# Long-Term Issues

# Rising Inequality, Public Policy, and America's Poor

Lane Kenworthy

*Those who defended the American model during its long period of growing income inequality argued that rising incomes at the top would result in faster economic growth and therefore rising incomes for those at the bottom. When looking at experiences in many countries, Lane Kenworthy finds that was not the case. Nor was it the case that rising incomes at the top measurably hurt the poor. It was public policy that made the difference.*

Income inequality has risen sharply in the United States since the late 1970s, with much of the increase consisting of growing separation between the top 1 percent and the rest of the population. In political philosopher John Rawls's conceptualization of justice, that is not objectionable if society's least well-off benefit in absolute terms.

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Have they? Have incomes for Americans at the low end of the income distribution increased more than they would have had a smaller share of income growth gone to the top 1 percent?

One way to explore this question is by examining the effect of inequality on economic growth and estimating the amount of growth that will trickle down to the bottom. I address the question a different way: I look directly at trends in household incomes at the low end of the distribution. I compare changes in income inequality and in low-end absolute incomes in the United States and thirteen other rich countries over the period from 1979 to 2005.

The comparative experience suggests that top-heavy increases in inequality have not tended to be Rawlsian. But neither have they tended to hurt the poor. The key driver of improvements in absolute incomes for the poor has been shifts in government transfers and taxes, and these do not seem to have been influenced by trends in income inequality.

## How Might a Top-Heavy Rise in Income Inequality Affect the Poor?

Income inequality has increased in most affluent countries since the 1970s, but it has done so to differing degrees and at varying points in the income distribution (Atkinson et al. 2009; Kenworthy 2008a; Smeeding 2005). I focus here on the rise at the top, in particular, the increase in the income share of the top 1 percent of households. A recent paper by Anthony Atkinson, Thomas Piketty, and Emmanuel Saez (2009) provides data for a number of rich countries. I use the figures considered most comparable, which are pretax and exclude capital gains.

Figure 1 shows developments in eight countries from 1950 to the most recent available year. In the first group—Australia, Canada, the United Kingdom, and the United States—the top 1 percent's share declined slowly for the first three decades after World War II and then grew sharply beginning around 1980. The second group—France, Germany, the Netherlands, and Sweden—experienced a similar decline up to 1980 but then either no increase or a small one.

