

TOWARDS AN HOUR-GLASS SOCIETY?

A NEW GLASSHOUSE FORUM PUBLICATION ON INCOME DIFFERENTIALS AND THE FATE OF THE MIDDLE CLASS

Towards an Hourglass Society?
Income Differentials and the Fate of the Middle Class
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Glasshouse Forum

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Contemporary capitalism – although at bay at the moment¹ – 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 countries² 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 the publication *Towards an Hourglass Society?* containing a re-

view of trends in income differentials between and within countries, and country-specific reports and interviews about the US, 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 of the book and on page 11 in this issue of *Looking Glass*. In the book’s 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

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”, in *Towards an Hourglass Society? Income Differentials and the Fate of the Middle Class*, Kay Glans and Johanna Laurin (eds.), Glasshouse Forum 2008, 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

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. 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 1980s 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 outdistancing 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 1970s and even 1980s, 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 added 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.

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REFLECTIONS ON THE CONSEQUENCES OF THE FINANCIAL CRISIS ON INCOME DIFFERENTIALS AND THE MIDDLE CLASS

Q&A WITH THE AUTHORS AND INTERVIEWEES

Since the summer of 2008, when the texts in *Towards an Hourglass Society?* 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.

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 argu-

ment 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.