Why Is Inequality Rising?

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Introduction

Back at the turn of the century, few would have imagined that an issue long seen as the preserve of left-wing cranks and mild-mannered Utopianists would become one of the hottest economic and political issues of our time. But that is precisely what has happened to income inequality. In this era of slow growth and economic uncertainty, no international gathering is complete without at least a nod towards widening income gaps. For example, when the legendary "Davos Man" (and painfully few women) arrived in Switzerland for the World Economic Forum in 2015, income inequality was described as "top of the agenda".

But you don't have to climb to the top of a Swiss mountain to find unease about the growing gap between rich and poor. Back in 2011, the Occupy movement in New York gathered around a slogan that would soon go global: "We are the 99%." According to *The Guardian*, there were subsequently more than 750 similar protests worldwide. There have been other signs, too. *Capital in the Twenty-First Century*, a 700-page tome on wealth inequality by the French economist Thomas Piketty, was a bestseller in several countries after its publication in 2013. And according to a 2015 survey by the Pew Research Centre, majorities in 44 countries polled described the gap between rich and poor as "a big problem". Even billionaires admit to feeling troubled: property tycoon Li Ka-shing has spoken of sleepless nights as he contemplates widening inequality in wealth and opportunities, which "if left unaddressed, could fast become 'the new normal'".

So why are so many people worried about inequality? The simple explanation is that, in many of the world's wealthiest countries the rich do indeed *seem* to be getting richer while many others, especially those on low incomes, *feel* that they are struggling to keep up.

Surging Ahead & Falling Behind

How accurate are those perceptions? From a global perspective, income inequality is actually falling. As the Serbian-American economist Branko Milanovic has shown, that's largely because of the emergence of a vast and reasonably prosperous "middle class" in China and some other emerging economies since the late 1980s, which has lifted hundreds of millions out of poverty. However, when we shift our focus to the situation *within* countries, we find that inequality is often rising. That's true, too, in OECD countries — the traditionally wealthy countries, including the United States and Canada, most of Western Europe and Japan.

Some numbers: 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 nine and a half times higher. The gaps are even more visible when we switch from looking at the wealthy (the top 10%) to looking at the very wealthy (the top 1% of earners). In the 1980s, the top 1% commanded less than 10% of total pre-tax income in every OECD country except one. Thirty years later, their share was above 10% in at least nine OECD countries. So, many among the rich are indeed getting richer.

But focusing on the gains of high earners shows only part of the inequality picture. We also need to look at what's happened to low earners. According to the 2015 OECD report *In It Together: Why Less Inequality Benefits All*, for 11 countries for which long-term data are available, incomes for the bottom 10% in the past quarter of a century "increased much less than the rest as they grew less during expansions and fell more during recessions." In other words, lower earners gained relatively little during economic upturns and lost even more during downturns. There's a similar picture in Japan, as the OECD reported in July 2016 ("Employment Outlook 2016 — How Does Japan Compare?"): "The good performance of Japan in terms of high employment and low unemployment has not carried over to strong wage growth, especially for workers at the bottom of the jobs ladder."

All these numbers can be a little overwhelming, but they are important to understanding the complex nature of rising inequality. Despite what "We are the 99%" might lead us to believe, this is not just a simple story of the 1% surging away from everyone else. Rather, it is a picture of widening fissures across the income spectrum. Yes, there's a growing gap between the 1% and everyone else. But, at the other end of the spectrum, there's also a growing gap between very low earners and everyone else. And, in many OECD countries, there are worrying signs that a once relatively secure group of low-to-mid-level earners — perhaps as much as 40% of the population in some countries — are finding it harder to keep up.

The implications of these fissures are significant. For one thing, they show that the roots of widening income inequality lie not in just one economic or social factor but many. They also compel us to ask how these income inequalities affect people across the income spectrum — from high to low earners. Crucially, they raise important questions about how policy can best address widening inequality. And, finally, they surely compel us to think about just how much — and what sort of — inequality our societies are comfortable with.

