

Why Inequality is Bad for the Economy: Geese, Golden Eggs, and Traps

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Whenever progressives propose ways to redistribute wealth from the rich to those with low and moderate incomes, conservative politicians and economists accuse them of trying to kill the goose that lays the golden egg. The advocates of unfettered capitalism proclaim that inequality is good for the economy because it promotes growth. Unequal incomes, they say, provide the incentives necessary to guide productive economic decisions by businesses and individuals. Try to reduce inequality, and you'll sap growth. Furthermore, the conservatives argue, growth actually promotes equality by boosting the have-nots more than the haves. So instead of fiddling with who gets how much, the best way to help those at the bottom catch up is to pump up growth.

But these conservative prescriptions are absolutely, dangerously wrong. Instead of the goose-killer, equality turns out to be the goose. Inequality stifles growth; equality gooses it up. Moreover, economic expansion does *not* necessarily promote equality—instead, it is the types of jobs and the rules of the economic game that matter most.

Inequality: Goose or Goose-Killer?

The conservative argument may be wrong, but it's straightforward. Inequality is good for the economy, conservatives say, because it provides the right incentives for innovation and economic growth. First of all, people will only have the motivation to work hard, innovate, and invest wisely if the economic system rewards them for good economic choices and penalizes bad ones. Robin Hood-style policies that collect from the wealthy and help those who are worse off violate this principle. They reduce the payoff to smart decisions and lessen the sting of dumb ones. The result: people and companies are bound to make less efficient decisions. "We must allow [individuals] to fail, as well as succeed, and we must replace the nanny state with a regime of self-reliance and self-respect," writes conservative lawyer Stephen Kinsella in *The Freeman: Ideas on Liberty* (not clear how the free woman fits in). To prove their point, conservatives point to the former state socialist countries, whose economies had become stagnant and inefficient by the time they fell at the end of the 1980s.

If you don't buy this incentive story, there's always the well-worn trickle-down theory. To grow, the economy needs productive investments: new offices, factories, computers, and machines. To finance such investments takes a pool of savings. The rich save a larger fraction of their incomes than those less well-off. So to spur growth, give more to the well-heeled (or at least take less away from them in the form of taxes), and give less to the down-and-out. The rich will save their money and then invest it, promoting growth that's good for everyone.

Unfortunately for trickle-down, the brilliant economist John Maynard Keynes debunked the theory in his *General Theory of Employment, Interest, and Money* in 1936. Keynes, whose precepts guided liberal U.S. economic policy from the 1940s through the 1970s, agreed that investments must be financed out of savings. But he showed that most often it's changes in investment that drive savings, rather than the other way around. When businesses are optimistic

about the future and invest in building and retooling, the economy booms, all of us make more money and we put some of it in banks, 401(k)s, stocks, and so on. That is, saving grows to match investment. When companies are glum, the process runs in reverse, and savings shrink to equal investment. This leads to the “paradox of thrift”: if people try to save too much, businesses will see less consumer spending, will invest less, and total savings will end up diminishing rather than growing as the economy spirals downward. A number of Keynes’s followers added the next logical step: shifting money from the high-saving rich to the high-spending rest of us, and not the other way around, will spur investment and growth.

Of the two conservative arguments in favor of inequality, the incentive argument is a little weightier. Keynes himself agreed that people needed financial consequences to steer their actions, but questioned whether the differences in payoffs needed to be so huge. Certainly state socialist countries’ attempts to replace material incentives with moral exhortation have often fallen short. In 1970, the Cuban government launched the *Gran Zafra* (Great Harvest), an attempt to reap 10 million tons of sugar cane with (strongly encouraged) volunteer labor. Inspired by Che Guevara’s ideal of the New Socialist Man (not clear how the New Socialist Woman fit in), the effort ended with Fidel Castro tearfully apologizing to the Cuban people, in a nationally broadcast speech, for letting wishful thinking guide economic policy.

But before conceding this point to the conservatives, let’s look at the evidence about the connection between equality and growth. Economists William Easterly of New York University and Gary Fields of Cornell University have recently summarized this evidence:

- Countries, and regions within countries, with more equal incomes grow faster. (These growth figures do not include environmental destruction or improvement. If they knocked off points for environmental destruction and added points for environmental improvement, the correlation between equality and growth would be even stronger, since desperation drives poor people to adopt environmentally destructive practices such as rapid deforestation.)
- Countries with more equally distributed land grow faster.
- Somewhat disturbingly, more ethnically homogeneous countries and regions grow faster—presumably because there are fewer ethnically based inequalities.

