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Luxembourg Income Study Working Paper Series

Working Paper No. 367

**Public Policy and Economic Inequality:
The United States in Comparative Perspective**

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**Public Policy and Economic Inequality:
The United States in Comparative Perspective**

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Over the last four decades, the United States has seen large increases in economic inequality. In this, it is not unique; many developed countries have experienced at least modest increases in the inequality of market and disposable income, but none so sustained as in the United States, which began this period with the highest level of inequality in the rich nation OECD (Organization for Economic Cooperation and Development) world. As economies and labor markets become more international and these countries wrestle with the social and economic consequences of an aging population, increased market work by women, and marital dissolution, public interest has come to focus on how successfully different social policies are coping with inequality, poverty (relative low income) and joblessness.

This heightened interest has led to greater efforts to assemble comparable cross-national measures of economic inequality and better measures within any one country (like the United States). Thanks to the Luxembourg Income Study (LIS) it is now possible to provide a more complete picture of cross-national differences at many points in the income distribution, instead of merely providing snapshot comparisons of the “average” or “typical” family in different countries. Researchers have not only been able to address the factual question of whether inequality has grown in other countries, but also to start to probe more deeply into causes—the influences of different trade or labor market policies, of industrial structures, or of unionization, for instance.

This article compares recent economic inequality in industrialized nations, largely those belonging to the Organization for Economic Cooperation and Development (OECD).¹ We find that the United States has the highest overall level of inequality of any rich OECD nation in the mid-1990s. We also find that the increases in the dispersion of total household income in the United States have been as large as, or larger than, those experienced elsewhere between 1979 and 2000, despite the fact that our nation began the period with the highest level of inequality. We also look at the trend in inequality within the United States using various series from published and unpublished data to examine exactly how our inequality changed over the past several decades.

Next, we examine the effects of government policies and social spending efforts on inequality, finding that the United States has lesser effects than any other rich nation, and that both low spending and low wages have a great impact on the final income distribution, especially among the non-elderly. We then are in a position to answer a number of questions. What role does policy; therefore, play in the final determination of income inequality? Can these differences be explained by demography (more single parents; more immigrants; or more elders?) or can they be attributed to American institutions and lack of spending effort on behalf of low-income families? And finally, does inequality of before tax and benefit income itself have anything to do with low social spending?

I. Methodological Details

First, some clarifications of our approach. Our analysis concentrates on income inequality among households and does not directly address the issue of individual earnings inequality. Granted that earnings are generally the largest part of income, nevertheless, these are very different phenomena. Earnings refers to persons, and income to households. Income pools the earnings of household members, taxes, transfers, pensions, and capital income, each of which is liable to make the distribution of household income very different from the distribution of individual or household earnings.

We measure disposable money income. For most families, the primary income source is market income, which includes earned income from wages, salaries, and self-employment and other cash income from private sources—from property, from pensions, from alimony or child support. To reach disposable income, governments add public transfer payments (retirement, family allowances, unemployment compensation, and welfare benefits) and deduct income tax and social security contributions from market income. The cross-national comparable definition of

income is hardly comprehensive, typically excluding much of capital gains, imputed rents, home production, and in-kind income. We take no account of indirect taxes or of the benefits from public spending on such social goods as health care, education, or most housing subsidies.² But recently the Congressional Budget Office (CBO) has created such a series for the United States alone and we use that series below. We also measure income on an annual basis. This may be too long an accounting period for families that are severely credit constrained, too short for those that can smooth consumption over multiple years—but almost all the available surveys report income for the calendar year.

The answer to the question “distribution among whom?” is “among individuals.” Some surveys focus on the individual as the unit of analysis, some on the household as the unit of income sharing. The most common unit of analysis is the household, defined as all persons sharing the same housing unit, regardless of any familial relationship.³ We, therefore, estimate individual disposable income by aggregating the income of all household members and using an equivalence scale to arrive at individual equivalent income.⁴ In some datasets, (e.g. CBO) we are constrained to use households alone.

II. Differences in Inequality across Nations and in the United States: Levels and Trends

A large body of research has documented comparative levels of inequality among nations and also the substantial increases in inequality in the United States, beginning in the 1970s. How do other industrialized nations measure up?

Figure 1 compares the distribution of disposable income in 30 nations for various years around the turn of the century (2000). Within each country we focus on the relative differences between those at the bottom and those at the top of the income distribution. To do so we first

measure, in each country, the ratio of the income of a household at the 10th percentile (P10, in Figure 1) and a household at the 90th percentile (P90) to median income. This gives us some indication of how far below or above the middle of the distribution the poor and the rich are located on the continuum of income. Second, we measure the ratio between the incomes of those at the 90th and 10th percentiles (the “decile ratio”). This gives us the size of the gap between the richest and the poorest in each country. These measures—measures of socio-economic distance, if one will—are easy to understand but focus on only a few points in the distribution of income. An alternative measure of inequality across the entire distribution is the Gini coefficient, much used by economists in studies of inequality.⁵ We include this number also in Figure 1.

Figure 1 shows us that the United States is indeed an outlier among rich nations. Only Russia and Mexico have higher levels of inequality and these nations are thought of as still ‘developing’ by most analysts. Among the richest OECD nations (all but Eastern Europe and Mexico in Figure 1), we have the highest level of inequality by far. A low-income American at the 10th percentile in 2000 had an income that is only 39 percent of median income, whereas a high-income American in the 90th percentile had an income that is 210 percent of the median. The income of the high-income American is over five and a half times the income of the low-income American, even after we have adjusted for taxes, transfers, and family size (the decile ratio is 5.45). In contrast, across the other countries in Figure 1 (excluding the United States), the income of the poor averages 50 percent of the income of middle-income persons; that of high-income person averages 195 percent of the median income. The average rich person has only 3.5 times the income of the average poor person.

The countries in Figure 1 fall into clusters. Inequality is least in Northern Europe (the Scandinavian countries, Belgium, the Netherlands), where the income of those at the 10th percentile is 57 percent of the median. Central Europe comes next (Switzerland, Germany, and

France). Then southern Europe; followed by an eclectic mix (Ireland, Estonia, and Japan). The large Anglo-Saxon nations: Canada, Australia, and United Kingdom are roughly at the same level, less equal than Europe, but still more equal than the United States. Israel and Italy have the highest levels of inequality outside the United States. In some rich countries, for example, Luxembourg, Israel, Ireland, and the United Kingdom, the incomes of the richest (those at the 90th percentile) are all more than 200 percent of median income—not so very different from the United States in relative terms. The United States differs, above all, in the relative disadvantage of its poorest residents. Our poorest residents have incomes only 39 percent of the median—in other rich nations they are much higher.

Absolute Differences in Income Inequality across Nations

It is often argued that the higher the average standard of living in a particular nation, the better off are its citizens. By this argument, the United States resident is, “on average,” better off than residents of the United Kingdom or Finland, because United States real GDP (Gross Domestic Product) per capita in 2000 was \$34,100, compared to \$23,720 in the United Kingdom and \$24,530 in Finland (Appendix Table A-1). Does the higher average United States standard of living extend to all levels of the income distribution? We examined this question by converting the incomes of a set of rich nations (from Figure 1) into real 2000 United States dollars, using a standard measure of purchasing power parity (PPP). We then recomputed low-, median-, and high-incomes in these countries as a fraction of the United States median (“real incomes”) and present them in Figure 2. Because conversion of real income across countries is sensitive to the PPP index used and to other factors, these comparisons should be taken as rough indicators of “real living” standards.

Low-income people, whose relative incomes averaged 50 percent of median income in their own countries (51 percent in the subsample selected here), have real incomes only 40 percent of

the United States median. When compared against median United States income, for example, the median German whose living standard is only \$25,330 or 74 percent as high, would appear to enjoy a lower standard of living than the median American at \$34,100. But the real incomes of Germans at the 10th percentile are on average 2 percentage points higher than the real incomes of Americans at the 10th percentile. Low-income Canadians are even better off, with incomes 6 percentage points higher than low-income Americans. Only in Great Britain (whose GDP per person is less than 70 percent of that in the United States in Table A.1) were the living standards of low-income house holds measurably lower than in the United States (35 vs. 39 percent). Overall, lower-income Americans are no better off and often worse off than the low-income persons in other nations. Of course, our richness extends to high the high end as well, and here we far surpass the rich in any other nation observed and are far above the other country average. The average “rich” American is 30 percentage points above the average rich Canadian and 53 points above the average rich British person. All other “rich” persons are below the average.

We can also measure the income distance between top and bottom, all in US 2000 PPP adjusted dollars now. The gap in the United States is \$42,000 per person—the lower-income person has resources of about \$9,500 per person, while the rich person has about \$51,500 per person. The gap is much higher than in any other nation and more than twice as high as in Sweden and Finland; almost twice as high as in Germany, Belgium, and the Netherlands.

These real income measures are admittedly crude. They should be seen as measures of net spendable income rather than of total consumption, which would also include goods and services such as health care, education and child care that are provided at different prices and under different financing schemes in different nations. To the extent that low-income citizens elsewhere need to spend less out of pocket for such goods as these than do low-income Americans, the latter are at an even greater real income disadvantage.

The claim that “the United States enjoys the world's highest living standard” must be evaluated alongside the equally valid claim that the United States enjoys the greatest level of real income inequality among the countries we study. And the social costs of low absolute incomes may be quite high, especially for families with children. From other research, we know that young children living in households with incomes at 75 percent of the official United States poverty line—that is, households at roughly the 10th percentile in the income distribution are at severe risk of poor health, subsequent poor educational performance, and diminished achievement.⁶ The P10 for United States children in single parent households is, in fact, 21 percent of the median, by far the lowest in any nation (Smeeding 2003, Figure 6).

Cross-National Trends in Inequality

Do the differences in economic inequality among the OECD countries in the early 1990s reflect convergence to a common level of inequality, or are countries that are already more unequal, such as the United States, the United Kingdom, and Canada becoming even less equal? To answer this question, we first compare relatively short-term trends in inequality, from the late 1970s to 2000.

Figure 3 shows changes in income inequality after 1979 as measured by the change in the Gini coefficient in each of seven nations for whom we have comparable time series. It is hard to read any consistent relation between the trend in the 1980s and 1990s and the level of inequality at the beginning of the period. Inequality increased noticeably in five nations over this period—the United Kingdom, the Netherlands, Belgium, Germany, and Norway. It barely rose in Canada (and then depending on the year where the time series begins). In France, inequality declined modestly. The largest percentage changes took place in two different countries, the United Kingdom and the United States. In the United Kingdom, between 1979 and 1991-1992, the Gini coefficient rose by more than 30 percent, more than double the decline that the country had experienced from 1949 to

1976 (not shown here but see Gottschalk and Smeeding 1997; 2000 for longer trends). But British inequality has remained roughly constant since 1992. In the United States, the increases in inequality began in the 1980s and continued throughout the 1990s up to at least 2000 (even removing the discontinuity in the Census Bureau time series).

