5

How can governments respond to income inequality?

Government policy can respond to rising income inequality in many different areas, with a particular focus on three policy areas – education, jobs and taxes and transfers.

Key themes

At the heart of the inequality debate lies a deeper question: Who benefits from economic growth? It's become clear in many OECD countries that the benefits of economic growth are increasingly not being evenly shared. To some extent, this trend reflects fundamental changes in the global economy. But this is not to say that our societies can't – or shouldn't – respond by trying to make growth more inclusive.

An important way of achieving this is through government action. This may mean rethinking ***policy goals*** to better balance the pursuit of prosperity with broader social and environmental progress and to ensure opportunity is widely spread. This sort of approach asks us some fundamental questions about how we measure progress. It can also confront us with some difficult choices between policies that may be good for growth but not for well-being.

In seeking to make growth more inclusive, governments must work across a wide range of policy areas. One of the most important is education, which is key to determining each individual's life chances. That's why education policy needs to address the needs of young ***people from pre-school to university***, ensuring they get the best start in life and the support they need throughout their education.

Education is closely tied to ***skills and training***, and these, in turn, increasingly determine people's ability to earn a decent living. That's why policy must work to ensure workers have the training they need and that workers can make the best use of their talents in the workforce.

Work is also key to reducing inequality and to ensuring that families don't get trapped in poverty – an issue that has become a focus of serious concern in many OECD countries since the financial crisis. As well as building the economic conditions for job creation, policy needs to aim to ***get people into the workforce***, especially women and young people.

A final area of policy focus is ***taxes and transfers***, or the money that the state gives and takes. In developed economies, taxes and

transfers do much to reduce inequality, although there is room in many countries to improve their performance. That may mean better focusing assistance on those who need it most and limiting tax breaks and allowances that disproportionately benefit high earners.

5.1. Policy goals: Growth, well-being or both?

In recent decades, a rising share of the benefits of economic growth in many countries has flowed to people who are already at the top of the economic pile. This trend has led many to question the focus of economic policy – should it aim for growth for its own sake, and hope that it "lifts all boats"? Or should it aim explicitly for more inclusive growth – ensuring the fruits of growth are spread more evenly and that economic goals are balanced with a wide range of social and environmental objectives?

More than growth

Economic growth is, naturally enough, usually a key policy goal. It's essential if societies are to pay for things like healthcare, education, public parks and so on. But a rise in GDP – the most widely used measure of economic progress – is not necessarily a sign that all is going well. For example, it can disguise underlying problems – such as build-ups of unsustainable debt – that may eventually trigger a painful reversal.

Single-minded pursuit of growth also risks eroding the resources necessary to sustain growth. This issue is especially evident in one of the world's economic powerhouses, China. Less than 1% of China's 500 biggest cities meet the World Health Organisation's air-quality guidelines, according to the Asian Development Bank. The tensions inherent in China's rapid growth have been recognised by the government, with Premier Li Keqiang stating that "we shouldn't pursue economic growth at the expense of the environment."

Less obviously, unbalanced economic growth can fuel income instabilities that threaten social stability and undermine future growth by curbing the ability of poorer families to invest in skills and education (*see* ***Section 4.2***).

Measuring our societies' well-being

If rising GDP isn't an automatic indicator of progress, then what is? That question has been asked increasingly in recent years amid rising concern that our societies aren't always very good at measuring what really matters. "What we measure affects what we do", a report by the distinguished economists Joseph Stiglitz, Amartya Sen and Jean Paul Fitoussi stated in 2009, "and if our measurements are flawed, decisions may be distorted."

GDP – or "gross domestic product", a very widely used measure of economic activity – has borne the brunt of the criticism, albeit not always fairly. After all, it was never designed as a measure of well-being. And even as an economic measure, it offers only a very limited sense of whether people are managing to make ends meet. That's true too of measures derived from GDP, such as GDP per capita (which divides the size of an economy by the size of the population): "If inequality increases enough relative to the increase in average per capital GDP, most people can be worse off even though average income is increasing", the Stiglitz-Sen-Fitoussi commission noted.

That's why we need to dig beneath the data to determine if growth – rising GDP – really is inclusive, or bringing wide benefits. Data on inequality and poverty can help us do that *(see **Chapter 1**)*. But we can also look beyond pure income and inequality data to develop a broader sense of how people's lives are evolving.

Over the years, various measures have emerged that aim to provide this broad sense of the state of our societies. Among them is the Human Development Index, produced by the United Nations Development Programme. It uses a single number to indicate the level of a country's development, based on three separate indicators: income; life expectancy, which reflects the state of people's health; and years spent in education. In 2012, the index scored Norway – where life expectancy exceeds 81 years – as first in the world for human development; by contrast, Niger, where life expectancy is just 55 years, was ranked 186th.

The OECD also examines broader issues of well-being in its Better Life Index, which rates a wide range of developed and emerging economies for their performance in 11 areas, including housing,

income, education and life satisfaction. Some countries score well for average household disposable income (*see* **Section 1.2**), such as the United States, Luxembourg and Switzerland, but do less well on the Better Life Index's broader measures of well-being. Others, such as Australia, Sweden and Canada, may have lower income rankings but rank higher on "happiness" issues like work-life balance and life satisfaction.

