

Authors

Balancing Economic Efficiency & Social Equity



Michael F. Förster

John P. Martin

By Michael F. Förster & John P. Martin

Introduction: Why Should We Care about High & Growing Inequality?

The gap between rich and poor in OECD countries has reached its highest level in 30 years. Rising income inequality creates economic, social and political challenges and risks leaving more people behind in an ever-changing world economy. It can jeopardize social mobility: inter-generational earnings mobility is low in countries with high inequality and higher in countries where income is distributed more evenly. The resulting inequality of opportunities can then have a negative impact on economic performance and well-being. Inequality can also fuel protectionist sentiments. People will no longer support open trade and free markets if they feel that they are losing out while a small group of winners is getting richer and richer. Finally, a high level of inequality also raises political challenges because it breeds social resentment and generates political instability.

High and increasing inequality may also fuel economic instability. Aggregate demand can be reduced when resources are redistributed from poorer credit-constrained households to richer households with a higher propensity to save. The period of the Great Moderation that started in the mid-1980s prompted low interest-rate policies which helped trigger increases in household and sovereign debt beyond sustainable levels. In parallel, the search for high returns by investors with rapidly growing incomes might have contributed to asset-price bubbles.

to treat poverty as a *relative* concept in developed economies. The comparison of *absolute* incomes between countries shows, for example, that the poorest 10% in Japan have more money (in terms of purchasing power parities) than the average Mexican person. But what matters is the standard of living *relative* to other people in the country. Here, poverty is measured as half of the national median household income. This benchmark, of course, also varies over time. Around 11% of the population, on average across the 34 OECD countries, fell below this poverty threshold (yellow diamonds in *Chart 1*). Again, this differs hugely between countries: from 6% in Denmark and the Czech Republic to 20% and more in Israel and Mexico. Poor people, by this relative definition, make up around 16% of the population in Japan. Countries with a wider distribution of income tend to have more widespread income poverty though measures of inequality and poverty do not necessarily go hand-in-hand. In New Zealand and the United Kingdom, for instance, inequality is higher than in Japan and Korea, but poverty is higher in the latter two countries.

In emerging economies, sustained economic growth and policy reforms have served to lift hundreds of millions of people out of extreme poverty. But the benefits of strong economic growth have not been evenly distributed and high levels of income inequality have risen further. Among the large emerging economies, only Brazil managed to reduce inequality significantly. But the level of inequality in that country, as measured by the Gini coefficient, is almost twice the OECD average.

How Unequal Are OECD Societies?

There are large differences in inequality levels across countries. Today in the OECD countries, the average income of the richest 10% of the population is about nine times that of the poorest 10%. In some European countries, the gap is much smaller, with the incomes of the richest 10% being five times those of the poorest 10%, while in the United States, the ratio raises to around 14 to one, and in Chile and Mexico to a high of 27 to one. In Japan, the rich have incomes more than 10 times those of the poorest – in 1985, this ratio was less than nine to one. The Gini coefficient, a standard summary measure of inequality that ranges from zero (when everybody has identical incomes) to one (when all income goes to only one person), stood at an average of 0.31 in OECD countries around 2008, ranging from 0.24 in Slovenia to 0.49 in Chile (*Chart 1*).

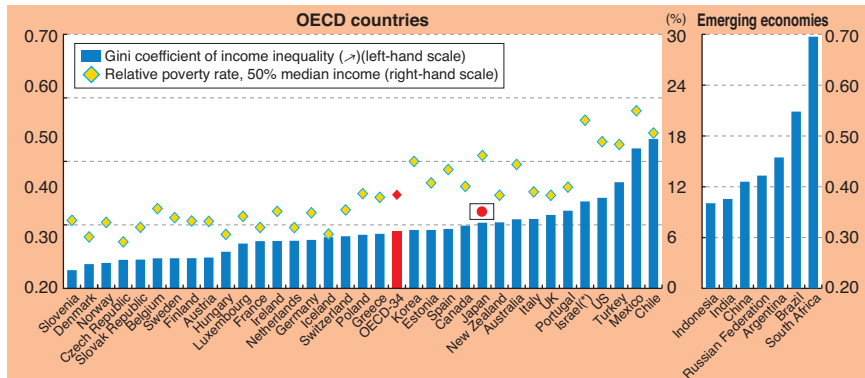
How widespread is poverty? For the purposes of cross-country comparisons, the standard practice is

Has Gap between Rich & Poor Widened?