A wide spectrum of countries is exhibiting greater secular increases in inequality, but it is not yet clear how far this will spread. Most OECD nations are still experiencing high unemployment and rising earnings inequality. In some countries, employment policy, tax and transfer policy, and other factors such as increased work by married women have muted the effects of these market influences on the distribution of disposable income. In the countries which exhibited the largest rise in inequality, e.g., in the United Kingdom, these increases may have reached a plateau. However, they have not plateaued in the United States, which began the series with the highest level and then continued throughout the late 1990s, the strongest period of economic growth in our nation since the 1950s.

The United States in Greater Detail

There are several sources of income data for the United States and while they tell a relatively similar story, the most complete sets of data show the largest changes in inequality while also allowing us to broaden the income definition beyond even that which LIS offers.

First, Figures 4 and 5 (from Burtless and Jencks 2003) are based on official Census money income before taxes. This series runs back as far as 1947 and allows the longest look at inequality, though using the narrowest income definition. Here, we see the top of the distribution (95th percentile) pulling away from the middle after 1970, despite the fact that it grew closer during the period from 1950-1964. By 2001, the 95th percentile family had an income 3.2 times that of the middle family—roughly \$125,000 compared to \$40,000 in that year. In contrast, the same middle (or 50th percentile) family has incomes about 2.0 to 2.2 times that of the 20th percentile family

(about \$19,000- \$20,000 person in 2001), and this ratio has not changed much over the 54 years we observe in the data. Clearly, the top end is running away from the middle according to these figures.

But these are all relatives—how did absolute incomes change across the distribution over this period, given that real disposable incomes per capita rose by about four times over this same 57 year period. Figure 5 suggests that there were two distinct periods—the 26 years from 1947-1973 and the next 27 years, 1973-2001. During the first period, all boats rose and the rowboats (at the bottom) rose faster than did the yachts (at the top) or the tugboats in the middle. But since 1973, the yachts have pulled away from both the tugboats and (especially) the rowboats.

A second series (Figure 6, Burtless and Jencks 2003) improves on the Census numbers by subtracting out income and payroll taxes and adding in near cash benefits and refundable tax credits from 1979-2000. Since Food stamps, rental housing and the Earned Income Tax Credit (EITC) have all grown over this period, this series offers a more complete look. In fact, these data were explicitly intended to mimic the LIS data used in Figures 1 and 2 above, using the same household accounting unit, equivalence scales, and person weights.

The bottom half of the figure shows market or earned income inequality indexed to 1979. The 1980s were a period of very divergent change—with the bottom (10th percentile) worse off until 1990 and then falling even further through the recession of the early 1990s. The real earnings of low-wage households only recovered in a serious way in 1997 and then mushroomed in relative terms through the strong recovery of the late 1990s. Much of this growth in earnings among the poor was a result of the strong economy (low joblessness) which pushed more single mothers into the labor force and welfare reform. In any case, real earned income boomed over this period. In fact, low-income Americans, especially single mothers, now work roughly twice as many hours as do their counterparts in the United Kingdom, Germany, Canada, and other similar nations

(Smeeding 2003). The middle-income family had flat income until after the 1991-1993 recession and then experienced modest real earnings growth (about 20 percent) after 1994. The high-income family saw a steady growth in real earned and other market incomes through most of the period and especially in the late 1990s.

But this picture is only for market income. The top of Figure 6 shows the change in after tax and transfer income. Since the poor substituted earnings for welfare and other benefits, their real after tax incomes only rose after 1995 and then only modestly. The middle family did a bit better, with real growth after 1985 and ending the period with more than 20 percent net income gain (despite the fact that they too worked many more hours as married women's labor force participation rose throughout the period, as well as lone parents work efforts). And the well to do showed about the same pattern of real incomes growth after tax as before tax, so they did best of all. Note that 1994-2000 was a great period in American economic history because all the boats rose—inequality continued to increase, but everyone was better off in real terms.

Finally, Table 1 is based on a recent CBO (2003) report covering the period 1979-2000. Here income includes all of taxable income as measured by the Internal Revenue Service (IRS) including stock options realized, capital gains, and other forms of income not recorded well (or at all) in Census surveys. It also includes employer and government subsidies for medical care as well as food and housing. Finally, the CBO fully measure the incomes of the richest Americans whereas the Census has to “top code” these incomes above a certain level for confidentiality purposes. Thus, the final United States series shows the most comprehensive income series of all.

The basic patterns are not very different from the previous estimates, though they are more skewed. Figure 6 shows the top incomes growing by about 50 percent in after tax terms, from 1979 to 2000; Table 1, Panel B shows them growing by 68 percent over this period. Other changes are similar for both middle and lower income households in Figure 6 and Table 1. Both gained in after

tax incomes but the gains were modest compared to those of the top income groups (e.g., \$1,100 in the bottom quintile; \$5,500 in the middle and \$57,400 at the top in Panel B of Table 1). In terms of relative shares, only the top quintile gained over the past 25 years according to these data (Panel C). Hence, while the late 1990s were good for lower and middle class families, they were even better for high-income families and the very best for the richest families. The top quintile income share rose 8.9 percent while the bottom 80 percent of the distribution each lost about 2.0-2.5 percent of their income shares over this period.

The beauty of the CBO data is that it allows us to look further within the top income groups with some degree of accuracy not afforded by other data. Here we see that indeed the very top gained most of all. Before tax (market) incomes rose most for the top quintile, but even within that group the richest did better than the others. The after tax changes were smaller than the before tax changes because the rich pay the highest share of income taxes. According to Johnston (2003) the top 1 percent of taxpayers, about 129,000 households paid about 37 percent of all income taxes in 2000. Thus before tax and after tax incomes differ substantially for the rich. Still, on a percentage basis, the top income earners gained more in after tax income than in pre tax income over this period:

Since the end of 2000, there has been both good and bad news at the top of the income distribution. The recession of 2001-2002 reduced the incomes of the top 1 percent of earners by about 18 percent (Johnston 2003). The even more recent recovery of the stock market has helped restore some of that gain. The Bush income tax cuts from 2001 and 2003 also reduced taxes at the top by about 8 percent, restoring 5.4 percent of after tax incomes by themselves alone in 2003 (Greenstein and Shapiro 2003). Further scheduled tax cuts will increase this give back in coming years. Thus, the picture we see here at the end of 2000, at the very end of the strongest peacetime expansion in the past half century, is not very different from what we find in 2004.

Conclusions So Far

Americans have the highest income inequality in the rich world and over the past 20-30 years Americans have experienced greatest increases in income inequality among rich nations. The more detailed the data we can use to observe this change, the more skewed the change appears to be. While income mobility has surely shifted many of the top 1 percent to slightly lower income levels over this period, the majority of large gains are in deed at the top of the distribution. Federal Reserve board wealth data confirm the permanence of this shift (Kennickell 2003). In 2001, the top 1 percent of income earners received 15.5 percent of net income, but they held about 1/3 of all net worth (financial assets, businesses and housing) in America in 2001. The top 10 percent of households received 37.1 percent of all income but held a full two thirds of all the net worth in the nation in 2001. And the plutocrats are a larger group than one might think—the Forbes 400 richest Americans held only 2.2 percent of all net worth; the other 128,600 top wealth households held another 31 percent of net worth in 2000! The lowest 90 percent of the distribution had 63 percent of the incomes and one third of all net worth. But these figures beg an explanation—how does government affect income distribution in America and elsewhere? We now turn to this explanation.

III. Why is the United States so Different?

Our understanding of levels and trends in income is necessarily incomplete because of the complex interactions among markets, demographic, institutional, and policy forces and behavioral change by individuals, families, and households. We know for example that families take account of all sources of income available to them in deciding how much each family member will work and in structuring living arrangements. And governments respond to changing levels of market income with very different kinds of macroeconomic and redistribution policies. Germany, Italy, and the Scandinavian countries, for example, have fairly centralized wage-setting institutions, and

a high proportion of their workforce is covered by collective bargaining. At the other extreme, unionization rates have declined in the United States and the United Kingdom, and wage bargaining has become less centralized in many OECD countries.

We have noted that the United States stands out in the relative position of those at the bottom of the distribution. This reflects relatively low wages at the bottom of the distribution in the United States compared to other developed nations. But it also reflects the relative weakness of the income support system for families with children and for the low-income elderly in the United States.

Macroeconomic Comparisons

We begin by comparing three features of the economic and social institutions of each nation: standard of living (as measured by Gross Domestic Product (GDP) per capita in 2000 PPP adjusted dollars); unemployment (as measured by OECD/Standardized unemployment rates), and cash and near cash social expenditures for the non-elderly (OECD 2002). Table A-1 shows that the United States is far and away the richest nation that we observe among our set, with 2000 GDP per capita of \$34,100. With the exception of the Netherlands, the United States also enjoyed the lowest unemployment rate of all nations during the 1997-2000 period. Canada, Finland, and Belgium all had unemployment rates more than twice the United States rate, with the variance in unemployment far exceeding the differences in incomes across these select nations.

While the United States is unique in both its high standard of living and its low unemployment rate, it is also unique in the tiny amount of its resources devoted to cash and nearcash social transfer programs. In 1999 (latest year available), the United States spent less than 3 percent of GDP on cash and nearcash assistance for the nonelderly (families with a head under age 65, with and without children, and the disabled). This is less than half the amount spent by Canada or the United Kingdom; less than a third of spending Germany, the Netherlands, or

Belgium; and less than a quarter of the amount spent in Finland or Sweden. While there is a rough correlation between social spending and unemployment, the differences we see here are not cyclical, but are rather structural.

In order to examine structural differences, we show the generosity of income transfer programs by tracing the trend in non-elderly cash and near cash (food, housing) benefits for OECD countries back over the past 20 years, using data from the OECD (2002). We present these estimates in comparable format in Figure 1. Here the 17 OECD nations, all of the major nations except for the Central and Eastern Europeans, have been grouped into seven clusters: Scandinavia and the Nordic nations (including Finland and Sweden); Northern Europe (including Belgium and the Netherlands); Central and Southern Europe (including Germany); Anglo Saxony (including the United Kingdom and Canada); the United States and Mexico. We show only non-elderly patterns because elder benefits, especially social retirement benefits, depend heavily on the design of systems of income support in each nation. These figures illustrate the wide differences that one can find for both levels and trends in social spending, using figures that abstract from financing of health care, early childhood education, and retirement for the elderly. They also correspond very closely to the measures of money and near-money income transfers used in the analytic literature in this area, including that presented below.

The Scandinavian and Northern Europeans shown in Figure 1 follow similar patterns—high levels of spending which varied with the recession of the early 1990s in Sweden and Finland (when transfers rose and GDP fell), and a tapering of outlays after these events. The Central and Southern Europeans and the Anglo-Saxon nations show remarkably similar spending patterns, again rising in the early 1990s but overall at a level distinctly below that the other two groups. The United States is significantly below all these others and, by the late 1990s is spending at a level closer, in terms

of a fraction of GDP per capita, to Mexico than to the other richer OECD nations. Even before the “Bush revolution,” we are a distinct lower bound outlier in social spending on the non elderly.