> **More from the OECD:** The OECD's Better Life Index lets users compare well-being across countries based on 11 topics identified as essential in terms of meeting people's material needs and ensuring a decent quality of life, *http://www.oecdbetterlifeindex.org/.*

Inequalities that go beyond income

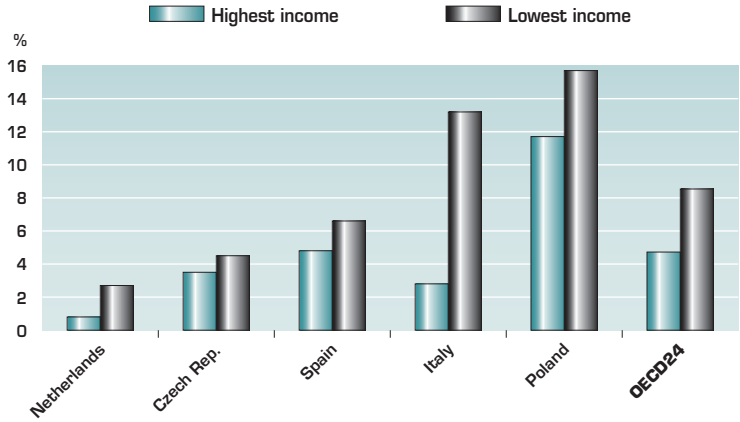
But looking at national figures only takes us so far. Broad measures of "well-being" may not shine a light on significant inequalities within societies in areas like health and access to healthcare and education. These inequalities can be striking. In Scotland, for example, the life expectancy of a boy in Lenzie, a fairly affluent town on the outskirts of Glasgow, is about 82 years, according to data quoted by the World Health Organisation. Twelve kilometres away, in the deprived Calton area, a boy can expect to live to just 54.

As well as such health inequalities, most countries have inequalities in access to public services like healthcare and education. Across OECD countries for which there is data, low-income adults are always less likely to have seen a dentist in the previous 12 months. Similarly, low-income adults are less likely to undergo screening for breast, colorectal and cervical cancers. Access to education can also show sharp divergences depending on people's family background (*see* **Section 4.4**).

All this highlights the reality that policies targeting inequality and inclusive growth need to go beyond just supplementing people's incomes. For example, policy may need to focus more on supporting young people from poorer families in education and on creating health and lifestyle programmes specifically targeted at low-income groups.

Data: People on lower incomes are more likely than those on higher incomes to report that they have not been able to meet their care needs. Cost is the most commonly cited obstacle.

Unmet care needs for medical examination by income level, European countries, 2011



Source: OECD (2013), *Health at a Glance 2013*, *http://dx.doi.org/10.1787/888932918643*.

Policy trade-offs – hard choices

So, the policy response to inequality and to making growth more inclusive is complex and multidimensional, and can involve initiatives across a range of fronts – taxation, health and education policy, labour markets and so on. But it can also involve some tough choices. Some policies may be good for growth and good for reducing inequality – a win-win. That's usually the case for policies that improve people's access to education and, especially, that improve the quality of early childhood care and education *(see* ***Section 5.2****)*.

By contrast, certain forms of taxation may be good for growth but bad for inequality. For example, economists typically argue that indirect taxes – such as consumption taxes like VAT – have a much smaller impact on economic activity than direct taxes, like income tax. However, from the perspective of income inequality, indirect taxes tend to hit lower earners proportionately harder than higher earners, and so typically add to inequality *(see* ***Section 5.4****)*.

> **More from the OECD:** Potential trade-offs between growth and equality are examined in *Economic Policies 2012: Going for Growth*, *http://dx.doi.org/10.1787/growth-2012-en*.

These examples help underline an important point about inequality: Many of the key policy decisions have less to do with economic decisions and more to do with politics – or, the way in which power is exercised in societies and collective decisions made. The choices societies take often reflect the extent of their "taste" for inequality. Some may favour a policy mix that seeks to narrow the income gap as much as possible; others may prefer policies that incentivise economic "winners" to push for growth.

5.2. Education: From pre-school to university

Social background is strongly linked to how well children and young people do in education (*see* ***Section 4.3***). But, as the OECD's PISA studies show, this "rule" can be broken. Every country has examples of children from disadvantaged families who excel in their schooling. Equally, some countries are much better than others at reducing the impact of social background in education. But for this to happen, care and education policies need to be effective across young people's lives, starting in their very earliest years.

There are a couple of "big ideas" that can help frame any discussion of the role of education in countering inequality. One is the idea of equity, which, in turn, is built on two key principles: Fairness, or ensuring that a person's own background or circumstances – such as gender, ethnicity or family situation – are not allowed to limit their success in education; and inclusion, a broad concept that boils down to the idea that everybody – regardless of background – should develop certain basic skills through education (see below). The second big idea is quality. That means good schools, but it also means overall education systems that meet the needs of students and that provide them with a full range of options to meet their individual capacities and aptitudes.

Pre-school care and education

In recent decades, there's been growing recognition of the importance of children's very earliest years in determining their lifelong development. The advantage that children from better-off families enjoy in these early years can be substantial, but some of this gap can be bridged by providing children from less-advantaged families with high-quality day-care and pre-school.

