PETERSON INSTITUTE FOR INTERNATIONAL ECONOMICS

Comment on “Confronting Inequality” by Jonathan Ostry, Prakash Loungani and Andrew Berg

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My major comments on the book

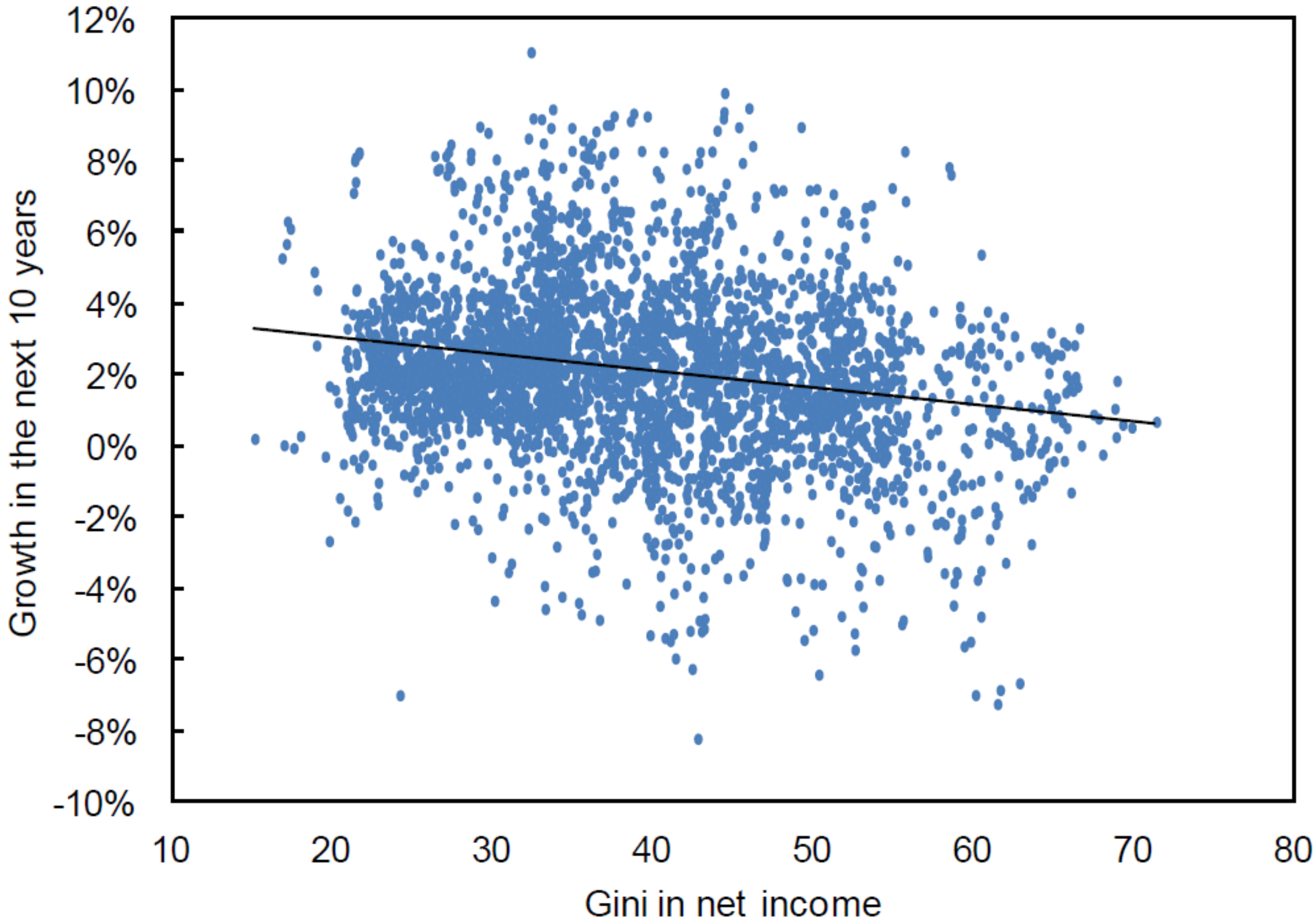
- It’s great, you should read it
- Little to disagree with
- But I’ll still try

It’s great, you should read it

Fundamental re-thinking of much of the conventional wisdom and policy prescriptions from a decade ago. Some of the many examples:

- **Inequality** is bad for growth and redistribution does not harm growth.
- **Financial liberalization** is lose-lose (worse on growth and inequality) in countries with low financial depth and/or low financial inclusion.
- **Austerity** can fail a cost-benefit test: “the cost of the tax increases or expenditure cuts needed to bring down the debt are much larger than the reduced crisis risk from lower debt.”
- **Monetary expansions** reduce inequality.

Try #1: More research finds inequality bad for growth but some results mixed and fragile



Source: Ostry, et al. (2014).

