4

How does income inequality affect our lives?

Inequality affects economies and societies, with growing evidence that excessive inequality may be bad for growth. There are also concerns that inequality may dampen educational opportunities and social mobility.

Key themes

In 2012, Facebook founder Mark Zuckerberg exercised some of his stock options in the social-networking company. That decision cemented his position among the super-rich and prompted this rhetorical question: "How would the typical American end up better off if [...] Zuckerberg could not exercise his options?" asked Scott Winship, then a Fellow at the Brookings Institution.

That question goes to the heart of a key issue in economic inequality: If a few people get wealthy, does that hurt – or help – the economic prospects of everyone else and does it make our societies worse places to live? These questions aren't new: In Plato's *Republic*, written more than 2,300 years ago, discussion turns to what happens when a society is ruled by its elites: "… such a city should of necessity be not one, but two, a city of the rich and a city of the poor, dwelling together, and always plotting against one another."

The relationship between growth and inequality has long been an important question for economists, and a number of influential ***theories*** have emerged over the years. But for most people, the issue boils down to this: ***is rising inequality good or bad for growth?*** Those who believe it's good, or at least necessary, argue that it provides incentives to entrepreneurs and a source of overall investment for the economy. Those who believe it's bad argue that it can prevent poorer people from investing in their education and encourage the rich to grab a bigger slice of the economic pie without making the pie any bigger.

The impact of rising inequality on societies is also drawing concern: "The social compact is starting to unravel in many countries", OECD Secretary-General Angel Gurría has said. "Uncertainty and fears of social decline and exclusion have reached the middle classes in many societies."

Inequality is also a key issue in ***education***. Education can play a powerful role in providing opportunities for people from all sorts of backgrounds, but it can also reinforce existing economic divisions in society. The OECD's PISA programme has shown that some countries' education systems do a much better job than others in helping students from poorer families achieve excellence. Inequality has other impacts on ***societies***, too, including reducing mobility and, some argue, fostering crime and harming people's health.

4.1. Theories: How economists think about inequality

Economists have long been interested in the idea that a country's level of development might help determine its level of inequality. One of the most famous theorists was Simon Kuznets, a Russian-American economist born at the start of the 20th century, who argued that inequality follows a natural trajectory as economies move further away from their agricultural roots.

Kuznets' hypothesis

According to Kuznets, inequality is low in pre-industrial societies, where most people live at subsistence levels. As industrialisation begins, however, gaps start to widen thanks to the rising earnings of factory workers compared to those of farmers, and they continue to grow with the emergence of increasing specialisation among industrial workers. But then, argued Kuznets, gaps start to narrow as the state begins collecting more taxes and distributing them as benefits.

Kuznets' hypothesis, as it became known, was influential in the 20th century, and the shape of inequality that it traced – an inverted-U – seemed to match the facts reasonably well. However, it's fared less well in recent years – rather than rising and then falling, the trajectory of inequality now appears to be more U-shaped: It was high at the start of the 20th century, fell in the middle of the century, but has been rising since the 1970s.

The apparent failure of Kuznets' hypothesis reflects another problem economists face in determining the link between inequality and growth – namely, if there is a link it doesn't appear to be direct. If it were, it would be possible – in theory at least – to figure out a country's growth rate from its level of inequality.

A complex and dynamic relationship

It's also possible to look at the relationship between inequality and growth from the opposite direction: Does inequality affect growth and, if so, how? The Harvard economist Richard B. Freeman is one of those who believe it does. He argues that inequality is good for growth – up to a point. But after that point, rising inequality means falling growth: "The few people with the skills or background to compete for the top jobs work hard", according to Prof Freeman, "while everyone else coasts because they have little or no chance of reaching the top." This argument makes a case for "optimal" inequality or, what some have called, "just-right inequality" – not too little, not too much.

