TRADE UNION ADVISORY COMMITTEE
TO THE ORGANISATION FOR ECONOMIC
COOPERATION AND DEVELOPMENT
COMMISSION SYNDICALE CONSULTATIVE
AUPRÈS DE L'ORGANISATION DE COOPÉRATION
ET DE DÉVELOPPEMENT ÉCONOMIQUES

The OECD New Approaches to Economic Challenges (NAEC) Project: from analysis to policy recommendations on reducing income inequality and moving to inclusive growth

TUAC Discussion Paper for Consultations with the OECD Liaison Committee (15 December 2014)[1]

"Going forward, the focus of our work will be on promoting more inclusive growth, to foster economic activity that aims to improve both people's material living conditions and their quality of life, while at the same time considering the distribution of well-being outcomes. Again, building on the results of NAEC, we are developing a comprehensive inclusive growth initiative that will result in an enhanced analytical framework and actionable policy recommendations." Strategic Orientations of the OECD Secretary-General, 2014[2]

I - Introduction

1. Within the NAEC project the priority must be to move forward from analysis to recommendations. One of the key messages given to Ministers at the MCM in May was the need to move to a more inclusive model of growth that begins reducing the widening income gaps seen in much of the OECD area over the past 30 years (see Box 1).

2. The OECD has been at the forefront of presenting evidence on income inequality since the publication in 2008 of "*Growing Unequal?*"[3], and "*Divided We Stand*"[4] in 2011. Most OECD countries have experienced rising income inequality and in-work poverty for several decades and now as shown by the 2014 OECD Employment Outlook[5] falling or stagnant real wages.

3. Rising income inequality is no longer just an ethical or normative issue – it has economic cost and restrains a broad-based and sustainable recovery. There are also serious long-term consequences. High inequality leads to low inter-generational mobility. The capture of the policy agenda by top income earners through their excessive domination of political funding in some countries is leading to a serious distortion of public policy and builds inequity into economic growth models. As the NAEC report states the rise of inequality "can affect economic growth, weaken social cohesion and sap trust in markets and institutions".

[1] This discussion paper updates and recasts the TUAC statement to the 2013 Liaison Committee in the light of the NAEC project and subsequent analysis of the OECD and TUAC
[2] OECD (2014) Strategic Orientations of the Secretary-General
[3] OECD (2008) "Growing Unequal? Income Distribution and Poverty in OECD Countries"
[4] OECD (2011) "Divided We Stand. Why Inequality Keeps Rising"
[5] OECD "Employment Outlook 2014"

4. The debate on the definition of inclusive growth is still far from conclusive as the breadth of the recent OECD report[6] on "Making Inclusive Growth Happen" shows. TUAC hopes that the OECD, assisted by this discussion at the Liaison Committee, can focus on income inequality and move forward on a comprehensive strategy to change policies and institutions so as to reverse the rise in income inequality. Part II of this discussion paper sets out the evidence on causes and effects of rising income inequality. Part III sets out some of the causes. Part IV sets out the direction of policy that is needed to reverse the increase.

Box 1
Message 2 from the NAEC Executive Summary for the OECD Ministerial Council Meeting May 2014: Move towards a more inclusive growth

The last three decades have seen a rise of inequality, which can affect economic growth, weaken social cohesion and sap trust in markets and institutions. To address the growing concerns linked to increasing inequality, policy makers are advised to support a move towards a more inclusive and sustainable economic approach and to:

- Move towards an inclusive growth model in which income inequality is one element, but broaden it to include several other dimensions that matter for people's well-being, including health, employment and the environment. Put more focus on multidimensionality of policy objectives and distributional issues.
- Develop more effective policies to tackle social challenges, focusing on the median and household disposable income and avoiding average indicators that hide disparities.
- Pay more attention to trade-offs and complementarities when designing and implementing structural reforms, and consider their short- and long-term distributional implications.
- Foster new sources of employment, including by promoting policies that allow young firms to experiment and ensure a level playing field for new and innovative firms.
- Pay more attention to job quality.
- Invest in education, skills and life-long learning for all and develop new dimensions in education objectives, encompassing soft skills that foster creative thinking, team work, self-awareness and tolerance.
- Ensure fairness in the tax system including tax compliance by all taxpayers.

