

# **Income Inequality and Public Policy**

**Brian Nolan**

**Department of Social Policy and  
Intervention/Institute for New Economic  
Thinking/Nuffield College, University of Oxford**

**TASC Annual Lecture**

**November 2014**

# Outline

- Introduction: following Piketty!
- What has happened to income inequality in rich countries over past 30 years, and why?
- What has been the impact of the Crisis?
- Why should increasing inequality be addressed?
- What can public policy do?

# Core Concern

- There is widespread concern that
  - income inequality increasing across OECD, driven inexorably by technological change and globalisation
  - accelerated by the Economic Crisis and its aftermath
  - higher/increasing income inequality produces
    - more family fragmentation and crime,
    - poorer health and greater health inequalities,
    - less social solidarity and cohesion,
    - reduced intergenerational mobility and greater inequality of opportunity
  - threatens democratic politics
  - and undermines future economic growth, prosperity

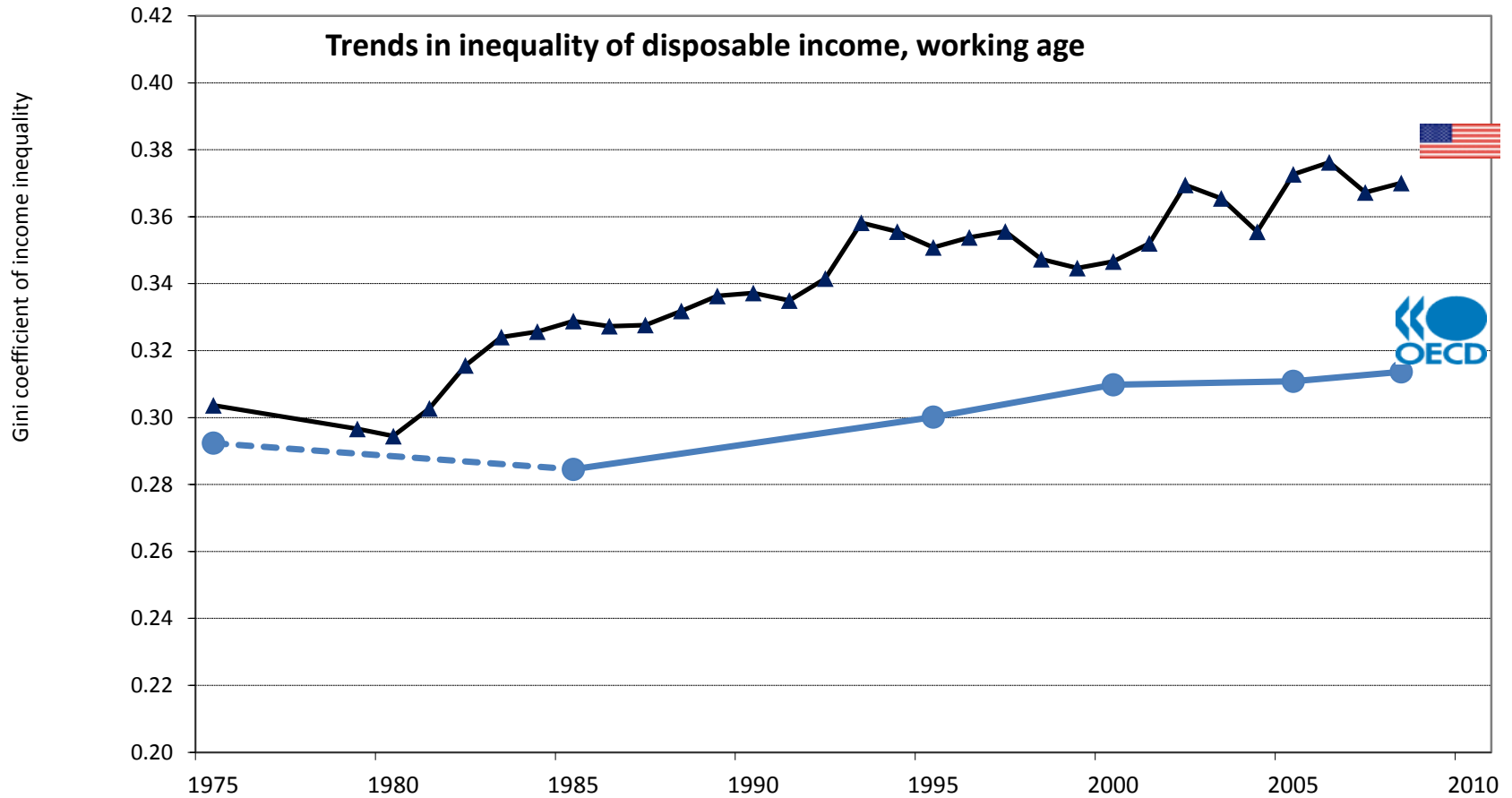
# Capturing Income Inequality Trends

- Inequality in terms of household net income
  - Sum of labour earnings, investment and property income, cash transfers less income taxes and social insurance contributions, adjusted for household size
  - not consumption expenditure, wealth, 'happiness', or 'capabilities'
- 'Non-cash benefits' from social expenditure not included
- Rely mostly on survey data – but top incomes estimated from tax data
- Income inequality measured in various ways –
  - Gini coefficient most widely used, range among industrialised countries c. 0.20-0.40

# Income Inequality Trends

- OECD has assembled data from countries for 1985, 1990, 1995 .....
- Shows income inequality trending upwards from 1980s in many OECD countries
  - Up in 2/3rds OECD countries from mid-1980s to mid-2000s
  - “Moderate but significant” rise – [*Growing Unequal*, 2008]
  - Average Gini coefficient for working-age households across OECD up from 0.29 in 1980 to 0.316 by 2009
- Comparative micro-data on income inequality from Luxembourg Income Study, also in ‘waves’ rather than annually, shows similar though not identical picture

