INEQUALITY

EE461 Sem 2/2019

Understanding inequality

Addressing inequality

Aspirations and savings

- Striving for economic self-betterment is a large part of what we are all about.
- Behaviors of individuals and families are molded by their aspirations to a better economic life.
- Individuals in this society all aspire to the standards set by society in general
- Aspirations are unselfishly long term: from generation to generation.

Aspirations and savings

- Such individuals typically save large fractions of their income, both on average and at the margin.

- Marginal saving rate and average saving rate should be increasing with level of aspiration.

The effect of savings behavior on the evolution of economic inequality

- If inequality is low to begin with, these low levels of inequality may be sustainable over time.

- When neither the standards of living nor the underlying incomes (or wealths) are too heterogeneous, we expect a commonality of savings behavior which has the effect of keeping different economic groups in the society close together over time.

The effect of savings behavior on the evolution of economic inequality

- Income is relatively equal. >> homogenous aspiration level >> homogenous saving behavior >> Continue to have income equality.

The effect of savings behavior on the evolution of economic inequality

- If initial inequalities are high, they may be preserved or widened over time.

- For many groups in society, there is now a substantial difference between their notions of a desired standard of living and their actual standard of living.

- This has an effect on savings behavior.

The effect of savings behavior on the evolution of economic inequality

- Imagine for simplicity that the desired standard is set by the richest groups in the society.

- Then, we can measure the shortfall of income from the income deemed necessary to achieve the desired standard of living.

- As the shortfall increases, aspirations are created, which initially raises the rate of savings for such income groups.

The effect of savings behavior on the evolution of economic inequality

- This aspiration effect lasts to only up to some level of the shortfall.

- As the shortfall continues to increase, poorer groups find that a high savings rate is simply too costly in terms of the deleterious effects on their much-needed current consumption. Then, the savings rate starts to fall again.

