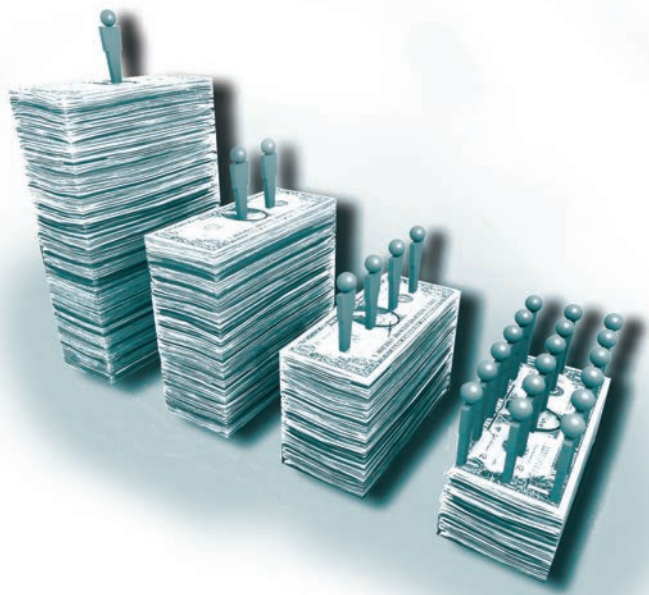
OECD INSIGHTS

BRIAN KEELEY

INCOME INEQUALITY

The Gap between Rich and Poor



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Income Inequality

The Gap between Rich and Poor

Brian Keeley

OECD
BETTER POLICIES FOR BETTER LIVES

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Foreword

Inequality is bad and getting worse. In the 1980s, the richest 10% of the population in OECD countries earned 7 times more than the poorest 10%. They now earn nearly ten times more. When you include property and other forms of wealth, the situation is even worse: in 2012, the richest 10% controlled half of all total household wealth and the wealthiest 1% held 18%, compared to only 3% for the poorest 40%.

The poorest members of society suffer immediately from inequality, but in the longer term, the whole economy is also damaged. OECD figures show that the rise in inequality observed between 1985 and 2005 in 19 OECD countries knocked 4.7 percentage points off cumulative growth between 1990 and 2010.

To reduce inequality, we have to promote inclusive growth. Create economies where every citizen, regardless of income, wealth, gender, race or origin is empowered to succeed. Our approach to doing this rests on four main pillars.

- **Overcome gender inequalities.** The fact that more women have worked full-time and earned higher wages since 1990 has limited the rise of inequality, but we cannot be happy with the slow pace of change, and we cannot afford to waste the potential of the many women who are excluded from the labour market.
- **Labour market policies need to address working conditions as well as wages and their distribution.** In 2013, about a third of total OECD employment was in "non-standard" jobs: temporary jobs, permanent part-time jobs and self-employment. Youth are the most affected group: 40% are in non-standard work and about half of all temporary workers are under 30. Working conditions are often precarious and poor, and can trap workers at the bottom of the ladder. Among those on temporary contracts in a given year, less than half had full-time permanent contracts three years later.
- **A focus on education in early years is essential to give all children the best start in life.** This investment needs to be continued throughout life to prevent disadvantage, promote

better opportunities and educational attainment. High inequality makes it harder for lower-middle and working class families to invest in education and skills.

- **Governments should not hesitate to use taxes and transfers to moderate differences in income and wealth.** Well-designed, prudent redistribution need not harm growth. We do not need new instruments; we simply need to use better the ones we have: scaling back tax deductions, eliminating tax exemptions, making tax systems more progressive, using property taxes batter and above all, ensuring greater tax compliance. And let's not forget government transfers. They play an important role in guaranteeing that low-income households do not fall too far behind.

This new book in the "*OECD Insights*" series explores how inequality is rising, why it is rising and the impacts of this rise on people's lives. We argue that rising inequality can be avoided if we take decisive action to promote inclusive growth.

Angel Gurría
OECD Secretary-General

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Currency Note

Currency references are in US dollars unless otherwise indicated. Constant dollar values have been adjusted to account for inflation. Current dollars are the sums actually given or received.

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WE ARE THE
99%

Introduction

Income inequality has risen in much of the world, sending the issue to the top of the policy agenda. The rise of the "top 1%" gains the lion's share of attention, but there's also concern about large numbers of low earners who look to be slipping further and further behind.

Introduction

In late 2011, a group of protesters set up camp in New York not far from Wall Street, the heart of global capitalism. The Occupy protestors represented a diverse set of interests and concerns, but around one slogan they could unite: "We are the 99%." The movement soon spread. According to Britain's *Guardian* newspaper, at least 750 similar protests followed worldwide, mostly in North America and Europe.

The timing of the protests was significant. It followed a once-in-a-generation financial crisis that brought in its wake sharp falls in economic growth and sharp rises in unemployment. The protests also came at a time when public consciousness was growing of a longer term trend that predated the economic crisis. In its campaigning for "the 99%" against "the 1%," the Occupy movement arguably represented the strongest statement yet of concern over one of today's hottest policy issues – income inequality.

There are few signs that this concern is easing. At the 2015 Davos World Economic Forum – an event one commentator described as "dominated by the proverbial 1%" – income inequality was "top of the agenda". The past few years have also seen a 700-page tome on inequality, Thomas Piketty's *Capital*, rise to the top of the best-seller list. And they have produced survey findings indicating public disquiet over the gap between rich and poor – "a big problem," according to majorities in 44 countries polled by the Pew Research Centre.

Rising inequality

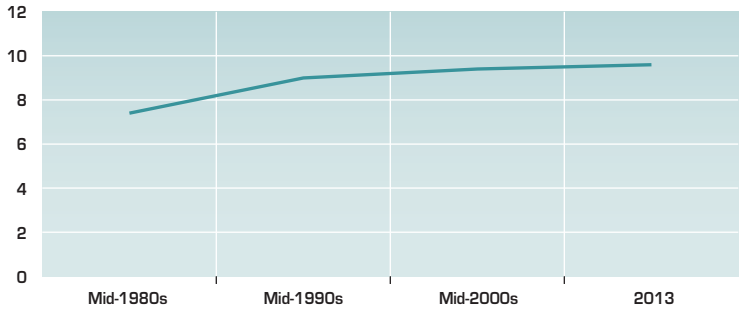
Income inequality has been rising in many wealthy countries in recent decades. In the 1980s, the average disposable income of the richest 10% in OECD countries was around seven times higher than that of the poorest 10%; today, it's around 9½ times higher.

Income gaps are even more striking when it comes to the highest earners. In the 1980s, the top 1% of earners commanded less

than 10% of total pre-tax income in every OECD country bar one. Thirty years later, their share was above 10% in at least nine OECD countries and above 20% in the United States.

Data: The gap between rich and poor is at its highest for 30 years, with the top 10% now earning 9.6 times more than the poorest 10%

Income ratio between top and bottom deciles in OECD countries



Source: OECD (2015), *In It Together: Why Less Inequality Benefits All*, *http://dx.doi.org/10.1787/9789264235120-en*.

Much of the focus of the inequality debate has been on the rising incomes of the 1%. But there is also growing concern about the economic situation of a large swathe of low-earners – perhaps as much as the bottom 40% in some countries – who have been slipping behind. As a 2015 OECD report pointed out, "When such a large group in the population gains so little from economic growth, the social fabric frays and trust in institutions is weakened."

It's not just wealthy countries that are seeing growing gaps between rich and poor. While developing countries have made impressive strides in reducing poverty in recent years, many have also seen a rise in income inequality. In Asia, income inequality has grown in a number of the region's economic powerhouses, including China, India and Indonesia; in China, it rose by about 1.6% a year in the two decades following 1990. It rose, too, in sub-Saharan Africa but declined in many South American countries, although it remains high by global levels.

And in both developed and developing countries, income is only one aspect of broader economic and social inequalities. These are often characterised by inequality of opportunity, especially in areas like access to high-quality education, adequate healthcare and decent employment. Such inequalities can lock in privilege and exclusion and prevent people from poorer families from moving up in society and making the most of their potential.

The causes of these growing income gaps are complex and reflect both economic and social changes. Globalisation, and in particular the impact of technology on the workforce, is one important factor. Social changes, such as shifts in marriage patterns have also played a role. And, when it comes to the rise of top incomes, a number of special factors come into play, including the growing use of performance pay, shifting pay expectations and changes in tax policy.

Why inequality matters

Some might now ask why rising income inequality matters – hasn't there always been a gap between rich and poor? It's true that, with the exception of some nomadic and hunter-gatherer groups, inequality has long been a fixture of human societies. Indeed, some level of inequality is widely seen as essential to create incentives for entrepreneurs to take risks.

But there's growing concern over what happens when the gap between rich and poor grows too wide and when economic growth delivers benefits only to the well off. Evidence increasingly suggests that high inequality slows economic growth and reduces social mobility. Many also fear that widening divisions threaten the stability of our societies and could hold back the development of consensus on meeting common challenges.

In the years since the financial crisis, these concerns have entered the political and economic mainstream. U.S. President Barack Obama has described rising inequality and declining mobility as the "defining challenge of our time". And Angel Gurría, Secretary-General of the Organisation for Economic Co-operation

and Development (OECD), has warned that "high levels of inequality generate high costs for society, dampening social mobility, undermining the labour market prospects of vulnerable social groups, and creating social unrest."

Understanding income inequality

Drawing on the research and analysis of the OECD and other sources, this *OECD Insights* introduces and explains some of the key issues in inequality today. It looks at how income inequality has developed over time, explains why the gap is growing, examines the consequences for our societies and economies and, finally, looks at how governments can shape policies to ensure a more even distribution of opportunity in our societies. The discussion is structured around five questions:

1. What are income and wealth?

Getting to grips with the income inequality debate means understanding certain key terms, such as income and wealth. It also means understanding how inequality is measured, a complex task that poses serious data challenges. Of course, income inequality is only one measure of how economic resources are shared across societies. To supplement them, it's essential to draw on measures of poverty.

2. What's happening to income inequality?

Income inequality has risen in many developed countries, but there are striking variations between countries. These reflect two main factors: the size of the gap between the highest and lowest salaries in a country and the extent to which the state redistributes income through taxes and benefits. Income inequality has also risen in developing economies, even during a period that has seen sharp falls in extreme poverty and the emergence of a new, albeit fragile, middle class.

3. Why is income inequality rising?

The causes of rising inequality are complex, but include the growing role of technology in our economies and the impact of globalisation. These factors also help to explain a shift in which groups benefit most from the economy, with the balance shifting from labour to capital. Inequality is also being fuelled by social factors, such as changes in marriage patterns, and shifts in the workplace – more people are now working part-time and on temporary contracts and fewer are in unions. The state's role has evolved, too, with a general tendency towards less redistribution. All these factors can explain much of the overall rise in income inequality, but not necessarily why the incomes of the top 1% have risen so sharply. To understand that, some special factors need to be considered.

4. How does income inequality affect our lives?

Economists have long theorised over the relationship between growth and inequality, and vice versa. Today, there appears to be increasing evidence that excessive inequality is bad for economic growth. High inequality has other negatives too, such as lowering social mobility and, in education, reducing people's opportunities to learn. And there's much debate over other social ills that may be linked to inequality, such as higher rates of crime and ill health.

5. How can governments respond to income inequality?

If the ill-effects of income inequality are to be tackled, ways will need to be found to promote inclusive growth. Doing that means examining policy goals – should governments be pursuing growth or well-being, or a better balance of both? In using policy to address income inequality, a number of areas stand out. Education and skills are key – policy must ensure that as many people as possible enjoy access to high-quality opportunities to learn, especially early in life, and that people can go on learning throughout their lives. Jobs are also essential, and key to tackling poverty. And the role of taxes and transfers in redistributing income and wealth must also be considered.

Throughout this *OECD Insights*, you can explore income inequality in even greater detail by following three different sorts of links:

- **More from *Insights*** will take you to material aimed at the non-specialist reader, mostly from the OECD Insights Blog and book series.
- **More from the OECD** will take you to material that may be more suitable for the reader with specialist knowledge, mainly from OECD reports and publications.
- **Data** will take you to data from the OECD, including static charts as well as interactive data (online only) from the OECD Data Portal. Users can access the background data to charts and tables, as well as important notes and disclaimers, by using the StatLink.

1

What are income and wealth?

A number of key concepts are essential to any discussion of income inequality. These include the distinction between income and wealth as well as definitions and measures of inequality and poverty.

Key themes

For centuries, the nursery song "Tinker, Tailor" was used by children to determine who they might marry. Counting out cherry stones or daisy petals, they would chant a still familiar rhyme:

Tinker, tailor, soldier, sailor,
Rich man, poor man, beggarman, thief.

With origins that can be traced back to at least 1475, the song is a reminder that, in much of human history, some level of economic inequality has been a recurring theme. In other words, some people have usually had more than others. But the extent of this inequality has varied considerably. Today in northern Europe, for example, the gap between rich and poor is still relatively narrow compared to other developed countries. In other countries, such as the United States and Turkey, China and in Central and South America, it's typically much wider.

Why does this matter? Later sections will explore the impacts of income gaps on our economies and societies. But, for now, it's enough to say that we need to understand how economic resources are spread across society to determine the extent to which people are in the economic mainstream or on its fringes.

To develop a full picture of people's economic resources, two concepts are particularly important – ***income and wealth***. Income is the flow of money that comes into a household from employers, owning a business, state benefits, rents on properties, and so on. Wealth essentially represents people's savings and it's typically higher – and spread out more unevenly – than income. Wealth matters but, in some ways, income matters more. That's because it's usually a better indicator of people's day-to-day economic resources.

The task of ***measuring income (and wealth) inequality*** is challenging. It's hard, too, to represent the results in a meaningful way. Today, the most widely used measure is the Gini coefficient. But the Gini only shows part of the story. While it gives a good overall sense of income distribution, it doesn't show us how many people are lacking even basic resources. For that reason, inequality measures are usually supplemented with ***measurements of poverty***.

1.1. Income vs. wealth: Similar but different

Income and wealth are often used interchangeably but they're not the same. A pensioner living in a house valued at $500,000 might be considered wealthy, but if her pension brings in just $100 a week, most would consider her as having a low income. This is why it's important to understand the difference between income and wealth.

What is income?

People sometimes think of their before-tax salary as their income, even though it's rarely the same as what they actually receive into their hands each month. So, instead, it's useful to think in terms of *disposable* income (or income after taxes and transfers), which gives a much clearer sense of how much money people actually have available to them to spend on rent, food, clothes and so on.

In basic terms, disposable income is determined by the flow of money into a household (usually salaries and payments from the state) minus what goes out in taxes. Think of it as "incomings" and "outgoings":

- The incomings side can include salaries or wages, earnings from investments and rents on properties. It also includes direct benefits, or transfers, received from the state, such as child benefits. Some measures of disposable income also include non-cash benefits from the state, such as education or healthcare – an important benefit for many families.

- The outgoings side typically includes taxes and other charges, such as social security, that are paid to the state as well as some payments to other households, such as to divorced spouses.

The difference between *market* income (i.e. income before taxes and transfers) and *disposable* income is substantial in most OECD countries. Without taxes and transfers, inequality would be even higher than it currently is (*see* **Section 3.5**).

Income is also often discussed in terms of "equivalised household income" or "household per capita income". To explain: Households vary greatly in size – in a wealthy country, an income of $10,000 might be enough to support someone living on their own but could pose problems for a family of four. That's not to say that such a family needs four times what a single individual needs – one TV set, one fridge should be enough to meet their needs. But such economies of scale don't apply quite so much in other areas, like clothing and food. The equivalised figure takes account of all this. It's computed by dividing household income by the square root of the household size. So, according to standard economic calculations, to match that income figure of $10,000 for a single person, a family of four would actually need an income of $20,000 to reach the same level of well-being.

> **More from the OECD:** How does your income compare with everyone else's? And how well do you understand how income is spread out across society? Get the answers with the OECD's Compare Your Income tool: *http://www.oecd.org/statistics/compare-your-income.htm*.

What is wealth?

Most people have an instinctive feeling of what wealth means – money in the bank, property and land, shareholdings, jewellery and art, pension rights and possibly life assurance, and so on. But wealth has both a positive and a negative aspect. As well as assets, like our savings, we may also have liabilities, such as loans and mortgages. Combine these assets and liabilities and we come up with a picture of people's net wealth.

Wealth is important for several reasons: It gives people a cushion if they lose their job or fall on hard times; it can also provide a source of income, for example, through interest payments on bank deposits or dividends on shares; and it allows people to make one-off or large-scale investments, such as in their education or in property.

Measuring wealth is a complex business, and not all countries do it the same way – for example, some may include the value of a pension, others may not. For this reason, it's important to look at the fine print of any measure of wealth to see what's included and what's left out.

Comparing wealth and income

Because wealth is accumulated over time, it's unsurprisingly typically higher on average than income. For example, in OECD countries average household disposable income per capita is $25,908 a year but average household net financial wealth per capita is $67,139.

A second feature of wealth is that it's typically spread out even more unequally than income – in other words, wealth inequalities tend to be more pronounced than income inequalities. Why does this matter? Wealth can, in itself, generate income, and so as wealth inequalities widen, they, in turn, fuel income inequalities. And as wealth is a source of investment, widening inequalities mean a growing gap between rich and poor in their abilities to take advantage of investment opportunities.

> **More from the OECD:** Data on income and wealth can be found at the OECD's Better Life Index (*http://www.oecdbetterlifeindex.org*) and at the OECD Data Portal (*https://data.oecd.org*).

1.2. Measuring inequality: A challenge for data

Inequality can be explored in several ways, all of which give a different sense of how economic resources are spread out across society and even the world. One approach is to look at global wealth

inequalities, which are extreme. For example, Credit Suisse's annual *Wealth Report* reported in 2014 that "that the lower half of the global population collectively own less than 1% of global wealth". By contrast, the bank calculated that the richest 10% owns 87% of global assets, while the top 1% accounts for "almost half of all assets in the world".