In countries with higher levels of enrolment in day-care and pre-school and higher levels of spending, social background appears to play a smaller role in influencing how well students do in secondary school. There are other benefits, too. Where high-quality and affordable childcare is available, parents – and especially mothers – may find it easier to go out to work, which can help reduce poverty and raise employment rates.

Such programmes are not always universally popular, in part because returns from investment in the care and education of very young children can take a long time to materialise. But, when they do, they can be greater than almost any form of investment in young people. As the economist James Heckman has argued, young people who benefit from early childhood care and education have a whole lifetime to reap the benefits. In addition, learning at a very young age makes it easier to go on learning throughout life, enabling people to go improving their skills and education.

> **More from the OECD:** Volume III of *Starting Strong* examines the challenges of providing high-quality pre-school care and education, *http://dx.doi.org/10.1787/9789264123564-en*.

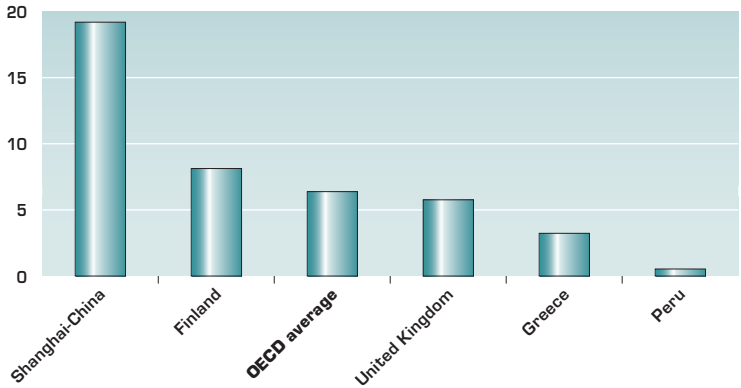
Quality, however, is key, and needs to underpin the regulation of pre-school care and the design of curricula and learning goals. It also needs to be evident in the staffing of care and education centres – research shows that children do better in the care of well-qualified staff, who have the knowledge and skills needed to create a stimulating environment in which children learn and develop through play.

Equity in education

Some of the most important insights into equity in education – ensuring fairness and opportunity for all young people – have come from the OECD's PISA programme. These three-yearly assessments of 15-year-old students in more than 60 countries show clearly that some educational systems do much better than others in lowering socio-economic barriers to success. One marker of this is the proportion of "resilient" students – young people who "beat the odds" and perform better than their family background might predict. In a number of East Asian economies and countries, more than 15% of students are resilient, according to PISA 2012; by contrast, the average for OECD countries is just over 6%.

Data: The proportion of resilient children – or children who do better in PISA than their social background might indicate – varies greatly.

Percentage of resilient students among all students, PISA 2012



Source: OECD (2013), *PISA 2012 Results: Excellence Through Equity (Volume II): Giving Every Student the Chance to Succeed, http://dx.doi.org/10.1787/888932964813.*

Over the years, PISA has highlighted several factors that promote equity in education. Chief among these are teachers. "Nowhere does the quality of a school system exceed the quality of its teachers", says Andreas Schleicher, who runs the OECD's PISA programme. Many of the most successful school systems have

figured out how to attract the most talented teachers to work in disadvantaged schools. They also understand that, while it's important to set ambitious learning goals for students, it's also important to train teachers so that they can understand each child's needs, and then personalise their teaching in ways that meet these needs. It's also essential to support teachers throughout their careers by encouraging collaboration and mutual learning among teachers in schools as well as continuous professional training and development.

> **More from the OECD:** Find out what teachers themselves think of their working conditions and schools with the OECD's Teaching and Learning International Survey (TALIS), *http://www.oecd.org/edu/school/talis.htm*.

PISA has also highlighted a number of other factors that are associated with successful school systems. One of these is inclusiveness, an idea that covers a lot of ground. Encouraging inclusiveness can mean educating children with disabilities in regular classrooms; it can also mean educating children from poorer and better-off families together; and it can mean delaying the "streaming" of children into different programmes. In some countries, social background has traditionally been as important a factor as aptitude in determining whether a child is directed towards an academic or a vocational education. That sort of approach risks devaluing vocational education, which should be an attractive option in every country's education mix, and unfairly limits the choices of young people.

> **More from the OECD:** Findings from PISA on equity in education are presented in *PISA 2012 Results: Excellence through Equity*, *http://dx.doi.org/10.1787/9789264201132-en*.

Who's represented in education?

Young people from poorer backgrounds are underrepresented in tertiary education. One indicator of this can be seen in the student make-up of universities and colleges. If enrolment in tertiary education accurately reflected the general population, there would be almost twice as many young people from families with parents

who have low levels of education (i.e. who didn't complete secondary education). Of course, many young people from poorer families do make it to university, but even here the influence of social background is apparent. There is evidence that many attend low-status, rather than elite institutions; enrol in short programmes leading to vocational degrees, such as vocational therapy, rather than long programmes, like medicine; and are particularly underrepresented in advanced tertiary education, such as doctoral programmes.

