ELSEVIER European Economic Review 44 (2000) 706–712

EUROPEAN ECONOMIC REVIEW

www.elsevier.com/locate/econbase

Income distribution and the process of development

Oded Galor[a,b,c,*,1]

[a]Brown University, Providence, RI 02912, USA
[b]Department of Economics, Hebrew University, Jerusalem, 91905, Israel
[c]Centre for Economic Policy Research, London, UK

Abstract

This paper examines the evolution of the role of income distribution in the process of development. It presents a unified model that encompasses the transition between distinct regimes that have characterized the relationship between income inequality and the process of development. This unified modeling provides an intertemporal reconciliation for conflicting viewpoints about the effect of inequality on economic growth – the classical approach which argues that inequality stimulates capital accumulation and economic growth, and the modern approach which suggests, in contrast, that for sufficiently wealthy economies equality stimulates investment in human capital and economic growth.

JEL classification: O11; O15; O40

Keywords: Income distributions; Growth; Credit constraints; Human capital

1. Introduction

This paper examines the dynamic evolution of the effect of income distribution on the process of development. It presents a unified growth model that

* Correspondence address: Department of Economics, Hebrew University, Jerusalem 91905, Israel. Tel.: 972-2-5883239; fax: 972-2-5816071.

E-mail address: msgalor@mscc.huji.ac.il (O. Galor)

[1] Research is supported by NSF Grant SBR-9709941.

0014-2921/00/$ - see front matter
PII: S0014-2921(99)00039-2

encompasses the transition between distinct regimes that may have characterized the relationship between income inequality and the process of development. I view the unified modeling of this long transition process as a significant research challenge facing economists interested in the understanding of the role of income inequality in the process of development and in the determination of long-run economic growth.[2]

Existing theories about the effect of income distribution on the process of development can be classified into two broad categories distinguished by their conflicting predictions. The classical approach suggests that inequality stimulates capital accumulation and thus promotes economic growth, whereas strands of the modern approach argue in contrast that for sufficiently wealthy economies equality stimulates investment in human capital and hence may enhance economic growth.

The classical approach was originated by Smith (1776) and was further interpreted and developed by Keynes (1920), Lewis (1954), Kaldor (1957), and Bourguignon (1981). According to this approach, saving rates are increasing function of wealth, and inequality therefore channels resources towards individuals whose marginal propensity to save is higher, increasing aggregate savings and capital accumulation and enhancing the process of development.

The modern paradigm has been dominated by two complementary approaches. The capital markets imperfections approach, first developed by Galor and Zeira (1988, 1993), has argued that, in the presence of credit markets imperfection, equality in sufficiently wealthy economies stimulates investment in human capital and in (individual specific projects) and enhances economic growth.[3] The political economy approach has subsequently argued that equality diminishes the tendency for socio-political instability, or for distortionary redistribution, and hence it stimulates investment and economic growth.[4]

A unified model of the process of development may provide, however, an intertemporal reconciliation between these conflicting viewpoints about the

[2] This unified approach complements the research of Galor and Weil (1996, 1999, 2000) who developed unified models that encompasses the transition between three distinct regimes that have characterized the process of economic development: the 'Malthusian Regime', the 'Post-Malthusian Regime', and the 'Modern Growth Regime', focusing on the historical evolution of the relationship between population growth, technological change, and economic growth.

[3] See Banerjee and Newman (1993), Benabou (1996a), Durlauf (1996), Fernandez and Rogerson (1996), and Aghion and Bolton (1997) as well. This macro-growth literature should be distinguished from earlier micro studies that examined the effect of family background on the transmission of inequality across generations in the presence of credit market imperfections. The micro literature has not generated hypothesis about the relationship between inequality and the process of development.

[4] See Alesina and Rodrik (1994), Persson and Tabellini (1994), Alesina and Perotti (1996), and Benabou (1996b).