



More incentives and opportunities instead of more redistribution

When tackling current challenges, policymakers should focus more on distribution implications

The consequences of the COVID-19 pandemic, ambitious climate policies, persistently negative interest rates, and large-scale security purchases by the ECB are increasingly raising the issue of a fair distribution.

Policymakers tend to focus on the symptoms in order to appease their voters – and in doing so, they often neglect the root causes. Existing redistribution issues and long-term growth and fiscal consequences hardly play a role in the discussion. Targeted measures, however, might help to create opportunities for individuals and increase social and economic independence. In addition, they might contribute to Germany's competitiveness as a business location and to its political stability.

Degree of inequality has not changed in recent years – contrary to popular belief

From the 1980s until the beginning of the 2000s, globalization, technological progress and demographic and social change have increased income inequality in Germany (and in most other industrialized countries). Since then, however, the degree of inequality has remained largely unchanged. Due to a significant increase in social transfers (by 30% since 2010 alone), income distribution after taxes is still quite homogeneous in Germany, at least on an international comparison.

Nevertheless, many Germans feel that both their own incomes and those of lower-income households are too low. However, like their counterparts in other countries, they are misjudging both their own position on the income scale and the overall distribution of incomes.

Education is key, supplementary social transfers should become more efficient

What is necessary is to make the education system fit for meeting the requirements of the future. More young people should have a chance to go to university. The social transfer system should be streamlined so that it can supplement the primary distribution more effectively when wage gains from productivity growth prove impossible.

And finally, any future distribution policies should make clear not only who is benefiting from them, but also what social and fiscal burdens they may imply.

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Distribution issues are moving into the center

“Our most important problem is growing inequality, not just in terms of income and wealth, but also in terms of social appreciation.” – Hubertus Heil (SPD, parliamentary debate on the federal budget for 2021, 11 December 2020; own translation)

COVID-19 pandemic and energy policies intensify discussion about fair distribution of wealth

Social inequality is one of the most important issues for voters. The discussion has intensified as the COVID-19 pandemic has placed an additional burden on low-income households and the goal of climate neutrality by 2045 will entail additional costs and expenses in the near future. According to a report by the Institute of Economic and Social Research (Wirtschafts- und Sozialwissenschaftliches Institut, WSI), lower-income households have suffered the largest income losses due to the pandemic by far.¹ In addition, it has become clear just how important many occupations in the nursing, care, and education sectors are. Since workers in these jobs often do not earn very much, people have started to ask questions about what a fair wage for these occupations might be in view of their overall contribution to society (“systemic relevance”). The federal government has adopted a care reform, which foresees that care and nursing institutions will be required to pay their workers at least the wage agreed in collective wage agreements from September 2022.² Moreover, research studies for several countries have shown that loose monetary policies may have increased the degree of inequality recently because wealthier individuals benefit more from valuation gains in the financial markets than lower-income households. The latter rely mostly on employment effects to improve their incomes.³

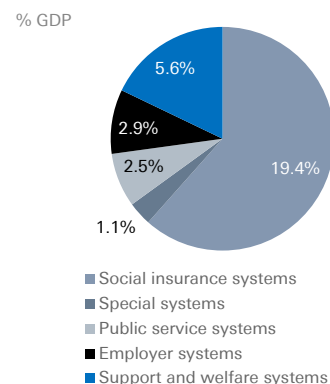
Surveys reflect concerns and perception of injustice among Germans

Against this background, it is not surprising that, despite the comprehensive social security system, poverty and social inequality have been the most important concerns for Germans for years now. Only in Latin America, Hungary and Russia are concerns about these issues higher.⁴ Just about half of all Germans think their own income is fair. In general, Germans regard lower incomes more often as unfair than higher incomes. This suggests that most people agree with appropriateness and performance principles.⁵ This general perception currently translates into significant support for more state-focussed parties (SPD: 21%; Greens: 19%; Left: 7%⁶), whose programs include major redistribution plans.⁷

Political issues always entail distribution issues

At the moment, the German government spends about 31.5% of total GDP on social transfers, which help to reduce aggregate income inequality by c. 44%.⁸ Roughly two-thirds of the expenditure goes to social security payments, with half of that amount being used for pensions.⁹ Apart from direct redistribution measures, the

Figure 1: Structure of social budget, 2019



Source: BMAS

1 WSI (2020). Verteilungsbericht 2020.

2 ZEIT ONLINE (2021). Regierung einigt sich auf bessere Löhne für Pflege. See: [Altenpflege: Regierung einigt sich auf bessere Löhne für Pflegekräfte](#), ZEIT ONLINE, 30 May. Download on 16 July 2021.

3 Anderson et al (2021). Monetary Policy and Inequality; Dolado et al (2021). Monetary Policy and Inequality under Labor Market Frictions and Capital-Skill Complementary; Schularick et al (2021). Monetary policy and racial inequality.

