Roland Berger · David Grusky · Tobias Raffel
Geoffrey Samuels · Christopher Wimer

The Inequality Puzzle

European and US Leaders Discuss Rising Income Inequality

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A View from the Top

David B. Grusky and Christopher Wimer,
Stanford Center for the Study of Poverty and Inequality

The preceding chapter provides a comprehensive summary of the many issues addressed by our contributors. In this chapter, we provide yet another summary, but now one that is oriented to a more delimited set of themes. We present such themes in the form of answers to three questions: (a) Is rising inequality a problem?; (b) What are the causes of rising inequality?; and (c) How, if at all, should inequality be reduced? These questions, which are addressed in turn below, merit a special chapter because they are so central to public debates about inequality.

Is Rising Inequality a Problem?

We led off the first chapter by noting that unusually high levels of inequality, such as those observed in the U.S. or Italy, are typically deemed acceptable when (a) the population is convinced that rewards are fairly allocated, and (b) the opportunity for a comfortable working-class or middle-class life is quite widely available. We referred to this two-pronged formula for justifying and legitimating inequality as a fundamental "social compact" that has generated widespread buy-in and stability even as inequality took off. We further suggested that the combination of the financial crisis and recession may be calling this compact partly into question. That is, insofar as compensation practices at the very top are not as tightly tied to merit as was previously assumed, then the public may be less willing to tolerate high pay at the top. Obversely, insofar as hard-working employees are laid off during the recession and cannot find new jobs, it's again more difficult to argue that the treatment they're receiving is just or merited.

Do concerns of this sort appear among the business, labor, and political leaders interviewed here? Although their views are subtle and diverse, it is notable that several commentators suggested that the public is indeed increasingly questioning whether rewards at the top of the class structure are always closely tied to merit. The merit-reward connection, which is of course the core of the social compact, may be called into question insofar

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as top executives, financiers, and bankers were understood to be securing substantial compensation even as their companies were failing and even though their financial maneuverings may have precipitated the economic crisis. The CEO of Publicis, Maurice Lévy, comments on the likely fallout when compensation practices are perceived as unfair:

> *Lots of people are having a tough time and live with revenues which are insufficient. This is a reality and is exacerbated by the fact that they don't see how their life can improve with the current state of the economy. It can only get worse. It is also exacerbated when they see in the press the millions that executives are making, including when they fail. And it is normal that they have this feeling of "injustice" and get angry.*

The same concern is expressed, now in more strident tones, by John Monks, the General Secretary of the European Trade Union Confederation:

> *I can acknowledge a deserving rich, and I'd like to find some way to separate them from the undeserving rich, many of whom are fairly ordinary people who happen to be working in certain areas and do what everybody else does, and make a fortune. I don't think in a period when living standards were generally going up, people noticed [that top pay was going up]. I think they're noticing now what has happened to top wages when the economy's gone down. And who are the people responsible for the collapse? ... Certainly it hasn't been the shareholders, it hasn't been the workers, it hasn't been the customers, it has been the executives. Outside people have been noticing, and if I can do anything to help them notice more, I shall certainly do so.*

In our interview with Jerry Yang, the co-Founder of Yahoo!, we find yet another explicit reference to issues of fairness, the concern again being that seemingly undeserving executives have been paid far more than was warranted:

> *The financial crisis has, reasonably enough, led some to question the assumption that inequality will generate high performance. With the financial crisis, some people are wondering why top managers who seem to be making mistakes are still getting so much money, why managers whose firms are failing are still well paid.*

The presumption here is that those at the top were sometimes paid excessively and without much justification in terms of underlying merit, talent, or effort. This sentiment reappeared more or less forcefully in other interviews as well. The Chairman of Deutsche Bank, Josef Ackermann, insisted that "we in the financial industry have to make sure remuneration is well-deserved and based on proven and solid lasting performance," while the Honorary Chairman of Lafarge, Bertrand Collomb, stated quite frankly that the practice of treating CEO pay as a "special case outside of a normal compensation scheme has always shocked me."