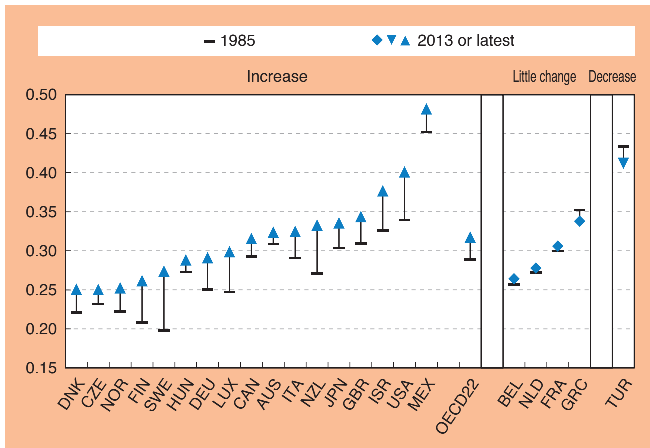
The Many Roots of Inequality

Why is inequality rising? The question is simple, the answer is not. Nevertheless, a number of factors seem to be at work (although economists don't always agree on all of them or on their relative

CHART 1

Income inequality increasing in most OECD countries

Gini coefficients of income inequality, mid-1980s and 2013, or latest date available



Note: "Little change" in inequality refers to changes of less than 1.5 percentage points.
Source: In It Together: Why Less Inequality Benefits All © OECD 2015

importance). Among others, they include technological change, a shift in the share of national income towards capital and away from labor, changes in pay norms and in taxation, the growth of part-time employment and shifting social patterns.

The list is long and, as with much else connected to income inequality, the picture is complex. For one thing, some of these factors play a bigger role in some countries than in others. In much of the English-speaking world, for example, increases in the incomes of top earners reflect shifting pay norms — in effect, the income levels that societies are "comfortable" with. By contrast, many European countries have proved much less willing to accept soaring salaries for chief executives and, as a result, have seen smaller increases in pay gaps. Equally, the relative impact of some of these factors varies greatly depending on which part of the income scale you're examining. For example, changes in taxation have boosted the incomes of the top 1% of earners; by contrast, the growth of part-time and temporary work has, in many cases, had the opposite effect on the incomes of lower earners.

The Race Against the Machine

Nevertheless, some factors are clearly having a wide impact on inequality, perhaps none more so than technology. This is nothing new. From the Luddites who smashed up machinery in 19th century English cotton mills to the bank clerks who saw their jobs replaced by ATMs, and on to the "chief listening officers" who owe their jobs to the emergence of social media, technological change has long helped to shape how people earn a living.

It does this because technological change devalues some skills, revalues others and, of course, creates whole new skills and jobs. The response of societies to this change is determined by the outcome of what the Dutch economist Jan Tinbergen referred to as the "race between technology and education". When education is winning, more people are able to keep up with new technologies and make use of them in their work, with the result that the income rewards are spread widely; when technology is winning, a larger slice of the income pie goes to fewer people, chiefly the owners of those new technologies.

In the past, while technological change created economic "losers" — for want of a better word — it seems fair to say that, over time, it created more winners. These days, however, many fear that technology is racing so far ahead that education just can't keep up. The result is that growing numbers of people risk losing their jobs. According to forecasts by Carl Benedikt Frey and Michael Osborne, 47% of total US employment is at high risk of being automated over the next decade or so ("The Future of Employment: How Susceptible Are Jobs to Computerisation?", University of Oxford, September 2013). Other estimates paint a less gloomy picture. Research by the OECD (OECD Social, Employment and Migration Working Paper No. 189) distinguishes between individual tasks and actual jobs, which typically involve a wide number of tasks, some automatable but some not. On that basis, it suggests that only around 9% of jobs in OECD countries (and around 7% in Japan) will be automatable. But even that is significant. And, from the point of view of income inequality, it's notable that those most at risk of losing their jobs are very low earners and people with low levels of education.

