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# Does wealth inequality matter for growth? The effect of billionaire wealth, income distribution, and poverty<sup>☆</sup>

Sutirtha Bagchi<sup>a</sup>, Jan Svejnar<sup>b,\*</sup><sup>a</sup> Villanova School of Business, Villanova University, Villanova, PA, USA<sup>b</sup> School of International and Public Affairs, Columbia University, NY, USA and CEPR, IZA, CERGE-EI

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## ABSTRACT

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A fundamental question in social sciences relates to the effect of wealth inequality on economic growth. Yet, in tackling the question, researchers have had to use income as a proxy for wealth. We derive a global measure of wealth inequality from Forbes magazine's listing of billionaires and compare its effect on growth to the effects of income inequality and poverty. Our results suggest that wealth inequality has a negative relationship with economic growth, but when we control for the fact that some billionaires acquired wealth through political connections, the relationship between politically connected wealth inequality and economic growth is negative, while politically unconnected wealth inequality, income inequality, and initial poverty have no significant relationship. *Journal of Comparative Economics* 000 () (2015) 1–26. Villanova School of Business, Villanova University, Villanova, PA, USA; School of International and Public Affairs, Columbia University, NY, USA and CEPR, IZA, CERGE-EI.

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## 1. Introduction

A central question in the social sciences is whether inequality in control over a society's resources facilitates or hinders economic growth. Although there is a large theoretical and empirical literature on this topic, the question is far from settled.

Three important features of the literature contribute to this lack of consensus. First, although theoretical arguments are usually based on the distribution of wealth, nearly all empirical studies use the distribution of income rather than wealth because data on the distribution of wealth do not exist for a sufficient number of countries. As [Aghion et al., \(1999, pp. 1617–1618\)](#) explain, "... the absence of data on the distribution of wealth for a sufficient number of countries forces researchers to use proxies in empirical studies. The most common approach is to use data on income inequality as a proxy for wealth inequality." [Bénabou \(1996\)](#)

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\* Corresponding author.

E-mail addresses: [sutirtha.bagchi@villanova.edu](mailto:sutirtha.bagchi@villanova.edu) (S. Bagchi), [svejnar@columbia.edu](mailto:svejnar@columbia.edu), [cgeg@columbia.edu](mailto:cgeg@columbia.edu) (J. Svejnar).

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echoes this point when he notes that the lack of almost any data on the distribution of wealth is a general problem, given that in most theories it is this distribution rather than that of income which is the determinant of outcomes. Finally, while discussing studies that use income inequality, [Ravallion \(2012, p. 506\)](#) emphasizes that “wealth inequality is arguably more relevant though this has been rarely used due to data limitations.”<sup>1</sup>

Second, the literature does not adequately account for the sources of inequality. Consider Indonesia and United Kingdom. Although these countries appear similar on measures of income inequality, their respective Gini coefficients being 32.5 and 33.7, they differ markedly on such dimensions as the role that political connections have played in achieving economic success and bringing about their distribution of income and wealth. Yet, virtually all empirical studies ignore this distinction and examine the effects of aggregate measures of inequality on economic growth.<sup>2</sup>

Third, in an important multi-country study, [Ravallion \(2012\)](#) has recently cast serious doubt on inequality as a determinant of growth, suggesting that it is initial poverty rather than income inequality that affects economic growth of countries.

In this paper, we address the shortcomings noted in the first two points above and we provide new evidence on the third point, namely the issue of whether inequality or poverty affects growth. The foremost contribution of our paper is in developing a measure of wealth inequality based on Forbes magazine’s annual world-wide listing of billionaires. Second, we introduce two new variables reflecting the extent, if any, to which billionaire wealth has been obtained through political connections (cronyism). We next use annual data for 1987–2007 to construct four five-year panels and test hypotheses regarding the effects on growth of our overall measure of wealth inequality, our measures of politically connected and unconnected wealth inequality, income inequality, and poverty. To the best of our knowledge, ours is the first paper to examine the relationship between wealth inequality and economic growth in a cross-country, panel data setting. It estimates an encompassing model that compares the relationship between economic growth and wealth inequality, income inequality, and poverty.<sup>3</sup> Our econometric analysis, covering the period 1987–2007, is complementary to the larger historical study of [Piketty \(2014\)](#) who constructs data on income and wealth distribution and examines their relationship to economic growth over many decades and even centuries.<sup>4</sup>