Arguments like this underline the complexity of the link between inequality and growth. Not only is it a dynamic relationship, it's also – according to many economists – determined by the particular "shape" of inequality in each society. To explain, inequality can take different forms. Some societies may be divided between a rich elite and everyone else. Others may have relatively small numbers of rich and poor and a large middle class. These variations may determine the relationship between inequality and growth for two main reasons, according to researcher Sarah Voitchovsky. First, inequality may affect how different income groups *behave*. Second, it may affect how different social groups *interact*. Some examples:

If inequality affects how income groups **behave**…

- **The poor:** If there are large numbers of poor people, economic growth may be affected by their inability to invest in education and their lower health levels, among other factors.
- **The middle classes:** If inequality "squeezes" the middle class, it may reduce its demand for goods and services.
- **The rich:** If inequality means rising incomes among the rich, it could see them accumulate savings, which banks can then lend out, so increasing investment in the economy. Or, the rich may use their economic power to lobby against policies that don't serve their needs, for example investment in public health and education.

If inequality affects how different income groups **interact**...

- **Trust:** Higher inequality is probably associated with reduced trust, which may hurt business by imposing higher "transaction costs". For example, if a business trusts a customer, and vice versa, they may be able to agree a deal without expensive legal advice and contracts.
- **Social capital:** In an unequal society, people's network of social relationships – their social capital – may not extend beyond their own income group and so may not be useful in helping them to find work. Equally, elite groups may use their social networks to exclude "outsiders" from economic opportunities.
- **Social unrest:** Large wealth gaps can be associated with social conflicts, and with higher security costs, for both businesses and governments.
- **Volatility:** High levels of inequality may make it hard for societies to come to a political consensus, resulting in sudden policy shifts or governments serving the interests of their own supporters at the expense of the greater good.

This framework can be helpful when it comes to understanding how the link between inequality and growth is debated in the "real" world, where discussion typically boils down to this question: Is inequality good or bad for growth?

4.2. Economies: Is inequality good or bad for growth?

Rising income inequality has focused increasing attention on to whether it's helping or hurting growth. Is it, as some contend, a necessary evil that must be tolerated in the interests of economic growth? Or is it in itself an obstacle to growth? Here are some of the main arguments from both camps:

Inequality is good for growth...

Perhaps the most obvious way in which inequality drives growth is that it allows for entrepreneurs – like Apple's Steve Jobs or HTC's Cher Wang – to enjoy the rewards of their risk-taking.

"Imagine a society with perfect economic equality", the Harvard economist Greg Mankiw has written. One day, an entrepreneur comes up with a new product. "Everyone in society wants to buy it. They each part with, say, $100. The transaction is a voluntary exchange, so it must make both the buyer and the seller better off. But because there are many buyers and only one seller, the distribution of economic well-being is now vastly unequal. The new product makes the entrepreneur much richer than everyone else."

As Prof Mankiw goes on to point out, the society in this scenario is then faced with a set of choices, as much political as economic: Does it tax the entrepreneur heavily to curb income inequality but possibly also reduce her incentives to innovate. Or, does it leave things alone, so encouraging other entrepreneurs to take similar risks, with potential benefits for anyone who can make use of the resulting new products and services.

Proponents of the second option – light tax and relatively little redistribution – support their case with two arguments. The first is that allowing people to accumulate wealth means they become sources of investment for the economy. Writing about the build-up of inequality in Europe before World War I, J.M. Keynes stated that if the wealthy had frittered their money away on pleasure, "the world would long ago have found such a regime intolerable. But like bees they saved and accumulated, not less to the advantage of the whole community …".

The second argument, promoted most famously in the 1970s by the American economist Arthur Okun, is that there may be a trade-off between inequality and economic efficiency – in other words, attempting to reduce inequality beyond a certain level may lead a society to use its economic resources less efficiently than it could do. In a famous phrase, Okun theorised that money taken from the rich in taxes would be carried to the "the poor in a leaky bucket. Some of it will simply disappear in transit, so the poor will not receive all the money that is taken from the rich."

Inequality is bad for growth…

However the idea that there is a trade-off between inequality and efficiency is increasingly criticised, and there is rising evidence – from the OECD, IMF and others – that excessive inequality is bad for growth.

Recent OECD research indicates that this impact can be substantial. In OECD countries, the average increase in inequality of 3 Gini points over the past couple of decades is estimated to have cut GDP by around 8.5%.