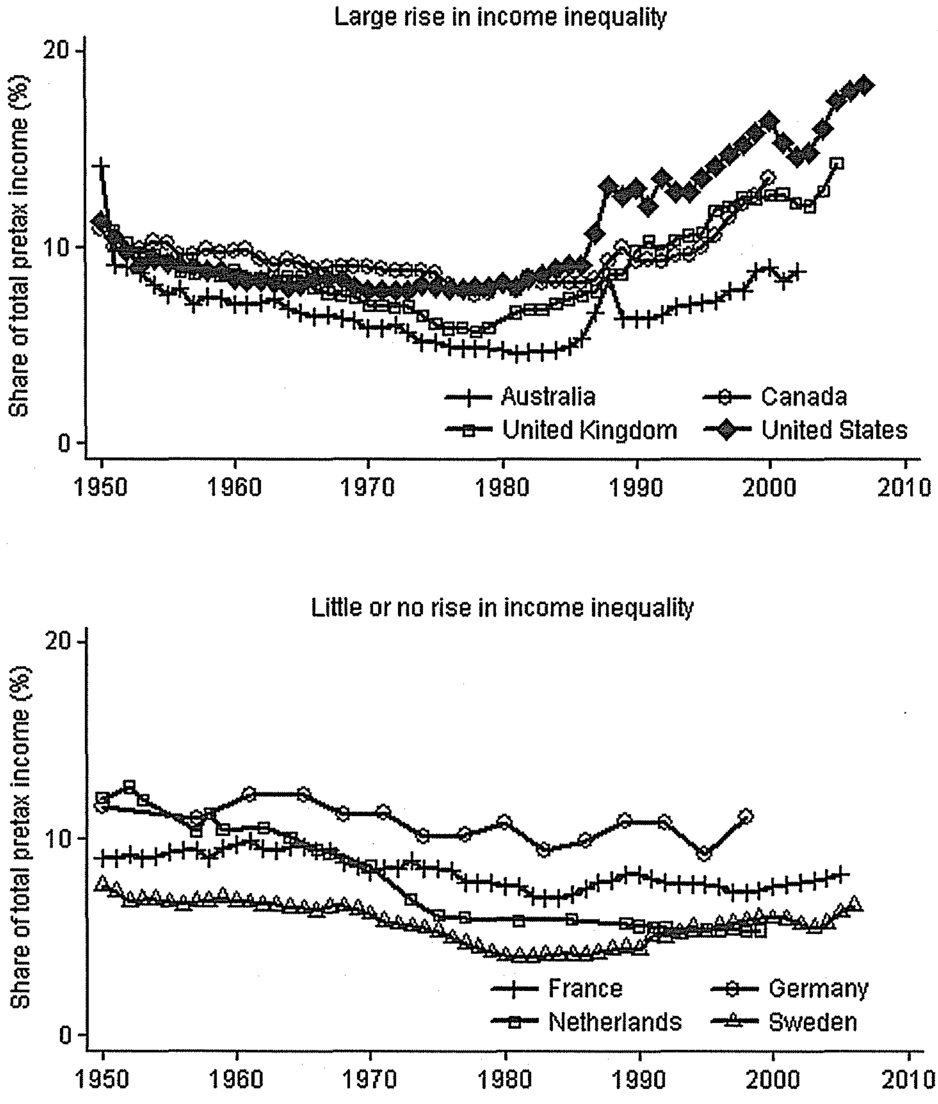



**Figure 1. Top 1 Percent's Share of Income, from 1950 Onward**

*Source:* Atkinson, Piketty, and Saez data set, http://elsa.berkeley.edu/~saez/atkinson-piketty-saezJEL09series.xls.

*Note:* Share of pretax income (excluding capital gains) going to the top 1% of taxpaying units.

Have top-heavy increases in income inequality been good or bad for the poor?

If we approach this question in relative terms, the answer almost certainly is "bad." It is conceivable that a rising income share for the top 1 percent comes mainly at the expense of those just below them, or perhaps of the middle class. But much more likely is that it reduces the income shares of most of those in the lower 99 percent of the distribution, including the poor. For the United States, the Congressional Budget Office (2009) has merged income tax return data with income survey (CPS) data to create estimates of income developments throughout the full distribution in recent decades. These estimates include government transfers and subtract tax payments. According to these data, between 1979 and 2005 the income share of the top 1 percent of households jumped from 8 percent to 15 percent. The share going to the bottom quintile of households fell from 7 percent to 5 percent.

But perhaps we should instead focus on what happens to the *absolute* incomes of the poor. According to John Rawls (1971), for instance, an increase in income inequality is morally just if it is to the benefit of the least well-off—in other words, if it contributes to higher absolute incomes for the poor than would otherwise be the case.

There are several paths through which a top-heavy rise in income inequality might boost the absolute incomes of households at the bottom. One is an increase in economic growth. Growth can trickle down to the poor via more jobs, additional hours for those in jobs, rising wages, and higher government tax revenues that can be redistributed in the form of transfer increases or tax reductions. A second path is a fairness response by government. Policymakers might increase the statutory minimum wage (if one exists) or enhance the generosity of tax-transfer programs in reaction to a sharply rising income share at the top. Third, if the tax system is progressive, a top-heavy rise in inequality will increase tax revenues by shifting income to households that are taxed at higher rates. This additional revenue can be used to improve tax-transfer benefits for the poor.

But if rising inequality does not boost economic growth or produce pro-poor changes in government transfers and taxes, its effect on low-end incomes is likely to be negative. Income that goes to the rich is income that otherwise could have gone to the poor (Kenworthy 2008b). In this scenario, rising inequality is bad for the poor in not only a relative sense but also an absolute one.

## Comparing Change Across Countries

For analytical purposes, the fact that income inequality has risen sharply in some countries but not others is useful. We can compare changes in absolute income at the low end of the distribution in countries with varying degrees of change in the top 1 percent's income share. Have absolute incomes at the bottom risen more in nations with larger increases in the top 1 percent's income share than in nations with little or no increase?