Patterns of Redistribution

Every nation’s tax and benefit system reduces market income inequality, but not all are equally effective in doing so. Figure 8 uses the Luxembourg Income Study to demonstrate both market income inequality and disposable income inequality amongst a set of 13 nations using the gini coefficient (rounded to two digits and multiplied by 100). In all nations disposable income inequality is less than market income inequality, suggesting that the tax and benefit system reduces overall inequality. Leaving Russia and Mexico aside for a minute, we see that the market generates similar patterns of income inequality in all rich nations. The gini for market incomes varies only from 39 to 50 across these 11 nations and the United States at 45 is right in the middle of these nations. Yet after tax and transfer disposable income inequality measures range from 24 to 37 and the United States has the most remaining inequality at 37, consistent with Figure 1 earlier in the paper. The percentage reduction in before tax and benefit inequality in the United States is only 18 percent, the lowest in the table. Only Switzerland with a 20 percent reduction and Canada and the United Kingdom at 24 are even close. And in each of these nations the level of final income inequality is far below that in the United States.

Two additional comparisons are important. First, the percentage reductions in the microdata here are very consistent with the patterns of aggregate non-elderly spending just observed in Figure 7. The high-spending Northern and Central European and Scandinavian nations have the highest degree of inequality reduction, from 40 to 48 percent; the Anglo Saxon nations (excluding the United States) are next with 24 to 31 percent reductions; the United States with an 18 percent reduction is above only Mexico (8 percent) and Russia (12 percent) in terms of the effects of taxes and benefits on inequality. Second, the highest spending nations do not have the highest levels of

market income inequality. In fact, before tax and benefit inequality in Finland, Netherlands, Germany and Sweden are less than that found in the United States. Those that redistribute the most are not the ones who have indirectly created the greatest degree of market income inequality via their tax and benefit systems. When one looks at redistribution, they usually concentrate on how it affects poverty and the lowest part of the income distribution and so we take a comparative look here as well.

The Antipoverty Effect of Taxes and Transfers

In every nation, benefits from governments, net of taxes, reduce income poverty. Figure 9 is taken from a recent paper (Smeeding 2003). Here we look at the poverty rate, the percent of persons with both market and disposable incomes less than half of the median disposable income in eight nations. As with the inequality measures in Figure 8, poverty rates computed using before-tax-and-transfer household income does not differ among countries as much as do those calculated after taxes and transfers (Figure 2). Here we find that the United States before-tax-and-transfer poverty rate is actually below average, but not as low as in two high spending nations (Finland and the Netherlands). This finding implies that different levels and mixes of government spending on the poor have sizable effects on national poverty rates (Burtless, Rainwater, and Smeeding 2001). In fact, detailed analysis shows that higher levels of government spending (as in Scandinavia and Northern Europe) and more careful targeting of government transfers on the poor (as in Canada, Sweden, and Finland) produce lower poverty rates (Smeeding 2003). Unemployment (Table A-1) is not well correlated with either market income poverty or disposable income poverty. Rather, earnings and wage disparities are important in determining both market income and disposable income poverty rates, especially among families with children (Jäntti and Danziger 2000; Bradbury and Jäntti 1999). Countries with an egalitarian wage structure tend to have lower child poverty

rates, in part because the relative poverty rate among working-age adults is lower when wage disparities are small.

As one might expect based on the previous analyses, the United States shows the least antipoverty effect of any nation. We reduce poverty by 28 percent compared to the average reduction of 62 percent in Figure 9 . The nation closest to the United States in terms of overall effect is Canada. But even there, government programs reduce market income-based poverty by 52 percent. In all other nations the effects are much larger and the resulting poverty is much lower than in the United States.

Our social insurance and direct (payroll and income) tax system is weak, while our safety net and social assistance system produces only a small additional amount of poverty reduction (including the effect of the EITC in the social assistance category). All other nations get a much larger poverty reduction from social insurance. In heavily insured countries like Sweden, Belgium, and Germany, social insurance (unemployment and workers' compensation, disability benefits, paid family leave) reduces poverty by over 70 percent. In the case of social assistance, large effects of targeted programs are found in Finland and the United Kingdom, while relatively lower ones are observed in the more socially insured nations where the heavy lifting has already been done by these benefits (e.g. in Germany, Belgium, the Netherlands, and Canada). It should be apparent that different nations use different instruments and different "income packages" to achieve their antipoverty effects. There is no one program or one type of policy instrument that is universally generous and common across these eight nations. Yet they all are more effective than the United States.

Explaining the Differences

There have been few attempts to explain the differences we find in economic inequality across the rich nations (Jacobs and Gornick 2001; Jencks 2002; Gottschalk and Smeeding 1997,

2000; Gustafsson and Johansson 1997), so what we have here is a piecemeal (but still instructive) explanation of our initial explorations of these differences. The effects of government on inequality can come from two sources. Either direct effects of redistribution (as shown above) or via indirect effects created by institutions and regulations such as minimum wages, unionization and collective wage bargaining. Each of these has an effect on the United States income distribution

First, it is important to note, that explanations of differences in inequality across countries differ according to which end of the income distribution one is addressing. That is, rather than ad-hoc decompositions of aggregate indices, often more can be learned from addressing the explanations of the differences in incomes at each end of the income distribution separately.

For instance, low incomes (10-50 ratios or poverty rates) are quite well correlated with the prevalence of low-wage workers within each nation (Figure 10) and with levels of non-elderly social transfers within each nation (Figure 11). The effects of different policies to raise wages, e.g., by administrative fiat (minimum wages) or by increasing labor productivity, or by collective bargaining are clearly raised in Figure 10.

Countries that have many jobs at low wages, United States, Canada, and the United Kingdom, tend to have lower 10/50 ratios than do nations with higher wages at the bottom end. Of course, many nations with higher minimum wages also suffer higher rates of unemployment. But unemployment is not highly correlated with 10/50 ratios (or gini coefficients) across OECD nations, largely because those nations with the lowest fractions of low-wage workers have generous income transfer systems which provide low-income, unemployed workers with high net disposable incomes (see also Gustafsson and Johansson 1997; Gottschalk and Smeeding 1997, 2000).

Similarly, the relationship between cash social transfers to the nonaged and low incomes as measure by the 10/50 ratio is also strong (Figure 3).⁷ Countries that spend less on their safety nets

suffer higher levels of inequality as measured by the 10/50 ratio (just as they suffer higher after tax and transfer poverty ratio in Figure 9. Mexico and Russia are just two examples of what one would find were we able to extend this chart to other middle-income nations. Clearly both wage levels and social benefits affect low incomes.

Other Explanations

Other explanations for differences in incomes and inequality across nations are many and complex, especially as they affect incomes at the top of the distribution. First, consider the arguments that the United States is richer than other nations because it is more efficient. Jencks (2002) recently addressed this question using LIS data and OECD data. He concludes that one major reason the United States is richer is because we employ more people who work longer hours than do their counterparts, in say Germany or France. When he corrects Gross Domestic Product (GDP) per capita for hours worked, and labor force participation, GDP per hours worked is actually about the *same* in the United States than in Germany or France. Correcting for unemployment, by adding the total number of hours unemployed workers in these countries want to work—even if unemployed (GDP per available hour)—does not change this result by much at all.

While these data say nothing about inequality, per se, the number of hours worked is clearly an important ingredient for measured inequality (just as the distribution of wage rates are important). But other studies of Germany and the United States (Devroye and Freeman 2001), and a set of countries including Canada and Germany (Jacobs and Gornick 2001), indicates that not only do United States workers work more hours overall, but high-income United States workers work many more hours per year than do their counterparts in other nations. Moreover, high-income United States workers are more likely to be married to spouses who also work multiple hours more than in other nations (Jacobs and Gornick 2001). While the effects of these differences are yet to be

completely and systematically worked out, the amount of work effort at each end of the distribution, as well as the reward for that work, are both clearly important. For instance, Smeeding (2003) shows that lowest quintile single mothers in the United States work an average of 1100 hours per year, almost twice as many as in Germany and more than twice as much as in the UK, France, Netherlands Belgium or Canada (while at the same time receiving less in benefits and having higher poverty rates than in these other nations). Therefore, both rich and the poor in the United States work more hours than do their counterparts in other rich nations (Osberg 2002).

Closely tied to the number of hours worked and earnings patterns are demographic differences in household composition across nations. In general, nations with relatively higher levels of immigrants and relatively more single parents will have greater inequalities, especially at the lower end of the income distribution, than do nations which have fewer single parents and lower levels of immigration, all else equal. But the fraction of elderly households in a nation does not affect income distribution comparisons across countries largely because the elderly have levels of inequality that are similar to those of the non elderly (Osberg 2000). Comparisons of the high immigrant, high single-parent, Anglo-Saxon countries (e.g., Canada, Australia, the United Kingdom) with the United States suggest that immigrants and single parents alone do not account for differences in the level of inequality. In fact Australia and Canada have higher fractions of foreign born than in the United States but lower overall inequality. Trends in inequality find the same pattern—while more immigrants contribute to higher inequality, inequality has also increased amongst non-immigrants (Leonhardt 2004). And income inequality has increased much more in the United States than in Canada, despite similar levels of immigration (Figure 3).

The most comprehensive study of demographic effects was carried out by Rainwater and Smeeding (2003). They took the demography of each nation (relative numbers of single parents, elders, families with children, childless adults, etc.) and its income package (taxes and benefits)

and simulated the United States demography with the packages of each nation. The effects of demography were very small—the effects of the income package accounted for over 90 percent of the differences across nations. Thus the United States redistributive package is the prime explainer of the differences between market and disposable income that we observe here, not our demographic make up.

Other factors are less easily accounted for. Many authors find that labor market institutions, especially collective bargaining, wage setting, levels, and penetration of minimum wages, are important for determining the level of inequality in wages and earnings across nations (Gustafsson and Johansson 1997; Gottschalk and Smeeding 1997). Differences in educational attainment are also important as the better educated earn more than the less well-educated, all else equal, in every country (see Rehme 2002a, 2002b; Smeeding and Sullivan 1998). But recent evidence suggests that it is the former (institutions) rather than the latter (skills per se) that is more important in explaining differences in the cross-section. Blau and Kahn (2001) find that workers within single categories of education and adult test scores in the United States (e.g., high school graduates with median level skills as measured by the OECD individual adult cognitive literacy survey), have distributions of wages and earnings which differ amongst themselves by more than does the entire distribution of wages differ (across all skill and education groupings) in Germany, Netherlands, and Sweden. The differences in wage setting institutions across countries therefore account for many of the differences in pay that we find at any point in time.

Finally, consider the arguments of Cook and Frank's (1996) book, *The Winner Take All Society*. In an increasingly global economy, where markets are ever widening, where pay is tied to output and productivity—not only for chief executives and business men, but for professionals (like lawyers, physicians, and scientists) as well, and where labor and firms can migrate to the highest profit areas, we expect that the wage distribution at the top of the market will continue to

widen at the top of the distribution, as it has in some nations, notably the United States and the United Kingdom, but now also in Sweden, Germany, France, and Canada.

Summary

We are not in a position to determine how much of the United States position is attributable to each factor. It is clear that differences in the wage distribution must have a strong effect on family income inequality, for earnings make up about 70 percent of all household income. Whereas wage inequality is clearly mitigated by government transfer policy, the original wage inequality may itself partially reflect the generosity (or lack thereof) of the social welfare system. While explanations of these different levels and trends in inequality and their periodicity must be high on any research agenda, the basic facts of American inequality and the effects of policy on inequality remain clear-cut. America has more inequality and less redistribution (lesser amounts and less effective as an anti-poverty device) than in any other rich nation. Large numbers of low-skill workers and inadequate safety nets are two important reasons for these outcomes.