Saving rate, aspiration, and shortfall of income

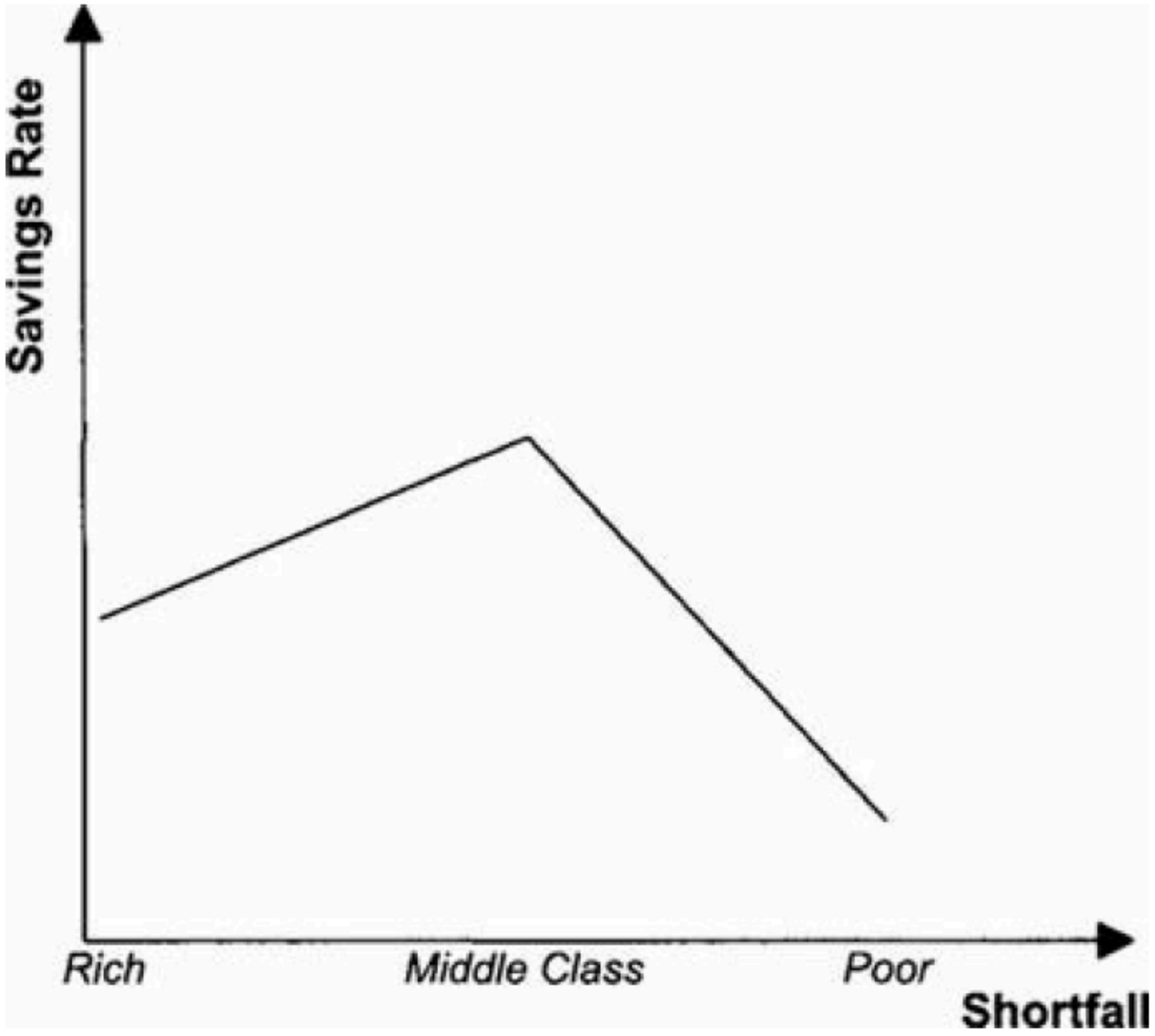


Figure 7.4. Desired standards of living, income, and savings rates.

Saving rate, aspiration, and shortfall of income

- Savings behavior is not only determined by income but by income and aspirations.

- Aspiration depends on existing inequalities of income and wealth.

- Thus the relatively poor, who have high current shortfall of income, might have low aspiration, low saving rate, and might find themselves in a self-sustaining low-income trap.

Saving rate, aspiration, and shortfall of income

- The middle class grows more rapidly than either rich or poor.

- Inequality is history-dependent.

Redistribution and Predistribution

- Governments can influence the degree of inequality in the economy in two ways: Redistribution and Predistribution

- Predistribution: Government actions that affect the distribution of earnings before taxes and transfers or the distribution of privately held wealth. Predistribution policies affect the endowments people have and their value of those endowments, leading to a change in the inequality in market income.

- Examples include education, minimum wage, and anti-discrimination policies.

Redistribution and Predistribution

- Governments can influence the degree of inequality in the economy in two ways: Redistribution and Predistribution

