Income and wealth inequality make recessions worse, research reveals

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"The Great Recession is the biggest economic downturn since the Great Depression of the 1930s. If you can't make an argument that inequality matters for the severity of this downturn, then it's unlikely to matter much for smaller recessions, or for normal times."

That was the starting point for a new working paper from Dirk Krueger of the University of Pennsylvania, in collaboration with alum Kurt Mitman, currently at the Institute for International Economic Studies, and Fabrizio Perri of the Federal Reserve Bank of Minneapolis. The paper, online now, is slated for eventual publication as a chapter in *The 2017 Handbook of Macroeconomics*.

The book editors charged the research team with looking at the relationship between income, wealth and consumption inequality, as well as the U.S. macroeconomy as a whole. The researchers chose the Great Recession as an example to make a larger point.

Given the highly unequal wealth distribution in the United States, where the top 20 percent holds more than 80 percent of all wealth and the top 1 percent owns more than 30 percent, an event like the Great Recession hit harder than it would have in a place with a more level economic playing field. Specifically, total consumption would have fallen 0.5 percent less, about $200 per household per year, in an economy with a smaller wealth and income gap.

"The recession is deeper, if you will," Krueger said.

To draw these conclusions, Krueger and colleagues started with raw data, poring over income, wealth and spending of individual households in 2006. "Income" in this case means household earnings from the labor market plus interest from savings. Think of "wealth" as net worth, or the value of that family's assets (a house, say) minus its liabilities (the mortgage on that house).

Next the researchers built a model of the 2006 U.S. economy that incorporated household spending preferences, in other words, whether a family saved or used the money it brought in for consumption purposes. This step ensured an accurate model of the U.S. economy prior to the Great Recession and gave the researchers some confidence that the model replicated what actually happened during the slump.

"You might ask, 'Why do you need a model for that since we have the data?'" Krueger said. "What you can't do in the data is ask the counter-factual question: Suppose that inequality was smaller than it actually is? How much smaller would the recession have been? There's no parallel universe to look at. To shrink the inequality and then see how the recession would have played out, for that you need a model."

This knowledge doesn't necessarily provide a path toward fully avoiding recessions caused by shocks beyond the control of economic policy. But it can provide decision makers with important information to assist individuals and households when a similar circumstance arises. For example, Krueger said, policies that reallocate funds to households with different levels of wealth could lead to a "softer" recession. Extended unemployment benefits might also help, though Krueger points out his team did not conduct a full-fledged welfare analysis of this question, so more research is needed.

And though $200 per household doesn't sound like a significant amount of money, consider this. It's a change that would happen for more than

116 million households in the U.S., totaling some $23.2 billion.

"This is on the order of magnitude of what major tax or trade policy reforms would look like," Krueger said. "In economics, you typically don't come up with welfare losses that are larger than that for making policy changes. Finding an impact number of 10 percent of lifetime consumption, that is not in the books for reasonably functioning economies."

The research has a broader aim, too, to help economists better understand the Great Recession, an event few saw coming.

"We had this massive event that most basic research would not have predicted. Now let's come to terms with it," he said. "For most economists, the Great Recession was a big surprise when it happened, and in the past few years we have been grappling with understanding it better."

More information: Macroeconomics and Household Heterogeneity. economics.sas.upenn.edu/~dkrue … esearch/Handbook.pdf

Provided by University of Pennsylvania

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