Such wealth studies are eye-catching, but they present problems. Not the least of these is that data on wealth is extremely hard to come by, so it's hard to develop reliable figures. That's one reason why inequalities in income have historically been studied more closely.

> **More from the OECD:** Wealth inequality generally fell in the middle of the 20th century but has risen in recent years. See "The Distribution of Wealth", (Bonesmo Fredriksen, 2012), an OECD working paper, *http://dx.doi.org/10.1787/5k9h28t0bznr-en*.

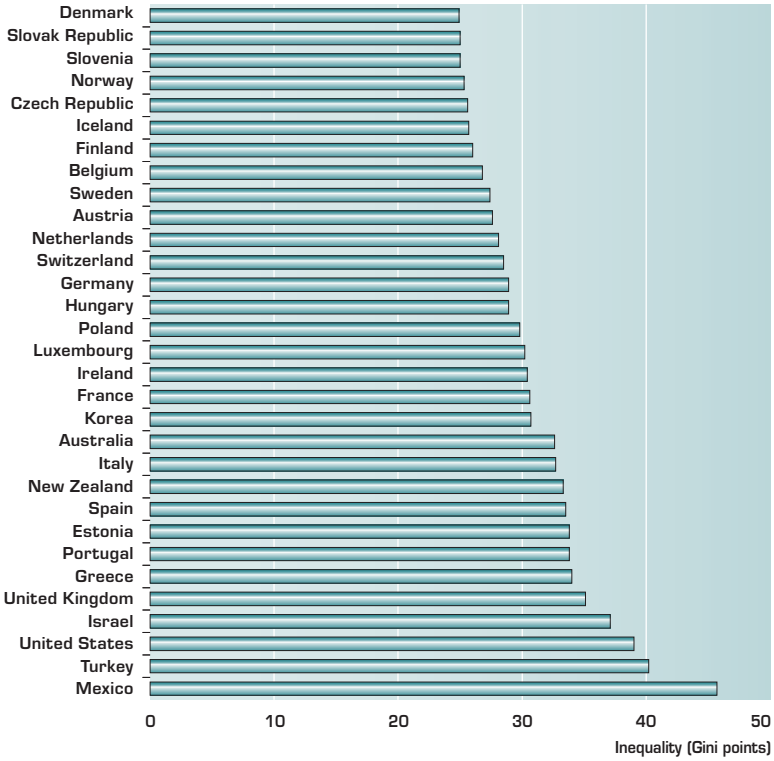
Representing inequality

Finding a way to represent inequality using just a single number is challenging, and over the years many approaches have been taken. But the one that's probably best known today is the Gini coefficient, which was defined by the Italian economist and statistician Corrado Gini in the early 20th century.

The basic idea behind the Gini coefficient is straightforward. It uses a value of 0 to represent a society where everyone has the same income and which, therefore, has no inequality; at the other end of the scale, it uses 1 to represent a society where only one person has all the income and which, thus, has maximum inequality. To make them easier to understand, Gini values can also be represented as Gini points. This is done simply by multiplying each value by 100, so a Gini coefficient of 0.28 becomes 28 Gini points. In public debate, a Gini score of 40 points and above is sometimes considered critical.

Data: In the OECD, income inequality varies from around 25 Gini points in some Nordic countries to over 40 Gini points in Turkey and Mexico.

Income inequality in OECD countries, 2012



Source: OECD (2015a), *OECD Data Portal*, *https://data.oecd.org/chart/4lzS*.

What are typical Gini values? The average Gini value across OECD countries is 31.5 points, although there is quite a lot of variation between countries. The societies with the lowest levels of inequality, Slovenia and some of the Nordics, score around 24 to 28 Gini points; the most unequal societies, such as Mexico and Chile, score around 45 points.

Discussions of Gini values can revolve around very small changes, perhaps around only one or two points. Can these really matter? It depends. Small fluctuations from one year to the next may reflect issues with data and calculations rather than underlying economic realities. However, small changes that are sustained over time may indeed be significant. "Because the Gini is a sluggish measure, even 1-2 Gini-point increases annually are a big deal," Branko Milanovic, a World Bank expert on inequality, has written.

Gathering the data

For many reasons, measuring inequality is a challenge. One of the biggest problems lies simply in gathering basic income data. Statisticians use two main sources – tax data and household surveys. Both of these have drawbacks, especially when it comes to estimating the incomes of very low and very high earners.

Household surveys: Better-off people often fail to respond to surveys and, when they do, may not always be willing to reveal their full financial situation; at the other end of the scale, the very poorest people may be so far out on the margins of society that surveys don't reach them.

Tax data: Information gathered from tax collection gets around some of the problems in household surveys. This is demonstrated by the fact that it tends to report higher earnings among the wealthy than household surveys do. (Indeed, tax data tends to yield far more insights into the situation of top earners rather than low earners.) Still, there are issues. For example, income is often underreported to tax authorities, which may lead to the income of top earners being underestimated. Also, in some countries, people who earn too little to be taxed may not be required to declare their income. And, in most economies, there's at least some activity in the "shadow" economy, where transactions are paid for in cash and not reported to the tax authorities.

1.3. Measuring poverty: Relative and absolute

Poverty is often thought of narrowly in terms of people's economic resources – a lack of money to buy life's essentials. Indeed many measures of poverty are based around income levels. But poverty is about more than not having money in a purse. It can also be thought of in terms of possessing the basics of life, like shelter or nutritious food; having access to services that improve people's lives, like roads, education and healthcare; being free of the threat of violence; and being able to contribute to decisions that will shape you or your community's future. The impact of these forms of multidimensional poverty is increasingly recognised.

> **More from *Insights*:** We need to dig behind the headline figures to understand what poverty really means, says the OECD Insights Blog, *http://wp.me/p2v6oD-1MH*.

Absolute poverty

At its most basic, poverty is often discussed in terms of a poverty line – a fixed daily income, such as a dollar a day, or an income below which people cannot afford a basic basket of goods and services. These forms of poverty are referred to as *absolute* poverty. One of the most famous measures of absolute or extreme poverty is indeed the dollar a day. When this level was set by World Bank economists in 1990, it matched closely to the poverty line in many poor countries – in other words, the basic income people needed in order to survive. But the dollar a day was also picked because it was simple and striking: "We intended to have some impact with it," Martin Ravallion, an economist who was formerly at the World Bank, told the BBC. "Make well-heeled people realise how poor many people in the world are."

Despite its apparent simplicity, the dollar a day is more complicated than it seems. For one thing, it's not actually a real U.S. dollar but rather a purchasing power parity dollar (PPP$). This is used because it makes it possible to take account of differing standards of living between countries – in a wealthy country like the United States, a dollar buys very little; in a very poor country, it can

go quite a bit further. The calculations are complicated but, in very basic terms, the PPP$ represents how much someone would need in a local currency to buy an item costing $1 in the U.S.

Another complication is that the dollar a day is no longer a dollar. Some years ago, it was revised up to $1.25 and, in 2015, it was due to be revised again – to around $1.90. It's difficult to say how this change will affect data on global poverty. According to one set of calculations by World Bank economists, raising the poverty line to $1.92 would add 148 million to the numbers of people said to be living in extreme poverty.

The dollar-a-day measure is not without its critics. Some argue that the concept is misleading and can create a sense that people living in poverty have a reliable, albeit very small, income. In reality, they argue, people's income can be unpredictable and sporadic – farmers, for instance, may earn all their money just once or twice a year after harvest time. Also, the idea of a subsistence income risks painting an overly simplistic portrait of poor people's lives. As the work of economists Abhijit Banerjee and Esther Duflo has shown, the poor – just like the wealthy – take active decisions on how to spend their incomes, sometimes sacrificing nutrition in order to save for celebrations, for example. Understanding how people make these decisions can be important for the design of national and international aid programmes.

Nevertheless, the idea of measuring absolute poverty in developing countries in terms of a fixed daily income – whether it's $1, $1.25 or around $1.90 – has shown great staying power, especially by helping to anchor the main Millennium Development Goal for poverty reduction.

> **More from *Insights*:** Attitudes to poverty have changed greatly, explains the OECD Insights Blog, *http://wp.me/p2v6oD-1zo*.

Relative poverty

The concept of dollar-a-day poverty tends to be used in the context of developing – rather than developed – countries. But many rich countries also produce absolute poverty measures, typically

based around the idea of a fixed basket of goods and services that economists estimate are the basic minimum that families need in order to get by. But there's no international agreement on what should be in these baskets, which makes international comparisons of absolute poverty very challenging. That's why for wealthier countries the concept of relative poverty can be more useful. Rather than measuring people's economic situation against a fixed bar, relative poverty gauges where people stand compared to everyone else in their society.

> **More from the OECD:** Poverty has tended to increase in OECD countries in recent years. For the latest numbers, visit the OECD Data Portal, *https://data.oecd.org/*.

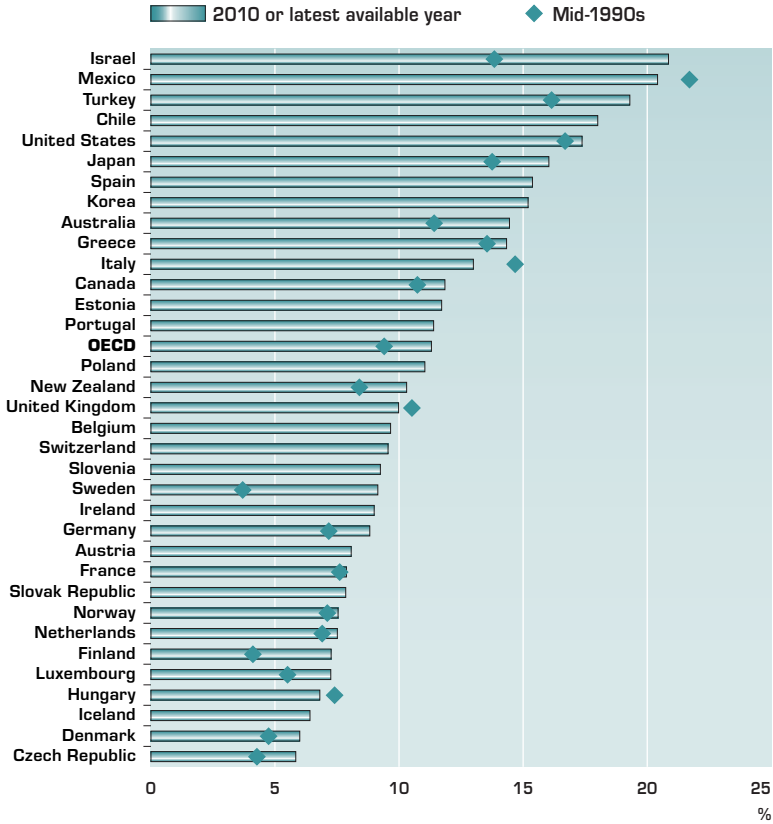
To calculate relative poverty, statisticians fix on a poverty line. There are many ways of setting this line, but here's how the OECD does it: First, statisticians examine the full range of incomes in a country – from lowest to highest– and identify the point that separates the top half of earners from the bottom half. This is the median income. The poverty line is then calculated at 50% of the median income.

Counting the number of people living below the poverty line gives the poverty rate. This figure can be refined still further with a measure called the poverty *gap*, which represents the average income of people living below the poverty line. For example, in both Belgium and the Czech Republic around 9% of people were living below the poverty line in the early 2010s. But in Belgium, their mean income was only around 19% below the poverty line while in the Czech Republic it was around 28%. This means, in effect, that poor people in the Czech Republic were generally poorer than those in Belgium.

As well as these overall measures of poverty, specific measures have also been developed to give a sense of how individual social groups are faring, especially vulnerable groups like children.

Data: Poverty has risen in some OECD countries since the 1980s; around 11% of people in OECD countries live below the poverty line.

Trend in poverty rates in OECD countries since the mid-1980s



Source: OECD (2014), *OECD Factbook 2014, http://dx.doi.org/10.1787/888933025062*.

More from the OECD: Children in OECD countries are more likely to live in poverty than any other social group. Explore the *OECD Family Database*, *http://www.oecd.org/els/soc/oecdfamilydatabase.htm*.

Multidimensional poverty

Increasingly, however, income alone is regarded as an insufficient indicator of poverty and economic inequality, especially in developing countries. People may lack access to education and healthcare, for example, in part because of their individual circumstances, such as gender, ethnicity or place of birth. These deficiencies may greatly reduce people's lifetime opportunities every bit as much as low income, and are far more widespread than traditional measures of poverty might indicate. The United Nations Development Programme calculates that in the 104 countries represented on its Multidimensional Poverty Index (*http://hdr.undp.org*), at least 1.57 billion people are living in multidimensional poverty, representing deprivations in health, education and their standard of living. This is much higher than the roughly 800 million people worldwide estimated to be living in absolute – or $1.25 a day – poverty.

2

What's happening to income inequality?

Income inequality has risen in many parts of the world, including in wealthy, emerging and developing countries. In parallel, many emerging countries have seen the emergence of a middle class, which, though still fragile, could play a major role in the future development of economies and societies.

Key themes

For much of the 20th century, the gap in incomes between the well-off and less well-off is generally thought to have narrowed in much of the world. In effect, the rich didn't get much richer while the poor caught up a bit. According to research based on The World Top Incomes Database, this decline in inequality began in North America and much of Europe in around the 1920 and 1930s and a little later, perhaps the 1950s, in some developing countries. But then, in the 1970s and 1980s, the pattern began to reverse, and inequality began to rise again.

In very basic terms, then, the pattern of inequality in the 20th century and up to today resembles a "U" – a long decline followed by a slow rise. That shape, incidentally, is the inverse of what some economists predicted would happen *(see* ***Section 4.1****)*.

This rise in inequality over recent decades is evident in most – but not all – ***rich economies***. It has affected not just economies with a history of relatively high inequality, but also countries where traditionally there was less inequality, like Denmark, Germany and Sweden.

Inequality has also grown in ***emerging and developing economies***, although not always for quite the same reasons. In recent decades, the economic rise of countries like China, Brazil and India has reshaped the global economy. Among its most striking effects has been the sharp fall in the number of people living in absolute – or dollar-a-day – poverty and the emergence of a new middle class. But poverty hasn't gone away. Indeed, in many emerging and developing countries, *relative* poverty is proving stubbornly resistant and inequality, too, is widening.

2.1. Rich countries: Inequality rising since the 1980s

Since the 1980s, income inequality has risen in most OECD countries. A quarter of a century ago, disposable income of the top 10% of earners was on average around 7 times higher than that

of bottom 10%; by 2010, it was around 9½ times higher. Since the mid-1980s, average inequality in OECD countries has risen by almost 10% to just under 32 Gini points, the standard measure of inequality.

The shift was even more pronounced over roughly the same period among the top 1% of earners, especially in English-speaking countries. In the United States, for example, the share of pre-tax income going to the richest 1% more than doubled, reaching almost 20% in 2012.

Who's benefiting from growth?

The rise in inequality in many countries since the 1980s (and even earlier) underlines a significant economic trend. In simple terms, the benefits of economic growth have tended increasingly to go to a smaller segment of society. In the United States, for example, between 1975 and 2012 around 47% of total growth in pre-tax incomes went to the top 1%. The share was also high in a number of other (mostly) English-speaking countries: 37% in Canada and over 20% in Australia and the United Kingdom.

But even in countries where the 1% didn't do quite so well, the fruits of economic growth have tended to flow more towards the top 10% of earners than towards the bottom 10%. This shift has sparked increasing discussion of the need for "inclusive growth", with the potential to ensure as many people as possible enjoy greater prosperity, have decent opportunities in areas like work and education, enjoy access to healthcare and a clean environment and are able to play a full role in society.

> **More from *Insights*:** *Is the world today more unequal than it was 200 years ago?*, asks the OECD Insights Blog, *http://wp.me/p2v6oD-1RQ*.

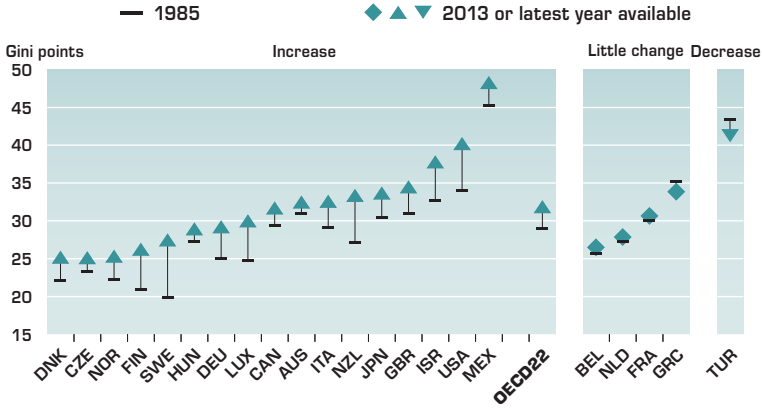
Why is inequality higher in some countries than in others?

The variations in inequality between OECD countries are striking. Inequality is particularly high in Chile, Israel, Mexico, Turkey and the United States, and particularly low in Denmark, Norway, the Slovak Republic and Slovenia. Equally, while inequality tended to rise in most countries between the mid-1980s and

mid-2000s, there were again striking variations between countries. To be sure, it rose in most, notably the United States, New Zealand and – perhaps surprisingly – Finland and Sweden. But in some others, such as France, it barely budged.

Data: Income inequality has increased in most OECD countries since the mid-1980s.

Gini measure of income inequality, mid-1980s and 2013



Source: OECD (2015), *In It Together: Why Less Inequality Benefits All*, *http://dx.doi.org/10.1787/888933207711*.