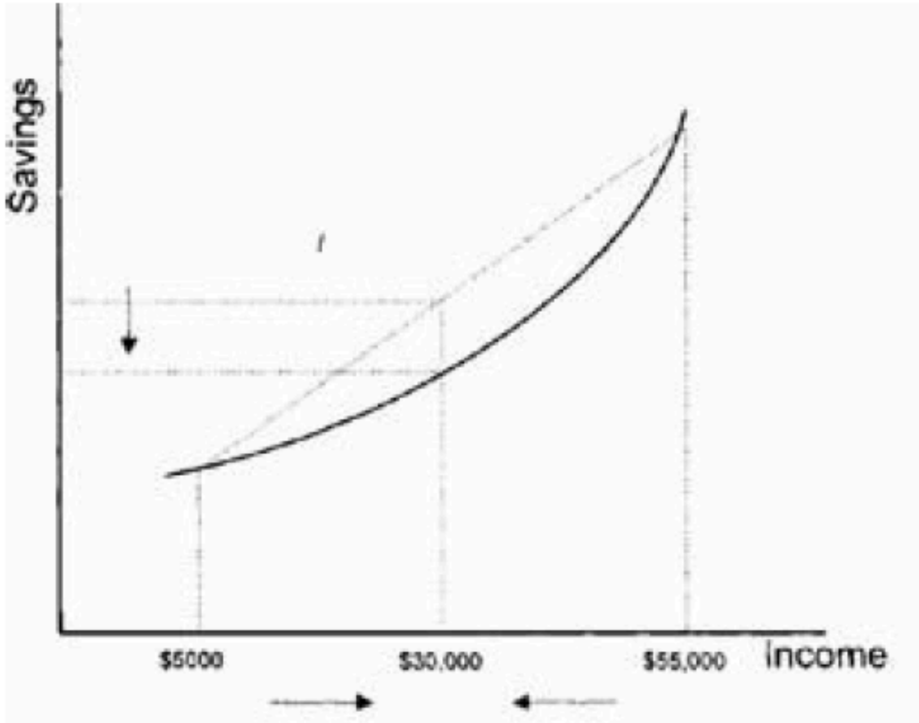
- Redistribution policies are policies on taxes, monetary, in-kind transfers of the government, and on expenditure that provides public services to households that result in a distribution of final income that differs from the distribution of market income.

Disposable income and final income

In-kind transfer is public expenditure in the form of free or subsidized services for households rather than in the form of cash transfers.

Effect of redistribution on savings and growth

- Suppose that as income increases, the marginal savings rate increases.



(a) Increasing Marginal Savings Rate

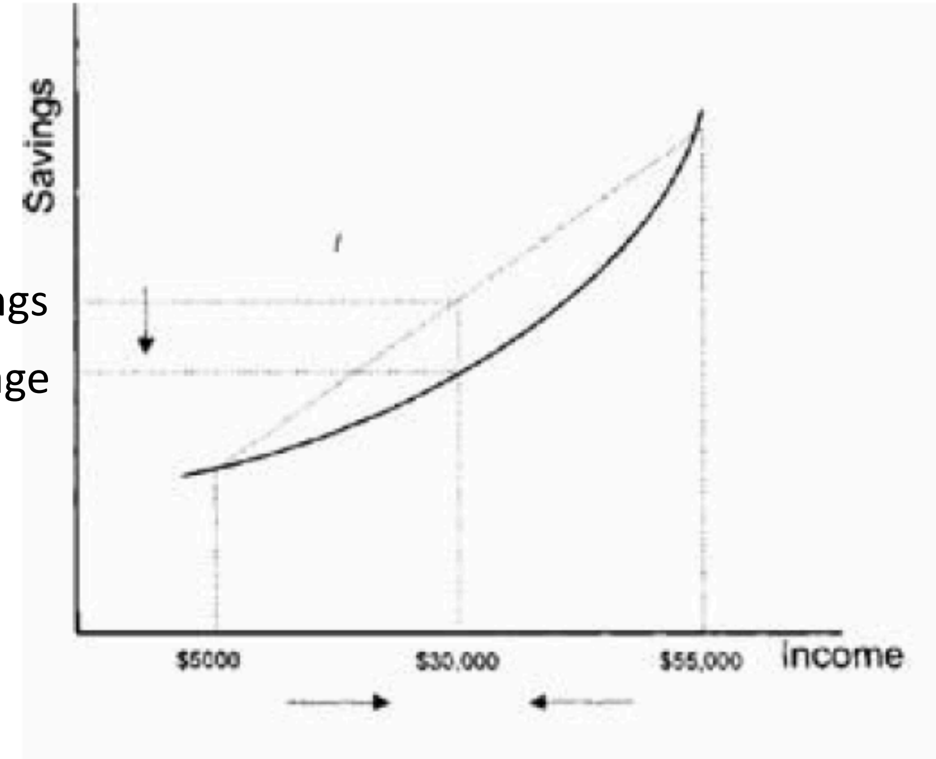
- If we were to transfer a dollar of income from a rich person to a poor person, less of that dollar would now be saved as a result of the transfer.

