Income Inequality and its Sources
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It is generally recognized that the distribution of income in the United States and within many other countries has become less equal since the 1980s. Increased inequality has been popularly interpreted as a negative development, and many proposals have been offered to reverse or offset the change in inequality. However, the interpretation of increased inequality depends on the source of the change. Increased inequality could be the result of technical improvement that raises total income, or it could be the result of restrictions that increase the monopoly power of special interests that reduces total income of a nation; Mankiw, 2013). Changes in the distribution of income are the result of more fundamental shocks to an economy, and failure to recognize the source of change could block innovations that would benefit most of the population.

The distribution of income can be divided into the distribution of labor earnings and the distribution of income from property (capital). The contribution of capital income to greater inequality has received a great deal of attention from many people, including Thomas Piketty, who hypothesized that developments in the last 30 years are part of a longer historical pattern of changes in the distribution of income. Karabarbounis and Neiman (2014) have shown that the increased share of capital income is a broad phenomenon that has occurred in most of the 58 countries in their sample. The increase in the share of capital income has also occurred in most of the 50 states of the U.S. The rise in capital's share has contributed to greater inequality, but changes in the earnings of labor have also contributed to greater inequality. Incomes of high skilled labor have increased relative to earnings of middle and low-skilled workers. A satisfactory explanation of changes in income inequality must explain similar changes in many countries, and it must...
also be capable of explaining increased earnings of both capital and high-skilled labor. An explanation for rising inequality based solely on developments in the United States (taxes, government spending, minimum wage, unions) is not sufficient.

Technical change has had a major effect on national income, the rate of economic growth, and the distribution of income. Technical change has occurred across countries and industries, and the forces of globalization have contributed to its dissemination. Innovations have been a specific type biased toward using capital and high-skilled labor and against the use of middle and low-skilled labor. Technical change has contributed to greater prosperity by raising the productivity of capital and labor, but a side effect of recent technical change has been a redistribution of income in favor of owners of high-skilled labor and capital.

Equal opportunity is important for efficiency and economic growth. It is important for people to be able to acquire skills, enter occupations, and start businesses without restrictions. However, equal opportunity to use one’s labor and capital productively does not imply equality of results or equal incomes. Economic history is filled with spurts of innovation (shipping innovations in the 15th century, the steam engine, petroleum related innovations, and the microprocessor that Intel introduced in 1971) in which the innovators received large rewards that temporarily increased income inequality (Gordon, 2014). Greater concentration of wealth has provoked envy and resentment, but attempts to use government policy to increase equality may reduce the incomes of both the poor and the rich, even if they increase the share of the poor in a smaller total income. Failed experiments with planned economies in China and the Soviet Union, intended to promote greater equality, are extreme examples, but Casey Mulligan (2014) has documented recent US policies intended to reduce inequality, that have also reduced incentives for people to work.

Observed increases in inequality in a given year should not be confused with changes in intergenerational economic mobility. Some critics have claimed that America is no longer a “land of opportunity”? A recent study by Chetty et al (2014) challenged this claim and concluded that “young adults entering the labor market today have roughly the same likelihood of moving up the income distribution ladder relative to their parents as those who were born in the 1970s and entered the labor market two decades ago”. Increases in inequality in particular years have not prevented individuals from rising above or falling below the incomes of their parents.

**SOURCES OF INCREASED INEQUALITY**

Technical change has been the main source of increases in income inequality across many countries. It has been biased toward using higher-skilled labor and capital, and it has been widely disseminated by globalization. New patterns of international trade have contributed to the bias against middle and low skilled labor. Production of many products has become increasingly specialized (fragmented), such that components of the final product have been produced in many different countries. The fraction of foreign value added in a typical product has increased substantially in recent years. A well-known study of iPods shows that components were made in 13 different countries and assembled in China (Dedrick et al, 2010).
When they are imported into the U.S., iPods are classified by Customs officials as “made in China”, even though only 3% of the total value added comes from China, and 33%-50% accrues to Apple. The supply chain is managed by Apple in the U.S. so as to use the best technology in a way that minimizes total cost. One result of this complex fragmentation of production is an increase in the share of skilled labor and capital in total value added and a reduction in the shares of middle and unskilled labor. This process that favors skilled labor and capital also applies to other Apple products, and it has been shown to apply to a wide variety of other manufactured products in a sample of countries that comprise 85% of world GDP. (Timmer et al, 2014).

