Models of inequality

Advanced Macroeconomics QF: Lecture 11
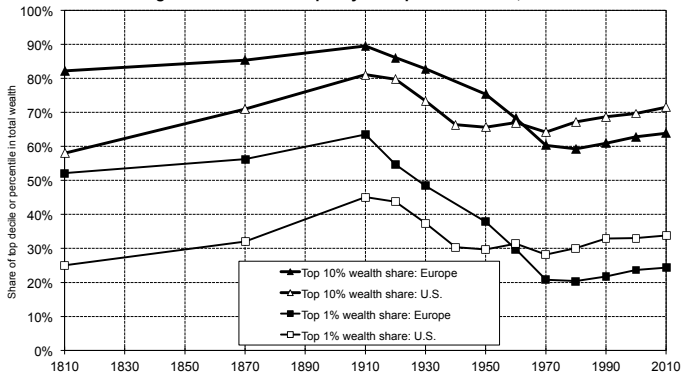
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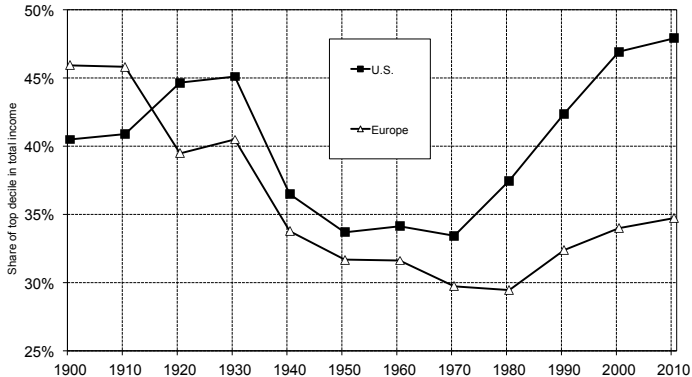Figure 10.6. Wealth inequality: Europe and the U.S., 1810-2010

Until the mid 20th century, wealth inequality was higher in Europe than in the United States.
Sources and series: see piketty.pse.ens.fr/capital21c.

Piketty (2014) Capital in the Twenty-First Century

Figure 9.8. Income inequality: Europe vs. the United States, 1900-2010

Piketty (2014) Capital in the Twenty-First Century
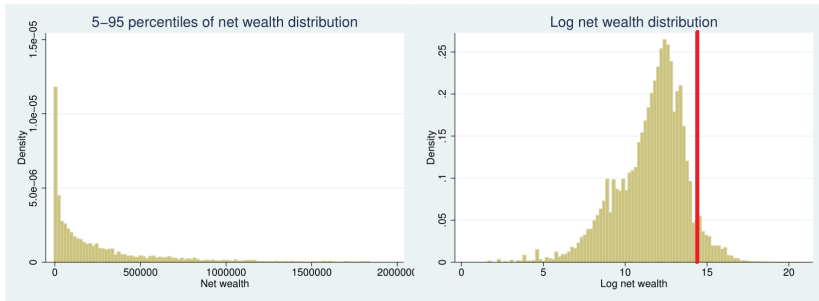
1. Model of (top) wealth inequality
   based on Jones (2015)

2. Simple model of precautionary savings
   and the role of borrowing constraints

3. Quantitative models of income and wealth inequality
   based on De Nardi (2015)
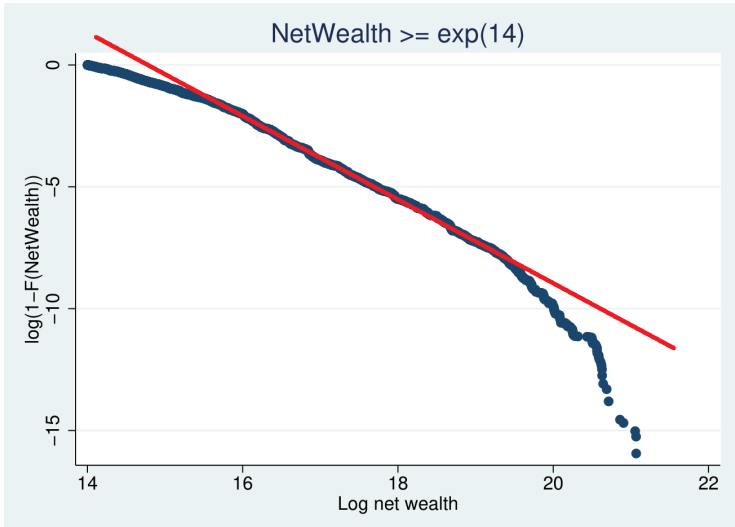
(Top) wealth inequality
– Jones (2015)

Ben Moll's lecture

Features of US Wealth Distribution:

- right skewness
- heavy upper tail
- Pareto distribution

US wealth distribution

Ben Moll's lecture

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Properties of Pareto distribution