# Inequality Trends in OECD

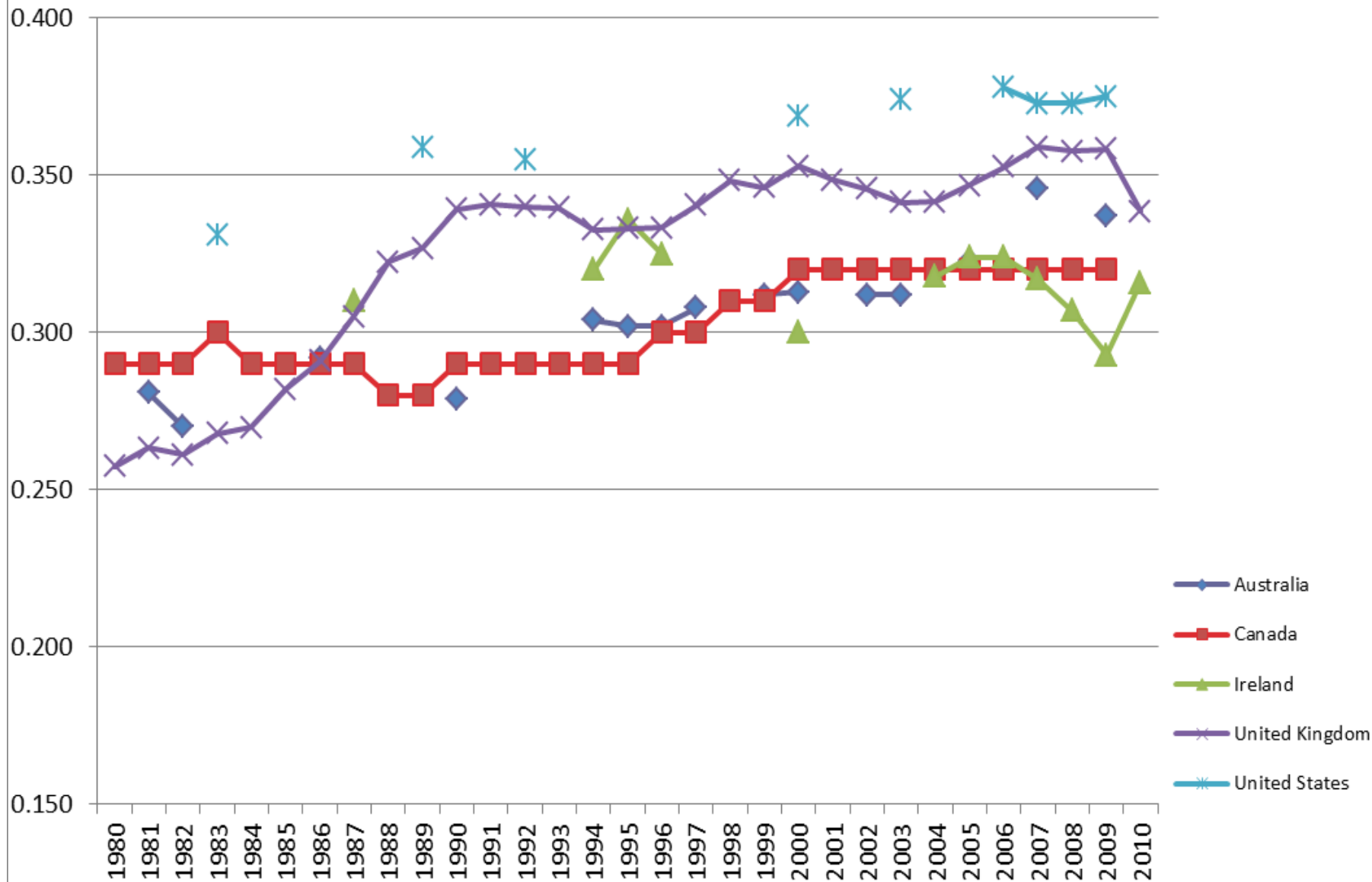




# The 'GINI' Research Project

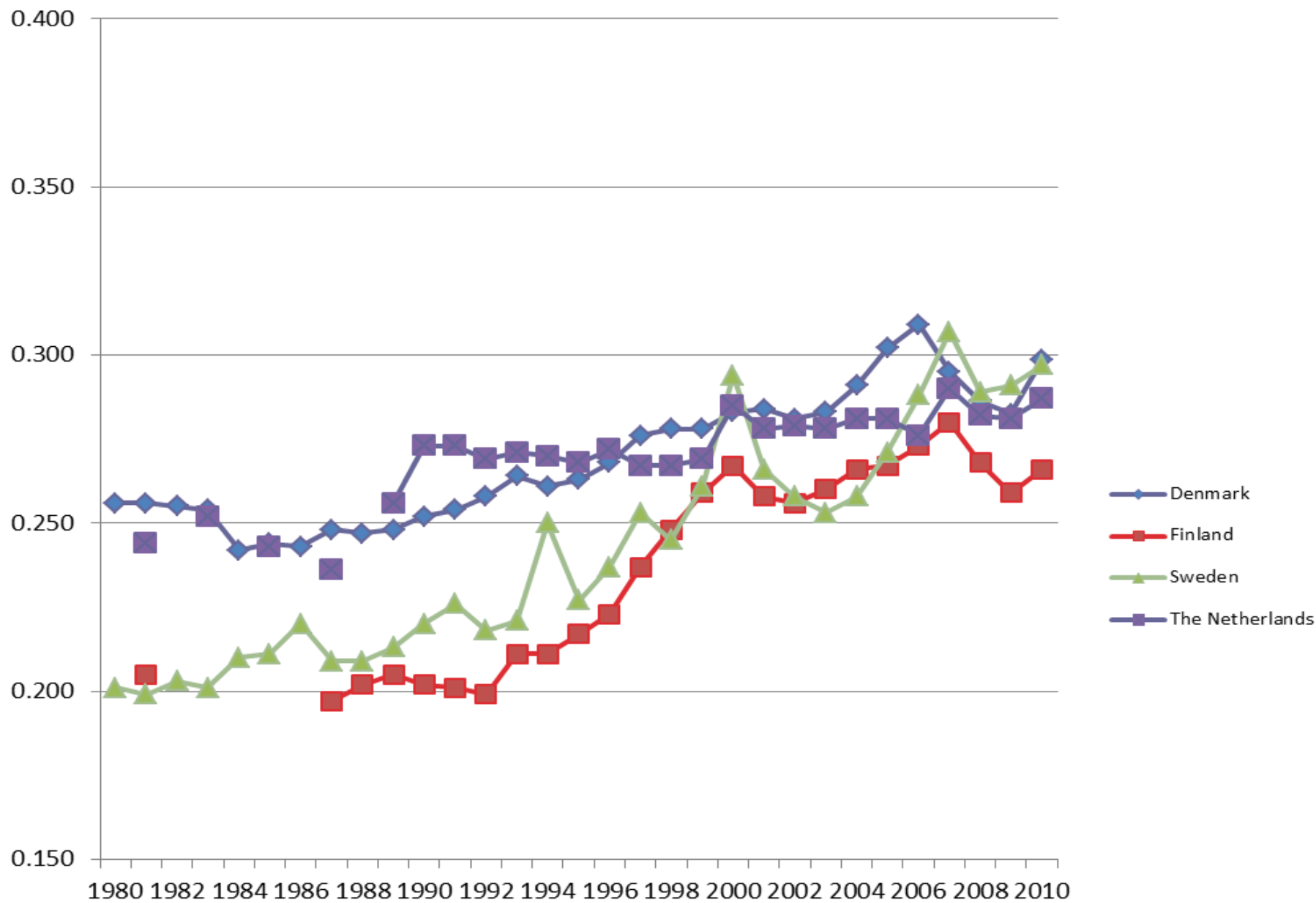
- FP7 project to capture and understand income inequality trends and their impacts
  - two books from Oxford University Press end-2013
- Studied 30 countries over 30 years 1980-2010
- Assembled, analysed annual data on income inequality, social and political outcomes, policies (also studied wealth, education)