Technology is also at the heart of another fundamental change in the economy that, again, may well be linked to widening inequality — namely, a shift in the share of national income towards capital and away from labor. Where workers are replaced by robots or computers, the income that would once have made its way to labor now goes to the owners of those robots and computers, i.e. capital. This shift does seem substantial: in the early 1990s, the share of income going to labor across all OECD countries was about two-thirds, or 66.1%; by the late 2000s, it had fallen to 61.7%. Potentially, this can increase income inequality because, firstly, capital generates income and, secondly, the well-off own an even bigger share of the capital pie than they do the income pie. Diluting this somewhat, however, is the fact that the lines are blurred between labor and capital — a salaried worker may also own shares, giving her a foot in both the labor and capital camps.

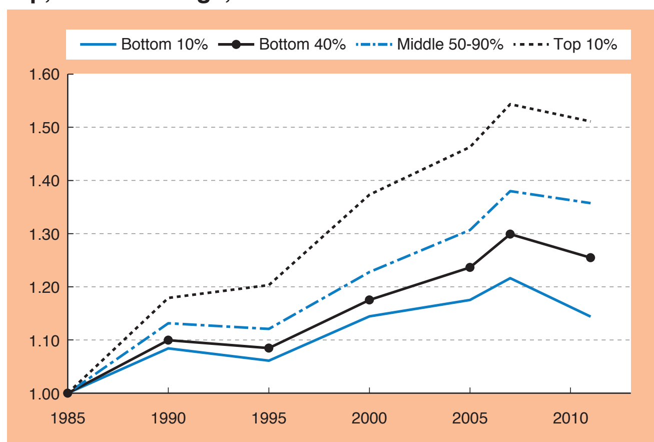
Aside from technology, other factors that have helped fuel income inequality, especially among lower earners and the low-educated, include the decline of the traditional and secure 9-to-5 job in favor of lower-paid temporary or part-time work that offers little in the way of either security or promotion prospects. There have also been shifts in the way we live, for example in who we marry. Largely reflecting the welcome progress that women have made in education and the workforce, people these days are much more likely to marry someone from a similar social background than in the past. In about 40% of working couples, both partners have very similar earnings; in the early 1990s, the proportion was about 33%.

One other factor that's worth noting is shifts in systems of taxes and transfers — the money the state takes and the money it gives. Taxes and transfers play a huge role in reducing income inequality, but in recent decades that impact has declined in many countries, in large part because state benefits have become less generous. On the other side of the equation, taxes have tended to become more progressive, although with one important exception — taxes affecting very high earners. In OECD countries, the average top statutory tax rate fell from

CHART 2

Lower & lowest incomes increasingly left behind

Trends in real household incomes at bottom, middle & top, OECD average, 1985 = 1



Note: Income refers to disposable household income, corrected for household size. OECD is the unweighted average of 17 countries.

Source: In It Together: Why Less Inequality Benefits All © OECD 2015

66% in 1981 to 41% in 2008. There have been other shifts in tax that have also benefited high earners, for example reductions in property and inheritances taxes, which have allowed high earners to build up wealth (which, in turn, generates income).

Rising at the Top

But taxes — and, as we saw earlier, changing pay norms — are not the only factors that have helped high earners grab such a large share of overall income growth since the mid-1970s. It's worth taking a moment to look at just how much their share has grown. Between 1975 and the start of the financial crisis, the top 10% benefited more from growth than the rest of the population in *all* OECD countries for which data are available ("Focus on Top Incomes and Taxation in OECD Countries: Was the crisis a game changer?", OECD 2014). The share of income growth that went to the top 10% was particularly striking in some OECD countries — around 80% in the United States, around two-thirds in Canada and around half in the United Kingdom and Australia. Based on numbers like these, it now seems fair to say that in many OECD countries the rising tide of economic growth no longer lifts all boats.