We also tackle a methodological criticism of much of the literature in this area, namely that findings may be biased on account of endogeneity of inequality in the growth regressions. We follow one of the leading empirical studies in this area – [Forbes \(2000\)](#) – and estimate a fixed effects model with lagged values of the explanatory variables. In addition, while finding valid instruments for traditional instrumental variable (IV) estimation is very difficult in this setting, we also discuss estimates based on two time-varying IVs for wealth inequality. Finally, we find that our main results pertaining to the relationship between wealth inequality and economic growth hold when we use random effects or system-GMM or difference-GMM methods in estimation.

Our first finding suggests that wealth inequality has a negative, statistically significant relationship with economic growth, while the effect of income inequality is insignificant or only borderline significant, and the effect of poverty is statistically insignificant in nearly all specifications. Hence, using an encompassing model, we show that in the head-on comparison it is wealth inequality, rather than income inequality or poverty that is significantly related to economic growth.

Our second set of results comes from specifications in which we control for the fact that some billionaires acquired wealth through the use of political connections or cronyism, while others obtained it in a relatively standard legal environment. This estimation is based on a categorization of billionaires that is somewhat subjective.<sup>5</sup> We are conservative about classifying someone as being politically connected and are also fully up-front about how we carry out the classification. Using the classification, our results suggest that politically connected wealth inequality and growth are negatively related, while the effects of politically unconnected wealth inequality, income inequality, and initial poverty are statistically insignificant. The second set of results hence suggests that one needs to pay attention to the sources and nature of wealth inequality.

Our third set of results shows that our estimates are robust to a number of alternative specifications and explores the reason why our results with respect to income inequality differ from those of [Forbes \(2000\)](#) and those with respect to poverty from those of [Ravallion \(2012\)](#).

The structure of the paper is as follows. In [Section 2](#), we offer a brief review of the theoretical and empirical literature that examines the impact of inequality and poverty on growth. In [Section 3](#), we present our empirical strategy and describe the data set used. In [Section 4](#), we validate the use of the inequality variables constructed from Forbes magazine’s annual listing of billionaires as reasonable measures of wealth inequality and the importance of political connections in a country’s socioeconomic system. In [Section 5](#), we present the main results capturing the impact of wealth inequality (and its components),

<sup>1</sup> The only study that directly uses wealth inequality data and looks at the effect of wealth inequality on growth is a paper by [Ravallion \(1998\)](#) who studies the effect of geographic differences in the distribution of wealth on growth in China and finds evidence that high wealth inequality impedes growth.

<sup>2</sup> [Easterly \(2007\)](#) is a notable exception in that he distinguishes between structural and market-based inequality. A fuller discussion of the relationship between his paper and our work is provided in [Sections 2 and 4](#) below. Moreover, as we discuss below, [Morck, Stangeland, and Yeung \(2000\)](#) note that when they divide billionaires into those who were self-made versus those who inherited their wealth, a country’s per capita GDP grows faster if its self-made billionaire wealth is larger as a fraction of GDP and slower if inherited billionaire wealth is larger as a fraction of GDP.

<sup>3</sup> As we discuss below, a pioneering study by [Alesina and Rodrik \(1994\)](#) and an important later study by [Deininger and Olinto \(2000\)](#) use land inequality as a proxy for wealth inequality, but this measure is more appropriate for low income agrarian societies than the world as a whole.

<sup>4</sup> [Piketty’s](#) main point is that historically the rate of return on capital (wealth) exceeds the rate of growth of the economy and that after a hiatus in the second half of the twentieth century it will continue to do so. As a result, the income and wealth of the rich (who live off of return on capital and save-and-invest most of it) will grow faster than the average income from work. This will lead to an increasing inequality in both wealth and income.

<sup>5</sup> This is in the same vein as the Corruption scores of the [International Country Risk Guide \(ICRG\)](#) of the University of Maryland, Transparency International’s Corruption Perceptions Index, and [Fisman’s](#) classification scheme (2001) which are also based on perceptions rather than on objective data.

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