



United States

TACKLING HIGH INEQUALITIES
CREATING OPPORTUNITIES FOR ALL

JUNE 2014



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Executive summary

This note provides an overview of income inequality trends in the United States from an international perspective and sketches the key elements of a policy package for promoting equality of opportunities in the US, which builds on four pillars:

- investing more in human capital;
- promoting inclusive employment;
- improving the tax and benefits system; and
- providing more efficient public services.

Income inequality is high in the US, compared to other OECD countries. Across countries, higher levels of income inequality are associated with less social mobility, and hence lower equality of opportunities. Therefore, addressing high and rising gaps between rich and poor has gained center stage in policy debates in the US and elsewhere. Comparing living standards around the world, the average American is far richer than most. But this is not true for the poorest 10 percent of Americans. The average income of this poorest group actually fell in the US by 15%, in real terms, between 2000 and 2010, before recovering only modestly during 2011 and 2012. At the same time, top incomes rose to dizzying heights in the US, as well as in other OECD countries. The richest 1 percent of Americans now account for 20% of national pre-tax income.

Rising inequality in the US and across the OECD reflects a trend toward greater dispersion of wages and salaries. Demographic and societal change also played a role, but much less than labor market-related factors. Technological progress, pressures from globalization and regulatory reforms have been a key driver of economic and employment growth but, at the same time, often contributed to wages becoming more polarized. The economic crisis has reinforced the pressure on household disposable incomes.

The effectiveness of redistribution through income taxes and cash transfers was on a declining trend in most OECD countries since the mid-1990s and in the US during the early 2000s. Redistribution is considerably lower in the United States than in most other OECD countries, although the combined effect of higher expenditures on social transfers and lower tax burdens offset two thirds of the fall in household income brought by the crisis between 2008 and 2010.

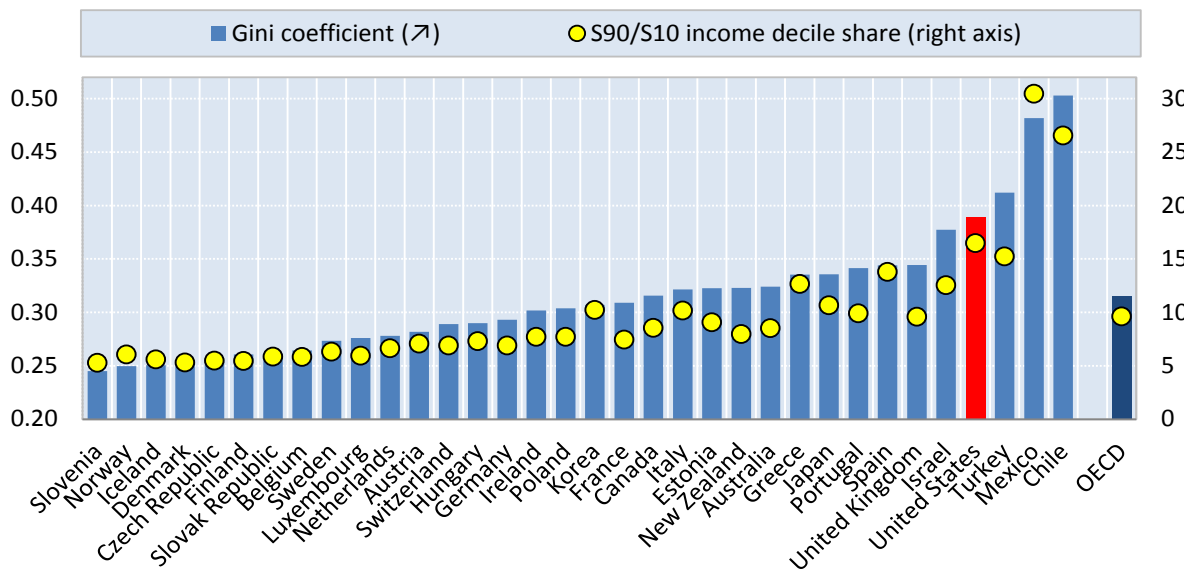
The most effective policy tool kit to address high inequalities and to extend opportunities is one that combines education and job training measures, policies to boost job creation, and reforms to make the tax and benefit system and public services more efficient.

Income inequality in the US is higher and increased more than in most OECD countries

Inequality of disposable income, i.e. income after taxes and transfers, in the United States is the fourth highest in the OECD when measured by the Gini coefficient, a measure of inequality where 0 means everyone has the same income and 1 means one person has all the income (see bars in Figure 1). This conclusion also holds when using other measures of income inequality, e.g. the gap between the average income of the richest and poorest 10% (S90/S10 ratio in Figure 1). In the United States, the average income of the richest 10% is 16 times as large as for the poorest 10%. The OECD average is 9.6 and only in Mexico and Chile is this measure higher than in the US.

Figure 1. Large differences in levels of income inequality across OECD countries

Gini coefficient and gap between richest and poorest 10%, 2011/12



Notes: Data refer to 2011, except 2009 for Japan; 2010 for Belgium; 2012 for Australia, Finland, Hungary, Korea, Mexico, the Netherlands and the United States. Throughout this document, (↗) (or ↘) in the legend relates to the variable for which countries are ranked from left to right in increasing (or decreasing) order.

