Contributing Factors of Income Inequality

While globalization has an impact on practically all facets of human life, economic globalization is perhaps the most examined aspect of this world-connecting force. Through increased national trade, foreign direct investment, and technological advancement, globalization is continually guiding the economies of the world into a more complex, interdependent, and profitable state. While financial globalization is generally favorable for all parties involved, not all economic benefits are reaped equally on both national and individual levels. These massive wealth inequalities created at the hands of globalization are most evident when examining the disparities of income growth, which are decreasing *across* nations but drastically increasing *within* nations. Some of the hypothesized causes for this increase in inequality include foreign direct and portfolio investment, changing tax policies, and so forth. While other perceived drivers of inequality are certainly not negligible, it is changing labor demands as a result of technological advancement and the accumulation of wealth, as it relates to capital income, that have had the biggest impact on increasing income inequality in our era.

Globalization has resulted in sweeping industrial and commercial technological advancement which is very much correlated to the rise in income inequality. While such technology is certainly valuable for corporations as it allows for more efficient production and increased quality of output, a large portion of workers are now finding their labor to be either replaceable or less demanded. Simply put, increased mechanization of production has resulted in a “skills gap” that places higher value in high-skilled labor, while decreasing the demand for low-skilled labor which can be replaced by automation.[1] The degree of this decline in labor demand is most drastic in countries with an ample supply of skilled labor.[2] Unfortunately for low skilled workers in these advanced nations, not only is automation employed more frequently as a result of better funding, but these workers must also compete with their low-skilled counterparts in other countries. The United States, generally a global trend setter, is a prime example of this phenomenon of changing labor demands. In the US, where primary income concentration is currently at an all time high, there has been a radical increase in top labor incomes; these include professions such as doctors, attorneys, business executives, and so forth.[3] On the other hand, in his study of over 40 countries, economist Dani Rodrik found that over the last 15 years there has been significant reduction in low skill manufacturing employment as compared to medium and

---

[1] Guillén, Mauro F., and Emilio Ontiveros. *Global Turning Points: The Challenges for Business and Society in the 21st Century*. 2nd ed., Cambridge University Press, 2016. pp. 79

[2] Milanovic, Branko. “Can We Discern the Effect of Globalization on Income Distribution? Evidence from Household Surveys.” *The World Bank Economic Review*, vol. 19, no. 1, 2005, pp. 22

[3] Piketty, T., and E. Saez. “Inequality in the Long Run.” *Science* 344, no. 6186 (2014): pp. 839

high skill employment in the same industries.[4] Decreased income for low skill labor is an economic consequence of its decrease in demand as corporations aren't willing to pay as much for this type of labor. Technological advancement increases the demand for skills, and considering that we are in the midst of what appears to be a technological revolution, rising income inequality as a result of an increasing skills gap is no surprise.

The other most relevant cause of rising income inequality is wealth accumulation as the incomes of rich individuals are supplemented by capital income. Rising income inequality cannot entirely be attributed to the aforementioned technological advancements as not all developed nations, despite having access to the same industrial technologies, see the same drastic levels of income inequality. In fact, while in the last 20 years in the US the income share of the top 1% has more than doubled, in developed regions such as Japan and continental Europe, top income shares have seen much less variance.[5] The other factor that must be taken into account is wealth accumulation and how it contributes to inequality of income through capital income only available to the wealthier portion of populations; since capital income is more concentrated towards the top of income distributions, it undoubtedly augments income inequality. Capital income is income not earned through labor, but earned passively through rents, interest, and dividends.[6] In their analysis of the contribution of capital income to income inequality in OECD nations, economists Johannes Schwarze and Markus Grabka found that capital income accounts for a disproportionately large fraction of income inequality in countries such as Germany and the United States; this is based on the tendency of high income individuals in these nations to invest more.[7] Using data from six major panel surveys, Schwarze and Grabka show that the gini coefficient (a measure of income inequality between 0 and 1) for capital income in Germany and the USA have ascended to the large values of 0.81 and 0.78 respectively.[8] Furthermore, capital income for the top income quintile has recently seen a 10% increase in the USA, and a whopping 30% increase in Germany.[9] When examining the tax policy of the US, the nation with the second largest gini coefficient in the world, it is even more evident how wealth accumulation has contributed to income inequality.[10] In the US, top tax rates are less than half of what they were in 1950.[11] With more disposable income as a result of lower tax rates, top income groups have more opportunity to invest their wealth for additional capital gains. Clearly there is a significant

---

[4] Norton, Andrew. "Automation and Inequality. The Changing World of Work in the Global South." Issue Paper. IIED, London. pp. 13

[5] Alvaredo, Facundo, et al. "The Top 1 Percent in International and Historical Perspective." *The Journal of Economic Perspectives*, vol. 27, no. 3, 2013, pp. 5

[6] Alvaredo, Facundo. pp. 12

[7] Fräßdorf, A., Grabka, and M.M. & Schwarze. "The Impact of Household Capital Income on Income Inequality." *J. J Econ Inequal* (2011). pp. 1

[8] Fräßdorf, A., Grabka, and M.M. & Schwarze. pp. 10

[9] Fräßdorf, A., Grabka, and M.M. & Schwarze. pp. 10

[10] Lecture 11, slide 6

[11] Alvaredo, Facundo. pp. 7

correlation between top tax rates and how they contribute to top income individuals and their subsequent ability to reinvest their income.[12]

In conclusion, wealth concentration at the higher end of the income distributions within countries and technological advancement account for the two largest contributors to income inequality within nations. While it is undisputed that income inequality within nations is on the rise, the root cause of such increases remains heavily disputed as a result of all the factors involved in one's income, and the inconclusiveness or lack of data surrounding income distributions. While it is not certain, and perhaps unlikely, that technological advancement and wealth accumulation account for all of the observed income inequality, it is both intuitive and backed by analytical research that they have a significant impact on it.

References:

Alvaredo, Facundo, et al. "The Top 1 Percent in International and Historical Perspective." *The Journal of Economic Perspectives*, vol. 27, no. 3, 2013, pp. 3–20.

Fräßdorf, A., Grabka, and M.M. & Schwarze. "The Impact of Household Capital Income on Income Inequality." *J. J Econ Inequal* (2011) 9: 35.

Guillén, Mauro F., and Emilio Ontiveros. *Global Turning Points: The Challenges for Business and Society in the 21st Century*. 2nd ed., Cambridge University Press, 2016.

Milanovic, Branko. "Can We Discern the Effect of Globalization on Income Distribution? Evidence from Household Surveys." *The World Bank Economic Review*, vol. 19, no. 1, 2005, pp. 21–44.

Norton, Andrew. "Automation and Inequality. The Changing World of Work in the Global South." Issue Paper. IIED, London.

Piketty, T., and E. Saez. "Inequality in the Long Run." *Science* 344, no. 6186 (2014): 838-43.

[12] Alvaredo, Facundo. pp. 7