Figure 2 plots changes in low-end incomes by changes in income inequality in fourteen affluent countries for which data are available. The period covered is 1979 through the mid-2000s, though the particular years and length of time differ depending on the country. Income inequality is measured, as in Figure 1, with the top 1 percent's share of pretax income (excluding capital gains). Low-end incomes are measured as posttransfer–posttax household income at the tenth percentile of the distribution. These figures are my calculations from data in the Luxembourg Income Study (LIS) database, which are the best available for cross-country comparison (Atkinson and Brandolini 2001). Incomes are adjusted for household size with a conventional equivalence scale, adjusted for inflation, and converted to a common currency (year 2000 U.S. dollars) using purchasing power parities. For both measures, change is calculated as the difference (absolute, not proportional) between the ending value and the beginning value, annualized and expressed on a per-decade basis.

The dashed regression line suggests a positive association between change in top-end income shares and change in low-end absolute incomes. This seems, at first glance, to support a conclusion that rising inequality has tended to be Rawlsian. But the association is

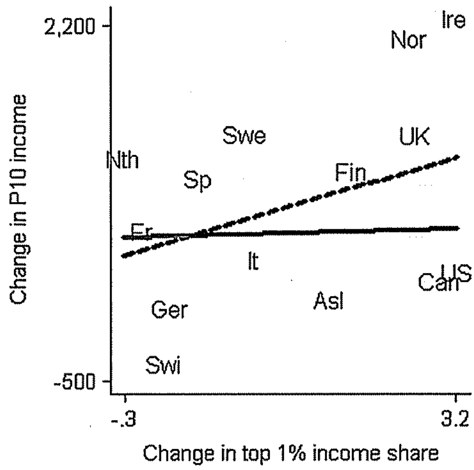



**Figure 2. Change in Low-End Absolute Incomes by Change in Income Inequality, 1979 to Mid-2000s**

*Source:* Atkinson, Piketty, and Saez 2009; Kenworthy 2011, using Luxembourg Income Study data.

*Note:* Actual years vary depending on the country. Top 1% income share is pretax, excluding capital gains. P10 (tenth percentile) income is posttransfer-posttax, in 2000 U.S. dollars per equivalent person. Each is expressed on a per-decade basis (annualized and multiplied by 10). The dashed line is a regression line with all fourteen countries included; the solid line is a regression line with Norway and Ireland omitted.

weak. And it hinges on the position of a few influential countries—most notably Ireland and Norway, in which both the top 1 percent's income share and the absolute income level at the tenth percentile rose sharply.

Do the details for these two countries support a conclusion that rising inequality helped to boost low-end incomes? First, was the timing consistent? For Ireland, the answer is yes (see Figure 3 below). The top 1 percent's income share began increasing in the late 1980s and continued to do so at least through 2000, which is when the data series ends. The LIS data on low-end incomes are available for the years 1987 to 2000, and they indicate a steady rise during this period. For Norway, on the other hand, the timing is less consistent. Data for both measures are available from 1979 to 2004. Much of the rise in low-end incomes occurred between the late 1970s and the early 1990s, when the top 1 percent's income share was flat. For the remainder of the period the top-end income share rises, and so do P10 incomes, but there is no acceleration in the pace of increase for the latter.

What about the links in the causal chain in these two countries? Both experienced rapid economic growth, but a strong case can be made that rising inequality played little or no role in that growth. In Norway the chief source of strong growth, arguably, has been oil. In Ireland it has been massive foreign investment, encouraged by improving labor-force skills, English language, and access to Europe's markets.

The solid regression line in Figure 2 summarizes the pattern with Ireland and Norway omitted. It is flat, suggesting no association between change in income inequality and change in low-end incomes.[1]

The positive association suggested by the dashed line in the figure also is helped by Germany's position in the lower-left corner. Germany, too, should perhaps be discounted, as it absorbed a poor country (the former East) in the middle of the period under consideration.

My conclusion is that the top-heavy rise in income inequality over the past generation has not tended to be Rawlsian. The incomes of low-end households have increased about as much in slowly-rising-inequality countries as in rapidly-rising-inequality countries.

## Why No Effect?

Top-heavy increases in inequality have tended to be neither good nor bad for the absolute incomes of the poor. Why is that?