# English speaking liberal welfare states+US

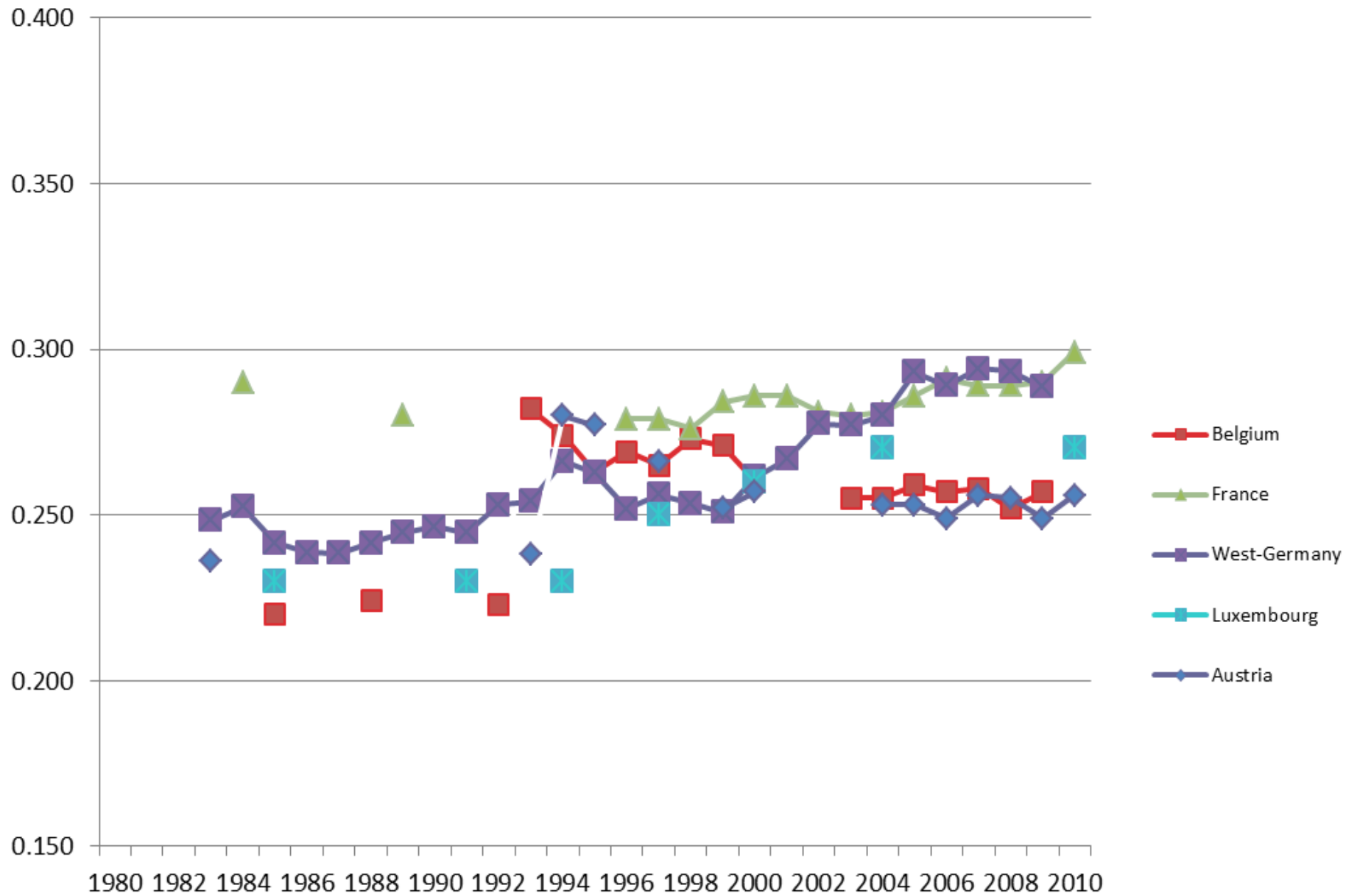




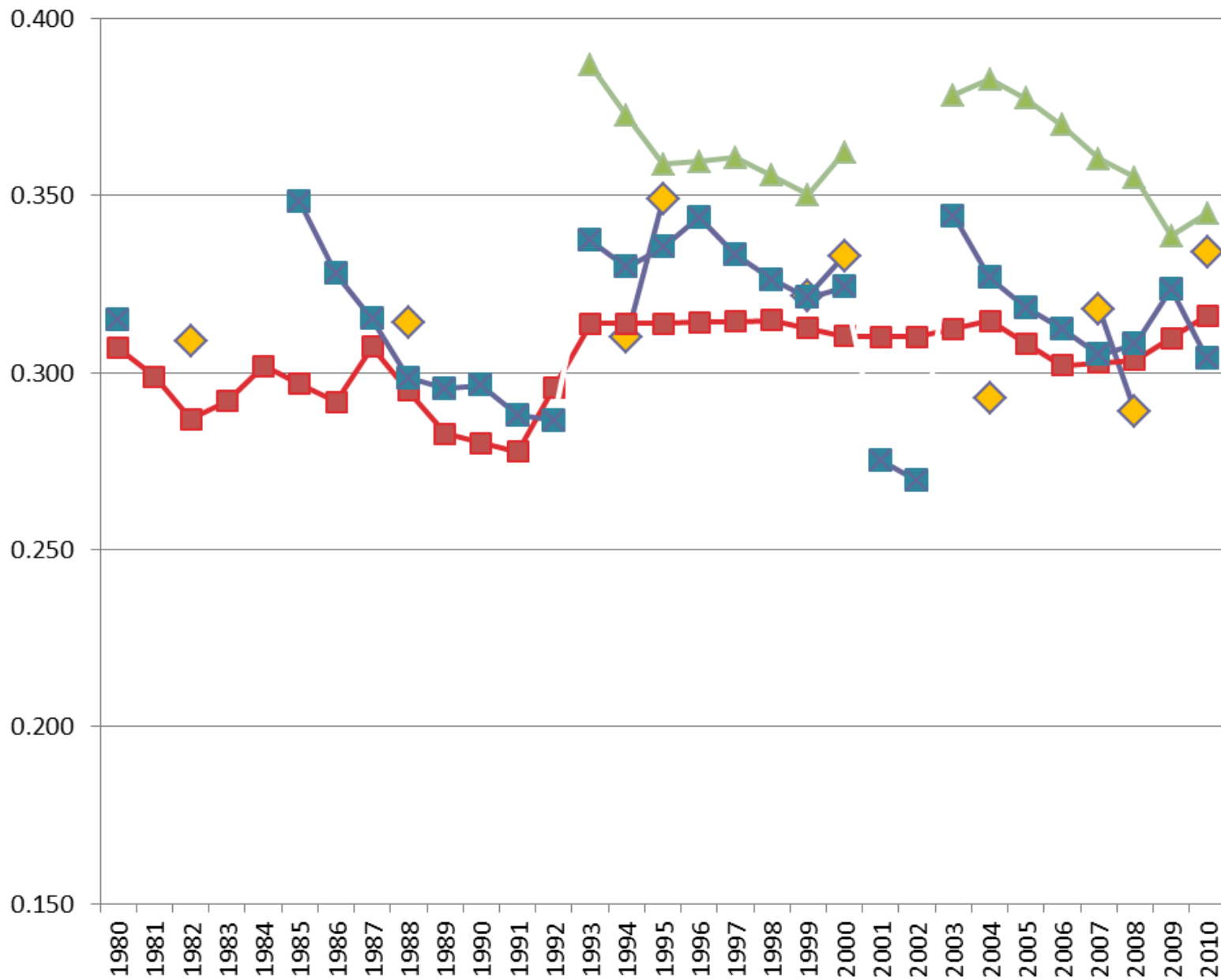
# Nordic EU countries + Netherlands



# Continental European welfare states

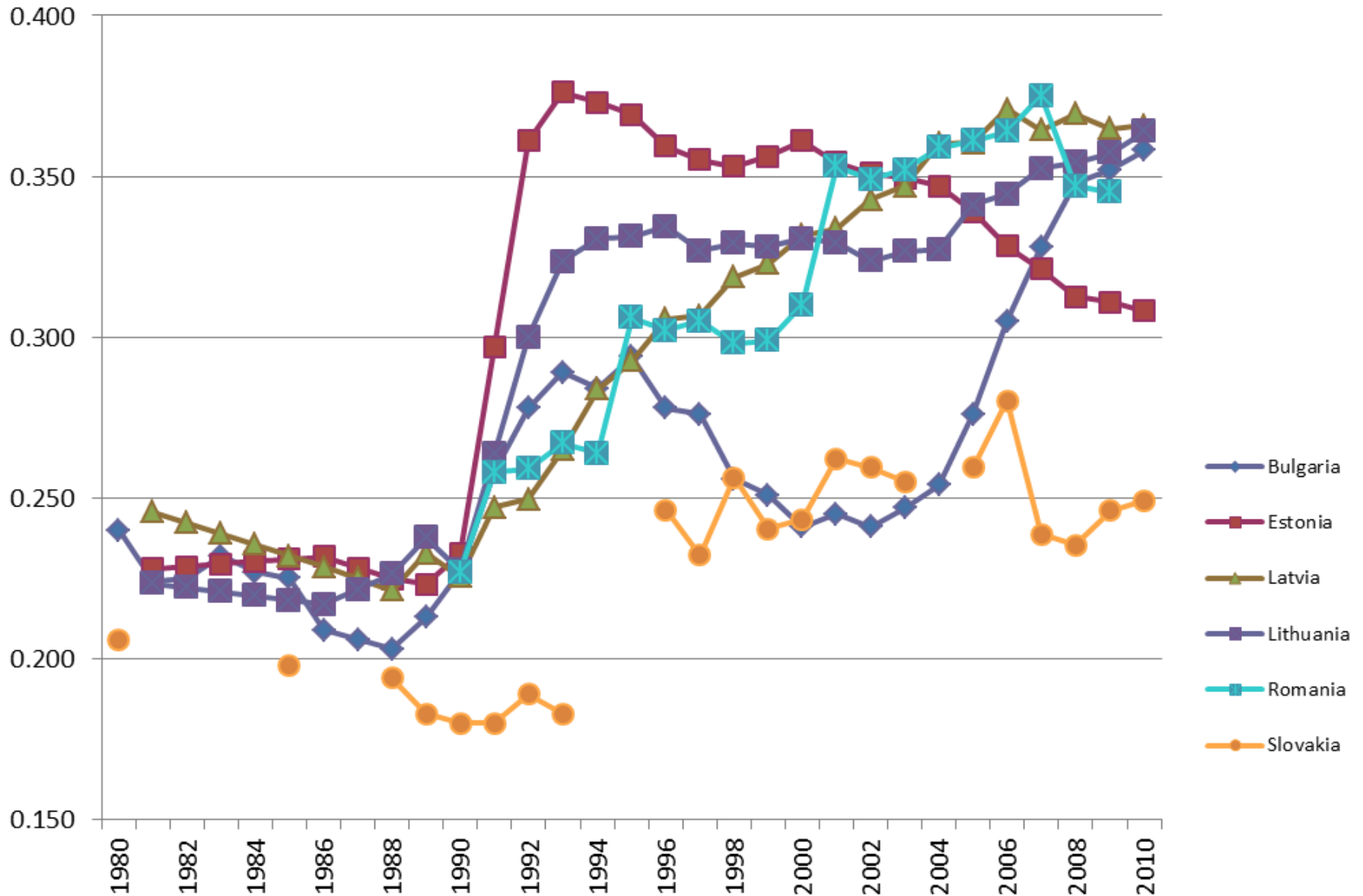


# Mediterranean countries

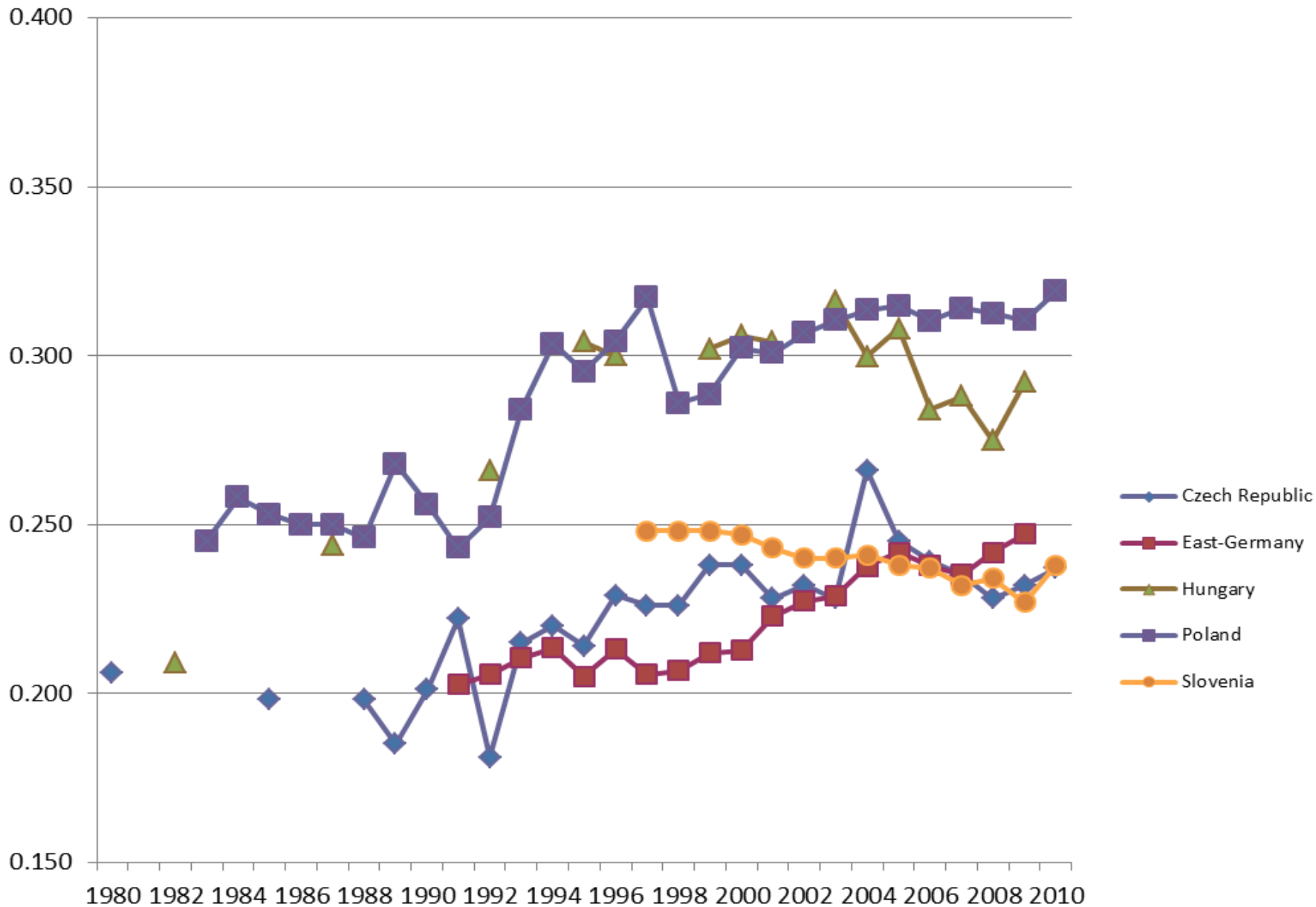


- Greece
- Italy
- Portugal
- Spain

# Shock-transition CEE countries



# Smooth transition CEE countries

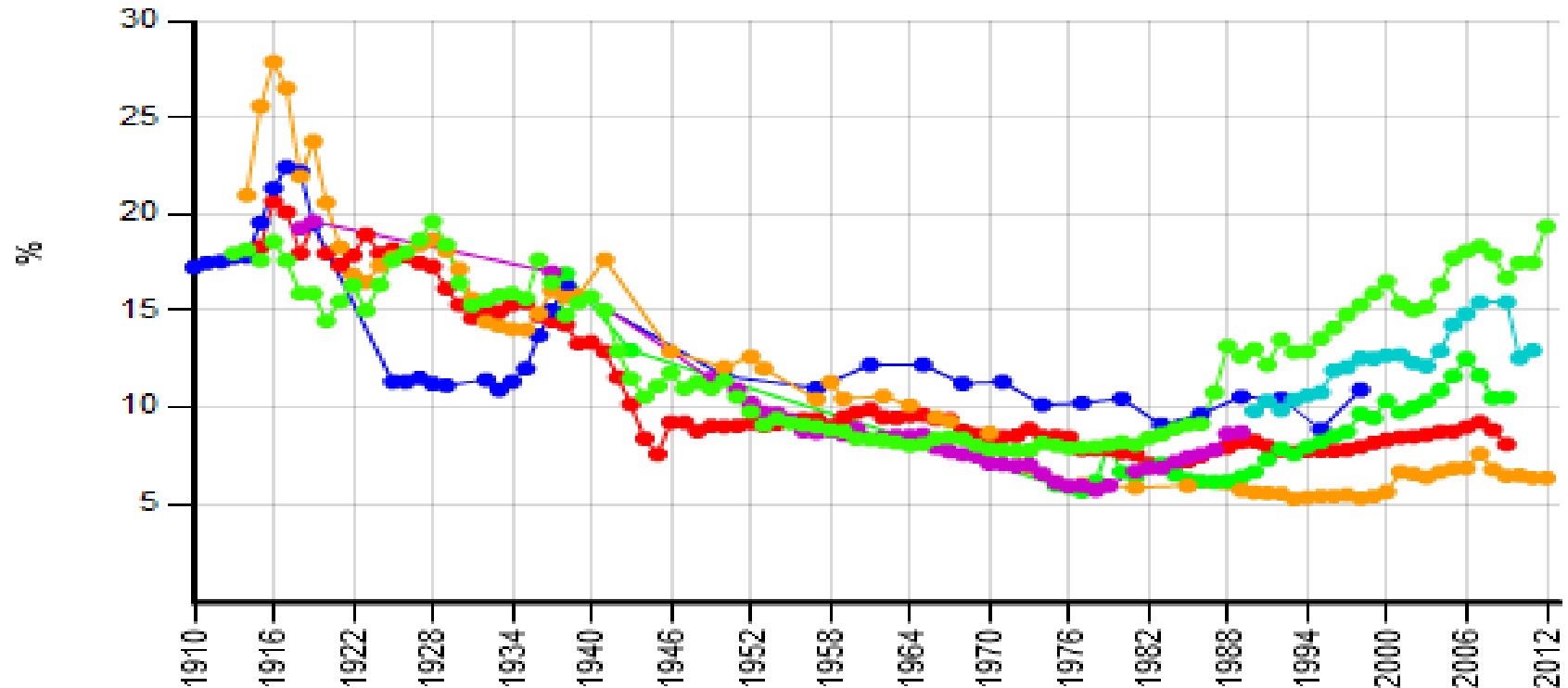