4 IPSOS (2021). What worries the world, June 2021

5 Statistisches Bundesamt (2021). Datenreport 2021. Sozialbericht für Deutschland.

6 Sonntagsfrage, Forsa, 18 August 2021.

7 Although the Greens are probably gaining popularity mainly because of their climate policy positions, we rank them here together with the SPD and the Left because of their social policy agenda.



government shoulders important expenditure for public goods such as education, culture or sports, which are used to a different extent by different groups in society. Public spending on education alone amounted to about 5.2% of GDP in 2018. Moreover, some fees for publically-provided services depend on household income. The provision of public goods also entails additional distribution effects which are difficult to gauge. Ultimately, almost all political issues come down to distribution issues, which is why fairness is such an important concept. The debate usually focuses on the beneficiaries; the question of who has to pay for the benefits is often neglected or asked only by the opposition.

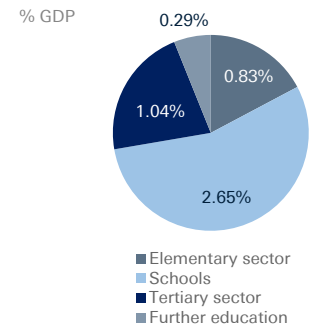
Perception of the degrees of inequality may be distorted ...

Despite the vast social state, Germans are concerned about fairness issues. This may be due to perceived inequality. However, as studies have shown, this perception is not fully free from cognitive dissonance. The divergence between perceived and measured income inequality is an international phenomenon, which cannot be fully explained today. As a rule, people in countries with more pronounced perceived inequality tend to be more critical of differences in income.¹⁰ In Germany, people tend to underestimate the size of the middle income class and overestimate the size of the lower and higher income classes. This is surprising, seeing that persons in the lower income deciles tend to overestimate and higher income earners tend to underestimate their respective positions on the income scale; rather both groups put themselves in the middle.¹¹ This may be one explanation for the fact that people's general preferences and their assessment of their own, personal situations diverge. For their 2016 study, Engelhardt and Wagener asked participants to gauge their own positions on the income distribution scale and to explain their redistribution preferences. Once participants had been informed of their own positions on the scale, those who found themselves to be net payers reduced their preference for redistribution.¹² It seems likely that, in making these assessments, people rely on the evidence of their own (often homogeneous) social environment, rather than seeing the complete picture.

... and contributes to social segregation and political polarization

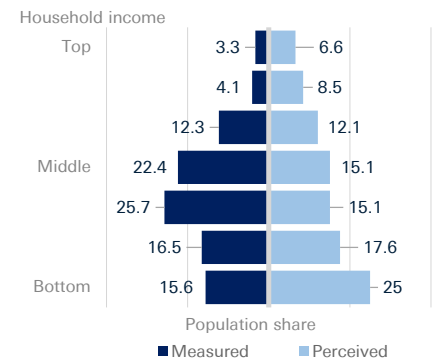
As a matter of fact, studies suggest that rising economic inequality may promote segregation, polarization and extremism and thus endangers political stability. Individuals increasingly attach more importance to their position on the distribution scale, and they identify their peer groups more and more on the basis of opportunity or income-based indicators. The emergence of more homogeneous groups may fuel populist "us vs. them" world views and intensify self-segregation on the basis of social environments.¹³ Political phenomena such as the gilets jaunes, Black Lives Matter, Brexit or the surge in populist parties may be regarded as an expression of discontent with perceived growing inequality: people may feel that other groups are being preferred at the expense of their own. In the long run, inequality may therefore lead to political fragmentation and increase support for extremist parties or policies.

Figure 2: Public expenditure on education, 2018



Source: BMBF

Figure 3: Inequality in Germany



Source: Niehues (2014)

8 Measured by the relative difference in the Gini index between market and disposable income.
 9 BMAS (2019). Sozialbudget 2019.
 10 Judith Niehues (2014). Subjektive Ungleichheitswahrnehmung und Umverteilungspräferenzen.
 11 Bublitz (2017). Misperceptions of income distributions: Cross-country evidence from a randomized survey experiment.
 12 Engelhardt, Wagener (2016). What do Germans think and know about income inequality? A survey experiment.
 13 Windsteiger (2017). The Redistributive Consequences of Segregation; Dorn et al (2018). Inequality and Extremist Voting: Evidence from Germany.



Incentive problems for policymakers and conflicts between different economic targets

Disagreement and incentive problems lead to policies which focus on symptoms ...

While participants in discussions about a fair distribution of income and wealth usually agree on a number of symptoms, the vast number of available indicators open the door to purely interest-based arguments. But, there is usually disagreement about the causes of unfair distribution and about suitable countermeasures.

During the past two legislative periods, the grand coalition has adopted numerous measures which have increased payments to beneficiaries and/or improved the claims of the target groups. In terms of political economy, short-term redistribution measures appear quite rational. They do not give rise to much conflict at the beginning, and a governing party can “reward” its voters (“rent seeking”). However, they tend to tie up limited financial means for the long term; once a support measure is adopted, it will not be abolished any time soon.

... and prevent the resolution of structural problems

Overall, the structural framework conditions which may enable people to improve their position by their own efforts have remained largely unchanged. These framework conditions include education and training opportunities, a labor market that is fit for the future or the option to find new sources of income, for example. Important investments in schools, administrative structures, infrastructure or the promotion of innovation have been postponed. Had they been made, they might have reduced distribution imbalances and improved the long-term growth potential and the attractiveness of Germany as a business location. The situation is unlikely to change significantly in the future; rather, more heterogeneous government coalitions may make it even more difficult to agree on consistent, future-oriented projects.