There is some concern, then, that the connection between merit and reward may not be as strong as it should be at the very top of the income distribution. If one considers next the middle and bottom of the distribution, here again some of our commentators express concern that the merit-reward connection is not strong enough, although the problem in this case is not that rewards exceed merit (i.e., excessive CEO pay) but that merit exceeds rewards (i.e., laid-off or underpaid workers). It has long been noted that workers born into poor families or neighborhoods may suffer disadvantages (e.g., poor schooling) that are inconsistent with a commitment to equal opportunity. The former President of the AFL-CIO, John Sweeney, concludes that "people today are not confident that their son or daughter will automatically experience the American Dream." Outside the U.S., there seems to be even more concern that opportunities to get ahead are closing off, with the presumed psychological consequence being a burgeoning frustration at the bottom of the income hierarchy:

> *I strongly believe in equality of opportunity and social mobility. ... The feeling is growing, especially in Germany and other European countries, but probably less so in the United States, that people with a modest social background don't have the same opportunities. This is creating a tremendous amount of frustration. (Josef Ackermann)*

The underlying worry expressed in this passage is that the run-up in inequality won't long be tolerated if it's understood as an inside game in which only those from more privileged backgrounds have the means with which to get ahead.

The social compact, as we've described it here, rests not only on the fairness with which rewards are allocated but also on the market's ability to "deliver the goods" to everyone who works hard and plays by the rules. The runup in inequality presumably becomes more tolerable when most workers are at least able to get a job, earn a decent living, and otherwise get by. As Josef Ackermann observes, "when you are in a stagnant or recessionary environment, when people have to fear job losses or major salary reductions, inequality is perceived much more clearly." Likewise, John Monks suggests that, when living standards were going up and people were doing well, they didn't "really notice or care" about rising inequality. However, now that living standards are "going down," he suggests that they're definitely "noticing now." These comments, if an accurate barometer of public mood, suggest that the two-pronged social compact may be doubly vulnerable. That is, there may be a growing tendency to question (a) whether those at the top truly merit their increasingly high pay, and (b) whether those at the bottom truly merit their fate of increasing unemployment and financial distress.

But how problematic is this fraying of the social compact? The interviews reveal a wide gamut of views on this question, with a few commentators adopting an almost alarmist rhetoric, and the majority adopting a more measured tone. On the alarmist side of the continuum, one finds John Monks suggesting that "the excesses of capitalism are the biggest threat to capitalism," while the President of the Party of European Socialists, Poul Rasmussen, stresses that a sea change in attitudes may be underway:

> *The U.S. is probably the part of the world where the anger is not only most visible, but also most widespread among the population. Ordinary American working families, the mainstream, feel that Wall Street has simply been too greedy. You cannot expect these workers to go to work and forget all about it – that will not happen. ... Anger is very high, and it will not go away.*

The foregoing sentiment is by no means an exclusively socialist one. Although many commentators agreed with Monks and Rasmussen that high and increasing inequality is problematic, they often did so in more muted tones and with greater appreciation of the possibility that some of the public anger is misplaced. The former Chairman of Anglo American, Sir Mark Moody-Stuart, comments that "the divergence of remuneration between the top and bottom of an organization is now causing strain in society," while the Chairman and CEO of Publicis, Maurice Lévy, refers to the growing "angst," "bitterness," and "anger" within the population, and the former Republican Governor of Massachusetts, William Weld, advises, "If you don't have some spreading out, some flattening of these curves, you're going to have sufficient disquiet so that sand will be thrown in the gears of commerce." For these commentators, the possibility is raised that the public may be making too much of the most egregious and highly publicized cases of excessive compensation, but even so such changes in public perception are clearly regarded as worrying and worth addressing.

What Caused the Rise in Inequality?

