# The Inequality Puzzle

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

# The Inequality Puzzle

European and US Leaders Discuss Rising Income Inequality

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Prof. Dr. Roland Berger
Roland Berger Strategy
Consultants GmbH
Mies-van-der-Rohe-Str. 6
80807 Munich
Germany
Roland_Berger@de.rolandberger.com

Prof. David Grusky
Stanford University
Sociology
Serra Mall 450
Stanford, CA 94305
USA
grusky@stanford.edu

Dr. Tobias Raffel
Roland Berger Foundation
Alt-Moabit 101b
10559 Berlin
Germany
Tobias_Raffel@de.rolandberger.com

Geoffrey Samuels
P.O. Box 188
Jamison, PA 18929
USA
gs@geoffreysamuels.com

Christopher Wimer
Stanford University
Institute for Research in the
Social Sciences
MC 2066
Stanford, CA 94305
USA
cwimer@stanford.edu

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# Preface

Is there too much inequality? We are witnessing for the first time in many decades a vigorous public debate in the United States and many European countries as to whether income inequality is approaching unjustifiable levels. The financial crisis has drawn special attention to remuneration at financial firms, as well as other more broadly based increases in inequality, and the pendulum may well have swung back toward attitudes favoring strengthened regulations.

It is against this background of shifting public and political views about income inequality that the Roland Berger Foundation decided to solicit the opinions of U.S. and European political, business, and labor leaders by partnering with the Stanford Center for the Study of Poverty and Inequality. This initiative, led by a diverse team of five authors, sought to cast light on how prominent European and U.S. leaders are making sense of rising inequality. The objective was not to provide yet another scholarly tome on inequality, or another analysis of how the general public views inequality. We are already awash in such analyses. What we don't know, and what we have sought to offer, is a window into how senior leaders view this historic moment.

In the summer of 2009, we interviewed thirteen political, business, and labor leaders and presented these interviews in their original form. Ten years ago, we doubt that so many prominent leaders would have agreed to discuss issues of income inequality, and their willingness to do so now is an important signal that times have changed. This new orientation also suggests that issues of income inequality deserve a more prominent and constructive place on the contemporary public agenda.

We have framed the thirteen interviews with our own accompanying commentary to introduce the topic of inequality, summarize some of the themes in the interviews, and put forward various remedies. Because we come from different backgrounds, we do not always view the transcripts in the same light, and we have made no effort to paper over our different views. These differences, we believe, are far better exposed. Although we often have real differences of opinion, we also arrive at similar views in ways that may surprise some readers.

This book is no less distinctive in bringing together voices from both sides of the Atlantic. The United States and Europe have historically approached inequality from quite different positions, and it's instructive to learn how such differences play out within the worlds of business, politics, and labor.

We suspect that our readers will agree with us that the conventional wisdom on U.S.-European differences is unduly simple and is not mimicked by the positions of our contributors.

We would like to thank Roland Berger Strategy Consultants for providing the financial support to conduct personal one-hour interviews at locations in Europe and the United States. We would also like to thank the Roland Berger Foundation for initiating and supporting this project and the Stanford Center for the Study of Poverty and Inequality and the Elfenworks Foundation for providing additional support. We are grateful also to Alice Chou for her careful work soliciting some of the interviews, transcribing some of the texts, and assembling the manuscript.

