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Inequality, Financial Development and Economic Growth in the OECD, 1870-2011¹

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Abstract. Inequality's effect on growth remains elusive, largely due to endogeneity, complex interactions, and lead-lag relationships. We revisit this issue by examining the four main channels through which inequality transmits to growth: savings, investment, education, and knowledge production. We construct new panel data for 21 OECD countries spanning 142 years. External communist influence is used as a new time-varying instrument for inequality and the effects of inequality on the outcome variables are made conditional on the stage of financial development. Our results show that inequality hampers growth at low to moderate levels of financial development but has little effect on growth at advanced levels of financial development.

Keywords: inequality, financial development, transmission channels

JEL codes: E20, O15, O40

1. Introduction

One of the long-standing questions in macroeconomics is whether income inequality impairs or promotes growth. Despite a burgeoning literature on the growth effects of inequality, the empirical evidence remains inconclusive and a definitive assessment of the effects of inequality on growth remains elusive.² This impasse is not surprising given that the relationship between inequality and growth is masked by various channels that transmit to growth with markedly varying lags, inequality

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² Studies that investigate the relationship between inequality and growth include Barro (2000), Forbes (2000), Panizza (2002), Banerjee and Duflo (2003), Voitchovsky (2005), Easterly (2007), Berg *et al.* (2012), and Halter *et al.* (2014). Most studies conclude that the empirical evidence is ambiguous.

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