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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Is There Too Much Inequality?

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

Should we be troubled by the recent increase in income inequality? Throughout human history, even quite extreme levels of inequality have tended to be accepted as part of the natural order, indeed "just the way things are." This is not to imply that such acquiescence has ever been so complete as to eliminate *all* opposition. With the Enlightenment, a critical rhetoric of equality emerged in opposition to the civil and legal advantages of the aristocracy, a rhetoric that ultimately provided the intellectual underpinnings of socialism. This egalitarian rhetoric was of course the implicit narrative behind some of the world's most famous revolutions (e.g., the French Revolution, the Russian Revolution). However, such revolutions are rare events that stand out precisely because the larger and dominant tendency is to accept the current regime, even a highly unequal one, as legitimate. The contemporary world is no exception to this general pattern of acquiescence. Although public opinion polls have registered *some* dissatisfaction with the amount of inequality, this dissatisfaction is usually quite muted and, at most, registers as a worry or complaint in conversations with friends, family, or pollsters rather than spontaneous protests in the streets or more organized anti-inequality political movements.

The tendency to accept and even embrace inequality underlies the extraordinary stability of contemporary capitalism. But recent events, most obviously the financial crisis and recession, may bring about a refashioning of the long-standing "social compact" that to date has convinced vast swaths of the population to regard inequality as quite acceptable. This compact, as it is usually understood, holds that high levels of inequality are justified and unproblematic as long as (a) those who come out ahead do so by winning a fair and open competition, and (b) the rest of the population, although by no means rich, can expect to enjoy a comfortable and decent lifestyle as long as they work hard and play by the rules. In all market economies, this type of compact enjoys considerable support, although it is certainly more deeply institutionalized in Anglo-American societies than Continental or Nordic ones.

The question then becomes whether the financial crisis and subsequent recession will make some people less willing to accept or justify inequality

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as the outcome of hard work and talent. This typical justification, which is the heart of the social compact, might be undermined in two ways. First and most obviously, insofar as a great many talented and hard-working workers remain unemployed or underemployed during a prolonged recession, it becomes more difficult for them (and perhaps others) to embrace the simple premise that hard work and talent straightforwardly make for success. Second, such widespread duress at the bottom of the class structure, in itself challenging to the compact, has developed amidst highly public revelations that at least some top executives have reaped extraordinary riches despite their firm's poor performance. The presumption that merit earns rewards may therefore come under challenge in light of concerns that neither the unemployed poor or amply compensated rich fully deserve their fate. It may not help in this regard that precisely those who reaped riches at the top are regarded by many as responsible for the economic crisis and the economic difficulties it caused for the less fortunate.

We don't yet know how, if at all, these various developments will affect public views about inequality. It is altogether possible that the vast middle class, or at least that portion of the middle class that feels secure about its economic future, will remain untroubled by these developments. At this very early juncture, it does nevertheless appear that the recession and financial crisis have triggered some public awareness of rising income and wealth inequality, and even outright anger that workers at the top, particularly in the financial and banking sectors, were permitted to reap rewards that may be in excess of what their performance merited. We have accordingly witnessed increasingly strident calls to restrict executive compensation, to tie it more directly to merit or firm performance, and to overhaul tax regimes. In late 2009, when the BBC World Service completed a global poll on a range of economic and inequality topics, approximately 41% of U.S. respondents and 67% of U.K. respondents were in favor of government "doing more to distribute wealth more evenly."[1] It is striking that such strong support could appear in countries that so famously support deregulated capitalism and competitive markets. When the same question was asked in Germany, France, and Italy, the percent of the population favoring more active redistribution was significantly higher (77%, 87%, and 89%, respectively). It also bears noting that some concerns about rising inequality predated the full-blown financial crisis. According to a 2008 FT/Harris poll, three-quarters of adults in the five largest European coun-

