

Why is income inequality rising?

Many factors explain the rise of income inequality. Some are economic, such as the role of technology in the globalising economy; others are social, such as shifts in who people marry; and some relate mainly to the rising incomes of top earners.

Key themes

The rise of the 1% is the most visible face of income inequality, but fissures have opened up elsewhere, such as between a large group of low earners – as much as 40% in some countries – and everyone else. It's important to understand that the factors driving rising inequality in one part of the population, say between the 1% and the 99%, don't always fully explain why inequalities are rising elsewhere. It's important, also, to realise that a whole range of factors – economic, social and the role of the state – are contributing to rising inequality.

One of the most important of these is the impact of **globalisation**, or the process through which the global economy has become more integrated through a complex series of “flows”, including technology and information, trade and investment. Just as it has in the past, technology is destroying old jobs and creating new ones. This is making high-skilled workers even more valuable and killing off the jobs of some middle and low-skilled workers. It's also helping to shift the balance between **labour vs. capital**, delivering a larger share of income to the owners of capital, such as entrepreneurs, and a smaller share to the people who work for them.

Inequality has also been affected by changes in our **societies**, such as the growing tendency for people to marry people from very similar social and education backgrounds, and by changes in **the workplace**, such as the rise in part-time working and the decline in union membership.

Through the taxes it collects and the benefits it pays out, the state plays a major role in reducing inequality. But **the state's role** has been evolving, with a general trend towards policies that redistribute less. Other economic policies, such as a move to reduce regulation, have also probably helped to increase inequality.

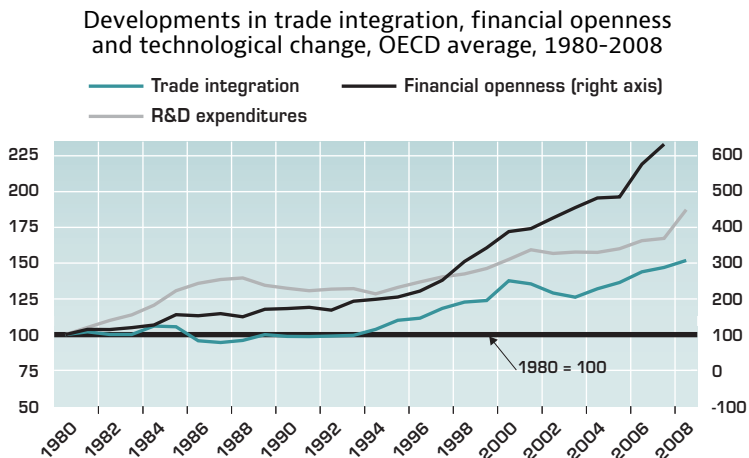
Some of these factors have also contributed to the rise of “the 1%”. But a range of special factors have also been involved in boosting **top incomes**. These include the emergence of a “superstar” labour market, the growing use of stock options and performance pay and the “financialisation” of economies.

3.1. Globalisation: A key role for technology

“Globalisation” means different things to different people. For some, the spread of Western-style lifestyle and culture – embracing everything from American coffee chain Starbucks to Korean K-Pop music – is its most visible face. But in the context of income inequality, it’s economic globalisation that matters – or the way in which the world economy has become increasingly integrated and interconnected through five global “flows”:

- Technology and information
- Trade
- Finance and investment (or the ability of capital to flow across borders)
- Production (or the ability of businesses to move operations around the world)
- International migration

Data: The pace of globalisation – represented here by rising trade, the opening of financial markets and technological progress – sped up in the mid-1990s.



Source: OECD (2011), *Divided We Stand: Why Inequality Keeps Rising*, <http://dx.doi.org/10.1787/888932535223>.

Globalisation can be a divisive issue, and polls suggest that in many parts of the world there's a perception that its benefits are not being enjoyed equally across societies. In many developed countries, there's also a perception that aspects of globalisation, such as outsourcing by businesses, are costing jobs and driving down incomes.

More from *Insights*: The causes and consequences of globalisation are examined in *OECD Insights: Economic Globalisation* (OECD, 2013), <http://dx.doi.org/10.1787/9789264111905-en>.