- When a variable (e.g. wealth) is Pareto distributed, it satisfies:

$$\Pr\left[\text{wealth} > a\right] = (a/a_{min})^{-1/\eta}$$

which means the fraction of people with wealth greater than some cutoff is proportional to the cutoff raised to some power

- Under Pareto distribution, computation of "top shares" is easy. The fraction of wealth going to the top p percentiles is given by:

$$(100/p)^{\eta-1}$$

- The higher η is, the more unequal the distribution

- For $\eta = 0.5$ the top 1% wealth share is $100^{-0.5} = 10\%$
  For $\eta = 0.75$ the top 1% wealth share is $100^{-0.25} \approx 32\%$

- Piketty (2014): in the US the top 1% wealth share $\approx 33\%$, in UK and France between 25% and 30%

Core intuition

- Assume (for now) that the size of population does not change

- Suppose households face a constant probability of death d

- Then the probability that an individual is of at least age x is:

$$\Pr[\text{age} > x] = e^{-dx} \approx (1-d)^x$$

- Assume (for now) that everyone had the same initial wealth = 1

- Let the wealth of households increase with age at rate μ:

$$a(x) = e^{\mu x} \approx (1+\mu)^x \quad \rightarrow \quad x(a) = (1/\mu) \cdot \ln a$$

- Then we can easily map the probability of holding at least some amount of wealth to the probability of being old enough:

$$\Pr[\text{wealth} > a] = \Pr[\text{age} > x(a)] = \exp\left(-(d/\mu) \cdot \ln a\right) = a^{-d/\mu}$$

- Wealth is Pareto distributed with $\eta = \mu/d$

Demographics

- Maintain the assumption of constant death probability

- Allow population size to change over time

- Denote with B_t the number of people born in period t

- Define a (crude) birth rate b and assume it's constant:

$$b = B_t/N_t \quad \rightarrow \quad B_t = bN_t$$

- Population growth rate n is the difference between crude birth and death rates:

$$1 + n = \frac{N_{t+1}}{N_t} = \frac{N_t\,(1-d) + B_t}{N_t} = 1 - d + b$$

$$n = b - d \quad \rightarrow \quad b = n + d$$

- Share of people born in t relative to population in period t:

$$B_t/N_t = b$$

Age distribution

- Share of people born in t relative to population in period $t+1$:

$$\frac{B_t(1-d)}{N_{t+1}} = \frac{B_t(1-d)}{N_t(1+n)} = b\frac{1-d}{1+n}$$

- Share of people born in t relative to population in period $t+2$:

$$\frac{B_t(1-d)^2}{N_{t+2}} = \frac{B_t(1-d)^2}{N_t(1+n)^2} = b\left(\frac{1-d}{1+n}\right)^2$$

- Share of people aged x in the population is given by:

$$sh(x) = b\left(\frac{1-d}{1+n}\right)^x \approx b(1-d-n)^x = b(1-b)^x \approx be^{-bx}$$

- Probability that a person is at least of age x:

$$\Pr[\text{age} > x] = \int_x^\infty be^{-bs}\,ds = e^{-bx}$$

Households' choice

- Households solve the following utility maximization problem:

$$\max \quad U = \sum_{t=0}^{\infty} [\beta (1 - d)]^t \ln c_t$$

$$\text{subject to} \quad a_{t+1} = (1 + r - \tau) a_t - c_t$$

where households do not receive any labor income
and τ is a proportional tax on wealth

- Euler equation: $\qquad c_{t+1} = \beta (1 - d) (1 + r - \tau) c_t$

- Guess-and-verify that households consume a fixed fraction α
of their wealth ($c_t = \alpha a_t$, value of $\alpha \approx \rho + d$ is of no importance):

$$\alpha a_{t+1} = \beta (1 - d) (1 + r - \tau) \alpha a_t$$

$$\alpha [(1 + r - \tau) a_t - \alpha a_t] = \beta (1 - d) (1 + r - \tau) \alpha a_t$$

$$(1 + r - \tau) - \alpha = \beta (1 - d) (1 + r - \tau)$$

Wealth dynamics

- Budget constraint then determines the dynamics of wealth:

$$a_{t+1} = (1 + r - \tau - \alpha) \, a_t$$
$$a_t = (1 + r - \tau - \alpha)^t \, a_0$$

- Let $a_t(x)$ denote the wealth of a person aged x at time period t:

$$a_t(x) = (1 + r - \tau - \alpha)^x \, a_{t-x}(0)$$

- Assume that newly born agents inherit wealth of the deceased:

$$a_t(0) = \frac{dK_t}{B_t} = \frac{dK_t}{bN_t} = \frac{d}{b} k_t$$

- Assume the BGP economy with exogenous tech. progress:

$$k_t = (1 + g)^t \, k_0$$

- Wealth inherited by newborns in period $t - x$:

$$a_{t-x}(0) = \frac{d}{b} k_{t-x} = \frac{d}{b} (1 + g)^{-x} \, k_t$$

Wealth distribution

- Wealth of people aged *x* at time period *t*:

$$a_t(x) = (1 + r - \tau - \alpha)^x \cdot \frac{d}{b} (1+g)^{-x} k_t \approx \frac{d}{b} k_t \cdot e^{(r-g-\tau-\alpha)x}$$
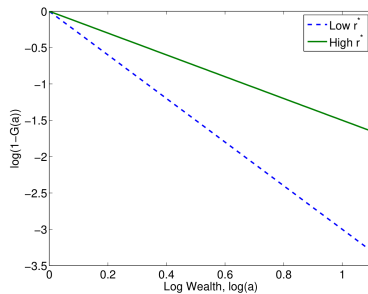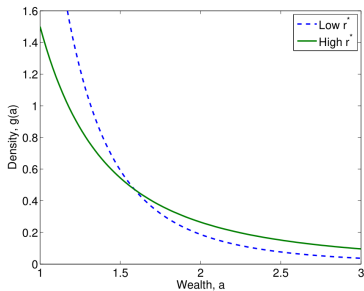
- Age *x* needed to accumulate wealth *a*:

$$x(a_t) = \frac{1}{r-g-\tau-\alpha} \cdot \ln\left(\frac{a_t}{(d/b)\,k_t}\right)$$

- Probability of holding wealth of at least *a* is then given by:

$$\Pr[\text{wealth} > a] = \Pr[\text{age} > x(a)] = e^{-bx(a)}$$

$$= \exp\left[-\frac{b}{r-g-\tau-\alpha} \cdot \ln\left(\frac{a_t}{(d/b)\,k_t}\right)\right] = \left[\frac{a_t}{(d/b)\,k_t}\right]^{-\frac{b}{r-g-\tau-\alpha}}$$

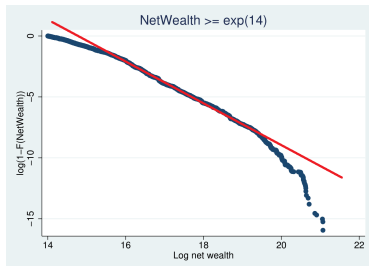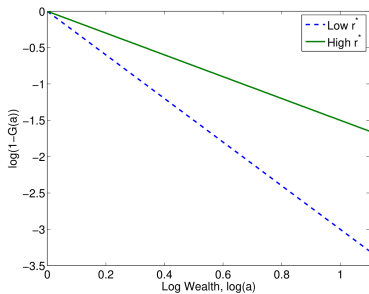- Wealth is Pareto distributed with $\eta = \dfrac{r-g-\tau-\alpha}{n+d}$

Ben Moll's lecture

Ben Moll's lecture

Figure 10.10. After tax rate of return vs. growth rate at the world level, from Antiquity until 2100
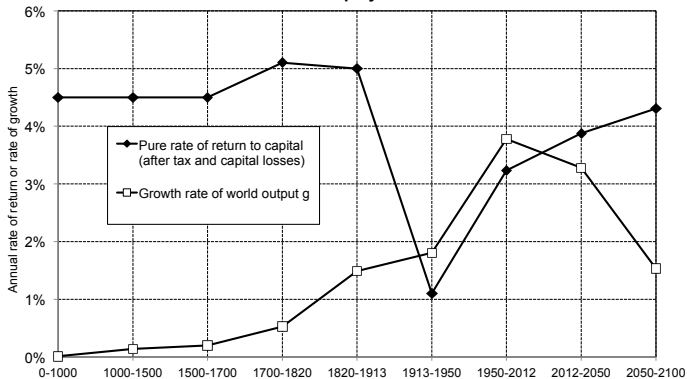
The rate of return to capital (after tax and capital losses) fell below the growth rate during the 20th century, and may again surpass it in the 21st century. Sources and series : see piketty.pse.ens.fr/capital21c

Piketty (2014) Capital in the Twenty-First Century

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$r > g$ t-shirts

- Wealth is Pareto distributed with $\eta = \dfrac{r - g - \tau - \alpha}{n + d}$
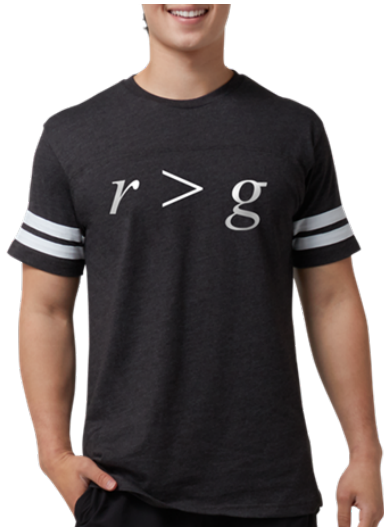
- Those lucky to live a long life (members of long-lived dynasties) will accumulate greater stocks of wealth

- Piketty (2014): increase in $r - g\,(-n)$ increases wealth inequality

- 19th century: low g and low $n \rightarrow$ high inequality

- Middle 20th century: high g and $n \rightarrow$ low inequality

- 21st century: declining g and $n \rightarrow$ back to 19th century (?)