Effect of redistribution on savings and growth

- Suppose that as income increases, the marginal savings rate increases.

Average of savings

Savings of the average

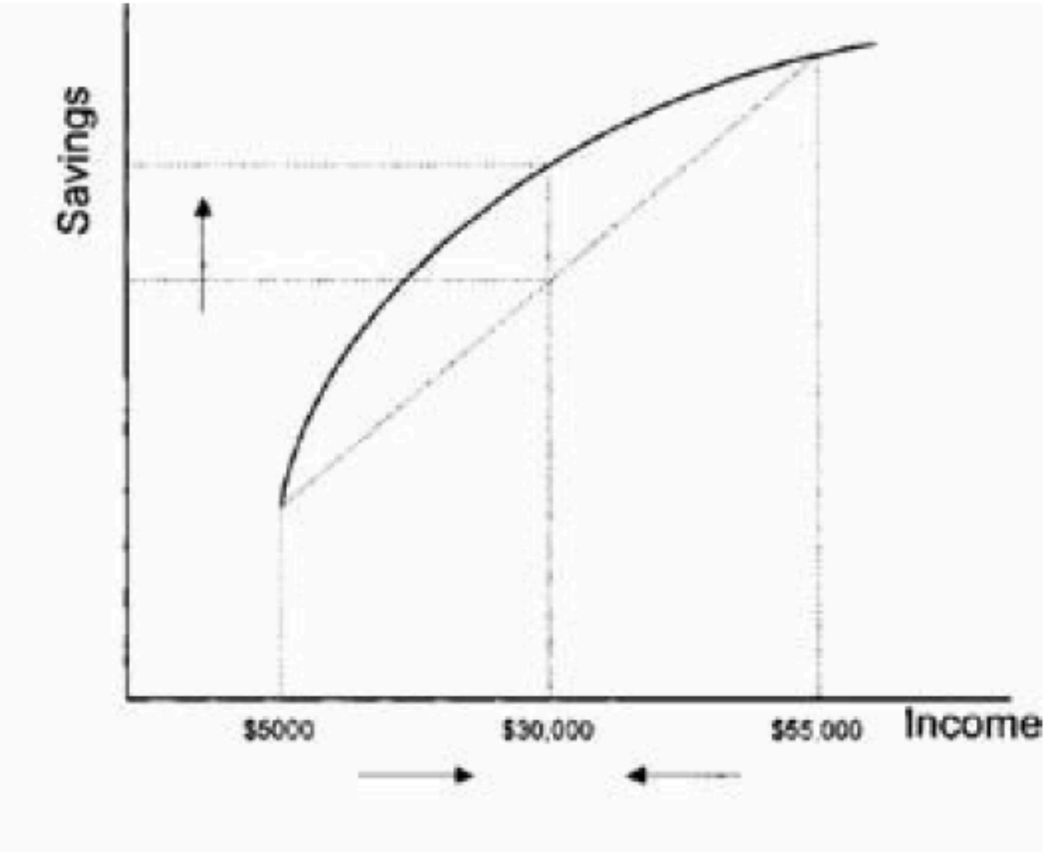


(a) Increasing Marginal Savings Rate

- The average of saving of the rich and saving of the poor is more than the saving of the middle income.
- A reduction of income inequality will decrease the volume of savings in the economy.

Effect of redistribution on savings and growth

- Suppose that as income increases, the marginal savings rate decreases.



