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Article

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European Journal of Economics and Economic Policies: Intervention (EJEEP)

Provided in Cooperation with:

Edward Elgar Publishing

Suggested Citation: Boushey, Heather (2015) : Bringing inequality back in, European Journal of Economics and Economic Policies: Intervention (EJEEP), ISSN 2052-7772, Edward Elgar Publishing, Cheltenham, Vol. 12, Iss. 2, pp. 183-189, <https://doi.org/10.4337/ejeep.2015.02.04>

This Version is available at:

<https://hdl.handle.net/10419/277328>

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Bringing inequality back in

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Economic inequality has traditionally not been the center of mainstream macroeconomic thought. Rethinking whether and how today's high economic inequality – along all axes, not just income – affects economic growth and stability is an increasingly relevant and important field of inquiry. This paper investigates how economic research can inform the debate on the relationship between inequality and growth. I define the relationship between inequality and growth as well as briefly review the literature on their relationship. Then, I outline the channels through which inequality may affect growth. And finally, I address possible avenues for public policy going forward.

Keywords: *inequality, economic growth, public policy*

JEL codes: *O40, I24, D63, D31*

1 INTRODUCTION

For many years, the relationship between economic inequality and growth was not a topic of great concern for economists. Let me start with an example.

In 2010, Paul Krugman gave a speech at a conference held by the Luxembourg Income Study. He said that, before the financial crisis in 2008, when people pointed to the similarities in the rise in income inequality in the 1920s and the past few decades, he had reservations that the prevailing high levels of inequality would lead to the same kind of economic crisis as we saw in the 1930s (Krugman 2010). In his speech, he questioned his earlier skepticism and suggested that there is a serious research agenda within these trends that economists need to pursue.

Rethinking whether and how today's high economic inequality – along all axes, not just income – affects economic growth and stability is the focus of my remarks today. This paper investigates how economic research can inform the debate on the relationship between inequality and growth. In Section 2, I will define the relationship between inequality and growth, as well as briefly review the literature on their relationship. Then, in Section 3, I will outline the channels through which inequality may affect growth. Finally, in Section 4, the conclusion will address possible avenues for public policy going forward.

2 DEFINING THE ISSUE

Economists used to assume that developed economies would become more equal over time. Back in the mid 1950s, economist Simon Kuznets postulated that the US economy would see less inequality as it developed. In 1955, as President of the American Economic Association, he published an article hypothesizing a long-run relationship between inequality and economic growth. His data led him to conclude that countries would become more unequal as they developed, and that, after reaching a certain level of economic development, they would become more equal again (Kuznets 1953). He based his

theory on empirical evidence from the early twentieth century for the United States and other countries. At the time, this made sense. In the decades just after World War II, from 1947 to 1979, American families across the income distribution saw their incomes grow at about 2 percent per year.

However, looking at the US economy over the past half-century reveals a story of a sustained rise in inequality in wages, incomes, and wealth, especially for those at the top. In the United States, this higher inequality is associated with slower income growth. Between 1979 and 2007, just before the economic crisis and the Great Recession, families in the bottom quintile experienced essentially no income growth, while families in higher quintiles saw progressively greater annual income growth (Mishel et al. 2012). During this period, all groups saw their wages grow more slowly than 2 percent, even those in the top quintile. Only those at the very top of the wage distribution experienced higher rates of income growth.

Though inequality in the United States did decrease over in the decades just after World War II, in hindsight this was an aberration due to the economic consequences of two World Wars and the Great Depression rather than any long-term trend. This is the conclusion Thomas Piketty (2014) reaches in his book *Capital in the Twenty-First Century*, where he builds on Kuznet's data and methods. Data from Piketty and his colleagues' World Top Incomes Database shows that the period of greater equality in developed economies during the mid twentieth century was transient. I would argue that understanding these data and what they mean is among the most important economic issues of our times.

On the first evening of the conference at which this paper was presented, Jonathan Ostry of the International Monetary Fund showed us the findings from his and his IMF colleagues' research on the implications of redistribution for economic growth and stability (Ostry et al. 2014). Two points he raised provided an important starting place for discussion. First, he explained that, in his analysis, the coefficient of redistribution is positive, invalidating Arthur Okun's earlier notion of a 'leaky bucket' (Okun 1975: 91). Second, when Ostry was asked about the policy implications of these findings, he said, 'regressions will not inform actions of the [IMF],' but they can inform the debate.

Let me provide a reminder of Okun's 'leaky bucket.' Okun's main concern was that, as income and wealth are transferred through redistributive policies from the rich to the poor, much 'leaks' out due to systematic costs. There is a long tradition in economics arguing that any policy that reduces inequality would be counterproductive. Okun summarized this view in his 1975 book, *Equality and Efficiency: The Big Tradeoff*:

The contrasts among American families in living standards and material wealth reflect a system of rewards and penalties that is intended to encourage effort and channel it into socially productive activity. To the extent that the system succeeds, it generates an efficient economy. But that pursuit of efficiency necessarily creates inequalities. And hence society faces a tradeoff between equality and efficiency. (Okun 1975: 1)

This tradeoff happens because monetary rewards and penalties – economic incentives – drive productive activity. These rewards and penalties are optimal for growth, while economic interventions are distortionary and will lower economic growth, he argued.