One possibility is that the true association between changes in top-end income shares and low-end absolute incomes actually is negative, but this is hidden in the bivariate pattern. In support of this hypothesis, one could begin with the sorts of considerations raised in the previous section about the details of the Irish, Norwegian, and German cases. One could then posit that the English-speaking countries, due to the more market-friendly structure of their economies (corporate governance arrangements, product and labor market regulations, union strength), have been able to grow more rapidly than the others. If we assume a similar rate of trickle-down in all countries, this difference in economic growth would produce a larger increase in low-end incomes in the Anglo countries. Controlling for this would push these countries—Australia, Canada, the United Kingdom, and the United States—lower on the vertical axis in Figure 2. Since all of them are to the right on the horizontal axis, the association in the figure would be more likely to be negative.

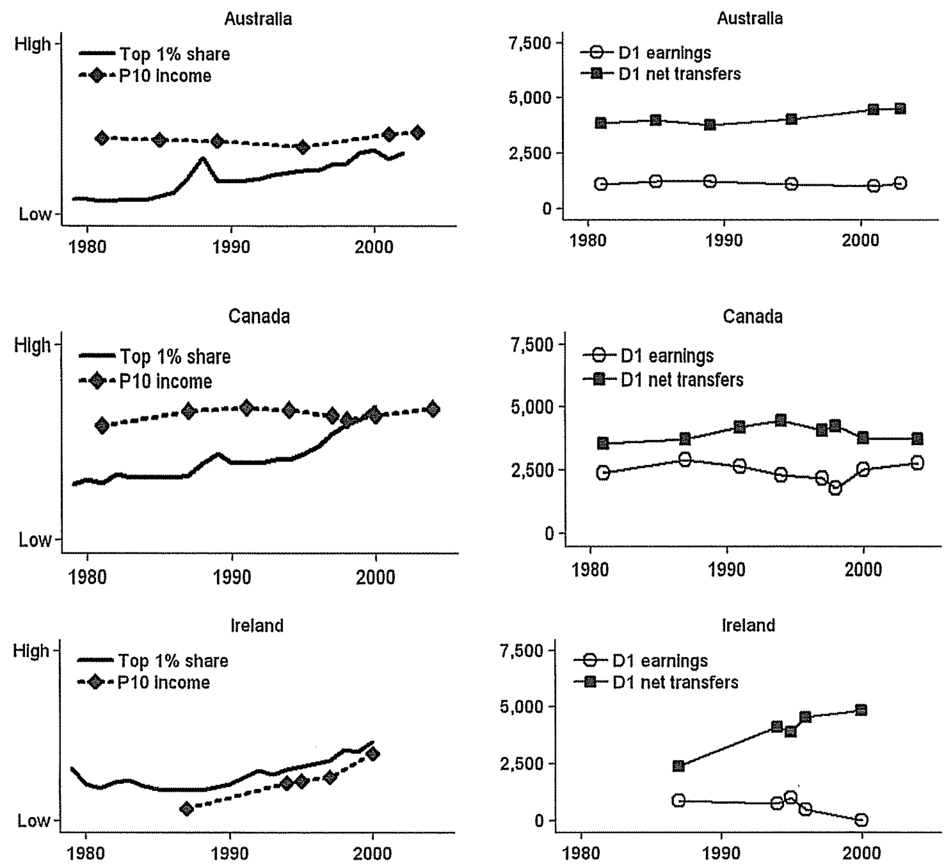
This hypothesis is plausible but probably wrong. The average change in GDP per capita (calculated as a per-decade average, like the measures used in Figure 2) for Australia, Canada, the UK, and the United States was $4,700. For the other countries, excluding Ireland and Norway, the average change was virtually identical at $4,500.

If there truly is no association between countries' changes in income inequality and changes in low-end absolute incomes, we are left with two possibilities. One is that rising inequality has no effect. The other is that it has both positive and negative effects, which offset one another.

A recent study by Dan Andrews, Christopher Jencks, and Andrew Leigh (2009) suggests a reason we might favor the offsetting-effects hypothesis. They find, based on analysis of lengthy time series for twelve countries, that a rising income share for the top 1 percent is associated with faster economic growth. Some of this is likely to trickle down to the poor. But part of the rising share going to the top 1 percent will come at the expense of the poor. Andrews et al. estimate that in the short run the negative effect of rising inequality will dominate, while in the long run the positive effect will dominate. In the medium term it is quite possible that these two effects will cancel each other out.