We turn next to the causes of the takeoff in income inequality that has played out in many (but not all) OECD countries. Although the takeoff has been the focus of much scholarly discussion and research, it is striking that this discussion has not been well informed by the views of CEOs and other elites who can offer that rare behind-the-scenes account of how inequality is generated. How *do* elites account for the increase in inequality?

The prevailing view among scholars of inequality has the takeoff arising from a historic increase in the demand for skilled labor (i.e., skill-biased technological change), a resulting shortage in the number of skilled and educated laborers who might meet this new demand, and a consequent bidding-up of the price for skilled labor. The growing divide between the earnings of skilled and unskilled labor is interpreted under this account as an important source of rising inequality. When our commentators did take on this standard account, they tended to do so with some sympathy, although they were typically more focused on the short supply of skilled labor than on the ramped-up demand for such labor.[1] This shortage was in turn typically attributed to deficiencies in the educational system. For example, Bertrand Collomb argues that, because educational institutions haven't been doing their job well, much of the population remains "undereducated, underskilled, and ... paid at the level influenced by competition from the emerging markets workforce." The Chairman, President, and CEO of FedEx, Fred Smith, provides an insightful elaboration of this account, his claim being that the real problem is not so much a shortage of educated labor as a shortage of the *right type* of educated labor:

> *I think our society has become so enamored of getting that degree from a prestigious institution, regardless of what type of degree, that we have a complete mismatch between what the educational structure is producing relative to what society needs and will compensate. Building new sources of wealth in the future will be basically focused on scientific, engineering, and managerial disciplines.*

If this account is on the mark, it implies that students are too often investing in the wrong fields, with the result being a mismatch between the type of skills the labor market is supplying and the type of work the economy is demanding.

[1] Goldin, Claudia, and Lawrence Katz. 2008. *The Race Between Education and Technology.* Cambridge: Harvard University Press.

The interviews also addressed the causes of rising executive pay. The conventional approach among scholars has been to explain the increase in executive pay in terms of some corresponding increase in the marginal product of executives.[2] If, for example, globalization means that executives are making decisions involving ever-larger global markets, then good decisions will be worth more because they can pay off globally; and executives can reasonably expect to be paid in keeping with their growing marginal product. This type of account did occasionally come up in our interviews, but it was not featured all that much. Instead, many of our business leaders drew on more subtle sociological mechanisms to explain rising pay, mechanisms that are closely related to one another and thus emerge from the transcripts as a coherent, integrated, and almost seamless whole. We review these various mechanisms below.

The transparency movement plays a featured and fascinating role in this narrative. It is fascinating because its main rationale, which was to discourage egregious compensation by openly and fully revealing pay packages, appears not to have been realized very successfully. As Maurice Lévy so engagingly relates, the actual affect of transparency was to make pay comparisons possible and to ratchet up competition between executives, a type of competition that had long been suppressed because executives simply didn't know how much their peers were paid.

> *In Europe, and particularly in France, we have been faced with the consequences of transparency. What happened was that salaries or compensation were benchmarked and adjusted to the highest-paid person. New experts appeared whose analysis was that if you wanted to keep your people, you had to be in top quartile. ... The transparency which was meant to moderate has in fact created a serious inflation.*

The main effect of the transparency movement was to set in motion a race to the top by engendering competition rather than self-limitation. Once the possibility of comparison is unleashed, Bertrand Collomb argues that status competition among peers will instantly emerge, a competition that in turn precipitates an inflationary pay spiral:

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[2] Gabaix, X., and A. Landier. 2008. "Why Has CEO Pay Increased so Much?" *Quarterly Journal of Economics* 123, pp. 49–100. For a review of relevant evidence, see Bebchuk, Lucian A., and Michael S. Wiesbach. 2009. "The State of Corporate Governance Research." Dice Center Working Paper 2009-21.