Performance incentives or better participation

From an economist’s vantage point, the short and long-term effects on the economy should be important considerations. While different yardsticks may be used to assess redistribution mechanisms, most of them are derived from either performance-related or needs-related criteria. In the former case, a certain degree of inequality is regarded as helpful: it creates incentives for innovation and entrepreneurship and thus promotes growth. Proponents of this concept also point out that (redistribution-related) administrative procedures result in efficiency losses. Supporters of needs-based concepts emphasise that people need a certain level of income to participate in social life and ensure intergenerational mobility. Excessive inequality may result in the loss of talents because young people cannot get an adequate education and discover their talents simply for lack of money. Both concepts are ultimately compatible; the main issue of the discussion is where the optimal balance is and which policies might bring us there.

Social transfers may stabilize demand, but weaken innovative momentum

High inequality may have a negative impact on overall demand, as higher-income households tend to save a larger share of their income. In turn, this may weigh on corporate earnings, as economies of scale decline, and lead to job shedding. In a globalized world, savings may also be invested abroad and not be available for domestic investment efforts any more. On the grounds of this reasoning,



redistribution policy relies on social transfers to stabilize demand in the short term. By doing so, however, it may squeeze out demand for innovative, higher-quality products in the long run.

Trade-offs between goals are often ignored in the political discussion

There may be an “optimal” level of inequality or transfer spending in economic theory at least. However, this optimal level probably varies with time and the rate of growth. The results of any efforts to determine this by empirical means will depend on the method and on the initial assumptions; moreover, these tend to be heavily influenced by the analyst’s interests. Economic trade-offs usually do not play a major role in the social or political debate anyway. In most cases, people focus on arguments which support the current redistribution goal (“motivated reasoning”). Let us, therefore, consider the evidence for now.

The current situation: Worldwide and in Germany

Asia’s rise reduces inequality at the global level

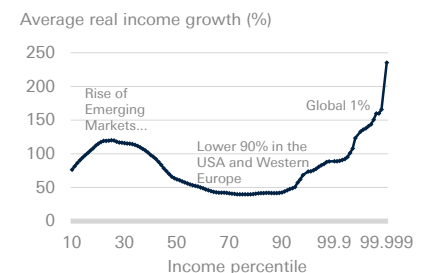
Distribution issues are usually discussed in a national context. That is why people often overlook the fact that, at the global level, income inequality has clearly declined as China and other Asian countries have caught up over the last few decades. The global Gini coefficient fell from 0.69 in 2003 to 0.65 in 2013. During the same period, global median income (as measured by purchasing power parity in real terms) doubled from USD 1,090 to USD 2,010.

Asian medium and high-income earners have gained at the expense of lower and medium-income households in the developed markets

Inequality researchers, led by Thomas Piketty, have shown that, worldwide, the lowest 40% and the top single percent of global income earners gained most between 1980 and 2016. The former group mainly consists of Asian citizens. Asian countries have benefited enormously from globalization, which helped to industrialize their economies and create new jobs. During the past 30 years, this effect has lifted millions of people out of poverty. Only the global top percent of income earners has benefited even more strongly from global value creation chains and international capital markets. Lower and medium-income earners in the industrialized countries benefited least.¹⁴

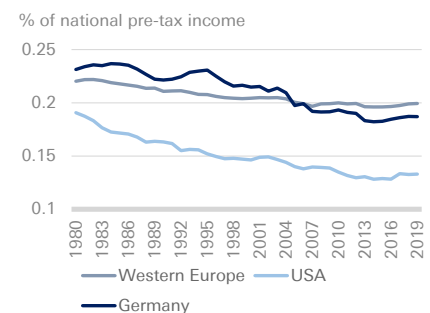
While global inequality has declined as global incomes have converged, inequality within individual countries has increased. Emerging Asian countries have seen the emergence of an urban middle class, which earns much more than the rural population. At the same time, medium and low-income earners in western countries suffered relative losses. The share of the bottom 50% in aggregate national income fell across almost all countries. In Germany, it declined by four percentage points, to 19%, between 1980 and 2019. In contrast, the top 10% increased their share in national income. In Germany, it is about 38% right now. Income earners between the 50th and the 90th percentile receive about 44% of total income in Germany. At the same time, western European countries were overall more successful than the US in controlling the divergence of pre-tax income. The most recent major drift in income distribution took place in 2013.¹⁵

Figure 4: Income growth of the global income groups



Source: WIR (2018)