- Piketty's prescription: increase τ to counteract g and n

Wealth inequality (General Equilibrium)

- Relationship between aggregate capital and individual wealth:

$$K_t = \sum_{x=0}^{\infty} sh(x) N_t \cdot a_t(x) = \sum_{x=0}^{\infty} b(1-b)^x N_t \cdot \frac{dk_t}{b} (1+r-g-\tau-\alpha)^x$$

$$\approx dK_t \sum_{x=0}^{\infty} (1+r-g-\tau-\alpha-b)^x = \frac{dK_t}{1-(1+r-g-\tau-\alpha-b)}$$

- Real interest rate under General Equilibrium is given by:

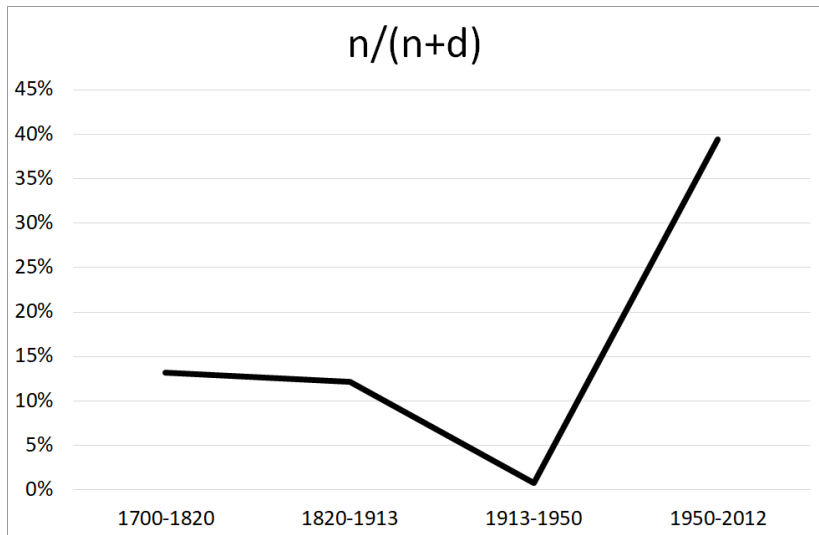$$d = -(r-g-\tau-\alpha-d-n) \quad \rightarrow \quad r = n+g+\tau+\alpha$$

- Wealth inequality coefficient under General Equilibrium:

$$\eta = \frac{r-g-\tau-\alpha}{n+d} = \frac{n+g+\tau+\alpha-g-\tau-\alpha}{n+d} = \frac{n}{n+d}$$

- Wealth inequality is determined purely by demography!

Role of demography: based on French data

n/(n+d)

| | 1700-1820 | 1820-1913 | 1913-1950 | 1950-2012 |

$$\eta^{PE} = \frac{r - g - \tau - \alpha}{n + d} \quad \text{vs} \quad \eta^{GE} = \frac{n}{n + d}$$

- Both results hinge on assumptions regarding inheritance
- If $n > 0$, more people are born than die, and newborns inherit less than the average wealth per capita
- If $n = 0$, there is no inequality under General Equilibrium!
- Need for richer framework, including bequests, social mobility, progressive taxation, micro- and macroeconomic shocks
- Piketty is right to highlight the link between $r - g$, population growth, taxes and top wealth inequality (under PE)
- But these results are fragile and can disappear under GE $\rightarrow$ more research needed (empirics & theory)

Figure 11.6. Observed and simulated inheritance flow, France 1820-2100

Piketty (2014) Capital in the Twenty-First Century

Precautionary savings
and borrowing constraints

- Consider a two-period expected utility maximization problem:

$$\max_{c_1, c_2, a} \quad U = \ln(c_1) + \beta E_1\left[\ln(c_2)\right]$$

$$\text{subject to} \quad c_1 + a = y_1$$

$$c_2 = y_2 + (1+r)a$$

- First period income is certain and equals y

- Second period income will be equal to either $y + e$ or $y - e$, with 50%-50% probability:

$$y_2 = \begin{cases} y + e & \text{w. prob. } 1/2 \\ y - e & \text{w. prob. } 1/2 \end{cases}$$

- Assume $\beta = 1$ and $r = 0$ for simplicity
- Use budget constraints to express consumption levels:

$$c_1 = y - a$$

$$c_2 = \begin{cases} y + e + a & \text{w. prob. } 1/2 \\ y - e + a & \text{w. prob. } 1/2 \end{cases}$$

- Rewrite the problem as choosing the optimal a alone:

$$\max_a \quad U = \ln(y - a) + \frac{1}{2}\ln(y + e + a) + \frac{1}{2}\ln(y - e + a)$$

- First order condition:

$$-\frac{1}{y - a} + \frac{1}{2}\frac{1}{y + e + a} + \frac{1}{2}\frac{1}{y - e + a} = 0$$

- Solution: ▶ full solution

$$a = \frac{1}{2}\left(\sqrt{y^2 + 2e^2} - y\right)$$

Precautionary savings

$$a = \frac{1}{2}\left(\sqrt{y^2 + 2e^2} - y\right)$$

When second period income is certain ($e = 0$) then
(given $\beta = 1$ and $r = 0$) the household holds no assets in optimum.
It allows them to smooth consumption over time, since $c_1 = c_2 = y$.