> *If I look at the view of the executives, they live in an unequal world and they've seen inequality rising. They know what public opinion doesn't know, that their investment banker is making millions, that their lawyer is making millions, that the fund managers are making millions. They generally work in a world where their Brazilian partner belongs to a very wealthy Brazilian family. When they are French, they see their American colleagues making ten times what they are making, so they don't feel rich and they don't feel overpaid. They feel that, given the amount of responsibility they have, it's not abnormal to be among the people who have high compensation, not necessarily the highest, because a lot of people are paid more, but in that league. So I feel many mistakes made in executive compensation are rooted in the feeling that they don't feel overpaid by comparison.*

These comparisons were of course prosecuted in terms of the only shared metric that was available (i.e., money). It follows that everyone's focus shifted laser-like to the monetary side of the employment relationship.

This is a crucial shift. As many commentators noted, the CEO job has not historically been just about money, rather it's also been about the intrinsic satisfaction and sense of accomplishment that comes from building something. These intrinsic incentives are undermined, however, when CEOs become more focused on immediate economic payout. If companies are ruthlessly focused on the marginal product of their executives, then executives will likewise come to view their worth in terms of a compensation package that's assumed to equal their marginal product. The result, as Sir Mark stresses, is that companies begin to treat executives as a simple "financial investment" in which the desired behavior has to be elicited by building financial mechanisms directly into the compensation package. "The more you devise these crafty mechanisms," Sir Mark notes, "the more you forget that pay is only a little piece of the whole motivation of people."

The extrinsically motivated executive will also feel less loyal to her or his company and be more likely to consider moving to a new one. Here again, if the executive is reduced to a "financial investment" on the part of the company, then that executive will naturally in turn become committed mainly to the compensation itself, and any residual interest in the company itself is quite reduced. Moreover, insofar as investors and companies emphasize short-term financial returns, it becomes acceptable to frequently replace executives as a means of improving such returns. "While mobility is in principle a good thing," notes Sir Mark, "in many corporations I think there has been a decrease on both sides in long-term commitment and loyalty." Although our commentators left the connection between mobility and pay implicit, the standard academic account on this point is that mobility increases efficiency by imposing a more frequent market test on compensation, a market test that then moves pay ever closer to true marginal product. If the loyal executives of the past were typically underpaid relative to their product, then a reduction in loyalty will serve to increase pay.

The new brand of CEO that emerges from these accounts is increasingly mobile, status-competitive, and compensation-oriented. This CEO is less committed to the firm's welfare, less committed to any larger societal welfare, and less committed to any ethical framework that might mitigate against the pursuit of ever-higher income. The Chairman of Telecom Italia, Gabriele Galateri, discusses quite explicitly this cultural shift:

> *Guys of forty, forty-five years old, who were earning as much as 20 or 30 million euro in one year, went completely unnoticed and did not give rise to perplexity in anyone. ... If you work in a normal company then it doesn't make any sense. But there has been a sort of addiction that made us accept this as a fact of life, instead of saying that there was something wrong going on. I think it reflects a much wider problem than corporate governance. There was an overall worldwide cultural movement that has slowly taken over and reduced the importance of many rules, legal or natural, that kept people on track.*

The claim, in short, is that narrowly self-interested behavior has come to be viewed as ever more acceptable, indeed any deviations from such behavior are understood as pathological, perhaps even a signal of weakness. The same idea shows up in various forms in many of the transcripts. For example, John Sweeney refers to the growing "greed of the highest paid," while John Monks suggests that an earlier sense of "mutual obligation" has gradually weakened and that the rich have "forgotten those responsibilities and obligations."

There is, then, a novel line of argumentation running through much of the commentary on executive compensation. We do not mean to suggest that all of our commentators adopted this particular account or that it was presented by any of them in the especially simplified form rendered here. There was, however, a shared kernel to the commentary on executive compensation that is quite striking and would be intriguing to explore further.

How Might Inequality Be Remedied?

We will close off our review by briefly rehearsing the various remedies for inequality that our commentators have advanced. It is sensible to treat the topic in short order because our two concluding essays will engage at length with our commentators on the matter of remedies.