(b) Decreasing Marginal Savings Rate

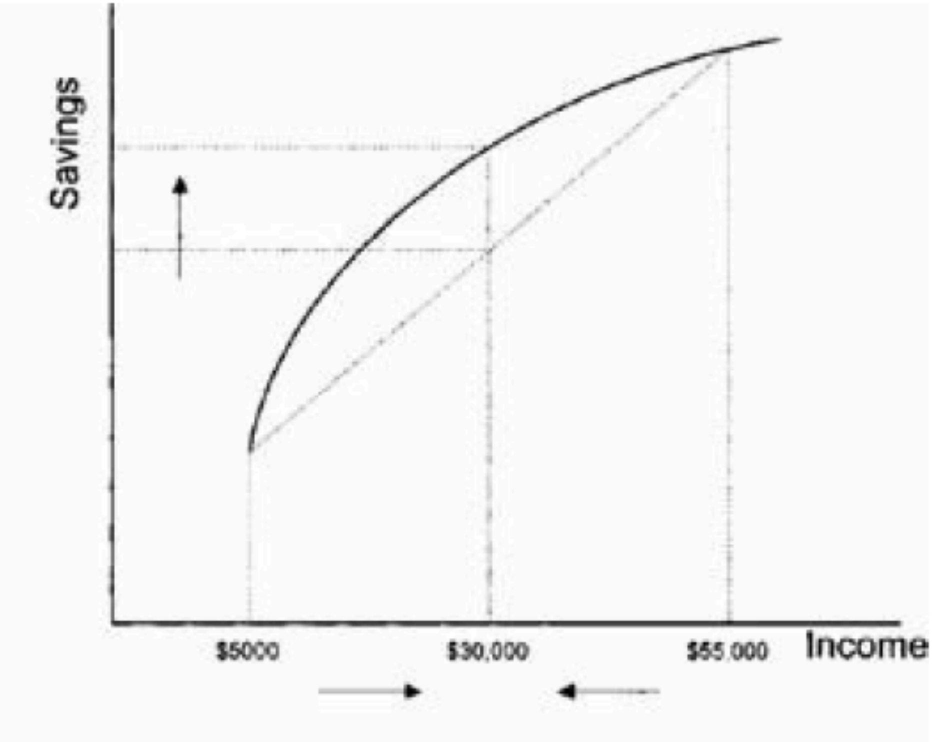
- If we were to transfer a dollar of income from a rich person to a poor person, more of that dollar would now be saved as a result of the transfer.

Effect of redistribution on savings and growth

- Suppose that as income increases, the marginal savings rate decreases.

Savings of the average

Average of savings



(b) Decreasing Marginal Savings Rate

- The average of saving of the rich and saving of the poor is less than the saving of the middle income.
- A reduction of income inequality will increase the volume of savings in the economy.

Effect of redistribution on savings and growth

- What is the the behavior of individual savings as income changes?

- As individual income increases, total savings are initially zero or even negative.

- At some break-even point, savings turn positive and rise thereafter. Marginal dollar of income earned is plowed to a larger and larger extent into savings. This is the income zone where economic aspirations not only matter (they surely matter for everyone), but can be pursued.

- Finally, as we enter regions of high income, even though total savings continues to rise, the marginal savings rate starts to decline, because the aspiration effect wears thin on the already rich.

