Divided We Stand: Why Inequality Keeps Rising

The gap between rich and poor has widened in most OECD countries over the past 30 years. This occurred when countries were going through a sustained period of economic growth, before the Great Recession. What will happen now that 200 million people are out of work worldwide and prospects of growth are weak? New OECD analysis says that the trend to greater inequality is not inevitable: governments can and should act.

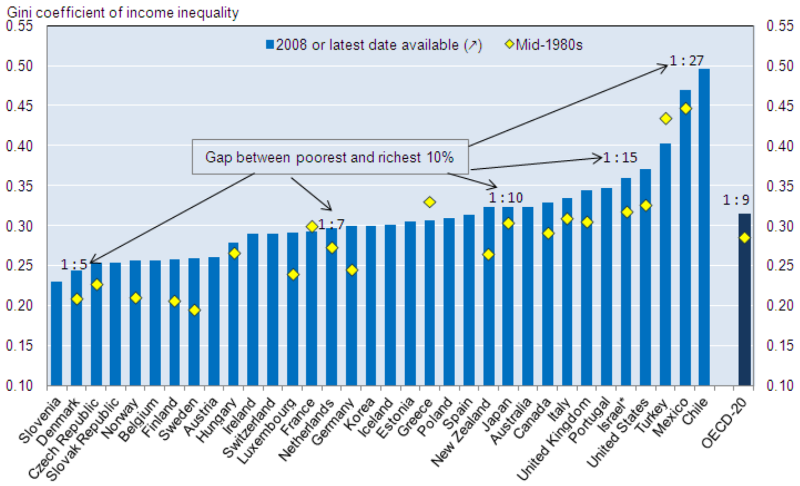
The landmark 2008 OECD report *Growing Unequal?* showed that the gap between rich and poor had been growing in most OECD countries. Three years down the road, inequality has become a universal concern, among both policy makers and societies at large. The new OECD study *Divided we Stand: Why Inequality Keeps Rising* reveals that the gap between rich and poor has widened even further in most countries.

Today in advanced economies, the average income of the richest 10% of the population is about nine times that of the poorest 10%. Even in traditionally egalitarian countries – such as Germany, Denmark and Sweden – the income gap between rich and poor is expanding – from 5 to 1 in the 1980s to 6 to 1 today. It's 10 to 1 in Italy, Japan, Korea and the United Kingdom, rising to 14 to 1 in Israel, Turkey and the United States and reaching more than 25 to 1 in Mexico and Chile.

The Gini coefficient, a standard measure of inequality, where zero means everybody has the same income and 1 means the richest person has all the income, stood at an average of 0.29 for working-age persons in OECD countries in the mid-1980s. By the late 2000s, it had increased by almost 10% to 0.316.

Figure 1. Huge differences in income gaps between rich and poor across OECD countries

Levels of inequality in the latest year before the crisis and in the mid-1980s, working-age population



Note: The Gini coefficient ranges from 0 (perfect equality) to 1 (perfect inequality). Gaps between poorest and richest are the ratio of average income of the bottom 10% to average income of the top 10%. Income refers to disposable income adjusted for household size. * Information on data for Israel: *http//dx.doi.org/10.1787/888932315602.*

Source: OECD Income Distribution and Poverty Database (www.oecd.org/els/social/inequality).

Using this measure, inequality rose in 17 of the 22 OECD countries for which long-term data series back to the 1980s are available. It climbed by more than 4 percentage points in Finland, Germany, Israel, Luxembourg, New Zealand, Sweden, and the United States. Inequality remained relatively stable in France, Hungary, and Belgium while there were declines in Greece and Turkey and, more recently in Chile and Mexico, but from very high levels.

A sustained period of strong economic growth has allowed emerging economies to lift millions of people out of absolute poverty. But the benefits of strong economic growth have not been evenly distributed and high levels of income inequality have risen further. Among the BRICs, only Brazil managed to strongly reduce inequality. But the gap between rich and poor is still at 50 to 1, five times that in the OECD countries.

What is driving the increase of income inequality?

