

Inequality Undermines Democracy and Growth

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Background

- Inequality of income and wealth has suddenly captured the attention of economists as well as the attention of politicians
- Inequality among nations has decreased with the ascent of China and India while inequality within nations has increased since 1980
- Increased inequality has transformed politics ...
 - *Exhibit A*: Sen. Sanders became a mainstream politician
 - *Exhibit B*: Trump won presidency by appealing to those left behind
 - *Exhibit C*: UK voters chose Brexit
 - Democracy is under stress in Europe and US
- ... and merits closer economic analysis

Outline

- Main aim is to chart cross-country relationships among income distribution, economic growth as represented by per capita GNI, and several determinants of growth
- Growth is driven by buildup and use of four kinds of capital
 1. Physical capital -- Accumulation
 2. Human capital
 3. Natural capital
 4. Social capital
- Here we stress social capital and five particular aspects of it:
 - Democracy, equality, rule of law, transparency, and trust

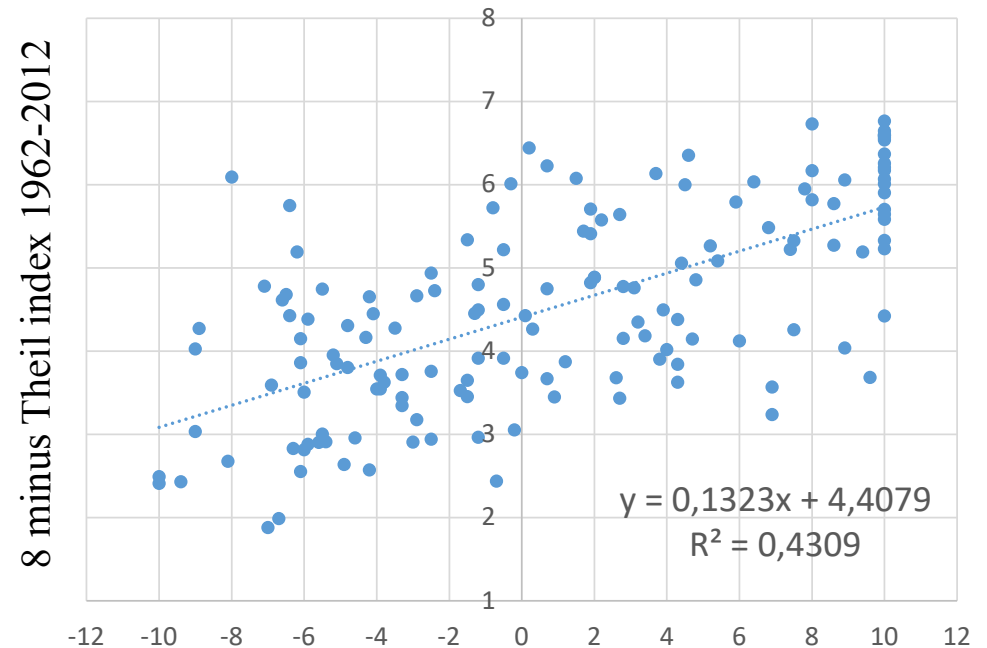
Proceed in three steps

1. Does economic diversification – i.e., distribution of GNI across industries – matter for level of GNI?
 - If diversification boosts output, that may help to explain why natural resource dependence, if not well managed, may stunt output
2. Does political diversification through democracy matter for economic diversification and GNI?
 - Economic and political diversification can be viewed as parallel ways to avoid having too many eggs in one basket
 - Both types of diversification aim to avert excessive concentration and associated risk
3. Do different aspects of social capital – equality, rule of law, transparency, trust – matter for diversification and GNI?

Double diversification

- Two sides of the same coin
 - Economic diversification means diversification of exports and output away from excessive dependence on natural resources
 - Political diversification means increased democracy, i.e., diversification away from excessive dependence on a narrow political base toward political pluralism
 - Both aim to avert national risk

Policy2 index of democracy 1960-2012 and Theil index of export diversification 1962-2010 (148 countries)



Note: Vertical axis shows 8 minus Theil index so diversification increases upward along vertical axis

From diversification to growth

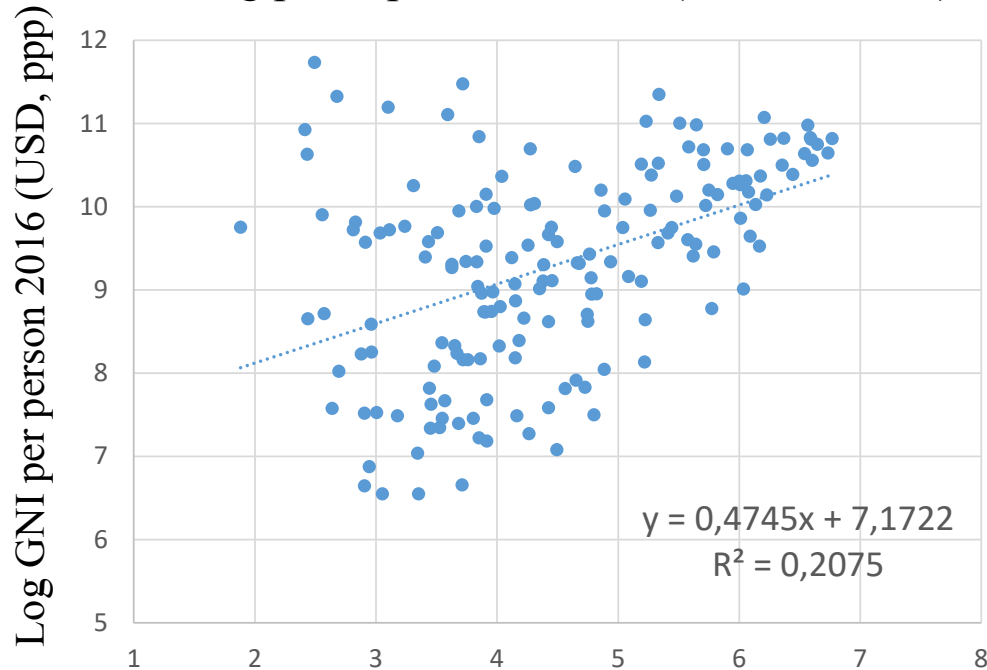
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- Most countries, especially those that rely on a few industries or resources for much of their incomes, seek to diversify their economies
 - They view diversification as an essential aspect of national risk management
 - Some may suspect that, by reducing risk, diversification may also encourage economic efficiency and growth
 - What do the data say?
 - Let's take a look at some simple correlations in preparation for more comprehensive econometric work yet to be undertaken