Effect of redistribution on savings and growth

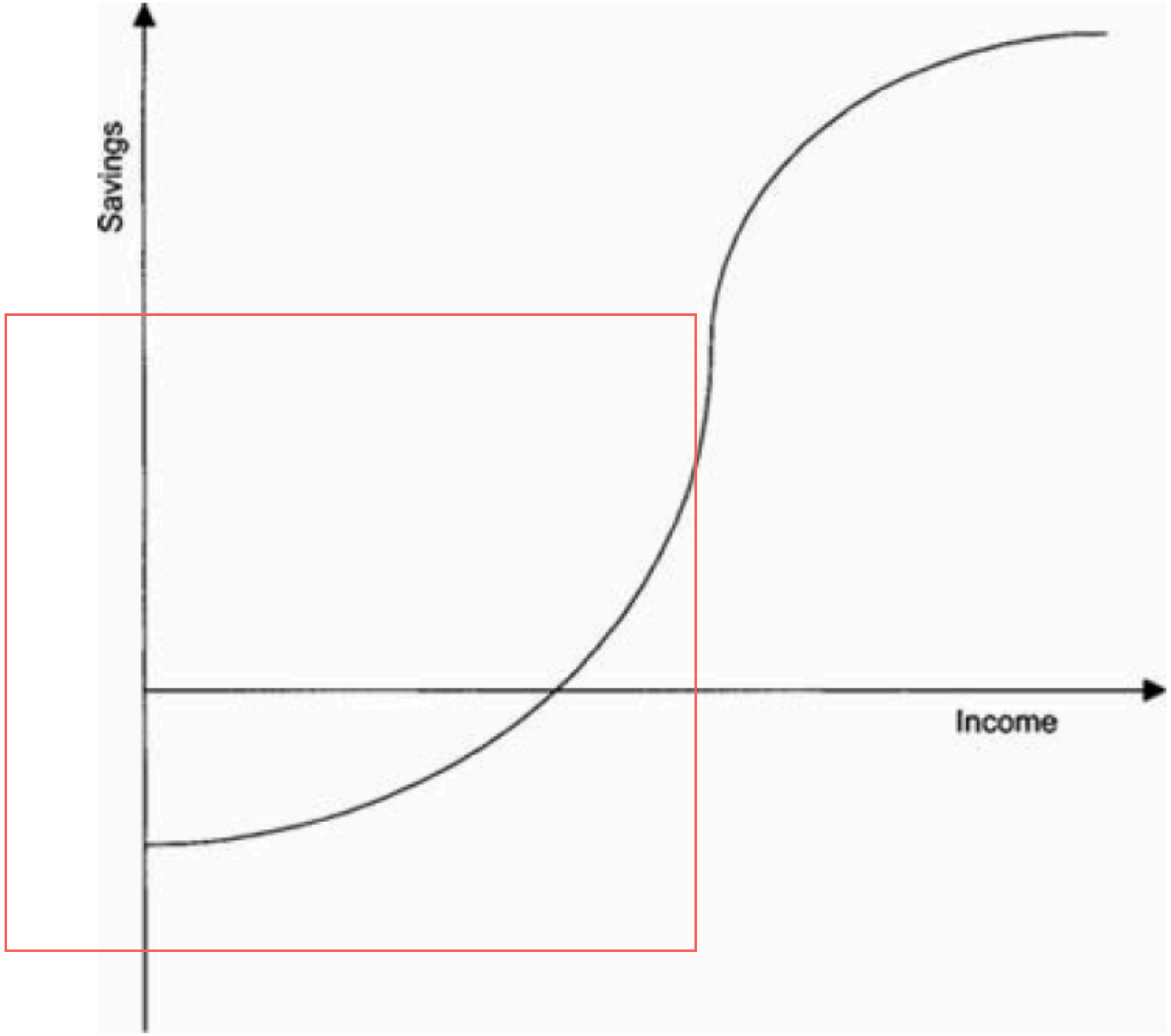


Figure 7.3. Savings and income: a more detailed view.

Effect of redistribution on savings and growth

- The effect of a reduction in income inequality on the rate of savings, and therefore on the rate of growth, is likely to be complex.

- In an extremely poor country, redistributive policies may bring down the rate of savings and therefore the rate of growth in the medium or even long run.

- Without redistribution, there is a fraction of the population (however small) who possess the desire and the means to accumulate wealth.