Roland Berger
David B. Grusky
Tobias Raffel
Geoffrey Samuels
Christopher Wimer

July, 2010

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# Part 1: Introduction

# Is There Too Much Inequality?

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

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

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

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

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

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

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

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

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

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

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

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

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

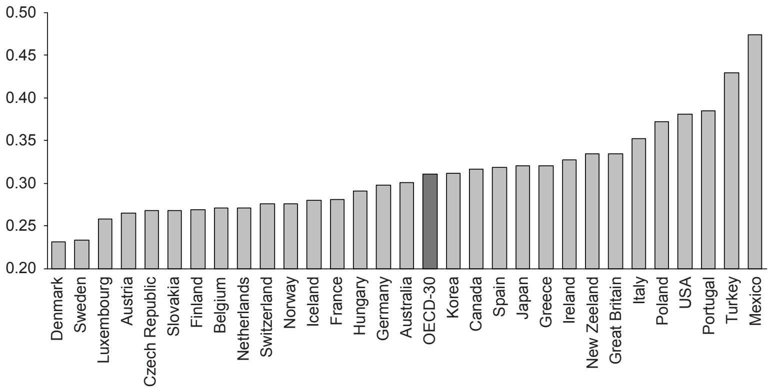


**Figure 1:** Gini coefficients of income inequality in OECD countries, mid-2000s (Source: OECD income distribution questionnaire)

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

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

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

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

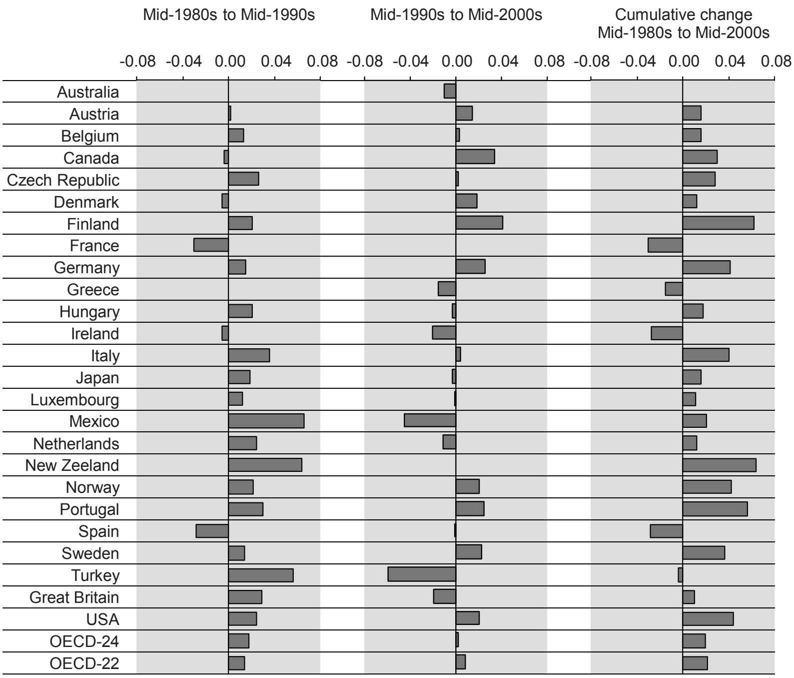


**Figure 2:** Trends in income inequality: Point changes in the Gini coefficient over different time periods (Source: Computations from OECD income distribution questionnaire)

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

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

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

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

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

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

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

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

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

**Europe**

Josef Ackermann, CEO and Chairman, Deutsche Bank

Bertrand Collomb, Honorary Chairman, Lafarge

Gabriele Galateri di Genola, Chairman, Telecom Italia

Jürgen Hambrecht, Chairman, BASF

Maurice Lévy, Chairman and CEO, Publicis

John Monks, General Secretary, European Trade Union Confederation

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

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

**United States**

Fred Smith, Chairman, President and CEO, FedEx

John Sweeney, President Emeritus, AFL-CIO

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

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

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

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

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

# Part 2: Interviews

# Josef Ackermann
## CEO and Chairman, Deutsche Bank

*"My personal view is: To regain trust, we in the financial industry have to make sure remuneration is well-deserved and based on proven and solid lasting performance."*

