OECD MINISTERIAL MEETING ON SOCIAL POLICY

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Tackling Inequality

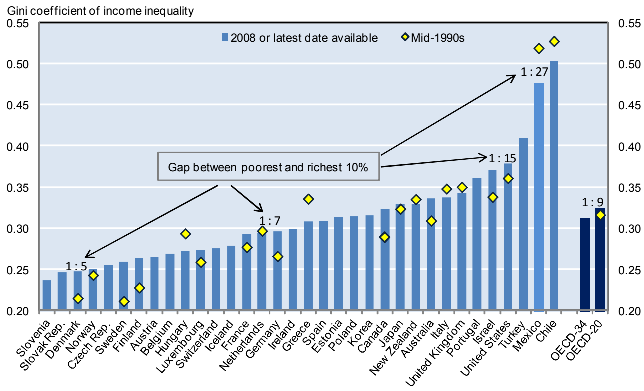
The gap between rich and poor in most OECD countries has widened over the past decades. Income inequality has grown in over three quarters of OECD countries and in many emerging economies. Greater inequality raises economic, political and ethical challenges and risks leaving more people behind in an ever-changing world economy. Which policies can promote both stronger and fairer economic growth?

How unequal are OECD countries and emerging economies?

Across OECD countries, the income of the richest 10% of people around 2008 was, on average, nearly nine times that of the poorest 10%. But there are large differences across countries. In some Nordic and central European countries, the gap is much smaller, with the incomes of the richest 10% being five times those of the poorest 10%, while in Mexico and Chile, the rich have incomes more than 25 times those of the poorest. In most countries, increasing inequality was due to rich households faring much better than both low-income and middle-income families.

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

Levels of inequality in the latest year before the crisis and in the mid-1990s

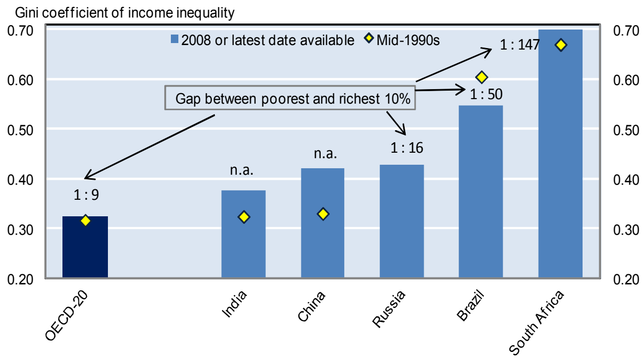


Source: Provisional data from *OECD Income Distribution and Poverty Database* (www.oecd.org/els/social/inequality).

In emerging economies, greater integration into the world economy and policy reforms have resulted in high economic growth. This has resulted in impressive progress in the reduction of *extreme poverty*, defined as living on less than USD 1.25 per day. Income inequality, however, has risen from already high levels in emerging economies, apart from Brazil which has seen a sharp reduction of income inequality during the past decade. Real income growth in Brazil largely benefited the lowest income groups, whereas in China, India and South Africa income has become more concentrated among the top earners. But even in Brazil, the gap in average incomes between the top and the poorest ten percent of the population is still 1: 50, down from 1: 79 in the early 1990s.

Figure 2. Inequality is generally high in large emerging economies

Levels of inequality in the latest year before the crisis and in the mid-1990s



Source: OECD (2010), *Tackling Inequalities in Brazil, China, India and South Africa - The Role of Labour Market and Social Policies* (www.oecd.org/els/social/inequality/emergingeconomies).

The economic crisis has put additional pressure on the distribution of incomes in both OECD and emerging economies. While it is still too early to see the full impact, some trends can be identified. As changes in labour earnings have been important drivers for increased income inequality in recent years, the loss of millions of jobs has likely contributed to higher inequality and has put pressures on middle-income workers. At the same time, incomes at the top have fallen; this may have reduced some of the inequality, at least temporarily. As many governments are embarking on the path of fiscal consolidation, further effects on inequality can be expected, depending on where and how much public spending is cut or which taxes are increased.

What is driving the increase of income inequality?

Globalisation is often blamed for growing inequality. The increased productivity and opportunities for trade and foreign direct investment (FDI) that globalisation brings in its wake have contributed to raising the growth potential in both advanced and emerging economies. But the benefits of greater trade and FDI integration and economic growth have often not been distributed equally. High-skilled, highly-educated workers in OECD countries and some of the emerging economies have gained the most. Economic globalisation has many facets, however, such as greater openness of markets, integration of financial markets, relocation of production, and international migration. Each of these facets has a potential impact on inequality and needs to be taken into account when assessing the overall effect.