One way to explore this empirically is to look more closely at over-time developments in low-end incomes in each of these countries. I use the LIS database to calculate average levels of the three main sources of income—earnings, other market income, and net government transfers (transfers received minus taxes paid)—for households in the bottom decile of the posttransfer–posttax income distribution.

Figure 3 shows the patterns over time in seven countries with rapidly rising income inequality: Australia, Canada, Ireland, the United Kingdom, Finland, Norway, and the United States. For each country




## Figure 3. Trends in Income Inequality, Low-End Incomes, and Sources of Low-End Incomes: Seven Countries with Rapidly Rising Income Inequality

First chart:
*Source:* Atkinson, Piketty, and Saez 2009; Kenworthy 2011, using Luxembourg Income Study data. Top 1%'s income share: pretax, excluding capital gains; range = 3.5% to 18.3%. P10 income: posttransfer-posttax household income; range = $4,000 to $13,000, in year 2000 U.S. dollars per equivalent person.

Second chart:
*Source:* Kenworthy 2011, using Luxembourg Income Study data.
The data are averages for size-adjusted income among households in the bottom decile (d1) of the posttransfer-posttax income distribution, in year 2000 U.S. dollars per equivalent person.

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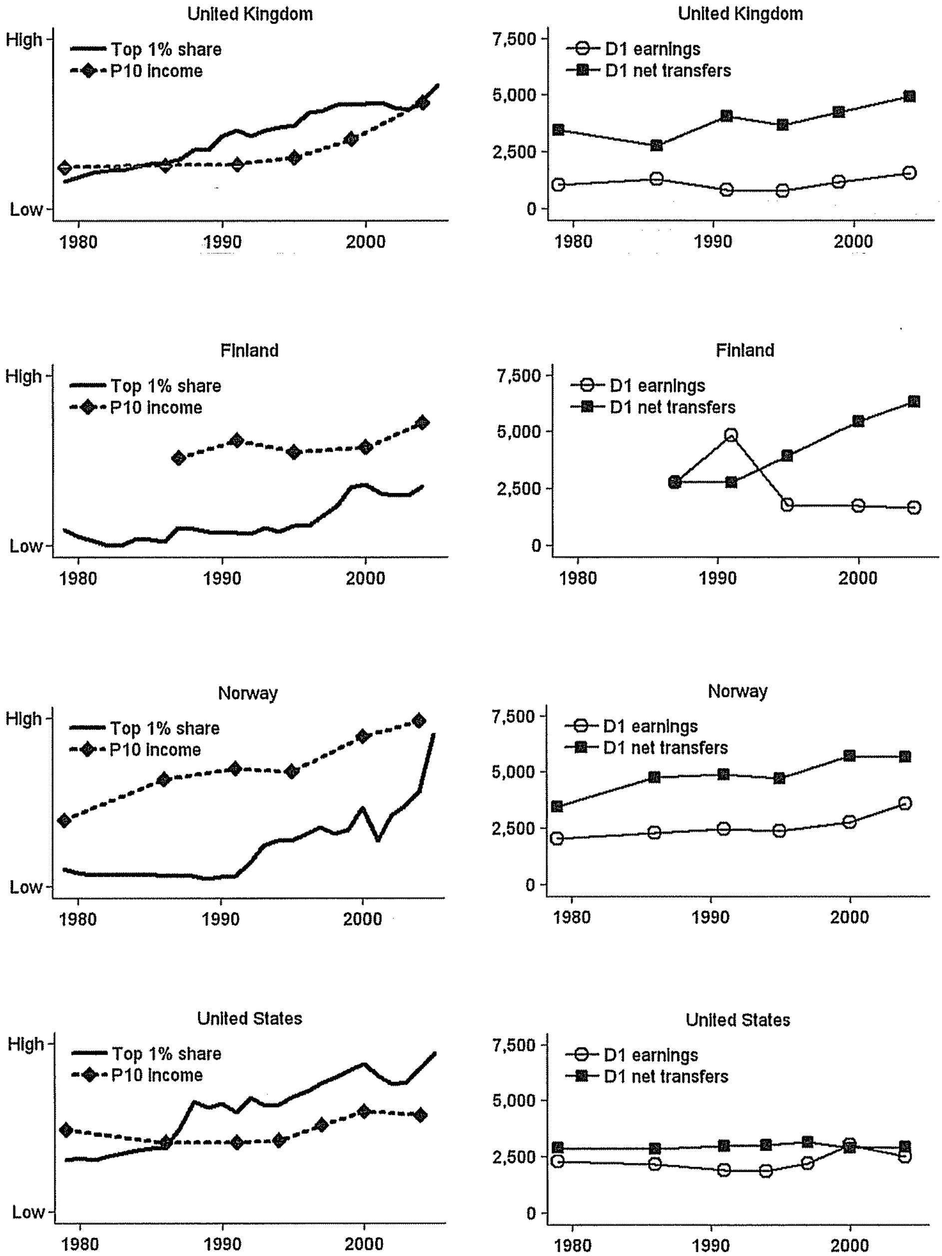



