

# The effects of economic inequality

Torben M. Andersen

Department of Economics

Aarhus University

October 2022

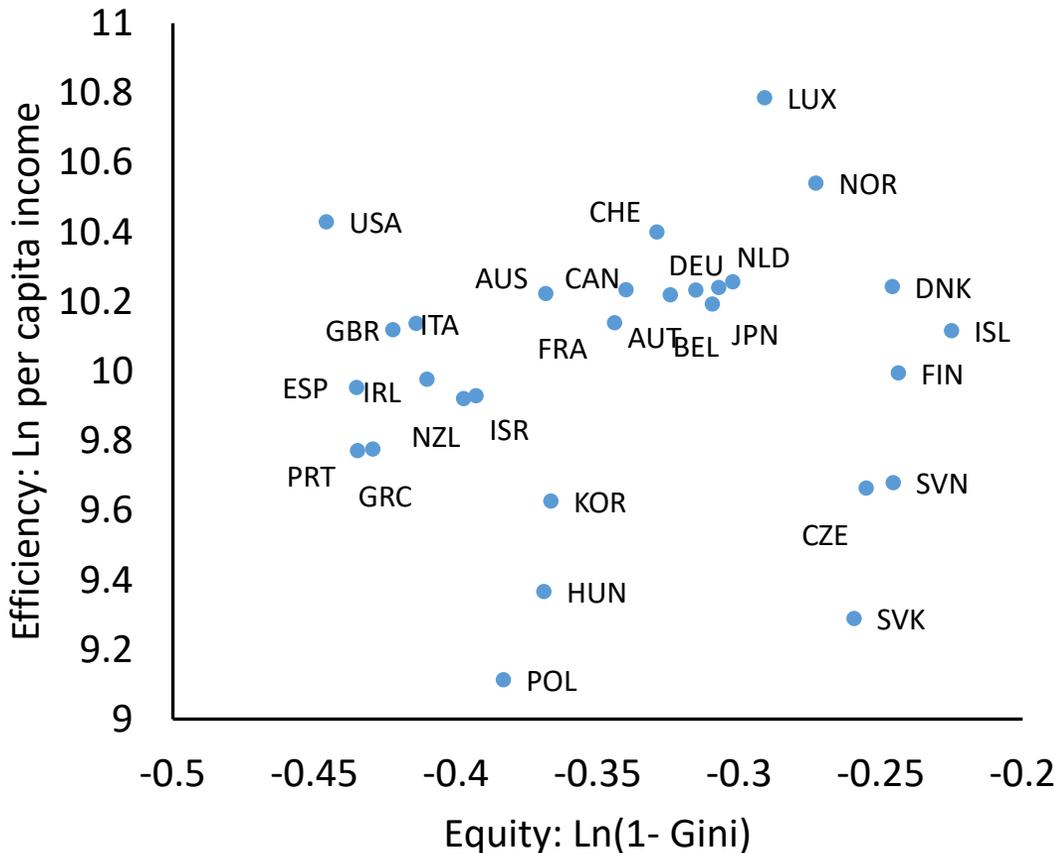
Swedish Fiscal Policy Council conference on economic inequality

