Inequality and Economic Performance: What Do We Know?

Paul Krugman
Of the tendencies that are harmful to sound economics, the most seductive, and in my opinion the most poisonous, is to focus on questions of distribution.

-- Robert Lucas, 2003

In the real world, incentives spur productivity, which creates wealth that is shared unevenly.

The alternative is equality in poverty, or at least in a lower standard of living.

Welcome to economics 101.

-- Peter Brown, 2006 (cited by Greg Mankiw)
Conventional view: Inequality necessary as incentive;

Leaky bucket if you try to limit inequality

Alternative view: Excessive inequality bad for growth and/or stability; the leaky bucket is a widow’s cruse

Resources versus incentives? Rat races?

How do we get at this? Much reliance on reduced-form regressions

At the very least we should put names on the points so we know what we’re talking about
Inequality versus growth in real GDP per working-age adult
What about poverty?
What about the one percent?
Cycles and growth

GDP per working-age adult

US
Sweden

[Graph showing GDP per working-age adult from 1990 to 2012 for the US and Sweden, with fluctuations and trends over time.]
Can we do better? Suggestions:

1. Structural – look at the specific channels, e.g. access to health care or education

2. Look for natural experiments – spread of benefits, land reform, etc.
Cyclical performance: Two peaks, two great crises. But why?

Source: Piketty and Saez, 2003 updated to 2011. Series based on pre-tax cash market income including realized capital gains and excluding government transfers.
What to do? Again, go structural. E.g.:
The simple underconsumption story doesn’t seem to work

Maybe inequality leads to excessive leverage?
Those indebted welfare states
Another possibility: The “episode” methodology common in international finance (currency crises, Reinhart/Rogoff when they were good)

Financial crises are well-identified; how do they differ in high- and low-inequality societies?
An example

[Graph showing real GDP per capita for the US 2007 (Gini = 0.378) and Sweden 1990 (Gini = 0.212) over several years.]