II - Rising Income Inequality - The Evidence

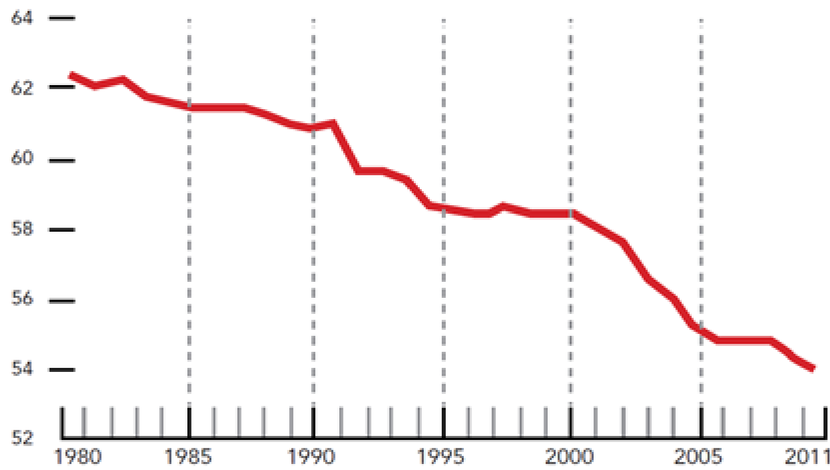
The declining wage share

5. For the first part of the post-war period productivity and the compensation of a typical worker in OECD countries grew almost in tandem. However, since the 1980s real wages have failed to grow at the same rate as productivity and as a result the share of wages in output and income has fallen. OECD data shows that the share of labour compensation in national income declined in 26 out of 30 OECD economies for which data were available over the period from 1990 to 2009. The median labour share of national income across these countries fell from 66.1% to 61.7%[7]. Figures 1 and 2 show the trends for both the global economy and for G20 advanced economies.

[6] OECD (2014) "All on Board : Making Inclusive Growth Happen"
[7] OECD Employment Outlook 2012

Figure 1: Share of World Labour Income in World Gross output, 1980-2011

Weighted averages, per cent



Source: UNCTAD Trade and Development Report 2013

Figure 2: Productivity and wage index (G20 advanced economies)

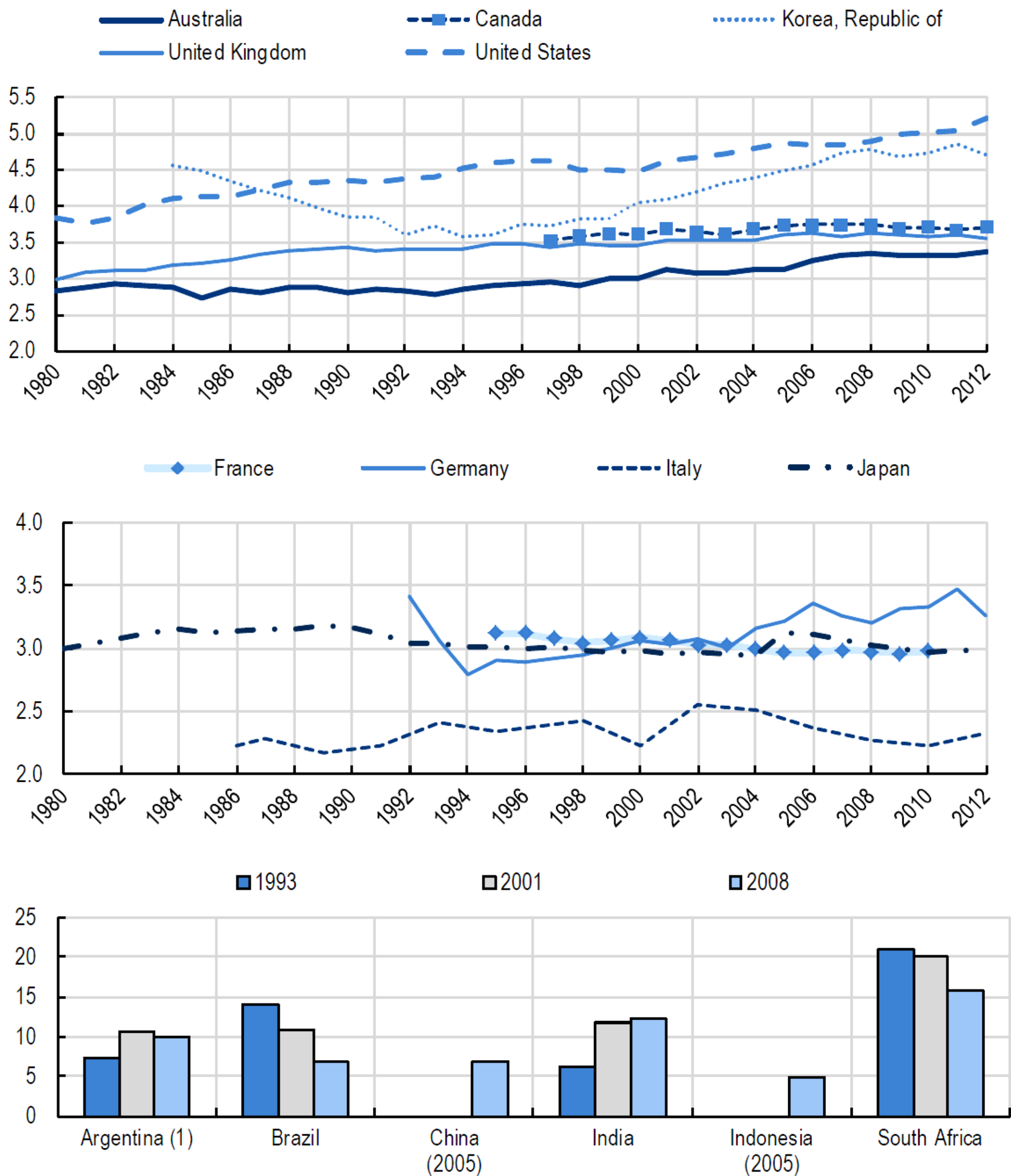
Source: OECD, ILO, World Bank Report prepared for the G20 Labour and Employment Ministerial Meeting Melbourne, Australia, 10-11 September 2014