The impact of technology

All of the flows that constitute globalisation can have some impact on income inequality, but perhaps none more so than technology and information flows. That's not so surprising – technology has long had an impact on people's livelihoods. Take the Luddites, textile workers in 19th century England who smashed up newly installed machinery. The Luddites are sometimes portrayed as having been almost irrationally fearful of technology. In fact, they had good reasons to oppose it. They were craftsmen who had invested time in developing their skills. As the Industrial Revolution dawned, they didn't want to see those skills thrown into the dustbin of progress. As the economist Paul Krugman has written, "Mechanization eventually – that is, after a couple of generations – led to a broad rise in British living standards. But it's far from clear whether typical workers reaped any benefits during the early stages of the Industrial Revolution; many workers were clearly hurt."

More from *Insights*: Some experts argue that technological change is destroying jobs faster than creating them, says the OECD Insights Blog, <http://wp.me/p2v6oD-1xZ>.

The Luddites illustrate the reality that almost every wave of technological change brings losers as well as winners. Today is no exception. Over just the past few decades, the number of people employed as telephone operators and shorthand typists has dwindled markedly. Other jobs will go in the future; including some "knowledge work" that today might seem to be immune to technology. Indeed, there are already signs that this is happening: As *The New York Times*

reported, in the late 1970s, a small army of lawyers worked for months to analyse 6 million documents in an antitrust lawsuit at a cost of \$2.2 million; 33 years later, specialised software conducted similar analysis on 1.5 million documents at a cost of just \$100,000.

So, technological change affects the world of work, devaluing and revaluing skills and, of course, creating whole new skills and jobs – think of app developers and social media strategists. This relationship between skills and technology is regarded by many as an important, perhaps the most important, factor behind rising income inequality. It was characterised by the Dutch economist Jan Tinbergen as “the race between technology and education”. The authors of a book that took Tinbergen’s phrase as their title, Claudia Goldin and Lawrence Katz, explained his thinking thus: “When technological advance vaults ahead of educational change, inequality generally rises. By the same token, when increases in educational attainment speed up, economic inequality often declines.”

Looking at the current state of the race between technology and education, it’s often argued that technology is now in the lead and that education is failing to keep up. The result is that people with lower levels of education are in growing danger of seeing their jobs replaced by technology. On the other hand, people with high-level skills are well positioned to put new technologies to good use and are enjoying increasing returns to their education.

The impact of trade and investment

After technology, the two globalisation flows with the greatest potential to affect incomes are probably trade and investment.

Trade: According to standard trade theory, increases in global trade should widen the wage gap in developed countries and narrow it in developing countries. In practice, it’s not clear that this has actually happened; if it has, the impact looks to have been, at most, extremely modest. Indeed, some studies suggest wage gaps have risen in *both* developed and developing countries.

More from Insights: The impact of trade in our societies and economies is examined in *OECD Insights: International Trade – Fair, Free and Open?* (OECD, 2009), <http://dx.doi.org/10.1787/9789264060265-en>.

There are countries, however, where rising trade does seem to have had more of an impact, most notably where employment-protection legislation is relatively loose. In effect, in countries where it's easier to hire and fire workers, increasing imports do appear to have more of an impact on the income gap, especially if they come from low-income countries.

Investment: For much of the 20th century, money rarely crossed borders. True, some funds were sent abroad to pay for imports and as remittances, but this formed a very small slice of most countries' economic activity. Equally, businesses tended to invest mainly at home, and spent very little on foreign direct investment (FDI) – buying foreign businesses or setting up operations abroad. As recently as the early 1980s, FDI accounted for no more than a twentieth of economic activity in OECD countries.

More from the OECD: The impacts of globalisation on income inequality are discussed in Chapter 2 of *Divided We Stand: Why Inequality Keeps Rising* (OECD, 2011), <http://dx.doi.org/10.1787/9789264119536-en>.

Today, it typically accounts for around half, ensuring that FDI is one of the most visible faces of globalisation – examples abound: American chipmaker Intel designs silicon chips in India; Indian conglomerate Tata employs 20,000 workers in the U.S. in its information technology division. It's also one of the most controversial. Offshoring is widely blamed for taking away jobs in developed countries, especially among low-skilled workers, and there is some truth to this. How much, though, is hard to say. FDI, trade and the rising use of technology are so intertwined that it's very difficult from an analytical perspective to state the relative importance of one versus the other.