When there is uncertainty about second period income ($e > 0$),
the household accumulates **precautionary savings** to self-insure
against the scenario of low income in the second period.

We can easily demonstrate that the more variable second period
income is, the higher is the stock of accumulated assets:

$$\frac{\partial a}{\partial e} = \frac{1}{2} \cdot \frac{1}{2\sqrt{y^2 + 2e^2}} \cdot 2 \cdot 2e = \frac{e}{\sqrt{y^2 + 2e^2}} > 0$$

Incomplete markets and borrowing constraints

- But what if they could purchase insurance against shocks?
  - insurance pays $+e$ under negative shock and $-e$ under positive
  - consumption always equals y, no matter the state of the world
  - expected insurance payout = 0, should be available at low cost
  - its absence evidence for market incompleteness
  - real-world example: no full unemployment insurance
- HH could not borrow in period 2 to smooth out the shocks
- Can be shown that (assuming $\beta(1+r) = 1$) infinitely lived household does not change consumption under temporary income shocks when borrowing constraints are absent
  - asset holdings follow random walk
  - wealth distribution indeterminate
- Market incompleteness and borrowing constraints generate stationary wealth distribution under idiosyncratic shocks
  - typically under GE $\beta(1+r) < 1 \rightarrow$ "excess" savings
  - capital taxation may increase welfare if finances insurance

Solution to precautionary savings problem I

Rewrite the FOC:

$$\frac{1}{y-a} = \frac{1}{2}\frac{1}{y+e+a} + \frac{1}{2}\frac{1}{y-e+a} \quad | \quad \cdot 2$$

$$\frac{2}{y-a} = \frac{1}{y+e+a} + \frac{1}{y-e+a}$$

$$\frac{2}{y-a} = \frac{y-e+a+y+e+a}{(y+e+a)(y-e+a)}$$

$$\frac{2}{y-a} = \frac{2y+2a}{y^2 - ye + ya + ey - e^2 + ea + ay - ae + a^2}$$

$$\frac{2}{y-a} = \frac{2(y+a)}{y^2 + 2ay - e^2 + a^2}$$

$$\frac{1}{y-a} = \frac{y+a}{y^2 + 2ay - e^2 + a^2}$$

Solution to precautionary savings problem II

Cross-multiply the above equation to get:

$$y^2 + 2ay - e^2 + a^2 = (y + a)(y - a)$$
$$y^2 + 2ay - e^2 + a^2 = y^2 - a^2$$
$$2ay + 2a^2 - e^2 = 0$$

The result is the following quadratic equation for a:

$$a^2 + ay - \frac{e^2}{2} = 0$$

The above quadratic equation has two roots: ◂ back

$$a = \frac{-y + \sqrt{y^2 + 2e^2}}{2} \quad \text{or} \quad a = \frac{-y - \sqrt{y^2 + 2e^2}}{2}$$

Discard the second root – in this case for $e = 0$ we get $a = -y$ and $c_2 = 0$, which is clearly not the solution of the consumer's problem

Income and wealth inequality – De Nardi (2015)

Basic infinitely-lived Bewley model

- Framework proposed by Bewley (1977)
- Labor market status z_t (e.g. $z_t = \{0, 1\}$) evolves according to the transition matrix P (with stationary distribution $\bar{P}$)
- Households want to maximize lifetime expected utility:

$$\max_{\{c_t\}_{t=0}^{\infty}} \quad U = E_0 \left[\sum_{t=0}^{\infty} \beta^t u\left(c_t\right) \right]$$

$$\text{subject to} \quad c_t + a_{t+1} = z_t w + (1 + r)\, a_t$$

$$a_{t+1} \geq \underline{a}$$

$$z_{t+1} \sim P\left(z_t\right)$$

- Solution: infinite sequence of consumption plans $\{c_t\}_{t=0}^{\infty}$
- Can rewrite this problem as: choosing today's consumption and tomorrow's assets only, conditional on today's assets and labor market status

Recursive formulation of household's problem

- We can rewrite the utility function into the **value function**:

$$V(a_t, z_t) = \max_{c_t,\, a_{t+1}} \{u(c_t) + \beta E_t [V(a_{t+1}, z_{t+1}) | z_t]\}$$

$$\text{subject to} \quad c_t + a_{t+1} = z_t w + (1+r) a_t$$

$$a_{t+1} \geq \underline{a}$$

- Even more compactly:

$$V(a_t, z_t) = \max_{a_{t+1} \geq \underline{a}} \{u(z_t w + (1+r) a_t - a_{t+1}) + \beta E_t [V(a_{t+1}, z_{t+1}) | z_t]\}$$

