

# Inequality and the Process of Development

CICSE Lectures, Naples

## Lecture II: A Unified Theory of Inequality and Development

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# Objectives

## A unified theory of inequality and economic development

(Galor and Moav (2004):

- Captures the changing role of inequality in the growth process
- Unifies the Classical and the Modern Paradigms
- Provides an intertemporal reconciliation between conflicting viewpoints about the effect of inequality on economic growth
- Generates novel testable predictions that may resolve empirical disputes about the relationship between inequality and growth

# The Classical Approach

Inequality is beneficial for growth

- The marginal propensity to save increases with income
- Inequality channels resources towards individuals whose marginal propensity to save is higher
  - ⇒ increases aggregate savings & capital accumulation
  - ⇒ enhances the development process

# The Credit Market Imperfections Approach:

Inequality is harmful for growth

- CMI increases the cost of investment in human capital for less endowed individuals
- Inequality increases the fraction of society for which investment in human capital is suboptimal
  - ⇒ reduces human capital accumulation
  - ⇒ slows down the development process

# A Unified Theory of Inequality and Development

- A unified theory of the dynamic implications of inequality on the growth process
- Places the dominating modern theories within a broader unified structure
- Provides an intertemporal reconciliation between the Classical viewpoint and the Modern perspective

# Main Hypothesis

- The replacement of physical capital accumulation by human capital accumulation as a prime engine of economic growth has changed the qualitative impact of inequality on the process of development
- Early stages of industrialization: physical capital accumulation is a main engine of growth  $\implies$ 
  - Inequality enhanced development by channeling resources towards individuals whose marginal propensity to save is higher
- Later stages of development: the return to human capital increases due to capital-skill complementarity and human capital became the prime engine of growth  $\implies$ 
  - Inequality, due to credit constraints, is harmful for growth

# Central Argument

Fundamental asymmetry between:

- Human capital accumulation
- Physical capital accumulation

# Human Capital vs. Physical Capital Accumulation

- Human capital is embodied in humans  $\implies$ 
  - Physiological constraints subjects its accumulation *at the individual level* to diminishing returns
  - The accumulation of human capital would be larger if it would be widely distributed among individuals in society
- Physical capital accumulation may benefit from the concentration of wealth among individuals whose marginal propensity to save is larger



# Inequality and Physical and Human Capital Accumulation

- **Inequality** is conducive for **physical capital** accumulation, as long as the marginal propensity to save rises with income
- **Inequality** is harmful for **human capital** accumulation, as long as credit constraints are binding

# Inequality and Growth in Different Stages of Development

- **Inequality** stimulates economic growth in stages of development in which **physical capital** accumulation is the prime engine of growth
- **Inequality** is harmful for economic growth in stages of development in which **human capital** accumulation is the prime engine of economic growth and credit constraints are still binding

## Early Stages of Industrialization

- Labor (and thus human capital) is abundant and physical capital is scarce
- The return to physical capital is higher than the return to human capital
- Physical capital accumulation is the main engine of growth

⇒ Inequality is conducive for growth

## Later Stages of Development

- Physical capital accumulation complements human capital
- The return to human capital increases sufficiently so as to induce human capital accumulation (Nelson and Phelps (1966), Shultz (1975), Foster and Rosenzweig (1996))
- Investment in human capital is sub-optimal due to CMI  $\Rightarrow$  the return to human capital is higher than on physical capital
- Human capital accumulation is the main engine of growth

$\Rightarrow$  Inequality is harmful for growth

## Reconciliation: The Classical and Modern Approaches

- A positive effect of inequality on growth underlined by the **Classical Approach** reflects early stages of industrialization when physical capital accumulation was the prime engine of growth
- A negative effect of inequality on growth underlined by the **Modern Approach** reflects later stages of development when human capital accumulation becomes a prime engine of growth, and credit constraints are still binding

# The Basic Structure of the Model

- Overlapping-Generations economy
- $t = 0, 1, 2, 3, \dots$
- One good
- Two factors:
  - Physical capital (PC)
  - Human Capital (HC)

## The Basic Structure of the Model

- Output per-capita grows over time due to the accumulation of factors of production.
- The stock of physical capital: Output produced in the preceding period net of consumption and HC investment
- The level of HC: Outcome of education decisions, subject to borrowing constraint