Many of the barriers to disadvantaged young people entering tertiary education have their roots not in financial constraints – although these can certainly be a factor – but in the fact that they don't have the right qualifications. This only underlines the importance of moving early to support young people throughout pre-school and compulsory education; delaying until they are at the age to enter university is likely to represent a lost opportunity. Career guidance is also important during secondary schooling to ensure parents with low levels of education and their children understand the potential benefits of tertiary education.

> **More from *Insights*:** Education's power to drive social mobility is weakening, says the OECD Insights Blog, *http://wp.me/p2v6oD-1Pj*.

Education systems also shouldn't limit future student's future options early on in their school careers by putting them on an exclusively vocational education track. The benefits of offering opportunities for vocational education are increasingly recognised, especially for students who might otherwise drop out of school. However, entry into vocation education is all too often determined solely by social background. Children, especially from disadvantaged families, may be put on a vocational track when they're as young as 10 or 12, effectively closing off academic options at an age when their interests and aptitudes are still not fully developed. That's why there should be plenty of doors in the walls separating academic and vocational secondary education to ensure students aren't overly restricted in their choices.

5.3. Skills: Equipping workers for change

One of the significant drivers of income inequality is the expanding pay gap between high and low-skilled workers (*see* ***Section 3.3***). It's clear that workers with relatively weak skills will continue to face increasing challenges in the modern economy. According to economists Carl Benedikt Frey and Michael Osborne, 47% of existing jobs in the United States are under threat from computerisation. Many of these will be routine office jobs, but, as artificial intelligence advances, even high-level tasks will face increasing competition from computers.

> **More from *Insights*:** *Will a robot take your job?*, asks the OECD Insights Blog, *http://wp.me/p2v6oD-1NQ*.

But you don't need to look into the future to see the cost of insufficient or outdated skills, both for national economies and individuals. Nationally, the wage gap between high and low-paid workers tends to be narrower in countries where skills are more evenly distributed across the workforce. For individuals, low skill levels are linked to higher rates of unemployment and lower incomes. They are also linked to other unwelcome outcomes, including a greater likelihood of health problems and lower levels of social engagement (although the cause-and-effect relationship is not necessarily straightforward).

Ensuring that people are equipped to thrive in the economies and societies of tomorrow is a process that needs to start in the earliest years of life and then continue throughout young people's formal education. But the task doesn't end once young people leave education. Throughout people's working lives, government policies need to encourage continuous investment in training, ensure that people who want to work can work, and ensure a better match between people's abilities and the jobs they actually do.

Developing skills

Even at the height of the Great Recession, some employers had problems hiring. In Greece in 2010, for example, the unemployment rate of almost 18% was exceeded by the percentage of businesses

reporting recruitment difficulties, 41%. The reasons for such mismatches are complex. Potential hires may be living in the wrong part of the country or may be deterred by low pay or poor conditions on offer. Or they may lack the qualifications businesses are looking for.

These complexities underline the need to develop a clear picture of who can do what in the workforce, which, in turn, can guide the design of policies that boost people's job prospects. Some policy approaches are fairly obvious. For example, young people are likely to benefit from high-quality training that takes them out of the classroom and into the workplace. This can help ensure that they develop not just "hard" skills on real equipment but also "soft" skills like teamwork. Less obviously, tax systems can be designed to provide businesses and individuals with incentives to invest in training.

> **More from the OECD:** *The OECD Skills Strategy* aims to help countries create and make the best use of high-quality skills, *http://dx.doi.org/10.1787/9789264177338-en*.

Putting skills to use

For a variety of reasons, many people with useful skills are deterred from working. That's a particular issue for women but also for other groups, such as workers reaching the ends of their careers. In Iceland and New Zealand, more than three-quarters older people (55 to 64) are still in the workforce; in a dozen other OECD countries, the proportion is below half.

In many cases, people decide that it just doesn't pay to work. Costly childcare is a particular obstacle for many women (*see* **Section 5.5**), but so is the lack of job flexibility, such as part-time working. For older workers, pension systems may effectively encourage them to retire early by limiting the financial benefits of working beyond their mid-50s. As populations age, governments have been increasingly tightening rules that encourage workers to retire early. In New Zealand, for example, the proportion of older people still at work rose from 44% in 1990 to 76% in 2010.

Matching skills with jobs

Young people may find it particularly difficult to make effective use of skills and training. As well as suffering higher rates of unemployment, they frequently find themselves in unstable jobs that don't match their qualifications and offer little job security. Long-term unemployment at an early age risks "scarring" young people, resulting in a lifetime of weakened job prospects.

> **More from the OECD:** Find out how young people can get their working lives off to a good start in the OECD's Jobs for Youth project, *http://dx.doi.org/10.1787/9789264096127-en*.