IV. Overall Summary and Conclusions

Do American policies exacerbate or ameliorate inequality and poverty? That is the question we began this paper with. We have found that the United States has the highest level of inequality amongst the rich nations of the world. Our direct income transfer policies do less to redistribute overall and to lower income persons than do the policies in other nations. America began the last quarter of the 20th century with higher inequality than in any other nation and our inequality increased by more than in any other nation over this period, through expansion and contraction of the economy.

The effects of other direct and indirect policies are harder to nail down, but they also affect well being in unequal ways. We have all but eliminated welfare in America and in so doing have turned the welfare poor into the working poor. But poverty rates did not go down along with welfare rolls. Instead we have the hardest working low income single parents, who also have the highest poverty rates in the rich world. While market forces have increased inequality in most nations we examine, policy can make a difference. Seven years ago British Prime Minister Tony Blair announced his government's pledge to end child poverty. Since then the child poverty rate in Britain has shrunk—almost in half—from 25 to 13 percent on an absolute basis (Hills and Sutherland, 2004). They did it by enacting policies that help low-income families. Blair reformed the British tax system, offering a Working Tax Credit (similar to the United States EITC) to parents working for 16 or more hours a week. And they offered an additional tax credit to pay for up to 70 per cent of childcare costs, plus other work related benefits (including paid family leave). In the US, on the other hand, President Bush has made no such pledge. In fact, the number of poor children in the United States has actually increased under Bush's watch. The lesson is clear—if one decides to make poverty or inequality an active policy goal they can make a difference. We have more inequality and poverty than other nations because we choose to have more. But why do we make these choices?

While the other papers and authors at this symposium are better qualified than I to discuss the relationship between inequality and politics, inequality itself—especially the economic distance from the rich the middle—may be closely related to the levels and patterns of redistribution that we find in the United States compared to other nations. In a recent paper (Schwabish, Smeeding, and Osberg 2003) we argue that as the “rich” become more distant from the middle and lower classes, they find it easier to opt out of tax financial public redistribution programs and to either self insure or to buy substitutes in the private market. The implication is, therefore, that “two income”

households with two highly educated parents have little need for redistributive cash and near cash social benefits because they are very unlikely to directly benefit from such transfer programs. High income parents can also find better schools or buy private schooling if the public schools do not measure up. They have good employer health insurance so the need for better public insurance is not a relevant consideration (except perhaps for Medicare). The conclusion is that higher economic inequality produces lower levels of those publicly shared goods which foster greater equality of opportunity and greater upward mobility: income insurance, equal educational opportunity, and more equal access to high quality health care.

Having greater numbers of rich in a nation does not lead to additional redistribution because the lower and middle classes do not have the political power, voice and access to legitimize these claims. Dissimilarities in the institutions that represent social and economic rights in the political arena may well determine redistributive government spending. Our analyses suggests that ideology and efficacy may both matter. Ideology—in the sense of national understanding of the meaning of “fairness,” altruism and basic human rights—may play a crucial independent role in defining the acceptable domains of inequality. But efficacy in the ways in which social institutions and political parties can influence government, is likely to be crucial in understanding whether demands are made of the political system to reach these “fairness” objectives.

The many factors that effect public social expenditures are complex and intertwined. Certainly, social values and institutions in the United States differ from those found in other nations, and our belief in the market system is much more central and critical to social outcomes than in other advanced nations. Yet even within these beliefs, it seems clear that we do not possess the social institutions or political movements which might bring about greater levels of redistribution, even for those who are more clearly deserving because of their work effort or other

factors. In the end, it is clear that the high level of market driven economic inequality which we tolerate is in large part a determinant of the relatively poor social outcomes and social policy outcomes which we observe.

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Endnotes

1. The research that we summarize here is reported more fully in the following articles: Gottschalk, P., and T.M. Smeeding. 1997. "Cross-National Comparisons of Earnings and Income Inequality." *Journal of Economic Literature* 35(June):633-657; and Gottschalk, P., and T.M. Smeeding. 2000. "Empirical Evidence on Income Inequality in Industrialized Countries." In A. Atkinson, and F. Bourgignon (eds.), *Handbook of Income Distribution*, Amsterdam: North Holland Press; and also available on the LIS website, <http://www.lisproject.org> *Luxembourg Income Working Paper No. 154*; and in Smeeding, T.M. 1998. "U.S. Income Inequality in a Cross-National Perspective: Why Are We So Different?" In J. Auerhach and R. Belous (eds.), *The Inequality Paradox: Growth of Income Disparity*, Washington: National Policy Association.
2. In general, countries which spend more for cash benefits also tend to spend more for noncash benefits, so that the distribution of housing, education and health care benefits reinforces differences in income distribution for at least some western European nations. This is not necessarily so, however- for other countries or other methods of accounting.
3. Some countries use more restrictive definitions, Sweden, for example, uses the nuclear family as the accounting unit.
4. We use the square root of family size to obtain equivalent income.
5. The Gini coefficient uses a scale from 0, perfect equality, to 1, perfect inequality. Thus, in Figure 1 Finland, with a Gini coefficient of 0.223, has the least inequality and the United States, with a Gini coefficient of 0.368, has the highest level of inequality.
6. G. Duncan, W. Yeung, J. Brooks-Gunn, and J. R. Smith. 1998. "How Much Does Childhood Poverty Affect the Life Chances of Children?" *American Sociological Review* 63(3) (June):406-423.
7. That is, the top 1 percent of households ranked by income in 1979, 1987 and 2000 are mostly different households. However, the vast majority of these households remain in the top 20 percent of the income distribution.
8. Here we have excluded transfers to the elderly, but even when they are included, the same relationship holds (see Smeeding 1998; Burtless, Rainwater, and Smeeding 2001).

Table 1.**A. Average Pre-Tax Income by Income Group** (in 2000 dollars)

Income Category	1979	1989	2000	Percent Change 1979-2000	Dollar Change 1979-2000
Lowest fifth	\$ 13,700	\$ 13,100	\$ 14,600	6.6%	\$ 900
Second fifth	29,800	29,100	33,300	11.7%	3,500
Middle fifth	44,700	45,700	50,300	12.5%	5,600
Fourth fifth	60,500	65,100	74,500	23.1%	14,000
Highest fifth	115,800	144,400	196,500	69.7%	80,700
81st-95th Percentile	85,900	98,900	117,200	36.5%	31,300
96th-99th Percentile	143,300	173,100	220,200	53.6%	76,900
Top 1 Percent	454,200	712,100	1,290,800	184.2%	836,600

B. Average After-Tax Income by Income Group (in 2000 dollars)

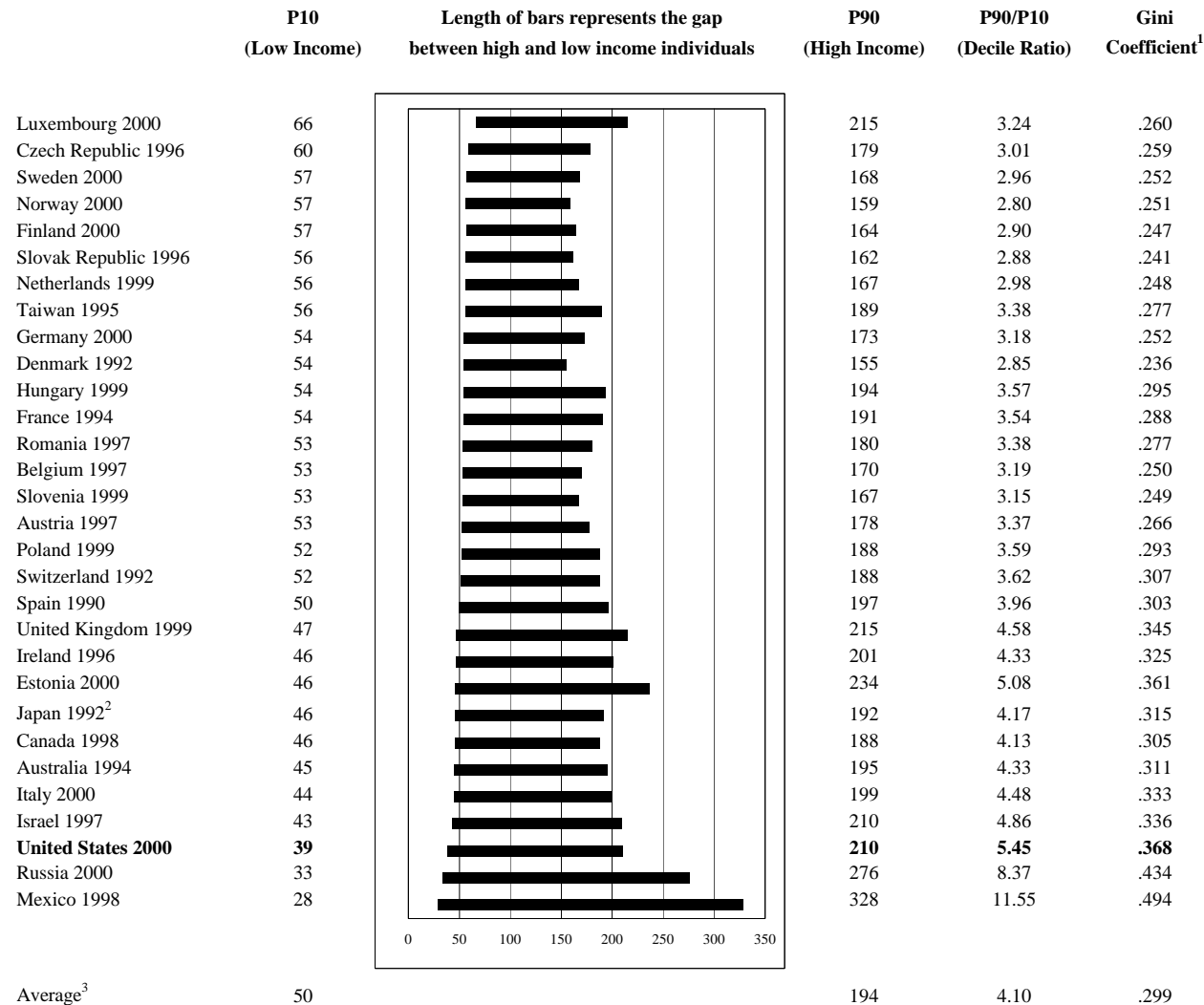
Income Category	1979	1989	2000	Percent Change 1979-2000	Dollar Change 1979-2000
Lowest fifth	\$ 12,600	\$ 12,100	\$ 13,700	8.7%	\$ 1,100
Second fifth	25,600	25,100	29,000	13.3%	3,400
Middle fifth	36,400	37,500	41,900	15.1%	5,500
Fourth fifth	47,700	51,800	59,200	24.1%	11,500
Highest fifth	87,000	10,800	141,400	68.3%	57,400
81st-95th Percentile	65,300	75,800	88,700	35.9%	23,400
96th-99th Percentile	103,600	129,100	158,600	53.1%	55,000
Top 1 Percent	286,300	506,500	862,700	201.3%	576,400

C. Shares of After-Tax Income by Income Group

Income Category	1979	1989	2000	Percentage Point Change in Shares 1979-2000
Lowest fifth	6.8%	5.1%	4.9%	-1.9
Second fifth	12.3%	10.8%	9.7%	-2.6
Middle fifth	16.5%	15.7%	14.6%	-1.9
Fourth fifth	22.3%	21.9%	20.2%	-2.1
Highest fifth	42.4%	47.6%	51.3%	+8.9
81st-95th Percentile	24.3%	24.6%	23.8%	-0.5
96th-99th Percentile	10.6%	11.7%	12.0%	+1.4
Top 1 Percent	7.5%	11.3%	15.5%	+8.0

Source: CBO (2003) for 81st-95th and 96th-99th percentiles; CBPP calculations from the CBO data for other tables (Greenstein and Shapiro (2003)).