# Empirical evidence – inequality and economic performance

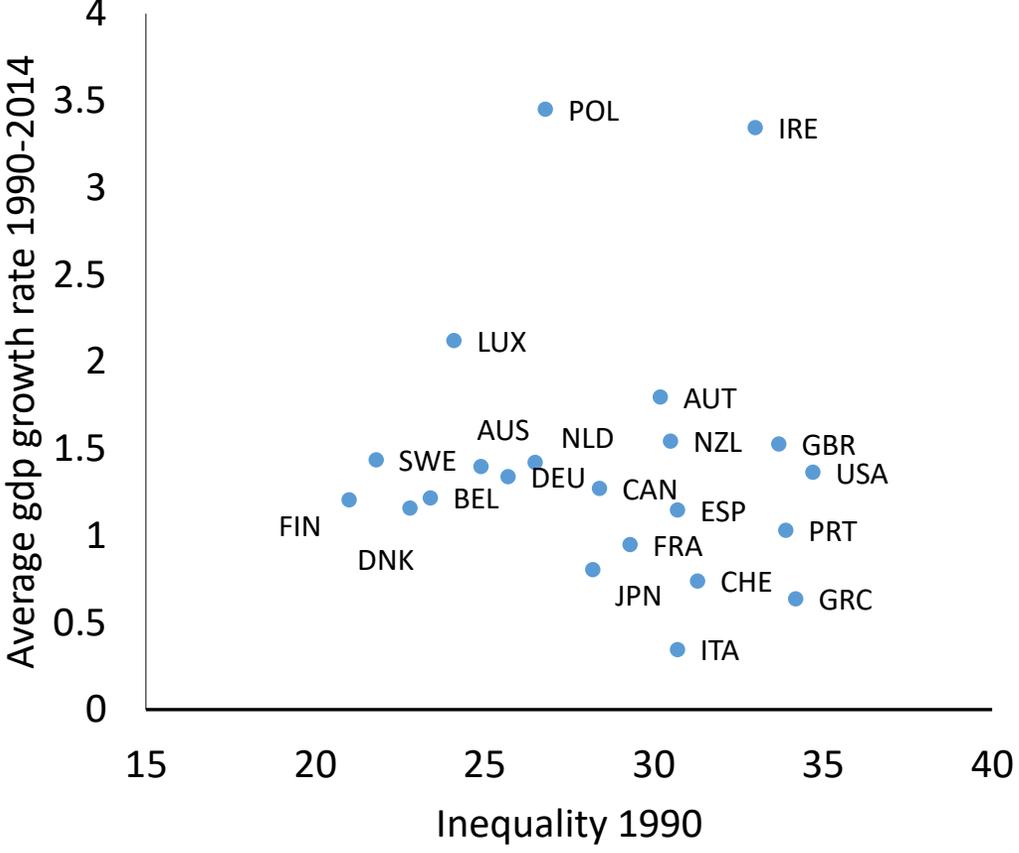
- Large literature relating measures of inequality (typically GINI disposable income) to metrics of economic performance (typically GDP per capita or growth rates)
- Results are very sensitive to sample, data, estimation method
- Few clearcut findings – “it depends”!
- Policy conclusions unclear – correlation between two endogenous variables

# Empirical evidence

### Income inequality and GDP per capita

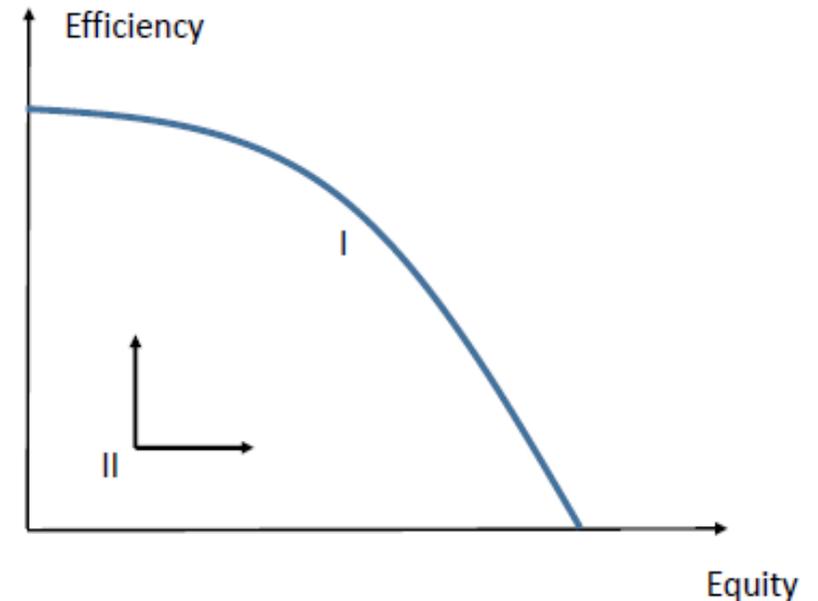
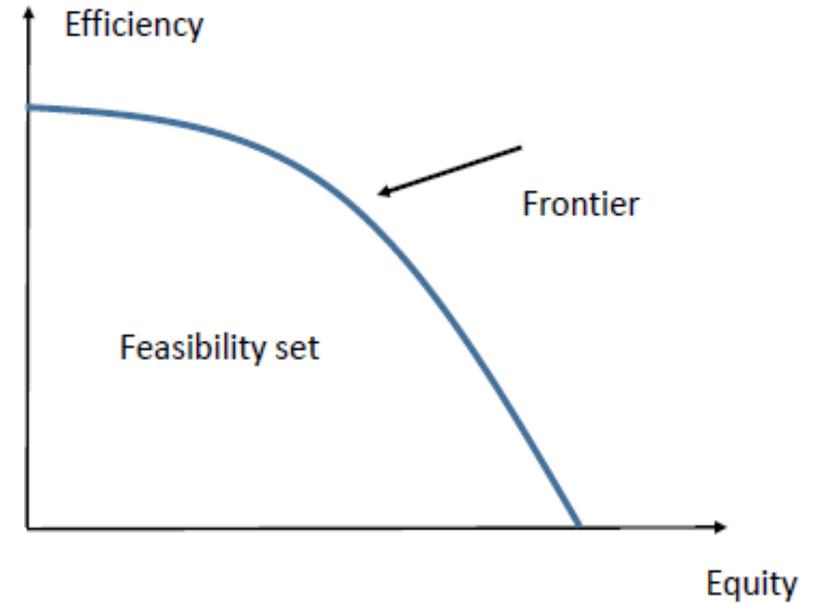


