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The Inequality Puzzle

European and US Leaders Discuss Rising Income Inequality

Can Inequality Be Reduced by Building Better Markets?

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The growth in wage inequality within many late-industrial countries is one of the most spectacular and consequential developments of our time, spectacular because the turnaround was so sudden and undermined the conventional view that economic development would bring about widely diffused affluence, consequential because it is affecting the lives of so many people and in such profound ways. During the early stages of this takeoff in inequality, the dramatic changes in remuneration were happening largely under the radar, indeed the public was not just unconcerned by the changes but in fact largely unaware of them.[1] But that's no longer the case. We are now in the midst of a historic moment in which public debates about the legitimacy of extreme poverty and inequality have taken on a new prominence and urgency.

There are some scholars who regard this rise in inequality as entirely unproblematic.[2] However, the increasingly dominant view among scholars is that the the takeoff is problematic, and now is a rare moment in which the public is inclined to agree with such an assessment and may be poised to support reasonable anti-poverty and anti-inequality initiatives. It is striking that most of our contributors, themselves typically the beneficiaries of this takeoff, likewise tend to agree that inequality in its "excessive" form has become a major social problem. The question that then arises is that of how best to develop a winning strategy for reform.

We don't of course harbor any illusions that a major change in strategy can easily be achieved. In any late-industrial country, one will find a well-developed and deeply institutionalized apparatus for addressing poverty and inequality, and any changes in that apparatus will at this point likely be glacial. It is nonetheless important to continue revisiting and redefining

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1 McCall, Leslie and Lane Kenworthy. 2008. "Inequality, Public Opinion, and Redistribution." *Socio-Economic Review* 8:35-68.

2 Henderson, David R. 2006. "Income Mobility: Alive and Well." *Hoover Digest* 2006 (1).

R. Berger et al., *The Inequality Puzzle: European and US Leaders Discuss Rising Income Inequality*, DOI 10.1007/978-3-642-15804-9_18, © Springer-Verlag Berlin Heidelberg 2010

the rationale behind such an apparatus and thereby ensure that any further changes and elaborations are consistent with that rationale. We will attempt in this chapter to lay out what we think is a promising rationale and how existing policies might then be elaborated to better serve it.

This type of exercise is only infrequently attempted. In many countries, perhaps especially the United States, there's a rather strong strand of pragmatism underlying poverty and inequality policy. If an anti-poverty program can be shown to work at low cost (i.e., reduce poverty), then that's enough for us and we're all for it and will embrace it. This pragmatist movement to identify "what works and what doesn't," which again is a movement that's especially prominent in the United States, thus elevates to center stage the very simple empirical question of whether a given program has its intended effects. We are of course all for program evaluation. But the usual evaluation exercises, almost by definition and certainly by convention, don't take into account the long-range effects of policy and, in particular, whether that policy is properly accumulating into a set of institutions that resonate well with our larger ideals.

We are therefore suggesting here that we would do well to have an ideology, a "constitution" of sorts, that underlies reform efforts, just as we have an ideology that underlies our attempts to fashion a more productive economy. We are of course continuously engaged in reforming our economic institutions: We have to decide whether to enter into proposed trade alliances, whether to reform tax law, whether to allow new types of corporate forms, and so forth. When such decisions are being made, we typically refer back to first principles by asking whether the proposed reform will be competition-enhancing, in effect whether it will allow the "invisible hand" to better operate. We call ourselves market economies precisely because of this a priori commitment. When, however, we turn to poverty and inequality reform, we seem rather less tethered to any a priori commitments. In the absence of principles, our interventions tend to grow and accumulate into a sprawling array, one without any obviously unifying rhyme or reason. The suggestions that we make in this chapter will, by contrast, be quite explicitly tethered to a simple guiding principle.

What might that principle be? We did not by happenstance alone choose to contrast our ideology-rich economic policy with our ideology-poor poverty and inequality policy. The contrast is especially instructive, we argue, because poverty and inequality policy is best founded on the same market principles that now inform our economic policy. We make this argument in particular for countries, such as the U.S., Germany, and the U.K., in which market principles are deeply written into the cultural DNA and

hence have a special and abiding resonance. For other countries (e.g., Nordic countries), such principles are a less fundamental cultural commitment, and the rationale for building them into poverty and inequality policy is less compelling.