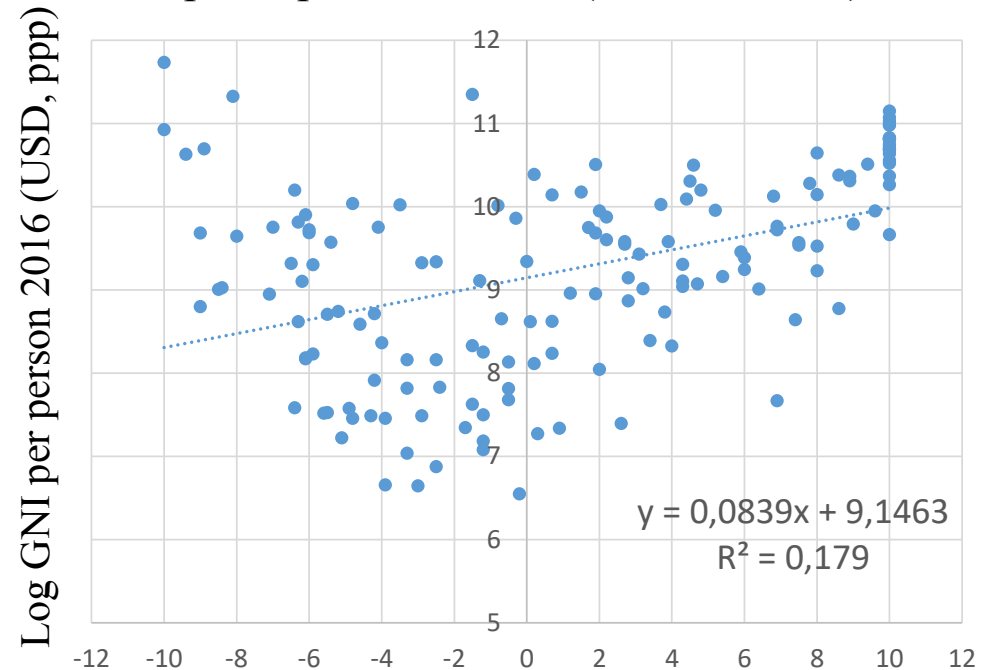
From double diversification to per capita income

“20/50 rule”

Theil index of export diversification 1962-2010 and log per capita GNI 2016 (167 countries)



Policy2 index of democracy 1960-2012 and log per capita GNI 2016 (154 countries)



Note: Horizontal axis in left panel shows 8 minus Theil index so diversification increases from left to right; horizontal axis in right panel shows Polity2 index of democracy

Source: Author's computations

20/50 rule

- An increase in economic diversification by 20% of the scale of the diversification index along horizontal axis is accompanied by a 50% increase in per capita GNI along vertical axis
- An increase in political diversification (democracy) by 20% of the scale of the democracy index along horizontal axis is accompanied by a 50% increase in per capita GNI along vertical axis

Clear impression from data

- Economic diversification is positively correlated with per capita GNI across countries
 - All available measures of diversification give same result
- Perhaps an index of economic diversification belongs in cross-country growth regressions as a more broadly based replacement for indicators of natural resource intensity currently in use
 - Work in progress

Social capital: Transparency

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- Lack of transparency can undermine democracy and growth
 - “Publicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants; electric light the most efficient policeman.”

Louis Brandeis, US Supreme Court Justice 1916-1939

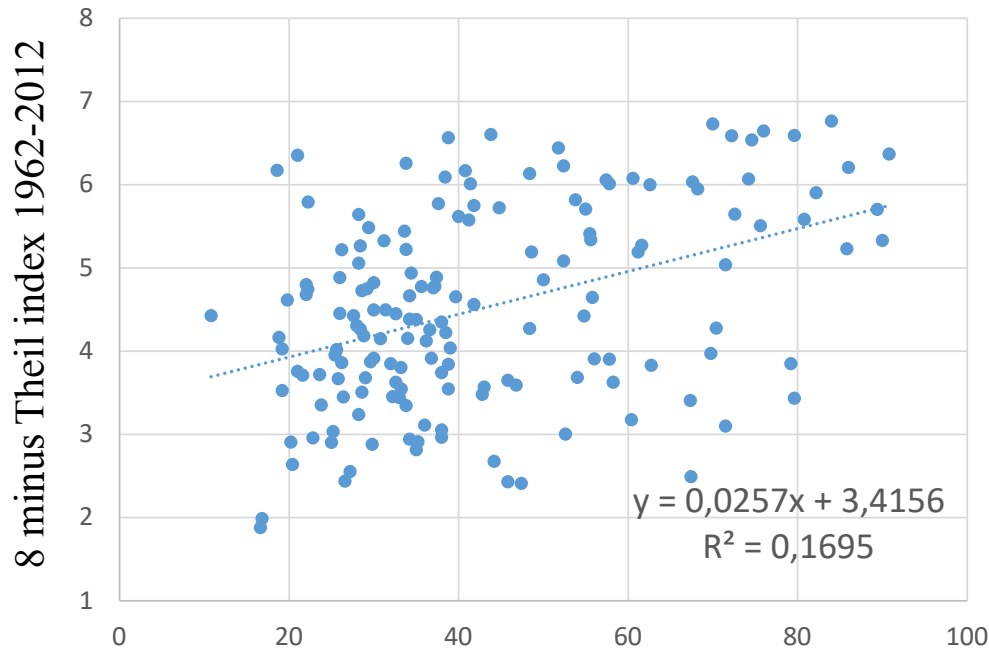
- No independent statistical measure of transparency exists yet
- So, given that Corruption Perceptions Index varies inversely with corruption by construction, we define transparency as

Transparency = Corruption Perceptions Index

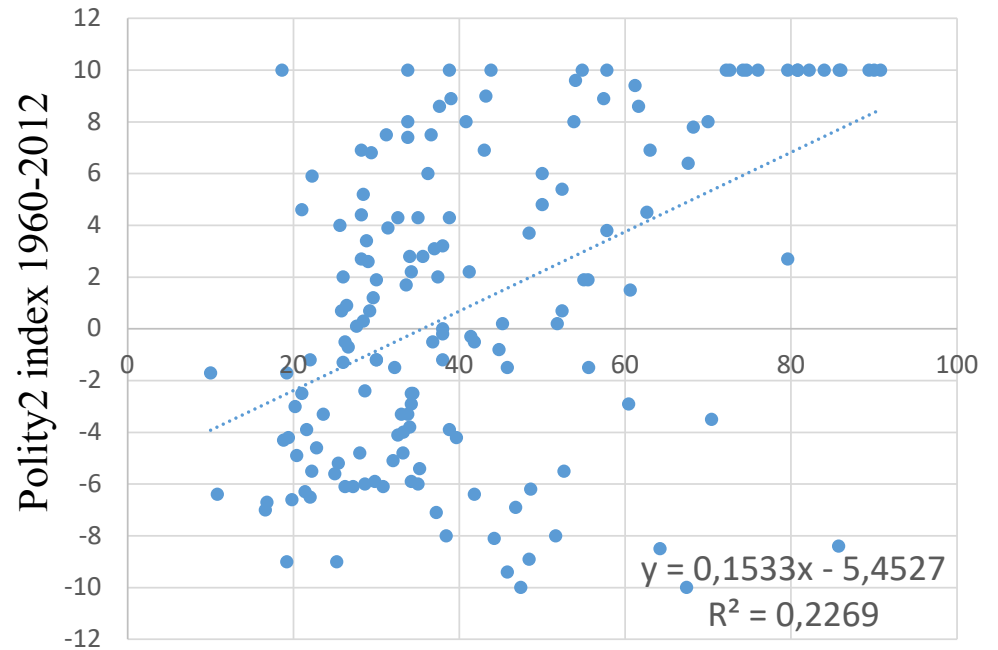
Source: Transparency International

From transparency to double diversification

Transparency index of 2012-2016 and Theil index of export diversification 1962-2010 (159 countries)



