Towards an Hourglass Society?

Income Differentials and the Fate of the Middle Class

Edited by Kay Glans & Johanna Laurin

Glasshouse Forum

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Glasshouse Forum brings together concerned capitalists and researchers from different disciplines and provides an arena for critical reflection on the merits and problems of capitalism.

Glasshouse Forum is research-oriented and interdisciplinary. It is politically independent and takes a pluralistic approach. It does not engage in lobbying activities, or make policy recommendations.

Glasshouse Forum is dedicated to deepening the debate about capitalism through various forms of meetings, seminars and publications.

Glasshouse Forum

First published in 2008

Katarinavägen 15, Box 1719, SE-111 87 Stockholm

Print: Nya RS Screen AB and Brommatryck & Brolins AB
Graphic design: Sandra Praun, Designstudio S

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Preface

Stockholm, December 2008
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Contemporary capitalism – although at bay at the moment[1] – is unrivalled as regards the creation of material affluence. But this is apportioned increasingly unequally. The gap between rich and poor has widened in most developed countries[2] and much evidence points to the fact that, in the long term, things will get a lot worse for the middle class in the West, as the new phase of globalisation with "tradable skills" means that, to a completely different extent, the middle class competes with labour in Asia.

It is also noticeable that social mobility is diminishing. The class into which you were born more and more determines the course of your life. We have a new class society, partly structured along ethnic dividing lines. In the USA it is the blacks and Hispanics who dominate among the poor; in Europe immigrants dominate the alienated groups. At the same time demographic developments, with a rapidly ageing European population, demand that Europe succeeds in integrating more immigrants.

Who are the winners and who are the losers in this development? What will the consequences be of socio-economic stratification, and why does it arise? Is it the more or less inevitable consequence of the new phase in globalisation, or are there alternatives? Social gaps of this kind are not politically legitimate in a democratic age, and, if the differences become permanent, this will give rise to strong political reactions.[3] Historical experience shows that societies with large income differences are not politically stable.

Glasshouse Forum begins its project on the middle class in the Western world with this publication containing a review of trends in income differentials between and within countries, and country-specific reports and interviews looking at the situation in the US,

1) See *The Economist*, October 16 2008.

2) See for example Lars Magnusson, "Is Globalisation Widening or Narrowing the Gaps? – A Progress Report from a Research Minefield", chapter 3 in this volume, and *Growing Unequal?: Income Distribution and Poverty in OECD Countries*, OECD 2008.

3) See for instance the review of David Rothkopf's book *Superclass – The Global Power Elite and the World They are Making*, in *LookingGlass* No. 1/2008, http://www.glasshouseforum.org/newsletter_1_bookreviews.html

Germany, France and Sweden. Since the summer of 2008, when these texts were written, we have witnessed dramatic developments in the financial crisis. In order to put the researchers' analyses into context we have asked them to reflect upon recent developments and the repercussions for the middle class. You will find their answers in chapter two. In the introductory chapter we have attempted to investigate the relation between the expansion of the financial sector and income inequality and short-termism.

In chapter three, economic historian Lars Magnusson reviews the research into changes in income differentials between and within countries, establishing a basis for further discussion and country specific reports. He draws some tentative conclusions – nothing else is possible as research stands:

- The gap between the poorest and richest countries has increased since the 1980s. This is due above all to the slow growth in sub-Saharan Africa and Latin America. The number of impoverished people in the world however has diminished by 300 million in the last 30 years, mainly due to the progress in China and India. In general, regional patterns for income gaps are stable.

- There is no uniform trend in changes in income differentials within countries. In the USA and Great Britain, differentials are increasing significantly. In countries like Austria, Finland and Australia, there is an increase but not on the same scale, while in Germany, France, Canada and Sweden the gaps on the contrary decreased up to the year 2000.

- The downward pressure on lower incomes which many had predicted as a consequence of globalisation is as yet difficult to detect. Increased differences are not due to the lowest strata losing ground, but rather the upper stratum outrunning them. Above all in the USA and Great Britain, but also in other countries, the rich are getting richer. There is much to indicate that this trend will continue.

- In general, differences between individuals within a country are due more to domestic factors than to globalisation. National traditions regarding the welfare state and labour market organisation have not been eradicated. On the contrary, global competition may lead to a strengthening of welfare capitalism to overcome citizens' anxiety.

In the following chapters this overall picture is complemented by two more in-depth studies on the situation in the USA and Sweden and two interviews on the German and French trends in income differentials.

It is a central question whether the Western world is converging on the Anglo-Saxon model, so that other countries follow US trends in income differentials. In chapter four, "Globalization and American Income Polarization", Gary Burtless at the Brookings Institution in Washington DC, discusses the causes of the increasing gap between rich and poor that has been particularly striking in the USA. Until the beginning of the 1990s, the proportional income gap between Americans increased at the top and bottom of the income distribution. Then the inequality trends changed course. The trend toward lower earnings in the bottom ranks of the wage distribution came to an end in the mid-1990s. While the gap between high-income Americans and the middle class continued to grow, the gap between middle class Americans and those at the bottom narrowed. Wage gains at the very top far outpaced those of ordinary workers.

The trend during the 80s can be partially explained by competition from low income countries affecting low skilled workers. The subsequent differences are more difficult to explain as a consequence of increased globalisation. The widening gap is due above all to top earners out-distancing the others: if it were due to increased economic integration, we would see the same trends in Japan and France, which as yet we do not see.

Salary income trends are just one factor behind the widening gaps. Changing family patterns are also of big significance. The number of Americans who live in married-couple families is diminishing, and the number of children growing up in single-mother families is increasing. In the upper income brackets, the position of families has been strengthened because women work and earn well. At a guess, only half the increasing income differentials between households in the USA is due to salary trends.

Lars Magnusson holds in his research review that it is difficult to discern a uniform pattern in the trend in income differentials. In some ways, Sweden is a contrast to the USA, because it has such a strong tradition of equality and is one of the world's most dedicated welfare states. Has the national tradition of equality been affected by global market exposure? Are low income earners losing ground due to competition from the low income countries? Or has the middle class fallen behind the highest earners, as is happening in many other countries?

In chapter five, "Income Distribution in Sweden Since 1990", Daniel Waldenström, specialist on Sweden's income structure, looks at what has happened since the beginning of the 1990s. Developments in Sweden over this period were investigated as regards both labour income and disposable income, to differentiate between developments on the labour market and those due to political measures.

The vast majority in Sweden have enjoyed increases in real income, which sets Sweden apart from many countries. The increase has however been greater at the top than at the bottom, partly because unemployment has been higher in the latter stratum. Those who have been on the labour market have marginally lost out relative to the middle of the income distribution. Relations within the upper half of the income distribution have been relatively stable, in particular as regards dispersion of reported labour incomes. If one takes return on capital into account, the picture is a different one. The upper stratum has experienced a large increase and has increased its lead. Some of this return can however be disguised salary. In this increased concentration of income to the top stratum, Sweden is following an international trend

In addition to the reports from the US and Sweden, we have taken the pulse of the two of the great economies in Europe – Germany and France – through two interviews on the change in income differentials and the situation of the middle class.

In chapter six, "The Era of the Ever-Expanding German Middle Class has Come to an End", Stefan Hradil at the Johannes Gutenberg University in Mainz is interviewed by Kay Glans about Germany whose "co-ordinated capitalism" is often cited as an alternative to the Anglo-Saxon model. Here, primary income distribution (the income that people get from the labour market, assets etcetera) is becoming more unequal. Secondary income distribution (income after redistribution by the welfare state) is also becoming more unequal, but very moderately so. The reason behind the growing income inequality is not globalisation but technological development, which demands that people have more and more qualifications. Globalisation only accelerates this process.

The welfare state is able to moderate the growing income inequality, but this also has negative consequences, for instance in the lower strata. If you place emphasis on minimum wages and equalise in the lower income bracket, you risk a relatively high level of unemployment. In Germany 25 per cent of low qualified people are unemployed and a new kind of lower class is emerging.

The German middle class was growing in the 70s and even 80s, especially among qualified personnel in the service sector. The integration of society was to a considerable extent enabled by this growing middle class. It bound society together. People could move upwards and they had the impression that it was a just society. But there has been a dramatic decline in the German income middle class, from 62 per cent of the population in 2000 to 54 per cent in 2006. Even in the core middle class of the information society – qualified professions in the service sector – one can detect stagnation since 2000. As the middle class is shrinking, the chances of upward mobility for the lower classes are diminished. Social mobility is blocked and disintegration becomes a real political danger.

Chapter seven, "The Changing French Model – While Top Incomes Skyrocket the Middle Class Fears a Downward Social Slide", contains an interview by Lisa Irenius with Camille Landais, researcher at the Paris School of Economics. His research shows that top incomes have increased substantially in France over the last eight years, whilst average and median incomes have only shown a slight increase. This indicates that the situation in France may come to resemble that in the Anglo-Saxon countries. In France there are social and fiscal restrictions. CEO salaries have, for example, incurred the same social security contributions as other salaries, which has prevented large salary increases. But these restrictions are now disappearing. CEOs will pay less tax and there is a greater knowledge of what top bosses in other countries earn, which is adduced in order to force up salaries.

The French middle class has not developed very much in recent times. In France salaries have been very stable over the past 20 years, apart from top salaries. Nor has there been any major change in redistribution of wealth. On the other hand, low-income earners have begun to catch up with the middle class, at the same time as one can see a major increase in top salaries. This may create a feeling of inequality.

1. Introduction
Towards a New Paradigm?

Glasshouse Forum Takes a Look at the Financial Sector and Its Relation to Income Differentials and Short-Termism

The broad wall of Babylon
Shall be levelled to the ground,
And her high gates
Shall be burned with fire.
The peoples labour for nothing,
And the nations weary themselves only for fire

Jeremiah 51:58

The atmosphere has changed in the European capital of finance, London, in connection with the financial crisis. The *Financial Times* notes that exuberance has given way to a new austerity (18/11 2008). The old indebtedness culture, which means servicing one's old debts by taking new ones, is said to be dead. The spirit of the age is more frugal and restrained with regard to conspicuous consumption. Those who still have money refrain from provoking them who have just lost theirs. Even shoplifting is showing signs of the new austerity. The British supermarket chain Tesco reports a 36 per cent increase in shoplifting. People are not stealing luxury items but to meet more mundane, practical needs.

The financial crisis is hitting London hard. According to the Centre for Economics and Business Research, the financial sector in Great Britain will shrink from a peak of 353,000 employees last year to 291,000 by 2009. The same source estimates that bonus payments will fall from 8 billion GBP in 2006 to 2.6 in 2009.

So it is not just a rumour that Babylondon, the financial capital that dwarfed the real economy, has fallen. The expansion of the financial sector in recent decades has been concentrated above all to the USA and Great Britain, that is, the metropoli of New York and London. In the USA, financial services in 2004–6 constituted 20–21 per cent of GDP, while manufacturing represented 12–13 per cent. In the USA and Great Britain, the financial sector accounted for 35 per cent of corporate profits in 2005. (see *Financial Times* 15/11 2008). British manufacturing today provides 13 per cent of the GDP.[1]

1) See "The return of manufacturing in Britain", A Prospect magazine supplement October 2008.

Quite recently the City appeared to be the right place to be at. Today it is of no use to be skilled at handling the mathematical formulae of financial innovations: another type of calculation is on the way. Now we will be hearing all the questions surrounding the expansion of the finance sector that should really have come before the crisis, and which in some cases did, although with limited impact.

The American writer Kevin Phillips, a fervent and persistent critic of contemporary Anglo-Saxon capitalism, claims in his new book *Bad Money – Reckless Finance, Failed Politics, and the Global Crisis of American Capitalism* (2008) that one sign marking the start of a nation's decline is when people become too absorbed with moving money around instead of manufacturing and moving products. There are many examples throughout history of countries that have lost control of their financial sector and gradually lost their position. Significantly, this phase often follows an extended period of affluence. Phillips mentions Spain under the Habsburgs, Holland in its imperial phase, and the British Empire. There is a heavy foreboding in the air due to fears that that the present crisis marks a turning point – the American century has ended and from now on the economic and political influence of the USA will gradually diminish.

Financial crises are much more frequent than most people would think. Based on more complete data than research has previously had, Carmen M. Reinhart and Kenneth S. Rogoff have shown that financial crises have been a constant feature in the international economy over the past eight centuries. Waves of increased mobility of capital are often followed by a series of national bank crises. The crises have often emanated from the financial centre and in that respect the American subprime crisis of 2007–2008 is not at all unique.[2]

Nor is criticism of the financial sector a new phenomenon, and it can easily take on a demagogic quality. To set actual manufacturing against abstract financial activities is a rhetorically suggestive method. To differentiate between manufacturing (German) and financial activities (Jewish) was prerequisite to the combination of pro- and anti-capitalism in modern anti-Semitism. One finds this polarity fully developed as early as in the German economist Werner Sombart's *Die Juden und das Wirtschaftsleben* ("The Jews and Economic Life") (1911). Naturally, this historical background does not preclude criticism of the financial sector, but one should be aware that there are powerful magnetic forces under the surface which easily take hold of arguments and order them to their own patterns.

The financial sector has been a golden calf, above all to the USA and Great Britain, and to certain strata. (However, many must help pay the piper.) Nevertheless, as pointed out by George Soros among others, it is not in fact clear why the financial sector has become so big or for whose sake. There is also reason to wonder whether several of the problematic tendencies in contemporary capitalism that Glasshouse Forum wishes to spotlight in its project "Globalisation and the middle class in the West" and "Short-termism in the long run" are linked to financial sector expansion and influence on the economy and society.

For example, to what extent is the unequal distribution of prosperity a consequence of the development of the financial sector? Glasshouse Forum's investigation of the growth of income differentials in the Western world, which follows in this volume, shows that differentials have grown most dramatically in countries like USA and Great Britain, which of course also have the largest financial sectors. It is striking also that the uppermost stratum in income distribution is accelerating ahead of other groups. Is it just a coincidence, or are the generous salaries in the financial sector a significant factor in this context?

Steven N. Kaplan and Joshua Rauh at the University of Chicago in their paper "Wall Street and Main Street: What Contributes to the Rise in the Highest Incomes" have tried to estimate the contribution of the financial sector (Wall Street) to the increasing income differentials in the USA. Their focus is on the topmost level in operations and income distribution. They then compare this with developments in Main Street (non-financial top executives). By Wall Street they mean the investment banks, hedge

2) See Carmen M. Reinhart, Kenneth S. Rogoff, "This time it is different: A panoramic view of eight centuries of financial crises". *NBER Working Paper* No. 13882, 2008.

funds, venture capital, private equity fund and mutual funds investors. There is considerable uncertainty in the estimates since many financial players are not required to disclose the number and size of individual payments, but the authors are certain that their estimates are on the low side.

This sector has grown dramatically in recent times and so has remuneration to those operating there. The top 25 individual hedge fund managers in the U.S. earned a combined total of 5.2 billion USD, 6.3 billon USD and over 9 billion USD respectively in 2003, 2004 and 2005. Kaplan and Rauh find twice as many players from Wall Street as players from Main Street in the top 0.5% and the top 0.1% of the AGI (adjusted gross income) distribution. They also find that Wall Street constitutes a greater proportion of the top 0.01% than Main Street, an equally large proportion of 0.001% and a substantially larger proportion of 0.0001%. Many of the richest citizens of what the journalist Robert Frank calls Richistan receive their incomes from the financial sector.[3]

Will the trend towards greater inequality be moderated by the financial crisis? The kind of impact you expect depends, as Camille Landais points out in his commentary on page 40, on how you see the origin of the differentials. The American economist Frank Levy of MIT is among those who consider that changes in social norms play a vital role. In an essay written together with Peter Temin, he points out that if an American business leader in the 1960s had received remuneration of the kind which is commonplace today, it would have been an issue for the then President. It was quite simply not accepted under the social norms of the time.[4] Glasshouse Forum asked Frank Levy whether the wheel has turned a complete revolution now. Politicians are criticising the generous remunerations in business, and companies have begun to block bonuses for the year 2008, for example the Swiss bank UBS. Seven leading Goldman Sachs executives plan to waive their bonuses. Perhaps this will set a trend. Perhaps a social norm is being re-created, that will put a check on this type of remuneration.

"The economics writer Robert J. Samuelson made an interesting comment on that paper and the point you quote", says Frank Levy. "He said that in this country, businessmen had come out of the Great Depression with a generally bad reputation and this was reinforced by World War II when there was some spirit of overall sacrifice (and occasional congressional hearings on war profiteering). So it would have looked very bad for CEOs to start taking huge salaries, even if they had the economic power to do so, and it would have been very popular for politicians to attack such power."

"This attitude changed in the 1980s – i.e. nothing wrong with being very wealthy – and as long as totally unregulated markets appeared to be bringing general prosperity that was likely to stay. But now that the activities that generated extremely high financial incomes seem to have brought the economy to the edge of disaster, that attitude may well swing again."

"My guess is that in the last decade in particular, high incomes depended in part on the lack of regulation of certain kinds of financial instruments which allowed firms to take on enormous leverage – i.e. huge amounts of borrowing given their capital base – and it was the extent of the borrowing that generated much of the high incomes. Now that that has blown up, I think going forward that you will see a more regulated and, therefore, a smaller financial sector with somewhat more modest salaries. This won't affect the broad based inequality between, say, high school and college graduates – that was much more a supply/demand phenomena – but it will reduce some of the extreme upper tail inequality."

It appears probable that a downsizing of the financial sector in combination with stronger social norms will moderate the tendency for the uppermost stratum to outdistance others as regards income, something seen not only in the USA and Great Britain but also for example in France and Germany, although in a less marked form.

Why then has the financial sector grown so dramatically? The so called efficient market hypothesis has no problem with this. Growth is quite simply a consequence of efficiency. According to this

3) Robert Frank, *Richistan. A Journey Through the American Wealth Boom and the Lives of the New Rich*, 2007.

4) "Inequality and Institutions in 20th Century America" *NBER Working Paper* No. W13106 2007.

hypothesis the collapse that has now occurred cannot in fact occur, since market mechanisms quickly create a new equilibrium. This view has lost much of its credibility now that the financial sector has destabilised itself with dire consequences to the real economy. Nor it is particularly convincing as an explanation for the expansion of the financial sector.

A completely different approach to the financial sector is put forward by the British economist Paul Woolley of the London School of Economics. He has a background both as an assets manager and IMF economist. Woolley's formative professional years were during the IT bubble, when his company lost customers because it did not follow the trend, but insisted on a more sober and traditional valuation. (They later returned.) One of his initiatives was to start, and fund, The Paul Woolley Centre for the Study of Capital Market Dysfunctionality, which has quite recently issued a report that has caused quite a stir: "An Institutional Theory of Momentum and Reversal", written by Woolley and Dimitri Vayanos.

Irrational motives are often invoked in order to understand the bubbles and the almost inexplicable vagaries of the stock markets, both in the form of shares rising far more than is justified and suddenly falling in them for reasons equally difficult to explain. For example, Robert J. Shiller in his new book *The Subprime Solution. How Today's Global Financial Crisis Happened, and What to Do about It* (2008) speaks of contagion, in a social sense, a concept that is reminiscent of the classical sociologists. Woolley is critical to this tendency and considers it a scientific dead-end. These phenomena are not due to irrationality among the players, but are the result of the interaction between the investors and those who manage their money.

"You don't have to blame irrational exuberance for bubbles", says Paul Woolley to Glasshouse Forum. "You can actually get bubbles in a perfectly rational framework because of the agency problem and momentum and short-termism that go along with it. My co-author and I explain bubbles and collapses and reversal in a formal, rational expectation framework. It seems to me if economics is going to be treated as a science, it needs as far as possible to explain things in rational terms."[5]

It is above all the money managers' role that Woolley deems of crucial importance to the growth and actions of the financial sector. Through their preponderance of information – reinforced of course by financial innovations, they can to great extent dictate the conditions for the traffic. Since these managers of other people's money earn on each transaction they benefit from an increase in the turnover rate. In 1965 the annual turnover of British equities was worth 10 per cent of the nominal GDP, and in 2007 almost 300 per cent (*Financial Times*, 15/11 2008). Woolley illustrates the fact with the following example: we have the manager of an actively managed pension fund with a 100 per cent turnover of holdings per year. Over a 25 year period, he will exchange the same equities with other managers for no collective gain. The end value of the fund falls by 25 per cent. But the manager himself earns by it. It is a kind of taxation to which the managers expose the savers.[6]

The actual prerequisite for this is that there is asymmetry of information in the relations between the banker, fund manager, broker etc; and the end investors. These players have an enormous preponderance of knowledge over the end investors and use this to benefit their own prosperity. This preponderance has been reinforced by financial innovations which are beyond the comprehension of a good many players.