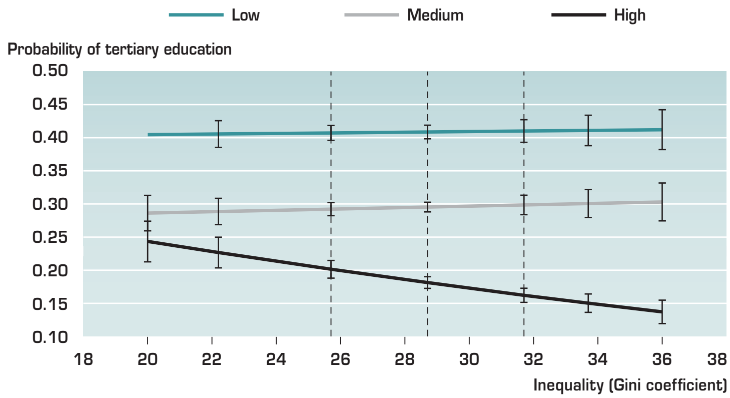
> **More from *Insights***: "If a large swathe of the population is unable to invest in its skills, that's bad news for the economy", says the OECD Insights Blog, *http://wp.me/p2v6oD-1VR*.

So, what's happening? Numerous theories have been put forward to explain why inequality might be bad for growth (see below), but the OECD research centres in on one in particular – namely, that a widening wealth gap leads low-earning families to invest less in education and skills. This probably hurts growth by reducing the number of skilled – and more highly productive – workers available for hire in the economy.

The effect of inequality on people's human capital can be seen in the graphic below, which compares the numeracy skills of people from three backgrounds – families where the parents have high, medium and low levels of education. Here, parental education

Data: As inequality rises, numeracy skills of poorer people decline.

Average numeracy score by parental educational background (PEB)



Source: OECD (2015), *In It Together: Why Less Inequality Benefits All*, *http://dx.doi.org/10.1787/888933207742*.

background (or PEB) represents socioeconomic status, so in effect these three groups correspond to familiar social groups – well-off, middle-income and poorer people. The chart shows that as inequality rises, there is little change in the numeracy skills of people from well-off and middle-income backgrounds. However, there is a substantial decline among poorer people.

This effect is visible not just in maths skills. It can also be seen in the length of time people spend in education and employment – rising inequality has little impact on the numbers of people from better-off and middle-income families who graduate from university or on how they do in the job market. The same is not true for people from poorer backgrounds. As inequality rises, they become less likely to graduate from university and more likely to endure periods of unemployment.

Other research also supports the idea that there need be no trade-off between equality and a strong economy. According to economists Andrew Berg and Jonathan Ostry of the IMF, over the long term "equality appears to be an important ingredient in promoting and sustaining growth". They offer a number of reasons for why a growing gap between rich and poor could impede growth, including the possibility that it may create political and social instability, which, in turn, may deter investment. Social divisions fuelled by inequality may also make it more difficult for governments to find the necessary consensus in society to meet economic and financial crises.

> **More from the OECD:** The impact of inequality on growth is investigated in Chapter 2 of *In It Together: Why less Inequality Benefits All* (OECD, 2015), *http://dx.doi.org/10.1787/9789264235120-5-en*.

Critics have also linked high levels of inequality to rent seeking, which the economist Joseph Stiglitz has defined as "efforts that people take to get a larger share of the pie rather than to increase the size of the pie". This can happen in the political arena in both democratic and authoritarian systems. In democracies, wealthy individuals may use their ability to, say, fund political parties to influence policies in a way that benefits them; in authoritarian systems, says former IMF economist Simon Johnson, "governments and their private-sector allies commonly form a tight-knit – and, most of the time, genteel – oligarchy, running the country rather like a profit-seeking company in which they are the controlling shareholders." Such tensions have long been recognised. Almost a century ago, the jurist Louis D. Brandeis declared, "We may have democracy, or we may have wealth concentrated in the hands of a few, but we can't have both."

Rent-seeking can also show up in the corporate sector: One example is the huge increase in pay and bonuses of top executives in big corporations and financial institutions (*see* ***Section 3.6***), especially in English-speaking countries, which, some critics argue, have become increasingly detached from firms' actual performance.

Rising inequality may also skew an economy in ways that reduce overall middle-class demand for consumer goods or even fuel debt crises. For example, high earners may have a lot of surplus wealth that they need to find ways to invest. After all, says World Bank economist Branko Milanovic, "there is a limit to the number of Dom Perignons and Armani suits one can drink or wear". He argues that this is exactly what happened in the run up to the financial crisis: "Overwhelmed with such an amount of funds, the financial sector became more and more reckless, throwing money at anyone who would take it." On the other side of the coin, he argues, lower earners took advantage of banks' largesse to borrow money they couldn't afford to repay, thus fuelling a debt crisis.