Maybe this is because there is no grand unified answer to the effect of inequality on growth

In fact, Ostry, Loungani and Berg have an entire chapter on structural reform that finds the following policies help growth but worsen inequality:

- Domestic finance reforms
- Tariff reforms
- Current account liberalization
- Capital account liberalization
- Network reforms
- Collective bargaining
- Rule of law

Try #2: Even if bad for growth, unclear how to interpret when the RHS variable is "inequality" not "policies to reduce inequality"

Model 1: Inequality leads to populism and anti-growth policies like tariffs.

Model 2: Inequality leads to plutocracy and stops pro-growth policies like education.

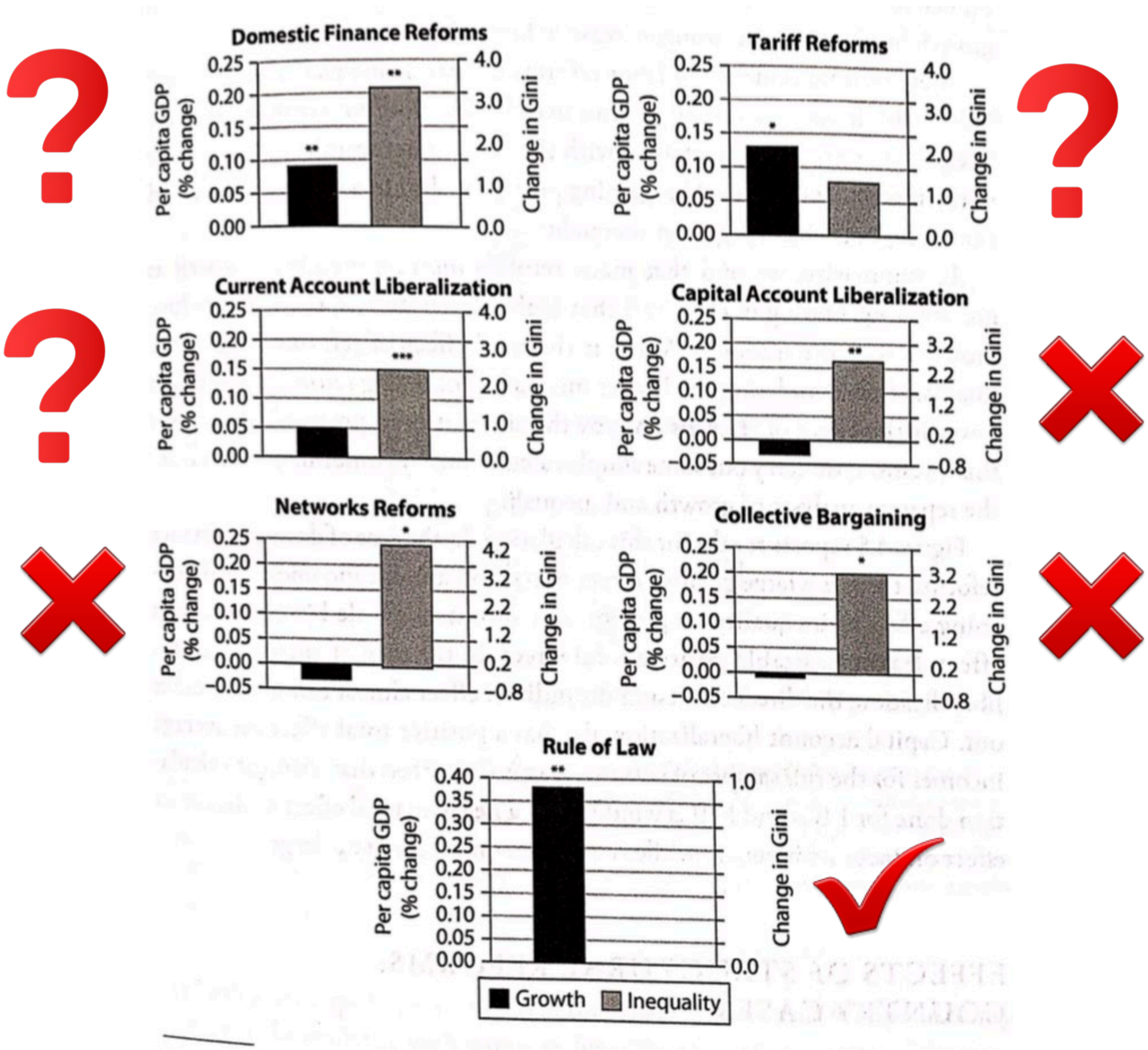
These are observationally equivalent. Which is why a positive or negative aggregate relationship has little bearing on policy choices.

Try #3: The authors try to avoid value judgments, but these are unavoidable—and policymakers need guidance

- **No *a priori* normative relevance to growth.** Is just the arithmetic average of incomes—which implicitly is a Social Welfare Function no one would defend (e.g., are we better off if a billionaire makes an additional $1 billion annually and 1 million low-income households all lose $900 annually?)

- **No *a priori* normative relevance to gini coefficients.** A measure of inequality, not well being.

Which of these policies for low/middle income countries would you recommend?



Do you know how to trade off inequality for growth?