What accounts for these variations? A number of factors play a role, but two are of particular importance. The first is the wage gap (or "wage dispersion") – that's the gap between the wages of high and low-income workers. In some countries, this gap is much wider than in others. The second is the role of the state, which takes income in the form of taxes and hands it back in the form of transfers. Taxes and transfers reduce income inequality in *all* OECD countries (*see* ***Section 3.5***), but far more in some than in others.

These factors can be seen at work by comparing the inequality record of different countries. At the low end, the Nordic countries (Denmark, Iceland, Norway, and Sweden) and Switzerland all have below-average inequality and below-average poverty. Unemployment is low and the wage range is relatively narrow – very high wages are

relatively rare. Most people receive cash transfers from the state, and income taxes are strongly progressive – in other words, higher earners lose a bigger share of their income in tax.

> **More from the OECD:** Inequality patterns across OECD countries are examined in "Mapping Income Inequality Across the OECD", (Hoeller, P. et al 2012), an OECD working paper, *http://dx.doi.org/10.1787/5k9h297wxbnr-en*.

At the other end of the scale are a group of countries such as Chile, Israel, Mexico, Portugal, Turkey and the United States, which have relatively high income inequality. Several factors are at work – the wage range is relatively wide, with some people on very high wages, and the state often provides less in the way of cash transfers.

2.2. Developing countries: Inequality rises, but a middle class emerges

Since the late 1990s, the engine of the world economy has moved from the traditionally wealthy OECD countries to developing and emerging economies – a phenomenon sometimes called "shifting wealth". China and India are the most famous examples, but they're not alone: In the 1990s, only 12 developing economies saw their GDP per capita grow at more than double the rate of OECD countries; in the 2000s that number soared to 83.

> **More from the OECD:** The OECD's Development Centre explores "shifting wealth" in its annual *Perspectives on Global Development*, *http://dx.doi.org/10.1787/22224475*.

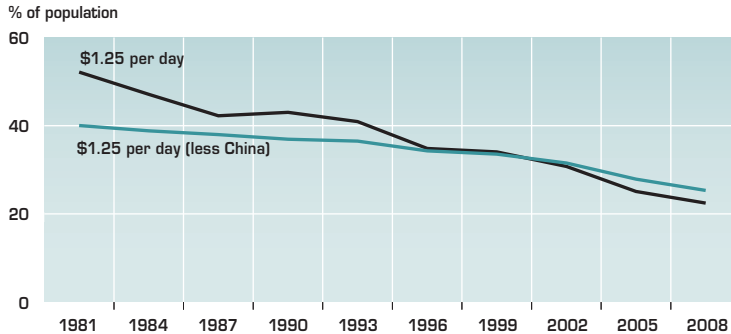
Lately, economies in many emerging economies have slowed, reducing the pace of this shift in global wealth – as *The Economist* has noted, "its most tumultuous phase seems to have more or less reached its end". Nevertheless, the impact of this shift has been profound. Many developing countries are seeing huge numbers of people escaping poverty and the emergence of a new middle class – even if many of its members are still on a very fragile financial footing. But, many also, are seeing widening income inequality, although the factors behind this are not always quite the same as in developed countries.

Falling poverty, rising inequality

A striking statistic: Compared to 1981, worldwide there are now around 650 million *fewer* people living in extreme poverty – i.e. on less than $1.25 a day – even though, over that same period, the global population rose by about 2 billion. Many factors have contributed to that decline, but the most important is the rise of China – it alone accounted for around half a billion people moving out of extreme poverty.

Data: Poverty rates in developing countries have fallen sharply since the early 1980s, although much of the decline reflects China's economic resurgence.

Poverty rates for the developing world, 1981-2008
% below poverty line



Source: OECD (2013), *Perspectives on Global Development 2013*, *http://dx.doi.org/10.1787/888932812908*.

But while $1.25-a-day poverty has been falling in much of the developing world, the same is not always true of relative poverty, which in many cases is at best stagnating. In addition, many of the countries that have made the biggest contributions to reducing poverty also have very high levels of inequality. In Brazil and much of South America, these often exceed 50 Gini points while in South Africa inequality touches 70 Gini points. It's high, too, in India (around 34 Gini points) Indonesia (around 40 points) and China (around 45 points).

Although high, these figures are, in some cases, actually lower than they used to be, especially in parts of Latin America. On the other hand, South Africa, Indonesia and China all saw increases in inequality, although, in the case of China, it may now be stabilising.

One consequence of these trends is that most of the world's poorest people no longer live in the world's poorest countries. According to the British researcher Andy Sumner, about three-quarters of the world's 1.3 billion poorest people now live in what the World Bank classes as middle-income countries (MICs), most notably India. That raises the question of whether or not growth is inclusive – is it simply enriching an educated elite or is it bringing broad benefits? The answer to that isn't always clear. As the development expert Owen Barder has noted, "The figures suggest that the biggest causes of poverty are not lack of development in the country as a whole, but political, economic and social marginalisation of particular groups in countries that are otherwise doing quite well."

> **More from *Insights*:** "... if we focus on the poorest countries, we'll actually miss most of the world's poor." OECD Insights Blog, *http://wp.me/p2v6oD-Bu*.

What's driving inequality in developing countries?

In many developing countries, travelling from the bustle of a busy city to the quiet of a country village can feel like a journey through time. In some ways, it is. While cities have become increasingly plugged into the globalising economy, life in many rural areas has often changed little. These differences between urban and rural areas, or between different provinces and regions, reflect what are called spatial inequalities, and they can be a significant contributor to overall inequality in many developing countries.

Income explains only some of these regional inequalities, although in some emerging economies – notably China and India – it's significant, with urban incomes rising faster than rural. But there are also inequalities of opportunity – notably access to healthcare, education and jobs – that are perhaps more important. For example, in some emerging economies, enrolment in secondary education is much lower in rural areas than in urban, especially for girls. Access

to basic healthcare can also vary greatly depending on where people live. In Asia, for example, infant mortality is typically much higher in the countryside than in the cities. And, in many parts of the world women still face many barriers that deprive their families and communities of valuable economic contributions.

Other factors are also at work. One, for example, is the extent to which people in many poorer countries work informally, with no written contracts and little in the way of terms and conditions of employment. In Mexico and Brazil, around half of jobs are in the informal sector, a level that rises to around 80% in India and Indonesia. Such jobs contribute to inequality in a number of ways – for one thing, they pay less than formal jobs. They also rarely offer workers opportunities for training and promotion. And they are unpredictable, meaning workers may find themselves without an income at very short notice.

> **More from the OECD:** The role of informal work in developing countries is explored in *Is Informal Normal?* (Jütting and de Laiglesia, 2009), *http://dx.doi.org/10.1787/9789264059245-en.*

Finally, in developed countries, taxes and transfers do much to reduce income inequality, but in many developing countries these systems are rarely well developed. There are exceptions: In Brazil, for example, the Bolsa Familia, or family allowance programme, makes payments to more than 13.3 million families, representing nearly a quarter of the population, on condition that they enrol children in school and take part in health programmes. That has helped to reduce rates of both child poverty as well as inequality.

Emerging middle class?

One of the most closely watched aspects of "shifting wealth" is the emergence of a new middle class, even if in many cases its members don't yet enjoy the prosperity and economic security that has traditionally been associated with the middle class in many wealthy countries. Nevertheless, this middle class may have the potential to play a transformative role in both the economy and society.

> **More from *Insights*:** *Who are the middle classes?,* asks the OECD Insights Blog, *http://wp.me/p2v6oD-1zP*.

By definition, "middle class" is a relative term – it's somewhere above poor but below rich, but where? Answers vary widely. Some economists, such as Brazil's Eduardo Giannetti da Fonseca, prefer a descriptive approach: "People who are not resigned to a life of poverty, who are prepared to make sacrifices to create a better life for themselves but who have not started with life's material problems solved ...." Others define it numerically, but even here there are different ways of thinking. One approach is to come up with a relative figure based on income levels in each country: For example, anyone earning between 50% and 150% of the median income. Other approaches are more global, and define middle class simply as households with a certain level of income. In 2008, Goldman Sachs put that figure at between $6,000 a $30,000 a year; by contrast, experts working in development tend to use a much lower figure, such as between $10 and $100 a day.

However it's measured, the key point is that even though this new middle class remains economically vulnerable, it has at least risen above day-to-day subsistence living and can plan for, and invest in, the future. And that, historically, has been one of the most significant attributes of the middle classes. In the words of the development expert Homi Kharas, "the middle class has been thought of as the source of entrepreneurship and innovation – the small businesses that make a modern economy thrive. Middle class values also emphasise education, hard work and thrift. Thus, the middle class is the source of all the needed inputs for growth in a neoclassical economy – new ideas, physical capital accumulation and human capital accumulation." It's also traditionally seen as an important political player, both as a source of stability and a force for policies like investment in education.

> **More from the OECD:** Shifting social patterns are examined in *The Emerging Middle Class in Developing Countries* (Kharas, 2010), a study for the OECD Development Centre, *http://dx.doi.org/10.1787/5kmmp8lncrns-en*.

The role of these middle classes is likely to grow: Homi Kharas projects the middle class could expand from around 1.8 billion people today to 3.2 billion by 2020 and 4.9 billion by 2030, with the bulk of this growth – about 85% – coming from Asia.

EURUSD,H4 1.3679 1.3685 1.3677 1.3684
USDCHF,H4 0.9021 0.9025 0.9018 0.9019
MACD(12,26,9) -0.00240 -0.00168

3

Why is income inequality rising?

Many factors explain the rise of income inequality. Some are economic, such as the role of technology in the globalising economy; others are social, such as shifts in who people marry; and some relate mainly to the rising incomes of top earners.

Key themes

The rise of the 1% is the most visible face of income inequality, but fissures have opened up elsewhere, such as between a large group of low earners – as much as 40% in some countries – and everyone else. It's important to understand that the factors driving rising inequality in one part of the population, say between the 1% and the 99%, don't always fully explain why inequalities are rising elsewhere. It's important, also, to realise that a whole range of factors – economic, social and the role of the state – are contributing to rising inequality.

One of the most important of these is the impact of ***globalisation***, or the process through which the global economy has become more integrated through a complex series of "flows", including technology and information, trade and investment. Just as it has in the past, technology is destroying old jobs and creating new ones. This is making high-skilled workers even more valuable and killing off the jobs of some middle and low-skilled workers. It's also helping to shift the balance between ***labour vs. capital***, delivering a larger share of income to the owners of capital, such as entrepreneurs, and a smaller share to the people who work for them.

Inequality has also been affected by changes in our ***societies***, such as the growing tendency for people to marry people from very similar social and education backgrounds, and by changes in ***the workplace***, such as the rise in part-time working and the decline in union membership.

Through the taxes it collects and the benefits it pays out, the state plays a major role in reducing inequality. But ***the state's role*** has been evolving, with a general trend towards policies that redistribute less. Other economic policies, such as a move to reduce regulation, have also probably helped to increase inequality.

Some of these factors have also contributed to the rise of "the 1%". But a range of special factors have also been involved in boosting ***top incomes***. These include the emergence of a "superstar" labour market, the growing use of stock options and performance pay and the "financialisation" of economies.

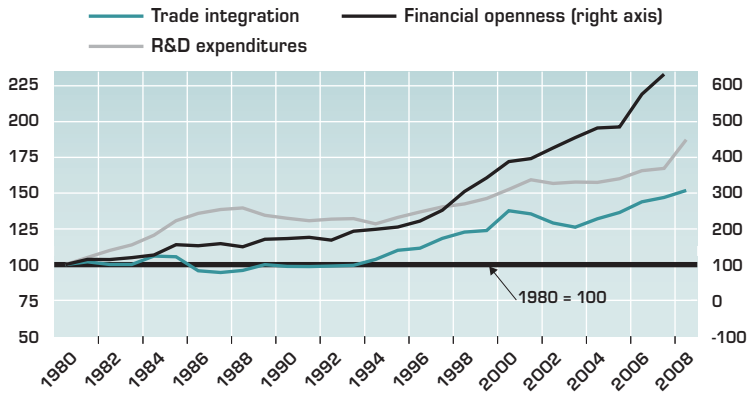
3.1. Globalisation: A key role for technology

"Globalisation" means different things to different people. For some, the spread of Western-style lifestyle and culture – embracing everything from American coffee chain Starbucks to Korean K-Pop music – is its most visible face. But in the context of income inequality, it's economic globalisation that matters – or the way in which the world economy has become increasingly integrated and interconnected through five global "flows":

- Technology and information
- Trade
- Finance and investment (or the ability of capital to flow across borders)
- Production (or the ability of businesses to move operations around the world)
- International migration

Data: The pace of globalisation – represented here by rising trade, the opening of financial markets and technological progress – sped up in the mid-1990s.

Developments in trade integration, financial openness and technological change, OECD average, 1980-2008



Source: OECD (2011), *Divided We Stand: Why Inequality Keeps Rising*, *http://dx.doi.org/10.1787/888932535223*.

Globalisation can be a divisive issue, and polls suggest that in many parts of the world there's a perception that its benefits are not being enjoyed equally across societies. In many developed countries, there's also a perception that aspects of globalisation, such as outsourcing by businesses, are costing jobs and driving down incomes.

> **More from *Insights*:** The causes and consequences of globalisation are examined in *OECD Insights: Economic Globalisation* (OECD, 2013), *http://dx.doi.org/10.1787/9789264111905-en*.

The impact of technology

All of the flows that constitute globalisation can have some impact on income inequality, but perhaps none more so than technology and information flows. That's not so surprising – technology has long had an impact on people's livelihoods. Take the Luddites, textile workers in 19th century England who smashed up newly installed machinery. The Luddites are sometimes portrayed as having been almost irrationally fearful of technology. In fact, they had good reasons to oppose it. They were craftsmen who had invested time in developing their skills. As the Industrial Revolution dawned, they didn't want to see those skills thrown into the dustbin of progress. As the economist Paul Krugman has written, "Mechanization eventually – that is, after a couple of generations – led to a broad rise in British living standards. But it's far from clear whether typical workers reaped any benefits during the early stages of the Industrial Revolution; many workers were clearly hurt."

> **More from *Insights*:** Some experts argue that technological change is destroying jobs faster than creating them, says the OECD Insights Blog, *http://wp.me/p2v6oD-1xZ*.

The Luddites illustrate the reality that almost every wave of technological change brings losers as well as winners. Today is no exception. Over just the past few decades, the number of people employed as telephone operators and shorthand typists has dwindled markedly. Other jobs will go in the future; including some "knowledge work" that today might seem to be immune to technology. Indeed, there are already signs that this is happening: As *The New York Times*

reported, in the late 1970s, a small army of lawyers worked for months to analyse 6 million documents in an antitrust lawsuit at a cost of $2.2 million; 33 years later, specialised software conducted similar analysis on 1.5 million documents at a cost of just $100,000.

So, technological change affects the world of work, devaluing and revaluing skills and, of course, creating whole new skills and jobs – think of app developers and social media strategists. This relationship between skills and technology is regarded by many as an important, perhaps *the* most important, factor behind rising income inequality. It was characterised by the Dutch economist Jan Tinbergen as "the race between technology and education". The authors of a book that took Tinbergen's phrase as their title, Claudia Goldin and Lawrence Katz, explained his thinking thus: "When technological advance vaults ahead of educational change, inequality generally rises. By the same token, when increases in educational attainment speed up, economic inequality often declines."

Looking at the current state of the race between technology and education, it's often argued that technology is now in the lead and that education is failing to keep up. The result is that people with lower levels of education are in growing danger of seeing their jobs replaced by technology. On the other hand, people with high-level skills are well positioned to put new technologies to good use and are enjoying increasing returns to their education.

The impact of trade and investment

After technology, the two globalisation flows with the greatest potential to affect incomes are probably trade and investment.

Trade: According to standard trade theory, increases in global trade should widen the wage gap in developed countries and narrow it in developing countries. In practice, it's not clear that this has actually happened; if it has, the impact looks to have been, at most, extremely modest. Indeed, some studies suggest wage gaps have risen in *both* developed and developing countries.

> **More from *Insights*:** The impact of trade in our societies and economies is examined in *OECD Insights: International Trade – Fair, Free and Open?* (OECD, 2009), *http://dx.doi.org/10.1787/9789264060265-en.*

There are countries, however, where rising trade does seem to have had more of an impact, most notably where employment-protection legislation is relatively loose. In effect, in countries where it's easier to hire and fire workers, increasing imports do appear to have more of an impact on the income gap, especially if they come from low-income countries.

Investment: For much of the 20th century, money rarely crossed borders. True, some funds were sent abroad to pay for imports and as remittances, but this formed a very small slice of most countries' economic activity. Equally, businesses tended to invest mainly at home, and spent very little on foreign direct investment (FDI) – buying foreign businesses or setting up operations abroad. As recently as the early 1980s, FDI accounted for no more than a twentieth of economic activity in OECD countries.

> **More from the OECD:** The impacts of globalisation on income inequality are discussed in Chapter 2 of *Divided We Stand: Why Inequality Keeps Rising* (OECD, 2011), *http://dx.doi.org/10.1787/9789264119536-en*.

Today, it typically accounts for around half, ensuring that FDI is one of the most visible faces of globalisation – examples abound: American chipmaker Intel designs silicon chips in India; Indian conglomerate Tata employs 20,000 workers in the U.S. in its information technology division. It's also one of the most controversial. Offshoring is widely blamed for taking away jobs in developed countries, especially among low-skilled workers, and there is some truth to this. How much, though, is hard to say. FDI, trade and the rising use of technology are so intertwined that it's very difficult from an analytical perspective to state the relative importance of one versus the other.

3.2. Labour vs. capital: A shifting balance

The impact of technology is also evident in another economic trend that is going hand-in-hand with – and arguably contributing to – the increase in income inequality, namely a shift in the share of

national income from labour and towards capital. In other words, less of the income generated by the economy now goes to workers and more goes to the people who own businesses.

