Predictable Life-Cycle Shocks, Income Risk and Consumption Inequality

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The income-consumption inequality puzzle

- The fact: earnings inequality has increased a lot in the past two decades
- Decomposition of earnings inequality into permanent and transitory components
  - Gottschalk&Moffitt[1994], Dickens[2004]
- Almost no change in consumption inequality
  - Blundell&Preston [1998]
- How to reconcile?
  - credit markets
    - Krueger&Perry [2002], Blundell&Pistaferri&Preston [2005]

The authors' solution of the puzzle

- while income is affected by all types of shocks (permanent expected, permanent unexpected and transitory)

$$y_{it} = y_{it-1} + \upsilon_{it} + \alpha_{it} + \Delta u_{it}$$

- under consumption smoothing, only unexpected permanent income shocks affect consumption

$$c_{it} = c_{it-1} + \upsilon_{it}$$

- Combine data on consumption and income to disentangle expected and unexpected permanent income shocks

$$\begin{aligned} \Delta var_t(y) &= var_t(\upsilon) + var_t(\alpha) + \Delta var_t(u) \\ \Delta var_t(c) &= var_t(\upsilon) \end{aligned}$$

  - transitory shocks are (as usual) identified by the auto-covariance of income.

Main results

1. Most of the increase in earning dispersion [$var_t(y)$] is due to expected permanent income shocks [$var_t(\alpha)$]

2. This is why consumption inequality did not increase.

The role of earnings instability

- The result that the transitory variance of earnings plays no role is surprising
  - Gottschalk&Moffitt [1994, 2002], Dickens [2000] find 30% to 50% of the total increase due to transitory shocks, with large differences across skill groups (education or occupation).

- In fact, another important puzzle in the literature is: **why has the transitory variance of earnings increased so much?**

- Explaining changes in the variance of the permanent variance is (relatively) easy...a lot more difficult to find causes for increased earnings instability

Reconciling results

- Differences in data:
  - earnings versus income (?)
- Modelling and assumptions
  - not surprising that unexpected income shocks are not so important

$$\Delta var_t(c) \simeq \Delta var_t(\upsilon) \simeq 0$$

    this is why you need credit constraints:

$$\Delta var_t(c) = var_t(\upsilon) + \lambda var_t(\alpha) + \lambda \Delta var_t(u)$$

  - imposing a low variance of υ has implications for the relative importance of $var_t(\alpha) + var_t(u)$?
- Composition effects (education, occupation)

The importance of better data on credit constraints

- Apparently, introducing credit constraints is crucial

- Why not using more direct information from the raw data to identify λ?
  - mortgage, leased cars, savings&investments, real estates, financial situation.
  - durable and non-durable consumption. Possibly different propensities to consume out of different types of shocks.

More data and less assumptions

- Wider issue in this branch of the literature

- There seems to be a lot of unexploited information in survey data that could be used to identify transitory vs. permanent shocks (an possibly also expected vs. unexpected shocks)
  - promotions (private vs. public sector), firm closures, lotteries, inheritance.
  - expectations (SHIW - Pistaferri[2003]).