1 See http://www.bbc.co.uk/pressoffice/pressreleases/stories/2009/11_november/09/poll.shtml for more details on the survey.

tries and the United States not only regarded the gap between rich and poor as excessive, but additionally expected it to widen over the next five years.[2]

Because we know even less about the views of political, economic, and labor elites, it would be helpful to examine how they have come to understand inequality and what, if anything, should be done to reduce it. Do elites think that the post-war social compact may be weakening and that high levels of inequality will accordingly be regarded as less defensible? Do they view the takeoff in executive compensation as a violation of the social compact? Are they interested in reigning in such compensation? Do they also worry about the growing gap between highly educated and less-educated workers? Is poverty a matter of concern? The purpose of this book is to address such fundamental questions by interviewing a cross-section of some of the world's most powerful business, political, and labor leaders. We wish to open a window into how elites assess inequality in these extraordinary times.

We are not just interested in how elites understand rising inequality but also how, if at all, they propose to reduce it. We have asked them whether there is a role for government in combating possibly excessive levels of inequality, whether some of the more commonly advanced solutions might do more harm than good, and whether new and creative solutions to excessive inequality can be offered. The resulting in-depth interviews provide a platform for those who witnessed firsthand the takeoff in inequality to reflect candidly on where we are and what is to be done. This format makes it possible for them to go beyond the occasional media sound bite and engage instead in more sustained reflections about one of the most prominent developments of our time.

The backdrop to the economic crisis is, of course, an ongoing increase in income inequality in most, but not all, rich countries. Because our contributors make frequent reference to these trends, it is useful to conclude this introductory chapter with a brief summary of the current state of evidence on inequality. We rely on the definitive report *Growing Unequal?* recently published by the Organization for Economic Cooperation and Development (OECD).

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2 Financial Times/Harris Poll, 2008 (May). "Monthly Opinions of Adults from Five European Countries, China, Japan, and the U.S." http://www.harrisinteractive.com/news/FTHarrisPoll/HI_FinancialTimes_HarrisPoll_May2008.pdf.

We begin, then, by examining the overall level of income inequality within 30 OECD countries. As shown in Figure 1, there's substantial variability across these countries in the extent of income inequality, with of course the Nordic countries, especially Denmark and Sweden, registering the lowest levels of inequality. The middling ranks include such countries as France, Germany, Austria, Canada, and Japan, while the most extreme inequality appears in such countries as Italy, the United States, Turkey, and Mexico. The Gini coefficient, a commonly used indicator of inequality, has been applied in Figure 1,[3] but much the same conclusions would be reached with other measures.

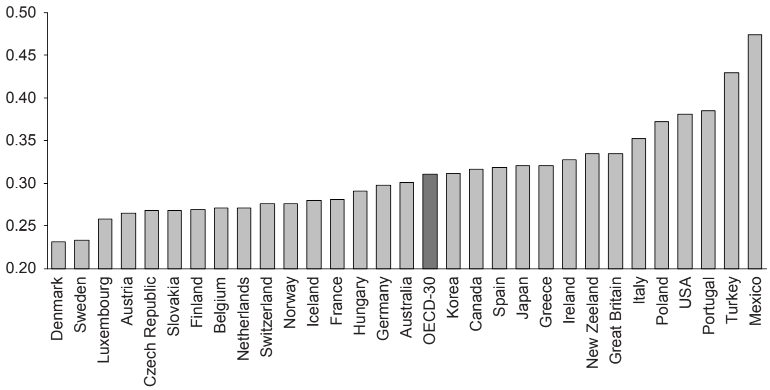

Figure 1: Gini coefficients of income inequality in OECD countries, mid-2000s (Source: OECD income distribution questionnaire)

What about trends in income inequality? In the same report, the OECD observed that income inequality rose at a "moderate but significant" pace, with the data suggesting an average increase across countries of approximately two Gini points in the last 20 years (see Figure 2). Likewise, data from the Luxembourg Income Study,[4] perhaps the best comparative resource on income and inequality in rich countries, show that most countries have experienced at least a modest rise in income inequality at some

[3] The Gini coefficient for income measures the dispersion or spread of income across a society. It equals one if a single person holds all of a society's income and equals zero if everyone holds exactly the same amount of income.