"I regard the size of the financial sector as a function of the inefficiency of markets. If markets were efficient, as the academics have preached for many decades, the financial sector wouldn't have grown to such a ridiculous size. It's only grown to account for about 35, 40 per cent of corporate profits in the UK, the US and some other countries, because it is fundamentally inefficient. Inefficient is too weak a word. Inefficient suggests mispricings of a minor degree or of a systematic degree, but in fact what we have is a propensity for dysfunctionality, sometimes on a gross scale", says Woolley.

5) Editors' note: Agency problem is a conflict of interest arising between the creditors, shareholders and management because of different goals, for example when managers and stockholders have conflicting ideas of how the company should be run.

6) See also Jonathan Ford, "A greedy giant out of control", *Prospect*, November 2008.

"Practitioners have enjoyed the situation and have exploited the agency problem to the full with the endorsement of the academic community, and indeed with the encouragement of governments who see the finance sector as a source of tax and employment and foreign exchange."

"But it's like a tumour and nobody has really realized that. I find it totally extraordinary that the only academic papers that have looked at the size of the financial sector have done so with regard to developing countries and they said that it helps to provide growth. If something is efficient, you don't expect it to be ballooning like that. It's a tax on the productive sector of 40 per cent."

Woolley considers also that the financial sector has had major significance in the spread of short-termism. It is in the interests of the financial players to increase the tempo, since they earn on each transaction.

"One of the most serious aspects of the financial sector is the short-termism or momentum effect in stock markets. The trouble we're in now internationally derives from the technology bubble in the stock markets in 1999–2000, and then the policy response of the central banks to keep interest rates too low too long which stoked the real estate and debt bubble, which is now collapsing. Low rates promoted not only the bubble but also the carry trade and the hedge funds with high leverage. What we've seen now is simply the unwinding of that. The origins of the crisis lay in the short-term momentum-driven investment strategies adopted in the tech bubble and then pursued again in response to the low interest rates that prevailed in the early 2000s."

"You only have to look at the level of turnover in equity markets to realize how short-termist we've become around the world in our investment strategies. For an equity portfolio you typically have 100 per cent turnover per annum, which means the holding period is a year. And the hedge funds have even shorter holding periods on average."

Even if the financial sector is temporarily under pressure and will probably shrink, one of its basic preconditions is still in place and will perhaps lead to new bubbles in the future. The stratum of managers has of course been dependent on the capital that has been

made available from pension funds, insurance companies and similar, and which is in search of returns. This will not decrease in the future. Simply consider what Asian pension savings can lead to when its population, such as in China, quickly begins to age. So the task for the future is to develop strategies so that the capital managed by institutes will not be exploited in the same way.

"That's obviously the key question," says Woolley to Glasshouse Forum, "and unfortunately all people are doing now is trying to patch up the system. The great danger is that lowering interest rates to zero will just set the stage for the next great bubble without actually addressing the fundamental problem."

"There are fundamental problems in the way that the finance sector works. Adam Smith's dictum that "everybody pursuing their own self-interest leads to the highest utility for all" doesn't work in finance. The agency problem gives rise to mispricing which misallocates capital and can have huge macroeconomic implications. The other problem is that it also captures increasing chunks of the return from productive investment. That's what we've seen over the last 20 years. Now the profits are down, but look at the damage that's being done and the costs to society. We're just paying for the finance sector by a different route now, instead of their profits."

"And frankly, the finance sector actually benefits from volatility of the system. They won't see it as them benefiting now, but there will be huge gains made when they rebuild the private sector entities over the next 10 years. They've benefited not only from the volatility of prices of stocks and bonds. They will benefit from the volatility of the infrastructure itself. An efficient, smooth-functioning, stable market is death on wheels to them."

"I think the absolutely prime thing is to understand that finance doesn't work like everything else. The agency problem creates these two major problems of mispricing and capture of the rents. It's handled in the contracts between pension funds and their managers, their agents. It's handled by getting a focus on medium- and long-term investment. It can be resolved by trying to reduce moral hazards among agents by extending the period over which performance is measured, and thus bonuses and performance fees and so on."

"Principals and end investors and trustees must change the way they act. There's nothing wrong with active management, it's just that the fee structure is ridiculous. The argument is that it's irrational exuberance and we are just paying the price for that and that all you need are a few more instruments to hedge risk – in that way, you're just pandering to the finance sector and making it even bigger. The scale of the derivatives markets was simply a function of the fundamental inefficiency of the underlying equity markets."

"Jane Austen, when she described somebody's wealth, she very rightly described the eligibility of a bachelor in terms of his annual income, not his mark-to-market value. And we should focus on the old fashioned idea of investing for dividends and investing for the medium and long term."

It is perhaps time now to rejoin Jeremiah and the sermons of retribution about Babylon and the triumph at its fall. There are overtones of such Old Testament indignation in the debate about Babylondon. It is difficult to resist temptation. One stratum has, with the help of other people's money, known as financial innovations, and the goodwill/compliance of politicians, succeeded in favouring itself by taking risks which in many ways are handed over to the man on the street, both through taxes and through the downturn which is now due to hit not only Wall Street but also Main Street.

The opinion of David Goodhart for example in *Prospect* is that there may be such a thing as a good recession, which allows us to see things more clearly.[7] It would among other things encompass a reduction in income differentials, renewed interest in major political issues and the political institutions, and strengthened focus on the middle stratum instead of as now the upper and lower strata. This middle Britain has nothing at all against seeing the kings of finance humiliated a little, Goodhart thinks.

It is too early to declare winners and losers, because we do not know how deep the crisis will be. It may well be as Jeremiah says:

The peoples labour for nothing,
And the nations weary themselves only for fire

Intellectually and politically it is somewhat easier to identify winners and losers.

That which we usually call Washington Consensus has used up its credibility, now that the market has destabilised itself in this fundamental way. The idea that the solution to the problem was deregulation and rolling back the state has been a dominant idea for almost exactly 30 years, the space of time that in the past was called a generation. As pointed out by José Ortega y Gasset among others, history often turns out to have a rhythm created by this type of generation handover. Completely new climates appear with these intervals; that which was – if not impossible to imagine, then at least difficult to gain support for – suddenly becomes something worth discussing. That which was the rearguard suddenly becomes the vanguard. George Soros asserts that a market ideology that rejected regulation has been a basic cause of a super-bubble built up over decades. Now the state must act to regulate the market tendency toward instability.

It is no coincidence that at this time people are remembering a maverick among economists, Hyman Minsky, whose theory of the instability of the financial market has become the object of renewed interest.[8] Minsky held that the capitalistic economy is inherently unstable and that disequilibrium and unemployment are so to speak a normal condition. Its own driving forces sooner or later create a transition from robustness to fragility and if the state does not intervene, a boom-bust cycle arises, to which the banks contribute by meeting credit needs in an increasingly aggressive way. The unsustainable boom, which is characterised by speculative financial action, is corrected by the creative destruction of the depression.

Creative destruction is one of the things that are much more

7) *Prospect*, November 2008.

8) Hyman P. Minsky, "The Financial Instability Hypothesis", 1992.

fun to talk about than to live through. The costs for society generally become far too great and it is therefore important for the state to intervene with Keynesian measures. In that sense Minsky was a follower of Keynes. But he went a step further and formulated what Gary Dymski and Robert Pollin have called "the Minsky Paradox". Interventions maintain an existing fragile financial structure which would otherwise have been corrected through a depression. When borrowers and lenders realise that there is a safety net, their inclination to take risks and debts increases. This means that attempts to combat economic depressions will be less effective over time, according to Minsky. It is such a paradox we are living in right now: the financial markets have shown themselves to be intrinsically unstable and state intervention ultimately risks underpinning the behaviour it aims to deal with. It would not seem a reasonable political solution for the state to intervene in order then to give back the reins to the market forces. The state will remain present, for a generation or two, however long a paradigm lasts.

Another cornerstone in the philosophy of neoclassical economics is the notion of the rational actions of homo economicus. Its reasoning assumes that the individual makes rational decisions after having systematically absorbed information. All one needs to do is create a maximum of individual freedom of choice, and rationality will dominate. This perception is undermined from various angles. Robert J. Shiller shows in *The Subprime Solution* the ways in which contagion disabled rational thinking during the housing bubble. All the explanations of why house prices should continue to rise lack foundation. There is nothing to support the fact that raw materials – or land – should become scarcer. One problem is that we do not measure inflation correctly and therefore we do not understand the extent to which property price rises are an illusion. The action programme which Shiller above all recommends is democratisation of financial advice, so that people in general understand what they are investing in. Additionally, there are indications that in recent years there has been a particular focus on for example the elderly to get them to make fateful decisions.

From elsewhere too, well planned death blows are dealt to the notion of the rationality of market players. Richard Thaler and Cass

Sunstein summarise a good portion of behavioural science research in their book *Nudge* (2008) which quintessentially holds that we as individuals are very bad at choosing, and need constant support from what they call choice architectures. The neoclassical economy's conception of homo economicus, who makes decisions with icy rationality, is completely unrealistic. The creature of flesh and blood that actually exists acts in a far less rational way. There is no need for a guardian of the old-fashioned sort, but rather a companion to encourage this creature through friendly nudges in the right direction. Glasshouse Forum asked Cass Sunstein whether right now we are going through a paradigm shift. What is known as the Washington Consensus, which was essentially a question of deregulating and letting market forces have their way, and was based on the conception of the rational human is being replaced by – what?

"Decades of work have shown that people are not fully rational", says Sunstein. "We are biased in our assessment; for example, many people are unrealistically optimistic. We use mental shortcuts, or heuristics, that create serious problems. For example, recent events have a big effect on us. If a disaster has occurred in the recent past, we think it will recur, even if statistics suggest that it won't.

"A new paradigm is indeed emerging. It includes 'libertarian paternalism' – an approach that respects freedom of choice but that is likely to move people in directions that will improve their welfare. We should expect to see a lot of libertarian paternalism – or 'nudges' – in the future."

Indebtedness has not only characterised the financial elites of the state. Generally speaking, we live in a debt culture that encompasses more or less every class. Sociologist Daniel Bell stated in his classic work *The Cultural Contradictions of Capitalism* (1976) that the credit card was a far greater change then we realised and that the mentality it brings will in time undermine capitalism. It encourages infantile behaviour which basically feels that immediate gratification is a little too slow. But the background is that American real incomes have stagnated and that households are increasingly compensating for this by becoming indebted and by using their homes as a kind of cash dispenser to finance consumerism. There is much talk of the US national debt, but it is quite small compared to private debt. The indebtedness of American households has increased from 680 billion USD in 1974 to 12, 873 billion in 2006.[9]

Cass Sunstein says that both state and companies must make commitments to prevent people falling victim to temptation. Glasshouse Forum objects that when it comes to companies it would be rather like asking a wolf to watch sheep, since it is in the nature of the market to tempt and arouse needs.

"A good question. But some companies do try to counteract temptation; consider green products (trying to get you to consider the long term) and those who sell especially healthy foods (trying to get you to think about your future). Markets often tempt, but some companies try to work against temptation, and they sometimes do really well. For financial services, companies might well start to say: Consider the long-term risks!

"We need to have a new set of social norms, so that people start planning for their future, and realize that the long-term is crucial. It's not too late to stop borrowing and to start paying off your debts, if you possibly can."

The American economic miracle, the long economic boom, has been largely fuelled by over-consumption, a consumption bubble. The USA has lived beyond its resources and in that capacity has kept the world economy going, supported by China. These two great powers have been in symbiosis: one under-consuming, and the other over-consuming. Such constellations do not usually last. As a Western company leader recently said when visiting China: "When a country gets into such large debt, it is very likely to lose a lot of its political power also" (*Financial Times*, 21/11 2008). It may be the case that the financial crises will be the catalyst for the relocation of the power centre to Asia as many predict, even though China seems hesitant. It is quite clear that the economic policy requires basic reforms so that domestic Chinese demand takes off. If that is successful, then the shift in the centre of gravity will accelerate dramatically.

What will happen with the openness of the world and with globalisation if such a transfer of influence becomes marked? So far it has been possible to sell globalisation to the broad masses in the West with the argument that everyone benefits in the long run. It is

more difficult to do so today, and perhaps the loss of manufacturing jobs will be seen in a new light as the financial sector shrinks.

A sceptical attitude towards globalisation is not necessarily based on narrow-mindedness. It also applies that equality and social responsibility are not always completely compatible with mobility. It is difficult to make demands on capital when it always has the option of moving elsewhere. It can even be difficult for business leaders themselves to take a social responsibility if they have that option. The German sociologist Wolfgang Streeck illustrated this by invoking the famous reasoning by Karl Marx in *Das Kapital* regarding child labour in England. The individual capitalist could be well aware that child labour in the long run could damage both society and him, since the workforce does not procreate sufficiently. Nevertheless it could be difficult for him to refrain from it, since it would make him less competitive. Therefore he could welcome an intervention by the state with regulations making the conditions the same for everyone.

This has parallels to this day, according to Streeck. A capitalist should realise that he is dependent on positive demographic development and that there is therefore a need to organise working life so that giving birth to children is encouraged. In the same way, he should further the interests of capitalists that people should not burn out by the age of 35, but manage to work until their seventies to reduce the consequences of an ageing society. To an individual capitalist, it is perhaps not possible to bear the possible costs for this if it impairs competitiveness, so that in principle a societal intervention should be welcome. But today's mobility makes such an intervention more difficult, since the companies can lay claim to the population of another company by relocating, in particular to Asia.[10]

There are parallels to what happened during the last wave of globalisation, the one preceding 1914. Then, as Jeffry Frieden has

9) See US Federal Reserve's Flow of Funds Accounts of the United States, "Debt Outstanding by Sector", September 17, 2007.

10) Wolfgang Streeck: "Industrial Relations Today: Reining in Flexibility". *MPIfG Working Paper* 08/03.

shown in *Global Capitalism* (2006), the world was in many ways more globalised than today. National governments gave higher priority to their credibility with international players than listening to the demands of their own populace. This was possible among other things because the majority of the population had limited influence. But the wave of globalisation gave way to a back-slide with strivings for autarchy in many cases. Naturally, this must be seen in the light of the First World War, but also of the crises that followed in the Twenties and Thirties. The populations saw globalisation as a threat, as a source of insecurity. Acceptance of globalisation has always been dependent on its ability to create and spread prosperity, writes Frieden.

It is not difficult to find examples of recent reactions to globalisation. Listed Japanese companies began to protect themselves against takeovers last year through poison pills. The French President Sarkozy has argued for a European sovereign wealth fund which could buy up important European companies in the event of a recession – in other words so that they do not end up in foreign hands. European companies that previously turned to China have to a greater extent begun to locate production to Eastern Europe, which is known as near-shoring. It is also possible that the multipolar world that is taking shape in the political sense will form a catalyst for the erection of barriers between different blocs.

2. Reflections on the Consequences of the Financial Crisis on Income Differentials and the Middle Class

By the Authors and Interviewees
November 2008

Have the recent dramatic developments in the financial crisis in any way affected your conclusions? If you were to write the report/give the interview about the trend in income gaps today, what, if anything, would you have written/replied differently?

Lars Magnusson: As a matter of fact they haven't. Mine is a more long-term analysis and there is every indication that it is essentially correct. This autumn, the OECD published an analysis that indicates increased income differentials in the way I described in the essay.

Gary Burtless: No. The goal of my essay was to examine the probable contribution of globalization to widening U.S. income polarization. The financial crisis does not affect any of the conclusions I draw nor does it shed new light on trends in U.S. or world income inequality.

Daniel Waldenström: My report is a representation of recent years' trend in income distribution in Sweden and since there are no reliable data for the period following 2006, it would still be impossible to analyse the effects of the crisis. At the same time it is clear that the report in its forward-looking analysis should have mentioned that the financial crisis would probably moderate the trend in recent decades of a distinct growth in top income shares.

Camille Landais: It is undeniable that the recent economic downturn will in the short-run slow down the surge of top incomes, at least in the US, where the financial industry, which accounts for an important portion of the increase in top income shares according to Kaplan and Rauh, has been badly hit by the crisis. But it is difficult for the moment to say in what sense the overall picture of income inequality will be affected.

Based on your research – or if you are permitted to speculate a little – and in the light of the financial crisis, is it possible to say anything about the future concerning developments among the lowest income groups, the middle groups and the top earners?

Lars Magnusson: I don't think the financial crisis will affect these differences in the long term. One can however note that 1) the imminent downturn in the real economy will probably affect income distribution in that the gaps will widen when (the presumed!) unemployment rises. Perhaps one can also 2) speculate over whether the super-rich will become less rich due to the combined effect of the financial crisis and the downturn together with the political interventions that slash the most generous of the bonus programmes.

Gary Burtless: The financial crisis will cause income losses for people in all ranks of the U.S. income distribution; though many folks at the bottom of the distribution – who have neither labor earnings nor capital assets – will escape largely unscathed (people who live on government transfer payments don't have much to worry about). Low income workers are likely to experience big percentage losses in income, mainly because their work hours and employment rates will be hurt by the recession. Middle income workers will be hurt, but based on previous recessions their earnings losses will be smaller than those of low-wage, low-skill workers. That's because a smaller percentage of them will lose their jobs altogether. Workers with high wages will lose mainly because bonuses and other performance-linked pay will fall sharply (in fact, it has almost certainly fallen sharply already). The workers who do not face much risk of unemployment and who do not receive performance-linked pay are likely to see the smallest losses in real earnings.

Bear in mind that middle- and high-income households have already suffered massive losses in wealth as a result of the crisis. In inflation-adjusted dollars, stock market prices fell about 46 percent between October 31, 2007, and October 24, 2008, even taking account of reinvested dividends. This has probably wiped out USD 8 trillion in household wealth, most of it held by high-income families but some of it also held by middle-income families (mainly in their retirement accounts). The loss of housing wealth has also been massive, especially for families who had big mortgages (in relation to the value of their homes) in 2006 and early 2007. Many families with large mortgages now have negative net worth – their debts are larger than the value of their financial and nonfinancial assets, including their homes. It is very likely that the percentage drop in income (compared with incomes in 2006 and 2007) is bigger at the very top of the distribution than it has been for middle income households. See what happened to the incomes of Americans in the top 1% of the income distribution between 2000 and 2002 in Figure 1 of the essay I submitted to you [published in this volume, p. 87]. My guess is that the proportional loss in top-end income will be even more massive in 2008–2009.

Daniel Waldenström: So far it is difficult to overview the ultimate effects of the financial crisis on the financial sector and the real economy. Here are some plausible scenarios.

The rich will be affected most of all, and in negative ways. The dramatic depreciation of the finance markets hits their particular assets and income flows, which are mainly based on different forms of capital. In Sweden the richest tenth owns more than 90 per cent of all stock market shares, and if their value is halved, the income of the wealthiest will be slashed. In this way the financial crisis will lead to a levelling-out, albeit short-term, in both incomes and assets. One argument why top income shares will be restrained even in the long term is that belief in bonus systems for directors and other top earners has been shaken among both economists and the market players themselves. Many have even asserted that these bonus systems were the reason why the financial crisis has occurred. And if these systems are scaled down we can see a more tenuous link between economic growth and top incomes, which generally leads to a greater income distribution.

The middle class is probably the group least affected by the crisis. Their financial assets are protected by state deposit guarantees. In the short term the crisis reduces their pension assets and the present value of the pensions is today less than it was. For those whose retirement lies far ahead, however, this is not significant since we will probably see a recovery of these assets in the long term. For those who are pensioners today or soon will be, the downturn will be more noticeable. At the same time, this particular age group has benefited from decades of rising house prices, and many therefore can afford this setback.

Low-income earners are also protected by different welfare systems and neither will they notice much of the crisis, at least not in the short term. Nevertheless, the Nordic welfare model is under strain and perhaps there will be no return to the re-distribution levels of the past. If today's financial turbulence has long-term tangible effects, e.g. in the form of a persistent economic downturn that is perhaps exacerbated by a structural transformation in which the car industry practically disappears from Sweden in the same way as the shipyards thirty years ago, then unqualified low-income earners will suffer.

Camille Landais: In the short term, it is pretty certain that the economic downturn, implying rapid growth of unemployment rates and higher credit constraints, will affect low-income families. Concerning top incomes, it is much more difficult to say whether, apart from a short-term effect, the rising concentration of income will be stopped by the new economic environment. Our understanding of the forces at work behind the increase in top incomes is still too limited to predict the evolution of top incomes in the near future given the financial crisis. If we believe that rising inequality is just a superstar effect combined with some skill-biased technological change, then it is unlikely that the crisis will affect the trend of rising inequality in itself. On the contrary, if we think that institutional factors have played a major role (cf. for instance Levy and Temin's paper "Inequality and Institutions in 20th Century America"), then these factors may be reversed by the crisis.