In addition, more worker rights are associated with higher rates of economic growth, according to Josh Bivens and Christian Weller, economists at Washington think tanks the Economic Policy Institute and the Center for American Progress.

These patterns recommend a second look at the incentive question. In fact, more equality can actually *strengthen* incentives and opportunities to produce.

Equality as the Goose

Equality can boost growth in several ways. Perhaps the simplest is that study after study has shown that farmland is more productive when cultivated in small plots. So organizations promoting more equal distribution of land, like Brazil’s Landless Workers’ Movement, are not just helping the landless poor—they’re contributing to agricultural productivity!

Another reason for the link between equality and growth is what Easterly calls “match effects,” [< IS THIS EASTERLY’S TERM OR DOES EVERYONE USE IT? I’ve just seen Easterly use it] which have been highlighted in research by Stanford’s Paul Roemer and others in recent years. [IS THIS ACCURATE? Yes>] One example of a match effect is the fact that well-educated people are most productive when working with others who have lots of schooling. Likewise, people working with computers are more productive when many others have computers (so that, for example, e-mail communication is widespread, and know-how about computer repair and software choices is easy to come by). In very unequal societies, highly educated, computer-using elites are surrounded by majorities with little education and no computer access, dragging down their productivity. This decreases young people’s incentive to get more education and businesses’ incentive to invest in computers, since the payoff will be smaller.

Match effects can even matter at the level of a metropolitan area. Urban economist Larry Ledebur looked at income and employment growth in 85 U.S. cities and their neighboring suburbs. He found that in cities where the income gap between those in the suburbs and those in the city was largest, income and job growth was slower for everyone.

“Pressure effects” also help explain why equality sparks growth. Policies that close off the low-road strategy of exploiting poor and working people create pressure effects, driving economic elites to search for investment opportunities that pay off by boosting productivity rather than squeezing the have-nots harder. For example, where workers have more rights, they will place greater demands on businesses. Business owners will respond by trying to increase productivity, both to remain profitable even after paying higher wages, and to find ways to produce with fewer workers. The CIO union drives in U.S. mass production industries in the 1930s and 1940s provide much of the explanation for the superb productivity growth of the 1950s and 1960s. (The absence of pressure effects may help explain why many past and present socialist countries have seen slow growth, since they tend to offer numerous protections for workers but no right to organize independent unions.) Similarly, if a government buys out large land-holdings in order to break them up, wealthy families who simply kept their fortunes tied up in land for generations will look for new, productive investments. Industrialization in Asian “tigers” South Korea and Taiwan took off in the 1950s on the wings of funds freed up in exactly this way.

Inequality, Conflict, and Growth

Inequality hinders growth in another important way: it fuels social conflict. Stark inequality in countries such as Bolivia and Haiti has led to chronic conflict that hobbles economic growth. Moreover, inequality ties up resources in unproductive uses such as paying for large numbers of police and security guards—attempts to prevent individuals from redistributing resources through theft.

Ethnic variety is connected to slower growth because, on the average, more ethnically diverse countries are also more likely to be ethnically divided. In other words, the problem isn’t ethnic variety itself, but racism and ethnic conflict that can exist among diverse populations. In nations like Guatemala, Congo, and Nigeria, ethnic strife has crippled growth—a problem alien to

ethnically uniform Japan and South Korea. The reasons are similar to some of the reasons that large class divides hurt growth. Where ethnic divisions (which can take tribal, language, religious, racial, or regional forms) loom large, [WOULD IT BE ACCURATE TO INSERT “DOMINANT” HERE?Yes] ethnic groups seek to use government power to better themselves at the expense of other groups, rather than making broad-based investments in education and infrastructure. This can involve keeping down the underdogs—slower growth in the U.S. South for much of the country’s history was linked to the Southern system of white supremacy. Or it can involve seizing the surplus of ethnic groups perceived as better off—in the extreme, Nazi Germany’s expropriation and genocide of the Jews, who often held professional and commercial jobs.

Of course, the solution to such divisions is not “ethnic cleansing” so that each country has only one ethnic group—in addition to being wrong, this is simply impossible in a world with 191 countries and 5,000 ethnic groups. Rather, the solution is to diminish ethnic inequalities. Once the 1964 Civil Rights Act forced the South to drop racist laws, the New South’s economic growth spurt began. Easterly reports that in countries with strong rule of law, professional bureaucracies, protection of contracts, and freedom from expropriation—all rules that make it harder for one ethnic group to economically oppress another—ethnic diversity has *no* negative impact on growth.

