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Inequality is bad for growth of the poor

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Bonn, Washington, 22 February 2016. With the recent adoption by the UN last year of the new Sustainable Development Goals (SDGs), an important global agenda has been set for the 2015-2030 period. An issue that seems to have attracted considerable attention in the process of setting up the goals is income inequality. While this is by no means a new topic, a growing consensus seems to be emerging that inequality needs to be tackled.

A good chunk of the economic and political thinking since the 1950s has considered the effect of inequality on growth to be positive. A certain concentration of wealth was thought to facilitate the accumulation of savings that would fund growth-enhancing investments. In addition more unequal societies are believed to provide stronger incentives for individuals to work harder in order to succeed. But, as is often the case in economics, one can also think of arguments that would predict an opposite relationship. For example it can be argued that in modern societies the key to stimulating growth is the accumulation of human capital – that is education – more so than the accumulation of physical capital. If a significant share of the population has imperfect access to good quality education, then future growth may be constrained. Think of a society where good schools are not for everyone; where good schools come with high tuition fees or are tied to specific neighbourhoods; a society where affordable public schools are falling behind because the rich do not have an interest to invest in them. A similar argument can be applied to health care.

The question whether high inequality today bodes well for future rates of income growth and poverty reduction has recently acquired added relevance because of the slowdown of growth in rich countries and simultaneously rising inequality. The relationship between inequality and future growth has been extensively researched but, unfortunately, the results proved to be inconclusive. We argue that by looking at growth of average incomes (or Gross Domestic Product, GDP, per capita) important heterogeneities are being overlooked. The question we should be asking is: How do individuals at different steps of the socio-economic ladder fare in societies with different levels of inequality? This is precisely what two of us have just done in a recent study.

Using data for the United States spanning the years 1960-2010 – a period of substantial transformation of America's economy and society during which growth moved from being pro-poor to being pro-rich – the study establishes an important stylized fact: High levels of income inequality are associated with lower future growth rates for the poor and the middle class. No such negative correlation is found to hold for the rich, if anything, higher inequality is found to help their future growth prospects. In other words, highly unequal societies are found to stimulate the type of economic growth that further enhances inequality, at least in the United States for the time period under consideration.

What makes it so hard to put a halt to this cycle and – in the case of the United States – put the country back on a trajectory where growth is shared by all? We hypothesize that when inequality is high and top incomes are significantly greater than the incomes of the middle classes, the rich prefer to opt out of publicly-funded and publicly-provided education, health care and other services, as they increasingly consume them privately. This can be seen as "social separatism". Indeed, when asked if they would be willing to cut public spending on education and health as a way to reduce the deficit, 58 % of the rich in the United States are in favour of such cuts versus only 21 % among the rest of the population. The public goods that the rich are not interested to invest in are, however, crucial for real income growth of the poor. Unfortunately for the poor, the preferences of the rich have been found to carry more weight in public decision making than the preferences of the poor or even those of the median voter. It is a model of society where high inequality, combined with credit constraints and influence of the rich on the political process, results in a steady-state of low government spending, which in turn holds back the rise of poor people's incomes and perpetuates inequality.

While this study does not provide direct evidence for it, policies that would arguably reduce inequality and improve the growth prospects of the poor and the middle class include curbing the influence of money in politics, confronting socio-economic segregation, and ensuring that every child regardless of socio-economic background has access to good quality education.

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