3.2. Labour vs. capital: A shifting balance

The impact of technology is also evident in another economic trend that is going hand-in-hand with – and arguably contributing to – the increase in income inequality, namely a shift in the share of

national income from labour and towards capital. In other words, less of the income generated by the economy now goes to workers and more goes to the people who own businesses.

The factors of production

Societies call on a vast range of resources to produce goods and services. Take something as basic as a T-shirt: Somebody needs to take the initiative to produce the garment and to buy the weaving machinery; cotton needs to be grown; cloth needs to be woven; the T-shirt needs to be designed, and so on... Despite this complexity, economists usually boil down all these separate elements into just four “factors of production” – land, labour, capital and enterprise (or entrepreneurship).

For income inequality, the relationship between two of these factors is especially important. The first is labour, the workers paid to carry out certain duties – such as operating a T-shirt production line. The second is capital, or financial resources and assets that are put to economic use – such as the entrepreneur who buys the equipment for the production line. Ultimately, capital is owned by somebody somewhere – it might be an individual, a family or, more usually these days, shareholders.

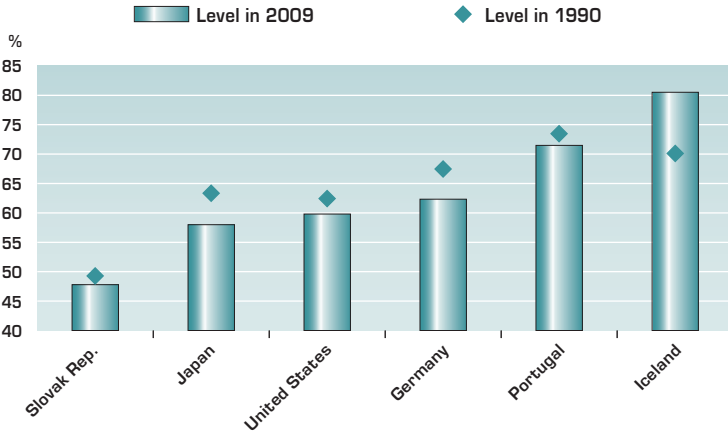
All these economic activities generate income but, historically, economists have believed that the proportion of this income that goes to labour and the proportion that goes to capital don’t really change. Yes, it might rise or fall a little but, over time, it looked to be stable. Indeed, so fixed was this idea that it formed one of six “stylised facts” – or generalisations that are basically true – of long-term economic growth set down by the economist Nicholas Kaldor in the 1950s.

Balance shifts to capital

The past few decades have increasingly challenged Kaldor’s finding. There is increasing evidence that the share of national income going to capital is rising and that the share going to labour is falling, and that this is now a global phenomenon. In the early 1990s, the share going to labour across all OECD countries was about two-thirds, or 66.1%; by the late 2000s, it had fallen to 61.7%.

Data: Labour's share of national income fell in almost all OECD countries in recent decades.

Labour share of national income in OECD countries, 1990 and 2009



Source: OECD (2012), *OECD Employment Outlook 2012*, <http://dx.doi.org/10.1787/888932651503>.

A range of factors have fuelled this decline in the “labour share”, for example competition from exports from developing countries and loosening in the rules covering jobs and employment. But the biggest factor looks to be technology, accounting for perhaps 80% of the shift, according to OECD estimates (although others argue that financial globalisation is the main factor). This represents the increased use of robots and automation as well as the growing sophistication of information processing. The implications are clear: Income that once went to workers now goes to the owners of capital who financed the machines or software that – to a greater or lesser extent – have replaced those workers.

But is this shift in income share from labour to capital fuelling income inequality? It's difficult to say for sure. The two processes have certainly moved in parallel with each other in recent decades, but establishing a causal link between the two is challenging. One obstacle, among many, is that the lines between labour and capital are not as clear as they once were. In the early industrial age, when

workers manned assembly lines and factories were owned by individuals or families, it was easy to see who represented labour and capital. But today, it's not so rare for workers to also have a foot in the capital camp through shareholdings and investments in unit trusts. Nevertheless, some research does show that the decline in labour's share of income is fuelling inequality: For example, a report by the International Labour Organisation on G20 countries suggests that a 1% decrease in the labour share increases inequality in market income (i.e. income before taxes and transfers) by between 0.1% and 0.2%.

More from the OECD: The shifting balance between capital and labour's share of national income is examined in the *OECD Employment Outlook 2012* (OECD, 2012), http://dx.doi.org/10.1787/empl_outlook-2012-en.