### Income inequality and growth



# Taking theory seriously

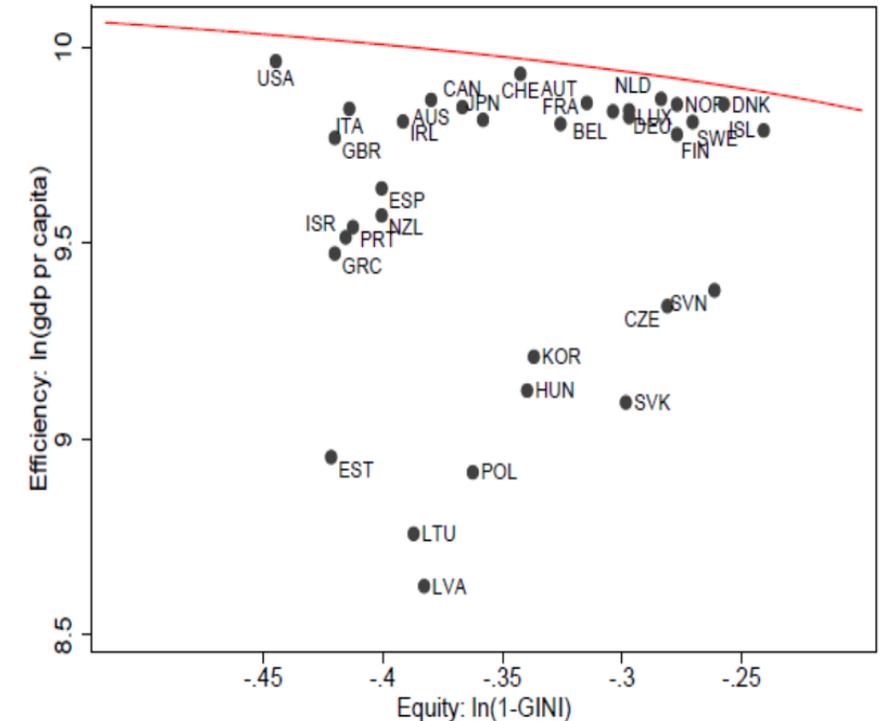
- Most work not consistent with basic insights from economic theory
- Political opportunity set in efficiency-equity space has a downward sloping frontier
  - Some countries at the frontier (I)
  - Some inside (political imperfections) (II)
- Average vs. marginal effects of policy



# Empirical implications

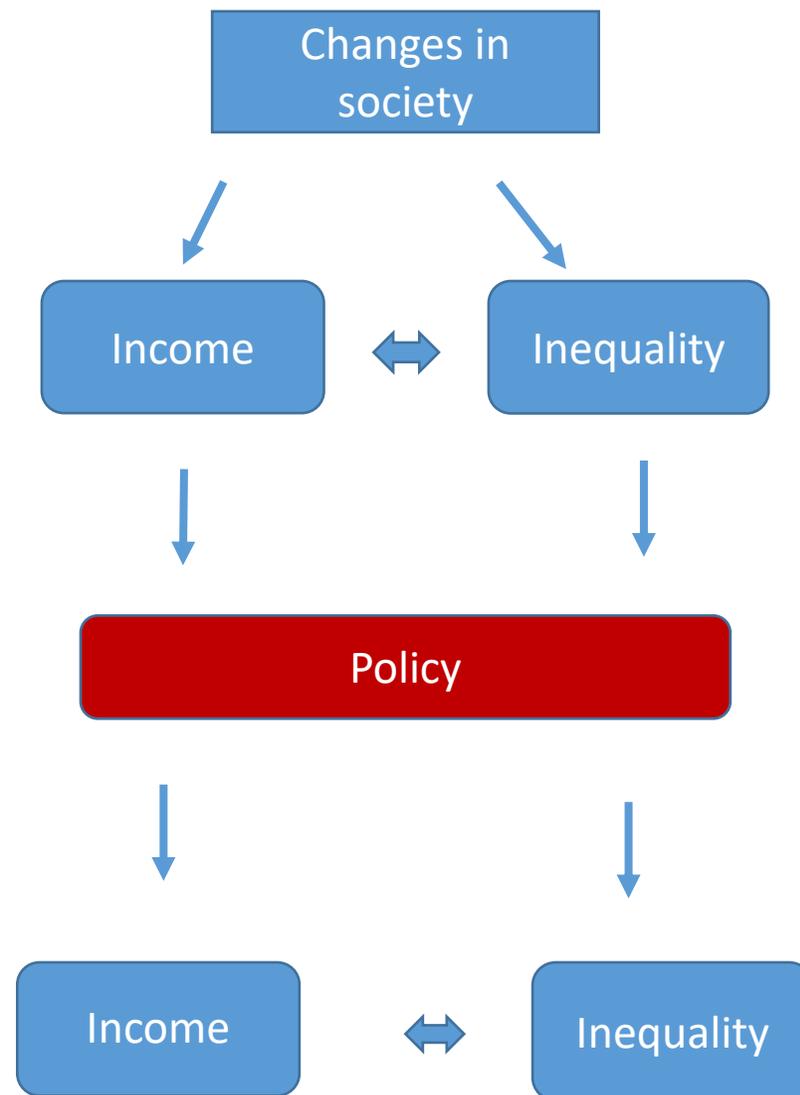
- Best practice frontier estimation:
  - Some countries at the frontier (A or B)
  - Some are in the interior due to political imperfections
- At the frontier – a trade-off
- Some countries are consistently at or close to the frontier, e.g. Sweden
- Slope of frontier is stable across time - despite globalization, technological changes etc.
- Growth shifts up the frontier – unchanged slope

