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Guest Editors' Introduction for Special Issue on "Inequality: mechanisms and effects"

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EDITORIAL

Mechanisms of inequality: an introduction

1. Understanding economic inequalities

Inequality is a multidimensional phenomenon involving both economic and social processes, and regulated by a variety of political processes and policies. Measures of economic inequality, in terms of income and wealth, however, provide an effective picture of broad patterns of inequality. Between the end of the 1970's and mid-2000's, such indicators have documented a general growth in inequalities within and between countries, highlighting a major aspect of economic development over that period.

Considering inequalities in household disposable income, measured by the Gini coefficient, countries such as Germany, Spain, Greece, Ireland, the UK, Italy, Poland and Portugal, as well as the USA, Canada and Japan, have now a value around or above 0.30, a threshold of high income inequality among households; Denmark and Sweden, however, remain the least unequal advanced countries, with Gini values around 0.23. Almost all OECD countries have experienced a growth in such measures, with particularly strong increases in the USA, Finland, Norway, Germany, Portugal and Italy. A rise in income shares by the top quintile of the income distribution – the richest 20% among households – is a key determinant of greater inequalities over the last decade in Finland, Norway, Sweden, Denmark, Germany, Austria, Italy, as well as in the USA and Canada. The Organisation for Economic Co-operation and Development (OECD 2008: 27–31) showed that the average annual growth of real incomes of the top quintile has been twice as large as that of the bottom quintile – the poorest 20% of households – in Finland, Sweden, the UK, Germany, Italy, as well as in the USA. The International Labor Organization (ILO 2009) believe that the recession that has followed the international financial crisis of 2008, is bound to further exacerbate income inequalities and to increase the problems of unemployment and poverty in Europe, making the already high social costs of inequality, even higher.

Inequalities in disposable income are the result of changes taking place in the labour market, in other markets, in a series of social variables and in the redistributive activity of the welfare state. Our understanding of this chain of events and of the role played by each factor involved is by now supported by substantial evidence.

First of all, labour market mechanisms influence wage dispersion among workers on the basis of education, skills, professional groups, types of labour contracts, presence of unions and, more generally, through the regulations of labour markets. These outcomes are, in turn, shaped by far-reaching economic processes – such as technological change and globalisation – and by institutional change in the labour market. In the case of transition economies, 'internal' factors of reforms – such as

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price liberalisation and privatisation – may play a specific and important role in the rise of inequality.

The relationship between innovation and inequality can hardly be reduced to the Skill Biased Technical Change hypothesis. Advanced countries did not experience a general upskilling as a result of technological change; rather, a strong polarisation of the professional structure of employment has emerged in Europe, with jobs offered mainly to managers and professionals and to unskilled manual workers, while job losses have mainly concerned clerks and craft manual workers. A similar polarisation is evident in the distribution of wages in Europe, as relatively few top managers (classified as employees and not as capitalists) and professionals have obtained unprecedented high incomes. Conversely, the lower tail to the wage distribution has been further lowered by the diffusion in several countries – Italy, Spain, Ireland and Germany in particular – of part-time, temporary and outsourced work; this is the result of policies of precarisation of employment that have led to the emergence also in Europe of 'working poor', i.e. people with jobs who remain in conditions of poverty. Patterns of wage polarisation also differ across industries, with the strongest differences between compensations of high and low skilled workers in the sectors with high job growth, relevance of workers with university education, and product innovation. Increasing international integration – through trade, foreign investment and cross-border organisation of production – has further contributed to such labour market outcomes, especially in some European countries.

A second key process involves the functional distribution of income between wages, profits and rents. As a result of changes in labour relations and in the balance of forces between labour and capital, most European Union (EU) countries have experienced a significant reduction of the labour share in gross domestic product (GDP) from the mid-1970's to mid-2000's, and since 2003 one third of European workers has experienced a decline in real wages. A major problem is the ability of labour to capture an adequate share of productivity gains, often resulting from technological change or international production systems; since 2003 almost two thirds of European workers saw their wages growing, on average, less than their labour productivity.

Market income inequality – i.e. inequality in household income measured before the redistributive action of the state – has been negatively affected by these developments due to the greater inequality in the distribution of capital incomes (profits and rents). Other factors making for a higher market income inequality have been the growing importance of self-employment income – itself rather unequally distributed – and some social variables like the composition of households, the number of workers per household and gender disparities.

In order to assess inequalities in terms of disposable income, we need to take into account the role of the state, acting through taxation, social transfers and the provision of in-kind services. Therefore, the third issue to be considered is the redistributive activity of the welfare state. National experiences widely differ. Nordic welfare states are very effective in reducing market income inequality while a much weaker redistribution takes place in Mediterranean countries. However, assessments are made difficult by the problems in estimating the impact of in-kind transfers.

The declining redistributive effect of the welfare state can be traced back, at least partially, to the acceptance by policy makers of the idea that progressive taxation is an obstacle to economic growth in a globalised world. A reinforcing factor may have been the inadequate design of social expenditures, as the adoption of selective measures based on means-testing, was not always effective.