- Solution is the **policy function** A which maps from (a_t, z_t) to a_{t+1}:

$$a_{t+1} = A(a_t, z_t)$$

- We can also use the budget constraint to obtain
the policy function C which maps from (a_t, z_t) to c_t:

$$c_t = C(a_t, z_t) = z_t w + (1+r) a_t - A(a_t, z_t)$$

Example

- Solutions are obtained numerically
  using a variety of computational methods

- Example model:
  - households have low ("unemployed")
    or high ("employed") labor productivity
  - low productivity is 10% of high productivity
  - $z_t = [0.1, 1]$, $P = \begin{bmatrix} 0.9 & 0.1 \\ 0.1 & 0.9 \end{bmatrix}$, $\bar{P} = [0.5, 0.5]$
  - borrowing constraint $\underline{a} = 0$
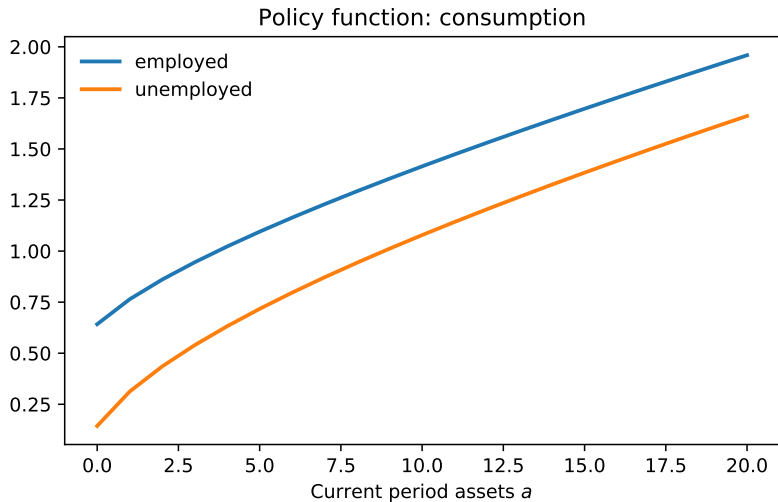 - $u(c) = \ln c$, $\beta = 0.96$
  - $r = 2\%$

Policy function: assets
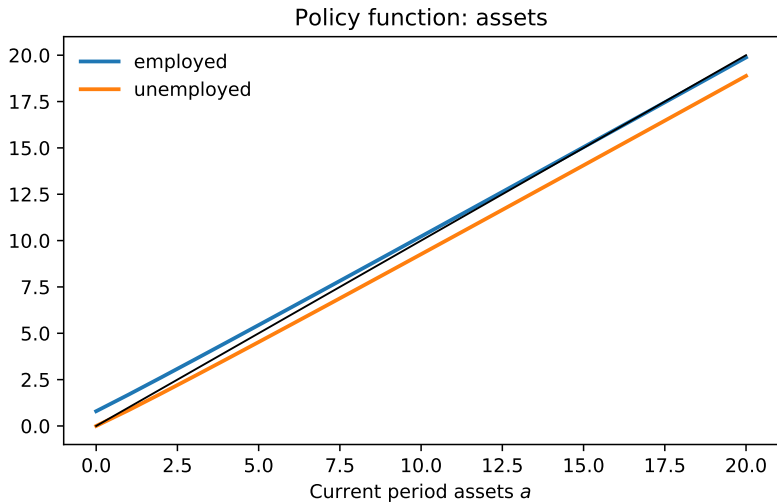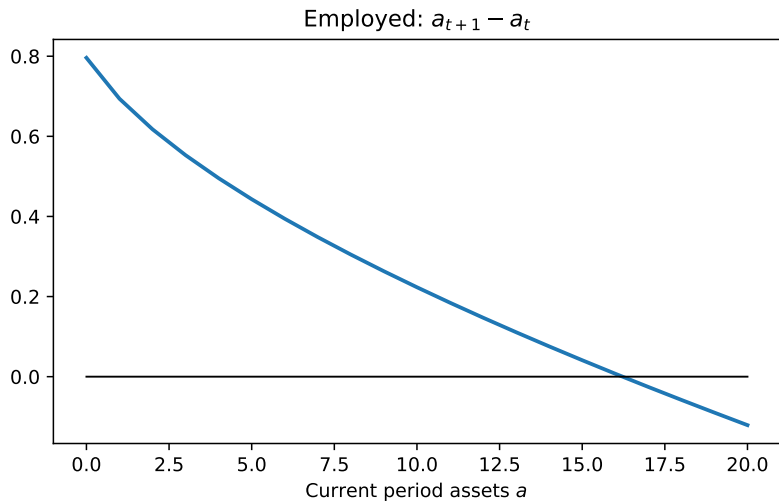
Employed: $a_{t+1} - a_t$

