Lifetime income inequality with taxation and public benefits

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Abstract

In this paper, we show how taxation, unemployment insurance, welfare, disability benefits and public pensions affect the inequality of lifetime income. Using results from a dynamic life-cycle model estimated using German panel data, we show that taxation and public benefits combined reduce the inequality of lifetime income, measured by the Gini coefficient, by 22%. Pensions only slightly reduce inequality in lifetime income. Welfare benefits, meanwhile, make persistent transfers to individuals at the bottom of the distribution of lifetime income and, therefore, are highly effective at reducing the inequality of lifetime income. Welfare benefits and disability benefits have increasingly progressive effects on lifetime income as the persistence of employment shocks increases, suggesting that these program are particularly important for targeting lifetime inequality when labor market frictions are high.

Key words: Lifetime income inequality; lifetime earnings; unemployment insurance; pensions; welfare benefits; disability benefits; redistribution; life-cycle labor supply.

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