For a quarter of a century, the gap between rich and poor has widened in

CHART 1

Huge differences in gaps between rich & poor across OECD countries & emerging economies



Note: Data refer to household disposable income, except for India and Indonesia (consumption). Poverty rates refer to the percentage of persons living in households with less than half the median income, in each country. * Information on data for Israel: <http://dx.doi.org/10.1787/888932315602>.

Source: OECD

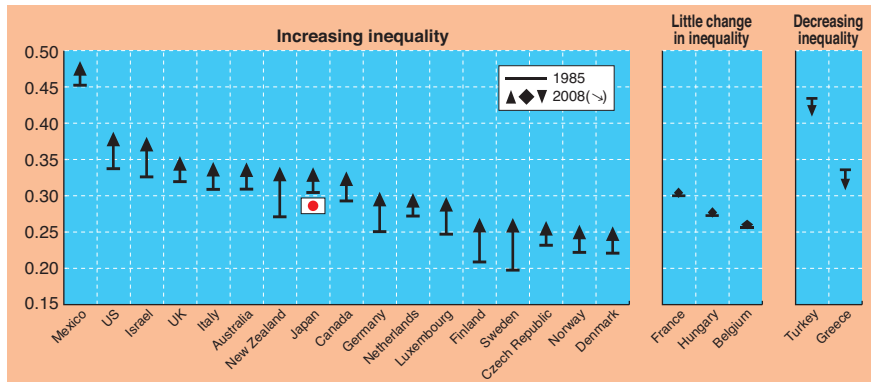
CHART 2

Income inequality (Gini coefficients) increased in a large majority of OECD countries

over three-quarters of OECD countries for which long-term data series back to the 1980s are available (Chart 2). It climbed by more than four percentage points in Finland, Germany, Israel, Luxembourg, New Zealand, Sweden, and the US. Only Turkey, Greece, France, Hungary, and Belgium recorded no increase or small declines in their Gini coefficients.

Income inequality followed different patterns across the OECD countries over time. It first started to increase in the 1980s in some English-speaking countries, notably the UK and the US, but also in Israel. The trends in the 2000s showed a widening gap between rich and poor not only in some of the already high-inequality countries like Israel and the US, but also – for the first time – in traditionally low-inequality countries, such as Germany, Denmark, and Sweden (and other Nordic countries), where inequality grew more than anywhere else in the 2000s. At the same time, Chile, Mexico, Greece, Turkey, and Hungary reduced income inequality considerably – often from very high levels. There are thus tentative signs of a possible convergence of inequality levels towards a higher average level across OECD countries.

In most countries, increasing inequality was due to rich households faring much better than both low-income and middle-income families. There has been a marked increase in the share of top incomes, especially the top 1% of earners. This has often been attributable to higher shares of labor, not capital, income – partly due to the development of stock options which are reported as part of wages and salaries. The rise at the top was most marked in the US where the share of the richest 1% in all pre-tax income reached 18%. However, 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 the Scandinavian and Mediterranean countries than in Continental European countries. Even *within* the group of top income earners, incomes became more concentrated. In the US, for instance, the share of the top 0.1% in total pre-tax income quadrupled in the 30 years to 2008 from 2% to 8% of total pre-tax incomes. The top 0.1% accounted for some 4-5% of total pre-tax incomes in Canada, the UK and Switzerland, and close to 3% in Australia, New Zealand, and France.



