# Are we growing unequal?

New evidence on changes in poverty and incomes over the past 20 years

The gap between rich and poor in most OECD countries has widened over the past two decades. This risks leaving more people behind in an ever-changing world economy. But the trend to greater inequality is not inevitable: governments can close the gap with effective social policies, many of which do not need more social spending.

Inequality of incomes was higher in most OECD countries in the mid-2000s than in the mid-1980s. Only a few bucked the trend: France, Greece and Spain moved towards greater equality of incomes over the past 20 years.

This phenomenon continues: the past five years saw growing poverty and inequality in two-thirds of OECD countries. Canada, Germany, Norway and the United States are the most affected. The remaining third – particularly Greece, Mexico and the United Kingdom – have seen a shrinking gap between rich and poor since 2000. This proves that there is nothing inevitable about these changes.

Many people in OECD countries are worried about these trends. In Japan, two-thirds of the population think that inequality is too great, while 90% or more of people agree in Hungary, Italy, Portugal and the Slovak Republic.

Politicians, across the whole spectrum, are also concerned. For example, George Bush, President of the United States, said in 2007, 'our citizens worry about the fact that our dynamic economy is leaving working people behind'. He added, 'Income inequality is real; it's been rising for more than 25 years'.

## Why inequality matters

Inequality of incomes raises both political and economic challenges. Politically, income inequality can fuel populist and protectionist sentiments. Also, societies with a large gap between rich and poor face the threat of political power being confined to the hands of a few wealthy citizens.

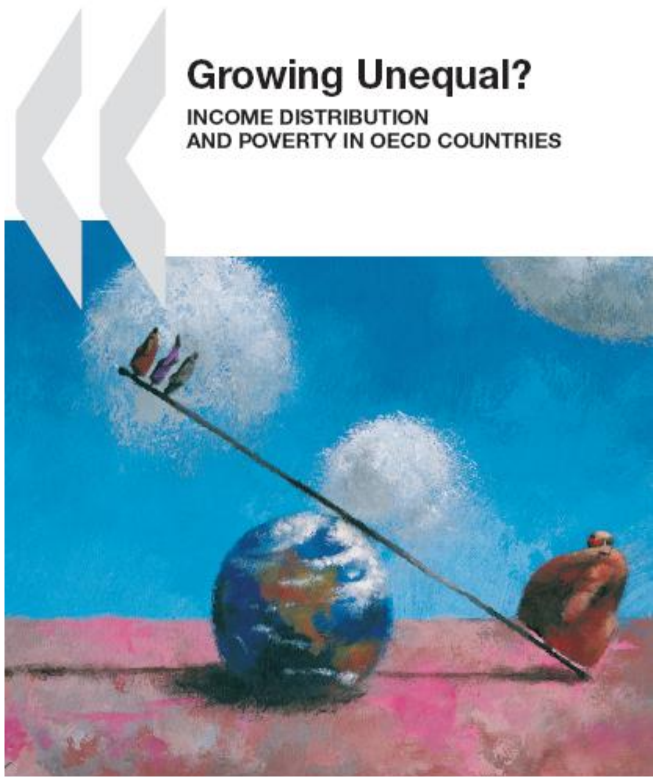
The economic price of greater income inequality is the waste of human resources implied by a large portion of the population out of work but able to work or trapped in low-paid, low-skilled jobs.

But inequality is not just about income: it is about both *opportunities* and *outcomes*. Publicly provided services, such as education, health and housing can also create fairer societies. There are still starker differences in financial assets between rich and poor than there are in income. Also, a low income for short periods (between jobs, say) is less hard on people than persistent poverty.

## *Growing Unequal?* A new OECD report

Has income inequality increased over time? Who has gained and who has lost? Were OECD countries affected uniformly? To what extent is wider income inequality the consequence of greater differences in earnings or are there other explanations? How do governments affect family incomes through redistribution in the tax and benefit system?