Transparency index 2012-2016 and polity2 index of democracy 1960-2012 (158 countries)



Note: Horizontal axes show Transparency index

Social capital: Rule of law

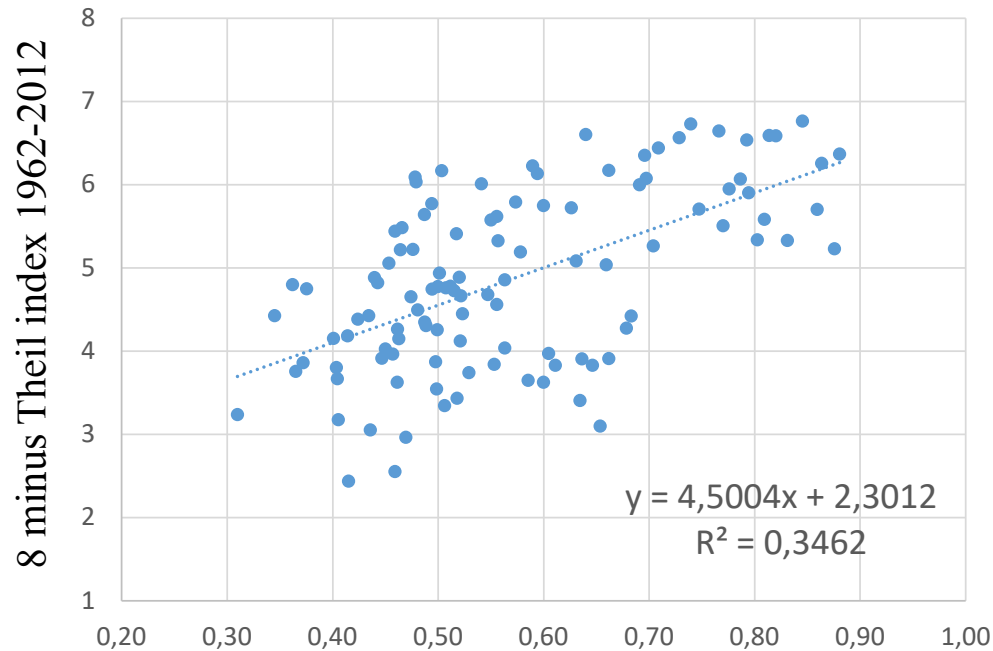
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- Weak rule of law can undermine democracy and growth
 - “... human rights, the rule of law and democracy are interlinked and mutually reinforcing and ... they belong to the universal and indivisible core values and principles of the United Nations”

Declaration adopted on 24 September 2012 by UN General Assembly
- New statistical measure of rule of law is now available from the World Justice Project, based on expert opinion as well as public opinion
 - Composite index, reflecting various aspects of the rule of law
 - Coverage: 2012 to date

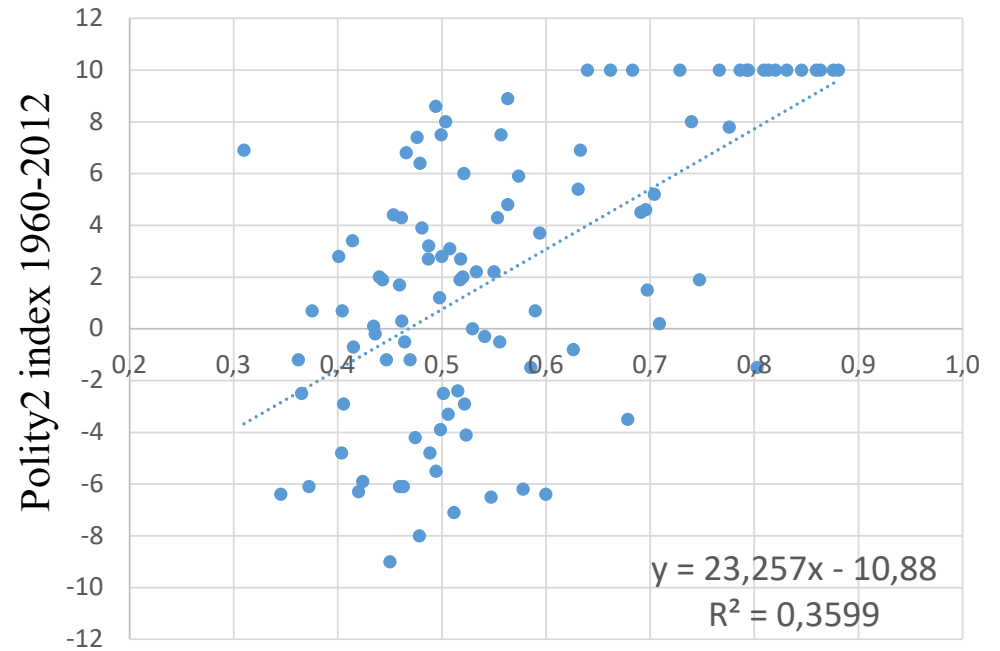
From rule of law to double diversification

Rule of law index 2012-2018 and Theil index of export diversification 1962-2010 (110 countries)



Note: Horizontal axes show Rule of law index

Rule of law index 2012-2018 and polity2 index of democracy 1960-2012 (151 countries)



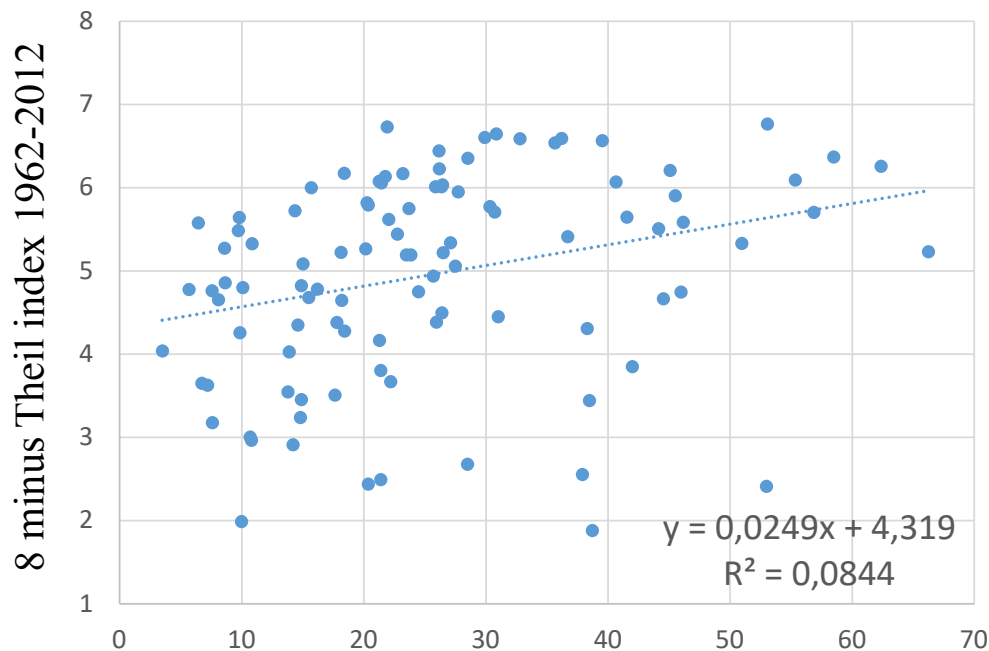
Social capital: Trust

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- Trust is another important ingredient of social capital
 - Emerging signs of declining trust
 - Robert Putnam's *Bowling Alone* (2000)
 - Gallup reports that public confidence has been eroded
 - Trust in US Congress decreased from 42% in 1972 to 12% in 2017
 - Trust in US presidency decreased from 52% in 1975 to 32% in 2017
 - Trust in OECD banks decreased from 55% in 2007 to 46% in 2015
- World Values Survey has gauged trust in six waves 1981-2014
 - “Most people can be trusted” vs. “Need to be very careful”