Figure 5: Share of the bottom 50% in income



Source: WID

14 Alvarado et al (2018). The Elephant Curve of Global Inequality and Growth.

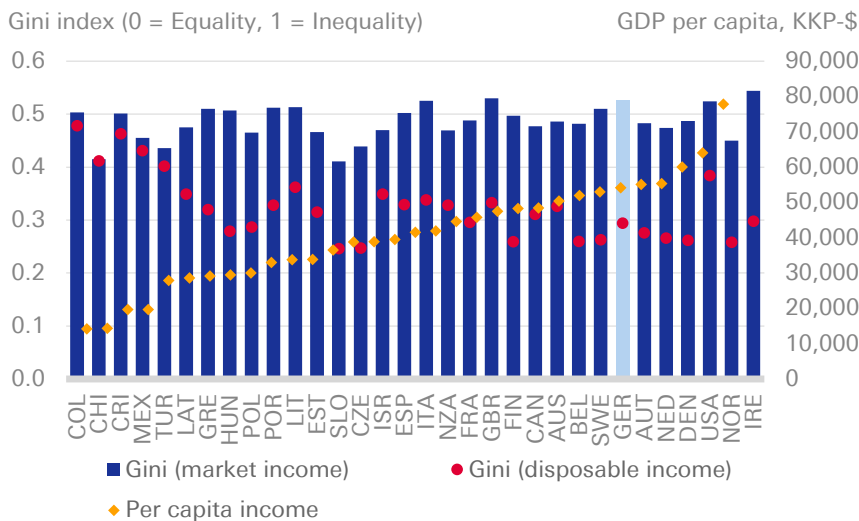
15 Alvarado et al (2018). World Inequality Report 2018.



Industrialized countries in continental Europe redistribute most

A comparison of the OECD countries shows that income inequality, as measured by the Gini index, is relatively high in Germany, at 0.53 points. Only the Anglo-Saxon economies (the US, the UK, and Ireland) and Italy register similar index values, and Ireland is the only country which has implemented redistribution measures on a comparable scale. While the spread between market incomes is less pronounced in Germany's continental European neighbors, redistribution efforts are similar. Non-European countries with lower per-capita incomes redistribute less, probably because they simply lack the funds to do so. However, there is no direct relationship between the (un-)equal distribution of market incomes and the general standard of living. Rather, the distribution of disposable incomes depends on a country's social security system. The degree of redistribution obviously depends on people's preferences about the government's role in the (re-)allocation of income.

Figure 9: Income inequality and wealth in the OECD, 2017



Source: SWIID, World Bank

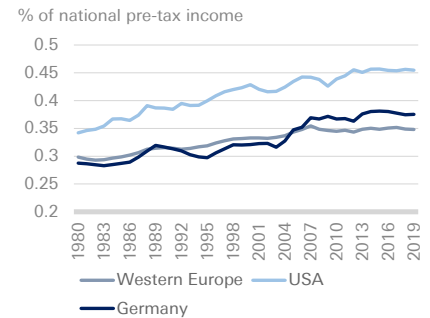
Income inequality in Germany roughly unchanged since 2005

As measured by the Gini coefficient, the inequality of market incomes in Germany – a country which considerably benefits from the international division of labor – rose from 1973 until about 2005.¹⁶ However, increasing redistribution efforts have kept disposable income inequality relatively stable or even reduced it for a long time.

During the past 15 years, i.e. since 2006, the Gini index for market incomes has been relatively steady at about 0.55 points, apart from a jump in 2013. The initial increase in market income inequality, which probably stemmed from the Hartz reforms implemented in 2005 in the framework of the Agenda 2010, was offset by additional transfers and favorable labor-market trends, which cushioned the increase in inequality at the level of disposable incomes. As the Gini index shows, income distribution has not changed much in recent times, at least not at the aggregate level.

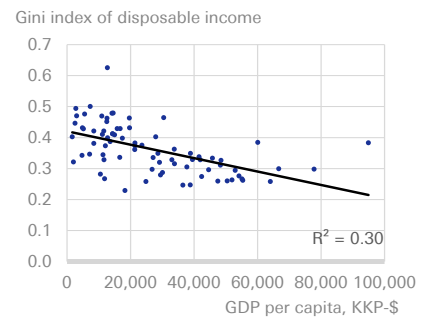
¹⁶ The Standardized World Inequality Database (SWIID) provides the most comprehensive internationally comparable estimates of income inequality at the country level.

Figure 6: Share of the bottom 50% in income



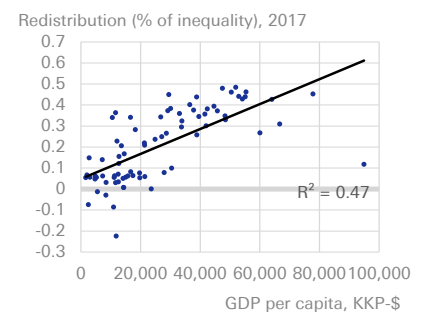
Source: WID

Figure 7: Income inequality and wealth



Source: SWIID, World Bank

Figure 8: Redistribution and welfare



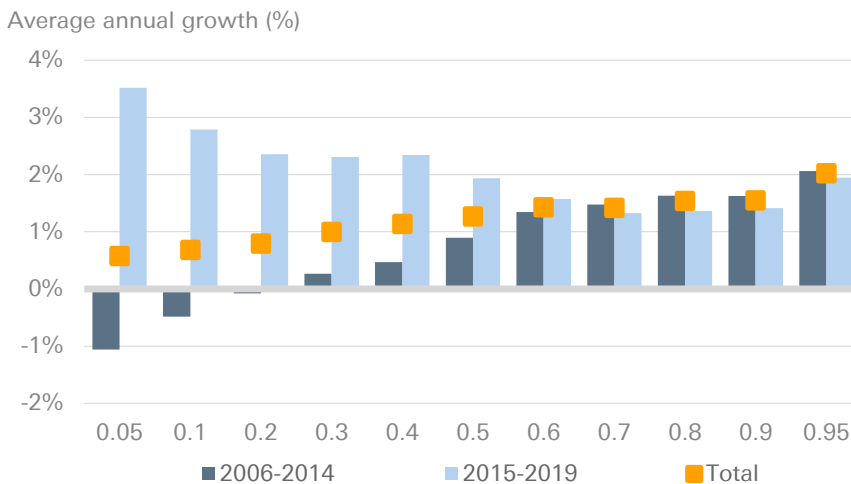
Source: SWIID, World Bank, Deutsche Bank Research



