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End of previous Forum article

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Myths and Facts About Inequality

The remarkable political polarisation in much of the Western world in recent years has been a rude awakening for political and economic elites. Populism and political polarisation were considered impossible only ten years ago. But the rise of governments pursuing increasingly nationalistic policies, coupled with strong right-wing and left-wing extremist parties, has affected most Western countries. It has also induced soul-searching for the causes of an growing dissatisfaction among citizens. There is increasing evidence that the rise in economic and social inequality has played a major role in these political developments.[1]

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1 D. Acemoglu: Thoughts on Inequality in Financial Crisis, presentation at the American Economic Association Annual Meeting, Denver, January 2011; A. Alesina, D. Rodrik: Distributive Politics and Economic Growth, in: Quarterly Journal of Economics, Vol. 109, No. 2, 1994, pp. 465-490; A.B. Atkinson: Inequality: What Can Be Done?, Cambridge, MA 2015, Harvard University Press; T. Piketty: Capital in the 21st Century. Cambridge, MA 2014, Harvard University Press; OECD: Divided We Stand: Why Inequality Keeps Rising, Paris 2011, OECD Publishing; A. Sen: On Economic Inequality, Oxford 1997, Clarendon Press / Oxford University Press.

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In the field of economics, inequality in income and wealth distribution had long been considered an esoteric topic. Since many subfields of economics hardly communicate with one another, macroeconomists tended to consider inequality largely irrelevant. They viewed themselves as social welfare planners, or even, "benevolent dictators", aimed at maximising total welfare rather than that of individuals. But with a gradual shift in the research agenda and with the emergence of powerful academic voices, this has started to change.

For most of the last five decades, inequality was considered a necessary by-product of a functioning market economy in which individuals are free to make decisions about their education, work and risk-taking. In fact, inequality was largely considered a useful device for providing incentives to take risks and work hard, thereby generating economic benefits for all. Numerous previous studies found that inequality had no significant negative impact on economic growth or on other economic aggregates.

Because part of the orthodox literature acknowledges that the market economy may not always work perfectly, it also considers a strong social welfare state a useful tool for compensating losers and ensuring social peace. When inequality started rising in the 1980s and 1990s in many Western economies, academics and policymakers could no longer ignore the trend. The initial reaction

was to blame globalisation as the main culprit and insist that national policymakers could do little about it. Rising inequality coincided in many countries with a stronger welfare state and an attempt to use redistribution to assist people who were left behind. This closely follows the neoclassical assumption that markets generally work as does deregulation when market participants self-regulate.

These are some of the myths within the economics profession. But the picture has changed fundamentally in recent years as new research has challenged conventional methodological approaches and findings.[2] This paper confronts some of these myths. To do so, it focuses on the case of Germany. Germany is considered by many as an example of a country with low inequality, high social mobility and a strong, efficient social welfare state. However, this paper will show why inequality is remarkably high in Germany and try to address some of the myths relating to the perception of inequality in the country, linking this to various conceptual and empirical studies reaching back several decades.[3]

Germany, a country of inequality

Germany's social contract, its "social market economy" for the past seven decades, has aimed at spreading wealth and providing a broad social safety net for all groups of society. Yet a defining feature of Germany's new economy has been the sharp increase in inequality. In particular inequality of opportunities, as well as inequalities in wealth and income, are higher in Germany than in most other industrialised countries.

Myth #1: Inequality is not considered a problem by most people, who see it as a fair part of the social contract.

For many of Germany's political and economic elites, social inequality is not a pressing issue. However, according to surveys, 70% of Germans believe social inequality is too high. They live with persistent fears and concerns about the lack of opportunities available to them. They feel like they are working harder but earning less. They do not believe that the social security system will be able to protect them from a massive decline in their quality of life if they get sick, lose their jobs or retire.

But is it possible that it is not the people who do not understand, but rather the inner circle of decision makers in politics, business and the media who are not getting the story straight?