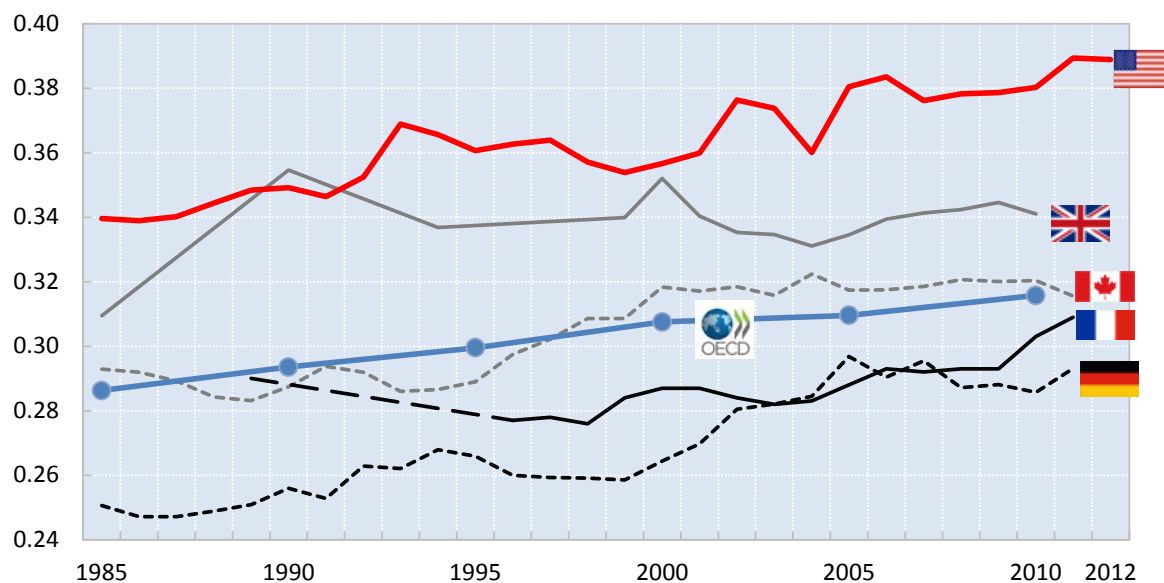
Source: OECD Income Distribution Database (2013), www.oecd.org/social/income-distribution-database.htm

This high level of income inequality is the outcome of a long-term trend increase. Income inequality in the United States increased significantly in the recent decades and at a stronger pace than the OECD average. Between the mid-1980s and 2012, inequality (measured by the Gini coefficient) went up by almost five points (or 15%) in the United States, from 0.34 to little under 0.39. Meanwhile, on average across OECD countries, inequality increased from 0.29 to 0.32; only in Sweden (from a low level), Israel and New Zealand did inequality grow faster than in the United States. In the US the increase was concentrated in three periods: from the 1980s to the early 1990s; during the early 2000s; and since the late 2000s (Figure 2).

Two recent surveys illustrate the concern about economic inequality in the US. 65% of American adults believe that the gap between the rich and everyone else has increased during the past decade (PRC, January 2014). And 67% of American adults are very or somewhat dissatisfied with the way income and wealth are currently distributed in the US (Gallup, January 2014).

Figure 2. Income inequality has been rising over the past three decades

Trends in inequality (Gini coefficient) 1985 – 2012, total population



Note: OECD average: un-weighted and based on 12 countries for which data are available at all points (Canada, Denmark, France, Germany, Israel, Italy, Netherlands, New Zealand, Spain, Sweden, United Kingdom and United States). Data for 2011 and 2012 are provisional.

Source: OECD Income Distribution Database (2013), www.oecd.org/social/income-distribution-database.htm

Income shares have soared at the very top

In most countries, increasing inequality was due to rich households faring much better than both low- and middle-income families. The share of top-income recipients in total gross income grew significantly in the past three decades in most countries, but it was particularly marked in the US, where the share of the richest 1 per cent in all pre-tax income more than doubled since 1980, reaching almost 20% in 2012. It was also large in a number of other English-speaking countries: Australia, Canada, Ireland and the UK. Elsewhere, increases tended to be greater in some of the Scandinavian and Mediterranean countries, especially in Portugal (Figure 3).

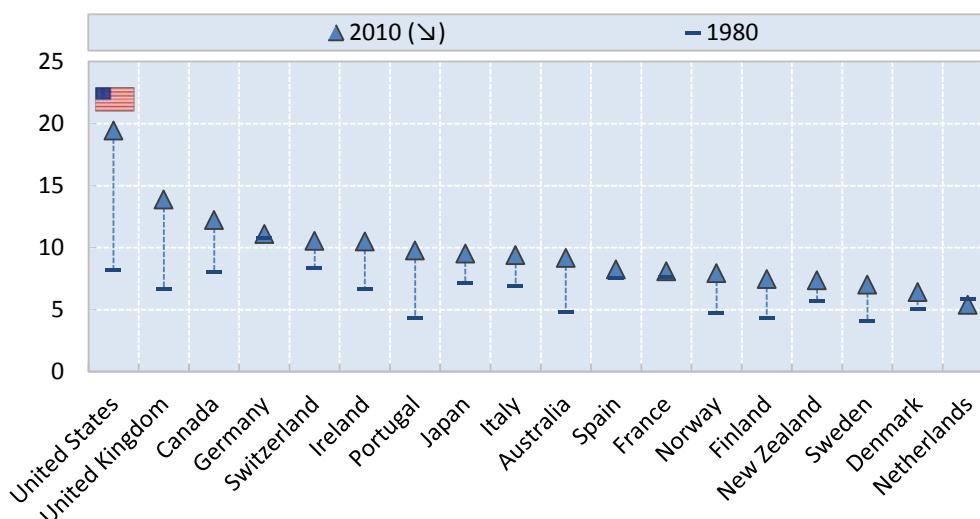
Even within the group of top-income earners, incomes became more concentrated. In the US, the share of the top 0.1 per cent in total pre-tax income quadrupled in the 30 years to 2010 from 2 per cent to over 8 per cent of total pre-tax incomes. In Canada, the UK and Switzerland, their share was 4 to 5 per cent, and close to 3 per cent in Australia, Italy, and France.

Moreover, people who achieve such a high income status tend to stay there: from one year to the next, only 25% drop out of the richest 1% in the US, compared to some 40% in Australia and Norway, for

instance. And such probability of staying in the top 1% group has remained remarkably stable in the US since the 1970s (Kopczuk et al., 2010).