Incomes have diverged, but lower income earners have recently caught up

Real disposable incomes have increased across all deciles since 2005. Two different stages are clearly visible. The period from 2006 until 2014 was characterized by increasing divergence. A catch-up process started in 2015, during which the incomes of the lower half of the distribution range rose more strongly – on average by about one percentage point. Still, this difference in growth rates had almost no impact on the distribution of overall disposable income.

Figure 11: Real income growth by percentiles, 2006-2019



Source : Eurostat, Deutsche Bank Research

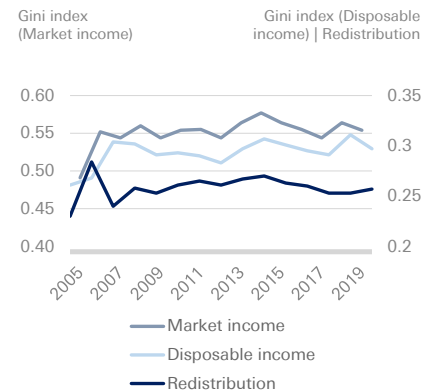
Government support ensured that COVID-19 did not have a major impact on income distribution in the short term. In the longer run, inequality threatens to increase

The COVID-19 pandemic completely changed the professional lives of many people. Many retailers and workers in the restaurant and cultural sectors had to put their businesses or work on hold. Due to their professional or social situations, people at the lower end of the income scale suffered most from the measures to combat the pandemic. This is particularly true for single parents, migrants and people in jobs which are not subject to social security contributions, shutting them off from short-term working benefits. The government has implemented large-scale measures to offset the income losses in the short term. According to a study, the two lowest income deciles benefited over-proportionally.¹⁷ In the long run, however, inequality is threatening to increase due to fewer training and education opportunities, accelerated structural change and permanent job losses.¹⁸

Drivers and influencing factors

Actual income distribution is heavily determined by a country's social system, its specific economic structure and the distribution of production factors which has developed over time. This means that there are many and complex drivers behind income (in-)equality.

Figure 10: Inequality in Germany



Source : Eurostat, Deutsche Bank Research

17 Bruckmeier et al (2020). COVID-19 Krise: Kein Anstieg der Einkommensungleichheit.

18 Leopoldina (2021). Ökonomische Konsequenzen der Coronavirus-Pandemie.



Production shifts and technological change, ...

Against the background of globalization, parts of the value chain and numerous jobs have been shifted abroad. Technological progress has enabled companies to automate production. These two factors have reduced demand for low- to medium-qualified workers in manufacturing,¹⁹ whose numbers declined considerably during the 1990s until about 2005. In contrast to the US, this downtrend in Germany was halted, not least by an increase in exports to China. From 2006, employment in the services sector has risen strongly, above all in part-time jobs. This development seems to have contributed to polarization in large cities.²⁰ One reason for increased wage spread within sectors is that highly productive and innovative companies tend to offer their employees better pay than their competitors. In addition, new jobs created by innovative procedures often focus on more complex and better-paid activities.²¹

... declining trade union power, ...

In addition, declining trade union membership and the shrinking scope of collective wage agreements have probably had a negative impact on wages. Trade unions which belong to the German Trade Union Confederation (DGB) have seen the number of their members decline by about 40% since 1994, to 5.8 million. During the past 20 years, the percentage of employees who are not covered by a collective wage agreement has almost doubled in western Germany, from 29% in 2001 to 47% in 2020. In eastern Germany, it has risen from 43.8% to 57% during the same period. At the same time, trade unions' bargaining power was limited further as companies had the option of shifting production abroad.²² The introduction of a minimum wage in 2015 helped to counteract the decline in bargaining power of low-income earners in particular. In fact, the minimum wage is behind a relatively large share of wage increases in the years after 2015.²³

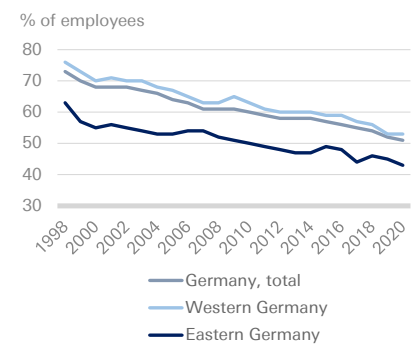
... and more immigration has put pressure on lower incomes

Developments in the low-income segment have been reinforced by the fact that increased immigration from eastern Europe during the 1990s and early 2000s has increased the labor supply and led to additional wage pressure. Refugee arrivals, particularly from 2015, are likely to boost this effect in the medium term. This applies not only to current workers, but also to the second or third generation, who tend to have considerably more limited access to (higher) education. Moreover, trade union membership is less common among migrants.

Financial globalization ...