The factors of production

Societies call on a vast range of resources to produce goods and services. Take something as basic as a T-shirt: Somebody needs to take the initiative to produce the garment and to buy the weaving machinery; cotton needs to be grown; cloth needs to be woven; the T-shirt needs to be designed, and so on… Despite this complexity, economists usually boil down all these separate elements into just four "factors of production" – land, labour, capital and enterprise (or entrepreneurship).

For income inequality, the relationship between two of these factors is especially important. The first is labour, the workers paid to carry out certain duties – such as operating a T-shirt production line. The second is capital, or financial resources and assets that are put to economic use – such as the entrepreneur who buys the equipment for the production line. Ultimately, capital is owned by somebody somewhere – it might be an individual, a family or, more usually these days, shareholders.

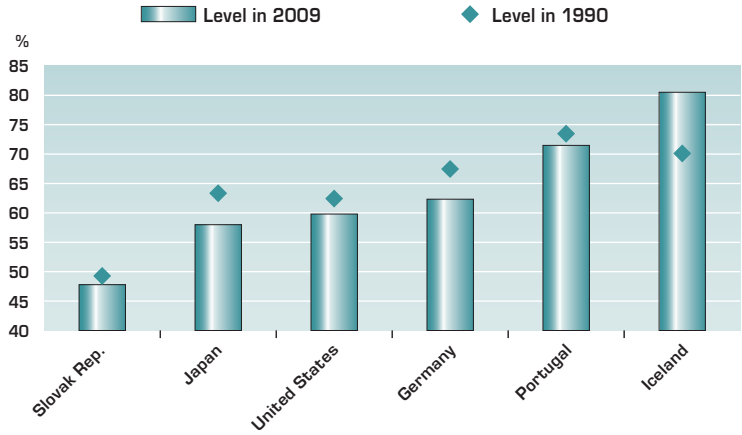
All these economic activities generate income but, historically, economists have believed that the proportion of this income that goes to labour and the proportion that goes to capital don't really change. Yes, it might rise or fall a little but, over time, it looked to be stable. Indeed, so fixed was this idea that it formed one of six "stylised facts" – or generalisations that are basically true – of long-term economic growth set down by the economist Nicholas Kaldor in the 1950s.

Balance shifts to capital

The past few decades have increasingly challenged Kaldor's finding. There is increasing evidence that the share of national income going to capital is rising and that the share going to labour is falling, and that this is now a global phenomenon. In the early 1990s, the share going to labour across all OECD countries was about two-thirds, or 66.1%; by the late 2000s, it had fallen to 61.7%.

Data: Labour's share of national income fell in almost all OECD countries in recent decades.

Labour share of national income in OECD countries, 1990 and 2009



Source: OECD (2012), *OECD Employment Outlook 2012*, *http://dx.doi.org/10.1787/888932651503*.

A range of factors have fuelled this decline in the "labour share", for example competition from exports from developing countries and loosening in the rules covering jobs and employment. But the biggest factor looks to be technology, accounting for perhaps 80% of the shift, according to OECD estimates (although others argue that financial globalisation is the main factor). This represents the increased use of robots and automation as well as the growing sophistication of information processing. The implications are clear: Income that once went to workers now goes to the owners of capital who financed the machines or software that – to a greater or lesser extent – have replaced those workers.

But is this shift in income share from labour to capital fuelling income inequality? It's difficult to say for sure. The two processes have certainly moved in parallel with each other in recent decades, but establishing a causal link between the two is challenging. One obstacle, among many, is that the lines between labour and capital are not as clear as they once were. In the early industrial age, when

workers manned assembly lines and factories were owned by individuals or families, it was easy to see who represented labour and capital. But today, it's not so rare for workers to also have a foot in the capital camp through shareholdings and investments in unit trusts. Nevertheless, some research does show that the decline in labour's share of income is fuelling inequality: For example, a report by the International Labour Organisation on G20 countries suggests that a 1% decrease in the labour share increases inequality in market income (i.e. income before taxes and transfers) by between 0.1% and 0.2%.

> **More from the OECD:** The shifting balance between capital and labour's share of national income is examined in the *OECD Employment Outlook 2012* (OECD, 2012), *http://dx.doi.org/10.1787/empl_outlook-2012-en*.

3.3. The workplace: Traditional jobs are declining

The past few decades have brought substantial changes to the way we work, with a decline in the traditional 9-to-5 job and a fall in the number of union members. Both these trends can affect income inequality.

The changing world of work

Non-traditional jobs – including part-time and short-term work as well as self-employment – are becoming more widespread. Since the mid-1990s, more than half of all new jobs in OECD countries were non-traditional. Whatever about the merits or otherwise of this sort of work – it's a welcome choice for some workers, an imposition for others – there are clear signs that its growth is linked to income inequality in a number of ways.

> **More from the OECD:** The rise of non-standard work and its impact on inequality is examined in *In It Together: Why Less Inequality Benefits All* (OECD, 2015), *http://dx.doi.org/10.1787/9789264235120-en.*

First, it's associated with a "hollowing out" of the workforce. In effect, the proportion of people in the traditional "middle" of the workforce – permanent staffers, such as accountants, who have mid-level skills and perform routine tasks – has declined. Between 1995 and 2010, the share fell from 53% to 41% of the workforce in OECD countries. But the share of people working at the two ends of the skills spectrum – high-skill workers like designers and lower-skill workers like drivers – has increased, and they're increasingly likely to be part-timers, temps or self-employed. This trend towards a more U-shaped workforce is in itself likely to increase income inequality.

The second important link between non-traditional work and income inequality concerns the pay and conditions of such workers. At the low-end of the skills spectrum, especially, such workers typically have both lower *annual* earnings (because they're working shorter hours or enduring periods of unemployment between contracts) and lower *hourly* earnings than permanent workers. Such jobs are often associated with poorer working conditions and less stability, a combination that has led some to describe this class of workers as the "precariat".

So, why is non-traditional work growing? Numerous factors help to explain it. One is technology, which both increases demand for part-timers and temps and makes it easier to employ them. Another factor is the changing face of the workforce itself, notably the rising number of women going out to work. Either by choice or because they have no options, large numbers of women choose part-time work to help balance their career and family demands. A third factor is a weakening in the laws protecting temporary workers, especially in countries where protection of permanent workers remains strict. In labour forces split between strongly protected permanent "insiders" and weakly protected temporary "outsiders", employers may prefer to recruit temps, who can be hired and fired more easily in response to changing business conditions.

> **More from the OECD:** How can policy respond to the rise of the non-traditional job? The options are examined in *OECD Policy Brief: Adapting to the changing face of work, www.oecd.org/policy-briefs/Adapting-to-the-changing-face-of-work.pdf*.

Declining union membership

The past few decades have seen a general decline in membership of labour unions, which have traditionally worked to counter inequality among workers – "a fair day's wages for a fair day's work". In New Zealand, for example, union membership fell from about 70% of workers in 1980 to just 17% in the late-2000s. Declines in many OECD countries reflect a number of social and economic changes, including the loss of traditionally unionised businesses, like heavy manufacturing. They also reflect changes in labour laws in some countries that have weakened unions' bargaining power.

Has the decline in union membership fuelled income inequality in OECD countries? Probably, although the picture is not black and white. Firstly, declining membership doesn't automatically imply that unions' negotiating power is fading. In many countries, the pay and conditions of non-union workers may still be covered in union-led negotiations. Secondly, the cause-and-effect relationship may run both ways. Some economists argue that workers may interpret rising inequality as a sign that unions can't represent their interests and so are not worth supporting. In that sense, declining union membership could be both a result and a cause of rising inequality.

3.4. Societies: Love, life and inequality

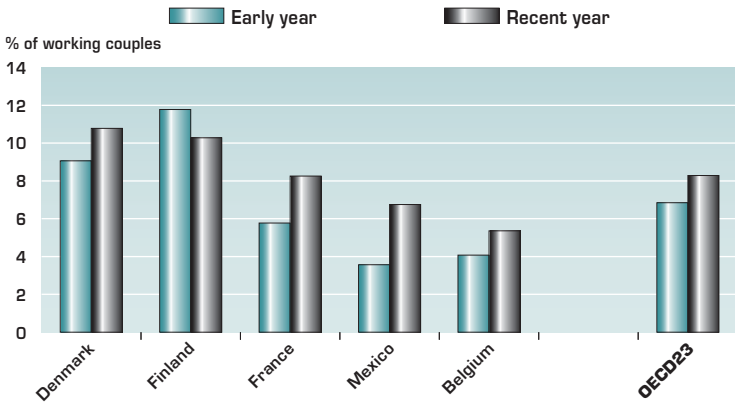
Changes in our societies are contributing to some extent in the rise in inequality. Possibly the most significant trends concern our relationships – are we married or single and, if we're married, is our partner earning a similar income?

Marrying people like us

People are now increasingly likely to marry or live with someone from a similar social background – a phenomenon that economists romantically refer to as "assortative mating". Today, in about 40% of working couples, both partners have very similar earnings; in the early 1990s, the proportion was about 33%.

Data: The proportion of people marrying partners with similar incomes has been rising in most OECD countries.

Percentage of workers in earnings decile with a spouse in the same decile, mid-1980s and mid-2000s



Source: OECD (2011), *Divided We Stand: Why Inequality Keeps Rising*, *http://dx.doi.org/10.1787/888932536515*.

This trend is, in part, a consequence of the welcome fact that women are now far more likely to have qualifications and careers that match or exceed men's. For example, not so long ago, a male doctor might have married a nurse; today, he's more likely to marry another doctor. The result is that a household that would once have brought in a doctor's earnings and a nurse's lower earnings today brings in two doctors' incomes, so concentrating higher incomes in fewer households.

Single-parent families

Another potentially significant social change is the rise in the number of single-parent families. In several of the Nordic countries and the United States, more than a quarter of families are led by single parents, and the average for OECD countries is around 20%; in the 1980s and early 1990s it was closer to 15%.

Media coverage tends to focus on families led either by low-income single-mothers or wealthy singletons but generalisations

are hard to make. Nevertheless, it's clear that – compared with two-parent families – single-parent families are more likely to rely on just one paycheque. And, in some countries, there's evidence that the proportion of single-parent families among low earners has been rising much faster than among higher-income groups. This puts such families at a double disadvantage: Not only are they relying on just one paycheque but that paycheque is not, relatively speaking, all that big.

> **More from the OECD:** Statistics on the size and shape of families can be found at the *OECD Family Database*, *http://www.oecd.org/els/soc/oecdfamilydatabase.htm*.

3.5. The state's role: Less regulation, less redistribution

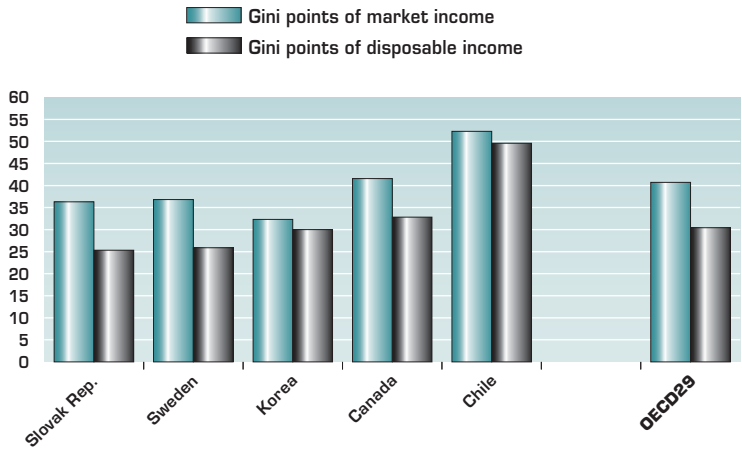
Policy decisions by governments play a big role in determining families' spending power. Some of these relate directly to our disposable income, such as the taxes we pay and the transfers, like unemployment benefits, that we receive. Some are only indirectly related to our incomes, such as the rules that regulate how markets work. These, for example, may increase competition in the marketplace but also reduce workers' job security and wage-bargaining powers.

Taxes and transfers

The wages we earn from our employers are only one factor – albeit an important one – in determining how much we have to spend on ourselves and our families. What really matters is what's left after we pay our taxes and receive state transfers – a total that economists refer to as disposable income. Taxes and transfers do much to reduce income inequality for two main reasons. Firstly, higher-wage workers tend to pay higher taxes than their lower-wage counterparts; secondly, lower-wage workers tend to receive more support from the state. Combined, these systems of taxes and transfers play a big role in narrowing income gaps.

Data: The taxes that workers pay to the state, and the transfers they receive, do much to narrow the earnings gap in OECD countries.

Inequality of market income (before taxes and transfers) and disposable income (after taxes and transfers) in OECD countries, late 2000s



Source: OECD (2011), *Divided We Stand: Why Inequality Keeps Rising*, *http://dx.doi.org/10.1787/888932536515*.

Up to the mid-1990s, taxes and transfers were tending to play a growing role in reducing inequality. But in the middle of that decade the pattern began to reverse. What happened? A key change seems to have come on the transfers side, especially a decline in spending on unemployment benefits. Unemployment fell, so fewer people were claiming benefits, while rules for claiming benefits were tightened.

What about taxes? In general they tended to fall, which typically would increase income inequality. However the picture is not as simple as that. On the one hand, some of the impact of this fall was cushioned by the fact that income taxes also became more progressive – if taxes fell on better-paid workers, they fell even more on lower-wage workers. On the other hand, very high earners ("the 1%") seem to have bucked this trend towards increasingly progressive taxation, enjoying a very considerable fall in their tax burden (*see* ***Section 3.6***).

Regulation

Up to the 1980s, OECD economies were generally more regulated than they are today. It wasn't unusual for a single national airline to have a monopoly on certain routes. In the decades since, most OECD countries have reformed the rules covering products, services and employment, with the aim of making their economies more dynamic.

Governments have also tended to take a more passive role in the labour market. In the past, wage rises were sometimes negotiated at a national level and there was relatively tighter regulation of how and when companies could let workers go. Today, market forces are generally allowed freer rein.

These reforms have not been universally welcomed but, by and large, they have helped boost the numbers of people in work. However, they have also tended to widen the wage gap, pushing down the wages of low-skill workers and pushing up the wages of high-skill workers. This happened for two main reasons. Firstly, the influx of new workers into the workforce included some very low-earners. Many of these – particularly part-time and temporary workers – are now covered by weaker employment protection laws than in the past. Secondly, in an increasingly competitive economy, skilled workers are increasingly in demand and can command higher wages.

Other policy areas

Governments can also influence income inequality through their policies in a wide range of other areas (*see* **Section 4.4**), including through their approaches to migration, the rules covering jobs and employment and, in particular, education.

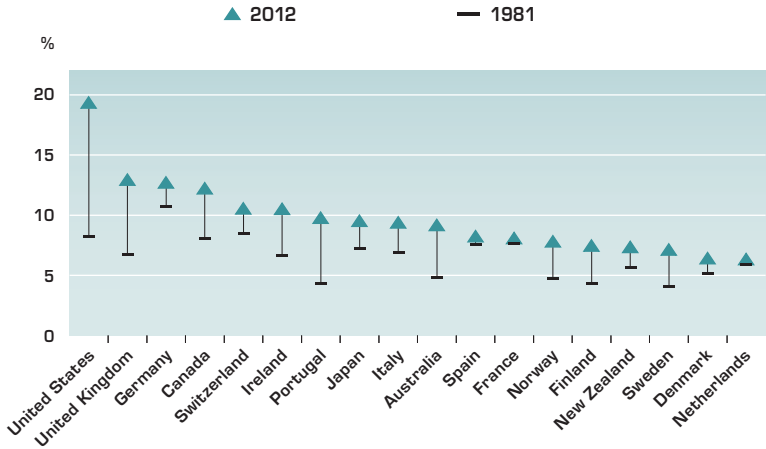
3.6. Top incomes: Why did the 1% get so rich?

Across much of the OECD, but especially in English-speaking countries, the share of national income taken by the top 1% of earners has risen, sometimes sharply, in recent decades. The rise

has been particularly striking in the United States: In 1980, the top 1% of income recipients in the U.S. earned 8% of all pre-tax income; by 2012, their share had risen to over 19%. Other OECD countries also saw big rises, including the United Kingdom and Australia.

Data: Top earners have increased their share of total earnings in most OECD countries since the 1980s.

Share of top 1% incomes in total pre-tax income, 1981-2012 (or latest year available)



Source: OECD (2014), "Focus on Top Incomes and Taxation in OECD Countries: Was the crisis a game changer?", *http://dx.doi.org/10.1787/888932965953*.

The rising income share of the 1% has become a hot issue, but some observers believe this focus actually misses much of the story of rising income inequality. As well as looking at the top 1% of earners, they argue, we should also look at an even smaller segment – the top 0.1% of earners (1 in 1,000), and even the top 0.01% of earners (1 in 10,000). As the Nobel laureate Paul Krugman has noted, data from the U.S. Congressional Budget Office shows that between 1979 and 2005, the after-tax income of Americans in the middle of the income distribution rose by 21%; among the 0.1% it was up 400%.

Understanding these figures is important if we want to develop a better picture of who's benefiting from economic growth. For example, in the decade to 2007, real household income increased by an average of 1.2% a year in the United States. But when the top 1% of earners is excluded, that figure falls to 0.6%. In effect, the 1% took 58% of the gain in real incomes. So, what looked to be an overall improvement in the population's economic well-being actually benefited a much smaller group than the broad figures seem to suggest.

And the winners are…

Some of the top earners are household names – sports stars like Serena Williams and entertainers like Jackie Chan and Taylor Swift – but most are not. In the United States in 2010, the largest group, about 41%, was made up of executives in non-financial businesses, like Apple and Walmart. Around 18% were employees – and not necessarily executives – in banks and finance houses. In the United Kingdom, the finance crowd accounted for about 21% of top earners and in France about 15%.