Figure 3. Top income shares surged

Shares of top 1% incomes in total pre-tax income, 1980 – 2010 (or closest)



Note: Incomes refer to pre-tax incomes.

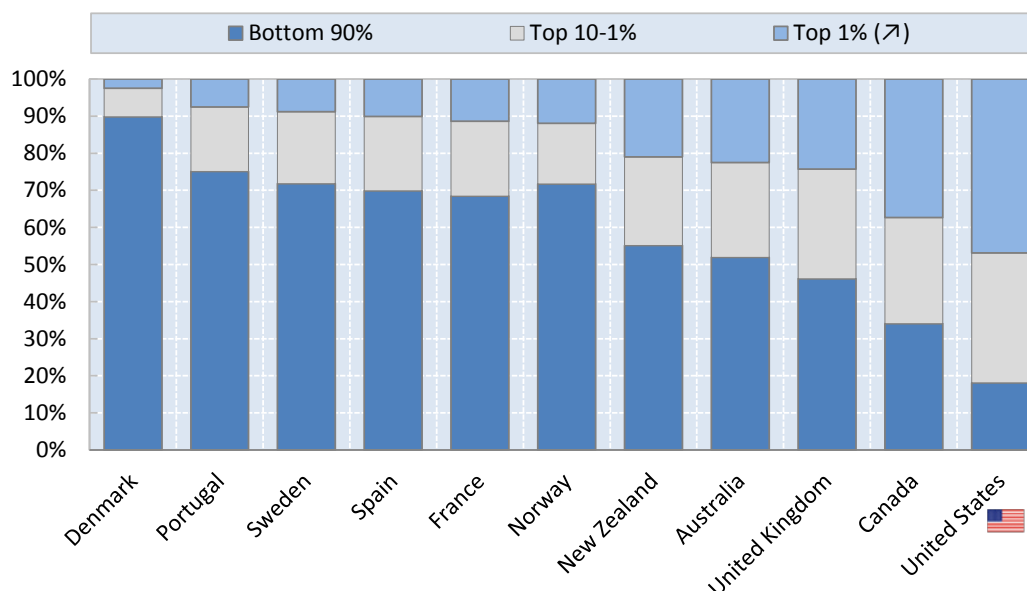
Source: OECD 2014, World Top Incomes Dataset.

Over the longer run, between 1976 and 2007, the average income of the top 1% of earners grew faster than the average income of the rest of the population almost everywhere (Figure 4). Over this period, a very large fraction of income growth was “captured” by the top percentile in English-speaking countries, particularly in North America: around 47% of total growth has benefited the top 1% in the United States, 37% in Canada and about 20% in New Zealand, Australia and the United Kingdom (Figure 4). Income growth was shared more equally in other OECD countries for which data are available, even though the top of the distribution still benefited more from income growth than the rest of the population.

From the mid-seventies to the late 2000s, the US average income grew at 1% percent per year. But if one strips out the growth that went to the top 1% of the income ladder, the rate drops to only 0.6%. This means that on the base of the 99% of the population of America, incomes in France grew faster than in the US in the past 40 years. This helps understand why the official growth rate does not quite match the experience of most people whose incomes grew by much less.

Figure 4. A significant part of income growth benefited the top income earners

Share of total income growth captured by income groups from 1976 to 2007



Note: Incomes refer to pre-tax incomes.

Source: OECD 2014, World Top Incomes Dataset.

The benefits of growth did not trickle down: lower income households fell behind

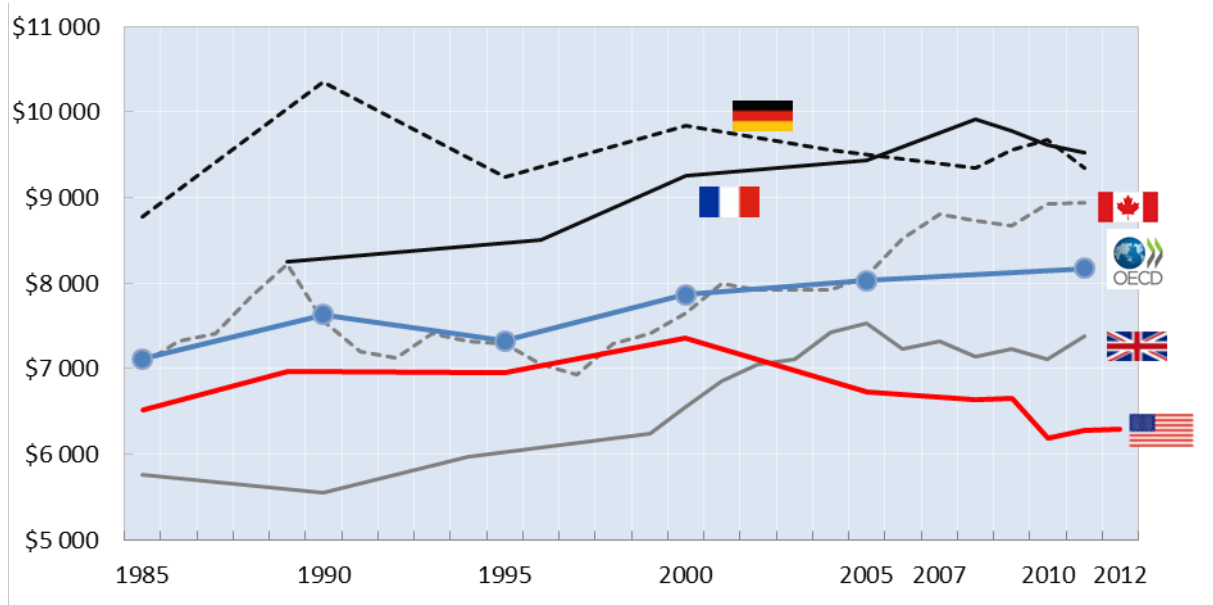
Is high and rising inequality a problem when average incomes and living standards are rising? Yes, when the poorest are left further behind, especially in terms of real incomes. This is what happened in the growth years prior to the crisis: In the United States, households at the bottom of the distribution – the poorest ten percent – could not keep pace with middle and higher income households. The average income of this poorest group actually fell by 10%, in real terms, between 2000 and 2008 and by a further 7% between 2008 and 2010, before recovering only modestly during 2011 and 2012 (Figure 5). Even looking backward, the evolution of incomes at the bottom was also disappointing: between 1985 and 2005, average household income in the United States grew by 25%, but only by 3% for the poorest 10 percent of Americans.