**Figure 3. (continued)**

there are two charts. The first shows the trends over time in the top 1 percent's income share and in the tenth-percentile absolute income. These are the data from which the change scores in Figure 2 are calculated. (For ease of exposition, I put the two on a common scale.) The second chart for each country shows patterns over time in average earnings and average net government transfers for households in the bottom income decile. I leave out "other" market income because it is minimal and constant over time in all the countries.

Figure 4 shows the same patterns in four countries with slowly rising inequality: Sweden, the Netherlands, Germany, and Switzerland. (The other three countries—France, Italy, and Spain—are not shown in Figures 3 or 4 because earnings for them cannot be separated from taxes in the LIS database.)

Among the countries with rapidly rising income inequality shown in Figure 3, we observe the following:

- Australia, Canada: stagnant low-end incomes
- Ireland, United Kingdom, Finland: increase in low-end incomes, due to increase in net government transfers
- Norway: increase in low-end incomes, due to increase in both transfers and earnings
- United States: small increase in low-end incomes, due to increase in earnings

Among the slowly-rising-inequality nations in Figure 4, we observe:

- Sweden: increase in low-end incomes, due to increase in net government transfers
- Netherlands: increase in low-end incomes, due to increase in both net government transfers and earnings
- Germany and Switzerland: stagnant low-end incomes

The principal way economic growth is expected to trickle down to the poor is via rising earnings. But in most of the countries in which bottom-decile incomes increased, the source of that rise was government transfers.

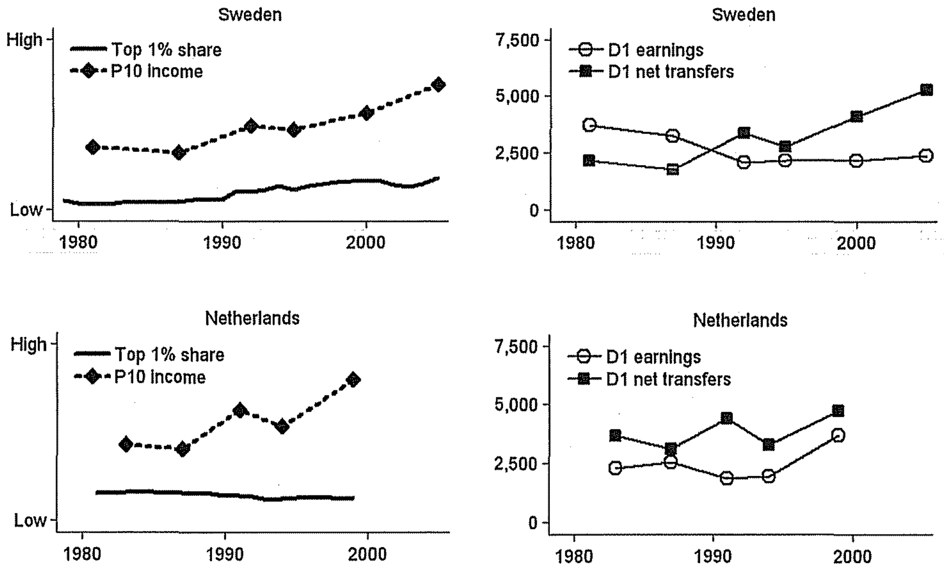
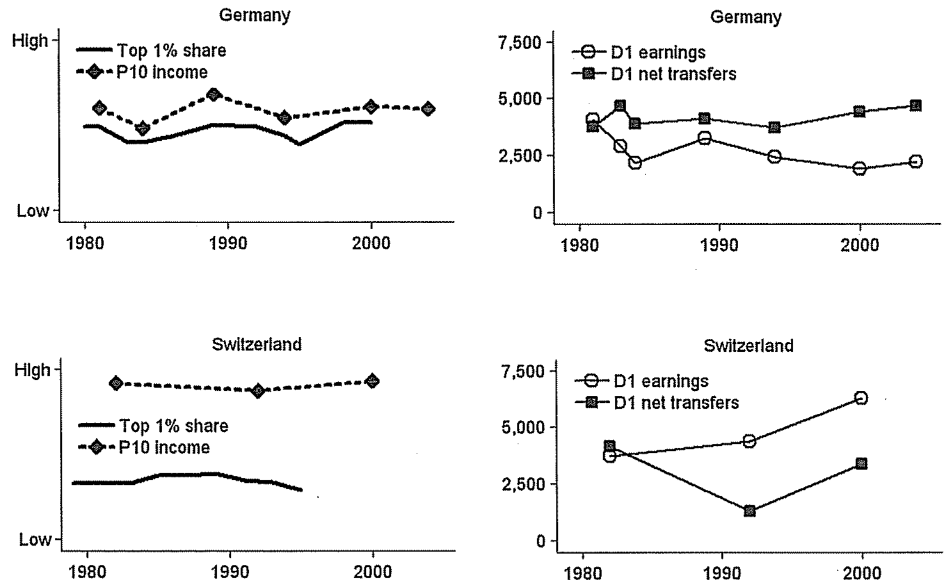



