

Max Rashbrooke

# Why Income Gaps Matter

## The Treasury and the tricky issue of inequality

The income gap between rich and poor, which is now much larger in most developed countries than it was 30 years ago, has become one of the more pressing problems facing both the public and policy makers. One approach to this problem of (in)equality is to argue that the income gaps themselves are concerning, and should be narrowed. If we think of the income distribution as a ladder, this is the equivalent of saying that the rungs on the ladder are too far apart. A second approach, however, is to say that income gaps per se are not of concern; what matters is whether people can move freely between those different incomes – whether they can jump, as it were, from one rung to another. There are still other approaches, of course, but the contrast between these two is very revealing and merits closer scrutiny.

In New Zealand one of the most important recent efforts to address these questions can be found in the Treasury's Living Standards Framework, which argues that 'increasing equity' is a key goal. The Treasury has, so far, embraced almost exclusively the second approach outlined above. But its thinking is still in development, and in the hope of contributing to that process this article highlights the strong evidence for putting much more emphasis on income inequality per se. In doing so, it makes three principal arguments. The first is that social mobility itself is less important than is argued: it often is either the wrong goal or fails to address some of the key problems of poverty and inequality. Second, even if social mobility remains of interest, it cannot be tackled without also addressing income inequality; the divide between the two concepts is a false one. And third, there is considerable evidence that income inequality is worth more attention than it has been given. There are, in other words, good reasons to think

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that it is the gaps between the rungs that matter most, not people's ability to move between them.

#### Moving on up?

In New Zealand since the mid-1980s incomes have increased by 80% for people in the top tenth, while increasing very slowly for those in the lowest tenth, and indeed for those in the middle (Rashbrooke (ed.), 2013, pp.27-8). This issue of widening inequality is addressed, at least partially, in the Treasury's Living Standards Framework. The Treasury has said that it sees itself as 'working for higher living standards for New Zealanders. This means thinking beyond just economic growth and considering the broad range of human, social and environmental factors that contribute' (Treasury, 2013,

implies a laser-like focus on making the school system do more to counteract socio-economic status, and on boosting work incentives (Treasury, 2013).

There are a number of problems here, not least the fact that the Treasury has not defined what it means by 'equity' with any great precision. It says simply that the 'starting point' for its thinking about equity is 'the ability to participate' in society. It also suggests that equity is equivalent to fairness, but does not explain what 'fairness' might be. Nor does it explore the difference between 'equity' and 'equality', potentially a major problem given the divergent ways in which those terms can be defined.

It is also unclear why the Treasury puts so much emphasis on 'the ability to participate'. This is only one part

social mobility, and the extent to which that choice is played out in the Living Standards Framework. Assuming that participation is a valid goal, we can then ask: is the Treasury right to argue that enhancing social mobility is the best means to that end? In doing so the Treasury has not defined precisely what it means by social mobility, but we can take the UK government's definition that it is about increasing the degree to which 'patterns of advantage and disadvantage' are disrupted, either within an individual's lifetime or across generations (HM Government, 2011, p.11, quoted in Nunn, 2012). So, does the Treasury's policy prescription – measures to boost both within-lifetime mobility (helping beneficiaries into work) and intergenerational mobility (a better education system) – seem the right one for enhancing equity and participation? The answer, in short, is no, for a host of reasons both philosophical and practical.

The Treasury's thesis rests on the assumption that short-term low income leaves no lasting impact, as long as people can rise out of it. But that assumption is strongly challenged by evidence from health and education research. First, the Dunedin longitudinal study, which looks (among other things) at children who grew up in poverty but later escaped it, finds that those children have better health than the ones who remained in poverty, but worse health than those who were never poor (Poulton et al., 2002). Second, the Competent Learners study found in 2002–03 that only 27% of 14-year-olds who had lived in low-income homes at age five had reading comprehension scores at the median level, 'even though many of their families had increased their incomes over the period'. In comparison, 74% of those from high-income homes had scores at the median level (Rashbrooke (ed.), 2013, p.136). In other words, even temporary poverty leaves a mark that later social mobility cannot erase. This suggests a need to focus not so much on social mobility but on reducing income inequality.