Source: OECD

Possible Culprits in Growing Divide

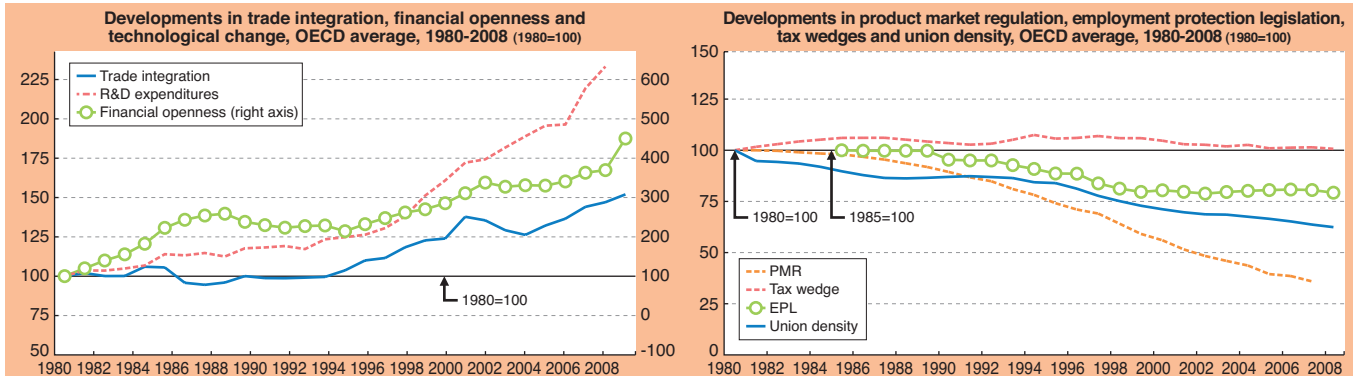
Globalization is often blamed for growing inequality. Over the past decades, OECD countries underwent significant structural changes, driven by their closer integration into the global economy and to rapid technological progress. Trade integration doubled in many OECD countries and outward stocks of foreign direct investment (FDI) increased steeply – from an average of less than 5% of GDP in 1980 to nearly 50% in the late 2000s.

The increased productivity and opportunities for trade and FDI have contributed to raising the growth potential but these changes often brought highly skilled workers greater rewards than low-skilled ones and thus affected the way earnings from work were distributed. Further, technological progress shifted production technologies in both industries and services in favor of skilled labor. These structural changes got underway in the early 1980s and accelerated from the mid-1990s (Chart 3, left panel).

But also changes in policy choices, regulations, and institutions have often been seen as culpable in increasing inequality. These changes can shape how globalization and technological changes affect the distribution of income. They can also influence income distribution directly, for example through deregulation in product markets, wage-setting mechanisms, or workers' bargaining power. Most OECD countries carried out regulatory reforms to strengthen competition in the markets for goods and services and to make labor markets more adaptable. All countries significantly relaxed anti-competitive product-

CHART 3

Economic integration & technological progress grew rapidly, while regulations & institutions became weaker



Note: Trade integration refers to total trade exposure. Financial openness is the sum of cross-border liabilities and assets as a percentage of GDP. "PMR" is a summary indicator for product market regulation. "EPL" is a summary indicator of the strictness of overall employment protection legislation. "Tax wedge" is the sum of income tax and employees and employers payroll taxes as a percentage of labor costs. "Union density" is the number of union members as a proportion of all employees.

Source: OECD

TABLE

Trends in technology, policies & education were the key drivers of changes in wage inequality & employment in the OECD area

	Economic impact on	
	Wage inequality	Employment rate
Globalization & technology		
Trade integration	=	=
Foreign direct investment (FDI) deregulation	=	=
Technological progress	+	=
Policies & institutions		
Declining union coverage	+	+
Product market deregulation (PMR)	+	+
Less strict employment protection legislation (EPL)	+	=
Declining tax wedges	+	++
Declining unemployment benefit replacement rate	+	+
Other control		
Upskilling (increased education level)	-	+

Note: Wage inequality defined as ratio of the 10% best-paid workers to that of the least-paid workers (D9/D1 ratio).

Source: OECD

market regulations and many also loosened employment protection legislation for workers with temporary contracts. Minimum wages also declined relative to median wages in a number of countries. Wage-setting mechanisms also changed: the share of union members among workers fell across most countries, although the coverage of collective bargaining generally remained rather stable over time. A number of countries cut unemployment benefit replacement rates and, in an attempt to promote employment among low-skilled workers, some also reduced taxes on labor for low-income workers (*Chart 3*, right panel).

Apart from economic globalization and regulatory change, other societal changes may also have had a direct impact on increasing inequality. In particular, changing family structures made household incomes more diverse and reduced economies of scale. Populations are ageing and there are more single-headed households with and without children today than ever before: in the mid-2000s, they accounted for 20% of all working-age households, on average, in OECD countries. In couple households, employment rates of the wives of top earners increased the most. And in all countries, marriage behavior has changed. People are now much more likely to choose partners in the same earnings bracket: so rather than marrying nurses, doctors are now increasingly marrying other doctors.