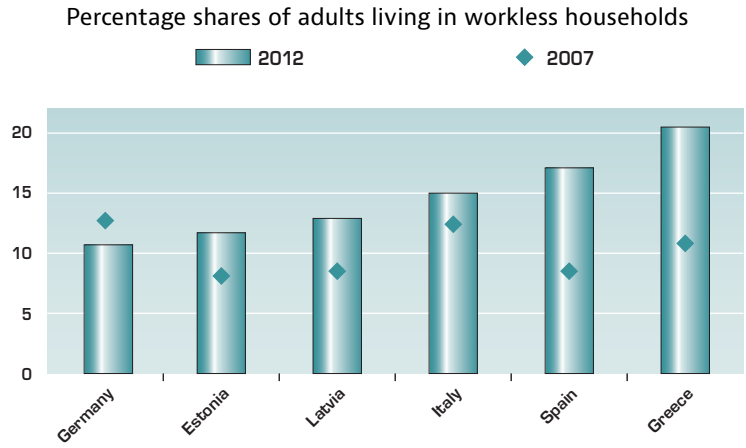
Government policies can work to discourage hiring-and-firing rules that penalise young people compared with other groups. They can also provide financial incentives to help overcome employers' resistance to hiring relatively inexperienced young people. Policies can also work to encourage entrepreneurship and innovative start-ups, which have a strong record in job creation and may offer work that's well-matched to young people's abilities.

5.4. Jobs: Getting more people into work

It's by no means the only answer to inequality and poverty, but work can go a long way to securing people's economic fortunes and putting them on a firm footing. "Employment can provide not just a salary but an opportunity for people to grow, to develop new skills and ambitions and to feel useful in society", according to an OECD *How's Life* report.

The role of work is brought into even sharper focus when it's in short supply, as it has been since in recent years. The impact of the jobs crisis can be seen in the rise in many OECD countries in the percentage of people living in "workless" households. In a number of Eurozone economies – Greece, Ireland and Spain – the percentage of people living in families where no one is working has doubled since 2007, while in several other countries it's up by at least 20%.

Data: After the financial crisis struck, some countries saw rises in the numbers of people living in households where no one is working.



Source: OECD (2014), *OECD Society at a Glance 2014*, *http://dx.doi.org/10.1787/888932965953*.

Families where no one is working are more likely to fall below the poverty line, and children living in such families may face a lifetime of disadvantage. To combat these ill-effects, it's important not just to get laid-off workers back into jobs but also to encourage employment among certain groups that are underrepresented in the workforce, most notably young people, people with long-term disabilities and – especially – women.

In-work poverty

But while work is probably the single most effective response to poverty, in recent years there's been concern that its power may be waning. There are several reasons for this. One is the existence of "in-work poverty", where workers earn too little to lift themselves above the poverty line.

What causes in-work poverty? Low wages and insufficient working hours are obvious factors. It's also linked to job instability, where people may move frequently between low-paid jobs and unemployment. Indeed, recent decades have seen the emergence of

a growing division in many workforces between workers with highly stable contracts and those on temporary contracts, who often have little job security and are at risk of repeated bouts of unemployment between jobs. The number of adults working in the household is also a factor. Typically, in-work poverty is lower where two or more adults work rather than one.

Policies for more and better jobs

What can governments do to get more people into the workforce? Creating the right economic conditions for job creation is clearly essential to ensure that there's a strong demand for workers. But policy can also help to ensure there are strong incentives for people to find work. In the area of unemployment benefits, this can mean shifting from "passive" state support, which may focus solely on the payment of benefits, to more "active" support. With this sort of approach, the state provides services like job-search support and training while making benefits payments contingent on people demonstrating that they're committed to finding work.

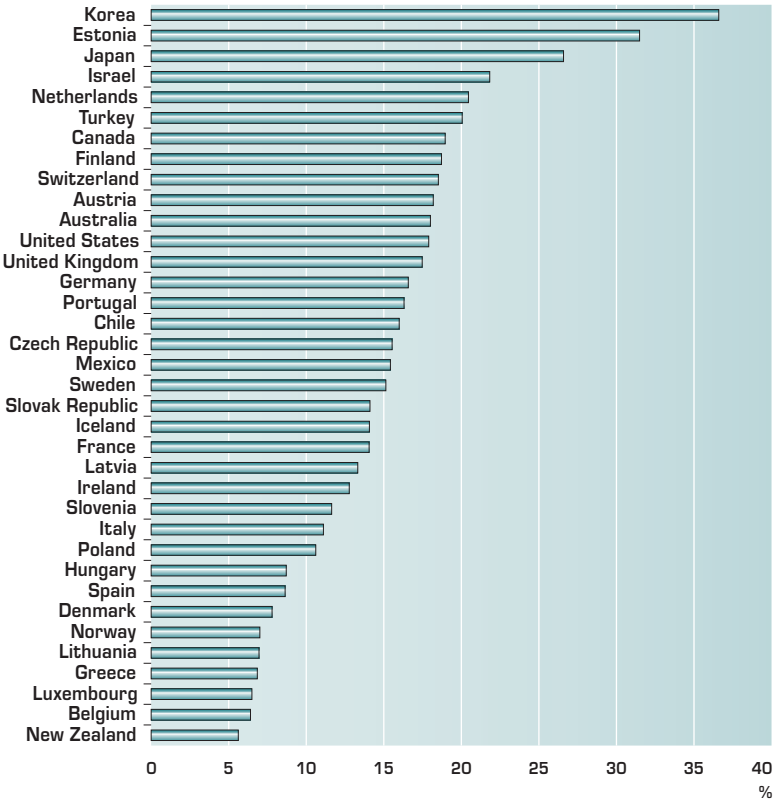
Specific policies can also help tackle the needs of groups that are underrepresented in the workforce, including women and young people, as well as particular groups of workers, like part-timers and temporary staffers.