# Production of Final Output

The output produced at time  $t$  :

$$Y_t = F(K_t, H_t) \equiv H_t f(k_t)$$

$K_t$  - PC

$H_t$  - HC (efficiency units)

$k_t \equiv K_t/H_t$



## Factor Prices

Demand for factors of production at time  $t$

$$r_t = f'(k_t) \equiv r(k_t)$$

$$w_t = f(k_t) - f'(k_t)k_t \equiv w(k_t)$$

# Individuals

- Continuum of measure 1
- Individuals have 1 parent and 1 child
- Identical in:
  - Preferences
  - Innate abilities
- Differ in:
  - Parental income  $\Rightarrow$  Inv't in HC

## Individuals of Generation $t$

- First period of life (Period  $t$ ):
  - Human capital formation
- Second period of life (Period  $t + 1$ ):
  - Supply their efficiency units of labor
  - Allocate income & inheritance to:
    - (a) Consumption (b) Transfers to children
- Transfers are allocated to:
  - Finance of offspring's education
  - Saving for offspring's future wealth

## Individual $i$ of Generation $t$ : Wealth

Second period wealth:

$$l_{t+1}^i = w_{t+1} h_{t+1}^i + x_{t+1}^i$$

$w_{t+1}$  – wage

$h_{t+1}^i$  – efficiency units of labor

$x_{t+1}^i$  – inheritance

## Individual $i$ of Generation $t$ : Budget Constraint

Second Period budget constraint:

$$c_{t+1}^i + b_{t+1}^i \leq l_{t+1}^i$$

$c_{t+1}^i$  – consumption

$b_{t+1}^i$  – transfers to the offspring

## Individual $i$ of Generation $t$ : Intergenerational Transfers

Transfer to offspring,  $b_{t+1}^i$ , is allocated between:

- Finance of offspring's education -  $e_{t+1}^i$
- Saving for offspring's future wealth

$$s_{t+1}^i = b_{t+1}^i - e_{t+1}^i$$

- Inheritance

$$x_{t+1}^i = s_t^i R_{t+1} = (b_t^i - e_t^i) R_{t+1}$$

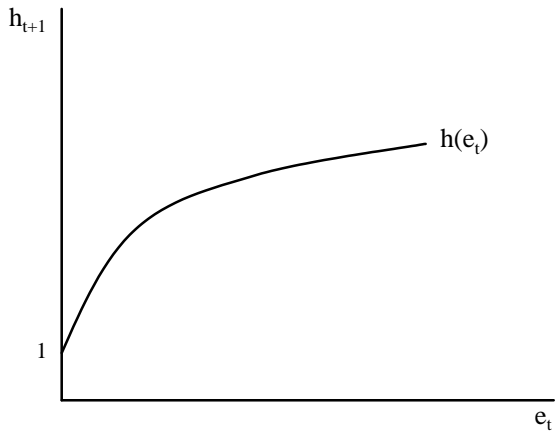
## Individual $i$ of Generation $t$ : Human capital formation

Efficiency units of labor in period  $t + 1$

$$h_{t+1}^i = h(e_t^i)$$

$e_t^i$  – expenditure on education

# Individual $i$ of Generation $t$ : Human capital formation





## Optimal Inv't in Education of Member $i$ of Generation $t$

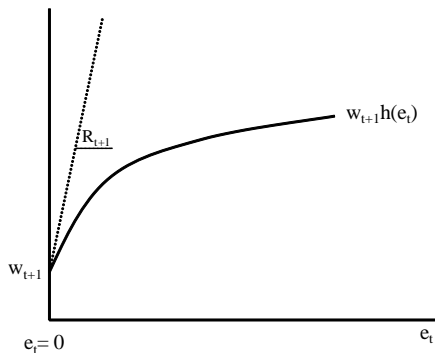
In the absence of borrowing constraints:

$$e_t^i = \arg \max [w_{t+1} h(e_t^i) + (b_t^i - e_t^i) R_{t+1}]$$

$e_t$  is unique and identical across members of generation  $t$

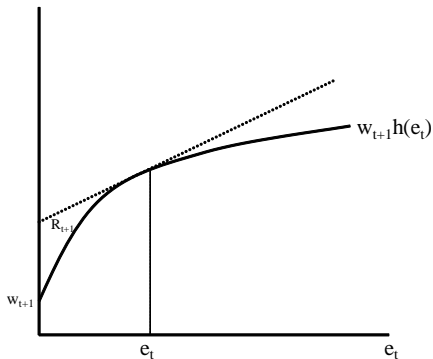
# Optimal Inv't in Education of Member $i$ of Generation $t$