[4] The Luxembourg Income Study is a cross-national data archive including income and wealth microdata from a large number of countries at multiple points in time. For further information, see http://www.lisproject.org/.

point since the 1980s, although there are of course important differences across countries in the timing and extent of such change.[5]

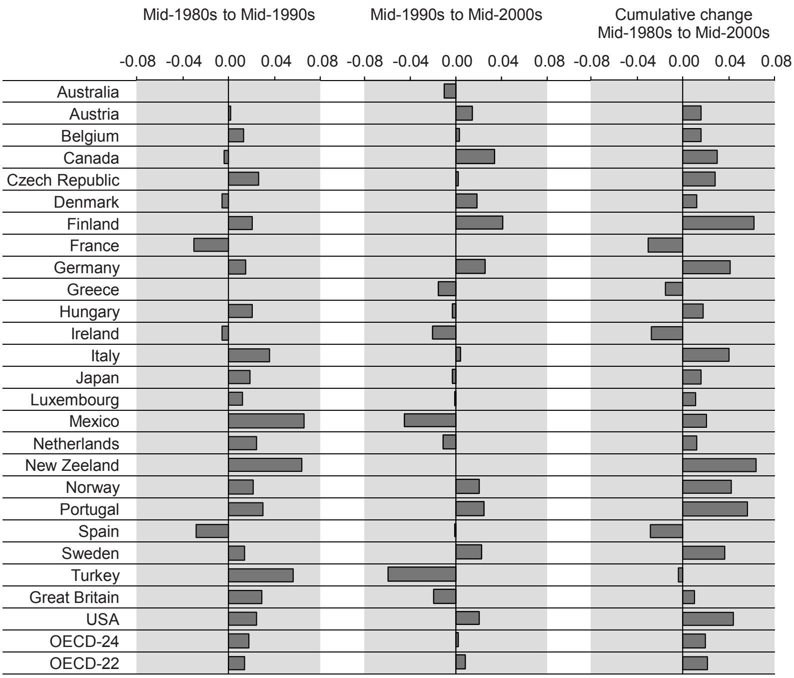

Figure 2: Trends in income inequality: Point changes in the Gini coefficient over different time periods (Source: Computations from OECD income distribution questionnaire)

These overall inequality trends cannot tell us whether certain sectors of the income distribution account for most of the changes when inequality rises or falls. We can better understand why income inequality has risen in cer-

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5 Brandolini, A., and T.M. Smeeding, "Patterns of Economic Inequality in Western Democracies: Some Facts on Levels and Trends," *Political Science and Politics* (January 2006), pp. 21-26. According to Brandolini and Smeeding, the U.S. and the U.K. have experienced the largest and most sustained increases in income inequality, while France experienced virtually no increase. The increases in the Netherlands, Sweden, and Finland were more modest than those in the U.S. and the U.K., while the increases in Germany and Canada were even smaller. The careful reader will note that the foregoing results, as reported by Brandolini and Smeeding, don't always accord perfectly with those reported by the OECD (as presented in Figure 2).

tain countries by examining which sectors of the distribution have driven most of the change. For example, in an important set of studies, Thomas Piketty and Emmanuel Saez have shown that much of the recent change in the income distribution of English-speaking countries (the U.S., the U.K., and Canada) has occurred at the very top of the distribution, with the fraction of total income going to that top fraction rising dramatically.[6] Other countries, such as France and Japan, have experienced only minor increases in top incomes in the modern era.