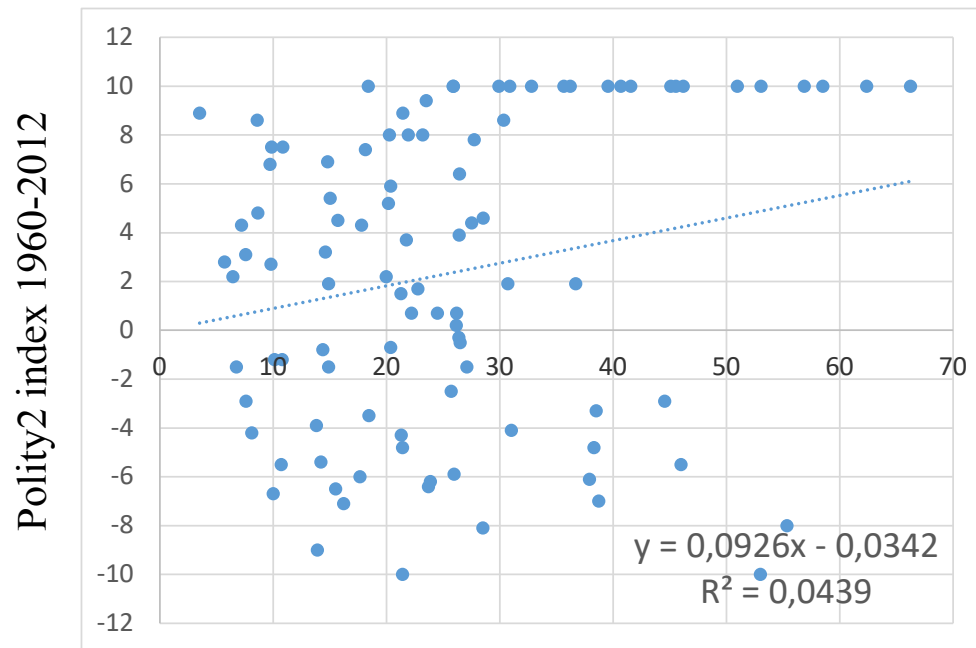
From trust to double diversification

Trust index 1981-2014 and Theil index of export diversification 1962-2010 (100 countries)



Note: Horizontal axes show Trust index

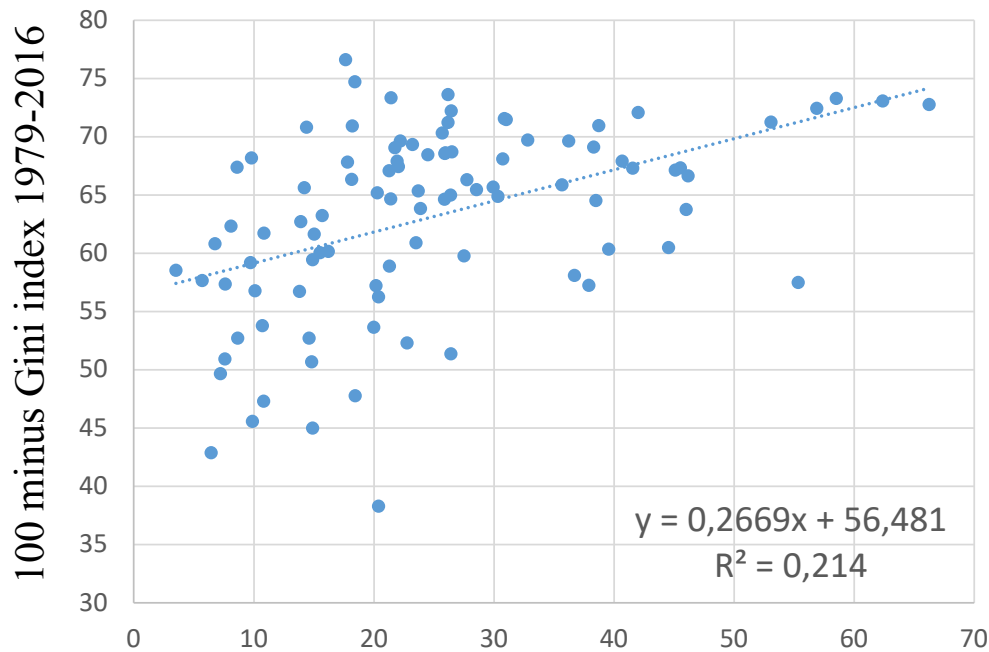
Trust index 1981-2014 and Polity2 index of democracy 1960-2012 (98 countries)



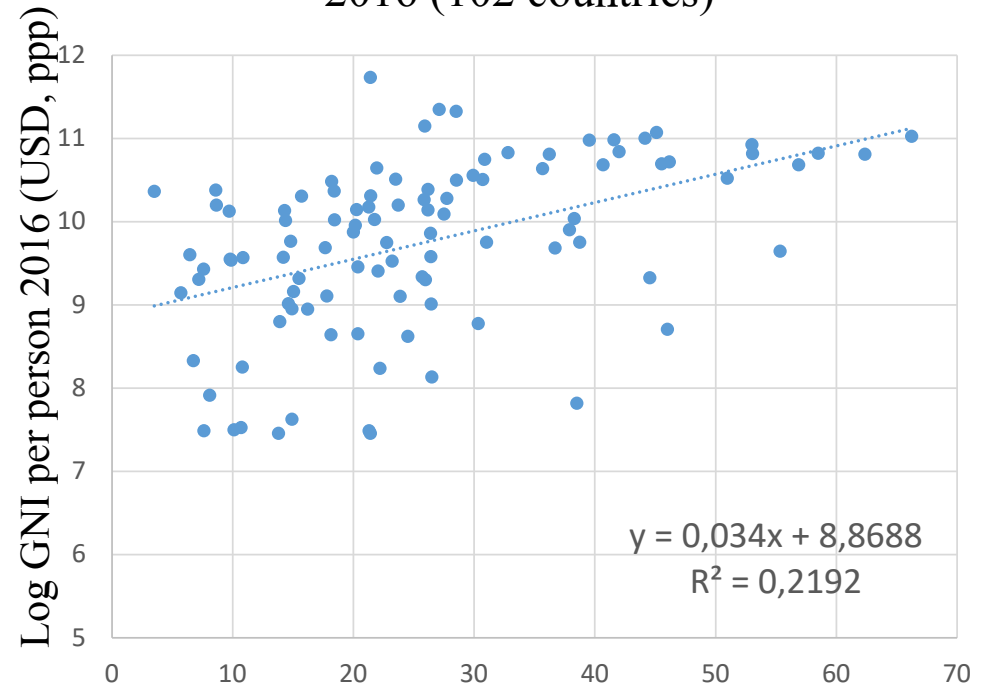
Source: Author's computations

From trust to equality and per capita income

Trust index 1981-2014 and Gini index of inequality 1979-2016 (95 countries)



Trust index 1981-2014 and log per capita GNI 2016 (102 countries)



Note: Horizontal axes show Trust index; in left panel, equality rises upward along vertical axis

Social capital: Inequality



- Inequality can undermine democracy and growth
 - “We can have democracy in this country, or we can have great wealth concentrated in the hands of a few, but we can't have both.”