# Income Inequality Trends: Top Incomes

- Household surveys cannot capture incomes right at the top of the distribution
- Major advance in knowledge due to recent use of income tax administration data to study shares of top 1%, 0.1%
  - Atkinson, Piketty, Saez
- Data now available for wide range of countries in *World Top Incomes Database*
- '1%/99%' distinction now in common use
- Estimates are for gross incomes, and not aligned with survey data for overall inequality

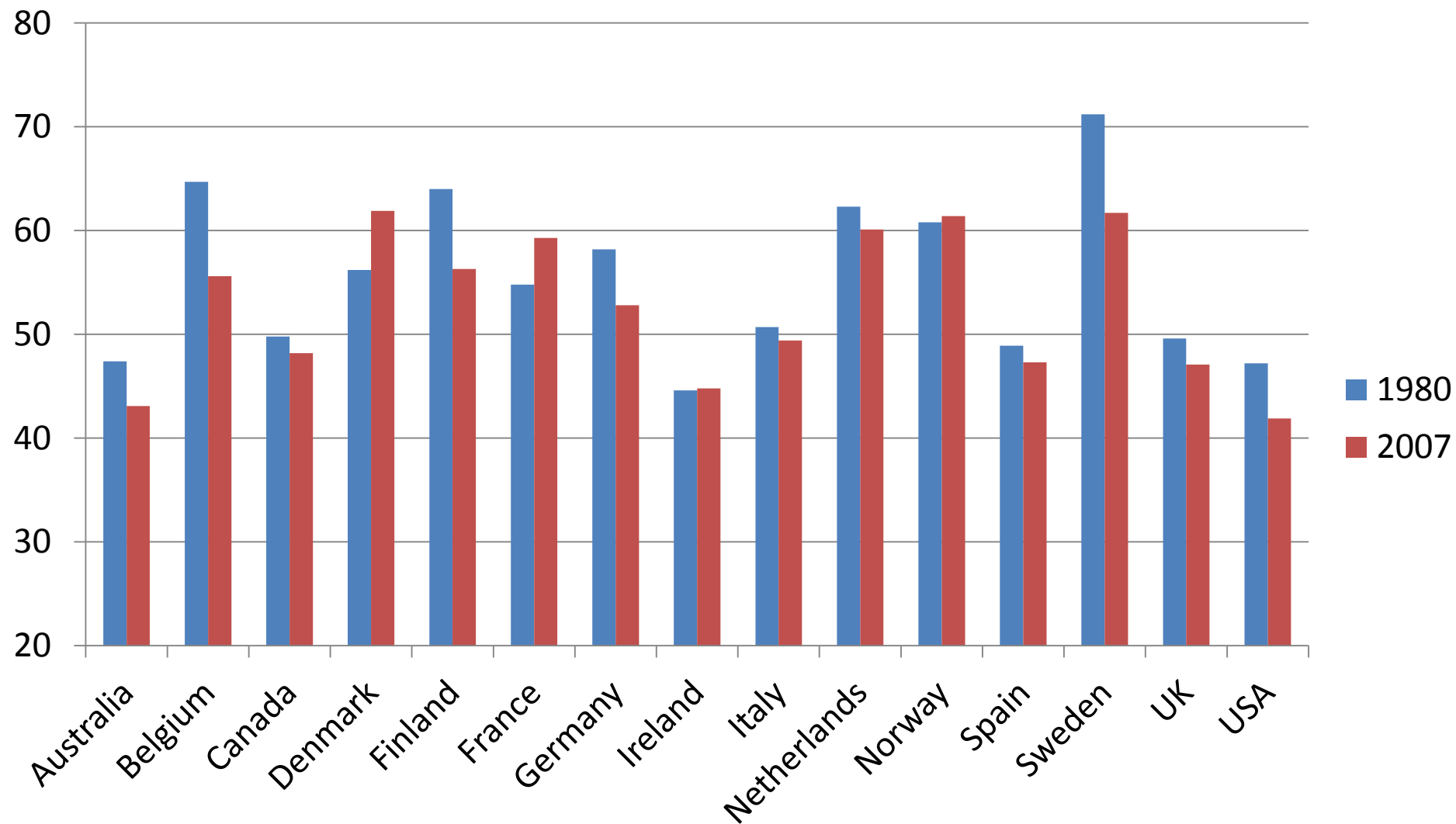
## Top income shares. 1910-2012

Sources: The World Top Incomes Database. <http://topincomes.g-mond.parisschoolofeconomics.eu/>



-  Top 1% income share (France)-Piketty (2001, 2007); Landais (2007)
-  Top 1% income share (Germany)-Dell (2007)
-  Top 1% income share (Ireland)-Nolan (2007)
-  Top 1% income share (Netherlands)-Salverda & Atkinson (2007); Salverda (2007)
-  Top 1% income share-married couples & single adults (United Kingdom)-Atkinson (2007)
-  Top 1% income share-adults (United Kingdom)-Atkinson (2007)
-  Top 1% income share (United States)-Piketty & Saez (2007)