Personal income inequality

6. Income inequality within the wage share has also increased in the majority of countries. Inequality as measured by the ratio of top to bottom deciles of income earners rose in most,

albeit not all G20 countries as shown in Figure 3. Inequality first started to increase in the late 1970s and early 1980s, notably the United Kingdom and the United States. From the late 1980s, the increase in income inequality became more widespread, though significant differences between countries remain. Increases in household income inequality have been largely driven by changes in the distribution of wages and salaries, which account for 75% of household incomes among working-age adults. The OECD report "How Was Life " estimates that global Gini coefficients of "within country" income inequality after falling to 36 in 1980 rose to 45 in 2000 – the level of 1820.

Figure 3: Trends in earnings inequality, 1980-2012

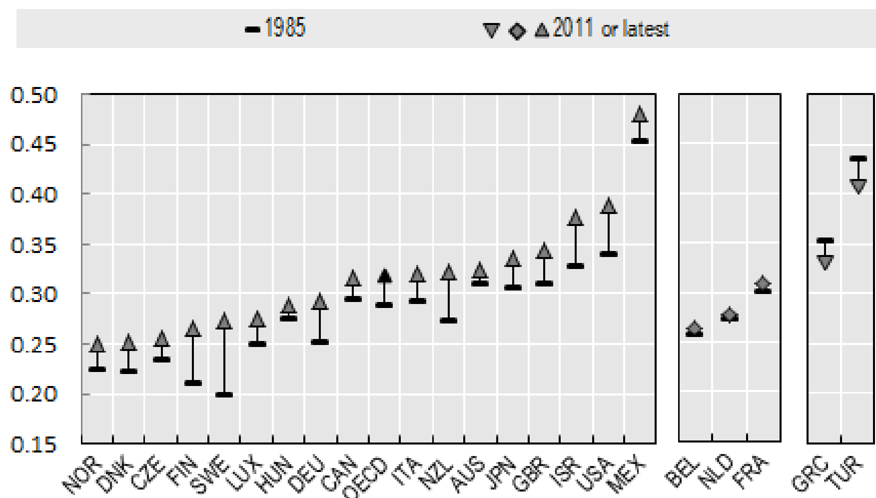


Source: OECD Earnings Database, ILO Global Wage Database and OECD-EU Database on Emerging Economies for Brazil, China, India, Indonesia and South Africa.