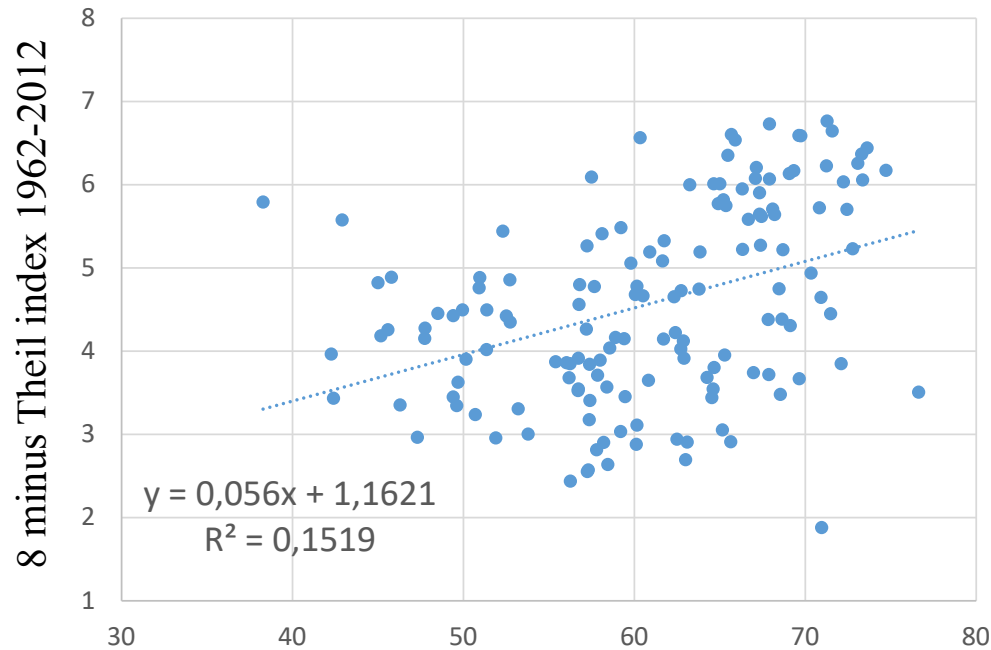
Louis Brandeis, US Supreme Court Justice 1916-1939

 - The top 1% of households saw its share in total pre-tax income rise from 8% in 1980 to 12% in Europe and 20% in US in 2015 as in Russia
 - The top 1% of households saw its share of total net wealth rise from 20% in 1980-1990 to 40% in 2015 as in Russia

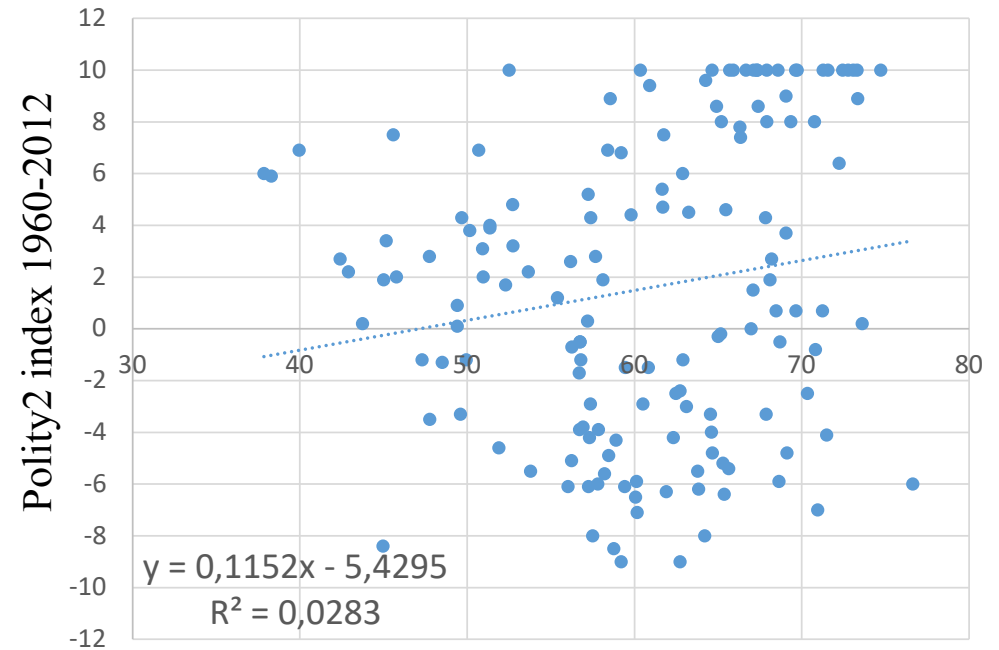
Source: World Inequality Database
 - Gini indices are averages taken from World Development Report
 - Coverage: 1979-2016 at most, usually much shorter periods

From equality to double diversification

Gini index 1979-2016 and Theil index of export diversification 1962-2010 (146 countries)



Gini index 1979-2016 and polity2 index of democracy 1960-2012 (146 countries)



Note: Horizontal axes show 100 minus Gini index so equality rises from left to right in both panels

Social capital: Democracy

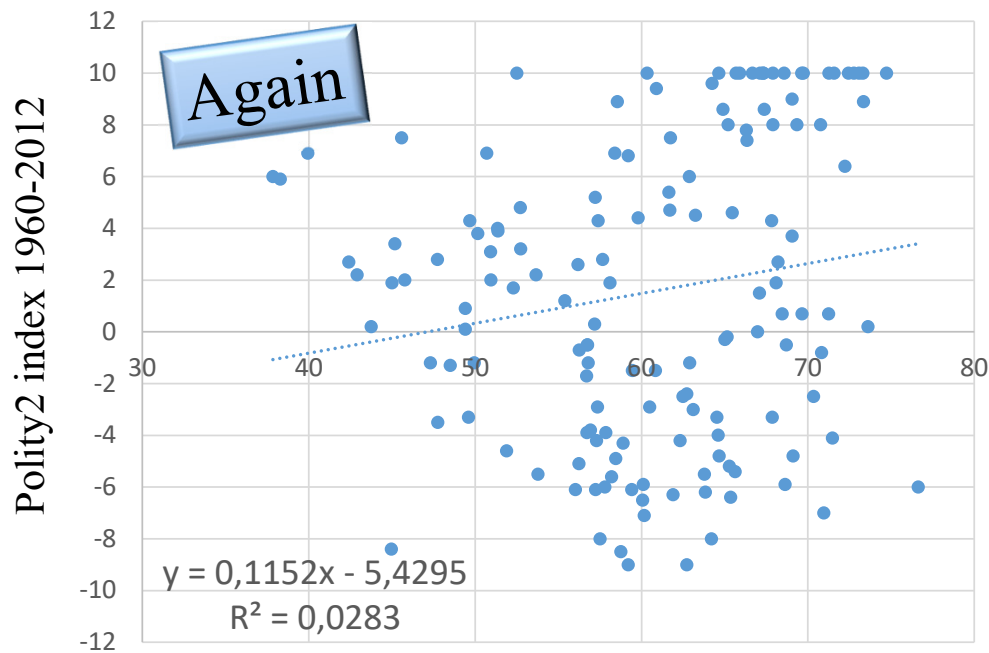
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- Democracy can be viewed as important pillar of social capital
 - “We can have democracy in this country, or we can have great wealth concentrated in the hands of a few, but we can't have both.”