Figure 1. Social Distance and Social Exclusion
(numbers given are percent of median in each nation and Gini coefficient)



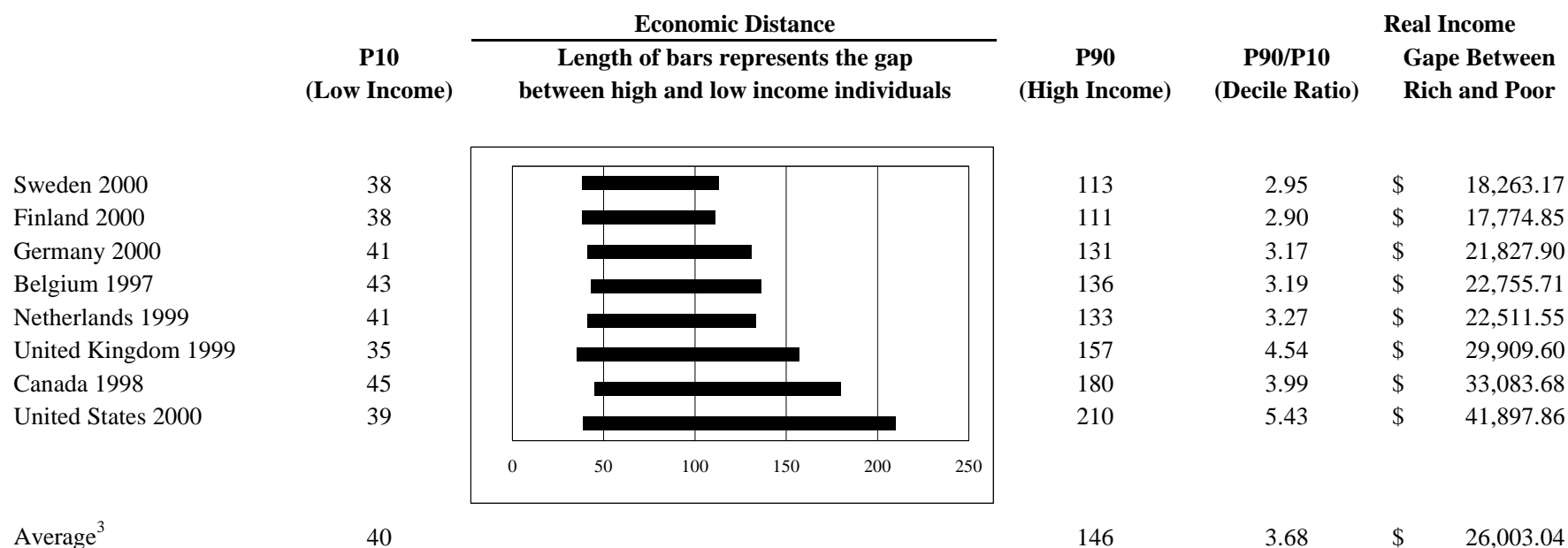
Source: Author's calculations from Luxembourg Income Study.

Notes: ¹Gini coefficients are based on incomes which are bottom coded at 1 percent of disposable income and top coded at 10 times the median disposable income.

²Japanese gini coefficient as calculated in Gottschalk and Smeeding (1997, 2000) from 1993 Japanese Survey of Income Redistribution.

³Simple average.

Figure 2. Real Income Well-being of All Persons in 8 Countries ¹
(as percentage of overall US 2000 median equivalent income in PPP terms)²



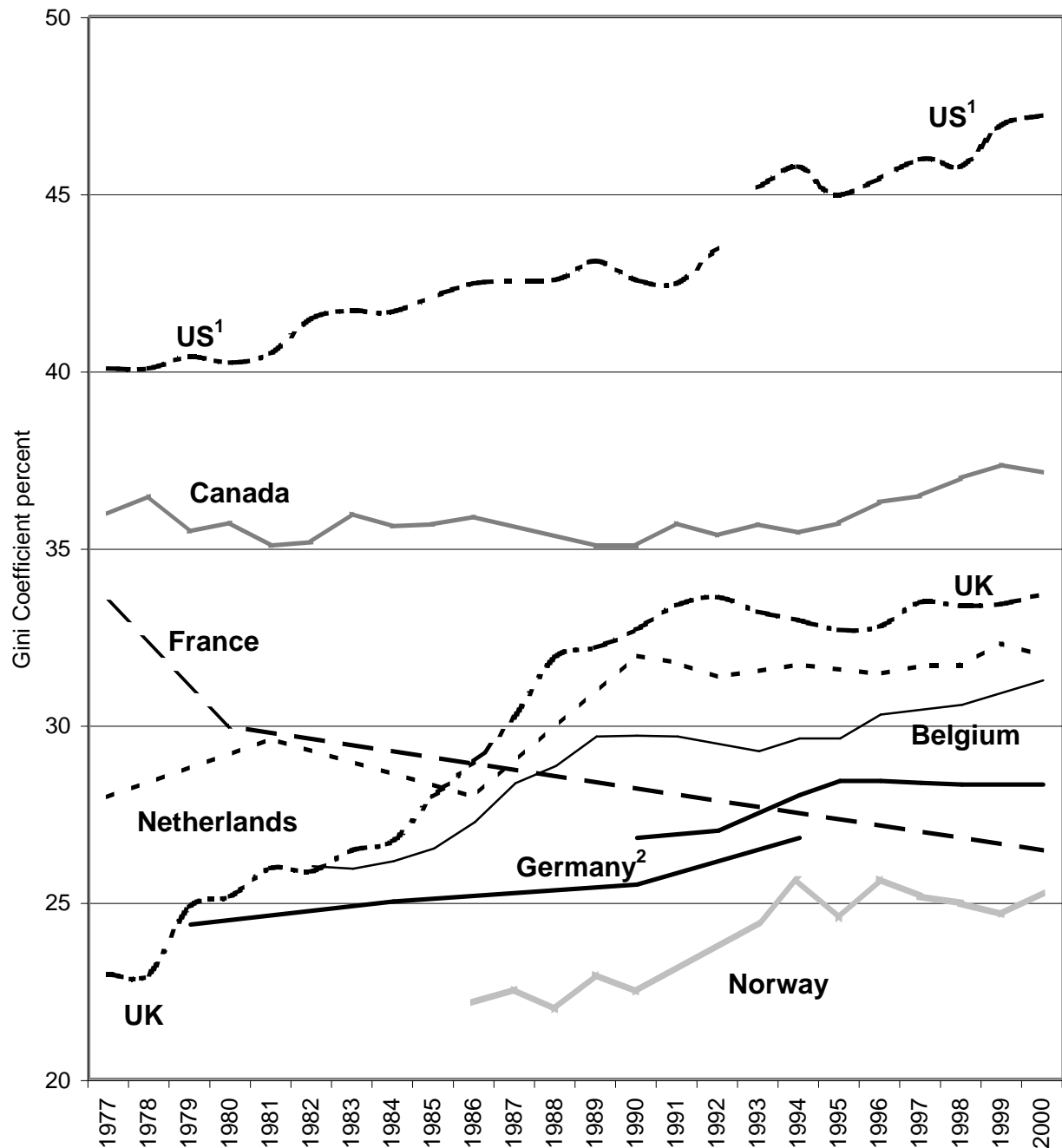
Source: Author's calculations from Luxembourg Income Study.

Notes: ¹Figures given are adjusted dollars per equivalent person (child) in own currency as a percent of own overall national median income (P50), weighted for the number of persons in each unit.

²Figures given are adjusted dollars per equivalent person 2000 U.S. dollars, weighted for the number of persons in each unit size, and relative to the overall U.S. median of \$24,416.

³Simple average.

Figure 3.
Visual Representation of Inequality Trends in a Selection of
OECD Countries

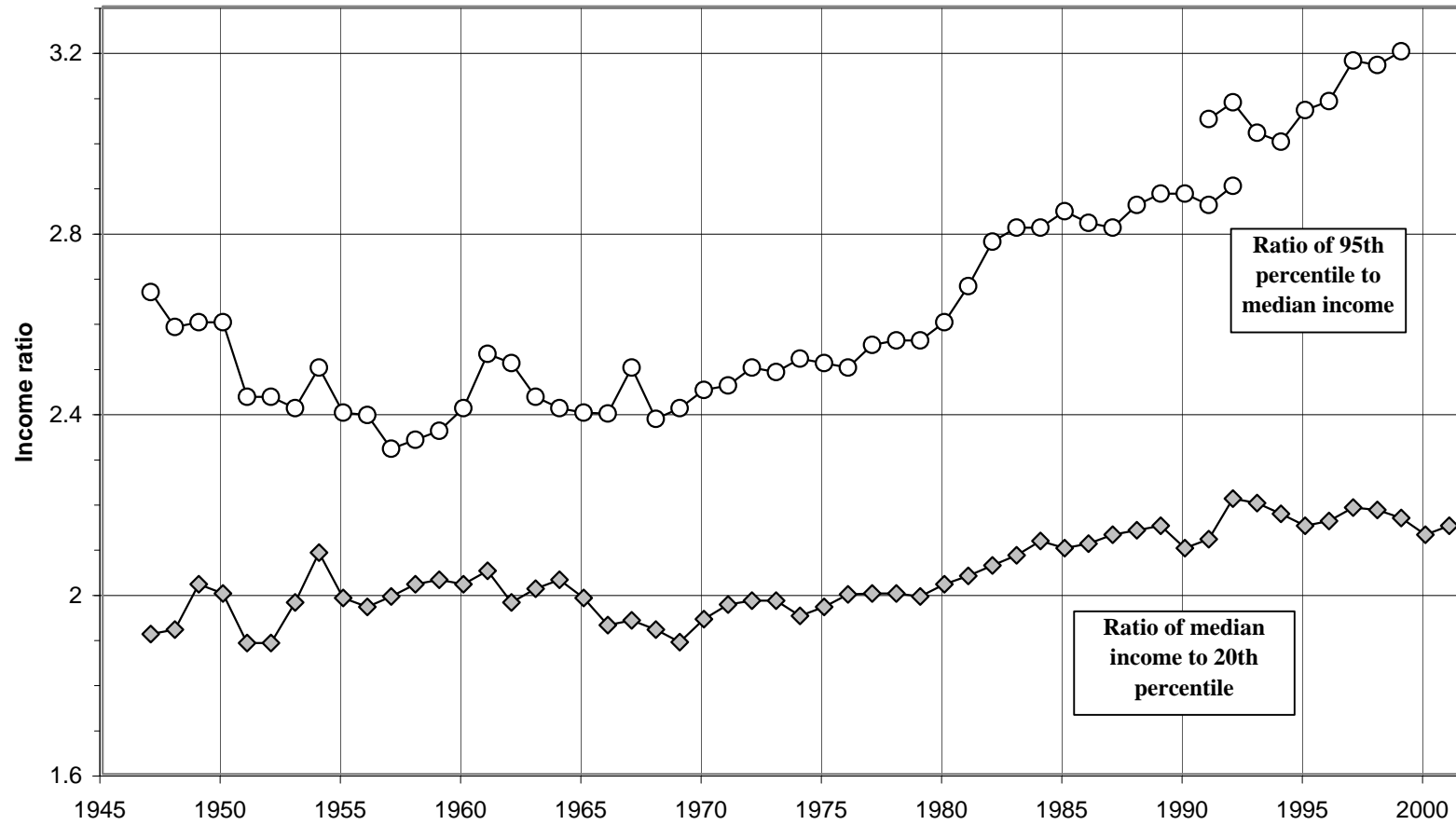


Sources: Atkinson (2000) and LIS; Canada, Statistics Canada (2002); United States, US Department of Commerce (2002: Table B-3, B-6); Hauser and Wagner (2002); Hauser (2000); Forster (2000).