These are some of the questions addressed in the new OECD report that compares poverty and income distribution in 30 countries. Many of the answers are surprising. This briefing sets out the key findings.



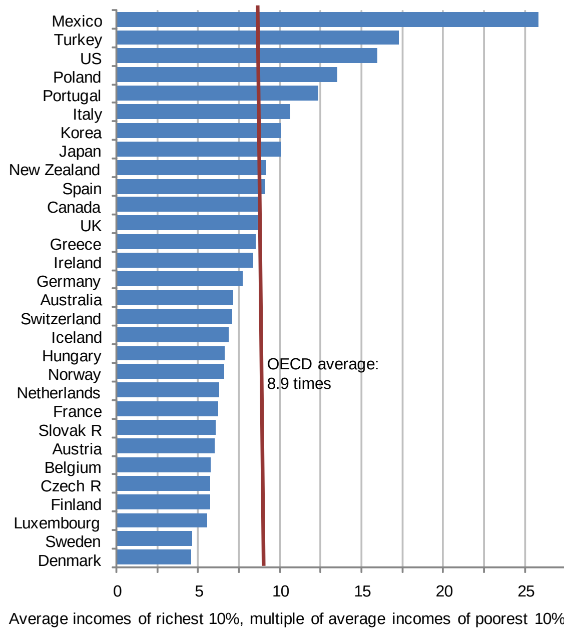
## How unequal are we?

The income of the richest 10% of people is, on average across OECD countries, nearly nine times that of the poorest 10%. But the size of income differentials varies. In Mexico, the richest have incomes of more than 25 times those of the poorest and, in Turkey, the ratio is 17 to one. The income gap between rich and poor is also well above the OECD average in Portugal, Poland and the United States (figure 1).

But in Nordic countries, such as Denmark, Sweden and Finland, the gap is much smaller. The incomes of the richest 10% average around five times those of the poorest 10%.

A number of countries are bunched together around the OECD average. This group comprises most of the English-speaking countries (Canada and the United Kingdom, for example) and some Southern European nations, such as Greece, Italy and Spain.

### 1 The gap between rich and poor in 2005



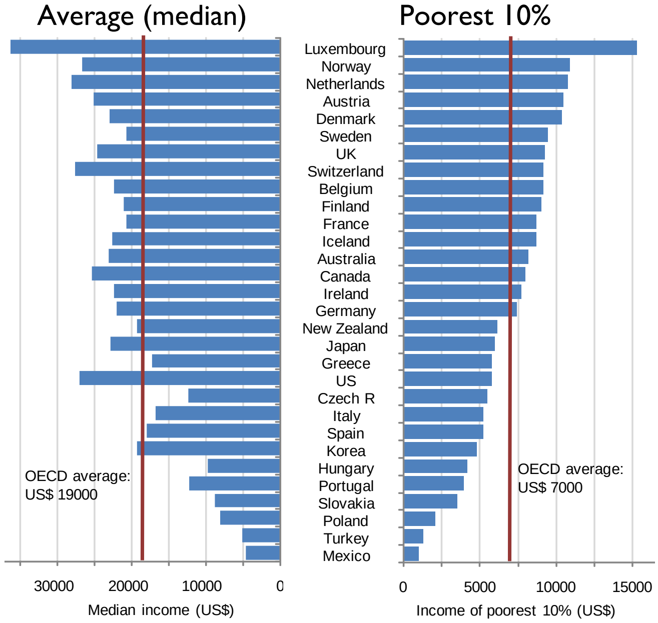

Source: *Growing Unequal?* OECD, 2008.

## Incomes of the poor

On average, the poorest 10% of the population have incomes of US$ 7 000 a year or less in OECD countries (right-hand panel of figure 2). This figure tends to be highest in Europe: averaging nearly US$ 8 000 compared with less than US$ 6 000 in the United States. It is much lower in the less-developed OECD economies: just US$ 1 000 in Mexico and US$ 1 300 in Turkey. These differences are not surprising: general living standards are lower in these countries than elsewhere in the OECD.