**Figure 4. Trends in Income Inequality, Low-End Incomes, and Sources of Low-End Incomes: Four Countries with Slowly Rising Income Inequality**

*First chart:*
*Source:* Atkinson, Piketty, and Saez 2009; Kenworthy 2011, using Luxembourg Income Study data. Top 1%'s income share: pretax, excluding capital gains; range = 3.5% to 18.3%. P10 income: posttransfer-posttax household income; range = \$4,000 to \$13,000, in year 2000 U.S. dollars per equivalent person.

*Second chart:*
*Source:* Kenworthy 2011, using Luxembourg Income Study data.
The data are averages for size-adjusted income among households in the bottom decile (d1) of the posttransfer-posttax income distribution, in year 2000 U.S. dollars per equivalent person.

This should not be too surprising. In most rich countries, 20–35 percent of all households have no earnings, and some of these are in the bottom decile of the posttransfer–posttax income distribution. As of the early to mid-2000s, the share of bottom-income-decile households with zero earnings was 40 percent in Finland and Norway, 55 percent in France and the Netherlands, 60 percent in Sweden, and 75 percent in Ireland (my calculations from LIS data). Some of these are elderly households with savings and pensions as the main source of income. Others are households with working-age adults whose chief income source is government transfers such as social assistance or unemployment, sickness, or disability compensation.




Over the past few decades, rising incomes at the low end of the distribution have been a product mainly of policy arrangements and choices that determine net government transfers, rather than of the rate of economic growth (Kenworthy 2011). This suggests reason for skepticism about the offsetting-effects hypothesis.

Why, then, do we not observe a tendency for top-heavy increases in income inequality to be either good or bad for the absolute incomes of the poor? Government transfers to the poor have been the chief determinant of trends in low-end incomes. Such transfers have increased in some rapidly-rising-inequality countries but not in others, and they have increased in some slowly-rising-inequality countries but not in others.

Why has that happened? In the Nordic countries—Denmark, Finland, Norway, and Sweden—the generosity of transfer programs tends to be tied to economic progress. Some benefits are indexed to keep up with earnings. In other instances this is achieved via periodic policy updates.

The United Kingdom is an interesting case because the policy strategy of the New Labour government from 1997 through 2010 was explicitly Rawlsian. Tony Blair, prime minister from 1997 to 2007, famously quipped, "It's not a burning ambition of mine to make sure David Beckham earns less money." While Blair's government did profess an interest in moving the UK in a broadly egalitarian direction, reducing (or even stabilizing) the income share of those at the top was not an element of its policy agenda. Poverty reduction was front and center. Indeed, the New Labour government set a target of completely eliminating child poverty within a generation (using a mix of absolute and relative poverty measures).

