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Growth Effects of Inequality and Redistribution: What are the Transmission Channels?

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Abstract

Evidence from a large panel of harmonized data highlights a negative effect of income inequality on economic growth. Less equal societies tend to have less educated populations and higher fertility rates, but not necessarily lower investment shares. These effects are particularly prevalent if credit availability is limited, while public education spending attenuates the negative effects of inequality. Public redistribution, measured as the difference between Ginis of market and net income, hampers growth via lower investment and increased fertility. Yet, combined with its positive effect through lower inequality, the impact of redistribution is insignificant. In developing countries redistribution can even be growth enhancing.

Keywords: Economic Growth, Redistribution, Inequality, Panel Data
JEL Classification: O11, O15, O47

1. Introduction

In his famous book *"Equity and Efficiency: The Big Tradeoff"*, Okun (1975) points out that the trade-off between social justice and economic efficiency "plagues us in dozens of dimensions of social policy". Okun's notion led to the widespread belief that public redistribution via taxes and transfers creates disincentives and inefficiencies that Okun compares to a "leaky bucket", with money lost whenever transfers are made from the rich to the poor. However, empirical evidence for the existence of such a trade-off is rather ambiguous.

The literature at hand can be divided into two distinct groups. One branch examines the link between inequality and growth, while the other studies the growth effects of redistributive taxes and social transfers. This paper follows a novel approach by simultaneously exploring the growth effects of both income inequality and effective public redistribution, with the latter computed as the difference between market and net income Gini coefficients. We find that a high level of inequality reduces GDP growth, but its remedy—redistribution

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