Is Equality Stable? (Mookherjee and Ray, 2002)

Economists have three dominant theories of why income inequality is present in every country in the world. First, current rich countries used their resources efficiently, while poor ones did not. Second, stochastic shocks introduce inequalities constantly. To illustrate this point, natural disasters can decrease the income of a portion of the economy while increasing another portion. The third idea is that income inequality is a feature of modern credit and labor markets.

One Sentence Summary

The authors argue that income inequality cannot be maintained in the long run because financial markets are not strong enough to provide educational opportunities to the poorest individuals.

Main Findings

Suppose jobs require a mandatory educational cost to be filled, and every job has to be filled for the economy to prosper. In addition, high-paying jobs require a high educational cost to be filled. Who pays for these educational costs? The parents in the economy. A parent receives a wage and has some financial assets that allow them to borrow, subject to a credit limit. Then they decide to allocate their income between consumption and investments towards their child's education. After the parent dies, the child fills an occupation according to their parent's investment and has their own child.

Mookherjee and Ray (2002) argued, with the latter framework, that long-run income equality is stable on one condition.

Condition 1: if the limit of borrowing of the least paid parent can give their child the necessary education to fill the most paid occupation.

When condition 1 is met, every child has can fill the highest paying job because every parent can afford it. If condition 1 fails, there will be a dynasty of high paid parents that accumulate wealth, as they need minor investments to finance their child's education. Thus, creating an income difference between the most paid parents and the least paid parents. Sadly, it is implausible that a country meets condition 1. In other words, there will always be inequality in the long run.

Most notably, the condition does not depend on starting conditions. For example, two identical countries can start with different income distributions. Country one has perfect income equality, and the other has some income inequality. In the long run, both countries will have a level of income inequality, as it is most likely that they will cannot meet the condition. Nonetheless, country one will enjoy equality for a certain amount of time until condition 1 fails.

Concluding Remarks

This paper presents a novel framework to understand income inequality. Because inequality is not caused by some exogenous variables like different initial conditions or stochastic shocks, income inequality is theoretically possible so long as condition 1 holds.

References

- Mookherjee, D., Ray, D., 2002. Is Equality Stable? Am. Econ. Rev. https://doi.org/10.1257/000282802320189357.