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Does Wealth Inequality Matter for Growth?

The Effect of Billionaire Wealth, Income Distribution, and Poverty

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A central question in the social sciences is whether inequality in control over a society's resources facilitates or hinders economic growth. Although a large theoretical and empirical literature examines 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.

Second, the literature does not adequately account for the sources of inequality. Consider Indonesia and the United Kingdom. Although these countries appear similar on measures of income inequality, they differ markedly on such dimensions as the role that political connections have played in achieving economic success and bringing about the distributions of income and wealth. Virtually all empirical studies ignore this distinction and examine the effects of aggregate measures of inequality on economic growth.

Third, a recent multi-country research study casts doubt on inequality as a determinant of growth, suggesting that initial poverty rather than income inequality affects economic growth of countries.

In our research, 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. We first contribute to the literature by developing a measure of wealth inequality based on *Forbes* magazine's annual worldwide listing of billionaires. Further, 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 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. We estimate a model that encompasses a range of hypotheses about the relationship between economic growth and wealth inequality, income inequality, and poverty. Our analysis, covering recent decades, is complementary to the larger historical studies that constructs data on income and wealth distributions and examine their relation to economic growth over many decades and even centuries.

Our first finding is that wealth inequality has a negative, statistically significant relationship with economic growth,

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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 head-on comparisons 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 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. 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 finding that it is politically connected rather than politically unconnected wealth that is likely to dampen growth may be illustrated by two country-specific examples. Consider the case of Russian billionaires first. Russia did not have a single billionaire on the *Forbes* list as recently as 1996, but then we see a spurt in their number starting with the 1997 list. Our view of the wealth accumulation process for these Russian billionaires is that these individuals were able to utilize their political connections to acquire stakes in natural resource companies at below market prices. For example, consider the rise to riches of Mikhail Fridman. As the *Wall Street Journal* describes, "Mikhail Fridman founded OAO Alfa Bank in 1991 and soon after recruited Pyotr Aven, former minister of foreign economic relations, to raise Alfa's political profile. The partners were among a handful of businessmen who helped to finance Boris Yeltsin's re-election campaign in 1996. The Kremlin rewarded these men by selling them state-owned oil and metals companies at bargain-basement prices." Once these individuals had acquired large stakes, it became difficult for the state to effectively regulate these sectors of the economy, which led to market failures. Beyond that, few oligarchs demonstrated a genuine commitment to building the long-term security of property rights in Russia.

Indonesia's tobacco industry provides another telling example of the effects of political connectedness. The influence of the tobacco industry on government policy is enormous and Indonesia is the only country in Asia to have not signed the World Health Organization's Framework Convention on Tobacco Control (FCTC), a treaty that as of September 2015 had been signed by 180 parties, including Iran, North Korea, Syria, and Sudan. The FCTC addresses a number of issues, such as promoting taxation as a way to reduce cigarette consumption; imposing restrictions on smoking in public places; enacting comprehensive bans on tobacco advertising, promotion, and sponsorship within five years of ratification; putting larger health warnings on cigarette packs; and intensifying the fight against tobacco smuggling. Indonesia has not signed the convention in spite of the fact that it is a country in which Muslims constitute approximately 86 percent of the population; smoking is either prohibited in Islam or regarded as abhorrent to such a degree as to be virtually prohibited. The effect of the tobacco industry on the Indonesian economy is also evident from the fact that Indonesia's average tobacco tax of 37 percent is the lowest in Southeast Asia and well below the global average of 70 percent of the sales price.

These and other examples, together with our formal statistical results, suggest that the policy debate about sources of economic growth ought to focus on the distribution of wealth rather than on the distribution of income. Moreover, particular attention ought to be paid to politically connected concentration of wealth as a possible cause of slower economic growth. Further research in this area is obviously needed, especially with respect to the effects of wealth inequality at different parts of the wealth distribution and the role of poverty.

NOTE

This Research Brief is based on "Does Wealth Inequality Matter for Growth? The Effect of Billionaire Wealth, Income Distribution, and Poverty," by Sutirtha Bagchi and Jan Svejnar, *Journal of Comparative Economics* (forthcoming).