

Predictable Life-Cycle Shocks, Income Risk and Consumption Inequality

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Summary

- analyze the joint evolution of income and consumption inequality
- using repeated cross sections from CEX
- finding that predictable permanent shocks have been mostly responsible for the increased income inequality
- which reconciles the views that (i) income shocks are permanent, (ii) consumption inequality has not risen (by so much).

Main Idea

Impact of Δy on Δc :

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At odds with time-series evidence on incomes. Though Gottschalk and Moffitt seem to emphasize the importance of transitory shocks.

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By Sherlock Holmes's principle:

“When you eliminated the impossible, whatever remains, must be the truth.”

Comments

1. Is there *direct evidence* on predictable shocks?
2. Predictable permanent shocks have different implications for *within-* and *across-cohort* inequality.
3. What about the *levels* of inequality?

Direct Evidence?

- Three main moment conditions:

$$\Delta \text{var}_t(y) = \overset{\text{permanent}}{\text{var}_t(v)} + \overset{\text{predictable}}{\text{var}_t(\alpha)} + \overset{\text{transitory}}{\Delta \text{var}_t(u)}$$

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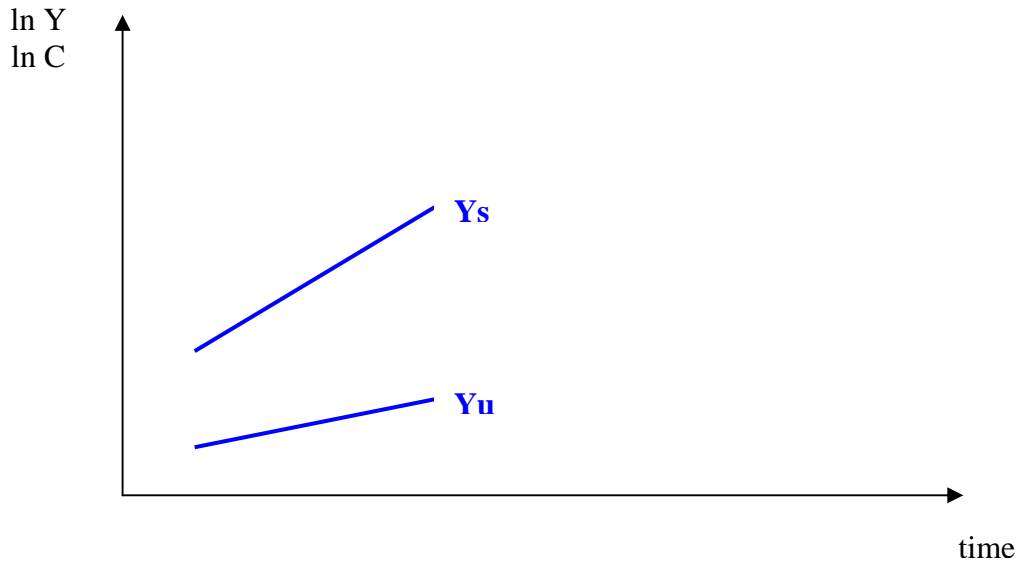
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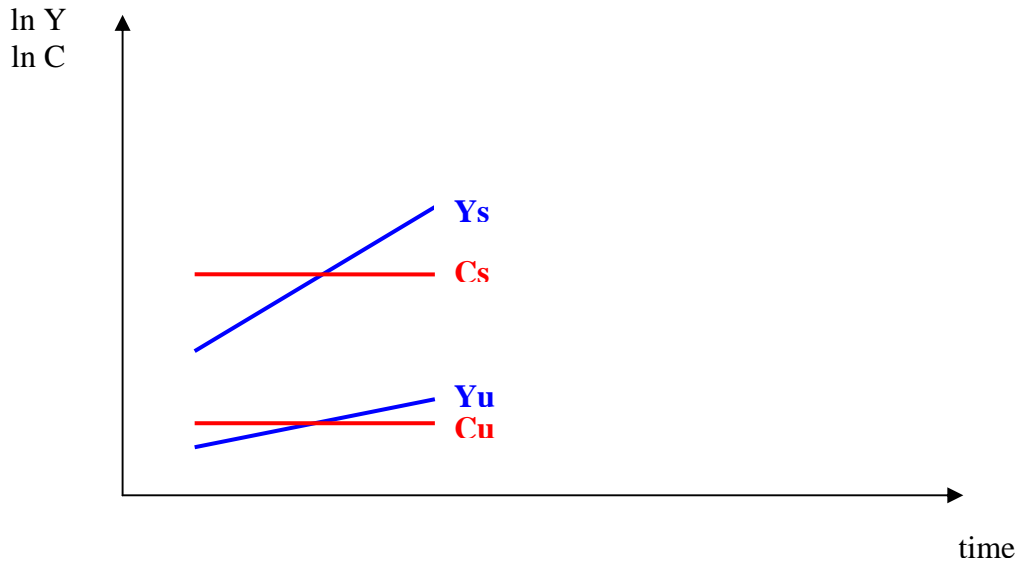
Suggestions

- Identify predictable shocks from PSID?
 - Income trends of individual/narrow groups?
 - Skill premium?