The effect of the crisis post-2008

7. Since the onset of the crisis, inequality in market incomes rose as much in-between 2007-2011 as in the previous 12 years in most OECD countries.[8] As shown in Figure 4, the impact on disposable incomes has been moderated due to the functioning of automatic stabilisers – mostly tax and expenditure policies. This, however, only holds true up to 2011 before austerity policies were applied in many countries. Disposable incomes now are dropping. The IMF has found that the pain of austerity has not been borne equally. Austerity reduces the share of income going to wage-earners. For every 1% of GDP of fiscal consolidation, inflation-adjusted wage income typically shrunk by 0.9%, while inflation-adjusted profit and rents fell by only 0.3%. Also, while the decline in wage income persists over time, the decline in profits and rents remains short-lived.[9] The OECD Economics Department tentatively confirmed the IMF analysis. It reported that "many consolidation instruments work in the direction of aggravating income inequality". That applies in particular to cuts in those benefits, which used to have redistributive power. The paper also reported that reducing the provision of public services likewise contributes to increasing inequality.

Figure 4: Income inequality increased in most, but not all OECD countries
Gini coefficients of income inequality, mid-1980s and 2011/12



Source: Trends in income inequality and its impact on economic growth. DELSA/ELSAC(2014)11

The top one per cent

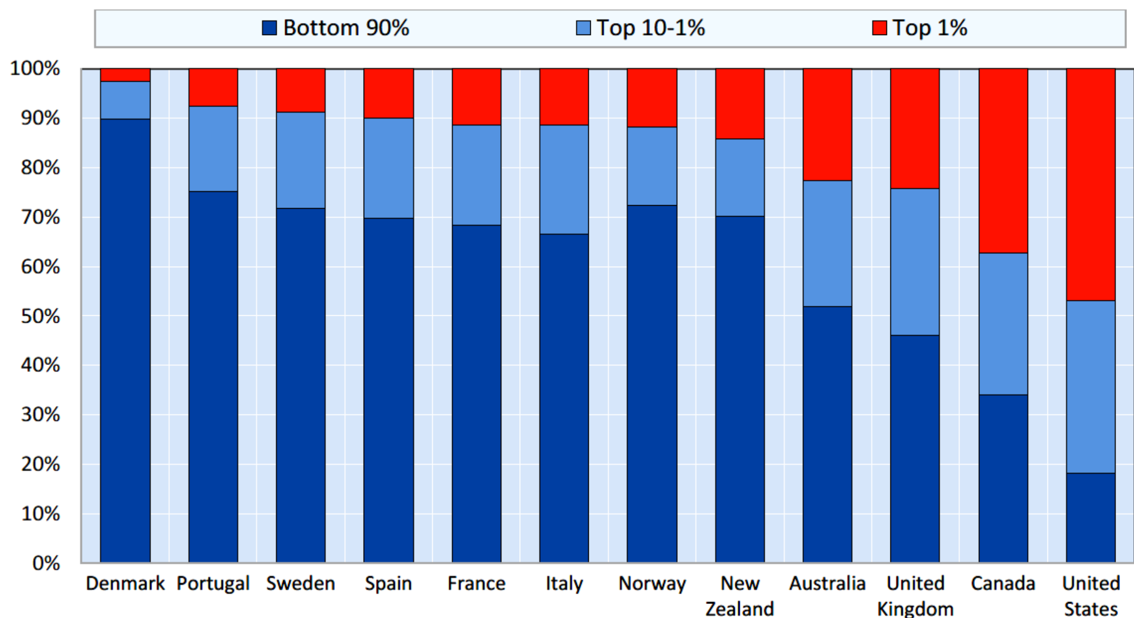
8. OECD work sheds light on the capture of much of the income gain over the past thirty years in some countries by the top one per cent. As shown in Figure 5 over the last three decades, the top 0.1% income share has been multiplied by about four in the United Kingdom and the United States, and by more than three in Australia. In the rest of Europe, the trend is less marked but still significant in some countries. Around 47% of total growth has benefitted

[8] OECD (2013), Crisis squeezes income and puts pressure on inequality and poverty, May 2013
[9] Laurence Ball, Davide Furceri, Daniel Leigh, and Prakash Loungani, IMF Research Department, June 2013

the top 1% in the United States, 37% in Canada and about 20% in New Zealand, Australia and the United Kingdom. Compared to English-speaking countries, the bottom 99% of the population in Nordic countries but also in Portugal and France benefitted more significantly from income growth by receiving about 90% of the total pre-tax income. It is unsurprising to note that the surge in top incomes does have an impact on measured real income growth. In the United States, average income grew at an annual rate of 1% over the 30 years period. However, when excluding the top percentile, the annual growth rate falls to a mere 0.6%.