Will there be changes in the discussion on convergence towards Anglo-Saxon development (with increasing income gaps)? If so, in which direction?

Gary Burtless: Absolutely. The lack of regulation and close supervision of industrial and financial activity, which is a hallmark of the recent Anglo-Saxon model, will appear much less attractive to policymakers, both inside and outside the Anglo-Saxon countries. Tough government regulation and closer government supervision of private businesses will seem like more attractive policies. In the U.S., I hope this is accompanied by better relative compensation for the public officials charged with regulation and supervision. The huge increase in earnings inequality was almost entirely concentrated in the American private sector. This trend, combined with insane restrictions on the pay of top federal government officials, made it much less attractive for the best and brightest in the younger generation to accept careers in the civil service. Consequently, the private sector got smarter at evading government supervision and the top public sector civil servants were placed at disadvantage in their relations with private sector miscreants. To give you a random example: I have a young friend who did well in law school and clerked for one year with a U.S. district court judge. At the end of this very brief apprenticeship and at the age of 28, he went to work as an associate for a big, well-known New York law firm. His starting annual compensation, including expected bonus, is higher than that paid to the Chief Justice of the U.S. Supreme Court, who is the highest ranking judicial officer in the world's richest country. When first-year private attorneys are paid more than the most important judges, you know our country has a problem.

Will "the return of the state" change developments in some way (e.g. more distribution policy, more protectionism which is expected to lead to protection of the vulnerable on the labour market)? Do you see signs of a new political climate?

Lars Magnusson: I have for some time predicted a kind of increased state activism, more regulation and perhaps also more protectionism. Of course, the US elections are crucial to this. But I think that we are going to see more state presence in the economy for a while. The problem with volatile pension funds etc. has been with us for years and demands for increased stability (particularly with regard to return on pension capital) have been voiced in the USA for a few years.

Gary Burtless: I have long urged improvements in social protection of workers who lose their jobs as a result of globalization, technical change, or shifts in consumer tastes. I think the improvements should emphasize two main aspects of employment: Giving re-employed workers partial insurance to replace the earnings they lose when they must accept lower-paying jobs; and reforming the U.S. health insurance system to protect low-pay and unemployed workers against the loss of health benefits. I hope a new administration takes up these two issues. We'll see.

Daniel Waldenström: I don't think we will be seeing more protectionism or more far-reaching distribution policy in Sweden. However, in the national sphere we may see more market regulation and state control over people's everyday lives. This is not so much due to the financial crisis as the general trend even among right-wing politicians to see taxes as an instrument for control, the regulation of public utilities, etc. This development is especially noticeable at global level, where transnational coordination is becoming increasingly common when dealing with existing problems. The joint initiatives by national banks during the financial crisis are an example; another, the way in which tax havens have been constrained in a way that nobody thought possible a few years ago. Perhaps the most important explanation for this trend however is not the financial crisis, but the global threat to the environment that has prompted governments in different countries to act in unison. We will see more of that type of increased degree of state control, both at national and global level.

Camille Landais: If we take as an example the situation that followed the Great Depression in the 1930s, it is truly likely that, as a reaction to what happened, taxation of top incomes will increase. In the 40s and 50s, top marginal tax rates were for instance raised to 90 per cent in the US! It therefore seems more than plausible that tax progressivity will increase in most countries in the years to come, which may undeniably affect the distribution of earnings.

Do you think that the trend towards widening gaps will change with the new US administration? If so, in what way?

Gary Burtless: If the downturn is deep and prolonged, there could

be a change in both social policy and in the pay-setting norms of private companies. As a result of the Great Depression and World War II, the bargaining power of low- and middle-rank workers was greatly expanded, both as a result of worker solidarity and more generous public policy. In addition, the arrogance and irresponsibility of wealthy business owners and managers was curbed, partly as a result of strongly redistributive federal tax policy and partly as a result of new social norms inside the biggest U.S. businesses. This could happen again. We'll see.

3. Is Globalisation Widening or Narrowing the Gaps?

A Progress Report from a Research Minefield

Lars Magnusson
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Introduction

The discussion of the effects of globalisation is often marked by overconfident pronouncements. Development is either painted in very bright or in very dark colours. On the one hand, commentators claim that globalisation is an answer to important questions for humanity, such as the eradication of poverty, growing prosperity for all and a lessening of political conflict. Contrary to what the demonstrators in Seattle and Genoa believe, globalisation has benefited the world's poor, thinks the Indian economist Deepak Lal (Lal 2006:139). Similarly, if we wish to see smaller income differentials in the world, we should advocate more and not less globalisation, claims the Spanish economist Xavier Sala-i-Martin (Sala-i-Martin 2002) based at Columbia University in New York.

Others claim that globalisation creates a world with greater and growing gaps. This leads to a crude exploitation of people and environments in the poor part of the world. In the old industrial countries it leads to greater exclusion, unemployment and widening income gaps. They consider the fact that globalisation is depressing wages in Europe and the USA as beyond dispute.

How can they arrive at such different answers? Is inequality in the world growing or decreasing? If it is growing, is the cause increasing globalisation?

Research is unanimous that since the 19th century we can distinguish two extensive waves of economic globalisation. It is, of course, not unequivocal what you mean by economic globalisation. If certain people mean that in recent years we have been experiencing a period of rapid globalisation, others claim that there has been no appreciable change in this regard (Magnusson 2002: Chapter 11). The difference in outlook results from people employing different criteria. Those who consider that globalisation is a fact often proceed from a stricter definition, which takes into account flows of goods, capital and labour between countries. Those who are more sceptical – such as the British researchers Paul Hirst and Grahame Thompson (Hirst & Thompson 1996) – require a high degree of economic integration between countries in order for us to talk about globalisation. But, as we know, most countries and regions are linked to each other economically in very different ways; some even stand outside such an integration (for example, several sub-Saharan African countries).

If by globalisation we "merely" mean a rapid increase in international flows of resources, it is simpler to claim that we are now living in a period of greater global economic activity. A first period of this kind occurred as early as the first half of the 19th century, and lasted until 1914. That period was marked, among other things, by the fact that the industrialised Western European countries rapidly pulled ahead of other regions and continents as regards income and wealth (Maddison 2003; see also Appendix, Table 1). After the Second World War – in particular from the 1960s onwards – globalisation has once again gathered momentum. Against this historical background it is not unreasonable to assume that this time, too, it will bring with it a rapid acceleration in the widening of gaps on a global level.

There is no real consensus that this actually is the case. It is partly because there are different ways of defining concepts such as increasing or decreasing differences. Most people measure income differentials in terms of monetary incomes which are primarily distributed via the market. Should we not perhaps, because a great deal of consumption at least in the poorer countries never appears on the market, instead measure the actual level of consumption (the supply of goods and services)? Should we even include indicators such as health, life expectancy, education, human rights and access to clean water and a healthy environment? Apart from the UN Human Development Index there are several large international bodies, for example the International Monetary Fund (IMF), and the World Bank, to name just two, who give partially different pictures of international developments as regards equality and inequality. Apart from which there are innumerable problems of measurement.

For this reason it is not strange that perceptions vary as to the extent of globalisation and its effects. In what follows I will discuss global inequality *between* regions and countries and inequality *within* regions and countries. The aim of this paper is to present the ongoing discussion, and to review those research results which today are accepted by most researchers. I also wish to present some

tentative explanations for the picture that we can nevertheless discern in the myriad of facts and preliminary truths to be found in the statistics.

The Optimistic Picture

When researchers such as Richard Barro and Xavier Sala-i-Martin (Barro and Sala-i-Martin 1992; Maddison 2003), Surjit Bhalla (Balla 2002) and Glenn Firebaugh (Firebaugh and Goesling 2004) present their relatively bright picture of the state of affairs in the world, they are basing that on a monetary GDP measure per country which is weighted in relation to that country's relative population. What we then get is a per capita measure of the development of incomes over a longer time period. Equality and inequality are defined on the basis of what is contained in the GDP concept. As we know, this concept has been criticised for a long period for being too narrow. Goods and commodities produced and distributed through channels other than the market are not included in the calculations. Everything that is included in GDP is perhaps not what actually increases our prosperity (e.g. car accidents and environmental pollution).

Barro, Sala-i-Martin and other researchers using these measurements show that inequality measured in GDP per capita across the world has decreased during the wave of globalisation that has taken place over the last three decades. They represent the so-called convergence thesis: in the longer term incomes in the world tend to be increasingly similar. Note, however, that they base their findings on global income per capita. Between countries differences can still grow, whilst differences between individuals shrink.

Researchers such as Sala-i-Martin adduce the number of relatively and absolutely poor people in the world to support their basically optimistic picture. The World Bank uses an income of two dollars a day in order to define "the poverty line", whilst a researcher like Bhalla uses 1.5 dollars a day. As I mentioned earlier, it is not merely data problems that make it difficult to determine what trends looks like. The different measures of poverty that are often employed are also contentious. You can see differences depending on the base year on which a dollar a day is based. But irrespective of the (eight) most commonly used measures for determining income trends that one uses, the result is unequivocal: poverty, particularly in relative terms, has declined substantially over the last 30 years (Sala-i-Martin 2005). If we take as our starting point the two dollar principle (in fixed prices), then 30 per cent of the world's population would have been below the poverty line in 1970, while for the year 2000 the proportion would have fallen to 11 per cent. This means that even the absolute number of poor has dropped rapidly, from approximately a billion in 1972 to 700 million 30 years later. In the World Bank's *Global Monitoring Report* from the summer of 2007 figures are presented which only refer to developing countries. Even if one only includes countries of this kind, the number of extremely poor people has dropped in both relative and absolute terms (World Bank 2007, Chapter 1). The proportion of extremely poor people living on less than a dollar a day has gone from approximately 41 per cent to 18 per cent between 1981 and 2004. Just between 1990 and 2004 the proportion dropped from 29 per cent to 12 per cent (World Bank 2007:65). This is a change that is as dramatic as it is pleasing. Seen in terms of numbers of people, the figure has dropped from one 1.5 billion in 1981 to 986 million in 2004. The World Bank expects this positive trend to continue. In 2015 the proportion of extremely poor people in developing countries is expected to have fallen to approximately 12 per cent, and the number – in absolute terms – to 721 million people.

Both Sala-i-Martin and the World Bank indicate, however, that this reduction is unevenly distributed. The very rapid growth in China, India and other parts of Asia explains most of this improvement. In Latin America the status quo has obtained since the end of the 1980s, and the development in sub-Saharan Africa is "a tragedy" (Sala-i-Martin 2005:22). This is also the main message of Firebaugh and Goesling (Firebaugh and Goesling 2004), and that of the World Bank's *Global Monitoring Report* from 2007. In China the number of extremely poor people has fallen by 500 million since 1981, maintains the World Bank (World Bank 2007:43). In the entire annals of economic history there is no instance of a recovery of the kind found in China over such a short period.

The Pessimistic Picture

The United Nations Development Programme in particular has, with its well-known Human Development Reports (UNDP 2001 etc.), had a strong impact in terms of a more pessimistic view. UNDP primarily pursued the thesis of divergence, the idea that income differentials are growing. But this general assessment depends primarily on the fact that they are here taking as a starting point the national per capita income without weighting for the size of the country (Sala-i-Martin 2002). This means, for example, that Liberia has the same weighting as China. If incomes are growing quickly among China's billion population this weighs less heavily than if some countries in Africa go in the opposite direction. It may, therefore, be the case that if we start from the concept of the nation, inequality of income is growing in the world, whilst the opposite is true if we look at the number of people. The large populations in the rapidly growing countries in Asia play a major role in a more positive scenario.

In his studies of the historical development of global income, Angus Maddison chooses to start from how the ratio between the richest and poorest countries and regions has developed measured in income per capita (Maddison 2003; see Appendix, Table 1). This crude measure shows that if we divide the world into seven regions, then the differential in 1913 between the richest and poorest region was 9:1. Between 1950 and 1973 this drops from 15:1 to 13:1, but it again increases to 19:1 by 1988. It is clear that the stagnation of Africa since 1973 is the main reason for this great divergence. If Africa is excluded, the picture looks completely different; the situation has actually improved somewhat since 1973.

Other pessimistic observers have borne in mind the familiar critical arguments against GDP per capita and have tried to use other measures as a basis. When Milanovic at the World Bank (Milanovic 1999) instead of GDP started from household studies of actual consumption, he found a growing global inequality from 1988 onwards. The problem with household studies is that they are not comprehensive; they only exist for some countries and particular periods. But above all they cannot be used to make comparisons further back in time than to the middle of the 1980s. If we can produce reliable household-based data these are preferable to the more uncertain GDP figures. So far, however, dropouts in the figures and other problems have meant that there are great uncertainties in them. We can nevertheless ascertain that this measure provides a different result than the one produced by the optimists. A further problem which has been emphasised by the pessimists is the situation of the ultra poor. For the slightly more than 160 million people who earn less than half a dollar a day development has proceeded slowly, according to a household questionnaire-based study from the International Food Policy Research Institute (*Svenska Dagbladet* December 23, 2007, Näringsliv). It is among these people we find starving individuals who are exposed to famine, war and epidemics.

The reason for the greater inequality in Milanovic's study was not primarily a greater inequality *between* countries, but *within* certain countries. This applies, for example, to Asia, where the differences between town and country as regards actual consumption have increased considerably since the 1980s. Unlike Sala-i-Martin and others he does not use the nation state as a unit. Even weighted GDP per capita can be misleading if there are major differences in income and consumption *within* countries. The high figures, for example for China, are of course an average that has been multiplied up by its big population. But if the middle class and upper class of the cities have a level of consumption resembling that in the West, whilst hundreds of millions of people in the countryside live just above the United Nations poverty line, figures of this kind are not accurate. We will shortly turn to discussing the question of differences in income and consumption between countries.

Is Global Inequality Increasing or Decreasing – a Résumé

As should have become evident, it is hard to draw any definite conclusions as to whether we are witnessing a global convergence as regards income and consumption. Different measures have different weaknesses, but the following can be said with a fair degree of certainty:

- If we start from the relative differences between the richest and poorest *countries* in the world, then inequality has grown since the 1980s.
- If we start from a GDP *per capita weighted* on the basis of different countries relative population size, then equality has become greater since the 1980s.
- If instead of GDP we employ household studies, which take into account different income and consumption patterns within countries, the data available to us indicates that inequality has grown.

But development in different parts of the world weighs heavily whether we assert the one or the other. Without doubt progress in the populous area of Asia justifies an optimistic picture. Development in above all China but also in other places results in fewer and fewer people in the world ending up below the absolute poverty line. On the other hand we see stagnation in Latin America and an actual increase in the numbers of poor people in sub-Saharan Africa.

The relative differences we can see today are historically based. By using so-called Gini coefficients – a frequently used measure for assessing income dispersion – the World Bank draws the conclusion that there is considerable stability in the system: the Gini coefficients are stable and high in Latin America and sub-Saharan Africa (see The World Bank Annual Report 1997). They are lower and stable in Asia, but even lower in the OECD countries. As regards income differentials, we can see stable regional patterns, which presumably are more important than any variations.

Against this background it is probably not even meaningful to say anything in general about global development. One cannot help remembering Mark Twain's famous paradox: if you stand with one leg in ice-cold water and the other in boiling water, can you then say that on average you are satisfied with the temperature?

Income Differentials Within Countries: the Kuznets Curve

We have already observed that income differentials *within* countries also have to be discussed if we are to obtain a picture of how equality in income and consumption has developed over recent decades. In this field there are two fundamental theories to which researchers often refer: the Kuznets Curve and the Great U-turn. As early as the 1950s the famous economist and statistician Simon Kuznets (1955) adduced that there is a clear empirical pattern as regards income distribution in those countries that, beginning in the 19th century, switched from agriculture to industry. At the beginning of this process – the industrial revolution – incomes diverged sharply. But from a little way into the 20th century development went in the opposite direction. With the help of historical statistics, Kuznets showed how incomes levelled out, particularly during "the golden era of capitalism" after the Second World War.

A conclusion of this kind was also plausible on the basis of current macroeconomic theory. Not least the so-called Heckscher-Ohlin Theorem indicated the probability of a levelling out of returns from factors of production (labour and capital) in the long term, given tolerably open economies and free trade. The orthodox view in this regard was confirmed by Samuelsson and Stolper in the 1940s.

Income Differentials Within Countries: the Great U-Turn

But this view of convergence was severely criticised as early as the 1980s. Instead the theory of "the Great U-turn" was introduced: incomes are levelled out first but then diverge again (Harrison and Bluestone 1988). Incomes both between countries and regions and within countries converged to be sure in what we earlier called "the golden age of capitalism" in the 1950s and 1960s. The USA experienced a reduction in income differentials during the years of the "Great Society" under Lyndon Johnson and Richard Nixon, but from the 1980s the differences grew rapidly once again. There is reason to assume that this also applies to other countries in the

industrialised world (see Appendix, Table 2). Below we will return to what that, in this case, may be due to.

Most commentators share the view that income differentials have grown both in the rich world and among developing countries over the past decades. Milanovic (Milanovic 2001), who has collated Gini coefficients for a total of 120 countries, draws the conclusion that in the longer term there is a tendency to convergence between the major blocs the USA, Western Europe and the OECD countries in Oceania. But in Latin America and the former Soviet bloc the differences have increased internally. This also applies to many countries within the OECD and in Europe.

Income differentials, such as those, for example, measured in Gini coefficients, are initially very large between different parts of the world. Africa and Latin America are still characterised by very high Gini coefficients (see Appendix, Figure 1). Western Europe is a particularly egalitarian region as regards income. In the former Eastern Bloc income differentials have clearly risen since the fall of the Berlin Wall. Even in the USA income differentials have increased, as they have in Asia. But the figures are still very much lower than in Africa and Latin America. Unfortunately data is too poor for exhaustive assessments of the development of income differentials over the long-term; this applies particularly to many developing countries. Available data indicates that old differences have remained in place in recent years, but the picture is so incomplete that it is difficult to draw any valid conclusions about long-term development.

The most important impression is that the "structural" differences between countries and regions still remain. At the same time, we can observe certain changes which admittedly do not alter this basic fact, but which nevertheless are significant at the margins. Here we will refer to a couple of more comprehensive and authoritative studies which primarily apply to the OECD countries, for which we have much better data. The most thorough study has been carried out within the framework of the LIS project (Luxembourg Income Study), a collaborative enterprise between approximately 25 national statistical authorities globally which has been ongoing since 1983 (Atkinson 2004). In order to analyse income differentials from the end of the 1960s onwards they have, for example, used data for a total of 16 countries (see Appendix, Figure 2).

On the basis of LIS researchers can show a significant increase in income disparities in two of the OECD countries, namely the USA and Great Britain (Nielsen *et al* 2005). The increase in the Gini coefficient was particularly marked in Great Britain between 1969 and 1999 (0.078). Other countries also experienced greater income differentials over the same period, but not as markedly; this applies to Austria, Finland, Italy, Australia and Luxembourg. In other countries – Norway, Belgium and Denmark – they can discern a small increase in income differentials. But in countries such as Germany, France, the Netherlands, Canada and Sweden equality has, if anything, increased. This applies therefore to roughly the 30 year period up to 2000.

According to an alternative estimate of data coming from LIS, Smeeding arrives at the fact that the trend towards greater income differentials within Europe is clear, particularly during the 1980s. But in certain countries not a lot happens; this applies particularly to Denmark and Slovenia (Smeeding 2002; Heiderich 2007).

Generally speaking it is difficult to see an unambiguous pattern in these figures. Political scientists and sociologists such as Gösta Esping-Andersen and others who have followed in his wake have often talked about different social and political models among the OECD countries with differences in emphasis on social and economic equality (Esping-Andersen 1990). In this way one would be able to distinguish an Anglo-Saxon model, a continental social-conservative model, a northern European or Scandinavian model, and possibly a fourth, southern European model. Then the developments in the USA and Great Britain, towards greater inequality, accords with our expectations of the Anglo-Saxon model's more market-liberal character. Otherwise the picture is more unclear. A Nordic country such as Finland and a continental country such as Austria, which both have strong social political traditions, have, according to LIS, experienced increasing income differentials, whilst, for example, Sweden, Canada and France have not done so.

Another frequently cited study of income differentials in a number of OECD countries (9 countries) has been conducted by the

economist Anthony B. Atkinson. He sets up an even longer time perspective, from 1945 to 2000. One might possibly claim that Atkinson's basic data is somewhat more fragile than in LIS. He has taken data from different sources, not merely the official sources such as LIS. On the other hand, he has more data than the Luxembourg group as regards drawing general conclusions about trends.