What OECD Evidence Tells Us about Main Culprits

The OECD's 2011 report *Divided We Stand: Why Inequality Keeps Rising* took a fresh look at the drivers and remedies for increasing inequality and reveals a number of surprising findings. It finds that neither rising trade integration nor financial openness had a significant impact on either wage inequality or employment trends within the OECD countries. The wage-inequality effect of trade appears neutral even when only the effects of increased import penetration from emerging economies, such as China and India, are considered – a finding that runs counter to the expectation that trade flows from such countries should drive down wages of workers in manufacturing and/or services in OECD countries. At the same time, technological progress, such as in information and communications, has exhibited a bias in favor of high-skill workers and this has been reflected in widening gaps in earnings between high-skilled and low-skilled workers.

On the other hand, regulatory reforms and institutional changes increased employment opportunities but, at the same time, contributed to widening wage disparities as more low-paid people were brought into employment. Thus, the increase in part-time employment, in atypical labor contracts, and a decline in the coverage of collective-bargaining arrangements in many countries also contributed to disparities in earnings.

However, the rise in the supply of skilled workers helped offset 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 growth in average educational attainment thus appears to have been the single most important factor that contributed not only to reducing wage dispersion among workers but also to increasing employment rates. On the basis of these results, the evolution of wage inequality across OECD countries over the past few decades could be viewed mainly as the difference between demand 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” (*Table*). This explanation, however, is less satisfactory in explaining the rapid rise in top-income shares. For the latter, other factors such as the growth of the financial sector, the spread of a “winner-takes-all” culture, and cuts in marginal tax rates on high incomes need to be taken into account too.

Importance of Tax/Benefit Systems

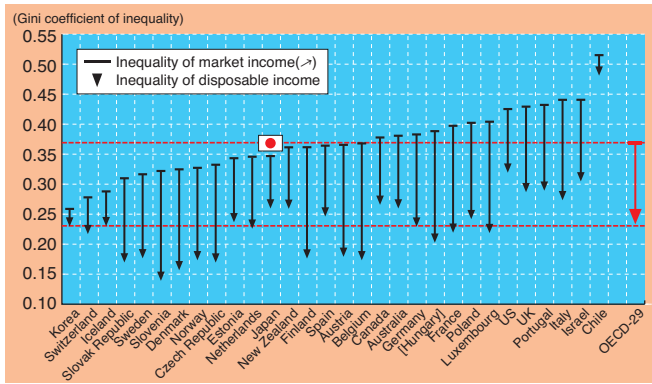
Public cash transfers, as well as income taxes and social security contributions, played a major role in all OECD countries in reducing market-income inequality. Together they were estimated to reduce inequality among the working-age population by an average of about one-quarter across OECD countries. This redistributive effect was larger in the Nordic countries, Belgium and Germany, but well below average in Chile, Iceland, Korea, Switzerland and the US (*Chart 4*).

In most countries, tax-benefit policies traditionally offset some of the large increases in market-income inequality, although they have become less effective at doing so since the mid-1990s. Until the mid-1990s, tax-benefit systems in many OECD countries offset more than half of the rise in market-income inequality. However, while market-income inequality continued to rise after the mid-1990s, the offsetting effect of taxes and benefits on household income inequality declined. Only a few countries bucked this trend. In Japan, for instance, the extent of redistribution continued to increase slightly, though its level is still lower than in most other OECD countries.

The main reason for the decline in redistribution lies on the benefits side: the real value of many social benefits fell, eligibility rules were tightened to contain spending on social protection, and transfers to the poorest failed to keep pace with earnings growth. In addition, spending on out-of-work benefits shifted towards “inactive” benefits, which resulted in reduced activity rates and thus exacerbated the trend towards higher market-income inequality. At the same time, and despite the substantial gains of high-income earners in some countries, income taxes played a relatively minor role in moderating trends towards higher inequality. The reason is that trends towards lower income taxes, on the one hand, and more progressive taxation, on the other, had opposite effects on redistribution and partly cancelled each other out.

CHART 4

Market incomes are distributed much more unequally than net incomes



Note: Data refer to working-age persons (18-65 years old).
Source: OECD

What Was the Impact of the Recent Great Recession?