Thus, new technology has produced valuable new products at costs that millions of consumers can afford, but an unintended side effect is increased inequality of income. The process is an example of Schumpeter’s “creative destruction”. The “destruction” can be avoided only by foregoing the valuable new products. The increased inequality need not be permanent. In the case of labor, lower skilled labor was matched to the old technology. If more workers acquire the higher skills that are in greater demand, relative labor earnings and the distribution of income will again become more equal. The dynamic process of adjustment to the innovation has been described as a “race between technology and skills” (Acemoglu and Autor, 2012).

Gordon has described major innovations in US economic history that increased economic growth, enriched innovators, and temporarily increased income inequality.

**WHAT SHOULD BE DONE ABOUT INCREASED INEQUALITY?**

The efficient response to increased inequality depends on what caused the increase. If technical change is the source, greater inequality of earnings performs a useful economic function of encouraging workers to acquire skills that are in greater demand. Policies that offset technologically-induced innovation decrease total income. For example, extending unemployment benefits to a longer period encourages workers to remain unemployed longer (or leave the work force), rather than acquire skills that are in greater demand under the new technology. Policies that motivate the unemployed to seek new employment and at the same time ease the acquisition of skills would increase total income and reduce inequality of earnings. In the “race between technology and skills”, faster response of skill supply to skill demand enhances economic efficiency. For example, the Hartz IV reforms implemented in Germany in 2005 that resulted in a significant cut in the unemployment benefits for the long-term unemployed along with Germany’s established dual vocational training system have been acknowledged to have significantly contributed to its low unemployment rate, including low youth unemployment.

Conversely, policies intended to reduce inequality (higher marginal tax rates, extended unemployment benefits, higher minimum wages) would have the unintended consequences of reducing total income and economic growth. Casey Mulligan (2014) has documented how policies that raised effective marginal tax rates (for example, extended unemployment benefits) have decreased employment and slowed the recovery from the Great Recession in the U.S.
If the source of greater inequality is greater privileges to the rich (rent-seeking) that enables them to protect themselves from competition, the solution is a more open and competitive economy. The rise of rich and powerful oligarchs in Russia and billionaires in China are examples of crony capitalism, in which politically powerful elites use the power of government to protect their economic interests. In the US, if influential individuals (Romney, Buffett) or corporations (General Electric) enhance their wealth by paying low or zero taxes, there is an economically efficient remedy. Closing the many loopholes in the tax code that favor special interests would broaden the tax base, and it would allow the government to receive the same tax revenue at lower tax rates. Eliminating sources of rent-seeking can reduce income inequality while also increasing economic efficiency.

CONCLUSION

The personal distribution of income has become less equal in the United States and many other countries in the last 30 years. This has been widely viewed as a negative development, and many proposals have been offered to achieve a more equal distribution. However, a prudent response depends on the source of the change in income inequality. Technical change that has spread to many countries and is biased toward using more skilled labor and capital is a major source of greater income inequality, but it is also a major source of economic growth. Since economic growth has been a major source of poverty reduction since the Industrial Revolution, it would be prudent to recognize that redistribution policies come at a cost.

REFERENCES


Piketty, Thomas. “Capital in the 21st Century”.

As pointed out in this post, the cause of the inequality (rents, increasing capital share, sunspots, etc) is irrelevant if the inequality is self-reinforcing. As economists, we are so enamored with negative feedback systems that we often ignore or dismiss systems characterized by positive feedback. It's not immediately clear that the path of economic inequality will exhibit positive feedback, but if it does, it is unambiguously negative, as it will inexorably lead to upheaval.

http://www.consciencewarrior.com/2014/06/dual-endogeneity-capital-share.html

Income levels are important. The average German has many more opportunities than the average Ethiopian. If income grows, people can rise out of poverty even if the distribution of income remains constant or even moves slightly in favor of higher income groups. In fact, millions of people have moved out of poverty since the Industrial Revolution. Conversely, if total income falls for everyone, but it falls a little less for the poor, will this redistribution in favor of the poor protect against "upheaval"? If lower income groups are satisfied with decreased incomes, then envy is a powerful motive.

It's entirely possible that developing countries might have to accept more inequality while they are growing. I'm not sure there are a lot of useful direct economic comparisons between Ethiopia and the United States in the 21st century, however.