Effect of redistribution on savings and growth

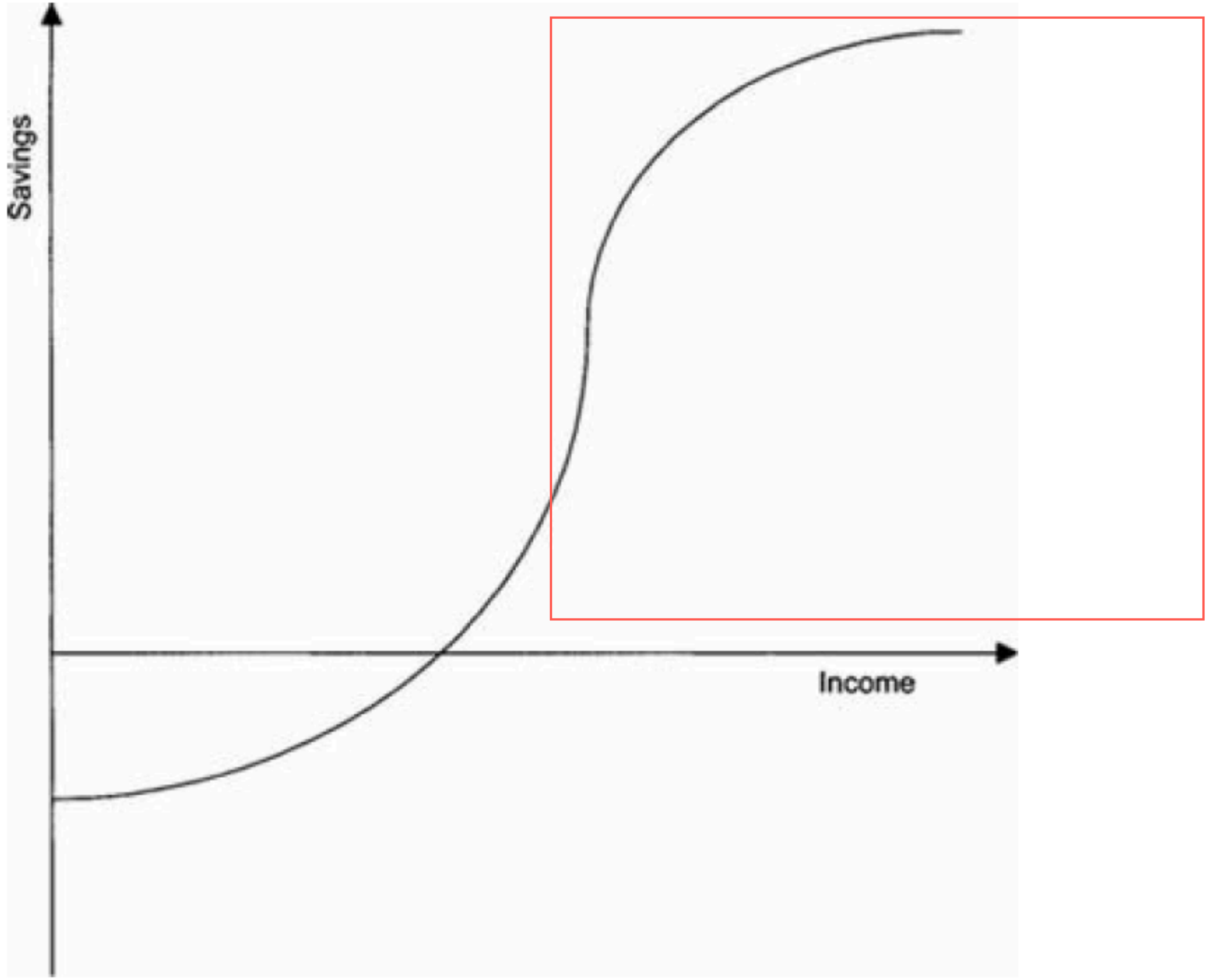


Figure 7.3. Savings and income: a more detailed view.

Effect of redistribution on savings and growth

- For medium-income countries, redistributive policies may generate a surge of savings at the national level, because they create a large and ambitious middle class with aspirations.

Progressive and regressive redistribution

- When the direct effect of a tax or transfer policy, compared to what would happen in the absence of the policy, is a reduction (a rise) in inequality, it is called **progressive (regressive).**

- A progressive (regressive) expenditure or transfer increases the incomes of poorer (richer) households by more than richer (poorer) households, in percentage terms.

- Policies that are neither progressive nor regressive are called **distributionally neutral. Such policy** does not alter the distribution of income.