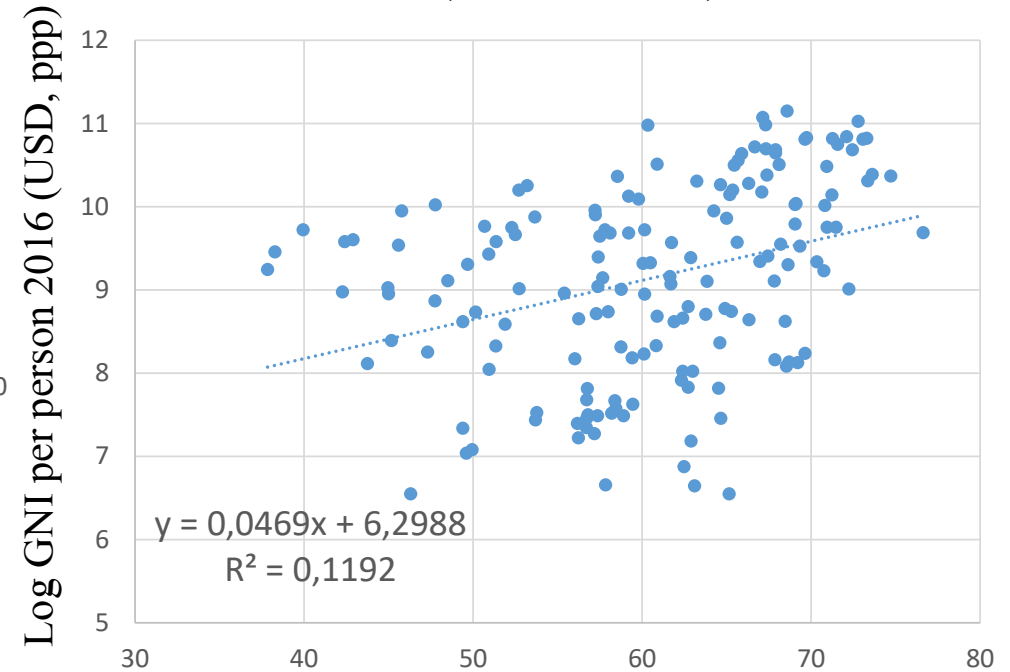
Louis Brandeis, US Supreme Court Justice 1916-1939
- Democracy is related to other aspects of social capital across countries
 - Equality
 - Rule of law
 - Transparency – i.e., absence of corruption
 - Trust
- Democracy has been under stress since 2006

From equality to democracy and growth

Gini index 1979-2016 and polity2 index 1960-2012 (146 countries), again



Gini index 1979-2016 and log per capita GNI 2016 (161 countries)



Source: Author's computations

Note: Horizontal axes show 100 minus Gini index so equality rises from left to right in both panels

Lessons for Europe and United States

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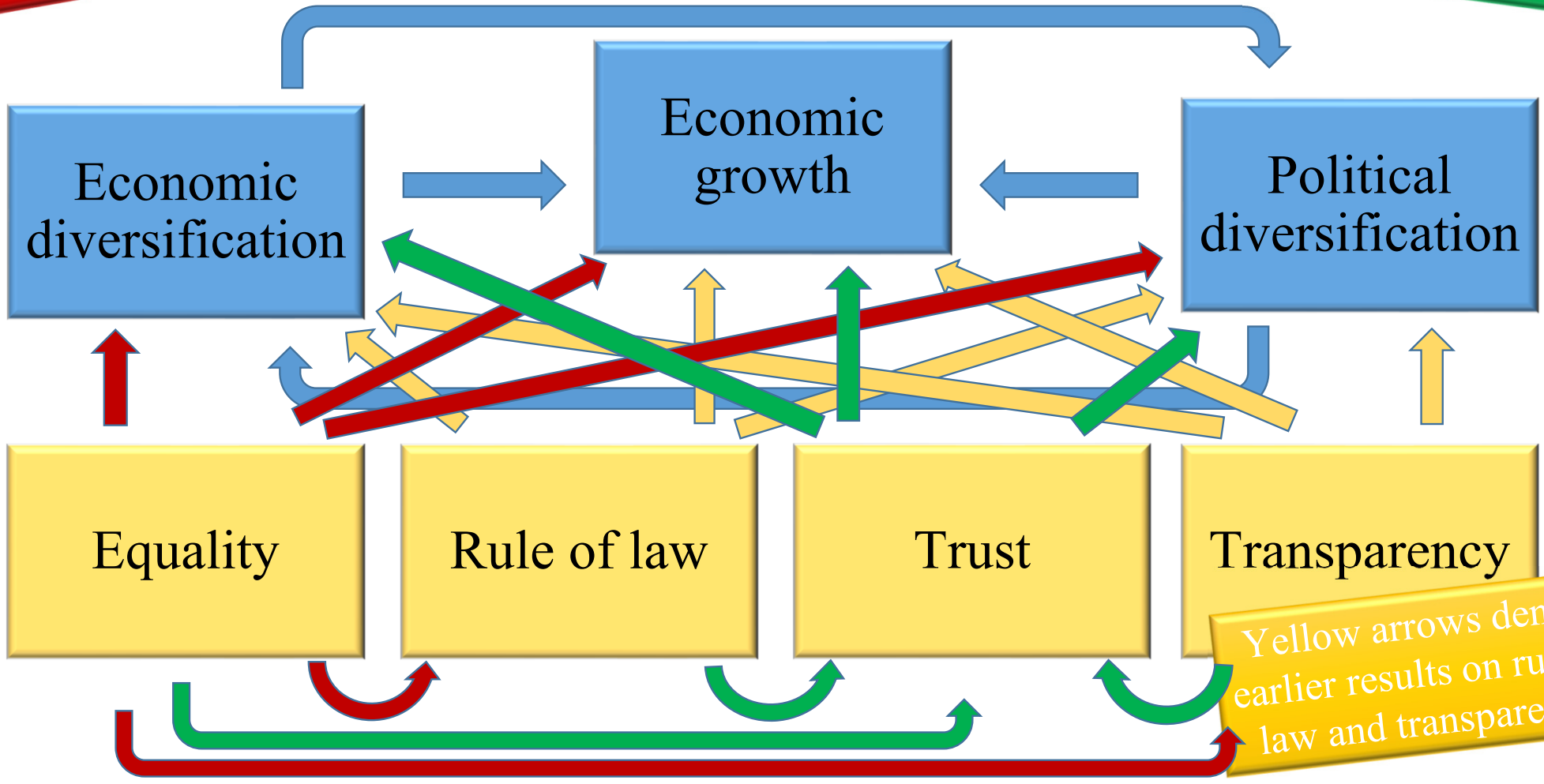
- Economic diversity shows no signs of weakening
- Democracy does, however, show clear signs of stress
 - Since 2008, Freedom House has gradually downgraded US to 86 compared with 99 for Canada
 - Supreme Court verdicts in 2008 and 2010 made gun control difficult and effectively abolished limits on corporate contributions to politicians
 - Burgeoning political science literature now describes US as an oligarchy that systematically disrespects the will of the people
 - Many Europeans and others also worry about recent political developments in Hungary and Poland (“illiberal democracy”)
 - Grim lesson from early 20th century
 - Increased inequality has undermined democracy before (Snyder, 2018)