Atkinson sees three different groupings in his material. In four of the nine countries the trend is unambiguously in the direction of greater income differentials, here too measured using Gini coefficients. This applies in particular to Great Britain, but also to Finland, the Netherlands and the USA. He also finds a rising Gini for Sweden and Canada. As regards Norway, (West) Germany and Italy the trend is more unclear, but presumably it is not a question of any major change in either direction. Different countries seem to show different pictures as regards income development. It is not possible to draw any grand general conclusions on the basis of existing empirical findings. To the extent that one can talk of greater income differentials in Europe as a general phenomenon the development has been checked towards the end of the 1990s. Eurostat, which is the EU's official statistical office, finds a clear pattern towards reduced differences from the middle of the 1990s in many countries, measured in Gini (see Appendix, Table 2). But again the picture is divided. For countries such as Sweden, Finland and Denmark the differences seemed to grow in the 21st century. This applies also to Latvia and Great Britain with already high Gini figures.

The Atlantic Consensus

During the 1990s it was popular to claim that there was a direct positive correlation between economic globalisation and greater income gaps, at least as regarded the "old" industrialised world. A particularly influential writer was Bill Clinton's former Secretary of Labor Robert Reich who in his *The Work of Nations* (1992) wrote that the "new economy", which is based on services and a greater knowledge base, presupposed greater income differentials in order to be able to function well (cf. also Smeeding 2002; Heiderich 2007). The polemic was not least directed at conventional liberal economists who – in accordance with Samuelsson and Stolper – claimed that to the extent that the "new economy" led to greater growth and rising incomes it would benefit everyone. According to the orthodox macroeconomic view, everyone would gain from globalisation. Greater growth means in the longer term both that the poor became fewer and that income differentials decreased (Bhagwati 1997; Lal 2006:139).

From the end of the 1990s onwards a view among researchers and debaters developed, which has come to be called "the Atlantic Consensus". The main argument was that globalisation presses down wages for unskilled labour, whilst individuals with unique knowledge and competence draw away from them in income. But this only applies in countries which are relatively open and where different types of regulations do not prevent wages from falling. In countries of this kind the result is instead that unemployment increases. At the end of the 1990s this scenario seemed to chime well with differences in the development of the labour markets between the USA and Western Europe. For the USA's part empirical study showed that wage differentials increased. The reason had to be competition from labour in low-income countries – they assumed. In Western Europe it was presupposed that we buy a higher so-called reservation wage, the lowest wage acceptable to wage earners to allow themselves to be employed, with relatively higher unemployment.

But as critics have pointed out, this theory is too simplistic to be able to explain a great deal. Firstly it presupposes that low-price countries bring down wages in the USA and create unemployment in Europe, but it says nothing about what happens to flows between Europe and the USA. As salaries fall in the USA that country should be able to increase its sales to Europe and in this way compensate for some of the drop in wages. The great loser would in that case be Europe, whilst the effects on the USA are in part much more unclear (Atkinson 2003:17f). This may be the case – or alternatively wages and prices are more flexible in Europe than one generally assumed.

Secondly, "the Atlantic Consensus" starts from the theory that

the greater wage differentials in the USA result from low-paid workers losing ground relatively speaking. But that is by no means definite. Several studies show instead that it is the upper strata who pull away. This applies particularly to those with incomes in the top percentile. This is where the super-rich are to be found, those whose incomes increase most rapidly of all. This observation fits in well with the "superstar theory" launched more than 20 years ago (Rosen 1981). According to this theory, the transition to a more knowledge-based service economy in the West means that the emergence of a small number of super-rich individuals who pull away from the rest in terms of income. It is possible to produce a great deal of empirical research to support such a thesis. One may, for example, indicate the increasingly rapidly growing income differentials between leading business executives and "ordinary" workers in the USA, a phenomenon that applies to most other countries. A large part of the greater income differentials during the 1980s and 1990s in the USA, and perhaps also in other countries, therefore results rather from the fact that they have become even richer, than that incomes further down the hierarchy have declined a great deal in relative terms (as an effect of low pay competition).

The question is, when all is said and done, what connection there is between openness to globalisation and growing wage differentials. It is not a foregone conclusion that a country like Finland is much more open than, for example, Sweden. In Finland wage differentials are growing relatively quickly, whilst changes in Sweden are very small. One may also ask the question why the differences are increasing in Austria but not in Canada. Vincent Mahler, who has attempted to measure the connection between the degree of globalisation and greater income differentials in different dimensions, finds a certain link between the country's openness as regards international finance and wage differentials (Gini). But generally speaking he finds no directly positive link if one uses a more complex and presumably more realistic definition of the degree of globalisation, which includes the proportion of GDP comprising foreign trade for a particular country etc. (Mahler 2004).

Domestic Causes

In all likelihood it is the case that actual differences in income *between* individuals *within* countries still to a great extent result from domestic factors, such as the policy a country is following as regards welfare, transfers of welfare between groups and individuals, taxation etc. In several countries within the OECD there is a system of institutions and mechanisms for transferring income. It is indisputably the case that high levels of compensation in the unemployment and health insurance systems create and maintain a high degree of equality of income. Countries with systems of this kind generally show smaller gaps measured in, for example, the Gini coefficients than countries with low levels of compensation. Particularly during periods of higher unemployment, inequality rises quickly in the latter. But bearing in mind how difficult it is to measure the effects, for example of transfers, it is not easy to measure the development in different countries, even less so to make comparisons between countries. The more ambitious attempts nevertheless to try to make such comparisons, as have been discussed here (particularly in LIS), endeavour in different ways to neutralise the effects of different countries' welfare and taxation systems. But the problems are great, and for this reason the results are also marred by a high degree of uncertainty.

There hardly exists any unambiguous link between the type of welfare policy followed and income distribution. Among the most egalitarian countries in the world we admittedly find ambitious welfare states with a commitment to redistributing incomes between the rich and the poor, such as the Nordic countries, Germany and so on. At the same time, it is clear that the development over recent decades has been different. As has been mentioned above, wage differentials increase in certain of those countries that belong to the Nordic model (for example Finland), but others have not gone along the same route (Denmark, and presumably Sweden and Norway). In the same way, income differentials are growing in certain other countries within the continental social model (for example Austria) but not in others (such as France and Germany).

Other internal factors than welfare policy may also clearly contribute to explaining the development of established and altered income differentials. Mahler has in the study mentioned above attempted to measure the correlation between income differentials (absolute and disposable) and such factors as the number of changes of parliamentary power, numbers of votes cast in general elections etc. He really only finds two links which have clear significance in the measurements: there is a link between a high degree of trade union membership and relatively small income differentials, and between a high degree of wage coordination and low income differentials (Mahler 2004: 1042). It should be pointed out that Mahler does not discuss altered income differentials over a longer time period, but measures the link between income differentials and different political variables at a certain point in time.

An important internal factor that plays a major role is, therefore, the extent to which wage negotiations are centralised. Also important is how the country's specific systems work for the parties on the labour market. Arrangements which *de facto* imply a high degree of centralisation as regards the setting of wages clearly function as a shock absorber as regards rising wage differentials.

Presumably *internal* factors are of greater significance than *external* ones when it comes to explaining income differentials within countries, just as when it is a question of the change in such differences over a longer period of time. The far-reaching effects of globalisation which have often been pointed out in public debate, for example in the form of a downward pressure on wages in high wage countries, is still not yet particularly visible if we look at empirical facts.

Conclusion

The aim here has been to provide a concise picture of the state of knowledge as regards the effects of economic globalisation on income levelling and possibly greater differences both *between* and *within* countries and regions. We have seen that it is extremely difficult to provide a definitive picture. A great deal depends on what measures one uses and how one defines central concepts. As regards global income differentials, it is clear that the number of poor people has diminished relatively and presumably also in absolute terms. At the same time it is clear that the reasons for this primarily lie in the remarkable development that has occurred in China, in Southeast Asia and in India (at least relatively speaking because here the number of poor people has as yet not diminished). This should then be weighed against the depressing decline which marks the peoples and countries of Africa, and the development in Latin America which must be regarded as a disappointment. Generally speaking, the world is perhaps a better place than it was 50 years ago – but this is hardly any consolation for sub-Saharan Africa.

As regards income development within countries, the theory of the Kuznets Curve has been questioned by those who have proposed the so-called U hypothesis, that is to say that inequality has again increased from the 1980s after some decades of general income levelling. There is some evidence supporting this hypothesis, at least as regards the 1980s and perhaps also the 1990s. But the trend looks different in different places and is not particularly clear-cut. Even more difficult is interpreting the causes behind these empirical observations. There is a great deal that supports the idea that countries with ambitious welfare and redistribution policies have both lower inequality figures and develop in a more egalitarian manner over a longer time period. But, as we have seen, this does not apply to all countries. Presumably other, primarily internal, factors play an important role here. This applies, for example, to the degree of wage coordination which must be emphasised as an important factor to explain wage differentials over a longer perspective. But there are certainly also other important factors playing a vital role in this context. The effect of globalisation in the form of wage competition etc., at least so far, weighs fairly lightly as a factor in the context.

The question is, of course, what will happen in the long term. It is probable that the trend we can discern in particular in the USA, with a number of super-rich individuals who pull away in terms of income, will continue and also spread to Europe and to rapidly developing countries in Asia, for example China and India.[1] The signs of this are already clear. For this reason one may assume that the gaps within countries may widen in many places. It is, however,

unclear to what extent the continued development will lead to downward pressure on wages within the rich countries, that is to say global wage convergence caused by increased competition on world markets.

Firstly the “old” social models (with relatively speaking higher reservation wages) have so far succeeded in defending their position. There is nothing to indicate that these will be phased out at a rapid pace. On the contrary, it is more probable that what we today call welfare capitalism – or what the economist Joseph Schumpeter half a century ago called “the tax state” or “state capitalism” – will grow in significance. Not least global competition brings forth such protective instincts within the Western democracies, including the USA. We can discern the growth of more protectionist strains (in particular in the USA) and in other places see how attempts to radically remodel established welfare systems meet with opposition among the voters (in particular within the EU). The “third way” between a “pure” capitalism and communism which many observers saw as a historical parenthesis has been very tenacious. Not least with regard to the demographic challenge these countries are faced with over the next few decades, economic policy, and active labour market policy and the art of social engineering with the aim of creating more employment-friendly institutions and incentives will become increasingly important aspects of the policies of national governments.

Secondly, the effects that greater global competition have on wage development are intimately linked with the long-term effects of the new international division of labour that has grown up over recent decades. This will in future continue to lead to greater specialisation, which makes it possible for certain countries to “tolerate” higher relative wages and a more developed welfare system than others. The demographic development with ageing populations and a diminished proportion of the population in work may very well involve a shortage of labour which results in wage increases (every-

1) Editors’ note: However, see also the discussion about the effects of the financial crisis in this volume’s introductory chapter.

thing else being equal of course). There is a great deal indicating that wage and other cost developments will rapidly go through the roof in those countries which are now going through a rapid process of industrialisation.
Presumably something similar will happen, for example in China. Here one can also count on rising costs as a result of social protests, a deterioration in the environment, and need to develop social infrastructure etc.

Thirdly – and this is a more pessimistic scenario – it is possible that the rapid wave of globalisation that we have experienced in recent decades will slacken off within the immediate future. As we have shown, waves of rapid globalisation have come and gone. This has very little to do with inexorable economic laws. A slackening off could be caused by social and political reactions, in the form of the greater uncertainty and concern for the future which economic globalisation brings with it. But other factors also play a part. A real or imagined shortage of resources, general political unease, terrorism and greater regional antagonisms can bring forth protectionists trends. Emigration and real or imagined mass movements of population have similar effects. It is difficult with certainty to say a great deal about the future as regards widening income gaps either within countries or between countries and regions. To the extent that overconfident pronouncements are being made, it is a question more of belief than of knowledge.

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Appendix

Table 1: *Levels of GDP per capita and interregional spreads, 1000–1998.* *(1990 international dollar)*

	1000	1500	1820	1870	1913	1950	1973	1998
Western Europe	400	774	1 232	1 974	3 473	4 594	11 534	17 921
Western offshoots	400	400	1 201	2 431	5 257	9 288	16 172	26 146
Japan	425	500	669	737	1 387	1 926	11 439	20 413
Asia (excluding Japan)	450	572	575	543	640	635	1 231	2 936
Latin America	400	416	665	698	1 511	2 554	4 531	5 795
Eastern Europe & former USSR	400	483	667	917	1 501	2 601	5 729	4 354
Africa	416	400	418	444	585	852	1 365	1 368
World	435	565	667	867	1 510	2 114	4 104	5 709
Inter-regional spreads	**1.1:1**	**2:1**	**3:1**	**5:1**	**9:1**	**15:1**	**13:1**	**19:1**

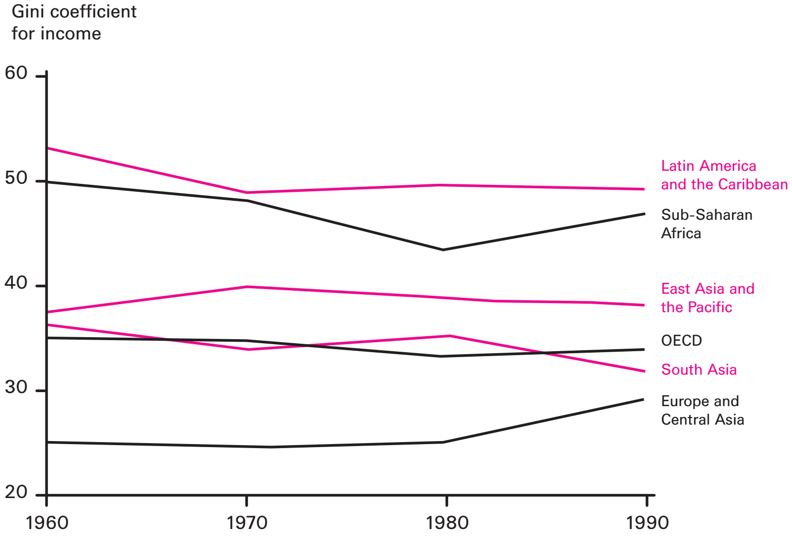
Source: Angus Maddison, *The World Economy. A Millennial Perspective.* Development Centre Studies, OECD (2001).

Table 2: *Inequality of income distribution (EU25; 1995–2004).*

	Time period	Gini coefficient		Income quintile share ratio	
		Earliest observation	Most recent observation	Earliest observation	Most recent observation
Belgium	1995–2004	29	26	4.5	4
Czech Republic	2001–2003	25	25	3.4	3.4
Denmark	1995–2004	20	24	2.9	3.4
Germany	1995–2004	29	28	4.6	4.4
Estonia	2000–2003	36	34	6.3	5.9
Greece	1995–2004	35	33	6.5	6
Spain	1995–2004	34	31	5.9	5.1
France	1995–2004	29	28	4.5	4.2
Ireland	1995–2004	33	32	5.1	5
Italy	1995–2004	33	33	5.9	5.6
Cyprus	1997–2003	29	27		
Latvia	2000–2003	31	36	5.5	6.1
Lithuania	2001–2003	31	29	5	4.5
Luxembourg	1995–2004	29	26	4.3	3.7
Hungary	2000–2003	26	27	3.3	3.3
Malta	2000–2000	30	30	4.6	4.6
Netherlands	1995–2003	29	27	4.2	4
Austria	1995–2004	27	26	4	3.8
Poland	2000–2003	30	31	4.7	5
Portugal	1995–2004	37	38	7.4	7.2
Slovenia	2001–2003	22	22	3.2	3.1
Slovakia	2003–2004	33	33	5.4	5.8
Finland	1996–2004	22	25	3	3.5
Sweden	1997–2004	21	23	3	3.3
United Kingdom	1995–2003	32	34	5.2	5.3

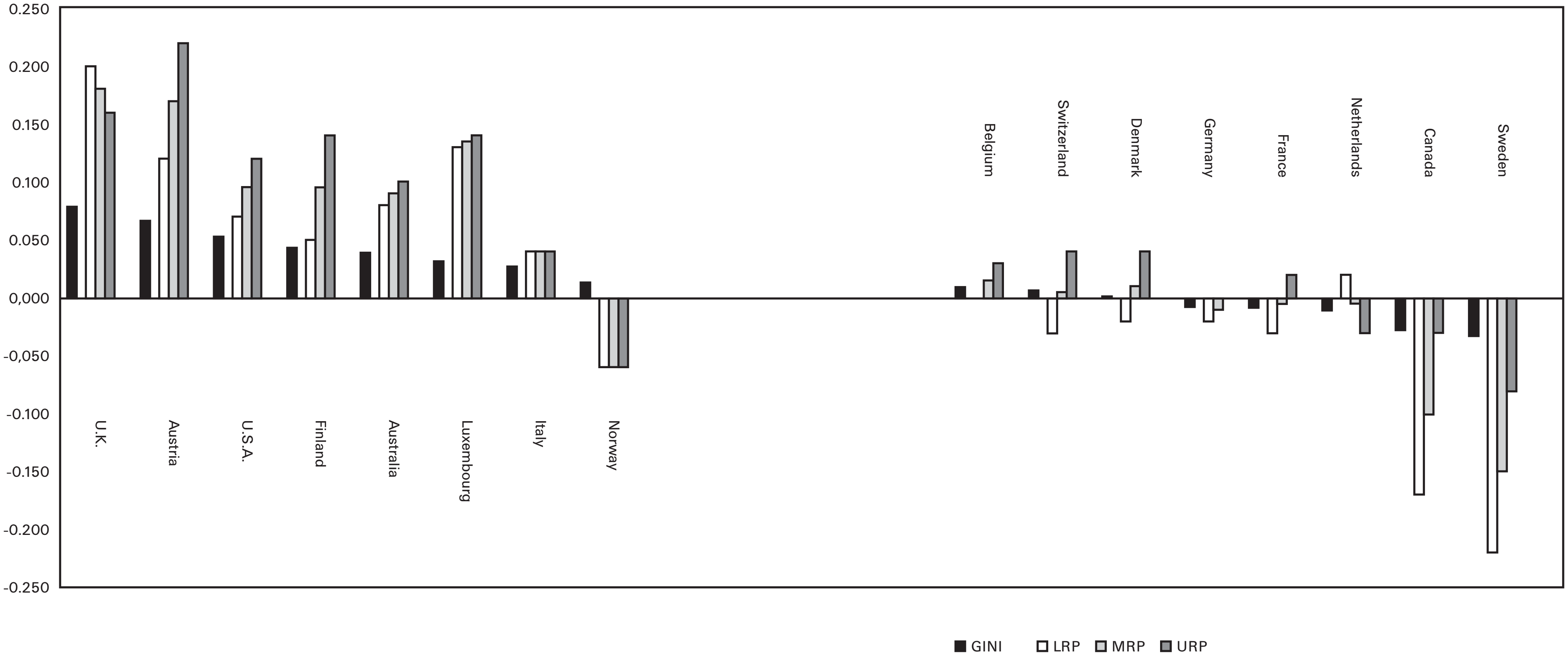
Source: Eurostat, http://epp.eurostat.cec.eu.int (5 March 2006).

Figure 1: *Income inequality differs across regions but changes little over time.*



Source: Martin Heidenreich, "The Development of Social Inequalities in Europe", in Lars Magnusson and Bo Stråth (ed), *European Solidarities. Tensions and Contentions of a Concept*. Brussels: PIE Peter Lang, 2007, p. 43.

Figure 2: *Change in Gini coefficients and polarization indices in 16 core societies, various periods.*



Note: Ranked from left to right in terms of the magnitude of change in Gini coefficient (GINI). LRP = Lower relative polarization index. MRP = Median relative polarization index. URP = Upper relative polarization index.

Source: Francois Nelson et al, "Exactly How has Income Inequality Changed?", *Luxembourg Income Study Working Paper Series*, No. 422 (May 2005), p. 22.

4. Globalization and American Income Polarization

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Introduction

Inequality has increased in many, though not all, rich industrial countries. Since 1980 the relative income differences between people with high and low ranks in the income distribution have widened. The increasing gap between rich and poor has been particularly striking in the United States.

One popular explanation for the growth in inequality is globalization. The economies of industrial countries have become more closely linked with one another and with economies in the developing world. The closer economic links between rich and poor countries are the result of conscious policy decisions and steady technical progress. After 1960 many countries agreed to reduce the barriers that impede cross-border movements of goods, services, savings, and investment. Faster and bigger airplanes move people and goods more quickly and cheaply than was possible in the past. Lower communication costs, driven by the revolution in information technology, make it cheaper and easier to integrate the production of goods and services across international boundaries. Although most national savings is still invested in home country businesses, ever larger pools of capital flow freely across national borders in search of the highest return.