We have already noted that the prevailing account of the takeoff emphasizes that the supply of skilled labor has not kept pace with the demand for such labor. Under this formulation, inequality is delivering a simple message to the workforce, a message to the effect that money can be made by acquiring those skills that are in short supply. The obvious role for policy here is to assist workers in responding to this message by improving access to and the quality of education. And indeed many of our commentators suggested just such an approach. For example, the Chairman of BASF, Jürgen Hambrecht, advocates "much, much more spending on education," while Poul Rasmussen argues for improved "education and training projects," and Jerry Yang stresses the need for "fair and equal access to high-quality education." For many of our commentators, including Hambrecht, Ackermann, and Galateri, early education is especially important because it's been shown to yield an attractive cost-benefit ratio. It bears noting, however, that Fred Smith takes a rather different tack in arguing that the conventional four-year college is too often oriented toward building skills for which there isn't much of an economic payoff. This line of reasoning implies that federal funding should instead target vocational skills of the sort that the economy is actually demanding.

If we turn to the matter of executive compensation, here the commentaries become more detailed and energized, and indeed some fascinating dilemmas are revealed. It bears recalling that many of our commentators understood the upward spirals in compensation as a consequence of fierce status competition that in turn was engendered by transparency reforms. Although such reforms may well be the smoking gun, none of our commentators suggested that they can or should be rolled back. To the contrary, Rasmussen suggests that the "number one" reform should be effecting *yet more* transparency, while Ackermann likewise notes that "transparency is key" insofar as public confidence is to be restored. The quite reasonable logic here seems to be that one can't possibly roll back on transparency in light of the now very public concerns about pay. The effect, however, of maintaining transparency is that the market is accordingly trapped in a high-competition system that then complicates any efforts to reign in pay. That is, insofar as compensation packages are inevitably a matter of public record, any remedies must now be focused on preventing transparency from generating the spiraling increases of the past.

How, then, are our commentators suggesting that such containment might be secured? Not surprisingly, there's rather little support for legally imposed limits on compensation, and not just because, as Hambrecht notes, such limits would be "diametrically opposed to the principles of a free-market economy." The further purely practical point made by Sir Mark is that legal limits "result in an enormous amount of effort being put into devising ways to get around the legislation." If legally imposed limits are rejected, then some form of self-regulation is of course required. It's useful in this regard to distinguish between three classes of self-regulation that could, according to our commentators, be deployed: (a) moral regulation, (b) stockholder regulation, and (c) performance regulation. We review each in turn.

The first approach, that of moral regulation, recognizes that excessive compensation packages offend the public and may be counterproductive from the firm's point of view because public hostility can exact a public relations toll or generate support for legally mandated limits on pay. How might such a moral cap in practice be set? The guiding principle, it would seem, is simply to be sensitive to the public's view of what's fair and reasonable. As Rasmussen puts it, the pay level has to be "negotiated on some ethical level," as it's simply disproportionate to have "finance executives earning 22,000 times the average wage of a hard-working American industrial worker." The case for moral regulation emerges even more clearly in Maurice Lévy's interview:

> *I think that it is very important to act reasonably,* avec mesure *as we say in France. It is clear that we have seen an escalation and it would be a good thing to bring compensation to more moderate levels ... I am of the opinion that the years to come will see the return of great values like ethics and the fading away of cynicism. I believe that this would help change behaviors particularly if appropriate didactic communication is applied. The effect on moderation of compensation would be much more important than any regulation.*

The idea of injecting moral sensibilities into the pay-setting exercise may be contrasted with the alternative view that such sensibilities are better expressed at the point of taxation. For example, Fred Smith suggests that, insofar as pay restraint is desired, it would be straightforward to "increase the marginal personal tax rate as [one goes] up the income scale."

