

Referee Report on:

“Stylized Facts on the Interaction between Income Distribution and the Great Recession”

by Karl Aiginger and Alois Guger

27 May 2013

The authors use cross country data to estimate the statistical relationships between numerous measures of income inequality in an economy (both levels and changes) prior to the recent worldwide financial crisis and the output performance of that country during the financial crisis. They find little empirical evidence to support the proposition that pre-crisis income inequality was associated with the output performance of a country during the crisis.

There are some obvious issues regarding the data, methodology and resulting interpretations of the empirical analysis included in this paper. I divide these loosely into ‘major’ and ‘minor’ issues below in more-or-less the order in which they occur in this paper.

Major Issues

- 1. Potential Outliers (Figures 2 and 3).** Although the authors find no consistent and robust evidence of a relationship between pre-crisis inequality and output performance during the financial crisis, they do point out two statistically significant negative correlations between Gini coefficients/wage shares and this overall output performance. These results are far from convincing. Both appear to be largely driven by the inclusion of the results from the three Baltic countries (Lithuania, Estonia and Latvia). If the results from these very similar countries are excluded from these calculations, they would almost surely overturn these findings of negative and significant correlations (just by eyeballing Figures 2 and 3 this would seem to be true). This issue deserves much more attention especially in light of potential data issues (see point 3 below).
- 2. Other Potential Explanatory Variables.** On page 19, the authors experiment with previous “good practice” regressions, which I assume means including the current account balance along with the various measures of inequality as explanatory variables in a regression where output performance is the dependent variable. This isn’t explained very well in this paper.

If the current account balance was suspected initially of being the best ‘single explanatory variable’ in such a regression, why wasn’t it included at the outset of this analysis? Moreover, what about the role of *other* potential explanatory variables for a country’s vulnerability to the worldwide financial crisis? From my perspective, these likely candidates would be pre-crisis ‘financial liberalization/deregulation’ and ‘expansionary/unsustainable fiscal policy’ (the latter never even gets a mention in this paper). If this approach were adopted the resulting partial correlations would be much more persuasive. I don’t find the dismissal for possibility of doing this kind of econometric analysis at the top of p.21 very convincing.

- 3. Data Issues.** Only near the end of this paper (Section 6, p.20) do the authors mention that basic income data (and measures of inequality) are somewhat inconsistent across countries (e.g., personal vs. household income, including vs. excluding taxes, transfers, etc.). The time series have substantial gaps in many countries. Particular problems are pointed out for Eastern Europe (see point 1 above on potential outliers).

There are two basic problems here. Firstly, if these data issues are as problematic as suggested, why wasn't this mentioned at the outset of this paper? Clearly, it would have been better to mention these concerns *before* the data were analysed. Secondly, after mentioning the potential depth and range of these problems in a single paragraph, the authors never go on to address some obvious and fundamental questions. How 'severe' are these data problems for this analysis? What, if anything, can be done to mitigate the impact of these errors-in-variables problems? How would they compromise the results and affect the interpretation of these findings?

Minor Issues

1. **(p.1, Title of the paper)**. It makes more sense to me to use the 'plural' in referring to the income distribution(s) mentioned in the title of this paper. Income distributions are country-specific in this analysis.
2. **(p.2, Section 1)**. The authors refer to a literature on "... how labor markets performed differently in the crisis." At least some references for these studies should be cited here.
3. **(p.5, Section 2)**. The study by Bordo and Messner (2011) is mentioned, but no reference for this work was given at the end of this paper.
4. **(p.10, Section 3 and throughout the remainder of this paper)**. To make it easier for the reader, I'd suggest replacing the words 'Distribution Level' with 'Inequality' (see for example the horizontal axis for Figure 1). Positive and negative values for output (the vertical axis) are straightforward, but positive and negative values for the distribution level (the horizontal axis) are less clear. An example of this is on p.13. Referring to countries that "... did not excel in income distribution" is awkward, and can easily be amended to refer to countries with "... low income inequality."