LECTURE 23
Income Inequality and Macroeconomic Behavior

April 18, 2013
Announcements

• Short paper is due on Tuesday, April 23rd.

• Remember to bring a hard copy to lecture and to submit your paper online. See the instructions in the ‘announcements’ section of the course website.
I. Overview
Top Decile Income Share, 1917–2010

- Including capital gains
- Excluding capital gains
Figure 8-5
Total Wage and Salary Income by Educational Group

Total wage and salary income, 2008 dollars


College graduates
High school graduates

Notes: Figures for full-time workers aged 25-65 who worked 50-52 weeks in the calendar year. Before 1991, education groups are defined based on the highest grade of school or year of college completed. Beginning in 1991, groups are defined based on the highest degree or diploma earned. Incomes are deflated using the CPI-U.
Decomposing the Top Decile Income Share
The Race between Education and Technology

• Technological change tends to increase inequality.

• Increases in education tend to decrease inequality.

• In the 1950s and 1960s, the two forces roughly balanced.

• Starting around 1970, increases in education slowed, so the effects of technological change dominated.
Figure 1-7
Mean Years of Schooling by Birth Cohort

Notes: Years of schooling at 30 years of age. Methodology described in Goldin and Katz (2007).
Other Factors that May Have Contributed Somewhat to the Rise in Inequality

• Weakening unions and falling relative minimum wages.

• Increases in international trade.

• Changes in social norms.
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Top Decile Income Share, 1917–2010

- Including capital gains
- Excluding capital gains
II. IS INEQUALITY A SOURCE OF RECESSIONS AND/OR FINANCIAL CRISSES?
Two Views of the Role of Inequality

- Inequality is important for many things, but it is not central to understanding short-run fluctuations and financial crises.
- High levels of inequality cause recessions and crises.
Idea #1

Because the rich spend a smaller fraction of their income than the poor, inequality leads to inadequate aggregate demand.

“When income is concentrated in relatively few hands, the overall demand for goods and services shrinks because the very rich do not nearly spend everything they earn.” (Reich, p. 32)
Difficulties

1. Low consumption hasn’t been a big problem in the U.S. in recent decades!
Figure 1-3
Personal Consumption Expenditures as a Share of GDP

Source: Department of Commerce (Bureau of Economic Analysis), National Income and Product Accounts Table 1.1.10.
Difficulties

2. Shifts of the IS curve will only affect output temporarily.
The Short-Run Effects of a Rise in Inequality the IS-MP Model
The Effects over Time of a Rise in Inequality the IS-MP Model
The Long-Run Effects of a Rise in Inequality the IS-MP Model
The Short-Run Effects of a Rise in Inequality If the Fed Wants to Offset the Output Effects
Could Reich’s idea help us understand the weak recovery?

When monetary policy is at the zero lower bound, a leftward shift of the IS curve reduces output, and conventional monetary policy and inflation adjustment cannot undo it.
The Short-Run Effects of a Rise in Inequality If Monetary Policy Is at the Zero Lower Bound
Idea #2

The wealthy make riskier investments. As a result, rising inequality raises the demand for risky assets, and so leads to bubbles.

“[R]icher Americans used their soaring incomes and access to credit to speculate in a limited range of assets. With so many dollars pursuing the same assets, values exploded.” (Reich, p. 23)
What Evidence Does Reich Provide for His Idea?

• Inequality rose in the 1920s, the 1990s, and the 2000s, and there were bubbles in these periods.
What Other Evidence Could You Get about Reich’s Idea?

• What does the evidence from other periods show?
• Do the wealthy hold riskier assets?
• Were previous bubbles fueled mainly by demand from the wealthy?
• Was the housing bubble smaller in countries where inequality was rising more slowly?
Idea #3

Stagnating incomes of the non-rich and rising inequality lead to unsustainable credit expansion.
Two Versions of Idea #3

- Reich: Pressure to maintain standards of living and keep up with the wealthy leads the non-rich to take on excessive debt. (“Middle-class consumers took on the huge amount of debt as a last resort ... [to] keep consuming as if wages hadn’t stalled.” [p. 64])
- Rajan: Politicians take steps to make easy credit available to the non-rich so that their consumption continues to rise. (“Politicians have ... looked for other ways [than education and redistributive taxation] to improve the lives of their voters. Since the early 1980s, the most seductive answer has been easier credit.” [p. 31])
What Evidence Do Reich and Rajan Provide for Their Idea?

- Broad patterns in the data: saving fell sharply, credit grew rapidly.
- Policymakers adopted policies to promote homeownership and mortgage lending to broad parts of the population.
- The housing boom was largest in lower-income areas.
What Other Evidence Could You Get about Reich’s and Rajan’s Idea?

- **Timing.** For example: Did credit grow less, or government policies about credit change less, when inequality was not rising?

- **Cross-section.** For example: Did credit grow faster in areas where inequality was higher (or where it grew faster)? Did types of credit where policymakers did not push for credit expansion grow more slowly?

- **Demand vs. Supply:** Did the cost of obtaining credit rise or fall?

- **Narrative.** For example: Did lenders say that affordable housing mandates were affecting their lending decisions?
Debt Outstanding Domestic Nonfinancial Sectors - Household, Home Mortgage Sector (HHMSDODNS)

Source: Board of Governors of the Federal Reserve System

Shaded areas indicate US recessions.

2011 research.stlouisfed.org
Total Consumer Credit Outstanding (TOTALSL)
Source: Board of Governors of the Federal Reserve System

Shaded areas indicate US recessions.
2011 research.stlouisfed.org
The Financial Crisis Inquiry Commission on Affordable Housing Goals

“We also studied at length how the Department of Housing and Urban Development’s (HUD’s) affordable housing goals for the GSEs affected their investment in risky mortgages. Based on the evidence and interviews with dozens of individuals involved in this subject area, we determined these goals only contributed marginally to Fannie’s and Freddie’s participation in those mortgages.” (FCIC Report, pp. xxv-xxvii; emphasis added.)
The Financial Crisis Inquiry Commission on Affordable Housing Goals (cont.)

“In 2003 and 2004, Fannie Mae ... would have met its [affordable housing] obligations without buying subprime or Alt-A mortgage–backed securities. In fact, none of Fannie Mae’s 2004 purchases of subprime or Alt-A securities were ever submitted to HUD to be counted toward the goals.” (FCIC Report, p. 123.)
“All but two of the dozens of current and former Fannie Mae employees and regulators interviewed on the subject told the FCIC that reaching the goals was not the primary driver of the GSEs’ purchases of riskier mortgages and of subprime and Alt-A non-GSE mortgage–backed securities.” (FCIC Report, p. 184)