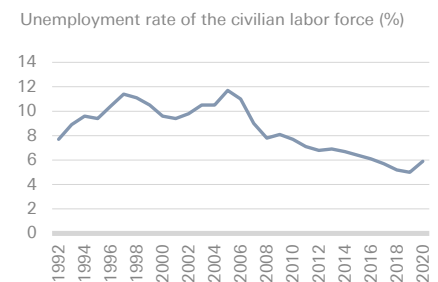
Globalization has not only had a direct impact on the labor markets, but also reduced the leeway of state tax and transfer systems. Capital market liberalization has increased capital mobility and potential returns and put the tax systems under pressure. Against this background, western industrialized countries have reduced corporate earnings taxes and replaced them by higher consumption taxes. This puts a disproportionate burden on lower income earners, who spend a larger share of their incomes on consumption. In addition, higher social security contributions have eaten away at the disposable incomes of medium-income earners.

Figure 12: Coverage of collective wage agreements in Germany



Source: WSI, IAB-Betriebspanel

Figure 13: Unemployment



Source: Federal Statistical Office

19 Geishecker (2002). Outsourcing and the Demand for Low-skilled Labour in German Manufacturing: New Evidence.
 20 Dauth, Findeisen, Suedekum (2017). Trade and Manufacturing Jobs in Germany; Dauth (2014). Job polarization on local labor markets.
 21 Cortes et al (2020). Technological Change, Firm Heterogeneity and Wage Inequality.
 22 Felbermayr, Baumgarten (2014). Increasing Wage Inequality in Germany. What Role Does Global Trade Play?
 23 Bossler, Schank (2020). Wage Inequality in Germany after the Minimum Wage Introduction.



... and socio-demographic factors put income distribution under pressure

Beyond the changes to economic structures since the 1980s, social factors have played a major role. The education offensive has considerably increased the number of university students. In the short term, the resultant reduction of income during university time has increased inequality within the age cohorts. In the longer run, however, higher income gains and the option to save money and receive investment income should have lifted the incomes of university graduates. In addition, the decline in the average household size has probably contributed to growing income inequality. The number of singles and single parents has increased since the 1990s. According to the Annual Report 2017/2018 of the German Council of Economic Experts (SVR), income inequality among single-person and single-parent households is more pronounced than among couple households.²⁴

Where should policymakers start?

Our education system should open up better opportunities ...

A good education enables people to choose from a broader range of professional options, to accept more challenging work and to generate innovative ideas. Quite apart from offering a chance for higher incomes, better education is increasingly becoming a necessity. Higher qualifications are needed to get well-paid jobs in sectors which may be just emerging. Nevertheless, a good education hinges more on pupils' origins and social environment in Germany than in many other countries.²⁵ Even before the COVID-19 pandemic, the education system had to cope with numerous challenges. According to the Federal Ministry of Education and Research, the share of secondary school students has remained at 38% (grade 8) since 2010. In particular, providing immigrant children with a qualified education is proving a challenge. In 2018, the percentage of children with an immigrant background amounted to just 5% in secondary schools, compared to 25% in secondary modern schools (Hauptschulen).²⁶ The pandemic has reinforced family-related inequalities in education and may have a long-term negative impact on income growth. Any potential countermeasures fall into one of two categories. The first category rewards individual performance and initiative and relies on individual initiatives, such as mentoring or additional exercise, the second offers transfer payments and grants to shoulder financial burdens during the education and qualification stage. In addition, overarching structural measures are necessary to ensure that lessons cover future-oriented topics and to improve the quality of teaching.²⁷ Policymakers agree on the general issue, but disagree vehemently about the best way to achieve it, particularly since the two categories of countermeasures mentioned above are based on different concepts of fairness.

... and thus ensure growth and more income equality in the long run

Education is a major determining factor for income later in life. Compared with other countries, Germany has considerable catch-up potential. Across the OECD countries, full-time employees tend to earn 54% more than their peers without tertiary education on average. In Germany, the difference amounts to 60%. At the level of the national economy, better qualification opportunities increase the supply of qualified labor. As a result, the quality of labor improves in general and across

24 Sachverständigenrat (2018). Jahresgutachten 2017/2018.

25 BMBF (2020). Bildung in Deutschland 2020.

26 BMBF (2020). Bildung und Forschung in Zahlen 2020.

27 The Leopoldina Academy of Sciences has most recently made extensive proposals. Hanushek, Woessmann (2020). The economic impacts of learning losses.



labor-market segments. This will reduce education returns and income inequalities between different degrees of qualification. Ideally, education makes pupils curious and creative and gives them confidence to take on new tasks and responsibilities. In fact, employees increase their incomes to a large extent by being promoted during their first years of work, i.e. when they enter the labor market and are full of energy after having graduated.²⁸

In addition, the number of company founders is higher among university graduates than among people with other degrees of qualification. In any case, the process of establishing a new company needs to be streamlined. Compared to other countries, the start-up ratio is very low in Germany. Surveys point to administrative hurdles, a lack of funds and insufficient preparation in society.²⁹ This becomes evident from the fact that, according to a GEM expert survey, maintaining a family tradition is the most important reason for founding a company. Overall, education and training is key for generating opportunities for social mobility on the basis of qualified employment and innovative spirit. That is it makes sense to improve the quality of school education in order to promote cognitive potential early on and enable pupils to obtain good qualifications without quality losses.