Red arrows denote new results on inequality

Blue arrows denote earlier results on diversification

Green arrows denote new results on trust

Web of linkages



Yellow arrows denote earlier results on rule of law and transparency

Conclusion: Reasonable equality, like trust, is good for democracy and growth

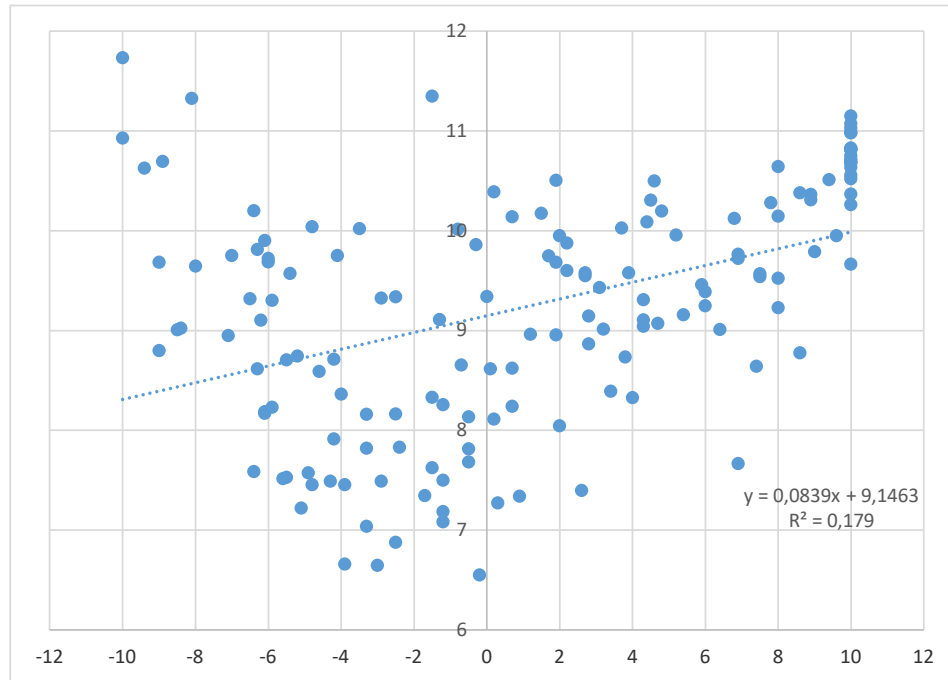
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- Equality and trust go along with several other key determinants of economic growth and with per capita GNI across countries
 - Equality in distribution of income goes along with
 - Economic diversification
 - Rule of law
 - Transparency
 - Trust
 - Democracy
 - All six are good for growth, as are saving, investment, education, and health care while natural resources can cut both ways
 - Need also to study equality in distribution of wealth and health

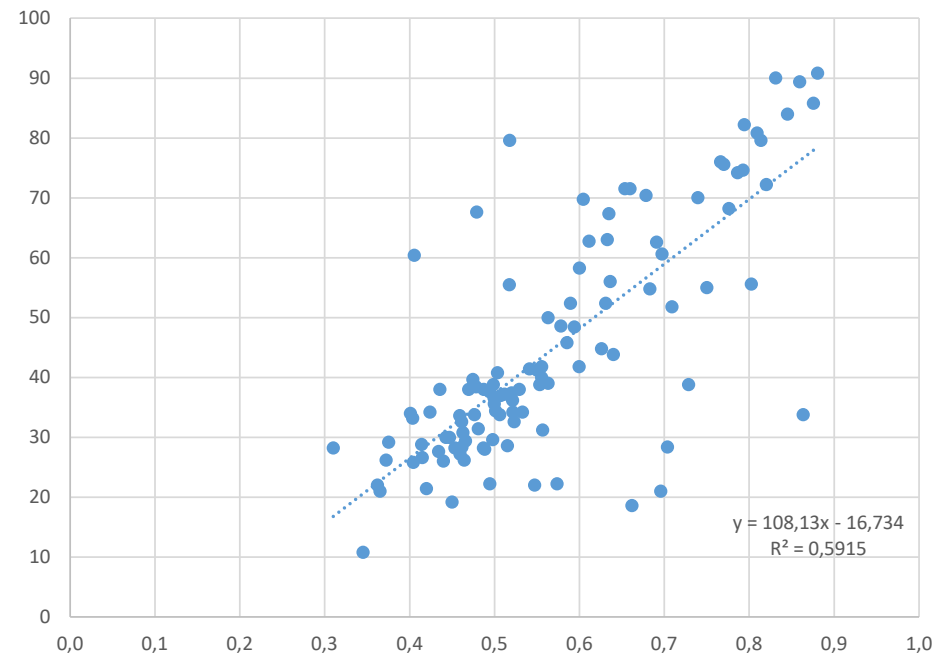
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Additional slides for paper