The OECD's new report *Divided We Stand: Why Inequality Keeps Rising* is taking a fresh look at these questions. The single most important driver has been greater inequality in wages and salaries. This is not surprising: earnings account for about three-quarters of total household incomes among the working-age population in most OECD countries. The earnings of the richest 10% of employees have taken off rapidly, relative to the poorest 10% in most cases. And those top earners have been moving away from the middle earners faster than the lowest earners, extending the gap between the top and the increasingly squeezed middle-class.

The largest gains were reaped by the top 1% and in some countries by an even smaller group: the top 0.1% of earners. New data for the United States, for example, show that the share of after-tax household income for the top 1% more than doubled, from nearly 8% in 1979 to 17% in 2007. Over the same period, the share of the bottom 20% of the population fell from 7% to 5%.

The study reveals a number of surprising findings:

- **First**, globalisation had little impact on both wage inequality and employment trends. Even though trade flows between countries around the world have been increasing rapidly, companies have been investing more and more directly in other countries, and imports from emerging economies, such as China and India, have surged, these trends were not major drivers of inequality in OECD countries.

- **Second**, technological progress has been more beneficial for workers with higher skills. People with much-demanded skills to deal with the new information and communication technologies or skills specific to the financial sector, for instance, have enjoyed significant earnings and income gains while workers with low or no skills have been left behind. As a result, the earnings gap between high- and low-skilled workers has been growing.

- **Third**, regulatory reforms and institutional changes increased employment opportunities but also contributed to greater wage inequality. These reforms were carried out to strengthen competition in the markets for goods and services and to make labour markets more adaptable. The good news is that more people, and in particular many low-paid workers, were brought into employment. But the logical consequence of more low-paid people in work is a widening distribution of wages.

- **Fourth**, Part-time work increased, atypical labour contracts became more common and the coverage of collective-bargaining arrangements declined in many countries. These changes in working conditions also contributed to rising earnings inequality.

- **Fifth**, the rise in the supply of skilled workers helped offset the increase in wage inequality resulting from technological progress, regulatory reforms and institutional changes. Raising the skills level of the labour force also had a significant positive impact on employment growth.

- **Sixth**, changing family structures make household incomes more diverse and reduce economies of scale. There are more single-headed households today than ever before; in the mid-2000s, they accounted for 20% of all working-age households, on average, in OECD countries. In couple households, employment rates of the wives of top earners increased the most. And in all countries, marriage behaviour has changed. People are now much more likely to choose partners in the same earnings bracket: so rather than marrying nurses, doctors are now increasingly marrying other doctors. Again, all of these factors contributed to higher inequality but much less so than the changes in the labour markets.

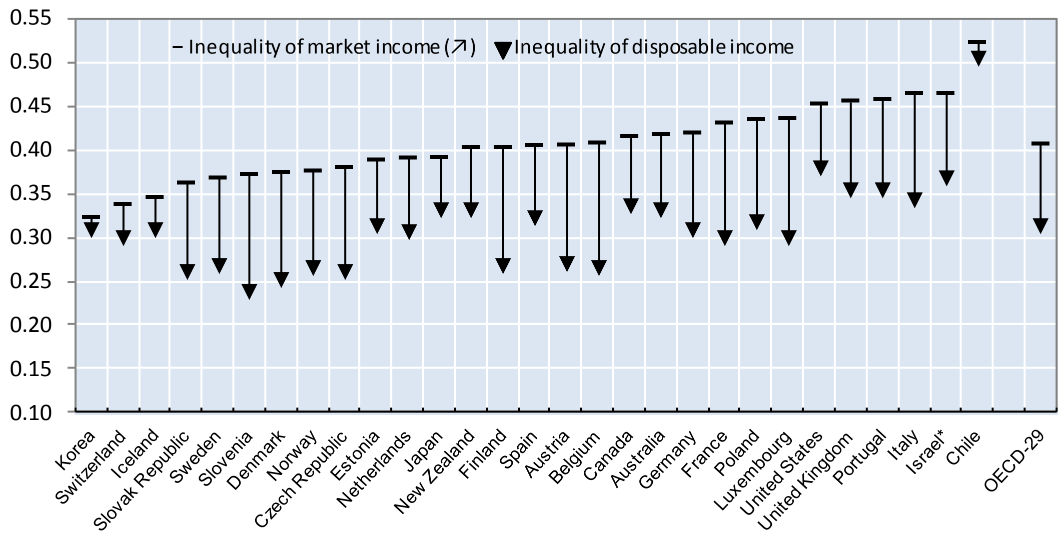
- **Seventh**, the distribution of non-wage incomes has generally also become more unequal. In particular, capital income inequality increased more than earnings inequality in two-thirds of OECD countries. But at around 7%, the share of capital income in total household income still remains modest on average.

