Warning! Inequality May Be Hazardous to Your Growth

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Many of us have been struck by the huge increase in income inequality in the United States in the past thirty years. The rich have gotten much richer, while just about everyone else has had very modest income growth.

Some dismiss inequality and focus instead on overall growth—arguing, in effect, that a rising tide lifts all boats. But assume we have a thousand boats representing all the households in the United States, with boat length proportional to family income. In the late 1970s, the average boat was a 12 foot canoe and the biggest yacht was 250 feet long. Thirty years later, the average boat is a slightly roomier 15 footer, while the biggest yacht, at over 1100 feet, would dwarf the Titanic! **When a handful of yachts become ocean liners while the rest remain lowly canoes, something is seriously amiss.**

In fact, inequality matters. And it matters in all corners of the globe. You need look no further than the role it might have played in the historic transformation underway in the Middle East.

The increase in U.S. income inequality in recent decades is strikingly similar to the increase in the 1920s. In both cases there was a boom in the financial sector, poor people borrowed a lot, and it all ended in huge financial crises. Did the recent financial crisis result somehow from the increase in inequality?

Some time ago, we became interested in long periods of high growth ("growth spells") and what keeps them going. The initial thought was that sometimes crises happen when a "growth spell" comes to an end, as perhaps occurred with Japan in the 1990s.

We approached the problem as a medical researcher might think of life expectancy, looking at age, weight, gender, smoking habits, etc. We do something similar, looking for what might bring long "growth spells" to an end by focusing on factors like political institutions, health and education, macroeconomic instability, debt, trade openness, and so on.

Somewhat to our surprise, **income inequality stood out in our analysis as a key driver of the duration of "growth spells".**

We found that high "growth spells" were much more likely to end in countries with less equal income distributions. The effect is large. For example, we estimate that closing, say, half the inequality gap between Latin America and emerging Asia would more than double the expected duration of a "growth spell". **Inequality seemed to make a big difference almost no matter what other variables were in the model or exactly how we defined a "growth spell".** Inequality is of course not the only thing that matters but, from our analysis, it clearly belongs in the "pantheon" of well-established growth factors such as the quality of political institutions or trade openness.

While income distribution within a given country is pretty stable most of the time, it sometimes moves a lot. In addition to the United States in recent decades, we've also seen changes in China and many other countries. Brazil reduced inequality significantly from the early 1990s through a focused set of transfer programs that have become a model for many around the world. A reduction of the magnitude achieved by Brazil could—albeit with uncertainty about the precise effect—increase the expected length of a typical "growth spell" by about 50 percent.

The upshot? It is a big mistake to separate analyses of growth and income distribution. A rising tide is still critical to lifting all boats. The implication of our analysis is that helping to raise the lowest boats may actually help to keep the tide rising!

The immediate role for policy, however, is less clear. More inequality may shorten growth duration, but poorly designed efforts to reduce inequality could be counterproductive. If these distort incentives and thereby undermine growth, they can do more harm than good to the poor.

Still, there may be some "win-win" policies, such as better-targeted subsidies, better access to education for the poor that improves equality of economic opportunity, and active labor market measures that promote employment.

When there are short-run trade-offs between the effects of policies on growth and income distribution, the evidence in our paper doesn't in itself say what to do. **But our analysis should tilt the balance towards the long-run benefits—including for growth—of reducing inequality.** Over longer horizons, reduced inequality and sustained growth may be two sides of the same coin.

Stepping further back, all this reminds us of the 1980s debt crises and the resulting "lost decade" of slow growth and painful adjustment. That experience brought home the fact that sustainable economic reform is possible only when the benefits are widely shared. **In the face of the current global economic turmoil and the need for difficult economic adjustment and reform in many countries, it would be better if these old lessons could be remembered rather than relearned.**