According to a widely held view, the shrinking barriers to cross-border trade and capital flows have inflicted serious harm on industrial workers in the rich countries. Unskilled and semi-skilled workers in newly industrializing countries work for much lower wages than workers with comparable skills in the industrial countries. Many observers think it is inevitable that overseas workers earning less than USD 5.00 a day must ultimately displace workers in rich countries earning USD 15.00 an hour or more. This view has been forcefully argued by the opponents of free trade, who warn that liberalized trade with poor countries has undermined labor protection laws in rich countries, threatened their social safety nets, eliminated good jobs, and reduced the wages of unskilled and semi-skilled workers.

Most American economists who have studied the direct effects of international trade are skeptical of these claims. With few exceptions, economists find little evidence that rising trade is the main source of growing wage and income inequality in the rich countries. Indeed, there are a number of rich countries, including Canada and France, where we see little or no evidence that income inequality has increased.[1]

Nonetheless, economists who argue in favor of free trade must face an uncomfortable fact. A classic doctrine of modern economic theory, the factor price equalization theorem, predicts that under realistic assumptions the elimination of trade barriers between a high-wage and a low-wage country will lead to a fall in the real wages of unskilled workers in the high-wage country. Consistent with this theory, the increase in manufactured exports from the developing world to industrialized countries has been accompanied by a loss of manufacturing employment in the industrialized countries and a decline in the relative wages earned by unskilled and medium-skill workers in those countries.

Even though they seem plausible, of course, the assumptions behind the factor price equalization theorem may not be true. The trends in manufacturing employment and wage disparities could be due to factors that are completely unrelated to trade. Even if the assumptions of the factor price equalization theorem are valid, and the trends in manufacturing employment and relative wages are partly caused by liberalized trade, it is important to establish whether trade has been a major contributor to the trend in inequality, or has played only a minor role.

Many American economists think the most persuasive explanation for widening U.S. wage disparities is a shift in employers' demand caused by the introduction of new kinds of production techniques and management methods. These changes have occurred in American industries where trade is not very important as well as in those where international trade plays a crucial role. Technological innovation and the entry of new market participants have put pressure on U.S. employers to change their production methods in ways that require a more able and skilled work force. Employers have followed this strategy in spite of rising wage premiums paid to the highly skilled workers. Bigger pay premiums for high-skill workers now make it more expensive to hire a highly skilled work force than

was the case in the 1960s or 1970s. The same trends in technology have pushed employers to reduce their use of unskilled and medium-skill workers. In order to find and keep jobs, workers with limited skills have been forced to accept wages that are a smaller fraction of the wages earned by high-skill workers.

The Facts

Income inequality. Income inequality rose sharply in the United States after 1980. In the 1980s and early 1990s the proportional income gap increased between Americans at the top and bottom of the income distribution. Income differences widened between families in the middle and at the bottom as well as between families at the top and in the middle of the distribution. Starting in the 1990s, inequality trends changed course. While the gap between high-income Americans and the middle class continued to grow, the gap between middle class Americans and those at the bottom narrowed. One reason is that U.S. unemployment fell to a 30-year low in 1999, giving a major boost to incomes received by Americans near the bottom of the income distribution. The recession in 2001 caused incomes to fall in every part of the U.S. income distribution, with particularly big declines at the top and bottom of the income distribution (see Appendix, Figure 1). Starting in 2003, however, incomes at the top of the distribution once again began to grow rapidly, reaching a new post-World War II peak in 2005. In the middle and at the bottom of the income distribution, however, real incomes recovered at a much slower pace.

An important explanation for the long-term rise in income inequality was the increase in wage disparities after 1980. Wage earners with limited skill and education saw their wages stagnate or fall, while workers in the top ranks of the wage distribution, who

1) Andrea Brandolini and Timothy M. Smeeding (2008), "Inequality: International Evidence". *New Palgrave Dictionary of Economics*, forthcoming.
http://darp.lse.ac.uk/papersdb/Brandolini-Smeeding_(Palgrave2e).pdf

typically have completed advanced education or possess valuable skills, enjoyed rapid gains in real wages. The trend toward lower real earnings in the bottom ranks of the wage distribution came to an end in the mid-1990s. In fact, after 1990 low-wage and low-skill workers obtained somewhat faster pay gains than mid-level and medium-skill workers. The long-term trend in favor of highly compensated workers continued without interruption, however. Between 1990 and 2005 the median annual earnings of a full-time, year-round American worker increased about 5 percent. At the 98th percentile real earnings rose 33 percent; at the 99th percentile they rose 37 percent; at the 99.99th percentile they rose 82 percent. Clearly, wage gains at the very top of the earnings distribution far outpaced those received by ordinary workers.

Figure 2 (see Appendix) shows the trend in hourly wage inequality after 1979. The top line in the chart shows the ratio of hourly wages at the 95th and 50th percentiles of the U.S. wage distribution, while the lower line shows the ratio of hourly wages at the 50th and 10th percentiles of the distribution. The path of the top line suggests that the proportional wage gap between top earners and median-wage earners has increased with little interruption since the late 1970s. In contrast, the gap between low earners and median-wage earners grew rapidly between the late 1970s and late 1980s, but then began to decline.

U.S. trade. Can globalization help explain these income and wage trends? To some degree it can. A simple indicator of the role of international trade in an economy is the sum of exports and imports measured as a percentage of national GDP. The United States has seen a sizeable increase in the share of international trade in its economy. Between 1972 and 2005 the foreign trade share of GDP increased about 0.4 percentage points a year, rising from 12 percent to 27 percent of U.S. GDP (see Appendix, Figure 3). Measured as a share of U.S. national income, merchandise imports from the rich industrialized countries nearly doubled between 1972 and 2005. Imports from lower income countries (excluding countries that mainly export oil) increased even faster, however (see Figure 4, Appendix). Imports from these countries tripled as a percentage of U.S. GDP between 1972 and 1993, and they more than

doubled between 1993 and 2005. Measured as a percentage of U.S. GDP, merchandise imports from developing countries are now more important than imports from other rich industrialized countries (6.7 percent versus 6.3 percent of U.S. GDP).

Among developing countries, Mexico and China are the two most important U.S. trading partners. In 2005 Mexican hourly compensation costs were just 11 percent of those in the United States. Compensation in China is lower still. A plausible estimate is that Chinese hourly compensation is less than a third of compensation in Mexico and only about 3 percent of hourly compensation in the United States. The sharp rise in imports from the developing world, especially from developing countries with extremely low wages, has placed intense competitive pressure on tradable goods industries that once employed a large number of unskilled and semi-skilled workers.

Some evidence of the potential adverse effects of trade can be seen in U.S. employment statistics. Manufacturing, which once offered good job opportunities to unskilled and semi-skilled workers, now accounts for a dwindling percentage of American jobs. If we define the "tradable goods industries" as manufacturing, mining, and agriculture, then the fraction of the U.S. workforce employed in tradable goods industries has been shrinking more or less steadily since the late 1960s. These industries employed 32 percent of working Americans in 1970, but this share fell to just 14 percent of the workforce by 2005. Of course, the decline in these industries has been more than offset by employment growth in other industries, mostly in the service sector and primarily in sectors, like health, education, and financial services, where international trade plays a comparatively minor role. The fraction of U.S. adults between 20 and 64 who are employed increased noticeably between 1970 and 1995, rising from 67 percent to 75 percent of the adult population. The adult employment rate has remained approximately steady since then. The robust health of U.S. employment in the face of closer global integration and rising imports from developing countries suggests that the adverse effects of trade, if any, have been reflected mainly in the wage distribution rather than in employment. The job displacement caused by international trade has not led to a permanently lower employment rate, although it may have pushed down hourly earnings among workers who face particularly intense competition as a result of overseas competition.

U.S. wage trends in the 1980s certainly seem consistent with the theory that international competition played an important role. Relative wages fell fastest for workers with limited skills, precisely the kind of workers who are most abundant in the rapidly industrializing low-income countries. Relative wages increased for high-wage American workers with good educational credentials and advanced skills. Since these kinds of workers are scarce in the developing world, they should be expected to derive the greatest gain from closer economic integration.

U.S. wage trends after the early 1990s are not so easy to explain using standard trade theory. Since 1990 there has been an explosion of U.S. trade with the poorest countries, especially China. This development should have placed intense downward pressure on wages earned by American workers with the least education and skill. Instead, U.S. workers in the bottom ranks of the wage distribution actually saw their earnings improve compared to earnings received by mid-level and middle-skill workers (see Appendix, Figure 2). To be sure, the relative wages of the top U.S. earners continued to pull further away from the wages earned by unskilled and semi-skilled workers. It is not obvious why this trend is linked to increased trade or closer world economic integration, however. Many observers believe it can be traced to shifting wage norms and changes in corporate governance.

The view that globalization is the main factor underlying long-term wage trends would seem more persuasive if we found that the demand for less skilled workers fell dramatically in trade-affected industries but remained comparatively strong in industries unaffected by trade. One fact to bear in mind is that relative wage disparities have changed similarly in both the traded-goods industries and in industries unaffected by trade. Earnings inequality in the United States followed an upward trend at a similar rate in both trade-affected industries and industries where international trade plays a minor role.

By itself, this pattern of wage change provides no evidence about the source of change in wage inequality. It simply demonstrates that, within a single labor market, relative wages move in the same way across industries.

There is no reason, however, to expect that utilization of less-skilled workers outside the trade-affected sector should fall just because globalization or rising imports from developing countries reduces the demand for unskilled workers. Firms that do not produce internationally traded goods or services should take advantage of the declining relative wage of unskilled workers by hiring more of them. If, instead, they adopt techniques that use unskilled labor less intensively, it seems likely that technical change or some other development has reduced their demand for less-skilled workers. Pressures originating in international trade cannot easily explain lower utilization of unskilled workers in industries that are not involved in international trade.

It is certainly the case that companies reduced their utilization of unskilled workers in industries producing internationally traded goods. Over the 35 years after 1970, the U.S. traded goods industries sharply reduced the proportion of less educated workers on their payrolls. By 2005, only 15 percent of full-time equivalent workers in these industries lacked a high school diploma, down from 46 percent of their workforce in 1970. Although the reduction in use of less skilled workers was large, it was not proportionately any larger than the reductions in industries where international trade plays a negligible role. For example, the percentage of workers without a high school diploma in the *least* trade-affected industries fell from 35 percent to 11 percent in the same period, a drop of more than two-thirds.

There is little evidence that the least skilled U.S. workers were displaced any faster in trade-affected industries than in industries that are not affected by international trade. This pattern of labor utilization is hard to square with the claim that rising earnings inequality has been caused mainly by pressures arising from globalization. Unless their hiring decisions were affected by some other set of factors (including changes in technology or new management practices), employers who do not produce internationally traded products have no particular reason to reduce the intensity of use of unskilled workers. The declining relative wage of unskilled workers actually provides employers in these industries with an incentive to substitute unskilled for skilled labor with existing production methods. It offers a powerful inducement for employers to look for new production methods that take advantage of a cheaper factor of production – low-skill workers. Instead, U.S. employers outside of the traded goods industries have elected to reduce their utilization of less-skilled workers about as fast as employers in the industries directly affected by competition from China and Mexico. It would be difficult to find an explanation for this choice based on international trade theory. Changes in technology *do* provide a straightforward explanation for the parallel trends inside and outside of the traded-goods industries.

Conclusion

As we have seen, U.S. wage trends may be partly explained by globalization and the increased economic integration between the United States and developing countries. However, the facts about globalization seem easier to square with wage trends in the 1980s than with wage developments since the early 1990s. The growth of U.S. trade with the poorest countries, including China and Mexico, has accelerated since the early 1990s, but the relative decline in workers' earnings at the bottom of the wage distribution has actually reversed since that time. After the 1980s wages at the bottom of the wage and skill distributions have increased compared with wages in the middle of the wage and skill distributions. The trend toward greater wage inequality in recent years has been driven almost entirely by the widening gap between U.S. workers who earn the highest wages and those who earn low or average wages. It seems unlikely that rapid earnings gains at the very top of the wage distribution can be explained mainly by global economic integration. For one thing, the soaring income of top earners is much more noticeable in the United States than it is in non-English-speaking countries such as Japan and France.[2] The fact that all of the industrial countries have become more closely integrated with developing countries, while only a few have seen dramatic income gains among top earners, suggests that

institutional and policy factors have played a larger role than globalization in explaining the evolution of top earners' incomes.

Finally, it is worth noting that growing wage inequality is only one of the factors behind the long-term rise in U.S. income inequality. Other factors have also played important roles, and it is often hard to see a link between these developments and globalization. One of the most important trends contributing to increased U.S. inequality is the shift in household living arrangements. Americans with a college degree have delayed marriage and child-bearing compared with earlier generations of college graduates. Americans with lower levels of education have been less likely to marry or to remain married, and a growing percentage of their children are being raised in lone-parent families. These trends have reduced the fraction of American adults and children who live in married-couple families, and they have increased the percentage of children being reared in single-mother families. These trends would have increased income inequality even if the distribution of U.S. wages had remained unchanged. These demographic trends accounted for between one-seventh and one-fifth of the overall rise in income inequality between 1980 and 2005. Another factor contributing to the growth in inequality is the increase in married women's employment and earnings. The earnings gains were particularly large for women married to highly compensated men. The earnings gains of these wives make income disparities bigger because they add to the incomes of families which would already have high incomes even without the wages of a working wife. My calculations suggest that this development may account for 10 percent to 16 percent of the total rise in U.S. income inequality since 1980.[3] Only about one-half of the rise in overall inequality can be traced directly to the rise in U.S. wage inequality. Therefore, even if globalization explained *all* of the increase in wage inequality, it would account for only about half the

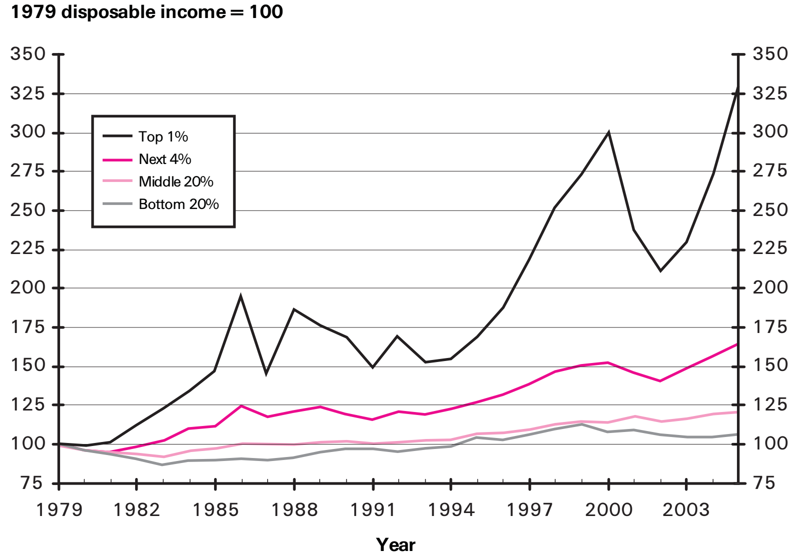
2) Thomas Piketty and Emmanuel Saez (2006), "The Evolution of Top Incomes: A Historical and International Perspectives". *American Economic Review* 96(2), pp. 200–205.

3) Gary Burtless (2007), *Globalization and Income Polarization in Rich Countries*, Issues in Economic Policy 5. Washington, DC: The Brookings Institution.

growth in income inequality. I am skeptical that globalization accounts for even half the increase in wage disparities. Like most economists, I think technological progress, changes in managerial practice, and gradual shifts in the composition of the workforce are the main factors behind increasing wage inequality. Globalization has contributed to the trend, and it has reinforced the effects of some of the other developments just mentioned. However, most of the rise in wage inequality – and nearly all the growth in *overall* income inequality – is due to factors other than globalization.

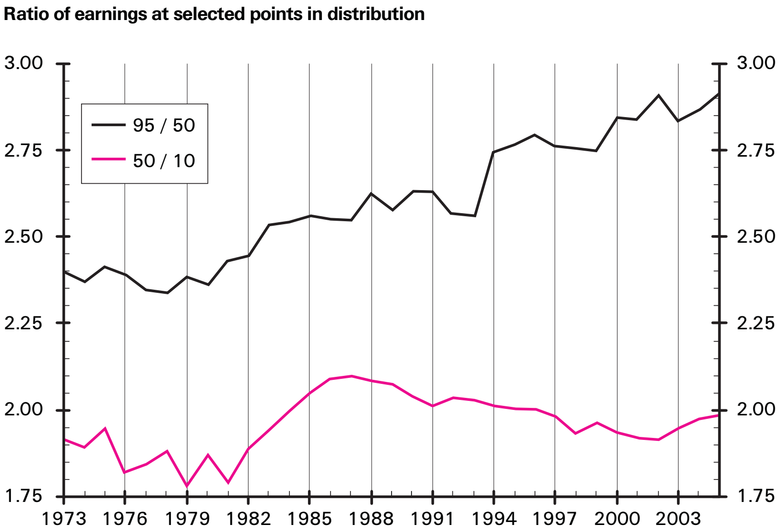
Appendix

Figure 1: *Trends in real after-tax, after-transfer income in selected parts of the U.S. income distribution, 1979–2005.*



Source: Congressional Budget Office (2007), *Historical Effective Federal Tax Rates, 1979–2005*, Table 1C, and author's estimates.

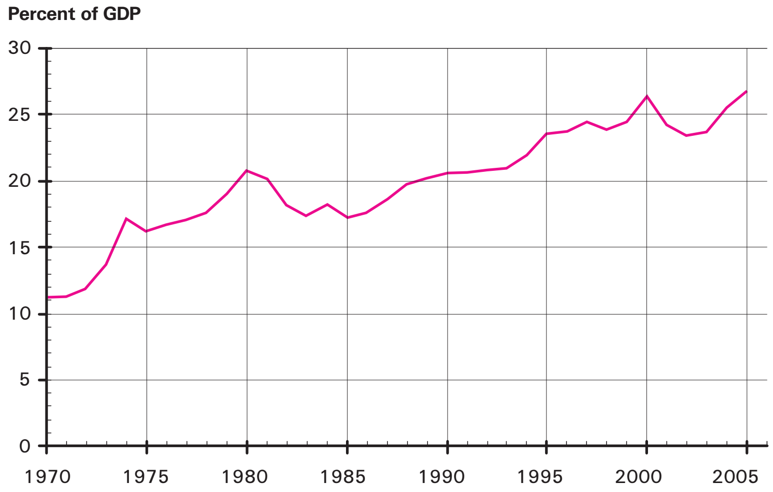
Figure 2: *Trends in relative hourly earnings of U.S. workers, 1973–2005*.*



* The figure shows trends in the ratio of wages at the 95th and 50th percentiles and at the 50th and 10th percentiles of the hourly earnings distribution.

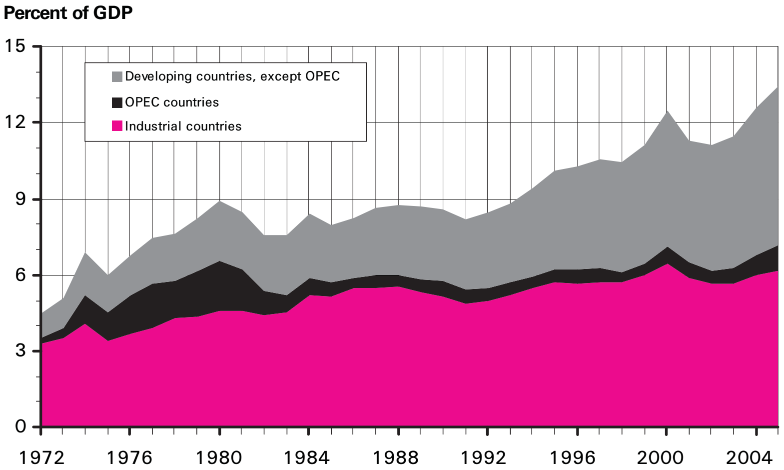
Source: Economic Policy Institute tabulations of hourly earnings data from the monthly Current Population. Survey files (http://www.epi.org/content.cfm/datazone_dznational).

Figure 3: *Exports plus imports as a percent of U.S. GDP, 1970–2005.*



Source: OECD.

Figure 4: *Source of U.S. merchandise imports as a percent of U.S. GDP, 1972–2005.*



Source: *Economic Report of the President*, selected years.