$$e_t = 0 \quad \text{if} \quad R_{t+1} > w_{t+1}h'(0)$$

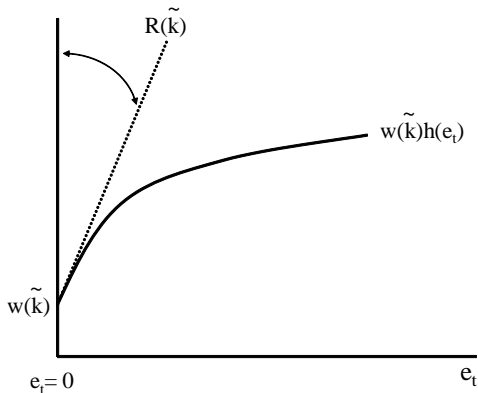


# Optimal Inv't in Education of Member $i$ of Generation $t$

$$e_t > 0 \quad \text{if} \quad w_{t+1}h'(e_t) = R_{t+1}$$



# Optimal Inv't in Education of Member $i$ of Generation $t$



## Optimal Inv't in Education of Member $i$ of Generation $t$

$$e_t = e(k_{t+1}) \begin{cases} = 0 & \text{if } k_{t+1} \leq \tilde{k} \\ > 0 & \text{if } k_{t+1} > \tilde{k} \end{cases}$$

where

$$e'(k_{t+1}) > 0 \quad \text{if } k_{t+1} > \tilde{k}$$

## Borrowing Constraint of Member $i$ of Generation $t$

Individuals cannot borrow to finance the education expenditure of their offspring:

$$e_t^i = \min[e(k_{t+1}), b_t^i]$$

## Preferences and Transfers of Member $i$ of Generation $t$

- Preferences:

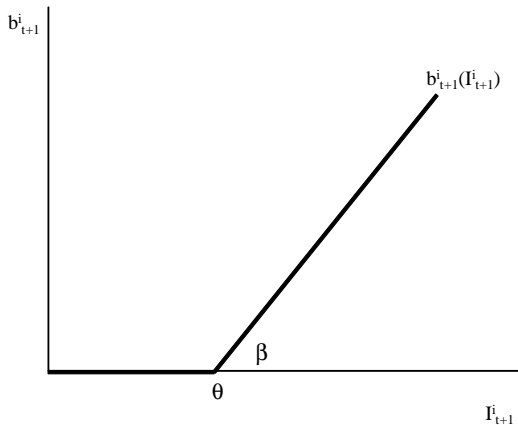
$$u_t^i = (1 - \beta) \log c_{t+1}^i + \beta \log(\bar{\theta} + b_{t+1}^i)$$

- Optimal transfer to offspring:

$$b_{t+1}^i = b(l_{t+1}^i) \equiv \begin{cases} \beta(l_{t+1}^i - \theta) & \text{if } l_{t+1}^i \geq \theta \\ 0 & \text{if } l_{t+1}^i \leq \theta \end{cases}$$

where  $\theta \equiv \bar{\theta}(1 - \beta)/\beta$

# Optimal transfer of a member $i$ of generation $t$





## Saving of Member $i$ of Generation $t$

$$s_t^i = \begin{cases} b_t^i & \text{if } k_{t+1} \leq \tilde{k} \\ b_t^i - e_t^i & \text{if } k_{t+1} > \tilde{k} \end{cases}$$

Saving rate  $s_{t+1}^i / l_{t+1}^i$  is increasing in  $l_{t+1}^i$

# Initial Wealth Distribution

The economy consists of two groups in period 0:

- Capitalists (R)
  - Fraction  $\lambda$  of all adult individuals
  - Equally own the *initial* capital stock
- Workers (P)
  - Fraction  $1 - \lambda$  of all adult individuals
  - No ownership over the *initial* capital stock

