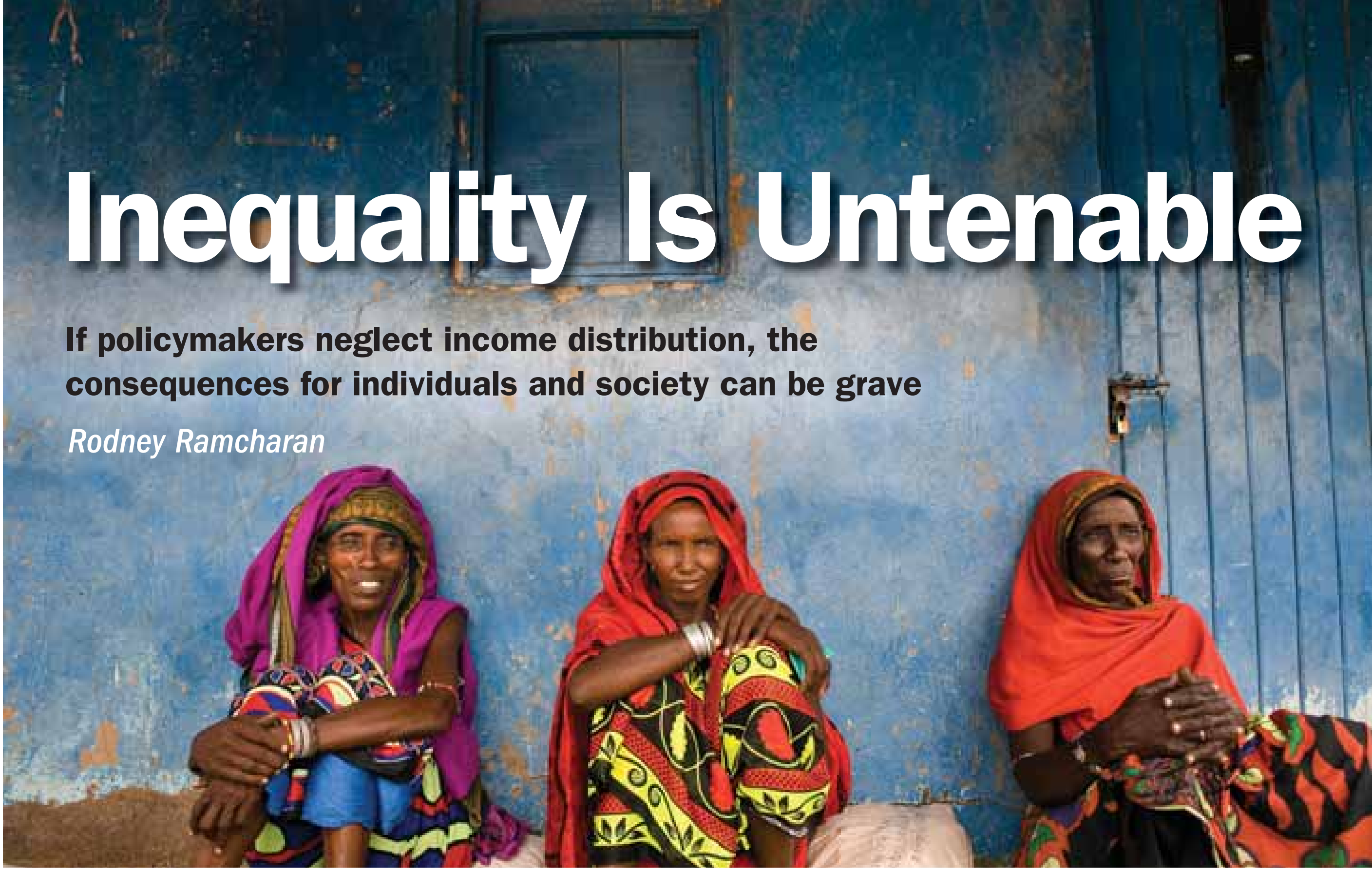
Inequality Is Untenable

If policymakers neglect income distribution, the consequences for individuals and society can be grave

Rodney Ramcharan



Pastoralist women in Malkona, Kenya.

SHOULD policymakers care about rising inequality? Or should they focus on fostering growth in output—gross domestic product (GDP)—in the belief that a rising tide lifts all boats? Economic theory and a growing body of empirical evidence suggest that inequality should be an important policy concern.

A case in point is the United States: After emerging from recession in 1982, the United States enjoyed one of the longest periods of economic growth in the post–World War II era—marred by only two brief downturns in the early 1990s and 2001. But it was not a shared prosperity. Even as economic activity accelerated during the Internet boom of the 1990s, there were winners and losers. In fact, during the 25 years of boom between 1982 and the onset of the global economic crisis in 2007, inequality rose sharply in the United States. From 1980 to 2004, the aggregate share of after-tax income held by the top 10 percent of earners increased from 7.5 percent to 14 percent (CBO, 2006). But more specific data over a longer time span suggest a starker rise in inequality. In 1976, the top 1 percent of households accounted for just 9 percent of income in the United States; by 2007, that share rose to about 24 percent. Similarly, the Gini index—a common measure of inequality that is 0 if everyone has identical incomes and 1 if a single person has all the income—rose by about 25 percent during the same period.

Inequality is far worse in many countries than it is in the United States. South Africa also enjoyed robust growth from 2000 to 2005, but inequality worsened dramatically. During those five years, South Africa's Gini index increased by about 12 percent to 0.58, making it one of the most unequal countries in the world.