The reader may at this point be perplexed. How, it might be asked, could we possibly build our main anti-inequality interventions around market principles? Aren't profound poverty and inequality the main consequences of adopting market principles? Shouldn't we therefore expect yet more poverty and inequality insofar as we build labor market institutions that better adhere to market principles? These are good and important questions, and the rest of our chapter will be devoted principally to answering them, to showing that market principles, if we were to truly and fully commit to them, would yield far less poverty and inequality than we now have.

We well realize that this is a radical view. The conventional wisdom is indeed that poverty and inequality are (unfortunate?) consequences of market processes, that those with a pro-market commitment must therefore reconcile themselves to much market-generated inequality, and that insofar as less inequality is preferred the only recourse is then to engage in much corrective after-market redistribution. This conventional wisdom is so widely diffused and taken for granted that many people presume that progressive taxation and other redistributive after-market interventions are the *only* way to address poverty and inequality. The presumption, in other words, is that the market generates inequality and that after-market interventions are therefore the only way to undo inequality. We will argue that in fact nothing could be further from the truth.

We thus take the obverse position that *market failure* is a main source of poverty and inequality. Put simply: We'd have far less poverty and inequality if our labor market institutions were *more* competitive, if we committed in a *meaningful way* to a competitive market economy, if our commitment to competition wasn't of the lip-service variety but was an *authentic commitment* to which we held even when the rich and powerful might thereby lose out. If market failure is the cause of poverty and inequality, then the correct prescription is market repair. We argue that we can take on poverty and inequality by making our labor market institutions more competitive and thereby reducing the amount of illicit, non-competitive inequality generated within the market. This approach reduces the pressure to take on poverty and inequality via redistributive approaches that are typically viewed as ideologically suspect. We instead take on poverty and inequality by simply acting on our widely shared commitment

to market principles, but now treating them as commitments to which we are *really* committed.

The test of any commitment is that we follow it no matter where it leads us. If the rich and wealthy, long the principal advocates of market principles, come to appreciate that they've been the principal beneficiaries of market failure and will in fact lose out under an authentically competitive market, then it's surely out of bounds if they then withdraw their commitment to the market. If they do, then their putative commitment is in the end merely convenient ideology. We are therefore asking the rich to bear the same harsh medicine of the market that has so long been doled out to the poor. The poor have, after all, long been lectured to the effect that the market's discipline must simply be borne, that the decline, for example, of manufacturing in the U.S. provides no justification for protectionism, that the 'losers' must instead take one for the team and get on with the market program. We will be arguing below that no less should be asked of the rich.

But so much for preliminaries. Let's get on now and make the case for two types of market repair. We begin by arguing that rising returns to schooling, well-appreciated as a main cause of rising inequality, are attributable to market failure in the form of barriers to free and open competition for higher education. We then argue that excessive executive compensation is likewise rooted in non-competitive practices and that a market wage would likely be inequality-reducing. Because of space limitations, we can't of course render the argument in any comprehensive way, and instead we refer the reader elsewhere[3] for a related and more comprehensive argument and supporting evidence. The two examples laid out here should be treated, then, as mere examples of the larger claim that market failure is a principal cause of inequality and that market repair is accordingly the correct prescription.

We will comment throughout this chapter on the matter of how this position is sometimes consistent and sometimes inconsistent with that of Roland Berger and our other contributors. In some cases, the reforms that we propose will be much the same as those proposed by Roland Berger (and some of the other contributors), but the rationale for carrying out those reforms will be different. Because the premise of our chapter is that principles matter, we'll take special care to lay out those instances in

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[3] Weeden, Kim, and David B. Grusky. 2010. "Market Failure and Inequality," Center for the Study of Poverty and Inequality Working Paper, Stanford University.

which we agree with our contributors about the types of reforms that are desirable or necessary, yet even so disagree with them on why they're necessary.