Is that how things played out in the United Kingdom? Well, not exactly. The top 1 percent's income share did indeed increase, but virtually all of that rise occurred under the Conservative governments from 1979 to 1997 (see the first UK chart in Figure 3). After that, the share was largely flat, with a small rise in the late 2000s. Tenth-percentile household income held constant throughout the period of rising inequality, but then increased sharply when income inequality flattened out.

One story we might tell is that the rising concentration of income during the period of Conservative government in the 1980s and early 1990s laid the foundation for subsequent rapid economic growth and consequently rising low-end household incomes. But as the lower chart for the United Kingdom in Figure 3 indicates, most of the rise in household income at the low end of the distribution consisted of increasing net government transfers. This was a political choice. Though the Blair government focused much of its rhetoric and policy reform on increasing employment and economic opportunity, it also increased benefits or reduced taxes for low earners, single parents, and pensioners (Hills et al. 2009; Waldfogel 2010). Tom Sefton, John Hills, and Holly Sutherland (2009, figure 2.5) calculate that benefit and tax changes between 1997 and 2005 increased real disposable income for bottom-income-decile households by about 20 percent.

What about Ireland? The available data cover the period from 1987 to 2000. The Irish economy experienced spectacular economic growth and rising employment during these years. Per capita GDP increased by $16,000 (in year 2000 U.S. dollars), and the employment rate rose by fifteen percentage points. The initial presumption therefore might be that incomes in the bottom decile increased due to rising employment and earnings. But as the second chart for Ireland in Figure 3 shows, that is not what happened. Earnings in bottom-decile households remained low throughout this period. As noted earlier, in 2000 three-quarters of bottom-decile Irish households had no earnings at all, a larger share than in most other rich countries. Rapid economic growth and rising employment surely had a sizable impact further up in the income distribution, but not at the bottom (Nolan 2008).

The rise in low-end household incomes instead was a product of rising real net government transfers (Daly and Yeates 2003, 93; Nolan 2008, 265; Nolan and Maître 2007, 38). Like elsewhere, this result was due to policy decisions to increase benefit levels and reduce taxes on low-end households, though policymakers' willingness to do this may have owed more to the strength of the economy in Ireland than in Norway or Finland or the United Kingdom under New Labour.

In the United States net government transfers received by bottom-decile households were flat throughout this period. This is consistent with what we know about trends in benefits from various programs (Moffitt and Scholz 2009; Scholz et al. 2009). The benefit level did increase for one important cash transfer: the Earned Income Tax Credit (EITC). But because EITC eligibility requires nontrivial earnings, relatively few households in the bottom-income decile get much from it. Moreover, the increase in the EITC in the mid- to late 1990s was partially offset by reductions in benefits from the Aid to Families with Dependent Children/Temporary Assistance for Needy Families programs during these years.

In short, changes in government transfers have been the chief determinant of changes in low-end incomes in the rich nations over the past several decades. Political decisions, rather than changes in the top 1 percent's income share, have determined the degree of change in those transfers.

## Conclusion

Have the top-heavy increases in income inequality in the United States and some other rich countries tended to improve the absolute incomes of the poor? Judging from comparison of over-time developments since the 1970s, the answer is no. But neither does rising inequality seem to have hurt the poor. Absolute incomes at the low end of the distribution have tended to increase at about the same pace in countries with little or no rise in inequality as in ones with rapidly rising inequality.

Where low-end incomes have increased, that typically has been a product of increases in net government transfers. Such increases are due to political choices, rather than to constraints or opportunities stemming from the share of income captured by those at the top.

Rising income inequality has a number of potential consequences—some of them, perhaps many, undesirable (Neckerman 2004). Its lack of systematic impact on the absolute incomes of the poor over the past generation ought not lead us to overlook this. Still, it is noteworthy that some affluent countries have managed to engineer increasing incomes for low-end households despite a significant top-heavy rise in inequality. For American policymakers, that might serve as welcome inspiration.

## Note

1. Controlling for change in the share of the population without a secondary education or the share that is elderly does not alter this pattern. Lack of longitudinal data makes it impossible to control for the share that is foreign-born.

## For Further Reading

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