

Inequality of Opportunity and Economic Growth: Does Inequality Hamper or Promote Economic Growth?

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Inequality of Opportunity and Economic Growth: Does inequality hamper or promote economic growth? The question has long been debated, because plausible arguments can be made in either direction. If the wealthy have a greater propensity to save and invest, inequality may promote faster capital accumulation and growth (Kaldor, 1960, Galor and Tsiddon, 1997). On the other hand, greater inequality may lead a (poorer) median voter to favor excessively high levels of taxation (Alesina and Rodrik, 1994, Persson and Tabellini, 1994). With imperfect capital markets, greater inequality translates into a larger share of the population that is excluded from productive investment (Galor and Zeira, 1993; Banerjee and Newman, 1993). Given the theoretical ambiguity, the question can only be settled empirically. Yet, the large empirical literature on the topic in the 1990s and 2000s produced an equally ambiguous set of results. A number of early papers, estimated on cross-sectional data, tended to find negative coefficients on initial inequality in growth regressions. Panel data, on the other hand, suggested a positive effect of inequality on subsequent economic growth, at least in the short- and medium-run (Forbes, 2000). But these results, too, have been criticized: on the bases of the specific functional form assumed; of the quality of underlying data; and of the use of a single inequality statistic to describe the distribution. This paper proposes an alternative explanation: There are two different underlying sources of income (or wealth) inequality. Some of the inequality we observe originates from differences in pre-determined circumstances, like race or family background – the literature has recently taken to calling this “inequality of opportunity”. But there is also inequality that arises from the market rewards to differential degrees of effort. Following Marrero and Rodriguez (2010), we hypothesize that the effect of overall inequality on growth may be ambiguous because, whereas inequality of effort promotes economic growth (via incentives for hard work and savings), inequality of opportunity hinders it (via reduced opportunities for education and investment for many). We test this hypothesis on an unbalanced panel data set with 40 countries, covering the 1975 to 2005 period. Unlike earlier studies, we construct our own measures of income or consumption inequality directly from unit-record household level data in all cases. For each survey, we also compute a measure of ex-ante inequality of opportunity (in the spirit of Checchi and Peragine, 2010; and Ferreira and Gignoux, 2011), based on a common set of circumstances available for all surveys in our meta-dataset. Once our new cross-country dataset of income and opportunity inequality measures is presented, we use alternative estimation methods to investigate the effect of inequality on economic growth. Following Forbes (2000), these include country fixed effects and Arellano and Bond’s first-difference generalized method of moments, but also system GMM estimation (Arellano and

Bover, 1995, and Blundell and Bond, 1998). Taking into consideration previous concerns, we allow for non-linearities of the effect of inequality on growth, include a higher proportion of middle- and low-income countries, and improve comparability of the inequality estimates by using similar data sources. Most specifications are supportive of our hypothesis: whereas the effect of income inequality on economic growth is generally statistically insignificant and not robust, the “inequality of opportunity” component generally has a negative effect on subsequent growth. These results are consistent with the findings of Marrero and Rodriguez for the United States.

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