Comparing living standards¹ in terms of income around the world, the average American is far richer than most: for every 100 Dollars the average OECD citizen makes, an American makes 123 Dollars. But this is not true for the poorest 10 percent Americans: they only make 73 cents for every Dollar of their OECD fellow counterparts. So while the US ranks third on average OECD incomes, behind only Luxembourg and Norway, it ranks only 18th for people in the bottom 10 percent.

¹ OECD work on inclusive growth builds directly on the work on income inequality but aims at introducing a multi-dimensional perspective by also considering health and jobs as determinants of living standards.

Figure 5. Differences in low-income trends

Average disposable annual income of the bottom 10%, in US\$ PPP and inflation adjusted, total population, 1985-2012 or closest



Note: OECD average: un-weighted and based on 12 countries for which data are available at all points (Canada, Denmark, France, Germany, Israel, Italy, Netherlands, New Zealand, Spain, Sweden, United Kingdom and United States). Data for 2011 and 2012 are provisional.

Source: OECD Income Distribution Database (2013), www.oecd.org/social/income-distribution-database.htm

Social mobility stifled

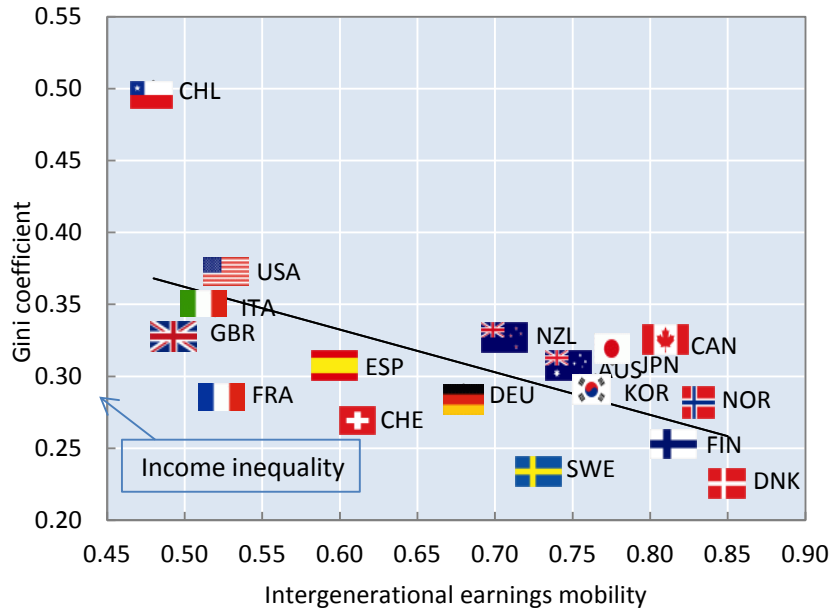
To many people, what matters is not so much inequality of *outcomes* (e.g. incomes) but rather inequality of *opportunities*. Income inequality today would be less of a problem if everyone had the same chances of climbing up the income ladder and when hard-working people can reach the top of the distribution tomorrow. One way to gauge the level of opportunity in a country is to look at how well children do relative to their parents – if most people end up at a different place in the earnings distribution than their parents, intergenerational mobility is high. On this account, the US is *less* mobile than most other societies in international comparison.

Across countries, there is clear evidence that countries with more unequal economic outcomes do not compensate by offering greater opportunities (Figure 6). To the contrary: there is less earnings mobility between generations in countries where income inequality is higher. More equal societies such as Denmark, Finland and Norway also have greater earnings mobility. Conversely, there is less intergenerational mobility in countries where income inequality is higher, particularly in Chile, but also in the United States, Italy and the United Kingdom.

In the United States, intergenerational mobility remained remarkably stable over a long period of time. American children who enter the labor market today have no greater (nor less) chances of moving up the income ladder relative to their parents than children born in the 1970s or 1980s (Chetty et al., 2014).

Figure 6. Social mobility tends to be higher in more equal societies

Income inequality and intergenerational earnings mobility, mid-2000s



Note: Intergenerational earnings mobility is measured by the earnings elasticity between fathers and sons.

Source: OECD (2008) and d’Addio (2014, forthcoming).

The crisis reinforced the pressure on household incomes

The Great Recession had a significant effect on income from work and capital (i.e., market income) in many OECD countries. In the United States, household market income fell, in real terms, by 5% between 2008 and 2010. This is slightly more than the OECD average (4.2%), but much lower than the dramatic falls experienced by some European countries. In Iceland, Greece, Estonia, Spain and Ireland, but also in Mexico, market income went down 10% or more. Like in most other countries, the fall in market income in the United States was driven mainly by surging unemployment and more jobless households. Almost 80% of the fall in market income was due to drops in employment income, 15% due to self-employment and the rest due to capital income. In other countries, the fall in employment income was less dominant (OECD, 2013).

As a consequence, market incomes drifted apart during the first phase of the crisis. Between 2008 and 2010, market income inequality rose by 1.3 percentage points in the United States and by 1.2 points on average in the OECD. With 6 percentage points, the increase was particularly large in Spain and Ireland.