The fact that so many of the top earners work for a living is striking. Back in the early 20th century, when income inequality last reached the levels we're seeing today, much of the income of top earners came from rents on land and property as well as income from investments in government bonds. By contrast, today's top earners are more likely to be either a salaried employee, for example an executive like Morgan Stanley chairman James Gorman, or a company founder, like Facebook's Mark Zuckerberg.

> **More from *Insights*:** *Rich Man, Poor Man: Are "the 1%" worth it?,* asks the OECD Insights Blog, *http://wp.me/p2v6oD-1AR*.

Why do the 1% earn so much?

There's no single answer to why the 1% earn so much. Multiple factors have contributed to the rise of top incomes, and the significance of each of these is not the same in every country:

"Superstars" in a global economy: The labour market for high-skilled workers has gone global, especially in sectors like finance, where firms in financial centres like London and Singapore

may be competing to attract the same people. In this competitive labour market, employers seek to attract not just good employees but the very best. That helps explain why there can be a wide pay gap between those seen as being at the very top of their game and those just behind.

Technology has played a role in this process, in part by helping to build a global labour market for skilled workers. Technology also tends to serve as a complement for high-skilled workers, making them potentially even more valuable – think of financial traders who can carry out transactions worth billions of dollars at the touch of a button. But there are limits to how much of the rise of the 1% can be explained by technology. Many in the top 10% are also highly skilled, but have not enjoyed the gains of the 1%.

Changes in the way top earners are paid: The heavy presence of top executives and finance professionals among top earners is significant. In recent decades, and especially in English-speaking countries, a growing slice of their income has come not in the form of a monthly salary payment but as valuable stock options.

The idea of paying managers in stock options arose as a response to "the agency problem" – when you hire someone to run your business, how can you ensure they act in your interests and not their own? Most shareholders have a tenuous relationship, at best, with the firms in which they hold shares, so it can be almost impossible for them to oversee management and ensure it's working in their interest. Giving managers a stake in a rising share price, it's argued, helps align their interests with those of shareholders. Since the financial crisis, this line of thinking has come under fire. Many now argue that stock options can promote short-term thinking among managers, who may try to boost the firm's share price in the short run to make a quick killing, even if it hurts the firm's long-term prospects.

"Financialisation": Stock options are also widely used in the financial sector, which plays a growing role in modern economies – albeit, not always a positive one, say critics. And these days, finance is not short of critics. In part that's a response to financial crisis of 2008, which was preceded by decades of rapid growth in financial

services. For example, since the 1960s, credit by financial institutions, including banks, has grown at three times the pace of economic activity. Over the same period, stock markets also grew at a fast pace.

The rapid expansion of finance has contributed to income inequality in a number of ways, the most obvious being that financial sector workers tend to be very highly paid. In Europe, they account for 1 in 5 of the top 1% of earners even though, overall, they account for only 1 in 25 of the total workforce. These high salaries might be justified if such workers had very high levels of productivity. However, comparisons with similarly skilled workers in other sectors suggest this is not the case. Financial workers – particularly the highest earners – thus seem to enjoy a wage premium over other comparable workers.

> **More from the OECD:** The impact of finance on inequality is examined in "Finance and Inclusive Growth", an *OECD Economic Policy Paper*, *http://dx.doi.org/10.1787/5js06pbhf28s-en*.

"Too much finance" fuels income inequality in other ways, too. The wide availability of credit allows high earners to increase their borrowings, allowing them to gain more from investment opportunities than people on lower incomes. In addition, higher earners also benefit from the expansion of stock markets. That's because they are always more likely to hold shares than lower earners. As markets expand, they benefit more from share dividends and capital market gains.

To be sure, financial sectors are essential to ensuring that capital and resources flow from those that have them to those who need them and to help balance risk with reward. But there is increasing evidence that their usefulness diminishes at a certain point or when they favour certain activities over others – for example, providing credit rather than facilitating financing through stock markets. Not only are such financial sectors bad for inequality, they're also bad for growth – in effect, they deliver a larger slice of the benefits of economic growth to a small number of high earners, many of whom work in finance itself.

> **More from *Insights*:** Too much money is bad for you, says the OECD Insights Blog as it looks at the impact of finance on growth, *http://wp.me/p2v6oD-28k*.

Many now wonder about the size of the financial sector as it currently exists, its potential to destabilise the "real economy" – the manufacturing and services in which most people work – and the fact that it attracts too many of the "brightest and best" graduates, who might better serve humanity in professions like medicine or engineering. The economics commentator John Cassidy has summed up criticisms of those who work in financial centres like the City of London and on Wall Street with the observation that "if they retired to their beach houses en masse, the rest of the economy would be fine, or perhaps even healthier."

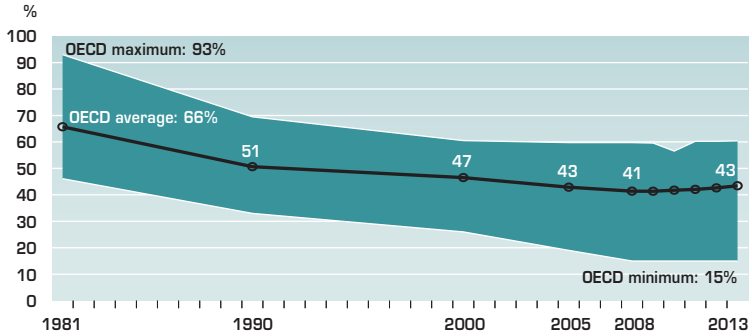
Changing pay norms: Societies differ in the extent to which they accept large income differentials. Implicit in these social norms is a trade-off: Stick to society's expectations and you preserve your reputation; breach the expectations and you'll earn more but hurt your image. But these norms can change over time and their influence can vary markedly. In much of the post-war period, there was an expectation that income differentials would be – by today's standards – relatively narrow. But in the 1980s these norms began fading, especially in English-speaking countries. By contrast, they still remain relatively strong in much of continental Europe, which has certainly played a role in limiting top incomes there.

Tax and pay: The past few decades have also seen substantial falls in top tax rates in many developed countries. Across OECD countries, the average top statutory tax rate fell from 66% in 1981 to 41% in 2008. High earners have benefited from other changes in tax regimes, too. Tax on property and on inheritances has tended to fall, allowing high earners to build up wealth.

As *The Economist* has noted, the usual justification for lower rates of tax on top earners is that it encourages growth: "Stop penalising success, goes the argument, and the economy will soar." But, as it has also noted, this link is not always supported by the evidence: "America's economy grew strongly in the 1920s and 1960s, when top rates were high. It fared better in the 1990s, when top rates increased

Data: Tax rates on top incomes fell substantially between the 1980s and the financial crisis.

Maximum, minimum and average statutory tax rates on top incomes in OECD countries, 1981-2013 (or latest)



Source: OECD (2014), "Focus on Top Incomes and Taxation in OECD Countries: Was the crisis a game changer?", *http://dx.doi.org/10.1787/888932965953*.

a bit, than in the 2000s, when they declined." Against that, many economists argue that there are limits to the amount of extra revenue that higher taxes can bring in. Higher taxes do inhibit growth, they argue, and they also increase the incentives for high earners to engage in aggressive tax planning, which allows them to reduce the share of income and wealth exposed to tax. (*see* ***Section 5.5***).

4

How does income inequality affect our lives?

Inequality affects economies and societies, with growing evidence that excessive inequality may be bad for growth. There are also concerns that inequality may dampen educational opportunities and social mobility.

Key themes

In 2012, Facebook founder Mark Zuckerberg exercised some of his stock options in the social-networking company. That decision cemented his position among the super-rich and prompted this rhetorical question: "How would the typical American end up better off if [...] Zuckerberg could not exercise his options?" asked Scott Winship, then a Fellow at the Brookings Institution.

That question goes to the heart of a key issue in economic inequality: If a few people get wealthy, does that hurt – or help – the economic prospects of everyone else and does it make our societies worse places to live? These questions aren't new: In Plato's *Republic*, written more than 2,300 years ago, discussion turns to what happens when a society is ruled by its elites: "... such a city should of necessity be not one, but two, a city of the rich and a city of the poor, dwelling together, and always plotting against one another."

The relationship between growth and inequality has long been an important question for economists, and a number of influential ***theories*** have emerged over the years. But for most people, the issue boils down to this: ***is rising inequality good or bad for growth?*** Those who believe it's good, or at least necessary, argue that it provides incentives to entrepreneurs and a source of overall investment for the economy. Those who believe it's bad argue that it can prevent poorer people from investing in their education and encourage the rich to grab a bigger slice of the economic pie without making the pie any bigger.

The impact of rising inequality on societies is also drawing concern: "The social compact is starting to unravel in many countries", OECD Secretary-General Angel Gurría has said. "Uncertainty and fears of social decline and exclusion have reached the middle classes in many societies."

Inequality is also a key issue in ***education***. Education can play a powerful role in providing opportunities for people from all sorts of backgrounds, but it can also reinforce existing economic divisions in society. The OECD's PISA programme has shown that some countries' education systems do a much better job than others in

helping students from poorer families achieve excellence. Inequality has other impacts on ***societies***, too, including reducing mobility and, some argue, fostering crime and harming people's health.

4.1. Theories: How economists think about inequality

Economists have long been interested in the idea that a country's level of development might help determine its level of inequality. One of the most famous theorists was Simon Kuznets, a Russian-American economist born at the start of the 20th century, who argued that inequality follows a natural trajectory as economies move further away from their agricultural roots.

Kuznets' hypothesis

According to Kuznets, inequality is low in pre-industrial societies, where most people live at subsistence levels. As industrialisation begins, however, gaps start to widen thanks to the rising earnings of factory workers compared to those of farmers, and they continue to grow with the emergence of increasing specialisation among industrial workers. But then, argued Kuznets, gaps start to narrow as the state begins collecting more taxes and distributing them as benefits.

Kuznets' hypothesis, as it became known, was influential in the 20th century, and the shape of inequality that it traced – an inverted-U – seemed to match the facts reasonably well. However, it's fared less well in recent years – rather than rising and then falling, the trajectory of inequality now appears to be more U-shaped: It was high at the start of the 20th century, fell in the middle of the century, but has been rising since the 1970s.

The apparent failure of Kuznets' hypothesis reflects another problem economists face in determining the link between inequality and growth – namely, if there is a link it doesn't appear to be direct. If it were, it would be possible – in theory at least – to figure out a country's growth rate from its level of inequality.

A complex and dynamic relationship

It's also possible to look at the relationship between inequality and growth from the opposite direction: Does inequality affect growth and, if so, how? The Harvard economist Richard B. Freeman is one of those who believe it does. He argues that inequality is good for growth – up to a point. But after that point, rising inequality means falling growth: "The few people with the skills or background to compete for the top jobs work hard", according to Prof Freeman, "while everyone else coasts because they have little or no chance of reaching the top." This argument makes a case for "optimal" inequality or, what some have called, "just-right inequality" – not too little, not too much.

Arguments like this underline the complexity of the link between inequality and growth. Not only is it a dynamic relationship, it's also – according to many economists – determined by the particular "shape" of inequality in each society. To explain, inequality can take different forms. Some societies may be divided between a rich elite and everyone else. Others may have relatively small numbers of rich and poor and a large middle class. These variations may determine the relationship between inequality and growth for two main reasons, according to researcher Sarah Voitchovsky. First, inequality may affect how different income groups *behave*. Second, it may affect how different social groups *interact*. Some examples:

If inequality affects how income groups **behave**…

- **The poor:** If there are large numbers of poor people, economic growth may be affected by their inability to invest in education and their lower health levels, among other factors.
- **The middle classes:** If inequality "squeezes" the middle class, it may reduce its demand for goods and services.
- **The rich:** If inequality means rising incomes among the rich, it could see them accumulate savings, which banks can then lend out, so increasing investment in the economy. Or, the rich may use their economic power to lobby against policies that don't serve their needs, for example investment in public health and education.

If inequality affects how different income groups **interact**…

- **Trust:** Higher inequality is probably associated with reduced trust, which may hurt business by imposing higher "transaction costs". For example, if a business trusts a customer, and vice versa, they may be able to agree a deal without expensive legal advice and contracts.
- **Social capital:** In an unequal society, people's network of social relationships – their social capital – may not extend beyond their own income group and so may not be useful in helping them to find work. Equally, elite groups may use their social networks to exclude "outsiders" from economic opportunities.
- **Social unrest:** Large wealth gaps can be associated with social conflicts, and with higher security costs, for both businesses and governments.
- **Volatility:** High levels of inequality may make it hard for societies to come to a political consensus, resulting in sudden policy shifts or governments serving the interests of their own supporters at the expense of the greater good.

This framework can be helpful when it comes to understanding how the link between inequality and growth is debated in the "real" world, where discussion typically boils down to this question: Is inequality good or bad for growth?

4.2. Economies: Is inequality good or bad for growth?

Rising income inequality has focused increasing attention on to whether it's helping or hurting growth. Is it, as some contend, a necessary evil that must be tolerated in the interests of economic growth? Or is it in itself an obstacle to growth? Here are some of the main arguments from both camps:

Inequality is good for growth…

Perhaps the most obvious way in which inequality drives growth is that it allows for entrepreneurs – like Apple's Steve Jobs or HTC's Cher Wang – to enjoy the rewards of their risk-taking.

"Imagine a society with perfect economic equality", the Harvard economist Greg Mankiw has written. One day, an entrepreneur comes up with a new product. "Everyone in society wants to buy it. They each part with, say, $100. The transaction is a voluntary exchange, so it must make both the buyer and the seller better off. But because there are many buyers and only one seller, the distribution of economic well-being is now vastly unequal. The new product makes the entrepreneur much richer than everyone else."

As Prof Mankiw goes on to point out, the society in this scenario is then faced with a set of choices, as much political as economic: Does it tax the entrepreneur heavily to curb income inequality but possibly also reduce her incentives to innovate. Or, does it leave things alone, so encouraging other entrepreneurs to take similar risks, with potential benefits for anyone who can make use of the resulting new products and services.

Proponents of the second option – light tax and relatively little redistribution – support their case with two arguments. The first is that allowing people to accumulate wealth means they become sources of investment for the economy. Writing about the build-up of inequality in Europe before World War I, J.M. Keynes stated that if the wealthy had frittered their money away on pleasure, "the world would long ago have found such a regime intolerable. But like bees they saved and accumulated, not less to the advantage of the whole community …".

The second argument, promoted most famously in the 1970s by the American economist Arthur Okun, is that there may be a trade-off between inequality and economic efficiency – in other words, attempting to reduce inequality beyond a certain level may lead a society to use its economic resources less efficiently than it could do. In a famous phrase, Okun theorised that money taken from the rich in taxes would be carried to the "the poor in a leaky bucket. Some of it will simply disappear in transit, so the poor will not receive all the money that is taken from the rich."

Inequality is bad for growth…

However the idea that there is a trade-off between inequality and efficiency is increasingly criticised, and there is rising evidence – from the OECD, IMF and others – that excessive inequality is bad for growth.

Recent OECD research indicates that this impact can be substantial. In OECD countries, the average increase in inequality of 3 Gini points over the past couple of decades is estimated to have cut GDP by around 8.5%.

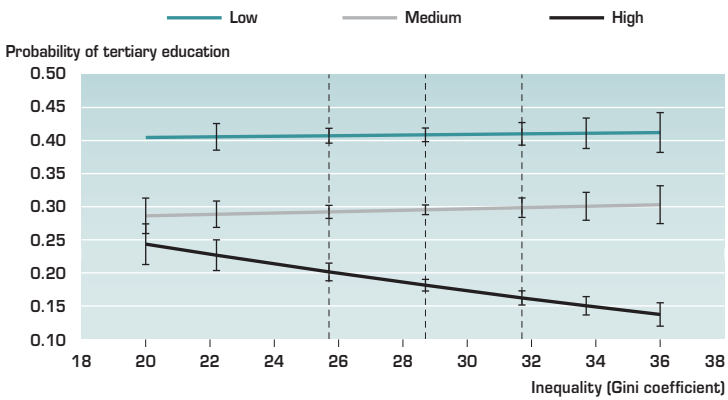
> **More from *Insights*:** "If a large swathe of the population is unable to invest in its skills, that's bad news for the economy", says the OECD Insights Blog, *http://wp.me/p2v6oD-1VR*.

So, what's happening? Numerous theories have been put forward to explain why inequality might be bad for growth (see below), but the OECD research centres in on one in particular – namely, that a widening wealth gap leads low-earning families to invest less in education and skills. This probably hurts growth by reducing the number of skilled – and more highly productive – workers available for hire in the economy.

The effect of inequality on people's human capital can be seen in the graphic below, which compares the numeracy skills of people from three backgrounds – families where the parents have high, medium and low levels of education. Here, parental education

Data: As inequality rises, numeracy skills of poorer people decline.

Average numeracy score by parental educational background (PEB)



Source: OECD (2015), *In It Together: Why Less Inequality Benefits All*, *http://dx.doi.org/10.1787/888933207742*.

background (or PEB) represents socioeconomic status, so in effect these three groups correspond to familiar social groups – well-off, middle-income and poorer people. The chart shows that as inequality rises, there is little change in the numeracy skills of people from well-off and middle-income backgrounds. However, there is a substantial decline among poorer people.

This effect is visible not just in maths skills. It can also be seen in the length of time people spend in education and employment – rising inequality has little impact on the numbers of people from better-off and middle-income families who graduate from university or on how they do in the job market. The same is not true for people from poorer backgrounds. As inequality rises, they become less likely to graduate from university and more likely to endure periods of unemployment.

Other research also supports the idea that there need be no trade-off between equality and a strong economy. According to economists Andrew Berg and Jonathan Ostry of the IMF, over the long term "equality appears to be an important ingredient in promoting and sustaining growth". They offer a number of reasons for why a growing gap between rich and poor could impede growth, including the possibility that it may create political and social instability, which, in turn, may deter investment. Social divisions fuelled by inequality may also make it more difficult for governments to find the necessary consensus in society to meet economic and financial crises.