We will not attempt to provide a protracted account of the political, economic, social, and cultural sources for this complex pattern of change. Although the consensus view continues to be that much of the increase in inequality stems from a rising demand for skilled labor and a corresponding increase in the payout to such labor, it's likely that other sources are also implicated, such as globalization, market liberalization, changing tax policies, financial innovation, changing social mores, deunionization, changing corporate governance, market failure, and shifting demographics. It is well beyond the scope of this book to offer new evidence on these competing accounts. Rather, we would like to present the *accounts* of rising inequality that business, political, and labor elites tend to mention.

Why are these accounts so important? The most obvious reason is that business, political, and labor elites have a special vantage point that scholars, the usual purveyors of scientific analysis, cannot readily access. If, in other words, you *really* want to know how executive compensation is generated, it's probably useful to ask those who have observed its workings intimately and on a daily basis. Likewise, if you *really* want to know how the pay of workers is set, it's probably useful to at least ask those who are intimately involved in firm governance. The observations of business, labor, and political leaders can be used in this way to produce a better and more informed understanding of how inequality evolves.

But these accounts are also of interest in their own right. Indeed, even if elites held grossly misleading views on how inequality unfolds, it is still important to understand their views precisely because they are so influen-

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6 Piketty, Thomas, and Emmanuel Saez, "Income Inequality in the United States, 1913–1998," *Quarterly Journal of Economics* 118 (2003), pp. 1–39. See also A.B. Atkinson and Thomas Piketty, 2010, *Top Incomes: A Global Perspective*, Oxford: Oxford University Press; A.B. Atkinson and Thomas Piketty, "The Evolution of Top Incomes: A Historical and International Perspective," *American Economic Review* 96 (2006), pp. 200–205.

tial. When regulatory, tax, and other policies are crafted, the opinions of elites tend to be especially influential and carry special weight, thus making it important to understand how elites view inequality and their recommended policies. The simple premise, then, behind this book is that we do well to understand how those who can influence inequality tend to view it. We have set out to provide just such an assessment "from the top" of why there's inequality, why it's increasing, and what, if anything, should be done about it.

In the summer of 2009, the authors conducted in-person interviews with a cross-section of top business and labor leaders in Europe and the United States, the resulting roster including some of the most influential leaders of our time. The interviewees are:

Europe

Josef Ackermann, CEO and Chairman, Deutsche Bank

Bertrand Collomb, Honorary Chairman, Lafarge

Gabriele Galateri di Genola, Chairman, Telecom Italia

Jürgen Hambrecht, Chairman, BASF

Maurice Lévy, Chairman and CEO, Publicis

John Monks, General Secretary, European Trade Union Confederation

Sir Mark Moody-Stuart, Former Chairman, Anglo American; Former Chairman, Shell

Poul Nyrup Rasmussen, President, Party of European Socialists; Former Prime Minister, Denmark

United States

Fred Smith, Chairman, President and CEO, FedEx

John Sweeney, President Emeritus, AFL-CIO

William Weld, Partner, McDermott Will & Emery LLP; Former Governor, Massachusetts

James Wolfensohn, Chairman and CEO, Wolfensohn & Co.; Former President, World Bank

Jerry Yang, Co-Founder and Chief Yahoo, Yahoo!

The centerpiece of the book is our interviews with these thirteen leaders. The transcripts, presented in unexpurgated form, provide a rare and important glimpse into how world leaders consider inequality.

In Part 3 of the book, we summarize the analyses and recommendations, as offered by our thirteen elites, and attempt to distill them into a set of principles. We then return to our central question, “What should be done?” in Part 4 of the book. We do so by contrasting the views of Roland Berger, Founder, Roland Berger Foundation, with those of David Grusky and Christopher Wimer, both U.S. academics within Stanford University’s Center for the Study of Poverty and Inequality. The key question here: Will representatives of the business and academic world react similarly or differently to this unique body of evidence? We leave it to our readers to make the final judgment on this matter, but our suspicion is that some may be surprised by the amount of common ground.