Policy, Inequality, and Growth -- Comments on Jason Furman

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Claim 1

- *Cross-country inequality-growth regressions are not very helpful for policy*
- What is an appropriate indicator of social welfare?
  - not growth or GPD/capita?
- What is the actual policy that affects inequality?
  - the tension between the social scientist and the policy analyst
  - which goes deeper: social scientist wants to explain through exogenous variation (history, geography); the more successful s/he is, the less room for agency for policy maker.
- But does that mean that cross-country empirical literature was useless?
  - maybe not, since it countered a widely held view that inequality was desirable for – or a necessary concomitant to – growth

Claim 2

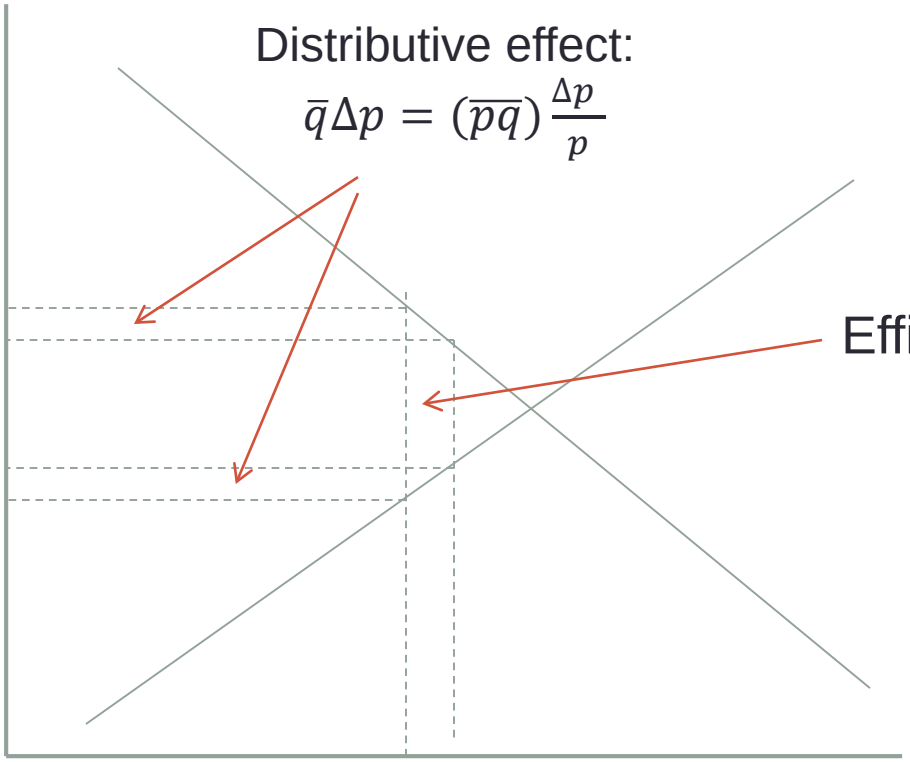
- *"Growth" effects of actual policies (such as tax changes) are much smaller than redistributive effects*
- Actually, not growth but level of steady-state output (in the paper)
- Essentially follows from the fact that distributive effects are rectangles (≈ qXΔp) while efficiency gains are triangles (≈ ½ΔqXΔp)
- Equally important, redistribution increases relative to efficiency effects as tax gets smaller
- Trade example to complement tax example in the paper
  - output/inequality trade-off with NAFTA (next)
- But what about real (endogenous) growth effects? (below)

Redistribution vs efficiency

Ad-valorem tax wedge: τ

Distributive effect:

$$\bar{q}\Delta p = (\overline{pq})\frac{\Delta p}{p}$$



Efficiency effect:

$$\overline{\tau p}\Delta q = \epsilon\bar{\tau}(\overline{pq})\frac{\Delta p}{p}$$

Key point: efficiency effect depends on size of tax wedge; redistribution does not.