But it does not follow that poor people in rich countries are always better off than their counterparts in lower income countries. For example, the poorest 10% in Sweden have incomes 1.5 times the level of the poorest 10% in the United States even though average incomes are higher there.

### 2 Low and middle incomes in 2005




Note: left-hand and right-hand horizontal scales are different
Source: *Growing Unequal?* OECD, 2008.

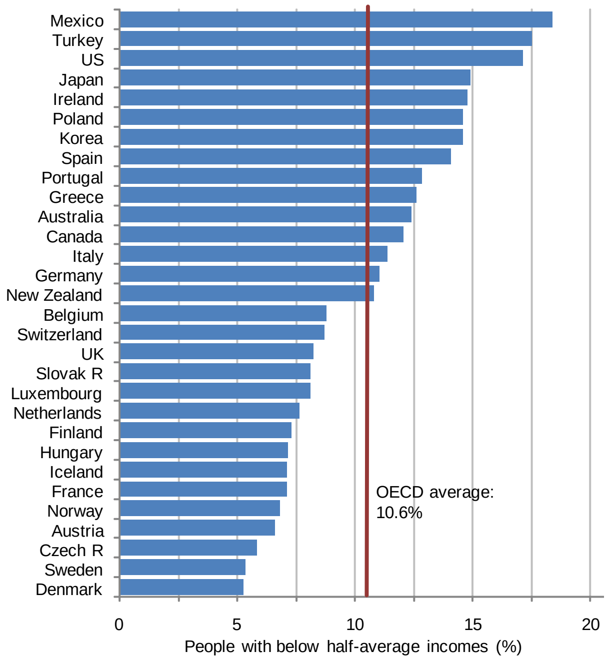
## How widespread is poverty?

It is important to remember that 'poverty' is a relative concept in developed economies. The comparison of incomes between countries shows, for example, that the poorest 10% in the United Kingdom have more money the average Portuguese person. But what matters is the standard of living relative to other people in the country. Here, poverty is measured against prevalent national living standards, as measured by the median household income (figure 2). This benchmark, of course, also varies over time.

Around one person in 10 in OECD countries had an income below half of the national median in 2005 (figure 3). But this differs hugely between countries: from one in 20 in Denmark to one in five in Mexico. Relative poverty rates are also low in the Czech Republic and Sweden. Poor people make up around 17% of the population in Turkey and the United States and 15% in Spain.

Countries with a wide distribution of income tend to have more widespread income poverty. But measures of inequality and poverty do not necessarily go hand-in-hand. In the English-speaking countries, income inequality is above the OECD average. However, poverty rates are above average in Australia, Canada, Ireland and the United States, about average in New Zealand but significantly below average in the United Kingdom.

### 3 Extent of poverty in 2005




Source: *Growing Unequal?* OECD, 2008.

## How are we growing more unequal?

Both income inequality and relative poverty have risen over the past 20 years. The rise has been significant and widespread, affecting more than three-quarters of OECD countries.

The income gap between the richest 10% and the poorest 10% has grown. Other, more sophisticated, measures of income inequality were 7-8% higher in the mid-2000s than they were in the mid-1980s.

This may not sound much of an increase, but it is equivalent on average to taking $880 away from the poorest 50% and giving $880 to the richest 50%, although incomes at every level grew over the two decades.

The poor population – with incomes below half the national median – grew by 1.3 percentage points, from a little 9.3% to 10.6% of the population in OECD countries.

These trends, however, have not been universal. The two poorest and most unequal OECD countries – Mexico and Turkey – saw substantial increases in inequality between the mid-1980s and mid-1990s. But there were equally substantial falls in the subsequent decade. In the United Kingdom, inequality increased significantly throughout the 1980s, then remained stable, and fell in the period 2000-05.

