WebMemo
Published by The Heritage Foundation

No. 1505
June 13, 2007

Performance-Based Pay Driving Increase in Inequality

James Sherk

Many commentators believe that the increase in income inequality over the last 30 years is a serious problem. They argue that America has become an increasingly class-based society where a rich minority lives in opulence while most other Americans struggle with little hope of becoming wealthy themselves. New research into income inequality debunks that notion. A quarter of the increased income inequality since 1976—and almost all of the increase in inequality among the top earners—is a direct result of the increased use of performance pay by American companies. Inequality is rising because hard workers are being increasingly rewarded for their higher productivity. Congress should not act to reduce inequality caused by wider use of performance pay, such as by allowing tax rates for entrepreneurs and investors to rise.

The Source of Inequality Matters. Recent attention to the subject has been fueled by a number of studies showing increased inequality over the past generation. Many analysts, especially those on the left, assume that the trend is inherently harmful and call for government intervention to correct it.

Increased inequality, in and of itself, is neither positive nor negative. What matters is why inequality has increased. In a class-based society where select families control most national wealth through inheritance or coercive means, rising inequality will harm many citizens. Higher inequality in 17th-century England or in contemporary Saudi Arabia, means increased hardship for most workers.

However, in an economy where most wealth is not inherited but earned, increased inequality can be beneficial. Consider the impact of Google, Inc. The company's founders, Larry Page and Sergey Brin, are now worth more than $16 billion each.[1] Their financial success has made America a demonstrably less equal country, and most Americans are better off for it. Google's various services allow tens of millions of Americans to quickly find what they want on the Internet, conveniently get directions to where they need to go, and use a quality e-mail server—all for free. Page and Brin became wealthy—and increased inequality—by improving the lives others.

There is no reason for the government to intervene when hard work and innovation increase inequality. Commentators ought to examine what has caused the increase in inequality before calling for tax increases to redistribute wealth.

Increased Use of Performance Pay. One of the major changes in the economy over the past generation has been the increased use of performance pay; that is, basing workers' pay on their productivity, not just on wages or salaries set in advance. Commissions, piece-rate pay, or performance bonuses have become increasingly common in the economy. The proportion of jobs that use perfor-

This paper, in its entirety, can be found at:
www.heritage.org/Research/Labor/wm1505.cfm

Produced by the Center for Data Analysis

Published by The Heritage Foundation
214 Massachusetts Avenue, NE
Washington, DC 20002–4999
(202) 546-4400 • heritage.org

mance pay rose from approximately 30 percent to 45 percent between 1976 and 1998.[2] Roughly 50 percent of salaried workers are now in jobs that offer performance pay.[3]

Companies have embraced performance pay because it encourages employees to work harder. New technologies have made it easier to accurately measure the performance of individual workers.[4]

Performance Pay Increases Inequality. Performance pay increases wage inequality for two reasons. First, such jobs usually pay more than jobs without performance pay. Performance pay makes workers more productive, allowing employers to increase pay.[5] However, higher wages for these workers, but not others, increases inequality.

Second, performance pay increases inequality directly because it means the workers who produce more, earn more. Imagine two car repair shops: The first pays employees a flat $15 per hour wage for installing replacement windshields; the second pays employees $20 for each windshield they install. There will be very little inequality in the first company since every worker earns the same wage. The second company pays more to diligent or talented employees because they install more windshields. Performance pay rewards productive workers more than less productive workers, meaning higher inequality.

New research from the National Bureau of Economic Research shows that 24 percent of the increase in wage inequality between 1976 and 1993 occurred because of the increasing number of jobs that use performance pay.[6] Even more strikingly, increased performance pay explains almost all of the increase in inequality at the top 20 percent of wage earners.[7] The much-maligned "rich" have earned so much not because they were born into the right family but because they are working harder.

Performance-based Inequality Benefits Workers. Performance pay has increased inequality, but in a way that benefits American workers. On average, performance pay raises wages because it encourages workers to become more productive and earn more.[8] Performance pay rewards employees for their hard work and diligence.

Many commentators equate rising inequality with reduced opportunities for people born into poverty. Performance pay, however, increases inequality *and* economic opportunity. With performance pay, race or family background does not matter; only how well a worker can do the job.[9] More performance pay means more opportunities for hard workers to distinguish themselves and be rewarded for their efforts. An economy that rewards hard work leads to an inequality that is indisputably fair. Policymakers should welcome the wider use of performance pay and the inequality it necessarily causes because it expands access to the American dream.

Conclusion. Understandably, many people consider inequality to be unfair to those born into difficult circumstances. However, one of the reasons for

1. "The World's Richest People," Forbes Magazine, March 6, 2007, at *www.forbes.com/lists/2007/10/07billionaires_Sergey-Brin_D664.html.*
2. Thomas Lemieux, W. Bentley MacLeod, and Daniel Parent, "Performance Pay and Wage Inequality," NBER Working Paper No. 13128, May 2007, table 8, at *http://papers.nber.org/papers/w13128* (NBER subscription required).
3. *Ibid*, p. 17.
4. *Ibid*, p. 7.
5. Edward Lazear, "Performance Pay and Productivity," The American Economic Review, Vol. 90, No. 5 (December 2000), pp.1346-1361, at *http://www.econ.ucsb.edu/~pjkuhn/Ec152/Readings/LazearAER.pdf.*
6. Thomas Lemieux, W. Bentley MacLeod, and Daniel Parent, "Performance Pay and Wage Inequality," NBER Working Paper No. 13128, May 2007, at *http://papers.nber.org/papers/w13128* (NBER subscription required), page 23.
7. *Ibid*, p. 24.
8. *Ibid*, p. 19.
9. Financially successful parents can invest in their children in a way that makes them more productive workers when they enter the workforce, such as by hiring after-school tutors or paying to send them to private schools. This will make them more productive workers and allow them to earn higher wages. However their higher pay is not a result of their family background per se, but because of their greater skills, which their parents had invested in.

rising inequality in the United States is that more companies are using performance pay. The practice accounts for a quarter of the increase in inequality in recent decades and almost all of the increase in inequality among the wealthiest fifth of workers. The resulting inequality benefits workers by increasing their total earnings and rewarding hard work irrespective of family background. This kind of inequality is hardly unfair. Congress should not intervene to reduce inequality caused by diligent and productive workers earning more.

—James Sherk is Bradley Fellow in Labor Policy for the Center for Data Analysis at The Heritage Foundation.