



Equality, Efficiency and Growth

Is There A Trade-Off?

The Seed Example- Revisited

- ✓ Seed from Heaven, Uncertainty
- ✓ Two Goods -- Manna and Leisure
- ✓ Manna=f(Seed, Labor, Luck)
 - 1 labor+2 seeds = 2 loaves + e
- ✓ Seed Endowments Not Observable
- ✓ Labor Endowments - 10 units each
- ✓ Consumption of Manna Is Observable
 - (1,2,3,5,9)

Why Trade-Off?

✓ Incentive Effects

- Labor supply

✓ Savings Behavior

- Higher propensity to save among rich

✓ Factor Mobility

- Progressive Tax can induce movement of capital and high income individuals to other countries or states.

Second Fundamental Theorem of Welfare Economics

- ✓ No trade-off if (a) markets are complete and perfectly competitive; and (b) it is possible to transfer wealth among consumers in an incentive neutral or lump sum matter.
- ✓ Incentive neutral -- income transfers based on personal characteristics which are unaffected by behavior.

Where Is Greater Equality More Efficient?

✓ Principal-Agent Problems

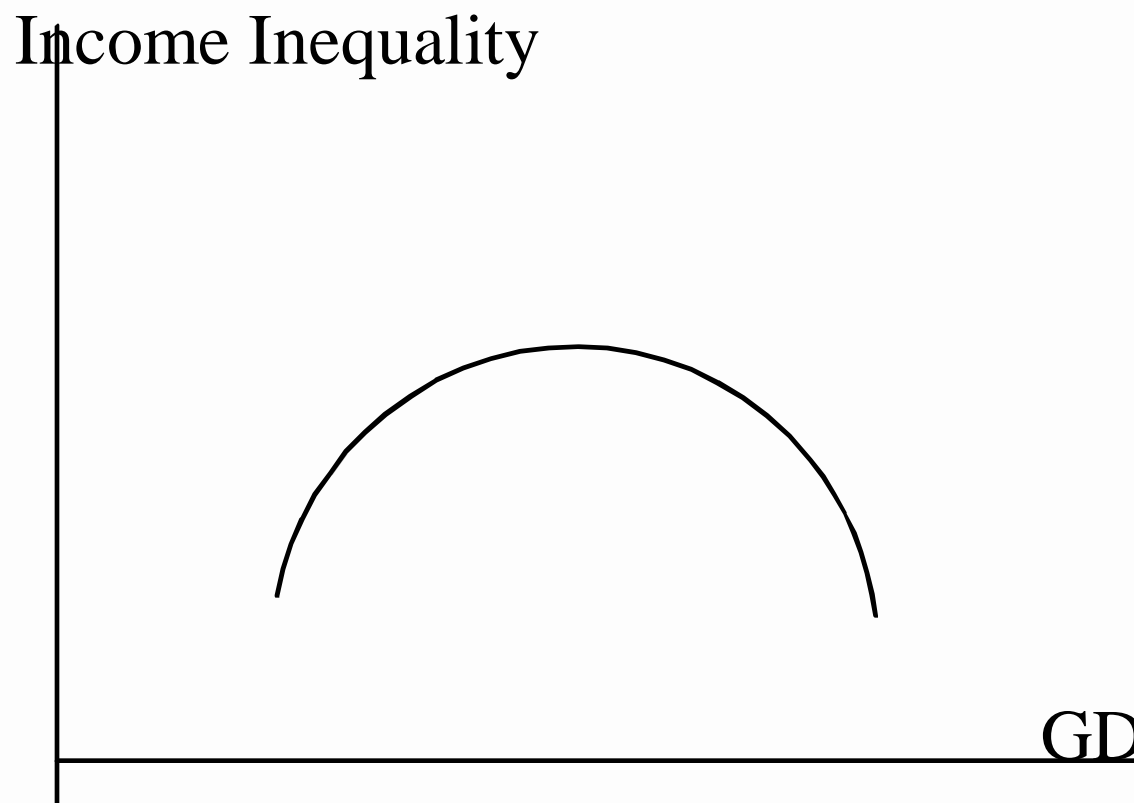
- Imperfect Information and Monitoring Costs
- Profit Sharing Increases Productivity

✓ Investments in Human Capital

- Imperfect Capital Markets
- Parent's Resources Constrain Investments
- Redistribution Can Improve Productivity

✓ Winner Take-All Contests?

Kuznets Hypothesis



Observations

- ✓ From 1929 to Post War, Income Share of Bottom Quintile of US Population Increase
- ✓ Similar Patterns in UK and Germany
- ✓ This is a puzzle that Kuznets analyzes in 1955 article in the American Economic Review.

Reasons to Expect Positive Correlation Between Income Inequality and GDP

- ✓ Concentration of savings in upper-income brackets should perpetuate and exacerbate existing inequality in the distribution of income.
- ✓ Shift out of agriculture should widen income inequality because inequality tends to be greater in industry. Urbanization also should widen inequality.

Factors That Tend to Counteract this Tendency

- ✓ Legislative interference; Politics.
- ✓ Demographic changes -- rich tend not to reproduce themselves.
- ✓ Technological change
- ✓ Slower productivity growth in incomes of rich.
- ✓ Narrowing inequality in industry

Kuznets Hypothesis

- ✓ Early stages of industrialization and urbanization characterized by increasing inequality.
- ✓ Late stages of industrialization characterized by decreasing inequality