3.3. The workplace: Traditional jobs are declining

The past few decades have brought substantial changes to the way we work, with a decline in the traditional 9-to-5 job and a fall in the number of union members. Both these trends can affect income inequality.

The changing world of work

Non-traditional jobs – including part-time and short-term work as well as self-employment – are becoming more widespread. Since the mid-1990s, more than half of all new jobs in OECD countries were non-traditional. Whatever about the merits or otherwise of this sort of work – it's a welcome choice for some workers, an imposition for others – there are clear signs that its growth is linked to income inequality in a number of ways.

More from the OECD: The rise of non-standard work and its impact on inequality is examined in *In It Together: Why Less Inequality Benefits All* (OECD, 2015), <http://dx.doi.org/10.1787/9789264235120-en>.

First, it's associated with a "hollowing out" of the workforce. In effect, the proportion of people in the traditional "middle" of the workforce – permanent staffers, such as accountants, who have mid-level skills and perform routine tasks – has declined. Between 1995 and 2010, the share fell from 53% to 41% of the workforce in OECD countries. But the share of people working at the two ends of the skills spectrum – high-skill workers like designers and lower-skill workers like drivers – has increased, and they're increasingly likely to be part-timers, temps or self-employed. This trend towards a more U-shaped workforce is in itself likely to increase income inequality.

The second important link between non-traditional work and income inequality concerns the pay and conditions of such workers. At the low-end of the skills spectrum, especially, such workers typically have both lower *annual* earnings (because they're working shorter hours or enduring periods of unemployment between contracts) and lower *hourly* earnings than permanent workers. Such jobs are often associated with poorer working conditions and less stability, a combination that has led some to describe this class of workers as the "precariat".

So, why is non-traditional work growing? Numerous factors help to explain it. One is technology, which both increases demand for part-timers and temps and makes it easier to employ them. Another factor is the changing face of the workforce itself, notably the rising number of women going out to work. Either by choice or because they have no options, large numbers of women choose part-time work to help balance their career and family demands. A third factor is a weakening in the laws protecting temporary workers, especially in countries where protection of permanent workers remains strict. In labour forces split between strongly protected permanent "insiders" and weakly protected temporary "outsiders", employers may prefer to recruit temps, who can be hired and fired more easily in response to changing business conditions.

More from the OECD: How can policy respond to the rise of the non-traditional job? The options are examined in *OECD Policy Brief: Adapting to the changing face of work*, www.oecd.org/policy-briefs/Adapting-to-the-changing-face-of-work.pdf.

Declining union membership

The past few decades have seen a general decline in membership of labour unions, which have traditionally worked to counter inequality among workers – “a fair day’s wages for a fair day’s work”. In New Zealand, for example, union membership fell from about 70% of workers in 1980 to just 17% in the late-2000s. Declines in many OECD countries reflect a number of social and economic changes, including the loss of traditionally unionised businesses, like heavy manufacturing. They also reflect changes in labour laws in some countries that have weakened unions’ bargaining power.

Has the decline in union membership fuelled income inequality in OECD countries? Probably, although the picture is not black and white. Firstly, declining membership doesn’t automatically imply that unions’ negotiating power is fading. In many countries, the pay and conditions of non-union workers may still be covered in union-led negotiations. Secondly, the cause-and-effect relationship may run both ways. Some economists argue that workers may interpret rising inequality as a sign that unions can’t represent their interests and so are not worth supporting. In that sense, declining union membership could be both a result and a cause of rising inequality.

3.4. Societies: Love, life and inequality

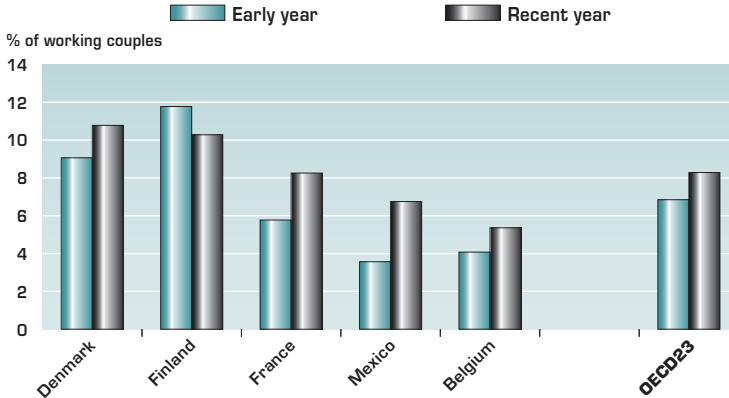
Changes in our societies are contributing to some extent in the rise in inequality. Possibly the most significant trends concern our relationships – are we married or single and, if we’re married, is our partner earning a similar income?