The role of incentives has a long history in economics. Adam Smith wrote in *Wealth of Nations* that keeping wages down for some workers would result in inequality that was 'upon the whole, perhaps, rather advantageous than hurtful to the public' (Smith 1904: 95). There is also a long tradition of seeing capital accumulation as a positive side-effect of inequality, as it drives growth.

But Ostry's work and the research of many others contradict Okun's conclusions. Last month, my colleague Carter Price and I released a short paper outlining this literature

(Boushey/Price 2014). What we found was that this literature was generally inconclusive until 5 to 10 years ago. Using higher quality and more comparable data, recent studies find that, over the long term, as inequality rises it depresses economic growth and reduces economic stability. Sarah Voitchovsky of the University of Melbourne closely tracks this research, as well. She has looked at 72 studies that regress inequality on growth and has arrived at a similar conclusion to my own: there appears to be a negative relationship between inequality and growth (Voitchovsky 2005).

In ‘Inequality is bad for the growth of the poor (but not for that of the rich),’ Roy van der Weide and Branko Milanovic don’t just look at the effect of inequality on overall output but instead observe its effect on household incomes across the distribution (van der Weide/Milanovic 2014). The authors find that inequality reduces the growth of incomes for lower- and medium-income households but doesn’t affect income growth for those at the top. This is an innovative way of analysing the relationship between inequality and growth that helps us understand how it impacts a majority of families.

Yet, as Ostry said, these regressions are not necessarily meaningful to policymakers. Instead, it is more helpful to explore the institutions, norms, and channels through which inequality might affect growth.

3 THE RELEVANT CHANNELS

The rest of this paper is framed in terms of some research that I think is most enlightening for policy and for informing our thinking about how inequality affects economic growth and stability. In my mind, there are four policy-relevant channels through which inequality could affect economic growth and stability: consumption, human capital, institutions, and entrepreneurship.

3.1 Entrepreneurship

I’ll turn to *entrepreneurship* first, simply because economists are least invested in it. We economists do not spend a lot of time thinking about what creates the drive or capacity for someone to go out on their own and start a new business or make a new innovation operational in the real economy. This is typically the purview of business or management schools, not those of us who think about the workings of the economy at large. I would like to argue that studying what encourages and fosters entrepreneurship is vital.

While I was conducting a literature review a number of years ago, I was surprised to find that many of today’s successful entrepreneurs come from the middle class. In fact, the Kaufmann Foundation found that less than one percent of all entrepreneurs came from extremely rich or extremely poor backgrounds (Wadhwa et al. 2009). This finding flies in the face of textbook economic predictions about incentives and capital accumulation. Why would this be the case? Well, that’s exactly why we need more research into this area.

3.2 Consumption

Turning to *consumption*, I’d like to start with a story.

In one of our meetings a few months ago, Brad DeLong, an economist at the University of California, Berkeley, shared a poignant anecdote from his time as a policymaker. DeLong served as an economist in the US Treasury Department in the early years of

the Clinton Administration. He said that when the new administration came to power, a conscious decision was made to take issues of demand off the table. They assumed that the Federal Reserve, then under Alan Greenspan, would take care of the issue. The role of the Treasury and the rest of the federal government, rather, was to act on boosting supply-side capacity through education. As we now know, this decision may not have been well-timed. The United States was about to enter a period of bubble-driven growth, first with the stock-market bubble of the late 1990s and then with the housing bubble of the mid 2000s.

The role of inequality in the issues of consumption and demand is not yet fully understood, even though there is very persuasive research showing that rising wealth inequality had a key role in the damaging effects of the housing bubble burst. I want to highlight one example of this research that I have found particularly compelling.

Recent work by economists Atif Mian and Amir Sufi shows how the rapid increase in household debt during the 2000s and the distribution of that debt led to the Great Recession and the current slow recovery (Mian/Sufi 2014). They note that, from 2002 to 2005, most of the increase in credit went to counties where wages were actually declining, suggesting that credit growth and wage growth were negatively correlated. When the housing bubble burst, the counties with the largest declines in total net worth were the ones where spending declined the most. In other words, the inequitable distribution of debt exacerbated the crisis. Mian and Sufi's research used microeconomic data – in their case, data on mortgage lending and credit ratings – to reach macroeconomic conclusions, diverging from the traditional micro-foundations theoretical approach. Their research is an example of some of the exciting methodologies and trends I've seen in recent years.

3.3 Human capital

Perhaps the most intuitive way to link inequality and economic growth, though, is *human capital*, the development of workers' skills and abilities. Inequality of income and wealth may provide unfair advantages to those born to high-income and high-wealth families, who have disproportionate means to develop their talents. There is emerging evidence that this is increasingly the case in the United States.