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p.1). The Living Standards Framework gives this new thinking concrete form by arguing that policy options should be evaluated on five fronts: economic growth; sustainability for the future; managing risks; social infrastructure; and increasing equity. (While the structure of this framework, and indeed the role of a finance ministry in driving something designed to move beyond financial measurement, could both be questioned, such points are beyond the scope of this article.)

The Treasury's argument about equity and how it relates to income distribution (made in the greatest depth in its background note on equity published in August 2013) is, unfortunately, far from clear, but it can be summarised as follows. Participation in society is central to equity, and low income matters because it can be a bar to that participation. However, only long-term low income is a problem, so the sole policy issue of any importance is how to boost social mobility and help people out of poverty. That in turn

of the broader concept of equality of opportunity, which is itself part of a wider set of 'equalities' includes equality before the law and equality of outcomes. It is true that, as Jonathan Boston has argued, there is merit in an approach of 'equalising opportunities to enable people to enjoy those *specific* goods and services that are essential for life and citizenship' (emphasis in original), which is perhaps not too far away from 'the ability to participate' (Rashbrooke (ed.), 2013, p.79). The idea of 'participation' also highlights that what matters is not just that people have achieved some absolute standard of living, but that they have a standard of living that approaches those of others around them. Nonetheless, the leap from equity to participation is not well-justified, and one hopes that the Treasury will define all the above issues in much greater depth as it develops the Living Standards Framework.

This article is most interested, however, in the high-level choice between reducing income gaps and increasing

benefits, people in precarious work and people on low wages. In the case of the first group, while it is arguably right to encourage more people on benefits into full-time work, perfect mobility will never be attained. There will always be those who are unable to work, through illness or other reasons, and those who are unemployed for long periods because of a shortage of work in their area, or because their lack of employable skills will take a long time to address. Given that benefits are often set too low to enable people to participate in society (a point explored in more detail below), the Treasury's social mobility policies would fail to provide equity for many, even if one accepts the Treasury's narrow definition of equity as participation.

The stress on mobility also fails to consider what mobility really looks like for many people, especially those shifting frequently between employment and unemployment. A seamless transition from benefits to a well-paid, stable job, for instance, is seldom the reality. Increasing numbers of people – at least 30% of the workforce, and probably much more, on one recent estimate – are in part-time, poorly paid, unstable, 'just in time' or otherwise precarious work (New Zealand Council of Trade Unions, 2013). There is good evidence that this kind of precarious work has severe negative consequences, for the individual's health, for their families and for their communities. Yet these are the people who would be deemed to be succeeding under a social mobility agenda, because they might, over a period of time, move regularly in and out of the bottom fifth and not technically be in 'persistent' poverty. In other words, it is not enough to stress mobility by itself without thinking about where and into what conditions people will become mobile.

Similar points can be made about people in the third group outlined above: those on low wages. While a social mobility agenda may help some people move from low-paid to high-paid work, there will always be those who remain in low-paid jobs for considerable periods. And it is far from clear that policy makers should be trying to shift those workers out of their jobs. Consider a typical aged-

care worker with one dependant, earning \$14.80 an hour, a pay rate that is standard in this industry (Rashbrooke (ed.), 2013, pp.87-8). That equates to a budget of \$490 a week after tax, which leaves little room for going to the movies, fixing a car, or even buying new clothes, and which is clearly insufficient for participation in society. But should this person look to become socially mobile by seeking other work? What she (it is invariably she) does is essential work, and since she has built up skills and knowledge in her many years in the job it is not obviously in New Zealand's interests that she stop doing it. Arguably, what she and the thousands like her need is not a social mobility agenda but a system in which their existing work is better paid.

people are supposed to be mobile – is difficult to justify either pragmatically or philosophically. While some income gaps (typically based on greater rewards for significant talent, effort or contribution) may be useful and justified, it is not clear that the very large gaps we have now are defensible. To return to the definition of social mobility given above, while it may be right to try to break 'patterns' of advantage and disadvantage, it also seems reasonable to question why so many people should be advantaged or disadvantaged in the first place. Stressing social mobility as a paramount objective may be defensible only if that mobility occurs within a relatively limited range of incomes, none of which confers either great advantage or great disadvantage.