Marrying people like us

People are now increasingly likely to marry or live with someone from a similar social background – a phenomenon that economists romantically refer to as “assortative mating”. Today, in about 40% of working couples, both partners have very similar earnings; in the early 1990s, the proportion was about 33%.

Data: The proportion of people marrying partners with similar incomes has been rising in most OECD countries.

Percentage of workers in earnings decile with a spouse in the same decile, mid-1980s and mid-2000s



Source: OECD (2011), *Divided We Stand: Why Inequality Keeps Rising*, <http://dx.doi.org/10.1787/888932536515>.

This trend is, in part, a consequence of the welcome fact that women are now far more likely to have qualifications and careers that match or exceed men's. For example, not so long ago, a male doctor might have married a nurse; today, he's more likely to marry another doctor. The result is that a household that would once have brought in a doctor's earnings and a nurse's lower earnings today brings in two doctors' incomes, so concentrating higher incomes in fewer households.

Single-parent families

Another potentially significant social change is the rise in the number of single-parent families. In several of the Nordic countries and the United States, more than a quarter of families are led by single parents, and the average for OECD countries is around 20%; in the 1980s and early 1990s it was closer to 15%.

Media coverage tends to focus on families led either by low-income single-mothers or wealthy singletons but generalisations

are hard to make. Nevertheless, it's clear that – compared with two-parent families – single-parent families are more likely to rely on just one paycheque. And, in some countries, there's evidence that the proportion of single-parent families among low earners has been rising much faster than among higher-income groups. This puts such families at a double disadvantage: Not only are they relying on just one paycheque but that paycheque is not, relatively speaking, all that big.

More from the OECD: Statistics on the size and shape of families can be found at the *OECD Family Database*, <http://www.oecd.org/els/soc/oecdfamilydatabase.htm>.

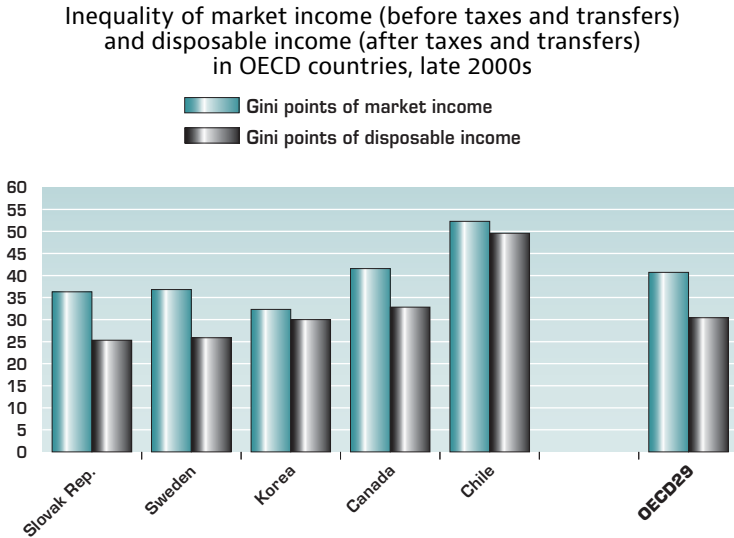
3.5. The state's role: Less regulation, less redistribution

Policy decisions by governments play a big role in determining families' spending power. Some of these relate directly to our disposable income, such as the taxes we pay and the transfers, like unemployment benefits, that we receive. Some are only indirectly related to our incomes, such as the rules that regulate how markets work. These, for example, may increase competition in the marketplace but also reduce workers' job security and wage-bargaining powers.

Taxes and transfers

The wages we earn from our employers are only one factor – albeit an important one – in determining how much we have to spend on ourselves and our families. What really matters is what's left after we pay our taxes and receive state transfers – a total that economists refer to as disposable income. Taxes and transfers do much to reduce income inequality for two main reasons. Firstly, higher-wage workers tend to pay higher taxes than their lower-wage counterparts; secondly, lower-wage workers tend to receive more support from the state. Combined, these systems of taxes and transfers play a big role in narrowing income gaps.