Women: Women are a growing presence in the workforce and are steadily narrowing the gap with men in terms both of employment and earnings. For example, over the past 20 years, the employment gap between men and women – that's the percentage of working men minus the percentage of working women – has narrowed by 7 percentage points. However, the gap still stands at 16 points. And that doesn't take account of the fact that more women work part-time than men. When that difference is factored in, the employment gap widens to close to 24 points.

Gaps also persist in pay, although these, too, have narrowed. Since 2000, the pay gap between full-time male and female employees has narrowed from around 18 points in OECD countries to around 15 points. However, this average conceals very big differences between countries, ranging from above 36 points in

Data: The pay gap between women and men is narrowing, but still stands at around 15 percentage points on average, and is around double that in some countries.

Wage gap between male and female full-time employees, OECD average, 2013 or most recent year.



Source: OECD Gender Data Portal, http://www.oecd.org/gender/data/genderwagegap.htm.

Korea to below 6 points in New Zealand. Other gaps persist, too: Around 83% of women work in the services sector compared with just 34% of men. Women are also much less likely to be in senior roles – in 2013, only just over a third of managers were women in OECD countries. There are gaps, too, when it comes to childcare – a significant factor for many women in determining whether they

work full-time, part-time or at all. Women still carry the heaviest burden of childcare: On average in OECD countries, women spend just over 4½ hours a day on unpaid work – chiefly childcare and housework – around double the average for men.

> **More from the OECD:** The *OECD Gender Data Portal* is a source for data on gender inequalities in education, employment and entrepreneurship, *http://www.oecd.org/gender/data*.

As well as the social and equality arguments for encouraging female employment, there are also many economic justifications. Not the least of these is that, broadly speaking, rising female employment has acted as a brake on rising income inequality. True, it hasn't halted the rise, but it has tended to slow it. If the proportion of households with working women had remained at the levels of the early 1990s, income inequality in the OECD would have increased by almost 1 Gini point more on average, i.e. by 4 rather than 3 points. In addition, the impact of more women working full time and narrowing the pay gap with men added another brake of 1 point.

To ensure even more women can enter the workforce and make the most of their career options, continued efforts to combat discrimination and remove barriers to female employment and career progression will be needed.

> **More from the OECD:** The *OECD Gender Recommendations* set out policy principles to level the playing field between women and men in education, employment and entrepreneurship, *http://www.oecd.org/gender/C-MIN(2013)5-ENG.pdf*.

Because of the burden of childcare that traditionally falls on women's shoulders, support for parents is also key to encouraging more women to enter the workforce. The OECD's Babies and Bosses project identifies the Nordic countries, which have very high rates of women in work, as a model. Traditionally, they've offered a continuum of support to families, from when children are very young and still at home, and then on to childcare and into pre-school, school and after-school activities. But other countries have also taken important strides in supporting parents to better share childcare duties. For example, Germany, Italy and France now

all offer "use it or lose it" leave to new fathers. Businesses, too, can play a role by offering greater flexibility in when – and where – workers carry out their duties and a more understanding attitude when parents need to take time off to care for children.

Young people: Compared to the rest of the population, young people are about twice as likely to be unemployed. Young people who experience prolonged unemployment can face a lifetime of reduced earnings and career possibilities. The needs of the young are looked at in the OECD's Jobs for Youth project, which recommends a range of policy approaches. These include moving quickly to provide young people with job-search assistance; strengthening apprenticeship and vocational programmes for young people with low skill levels; and providing financial incentives for businesses hiring young and low-skilled workers. Second-chance programmes for school dropouts are also important to ensure young people develop the skills they need to avoid dead-end work.

> **More from the OECD:** The state of vocational education and training is examined in *Skills Beyond School*, *http://dx.doi.org/10.1787/9789264214682-en*.

Supporting temps and part-timers: The traditional permanent 9-to-5 job is declining in OECD countries. Since the mid-1990s, more than half of all jobs created in OECD countries were in temporary and part-time work and in self-employment – what's sometimes called "non-traditional" employment. For a variety of reasons, this trend is tending to increase income inequality *(see* ***Section 3.3****)*. Because relatively high numbers of women and young people are in non-traditional jobs, policies targeted at these groups are likely to have a significant impact on a large share of the non-traditional workforce. But additional policies may also be needed, for example targeted social spending, such as in-work benefits, to reduce the numbers of working poor. Policies should also work to help ensure that temporary contracts become stepping stones to career progression rather than dead ends.

> **More from the OECD:** The impacts of rising female employment and non-standard employment on income inequality are examined in *In It Together: Why Less Inequality Benefits All* (OECD, 2015), *http://dx.doi.org/10.1787/9789264235120-en*.