The significant increase of inequality was occurring before the Great Recession when many countries were undergoing a period of fairly steady economic expansion. What will happen now that 200 million people are out of work worldwide? The jobs crisis is affecting the most vulnerable groups particularly hard, amid growing long-term unemployment and mounting youth unemployment, and this has put additional pressures on the distribution of incomes. And let us not forget that many governments are embarking on a path of fiscal consolidation.

Data on the distribution of income for the years 2009 and 2010 have recently become available for some OECD countries. These data suggest that the initial short-term impact of the crisis on inequality may have been smaller than commonly suggested in most OECD countries, with some notable exceptions, such as Ireland and Spain (Chart 5).

This apparently small effect was due first to stimulus packages and additional public support through the tax and benefit system in 2008 and 2009 which cushioned falls in household income levels at the bottom end. Secondly, households adopted coping strategies – young people returned to live with their parents, for example, or second earners increased their working hours. Thirdly, at the top end of the distribution, income shares have fallen due to declines in stock prices and interest rates, and a big drop in capital gains.

This fall in top incomes seems temporary, however, and has not reversed the preceding increase in top-income shares. Further, previous recessions have increased inequality in the mid-term because of an increasing employment divide between rich and poor. Finally, there is a risk of increasing inequality and, particularly, poverty if fiscal consolidation and austerity policies are not well balanced today.

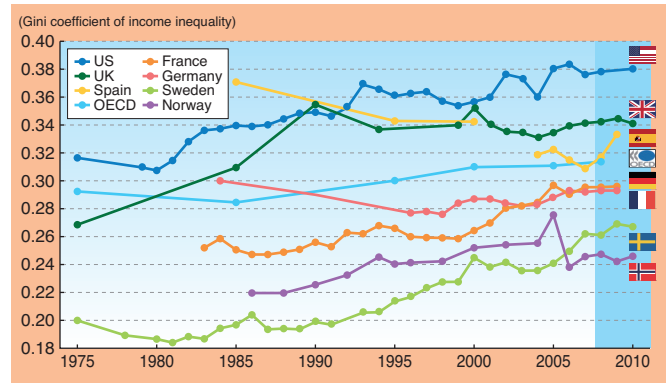
What Can Policies Do to Reduce Too-high Inequality?

The most promising way of reducing too-high inequality is through boosting employment and career prospects. Fostering more and better jobs, enabling people to escape poverty and offering real career prospects is the most important challenge for policy makers to address. 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. Such benefits are in place in

CHART 5

In many OECD countries, the initial inequality impact of the crisis remained small

Trends in income inequality (Gini coefficient) in selected countries, 1975 – 2010



Note: Break in series for Spain in 2000.
Source: OECD

about half of all OECD countries. Another important policy challenge is to improve access to, and the quality of, education and training which will enable workers to take up better-paid jobs and thus reduce inequality.

Investing in *human capital* is key. This must include the vital early childhood period and be sustained through compulsory education. This is key to ensuring 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.

Reforming tax and benefit policies is the third key to promoting a better distribution of income – taxes and benefits are the most direct instruments 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. They include not only the possibility of raising marginal tax rates on the rich but also improving tax compliance, eliminating tax deductions, and reassessing the role of taxes on all forms of property and wealth, including the transfer of assets.

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 – Japan spends 10-12% of GDP on such services. While the prime objective of such services is not redistribution, they reduce income inequality by a fifth. Public services such as high-quality education, furthermore, constitute a longer-term social investment to foster upward mobility and create greater equality of opportunities in the long run.

The new OECD work shows that there is nothing inevitable about growing inequalities. Globalization and technological changes offer opportunities but also raise challenges that can be tackled with effective and well targeted policies. Any policy strategy to reduce the growing divide between rich and poor should rest on three main pillars: inclusive employment promotion; a more intensive human capital investment; and well-designed tax/transfer redistribution policies.

JS

Michael F. Förster is a senior analyst at the OECD Social Policy Division, and has been involved in successive work on income distribution and poverty since the mid-1990s. He is co-author of Growing Unequal? (OECD 2008) and Divided we Stand (OECD 2011).

John P. Martin is director for employment, labor and social affairs at the OECD. He has published numerous articles and books on labor economics and international trade, and is currently OECD sherpa to the G20 labor ministerial process, as well as a part-time professor at the Institute of Political Studies (Sciences Po) in Paris.