9. Top marginal tax rates have declined considerably in most countries during the past decades. There is a strong negative correlation between the top marginal tax rates and the pre-tax shares of top incomes across OECD countries[10]. In the past decades, several countries abolished or decreased net wealth taxes and inheritance taxes. Net wealth is only taxed in a few OECD countries and property taxes on immovable property represent a small percentage of overall taxation. However, decreasing marginal tax rates for top incomes and tax exemptions on capital income, which are mainly capital gains, may imply that top incomes could accumulate more capital and wealth and transmit it through bequests.

Figure 5: Share of income growth going to income groups from 1975 to 2007



Source: OECD calculations based on the World Top Income Database.

The economic impact of rising inequality

10. High and rising inequality has a significant economic cost. A series of papers from the IMF research department has argued that rising inequality, combined with the behaviour of

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[10] The OECD-wide average top statutory personal income tax rate declined from 65.7% in 1981 to 41.7% in 2010. Similarly, the statutory corporate income tax rate declined from 47.4% in 1981 to 25.5% in 2012.

financial intermediaries contributed to the financial bubble prior to 2008[11]. Other work concludes that "equality appears to be an important ingredient in promoting and sustaining growth"[12]. The current path of rising inequality is increasingly at odds with paths towards sustainable growth and economic recovery. Leaving aside the moral case for greater equality, there is also a compelling economic case against inequality. Poverty excludes millions of citizens from the mainstream economy, depriving them of the opportunity to achieve their potential. At the same time, many working families face difficulties to pay for decent housing, appropriate health care, old-age security and decent education for their children. This reduces the prospects for sustainable growth in the medium term. A report by the Asian Development Bank argued that if in emerging Asian economies income distribution had not worsened over the past 20 years, the region's rapid growth would have lifted an extra 240 million people out of extreme poverty[13].

11. The decline in the wage share has also been a drag on growth. A recent OECD analysis has confirmed that higher inequality lowers economic growth.[14] The analysis "provides strong evidence that higher inequality has a sizeable and statistically significant *negative* impact on growth" (p. 28). The new evidence also suggests that it is in particular inequality at the bottom of the distribution that has a particular adverse effect on growth. The analysis concluded in this respect that it is not *just* poverty (i.e. the incomes of the lowest 10% of the population) that inhibits growth. Thus, *poverty alleviation* through anti-poverty programmes will not be enough to facilitate growth. The analysis found no evidence supporting concerns that redistribution policies in aggregate are bad for growth. Given the fact that past tax and benefit reform policies, which lowered benefits and marginal tax rates, contributed to the growing divide between rich and poor, tax and benefit systems need to be redesigned. The aim must be, as the analysis puts it, "to ensure that wealthier individuals contribute their fair share of the tax burden. This aim can be achieved in several different ways – not only via raising marginal tax rates on the rich but also improving tax compliance, eliminating or scaling back tax deductions which tend to benefit high earners disproportionally, and reassessing the role of taxes on all forms of property and wealth, including the transfer of assets. Broadening the tax base by closing loopholes in the current tax code has the potential to raise both efficiency and equity." (p. 28)

12. Modelling carried out for the L20 by the University of Greenwich[15] highlights the fact the world economy, in aggregate, is wages-led - that is, the more you pay people the more they will spend on goods and services that generate aggregate demand. In contrast, every one percentage point of simultaneous decline in the wage share has led to a decline in the global GDP by 0.36 percentage points. The L20 has proposed a balanced policy mix of restoring the wage share by between 1% and 5% over five years in G20 countries, and a 1% of GDP increase in infrastructure investment that could create up to 5.84% more growth and 33 million jobs by 2018 compared to business as usual.

[11] Michael Kumhof and Romain Rancière, IMF Research Papers, 2011
[12] Andrew G. Berg and Jonathan D. Ostry, IMF Research Department, 2011
[13] For richer, for poorer, The Economist, October 13 2012 issue
[14] Trends in income inequality and its impact on economic growth, DELSA/ELSA(2014)11
[15] Ozlem Onaran, University of Greenwich, "The case for a coordinated policy mix of wage-led recovery and public investment in G20", L20 Working Paper, 2014

Social impacts

13. The impacts of both the crisis and the on-going rise in inequality are also reflected in indicators measuring well-being and trust. The European Quality of Life Survey (EQLS), published by the European Foundation, conducted across 27 EU Member States from September 2011 to February 2012, found that happiness and optimism levels have fallen between 2007 and 2011, while perceived social exclusion has increased indicating a decline in overall well-being. The lowest levels of subjective well-being are reported by the unemployed, with changes in well-being closely related to income developments. In countries, where there have been increases in well-being, they tend to have been enjoyed by those in the highest-income quartiles. Conversely, the largest falls were experienced by those in the bottom-income quartile.