Myth #2: Inequality is rising mostly because the rich manage to get a bigger share of the pie.

Germany today is one of the most unequal countries in the industrialised world. This surprises many, as Germany had long pursued economic and social policies of moderation and redistribution. Germany faces three major "inequality puzzles". The first is a wealth puzzle: Germany has one of the highest per capita income levels in the world, and German citizens have a high propensity to save. This should logically mean that German citizens have been able to accumulate financial wealth, providing a safety net for retirement in one of the most rapidly ageing societies in the world.

The facts, however, paint a very different picture. The financial wealth of the average household in Germany is one of the lowest in all of Europe,[4] amounting to less than half of that in other euro countries. Such wealth includes cash, savings and other financial assets, real estate, durable consumer goods, life insurance, and the private ownership of firms. Not only is financial wealth among German households one of the lowest in Europe today, but it has shrunk over the past 15 years.

How do these seemingly contradictory facts fit together? Part of the answer is that Germany has the highest wealth inequality of any country in the entire euro area – at a level similar to that of the United States. The bottom 40% of German households have barely any net wealth,

2 OECD: Growing Unequal? Income Distribution and Poverty in OECD Countries, Paris 2008, OECD Publishing; OECD: In It Together: Why Less Inequality Benefits All, Paris 2015, OECD Publishing; J. Ostry, A. Berg, C. Tsangarides: Redistribution, Inequality, and Growth, IMF Staff Discussion Note, February 2014; J.E. Stiglitz: The Price of Inequality: How Today's Divided Society Endangers Our Future, New York 2012, Norton; A.B. Atkinson: The Changing Distribution of Earnings in OECD Countries, Oxford 2009, Oxford University Press; P. Aghion, E. Caroli, C. Garcia-Peñalosa: Inequality and Economic Growth: The Perspective of the New Growth Theories, in: Journal of Economic Literature, Vol. 37, No. 4, 1999, pp. 1615-1660; K.J. Forbes: A Reassessment of the Relationship between Inequality and Growth, in: American Economic Review, Vol. 90, No. 4, 2000, pp. 869-887; R.J. Barro: Inequality and Growth in a Panel of Countries, in: Journal of Economic Growth, Vol. 5, No. 1, 2000, pp. 5-32.

3 L. Erhard: Wohlstand für alle, Düsseldorf 1957, Econ-Verlag; S. Bach, A. Thiemann, A. Zucco: The Top Tail of the Wealth Distribution in Germany, France, Spain, and Greece, mimeo, DIW Berlin, August 2015; European Central Bank: The Eurosystem Household Finance and Consumption Survey: Results from the First Wave, Statistics Paper Series No. 2, April 2013; M. Fratzscher, S. Junker: Integration von Flüchtlingen: Eine langfristig lohnende Investition, DIW Wochenbericht No. 45, 2015, pp. 1083-1088; J. Goebel, M. Grabka, C. Schröder: Einkommensungleichheit in Deutschland bleibt weiterhin hoch: Junge Alleinlebende und Berufseinsteiger sind zunehmend von Armut bedroht, DIW Wochenbericht No. 25, 2015, pp. 571-586; M. Grabka, C. Westermeier: Reale Nettovermögen der Privathaushalte in Deutschland sind von 2003 bis 2013 geschrumpft, DIW Wochenbericht No. 34, 2015, pp. 727-738.

4 European Central Bank, op. cit.

after considering financial debt and other obligations. And in no other country of the euro area do the richest ten per cent of the population have a larger share of net wealth than in Germany.

Myth #3: Inequality is not rising in a meaningful way. In fact, it is falling across countries.

The second puzzle is the "income puzzle". Germany not only has large discrepancies in private wealth but also in income and wages. And the gap between households with high income and those with low income has increased tremendously over the past three decades. While it is true that inequality across countries has been declining – mostly because large emerging markets, such as China, are catching up with the rest of the world – income inequality within most countries has risen.[5]

Although Germany has experienced an employment miracle since 2005 – cutting its unemployment rate in half, despite the global financial crisis and the European debt crisis – the real wages of the bottom 50% of German workers have declined over the past 15 years. In contrast, real wages at the top have increased substantially during the same period.