Education and Market Failure

We begin by considering education policy. There may be nothing *less* controversial these days than issuing a call for increased investment in education. True to form, most of our contributors have indeed issued this call, although Fred Smith has additionally suggested that some workers might profit more from vocational training (or a community college experience) than a traditional four-year college experience. We agree that meaningful vocational training is undersupplied in many late-industrial countries (with the obvious exception of Germany). However, given that the rise in inequality is largely attributable to the growing earnings of the college educated, the undersupply of college education is arguably especially worth addressing insofar as the objective is to reduce inequality. The inequality-reducing mechanism is straightforward: Namely, if the supply of college-educated workers were increased, there would be more competition for the pool of jobs requiring a college education, such competition would in turn drive down the pay of college-educated workers, and inequality would accordingly decline. The implication is that, if we're really serious about reducing inequality, a simple but powerful way to proceed is to ratchet up the number of college-educated workers.

It might reasonably be asked why workers don't simply go ahead and pursue a college education when they well know that there's a high payoff to college. Are there, in other words, real structural impediments to raising rates of college attendance or are there just cognitive impediments? The "cognitive impediments" story, stated baldly, has it that workers are either stupid or lazy: That is, they may well understand that college yields a high payoff, but even so they just can't be bothered to pursue a college degree. The cognitive impediments theory strikes us, however, as rather less plausible than an account that recognizes that, while most workers appreciate that there's a payoff to college and are keenly interested in securing it, they are simply not in a position to do so. There are both supply-side and demand-side barriers that prevent enough workers from securing a college education: The *supply* of potential college students is artificially lowered because children born into poor families and neighborhoods don't have the training (in primary and secondary schools) that qualifies them for entry

into college,[4] while the *demand* for college students is kept artificially low because, in at least some countries, elite private and public schools engage in explicit rationing of their available slots. It's not as if Oxford University, for example, is meeting the rising interest in its degrees by selling some profit-maximizing number of them. If top universities did meet the demand in this way, the excessive returns to a high-prestige education would disappear. But instead they've decided to ration.

When, by contrast, the demand for hybrid cars increased dramatically in the U.S., car manufacturers responded by ramping up production to a profit-maximizing level, not by setting up hybrid-car "admissions committees," not by carefully interviewing and testing prospective buyers, not by asking them to submit detailed resumes and statements about how the hybrid-owning experience will change their lives. The market for cars is therefore truly a competitive market, whereas the market for education is anything but. We have become so accommodated to the contemporary practice of rationing higher education that we don't any longer appreciate that practice for the profound form of market failure that it is.

These bottlenecks on the supply and demand sides mean that those lucky enough to have a college education are artificially protected from competition and reap excessive pay as a result. If all children, even those born into poor families, had fair and open access to higher education, these excessive returns would wither away under the force of competition. It's in this very important sense that market failure is generating inequality. The prescription is likewise clear: If market failure is the cause of inequality, the proper response is market repair. We can straightforwardly repair the market by addressing the supply-side and demand-side bottlenecks that now prevent workers from acquiring college degrees.

Who would win and who would lose under such market repair? We have already noted that the losers would be those who are now artificially protected from competition and are therefore reaping excessive returns. The winners, by contrast, are of course those who are currently locked out of higher education but would gain access once markets were repaired. But these are not the only winners. The other main winners would be the businesses that currently pay inflated prices for high-skill employees but will no longer have to do so once higher education is opened up fully to competition. It should come as no surprise that many of the business leaders interviewed in this volume expressed considerable frustration with educa-

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

tional bottlenecks and noted that there just isn't a sufficient talent pool to maximize profit and growth. It's hardly in the interest of business to pay excessive returns to rationed secondary education, nor is it in the wider interest of any country to settle for the lower GDP that such restrictions on competition imply. The upshot is that market repair yields many winners and comparatively few losers.