Policy function: consumption

Wealth distribution
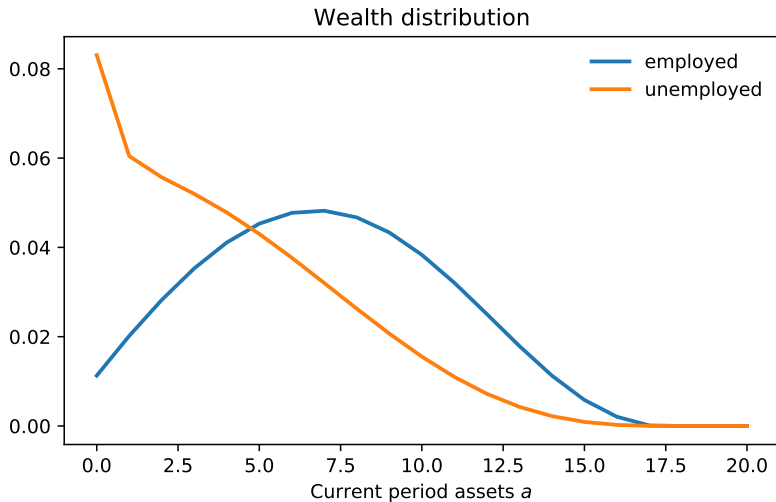
General Equilibrium

- Households (and firms) take prices w and r as given
- Assume standard production function:

$$Y = K^\alpha L^{1-\alpha}$$

- Prices depend on the supply of factors of production:

$$L = N \cdot \bar{P} \times z^T$$
$$K = \int_{\underline{a}}^{\infty} a \, dg(a)$$

- Expressions for prices:

$$w = \alpha K^\alpha L^{-\alpha}$$
$$r = (1-\alpha) K^{\alpha-1} L^{1-\alpha} - \delta$$

- Market clearing: equalize capital supply (households) with capital demand (firms) $\rightarrow$ equilibrium prices

Capital market equilibrium

Lorenz curve for wealth (General Equilibrium)

Some issues

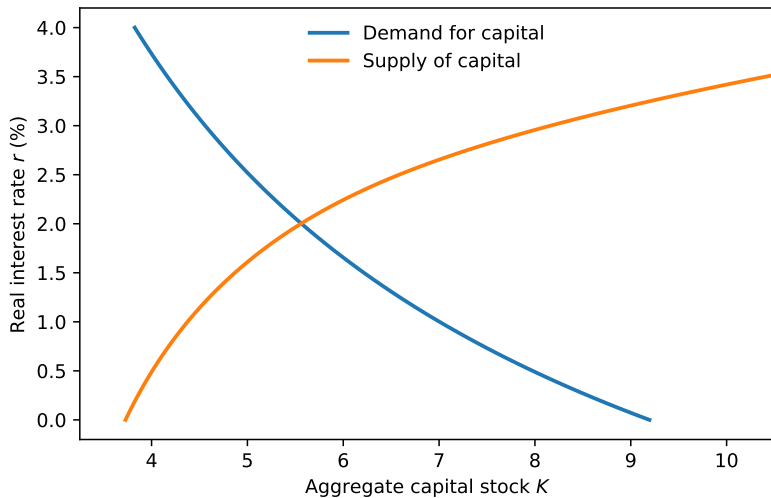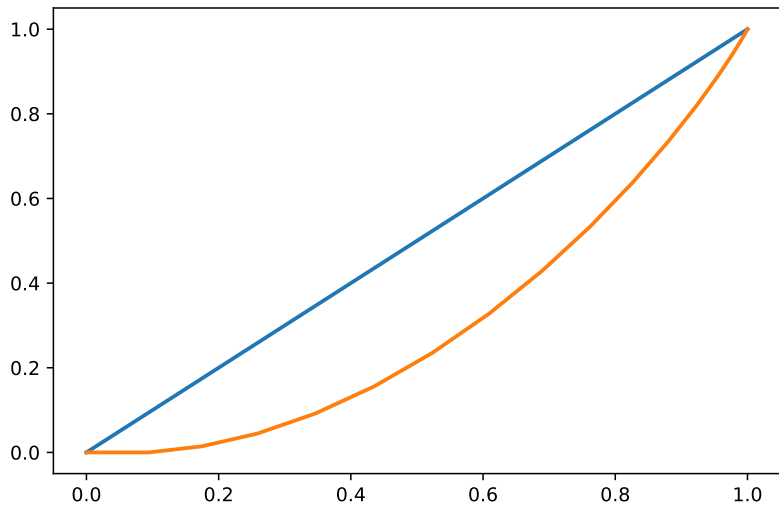- Since under General Equilibrium $\beta (1 + r) < 1$, households do not want to save without bound (good for computational reasons)

- Households are willing to hold positive assets because:
  - there is a borrowing constraint
  - they don't want to have low assets when "unemployed"
    $\rightarrow$ very low consumption
  - no reason to increase assets if the above possibility is small and in distant future