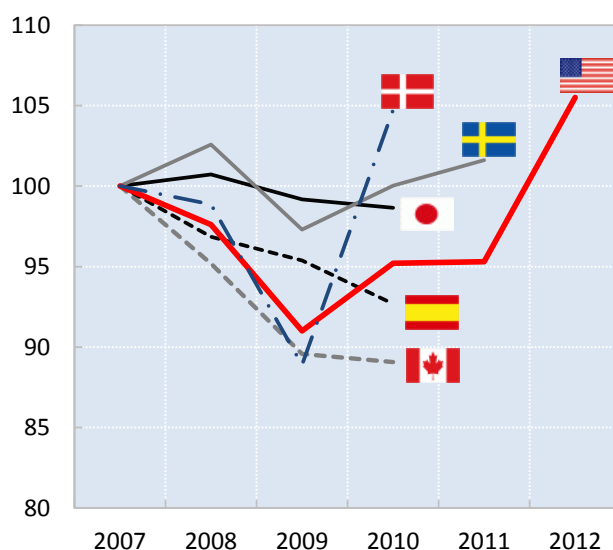
In countries where the crisis hit harder, poorer households either lost more income in the recession or benefited less from recovery. Likewise, income vulnerability increased among the young and children, while the income of the elderly was relatively more immune. Between 2008 and 2010, youth and children replaced the elderly as the groups facing the largest relative poverty risk. In the US, the share of 18 to 25 year olds living in households with less than half the median income (about US \$ 14,500 in 2010)

increased by 2 percentage points to 22%, while the share of elderly decreased by more than 2 percentage points to just under 20% in 2010, and further to 18.8% in 2012.

The Great Recession also had a major impact at the very top of the income distribution; it put a temporary halt to the increase in the share of pre-tax income flowing to the top earners, even if it did not undo the surge in top income shares over the past decades. During the first two years of the crisis, top earners experienced a higher income shock than the bulk of the population, confirming that top incomes are more sensitive to business cycle fluctuations than other groups (Figure 7). Recovery of top incomes has, however, started in the United States, Sweden and Denmark already in 2010, while in the remaining three countries for which data are available the top 1% income shares were still declining in 2010.

Figure 7. Top income shares declined sharply with the crisis, but recovered quickly in the US

Development of top 1% income shares during the crisis, 2007=100



Note: Incomes refer to pre-tax incomes.

Source: OECD 2014, World Top Incomes Dataset.

Looking at the impact of past recessions, Saez (2013) argues that “falls in income concentration due to economic downturns are temporary unless drastic regulation and tax policy changes are implemented and prevent income concentration from bouncing back”, as witnessed in the period following the Great Depression. In any event, with over 50% in 2012, the income share of the richest decile in the US has reached the highest value since recording started in 1917, even higher than in the years preceding the Great Depression.

The main drivers of the growing divide

In the United States, as well as other countries, the single most important *direct* driver of growing inequality has been greater dispersion in wages and salaries. This does not come as a surprise, since earnings account for three quarters of total household incomes among the working-age population. In the US in particular, the gap between the richest and poorest 10% of full-time workers has increased by almost one third, more than in most other OECD countries.

Contrary to the OECD trend, annual hours among lower-wage workers in the US increased over the past decades by more than 20% – probably linked to incentives embedded in policies such as the *Earned Income Tax Credit* (EITC), but also the relatively low level of the minimum wage. This trend only partially offset the rising wage gap and led to a more moderate increase in overall earnings inequality.

Demographic and societal change — more single and single-parent households, more people with a partner in the same earnings group — also played a role, but much less than sometimes assumed. Smaller households are less able to benefit from household economies of scale. And the so called “assortative mating” concentrates earnings of couples in the same income classes. Both trends contributed to higher overall inequality. However, in the US these factors accounted for only about 13% of the increase in household earnings inequality, much less than labor-market related factors: the widening dispersion of men’s earnings contributed about 46%, while the increase in employment, both among women and men, countered the increase toward higher inequality.

Labor markets have been undergoing profound transformations due to globalization, technological change and policy reforms – these constitute the three *underlying* drivers of inequality. People with skills in high demand – in IT or specific to the financial sector, for instance – saw their earnings rise significantly, while workers with low and middle skills have been left behind. Moreover, the US and most other OECD countries witnessed regulatory reforms, both in the markets for goods and services and in labor markets, such as lower minimum to median wage ratios, lower benefit replacement rates or weaker employment protection legislation and institutional changes, such as lower union density or coverage of collective-bargaining arrangements. These have promoted productivity and economic growth and brought more people into work, in particular many women and low-paid workers. But more part-time and low-paid work and more atypical labor contracts also means a widening distribution of wages.

However, the rise in the supply of skilled workers helped offset – but only partially – the increase in wage inequality resulting from technological progress, regulatory reforms and institutional changes. The upskilling of the labor force also had a significant positive impact on employment growth. The evolution of earnings inequality across OECD countries over the past few decades thus can be best viewed mainly as the difference between the demand for and supply of skills, or as neatly summarized by the Dutch economist Jan Tinbergen almost 40 years ago, the outcome of a “race between education and technology”.

This explanation, however, does not satisfactorily cover the rapid rise in top-income shares. For the latter, other factors need to be taken into account. They include a more global market for talent and a growing use of performance-related pay which particularly benefitted top executives and finance professionals, as well as changes in pay norms. The growth of the financial sector also played a role. In the US, the share of financial professionals among top earners increased continuously over the years, from 8 to 14%. Real estate and financial professionals within the top 0.1% group realized higher income growth than people in other occupations (such as lawyers or medical professionals), leading to a growing divergence of average incomes across professions among top earners (Bakija et al. 2012).

Behavioural responses to reductions in marginal tax rates also played a significant role in these developments. Tax rates affecting top earners – income from work, capital income, wealth, inheritance, property taxes – were all on a declining trend. Top rates of personal income tax, which were equal or above 70% in half of the OECD countries including the US in the mid-1970s, for instance fell to around 40% on average by the late 2000s.