Data: The taxes that workers pay to the state, and the transfers they receive, do much to narrow the earnings gap in OECD countries.



Source: OECD (2011), *Divided We Stand: Why Inequality Keeps Rising*, <http://dx.doi.org/10.1787/888932536515>.

Up to the mid-1990s, taxes and transfers were tending to play a growing role in reducing inequality. But in the middle of that decade the pattern began to reverse. What happened? A key change seems to have come on the transfers side, especially a decline in spending on unemployment benefits. Unemployment fell, so fewer people were claiming benefits, while rules for claiming benefits were tightened.

What about taxes? In general they tended to fall, which typically would increase income inequality. However the picture is not as simple as that. On the one hand, some of the impact of this fall was cushioned by the fact that income taxes also became more progressive – if taxes fell on better-paid workers, they fell even more on lower-wage workers. On the other hand, very high earners (“the 1%”) seem to have bucked this trend towards increasingly progressive taxation, enjoying a very considerable fall in their tax burden (see [Section 3.6](#)).

Regulation

Up to the 1980s, OECD economies were generally more regulated than they are today. It wasn't unusual for a single national airline to have a monopoly on certain routes. In the decades since, most OECD countries have reformed the rules covering products, services and employment, with the aim of making their economies more dynamic.

Governments have also tended to take a more passive role in the labour market. In the past, wage rises were sometimes negotiated at a national level and there was relatively tighter regulation of how and when companies could let workers go. Today, market forces are generally allowed freer rein.

These reforms have not been universally welcomed but, by and large, they have helped boost the numbers of people in work. However, they have also tended to widen the wage gap, pushing down the wages of low-skill workers and pushing up the wages of high-skill workers. This happened for two main reasons. Firstly, the influx of new workers into the workforce included some very low-earners. Many of these – particularly part-time and temporary workers – are now covered by weaker employment protection laws than in the past. Secondly, in an increasingly competitive economy, skilled workers are increasingly in demand and can command higher wages.

Other policy areas

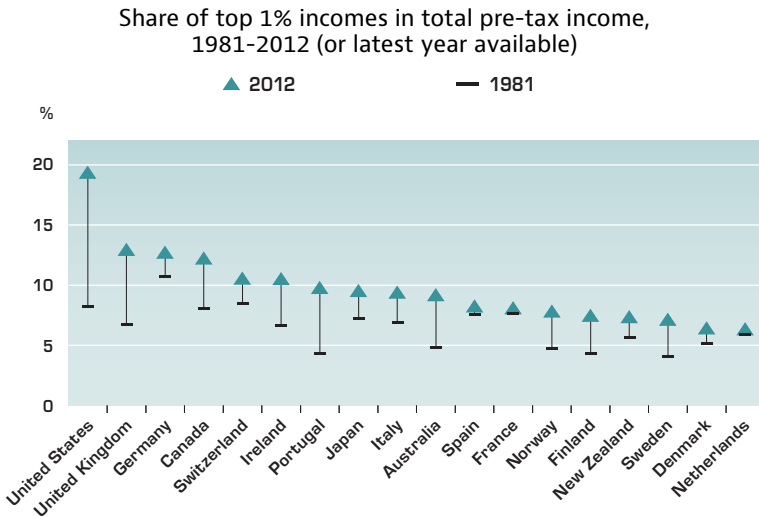
Governments can also influence income inequality through their policies in a wide range of other areas (see [Section 4.4](#)), including through their approaches to migration, the rules covering jobs and employment and, in particular, education.

3.6. Top incomes: Why did the 1% get so rich?

Across much of the OECD, but especially in English-speaking countries, the share of national income taken by the top 1% of earners has risen, sometimes sharply, in recent decades. The rise

has been particularly striking in the United States: In 1980, the top 1% of income recipients in the U.S. earned 8% of all pre-tax income; by 2012, their share had risen to over 19%. Other OECD countries also saw big rises, including the United Kingdom and Australia.

Data: Top earners have increased their share of total earnings in most OECD countries since the 1980s.



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>.