The Clash of Generations

- The theory mostly applies to *within-cohort* inequality (tracking a fixed set of infinitely-lived people).
- Newborns have not yet consumed their predictable permanent income.
- If income inequality increases *across cohorts*, consumption inequality will also increase, even if shocks are predictable.
- Aggregate inequality is increasing if
 1. within-cohort inequality is increasing,
 2. incoming cohorts are more unequal,
 3. society is aging.





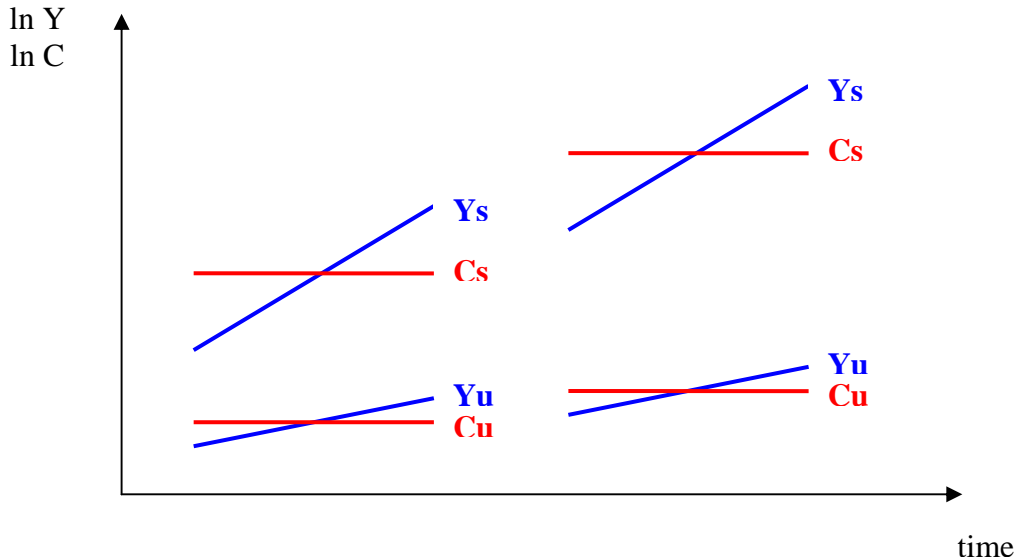
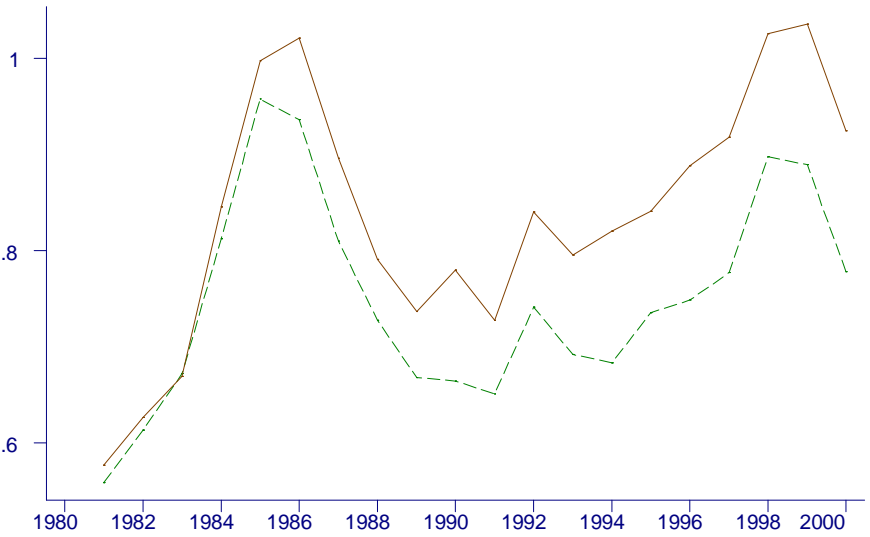


Figure 3

Aggregate (dashed) and average within cohort (solid) inequality

Income



Consumption



Suggestions

- Emphasize composition effects more. (Moment conditions?)
- Allow for cohort effects in $\text{var}(c)$.
 - PvR assume $\text{var}_{0,t}(c) = \text{var}_{0,s}(c)$
 - cannot separately identify age, cohort and time effects
 - you cannot restrict $\text{var}(y)$ and $\text{var}(c)$ independently

Levels of Inequality

- At any point in time, $\text{var}_t(c) \ll \text{var}_t(y)$.
- Approximately, $\text{var}(c) \approx 0.3 \text{var}(y)$.
- Inconsistent with permanent shocks: even if they are predictable, inequality levels should be comparable.
- Consistent with transitory shocks ($\text{MPC} < 1$) and borrowing constraints (MPC declines with Y).

Suggestions

- Include levels among the moment conditions.
 - Measurement error?
- More detailed treatment of constrained consumers?