Notes: ¹ major revisions in series (1993).

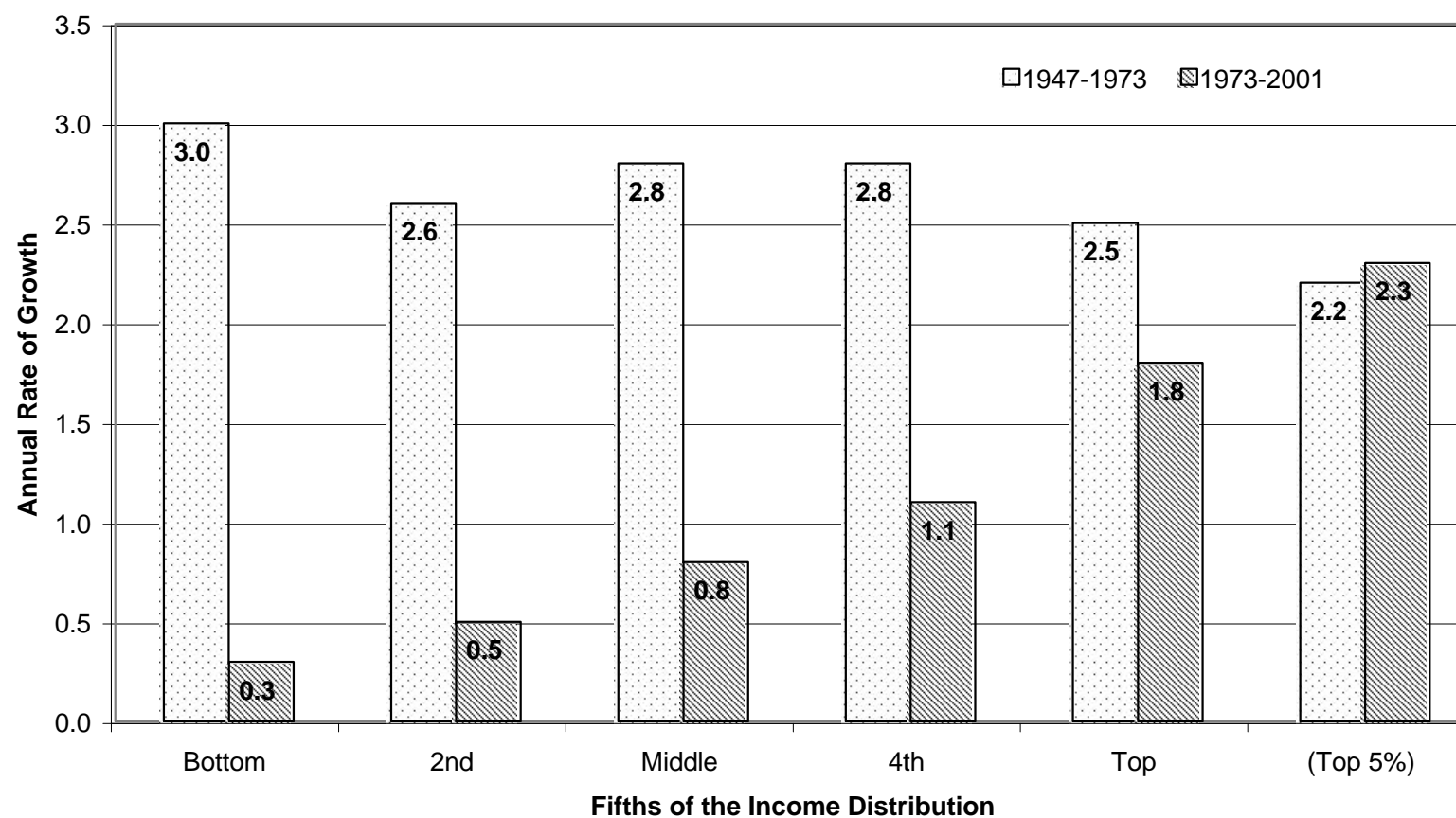
² German trends come from two time series. The government income and expenditure series until 1995 and the German Socio Economic Panel after. Germany includes the eastern states, as well as the western, after 1989.

Figure 4. Trend in Family Income Inequality, 1947-2001



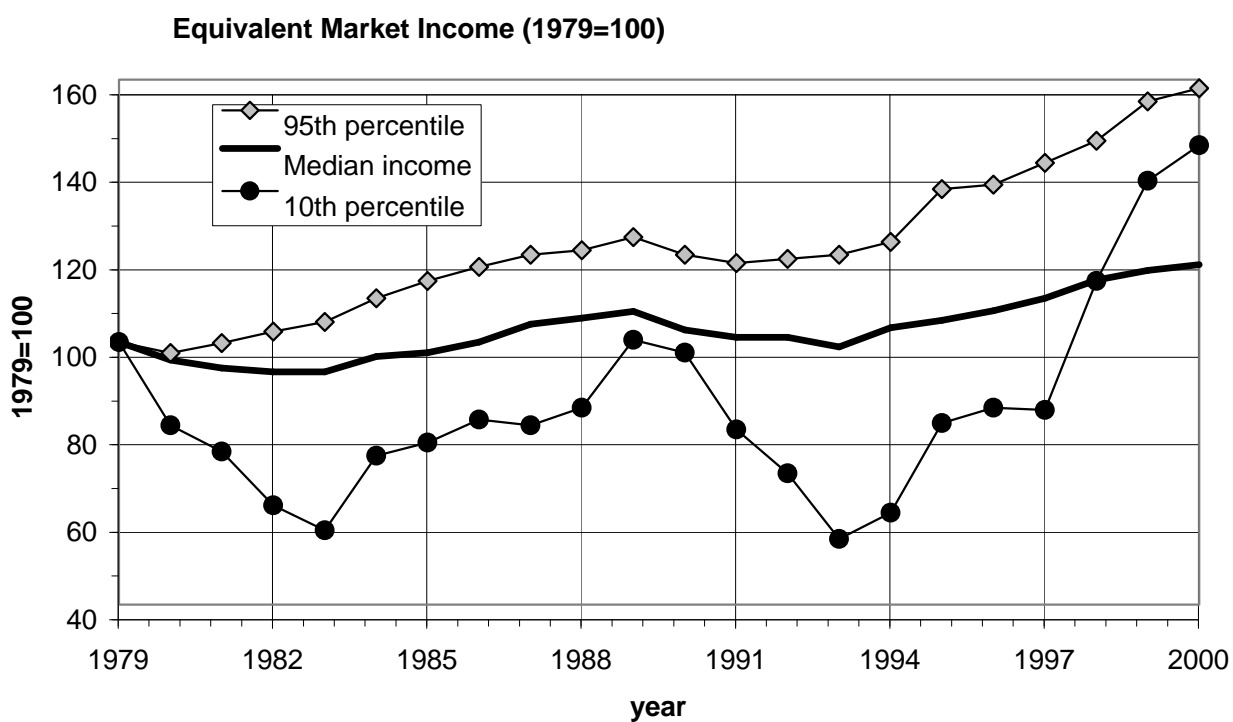
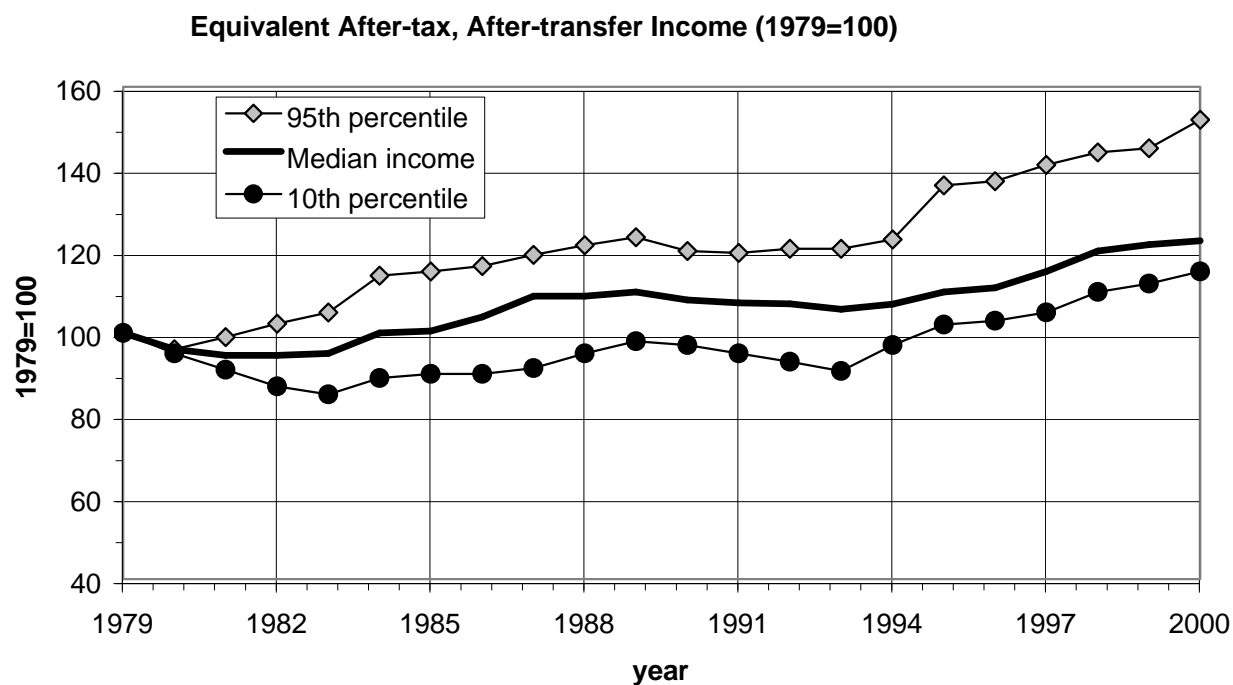
Source: Burtless and Jencks (2003).