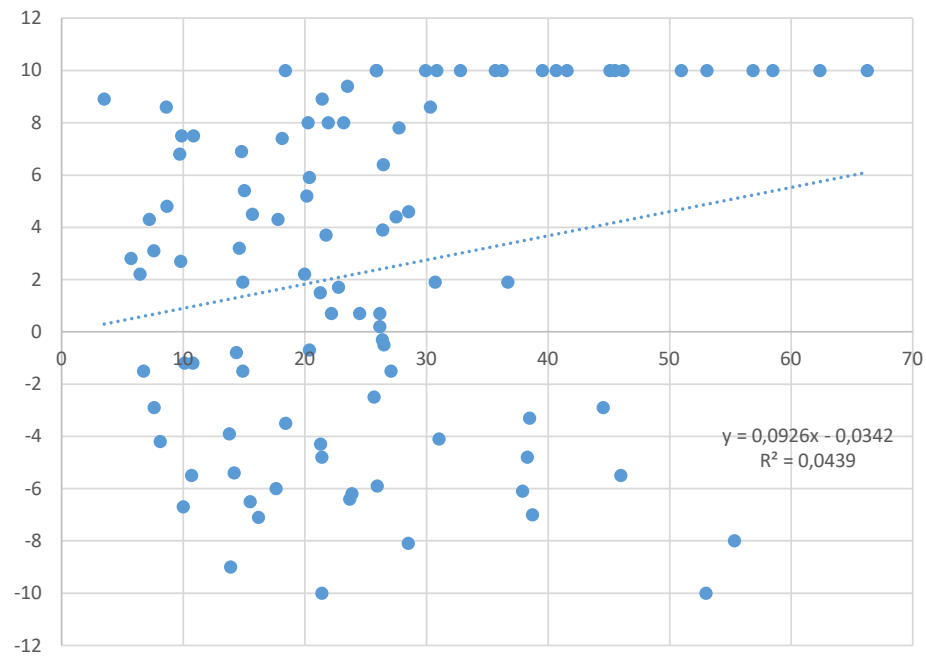
Democracy vs. Per capita GNI



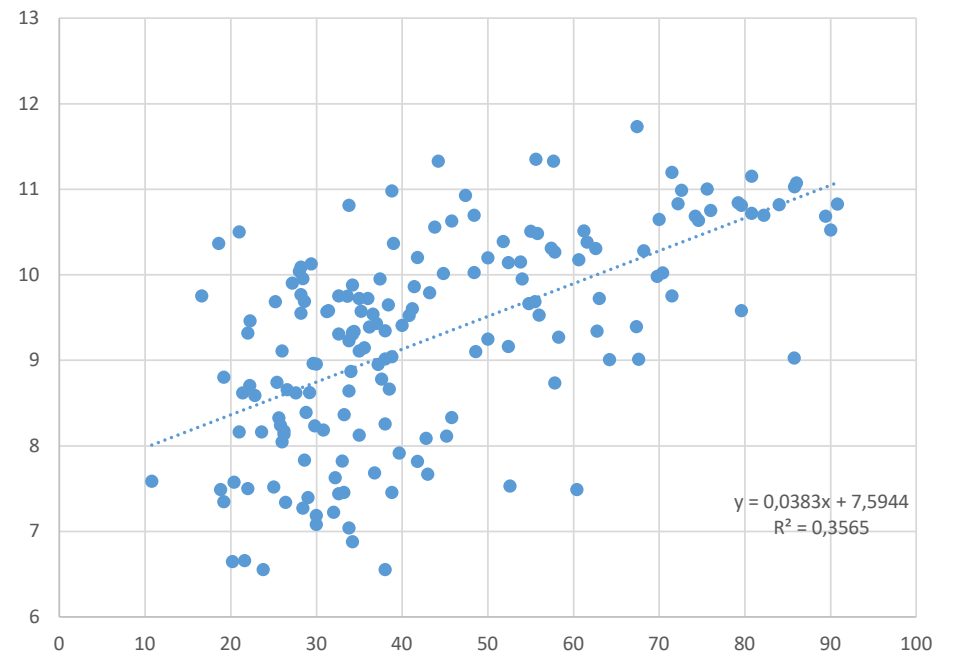
Transparency vs. Rule of Law



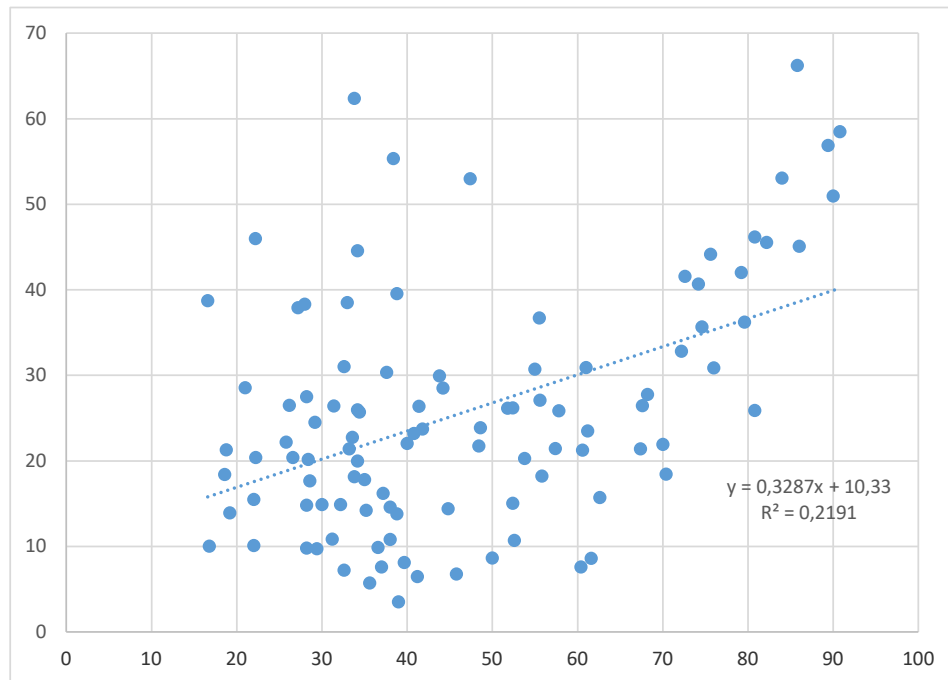
Trust vs. Polity2



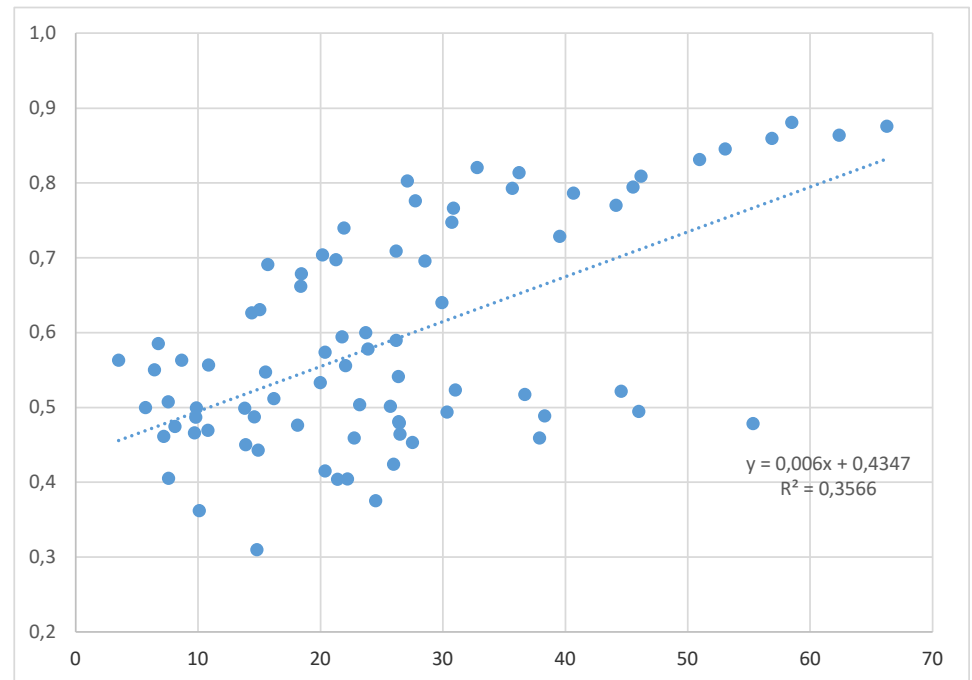
Transparency vs. Per capita GNI



Transparency vs. Trust



Trust vs. Rule of law



Rule of law vs. Per capita GNI