There are also other important drivers of inequality. Populations are ageing in OECD countries and will do so shortly, at a much faster pace, in emerging economies. Changing patterns of living together make household incomes more diverse. New work by the OECD on the causes of rising inequality shows that changes in product and labour market regulations had a bigger impact on the distribution of earnings than economic globalisation. The increase in part-time employment, in atypical labour contracts and a decline in coverage of collective-bargaining arrangements in many OECD countries also contributed to greater disparities in earnings. Changes in executive compensation and higher incomes from investments have boosted the pay of top earners. Tax and transfer policies in many countries were often less able to counter the strong increase in market-income inequality. On the other hand, higher female employment rates and the upskilling of the labour force have compensated for part of the rise in inequality. The need to address remaining gender gaps in education and employment should therefore be considered in the design of policies to counter widening overall inequality.

Income inequality was growing before the onset of the global financial and economic crisis. However, some have argued that inequality was actually one of the factors contributing to the crisis. Redistribution from poorer households which spend a larger part of their income to richer households which spend less and save more of their income can reduce aggregate demand. This can happen when resources are redistributed from credit-constrained households to those that face fewer such constraints. In turn, this may have prompted low interest-rate policies and triggered increases in household debt beyond sustainable levels. In parallel, the search for high returns by investors with rapidly growing incomes might have contributed to asset-price bubbles. High and increasing inequality may therefore have helped fuel economic instability.

The driving forces of income inequality are different in emerging economies. An important factor for inequality in these countries is the high share of employment in the informal sector. Informal workers generally have low-paid, low-productivity jobs and, in most cases, are excluded from formal social protection schemes. While informal employment has decreased significantly in Brazil since the mid-1990s, it increased in China, India and South Africa. Other important factors affecting inequality in emerging economies are, for example, disparities between different ethnic groups or regions, rural and urban populations and migrants and non-migrant workers.

Why should policy makers worry about inequality?

Rising income inequality creates economic, social and political challenges. It can stifle upward mobility, making it harder for talented and hard-working people to get the rewards they deserve. Intergenerational earnings mobility is low in countries with high inequality such as Italy, the UK and the United States, and much higher in the Nordic countries, where income is distributed more evenly. The resulting inequality of opportunities will inevitably impact economic performance as a whole even if the relationship is not a straight forward one. Inequality also raises political challenges because it breeds social resentment and generates political instability. It can also fuel populist, protectionist and anti-globalisation 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 to reduce inequality?

Social, labour-market and fiscal policies play a major role in redistributing income. On average, cash transfers and income taxes reduce inequality by one third and reduce poverty by about 60% in OECD countries. But the redistributive impact of the tax and transfer system on inequality and poverty has fallen in many countries in the past ten years. Within current budgets, policies to address the causes of growing inequality could be made more efficient, for example, by making more use of in-work benefits which encourage people to take up work and give additional income support to low-income households. Another important policy challenge is to improve equal access and quality of education and training which will enable workers to take up better-paid jobs and thus reduce inequality.

But inequality is not only about income but includes other dimensions which policies have to address. Publicly-provided services, such as health, education, housing or care services, also reduce inequality. Some countries rely more on such services than on cash transfers. The redistributive effect of public services in OECD countries is, on average, two-thirds of the impact of taxes and transfers. Public services such as high-quality education furthermore constitute a longer-term investment to foster upward social mobility and create higher equality of opportunities in the long run.

Redistributive policies are more difficult to implement in emerging economies due to their large informal sectors. Therefore, targeted benefit programmes, such as conditional cash transfers, may be more effective in reducing inequality while at the same time serving other objectives, such as increasing the use of health and education services. Universal basic pensions and unconditional child grants with higher rates for poorer households can also be powerful tools in reducing poverty, as the example of South Africa shows. In the medium term, however, the most effective route to reducing poverty and inequality is to promote the creation of better jobs in the formal sector and increase the coverage of social protection systems. Policies to improve the business environment may not be expensive for governments but can support the creation and expansion of firms, and thus jobs, in the formal sector.■

Notes for the figures:

Figures 1 and 2. The measure for inequality used here is the Gini coefficient, which takes values between 0 for a perfectly equal income distribution where every person has the same income, and 1 which refers to a situation of maximum inequality where all income goes to one person. The gap between poorest and richest 10% refers to the ratio of average income of the bottom 10% to the average income of the top 10% of the income distribution. Gini coefficients are based on different income concepts: on equivalised income for OECD countries and Russia; per capita incomes for Brazil, China and South Africa; and per capita consumption for India.

The statistical data for Israel are supplied by and under the responsibility of the relevant Israeli authorities. The use of such data by the OECD is without prejudice to the status of the Golan Heights, East Jerusalem and Israeli settlements in the West Bank under the terms of international law.

Issues

1 **How can we better share the benefits of economic globalisation and technological progress?**

2 **Which labour market and social policies (including taxes and transfers) will work best to reduce income and wealth inequalities in OECD countries and emerging economies and contribute to stronger and fairer economic growth, especially in an era of fiscal consolidation?**

3 **What role should in-kind services, such as health, education, housing and care services play in the reduction of inequalities?**

www.oecd.org/social/ministerial