## Factor Accumulation

$$K_{t+1} = \int_0^1 s_t^i di = \lambda(b_t^R - e_t^R) + (1 - \lambda)(b_t^P - e_t^P)$$

$$= K(b_t^R, b_t^P, k_{t+1})$$

$$H_{t+1} = \int_0^1 h_{t+1}^i di = \lambda h(e_t^R) + (1 - \lambda)h(e_t^P)$$

$$= H(b_t^R, b_t^P, k_{t+1})$$

# The Capital-Labor Ratio

$$k_{t+1} = \frac{K_{t+1}}{H_{t+1}} = \frac{K(b_t^R, b_t^P, k_{t+1})}{H(b_t^R, b_t^P, k_{t+1})}$$

$\implies$

$$k_{t+1} = \kappa(b_t^R, b_t^P)$$

## The Evolution of Transfers within group $i = R, P$

$$b_{t+1}^i = \max\{\beta[w_{t+1}h(e_t^i) + (b_t^i - e_t^i)R_{t+1} - \theta], 0\}$$

$\implies$

$$b_{t+1}^i = \phi(b_t^i, k_{t+1})$$

There exists  $\hat{k}$ , a critical level of  $k$  below which individuals who do not receive parental transfers (i.e.,  $b_t^i = e_t^i = 0$ ) do not transfer income to their offspring:  $w(\hat{k}) = \theta$

$$b_{t+1}^i = \phi(0, k_{t+1}) \begin{cases} = 0 & \text{if } k_{t+1} \leq \hat{k} \\ > 0 & \text{if } k_{t+1} > \hat{k} \end{cases}$$

## The Evolution of Transfers within Group $i = R, P$

$$\begin{aligned} b_{t+1}^i &= \phi(b_t^i, k_{t+1}) = \phi(b_t^i, \kappa(b_t^R, b_t^P)) \\ &\equiv \psi^i(b_t^R, b_t^P) \end{aligned}$$

# The dynamical system

$\{b_t^P, b_t^R\}_{t=0}^{\infty}$  such that:

$$b_{t+1}^P = \psi^P(b_t^R, b_t^P)$$

$$b_{t+1}^R = \psi^R(b_t^R, b_t^P)$$

# The Process of Development

- Regime I: PC Accumulation ( $k \leq \tilde{k}$ )
- Regime II: HC Accumulation ( $k > \tilde{k}$ )
  - Stage I of Regime II ( $\tilde{K} < K \leq \hat{K}$ )
  - Stage II of Regime II ( $\hat{K} < K < K^*$ )
  - Stage III of Regime II ( $K > K^*$ )

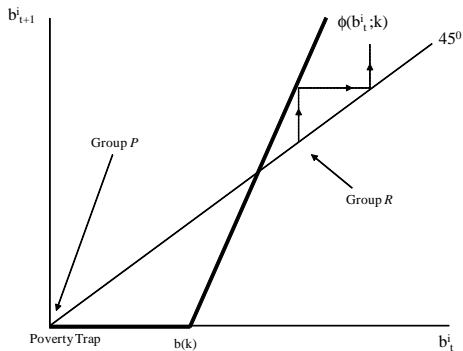


## Regime I: Physical Capital Accumulation

Early stages of development ( $k \leq \tilde{k}$ )

- $K$  is the main engine of growth:  $\rho^{HC} < \rho^K$
- No investment in education
- No Transfers within Group  $P$
- Transfers within Group  $R$   $\uparrow$
- Wages  $\uparrow$
- Income inequality  $\uparrow$

# The Conditional Dynamical System: Regime I



## Regime I: Effect of Inequality

Inequality enhances the process development

- A transfer of wealth from Group R to P  $\implies$ 
  - Aggregate consumption  $\uparrow$
  - Aggregate intergenerational transfers  $\downarrow$
  - Rate of capital accumulation  $\downarrow$

## Regime II: Human Capital Accumulation

Mature stages of development:  $(k > \tilde{k})$

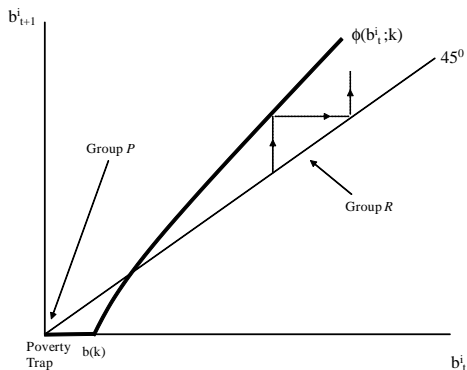
- HC is the engine of growth:  $\rho^{HC} \geq \rho^K$