> **More from the OECD:** The impact of inequality on growth is investigated in Chapter 2 of *In It Together: Why less Inequality Benefits All* (OECD, 2015), *http://dx.doi.org/10.1787/9789264235120-5-en*.

Critics have also linked high levels of inequality to rent seeking, which the economist Joseph Stiglitz has defined as "efforts that people take to get a larger share of the pie rather than to increase the size of the pie". This can happen in the political arena in both democratic and authoritarian systems. In democracies, wealthy individuals may use their ability to, say, fund political parties to influence policies in a way that benefits them; in authoritarian systems, says former IMF economist Simon Johnson, "governments and their private-sector allies commonly form a tight-knit – and, most of the time, genteel – oligarchy, running the country rather like a profit-seeking company in

which they are the controlling shareholders." Such tensions have long been recognised. Almost a century ago, the jurist Louis D. Brandeis declared, "We may have democracy, or we may have wealth concentrated in the hands of a few, but we can't have both."

Rent-seeking can also show up in the corporate sector: One example is the huge increase in pay and bonuses of top executives in big corporations and financial institutions (*see* **Section 3.6**), especially in English-speaking countries, which, some critics argue, have become increasingly detached from firms' actual performance.

Rising inequality may also skew an economy in ways that reduce overall middle-class demand for consumer goods or even fuel debt crises. For example, high earners may have a lot of surplus wealth that they need to find ways to invest. After all, says World Bank economist Branko Milanovic, "there is a limit to the number of Dom Perignons and Armani suits one can drink or wear". He argues that this is exactly what happened in the run up to the financial crisis: "Overwhelmed with such an amount of funds, the financial sector became more and more reckless, throwing money at anyone who would take it." On the other side of the coin, he argues, lower earners took advantage of banks' largesse to borrow money they couldn't afford to repay, thus fuelling a debt crisis.

4.3. Education: Reducing, reinforcing inequalities

Most OECD societies offer substantial educational opportunities to all citizens regardless of income. But in practice, while education systems can be a force for social mobility (*see* **Section 4.4**) they can also reproduce and reinforce a society's existing pattern of wealth distribution. On average in most countries, children from middle-class and wealthy families do better in school, are more likely to go to university and, eventually, earn more as adults.

Richer families can invest more

Some of these differences in learning opportunities come from outside the formal education system and, arguably, are becoming

more pronounced amidst rising income inequality. Some may even emerge before the child is born, when the health of the mother and availability of good nutrition can affect foetal development. And many of these advantages continue throughout the child's life. For instance, there's some evidence of a growing gap in investment in "enrichment" – spending on books, childcare, non-school activities – between rich and poor parents.

> **More from *Insights*:** Find out why it's "never too early to join the rat race" at the OECD Insights Blog, *http://wp.me/p2v6oD-1ws*.

According to Miles Corak, an academic, spending per child in this area among American families in the bottom fifth of the income distribution rose by just over 55% between the mid-1970s to around $1,300 in the mid-2000s. Among the top fifth, however, it rose by over 155% to $9,000 per child. Coupled with other advantages of coming from a well-off family – such as the likelihood that they can invest more in formal education and provide valuable social connections later in life – this early investment in enrichment is considered by many to be widening the education gap between rich and poor.

Social divisions in the classroom

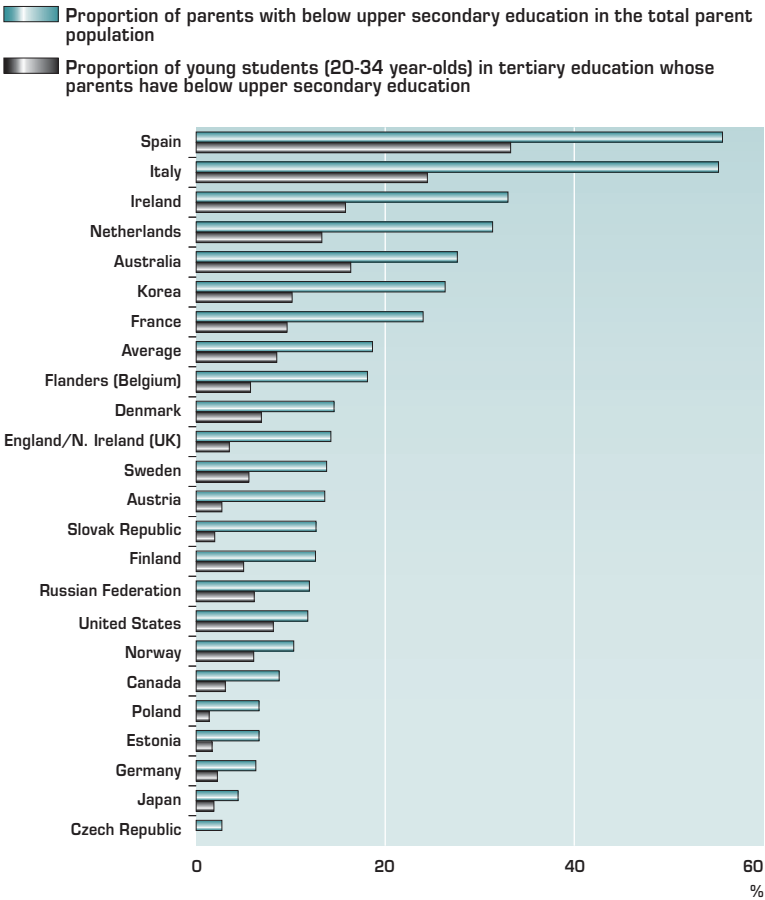
Education systems, too, can reinforce social distinctions by offering a lower quality of education or a narrower range of options to children from disadvantaged families. For example, schools with large numbers of disadvantaged students tend to find it harder to attract qualified teachers, even though – or, perhaps, because – the challenges of teaching children from disadvantaged families may be greater.

And in many countries, children from differing social backgrounds are essentially taught separately. That's despite evidence from the OECD's Programme for International Student Assessment (PISA) that combining children from different social backgrounds, and of different abilities, tends to raise overall performance without bringing down the performance of the strongest students. This segregation can happen because most schools tend to serve a particular area. But it can also happen if students are streamed into different classes by ability – weaker students are more likely to come from disadvantaged backgrounds.

Whatever the causes, the impact of social background on students is clearly evident in results from PISA, which surveys the performance of 15-year-old students worldwide in more than

Data: Young people whose parents didn't finish secondary education are themselves underrepresented in university-level education, indicating that inequalities in access to education persist from one generation to the next.

Participation in tertiary education of students whose parents have below upper secondary education (2012)



Source: OECD (2014), *OECD Education at a Glance 2014*, *http://dx.doi.org/10.1787/888933115654*.

65 countries. Across OECD countries, students from better-off families are almost a year ahead on average in maths compared to students from poorer families, according to PISA 2012.

> **More from the OECD:** PISA's findings on the inequality and equity in education are explored in *PISA 2012 Results: Excellence through Equity* (OECD, 2012), *http://dx.doi.org/10.1787/9789264201132-en*.

Who goes to university?

Social background also has a clear impact on who goes on to higher education. For example, in all OECD countries, the children of parents who did not attend university are themselves less likely to study at tertiary level. On average in OECD countries, the proportion of young people from families with low levels of education who are studying in university is only around half what it would be if social groups were proportionally represented in tertiary education.

Overcoming inequalities

It's striking, however, that some countries and some education systems do a much better job of minimising the impact of social differences in education *(see* **Section 5.2***)*. In PISA 2012, around 6% of disadvantaged students were "resilient" – in other words, they overcame social disadvantage to perform well in PISA. But in some countries, notably in East Asia, the proportion of resilient students was at least double this. These findings suggest that the right policies can do much to reduce the impact of social background in education.

4.4. Society: Inequality may hold people down

Many people fear that inequality has a corrosive effect on societies, making them worse places to live in, not just for the poor but also the rich. There are several different strands to this line of thinking. One is that inequality reduces social mobility – it's harder to climb the economic ladder if the rungs are growing further apart. Another strand is the possible impact of inequality on people's well-being – everything from health to happiness.

Back to The Great Gatsby

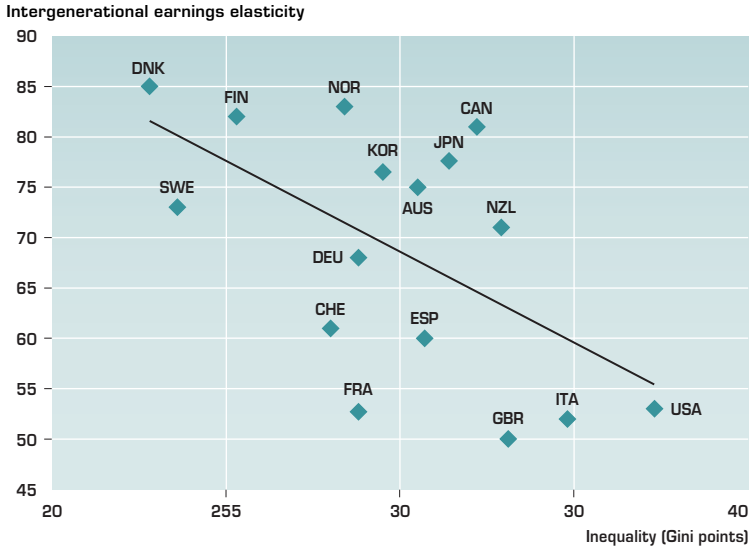
It's no surprise to learn that economic advantage passes down through generations. But, thanks to recent research, it's become clearer just how long these advantages can linger – perhaps for at least half a millennium. Researchers at the London School of Economics, for example, found that students with surnames like Baskerville and Mandeville, which can be traced back to the Norman invaders who took control of England in the 11th century, had attended the country's most exclusive universities, Oxford and Cambridge, continuously for around eight centuries. By contrast, students with "lower status" surnames were enrolled with much less consistency. The phenomenon is not restricted to the United Kingdom. Economist Gregory Clark has found evidence of the persistence of rigid class structures in societies as diverse as Japan, the United States and even China.

Do these intergenerational advantages linger longer in more unequal societies? Some researchers argue that they do, and for evidence they point to a piece of research that draws its title from an earlier period of soaring inequalities, the 1920s. "The Great Gatsby curve", named after the eponymous hero of F. Scott Fitzgerald's 1925 novel, compares inequality with social mobility in a number of wealthy countries. It suggests that in more unequal societies, people are less likely to rise – or fall – out of their slot in the income scale, especially if they are among the top or bottom fifths of earners. In effect, if you're born really rich or really poor you're likely to stay that way. The result of this, according to an OECD report, is that it "can stifle upward social mobility, making it harder for talented and hard-working people to get the rewards they deserve".

However, this research is not without its critics. For one thing, there are major data issues at the national level in pulling together statistics on mobility, and at the international level in producing numbers that can be compared between countries. And, as with so much in this area, correlation does not necessarily imply causation. For example, the relatively high rates of social mobility in many Nordic countries may partly reflect the fact that their societies have historically been relatively homogenous, reducing the potential impact of barriers like ethnicity that may restrict social mobility in other countries.

Data: Charts like this – similar to "the Great Gatsby curve" – suggest that countries with higher levels of inequality have lower rates of social mobility.

Inequality and mobility (intergenerational earnings elasticity) across OECD countries



Source: OECD (2015), *In It Together: Why Less Inequality Benefits All*, *http://dx.doi.org/10.1787/888933207806*.

How's life?

What about the impact of inequality on other aspects of our lives? The OECD has explored some of these issues in its How's Life? project, which explores well-being and quality of life issues. It has identified specific ways in which inequality can reduce people's well-being, for example by fuelling crime: As *How's Life 2013* noted, "…socio-economic inequality seems to play a central role in the occurrence of criminal victimisation as disadvantaged people are more likely to perpetrate and to be victims of crimes." And there may be a general correlation, too, between overall well-being and inequality: "Overall well-being is positively associated with low socio-economic differences in well-being measured by income or educational inequality."

Fierce debate

But linking inequality to specific social issues can be challenging, in part because it can be hard to distinguish the impact of inequality from that of poverty. For example, for a range of reasons, including weaker nutrition and lack of access to adequate healthcare, poorer people tend to suffer more health problems. But in a highly unequal society, might there also be special factors at work? The answers to these questions are important. Policies that target poverty, such as special payments to low-income families, may not be the same as those that target inequality, such as much higher taxes on high earners.

At the moment, the idea that inequality causes a range of social and medical problems is hotly debated. For example, the British epidemiologists Kate Pickett and Richard Wilkinson, have argued that there is indeed a special link between inequality and what *The Economist* described as "all manner of social ills … more crime, higher infant mortality, fatter citizens, shorter lives, more teenage pregnancies, more discrimination against women and so on." They argue that when humans perceive themselves to be socially inferior it leads to the release of the hormone cortisol. This, in turn, elevates blood pressure and blood sugar levels, which can cause a number of medical conditions. The social consequences of stress, it's argued, may lie in cortisol's tendency to override other socially useful hormones, such as oxytocin, which plays a key role in the formation of trust relationships. However, this research has been attacked, both for data reasons but also, say critics, because the cross-country comparisons fail to take a range of unrelated factors into account, like national diet and genetics.

An independent review of the research, commissioned by the Joseph Rowntree Foundation in the United Kingdom, probably gives the best summary of current thinking. It concludes that there is a consensus around the idea that inequality and health and social problems are *correlated*. However, it adds, "There is less agreement about whether income inequality causes health and social problems independently of other factors, but some rigorous studies have found evidence of this." Given the general rise of inequality, it seems likely that research in this area will continue.

5

How can governments respond to income inequality?

Government policy can respond to rising income inequality in many different areas, with a particular focus on three policy areas – education, jobs and taxes and transfers.

Key themes

At the heart of the inequality debate lies a deeper question: Who benefits from economic growth? It's become clear in many OECD countries that the benefits of economic growth are increasingly not being evenly shared. To some extent, this trend reflects fundamental changes in the global economy. But this is not to say that our societies can't – or shouldn't – respond by trying to make growth more inclusive.

An important way of achieving this is through government action. This may mean rethinking ***policy goals*** to better balance the pursuit of prosperity with broader social and environmental progress and to ensure opportunity is widely spread. This sort of approach asks us some fundamental questions about how we measure progress. It can also confront us with some difficult choices between policies that may be good for growth but not for well-being.

In seeking to make growth more inclusive, governments must work across a wide range of policy areas. One of the most important is education, which is key to determining each individual's life chances. That's why education policy needs to address the needs of young ***people from pre-school to university***, ensuring they get the best start in life and the support they need throughout their education.

Education is closely tied to ***skills and training***, and these, in turn, increasingly determine people's ability to earn a decent living. That's why policy must work to ensure workers have the training they need and that workers can make the best use of their talents in the workforce.

Work is also key to reducing inequality and to ensuring that families don't get trapped in poverty – an issue that has become a focus of serious concern in many OECD countries since the financial crisis. As well as building the economic conditions for job creation, policy needs to aim to ***get people into the workforce***, especially women and young people.

A final area of policy focus is ***taxes and transfers***, or the money that the state gives and takes. In developed economies, taxes and

transfers do much to reduce inequality, although there is room in many countries to improve their performance. That may mean better focusing assistance on those who need it most and limiting tax breaks and allowances that disproportionately benefit high earners.

5.1. Policy goals: Growth, well-being or both?

In recent decades, a rising share of the benefits of economic growth in many countries has flowed to people who are already at the top of the economic pile. This trend has led many to question the focus of economic policy – should it aim for growth for its own sake, and hope that it "lifts all boats"? Or should it aim explicitly for more inclusive growth – ensuring the fruits of growth are spread more evenly and that economic goals are balanced with a wide range of social and environmental objectives?

More than growth

Economic growth is, naturally enough, usually a key policy goal. It's essential if societies are to pay for things like healthcare, education, public parks and so on. But a rise in GDP – the most widely used measure of economic progress – is not necessarily a sign that all is going well. For example, it can disguise underlying problems – such as build-ups of unsustainable debt – that may eventually trigger a painful reversal.

Single-minded pursuit of growth also risks eroding the resources necessary to sustain growth. This issue is especially evident in one of the world's economic powerhouses, China. Less than 1% of China's 500 biggest cities meet the World Health Organisation's air-quality guidelines, according to the Asian Development Bank. The tensions inherent in China's rapid growth have been recognised by the government, with Premier Li Keqiang stating that "we shouldn't pursue economic growth at the expense of the environment."

Less obviously, unbalanced economic growth can fuel income instabilities that threaten social stability and undermine future growth by curbing the ability of poorer families to invest in skills and education (*see* ***Section 4.2***).

Measuring our societies' well-being

If rising GDP isn't an automatic indicator of progress, then what is? That question has been asked increasingly in recent years amid rising concern that our societies aren't always very good at measuring what really matters. "What we measure affects what we do", a report by the distinguished economists Joseph Stiglitz, Amartya Sen and Jean Paul Fitoussi stated in 2009, "and if our measurements are flawed, decisions may be distorted."

GDP – or "gross domestic product", a very widely used measure of economic activity – has borne the brunt of the criticism, albeit not always fairly. After all, it was never designed as a measure of well-being. And even as an economic measure, it offers only a very limited sense of whether people are managing to make ends meet. That's true too of measures derived from GDP, such as GDP per capita (which divides the size of an economy by the size of the population): "If inequality increases enough relative to the increase in average per capital GDP, most people can be worse off even though average income is increasing", the Stiglitz-Sen-Fitoussi commission noted.

That's why we need to dig beneath the data to determine if growth – rising GDP – really is inclusive, or bringing wide benefits. Data on inequality and poverty can help us do that *(see **Chapter 1**)*. But we can also look beyond pure income and inequality data to develop a broader sense of how people's lives are evolving.

