Income inequality and economic growth

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1. Introduction

This paper examines the relationship between income inequality and economic growth. Income inequality refers to disparities in the distribution of income, that is, the gap between the rich and the poor in a country. What relationship exists between income inequality and economic growth? Let us take two pairs of familiar examples, 1) East Asian and South American countries, 2) the United States and France. One of the most common features in the East Asian countries, where economic growth has been high for the past 30 years, is the declining income inequality (World Bank, 1993). South American countries, on the other hand, have experienced severe income inequality problems and economic downturn at the same time. Based on the case studies of East Asian and South American countries only, we may presume that there is a negative relationship between income inequality and economic growth. However, we can easily find other cases of industrialized nations, such as the United States and France. In recent years, economic reports say that the economic growth rate of the United States is higher than that of France, and that the United States suffers higher income inequality than France does.1 Based on the case studies of the United States and France, we may presume that there is a positive relationship between income inequality and economic growth. Therefore it is not possible to simply state a conclusion on either a positive or negative relationship involving these two economic factors.

Concerning the relationship between income inequality and growth performance, we can find both possibilities, a positive or negative, from the existing literature such as the two pairs of examples mentioned above. This paper aims to explain the disagreement consistently using one theoretical model. The results of the early research are summarized in Table 1.2 The research in the first row of Table 1 conclude a negative relationship between income inequality and economic growth. Oppositely, the research in the second row conclude a negative relationship between the two variables. The research in the third row conclude that there is a nonmonotonic relationship like the inverted U shape. The research in the last row conclude that no unique relationship is present or that it is inconclusive.

For example, Barro (2000) concludes that the effect of income inequality on economic growth is different contingent on the state of economic development. Income inequality in poor countries retards economic growth, but income inequality in rich countries encourages economic growth. Using the panel data, Barro (2000) shows that the effect of income inequality on economic growth is negative in countries with GDP per capita below 2070, and is conversely positive in countries with GDP per capita over 2070. Examining the two pairs of samples mentioned above, if we regard Asian countries and South American countries as examples of developing countries and the United States and France as examples of developed countries, the case of these samples is consistent with Barro (2000’s) conclusion.

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1 The average annual economic growth rate, measured real GDP per capita, of the United States and France from 1990 to 2007 are 1.916% and 1.322%, respectively. The figures are calculated by the author using the Penn World Table 6.3.

2 The existing literatures in Table 1 are using different data and analysis methods, respectively. See, Table 1 (page 38) in Sukiassyan (2007) for details.
The positive relationship between income inequality and economic growth might be explained as follows. In developed countries, the saving rate of rich people is higher than that of the poor. Income redistribution from rich people to poor people reduces the saving rate of the economy as a whole and thus could lead to a decline in economic growth. Another reason is that the income redistribution could lower the incentive for the rich to work hard, and that could also lead to an economic growth decline. As a result, we can infer that income equality makes economic growth lower, and income inequality makes it higher.

Meanwhile, the negative relationship between income inequality and economic growth might be explained as follows. In developing countries, poor people are under credit constraint. They do not have the opportunity of investing, and extremely poor people in income inequality cannot even participate in product activity. Income inequality might lead to political and social instability, and consequently to economic growth decline. As a result, we can infer that income inequality makes economic growth lower and income equality makes it higher.

Which explanation is more reasonable? In this paper, we attempt to make the disagreement comprehensible within a single framework. We examine the relationship theoretically using a stochastic optimal growth model composed by heterogeneous agents. We also introduce a progressive tax system into our model and get a numerical solution. We can conclude, in advance, (i) that depending on the opportunity of investing, and extremely poor people in income inequality cannot even participate in product activity. Income inequality might lead to political and social instability, and consequently to economic growth decline. As a result, we can infer that income inequality makes economic growth lower and income equality makes it higher.

In Table 1, we introduce a heterogeneous model including a progressive tax system and get a numerical solution. We can conclude, in advance, (i) that depending on the opportunity of investing, and extremely poor people in income inequality cannot even participate in product activity. Income inequality might lead to political and social instability, and consequently to economic growth decline. As a result, we can infer that income inequality makes economic growth lower and income equality makes it higher.

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