## Stage I of Regime II: HC Accumulation by group R

### Stage I of Regime II ( $\tilde{K} < K \leq \hat{K}$ )

- Members of group  $P$ 
  - No intergenerational transfers
  - No investment in education
- Members of group  $R$ 
  - Transfers  $\uparrow$
  - Expenditure on education  $\uparrow$
- Wages  $\uparrow$
- Income inequality  $\uparrow$

# The Conditional Dynamical System: Stage I of Regime II

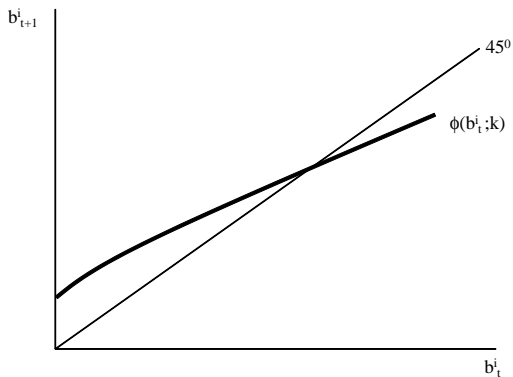


## Stage II of Regime II : HC Accumulation by the Poor

Stage II of Regime II ( $\hat{K} < K < K^*$ )

- Members of group  $P$  (credit constrained):  $\rho^{HC} > \rho^K$ 
  - Start to transfers
  - Start to acquire education
- Members of group  $R$  (not credit constrained):  $\rho^{HC} = \rho^K$ 
  - Invest optimally in human and physical capital

# Conditional Dynamical System: Stage II-III of Regime II





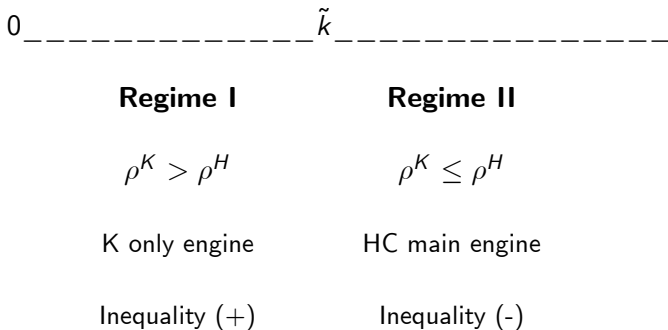
## Stage II of Regime II: Effect of Inequality

- More equality is beneficial for the process development
  - A transfer of wealth from group  $R$  to group  $P$  allows (due to credit constraint) a more efficient allocation of aggregate investment between HC and PC

## Stage III of Regime II : Credit Constraints are not Binding

- All individuals are not credit constrained:  $R^{HC} = R^K$
- Inequality has no effect on the process of development

# The changing Role of Inequality in the Development Process



## Effect of Inequality in Regime II

$\tilde{k}$  -----  $\hat{k}$  -----  $k^*$  -----

### Stage I

$$\rho^K < \rho_P^H$$

$$\rho^K = \rho_R^H$$

2 engines

### Stage II

$$\rho^K < \rho_P^H$$

$$\rho^K = \rho_R^H$$

HC main engine

Inequality (-)

### Stage III

$$\rho^K = \rho^H$$

2 engines

# Testable Implications

## The CMI approach

- The effect on inequality depends on the country's level of income. Inequality is beneficial for poor economies and harmful for rich ones

## The Unified Approach

- The effect of inequality on growth depends on the relative return to human and physical capital. The higher is the relative return to human capital the more harmful is inequality for economic growth

## Implications for DC and LDCS

- The replacement of physical capital accumulation by human capital accumulation as a prime engine of economic growth has changed the impact of inequality on the process of development
  - Inequality stimulates economic growth in stages of development in which physical capital accumulation is the prime engine of growth
  - Inequality is harmful for economic growth in stages of development in which human capital accumulation is the prime engine of economic growth
- Int'l capital inflow to LDCs and the adoption of skilled-biased technologies may place economies directly in the second stage in which inequality is harmful

## References

### Main Source:

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### Related Papers:

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