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Some of these issues could be resolved by pursuing a far more thorough social mobility agenda. That would involve aiming for something close to full employment; otherwise, once all job vacancies were filled people who found jobs would just be displacing those already in the workforce, which is a zero-sum game as far as both mobility and participation are concerned. But even then there would still be those unable to work or find work, who would need more generous benefits in order to be able to participate in society. There would also be those who were in work but on wages too low to allow them to participate fully; resolving that issue would involve either major labour market reform to boost their bargaining power, a much higher minimum wage, or a definitive shift to a high-wage, high-skill economy.

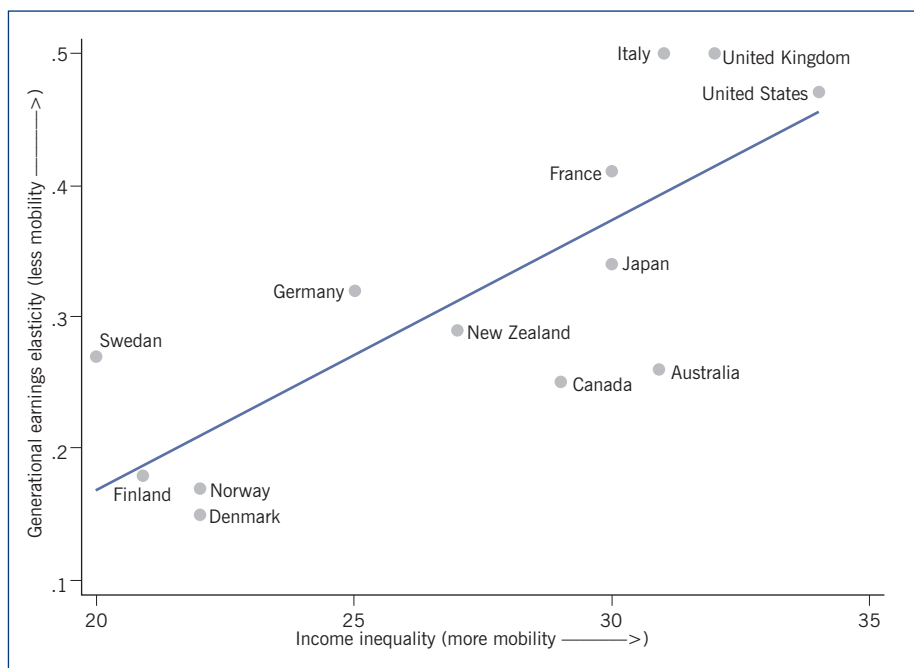
The central point, underlying this whole argument, is that the social mobility agenda's apparent acceptance of large income gaps – across which

Without greater income equality, in other words, social mobility is much harder to defend as a policy agenda.

#### **False divisions**

Indeed, even to the extent that we accept that some emphasis on social mobility is reasonable, and that we want to increase, in the Treasury's words, 'the opportunities that matter for people seeking to make the most of their chances in life, especially for people experiencing hardship', simply *achieving* it is arguably incompatible with very high income inequality (Treasury, 2013, p.3). The Treasury argues that international research 'suggests generally [that] countries with high income inequality have relatively low intergenerational mobility, but this is not always the case' (p.9). This reading, however, does not perhaps give the full flavour of the research. Figure 1 shows what is known as 'The Great Gatsby Curve' (Corak, 2013). What it shows is that there is a very strong correlation

**Figure 1: The Great Gatsby Curve: More Inequality is Associated with Less Mobility across the Generations**



Source: Corak(2013)andOECD.

between inequality and social mobility. (The measure of social mobility used here is intergenerational earnings elasticity: in non-specialist terms, how much of a person’s income can be predicted from the earnings of their parents, or, in many studies, the earnings of their father.)