There are also more political-economy arguments for the rise in top income shares, such as the spread of a “winner-takes-all” culture assisted by globalization, and the lobbying of the political elites by high earners in order to preserve their rents.

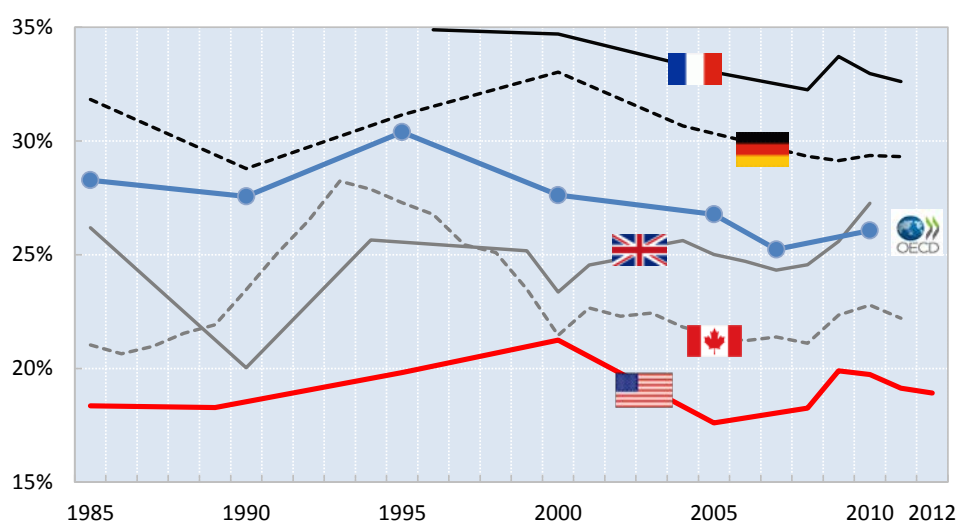
Redistribution matters

Taxes and transfers are the most direct and immediately effective policy levers that governments can use to redistribute incomes and reduce income inequality. Redistribution is not an end in itself but a means to achieve a socially desired outcome. Its level can change due to direct government interventions (fiscal or social reforms), or, if the system is progressive, automatically in response to changes in the distribution of market income.

Redistribution through income taxes and cash transfers is considerably lower in the United States than in most other OECD countries. They reduce income inequality among the working-age population by 20%, the OECD average is 26% and around 30% in France and Germany (Figure 8). In 2010, redistribution was lower only in Chile, Japan, Korea and Switzerland.

Figure 8. The crisis increased redistribution through income taxes and cash transfers

Trends in redistribution, working-age population, 1985 - 2012



Note: Redistribution is measured as the percentage difference between inequality (Gini coefficient) of gross market income and inequality of disposable income. OECD average: un-weighted and based on 10 countries for which data are available at all points (Canada, Denmark, Germany, Israel, Italy, Netherlands, New Zealand, Sweden, United Kingdom and United States). Data for 2011 and 2012 are provisional.

Source: OECD Income Distribution Database (2013), www.oecd.org/social/income-distribution-database.htm

The effectiveness of redistribution was on a declining trend in most OECD countries since the mid-1990s and in the US during the early 2000s. However, the economic crisis of 2008 has significantly reshaped the context in which redistribution is taking place in OECD countries. Large unemployment and rising market income inequality reduced incomes at the bottom of the distribution and widened income gaps, creating much greater demand for government support. Redistribution increased again during the first years of the crisis, though from a lower level than experienced earlier on in the 1990s.

Tax and transfer systems in Europe and the United States differed at the onset of the crisis, and so did the reforms in response to the crisis. European countries where transfers and taxes had a stronger redistributive role prior to the crisis were initially better equipped to limit income losses among households affected by unemployment and had less need to adjust benefit provisions. In the United

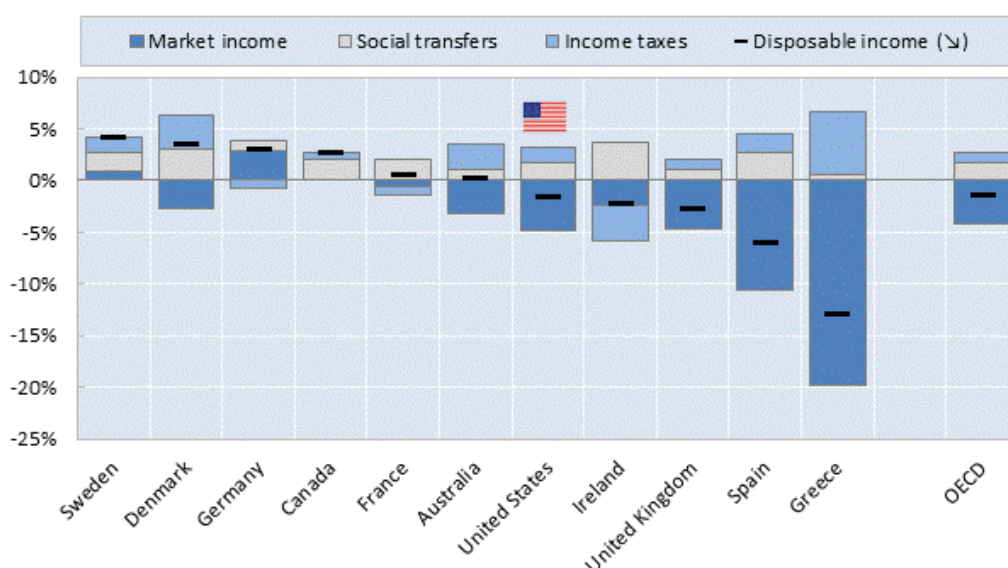
States, initially weaker redistribution and income protection policies were strengthened by policy measures that were either automatically-triggered or implemented discretionally (e.g., the 2009 American Recovery and Reinvestment Act (ARRA)).