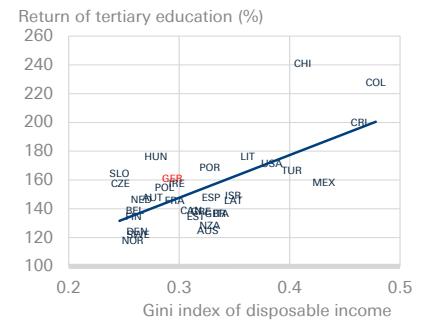
Intervention in the wage structure only as a last resort

In the future, demand for lower-qualified labor for manual, non-scalable services will increase. The COVID-19 pandemic has shown us once again just how important many jobs in this sector are. Wage adequacy is becoming an issue of fairness in these segments.

The government can take direct or indirect measures to influence wages. The most visible direct tool is the minimum wage, which was introduced in 2015 and currently amounts to EUR 9.50/hour. While a negative impact on employment had been feared, any such effects have been small so far. Minimum wages make sense if employee bargaining power in wage negotiations is structurally inadequate to obtain wages that reflect their productivity. The government can also use wages in the public sector to intervene in a more indirect way. This applies mostly to sectors in which the government directly competes with private employers, such as education, professional training or healthcare. Higher public-sector wages may lift wages in the private sector. Alternatively, the government can create incentives in certain sectors by requiring compliance with collective wage agreements before placing orders with the firms.

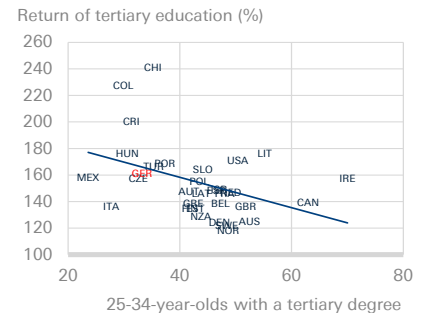
Consumer willingness to pay for certain products or services shows whether people are willing to accept a sustained wage increase beyond the level of (hard to measure) productivity in any given sector. After all, companies can only pay higher wages in the long run if they can obtain the necessary prices for their products on the market. As long as prices are a key criterion for consumption decisions, wage pressure in the relevant sectors will continue. If policymakers recognise this “natural” divergence, they will need to tackle the primary income distribution and intervene directly in the wage structure. However, doing so involves a tightrope walk in terms basic elements of regulatory and institutional policy (Ordnungspolitik).

Figure 14: Inequality and return of education



Source: OECD, SWIID

Figure 15: Share of academics and return of education



Source: OECD

28 Bayer, Kuhn (2019). Which Ladder to Climb? Decomposing Life Cycle Wage Dynamics.

29 KfW-Gründungsmonitor (2020); Global Entrepreneurship Monitor (2020).



Adjustments to primary income distribution via the tax and transfer system must become more effective

If measures addressed to improve primary distribution are not (or cannot) be effective, the government can use transfers to smooth out inequality in disposable incomes. In this case, the trade-off is between establishing sufficiently generous measures and running the risk of adverse incentives. Any such measures should therefore only supplement efforts to improve primary distribution. As individual and social circumstances are highly complex, it may be quite difficult to direct support to those who really need it. In addition, it becomes more difficult for both sides to touch the benefits and examine the applications. Broad-based, indiscriminate distribution creates incentive problems and free-riding, which is why taxpayers as a rule do not accept this approach.

Against this background, numerous well-meant individual measures for low-income earners may prove counterproductive due to the complexity of the situation. Policymakers should therefore focus not on redistributing more money, but on organizing the redistribution process more effectively and on offering better incentives for additional income earning. In 2018, the ifo institute conducted a study which found that the effective marginal burden for lower-income families ranges between 80% and 100%. This means that every additional euro earned improves their income only by 20 cents at most. The remainder is eaten up by implicit taxation or the loss of other income. Depending on individual family circumstances, households with gross incomes between EUR 1,750 and EUR 2,500 may not benefit at all from additional earnings because their support payments are reduced (too quickly) or offset each other.³⁰

In view of this complexity, simple and easy-to-understand concepts appear to make sense. Liberal policymakers often propose a negative income tax, in line with the ideas of Milton Friedman, for example. The concept foresees that, if incomes are below a set threshold, a tax rate is determined for the difference between the actual income and the threshold. The resultant amount is then paid out as additional income by the government. Supporters of the concept argue that there is no negative incentive which keeps people from working, as households will see their incomes rise in any case. In addition, companies will not have to shoulder additional burdens. And, the negative tax will not result in active labor market intervention. Any adjustments to general wage development will be relatively simple. However, the determination of the threshold may lead to considerable political challenges.

A universal basic income would be a more radical option. Under such a scheme, everybody, regardless of their needs, will receive a fixed sum of money. The idea of supporting a clear target group is evidently abandoned. The potential impact of the system is unclear. On the one hand, there would probably be some free-riding, with recipients reducing their working hours in favor of free time. On the other, a universal basic income may give people the option of undergoing new or additional training or founding a business, which they would not have had otherwise because these activities entail temporary income losses. Moreover, it is unclear to what extent a per-capita free income would actually offset the loss of other benefits; proponents of the idea argue that this would be the case. According to an OECD Policy Note from 2017, a budget-neutral universal basic income would bring almost no advantages for lower-income households.³¹

30 Bruckmeier et al (2018). Mehr Arbeitsanreize für einkommensschwache Familien schaffen.

31 OECD (2017). Basic income as a policy option: Can it add up?



Ultimately, disentangling the social transfer system will be a major effort, which will not be achieved by following ideologies, but by using pragmatic solutions, by assessing existing and planned measures thoroughly and independently and by paying particular attention to mutual side effects.