The rising income share of the 1% has become a hot issue, but some observers believe this focus actually misses much of the story of rising income inequality. As well as looking at the top 1% of earners, they argue, we should also look at an even smaller segment – the top 0.1% of earners (1 in 1,000), and even the top 0.01% of earners (1 in 10,000). As the Nobel laureate Paul Krugman has noted, data from the U.S. Congressional Budget Office shows that between 1979 and 2005, the after-tax income of Americans in the middle of the income distribution rose by 21%; among the 0.1% it was up 400%.

Understanding these figures is important if we want to develop a better picture of who's benefiting from economic growth. For example, in the decade to 2007, real household income increased by an average of 1.2% a year in the United States. But when the top 1% of earners is excluded, that figure falls to 0.6%. In effect, the 1% took 58% of the gain in real incomes. So, what looked to be an overall improvement in the population's economic well-being actually benefited a much smaller group than the broad figures seem to suggest.

And the winners are...

Some of the top earners are household names – sports stars like Serena Williams and entertainers like Jackie Chan and Taylor Swift – but most are not. In the United States in 2010, the largest group, about 41%, was made up of executives in non-financial businesses, like Apple and Walmart. Around 18% were employees – and not necessarily executives – in banks and finance houses. In the United Kingdom, the finance crowd accounted for about 21% of top earners and in France about 15%.

The fact that so many of the top earners work for a living is striking. Back in the early 20th century, when income inequality last reached the levels we're seeing today, much of the income of top earners came from rents on land and property as well as income from investments in government bonds. By contrast, today's top earners are more likely to be either a salaried employee, for example an executive like Morgan Stanley chairman James Gorman, or a company founder, like Facebook's Mark Zuckerberg.

More from Insights: *Rich Man, Poor Man: Are "the 1%" worth it?*, asks the OECD Insights Blog, <http://wp.me/p2v6oD-1AR>.

Why do the 1% earn so much?

There's no single answer to why the 1% earn so much. Multiple factors have contributed to the rise of top incomes, and the significance of each of these is not the same in every country:

“Superstars” in a global economy: The labour market for high-skilled workers has gone global, especially in sectors like finance, where firms in financial centres like London and Singapore

may be competing to attract the same people. In this competitive labour market, employers 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 has played a role in this process, in part by helping to build a global labour market for skilled workers. Technology also tends to serve as a complement for high-skilled workers, making them potentially even more valuable – think of financial traders who can carry out transactions worth billions of dollars at the touch of a button. But there are limits to how much of the rise of the 1% can be explained by technology. Many in the top 10% are also highly skilled, but have not enjoyed the gains of the 1%.

Changes in the way top earners are paid: The heavy presence of top executives and finance professionals among top earners is significant. In recent decades, and especially in English-speaking countries, a growing slice of their income has come not in the form of a monthly salary payment but as valuable stock options.

The idea of paying managers in stock options arose as a response to “the agency problem” – when you hire someone to run your business, how can you ensure they act in your interests and not their own? Most shareholders have a tenuous relationship, at best, with the firms in which they hold shares, so it can be almost impossible for them to oversee management and ensure it’s working in their interest. Giving managers a stake in a rising share price, it’s argued, helps align their interests with those of shareholders. Since the financial crisis, this line of thinking has come under fire. Many now argue that stock options can promote short-term thinking among managers, who may try to boost the firm’s share price in the short run to make a quick killing, even if it hurts the firm’s long-term prospects.

“Financialisation”: Stock options are also widely used in the financial sector, which plays a growing role in modern economies – albeit, not always a positive one, say critics. And these days, finance is not short of critics. In part that’s a response to financial crisis of 2008, which was preceded by decades of rapid growth in financial

services. For example, since the 1960s, credit by financial institutions, including banks, has grown at three times the pace of economic activity. Over the same period, stock markets also grew at a fast pace.

The rapid expansion of finance has contributed to income inequality in a number of ways, the most obvious being that financial sector workers tend to be very highly paid. In Europe, they account for 1 in 5 of the top 1% of earners even though, overall, they account for only 1 in 25 of the total workforce. These high salaries might be justified if such workers had very high levels of productivity. However, comparisons with similarly skilled workers in other sectors suggest this is not the case. Financial workers – particularly the highest earners – thus seem to enjoy a wage premium over other comparable workers.

More from the OECD: The impact of finance on inequality is examined in “Finance and Inclusive Growth”, an *OECD Economic Policy Paper*, <http://dx.doi.org/10.1787/5js06pbhf28s-en>.