Unemployment benefit duration was extended. Access and time limit conditions for the Supplemental Nutrition Assistance Program (SNAP) were loosened. Maximum benefit amounts of UI and SNAP were increased, as was the child tax credit amount. The *Earned Income Tax Credit* (EITC) was further extended by raising benefit ceilings. Finally, provisions governing unemployment and other benefits made transfers more generous, or more easily accessible, such as the extended unemployment benefit duration, known as Extended Benefits.

In most European countries, unemployment benefit duration – which was longer than in the US – remained largely unchanged. Eligibility requirements for minimum-income benefits in much of Europe were not adjusted in the aftermath of the crisis. Unemployment benefit amounts even became less generous in several European countries, while “safety-net” benefits remained unchanged. All in all, redistribution changes in the first years of the crisis were progressive in the United States, but flat or even regressive in many European countries.

That said, on both sides of the Atlantic, the welfare state mitigated the impact of the crisis on “take-home” household income, at least in the first years up to 2010. In the US, the combined effect of higher expenditures on social transfers and lower tax burdens compensated two thirds of the average fall in household income brought by market income, compared to 60% on OECD average. Increased public spending in the US contributed somewhat more (35%) than the fall in income taxes (30%). As a result, while market income fell by 5%, American households' disposable income fell only by 1.6% between 2008 and 2010 (Figure 9). Across all OECD countries, the fall in household disposable income was slightly lower at 1.4%.

Figure 9. Higher transfers and lower taxes mitigated falls in market income during the crisis
Percentage change in total disposable income 2008 – 2010, by income component



Note: Market income is the sum of gross earnings, self-employment and capital income. OECD-28 is the un-weighted average of OECD countries except Chile, Hungary, Japan, New Zealand, Switzerland and Turkey.

Source: OECD Income Distribution Database (2013), www.oecd.org/social/income-distribution-database.htm

Similar trends took place across other OECD countries. In fact, public social cash transfers received by households increased in all OECD countries and their contribution to cushioning income falls were noticeable in all countries hit hard by the crisis, with the exception of Mexico and Greece.

But redistribution is not only about cash. Governments spend as much on public social services, such as education, health and care services, as they do on all cash benefits taken together – the US spend as much on such services as a proportion of GDP as the OECD average: 13%. While the prime objective of such services is not redistribution, they reduce income inequality by a fifth in the US, as well as on OECD average. In the US, the redistributive effect is even much higher in an international context, more than one third, when inequality is measured by alternative indicators which give more weight to the top and the bottom of the distribution, such as ratios of the top 10 or 20% to the bottom 10 or 20% incomes. Among public services, by their mere overall share in expenditures, education and health make up the lion's share of redistributive effectiveness. In general, health services play a more important role than education in terms of redistribution, but in the US (as well as in Canada, Ireland, Italy, Mexico and Poland) this is not the case and the two contribute to a similar amount. Contrary to trends observed for cash transfers, the redistributive effect of services remained remarkably stable and did not decrease over the years prior to the economic crisis.

It is important to remember that these results only tell part of the story. Since 2010, the economic recovery has been anemic at best in a number of OECD countries, many people have exhausted their rights to unemployment benefits and many governments have shifted the fiscal policy stance toward consolidation programs. If sluggish growth and, in particular, the jobs crisis persists and fiscal consolidation takes hold, this is likely to limit the ability of the welfare state to alleviate the high and potentially increasing levels of income inequality and to protect the most vulnerable. Preliminary figures suggest that redistribution started declining again in 2010/11, at least in the United States as well as in Canada and France (Figure 8).

The way forward: which policies to reduce high income inequality and restore opportunities?

According to recent opinion polls, 69% of American adults think the government should do “a lot” or “some” to reduce income inequality, with a wide divide between the Democrats (90%) and Republicans (45%) (PRC, 2014). At the same time, a slight majority, 54%, are still satisfied with Americans' opportunities to “get ahead by working hard” (January 2014) – but this is down from 66% in 2006 and 76% in 2001 (Gallup, 2014; AIE, 2014)

How can trust and confidence in the possibility of social mobility be promoted again? As shown above, recovery alone will not be sufficient, and more needs to be done to improve the situation of low-income households and to prevent the middle-class from sliding further behind. A mix of policies is needed.

Recent OECD work (OECD, 2011) has shown that there is nothing inevitable about growing inequalities. The Great Recession has put an enormous pressure on household incomes and their distribution which needs to be tackled with effective and well-targeted policies.

An efficient policy strategy to reduce the growing divide between rich and poor in the United States and renew opportunities for all should rest on four main pillars (OECD, 2012):

- more intensive investment in human capital;
- inclusive employment promotion;
- reforms to improve the design of tax and transfer policies;
- policies for wide and equal access to high-quality public services.

The first pillar for promoting equality of opportunities and tackling high inequalities is **investing in human capital**. The trend to higher educational attainment and better skills has been one of the most important elements working against the increase in earnings inequality in the long run. Policies that promote the up-skilling of the workforce are key factors for reversing the trend towards further growth in inequality. Investment must start in the vital early childhood period and be sustained through compulsory education. This will help ensure equality of opportunity for children from disadvantaged backgrounds. Once the transition from school to work has been accomplished successfully, there must be sufficient incentives for workers and employers to invest in skills throughout the working life.

Investment in better education is essential in the US. The performance of American students in the latest PISA evaluation reflected “a picture of educational stagnation”, in the words of the US Secretary of Education, Arne Duncan. More resources need to be directed toward disadvantaged students providing them with valuable skills that will help them to raise their incomes and increase social mobility. States relying heavily on local property taxes to fund public elementary and secondary schools should consider moving to state-level funding to increase the resources and quality of teachers available to socially-disadvantaged students.