Even if we accept Kuznets' hypothesis about the hyperbolic relationship between inequality and growth, there is no reason to believe that the relationship is causal, never mind in which direction. There is much more recent work, such as Ostry, Berg, and Tsangarides (2014), showing a negative (or at least not-positive) relationship between inequality and growth in industrialized countries. Again, accepting Kuznets, maybe this means that the industrialized countries are on the right-hand side of the Kuznets Curve, where inequality and growth are negatively correlated.

As they wrote, one of the negative knock-on effects of high inequality is that it inspires countries to do all sorts of inefficient and harmful things to combat it. Wouldn't it be better to identify smart policies to turn back this trend, rather than play ostrich? It's sad to me that so few of Piketty's critics are willing to actually engage his arguments, and are content to simply respond to the arguments they think he's making.
I criticize the use of inequality of income as a measure of economic welfare. Knowing that the richest 20% have 30% of the income tells nothing about whether the country is as rich as Germany or as poor as Ethiopia. In fact, the greatest inequality exists in lower income countries. Brazil and South Africa are consistently among the least equal. My main point is that certain technological innovations might result in large changes in total income and reduce poverty, even if they also increase inequality of results. Equal opportunity is much more important.

I take Kuznets hypothesis to be an empirical regularity that held over a certain historical period that could easily be contradicted during another period. It is not an "iron law". Certain kinds of technical changes could decrease inequality whereas others could increase it. "Smart policies" would recognize that not all innovations that temporarily increase income inequality are harmful to most people.

Reformuj, a będziesz wybrany

[...] Grennes (Uniwersytet Północnej Karoliny) i łotewski ekonomista Andris Strazds wracają do tematu nierówności. Z ich analizy literatury przedmiotu wynika, że narastające nierówności [...]

Now if the major off-shoring of jobs for cheaper labor costs, etc could also be accounted for in the same way innovation is posited as a main contributor to income inequality maybe a somewhat fuller explanation could be apparent. As well, given the devastation of the 'investor-state dispute settlement ' clause that is the main component of every trade agreement to formulate an assured shareholder profit where losses should have happened as part of the normal course of business, a less skewed picture of outcomes would certainly be expected. Since the recession the US business community has been far more focused on stock speculation for earnings purposes than investing in productivity growth let alone innovation. For the last 7 years, the main complaint has been corporate reluctance to re-investing huge capital holdings into business growth. The additional fact of such high unemployment figures (last estimated to be well over 60 million) can only be explained by a total redirection away from producing products to stock speculation. And it is this singular speculation of corporate capital coupled with minimal regulation that led to the fiasco of job losses and increased debts as far as Main Street was and is concerned. Further extreme losses are expected if the TISA is agreed to, especially if the planned careless privatization of public services and pensions, education, health care and of course the free flow of global banking data and services are implemented to cement economic control. This fear-based economic plan is fueled by the belief in dwindling markets given global competition corporations and banks are now going after control over local markets and public assets to increase costs to consumers through extreme privatization, thus the overriding necessity of secrecy in all these trade negotiations. It is telling that little if any discussion of these developments are part of the current economic analysis due to the need to offset public reaction; which would, in many ways be as negative, as they were when public tax monies were used to bailout the mistakes and losses of banks, who, when the situation is reversed, simply allow their customer to actually deal with any losses or foreclosures as the expected end to bad decisions or unfortunate outcomes. It seems rather moot to say the obvious, after all when industrial pollution is discovered it is the taxpayers who are told they can expect to pay one way or another, right? Never the other way around, so much for legalities or equalities, of any kind including income or corporate subsidies.
Talk about slippery. To rebut the Piketty thesis about income inequality, the authors--not so deftly--slide off the top-to-bottom comparison into a discussion of labor-income inequality, a rather different subject. Then it becomes easy to castigate the slow, lazy, underperforming workers and say that they need to step up their game and that any government effort to help them carry their weight is, of course, counterproductive.

What's not said is that those at the top prosper in a myriad of ways from government action (or targeted inaction), including the very existence of government-created corporations (yes, they all are) and that, perhaps, sensible, balanced government policy might be an antidote to the breadth of inequality government policies have helped to create. Adding a tag at the end decrying "corporate subsidies" may be a denial of blindness, but it's hardly proof of clear vision.

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