France has a Gini of 0.29. Suppose a policy would take it up one standard deviation (within the OECD) to 0.33, the equivalent of Australia or Portugal. How much of a level increase in output would justify this increase?

(A) 0.1%
(B) 1%
(C) 5%
(D) 10%
(E) 15%
(F) No level increase in output could justify it

Plausible social welfare functions

Utilitarian: If people's utility is log(income) then you try to maximize the sum of log incomes.

Rough rule: Need a 3% increase in the level of output to offset each 0.01 increase in the Gini index.

Inequality Aversion: Need more than about a 5% increase in the level of output to offset each 0.01 increase in the Gini index.

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(A) 0.1%
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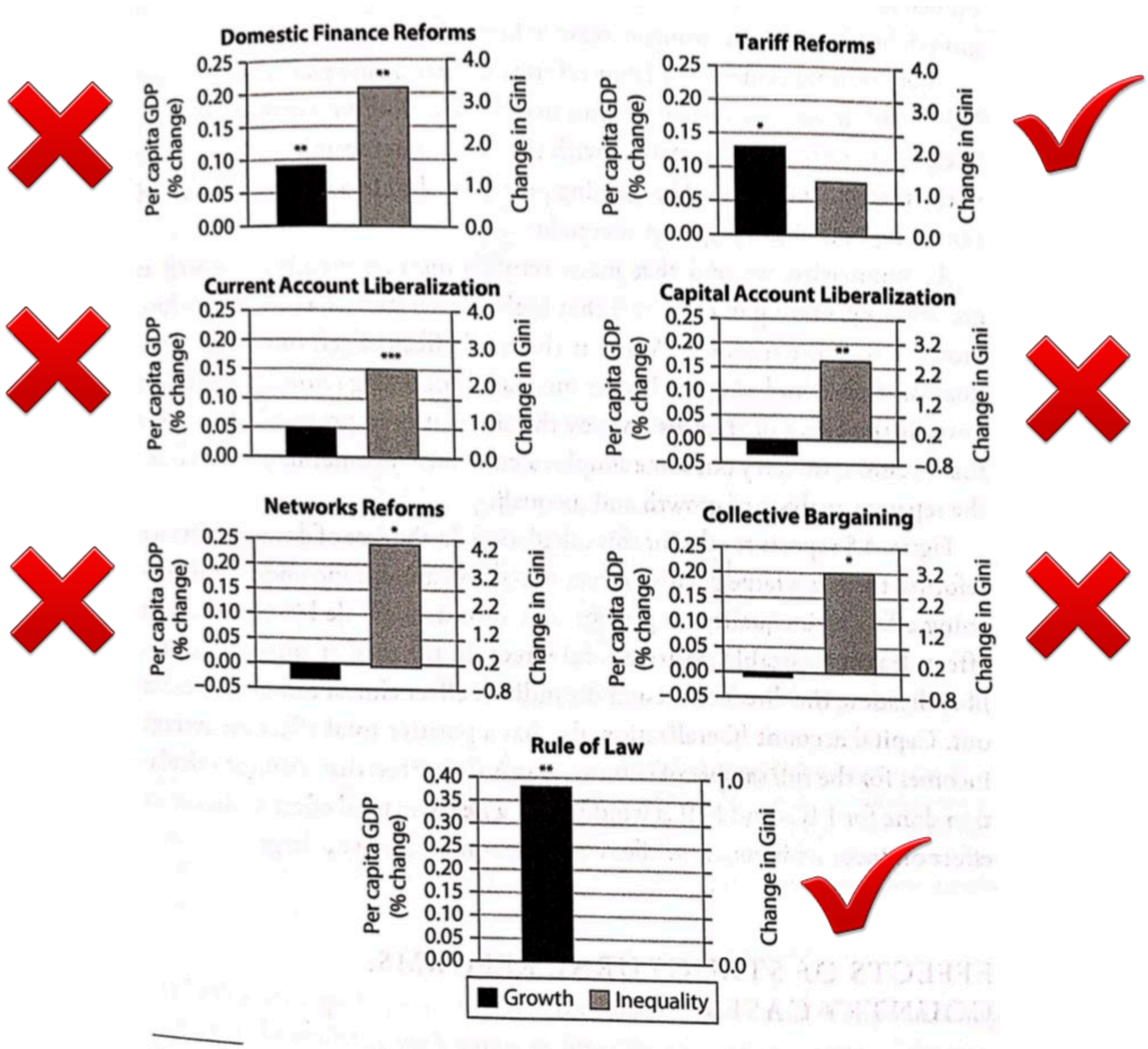
(D) 10%
(E) 15% - CORRECT (GIVEN SWF)
(F) No level increase in output could justify it

Which of these policies for low/middle income countries would you recommend?



The next book I would love to see from the authors

Build on what is already here (and ahead of many others)

- Distinguishing between factors and policies that push growth in the same/different directions.

- Focus on policies on inequality that are good/bad for growth more than on inequality as good/bad for growth.

And what I'm hoping to see added to the next book

- More micro, less macro.

- To the degree macro, more focus on indicators that reflect social welfare and less on the arithmetic average of incomes.

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