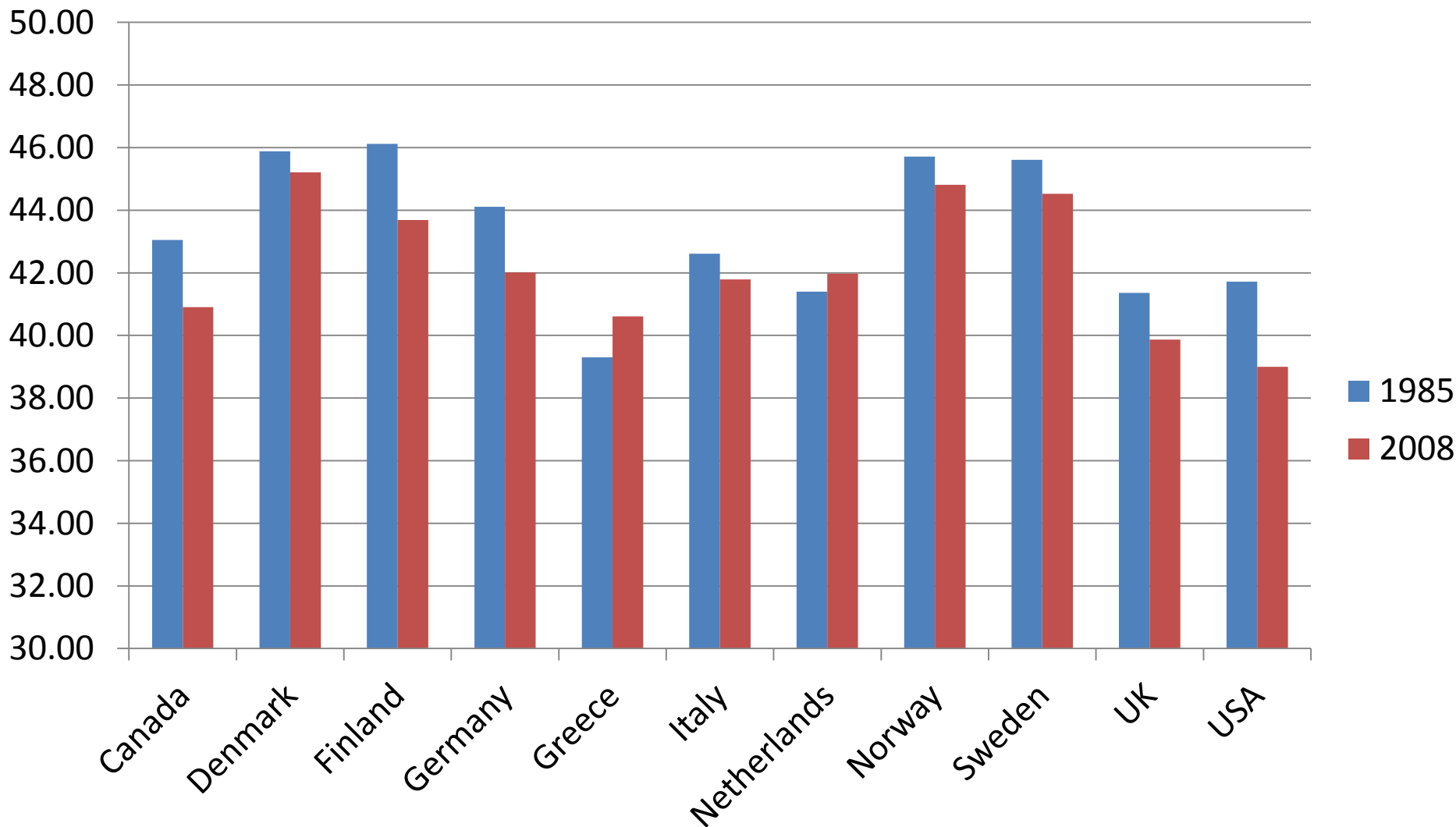
# Size of 'Middle' (75-150% of Median) Income Group Over Time, Selected OECD Countries Derived from LIS and EU-SILC (CREDOC)





# Income Shares of 'Middle' (Deciles 3-7) Over Time, Working Age Households, Selected OECD Countries

Derived from OECD Database



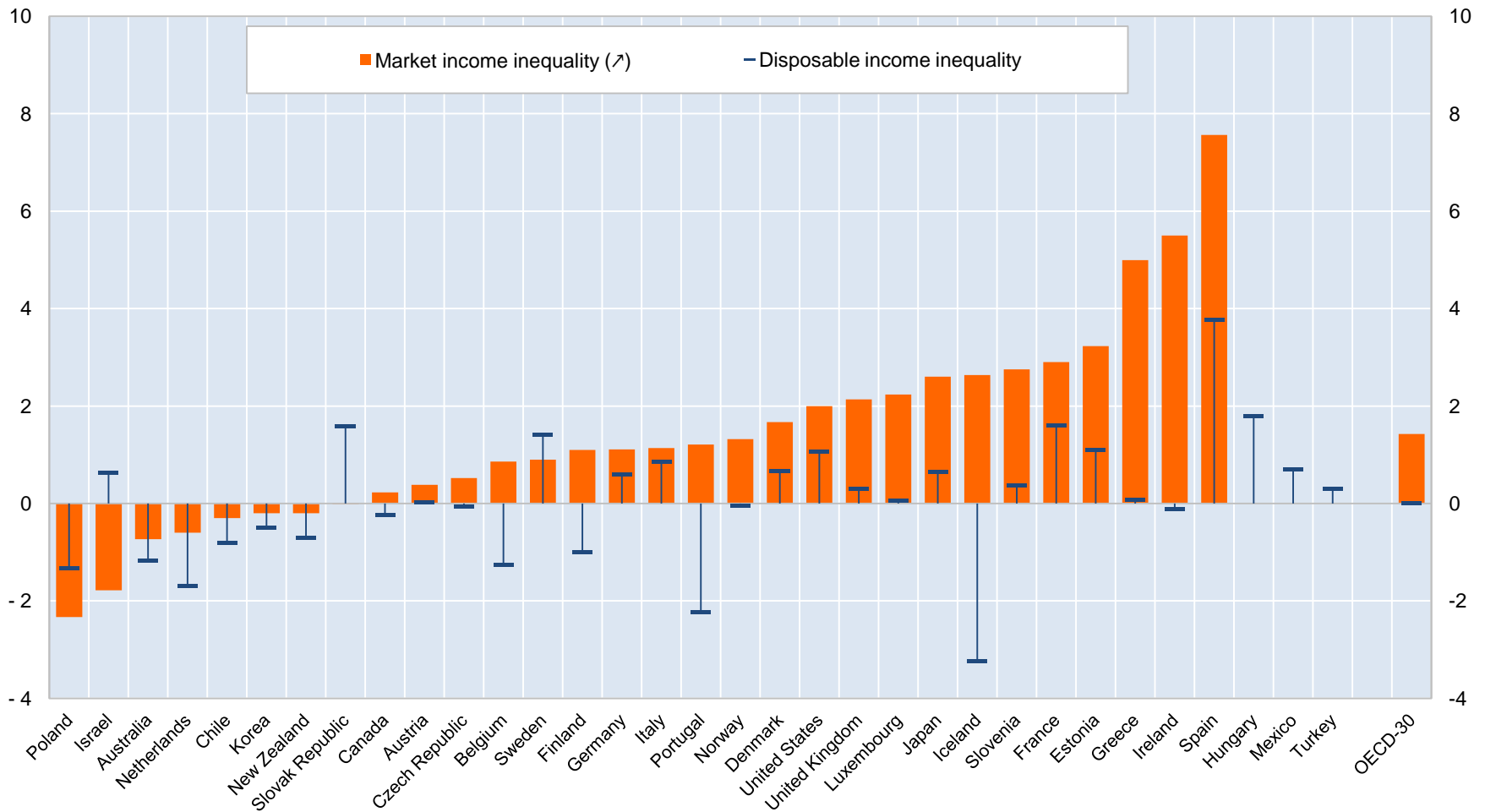
# Factors Driving Inequality Trends

- Increasing inequality in market income among households is key
  - related to increased dispersion in individual earnings (75% of household income), and to technology, globalisation, and institutional change
  - income from self-employment and capital also contributes
  - other factors, incl. age and household structures contribute – e.g. more single person households
  - multiple earners concentrated towards top
- Reduced redistribution via tax/transfers also contributes
  - especially in latter half of period
- Special factors at work at top of distribution
  - changing remuneration practices for top executives incl. link to stock market, financial sector, changing norms?