If we are quite uncontroversial, then, in issuing a call for more educational opportunities, the rationale that we have proffered for such a policy is not the conventional one on offer. The main reason for ramping up educational opportunities is, we have argued, that it repairs market failure and corrects the excessive payoff to a college degree that such failure brings about. As noted above, the business leaders in this volume have made reference not to such excessive returns, but rather to the market inefficiencies that educational bottlenecks will necessarily generate. It's notable that our business leaders also stressed that opportunity-increasing interventions will lend legitimacy to the system and deflect any possible criticism of inequality by inducing workers to focus on the possibility of experiencing mobility themselves. The idea here, one that has a provenance extending back at least to the work of Werner Sombart,[5] is that extreme inequality becomes more palatable in the eyes of workers when they have an opportunity to rise to the top. For example, Josef Ackermann writes that "the government should invest as much as possible in education .... [because it] gives citizens the feeling they have opportunities in life" (p. 19, emphasis added), while Sir Mark notes that "what's extremely disruptive in inequality is not just inequality itself, it's when individuals feel that they are trapped in the unequal half of the equation" (p. 90). If workers feel they have a chance to get ahead and that their position in the "unequal half of the equation" is but a temporary one, then the presumption is that they will give their full blessing to a highly unequal system.

In Roland Berger's insightful chapter, it's additionally stressed that "early childhood education and care offers substantial long-term benefits" (p. 201), the point here being that educational opportunities not only make the labor market appear fairer but also reduce poverty by improving labor market outcomes for disadvantaged children. This rationale, which emphasizes that human capital investments (i.e., schooling) generate higher earnings, should again be distinguished from our market failure approach (see, for example, Gary Becker for the definitive statement of the human capital

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5 Sombart, Werner. 1906. *Warum gibt es in den Vereinigten Staaten keinen Sozialismus?* Tübingen: Mohr.

model).[6] That is, Roland Berger nicely emphasizes the returns to college for the poor, whereas we've made the obverse point that, just as the poor will earn more, so too those who have been profiting from protection against competition will now face that competition and will earn less as a result. Under the new non-rationing regime, the poor who were formerly excluded from education will now receive it and earn more, while the college-educated workers who were once protected from competition will now be exposed to competition and earn less. The total effect is therefore a reduction in inequality.

We've made a point of the excess returns that now accrue to lucky degree-holders because doing so reveals the inequality-increasing effects of market failure. This is not to deny the additional negative psychological effects of educational rationing that some of our business leaders have emphasized. We indeed agree with them that increasing educational access will make the system appear fairer and render existing inequality more palatable. But truth be told, we are more concerned with reducing inequality than with convincing workers that the current levels of inequality are unproblematic. Even more important, there is polemical value in a market failure account, as it focuses attention on how our current system is built on a form of rationing, a foundation that just can't be reconciled with a commitment to competitive markets. It's not just a matter of helping poor people, nor is it just a matter of making them think the system is fair. These objectives are all well and good, but for most people they are just side commitments, not nearly as important as our core commitment to a market economy. The need for educational reform becomes more urgent when it's grounded in this pro-market rationale as opposed to a more conventional and softer "do-gooder" commitment to helping the poor.

It is worth asking exactly *how* such education reform might be implemented. If the objective is to correct for market failure, we must undertake educational reforms that (a) allow low-income students to more freely compete, and (b) prevent high-income families from unduly shielding their children from competition. This agenda is more controversial than the usual calls for ramping up our investments in education. Consider, for example, the case of preschool in the U.S. Currently, high-income parents purchase high-quality early education, a purchase that involves scheming to purloin one of the carefully rationed slots in a premium childcare center. By contrast, low-income parents face a patchwork of state and federal ear-

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6 Becker, Gary S. 1964. *Human Capital: A Theoretical and Empirical Analysis, with Special Reference to Education.* Chicago: University of Chicago Press.

ly education programs, many of which offer low-quality instruction and care that fail in the task of preparing children for school. If we are serious about correcting market failure, our publicly subsidized early education programs will have to look more like the high-quality environments purchased by high-income parents on the private market. Although we railed against the presumption that inequality-reduction can only proceed via ramped-up redistribution, ironically the road in this case to guaranteeing free and fair competition may well require just such redistribution.

