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TOO MUCH INEQUALITY TENDS TO RETARD ECONOMIC GROWTH

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Income should be somewhat equitably distributed to ensure effective demand and spur investment

Inequality in society is like air pollution. Everyone is affected by it to a varying extent. It's also an inevitable consequence of economic activity; i.e., people pursuing their dreams, some of them racing ahead, some falling behind. Inequality also arises and persists because of past factors that entrench disparity between social classes across generations. Kids from lower-income families do not have access to good-quality schools and can be trapped in low-paying jobs, or worse, fall into drug use and crime. The cycle can perpetuate. If inequality, measured by income, wealth, opportunity, or access to quality public services, is inevitable and much of it is inherited, should we worry about it? Depends on your perspective. If you are a diehard free market proponent who roots for small government, you may say let economic growth generate wealth, and let the rich do philanthropy to take care of the less fortunate. In this perspective, inequality is beyond the domain of economic policy, though it's a moral issue. State interference only makes it worse, they say. The other perspective is of the "bleeding heart liberal", who will insist on a large role for government in taking money from the rich and giving it to the poor. Their motivation is also morality and fairness, but unlike free marketeers, they see a solution only in coercive tax-and-spend policies.

There is a problem with both perspectives. Leaving the rich to freely decide on philanthropy is no guarantee that inequality will reduce. And insisting on government intervention through redistributive taxation might reduce growth itself, shrinking the available pie for transferring money to the poor. Is there a way a more scientific, reasoned approach to inequality?

Yes, there is. Thankfully, this debate has been informed by a rich body of literature from the field of political economy over at least six decades. A doyen of this field, Harvard economist Alberto Alesina passed away last month. His contribution through research, writing and mentorship of students has vastly improved our understanding of many aspects of political economy. In particular, his work sheds light on the interconnection between economic growth on one hand, and the health of democracy, political instability and inequality on the other. Based on his work, and that of several others, we can safely conclude that too much inequality hurts economic growth.

It works in several ways. It can cause social instability, leading to crime, and insecurity of private property, which could slow down investment and growth. Or it can cause the polity to get so divided that voting outcomes almost always deliver "left wing" high-tax policies, which reduce economic growth. If a vast majority of voters are poor, not themselves subject to a tax burden, they would vote for high government expenditure, which implies heavy taxation of the rich or high taxes on capital. This leads to lower investment and growth. For instance, in India we have only seven payers of direct taxes for every 100 voters. This ratio is among the most skewed in the world. Either our income tax system is too forgiving, or there are too many people below the minimum threshold. If, however, the underlying income distribution were less unequal, we might get electoral outcomes that favour growth and moderate levels of taxation and spending on redistribution. Thus, inequality affects growth through political channels. Is this a possible explanation for India's stagnant investment to gross domestic product ratio for the past four years? There is also a non-political channel of influence. If income distribution is highly concentrated, then it limits effective aggregate demand and investment in capacity creation. If rural purchasing power were too low, you would not see growth in sectors such as consumer goods and two-wheelers. Income should be somewhat equitably distributed to ensure effective demand and thus induce optimum growth. When Prime Minister Narendra Modi said India's strengths were democracy, demography and demand, he meant "effective demand" that is armed with sufficient purchasing power, which is impossible if income inequality is too skewed.

So, just how much inequality is too much? When does it call for redistribution and/or higher public spending? This is usually a question that society answers through its collective choice mechanism of elections. But given the covid pandemic and economic crisis, it is clear that we need to address it as a top priority. The effort starts with the universal distribution of foodgrain, pulses, oil and even soap. It includes cash injections into households for a period of four to six months. It calls for clearing the pending dues of tens of millions of small businesses; access to future loans is not the same as getting paid for past services.

Paying for such a necessary stimulus would mean borrowing from current or future generations, which is what deficit financing is all about. Keynesian policies only talked about filling gaps of aggregate demand, not fixing an income distribution skew. But we must acknowledge that a better distribution today creates conditions for faster overall growth tomorrow. Which in turn will make today's debt more affordable, because tomorrow's pie will be much bigger. Inequality reduction can be through explicit transfers, or by increases in the level and quality of public goods and services. The key insight of Alesina et al is that inequality reduction is just as important for growth as measures like the ease of doing business.

Ajit Ranade is an economist and a senior fellow at The Takshashila Institution

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