Since 2002, Josef Ackermann has been the CEO and Chairman of the Group Executive Committee of Deutsche Bank. Prior to joining Deutsche Bank, Ackermann worked at Schweizerische Kreditanstalt, now Credit Suisse, and in 1993 became President of the Executive Board. In 1996, Ackermann joined the Board of Managing Directors of Deutsche Bank with responsibility for the investment banking division. Under his leadership, the business unit developed into one of Deutsche Bank's principal revenue sources and entered the top tier of global investment banks. He is a member of the Supervisory Board of Siemens (Second Deputy Chairman), a non-executive member of the Board of Directors of Royal Dutch Shell, and a member of the Board of Directors of Zurich Financial Services (Vice Chairman). He also plays an active role, among various other activities, in the Initiative Finanzstandort Deutschland (member of the Initiators' Group), the Institute of International Finance (Chairman), the World Economic Forum (Co-Chairman of the Foundation Board), the St. Gallen Foundation for International Studies (Chairman), and the Metropolitan Opera New York (Advisory Director). Ackermann was recently appointed Visiting Professor in Finance at the London School of Economics, and Honorary Professor at the Johann Wolfgang Goethe University Frankfurt.

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*Is the level of inequality in Europe and the U.S. about right, or is there too much or too little? What do you think about the current level of inequality?*

In order to answer this question one must look at the prevailing socio-economic environment. Before the financial crisis, inequality was probably perceived differently from what it is today, and once we return to stronger and more sustainable growth the perception might change again. In the current socio-economic environment, there seems to be a broad consensus that the present degree of inequality is too high, less in terms of wealth than in terms of compensation. This certainly holds true for the United States, but also to a lesser degree for Europe. Even in the business community, this view is widely shared, especially regarding the financial industry. My personal view is: To regain trust, we in the financial industry have to make sure remuneration is well-deserved and based on proven and solid lasting performance.

*You mentioned the financial crisis; do you think the crisis has had an impact on the level of inequality?*

To a certain extent, no doubt. The concentration of wealth and income was mainly driven by the financial industry. As a consequence of the financial crisis, remuneration there as well as asset prices have come down, so the trend of increasing overall inequality should have been stopped if not reversed. However: When you are in a stagnant or recessionary environment, when people have to fear job losses or major salary reductions, inequality is perceived much more clearly. Discussions about income distribution and inequality are always more intense in such times.

*If we talk about Deutsche Bank and the inequality of pay, would you say that the pay differentials between different levels of employees are just about right or are there aspects you would like to see changed?*

It is essential that pay truly reflects performance and provides the right incentives. Deutsche Bank's compensation system has long been among those in the industry with a longer-term orientation. As a consequence of the financial crisis we have improved our system further by establishing a robust governance structure, introducing risk-adjusted metrics, and ensuring a significant proportion of variable compensation is deferred over three to four years and subject to stringent clawbacks. Having said this, the financial industry is very competitive and our people are our talent so we have to be cognizant of the actions of other firms in order to ensure that our pay levels and structures remain competitive.

*When you read about inequality, you definitely see that there are positive and negative effects. Do you think a different level of CEO or board remuneration at Deutsche Bank would affect the profitability of the bank?*

If you want to grow as a company and create profits you have to have the support of the society in which you are operating, you have to meet the requirements of your shareholders, but also of your other stakeholders. One has to take this into consideration when it comes to compensation at the board level in particular. We at Deutsche Bank are fully aware of this. However, I'm a bit concerned that the regulation of compensation systems might go too far. In the end, pay has to be based on merit, and it has to be competitive. There is a war for talent out there, and we see that some banks are losing good people to non-regulated institutions that do not have to disclose compensation packages. That is why regulation has to be industry-wide in order to avoid competitor distortions.

*If you follow data like the Gini coefficient, you will find that inequality measured by this indicator has increased in many, but not in all, OECD countries over the past twenty years. What do you think are the reasons for this trend?*

Let me take the financial industry. Today we are recruiting talent globally, in New York, London, Hong Kong, and many other places. This has led to higher compensation levels in many countries which were lagging behind internationally, like Germany. Secondly, public disclosures of compensation have made it possible to compare one's own pay with that of others. That again put upward pressure on compensation levels. Thirdly, for many years, our industry aligned executive pay to shareholders' interests by linking a certain portion of the remuneration package to the company's share price. Until the recent crisis, we had seen significant growth in share prices, which created unprecedented wealth for executives.