The measures in the *Race to the Top* (RTT) program launched in 2010 and aiming at reducing the impact of socio-economic background on educational outcomes need to be implemented quickly. For instance, RTT encourages states to turn around the lowest-performing schools and improve their programs of early learning and care (Denk et al., 2013).

Comprehensive education reform should also seek ways to upgrade the teaching profession, inter alia by raising the relatively low pay levels: OECD *Education at a Glance* (2011) shows that, a US high-school teacher with 15 years of experience receives only 65% of the earnings of a tertiary-educate individual working in another profession, compared to 85% on OECD average.

Skills also need to be upgraded throughout the working life. The OECD 2013 Survey of Adult Skills (PIAAC) found huge disparities in the literacy, numeracy and problem-solving competences of American workers. Improving access to, and the quality of, education and training is crucial as this will enable workers to take up better-paid jobs and thus reduce inequality.

The second pillar and most promising way of promoting equal opportunities and reducing high inequality is to **boost employment and career prospects**. Here, the focus for policy-makers should be on fostering more *and* better jobs, enabling people to escape vulnerability and offering real career prospects. Within current budgets, policies to address growing inequality could be made more efficient, for example, by making more use of in-work benefits which encourage people to take up paid work and give additional income support to low-income households.

Efforts to bring everyone back to work, and especially the most vulnerable, need to be stepped up. With the *Earned Income Tax Credit* (EITC), the United States has an excellent instrument at hand to encourage work incentives while, at the same time, improving the income position of low-wage workers. The temporary increase of the threshold for the phase-out of the EITC with the 2009 *American Recovery and Reinvestment Act* (ARRA) and the extension of this provision with the 2012 *American Taxpayer Relief Act*

(ATRA) were steps in the right direction. However, more can and needs to be done. Overall, OECD countries spend four times as much on average as the US to bring people back to work.

The third pillar, **reforms of tax and benefit policies** is the most direct and powerful instrument to redistribute income. As top earners now have a greater capacity to pay taxes than before, governments may consider re-examining their tax systems to ensure that wealthier individuals contribute their fair share of the tax burden. This aim can be achieved in several different ways – not only via raising marginal tax rates on the rich but also improving tax compliance, eliminating or scaling back tax deductions which tend to benefit high earners disproportionately, and reassessing the role of taxes on all forms of property and wealth, including the transfer of assets.

In 2013, the progressivity of the tax system has been reinforced by the ATRA which increased the top marginal income tax rate from 35% to 39.6%. The ATRA also raised the top marginal tax rates on long-term capital gains and dividends from 15% to 20%. That said, in the US as in many other OECD countries, the progressivity of the personal income tax system is reduced by various tax expenditures, including income exclusions and itemized deductions some of which lack a clear economic rationale. CBO (2013) estimates that, for FY 2013, little over half of total tax expenditures were captured by the top quintile. Therefore, a comprehensive reform to limiting tax expenditures that disproportionately benefit high earners is needed, for instance by limiting the marginal income tax rate at which deductions (such as for charitable donations) may be claimed and exclusions (such as for employer-provided health-insurance cover) permitted to 28%, as proposed in the Administration's FY 2014 budget

Broadening the tax base by closing loopholes in the current tax code has the potential to raise both efficiency and equity. This is particularly the case for the taxation of capital income, which is highly concentrated among wealthy households and represents a significant fraction of their total income. The unequal tax treatment of income from different asset classes increases inequality in some cases and distorts the allocation of capital. Equalizing the effective tax rates on debt-financed corporate investment and on housing at the higher rate on equity financed corporate investment while simultaneously lowering the corporate tax rate would reduce income inequality and improve the efficiency of investment.

Changes to the corporate income tax, for instance through channels laid out in *The President's Framework for Business Tax Reform* (2012), are necessary to lower existing tax incentives to move productions overseas and raise those to bring production back to the United States. They would help create domestic employment and raise domestic wages, with favorable impacts on the distribution of market incomes.

To effectively pursue the objectives of intergenerational social mobility and equality of opportunity, capital gains on bequeathed assets should be taxed at the standard rate and the estate tax should be replaced with an inheritance tax. Most OECD countries, in contrast to the United States, tax inheritances rather than estates, and the past several decades have seen a shift away from estate taxes, as for example in Ireland. From the perspective of intergenerational social mobility, taxing inheritances is preferable to taxing estates since what matters is how much a person receives from others, not how much a person leaves to others, and taxing inheritances would reduce income inequality if implemented in a revenue-neutral way.

At the lower end of the income spectrum, large and persistent losses in low-income groups following recessions underline the importance of well-targeted income-support policies. Government transfers have an important role to play in guaranteeing that low-income households do not fall further back in the income distribution.

In the US, the transfer system reduces inequality and poverty among specific groups, but leaves others unreached. Groups that are non-eligible to existing programs can fall through the cracks of the social

safety net, reflecting the absence of a universal means-tested cash transfer program. An increased focus of eligibility criteria on income level is necessary. Simplifying the myriad of transfer programs would lower administrative costs and increase take-up. Currently, there are 82 distinct major means-tested transfer programs at the federal level alone.

A fourth crucial pillar are policies to **promote and increase access to public services**. This concerns services such as high-quality education or access to health. The US spends much more on health per capita than all other OECD countries, but this does not reach everyone: in 2008, life expectancy in the US at birth was more than 14 years higher for the highest educated white men than for the lowest educated black males. Making health insurance coverage universal is important, however the most vulnerable will need additional attention from policy-makers. Such measures smoothen the inequality stemming from cash incomes immediately, but they furthermore constitute a longer-term social investment to foster upward mobility and create greater equality of opportunities in the long run.

It should be stressed, that redistribution strategies based on government transfers and taxes *alone* would be neither effective nor financially sustainable and a good **policy mix** needs to be adapted which includes measures in all of the four pillars described above to reduce high income inequality and restore equal opportunities.

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