Where inequality increased, it was usually due to rich households faring much better than low-income families. But in some countries – such as Canada, Finland, Germany, Italy, Norway and the United States – the rich also gained ground on middle-earners.

## Who is getting poor?

The most substantial shifts in poverty over the past two decades are between age groups. The risk of poverty for older people has fallen, while poverty of young adults and families with children has risen (figure 4).

## Poverty and material deprivation

Income is not a perfect yardstick for assessing who is or is not poor. A more direct approach is to look whether a household meets basic needs.

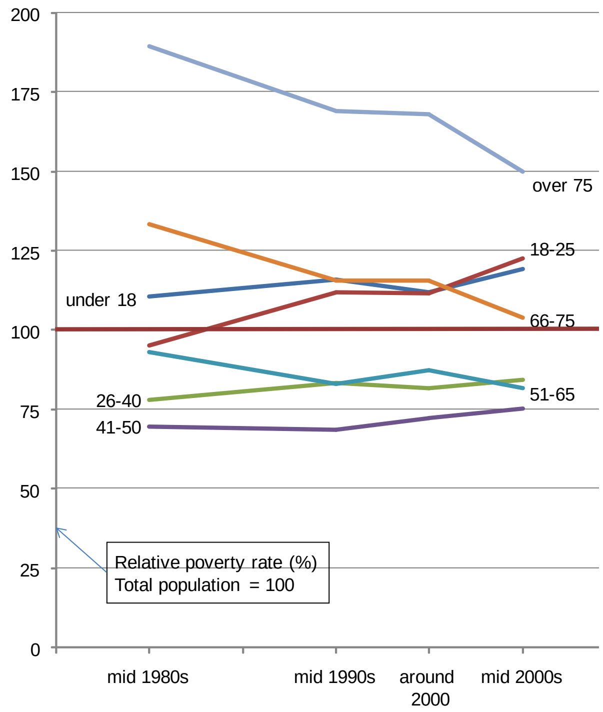
Overcrowding, inadequate heating, constrained food choices and arrears on important household bills are examples of 'material deprivation'. The proportion of people who do not meet these basic needs, unsurprisingly, has a similar pattern to income poverty (figure 3). It is 5-6% of people in the Nordic countries compared with 12-20% in southern Europe, Australia, Japan and the United States. However, material deprivation also depends on the level of average incomes in a country. More than 23% of people in Hungary, Poland and the Slovak Republic are materially deprived, which is not apparent from income-poverty statistics.

Older people are less likely to lack basic needs than people of working age. Older people also tend to have greater financial wealth. Taken together, these factors mean that income-based estimates of old-age poverty (figure 4) exaggerate the extent of material hardship among older people.

The over 75s remain the age group most likely to be poor, but the risk has fallen from nearly double the population average in the mid-1980s to 1.5 times higher in the mid-2000s. People aged 66-75 are now no more likely to be poor as the population as a whole.

Conversely, children and young adults have poverty rates that are now around 25% higher than the population average, while they were below or close to that average 20 years ago. And single-parent households are three times as likely to be poor as average. This disadvantage increased slightly between the mid-1990s and mid-2000s, albeit at a slow rate.

**4 Poverty by age over two decades: OECD**




Source: *Growing Unequal?* OECD, 2008.

## Explaining the changes: demography

All OECD countries are undergoing a demographic transition, meaning fewer babies and longer lives. The result is more older people – at greater risk of poverty than the average – and fewer people of working age –with relatively low poverty risk. There are also many more single parents.

Yet these changes in demography and living arrangements, although profound, are not the main driver of changes in income distribution. They account for more than 20% of the increase in income inequality only in Australia, Canada, France, Germany, the Netherlands and the United Kingdom.

