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The Effect of Distribution on Growth

Does the fact that contemporaneous changes in mean incomes and inequality do not seem to be systematically related necessarily imply that there is no link between the two variables at all? Could it be, for instance, that countries with higher initial (i.e. *ex ante*) inequality grow more slowly (or faster) than others? And if any such pattern emerged, what would explain it? Are there causal links between the dispersion of an income (or expenditure, or wealth) distribution and economic growth, or indeed other aspects of economic performance?

In the 1990s, the classical view that distribution (one aspect of which is measured by inequality indices) is not only a final outcome, but in fact plays a central role in determining other aspects of economic performance, has come back into fashion. While many economists often start working on a topic at the same time, much of the credit for pioneering this line of enquiry must go to [Oded Galor and Joseph Zeira](#), whose 1993 paper on "Income Distribution and Macroeconomics" concluded thus: "In general, this study shows that the distributions of wealth and income are very important from a macroeconomic point of view. They affect output and investment in the short and in the long run and the pattern of adjustment to exogenous shocks. It is, therefore, our belief that this relationship between income distribution and macroeconomics will attract more studies in the future." (1993, p.51).

They were certainly right in their last prediction. And most of the studies that followed concurred that they were right on the first point as well. Empirically, the proposition that initial inequality seemed to be associated with lower growth rates was put forward by [Persson and Tabellini](#) (1994) and [Alesina and Rodrik](#) (1994). Using the data sets available to them, both studies found that inequality variables had significantly negative coefficients in growth regressions, when controlling for a number of the usual right-hand side variables, such as initial income, schooling and physical capital investment. A survey by [Benabou](#) (1996a) listed a number of other cross-country empirical investigations of this relationship, and reported that the vast majority of them reached the same conclusion.

But the debate is not as settled as that survey implied. Since then, a number of studies drawing on the Deininger-Squire database - which is superior to those available to Persson and Tabellini or to Alesina and Rodrik, both in number of countries and in time-spans covered - have questioned the budding consensus. Adding a number of econometric methodological improvements to this better data

set, Forbes (1997) actually finds a positive and significant relationship between inequality and growth. Others have echoed her concerns and cautioned against a premature acceptance of the inverse relationship between initial inequality and growth as a new stylized fact of development economics.

However, the econometric problems that seem to beset the negative relationship in the newer data sets appear to be specific to inequality variables defined in the *income* (or expenditure) space. Deininger and Squire themselves, for instance, find that the negative coefficient on initial income inequality in their growth regressions becomes insignificant only when a variable for *asset* inequality (the Gini coefficient for land ownership) is introduced. [Birdsall and Londono](#) (1997) investigate a similar relationship for the other asset crucially important for the poor, namely human capital. Also using a subset of the Deininger-Squire database, they conclude that: "...initial inequalities in the distribution of land and of human capital have a clear negative effect on economic growth, and the effects are almost twice as great for the poor as for the population as a whole." (p.35) Once again, once these asset distribution variables are included, the significance of income inequality disappears.

The empirical issue is clearly not settled. Nevertheless, it would seem fair to report the current state of the debate as follows: while initial *income* inequality may not directly affect an economy's aggregate growth potential, others thing being equal, it does proxy for more fundamental inequalities of wealth. Once measures for those are included, there seems to be a significant negative relationship between *asset* inequality and growth.

Now, why would that be the case?

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