4.3. Education: Reducing, reinforcing inequalities

Most OECD societies offer substantial educational opportunities to all citizens regardless of income. But in practice, while education systems can be a force for social mobility (*see* ***Section 4.4***) they can also reproduce and reinforce a society's existing pattern of wealth distribution. On average in most countries, children from middle-class and wealthy families do better in school, are more likely to go to university and, eventually, earn more as adults.

Richer families can invest more

Some of these differences in learning opportunities come from outside the formal education system and, arguably, are becoming more pronounced amidst rising income inequality. Some may even emerge before the child is born, when the health of the mother and availability of good nutrition can affect foetal development. And many of these advantages continue throughout the child's life. For instance, there's some evidence of a growing gap in investment in "enrichment" – spending on books, childcare, non-school activities – between rich and poor parents.

> **More from *Insights***: Find out why it's "never too early to join the rat race" at the OECD Insights Blog, *http://wp.me/p2v6oD-1ws*.

According to Miles Corak, an academic, spending per child in this area among American families in the bottom fifth of the income distribution rose by just over 55% between the mid-1970s to around $1,300 in the mid-2000s. Among the top fifth, however, it rose by over 155% to $9,000 per child. Coupled with other advantages of coming from a well-off family – such as the likelihood that they can invest more in formal education and provide valuable social connections later in life – this early investment in enrichment is considered by many to be widening the education gap between rich and poor.

Social divisions in the classroom

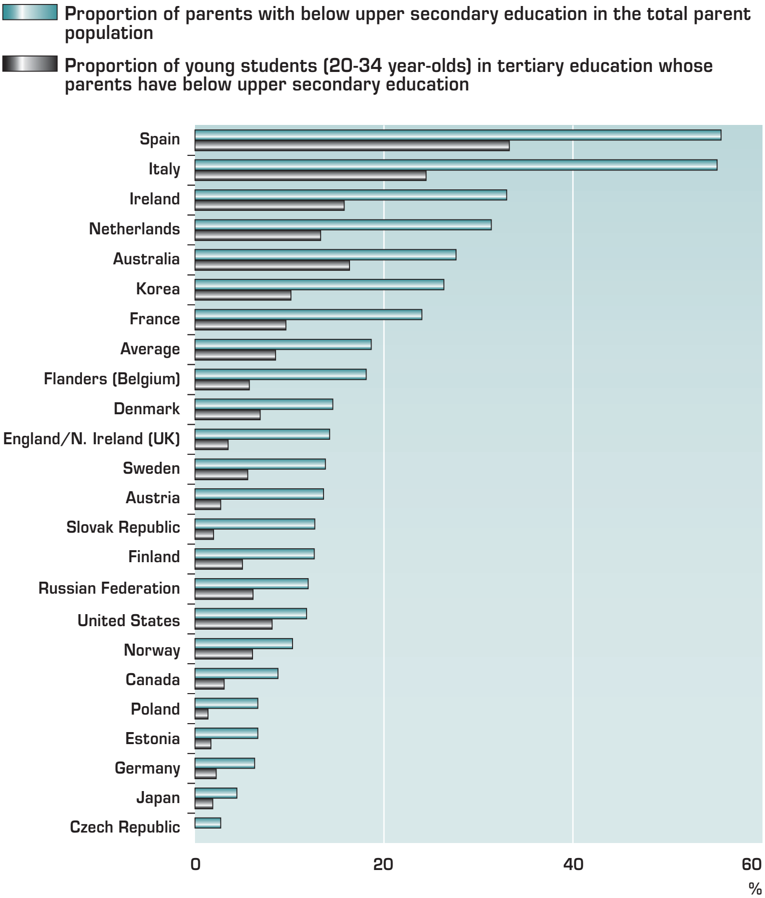
Education systems, too, can reinforce social distinctions by offering a lower quality of education or a narrower range of options to children from disadvantaged families. For example, schools with large numbers of disadvantaged students tend to find it harder to attract qualified teachers, even though – or, perhaps, because – the challenges of teaching children from disadvantaged families may be greater.

