

Inequality and Economic Performance

A Theoretical Perspective

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Back to the Future

- Large and active literature in 90's
 - ▶ e.g. Benabou (2000) “Unequal Societies: Income Distribution and the Social Contract” . Also work by Galor-Ziera, Durlauf, Fernandez-Rogerson, Ferreira,...

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 - ▶ Tomorrow's distribution of income / wealth depends on today's: inequality is **endogenous**
- Redistribution, social insurance and other **progressive policies** (e.g., in education finance) reduce future inequality + can increase social mobility

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 - ▶ **Efficient redistributions**: universal support behind veil of ignorance, wide support in a relatively homogeneous society. As inequality rises, will be opposed by increasing fraction of the rich \Rightarrow support declines (at least initially)
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 - ▶ The more so, greater the **elasticity of political influence to wealth**, the more so. (Imperfect political systems, state capture)

Back to the Future

- Importance of peer and neighborhood effects \Rightarrow residential and social stratification has effects similar to regressive redistribution (but of non-financial inputs into human and social capital).

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- 5 Inequality and growth can be negatively correlated (but need not be monotonic)

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- Key determinant of attitudes toward inequality and redistribution, both across individuals and across countries:
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- Sources of belief distortions / dissonance reduction / “false consciousness” :
 - ▶ “Supply side” : propaganda by those opposed to such policies
 - ▶ “Demand side” : “belief in a just world,” “system justification” . Brings in **behavioral economics** / psychology.

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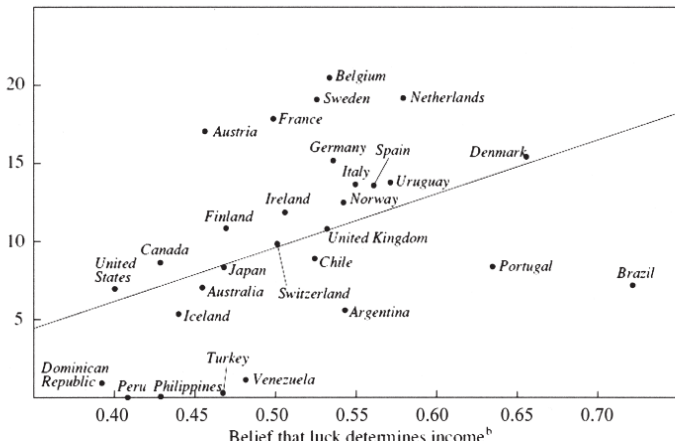
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The subjective mental constructs of the participants will evolve an ideology that not only rationalizes the society's structure but accounts for its poor performance. As a result, the economy will evolve policies that reinforce the existing incentives and organizations.

Evidence and Theory

Social spending (percent of GDP)^a



- Alesina et al. (2001)

Evidence and Theory

- Benabou-Tirole (2006) “Belief in a Just World & Redistributive Politics”
 - ▶ Endogenous belief distortions / rationalizations concerning the origins of inequality constitute another general-equilibrium **feedback force** that tends to make (high-inequality, low redistribution) and (low inequality, high redistribution) steady-states / social models persistent.
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- Need more work on the determinants of political attitudes, and in particular how they vary with individual mobility experiences and aggregate fluctuations, e.g.,
 - ▶ Giuliano et al. (2013) “Growing Up in a Recession: Beliefs and the Macroeconomy”
 - ▶ Call to integrate such “belief” questions into panel-data studies.
- Difficult issues, settling facts / theories may take time.

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- Argue that they are both!
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- A very large part of increase in earnings inequality has come through rise of performance-based pay
 - ▶ Bonuses, etc., but in fact all throughout wage structure, in US and UK
 - ▶ Evidence that increased competition for talent (and some SBTC) is a major driver of such evolutions

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- So is all well and fair? No
- In multitask setting (short vs. long term, expected return vs. hidden risks, cooperation vs. backstabbing, etc.), we know that giving too-high powered incentives is harmful.
 - ▶ Presumably, firms know it too. So why do they still often give them?

Bonus Culture

- When competing to attract or retain “talent”, which is imperfectly observable, performance pay becomes a **screening device**, its determination no longer in the hands of each single firm
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 - ▶ A fortiori, from social point of view if short-termism, hidden risks, etc., have negative social externalities.

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- Future research: externalities / competition among different types of firms, / industries Some for which performance pay is efficiency (little unobserved component to effort, e.g., hedge funds), others where it is not (e.g. traditional banks) forced to follow.
- Empirical side: need to look at different forms of earnings differentials, e.g., fixed versus performance-based pay, short-term vs. deferred compensation.