Over the years, various measures have emerged that aim to provide this broad sense of the state of our societies. Among them is the Human Development Index, produced by the United Nations Development Programme. It uses a single number to indicate the level of a country's development, based on three separate indicators: income; life expectancy, which reflects the state of people's health; and years spent in education. In 2012, the index scored Norway – where life expectancy exceeds 81 years – as first in the world for human development; by contrast, Niger, where life expectancy is just 55 years, was ranked 186th.

The OECD also examines broader issues of well-being in its Better Life Index, which rates a wide range of developed and emerging economies for their performance in 11 areas, including housing,

income, education and life satisfaction. Some countries score well for average household disposable income (*see* **Section 1.2**), such as the United States, Luxembourg and Switzerland, but do less well on the Better Life Index's broader measures of well-being. Others, such as Australia, Sweden and Canada, may have lower income rankings but rank higher on "happiness" issues like work-life balance and life satisfaction.

> **More from the OECD:** The OECD's Better Life Index lets users compare well-being across countries based on 11 topics identified as essential in terms of meeting people's material needs and ensuring a decent quality of life, *http://www.oecdbetterlifeindex.org/.*

Inequalities that go beyond income

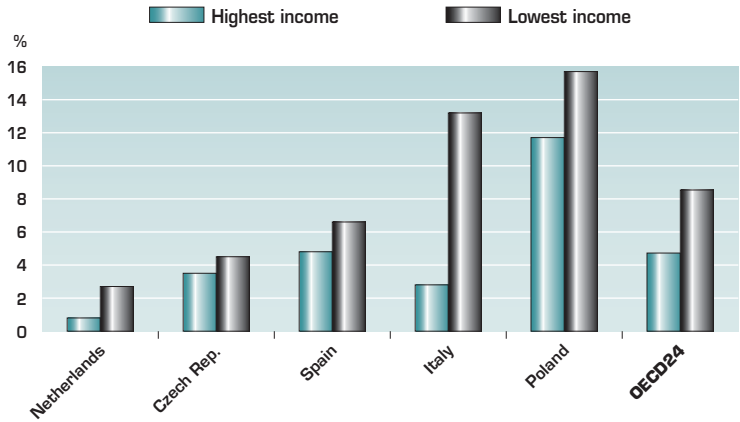
But looking at national figures only takes us so far. Broad measures of "well-being" may not shine a light on significant inequalities within societies in areas like health and access to healthcare and education. These inequalities can be striking. In Scotland, for example, the life expectancy of a boy in Lenzie, a fairly affluent town on the outskirts of Glasgow, is about 82 years, according to data quoted by the World Health Organisation. Twelve kilometres away, in the deprived Calton area, a boy can expect to live to just 54.

As well as such health inequalities, most countries have inequalities in access to public services like healthcare and education. Across OECD countries for which there is data, low-income adults are always less likely to have seen a dentist in the previous 12 months. Similarly, low-income adults are less likely to undergo screening for breast, colorectal and cervical cancers. Access to education can also show sharp divergences depending on people's family background (*see* **Section 4.4**).

All this highlights the reality that policies targeting inequality and inclusive growth need to go beyond just supplementing people's incomes. For example, policy may need to focus more on supporting young people from poorer families in education and on creating health and lifestyle programmes specifically targeted at low-income groups.

Data: People on lower incomes are more likely than those on higher incomes to report that they have not been able to meet their care needs. Cost is the most commonly cited obstacle.

Unmet care needs for medical examination by income level, European countries, 2011



Source: OECD (2013), *Health at a Glance 2013*, *http://dx.doi.org/10.1787/888932918643*.

Policy trade-offs – hard choices

So, the policy response to inequality and to making growth more inclusive is complex and multidimensional, and can involve initiatives across a range of fronts – taxation, health and education policy, labour markets and so on. But it can also involve some tough choices. Some policies may be good for growth and good for reducing inequality – a win-win. That's usually the case for policies that improve people's access to education and, especially, that improve the quality of early childhood care and education *(see* ***Section 5.2****)*.

By contrast, certain forms of taxation may be good for growth but bad for inequality. For example, economists typically argue that indirect taxes – such as consumption taxes like VAT – have a much smaller impact on economic activity than direct taxes, like income tax. However, from the perspective of income inequality, indirect taxes tend to hit lower earners proportionately harder than higher earners, and so typically add to inequality *(see* ***Section 5.4****)*.

> **More from the OECD:** Potential trade-offs between growth and equality are examined in *Economic Policies 2012: Going for Growth*, *http://dx.doi.org/10.1787/growth-2012-en*.

These examples help underline an important point about inequality: Many of the key policy decisions have less to do with economic decisions and more to do with politics – or, the way in which power is exercised in societies and collective decisions made. The choices societies take often reflect the extent of their "taste" for inequality. Some may favour a policy mix that seeks to narrow the income gap as much as possible; others may prefer policies that incentivise economic "winners" to push for growth.

5.2. Education: From pre-school to university

Social background is strongly linked to how well children and young people do in education (*see* ***Section 4.3***). But, as the OECD's PISA studies show, this "rule" can be broken. Every country has examples of children from disadvantaged families who excel in their schooling. Equally, some countries are much better than others at reducing the impact of social background in education. But for this to happen, care and education policies need to be effective across young people's lives, starting in their very earliest years.

There are a couple of "big ideas" that can help frame any discussion of the role of education in countering inequality. One is the idea of equity, which, in turn, is built on two key principles: Fairness, or ensuring that a person's own background or circumstances – such as gender, ethnicity or family situation – are not allowed to limit their success in education; and inclusion, a broad concept that boils down to the idea that everybody – regardless of background – should develop certain basic skills through education (see below). The second big idea is quality. That means good schools, but it also means overall education systems that meet the needs of students and that provide them with a full range of options to meet their individual capacities and aptitudes.

Pre-school care and education

In recent decades, there's been growing recognition of the importance of children's very earliest years in determining their lifelong development. The advantage that children from better-off families enjoy in these early years can be substantial, but some of this gap can be bridged by providing children from less-advantaged families with high-quality day-care and pre-school.

In countries with higher levels of enrolment in day-care and pre-school and higher levels of spending, social background appears to play a smaller role in influencing how well students do in secondary school. There are other benefits, too. Where high-quality and affordable childcare is available, parents – and especially mothers – may find it easier to go out to work, which can help reduce poverty and raise employment rates.

Such programmes are not always universally popular, in part because returns from investment in the care and education of very young children can take a long time to materialise. But, when they do, they can be greater than almost any form of investment in young people. As the economist James Heckman has argued, young people who benefit from early childhood care and education have a whole lifetime to reap the benefits. In addition, learning at a very young age makes it easier to go on learning throughout life, enabling people to go improving their skills and education.

> **More from the OECD:** Volume III of *Starting Strong* examines the challenges of providing high-quality pre-school care and education, *http://dx.doi.org/10.1787/9789264123564-en*.

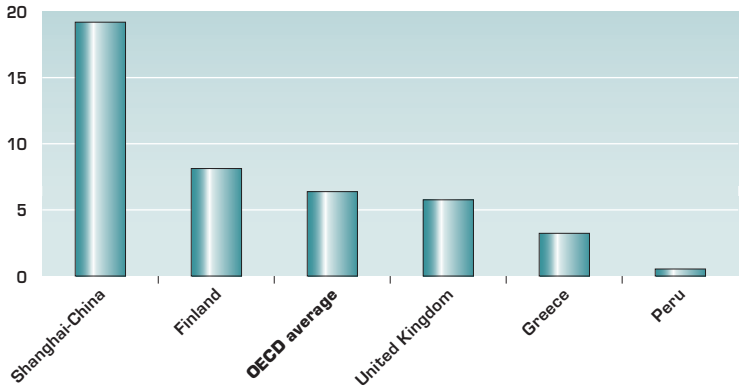
Quality, however, is key, and needs to underpin the regulation of pre-school care and the design of curricula and learning goals. It also needs to be evident in the staffing of care and education centres – research shows that children do better in the care of well-qualified staff, who have the knowledge and skills needed to create a stimulating environment in which children learn and develop through play.

Equity in education

Some of the most important insights into equity in education – ensuring fairness and opportunity for all young people – have come from the OECD's PISA programme. These three-yearly assessments of 15-year-old students in more than 60 countries show clearly that some educational systems do much better than others in lowering socio-economic barriers to success. One marker of this is the proportion of "resilient" students – young people who "beat the odds" and perform better than their family background might predict. In a number of East Asian economies and countries, more than 15% of students are resilient, according to PISA 2012; by contrast, the average for OECD countries is just over 6%.

Data: The proportion of resilient children – or children who do better in PISA than their social background might indicate – varies greatly.

Percentage of resilient students among all students, PISA 2012



Source: OECD (2013), *PISA 2012 Results: Excellence Through Equity (Volume II): Giving Every Student the Chance to Succeed, http://dx.doi.org/10.1787/888932964813.*

Over the years, PISA has highlighted several factors that promote equity in education. Chief among these are teachers. "Nowhere does the quality of a school system exceed the quality of its teachers", says Andreas Schleicher, who runs the OECD's PISA programme. Many of the most successful school systems have

figured out how to attract the most talented teachers to work in disadvantaged schools. They also understand that, while it's important to set ambitious learning goals for students, it's also important to train teachers so that they can understand each child's needs, and then personalise their teaching in ways that meet these needs. It's also essential to support teachers throughout their careers by encouraging collaboration and mutual learning among teachers in schools as well as continuous professional training and development.

> **More from the OECD:** Find out what teachers themselves think of their working conditions and schools with the OECD's Teaching and Learning International Survey (TALIS), *http://www.oecd.org/edu/school/talis.htm*.

PISA has also highlighted a number of other factors that are associated with successful school systems. One of these is inclusiveness, an idea that covers a lot of ground. Encouraging inclusiveness can mean educating children with disabilities in regular classrooms; it can also mean educating children from poorer and better-off families together; and it can mean delaying the "streaming" of children into different programmes. In some countries, social background has traditionally been as important a factor as aptitude in determining whether a child is directed towards an academic or a vocational education. That sort of approach risks devaluing vocational education, which should be an attractive option in every country's education mix, and unfairly limits the choices of young people.

> **More from the OECD:** Findings from PISA on equity in education are presented in *PISA 2012 Results: Excellence through Equity*, *http://dx.doi.org/10.1787/9789264201132-en*.

Who's represented in education?

Young people from poorer backgrounds are underrepresented in tertiary education. One indicator of this can be seen in the student make-up of universities and colleges. If enrolment in tertiary education accurately reflected the general population, there would be almost twice as many young people from families with parents

who have low levels of education (i.e. who didn't complete secondary education). Of course, many young people from poorer families do make it to university, but even here the influence of social background is apparent. There is evidence that many attend low-status, rather than elite institutions; enrol in short programmes leading to vocational degrees, such as vocational therapy, rather than long programmes, like medicine; and are particularly underrepresented in advanced tertiary education, such as doctoral programmes.

Many of the barriers to disadvantaged young people entering tertiary education have their roots not in financial constraints – although these can certainly be a factor – but in the fact that they don't have the right qualifications. This only underlines the importance of moving early to support young people throughout pre-school and compulsory education; delaying until they are at the age to enter university is likely to represent a lost opportunity. Career guidance is also important during secondary schooling to ensure parents with low levels of education and their children understand the potential benefits of tertiary education.

> **More from *Insights*:** Education's power to drive social mobility is weakening, says the OECD Insights Blog, *http://wp.me/p2v6oD-1Pj*.

Education systems also shouldn't limit future student's future options early on in their school careers by putting them on an exclusively vocational education track. The benefits of offering opportunities for vocational education are increasingly recognised, especially for students who might otherwise drop out of school. However, entry into vocation education is all too often determined solely by social background. Children, especially from disadvantaged families, may be put on a vocational track when they're as young as 10 or 12, effectively closing off academic options at an age when their interests and aptitudes are still not fully developed. That's why there should be plenty of doors in the walls separating academic and vocational secondary education to ensure students aren't overly restricted in their choices.

5.3. Skills: Equipping workers for change

One of the significant drivers of income inequality is the expanding pay gap between high and low-skilled workers (*see* ***Section 3.3***). It's clear that workers with relatively weak skills will continue to face increasing challenges in the modern economy. According to economists Carl Benedikt Frey and Michael Osborne, 47% of existing jobs in the United States are under threat from computerisation. Many of these will be routine office jobs, but, as artificial intelligence advances, even high-level tasks will face increasing competition from computers.

> **More from *Insights*:** *Will a robot take your job?*, asks the OECD Insights Blog, *http://wp.me/p2v6oD-1NQ*.

But you don't need to look into the future to see the cost of insufficient or outdated skills, both for national economies and individuals. Nationally, the wage gap between high and low-paid workers tends to be narrower in countries where skills are more evenly distributed across the workforce. For individuals, low skill levels are linked to higher rates of unemployment and lower incomes. They are also linked to other unwelcome outcomes, including a greater likelihood of health problems and lower levels of social engagement (although the cause-and-effect relationship is not necessarily straightforward).

Ensuring that people are equipped to thrive in the economies and societies of tomorrow is a process that needs to start in the earliest years of life and then continue throughout young people's formal education. But the task doesn't end once young people leave education. Throughout people's working lives, government policies need to encourage continuous investment in training, ensure that people who want to work can work, and ensure a better match between people's abilities and the jobs they actually do.

Developing skills

Even at the height of the Great Recession, some employers had problems hiring. In Greece in 2010, for example, the unemployment rate of almost 18% was exceeded by the percentage of businesses

reporting recruitment difficulties, 41%. The reasons for such mismatches are complex. Potential hires may be living in the wrong part of the country or may be deterred by low pay or poor conditions on offer. Or they may lack the qualifications businesses are looking for.

These complexities underline the need to develop a clear picture of who can do what in the workforce, which, in turn, can guide the design of policies that boost people's job prospects. Some policy approaches are fairly obvious. For example, young people are likely to benefit from high-quality training that takes them out of the classroom and into the workplace. This can help ensure that they develop not just "hard" skills on real equipment but also "soft" skills like teamwork. Less obviously, tax systems can be designed to provide businesses and individuals with incentives to invest in training.

> **More from the OECD:** *The OECD Skills Strategy* aims to help countries create and make the best use of high-quality skills, *http://dx.doi.org/10.1787/9789264177338-en*.

Putting skills to use

For a variety of reasons, many people with useful skills are deterred from working. That's a particular issue for women but also for other groups, such as workers reaching the ends of their careers. In Iceland and New Zealand, more than three-quarters older people (55 to 64) are still in the workforce; in a dozen other OECD countries, the proportion is below half.

In many cases, people decide that it just doesn't pay to work. Costly childcare is a particular obstacle for many women (*see* **Section 5.5**), but so is the lack of job flexibility, such as part-time working. For older workers, pension systems may effectively encourage them to retire early by limiting the financial benefits of working beyond their mid-50s. As populations age, governments have been increasingly tightening rules that encourage workers to retire early. In New Zealand, for example, the proportion of older people still at work rose from 44% in 1990 to 76% in 2010.

Matching skills with jobs

Young people may find it particularly difficult to make effective use of skills and training. As well as suffering higher rates of unemployment, they frequently find themselves in unstable jobs that don't match their qualifications and offer little job security. Long-term unemployment at an early age risks "scarring" young people, resulting in a lifetime of weakened job prospects.

> **More from the OECD:** Find out how young people can get their working lives off to a good start in the OECD's Jobs for Youth project, *http://dx.doi.org/10.1787/9789264096127-en*.

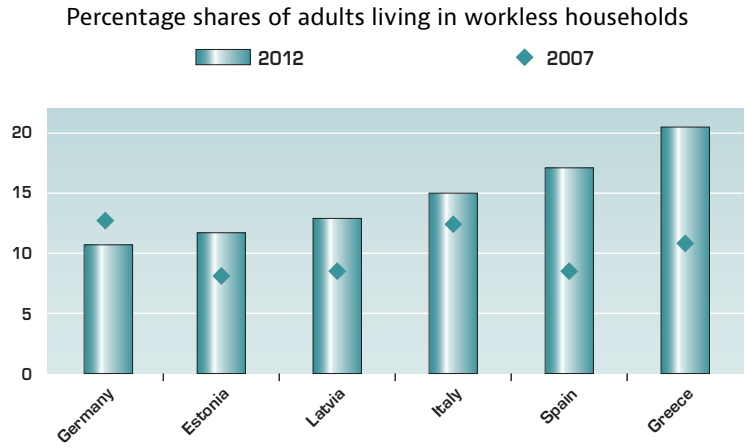
Government policies can work to discourage hiring-and-firing rules that penalise young people compared with other groups. They can also provide financial incentives to help overcome employers' resistance to hiring relatively inexperienced young people. Policies can also work to encourage entrepreneurship and innovative start-ups, which have a strong record in job creation and may offer work that's well-matched to young people's abilities.

5.4. Jobs: Getting more people into work

It's by no means the only answer to inequality and poverty, but work can go a long way to securing people's economic fortunes and putting them on a firm footing. "Employment can provide not just a salary but an opportunity for people to grow, to develop new skills and ambitions and to feel useful in society", according to an OECD *How's Life* report.

The role of work is brought into even sharper focus when it's in short supply, as it has been since in recent years. The impact of the jobs crisis can be seen in the rise in many OECD countries in the percentage of people living in "workless" households. In a number of Eurozone economies – Greece, Ireland and Spain – the percentage of people living in families where no one is working has doubled since 2007, while in several other countries it's up by at least 20%.

Data: After the financial crisis struck, some countries saw rises in the numbers of people living in households where no one is working.



Source: OECD (2014), *OECD Society at a Glance 2014*, *http://dx.doi.org/10.1787/888932965953*.

Families where no one is working are more likely to fall below the poverty line, and children living in such families may face a lifetime of disadvantage. To combat these ill-effects, it's important not just to get laid-off workers back into jobs but also to encourage employment among certain groups that are underrepresented in the workforce, most notably young people, people with long-term disabilities and – especially – women.