5.5. Taxes and transfers: What the state gives and takes…

Even if the term may not be in everyday use, tax and transfer systems are familiar to most people. The "tax" part needs little explanation, for now; the "transfer" part essentially covers payments made by the state, such as unemployment and family benefits. These days, complex tax and transfer systems are a feature of life in developed – and, increasingly, in developing – countries. They have many different social and economic objectives, but, from the perspective of income inequality, the main concern is over how much they redistribute across society. The extent to which this happens is determined by three main factors:

- **Size:** Simply, the amount the state takes in taxes and distributes in transfers.
- **Mix:** Some tax and transfer systems rely more on income taxes rather than consumption taxes, say, or pay out more in family benefits than in pensions. This "mix" helps determine overall redistribution.
- **Progressivity:** "Progressivity" is most easily explained in relation to taxes. A tax is progressive when it means that higher earners pay out a bigger *share* of their income than lower earners. By contrast, it's regressive when it hits lower earners proportionately harder than higher earners.

How transfers contribute to redistribution

Most – but not all – transfers are made through welfare systems, the roots of which can be traced back to Otto von Bismarck, the 19th century Prussian statesman. In a speech in 1884, he outlined his vision of state support: "Give the working man the right to work as long as he is healthy; assure him care when he is sick; assure him maintenance when he is old." The Iron Chancellor was not acting solely out of benevolence. In that same speech, Bismarck made it clear that he was mainly interested in curbing the appeal of socialism. Today's welfare systems have a broader scope than in Bismarck's day, thanks in part to the influence of the "Beveridge Plan", a programme designed by Lord Beveridge in the United Kingdom

in 1942 that led to the creation of the first unified social security system. These days, they can be said to have the following broad objectives:

- **Smoothing out people's incomes across their lives:** Welfare systems often provide people with pensions, funded – at least in part – by the taxes or social contributions they paid during their working lives.
- **Helping people cope with the unexpected:** Welfare systems provide support to people during crises such as job loss or sickness and disability.
- **Limiting the impact of poverty or reducing income inequality:** Welfare systems use a mix of two main approaches: Means-tested support to people on very low incomes and universal benefits, regardless of family income, such as child support.

As well as direct transfers, like unemployment benefits, states also make non-cash transfers through public services. For example, in most OECD countries, education is free or heavily subsidised until at least the age of 15. These public services have an important impact on families' finances: If the value of these services were translated into cash, the average annual household income in OECD countries in the late 2000s would have risen from around $22,000 a year to $28,000. Public services also play a major role in reducing income inequality, reducing it by between a fifth and a third, depending on the measure of inequality used.

Since the mid-1990s, tax and transfers systems have tended to become less redistributive in OECD countries, largely because of changes on the benefits side. Benefits have become less generous, eligibility rules have been tightened and transfers to the lowest income groups haven't kept up with earnings.

> **Go deeper:** OECD economists look at the role of taxes and transfers in reducing income inequality, *http://dx.doi.org/10.1787/eco_studies-2012-5k95xd6l65lt*.

Some transfers redistribute more than others

When it comes to redistribution, not all transfers are the same. Some significant transfers, such as pensions, can play only a fairly small role in redistribution (although the impact can vary depending on how it's measured). In part that's because, in many countries, a large slice of workers' pension payments are funded by money they themselves paid to the state during their working lives – in that sense, some pension systems may be regarded as delivering deferred earnings rather than redistributing income across society. Other factors also play a role. For example, lower-paid workers typically live shorter lives than their higher-paid peers. As a result, they may not draw down pension payments for as long as their better-paid and longer-lived peers and so, essentially, subsidise the pensions of higher-paid workers. Other transfers are typically more redistributive, for example family cash benefits. But as with so much in this area, a lot can depend on the benefit is designed – for example, whether it's means-tested or universal.

How taxes contribute to redistribution

Just as with transfers, the reasons why governments impose taxes go well beyond just redistributing income. Taxes help fund all the operations of government, including building schools and hospitals, paying for a bureaucracy and providing defence. They can also be used to guide certain behaviours: For example, cigarette and alcohol taxes aim to encourage healthier lifestyles.

While people generally think of transfers as the main means for redistributing income, the tax system itself can also play an important role. In the United States, for example, tax credits provide significant support for lower-paid workers. Typically, they allow taxpayers to directly cut their tax bill if they meet certain conditions, such as being a parent. In some countries, low earners can even receive a tax refund if their tax credits exceed their tax bill. Along with allowances and tax breaks, tax credits are a form of tax expenditure. This is another way of saying that governments sacrifice some of their potential tax take in return for pursuing social and economic goals, such as expanded home ownership, regional investment or support for specific business sectors.

Some taxes are more progressive than others

Overall, personal income taxes tend to be among the most progressive forms of taxation in OECD countries. And even though top rates of tax have been falling, they've become more progressive in recent years. That's been driven not by higher taxes at the top but by increases in tax credits and cuts in social security contributions for lower paid workers. But, equally, some tax credits – and tax expenditures more broadly – are moving against this trend towards greater progressivity. This happens especially when higher earners get substantial tax breaks on things like health and child care and retirement savings.

Other taxes can be less progressive and, in some cases, even regressive. One example is consumption taxes, such as value-added tax, or VAT. Because poorer households tend to consume a bigger slice of their income than wealthier households, who save more, they tend to be hit disproportionately by consumption taxes. Many countries try to address this by limiting consumption taxes on essentials like food. While this does help poorer families, it also benefits their wealthier counterparts.