The second approach, that of stockholder regulation, is well known and probably does not require much discussion. The logic behind the regulative approach is that stockholders are necessarily focused on bottom-line results and will accordingly be disinclined to approve any compensation package that can't be defended in such terms. As Sir Mark notes, shareholders tend to ensure that compensation packages have "sensible performance conditions," although he adds that such conditions could usefully be strengthened and made "more active and effective." Similarly, Galateri questions whether shareholder remuneration committees provide sufficiently active oversight, and he suggests that remuneration packages for top management should instead "pass through the shareholders' meeting and be approved by the shareholders, not just by the remuneration committee."

It's worth noting that our two labor leaders, Sweeney and Monks, are less enthusiastic about shareholder oversight. As Monks sees it, because shareholders have historically been focused on short-term stock appreciation, any performance conditions they might impose will likely be short term in form:

> *I don't think shareholders are long-termist. How do you get people to think more long term, about the growth of the business over a period? I posed these questions at a seminar in the City of London and some bright spark put his hand up and said, "I've got some long-term investments, Mr. Monks. They're short-term investments I can't get rid of."*

Although Sweeney is likewise skeptical, his main concern is that shareholders haven't "the will to be aggressive enough" and can't be counted upon for any serious oversight.

If shareholders won't reliably hold the line on pay, some companies could instead proceed by insisting that all contracts for top executives must have standardized performance incentives. This third approach, which in effect makes performance contracts a matter of company policy, focuses on bolstering the connection between merit and pay rather than on simply capping pay. There is a general consensus among our commentators in favor of Ackermann's recommendation that contracts "must take a long-term perspective and remuneration must be based on real, bottom-line contributions to earnings, not on revenues, with vesting over several years." These contracts should further have a "claw-back mechanism" to recoup bonuses whenever they're driven by transitory market events. The obvious difficulty with this approach, a difficulty that our commentators well appreciate, is that one cannot easily ensure that pay will exactly equal "bottom-line contributions to earnings."

Conclusions

We are in the midst of a special moment in history in which inequality has become an unusually prominent matter of public discussion. To date, our understanding of the views of business, political, or labor leaders has rested on the occasional brief interview or yet shallower sound bite, and rather little is therefore known about how elites are actually thinking about rising inequality during this unique period in history. The transcripts provided here allow for an unusually detailed accounting of how elites are making sense of rising inequality and the various proposals to address it.

It's rather surprising that scholarship on inequality is practiced with so little evidence from those at the top of the class structure. We routinely interview and study the poor; we routinely interview and study the middle class; we routinely poll and survey the general population. And yet we too often ignore those at the very top. Although sometimes it's claimed that elites will at all costs avoid the interview, we have found that access was often gladly provided and that, in most cases, our participants quickly warmed to the topic.

The case for interviewing elites rests in part on their familiarity with the processes by which inequality is generated. If we want to understand how CEO compensation works, it cannot hurt to talk to those who have been compensated as CEOs and who have sat on boards that decide on the compensation of other CEOs. If we want to understand why and how skill is remunerated, it cannot hurt to talk to those who have established the compensation schemes that implement those skill distinctions. If we want to know how skill deficiencies and mismatch play out in the labor market, it cannot hurt to talk with those who confront these deficiencies on a daily basis. The views of CEOs and other elites provide, then, an important window into the sources of changing inequality.

It's no less useful, however, to turn the microscope away from the labor market and wage-setting practices and onto elites themselves. We of course care about what elites are saying and thinking because their ideas are behind so much corporate and government policy. The transcripts provided here can therefore be doubly mined for the window they provide into the dynamics of inequality as well as for the window they provide into the minds of elites themselves.

We can't pretend to have reviewed here anything but a sampling of the themes that surfaced in the interviews. If only to keep our review tractable, we have focused on commentary addressing (a) the effects of the financial crisis on how inequality is viewed and explained, (b) the causes of the long-term increase in income inequality and executive compensation, and (c) the merits of various approaches to reducing inequality. The interviews themselves take on these and other questions in far more detail than can possibly be commented upon in this chapter. We encourage our readers to mine these transcripts as a fascinating commentary on this very special moment in the history of inequality.