Figure 5. Annual Growth Rate of Real Income across the U.S. Family Income Distribution, 1947-2001



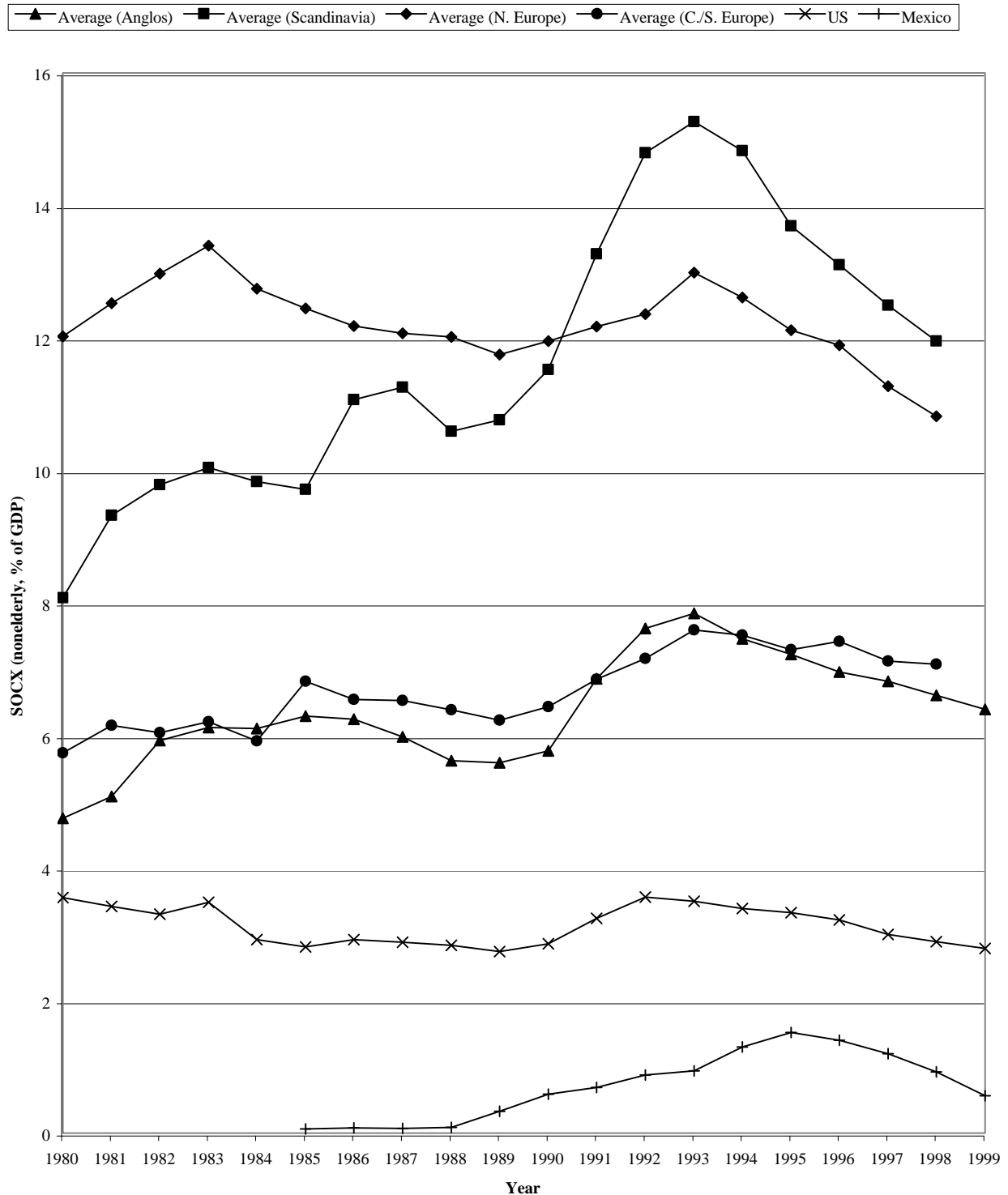
Source: Burtless and Jencks (2003).

Figure 6.
Trends in Size-Adjusted Household Incomes before and after Taxes and Transfers at
Selected Points in Distribution, 1979-2000



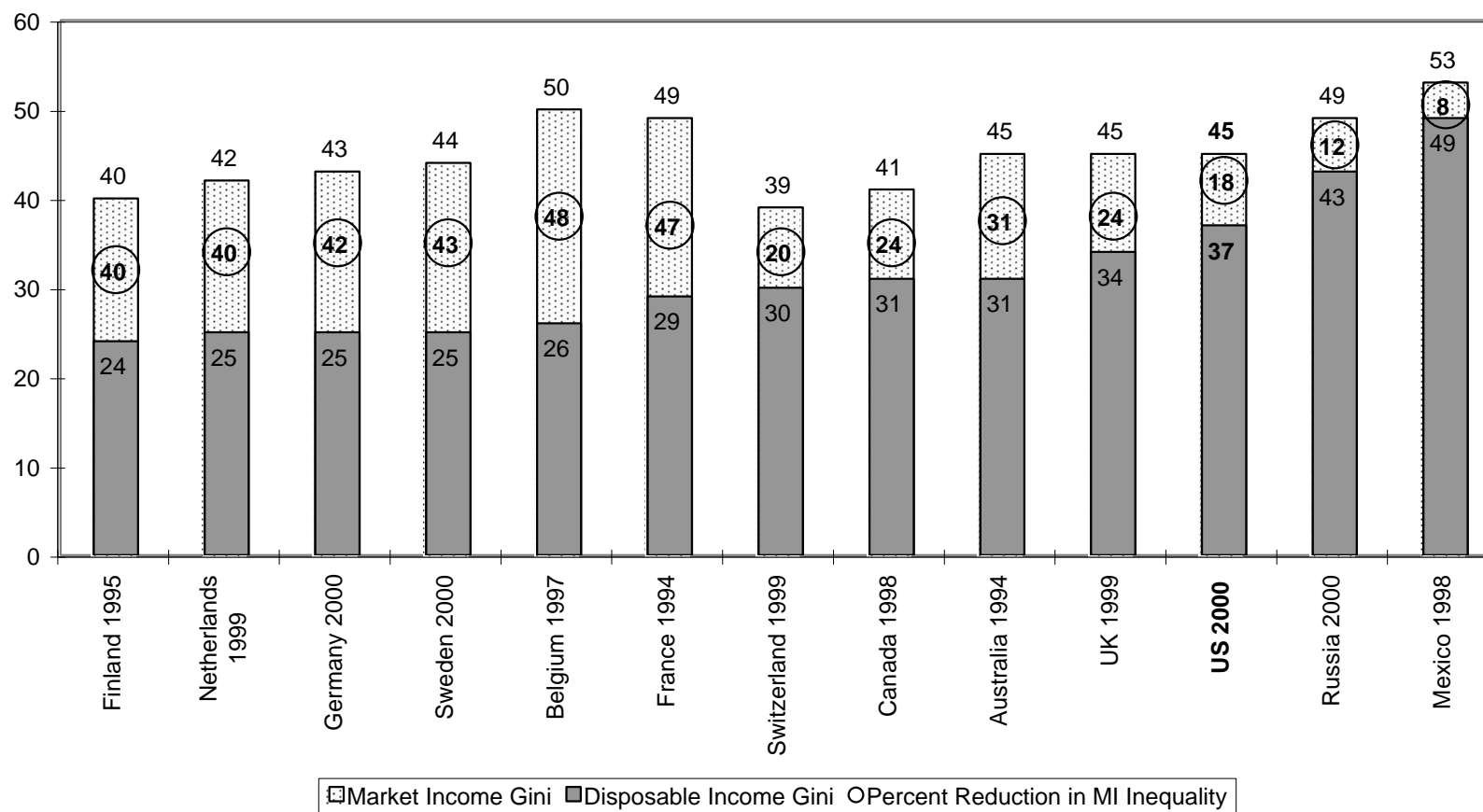
Source: Burtless and Jencks (2003).

Figure 7. Nonelderly Social Expenditures in 6 sets of 17 Nations*



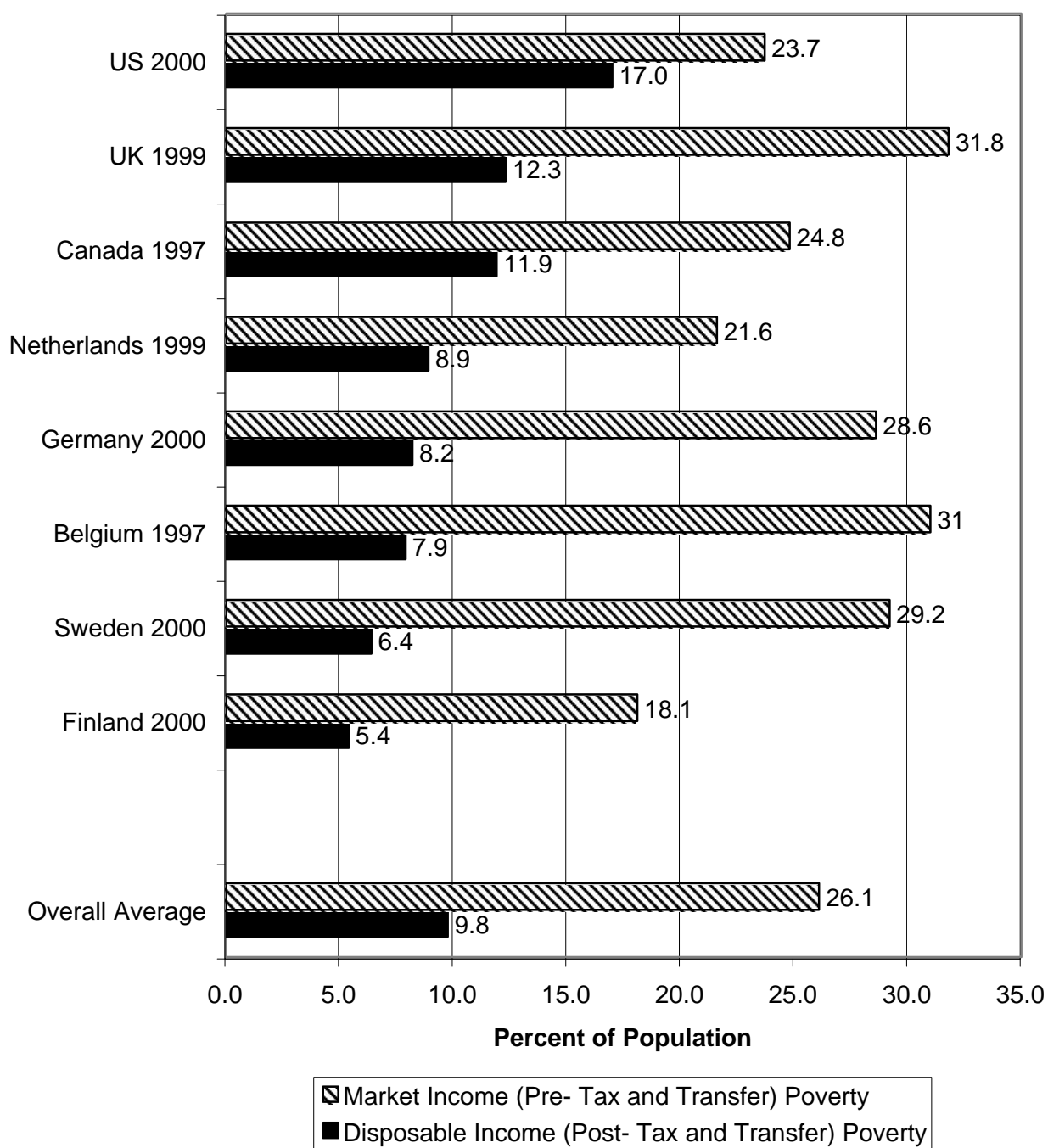
* Total Nonelderly Social Expenditures (as percentage of GDP), including all cash plus near cash spending (e.g., food stamps) and public housing but excluding health care and education spending. OECD (2002b). Anglos include Australia, UK, Canada; Scandinavia includes Finland, Norway, Sweden; Northern Europe includes Belgium, Denmark, Netherlands; Central/Southern Europe includes Austria, France, Germany, Italy, Luxembourg, Spain.