## Explaining the changes: labour markets

Developments in the labour market are the main origin of the changes in incomes. This is because earnings make up more than 70% of household incomes (before taxes). With a few exceptions, the disparity between the low- and high-paid has increased rapidly since the early 1990s. Usually, this was because the high-paid did particularly well, not only relative to low earners but also to middle-earners.

However, there are now more people in work in most OECD countries. Family incomes are mostly higher when people are in rather than out of work.

These two effects – more jobs, greater earnings inequality – offset one another to an extent. The rise in inequality of earnings between households has generally been less than growth in the pay gap between individuals.

Yet, there remains persistent joblessness, particularly among the low-skilled and those with few educational qualifications. Much of the increase in employment is from second earners in a household taking a job rather than people in jobless households finding work.

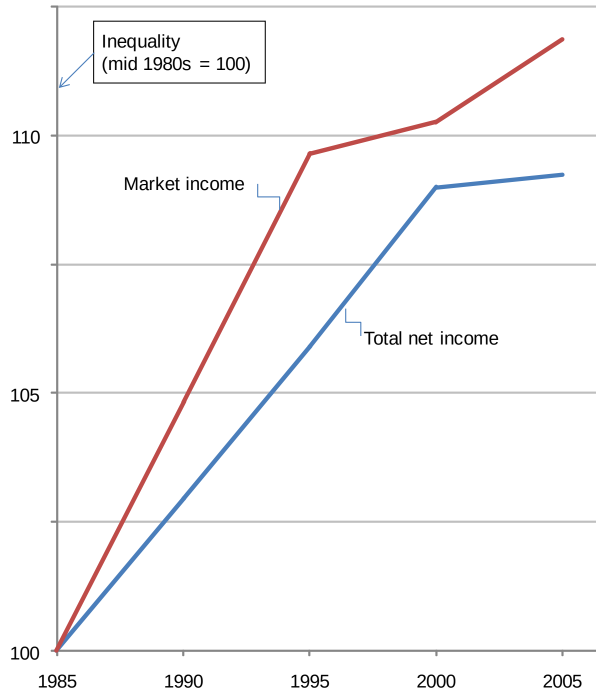
Paid work reduces the risk of poverty: 46% of single people without work have low incomes, compared with 28% who work part time and 8% of those working full time. The same is true of couples: one in three has an income below the poverty line when both do not work. This proportion is only 19% when one of them has a job and just 4% when both partners work.

However, there is no guarantee that more jobs mean fewer poor people. Japan and the United States, for example, have both high employment rates and above-average poverty. In Hungary, the position is the opposite: a relatively low share of people in jobs but also rather a low poverty rate.

As earnings have become more unequal, so has income from capital: dividends, interest, rent, capital gains and so on. The distribution of self-employment incomes has also widened. Together, these changes account for a significant part of the growth in inequality of household income (figure 5).

Inequality of market incomes (from earnings, self-employment, capital *etc.*) increased more rapidly than that for net incomes (including benefits, for example) between the mid-1980s and the mid-2000s.

## 5 Market and total income inequality trends




Note: OECD average. The inequality measure is the Gini coefficient, expressed as an index with the mid-1980s as 100.
Source: *Growing Unequal?* OECD, 2008.

## Explaining the changes: redistribution

Government plays a big role in determining incomes and living standards through the taxes it levies and the benefits it pays out.

In the Nordic countries, benefits and taxes are highly redistributive: taking money from the rich and giving it to the poor. Tax-and-benefit systems are also redistributive in Korea and the United States, but to a much lesser degree.

On average across OECD countries, cash transfers and income taxes reduce inequality by one third. Poverty is around 60% lower than it would be without taxes and benefits. Even among the working-age population, government redistribution reduces poverty by about 50%.

Nevertheless, the impact of taxes and benefits on both poverty and inequality has fallen in the past ten years in many OECD countries.

