Inequality, debt and growth

Resolution Foundation
15th May 2012

Paolo Lucchino
(NIESR)
Salvatore Morelli
(University of Oxford)
Report for the Resolution Foundation
Introduction

• **Part 1:** Provide a systematic review of recent hypotheses on the role of inequality in the run up to the crisis.

• **Part 2:** Explore the extent to which these are relevant to the UK context.

• **Part 3:** Explore, and quantify, the impact of more equal income growth in sustaining the UK recovery in the short term.
In recent hypotheses, inequality is a driver behind an unsustainable surge in the level of household indebtedness. Vulnerability of household balance-sheets in turn affects macro-economic stability.

Inequality works through three channels: demand for credit; political economy motivations leading to an excessive supply of debt; and crisis as co-incidental.

**DEMAND**: e.g. Frank et al. (2010): individuals emulate consumption habits of their slightly wealthier peers, triggering 'expenditure cascades'.

**SUPPLY**: e.g. Milanovic (2009): stagnation in middle class incomes gave rise to a political demand of redistribution. Rajan (2010): US Government responded by using regulatory tools to facilitate low income households' access to credit, particularly mortgages.

**COINCIDENTAL**: e.g. Krugman (2010) argues that liberalisation and rising top incomes may be a common result of a rightward shift in political thinking that has led to both rising inequality and a more vulnerable financial system.
P1: Weight of the evidence?

- Overall, the recent debate on the possible link between inequality and crisis is still in its infancy. It is therefore still too soon to know where the weight of the evidence lies.
  - Atkinson and Morelli (2010 and 2011) carried out one of the first systematic empirical investigations into this relationship. Do not find conclusive evidence on the hypothesis that a growing level of economic disparities leads to higher macroeconomic instability.

- The theories differ, for example, in the extent to which the potentially destabilising increase in inequality occurs at the top of the distribution, the bottom, both or by changes across the distribution.

- Which of these trends have occurred, both in the US and in other countries, and what effects they may have determined would be a welcome focus of further research.

- This wishes to be an initial contribution in the context of the UK.
P2: Inequality and debt

Figure 3: Trends in inequality and debt

Source: Atkinson & Morelli (2012), EUROSTAT
Figure 4: Saving ratios by income decile

Source: Family Expenditure Survey and successive datasets, 1971-2010
Figure 6: Real consumption and income growth 1997-2007, by disposable income decile

Source: Family Expenditure Survey and successive datasets, 1971-2010
P2: Bringing everything together

Figure 8: The possible inequality, household balances, growth nexus

Source: Atkinson & Morelli (2012), ONS, EUROSTAT
P3: Boost from broad-based growth?

Recessions in comparison

GDP: change from peak

Months from start of recession

1930-1934
1973-1976
1979-1983
1990-1993
2008-

Source: NIESR

- Could more equal or broad-based income growth have positive implications for the sustainability and strength of the UK economic recovery?
P3: Quantifying the effect

- Post-Keynesian *under-consumption* theory of economic stagnation: current context of tight *credit constraints* and household *rebalancing*, income inequality may have limiting effects on consumption growth.

- Task: *If the Keynesian model is a correct representation of reality, what is the quantitative effect of income distribution on consumption?*

- We carry out a *static simulation* on UK and explore three scenarios: ‘*policy intervention*’, ‘*back to the 70s*’, ‘*full equality*’
P3: Modest effect...

Figure 10: Actual and simulated aggregate propensity to consume

<table>
<thead>
<tr>
<th></th>
<th>Policy intervention</th>
<th>Back to the 70's</th>
<th>Full equality</th>
</tr>
</thead>
<tbody>
<tr>
<td>ppt change in APC</td>
<td>0.1</td>
<td>0.3</td>
<td>0.6</td>
</tr>
</tbody>
</table>
Conclusion

• The initial evidence we present, while only suggestive at this point, does hint at a possible relationship between inequality and the recent crisis, though more research is warranted to validate this hypothesis.

• Detailed micro-data analysis indicates a dramatic decline in saving among households at the lower end of the distribution. This is consistent increasing demand for, and supply of, credit to these households, which may have reduced the sustainability of their debt burden and increased the risk of crisis. Further research on debt levels welcome.

• Turning to the recovery, we find that even a substantial income redistribution may not significantly affect the aggregate consumption of households.

• In summary, while reduced inequality and more broad-based income growth might help reduce the probability of a future crisis - and hence make recovery more sustainable - it is unlikely to have a substantial impact on the short-term prospects for growth.
Thank you!

Contacts:
Paolo Lucchino:

p.lucchino@niesr.ac.uk

Salvatore Morelli:

salvatore.morelli@economics.ox.ac.uk
Annex
A: FES data and National Accounts

Reproduced from van de Ven (2011)
A: Who is in the bottom decile?

A: What about liquidity constraints?

Figure 11: Consumption pre- and post- crisis
Average propensity to consume by decile

Source: Living Cost and Food Survey, 2007 & 2010
A: What about liquidity constraints?

Figure 11: Simulated aggregate propensity to consume under strict liquidity constraints

<table>
<thead>
<tr>
<th></th>
<th>Policy intervention</th>
<th>Back to the 70's</th>
<th>Full equality</th>
</tr>
</thead>
<tbody>
<tr>
<td>ppt change in APC</td>
<td>0.2</td>
<td>1.2</td>
<td>3.0</td>
</tr>
</tbody>
</table>
A: What about housing debt?

Only a minority of households in the bottom deciles were paying into a mortgage and building up housing equity.

The share of mortgage holders in the bottom deciles was broadly stable in the years before the crisis.