5. Income Distribution in Sweden Since 1990

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Introduction

The income distribution in Sweden has been the subject of serious debate over the years and of a large number of studies.[1] This report describes how the Swedish income distribution has changed in the period 1991–2006.

The period since 1990 has been dramatic for Sweden in a number of ways. At the beginning of the period the country experienced possibly its worse economic and financial crisis ever (Hagberg and Jonung, 2005), with unemployment rising from 2 per cent to 10 per cent over a short period. Subsequently there followed several years of strong recovery with high growth figures, increased productivity and substantial increases in prices on the financial and real estate markets. What is more, Sweden's international integration developed markedly over the period. In 1989 all regulations of cross-border capital flows were removed; in 1995 Sweden joined the EU. During this period the information and communication technologies were revolutionised, which further lowered the costs of international exchange.

Sweden is one of the world's most ambitious welfare states, with high income tax and an extensive social security system. It is particularly interesting to study how the combination of global market exposure and national egalitarian welfare policy has influenced the development of income distribution. Has competition from low income countries or the threat of outsourcing production hit the least well-educated and poorest groups in Sweden? Or is it the Swedish middle class which has lagged behind the income elite, as capital has become increasingly mobile and exceptional talents have been revalued strongly upwards?

The report begins with a description of how Swedish incomes have developed *in absolute terms*, by which I mean the change in real incomes in different parts of the income distribution. After that I present how the *distribution* of incomes has evolved over the period. It is important that both the absolute and relative dimensions of

1) For recent surveys, see Magnusson (2008) or Roine, Vlachos and Waldenström (2008).

incomes are included. It could, for example, be the case that the entire population has experienced significant rises in income which is of importance to, for instance, welfare outcomes. If the incomes of certain groups have grown more rapidly than the incomes of others, however, this leads to increases or decreases of the income distribution which matters for equity considerations, for example.

The statistical data on which this analysis is based come from Statistics Sweden (Statistiska Centralbyrån), primarily Statistics Sweden's tax-based income statistics for *individuals* between 20 and 65 years of age. In certain cases data from Statistics Sweden's *household*-based income distribution study is used (see Appendix for details and also a discussion of the problems of statistics).

Throughout, outcomes are examined for two different income concepts: *labour incomes* and *disposable incomes*. Labour incomes consist primarily of cash wages and income from business, all before tax. Disposable incomes comprise the above-mentioned income from work, but also income from capital (interests, dividends and realised capital gains) after the deduction of tax and the addition of transfer payments. The reason for including two concepts of income is that they reflect different aspects of how society influences the income distribution. The distribution of labour incomes may be said primarily to be driven by forces on the labour market, whilst the distribution of disposable incomes to a greater extent reflects both the influence of capital and of politics. Presumably a proportion of labour income is taken out in the form of capital income, as this is taxed at a lower rate than labour income. For example, people can get their companies to invoice a service instead of themselves taking payment in the form of salary. When they then take out dividends from a company, these are taxed at 30 per cent marginal tax rate, while a salary, if it is large enough, has a marginal tax of more than 50 per cent. Similarly, a self-employed person who sells her company acquires a large capital gain, which is really to be regarded as an accumulated remuneration for that person's work. The Appendix contains a short and exploratory analysis of the significance vis-à-vis distribution of deducting an estimated return on a person's capital from disposable income, leaving only a more work-related labour income.

The Development of the Income Distribution Since 1990

How Have Swedish Real Incomes Developed?

This section starts with an account of the development of Swedish real incomes, that is to say changes in income after inflation has been discounted. The main results are presented in Figures 1a and 1b, showing the development of real income for different groups in the distribution. The population is divided into deciles, or tenths of the distribution on the basis of the their annual rank order in the income distribution. Decile groups 1–5 comprise the lower half of the distribution; decile groups 6–10 represent the distribution's upper half, whilst the top 1% is the roughly 55,000 individuals with the highest incomes each year. It should be noted that the rank order is revised from year to year, and that it is, therefore, not necessarily the same individuals who occur in each income fractile throughout the period. In the figures the real incomes have been shown in relation to the income level for 1991 in order more easily to be able to follow the development over the time period.

The overall result of Figures 1a and 1b is that a majority of Swedes have experienced considerable rises in real income over the period. As regards labour income before tax, this increased for almost 70 per cent of the population between 1991 and 2006, most at the top and least at the bottom of the distribution. At the same time considerable income reductions occurred within the 15-year period. These occurred in particular for the lower deciles and mainly in connection with the deep recession of the 1990s, when the unemployed, at times more than 10 per cent of the population, received no labour income.

The picture is roughly the same for disposable incomes as for labour incomes, although somewhat more positive – disposable real incomes increased for everyone except for the lowest decile.[2] The increase is larger higher up in the distribution. Particularly large real income increases appear at the top of the distribution. This mainly

2) As we have amalgamated the lowest 5 deciles, this result cannot be seen from this figure.

reflects the effect of very large capital incomes (Roine and Waldenström, 2006, 2008).

From an international viewpoint, these increases in real income for the vast majority distinguish Sweden from several other countries. This applies not least to the USA, where large parts of the working class and middle class have not seen their incomes increase by as much in real terms over this period.[3]

Figure 1a: *Real labour incomes in decile groups 1991–2006 (1991 = 1).*

Note: Labour incomes at 2006 prices, indexed using 1991 as the base year (1991 = 1). The decile groups have been calculated from Statistics Sweden's complete income statistics for individuals of 20 to 65 years of age.

Figure 1b: *Real disposable incomes in decile groups 1991–2006 (1991 = 1).*

Note: Labour incomes at 2006 prices, indexed using 1991 as the base year (1991 = 1). The decile groups have been calculated from Statistics Sweden's complete income statistics for individuals of 20 to 65 years of age.

A further, more detailed picture of changes in real incomes between 1991 and 2006 is provided in Table 1. Now the income changes *within* the top decile of the distribution is described more carefully, with even the top percentage being broken down into smaller fractiles. The result – that most Swedes have enjoyed considerable

3) See e.g. U.S. Census Bureau (2000), Lawrence (2007) and Dew-Becker and Gordon (2007).

increases in income throughout the period, although with certain variations from year to year – is the same of course. The five lowest income deciles increased their labour incomes by 1 per cent and their disposable incomes by 13 per cent, which corresponds to an annual real increase of between 0 per cent and 1 per cent. At the same time the table provides an important gradation of the development in the top income stratum. It shows that incomes for the lowest paid income-earners in nine tenths of the top decile (top 10-1%) was 37 per cent to 38 per cent in those two cases, whilst a corresponding increase for the top percentage (top 1%) was 69 per cent and 91 per cent respectively. Even higher in the income distribution, incomes grew even more; the incomes of the richest thousandth of the population grew by 112–113 per cent and the richest ten thousandth grew by 141–153 per cent, which corresponds to an annual real income increase of 6 per cent.

Table 1: *Real labour income and disposable income and their development in different fractile groups between 1991 and 2006 (2006 prices).*

a) Labour income

Income fractile	Average labour income 1991 (SEK)	Average labour income 2006 (SEK)	Change (%)
Decile 1-5	80,012	80,862	+1
Decile 6	179,247	229,126	+28
Decile 7	201,169	264,582	+32
Decile 8	227,869	300,163	+32
Decile 9	267,402	354,097	+32
Decile 10	408,943	586,106	+43
Top 10-1%	370,186	509,166	+38
Top 1%	757,756	1,278,567	+69
Top 0.1%	1,508,511	3,192,738	+112
Top 0.01%	3,323,737	8,395,068	+153
Median	165,557	211,636	+28
Average	63,960	80,862	+26

b) Disposable income

Income fractile	Average disposable income 1991 (SEK)	Average disposable income 2006 (SEK)	Change (%)
Decile 1-5	99,533	112,366	+13
Decile 6	149,951	186,888	+25
Decile 7	164,570	208,261	+27
Decile 8	181,922	233,280	+28
Decile 9	207,185	268,546	+30
Decile 10	323,889	484,690	+50
Top 10-1%	273,945	374,824	+37
Top 1%	773,385	1,473,484	+91
Top 0.1%	2,839,188	6,038,674	+113
Top 0.01%	11,223,222	27,028,386	+141
Median	141,323	175,019	+24
Average	152,518	194,350	+27

Note: Incomes are at 2006 prices. The decile groups have been calculated from Statistics Sweden's complete income statistics for individuals of 20 to 65 years of age.

All in all, the statistical picture shows that the real incomes of most Swedes have increased markedly over the period 1991–2006. The increase has, however, been greater at the top than at the bottom of the distribution, which implies that the spread of incomes has also increased.[4] The incomes of the lower half increased more slowly than those of the upper half, something which to a great extent is the result of greater unemployment among low income-earners. Within the upper half the differences in the rate of increase in incomes are perceptibly marginal, with the exception of the peak of the income distribution where capital incomes grew very rapidly during the period.[5]

4) Globalisation may, however, have had a squeeze effect on real income distribution if one takes into account that the increase in imports of cheap consumer goods from, above all, China, have particularly favoured low income-earners, which is shown to be the case in the USA (Broda and Romalis, 2008).

5) For example, in 2004 the richest 10th of Swedes owned 97 per cent of all the shares quoted on the Swedish stock exchange owned by households (Statistics Sweden, 2006, Table 2b).

Have Low Income-Earners Lost Ground in Relation to the Middle Class?

What has the relative income development looked like during this period? This section examines changes in the relative position of low income-earners in relation to the middle class. Figure 2 displays the so-called P10/P50 ratio, which measures the relationship between a common measure of low income, the 10th percentile in the income distribution (P10), and a common measure of middle class income, the median income (P50). In this figure data from Statistics Sweden's Income Distribution Survey has been used.[6] The picture shows that the relative income development of low income-earners has been relatively stable during the period. This applies particularly to labour incomes, but here one should remember that these series do not include individuals who have no labour income. If also the zero market incomes of unemployed would be included the P10/P50-ratio would increase markedly. In terms of disposable income the P10/P50 ratio has dropped between 1991 and 2006. The reduction is, however, not particularly large. The conclusion, therefore, is that those who have found themselves in the labour market but have had relatively low incomes have not lost out a great deal in the development of incomes in relation to the middle of the income distribution over the past 15 years.[7]

Figure 2: *The income development of low income-earners, 1991–2006.*

Note: Labour income for full-time all year employees, 20 to 64 years of age, who have no income from business. Disposable income including capital gains per consumption unit.

6) The analysis of relative incomes of low income-earners is based on data from Inkomstfördelningsundersökningen ("The Income Distribution Survey", Statistics Sweden, 2008). The reason is that the individual data used in the rest of the analysis is not optimal for describing income levels at the bottom of the distribution. There are several reasons for this. On the one hand, young people living at home are included, whose low incomes do not correspond to those labour market-related outcomes I really wish to discuss. On the other, tabulated income distributions exist which mean that the percentile boundaries at the bottom that have been worked out may be sensitive to definitions of income classes from year to year (see also my discussion in the Appendix). It should, however, be noted that Statistics Sweden's series in Figure 2 are not perfect for our purposes either. A major problem with them is that they are based on annual incomes of full-time employees and in this way exclude those effects on the income spread which result from e.g. unemployment and part-time employment.

7) One possible factor which would mitigate this relative deterioration is if the mobility of low income-earners increased and over the period they found themselves for a short period in the lowest decile groups. An increase in long-term unemployment during the study period speaks against an effect of this kind, however.

Have Top Incomes Left the Middle Class Behind?

How have middle class incomes developed in relation to top incomes? This question has been the subject of lively discussion in other countries, especially in the USA, where the incomes of the middle class have developed considerably slower than those at the very top (Piketty and Saez, 2003, Dew-Becker and Gordon, 2007).

As regards the income dispersion in the upper half of the distribution, we have already seen indications that it has increased in recent years. In order to be able to study this better, the dispersion is analysed between median income and three different top income levels, the 90th, 99th and 99.99th percentiles. The 90th percentile is the lowest income among the richest 550,000 individuals (the top decile), the 99th percentile is the lowest income earned by the richest 55,000 individuals (the top percentile), and 99.99th percentile is the lowest income among the richest 550 individuals (the top 0.01 percentile). The reason for studying three different top incomes is the relatively large variation between very highest income groups, which has been documented shown by several studies of the Swedish income elite (Roine and Waldenström, 2006, 2008). Particularly important is the fact that the majority of income-earners, that is to say those in the bottom 99 per cent of the income distribution, are in practice employees. Within the very top, on the other hand, incomes primarily comprise income from capital, that is to say interest, dividends and realised capital gains.

Apart from the composition of incomes of the top, their levels differ considerably. In 2006 the median income was in labour income SEK 211,000 and in disposable income SEK 175,000. For the 90th percentile in 2006 labour income was SEK 399,000 and disposable income SEK 290,000. Corresponding incomes for P99 were SEK 835,000 in labour income and SEK 625,000 in disposable income, and for P99.99 they were SEK 5 million and SEK 9.7 million.

Figure 3 shows three figures with ratios between the median income and the different top income levels for labour income and disposable income. As regards the P90/P50 ratio for labour incomes, this is about 1.8 to 2.0 for the entire period, that is to say, labour

incomes at the 90th percentile have been almost twice as large as median incomes over the period. This is somewhat greater than for disposable incomes, where the ratio is 1.6 to 1.7. Internationally speaking, this is on a par with other Western countries, with the exception of the USA, where the ratio for disposable incomes over the same period has been between 2.0 and 2.2.[8] It should, therefore, be noted that the dispersion between incomes among the middle-class (P50) and the upper middle class (P90) have not changed a great deal over the latest 15 year period, either as regards labour market incomes or disposable income.

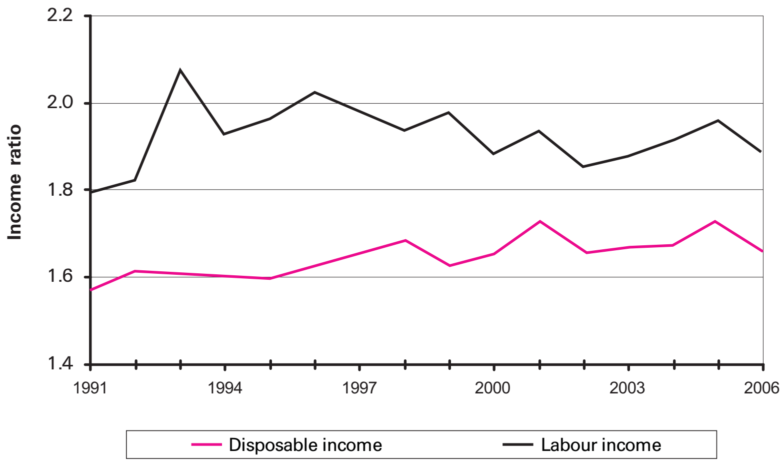
As regards the P99/P50 ratio, the same picture emerges to a great extent. The ratio is approximately twice as high as the P90/P50 ratio, that is to say, incomes at P99 are between three and five times as high as the median income. The development over a longer period of time is, however, markedly similar to that of the P90/P50 ratio, in that there are faint trends towards an increased dispersion of disposable incomes, whilst the trend in labour incomes is almost constant, with the exception of an increase during the recession of 1991 to 1994. When one finally comes to the very top elite's relative income development, shown in the P99.99/P50 ratio, the picture is very different. On the one hand, the level of income difference is notably higher. P99.99's labour income is approximately 20 times higher than the median, and its disposable incomes are between 30 and 60 times higher than the median. The record year of 2000 when a large number of capital gains were realised as a result of major share price rises in the IT industry, total income in P99.99 was a hundred times higher than it was for P50.[9] The dispersion also seems to have increased but the variability is too great to be able to determine any significant trends over the short period.

8) Statistics from Luxembourg Income Study, http://www.lisproject.org.

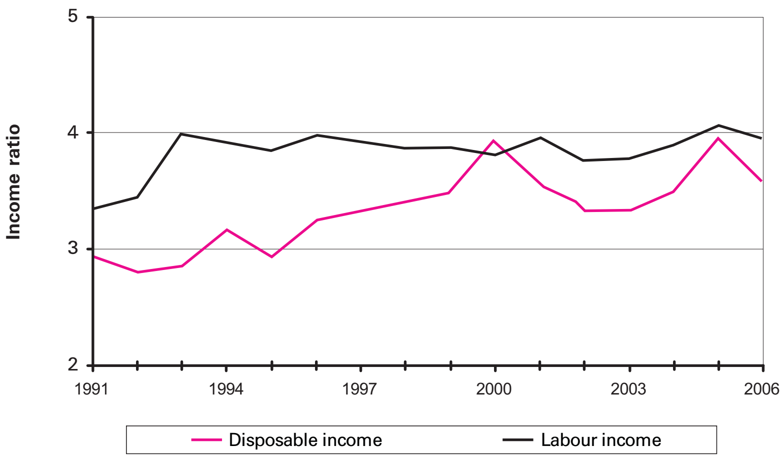
9) Even 1991 and 1994 contain great income from capital at the top, which is in part driven by income tax considerations.

Figure 3: *Income differences between median income (P50) and different levels of top income (P90, P99 and P99.99) 1991–2006.*

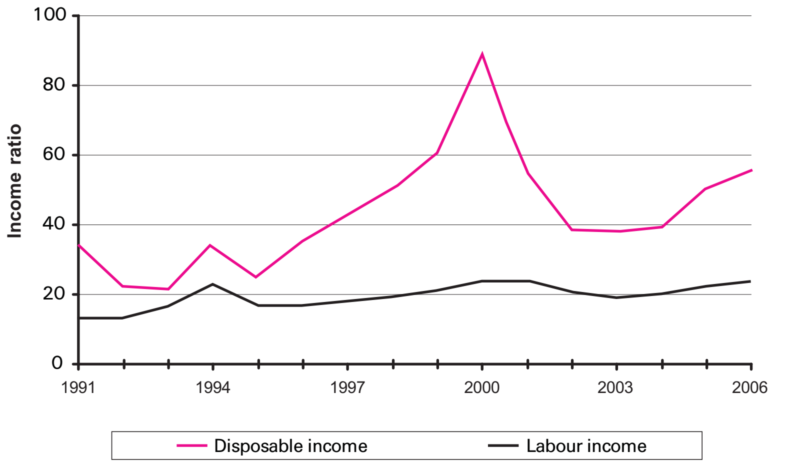
P90/P50



P99/P50



P99.99/P50



Note: Percentile income is based on Statistics Sweden's complete income statistics for individuals aged 20 to 65 years.

All in all, the spread of reported labour incomes in Sweden has not increased a great deal in recent years. A small increase seems to have occurred at the beginning of the 1990s, presumably closely tied to the then culminating economic crisis, but after that the spread is almost constant.

As regards the dispersion of disposable incomes, it has increased with respect to the trend throughout the period. The increased imbalance in the distribution seems to be driven primarily by greater income from capital, and then in particular realised capital gains at the top of the distribution. The effects of political redistribution on income distribution are hence overshadowed by the returns from the capital market. As mentioned earlier, there is, however, reason to believe that a significant proportion of this income from capital in actual fact comprises salary paid out in the form of realised option programmes, sale of own companies or dividends from own companies. The question is, of course, how great a proportion of this income from capital is earnings on capital and how much is a – for tax reasons – disguised form of salary?

It is not possible to gain complete clarity in answering this question on the basis of the available income statistics. But an attempt to approach some explanation of these circumstances is to be found in the Appendix, where a 5 per cent annual real return on taxable capital has been deducted from the disposable income across the entire income distribution. This analysis is naturally problematic for several reasons, among them the fact that the taxable capital does not capture all relevant capital producing revenue. Figures A1a-c in the Appendix show, however, that this adjustment reveals that disposable incomes are to a great extent to be regarded as a distribution of labour income, broadly defined, after tax and transfers. In other words, the dispersion of reported labour income could seriously underestimate the growing differences between middle class and top incomes, whilst they have no appreciable effect on either the trend or the level of income differences between the middle class and the upper middle class.

Concluding Discussion

This report has described the development of Swedish income distribution over the last 15-year period. The statistical picture initially shows that most Swedes have experienced a favourable development in real income. The income increases in the middle class (incomes between the 30th and 90th income percentiles) lies between 25 per cent and 30 per cent, which are internationally high figures.

As regards the distribution of Swedish incomes, the picture looks rather different depending on whether only labour incomes are taken into account or capital incomes are also included. The distribution of labour incomes has not changed a great deal during the period. Apart from a greater spread during the recession at the beginning of the 1990s, the difference between median labour income and labour incomes at the 90^{th}, 99^{th} and even 99.99^{th} percentiles has been constant.