14. The survey also found that the least unequal countries, i.e. the Nordic countries and the Netherlands, continue to enjoy the highest levels of well-being on most measures. The survey also revealed that GDP growth does not necessarily lead to better well-being across a society. For instance, of the participating countries that showed GDP growth, the seven (Belgium, Denmark, France, Latvia, Lithuania, Slovakia and Sweden) with the highest increase in the proportion of people reporting to have problems making ends meet all experienced an increase in inequality.

III - Causes of Widening Income Inequality

15. "Divided We Stand" suggested that skill-based technological change, lack of access to quality education and weakening labour market institutions were all factors that contributed to the rise in inequality. A debate is also underway raging on the impacts of globalisation and the impact of emergence of global supply chains in terms of their impact on income distribution. TUAC is engaging with the OECD secretariat in its work on GVCs and their social impacts. It is also heavily involved in promoting and implementing the OECD Guidelines for Multinational Enterprises, including in global supply chains.

Wage setting institutions

Box 2: The impact of labour market policies, institutions and regulations on inequality – Findings from *Divided We Stand*

Changes in institutions, policies and regulations in general are negatively correlated, albeit very modestly in most cases, with changes in wage dispersion within countries. For instance, a decline in union coverage is associated with an increase in wage dispersion, but driven by a few countries. A similar negative relationship is also witnessed between changes in centralisation/co-ordination of wage bargaining and change in inequality, but such correlation is rather moderate as many countries indeed did not register a change in this index over time.

Changes in both product market and employment regulations are also correlated with changes in wage inequality. For employment protection regulation (EPL), it is argued that stricter employment protection laws increase employers' costs to hire/dismiss workers and raise the reservation wage of the unemployed. Such policies would compress the wage differential if the associated labour adjustment costs are relatively more important for unskilled workers. For product market regulation (PMR), the channel of inequality transmission is more indirect as lower PMR values are expected to lead to an increase in competition in a respective sector which, in turn, should shift labour demand and increase

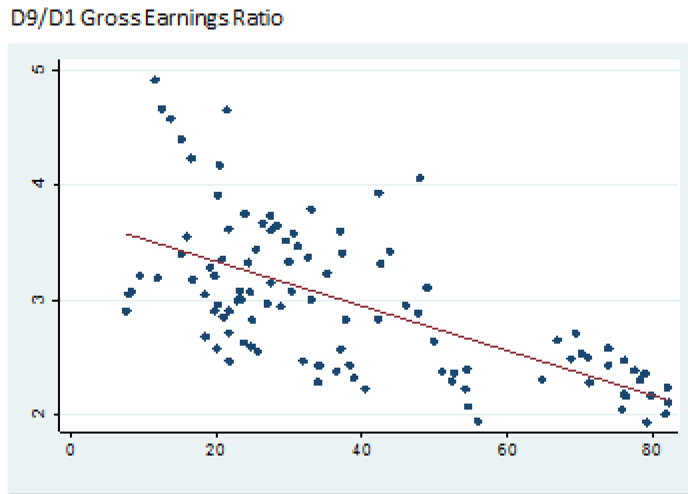
the returns to skills. The effect of PMR may indeed run through at the finer (firm) level. Less-regulated product markets tend to raise stronger competitive pressure and create more incentives to innovation and technological adoption with differential effects across workers within sectors and firms. The data suggest a very moderate negative relationship between changes in product market regulation and wage inequality. There is no correlation between the trends in overall employment protection and wage dispersion but some moderate negative association seems to exist between EPL for temporary workers and wage inequality trends.

Changes in tax wedges may also impact on trends in wage dispersion, *e.g.* a higher marginal tax rate may discourage less-skilled workers to enter the labour force for lower-paid jobs. A reduction in tax wedges could thus imply an increase in the supply of low-skilled labour and lead to higher wage differentials. The generosity of unemployment benefits could also have effects on wage inequality. It has been hypothesised that high replacement rates would strengthen the bargaining position of lower-paid workers more than that of higher-paid workers, and hence would lower the wage differential. Finally, an increase in the real minimum wage is likely to result in lower wage dispersion because it tends to benefit low-skilled workers. The association between trends in wage inequality and labour market institutions seems to provide some support to these hypotheses: changes in tax wedges, UI replacement rates and minimum-to-median wage ratios are somewhat negatively associated with changes in wage inequality.