Stochastic frontier estimation



# The mechanisms

- Complicated interrelationship: inequality and various measures of economic performance
- Mechanisms can run in various directions
- Finding certain relationships between income and inequality does not inform on how e.g. given policies reducing inequality work



# Inequality: concepts and measurement

- What is the problem?
  - Inequality per se or some notion of fairness?
  - Control vs non-control?
- What matters?
  - Ex post: distribution of income, wealth, health, gender... (outcome measures)
  - Ex ante: equality of opportunity, capabilities
- Which type of inequality?
  - Income inequality or poverty?
  - Top: concentration of economic/political power?
  - Bottom: poverty – social exclusion – lack of control?
- What is the driver?
  - Various factors affecting both inequality and economic performance
  - Factors affecting measured inequality only (age structure, number of singles)
  - Direct effect of inequality on economic performance?

# Links between inequality and economic performance

- Inequality is good for economic performance

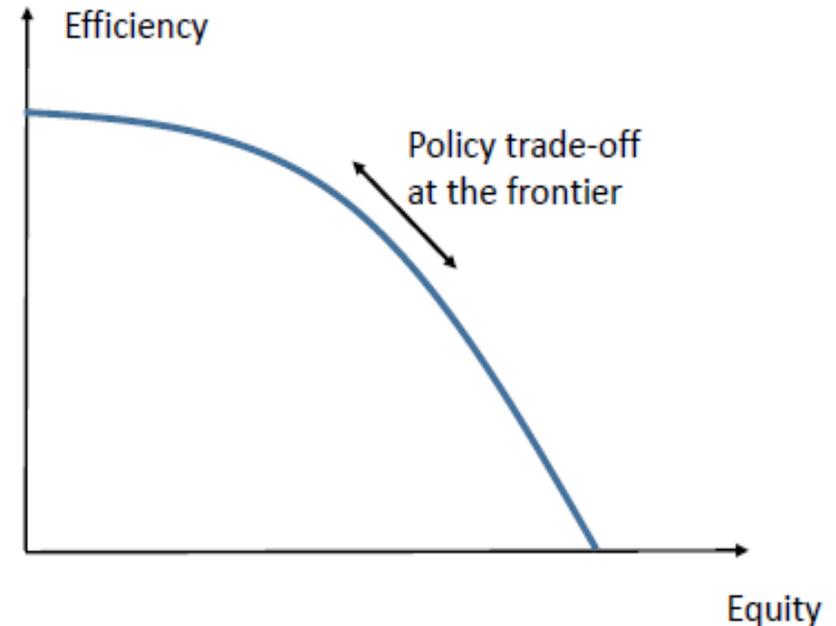
- Savings
- Incentives
- Trickle-down

- Inequality is bad for economic performance

- Education
  - Capital market imperfections
  - Social barriers
  - Neighborhood/segregation effects
- Social inclusion/trust (transactions costs)

# The standard view

- Economic outcome results in some distribution of outcomes (income)
- May not be politically acceptable – redistribution via distortionary taxes and transfers
- Trade-off: efficiency vs equity
- Direction of causality runs from distortionary policies to equity and efficiency



# Market failures

- Capital market failures
  - Borrowing constraints
  - Insurance



Public sector – social contract  
Implicit borrowing and insurance

- Channels
  - Education
  - Social safety net (Unemployment insurance)
  - Taxation



- Increase in human capital
- Insurance
  - Direct welfare effect (risk aversion)
  - Less ex post differences = less inequality
  - Flexibility (flexicurity)

