ELSEVIER

Journal of Development Economics
Vol. 63 (2000) 379–398

JOURNAL OF Development ECONOMICS

www.elsevier.com/locate/econbase

Income inequality, education expenditures, and growth

Kevin Sylwester *

Department of Economics, Mailcode 4515, Southern Illinois University-Carbondale, Carbondale, IL 62901, USA

Abstract

Recent studies have reported a negative association between income inequality and economic growth. If true, what accounts for this finding? What are possible transition mechanisms that might link the two? This paper explores one such mechanism. Income inequality raises expenditures for public education as a fraction of gross domestic product (GDP). Although public education expenditures are positively associated with future economic growth, the contemporaneous effect upon growth is negative. Given this cost upon current growth, these findings may help to explain the lack of a large, positive effect from the growth of human capital upon economic growth as reported in the literature. © 2000 Elsevier Science B.V. All rights reserved.

JEL classification: O4; O2
Keywords: Income inequality; Education expenditures; Economic growth

1. Introduction

How and why is the distribution of income related to economic growth?[1] Economists have primarily examined the first part of the question and some have found that the relation is negative. Alesina and Rodrik (1994) and Persson and

* Tel.: +1-618-453-5347; fax: +1-618-453-2717.
E-mail address: ksylwest@siu.edu (K. Sylwester).

[1] Although wealth might be the most relevant measure of a person's economic well being, I examine income inequality because it is more common in the literature and income inequality data are more available.

PII: S0304-3878(00)00113-9

Tabellini (1994) report that greater income inequality lowers subsequent growth after one controls for initial gross domestic product (GDP) per capita and initial human capital. Clarke (1995) shows that this finding is robust to changing the measure of income inequality and under many different model specifications.[2] But why does this relation hold? Attempts to answer this question include those which come from Alesina and Perotti (1993) who report that greater income inequality lowers growth by inducing political instability and Perotti (1994) who concludes that this relation is not due to greater income inequality raising government transfers, thereby lowering growth. Sylwester (1997) explores some other candidate transmission mechanisms but does not report any positive findings.[3]

A better understanding of how income inequality affects growth might shed light upon which policies could mitigate any negative effects of income inequality upon growth and show how various policies could indirectly affect this relation. Since few countries have been able to achieve a substantial reduction in income inequality in a short period of time (see Deininger and Squire, 1996a), such a rapid reduction may not be a viable option for most countries. Thus, finding the transmission mechanism may help to determine how changes in government policies can lower any negative impact that income inequality has upon economic growth. Of course, there may be other benefits and costs of such a policy and so, it is important to have a more complete picture as to how income inequality may affect growth.

This paper explores one such link; how does income inequality affect the amount of funding that goes to public education and how does this funding affect economic growth? If income inequality does lead to more expenditures for public education, then what is the impact upon growth? Do the positive benefits of acquiring skills and knowledge outweigh the negative effect of the costs (e.g. distortionary taxation) of financing these expenditures? Although it has been widely reported that growth is increasing with human capital, this does not necessarily imply that the process of increasing human capital raises economic growth. Instead, there might be costs upon economic growth associated with augmenting the stock of human capital.

[2] Although Deininger and Squire (1996a) report that income inequality does not lower growth, they used the average level of income inequality over the sample period instead of the initial level of income inequality for that period. Li and Zou (1998) use a panel data set and report that income inequality does not lower growth and may actually raise growth. I comment further upon this study in Section 3. Finally, Forbes (2000) reports that changes in income inequality are positively associated with economic growth.

[3] Sylwester (1997) reports that income inequality does not raise government transfers, government consumption, or public investment. In contrast to Alesina and Perotti (1993), high income inequality also does not increase political instability. Finally, high income inequality is also not shown to decrease the growth rate of the average education level of the population, possibly because of a positive relation between income inequality and public expenditures for education.