When income from capital is taken into account, the picture changes, however. Since 1991 the distribution of Swedish disposable incomes, that is to say incomes from all types of income after tax and transfers, has grown markedly. This development is explained primarily by much greater incomes from capital at the top of the distribution.

The reason for the increase in income from capital may be sought in an increasingly globalised capital market. At the end of the 1980s Sweden was opened up to international capital flows, which led to foreign capital pouring into the country and increasing demands for Swedish assets which then rose rapidly in value. This mostly favoured a very small group at the top which owns these assets (still in 2006 the richest tenth of Swedes owns more than 90 per cent of all of the Swedish-owned shares traded on the stock market). The rising market values of Swedish companies also created the prerequisites for profitable option deals for executives. If it is the case that these incomes from capital do not have any link to the work of top income-earners, this indicates instead that, precisely as at the beginning of the century, anyone getting rich in Sweden does so through making good investments and not through work. But if these capital gains instead are closely linked to the employment of the top income-earners, for example in the form of realised option programmes or the sale of their own companies, this would indicate that similar mechanisms operating in the USA and the UK also underlie the greater concentration of income in Sweden.

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Appendix

Description of the Income Statistics

The statistical analysis of Swedish income distribution is throughout divided into two different income concepts – *labour incomes* and *disposable incomes*. Labour income is primarily cash salary but also income from business, everything before tax. Taxable remuneration in, for example, unemployment or illness (apart from short-term sickness benefit) is not included. Sales of share options and other financial market-related bonuses are treated as income from capital, and these are not included either, despite the fact that in the strict sense they comprise remuneration for work carried out. The top labour incomes are, therefore, most likely underestimated. Income of all kinds (work, capital, business activity, capital gains) minus tax plus transfers is included in disposable income. Disposable income is the income concept in this study which to the greatest extent reflects the influence of politics. It is also the concept which best reflects people's buying power and prosperity.

Data on Swedish income distribution from 1991 to 2006 is based partly on Statistics Sweden's complete income statistics for *individuals* between 20 and 65 years of age, partly on data from Statistics Sweden's *household*-based income distribution study, HEK.[10] Statistics based on individuals differ from income statistics which are based on households (housekeeping units), which in certain respects provide a more representative picture of the prosperity of the individual members of the household. This particularly applies to young people over 18 years of age who live at home with their parents. In the individual statistics they are treated as their own household, whilst they do not comprise complete housekeeping units. The effect on the distribution is such that we will somewhat underestimate the lowest incomes, and for this reason we have in parts of the analysis amalgamated the lowest incomes to some extent in order to reduce the risk of errors in estimation.

The material includes both full-time and part-time workers, and no correction is made for creating full-time equivalent incomes. The reason is that we are interested in studying the effects of precisely those structural changes in, for example, the supply of jobs which affect people's income. These effects would be "erased" if we only included full-time employees with full-time incomes. On the other hand the differences are inflated between income series and corresponding series for wages. A greater income spread might be driven by both a greater wage spread and a lower participation in employment on the part of low income-earners with a constant wage spread.

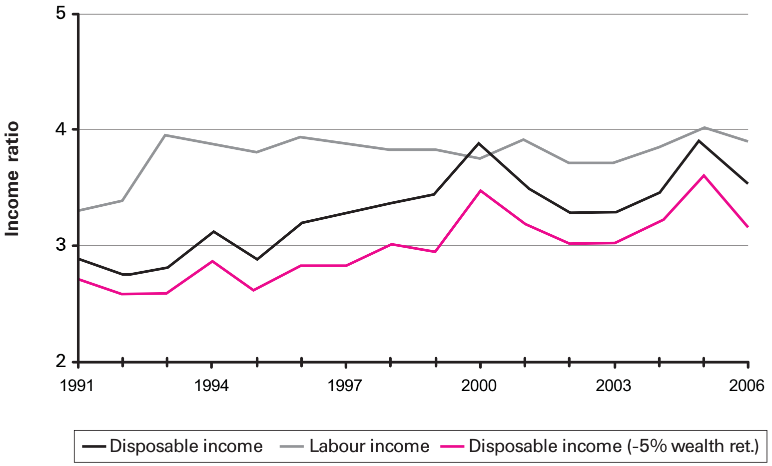
Figures A1a-c show the spread in disposable incomes between the median and three top income levels where a five per cent annual real return on the *taxable wealth* (*beskattningsbar förmögenhet*) has been deducted from the disposable income throughout the income distribution. Naturally this analysis is problematical. The return of five per cent is probably at the high end both since long-run real capital returns are typically three per cent and since much of the taxable wealth is not income generating (e.g. housing). At the same time the taxable capital underestimates the true capital of income-earners, on the one hand because of the basic allowance of between SEK 1 and 2 million per household, on the other as a result of tax regulations exempting important share capital at the top of the distribution.

10) I am using data from Statistics Sweden's complete statistics for the income years 1991–2006. The data has the form of tabulated income distributions, in which the population is divided into classes on the basis of size of income and where for each class we know the number or income-earners and the total of their incomes. The highest (open) income interval is SEK 30 million, which is why I have a relatively good coverage of the top of the distribution.

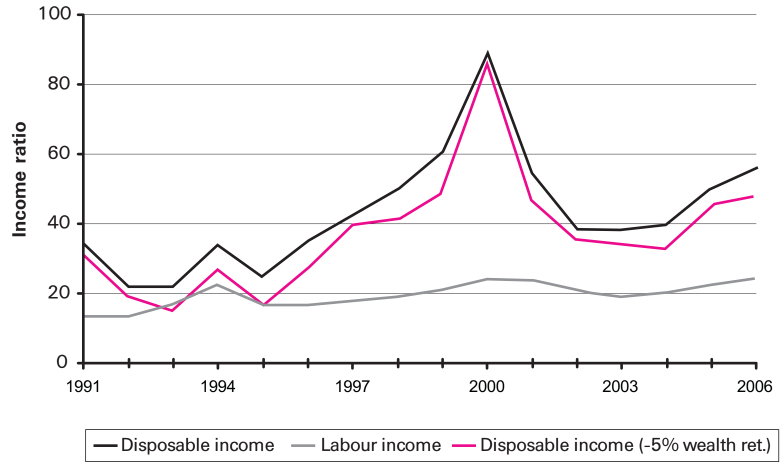
Figure A1: *Income differences between median income (P50) and different top-income levels (P90, P99 and P99.99) including when a 5% wealth return has been deducted from disposable incomes, 1991–2006.*

a) P90/P50

b) P99/P50



c) P99.99/P50



Note: The percentiles are based on Statistics Sweden's complete income statistics for individuals aged between 20 and 65. The return on capital is based on taxable wealth.

6. The Era of the Ever-Expanding German Middle Class has Come to an End

Interview with Stefan Hradil, Johannes Gutenberg University, Germany
by Kay Glans

A spectre is haunting Europe – the spectre of declassation. Fears are growing that the relatively cohesive society which the Western world has seen since the Second World War is dividing into a class society that is both old and new in character, and that the continent as a whole will decline. Growing segments perceive themselves to be exposed to competition, above all from the large economies, but also from eastern Europe, which in the long run can mean to the Europeans a convergence of salaries in a downward direction.

At the same time, the top income stratum has taken wings in more ways than one. The tendency is clearest in the USA, but it is beginning to make itself felt in Europe too. As regards prosperity, it has risen sky-high above the other strata and the closer to the top one looks, the clearer the differentials become. This elite has also taken wings in the sense that it has transcended the national context. Actions against it result in an exodus, or at least the threat of one.

In a way, Europe as a whole now finds itself in the classic dilemma of the middle class – the difficulty of maintaining a downward demarcation combined with the difficulty of safeguarding upward mobility.

Are European nations going to follow the Anglo-Saxon development, towards convergence in everything from corporate governance and market regulation to income differentials and the size of the welfare state? So far there are no clear-cut signs that this is the case. On the contrary, one influential school of research has in recent decades spoken of "varieties of capitalism". The original distinction was between Anglo-Saxon and Rhineland capitalism, there is now a series of different distinctions.[1] In the USA it is above all the middle class that has lost ground in recent decades.[2] Is Europe's middle class going the same way?

Glasshouse Forum has begun its project on the middle class with a number of studies of the change in income differentials in general, to form a better empirical ground for reasoning on the

1) For an overview, see "How Many Varieties of Capitalism?" by Gregory Jackson and Richard Deeg, Max-Planck-Institut für Gesellschaftsforschung, Discussion Paper 06/2.

2) See Gary Burtless, "Globalization and American Income Polarization", chapter 4 in this volume.

middle class. Lars Magnusson's initial research review (chapter 3) has been complemented with reports from Sweden (Daniel Waldenström, chapter 5) and the USA (Gary Burtless, chapter 4). In addition, we have taken the pulse of two of the great economies in Europe – Germany, and France – through two interviews on the change in income differentials and the situation of the middle class.

First out is Germany, whose "co-ordinated capitalism" is often cited as an alternative to the Anglo-Saxon model. One of the characteristics of German capitalism has been that the banks, not the stock market, have played the leading role in corporate financing. Through representation on company boards, the banks have functioned as a short-term economic watchdog. This seems to be changing; the networks between banks and companies are being dissolved and it will not be possible to re-create them.[3] The German model also encompasses a powerful welfare state, strong trade unions and moderate income gaps: properties that distinguish it from the Anglo-Saxon societies. Germany is interesting also because its proximity to the low income countries in eastern Europe has in a way put globalisation in its backyard. Therefore it should be possible in German society to accurately monitor the consequences of internationalisation to income trends. Some German companies for example have in negotiations with employees explicitly threatened to relocate production.

To many until quite recently, the fate of the German model seemed sealed. Reunification had been costly, the economy had been dogged by low growth and high unemployment. Powerful voices were being raised advocating comprehensive reform, often favouring the Anglo-Saxon model. Chancellor Angela Merkel went to the polls with what many considered a tough programme of reforms.

In part, the situation is different today. The German economy has performed well in recent years, public finances have improved, and unemployment has fallen. So perhaps the German model does have a future after all, at least in a more modern variant? When in summer 2008 Chancellor Angela Merkel was interviewed by the *Financial Times*, facing this Anglo-Saxon bastion she exuded something more like Rhineland capitalism self-confidence.[4] The fact that the US state in autumn 2008 has intervened on a massive scale to

save the financial system marks the end of the fair wind that market solutions have enjoyed since the end of the 70s. In some quarters, the financial crisis has been seen as confirmation that the European variant of capitalism works better than the Anglo-Saxon with its relaxed market controls. This could mean that we do not see any convergence, at least not with the Anglo-Saxon model.

That the economy is performing well does not mean that the general political climate in Germany is pro-business. There, as in many other parts of the world, public opinion has begun to react against the way in which the corporate elite reward themselves and each other and withhold their affluence from the tax authorities. The fact that the finance world is characterised by its privatising profits and socialising losses will hardly moderate such reactions.

I travelled to Mainz to discuss developments in Germany with Stefan Hradil, Professor of Sociology at the Johannes Gutenberg University. Over the years, he has published a series of studies on this theme: *Soziale Ungleichheit in Deutschland* (8th edition 2001), *Oberschichten – Eliten – Herrschende Klassen* (with Peter Imbusch, 2003) and *Die Sozialstruktur Deutschlands im internationalen Vergleich* (2004). He has also contributed to a recently completed project about the middle class in Germany, *Zwischen Erosion und Erneuerung. Die gesellschaftliche Mitte in Deutschland* (2007, together with the noted historian and social commentator Paul Nolte et al.).

3) See Paul Windolf's analysis in *An Edited Transcript from a Round-Table Conference on Short-Termism*, Glasshouse Forum, forthcoming.

4) *Financial Times*, 11 June 2008.

Do you share Lars Magnusson's opinion that it is difficult to distinguish a uniform trend in income differentials?[5]

"More or less," says Hradil, "but we have to differentiate. The primary income distribution, the income that people get from the labour market, assets etcetera, is becoming more and more disparate in nearly all countries. Concerning secondary income distribution, meaning income after redistribution by the welfare state, the picture is very different. Some states have an even more equal income distribution, in some states the income distribution remains unchanged, and many states show trends toward increasing inequality, but the speed of developments differ considerably. The welfare state is able to moderate the growing income inequality, but this also has negative consequences.

"We see it very clearly in Germany. Our welfare state has redistributed a lot. In Germany the primary income distribution is becoming more unequal, secondary income distribution is also becoming more unequal, but very moderately so. The problem is that in the lower strata, if you place emphasis on minimum wages and equalise in the lower income bracket, you risk a relatively high level of unemployment. That has been our problem for the last 20 years. In the upper strata, if you equalise the income distribution through high taxes for example, you risk having highly qualified persons leave the country. In the long run this will moderate the increase in GDP. You can even out income distribution, but in the long run you risk having less to redistribute."

What causes the increasing differentials when it comes to primary income?

"The reason behind the growing income inequality is not globalisation but technological development, which demands that people have more and more qualifications. If you do not have enough qualified people – and most countries don't – then those people who are qualified can demand higher wages. And there are so many unqualified people in the world relatively speaking and such a small percentage of jobs for them. Globalisation is in my view something like

a turbo, it accelerates this process. In a globalised world the unqualified in Germany compete not only with Germans, they compete with Poles, Ukrainians etcetera and it presses wages down. The highly qualified person can look for jobs outside Germany, and this presses salaries up."

The American economist Alan Blinder has published a much-discussed paper which shows that within 10–20 years, 22–29 per cent of the jobs in the USA may be offshored – even when educated employees are increasingly exposed to competition.[6] So are they not also feeling the effects of insecurity and pay pressure in the globalised economy?

"Perhaps a computer engineer from India competes with a Swedish or German engineer, since the Indian engineer works for lower wages. But on the whole there are so many new jobs for highly qualified personnel that the downward pressure is not so significant. For the unqualified, the downward pressures are extreme and that is one of the flaws of capitalism in a globalised world.

"For those that do not have sufficient qualifications because the educational system is bad or because they are not so intelligent, or because their personal background has not equipped them for education – for them, this new world is an ugly world. In Germany 25 per cent of our low qualified people are unemployed. We are developing a new kind of lower class. In other countries, in the USA for instance, this development has gone even further. All the measures that we now discuss in Germany will not solve the problem. The situation of the unqualified in the modern world is politically and socially dangerous."

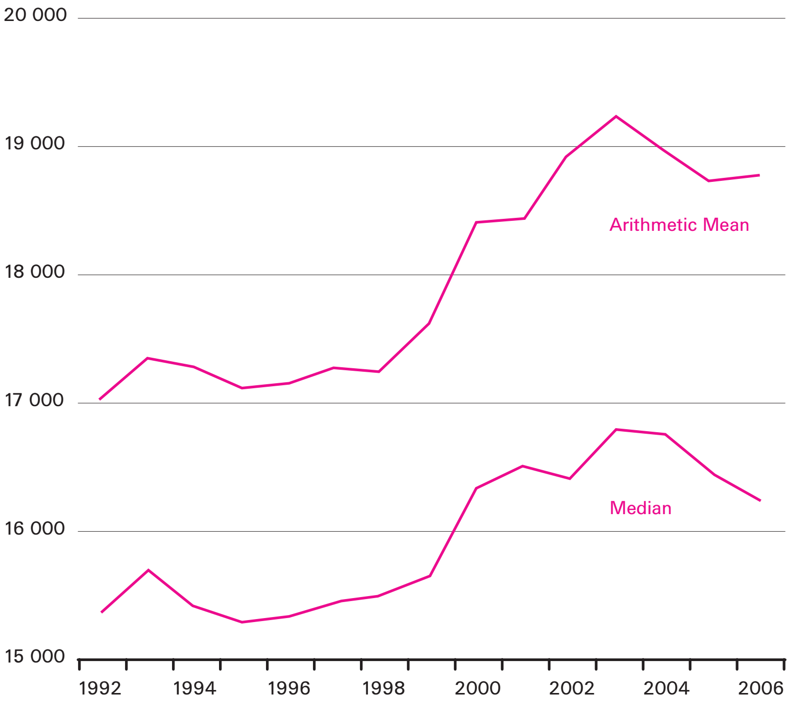
However, the uncertainty does not apply only to the lower class, but also the middle class. In spring the scientific research organisation Deutsches Institut für Wirtschaftsforschung published

5) See Lars Magnusson, *Is Globalisation Widening or Narrowing the Gaps? – A Progress Report from a Research Minefield*, chapter 3 in this volume.

6) See Alan Blinder, "How Many U.S. Jobs Might Be Offshorable?", CEPS March 2007.

a survey which showed a dramatic decline in the German income middle class, from 62 per cent of the population in 2000 to 54 per cent in 2006.[7] Hradil's own investigation focused on the qualified professions in the service sector. Even in that core middle class of the information society one can detect stagnation since 2000.

Figure 1: *Development of real equivalent income in Germany 1992–2006.*



Source: SOEP, persons in private households, retrospectively surveyed equivalent net household income of the previous year in 2000 prices. DIW Berlin 2008.

"In Germany in the 70s and even 80s, we had a growing middle class, especially among qualified personnel in the service sector. Even this middle class in the service sector is shrinking today. Quite a lot of the people in the middle classes in the service sector have chances to climb but an even bigger proportion are sliding back relatively speaking. There is a riskier and more fluid situation in the middle class. There are some advantages, but there are also big risks.

"In Germany the integration of society was to a considerable extent enabled by this growing middle class. It bound society together. People could move upwards and they had the impression that it was a just society, because members of the lower classes who really can work and are really capable have the possibility to be social climbers. If the middle class is shrinking, the chances of upward mobility for the lower classes are diminished. Social mobility is blocked and disintegration is a real danger in the society we have now. Maybe middle class fears are greater than the real risks, at least in Germany, but the risks are growing too.

"The time is past when the middle class was constantly growing. The social structures no longer resemble an onion. A colleague of mine has characterised it as an hourglass. That is an exaggeration, but society will be leaner, with a smaller girth."

On a clear day, you can see from Mainz to Frankfurt with its dynamic banking world and the high income financial sector – "to a university professor, incomprehensibly large sums of money", Hradil remarks in passing, but this also applies to large groups in the banking sector itself. According to a study by the management consultants Kienbaum, the income of top management in the companies listed on DAX increased on average by 23.3 per cent in 2007.[8] A new report from Deutsches Institute für Wirtschaftsforschung shows that an increasing number outside this small category are dissatisfied with their pay trends. In 2005, 26 per cent stated that they were dis-

7) See Markus M. Grabka and Joachim R. Frick, "Schrumpfende Mittelschicht: Anzeichen einer dauerhaften Polarisierung der verfügbaren Einkommen?", *Wochenbericht des DIW Berlin*, No. 10/2008, pp. 101–108.

8) See http://www.kienbaum.de/desktopdefault.aspx/tabid-15/9_read-40/, accessed 2008–09–30.

satisfied, in 2007 it was 35 per cent and the tendency is clearest with regard to the middle stratum.[9]

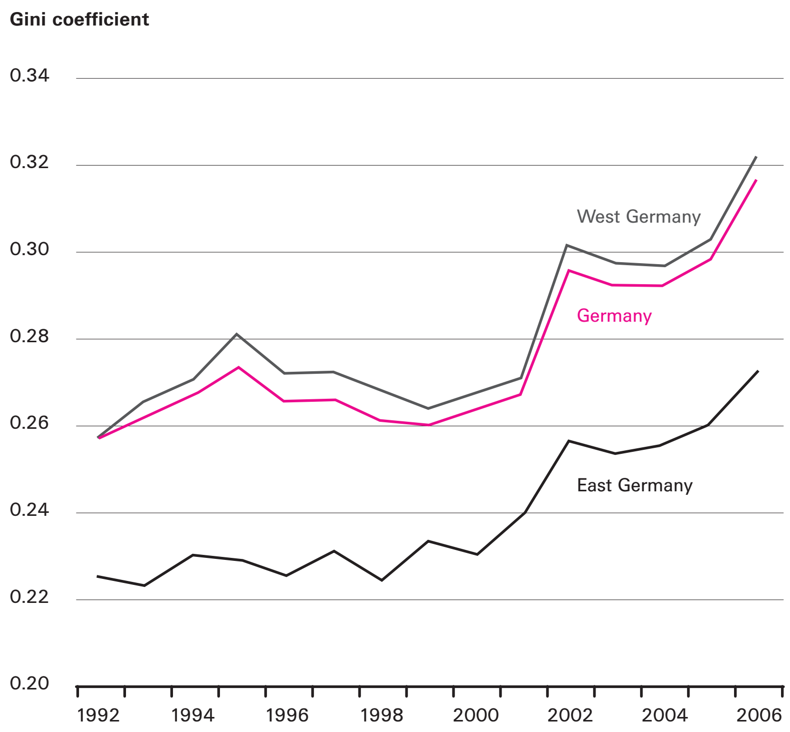
"Many people in Germany have the impression that salaries are not just", Stefan Hradil remarks. "There is no relation between achievement and salary. The salaries of the high flyers are too high and those of the unqualified worker are too low. This is not an envy debate. This impression is relatively independent of the income level of the respondent. Even those that make good money, at least in Germany, also have the opinion that this is not just.