# The 'Great Recession' and Inequality

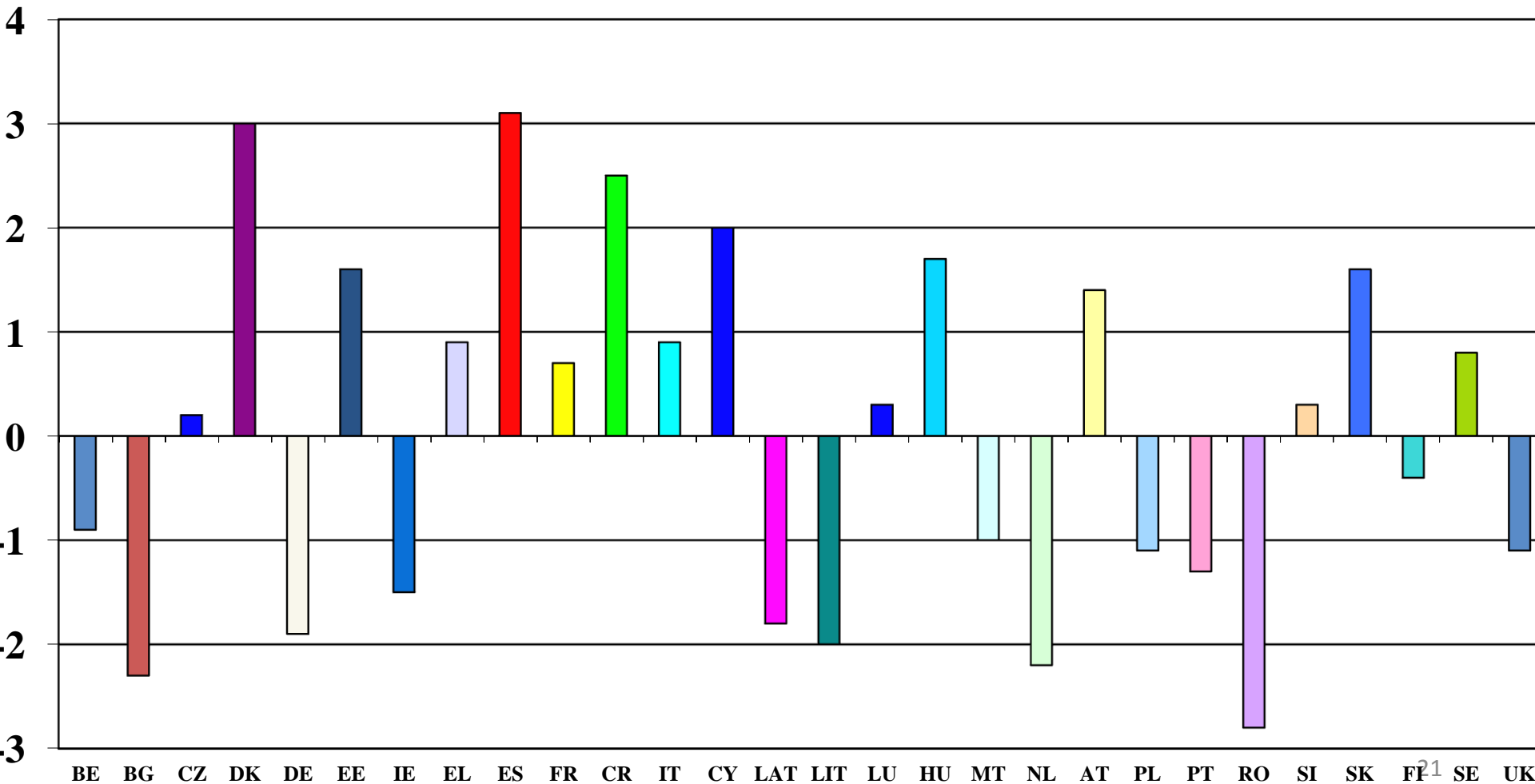
- Worst downturn since 1930s, but no 'rule' for inequality trend during recessions
- Jenkins, Brandolini, Micklewright and Nolan eds. (OUP, 2014) highlight
  - heterogeneity in impacts on GDP, employment
  - changes in income from capital vs labour
  - social transfers and taxes cushion initial impact on household disposable incomes via automatic stabilisers and delayed reaction, policy mixes adopted then vary across countries/over time
  - Some groups – notably elderly – protected relatively well

# Change in Market and Disposable Income Inequality 2007-2011, OECD Countries



# Change in Gini 2007-2012, EU27

[from Eurostat EU-SILC 2008 and 2013]



# Striking Variation across Countries

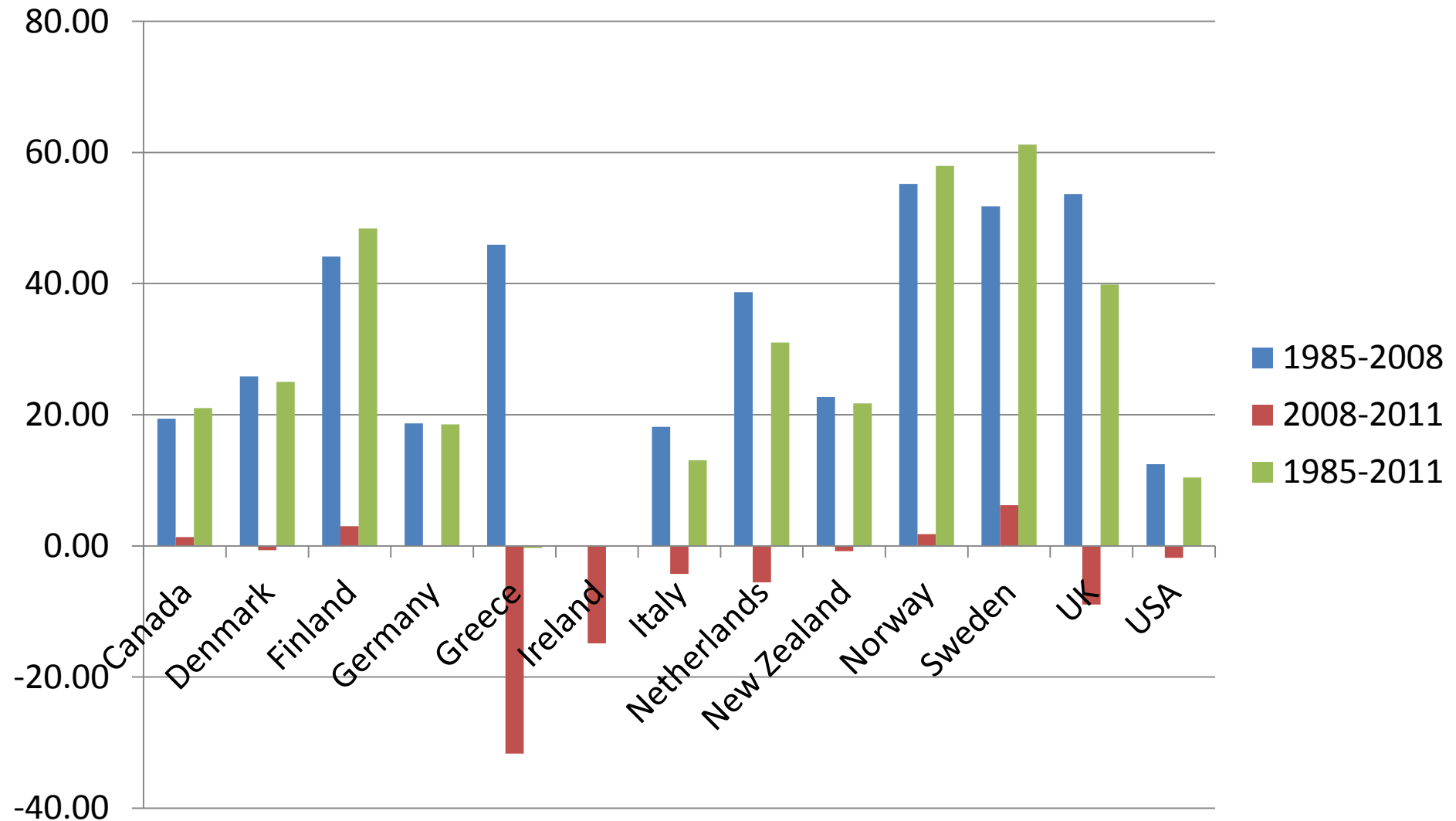
- In extent and pacing of inequality increase
  - Little higher in 2008 than 1980 in certain countries (France, Belgium, Austria, Ireland, Mediterranean)
  - Very substantial increase in Nordic countries, more than in 'liberal' regime countries (better measurement?)
  - Increase in some countries was in discrete 'episodes'
    - 1980s for UK
    - 1995-200 for Canada
    - 2000-05 for Germany
  - Transition countries had very different experiences
  - Crisis had very different effects in different countries