This pattern holds not only for wages but also for the market income of workers, partly due to the sharp rise in precarious employment contracts and the often involuntary increase in part-time work. Overall, Germany has one of the highest levels of inequality in market incomes in Europe. The state is trying hard to reduce this inequality through a comparatively high level of redistribution via taxes and transfers – albeit with only limited success, as the inequality of disposable income is still about average among OECD countries.

Income has increased in particular for those holding financial assets – despite a temporary reversal during the global financial crisis – and those owning companies. The direct ownership of companies, in particular in Germany's famed *Mittelstand*, is a key source of wealth and income for the top one per cent in Germany, a fact that plays a much more important role than in most other industrialised countries.

The third puzzle is the "mobility puzzle". Facts show that it is much harder for a German citizen to move up the income or wealth ladder than in most other industrialised countries. This economic immobility is particularly high among the richest as well as among the poorest citizens in Germany.[6] Those who have managed to obtain a high-paying job in Germany have a much better chance of maintaining this position than in many other countries. In particular, the strong correlation between income and wealth in Germany stands out among OECD countries.

The low mobility during the lifetime of an individual also extends to a low level of mobility across generations. Studies show that the level of income and wealth of individuals in Germany is much more dependent on the income, wealth, education and social standing of their parents than in most other countries. In fact, more than half of a worker's income in Germany is determined by the income and the education level of their parents. Possibly the strongest concern is that such mobility has decreased over the past few decades.

Myth #4: Inequality is not a problem in most Western societies, as a strong social welfare state helps explain inequality and compensates society's losers.

Germany's middle class is the main loser of the increasing trends in these three aspects of inequality. It is the people in the middle of society who face the strongest risk of losing their jobs, experiencing a decline in income and wealth, and not being able to build a private safety net.[7] The risk of a shrinking middle class is acute and is already taking place according to many measures, although there is much controversy surrounding this development in Germany.

Labour is factored into this equation more generally, as it is taxed more heavily than the capital factor compared to other countries. Germany's credo "welfare for everyone" no longer applies and has rather become a credo of "welfare for a lucky few".

Is inequality a problem?

A high degree of inequality in income or wealth is neither good nor bad per se from an economic perspective. Some people consider a high degree of inequality an injustice. Others see inequality as the inevitable or even desirable result of any market economy. The relevant question for this paper is rather how inequality affects various economic and social dimensions. In other words, the question is not only one of distribution, but also one of efficiency.

5 See e.g. OECD: In It Together. . . , op. cit.

6 C. Schröder, K. Spieß, J. Storck: Private Bildungsausgaben für Kinder: Einkommensschwache Familien sind relativ stärker belastet, DIW Wochenbericht No. 8, 2015, pp. 158-170.

7 M. Grabka, C. Westermeier, op. cit.

Myth #5: Globalisation is the main driver of inequality and governments can do little about it.

The causes and consequences of inequality are increasingly clear-cut. There is a broad consensus that the argument that high inequality is mainly due to a functioning market economy and a high degree of competition is incorrect. Additionally, politicians like to blame globalisation for the rise in income and wealth inequality. This is convenient, as they can argue that such an increase in inequality is beyond their control.

Yet there is increasing evidence that it is not globalisation, but rather three other factors that have been behind the increase in income and wealth inequality in most Western democracies over the past 40 years. Technological change, equal access to education and a fundamental shift in the power across groups of society – embodied, in particular, in the weakening of labour unions – are the dominant explanations identified by studies conducted by the OECD and IMF.

Myth #6: High inequality is necessary and good, as it reflects a functioning market economy, which ultimately makes everyone better off.