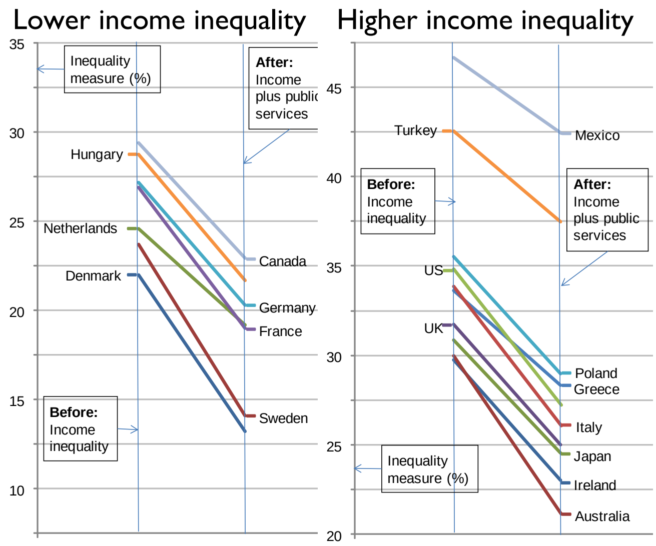
## Public services drive greater equality

Looking at differences in income alone can exaggerate inequality. The benefits of publicly provided services – education, health and so on – are distributed more equally than cash incomes, even after taxes and cash benefits are taken into account. As a result, adding the cost of providing these public services to incomes reduces a standard measure of inequality by nearly a quarter compared with income inequality alone.

The most important effects come from education, health and housing provision. The redistributive effect of public services is, on average, two-thirds of the impact of taxes and benefits.

Again, the effect varies between countries. Figure 6 compares income inequality alone with inequality in incomes plus receipt of public services. The two charts are divided by whether national income inequality is below or above the average for OECD countries.

## 6 Inequality in incomes and public services




Note: the inequality measure is the Gini coefficient, expressed as a percentage. Only selected OECD countries are shown. The vertical scale differs between the two charts.
Source: *Growing Unequal?* OECD, 2008.

Denmark and Sweden, on the left-hand side of the chart, have the least income inequality in the OECD. Yet they also have much redistribution through public-service provision (shown by the steep downward slope in the lines in figure 6), which cut inequality by a further 40%. In contrast, Mexico and Turkey, on the right-hand side, not only have the most unequal distribution of incomes but public services have the least effect on inequality.

In the Netherlands, incomes are comparatively equal, but public services reduce inequality by less than the average. The opposite is the case in Australia, which has about average income inequality whereas the effect of public services on inequality is the fourth largest.

Overall, the effect of public services on inequality tends to be a little higher in countries with less equal incomes. This means that cross-country disparities in inequality are somewhat lower once public services are taken into account than when comparing incomes alone.

## Further drivers of greater inequality

The incomes analysed above take into account 'direct' taxes, such as income tax and social security contributions. But living standards are also affected by indirect taxes, such as value-added, sales or goods-and-services taxes and excise duties (on alcohol, petrol *etc.*) Higher taxes on consumer spending mean that the same amount of income buys fewer goods and services.

Poorer people spend more of their income than richer people (who save some of theirs). More heavily taxed goods and services often make up more of the basket of spending of poorer households.

Taking these factors into account the standard measure of inequality is 7% higher on average than inequality of incomes. The difference between inequality before and after indirect taxes is largest in Denmark, Finland, Hungary, Norway and Sweden, mainly because of high indirect tax rates. The impact is negligible in Australia, Canada, Japan, Mexico, Switzerland and the United States, mainly because indirect taxes have relatively low rates.

Wealth, as well as income, affects people's possible living standards. Someone with a low income but plenty of financial assets is in a better position than someone with the same income but no assets.


Unfortunately, many countries do not collect information on the assets of households. Sometimes, data are incomplete: missing employer-provided pensions, for example. Also, it is much more difficult to compare wealth between countries than income.