While all these developments relate to 'within countries' inequality, differences 'between countries' and global inequalities are also very high and should be the object of a deeper analysis. Trade and economic growth have produced weaker – and less generalised – effects than expected on the process of convergence.

In the longer term, the intergenerational persistence of inequality emerges as a major issue; income disparities across generations in several countries are highly related to current inequalities, showing a persistency stronger than expected by the advocates of social mobility through 'equal opportunities' and market processes. All these mechanisms do not operate in isolation; for instance, welfare expenditures in education may alter, in the medium term, the supply of skilled workers and this, in turn, may change the degree of wage dispersion in the labour market.

Viewing inequality in disposable income as a result of processes involving markets, society and redistributive policies is not enough, however, to explain the *mechanisms* leading to inequality and its persistence. This is a much more complex challenge, for which we still lack a coherent and general model, having however several explanations of specific aspects. This issue of the *International Review of Applied Economics* aims to highlight a number of mechanisms that lead to economic inequalities, using models and empirical analyses that provide evidence on their role, relevance and effects. Such studies may contribute to a comprehensive understanding of the processes at the roots of economic inequalities.

2. In search of the mechanisms of economic inequalities

This issue collects investigations of various dimensions of inequality, exploring the different mechanisms involved, the major effects and some policy implications.[1] First, differences between countries in the impact of trade on per capita incomes are addressed in the article by Francisco Serranito on *Trade, catching-up and divergence.* Challenging the mainstream view that associates trade with convergence among countries in their per capita incomes, the article shows that for most developing countries – especially the poorer ones – trade had no effect on growth, and divergence is still the dominant trend.

The impact of increasing international openness in the case of transition economies is investigated by David Barlow, Gianluca Grimalda and Elena Meschi in the article on *Globalisation* vs *internal reforms as factors of inequality in transition economies*. Privatisation, price liberalisation and labour market reforms appear to have driven the rise in within-country inequality in the transition economies of Europe, while the role of rising trade and foreign direct investment appears of limited relevance.

Some of the same transition countries are investigated in the article by Marilena Giannetti, Daniela Federici and Michele Raitano entitled *Migrants' remittances and inequality in Central-Eastern Europe*; the findings show that remittances have a significant role in reducing income inequality and poverty in the countries of origin of migrants, although their relevance is lower than the one of welfare transfers.

The dynamics of wages in the EU's core countries is the object of two articles. *Innovation and wage polarisation in European industries* by Elisabetta Croci Angelini, Francesco Farina and Mario Pianta investigates the effects of technological change on wage inequality between three professional groups within manufacturing and service industries. A high wage polarisation is associated to strong product innovation, job creation and university education, while wage compression is found in industries where the diffusion of new technologies (through new machinery) and medium levels of education prevail.

The growth (or decline) of real wages in European industries is examined in *Poorer workers. The determinants of wage formation in Europe* by Francesco Bogliacino. Technology and globalisation affect workers' bargaining power as increasing wages are found in industries with product innovation and growing demand, while process innovation and greater international openness are associated with a reduction of real wages.

The intergenerational dimension of inequality in European countries is addressed in the article *Persistence of inequality in Europe: the role of family economic conditions* by Maurizio Franzini and Michele Raitano. They show that the income of parents affects the income of sons not only through the effects of education opportunities, but also through a direct influence independent from school achievements. These findings challenge the human capital explanation of inequality persistence and suggest that other factors contribute to reproduce inequalities in European societies.

In the article *National* vs *local funding for education: effects on growth and inequality* by Massimo Giannini, a model is developed in order to test whether different inequality outcomes can be expected when decisions on funding for schooling are taken at either the national or local level; a centralised system is shown to lead to a faster and more equal growth.

Finally, Debora Di Gioacchino and Laura Sabani in *The politics of social protection: welfare state* vs *market regulation* use a political economy model where social protection can be provided either through public transfers in flexible markets or through regulations limiting market competition; results show that voter coalitions are more likely to lead to policy outcomes that restrict markets favouring the *status quo*.

The results of these articles identify, first, the variety of mechanisms leading to economic inequalities, including technological change, globalisation, intergenerational persistence, liberalisation of markets, inadequate redistribution policies, etc. Second, they show the complexity of the relationships involved, as different types of innovation, labour institutions or education policies may have opposite impacts on inequality; moreover, the way such mechanisms operate in specific industries and countries may widely differ, leading to different outcomes. Third, the findings highlight the difficulty of introducing policy changes able to reduce inequalities, due to the complexity of such mechanisms, the conflicting social interests and the rigidity of the political process in most countries.

An awareness of such challenges is an important part of the policy lessons that can be drawn from research findings on the mechanisms of inequalities. On the one hand, in assessing policies on labour markets, international production, privatisation, welfare redistribution, etc., more explicit attention should be devoted to the inequality effects they may have. On the other hand, an awareness of how policies as different as employment contracts, education and taxation jointly affect the outcomes in terms of inequality within countries, may spur policy makers to develop a more integrated approach to action against inequalities.

In fact, an important conclusion we may draw from the investigations published in this issue is that a policy for reducing inequalities and regulating the mechanisms that increasingly produce uneven outcomes in terms of distribution of disposable incomes should become a new major priority for public policy in Europe and in the world.

Notes

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