As figure 1 demonstrates, in the developed world’s more equal countries less than 0.2 – one fifth – of a person’s income can be predicted from what their parents earned, but in the most unequal countries, such as Britain and the United States, fully half of someone’s income can be predicted from their parents’. Other studies on inequality and social mobility draw similar conclusions. Jäntti et al. (2006) show that in the United States only 8% of children born into the bottom fifth of households make it into the top fifth in adulthood; the majority stay either in the bottom fifth or the next quintile up. In more egalitarian Denmark, in contrast, 14% of those born into the bottom fifth make it into the top fifth, and relatively few remain in poverty.

Correlation, of course, is not the same as causation. But Miles Corak provides a convincing explanation for the link:

Socio-economic status influences a child’s health and aptitudes in the early years – indeed even in

utero – which in turn influences early cognitive and social development, and readiness to learn.

These outcomes and the family circumstances of children, as well as the quality of neighbourhoods and schools, influence success in primary school, which feeds into success in high school and college. Family resources and connections affect access to good schools and jobs, and the degree of inequality in labour markets determines both the resources parents have and ultimately the return to the education children receive. This entire process then shapes earnings in adulthood.

(Corak, 2013, pp.7-8)

One might also point out that, in a very unequal society, those with higher incomes are able to some extent to monopolise the best opportunities, while those on lower incomes are frequently dealing with multiple, overlapping forms of disadvantage that make it extremely difficult to take up the opportunities that exist. More equal societies tend to avoid both these issues (Rashbrooke (ed.), 2013, pp.14-15).

The Treasury may be right to point out that there are other factors at play, among them ‘wealth, parental

employment, parental education and the structure of the household (particularly the number of sole parent households)’ (Treasury, 2013, p.9). But many of these factors are themselves influenced by households’ levels of income. And the Treasury’s subsequent caution against expecting success from reducing income inequality ‘on its own’ is a classic straw person argument, largely irrelevant to the well-argued cases being made for tackling inequality alongside a range of other measures.

The Treasury does claim that New Zealand’s intergenerational mobility ‘is higher than would be expected by the level of [its] income inequality’ (ibid.). It is not clear why this might be so, but one can speculate that it is because New Zealand has had less income inequality than other countries for much of its history, and thus built up stores of trust, social cohesion and mobility – stores that it is now, in an era of much higher inequality, starting to run down.

**The gaps between rungs**

Income gaps are important not just to social mobility but in their own right. These gaps matter, firstly, in the sense that poorer households will struggle to fully participate in society. But this claim raises two questions: at what point does low income interfere with participation; and second, what about the argument that most people in short-term poverty are not in long-term poverty?

On the first point, it is unfortunate that, while the Treasury acknowledges that low income can be a problem (if it is persistent), it does not define what level of income is too low. It does briefly mention that there is a measure of 60% of median equivalised household disposable income: in other words, how many households have less than 60% of the after-tax income (adjusted for household size) of the typical household. But the Treasury fails to point out that this 60% figure has been recognised in international poverty measurement, and confirmed by New Zealand focus groups, as a level below which people tend to struggle to participate fully in society (Rashbrooke (ed.), 2013, p.8). So it could be suggested that income inequality

excludes from full participation the very large number of people living below the 60% line, some 800,000 people in 2011. (It would be highly complex, of course, to try to lift those 800,000 people above the poverty line, but those complexities are precisely what the Treasury needs to be addressing.) And since, as the Treasury notes, 65% of households that receive benefits are below the 60% poverty line, a discussion of benefit levels would seem to be crucial to any examination of participation and thus equity. Its omission is, therefore, hard to understand.

The Treasury's counter-argument to the above seems to be that the households living in poverty are not necessarily all struggling. Only half of those in poverty are in chronic poverty (defined as poverty lasting for seven years), and only one third of those in chronic poverty are technically in hardship. But, while this is important evidence, the picture is a little more complicated than those bald facts suggest. First, as described above, people who rise out of poverty may not rise very far above it, and may end up in unhealthy, unstable forms of work, still unable to participate fully in society. Second, the measure of hardship the Treasury uses is the number of households reporting three or more of the eight official markers of deprivation. It does not set out how many poor households report one or two of the markers – and since those markers are inherently significant things, such as having to visit a foodbank, even reporting one might be taken as a sign of non-participation and thus constitute a problem for equity, as defined by the Treasury.