For the OECD countries where comparable data are available, the distribution of wealth is much wider than the distribution of income. Intriguingly, the difference between income and wealth disparities is largest in countries with relatively equal distribution of incomes, such as Germany and Sweden.

## Persistence of poverty

It makes a big difference to individuals whether low income is just for a short period (as a student or between jobs) or poverty is persistent or even permanent. Other people may have recurrent spells of low income.

In most OECD countries, around half of poor people are better off and move above the poverty line within three years. This figure is the highest in Denmark and the Netherlands. Income mobility means that people who are persistently poor make up less than 2% of the population in these two countries. But persistent poverty is much more widespread – 7% of the population – in Australia, Greece, Ireland, Portugal and the United States.

Generally, the countries with more widespread poverty based on annual incomes (identified in figure 3 above) tend also to have more people who are persistently poor.

## Inequality of opportunity and outcome

Measuring equality of opportunity is much harder than measuring outcomes, such as income, wealth and so on. One way is to see how well children do relative to their parents. The idea is that if most people end up at a similar place in the earnings distribution as their parents, then both advantage and disadvantage are passed down through the generations. In contrast, if sons' earnings are less closely related to their fathers', then there is greater economic mobility.

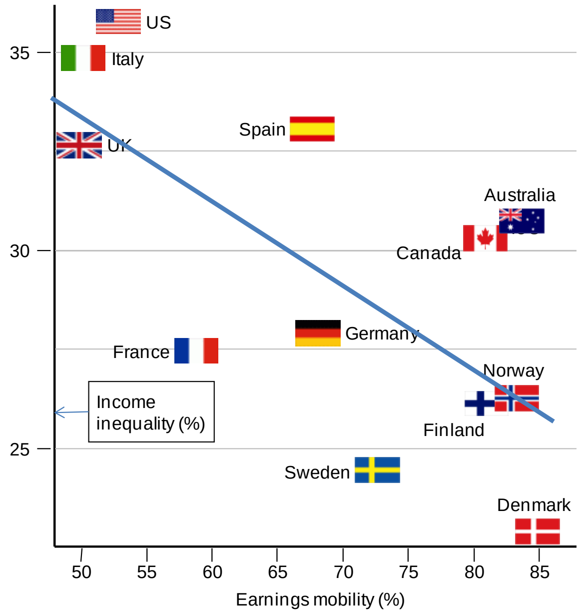
Most evidence is based on a comparison of the earnings of fathers and sons. (For women, it is difficult to disentangle the effect of changing patterns of work and social attitudes between generations, the impact of anti-discrimination laws and so on.)

Across the bottom of figure 7 is a measure of earnings mobility between generations. Zero would mean that fathers and sons were at exactly the same point in the earnings distribution; 100% shows that there is no relationship between the earnings of fathers and sons.

All countries show significant earnings mobility: the lowest figures – in Italy, the United Kingdom and the United States – are just over 50% and the highest are over 80%.

One important question is: Do societies that have more unequal economic outcomes compensate by offering greater opportunities? Figure 7 compares earnings mobility with income inequality. The chart shows that countries with more equal incomes (lower on the vertical axis) tend also to have greater differences in earnings between fathers and sons: Denmark, Finland and Norway. Conversely, there is less earnings mobility between generations in countries where income inequality is higher: Italy, the United Kingdom and the United States.

### 7 Earnings mobility and income inequality




Note: the inequality measure is the Gini coefficient, expressed as a percentage. The measure of earnings mobility is calculated from the intergenerational elasticity of earnings: see the report for details.
Source: *Growing Unequal?* OECD, 2008.

Taking the analysis of persistence of income poverty and mobility of earnings between generations together suggests that more unequal countries are prone to developing an 'underclass' who are poor themselves for long periods and so are their children.