Sean Reardon, a sociologist at Stanford University, has done work showing that over the past 30 years, educational inequality in the US, measured by standardized tests, has grown (Reardon 2011). Specifically, the gap between outcomes for children of rich households and children of middle-income households is widening much faster than any other gap. About 50 percent of this widening is due to increasing income inequality between households. The other 50 percent is due to an increasing correlation between income and educational outcomes. In other words, one extra dollar of income buys more educational success than it has in the past. Reardon's results on rising educational inequality is demonstrative of how the top of the distribution is pulling away from the rest.

There is also compelling evidence that poorer families are often unable to provide high quality pre-kindergarten enrichment activities, such as time spent reading to children or sending them to summer camps. Reardon confirms that rich children enter kindergarten much more prepared for their subsequent schooling than children from middle- and low-income households. This inequality in education among children aged 0 to 5 occurs before children even enter a classroom.

The policy response to educational inequality may rest less on the current educational system in the United States and more on the period before primary school or the home and family environment. I will come back to this momentarily.

3.4 Institutions

Of the four potential channels through which inequality might affect growth, *institutions* are certainly the most amorphous and least understood.

My thinking on the topic has been influenced by Daren Acemoglu and James Robinson's (2012) book, *Why Nations Fail*. The book has a simple yet powerful explanation for what drives long-run economic growth. Societies that create inclusive institutions, or institutions that encourage and allow for broad participation and political life, are more likely to be prosperous. Societies with extractive institutions that benefit elites will end up worse off in the long run. While measuring inclusiveness precisely remains a challenge, what I found so interesting is that it calls for us to think seriously and critically about the intersection between economics and society and the role of power.

While I agree that Acemoglu and Robinson's definition of inclusive institutions is broad, their resounding question is clear: how can we move forward with understanding and promoting inclusive institutions?

A number of political scientists are examining the role of inequality on political decision-making in a democracy. Martin Gilens and Benjamin Page have found that, alarmingly, in the United States, legislation does not become law unless the rich support the effort (Gilens/Page 2014). If the policy preferences of those at the top align with the rest of society, there is a mutual benefit. However, if the preferences of those at the top differ from the rest of society, laws may not reflect the consensus.

3.5 Possible policy avenues

Although I've cast doubt on the ability of the US political system to enact policies that benefit the broad population over the wealthy few, I'd like to highlight a few policy options that might help reduce inequality and boost economic growth for the bottom, middle, and top of the income distribution.

For families at the bottom of the income distribution, an increase in the minimum wage would be a welcomed policy response. The federal minimum wage has not been increased in more than 5 years, and in the long run, the purchasing power of the minimum wage has decreased substantially since its peak in 1968. This stagnation has contributed significantly to inequality at the bottom of the income distribution. According to one estimate by economists David Autor, Alan Manning, and Christopher Smith, 30 to 50 percent of the increase in the ratio of the median wage to the 10th percentile wage since the early 1980s is attributed to the declining value of the minimum wage (Autor et al. 2014). And contrary to the common belief that the minimum wage is a job killer, careful empirical research has found that moderate increases in the minimum wage have no effect on employment.

Job quality is also important for families in the middle of the income distribution (Boushey/Mitukiewicz 2014). And it isn't purely about wages, although wages are, of course, a key issue. To address the economic realities facing middle-class households, we need policies that help parents manage their responsibilities to their workplace and their families. While there are a variety of issues encompassed in this balance, increasing educational inequality may be the most pressing. One way to reduce educational inequality is to increase investments in early childhood education, specifically by providing universal pre-kindergarten for all children in the United States. Additionally, policies that help low- and middle-income families learn and practice parenting skills can augment educational and social outcomes for babies and toddlers. In fact, a recent study found that quality – rather than quantity – of communication between parents and their children

before age 3 is important in closing the education gap between rich and poor children. We know the returns on these investments are very large (Heckman/Raut 2013), but it will be instructive to see how their effects manifest.

Implementing a financial transactions tax or even an inheritance tax on families at the top of the income distribution could help alleviate economic inequality. The US financial sector has played a large role in the drastic rise of inequality at the top of the income distribution. In 2005, 18 percent of taxpayers in the top 0.1 percent of the income spectrum were employed in the finance industry, an increase of 7 percentage points since 1979 (Bakija et al. 2012). Given the role of rent-seeking in this increase (Philippon/Reshef 2012), we are likely to find that a tax on financial transactions might actually channel resources more productively and likely benefit economic growth.

Of course, Thomas Piketty's proposed global wealth tax is another option. Interestingly, Colombia is actually moving towards a progressive wealth tax inspired by his work (Medina 2014).

4 CONCLUSION

The research I outlined is far from definitive. We need far more research to unpack the complex issues related to inequality and growth in order to understand the prospects for more inclusive growth. By using an economic and policy framework to understand how to improve the lives of working families, we can find appropriate and equitable solutions. It won't be an easy task, but it is a critically important one.

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