We've all become inured to the severe bottlenecks in educational access and seemingly fail to appreciate them for the egregious form of market failure that they are. We should be able to say to ourselves that we're really committed to markets, that it's truly our signature commitment, and that we're prepared to engage in fundamental institutional reform to make that commitment real. It's high time, then, to move beyond the usual lip-service appeals to educational reform and appreciate that the current system makes a mockery of our market commitment and needs a massive overhaul.

Executive Pay and Market Failure

If one next considers CEO and executive pay, one again can't be all that impressed by our commitment to market principles. The main and well-known problem is that board members, sitting at the behest of the CEO, are making decisions about that CEO's pay.[7] This setup lends itself to board members favoring ample compensation packages because their own interests are best served by attending to the CEO. It should come as no surprise, for example, that CEO pay is higher when many of the outside directors have been appointed under the CEO.[8] It becomes difficult with such pay-setting practices to represent the resulting pay in market terms. It's rather like asking a professor's students to decide on the professor's pay in advance of receiving their grades. When the fox is guarding the henhouse, one has to believe the fox's interests are the principal interests being served.

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[7] Bebchuk, L. A., and J. Fried. 2004. *Pay without Performance*. Cambridge, MA: Harvard University Press.

[8] 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.

The board's particularism is, however, nicely camouflaged by the practice of hiring outside consultants to examine the pay of peer firms and make recommendations accordingly. The recommendation is of course represented as the pay level set by a competitive market. It's indeed the case that one can't expect CEOs to accept compensation below the prevailing compensation and that an individual firm may therefore have no reasonable alternative but to compensate at the prevailing level. It shouldn't, however, additionally be concluded that this package reflects the marginal product of the CEO. Rather, it's nothing more or less than the prevailing package, and the prevailing package simply reflects the prevailing practice of allowing CEOs to appoint board members who are then beholden to them. The resulting market pay is in fact simply the pay that's generated when non-market forces are allowed to affect the board's compensation decisions.

We don't of course mean to suggest that all economists see it this way. To the contrary, there's a large and powerful contingent of economists who instead view executive pay arrangements as the product of arm's length contracting between boards and executives, with the resulting compensation package indeed reflecting the marginal product of CEOs.[9] If existing corporate practices are delivering compensation that simply equals the value of the decisions the executive is making, then of course there's no market failure at all. The debate between economists who hold this view (i.e., the optimal contracting view) and those who reject it (i.e., the managerial power view) is long, acrimonious, and far from resolved.

Although we are deeply skeptical that existing governance practices can successfully deliver market pay, it goes well beyond our charge to review the relevant literature here and attempt to make that case. We will instead make the fallback point that one should at least avoid compensation practices that create the strong *appearance* of impropriety. It's possible that economists working within the optimal contracting view are entirely right that only the appearance of impropriety has been created and that at the end of the day compensation is efficient. But here's the rub: Even if this were true, the legitimacy of compensation practices are still everywhere doubted and called into question, and much corporate energy must accordingly be devoted to concealing, justifying, or explaining packages that the

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[9] Murphy, K. J., and J. Zabojnik. 2007. "Managerial Capital and the Market for CEOs." Working Paper, Queen's University; Gabaix, X., and A. Landier. 2008. "Why Has CEO Pay Increased so Much?" *Quarterly Journal of Economics* 123:49–100.

public and stockholders treat with much understandable suspicion. Because these packages are so public, the mere appearance of impropriety can lead to widespread cynicism about how fair our system is, with resulting costs in the form of increased disaffection and reduced initiative.

The upshot is that all of us, even those who hold to the optimal contracting view, should have an interest in setting up compensation practices that more plausibly generate the true market wage. We thus agree wholeheartedly with Roland Berger and Josef Ackermann that our remuneration systems need to be based on "real, bottom-line contributions to earnings, not on revenues, with vesting over several years." Although it's no easy task to develop such systems, Roland Berger and our contributors have advanced many sensible suggestions, including provisions for shareholder control (see Bertrand Collomb's and Gabriel Galateri's chapters) as well as "clawback mechanisms" to recoup bonuses due to transitory market events (see Josef Ackermann's chapter). We won't attempt to review such suggestions here. But the principle behind them should be clear: We must focus on compensating executives in ways that eliminate the appearance of impropriety and that plausibly approximate their marginal product.