"We have growing relative instability. German society will not explode in five years, but the political situation is growing more unstable. We have a left party now and the genesis of this party is no accident, it is a systematic structural process. Resentment is growing, especially in the last 3–4 years.

"Social justice is a big topic on the political agenda now. Politicians are forced to react to the demands for a more just society, but they are also forced to live in a global economy. And in a global economy it is not very easy to lower the very high salaries and to raise the very low salaries."

9) See Stefan Liebig and Jürgen Schupp, "Immer mehr Erwerbstätige empfinden ihr Einkommen als ungerecht", *Wochenbericht des DIW Berlin*, No. 31/2008.

Figure 2: *Income inequality in Germany 1992–2006.*



Source: SOEP, persons in private households, retrospectively surveyed equivalent net household income of the previous year. DIW Berlin 2008.

But do these international comparisons not show that through political decision-making one can temper the impact of the modern economy and that society need not go the same way?

"The empirical findings are quite clear. Countries with a centralised labour market, strong unions and wage control are more equal. But I am not sure if these regulations are favourable to economic development in the long run. In the short run they are an effective method to prevent income distribution from spreading too much, but in the long run you fail to create new jobs in the important growth fields. You have a certain sclerosis in society. That is the ambivalent story of wage control.

"Maybe there is a Scandinavian way, a liberal Anglo-Saxon way, but we must also consider the culture within these societies. You cannot implement the Scandinavian way in the USA or the Anglo-Saxon way in Scandinavia. People have different cultures and history. Therefore the scope for political reaction is not so broad. Politicians in Germany cannot react in a very liberal Anglo-Saxon way and let the income distribution become more and more unequal. That is only possible to a certain degree in Germany. Otherwise society would explode."

Has the take-off of the top stratum also to do with culture? The American economist Frank Levy has pointed out that if an American CEO in the 60s had received a salary corresponding to the highest salaries today, it would certainly have become hot political topic, perhaps a matter for the President. At that time there was low tolerance for such things: wealthiness was balanced by cultural and political values. Having money did not give a person preferential rights in culture and politics – on the contrary there was a clear tendency towards a power balance in this respect: in a way, wealth disqualified the person.

This power balance has gradually disappeared since then. The stagnation and fall of communism enfeebled the conceptual base for such an idea, and neoliberalism concealed the issue of such a power balance by referring to freedom of choice, and by asserting that prosperity would come to everyone sooner or later. In such a situation, there have of course been enormous opportunities for a small

stratum of insiders to mutually benefit each other. But just in the past year we have perhaps seen a break in the trend, which may herald the end of the period where market solutions ideological had the initiative. A majority in each Western world nation has tired of its elite; and economic inequality is perceived as a central issue all over the world. Perhaps we are now entering a long period characterised by a striving to re-create a power balance in relation to the upper strata. A revived class society will in all probability be met with a revived class struggle.

7. The Changing French Model

While Top Incomes Skyrocket
the Middle Class Fears
a Downward Social Slide

Interview with Camille
Landais, Paris School of
Economics, France
by Lisa Irenius

“In order to rehabilitate work a certain morality is required,” claimed Nicolas Sarkozy, before he became French president. He was appealing to all of those who felt unhappy with their own situation on the labour market. Later they would be his electors – wage-earners who consider that all their expenses are rising, but not their income, and who have witnessed top bosses raking in ever-increasing sums. *Les patrons voyous*, rogue bosses, as Sarkozy has called those managers supported by “golden parachutes”.

Camille Landais, researcher at the Paris School of Economics, is interested in the same issues, though with a different vocabulary and from a different perspective. He has, for example, written a report on “Les hauts revenus en France (1998–2006): Une explosion des inégalités?”[1] (“High Incomes in France (1998–2006): an explosion of inequalities?”). This report points out how top incomes have increased substantially in France over the last eight years, whilst average and median incomes have only shown a slight increase. The median income has increased by 0.6 per cent per annum (see Table 1, p. 134). 90 per cent of households which earn least have seen a total salary increase of only 4.6 per cent during the period (see Figure 1, p. 135). Those 5 per cent which comprise the wealthiest households have, on the other hand, had an increase of 11 per cent; the wealthiest 1 per cent have had salary increases of 19 per cent, and those households who earn most of all – 0.1 per cent and 0.01 per cent of households respectively – have had salary increases of 32 per cent and 43 per cent respectively.

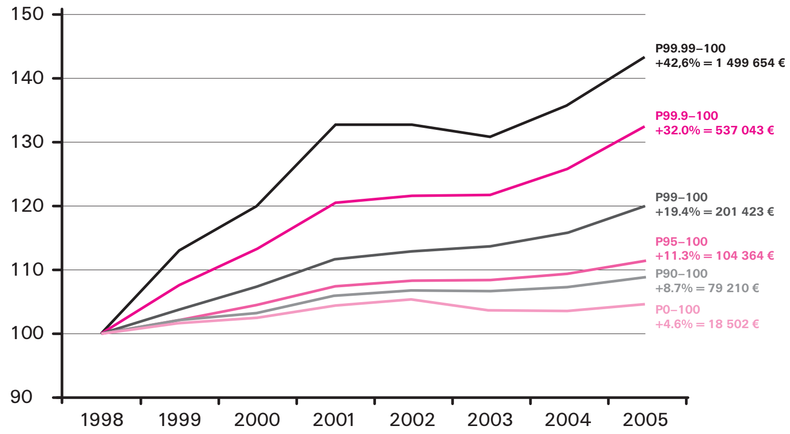
1) Camille Landais, “Les hauts revenus en France (1998–2006): Une explosion des inégalités?”, Mimeo, Paris School of Economics, 2007.

Table 1: *Incomes in France 1990–2005.*
The development of 1) total incomes in France, 2) average household income, 3) median income. As the number of households has increased over the period, total incomes have increased more than average income and median income.
Source: Camille Landais, "Les hauts revenus en France (1998–2006): Une explosion des inégalités?", Mimeo, Paris School of Economics, 2007, p. 3.

Year	Total income billion Euros 2006	Average income per household Euros 2006	Median income Euros 2006
1998	689,5	23 205	17 031
1999	710,9	23 564	17 223
2000	729,8	23 887	17 389
2001	754,3	24 336	17 658
2002	773,2	24 527	17 744
2003	796,3	24,264	17 548
2004	805,8	24 310	17 561
2005	820,7	24 574	17 762
Development 1998–2005	**19,03%**	**5,90%**	**4,29%**
Average annual increase 98–05	**2,52%**	**0,82%**	**0,60%**
Average annual increase 98–02	2,01%	1,39%	1,03%
Average annual increase 02–05	2,01%	0,05%	0,03%

Footnote: The incomes are declared incomes, excluding surplus value. Due to the demographic increase in the number of households, the increase in income per household is less than the total increase of declared incomes.

Figure 1: *The development of incomes for different fractiles 1998 (=100) to 2005 (euro 2006).*
P0–90 corresponds to 90% of the households which earn least; P90–100 corresponds to the wealthiest 10%; P95–100 the wealthiest 5%; P99–100 the wealthiest 1%; P99,9–100 the wealthiest 0.1% and P99,99–100 the wealthiest 0.01%.
Source: Camille Landais, "Les hauts revenus en France (1998–2006): Une explosion des inégalités?", Mimeo, Paris School of Economics, 2007, p. 6.



Footnote: The fractile P90–100 corresponds to the wealthiest 10% of households (3.5 million households out of 35 million), P95–100 the wealthiest 5%, etc. P99.99–100 corresponds to the wealthiest 0.01% of households (3500 taxpayers out of 35 million).

Why this development? What role does economic globalisation play in salary trends in France?

"The effect of globalisation on salaries is very different from how people *believe* it to influence salaries. In France the concept of globalisation causes people to think of outsourcing, moving production abroad. But in actual fact this is a very minor aspect of globalisation; we have not seen a great deal of outsourcing of production. Possibly the *threat* of outsourcing may play a certain role, but there is no evidence that it leads to lower salaries," says Camille Landais.

"As regards globalisation and salary levels, we can see a great number of different trends at an international level; this is explained very clearly in Lars Magnusson's report on the effects of globalisation on income differentials."[2]

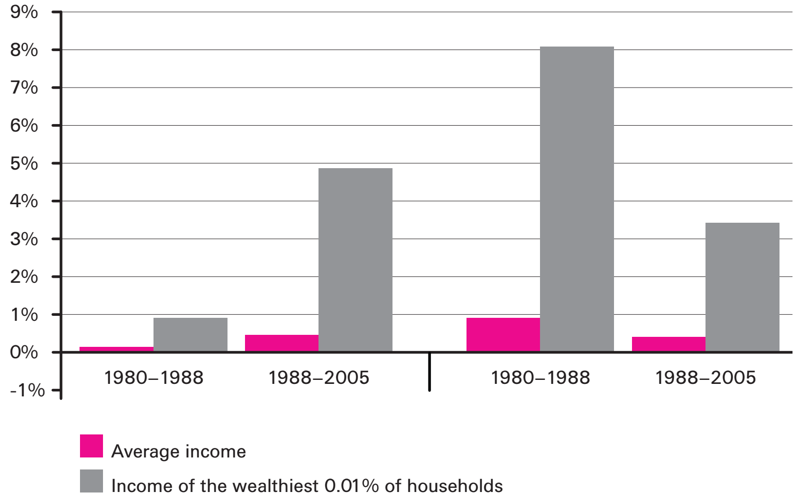
Landais points out how difficult it has been to capture the current development in all-embracing theories. The classic trade theory of comparative advantage, where the North derives benefits from higher educational levels and technical development, and the South competes with cheap labour, provides no viable explanation for the effects of globalisation on salaries. A more current theory predicts that technological developments require an increasingly highly qualified labour force, which is expected to result in a greater wage difference between unqualified and qualified labour.

"But that theory does not quite work either. The wider gaps only apply to a small group, 3–5 per cent of high-income earners; otherwise salary levels are relatively stable. If the theory of qualified labour held good, then all qualified labour should be in receipt of higher salaries. So what is explained by the salary development we can see? Today there is a great thirst for new explanations."

In an international, or rather a Western, perspective there have been certain common tendencies as regards salary trends. As Simon Kuznets showed in the 1950s, salary differences tended to be evened out in industrial countries after the Second World War. In the 1980s researchers instead talked about "the big U-turn"; after the period of reduced wage differences these began to increase again.[3] In the continental European countries, however, wage differences have relatively speaking been – and are still – less than in the Anglo-Saxon

countries. But will this continue to be the case? The greater differential between top French salaries and average French salaries indicates that the situation in France may come to resemble that in the Anglo-Saxon countries, according to Camille Landais (see Figure 3 below).

Figure 2: *Annual increase in real income for different fractiles in France and the USA, 1980–2005.*



Source: Camille Landais, "Les haut revenues en France (1998–2006): Une explosion des inégalités?", Mimeo, Paris School of Economics, 2007, p. 24.

"At the end of the 1970s and in the 1980s high incomes increased very rapidly in the Anglo-Saxon countries. For the past fifteen or twenty years the top incomes in the USA and Britain have represented an increasing share of salaries. It is exactly the same as at the

2) Lars Magnusson, *Is Globalisation Widening or Narrowing the Gaps? – A Progress Report from a Research Minefield*, chapter 3 in this volume.

3) See Lars Magnusson, ibid.

beginning of the last century; the pendulum has swung all the way back. When the development towards smaller salary differences was reversed in the 1980s, this meant the end of a historically-speaking exceptional era. The increasingly equal salary levels were a historical exception. But now it is not the low salaries which have changed and affected the statistics, but the high salaries. They are exceptional, and in historical terms unusual. It is not just a question of income from inheritance, as it was at the beginning of the century, but an explosion of a small number of very high salaries – CEO salaries. Why are they so well paid? Today it is an active group earning money at work, a kind of "working rich", says Camille Landais.

"In France, just as in most countries in continental Europe, salary levels are more equal than in the Anglo-Saxon countries. But since the end of the 1990s we can also observe an increase here in the top salaries. The situation in Sweden, Germany and France today is reminiscent of the situation in the Anglo-Saxon countries in the 1980s. Then there were, for example, in France and Japan, historical and legal structures which restricted the opportunities of high CEO salaries. In Japan there was for a long time a ban on option programmes. Germany has a tradition of co-determination, where employees are represented on company boards. In France there are social and fiscal restrictions. CEO salaries have, for example incurred the same social security contributions as other salaries, which has prevented large salary increases. But these restrictions are now disappearing. In France CEOs will pay less tax. What is more, there is a greater knowledge of what top bosses in other countries earn, which is adduced in order to force up salaries."

In the debate it has been claimed that there is a risk that the most competent managers will disappear abroad if salaries are not sufficiently high. But how great is the risk really? How international are French top managers?

"It is difficult to acquire data about this; there are no in-depth studies. But my impression is that the top echelon is not particularly international at all. It is primarily a classic argument to obtain higher salaries. In France many large companies are national companies,

where the state has a finger in the pie. These companies normally recruit locally to a large extent. The only example of foreign CEOs I can find are at Alcatel and Renault. [Alcatel merged with the American company Lucent in 2006.] French companies have become more international as regards share ownership, but openness remains limited."

Top management salaries have to an increasing extent become an issue in the French debate. Have there also been initiatives to legislation to restrict the increase in top salaries?

"There is a double trend in the debate. On the one hand, there is a great fear that competence will disappear from the country, and that tax revenue will disappear. For this reason ideas are put forward for reducing taxes and so on. On the other hand, there is a discourse about "golden parachutes" and "rogue bosses". But from the point of view of legislation very little has been done to restrict the increase in managerial salaries and option programmes etc. This year there has been a new bill to do with social security contributions on option programmes, but this is part of a larger bill which has contradictory effects. There is a great deal of discussion about this, but in practice not a lot is happening."

Parallel with the debate about increases in managerial salaries, France has had a discussion about the falling social status of the average Frenchman. In 2007 social researchers Philippe Guibert and Alain Mergier published their book *Le descenseur social*[4] ("Social Regression"), which attracted a certain amount of attention at the time of the presidential election. In their view this is what the French people nowadays fear the most – to be drawn into a social decline. Guibert and Mergier are interested primarily in the working class, who still comprise the majority of the active population, but similar analyses have been made of average income earners. How is the French middle class really holding up?

4) Philippe Guibert and Alain Mergier, *Le descenseur social. Enquête sur les milieux populaires*, Fondation Jean-Jaurès/Plon, Paris, 2006.

"The middle class is a fairly complicated concept. It is not just a matter of salaries but of incomes, even of pensioners' incomes. You look at standard of living, disposable income and size of household. The middle class ends up in between the rich and the poor. This is a result of the redistribution of wealth. In Mexico, for example, which does not have a comprehensive redistribution system, there is almost no middle class, just poor people and rich people. The concept of the middle class is undergoing change. At the same time everyone has this concept in their head, an image of a life with an education and children, of an average individual", says Camille Landais.

"Studies of people's subjective perceptions of class adherence show that many people regard themselves as middle class, approximately 65 per cent to 75 per cent of the population. The proportion of people who regard themselves as working class is, on the other hand, falling. Interestingly enough, it is only 10 per cent to 15 per cent who regard themselves as working class, while the working class in reality comprises 25 per cent to 30 per cent of wage earners. Only 5 per cent regard themselves as upper class. The middle class has not developed very much in recent times. In France salaries have been very stable over the past 20 years, apart from top salaries. Nor has there been any major change in redistribution of wealth. Poverty has declined as a result of social security payments, but the middle class has not changed. On the other hand, low-income earners have begun to catch up with the middle class, at the same time as one can see a major increase in top salaries. This may create a feeling of inequality. Playing on the bitterness of the middle class is a classic political strategy."

Studies show that the French are particularly concerned about the future for their children. In 2004, 60 per cent of the French were optimistic about their own future, but only 34 per cent optimistic about their children's future.[5] There is a fear that this is the end of a long period of higher standards and social mobility, claim sociologists Marie Duru-Bellat and François Dubet. Young people today earn, relatively speaking, a lot less than middle-aged people. In the 1970s the wage difference between 30-year-olds and 50-year-olds was 15 per cent; today the difference is 40 per cent. At the same time, education has ceased to be a sure path to success – about a

third of young people with higher education who entered the labour market in 1998 attained a worse position than they would have had in 1990. This loss of social position is particularly clear in the public sector, write Duru-Bellat and Dubet. There, 64 per cent of young people in work are considerably overqualified in relation to the formal requirements of their jobs.[6] Rapidly rising house prices add to the feeling of things getting worse. To rent the same floor area in the same neighbourhood today you have to work twice as long as in 1986, and if you wish to purchase the same flat, you have to work three times as long, states sociologist Louis Chauvel.[7]

In France purchasing power, *le pouvoir d'achat*, has long been a political as much as economic issue. During the presidential election of 2007 purchasing power became a key concept. Nicolas Sarkozy established at an early stage that he wanted to be "the president of strong purchasing power", which presumably contributed to his victory. But strong purchasing power has been a long time coming, and new scapegoats have been chosen, not least the euro. What effect has cooperation on the euro had on salary and price trends in France?

"It is easy to blame the euro. But the euro as such does not explain either prices or salaries. Rather it has had a positive effect in restricting inflation and price rises, through the agency of the European Central Bank. In France there is a schizophrenic political argument about this issue. On the one hand, people claim that it is the fault of the euro that prices are high. On the other, people claim that it is the fault of the European Central Bank if growth is not high enough. But you cannot have both at once", says Camille Landais.

"What makes the difference is not the euro, but the abolition

5) Note 397, DRESS, April 2007, quoted by Marie Duru-Bellat and Francois Dubet in "Déclassement: quand l'ascenseur social descend", in *La nouvelle critique sociale*, Editions du Seuil, Paris 2006.

6) Marie Duru-Bellat and Francois Dubet, "Déclassement: quand l'ascenseur social descend", in *La nouvelle critique sociale*, Editions du Seuil, Paris 2006.

7) Louis Chauvel, "Fracture générationnelle: une jeunesse sans destin", in *La nouvelle critique sociale*, Editions du Seuil, Paris 2006.

of frontiers in the European labour market. The fact that, for example, Polish workers have free job mobility makes a difference, not the euro. Nevertheless, the effects of free mobility of labour in Europe are not known yet; so far it has not changed very much."

What do peculiarly French features, such as the 35-hour week and the relatively high level of conflict on the labour market, mean for the dispersion and development of salary levels in France?

"It is fashionable to talk about the conflict level in France; there is an opinion that it is about a lack of trust. But I do not believe that salary levels result from conflicts and a limited social dialogue. What is peculiar in France is that the minimum wage is determined by the state. In France there are five trade unions which are said to be representative, but which in actual fact are weak and dependent on the state for their existence. As the state determines the minimum wage, this is an issue which concerns trade unions and the state, and not companies. For this reason the minimum wage in France is rather high. The 35-hour week was pushed through on the basis of two factors, on the one hand moderation of wage demands, on the other lower payroll tax on the lowest wages."

"It is only today that people are beginning to realise that high wages and the 35-hour week do not go together, that the 35-hour week has a price. There is an ambivalent attitude to it; many people like it, but they would also like to earn more money. At the same time the 35-hour week has meant a reduction in the cost of unqualified labour, in that the state then took over the social security payments for those with the lowest wages. A number of people on the Left saw this as a gift to the employers, but it was, of course, also a way of dealing with unemployment, as the minimum wage was too high in relation to other salaries. When the Left pushed through the 35-hour week, they therefore reduced the cost of unqualified labour without saying this, that is to say without reducing the minimum wage. This has meant major subsidies for unqualified work. But now people do not know what will happen in the future."

What should President Sarkozy do to strengthen the working climate and raise the work ethic, as he implied? French people are

waiting impatiently for the promised, stronger purchasing power. Sarkozy's popularity declined sharply when, at the beginning of the year, he disclaimed responsibility: "What do you expect of me? That I empty accounts which are already empty?" In the search for a scapegoat in the debate about the French labour market, the President appears to have been transformed from hunter into prey. This will scarcely facilitate the necessary reforms.

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This publication is part of Glasshouse Forum's project "Globalisation and the middle class in the West". Other Glasshouse Forum projects 2008/2009 are: "A consumed society?", "Short-termism in the long run" and "The return of the capitalist-authoritarian great powers".