- **Last but not least,** tax and benefit systems have become less redistributive in many countries since the mid-1990s. Currently, cash transfers and income taxes reduce income inequality by one quarter among the working-age population. The main reasons for the decline in redistributive capacity are found on the benefit side: cuts to benefit levels, tightening of eligibility rules to contain expenditures for social protection and the failure of transfers to the lowest income groups to keep pace with earnings growth all contributed.

Many of the driving forces of income inequality are the same in both emerging and OECD economies. But the setting is not the same. Emerging economies have large informal sectors: workers who are outside of social-protection systems and generally in low-paid, low-productivity jobs. Informal employment remains stubbornly high in many emerging economies despite strong overall economic growth. In these countries, disparities between ethnic groups and regions, rural and urban populations, and migrant and non-migrant workers are also significant.

Figure 2. Market incomes are distributed more unequally than net incomes

Inequality (Gini coefficient) of market income and disposable (net) income in the OECD area, working-age persons, 2008 (or closest)



Note: Market incomes are all gross incomes from earnings, savings and capital.

* Information on data for Israel: *http//dx.doi.org/10.1787/888932315602.*

Source: OECD Database on Household Income Distribution and Poverty (www.oecd.org/els/social/inequality).

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Why should policy makers worry?

The economic crisis has added urgency to the debate. The social contract is starting to unravel in many countries. Youths who see no future for themselves feel increasingly disenfranchised. They have now been joined by protesters who believe that they are bearing the brunt of a crisis for which they have no responsibility while people on high incomes appear to have been spared.

Rising income inequality creates economic, social and political challenges. It can jeopardise social mobility: intergenerational earnings mobility is low in countries with high inequality such as Italy, the United Kingdom and the United States, and higher in the Nordic countries, where income is distributed more evenly. The resulting inequality of opportunities will affect economic performance as a whole. Inequality can also fuel protectionist sentiments. People will no longer support open trade and free markets if they feel that they are losing out while a small group of winners is getting richer and richer.

What can policy makers do?

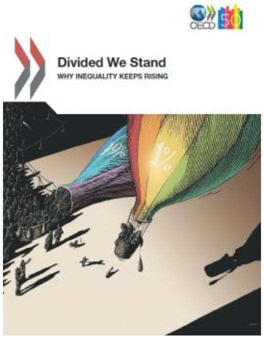
The most promising way of tackling inequality is through boosting employment. Fostering more and better jobs, enabling people to escape poverty and offering real career prospects, is the most important challenge for policy makers to address.

Investing in human capital is key. This must include the early childhood period and be sustained through compulsory education. Once the transition from school to work has been accomplished successfully, there must be sufficient incentives for workers and employers to invest in skills throughout the working life.

Even though taxes play a lesser role for redistribution, the growing share of income going to top earners means that they now have a greater capacity to pay taxes. Governments may consider raising marginal tax rates on income as a direct route to achieving this goal, but this might not be the most effective measure to raise tax revenues. Other measures include improving tax compliance, eliminating tax breaks; and reassessing the role of taxes on all forms of property and wealth, including the transfer of assets.

Providing freely accessible and high-quality public services, such as education, health, and family care is also important, especially for emerging economies. On average, OECD governments spend as much – some 13% of GDP – on public social services as they do on all cash benefits taken together, and this spending reduces inequality by about one fifth on average.

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



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