And in many countries, children from differing social backgrounds are essentially taught separately. That's despite evidence from the OECD's Programme for International Student Assessment (PISA) that combining children from different social backgrounds, and of different abilities, tends to raise overall performance without bringing down the performance of the strongest students. This segregation can happen because most schools tend to serve a particular area. But it can also happen if students are streamed into different classes by ability – weaker students are more likely to come from disadvantaged backgrounds.

Whatever the causes, the impact of social background on students is clearly evident in results from PISA, which surveys the performance of 15-year-old students worldwide in more than

Data: Young people whose parents didn't finish secondary education are themselves underrepresented in university-level education, indicating that inequalities in access to education persist from one generation to the next.

Participation in tertiary education of students whose parents have below upper secondary education (2012)



Source: OECD (2014), *OECD Education at a Glance 2014*, *http://dx.doi.org/10.1787/888933115654*.

65 countries. Across OECD countries, students from better-off families are almost a year ahead on average in maths compared to students from poorer families, according to PISA 2012.

> **More from the OECD:** PISA's findings on the inequality and equity in education are explored in *PISA 2012 Results: Excellence through Equity* (OECD, 2012), *http://dx.doi.org/10.1787/9789264201132-en*.

Who goes to university?

Social background also has a clear impact on who goes on to higher education. For example, in all OECD countries, the children of parents who did not attend university are themselves less likely to study at tertiary level. On average in OECD countries, the proportion of young people from families with low levels of education who are studying in university is only around half what it would be if social groups were proportionally represented in tertiary education.

Overcoming inequalities

It's striking, however, that some countries and some education systems do a much better job of minimising the impact of social differences in education (*see* **Section 5.2**). In PISA 2012, around 6% of disadvantaged students were "resilient" – in other words, they overcame social disadvantage to perform well in PISA. But in some countries, notably in East Asia, the proportion of resilient students was at least double this. These findings suggest that the right policies can do much to reduce the impact of social background in education.

4.4. Society: Inequality may hold people down

Many people fear that inequality has a corrosive effect on societies, making them worse places to live in, not just for the poor but also the rich. There are several different strands to this line of thinking. One is that inequality reduces social mobility – it's harder to climb the economic ladder if the rungs are growing further apart. Another strand is the possible impact of inequality on people's well-being – everything from health to happiness.

Back to The Great Gatsby

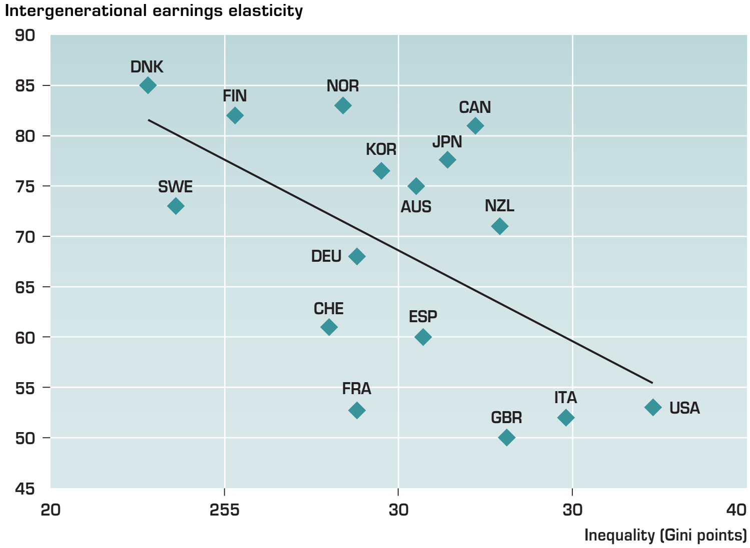
It's no surprise to learn that economic advantage passes down through generations. But, thanks to recent research, it's become clearer just how long these advantages can linger – perhaps for at least half a millennium. Researchers at the London School of Economics, for example, found that students with surnames like Baskerville and Mandeville, which can be traced back to the Norman invaders who took control of England in the 11th century, had attended the country's most exclusive universities, Oxford and Cambridge, continuously for around eight centuries. By contrast, students with "lower status" surnames were enrolled with much less consistency. The phenomenon is not restricted to the United Kingdom. Economist Gregory Clark has found evidence of the persistence of rigid class structures in societies as diverse as Japan, the United States and even China.