Third, many poor households avoid these markers of deprivation through means that are both sub-optimal and unlikely to be captured in official statistics: borrowing, relying on the support of family and friends, working in the black economy, or even crime. In short, the extent of non-participation in society among those in temporary poverty is likely to be far greater than the Treasury suggests, reinforcing the value of low income as a marker, and highlighting the centrality of income measures – and income inequality – to these arguments.

Income inequality matters also at the other end, in the sense that some people have significantly more than the median income. The Treasury's work is noticeably silent on this issue, despite its obvious implications for equity, especially if equity is conceived as being similar to fairness (though one could, of course, challenge this definition). Leaving aside the moral aspects of this issue, it can simply be noted that these very high incomes can be a concern in their own right – given, for instance, the evidence that large pay gaps in the workplace are demotivating for low- and middle-paid staff – or because households with very high incomes can translate that income into preferential access to education, health care, political power and other advantages (High Pay

those resources. Low wages pave the way for increased returns to shareholders. The same underlying philosophy – that people's pay accurately reflects their worth as determined by the market – is used to defend both very low and very high pay. Top-end inequality, in other words, is intimately linked to questions of low income, and therefore participation and equity.

This point about the intertwining of rich and poor leads neatly to a final claim: the importance of income inequality in the round, both for narrow questions of participation and more broadly for society. In its background paper, the Treasury underplays the evidence that more unequal societies suffer significantly more health and social problems. It

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Commission, 2011). This should prompt discussion of a range of initiatives, from measures to constrain unjustified high pay through to those aimed at breaking the link between high income and preferential access (measures sometimes described as 'blocking exchanges', to use Michael Walzer's term).

It is also important to recognise the connections between inequality at both ends. Increasing incomes at the top and stagnant incomes at the lower end are produced by the same mechanisms. Weaker bargaining power for many low-paid workers is the flipside of greater power for company managers. Resources are insufficient for those reliant on benefits in part because insufficient tax is collected from those at the top end (many of whom do not even pay the top tax rate), which could have helped fund

argues that there is at best a 'modest' linkage between inequality and social problems. But a range of authors and organisations, including Michael Marmot and the World Health Organisation, have presented persuasive evidence that income inequality is a significant cause of those problems (Marmot et al., 2010; Commission on Social Determinants of Health, 2012). The literature on this subject also suggests a number of plausible causal mechanisms: principally, the psycho-social stress, stigma and shame engendered by large income gaps. The findings of works such as *The Spirit Level* (Wilkinson and Pickett, 2009) have not been overturned in the peer-reviewed literature; indeed, that book's conclusions have been broadly endorsed by expert independent reviewers – including, curiously enough, one of the

authors, Karen Rowlingson, whose work the Treasury cites as evidence for not paying much attention to *The Spirit Level*. There is, in short, good evidence that the greater health and social problems of more unequal countries are real, and that they therefore constitute an equity (and participation) problem for those at the lower end, and for society more generally. There is, further, some evidence that income inequality distorts politics so that it favours the interests of the wealthy (Gilens, 2005). Inequality has also been linked to lower long-term economic performance (Berg and Ostry, 2011).

### Income inequality does matter

In the debate about social mobility and inequality, it is clear that much more attention needs to be given to the latter. A focus on social mobility seems justifiable only when income inequality is low enough that it no longer creates significant problems, either for individuals or for society as a whole. This recasts the task of social mobility from ensuring that people can rise out of poverty to that of guaranteeing that people can choose from a wide range of paths, each with a decent level of income attached. In any case, the evidence is that without greater income equality, efforts to boost social mobility are

unlikely to be very effective. So there are, to return to our opening metaphor, good reasons to think that, if there are rungs on the income ladder whose inhabitants struggle to participate in society, we might be better off lifting those rungs into a more comfortable position rather than just trying to make people's stay on them a little shorter than it would otherwise be.

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