With the benefit of hindsight, perhaps there should have been more stringent limits to compensation. This is something that our industry has recognized and dealt with by better aligning compensation to sustainable value creation.

But let's not forget: We operate in a very competitive market, and this market situation as well as the compensation practices of our peer competitors also contributed to the rise in senior executive pay. We have to offer competitive packages to attract and retain the most talented people.

*Besides executive and high-level compensation, we are also interested in the pay of rank-and-file employees lower in the organizational hierarchy. Is their pay about right or too low?*

I think pay here is broadly appropriate and linked to the position, performance, and also seniority of these colleagues. The current discussion is mostly centered around highly paid people, but these are only a small minority. It is wrong to believe that bonuses in general created bad incentives. For many bank employees, their bonuses plus fixed salaries taken together are not more than the salaries they would receive in other industries.

*Turning to wealth, which, according to the data, has also become much more concentrated among fewer people, what are the reasons for this development?*

Wealth, in my opinion, has become so concentrated because financial assets have experienced this tremendous rise in prices. If you were invested in financial assets, shares, or real estate, you benefited enormously from the inflation in asset prices we had until the crisis hit. Meanwhile that has been corrected, of course.

*What do you think about the future? Will this concentration leading to increasing inequality in terms of income or wealth continue, or will we see a reversing trend?*

Remuneration as well as asset prices have come down, or will come down. Political and regulatory pressure will increase, and that will probably lead, on a macro level, to a different trend. But overall, as long as we are operating in a market economy, those who have a higher net worth will benefit when asset prices rise again. Therefore, I would not expect the correction we have seen over the last twelve to eighteen months to continue. On the contrary, we will see certain values recover and that will help wealthy people in creating more wealth, which is already starting to happen.

*You noted that pressures to regulate remuneration will likely increase. Do you have any suggestions as to practical, effective, and appropriate regu-*

*lations? Do you have any cautions about types of regulation that might prove counterproductive and should be avoided?*

Basically, in a market economy, companies should be allowed to set remuneration levels and structures at their own discretion, governments should infringe as little as possible on private contracts. Therefore, the regulation of remuneration should be limited to setting a framework. The proposals issued by the Committee of European Banking Supervisors (CEBS) on remuneration in the financial industry provide a good basis for this. Essentially, these proposals define the requirements for transparency, the principles for remuneration structures, as well as the minimum standards for setting up remuneration structures within firms. Establishing such a framework is, in any case, better than to trying to enshrine specific rules, such as absolute pay limits or caps on the tax deductibility of pay. Experience has shown, such mechanisms will only lead to attempts to circumvent them.

Moreover, as far as the financial industry is concerned, there is also a need to differentiate between various functions. Performance-based pay has a different impact depending on whether it is used, for instance, as an incentive to sell retail products, as an incentive in proprietary trading or risk management operations, or at the board level. The key issue here is the extent to which performance-based pay affects the risk situation of the firm.

Finally, it would also be wise to keep regulation limited to broad principles, as there is a need to differentiate between industries. Arguably, there is greater justification for setting rules on remuneration in the financial industry, where – as we have just experienced – there is a greater likelihood of the state having to step in to prevent a systemic crisis than there is in other industries, which are also less likely to receive state assistance at some stage.

*Turning to recommendations, what, first of all, should the private sector do? Are there any practical actions the private sector should pursue?*

Again, let me speak about my own industry: The financial industry is particularly dependent on trust. For this, transparency is key. Second, we must take a long-term perspective, remuneration must be based on real, bottom-line contributions to earnings, not on revenues, with vesting over several years. I think the more critical part is really to establish some sort of clawback mechanism in the system such that if people make a lot of money in one year with very risky activities, they do not get the full payout if the