Inequality and the Process of Development

Lecture I: From the Classical to the Modern Perspective

Oded Galor

August 19, 2013

The Classical Theory

Inequality is beneficial for growth (in the post-industrialization stage)

Keynes (1920), Kaldor (1957)

- The marginal propensity to save increases with income
- Inequality channels resources towards individuals whose marginal propensity to save is higher

$\Longrightarrow$ increases aggregate savings & capital accumulation

$\Longrightarrow$ enhances the development process

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Equality and Development: Pre-Industrialization Stage

Equality may be essential for industrialization

Rosenstein-Rodan (1948), Lewis (1954), North (1959), Murphy, Shliefer and Vishny (1989)

- In the absence of international demand for domestic industrial goods, a broad distribution of income (from the leading agricultural sector) may be critical for the emergence of industry

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The Neoclassical Paradigm

The Representative Agent Approach

- Rejects the role of heterogeneity, and thus income distribution, in economic growth
  - Growth Process $\Rightarrow$ Income Distribution
  - Income Distribution $\not\Rightarrow$ Growth Process

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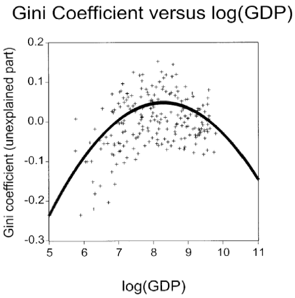
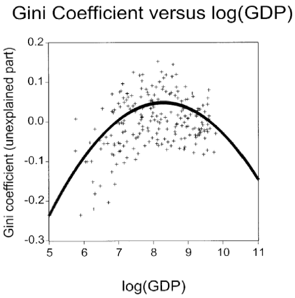
Inequality and Development: Kuznets' Inverted U



- Panel of Countries, 1960-1990. Normalized Gini coefficient after filtering out the estimated effects of other control variables (but log(GDP) and its square) Peak: $3320 (1985 U.S. dollars)

Inequality and Development: Kuznets' Inverted U



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The Modern Perspective: Origins

Galor and Zeira (1988, 1993)

- Unlike the Neoclassical Paradigm

  Income Distribution $\Rightarrow$ the growth process

- Unlike the Classical Perspective

  Underlined the *adverse* effect of Inequality on the process of development

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The Credit Market Imperfections Approach: Assumptions

Main assumptions:

- Credit market imperfections (e.g., differences in the interest rates for borrowers and lenders)

and either

- Fixed investment cost in education (Galor-Zeira (1993)) or in other individual-specific projects (Banerjee and Newman (1993) and Aghion and Bolton (1997))

or

- Saving and bequest rates are increasing function of wealth (e.g., subsistence consumption constraint) Galor and Moav (RES 2004)

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The Credit Market Imperfections Approach: Mechanism

- Inequality affects occupational choices – skilled vs. unskilled workers (entrepreneurs vs. workers)
- Non-poor economies:
  - Inequality $\Longrightarrow$ Under-investment traps: under-investment in human capital (inv't projects) that is transmitted across generations $\Longrightarrow$ lower output growth in the short-run and in the long-run
- Poor economies:
  - Inequality may permit some investment in HC (inv't projects) and may thus promote output growth
- The human capital channel is consistent with evidence (Perotti (1996))

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The CMI Approach: Additional Mechanisms

- Segregation and Neighborhood Effects
  - Inequality permits the segregation of individuals into homogenous communities
  - Local externalities in the production of HC $\Longrightarrow$ persistent inequality (Benabou (1996), Durlauf (1996), Fernandez and Rogerson (1996)
- Mobility and Social Status
  - Inequality generates an inefficient allocation of talents across occupations via:
    - limited intergenerational mobility (Galor-Tsiddon (1997))
    - Displacement of poor, high-ability individual by rich, low-ability individuals, if social status is associated with education (Ferstman, Murphy and Weiss (1996))

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Echoes the hypothesis of the CMI Approach

- Inequality is harmful for the growth process
    - Inequality $\Longrightarrow$ Political pressure for redistribution
    - Higher (distortionary) taxation $\Longrightarrow$ lower investment and slower economic growth

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Gender inequality is harmful for the growth process

Galor-Weil (AER 1996)

- Gender inequality reduces the opportunity cost of raising children more than it reduces household income

$\Longrightarrow$ increases fertility

$\Longrightarrow$ reduces human capital investment (quantity-quality trade-off)

$\Longrightarrow$ lowers female labor force participation

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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
- Underlines the role of inequality in triggering socio-political transition (Galor-Moav-Vollrath (2009), Galor-Moav (2006))

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