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Rising Income Inequality: Do Not Draw the Obvious Conclusions

Inequality is currently a hot topic that dominates the political agenda in various countries, many of which are still characterised by sluggish recoveries and high unemployment rates, especially among the youth. Vast majorities of the populations in Germany, the EU and the US believe that income and wealth are unfairly distributed, that social fairness has diminished in recent years and that governments should work to substantially reduce the income gap between the rich and the poor.1

Globalisation and migration are blamed by the public and populist politicians alike as decisive factors explaining the rise in inequality. These factors played a large role in recent political events and help to explain the unexpected outcome of the UK referendum in favour of Brexit and the stunning US presidential election victory of Donald J. Trump.

Populist parties draw their strength by taking advantage of fears of social decline, placing the blame on globalisation and migration. They typically put forward wishful thinking that a more nationalist-oriented economy could increase living standards and turn their countries into lands of milk and honey. We clearly oppose this simplification of arguments – one that neglects the huge benefits of a broader globalisation, including the freer movement of goods and workers across borders.

Impact of globalisation, technological change and labour migration

There is a wealth of evidence showing that, on the whole, consumers and corporations of countries opening up to trade largely benefit via an increase in their living standards. The purchasing power of consumers shoots up due to lower prices, and they enjoy a broader range of quality goods and services. For corporations, trade diversifies risks, and they typically profit from lower prices thanks to available imports of intermediates. Higher openness to trade also facilitates competition and investment, and it increases productivity.2

On balance, labour migration has a positive effect on the labour market as well as on the fiscal position and economic growth of the host country. Migrants typically fill niches of the economy and contribute significantly to labour market flexibility, especially in host countries with relatively inflexible labour market regulations, such as many of the countries in Europe. Migrants’ contributions to national social security systems is generally positive. Migration further boosts economic growth through increases in the share of the working-age population, since migrants are typically relatively young. They contribute to human capital formation and thereby to technological progress.3


2 Corporations can also boost their competitiveness by outsourcing parts of the value chain to other countries (global value chains), either by establishing subsidiaries, acquiring stakes in foreign companies or contracting third parties. See H. Peters: Global value chains secure competitive advantages for German companies, Focus Germany, 1 July 2013, Deutsche Bank Research.

Income Inequality

As an inequality measure, we use the Gini coefficient, which ranges from 0 (perfect equality) to 1 (maximum inequality, i.e. all income is held by one household) and is commonly used to condense the inequality of income distribution into a single number.\(^6\)

Rising global inequality as emerging economies close the gap with advanced economies

The global inequality of gross incomes has greatly increased over the past three decades for both advanced economies and emerging economies (see Figure 1). While inequality in emerging economies was lower compared to advanced economies at the end of the 1980s (0.39 vs 0.42), it has since then increased more rapidly in emerging economies. Today gross income inequality in emerging and advanced economies is more or less the same, with a Gini coefficient of slightly less than 0.50. However, gross income inequality differs widely among countries. In 2013 the five countries with the highest levels of inequality were Latvia (0.60), Lithuania (0.56), Ireland, Cyprus and Portugal (all 0.55), and the five countries with the lowest levels of inequality were South Korea (0.32), Iceland (0.37), Venezuela (0.38), New Zealand (0.38) and Sri Lanka (0.41).\(^7\)

As countries move up the income ladder, redistribution measures to finance, for example, social systems or public transfers are usually expanded. As a consequence, the gap between gross and net income inequality widens with a higher level of GDP per capita. In 2013 the gap was

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\(^{7}\) SWIID Version 5.1 database.