16. The weakening of labour market institutions is one key cause of income inequality. The “structural reform paradigm” employed since the 1980s had the undesirable effect of reducing the ability of labour market institutions to moderate market inequality. The growth in temporary work, casual work and other “flexible” forms of employment have begun to permeate global supply chains as “normal” form of employment relationship. However these trends could be addressed in part through a change in policy. The role of labour market institutions has been presented in the OECD Economics Department work[16] as a trade-off between efficiency and distribution effects. However, the World Bank assessment of the impact of labour policies has downplayed these negative effects: “The impact of labour policies is often the subject of heated debates. In the past decade, improved data and methods have generated a great deal of new information not only in industrialised countries but increasingly on developing countries as well. Estimated effects prove to be relatively modest in most cases – certainly more modest than the intensity of the debate would suggest. The weakness of labour market institutions is one key cause of income inequality. Excessive or insufficient interventions can certainly have detrimental effects on productivity. But in between these extremes lies a “plateau” where effects enhancing and underpinning efficiency can be found side by side and most of the impact is redistributive”[17]. Figures 6 and 7 show that robust minimum wages can reduce inequality as can higher trade union density and collective bargaining coverage.

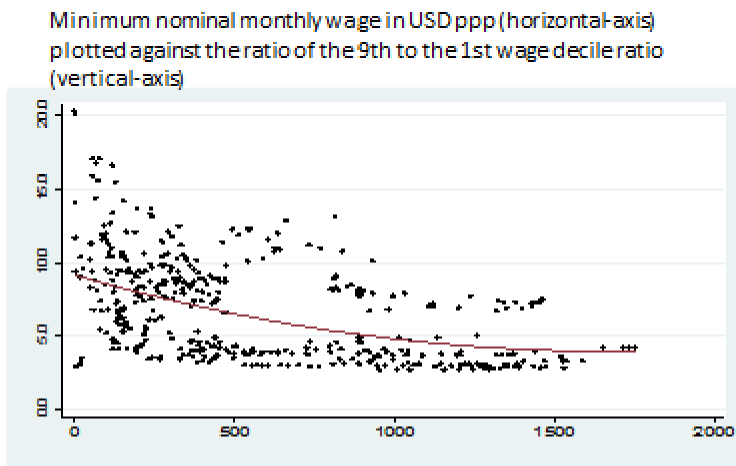
[16] Policy Challenges for the Next 50 Years, OECD Economic Policy Papers, §69-70, July 2 2014
[17] World Bank World Development Report 2013: “Jobs”, Chapter 8

Figure 6: The Impact of Trade Union Density (horizontal–axis, per cent) on Income Inequality (vertical-axis)



Source: ILO

Figure 7: The Impact of Minimum Wages on Income Inequality



Source: ILO

Skills and education

17. The "Tinbergen race" traditionally has described the effects of skill-biased technological change as a race between technological change and access to education and skills upgrading for workers. The OECD's *Education at a Glance 2014* shows that the share of national wealth devoted to educational institutions is substantial in all OECD countries. However, over the period between 2009 and 2011, public expenditure on educational institutions fell in one-third of OECD countries. On average across OECD countries, 84% of

all funds for educational institutions come directly from public sources; 16% come from private sources. Whilst the share of public and private funding varies widely among countries on average between 2000 and 2011, the share of public funding for primary, secondary and post-secondary non-tertiary education decreased slightly among the 20 countries with available data for all years. Over the same period private spending on education for all levels of education increased on average in the OECD countries. The average share of public funding for tertiary institutions decreased from 73.7% in 2000 to 68.3% in 2011, while the share of private funding for tertiary education increased during this period in more than three-quarters of the countries for which comparable data are available. With some delay the fall out of economic and financial crisis has started to adversely impact on public spending on education in a number of countries.

18. More needs to be done to make lifelong learning a reality for all workers. It is welcome that across OECD countries more than 50% of adults participate in formal and/or non-formal education in a given year. Regrettably, however, participation in formal and/or non-formal education in all countries continues to be strongly related to proficiency levels in key skills and educational attainment. That is most obvious with regard to adults of low educational attainment; they are caught in a vicious circle of low skills proficiency, and no access to formal education. Moreover, participation of adults in continuous training tends to be strongly age-biased. Participation in formal and/or non-formal education is most common among younger adults and declines steadily among older adults. Inequalities in education don't prevail in adult learning. Despite improved access to education, the educational background of parents continues to be a key determinant of educational attainment. However, its impact has become weaker in the advanced economies where educational mobility has started to slow down. That is reflected in the share of people with lower qualifications than their parents across all age groups; while the share is 9% among 55-64 year-olds, it has increased to 12% among 35-44 year-olds and is even higher with 16% among 25-34 year-olds.