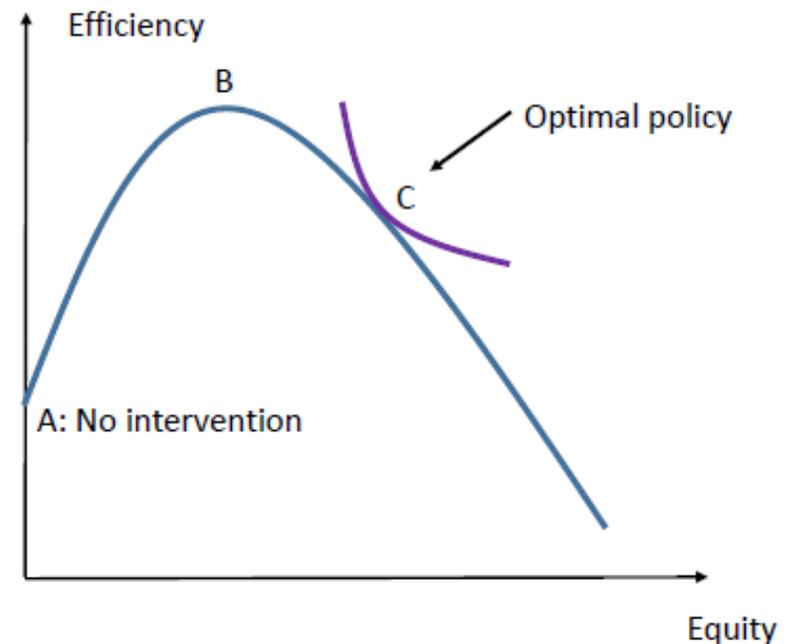
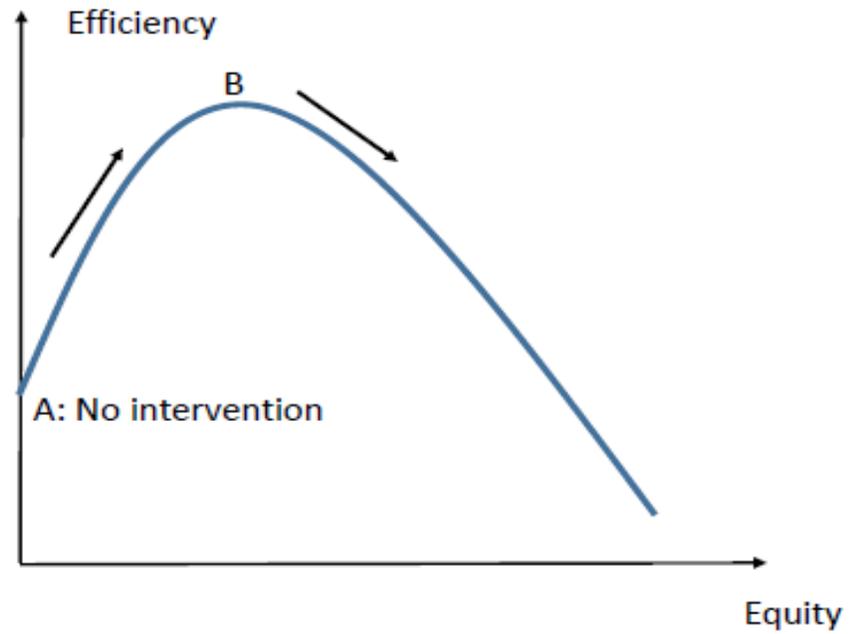
- Intervention may mitigate market failures

- Related to "dynamic expenditure effects"

- Tax: social cost larger than the direct effect due to distortions
- Expenditures: social costs less than the direct effect if overcoming market failures (increasing employment, wages...)

