Income inequality in the wake of the crisis

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Michael Förster,
OECD Social Policy Division

www.oecd.org/els/social/inequality
Questions addressed in the recent OECD inequality study “Divided we Stand”

1. How have inequalities developed over the long-term up to the Great Recession?
2. What are the major underlying forces behind trends in wage gaps and income inequality?
3. Which policies are most promising to counter increases in inequality?
Large differences in levels of income inequality across OECD countries

Source: OECD 2011, *Divided we Stand*. Note: The Gini coefficient ranges from 0 (perfect equality) to 1 (perfect inequality). Income refers to disposable income adjusted for household size.
Income inequality was on the rise in most OECD countries prior to the crisis.

Source: OECD 2011, Divided we Stand. Note: Income refers to disposable income adjusted for household size.
Income inequality increased in both high- and low-inequality countries alike (but decreased in a few very-high inequality countries);

Income inequality increased during both recession and boom periods;

Income inequality increased especially at the top;

Income inequality increased despite employment growth up to the Great Recession.
OECD evidence on main drivers of inequality

- Changes in **technology**: technical progress was more beneficial for high-skilled workers.

- **Globalisation** (trade, FDI, financial liberalisation) had little impact on earnings inequality trends *per se* but put pressure on policies and institutional reforms;

- Such **institutional and regulatory reforms** aimed at promoting growth and productivity – while they had a positive impact on *employment*, at the same time have been associated with increased *wage inequality*;

- Increases in **human capital** off-set much of the drive towards rising inequality.
OECD evidence on main drivers of inequality (cont.)

- Changes in **working conditions**: part-time work and non-standard labour contracts increased;
- Changes in **working hours**: many countries saw an increasing divide in hours worked between high- and low-wage workers;
- Changes in **household structure**: more people living on their own or with partners in the same earnings bracket;
- Changes in **tax and benefit systems**: in many countries, systems became less redistributive.
Redistribution through taxes and benefits plays an important role

Market incomes are distributed more unequally than household net incomes: taxes and benefits reduce inequality by a quarter

Source: OECD 2011, Divided we Stand. Note: Data refer to the working-age population.
.. but redistribution became weaker in most countries

How much of the increase in market income inequality since 1985 was offset by income taxes and cash transfers?

Source: OECD 2011, Income Distribution Database
Why have tax/benefit systems become less successful at reducing inequality?

- While overall redistribution has *increased*, this was not enough to offset growing market-income inequality;
- Changes in overall redistribution were mainly driven by *benefits*: those became more redistributive during the 1980s/early 1990s but less effective since then;
- Spending levels have been a more important driver of these changes than changes in targeting features;
- Spending shifted towards “inactive” benefits, leading to reduced activity rates and higher market-income inequality.
Income inequality since the Great Recession

• What is the possible impact of the financial and economic crisis on income inequality?
• What will be possible effects of the fiscal consolidation measures?
• Who is likely to bear the costs of the recession and austerity measures?
• Which tax-benefit policy mix helps best mitigating adverse distributional consequences?
The initial inequality impact of the crisis seemed to be small in many countries.

Source: OECD 2011, *Divided we Stand* and OECD income distribution database. Note: Income refers to disposable income adjusted for household size.
Why have initial effects on inequality been small?

• At the top end of the distribution, income shares have fallen due to declines in stock prices and interest rates, and a collapse of capital gains;

• This depression at the top seemed to be temporary, however, and did not undo the preceding increase in top income shares.
The increase of top income shares has come to a halt with the crisis – but only temporarily

Trends in top 1% income shares of total pre-tax income

In the US, the top 1% captured most of the income growth during the recovery 2010

### Real Income Growth by income groups, United States

<table>
<thead>
<tr>
<th>Period</th>
<th>Average real income growth</th>
<th>Top 1% real income growth</th>
<th>Bottom 99% real income growth</th>
<th>Total growth or loss captured by top 1%</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001 recession</td>
<td></td>
<td></td>
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<tr>
<td>2000-2002</td>
<td>-11.7%</td>
<td>-30.8%</td>
<td>-6.5%</td>
<td>57%</td>
</tr>
<tr>
<td>Expansion</td>
<td></td>
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<tr>
<td>2002-2007</td>
<td>16.1%</td>
<td>61.8%</td>
<td>6.8%</td>
<td>65%</td>
</tr>
<tr>
<td>Great Recession</td>
<td></td>
<td></td>
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<tr>
<td>2007-2009</td>
<td>-17.4%</td>
<td>-36.3%</td>
<td>-11.6%</td>
<td>49%</td>
</tr>
<tr>
<td>Recovery</td>
<td></td>
<td></td>
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<tr>
<td>2009-2010</td>
<td>2.3%</td>
<td>11.6%</td>
<td>0.2%</td>
<td>93%</td>
</tr>
</tbody>
</table>

Source: Saez (2012), *The Evolution of Top Income in the United States*. Incomes refer to family market incomes pre-tax and include capital gains.
Why have initial effects on inequality been small?

• At the **bottom end** of the distribution, stimulus packages have cushioned falls in household income levels;

• Household coping strategies, e.g. young people returning with their parents, second earners increasing working hours;

• ...but previous recessions have increased inequality in the mid-term because of an employment divide between rich and poor ...  

• ...and further tax-benefit changes could increase the cost of austerity to low-income groups
Initial crisis response raised social protection

Changes to redistribution policies, mid-2008 – mid-2010

The inequality impact of adverse shocks depends on adjustments via employment or earnings/hours.

Simulated impact of a 5% reduction in aggregate demand on household income inequality.

Source: OECD (2012, forthcoming), *What makes labour markets resilient during recessions?*

Note: Inequality changes in percentage point changes of Gini coefficients (0-100). Results are based on simulations undertaken by OECD and IZA (Peichl and Siegloch).
The distributional impact of recent austerity measures varies by country

Percentage change in household disposable income due to austerity measures up to mid-2011: results from microsimulation

Source: Callan et al. (2011), SSO Research Note 2/2011. Simulations based on EUROMOD and SWITCH.
Note: Austerity measures considered are changes to direct taxes, cash benefits and public sector pay.
The further distributional impact depends on the tax-benefit policy mix

Simulation and further analysis suggests:

• The impact of pay cuts on the public sector has been rather progressive, as they affect more households at the top of the distribution;

• Changes in direct taxes and social contributions affect higher incomes more, while changes to benefits and pensions tend to hit those on low incomes;

• More generally, tax hikes tend to contribute to a strong fall in inequality, while spending cuts are detrimental for income distribution (Agnello and Sousa 2012)

• VAT increases affect the bottom quintile disproportionately.
Cuts in public services spending can also have considerable redistributive effects.

Association between trends in size of public services and changes in inequality reduction, 2000-2007

Source: OECD 2011, Divided we Stand. Note: Percentage point changes in the share of in-kind benefits of services in disposable income, and of the percentage reduction in inequality (Gini coefficient), respectively.
Policy implications for OECD countries

1. Tax/benefit reforms
2. Employment measures
3. Education policies

→ Both redistribution and inclusive employment policies matter
→ Take account of equity/efficiency trade-offs
Thank you for your attention!