“Too much finance” fuels income inequality in other ways, too. The wide availability of credit allows high earners to increase their borrowings, allowing them to gain more from investment opportunities than people on lower incomes. In addition, higher earners also benefit from the expansion of stock markets. That’s because they are always more likely to hold shares than lower earners. As markets expand, they benefit more from share dividends and capital market gains.

To be sure, financial sectors are essential to ensuring that capital and resources flow from those that have them to those who need them and to help balance risk with reward. But there is increasing evidence that their usefulness diminishes at a certain point or when they favour certain activities over others – for example, providing credit rather than facilitating financing through stock markets. Not only are such financial sectors bad for inequality, they’re also bad for growth – in effect, they deliver a larger slice of the benefits of economic growth to a small number of high earners, many of whom work in finance itself.

More from Insights: Too much money is bad for you, says the OECD Insights Blog as it looks at the impact of finance on growth, <http://wp.me/p2v6oD-28k>.

Many now wonder about the size of the financial sector as it currently exists, its potential to destabilise the “real economy” – the manufacturing and services in which most people work – and the fact that it attracts too many of the “brightest and best” graduates, who might better serve humanity in professions like medicine or engineering. The economics commentator John Cassidy has summed up criticisms of those who work in financial centres like the City of London and on Wall Street with the observation that “if they retired to their beach houses en masse, the rest of the economy would be fine, or perhaps even healthier.”

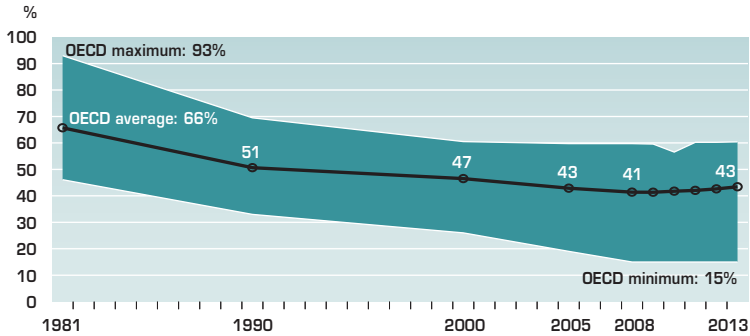
Changing pay norms: Societies differ in the extent to which they accept large income differentials. Implicit in these social norms is a trade-off: Stick to society’s expectations and you preserve your reputation; breach the expectations and you’ll earn more but hurt your image. But these norms can change over time and their influence can vary markedly. In much of the post-war period, there was an expectation that income differentials would be – by today’s standards – relatively narrow. But in the 1980s these norms began fading, especially in English-speaking countries. By contrast, they still remain relatively strong in much of continental Europe, which has certainly played a role in limiting top incomes there.

Tax and pay: The past few decades have also seen substantial falls in top tax rates in many developed countries. Across OECD countries, the average top statutory tax rate fell from 66% in 1981 to 41% in 2008. High earners have benefited from other changes in tax regimes, too. Tax on property and on inheritances has tended to fall, allowing high earners to build up wealth.

As *The Economist* has noted, the usual justification for lower rates of tax on top earners is that it encourages growth: “Stop penalising success, goes the argument, and the economy will soar.” But, as it has also noted, this link is not always supported by the evidence: “America’s economy grew strongly in the 1920s and 1960s, when top rates were high. It fared better in the 1990s, when top rates increased

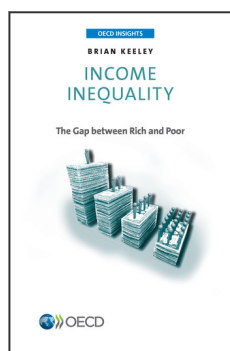
Data: Tax rates on top incomes fell substantially between the 1980s and the financial crisis.

Maximum, minimum and average statutory tax rates on top incomes in OECD countries, 1981-2013 (or latest)



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>.

a bit, than in the 2000s, when they declined.” Against that, many economists argue that there are limits to the amount of extra revenue that higher taxes can bring in. Higher taxes do inhibit growth, they argue, and they also increase the incentives for high earners to engage in aggressive tax planning, which allows them to reduce the share of income and wealth exposed to tax. (see [Section 5.5](#)).



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