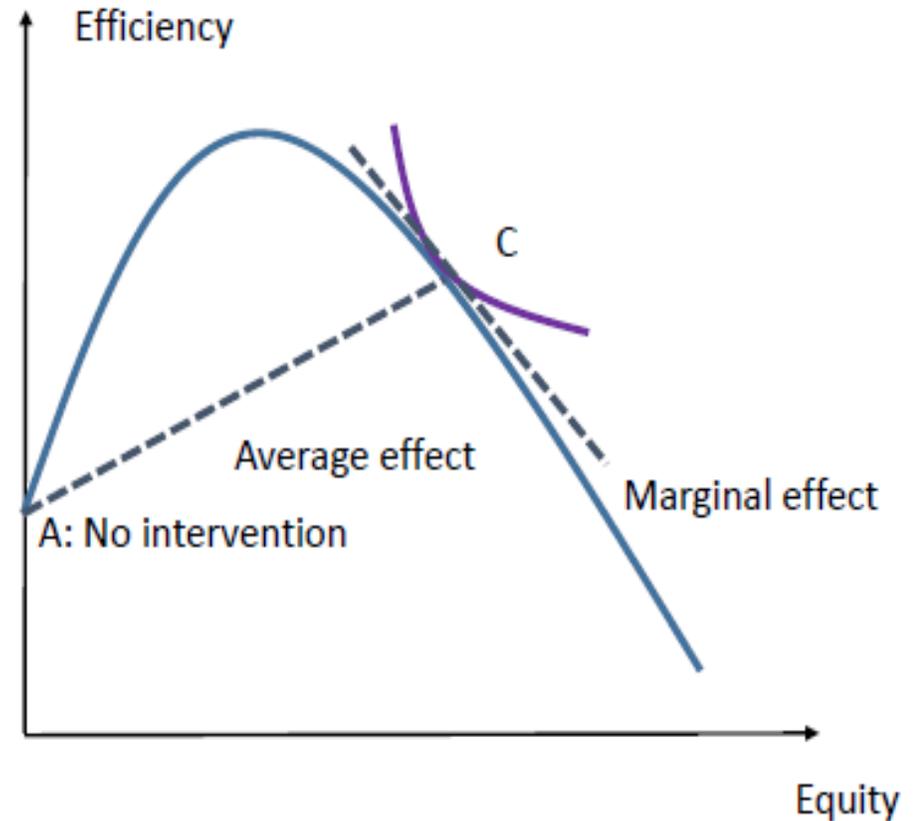
# Implications

- Market failures:
  - Intervention – over some interval - may be associated with both a decrease in inequality and increase in economic performance
  - Turning point (B): marginal benefits decline and marginal costs increase
- Optimal policies: a trade-off
  - Win-win gains have been reaped



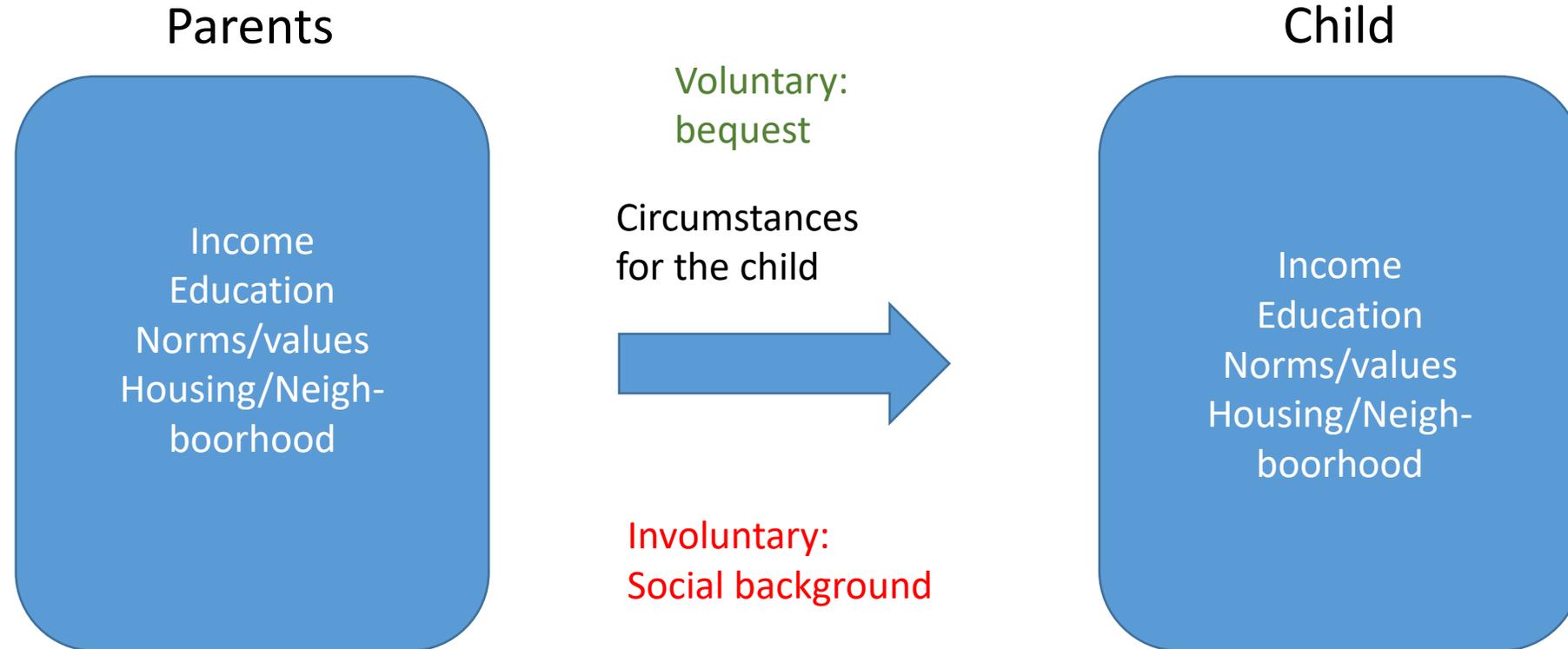
# Marginal vs average effects of policy

- The sign of the marginal and average effects of policy changes may differ!
- Explaining why the Nordic countries stand out with strong economic performance and low inequality?