Many academic studies show that a certain level of inequality of income and wealth is indeed the normal result of a well-functioning market economy. It is desirable to provide incentives for individuals to undertake risks in an effort to obtain wealth for themselves. Ultimately, a well-functioning market economy must reward successful individuals.

However, inequality in income and wealth becomes a problem if it no longer reflects the free decisions of individuals, but instead, a poorly functioning market economy in which individuals are deprived of opportunities to use their skills and talents in an even-handed, fair competition.[8] Such a market economy loses part of its potential that derives from the talents and abilities of individuals. This ultimately leads to lower productivity and economic growth. Studies by the OECD and others have shown that the rise in inequality in Germany since 1990 has lowered the level of economic activity by six per cent today.

Myth #7: Inequality is primarily about distribution, not efficiency. It has no major negative economic, social or political consequences for society.

The high level of inequality in income, wealth and opportunities has many adverse consequences. For example, research has shown that it has raised poverty levels in Germany, particularly among retirees and children. It has reduced social and political participation and thereby weakened the functioning of democracy. It increasingly deprives individuals of their independence and forces them to rely on their own precautionary savings for retirement or other purposes. As a result of the increase in inequality, more people in Germany are dependent on public transfers to make ends meet than ever. Such inequality has also been shown to have an adverse effect on other welfare indicators, ranging from health to happiness.

The trend towards rising inequality has led to increasing social conflict, a struggle for public resources and an increasingly intense fight for public transfers and privileges, which is reflected in a sharp increase in lobbying activities by special interest groups. It binds productive forces and is thus inefficient from an economic perspective. The fight for redistribution is hardly ever a zero-sum game, as it leads to an efficiency loss and, thus, less economic welfare. In other words, the fight over the cake actually reduces the size of the cake that can be distributed. However, redistribution can indeed increase the cake size if it improves equality of opportunity and allows more individuals to utilise their talents.

Myth #8: Inequality is best addressed by more redistribution and a larger social welfare state.

Germany's problem today, however, is not that the state does not sufficiently redistribute its many resources across groups within society. On the contrary: Germany has one of the higher tax rates and some of the largest transfers in the industrialised world. Yet such redistribution is often done in a highly ineffective manner. Too often, the transfer system not only redistributes resources to the richer and more privileged groups of society, but it also tends to harm economic activity and reduces the amount of resources that can be distributed. No democracy has the objective of making the level of income or wealth equal or the outcome identical for everyone. But every democracy aims at providing equal opportunity.

The single most important weakness of Germany's politics and society today is its dramatic failure to improve the equality of opportunity among its citizens. Few groups of people in Germany today have the opportunity to fully develop and utilise their skills and to reap the rewards of

8 J.E. Stiglitz, op. cit.; A.B. Atkinson: Inequality..., op. cit.; M. Corak: Income Inequality, Equality of Opportunity, and Intergenerational Mobility, in: Journal of Economic Perspectives, Vol. 27, No. 3, 2013, pp. 79-102.

their efforts – both for their own benefit, and for that of society as a whole.

Prospects for the future are deteriorating

The inequalities in opportunity, income and wealth have risen not only in Germany but also globally over the past several decades. And yet, the increase has been steeper and the level of inequality has grown significantly higher in Germany. Moreover, many indicators project a continued increase in the coming decades. This leads to a vicious cycle in which a lack of equal opportunity itself raises inequalities further. More privileged people are able to invest more in education, thus further entrenching inequalities in income and wealth. This also makes it more difficult for less privileged people to get access to good jobs and opportunities. This spiral will intensify if policymakers do not counteract it by providing a level playing field in education and the functioning of the labour market.

As Joseph Stiglitz has shown, globalisation will continue to benefit those with high skills and qualifications in particular, while it disadvantages those with fewer skills and less education.[9] Labour markets have become much more flexible as a result of globalisation. Yet studies show that labour market flexibility has often come at the expense of protecting the interests of the weakest members of society. Digitalisation and the continued rise of information and communication technology will increasingly expose and potentially shrink the middle class in industrialised countries, in particular in Germany. Policies such as the recent introduction of a minimum wage in Germany are aimed at the symptoms of this phenomenon, but they do not get to the root causes.