Policy approaches

Few areas of policy pose quite so many challenges as the design of tax and transfers systems, in part because of their complexity and the fact that they serve a very wide range of social and economic goals, not just redistribution. As a result, they are often the subject of intense political debate, and reaching a consensus can be a challenge.

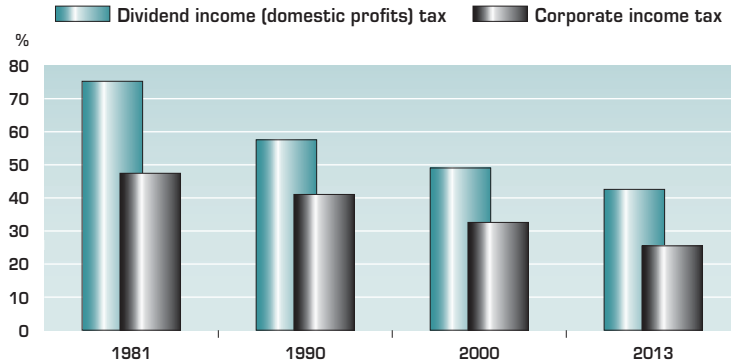
Nevertheless, from the point of view of income inequality, a number of ideas have emerged in recent years that seek to improve the performance of tax and transfer systems. On the transfers side, the budget squeeze facing many OECD governments makes it more important than ever to ensure that public spending delivers maximum benefits. This may strengthen the case for increasingly targeting payments on low-income families.

Similarly, recognition of the role of work in lifting families out of poverty and in building valuable social connections has shifted attention to in-work benefits. These can encourage people to take up

work and help reduce levels of in-work poverty. And the role of non-cash transfers – such as spending on education and healthcare – should not be forgotten. Education spending needs to be targeted in ways to ensure that as many people as possible can access a high-quality education.

Data: Taxes that affect mainly top earners have gone down.

Dividend income and corporate income statutory tax rates, OECD average, 1981-2013



Source: OECD (2014), "Focus on Top Incomes and Taxation in OECD Countries: Was the crisis a game changer?", *http://dx.doi.org/10.1787/888932965953*.

On the taxes side, there has been growing discussion around the idea of changing the tax treatment of top earners, which has tended to become more generous since the 1980s. Even without increases to top rates of tax, there is room in many countries for scaling back some tax deductions and credits that tend to benefit higher earners disproportionately. There may also be room for taxing benefits like stock options as ordinary income. Again, these sorts of benefits tend to be enjoyed disproportionately by high earners. Other approaches include making greater use of property and wealth taxes, such as inheritance taxes, and harmonising the way tax systems treat regular income and income from capital, which tends to be taxed less heavily.

Conclusions

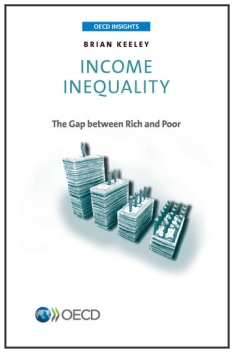
Income inequality is a complex subject that is sometimes reduced to overly simple explanations. The reality, as this *OECD Insights* has attempted to show, is that its causes are diverse. They can vary depending on whether we're looking at the rising incomes of "the 1%" or the growing gaps between, say, very low earners and the rest of the population. Equally, the consequences of rising inequality are multifaceted, and may be reflected in the pace of economic growth, reduced social mobility and, perhaps, even our health. Clearly, there is no single solution to harmful impacts of income inequality. A comprehensive response may require action across a broad swathe of policy areas, including in education, employment policy and taxes and transfers.

What is the future for income inequality? On the face of it, the outlook is not encouraging. Some of the most important drivers of inequality look increasingly to be embedded in our economies and societies. As one OECD paper recently noted, "the growing importance of skill-biased technological progress for growth and rising demand for higher skills will lead to continued polarisation of the wage distribution". It forecast that by 2060, and without a change in policy approaches, inequality in the *average* OECD country will match that found today in the most unequal countries.

But, of course, policy approaches can, and do, change. We take for granted much of the social and economic infrastructure that surrounds us – mass education, basic healthcare, social security. But there was a time when little of this existed. It came about because societies recognised the need to respond to changing circumstances. Rising inequality is certainly a changing circumstance, and there's no shortage of signs that more and more of us feel the need to respond. As Chrystia Freeland, a journalist and Canadian politician, has written, "Not so long ago, inequality was a dirty word. [Now] inequality hasn't merely become a subject fit for polite company, it has become *de rigueur*." But talking about a problem is one thing, finding solutions is another. Again, however, the examples of how societies have repeatedly acted to improve people's lives should give us reasons to be optimistic. As the economist Anthony Atkinson has

written, "The world faces great problems, but collectively we are not helpless in the face of forces outside our control."

Ultimately, the question for our societies is this: How much inequality are we prepared to accept? This goes to the heart of our attitudes to wealth and poverty, to inclusion and exclusion, to social mobility and immobility. Economics will no doubt play a part in how our societies formulate a response. But, fundamentally, these questions are political. Not in the sense of party politics, but in the sense of how our societies work collectively to make decisions that affect the lives of everybody, be they rich or poor.



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