable to employment income. A significant increase in the tax rate on capital gains (not proposed by Piketty) would have a negative effect on investments and economic growth.

Piketty also proposes a global tax on capital. This proposal, which entails an Orwellian process of disclosure and estimation of assets by all individuals, as well as a transnational sharing of the information thereby collected, has only an infinitesimal probability of being adopted.

Piketty and his colleagues therefore propose two measures, one based on a poor understanding of the dynamics of executive compensation and of changes in the financial industry, and the other on a program that is doomed from the start. However, it is possible to take concrete and effective action to have a clear and significant impact on economic inequality.

Here are **ten policy proposals** that are within the reach of governments or corporate boards:

1. A quality educational system accessible to everyone without regard to family income;
2. A change in the tax provisions to eliminate tax arrangements where they favour executive compensation schemes in the form of stock options and restricted stocks. However, such a measure must be synchronized with the relevant tax jurisdictions. Thus, Quebec would be ill advised, as is presently the case, to go it alone in this area.

3. The elimination of the U.S. tax benefit that gives businesses a tax credit for the difference between the strike price of a stock option and the market price at the time it is exercised by an executive. Canada, for example, does not grant such tax credits.
4. The gradual elimination *by corporate boards* of stock options as a form of compensation, as well as any other form linking compensation to the value of the corporation's stock.
5. Limits set *by the board of directors* on the ratio of the CEO's compensation to the firm's median compensation.
6. Implementation of compensation schemes which are sensitive to social issues of income inequality within society. If corporate boards are incapable of discharging this responsibility, governments will want to step in (which is not desirable) by enacting rules and regulations, such as the prohibition of compensation in the form of stock or stock options.
7. Governments should close the door on tax schemes that favour hedge funds and other financial industry players. Thus, the tax subterfuge which allows hedge funds, privatization funds and others to treat the compensation of their owners as "*carried interest*" taxable at the capital gains rate, i.e. 15% in the United States, should be disallowed.
8. Calibrate the tax on capital gains according to the holding period; any buy-sell transaction within a year would be taxable at the rate applicable to personal income; only investments held for three years or more would benefit fully from the lower tax rate on capital gains.
9. Governments should issue directives to public pension funds under their jurisdiction to the effect that they cannot hire fund "managers" who charge more than 3% to 5% in management fees and incentives. The actual percentage

would take into account the size of the fund and the level of hurdle rate to be met before any incentive is paid to the manager. Boards of large funds could also give serious consideration to this issue. It is curious that the same investment funds which rightfully complain about the high levels of compensation paid to executives of corporations in which they invest have no qualms about giving management contracts to hedge funds whose managers will collect unparalleled amounts for their performance.

10. As suggested by Leo Strine (2014), money managers should reflect in their investment strategies the time horizons of their investors.

Fiscal and social measures of a very different nature than those proposed by Thomas Piketty would go a long way towards reducing the economic disparities observed in the United States and help maintain the favourable situation we currently enjoy in Canada and Quebec.

DEFINITIONS OF TERMS USED

(according to Statistics Canada and the Congressional Budget Office)

- ***Household (United States)*****:** A household consists of the people who share a housing unit, regardless of their relationships.
- ***Quintiles (in Canada)*****:** All the units of the population, whether individuals or families, are ranked from lowest to highest by the value of their after-tax income. Then the ranked population is divided into five groups of equal numbers of units, called quintiles.
- ***Quintiles (in the United States)*****:** groups are defined by ranking all people by after-tax income and transfers, adjusted for household size—that is, divided by the square root of the number of people in a household. Quintiles contain equal numbers of people. Households with negative income are excluded from the lowest income category but are included in totals.
- ***After-tax income*****:** Total income minus income tax.
- ***Income of individuals*****:** income based on the information contained in federal and provincial tax returns of tax filers. Generally speaking, market income is comprised of earnings and income from investments, private pensions, dividends, capital gains, support payments paid to a spouse, and other taxable income.
- ***Market income*****:** sum of employment income (wages and salaries, or net amount from self-employed work), investment income, retirement income (private pension plan) and elements included in other income.
- ***Total or pre-tax income*****:** income from all sources including government transfers before deduction of federal and provincial taxes.
- ***Incomes used in calculating Canadian centiles***: the definitions of income used to determine centile groups in Canada and Quebec (0.01%, 0.1%, 1%, etc.) are different are different from those used for the quintiles. The concepts of income in the Longitudinal Administrative Databank (LAD) are based on information contained in the federal and provincial forms. Generally speaking, market income consists of income from earnings, investments, pensions, support

payments paid to a spouse, and other taxable income. Total (or pre-tax) income is equal to the market income plus government transfers and refundable tax credits. After-tax income is equal to total income minus federal and provincial taxes.

- ***Wealth:*** valuation of the net assets of a family unit (or a household in the United States), i.e., the amount the family unit would have after selling all its assets and paying off all its debts.

- ***Transfers*****:** transfers include cash payments and benefits received from social insurance and other government assistance programs. In Canada, these amounts include:

    - old-age security pension and guaranteed income supplement, allowance and allowance for the survivor;
    - Quebec Pension Plan or Canada Pension Plan benefits;
    - employment insurance benefits;
    - child benefits;
    - other income from public sources.

  In the United States, these amounts include:

    - Supplemental Nutrition Assistance Program
    - Medicaid
    - Medicare
    - Children's Health Insurance Program
    - Social Security

- ***Family units*****:** Comprise economic families of two or more persons and single persons. An economic family is a group of individuals sharing a common dwelling unit who are related by blood, marriage (including common-law relationships) or adoption.

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