**Figure 8. Inequality of Market Income and Net Disposable Income in OECD Countries:
Gini Coefficients before and after Taxes and Benefits**



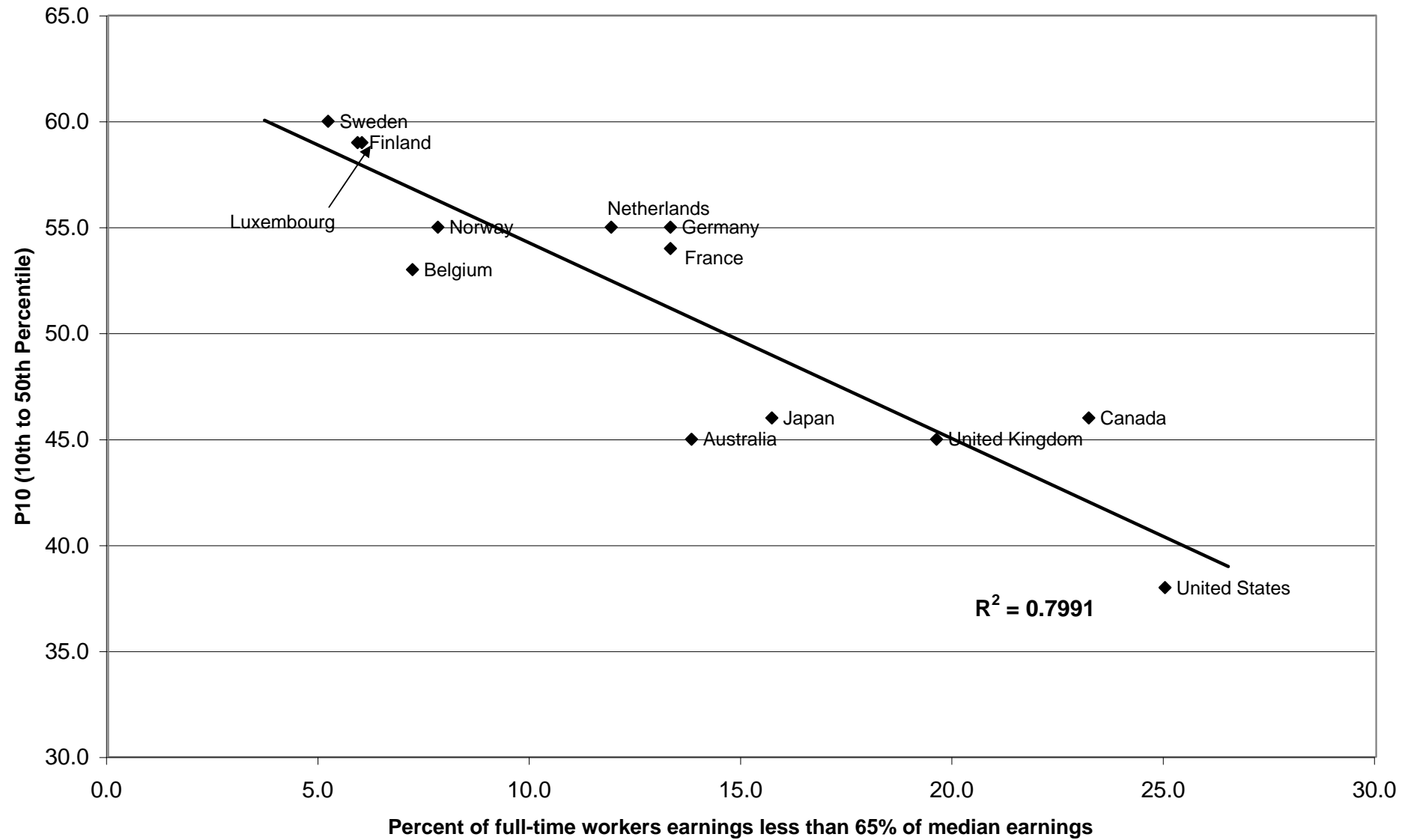
Source: Author's calculations from the Luxembourg Income Study.

Figure 9.
Relative Poverty Rates and Antipoverty Effects in 8 Rich Nations at the
Turn of the Century
(Percent of Persons with Market Income and Disposable Income Less than Half
of Adjusted National Disposable Median Income)



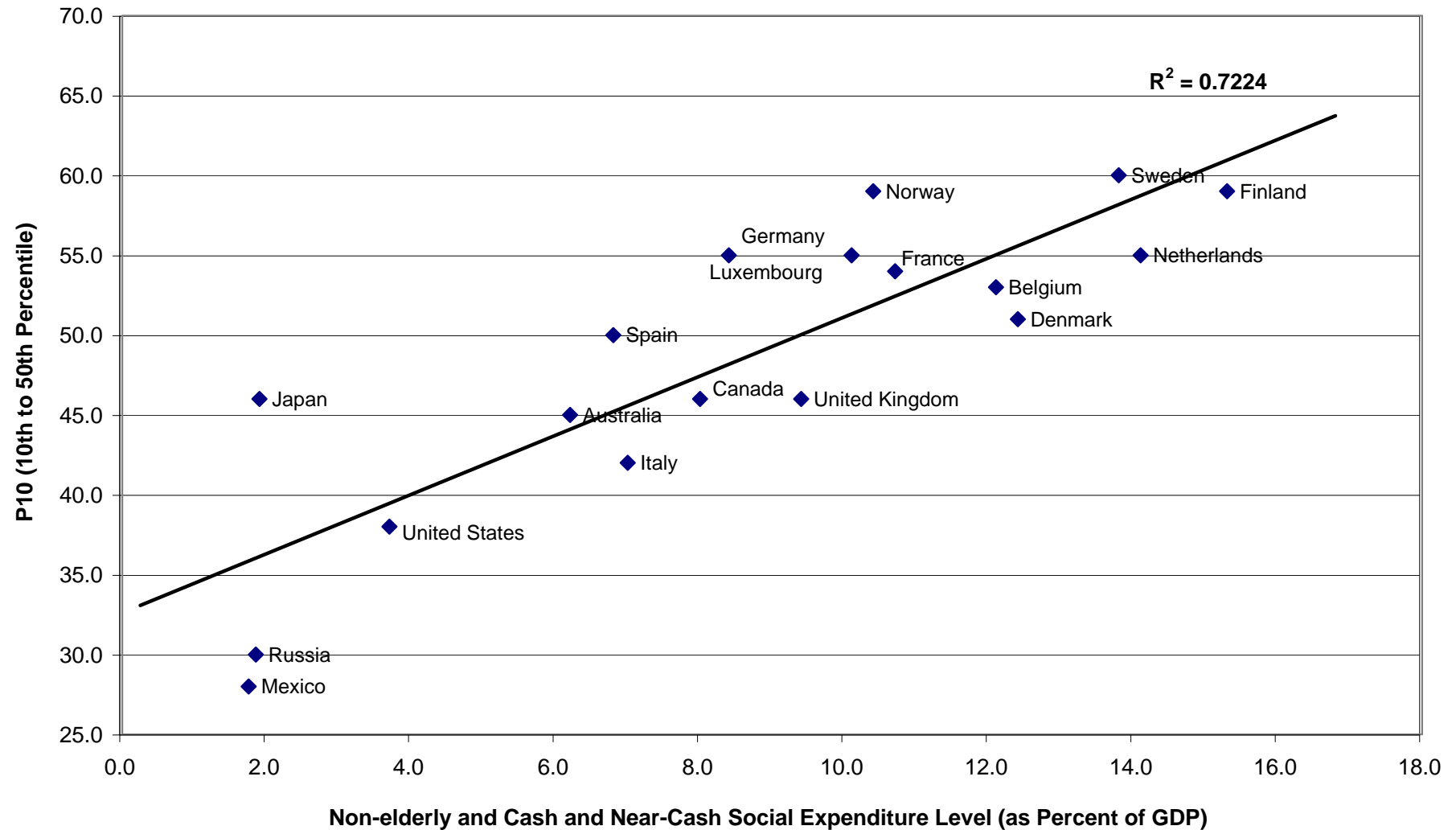
Source: Author's calculations from Luxembourg Income Study.

**Figure 10. Relationship of Low Pay and 10/50 Ratios in
Thirteen Industrialized Countries in the 1990s**



Source: OECD (1996) (percent of full-time workers earnings less than 65% of median earnings); authors' tabulations of the LIS data files, except for Japan, whose source is Smeeding (2002).

Figure 11. Relationship of Cash Social Expenditures for the Non-elderly and 10/50 Ratios in Eighteen Countries in the 1990s



Source: Source: OECD (2001) (non-elderly and cash and near-cash social expenditure level); and authors' tabulations of the LIS data files, except for Japan, which source is Smeeding (1997). Cash and non-cash social expenditures exclude health, education, and social services, but include all forms of cash benefits and near cash housing subsidies, active labor market program subsidies and other contingent cash and other near cash benefits. Non-elderly benefits include only those accruing to household head under age 65.

**Appendix Table A-1.
Macroeconomic Comparison**

Nation (year)	Average Standard of Living		OECD Standardized Unemployment Rate	OECD Social Expenditures on Non-elderly²
	GDP/Capita (in 2000 US\$)¹	Index		
United States (00)	34,106	100	4.0	2.8
Netherlands (99)	26,517	78	3.2	10.5
Sweden (00)	25,363	74	5.6	12.6
Germany (00)	25,329	74	7.8	8.9
Canada (97)	25,044	73	9.1	6.0
Finland (00)	24,530	72	9.8	12.1
United Kingdom (99)	23,723	70	5.9	6.4
Belgium (97)	23,541	69	9.2	8.9

Source: US Bureau of Labor Statistics (<http://www.bls.gov>); OECD (<http://www.oecd.org>); and OECD (2002).

Notes: ¹Using 2000 PPPs, price adjusted in each nation to correct year.

²Countries with data year 2000 are given the most recent (1999) values available from OECD. Definition of nonelderly social expenditures is given in note to Figure 7.