A trade illustration

- Ratio of redistribution to efficiency gains of removing trade barriers (in partial equilibrium) = $\frac{1}{\mu\varepsilon t}$
  - where μ = share of imports in domestic consumption, ε is the (absolute value) of the price elasticity of import demand, and t is the size of the trade barrier (in percent terms)

μ	ε	t	redistribution per dollar of aggregate gain
0.25	2	**0.4**	**5**
0.25	2	**0.3**	**6.7**
0.25	2	**0.2**	**10**
0.25	2	**0.1**	**20**

as trade is liberalized further and further…

The ratio of redistribution to efficiency gains is not only very large, it rises to ridiculous heights as the tax/policy distortion that is removed gets smaller

And in general equilibrium…

initial tariff being removed	change in low-skill wages (A)	increase in real income of economy (B)	absolute value of ratio (A)/(B)
40%	-19.44%	4.00%	4.9
30%	-15.22%	2.25%	6.8
20%	-10.61%	1.00%	10.6
10%	-5.56%	0.25%	22.2
5%	-2.85%	0.06%	45.5
3%	-1.72%	0.02%	76.6

Notes: Column (B) is computed using the standard formula for the gains from trade (e.g. Feenstra 2016, p. 220), assuming an import-GDP ratio of 25% and an import demand elasticity of -2. Column (A) is generated using a model with two factors (low- and high-skilled labor) and two goods with mobile factors, assuming the import-competing sector is low-skill-intensive. The cost shares of low- and high-skill labor in the import-competing sector are taken to be 0.80 (denoted θ_l^L) and 0.20 (θ_h^L), respectively. The factor cost shares in the exportable sector are symmetric – 0.20 (θ_l^H) and 0.80 (θ_h^H). To compute the change in real wages ($\widehat{\omega}_l$), I assume low-skilled workers spend 75 percent of their budget on the importable and 25 percent on the exportable. The corresponding derivation yields $\widehat{\omega}_l = \{[\theta_l^L - \theta_h^L \frac{\theta_l^H}{\theta_h^H}]^{-1} - 0.75\}\hat{p}$, where $\hat{p}$ is the percent change in the relative price of the importable implied by the tariff reduction.

What about the real world: effects of NAFTA

- Minute real income effects

Bilateral welfare effects from NAFTA's tariff reductions

	Terms of trade		Volume of Trade	
Country	NAFTA	Rest of the world	NAFTA	Rest of the world
Mexico	−0.39%	−0.02%	1.80%	−0.08%
Canada	−0.09%	−0.02%	0.08%	−0.04%
U.S.	0.03%	0.01%	0.04%	0.00%

Source: Caliendo and Parro (2015)

- Large distributional effects
  - wage growth in in the most affected industries was reduced by 17 percentage points (relative to other industries) (Hakobyan and McLaren 2016)

But what about real growth effects?

- E.g., many would say Caliendo-Parro type studies vastly underestimate “dynamic” effect of trade agreements
- New growth theory: policy can affect long-run growth
  - LBD, IRS, investment in R&D
  - models with inherent market imperfections: monopoly profits, externalities
- Hard to say anything in general
  - endogenous growth models can convert level effects into growth effects
  - but because they come with market imperfections, they also generate second-best, perverse effects
    - taxes, tariffs can increase growth (and welfare)

Claim 3

- *Developing economies should place comparatively more weight on growth because growth rate differentials are much larger*
- But what matters is the portion of the variation that is exploitable by policy
  - and not clear we have greater leverage there, except for in the extremes of bad policy
  - we know remarkably little about the relationship between actual policy and long-run growth, even in developing countries
- But larger distortions (tax or otherwise) do imply less redistribution per output gain (as per above)

Concluding remarks

- Broadly agree with paper, and sympathize with its aims
- Redistributive effects of tax/trade policies tend to be large and, equally importantly, are more predictable ex ante
- This is particularly important when tax/trade distortions are “small”
- Need to distinguish between level and steady-state effects and long-run growth effects
  - the latter can be quantitatively much more significant
  - though we understand them a lot less well
- But would certainly not want to give up on trying to get a grip on how policy affects long-run growth