Thomas Piketty's work, in particular his hypothesis that the rate of return on capital exceeds that of labour in the long run, has important implications for the trend of income and wealth inequality. There are two important reasons why Germany is likely to be more strongly affected by this than other countries. One is the high degree of wealth inequality in Germany, with the bottom half of the population basically having no net wealth. The second reason is the low mobility of individuals, both over their own lifetimes as well as across generations, implying a higher persistence in the distribution and thus a potentially stronger inequality trend.

But policymakers are not the only ones who need to act in order to address the sources and consequences of inequality. Economists have not yet adjusted to the overwhelming evidence of inequality. The mainstream still clings to the old orthodoxy – that inequality is, at best, an irrelevant issue and, at worst, a desirable consequence of a market economy. The profession needs to focus more on evidence-based, empirical facts than on neoclassical theories to understand the extent, causes and consequences of inequality. That also requires a more multidisciplinary approach that links economics with other social sciences.

The task of policymakers

So what is the best solution for Western societies to address inequality, in particular as technological change and globalisation are advancing rapidly? In light of the growing polarisation of society, some in politics – and ever more in academic and civil society – consider greater redistribution via the social state to be the best solution. Some call for taxes on the rich and higher monetary transfer benefits for the weakest segments of society.

Others want to instate unconditional basic income for everyone, a fixed monthly amount free of obligations or services in return. Its proponents claim this would create freedom – after all, people would no longer be economically strained in securing their livelihoods. But unconditional basic income is the wrong answer to the challenges of our time. It is neither egalitarian, nor liberal, nor individualistic, nor economically conducive. It would cement societal polarisation while failing to create more freedom and opportunity.

As an alternative, an opportunity credit would create a smart balance between an excessively dominant state on the one hand and the individual's autonomy and freedom on the other. Universal basic income creates autonomy and freedom in a very restricted sense. It gives people freedom from state requirements and constraints. But the extent to which it helps people to achieve their life goals is limited. After all, people need a state and society not only to support them with education, security and other benefits but also to ensure social cohesion.

The fight for redistribution will intensify in the years ahead. Importantly, the losers are not just the weakest groups, but all members of society. It is also in the interest of the most privileged groups to have a market economy in which as many people as possible have a fair chance to use and develop their skills and talents. Without such opportunities, the economy loses the huge potential stemming from its most important asset – the human capital of its citizens.

9 J.E. Stiglitz, op. cit.

Two central conclusions emerge. First: a lower degree of inequality is in the shared interest of all groups in society, not just a few. The detrimental fight for redistribution, which we have been experiencing with increased intensity in recent decades, will further increase until we realise and react to this fact.

Second, the lack of equality of opportunity is Germany's most important economic and social problem today. It is highly inefficient and counterproductive to deprive citizens of opportunities and then to try and compensate them later through an inefficient and costly system of redistribution via high taxes and transfers. Moreover, freedom has no financial price tag, as financial transfers cannot compensate for the deprivation of opportunities.

Instead of focusing narrowly on merely increasing redistribution via taxes, policymakers need to shift their efforts towards fundamentally changing the German education system and removing other barriers to social and economic mobility. This would also include making the current system of redistribution more efficient and targeted, and thus more successful in reducing harmful inequality. This would ultimately make the size of the economic benefits bigger for everyone, via higher and more equitable growth.

The recent elections in September 2017 – a protest vote that yielded the far-right, xenophobic AfD as the third-strongest party in parliament – should be a wake-up call for Germany's establishment. The country will only be able to secure its prosperity and its strong global economic standing if it invests substantially more, and more smartly, in its most important asset – the human capital of its citizens. Only then will Germany be able to come closer to its ideal of creating "welfare for everyone", the credo of its policies for the past seven decades.