19. Against the background of persistently high unemployment and increasing inequality, investing in education and training is even more important. In order to combat inequality and to facilitate employment, opportunities for education and training must be offered not only to all young people but also to adult learners. At the same time enterprises must invest more in workforce development. In order to facilitate better youth employment outcomes, governments must in close cooperation with employers and trade unions promote the expansion of quality apprenticeships. Even though spending on education is no panacea regarding unemployment and social inclusion, it remains an indispensable prerequisite for the transition towards a more just and fairer society.

Tax

20. Rising inequality should also, and quite obviously, be contemplated in the context of regressive tax reforms across OECD economies, pre- and post-crisis. In addition to cuts in top marginal tax rates, in wealth and property tax rates as discussed above (§9), tax cuts on capital gains and corporate income, and tax increases on consumption have had a combined effect of reducing the tax burden on high-income earners while squeezing low- and middle-income households. The tax reforms post-2008 did not significantly depart from that trend – and the OECD also encouraged these reforms in the 2009 edition of Going for Growth. The regressive effects of past tax reforms and their impact on inequality have been exacerbated by the continuing erosion of the tax income base of OECD economies generated by various forms of tax evasion and aggressive tax planning practices. Sophisticated tax planning and tax evasion

schemes indeed are far more accessible to large multinational enterprises and to wealthy entrepreneurs than they are to middle- and low-income households. Tax evasion and avoidance have an indirect impact on inequality in as far as they reduce the funding basis of public services, social protection and other welfare schemes.

21. Since 2009, some welcome analytical work has been conducted by the OECD on the tax effect on inequality. More recently the Organisation has taken decisive steps to curb both tax evasion and tax avoidance, respectively with the adoption of a Standard on automatic exchange of information between tax authorities and with the G20-endorsed Action Plan on Base Erosion and Profit Shifting respectively. However much remain to be done on the broader tax policy front. Avenues for change would include:

- A far more positive approach to eliminating tax exemptions in the financial sector (which by any standard is a primary source of increasing inequality).
- Reversing the downward trends in capital gain tax, top tiers of personal income tax and corporate income tax.
- Taking measures to redress tax bias toward debt (if indeed excessive financial leverage increases inequality).
- Restricting corporate tax exemptions and tax benefit schemes to those that have clear and uncontested employment or social cohesion objectives.
- Ensuring VAT-rates (general and reduced rates) are calibrated to protect middle- and low-income household purchasing power.

IV – Conclusion: The Need for a Comprehensive Strategy to Reduce Income Inequality

22. TUAC proposes that the comprehensive strategy on inclusive growth must:

(i) Address the growth of in-work poverty through establishment of well-set minimum wages in the light of national contexts.

(ii) Strengthen the coverage of collective bargaining by the social partners and adopt this as a government policy objective.

(iii) Undertake corporate governance reforms to curtail the excesses of top income remuneration and encourage the setting of limits of top pay to median incomes in the private sector.

(iv) Ensure access for all to quality education and training systems. Governments must ensure adequate and appropriate infrastructures and tools for the provision of high quality education in all our countries, in particular during times of crisis.

(v) Restore progressivity in the tax system and ensure effective taxation of international corporations.

(vi) Ensure that economic performance is judged by wider criteria than GDP per head.

(vii) Promote the OECD Guidelines for Multinational Enterprises, and the message that they apply to global supply chains, and step up actions aimed at improving the National Contact Points, including by increasing the regularity of country peer reviews.

(viii) Return to a policy of full employment whereby workers are not at a disadvantage in seeking wages that reflect productivity growth.

23. Some of these policies involve a change in the direction of current structural policy recommendations when applied in individual countries in the wake of the crisis. In this light, G20 Finance and Labour Ministers at their joint meeting in 2013 said that they would move forward by "implementing labour market and social investment policies that support aggregate demand and reduce inequality, such as broad-based increases in productivity, targeted social protection, appropriately set minimum wages with respect to national wage-setting systems, national collective bargaining arrangements, and other policies to reinforce the links between productivity, wages, and employment"[18].

[18] The G20 Labour and Employment and Finance Ministers' Communiqué, Moscow, 19 July 2013