# Striking Variation across Countries

- In patterns of increase in inequality
  - Almost all countries where inequality rose saw gains in share of top decile at expense of rest
  - But scale of that increase, and extent to which 'upper middle', lower middle or bottom lost out, varies
- In market income and role of redistribution
  - Market income inequality rose exceptionally rapidly in UK, whereas reduction in market income Gini by transfers + tax fell in Sweden from 45% to 39% and in Netherlands from 38% to 31%, rose in UK and was stable in USA
- In policy impacts more broadly
  - Significant policy 'drivers' of inequality - Hartz reforms in Germany, in-work versus non-working transfers in Sweden, UK labour market
- In relationship to evolution of real incomes

# 'Middle' (Deciles 3-7) Real Income Change Over Time, Working Age, Selected OECD Countries

Derived from OECD Database, Price Adjustment: CPI





# Some Implications

- Data matters – divergences across sources significantly complicates understanding
- Forces driving increases in market income inequality have had widespread impact, but country-specific institutions, contexts and responses very important
- Direct redistribution policies via taxes and transfers still central to distributional outcomes
- Scope for policy to affect distribution of market income considerable and could be expanded

# Why Address Rising Inequality?

- Can be motivated by normative views about what is 'fair'
  - e.g. CEO should not earn 120 times pay of 'ordinary worker'
- By concerns about its impact on poverty and exclusion
- By concerns about impact on social outcomes
  - family breakdown, crime, health
- By concerns about impact on political engagement, processes and democratic functioning
- By belief that it increases barriers to intergenerational mobility, so equality of opportunity more distant
- By concerns that it may undermine economic growth and prosperity

# Inequality and Poverty

- Relative income poverty broadly associated with level of inequality
  - but poverty varies among countries with similar inequality
- Relationship between trends in income inequality and in relative income poverty looser, variable
  - nature of inequality increase key
- Poverty measured against 'anchored' income benchmarks more closely linked to trends in average/median income
- Differences in material deprivation across countries and over time also strongly related to average income, with income inequality having much modest role

# Inequality and Social Outcomes

- Income inequality can explain little of dramatic change in family structures in recent decades
- Crime rates not strongly linked to inequality, but more unequal societies may be more punitive
- Levels of social solidarity and trust, and status anxiety, may be weakly related to inequality
- Health gradients/inequalities may increase with income inequality while population health improves
- Intergenerational mobility may be higher in lower-inequality countries, but no firm evidence that increasing inequality has generated lower mobility

# Inequality and Politics

- Increasing inequality is associated with increase in preferences/demands for redistribution
- ‘Discontent’ with inequality rises as inequality rises, but only moderately because
  - extent of increasing inequality not fully recognised
  - some increase in acceptability of higher inequality
  - ‘salience’ of inequality may be less
- Higher inequality is associated with lower civic participation, lower turnout among poor
- Increasing income/wealth concentration => greater political influence for rich

# Inequality and Equalising Opportunity

- Intergenerational mobility appears to be higher in lower-inequality countries, at least in terms of income
- but no firm evidence that increasing inequality has generated lower mobility as yet
  - Robust debate in UK, based on interpretation of cohort studies, between teams of economists who see decline in mobility and sociologists who do not
  - Conflicting studies for USA, with latest (Chetty et al., 2014) finding no evidence of changes in mobility comparing cohorts from 1970s, 1980s and 1990s

# Inequality and Economic Growth

- Combined with stagnating real incomes, may have fuelled credit boom and Economic Crisis
- May be dampening recovery and contributing to 'secular stagnation' via reduced aggregate demand
  - Rich have lower marginal propensity to consume, middle and lower incomes dealing with debt overhang
- In longer term, could
  - contribute to boom-bust cycle and retard investment
  - impede education and skill upgrading and increase barriers to socio-economic mobility, reducing productive workforce
- Could also
  - entrench elite capture and rent-seeking
  - fuel demands for protection and stifle innovation
  - undermine institutions critical for sustained growth

# Addressing Increasing Inequality

- Distributional role of social provision via health services, education etc. difficult to capture (esp. over time) but crucial
- Focusing on disposable income, potential policy levers include:
  - Strengthening direct redistribution
  - Influencing wage setting
  - Social Investment
  - Other



# Policy Options: Strengthen Redistribution

- Via taxes
  - more progressive income tax (incl. SI) structures
  - reverse shift towards indirect taxes
  - treatment of income from capital and/or capital gains
  - increase capacity to tax corporate profits
  - increase property taxes (including gifts and inheritance)
  - target tax havens/improve international co-operation
- Via transfers
  - restructure/reinforce transfers to working families
  - Improve family/child benefits
  - strengthen safety-nets in terms of coverage and adequacy

# Policy Options: Wage Setting

- Introduce/raise minimum wages
  - Germany now introducing MW, UK debating less cautious approach to setting level
- Encourage payment of ‘Living Wage’ – in private sector for companies that can afford it and in public sector
- Direct constraints on ‘top pay’ – bankers’ bonuses, CEO pay
- ‘Nudges’ to limit top pay via codes of conduct, public procurement requirements, promote move away from short-term link of remuneration to share price
- Collective bargaining institutions and practices

# Policy Options: 'Social Investment'

- Increase spending on/availability of/quality of early childhood education
- Improve (supports for)
  - completion of secondary level
  - proportion going on to tertiary level
  - proportion completing 3-4 year degrees
  - vocational education incl. apprenticeships
- Address multiple barriers facing disadvantaged throughout education
- Improve design and effectiveness of re-training/active labour market policies

# Policy Options: Other

- Widen distribution of wealth/ income from capital
- Seek to influence sectoral and regional pattern of growth
- Seek to influence nature of technological change
- Seek to influence family structures
- Reduce influence of wealthy on political process by changes in funding etc.
- Influence migration
- Increase protection of industries/sectors/regions

# Inequality and Public Discourse

- Assumption that growth will automatically ‘trickle down’ to disadvantaged, and that greater inequality promotes growth and social mobility, now dispelled
- In highlighting instrumental concerns about specific (potential) impacts of higher inequality, important not to lose sight of broader normative underpinnings
- Public policy has a range of levers available
- Job creation and education and upskilling have to play a major role but should be seen as representing elements in a much more encompassing strategy