

A general approach to income dynamics and inequality (PRELIMINARY AND INCOMPLETE)

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Abstract

It is pretty uncontroversial that not all types of inequality play the same role. When looking at income dynamics, only permanent differences across individuals – *permanent inequality* – should be targeted. At the same time, a theory of social justice called Equality of Opportunity (EOp) recognizes that all inequality arising from factors beyond individuals' control – *circumstances* and *luck* – should be compensated. In this paper, we propose a single approach to study inequality, where permanent inequality can be considered an *upper-bound* measure of Inequality of Opportunity (IOp), i.e. the maximum amount of inequality individuals are not responsible for.

Matching the theoretical moments with the sample ones, as in the income dynamics literature, in order to estimate the variance of the unobserved parameters by GMM, we provide a more comprehensive proxy of unfair inequality, which (*i*) includes both luck and circumstances, differently from the standard IOp approaches, that generally neglect all random factors; (*ii*) fully accounts for IOp dynamics. An application to the 1992-2012 waves of the German Socioeconomic Panel (SOEP) shows that static and aggregate measures of IOp may lead to underestimate its true contribution to total inequality, also because they do not account for the effect that some specific circumstances exerts on the dynamics of IOp.

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