Do these intergenerational advantages linger longer in more unequal societies? Some researchers argue that they do, and for evidence they point to a piece of research that draws its title from an earlier period of soaring inequalities, the 1920s. "The Great Gatsby curve", named after the eponymous hero of F. Scott Fitzgerald's 1925 novel, compares inequality with social mobility in a number of wealthy countries. It suggests that in more unequal societies, people are less likely to rise – or fall – out of their slot in the income scale, especially if they are among the top or bottom fifths of earners. In effect, if you're born really rich or really poor you're likely to stay that way. The result of this, according to an OECD report, is that it "can stifle upward social mobility, making it harder for talented and hard-working people to get the rewards they deserve".

However, this research is not without its critics. For one thing, there are major data issues at the national level in pulling together statistics on mobility, and at the international level in producing numbers that can be compared between countries. And, as with so much in this area, correlation does not necessarily imply causation. For example, the relatively high rates of social mobility in many Nordic countries may partly reflect the fact that their societies have historically been relatively homogenous, reducing the potential impact of barriers like ethnicity that may restrict social mobility in other countries.

Data: Charts like this – similar to "the Great Gatsby curve" – suggest that countries with higher levels of inequality have lower rates of social mobility.

Inequality and mobility (intergenerational earnings elasticity) across OECD countries



Source: OECD (2015), *In It Together: Why Less Inequality Benefits All*, *http://dx.doi.org/10.1787/888933207806*.

How's life?

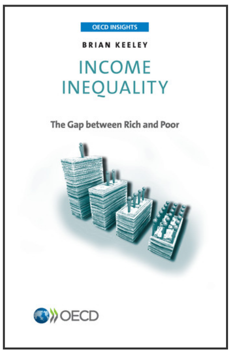
What about the impact of inequality on other aspects of our lives? The OECD has explored some of these issues in its How's Life? project, which explores well-being and quality of life issues. It has identified specific ways in which inequality can reduce people's well-being, for example by fuelling crime: As *How's Life 2013* noted, "...socio-economic inequality seems to play a central role in the occurrence of criminal victimisation as disadvantaged people are more likely to perpetrate and to be victims of crimes." And there may be a general correlation, too, between overall well-being and inequality: "Overall well-being is positively associated with low socio-economic differences in well-being measured by income or educational inequality."

Fierce debate

But linking inequality to specific social issues can be challenging, in part because it can be hard to distinguish the impact of inequality from that of poverty. For example, for a range of reasons, including weaker nutrition and lack of access to adequate healthcare, poorer people tend to suffer more health problems. But in a highly unequal society, might there also be special factors at work? The answers to these questions are important. Policies that target poverty, such as special payments to low-income families, may not be the same as those that target inequality, such as much higher taxes on high earners.

At the moment, the idea that inequality causes a range of social and medical problems is hotly debated. For example, the British epidemiologists Kate Pickett and Richard Wilkinson, have argued that there is indeed a special link between inequality and what *The Economist* described as "all manner of social ills … more crime, higher infant mortality, fatter citizens, shorter lives, more teenage pregnancies, more discrimination against women and so on." They argue that when humans perceive themselves to be socially inferior it leads to the release of the hormone cortisol. This, in turn, elevates blood pressure and blood sugar levels, which can cause a number of medical conditions. The social consequences of stress, it's argued, may lie in cortisol's tendency to override other socially useful hormones, such as oxytocin, which plays a key role in the formation of trust relationships. However, this research has been attacked, both for data reasons but also, say critics, because the cross-country comparisons fail to take a range of unrelated factors into account, like national diet and genetics.

An independent review of the research, commissioned by the Joseph Rowntree Foundation in the United Kingdom, probably gives the best summary of current thinking. It concludes that there is a consensus around the idea that inequality and health and social problems are *correlated*. However, it adds, "There is less agreement about whether income inequality causes health and social problems independently of other factors, but some rigorous studies have found evidence of this." Given the general rise of inequality, it seems likely that research in this area will continue.



From:

Income Inequality

The Gap between Rich and Poor

Access the complete publication at:
https://doi.org/10.1787/9789264246010-en

Please cite this chapter as:

Keeley, Brian (2015), “How does income inequality affect our lives?”, in *Income Inequality: The Gap between Rich and Poor*, OECD Publishing, Paris.

DOI: https://doi.org/10.1787/9789264246010-6-en