Discussion of:

Inequality and the Rise of Finance

by

Dario Laudati

Juan Castellanos

European University Institute

6th QMUL Workshop in Economics & Finance

May 31, 2024

EUROPEAN UNIVERSITY INSTITUTE

The paper in a nutshell

- **Research question**: Is there a common factor that jointly explains the rise in the financial sector (non-banks) and wealth inequality from the 1980s until the 2008 GFC?
- **Methodology**: stylized facts + macro-finance model + empirical tests
  * Constructs long time series to provide descriptive evidence on the common factor – the fall in the labor share – that explains part of the rise in shadow banking and inequality.
  * Builds a parsimonious macro-finance model to test, via a steady state comparison, how much of these trends can be explained by the fall in the labor share alone.
  * Empirically tests for:
    - Long run co-movement between the changes in financial assets to GDP and inequality
    - A *direct effect* of higher inequality leading to larger financial sector and a *feedback effect* that amplifies the rise in inequality
- **Main finding**: A change in the technological structure (increase in the capital share) can partly explain the rise in inequality, the growth of finance and the decline in real interest rates.

Comment 1: Return Uncertainty vs. Capital Share

EUROPEAN UNIVERSITY INSTITUTE

- An increase in **(capital) income volatility** σ_ε has similar *qualitative* implications in the model: (1) higher demand for safe assets, (2) lower interest rates, and (3) higher leverage

- If am not mistaken, the **baseline exercise increases both**: the capital income share from $\alpha_1 = 0.279$ to $\alpha_2 = 0.327$ and the idiosyncratic variance from $\sigma_{e,1} = 0.543$ to $\sigma_{e,2} = 0.57$
  * Since they reinforce each other, how much is the contribution of each of them to the overall increase in inequality, financial intermediation and fall in real interest rates?
  * It will be interesting to decompose these effects ...
  * It may be that you are looking at the change in both parameters combined to get less action on the portfolio composition as it doesn't change in the data and these two increases have opposite effects on the share of safe assets

- Has there been an increase in return uncertainty since the 1980s? What's the time series correlation with the top 5% wealth share?

Comment 2: Human capitalists & the labor share

EUROPEAN UNIVERSITY INSTITUTE

- Accounting for equity based compensation has important implications for the changes in factor shares (Eisfeldt, Falato, Xiaolan 2023)
    * *"The addition of equity pay to cash wages reduces the decline implied by the wage-only income share of value added in manufacturing since the 1980s by 32%"*
    * *"Without including equity pay, high-skilled labor's share decreased from 17% in the 1980s to 11% in the most recent decade. The inclusion of equity based compensation almost eliminates this decline"*
    * *"The high-skilled share of total labor income increases from one-third at the beginning of the 1960s to two-thirds in the 2010s when equity based compensation is included"*

- In the model most of the rise in inequality happens within investors! However, these facts seem to also point to a **rise in inequality within workers**
    * Division of workers between high and low skilled
    * A third factor of production: human capital

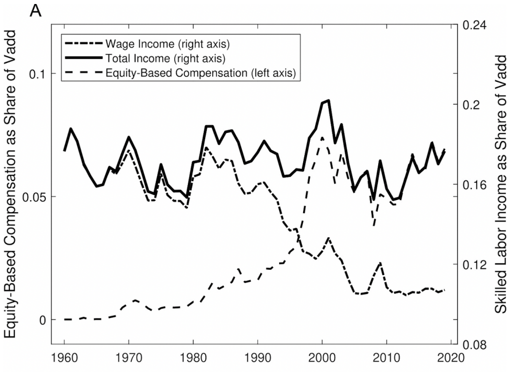
▷ Adjusted Income Shares

Well done!

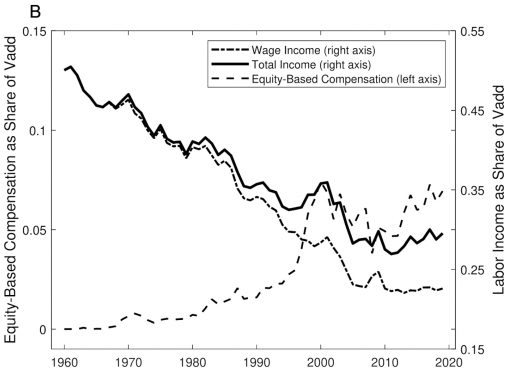
EUROPEAN UNIVERSITY INSTITUTE

- Cool stylized facts and an interesting hypothesis on how they explain each other.
- **Theory + empirics = great combo!**
- A follow up question on your work . . .
  * How are inequality and shadow banking expected to evolve in the future?
  * Is it possible that the causal relationship reverses and the rise of market-based finance leads to higher inequality?
  * A couple of thoughts:
    - In contrast to the traditional banking sector, non-banks are more lightly regulated
    - A more fragile banking sector increases the probability of a crisis, its duration and severity
    - Poor and middle income households may bear this cost = $\uparrow$ defaults $\implies$ higher wealth inequality in the long-run

Human capital share of income and total labor share



(a) Human Capitalists' Income Share



(b) Total Labor Share

▷ Back