In-work poverty

But while work is probably the single most effective response to poverty, in recent years there's been concern that its power may be waning. There are several reasons for this. One is the existence of "in-work poverty", where workers earn too little to lift themselves above the poverty line.

What causes in-work poverty? Low wages and insufficient working hours are obvious factors. It's also linked to job instability, where people may move frequently between low-paid jobs and unemployment. Indeed, recent decades have seen the emergence of

a growing division in many workforces between workers with highly stable contracts and those on temporary contracts, who often have little job security and are at risk of repeated bouts of unemployment between jobs. The number of adults working in the household is also a factor. Typically, in-work poverty is lower where two or more adults work rather than one.

Policies for more and better jobs

What can governments do to get more people into the workforce? Creating the right economic conditions for job creation is clearly essential to ensure that there's a strong demand for workers. But policy can also help to ensure there are strong incentives for people to find work. In the area of unemployment benefits, this can mean shifting from "passive" state support, which may focus solely on the payment of benefits, to more "active" support. With this sort of approach, the state provides services like job-search support and training while making benefits payments contingent on people demonstrating that they're committed to finding work.

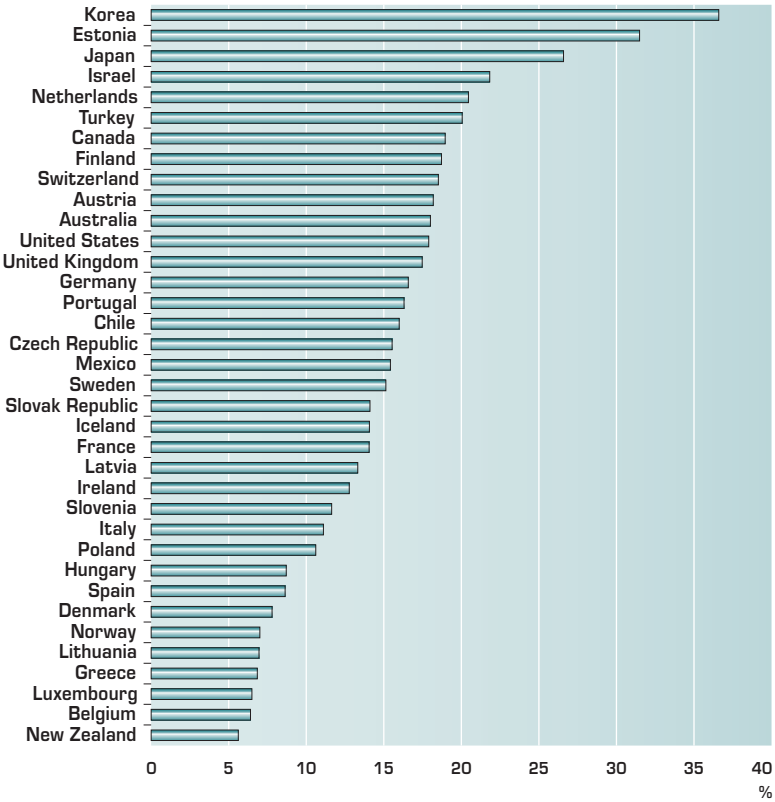
Specific policies can also help tackle the needs of groups that are underrepresented in the workforce, including women and young people, as well as particular groups of workers, like part-timers and temporary staffers.

Women: Women are a growing presence in the workforce and are steadily narrowing the gap with men in terms both of employment and earnings. For example, over the past 20 years, the employment gap between men and women – that's the percentage of working men minus the percentage of working women – has narrowed by 7 percentage points. However, the gap still stands at 16 points. And that doesn't take account of the fact that more women work part-time than men. When that difference is factored in, the employment gap widens to close to 24 points.

Gaps also persist in pay, although these, too, have narrowed. Since 2000, the pay gap between full-time male and female employees has narrowed from around 18 points in OECD countries to around 15 points. However, this average conceals very big differences between countries, ranging from above 36 points in

Data: The pay gap between women and men is narrowing, but still stands at around 15 percentage points on average, and is around double that in some countries.

Wage gap between male and female full-time employees, OECD average, 2013 or most recent year.



Source: OECD Gender Data Portal, http://www.oecd.org/gender/data/genderwagegap.htm.

Korea to below 6 points in New Zealand. Other gaps persist, too: Around 83% of women work in the services sector compared with just 34% of men. Women are also much less likely to be in senior roles – in 2013, only just over a third of managers were women in OECD countries. There are gaps, too, when it comes to childcare – a significant factor for many women in determining whether they

work full-time, part-time or at all. Women still carry the heaviest burden of childcare: On average in OECD countries, women spend just over 4½ hours a day on unpaid work – chiefly childcare and housework – around double the average for men.

> **More from the OECD:** The *OECD Gender Data Portal* is a source for data on gender inequalities in education, employment and entrepreneurship, *http://www.oecd.org/gender/data*.

As well as the social and equality arguments for encouraging female employment, there are also many economic justifications. Not the least of these is that, broadly speaking, rising female employment has acted as a brake on rising income inequality. True, it hasn't halted the rise, but it has tended to slow it. If the proportion of households with working women had remained at the levels of the early 1990s, income inequality in the OECD would have increased by almost 1 Gini point more on average, i.e. by 4 rather than 3 points. In addition, the impact of more women working full time and narrowing the pay gap with men added another brake of 1 point.

To ensure even more women can enter the workforce and make the most of their career options, continued efforts to combat discrimination and remove barriers to female employment and career progression will be needed.

> **More from the OECD:** The *OECD Gender Recommendations* set out policy principles to level the playing field between women and men in education, employment and entrepreneurship, *http://www.oecd.org/gender/C-MIN(2013)5-ENG.pdf*.

Because of the burden of childcare that traditionally falls on women's shoulders, support for parents is also key to encouraging more women to enter the workforce. The OECD's Babies and Bosses project identifies the Nordic countries, which have very high rates of women in work, as a model. Traditionally, they've offered a continuum of support to families, from when children are very young and still at home, and then on to childcare and into pre-school, school and after-school activities. But other countries have also taken important strides in supporting parents to better share childcare duties. For example, Germany, Italy and France now

all offer "use it or lose it" leave to new fathers. Businesses, too, can play a role by offering greater flexibility in when – and where – workers carry out their duties and a more understanding attitude when parents need to take time off to care for children.

Young people: Compared to the rest of the population, young people are about twice as likely to be unemployed. Young people who experience prolonged unemployment can face a lifetime of reduced earnings and career possibilities. The needs of the young are looked at in the OECD's Jobs for Youth project, which recommends a range of policy approaches. These include moving quickly to provide young people with job-search assistance; strengthening apprenticeship and vocational programmes for young people with low skill levels; and providing financial incentives for businesses hiring young and low-skilled workers. Second-chance programmes for school dropouts are also important to ensure young people develop the skills they need to avoid dead-end work.

> **More from the OECD:** The state of vocational education and training is examined in *Skills Beyond School*, *http://dx.doi.org/10.1787/9789264214682-en*.

Supporting temps and part-timers: The traditional permanent 9-to-5 job is declining in OECD countries. Since the mid-1990s, more than half of all jobs created in OECD countries were in temporary and part-time work and in self-employment – what's sometimes called "non-traditional" employment. For a variety of reasons, this trend is tending to increase income inequality *(see* ***Section 3.3****)*. Because relatively high numbers of women and young people are in non-traditional jobs, policies targeted at these groups are likely to have a significant impact on a large share of the non-traditional workforce. But additional policies may also be needed, for example targeted social spending, such as in-work benefits, to reduce the numbers of working poor. Policies should also work to help ensure that temporary contracts become stepping stones to career progression rather than dead ends.

> **More from the OECD:** The impacts of rising female employment and non-standard employment on income inequality are examined in *In It Together: Why Less Inequality Benefits All* (OECD, 2015), *http://dx.doi.org/10.1787/9789264235120-en*.

5.5. Taxes and transfers: What the state gives and takes…

Even if the term may not be in everyday use, tax and transfer systems are familiar to most people. The "tax" part needs little explanation, for now; the "transfer" part essentially covers payments made by the state, such as unemployment and family benefits. These days, complex tax and transfer systems are a feature of life in developed – and, increasingly, in developing – countries. They have many different social and economic objectives, but, from the perspective of income inequality, the main concern is over how much they redistribute across society. The extent to which this happens is determined by three main factors:

- **Size:** Simply, the amount the state takes in taxes and distributes in transfers.
- **Mix:** Some tax and transfer systems rely more on income taxes rather than consumption taxes, say, or pay out more in family benefits than in pensions. This "mix" helps determine overall redistribution.
- **Progressivity:** "Progressivity" is most easily explained in relation to taxes. A tax is progressive when it means that higher earners pay out a bigger *share* of their income than lower earners. By contrast, it's regressive when it hits lower earners proportionately harder than higher earners.

How transfers contribute to redistribution

Most – but not all – transfers are made through welfare systems, the roots of which can be traced back to Otto von Bismarck, the 19th century Prussian statesman. In a speech in 1884, he outlined his vision of state support: "Give the working man the right to work as long as he is healthy; assure him care when he is sick; assure him maintenance when he is old." The Iron Chancellor was not acting solely out of benevolence. In that same speech, Bismarck made it clear that he was mainly interested in curbing the appeal of socialism. Today's welfare systems have a broader scope than in Bismarck's day, thanks in part to the influence of the "Beveridge Plan", a programme designed by Lord Beveridge in the United Kingdom

in 1942 that led to the creation of the first unified social security system. These days, they can be said to have the following broad objectives:

- **Smoothing out people's incomes across their lives:** Welfare systems often provide people with pensions, funded – at least in part – by the taxes or social contributions they paid during their working lives.
- **Helping people cope with the unexpected:** Welfare systems provide support to people during crises such as job loss or sickness and disability.
- **Limiting the impact of poverty or reducing income inequality:** Welfare systems use a mix of two main approaches: Means-tested support to people on very low incomes and universal benefits, regardless of family income, such as child support.

As well as direct transfers, like unemployment benefits, states also make non-cash transfers through public services. For example, in most OECD countries, education is free or heavily subsidised until at least the age of 15. These public services have an important impact on families' finances: If the value of these services were translated into cash, the average annual household income in OECD countries in the late 2000s would have risen from around $22,000 a year to $28,000. Public services also play a major role in reducing income inequality, reducing it by between a fifth and a third, depending on the measure of inequality used.

Since the mid-1990s, tax and transfers systems have tended to become less redistributive in OECD countries, largely because of changes on the benefits side. Benefits have become less generous, eligibility rules have been tightened and transfers to the lowest income groups haven't kept up with earnings.

> **Go deeper:** OECD economists look at the role of taxes and transfers in reducing income inequality, *http://dx.doi.org/10.1787/eco_studies-2012-5k95xd6l65lt*.

Some transfers redistribute more than others

When it comes to redistribution, not all transfers are the same. Some significant transfers, such as pensions, can play only a fairly small role in redistribution (although the impact can vary depending on how it's measured). In part that's because, in many countries, a large slice of workers' pension payments are funded by money they themselves paid to the state during their working lives – in that sense, some pension systems may be regarded as delivering deferred earnings rather than redistributing income across society. Other factors also play a role. For example, lower-paid workers typically live shorter lives than their higher-paid peers. As a result, they may not draw down pension payments for as long as their better-paid and longer-lived peers and so, essentially, subsidise the pensions of higher-paid workers. Other transfers are typically more redistributive, for example family cash benefits. But as with so much in this area, a lot can depend on the benefit is designed – for example, whether it's means-tested or universal.

How taxes contribute to redistribution

Just as with transfers, the reasons why governments impose taxes go well beyond just redistributing income. Taxes help fund all the operations of government, including building schools and hospitals, paying for a bureaucracy and providing defence. They can also be used to guide certain behaviours: For example, cigarette and alcohol taxes aim to encourage healthier lifestyles.

While people generally think of transfers as the main means for redistributing income, the tax system itself can also play an important role. In the United States, for example, tax credits provide significant support for lower-paid workers. Typically, they allow taxpayers to directly cut their tax bill if they meet certain conditions, such as being a parent. In some countries, low earners can even receive a tax refund if their tax credits exceed their tax bill. Along with allowances and tax breaks, tax credits are a form of tax expenditure. This is another way of saying that governments sacrifice some of their potential tax take in return for pursuing social and economic goals, such as expanded home ownership, regional investment or support for specific business sectors.

Some taxes are more progressive than others

Overall, personal income taxes tend to be among the most progressive forms of taxation in OECD countries. And even though top rates of tax have been falling, they've become more progressive in recent years. That's been driven not by higher taxes at the top but by increases in tax credits and cuts in social security contributions for lower paid workers. But, equally, some tax credits – and tax expenditures more broadly – are moving against this trend towards greater progressivity. This happens especially when higher earners get substantial tax breaks on things like health and child care and retirement savings.

Other taxes can be less progressive and, in some cases, even regressive. One example is consumption taxes, such as value-added tax, or VAT. Because poorer households tend to consume a bigger slice of their income than wealthier households, who save more, they tend to be hit disproportionately by consumption taxes. Many countries try to address this by limiting consumption taxes on essentials like food. While this does help poorer families, it also benefits their wealthier counterparts.

Policy approaches

Few areas of policy pose quite so many challenges as the design of tax and transfers systems, in part because of their complexity and the fact that they serve a very wide range of social and economic goals, not just redistribution. As a result, they are often the subject of intense political debate, and reaching a consensus can be a challenge.

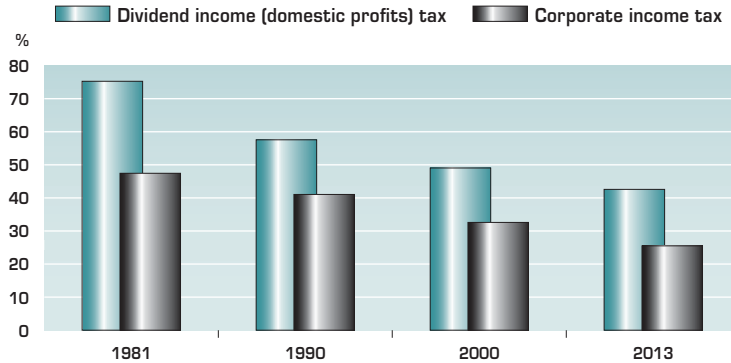
Nevertheless, from the point of view of income inequality, a number of ideas have emerged in recent years that seek to improve the performance of tax and transfer systems. On the transfers side, the budget squeeze facing many OECD governments makes it more important than ever to ensure that public spending delivers maximum benefits. This may strengthen the case for increasingly targeting payments on low-income families.

Similarly, recognition of the role of work in lifting families out of poverty and in building valuable social connections has shifted attention to in-work benefits. These can encourage people to take up

work and help reduce levels of in-work poverty. And the role of non-cash transfers – such as spending on education and healthcare – should not be forgotten. Education spending needs to be targeted in ways to ensure that as many people as possible can access a high-quality education.

Data: Taxes that affect mainly top earners have gone down.

Dividend income and corporate income statutory tax rates, OECD average, 1981-2013



Source: OECD (2014), "Focus on Top Incomes and Taxation in OECD Countries: Was the crisis a game changer?", *http://dx.doi.org/10.1787/888932965953*.

On the taxes side, there has been growing discussion around the idea of changing the tax treatment of top earners, which has tended to become more generous since the 1980s. Even without increases to top rates of tax, there is room in many countries for scaling back some tax deductions and credits that tend to benefit higher earners disproportionately. There may also be room for taxing benefits like stock options as ordinary income. Again, these sorts of benefits tend to be enjoyed disproportionately by high earners. Other approaches include making greater use of property and wealth taxes, such as inheritance taxes, and harmonising the way tax systems treat regular income and income from capital, which tends to be taxed less heavily.

Conclusions

Income inequality is a complex subject that is sometimes reduced to overly simple explanations. The reality, as this *OECD Insights* has attempted to show, is that its causes are diverse. They can vary depending on whether we're looking at the rising incomes of "the 1%" or the growing gaps between, say, very low earners and the rest of the population. Equally, the consequences of rising inequality are multifaceted, and may be reflected in the pace of economic growth, reduced social mobility and, perhaps, even our health. Clearly, there is no single solution to harmful impacts of income inequality. A comprehensive response may require action across a broad swathe of policy areas, including in education, employment policy and taxes and transfers.

What is the future for income inequality? On the face of it, the outlook is not encouraging. Some of the most important drivers of inequality look increasingly to be embedded in our economies and societies. As one OECD paper recently noted, "the growing importance of skill-biased technological progress for growth and rising demand for higher skills will lead to continued polarisation of the wage distribution". It forecast that by 2060, and without a change in policy approaches, inequality in the *average* OECD country will match that found today in the most unequal countries.

But, of course, policy approaches can, and do, change. We take for granted much of the social and economic infrastructure that surrounds us – mass education, basic healthcare, social security. But there was a time when little of this existed. It came about because societies recognised the need to respond to changing circumstances. Rising inequality is certainly a changing circumstance, and there's no shortage of signs that more and more of us feel the need to respond. As Chrystia Freeland, a journalist and Canadian politician, has written, "Not so long ago, inequality was a dirty word. [Now] inequality hasn't merely become a subject fit for polite company, it has become *de rigueur*." But talking about a problem is one thing, finding solutions is another. Again, however, the examples of how societies have repeatedly acted to improve people's lives should give us reasons to be optimistic. As the economist Anthony Atkinson has

written, "The world faces great problems, but collectively we are not helpless in the face of forces outside our control."

Ultimately, the question for our societies is this: How much inequality are we prepared to accept? This goes to the heart of our attitudes to wealth and poverty, to inclusion and exclusion, to social mobility and immobility. Economics will no doubt play a part in how our societies formulate a response. But, fundamentally, these questions are political. Not in the sense of party politics, but in the sense of how our societies work collectively to make decisions that affect the lives of everybody, be they rich or poor.

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