What other factors have driven up the incomes of top earners? To some extent, their rise reflects a fundamental shift towards what some have dubbed a "superstar" economy. That's true not only in the worlds of sports and entertainment but also in the broader economy, especially in areas like finance, where there is now a global market for top talent. In such highly competitive global labor markets, firms 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 plays a role here, too, complementing the skills of highly paid workers, for example financial traders, who can now carry out transactions worth billions of dollars at the touch of a button. Indeed, finance has contributed to the growing income gap in several ways, not least because financial firms tend to pay workers very well (both in cash and stock options, which are widely used in the corporate world and often enjoy more favorable tax treatment than, say, salary income). In Europe, financial workers account for 1 in 5 of top earners but only 1 in 25 of the total workforce.

Does Inequality Matter?

So we know that income inequality is rising in OECD countries (and elsewhere), but here's a question — does it matter? Some level of inequality is inevitable in almost any society — and indeed necessary: without the prospect of riches and fame, there would be far fewer incentives for entrepreneurs to get out of bed in the morning. But as the gap between rich and poor has grown in recent years, many believe we now have too much inequality. Much of the focus has been on the supposed high social costs of excessively high inequality — depending on whom you listen to, these can include reduced mobility, increased social tensions, higher rates of crime and even shorter lives and higher rates of obesity.

But there has also been growing interest in, and concern over, the potential *economic* cost of high inequality. Intriguingly, this flies in the face of a long-held view in some economic circles, namely that there is a trade-off between inequality and economic efficiency. The argument, most famously made by the American economist Arthur Okun, goes like this: attempting to reduce inequality beyond a certain level, by, for example, increasing taxes, may lead to economic resources being used less efficiently than would otherwise be the case. Or, as Okun famously put it, money taken from the rich in taxes would be carried to "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."

However, researchers at the IMF and OECD, among others, have increasingly called this belief into question. In particular, work by researchers at the OECD suggests the average increase in inequality over the past couple of decades cut GDP by around 8.5% ("The impact of income inequality on economic growth" in *In It Together: Why Less Inequality Benefits All*). The research zeroes in on how a widening wealth gap leads low-earning families to invest less in education and skills. This has the potential to hurt growth by reducing the number of skilled — and more highly productive — workers available for hire in the economy.

Inequality may be harmful for economic growth in other ways, too. For example, if rising inequality leads to a hollowing-out of the middle class, it may reduce demand for goods and services, to the detriment of the wider economy. And inequality can also create the conditions that encourage wealthy elites to push for policies that favor their interests over those of the broad society, perhaps through the funding of political parties. Such issues are not new. A century ago, the American 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."

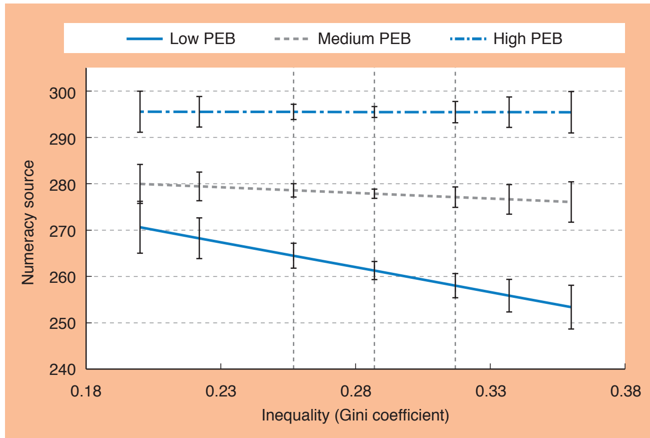
Policy Responses to Inequality

The increase in income inequality has sparked numerous warnings

CHART 3

Inequality lowers skills of the poor

Average numeracy score by parent educational background (PEB) & inequality



Note: The graph plots the average predicted numeracy score for individuals from low, medium and high family (educational) backgrounds, as a function of the degree of inequality (Gini points) in the country at the time they were aged around 14.