Conclusions

In a historical comparison, market income inequality is relatively pronounced in Germany due to a number of social and economic developments in the late 20th century. The government is taking large-scale redistribution measures to remedy the situation. In contrast to public perception, measured inequality has been largely stagnant since the mid-2000s. Nevertheless, calls for public redistribution are becoming louder, probably due to perceived inequality and the inflationary and opportunistic use of the word “unfairness” by numerous interest groups, who rely on it as an argument of last resort to justify their demands. In addition, unequal education opportunities, limited social mobility and the general polarization of the political debate are likely to play a role.

From our vantage point, it would make sense if the government offered people incentives and opportunities to take fate in their own hands and rely on education and entrepreneurship to catch up. A more balanced distribution of primary incomes should be the result of good policies, which provide incentives and support catch-up processes within societies. This is fairer to both the affected income earners and taxpayers and, in the long run, society as a whole should benefit more from such an approach than from ad-hoc redistribution based on clientelism and involving excess bureaucracy.

If that is not possible or if such efforts come too late, the government may actively influence the distribution of income. However, an ex-post redistribution of incomes entails a number of risks, such as inherent losses of efficiency due to increased bureaucracy, misallocation or adverse incentives – and, of course, the temptation for policymakers to push through clientele interests. Policymakers should disclose the intended positive and negative distribution effects when deciding on major distribution-policy efforts. Clear, simple guidelines would help. Independent institutions should assess the redistribution impact and call on policymakers to correct their course, if necessary.

During the coming decade, digitization and artificial intelligence, the shift towards a carbon-neutral society and the retarding impact from globalization and shrinking workforces will have asymmetric effects and trigger new and probably more pronounced distribution conflicts. In particular, these trends are likely to dampen potential growth rates, which means that income gains available for redistribution will become smaller. Policymakers should find it more and more difficult to meet the demands of an ageing society which desires to maintain the status quo without overtaxing the system.

We would like to thank Henry Minör for his valuable contribution.



Figure 16: Redistribution: An issue of political philosophy

The assessment of the “optimal” degree of inequality is based on valuation judgements and raises the question of fairness and justice. From an economic vantage point, the concept of utilitarianism has prevailed. Utilitarianism holds that actions which ensure the maximum of happiness for a maximum number of people are just. Wellbeing should be maximized at the level of society as a whole. In practice, this translates into striving for the highest possible GDP growth rate. However, the assessment always takes place at the level of society as a whole and does not take into account changes for individuals or individual groups. According to the classical theory, maximum happiness is achieved if everybody can act rationally and freely in their best interests.

This idea implies that any government interventions in the initial distribution of income should be as limited as possible because every intervention entails coercion and thus limits liberty and potential at the individual level. A less radical version of the concept says that the government should provide framework conditions which ensure that citizens enjoy maximum liberty. This will increase innovativeness and economic performance.

During the last third of the 20th century, behavioral economics have increasingly raised the question of whether people really act rationally. In fact, people may be subject to cognitive dissonance, behave altruistically (at least to some extent) and appreciate reciprocity and sociality. Some examples of cognitive dissonance are the increased preference for current gains, erroneous estimates of future returns or the disproportionate loss aversion linked to any estimates of expected returns. People tend to spend part of their income and time on social wellbeing and are strongly influenced by affectivity and social dynamics. Moreover, in terms of political economy, the freedom of individuals or groups may be structurally undermined by implicit, asymmetrical power relationships, which should be adjusted.

As a consequence, the government should play a much more active role and engage in targeted interventions in order to provide incentives to correct “irrational” behavior. Most societies, including Germany, have accepted this concept.

The ultimate question is to what extent the (economic) freedom of individuals should be limited in order to correct negative results of the production process that affect certain groups of society.

Figure 17: Method to measure income inequality

There are several methods to measure income inequality. Two questions are key: What is being measured? And how is it being measured? The first question refers to the type of income which is to be measured. As a rule, researchers focus on market and net household (or disposable) income.

Market income, as a gross concept, covers income from self-employment, employment, property and private transfers. Net household income refers to disposable income after taxes and state transfers.

The second question refers to the methodology. At the international level, the Gini index (or Gini coefficient) has become the standard tool to measure inequality. The index takes a value between zero and one. Zero means that incomes are completely equally distributed, one means that one single person reaps all income. The advantage of the Gini coefficient is that it reflects the complete distribution of income in a single figure.

The Gini coefficients for market and disposable incomes, or, more accurately, the difference between the two coefficients, provide a measure of the redistribution impact of taxes and transfers.

Alternatively, the ratios between the individual income percentiles or the shares of certain percentiles in overall income may be used. They show how “flat” distribution is at any given point of the curve and to what extent individual income segments benefit from value creation.



Appendix 1

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