## What is to be done?

Incomes are more equally distributed equal and fewer people are poor where social spending is high: the Nordic countries and western European countries, such as Austria, Belgium and the Netherlands. Social spending on people of working age was 7-8% of national income in 2005 and the share of working-age people in poverty was between 5% and 8%.

At the other end of the spectrum, Korea, Mexico, Turkey and the United States spent 2% or less of national income on benefits and had 12-15% of the working age population in poverty.

It is easy to conclude that countries have the poverty rate that they are prepared to pay for. In Mexico and Turkey, higher tax revenues – enabling an expansion of social programmes – would probably reduce inequality and poverty. But for most OECD countries, the answer is more complex.

In Canada, for example, total social expenditure (including spending on older people) increased from 16% to 21% of national income in the early 1990s but by the early 2000s had fallen back to 16% again. Over that period, a fairly constant 9-10% of the population were below the poverty line. In the Netherlands, stable public social spending went hand-in-hand with significant growth in poverty between the mid-1980s and mid-1990s. But after that point, social spending fell from 27% to 20% of national income while the poverty rate remained constant. In contrast, fairly stable social spending of around 28% of national income in Germany in the 1990s and 2000s was accompanied by significantly greater poverty: increasing from around 7% of the population to nearly 12%.

Higher social spending does not always reduce poverty and inequality. And the taxes needed to pay for it could have the perverse effect of pricing people out of work. Instead, within current budgets, more effective policies could address the cause of growing inequality more directly.

Demographic and social changes that drive greater inequality and poverty are largely inevitable and beyond the power of governments to affect. However, the cause of much of growing inequality lies in the labour market: a larger gap between the low- and high-paid and changing numbers of people out of work. These are much more amenable to public policies, such as education and training to improve skills and in-work benefits that provide a financial incentive to take a job.

# In brief

- The gap between rich and poor and the number of people below the poverty line have both grown over the past two decades. The increase is widespread, affecting three-quarters of OECD countries. The scale of the change is moderate but significant.
- Income inequality increased significantly in the early 2000s in Canada, Germany, Norway and the United States. But incomes in Greece, Mexico and the United Kingdom became more equal.
- The rise in inequality is generally due to the rich improving their incomes relative both to low- and middle-income people.
- Older people are much less likely to be poor than they were in the past. Poverty has shifted from pensioners to young adults and families with children.
- Demographic change – fewer babies, longer lives – explains some of the increase in inequality, mainly because it increased the number of single-adult households.
- Social change – especially the greater prevalence of lone parents – has had an important effect on inequality.
- The gap between the low- and high-paid has grown in most OECD countries. As with incomes, this is mainly driven by the high-paid pulling away from low- and middle-earners.
- There are now more people in employment than there were 10 or 20 years ago, which reduced the effect of higher earnings inequality on growth in household-income inequality. Nonetheless, there remain large pockets of joblessness among people with few skills and educational qualifications, which further blunted the impact.
- Incomes from capital and self-employment are very unequally distributed, and have become even more so.
- Work reduces poverty: almost six times as many jobless families are below the poverty line than working families.
- Work alone is not sufficient to avoid poverty: more than half of poor people live in households where one or more members are in work.
- Public services, such as education and health, are distributed more equally than income. Adding the cost of these services to the incomes of their recipients reduces inequality.
- Because the poor spend more of their income while the rich save some of theirs, indirect taxes (on goods and services) widen inequality.
- Household wealth is distributed much more unequally than income.
- Societies with greater income inequality also have less mobility: earnings of sons are closer to those of their fathers. More equal incomes go hand-in-hand with greater earnings mobility between generations.

## Follow-up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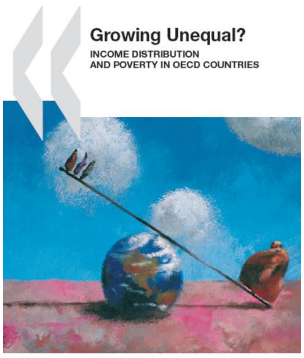


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