# Multiple equilibria – Poverty traps

## Intergenerational linkage

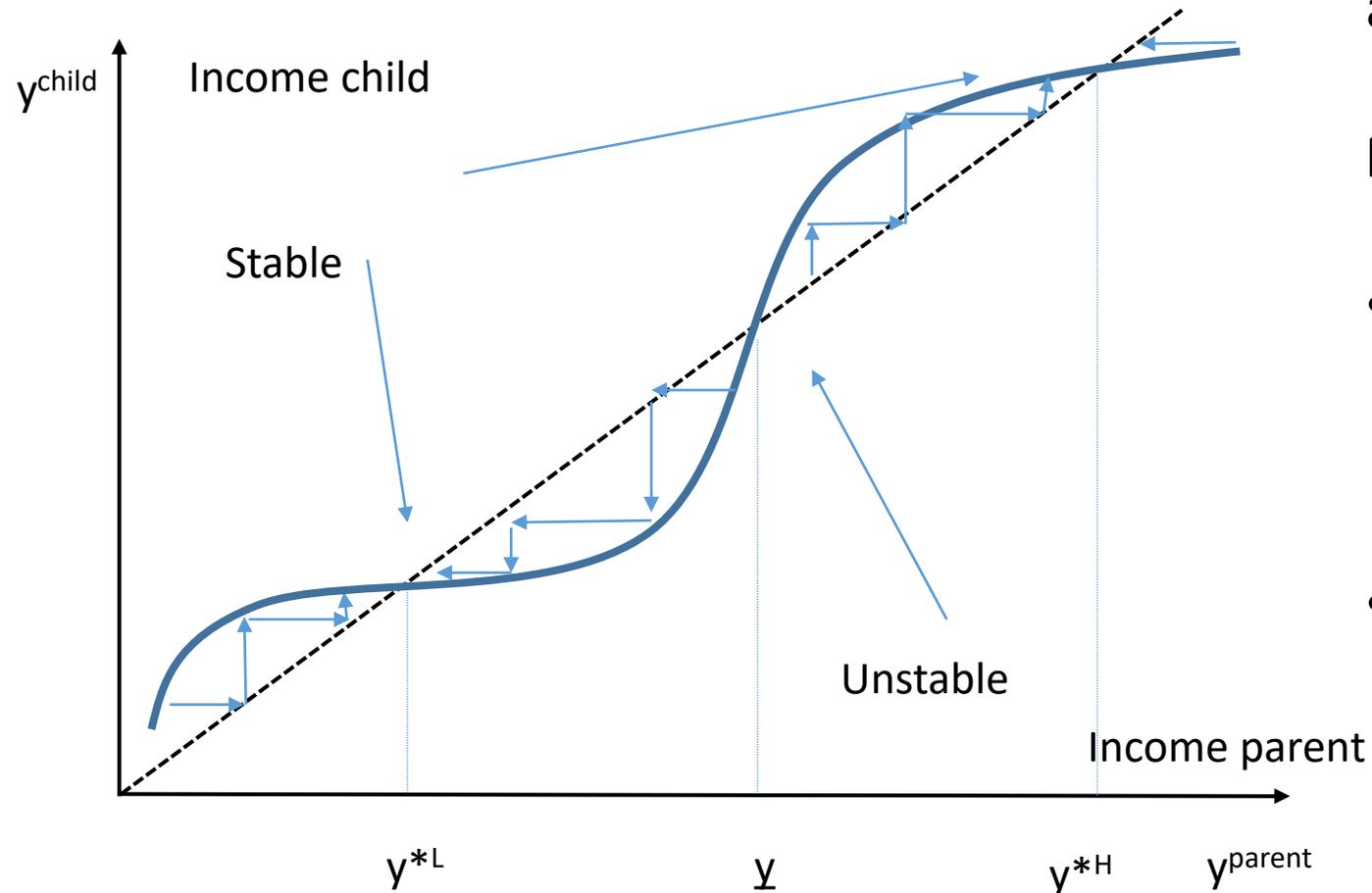


# Models of intergenerational dependencies

Inefficient use of human capital potential – more inequality and less income

## Multiple equilibria

- Few educated, high inequality and low income level
- Many educated, low inequality and high income