Source: In It Together: Why Less Inequality Benefits All © OECD 2015

about the need for action to ensure the fruits of growth are more widely distributed. For example, when world leaders gathered to agree the Sustainable Development Goals (SDGs) in late 2015, they included a commitment to "progressively achieve and sustain income growth of the bottom 40% of the population at a rate higher than the national average". But, as the SDGs also make clear, there's a strong sense in the international community that more needs to be done to bridge wider inequalities in areas like access to education, healthcare and services, between men and women, and between minorities and the rest of society.

So, what should be done? There are arguably three main (as well as several more minor) areas where government policy can work to help narrow income gaps — education and skills, employment and taxes and transfers.

Education is a particularly interesting case, especially as it is often touted by politicians as the main solution to inequality. However, education systems can also promote inequality, especially if they lock working-class children into non-academic streams or fail to ensure that working-class youngsters go to university in the same numbers as their middle-class peers — which is the case in all OECD countries. However, as the OECD's PISA student assessment program shows, some educational systems — particularly those in East Asia — do a much better job than others to help students overcome social disadvantage.

Still, it's clear that education needs to do more. Any policy framework should aim to ensure that all young people develop certain basic skills, receive an education that matches their individual capacities and aptitudes, and aren't held back by their gender, ethnicity or family situation. It should also aim to intervene early. In an era when wealthier parents are engaged in an arms race to provide their children with ever more "enrichment" activities, policy needs to ensure that children from poorer families have access to high-quality childcare from a very early age. The returns on such investment, both in terms of improved life opportunities for children and raising the quality of human capital in an economy, are far too often overlooked.

Employment policy is another important area for addressing not only widening inequalities but also poverty. It's clear that jobs alone are not always enough. In recent decades, many OECD countries have seen rising rates of in-work poverty — where the income workers receive is too low to raise them above the relative poverty line. In response, the OECD has argued for policies to promote both more and better jobs. That means a range of policies to better support groups that are underrepresented in the workforce, such as women and young people, as well as temporary and part-time workers. Among the many options are in-work benefits to help the "working poor"; stronger support with training and job-search for young people; and the provision of childcare and flexible working arrangements to help ensure more women can go out to work if they want to and to support both men and women in striking a better work-life balance.

A final area that deserves examination is taxes and transfers. Few policy areas pose so many challenges — taxes and transfers are not just highly complex but also serve a wide range of social and economic goals beyond just redistribution. Nevertheless, a number of priorities have emerged. On the transfers side, these include better targeting benefits towards low-income families, in part to try to counter the potential lifelong disadvantages children may suffer from early poverty. There has also been increasing interest in the provision of in-work benefits, both to reduce in-work poverty and to reduce incentives for people to remain out of the workforce. On the taxes side, there is probably room in many countries to scale back some tax deductions and credits that tend to benefit higher earners disproportionately. There may also be room for taxing certain earnings such as stock options — which again tend to benefit mainly high earners — as ordinary income.

How Much Is Too Much?

It's interesting to speculate on just why income inequality has attracted so much interest in recent years. One reason may be that inequality is not just about income distribution but rather goes to the heart of how our societies see ourselves. Where some see striving for success, other see greed; where some see support for the disadvantaged, others see feather-bedding; where some see the state exercising its duties to support the disadvantaged, others see unwarranted meddling. Each society resolves these tensions in its own way. But, to be sure, the task of doing so becomes ever more challenging — and potentially divisive — against a backdrop of rising inequality.

Views expressed in this article do not necessarily represent those of the OECD or its members.

This article draws from OECD Insights: Income Inequality — The Gap between Rich and Poor (2015) *by Brian Keeley, published by OECD Publishing and available at* http://oe.cd/1hQ JS

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