If more equality leads to faster growth so everybody benefits, why do the rich typically resist redistribution? Looking at the *ways* that equity seeds growth helps us understand why. The importance of pressure effects tells us that the wealthy often don’t think about more productive ways to invest or reorganize their businesses until they are forced to. But also, if a country becomes very unequal, it can get stuck in an “inequality trap.” Any redistribution involves a tradeoff for the rich. They lose by giving up part of their wealth, but they gain a share in increased economic growth. The bigger the disparity between the rich and the rest, the more the rich have to lose, and the less likely that the equal share they’ll get of boosted growth will make up for their loss. Once the gap goes beyond a certain point, the wealthy have a strong incentive to restrict democracy, and to block spending on education which might lead the poor to challenge economic injustice—making reform that much harder.

Does Economic Growth Reduce Inequality?

If inequality isn’t actually good for the economy, what about the second part of the conservatives’ argument—that growth itself promotes equality? According to the conservatives, those who care about equality should simply pursue growth and wait for equality to follow.

“A rising tide lifts all boats,” President John F. Kennedy famously declared. But he said nothing about which boats will rise fastest when the economic tide comes in. Growth does typically reduce poverty, according to studies reviewed by economist Gary Fields, though some “boats”—especially families with strong barriers to participating in the labor force—stay “stuck in the mud.” But inequality can increase at the same time that poverty falls, if the rich gain even faster than the poor do. True, sustained periods of low unemployment, like that in the late 1990s United States, do tend to raise wages at the bottom even faster than salaries at the top. But

growth after the recessions of 1991 and 2001 began with years of “jobless recoveries”—growth with inequality.

For decades the prevailing view about growth and inequality within countries was that expressed by Simon Kuznets in his 1955 presidential address to the American Economic Association. Kuznets argued that as countries grew, inequality would first increase, then decrease. The reason is that people will gradually move from the low-income agricultural sector to higher-income industrial jobs—with inequality peaking when the workforce is equally divided between low- and high-income sectors. For mature industrial economies, Kuznets’s proposition counsels focusing on growth, assuming that it will bring equity. In developing countries, it calls for enduring current inequality for the sake of future equity and prosperity.

But economic growth doesn’t automatically fuel economic growth. In 1998, economists Klaus Deininger and Lyn Squire traced inequality and growth over time in 48 countries. Five followed the Kuznets pattern, four followed the reverse pattern (decreasing inequality followed by an increase), and the rest showed no systematic pattern. In the United States, for example:

- incomes became more equal during the 1930s through 1940s New Deal period (a time that included economic decline followed by growth)
- from the 1950s through the 1970s, income gaps lessened during booms and expanded during slumps
- from the late 1970s forward, income inequality worsened fairly consistently, whether the economy was stagnating or growing.

The reasons are not hard to guess. The New Deal introduced widespread unionization, a minimum wage, social security, unemployment insurance, and welfare. Since the late 1970s, unions have declined, the inflation-adjusted value of the minimum wage has fallen, and the social safety net has been shredded. In the United States, as elsewhere, growth only promotes equality if policies and institutions to support equity are in place.

Trapped?

Let’s revisit the idea of an inequality trap. The notion is that as the gap between the rich and everybody else grows wider, the wealthy become more willing to give up overall growth in return for the larger share they’re getting for themselves. The haves back policies to control the have-nots, instead of devoting social resources to educating the poor so they’ll be more productive.

Sound familiar? It should. After two decades of widening inequality, the last few years have brought us massive tax cuts that primarily benefit the wealthiest, at the expense of investment in infrastructure and the education, child care, and income supports that would help raise less well-off kids to be productive adults. Federal and state governments have cranked up expenditures on prisons, police, and “homeland security,” and Republican campaign organizations have devoted major resources to keeping blacks and the poor away from the polls. If the economic patterns of the past are any indication, we’re going to pay for these policies in slower growth and stagnation unless we can find our way out of this inequality trap.

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Resources: William Easterly, *The Elusive Quest for Growth*, MIT Press 2001. Gary S. Fields, *Distribution and Development*, MIT Press 2001. Josh Bivens and Christian Weller, “Rights make might: Ensuring workers’ rights as a strategy for economic growth,” Economic Policy Institute 2003.