Is Equality Stable? (Mookherjee and Ray, 2002)

Economists have three main theories of why income inequality is present in every country in the world. First, different initial conditions can induce different income levels. For example, current rich countries used their resources efficiently, while poor ones did not. Second, stochastic shocks introduce inequalities constantly. 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. In this way, equality will never be stable in the long run.

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 many different jobs require a mandatory educational cost to be filled. Every job has to be filled in this economy. As the education cost increases, so do the associated wage. In this economy, there are several households with a parent and a child. A parent receives a wage and has some financial assets that allow them to borrow, subject to a credit limit. The parent decides to allocate their wage and assets 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 have their child. The process repeats again and again creating a family dynasty.

The authors argued, with the latter framework, that long-run 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 little 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 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 fail to 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 exogeneous variables like different initial conditions or stochastic shocks. Instead, it characterizes income inequality as a feature of credit and labor markets. Providing some relief that income equality can be achieved if we ensure condition 1 is always met.

References

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