This principle may seem obvious, but we were surprised that at least some of our business leaders don't wholly subscribe to it. It's useful in this regard to contrast two rather different approaches to reigning in compensation. The radical institutionalist approach, which we have been advocating here, entails recasting from the ground up the corporate institutions that generate pay packages, the objective being to eliminate the appearance of impropriety by developing practices that generate compensation rigorously in accord with product. We can, however, contrast our institutionalist approach with an alternative reformist approach that instead takes the existing corporate institutions as given and has us layering various pay-governing controls over those institutions. These additional controls may take the form, for example, of (a) internalized moral restraints on the amount of pay that executives should accept or be offered, (b) government regulations capping total compensation, (c) corporate pay scales constituting voluntary caps on compensation, or (d) government taxation of excessive compensation. Among the business leaders we interviewed, the preferred form of additional controls were not typically those emanating from government (i.e., government regulations or taxation), but instead were corporate-sponsored voluntary pay scales (see chapters by Poul Rasmussen and Maurice Lévy) or individualistic moral restraints (see chapters by Roland Berger, Gabriele Galateri, John Monks, Poul Rasmussen, and Jürgen Hambrecht).

These reformist approaches operate, it would seem, from the premise that two wrongs make a right. That is, they condition on deeply flawed institutions that are susceptible to non-market influence, yet instead of fixing those institutions they layer on top of them yet another non-market corrective (e.g., regulation). The evident premise is either that (a) two layers of non-market practices will, in conjunction, magically hit upon the true market wage, or (b) the main objective shouldn't be to capture that elusive competitive market wage but instead just to reign in compensation any way possible.

We think such cynicism underestimates the public and, in particular, their commitment to competitive markets. As we see it, the informed public wants nothing more or less than competitive market wages, and high levels of compensation are quite unproblematic in market-focused societies (e.g., U.S., U.K., Germany) when they're justifiable in market terms. There's much empirical evidence suggesting, for example, that the U.S. population is prepared to accept quite extreme inequality insofar as it's fairly generated under competitive market rules.[10] As Jürgen Hambrecht puts it, "people are more willing to tolerate differences in wealth if they can see a correlation between what a person earns and what they contribute to society." It's accordingly wrong to interpret the current public outrage about CEO pay as some mass protest against high compensation. It's rather a mass protest against corruption, against sweetheart deals, against foxes guarding the henhouse. If we're right on this point, the institutionalist approach is clearly preferred, and we should accordingly turn to developing corporate practices that will plausibly yield market pay.

Conclusion

We've argued here that there is much market failure in late-industrial societies, that such failure generates high inequality, and that market repair is our best bet for reducing inequality in a way that resonates well with our core commitments. The conventional wisdom is of course that competitive markets are inequality-generating machines and that perhaps the worst possible principle around which to build a commitment to equality is the market principle. This conventional formula confuses markets as they are with markets as they should be. In their current form, markets are indeed

[10] Hochschild, Jennifer. 1995. *Facing Up to the American Dream: Race, Class, and the Soul of the Nation.* Princeton: Princeton University Press.

inequality-generating machines, but that's mainly because they encompass various forms of closure, corruption, and supply bottlenecks that are inconsistent with a purely competitive market. If such market failure could be purged from the system, and we think it can, we would end up with strikingly less inequality. We have focused here on two especially important examples of this argument: (a) we first suggested that rising returns to schooling, well-appreciated as a main cause of rising inequality, arise because schooling is rationed in non-competitive ways; and (b) we next showed that excessive executive compensation is likewise rooted in non-competitive practices and that a market wage would likely be inequality-reducing.

We don't mean to suggest that inequality should exclusively be addressed via market repair. Although after-market redistribution is also an important tool for inequality reduction, it's too often assumed to be the only tool. The obvious problem with focusing exclusively on after-market intervention is that in some countries it's ideologically suspect and won't likely garner enough support to reduce inequality to palatable levels. The market principle is, by contrast, one of the core commitments of most late-industrial countries and hence a more promising base upon which to build anti-inequality initiatives.