The toll of risks

High inequality within a society can have significant economic and social costs both for individuals and, more broadly, for the society. Life is risky, and income inequality can determine how individuals manage risk. Business ventures can fail, and poor health can make it difficult to work. In a world with well developed capital markets—easily accessible banking systems and available insurance opportunities—individuals can insure themselves against misfortune, either through their own savings or by purchasing insurance contracts. But, as the recent debate over health care in the United States underscored, access to credit and insurance is imperfect in advanced economies. It is even more limited in less developed economies. Such limited credit access means that in many situations, individuals may have to bear fully most of life's risks—and that responsibility is more pronounced in less developed economies.

Therefore, in highly unequal societies, when an adverse shock such as illness or business failure strikes, a large chunk of the population may not have either the credit access or the personal wealth to replace lost income or smooth the impact of the shock on consumption. Hence, although per capita economic growth, a concept that measures the change in the income of the average person, might be growing, the income gap could continue to widen as relatively more income goes to the top earners. So even when per capita income is growing, the wellbeing of most people could be little changed or worse, even during a boom.

For a society as a whole, the combination of high income inequality and limited credit access can hinder economic development. Education, for example, is generally considered a key ingredient for economic development. But acquiring an education takes significant time and money, including the income an individual forgoes while in school. Likewise, entrepreneurship is also important for development, but turning a business idea into an actual business often requires a significant up-front investment. Rising inequality, which leaves much of the population unable to undertake these investments, can thus lay the foundation for much weaker growth. Moreover, high levels of inequality might also increase calls from the disadvantaged for a redistribution of income—through potentially inefficient methods of transfer payments or taxes—which could result in lower growth. The pressure for inefficient policies could take even more insidious forms. Rajan (2010), for example, argues that politicians in the United States might have been tempted to support economically risky policies such as the over-expansion of bank credit to help ameliorate the welfare cost of high inequality, thereby paving the way for a damaging credit bust.

Political consequences

But perhaps the most pernicious cost of inequality is its impact on the political system. In highly unequal societies, a small minority of the population not only controls a significant share of economic resources, but also is likely to organize more effectively and act with a single, coherent voice in the political process. In other words, the rich can more easily act collectively than can poorer segments of society. This combination of large resources and effective collective action can give the rich an outsized voice in the political process, which can engender economic policies that benefit a few at the expense of the majority.

Consider the provision of public goods, such as education. Because education has broad social value, many governments mandate that all children attend school for some period, and fund public education through taxation. But while the less well off disproportionately benefit from public education, the cost is often borne by higher income earners, who often opt out of the public education system but must still pay taxes. Therefore, high levels of inequality that strengthen the political voice of the rich at the expense of those lower down in the income distribution ranks can result in the underfunding of education and other important public goods (Ramcharan, 2010). Indeed, some economists have argued that because education mainly benefits some types of production such as manufacturing, land-owning elites in some countries may have persuaded governments to purposefully withhold funding for public schooling, delaying economic development (Galor, Moav, and Vollrath, 2009).

Financial sector policies are another sphere in which inequality and political capture can delay economic development. The contestability of markets is a sign of a well developed financial system. In such a system, markets are open and competitive and individuals can access credit easily. But potential market entrants can threaten the economic rents and political power of incumbent businesses. So in highly unequal societies, these incumbents, often the economic elite, can more easily use the political process to block financial development. Concentrated interests can, for example, push for the passage of restrictive financial legislation, as seen in past battles over banking in the United States (see Rajan and Ramcharan, 2010a and 2010b). Or, these groups may press for banks to remain under state control, with lending directed to a handful of connected firms. In either case, the resulting collateral damage to the economy can often be severe as inefficient firms persist and innovation slows. Of course, once an elite group solves the collective action problem and learns to influence the political process, its impact can extend far more broadly. Alston and Ferrie (1993), for example, argue that until the mechanization of cotton production made unskilled agricultural labor redundant in the 1940s, a small group of Southern landowners used their influence in Congress to delay the development of social welfare in the United States to maintain their hold on unskilled labor.

Societal welfare at stake

In sum, when economic growth is positive, society might be better off when compared with the past. But economic policies that simply focus on average growth rates could be dangerously naïve, especially in countries with high existing levels of inequality. The costs of high inequality to the wellbeing of society can be very high, especially when credit markets are underdeveloped, and can also limit growth-enhancing physical and human capital investments and increase calls for possibly inefficient redistribution. But high inequality also has the potential to alter the political process, giving the rich a relatively greater voice than the less homogenous majority. This imbalance of power can produce policies and economic institutions that benefit a few at the expense of the broader society. These policies can in turn further skew the income distribution and ossify the political system, leading to even graver political and economic consequences in the long run. ■

Rodney Ramcharan is a Senior Economist in the IMF's African Department.

References:

Alston, Lee, and Joseph Ferrie, 1993, "Paternalism in Agricultural Labor Contracts in the US South: Implications for the Growth of the Welfare State," American Economic Review, *Vol. 83, No. 4, pp. 852–76.*

Congressional Budget Office (CBO), 2006, Historical Effective Federal Tax Rates: 1979–2004 *(Washington, December).*

Galor, Oded, Omer Moav, and Dietrich Vollrath, 2009, "Inequality in Land Ownership, the Emergence of Human-Capital Promoting Institutions, and the Great Divergence," Review of Economic Studies, *Vol. 76, No. 1, pp. 143–79.*

Rajan, Raghuram, 2010, Fault Lines: How Hidden Fractures Still Threaten the World Economy *(Princeton, New Jersey: Princeton University Press).*

———, and Rodney Ramcharan, 2010a, "Land and Credit: A Study of the Political Economy of Banking in the United States in the Early 20th Century," Journal of Finance, *forthcoming.*

———, 2010b, "Constituencies and Legislation: The Fight over the McFadden Act of 1927" (unpublished).

Ramcharan, Rodney, 2010, "Inequality and Redistribution: Evidence from U.S. Counties and States, 1890–1930," Review of Economics and Statistics, *forthcoming.*