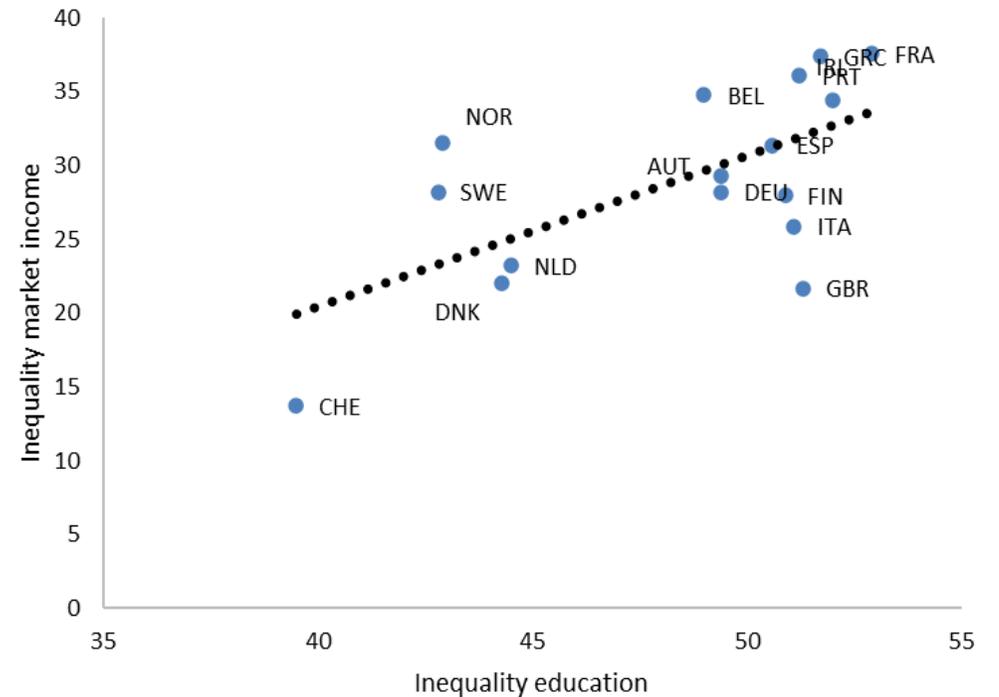


# Policy implications

## Reducing inequality

- Passive: redistribution = less inequality = less educated = less income
- Active: public education = more educated = less inequality and higher income

Inequality in education and income  
European countries



# Social Cohesion and Political Economy

- Increasing inequality – a changed political equilibrium?
  - Changing fundamentals technology, globalization.....
  - Changing political preferences/redistribution has become more costly
- Winners and losers
  - Can the winners compensate the losers?
  - Does it happen?
- Political consequences – trust in institutions, democracy, free trade (populism, nationalism)
- Economic consequences
  - Social cohesion and trust – “transactions” costs
  - Political fragmentation – political instability, trust in institutions/democracy
  - Support for reforms, free trade declining

# Economic effects of inequality

- Context and policy dependent relation between inequality and economic performance
- Policy targetted market imperfection may both improve economic performance and reduce inequality
- Active vs passive redistribution
- Structural changes and reforms – winners and losers

## References

- For references and discussion see Andersen, T.M., 2019, Inequality and Economic Performance, Långtidsutredningen 2019, <https://www.regeringen.se/4aedbb/contentassets/6f8ed59f044c46579c8c05de3bf73985/inequality-and-economic-performance-sou-201954.pdf>

### Selected recent references – empirical analyses:

- Baselgia, E., R. Foellmi, 2022, Inequality and Growth: A Review on a Great Open Debate in Economics, CEPR DP17483
- Blanchet, T., L. Chancel, and A. Gethin, 2022, Why Is Europe More Equal than the United States?, American Economic Journal: Applied Economics, 14 (4): 480-518.
- Blundell, R., X. Jaravel, and O. Toivanen, 2022, Inequality and creative destruction, IFS Working Paper 22/08
- Cerra, V., R. Lama, and N. Loayza, 2021, Links between growth, inequality, and poverty: A survey, Chapter 2 in Valerie Cerra, Barry Eichengreen, Asmaa El-Ganainy, and Martin Schindler (eds.), How to Achieve Inclusive Growth, Oxford University Press.
- Cuberes, D., M. Newiak, and M. Teignier. 2017. Gender Inequality and Macroeconomic Performance. In Women, Work, and Economic Growth: Leveling the Playing Field, edited by K. Kochhar, S. Jain-Chandra, and M. Newiak. Washington, DC: International Monetary Fund.
- Furceri, D., and J. D. Ostry. 2019, Robust Determinants of Income Inequality, Oxford Review of Economic Policy 35 (3): 490–517.
- Hendren, N., and B. Sprung-Keyser. 2020, A Unified Welfare Analysis of Government Policies, Quarterly Journal of Economics 135 (3): 1209-1318.