- Hard to generate households with very high wealth

- Inequality does not matter much for aggregate outcomes
  - Policy functions close to linear
  - Households with low assets have low consumption
    $\rightarrow$ impact on aggregate consumption small
  - Not that many of borrowing-constrained households

- Aiyagari (1994) approximates the earnings process of US workers by an AR(1) process in logs:

$$\ln z_t = \rho \ln z_{t-1} + \varepsilon_t$$

- Autocorrelation $\rho = 0.6$ and standard deviation $\sigma_\varepsilon = 0.2$
- Labor productivity can take 7 values

	% wealth in top		
Gini	1%	5%	20%
U.S. data, 1989 SCF			
.78	29	53	80
Aiyagari Baseline			
.38	3.2	12.2	41.0
Aiyagari higher variability			
.41	4.0	15.6	44.6

Huggett (1996)

- Huggett (1996): overlapping generations variant of the Bewley model

- Households can live for up to T periods and face age-dependent survival probability s_t

- Value function is age-dependent:

$$V_t\left(a_t, z_t\right) = \max_{c_t,\, a_{t+1}} \left\{u\left(c_t\right) + \beta s_{t+1} E_t\left[V_{t+1}\left(a_{t+1}, z_{t+1}\right) | z_t\right]\right\}$$

$$\text{subject to} \quad c_t + a_{t+1} = e_t\left(z_t\right) w + \left(1 + r\right) a_t + b_t$$

$$a_{t+1} \geq \underline{a}$$

where b_t are bequest from the deceased (redistributed equally) plus Social Security payments to retirees

- Partial Equilibrium very easy to solve since V_T is known

De Nardi (2004)

- De Nardi (2004): Huggett model with intergenerational links
  - voluntary bequests from parents to children (utility from giving)
  - transmission of labor productivity from parents to children

| Transfer wealth ratio	Wealth Gini	Percentage wealth in the top					Percentage with negative or zero wealth
		1%	5%	20%	40%	60%	
U.S. data, 1989 SCF							
.60	.78	29	53	80	93	98	5.8–15.0
Equal bequests to all (Huggett)							
.67	.67	7	27	69	90	98	17
Unequal bequests to children (unintentional)							
.38	.68	7	27	69	91	99	17
Parent's bequest motive							
.55	.74	14	37	76	95	100	19
Parent's bequest motive and productivity inheritance							
.60	.76	18	42	79	95	100	19
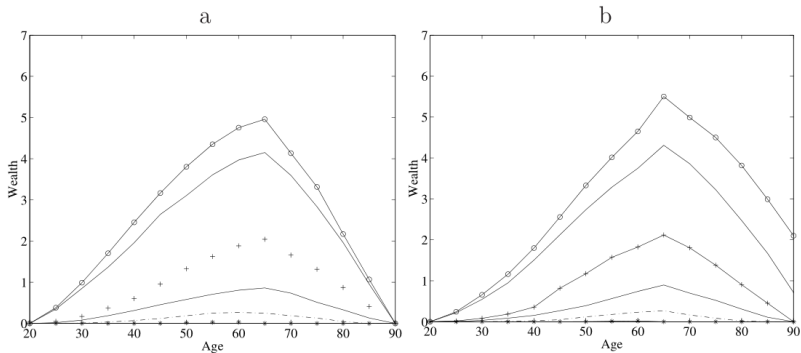
Figure 2: Wealth .1, .3, .5, .7, .9, .95 quantiles. No links, equal bequests to all, panel a, and Bequest motive, panel b. *De Nardi (2015)*

Cagetti and De Nardi (2006)

- Entrepreneurs: households who declare being self-employed,
  own a privately held business (or a share of one),
  and have an active management role in it

- Small fraction of the population,
  but hold a large share of total net worth

Top %	1	5	10	20
Whole population				
percentage of total net worth held	30	54	67	81
Entrepreneurs				
percentage of households in a given percentile	63	49	39	28
percentage of net worth held in a given percentile	68	58	53	47

Cagetti and De Nardi (2006)

- Cagetti and De Nardi (2006): Altruistic agents care about their children
- Every period, agents decide whether to run a business or work for a wage
- Entrepreneurial production function depends on entrepreneurial ability and working capital
- Borrowing for working capital is constrained by agents' assets
- Rationale for holding high levels of wealth

Wealth Gini	Fraction of entrepreneurs	Percentage wealth in the top			
		1%	5%	20%	40%
U.S. data					
0.8	7.55%	30	54	81	94
Baseline model with entrepreneurs					
0.8	7.50%	31	60	83	94

- Intergenerational linkages and entrepreneurship can account for the observed wealth inequality

- Caution: changes in these assumptions can yield vastly different welfare effects of policies!

- To get macroeconomic effects of inequality usually at least two assets are needed: Ahn et al. (2017)
    - think liquid assets and housing
    - "wealthy hand-to-mouth" agents: low liquid asset holdings and mortgaged house
    - consumption choices of these agents matter for aggregate consumption $\rightarrow$ they consume a lot and are quite numerous (up to 50%)