Some relations between inequality, economic outcomes and democracy

Sebastian Galiani

Mancur Olson Professor

University of Maryland

Inequality Matters

- There are two reasons to be interested in the inequality of income and wealth distribution:

1. Philosophical and ethical grounds for aversion to inequality per se: Inequality at an intrinsic level.

2. Even if we are uninterested in inequality at an intrinsic level, it could have an impact on other economic features that we do care about.

Inequality as a determinant of Growth: A simple example

- One of the mechanisms though which inequality is suggested to affect growth rely on political economy considerations.

- Policy decisions are the result of political interactions that can be modeled as votes on the values that certain policy variables (such as tax rates) are to take.

Median Voter Theorem

1. If preferences for a policy variable (say: a proportional tax rate τ) vary monotonically across the distribution of some attribute of the population (say: income), and,

2. Each person has one vote (with equal weight),

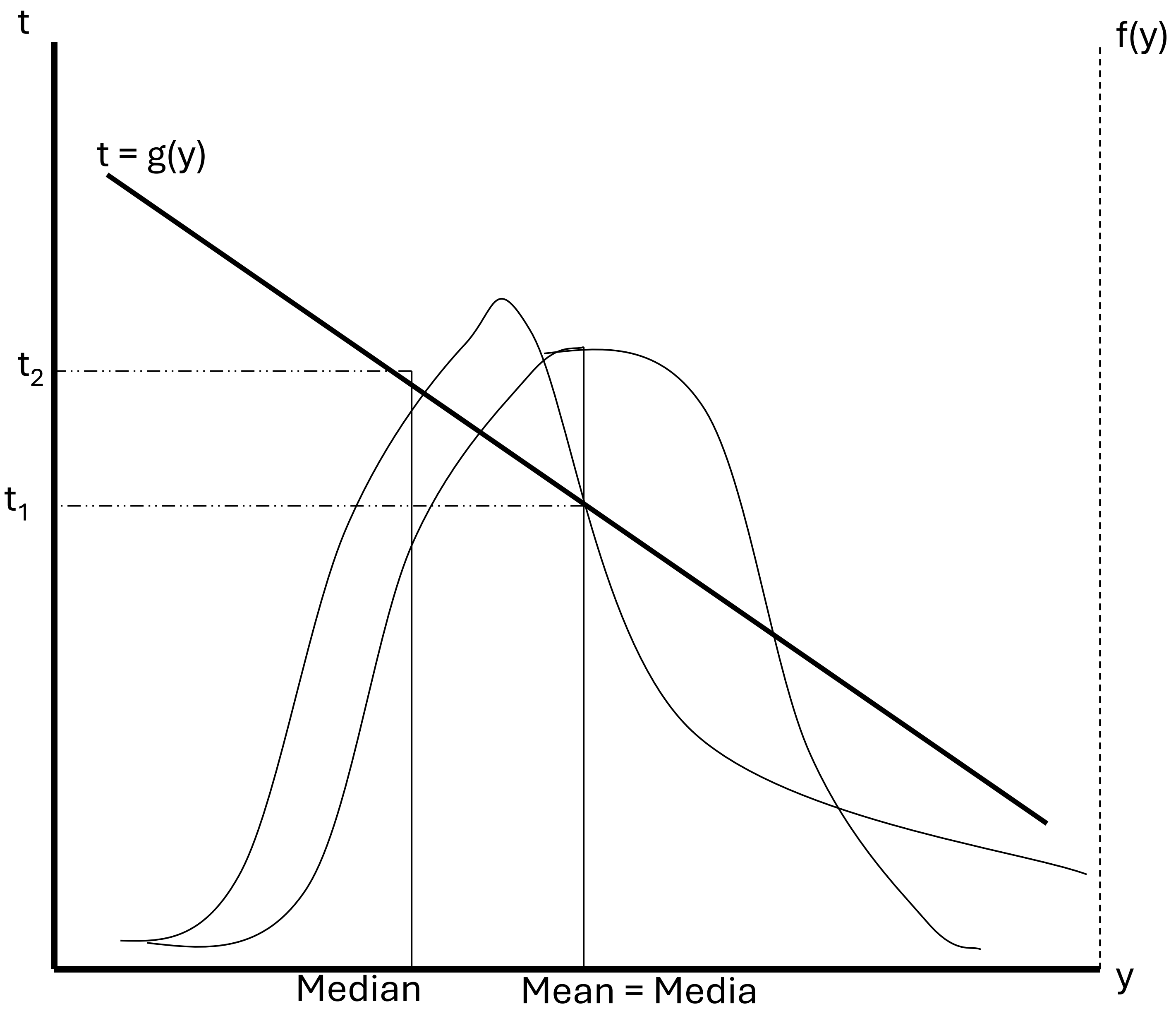
- Then, the preference of the voter which occupies the median position in that distribution will be the outcome of the voting process.

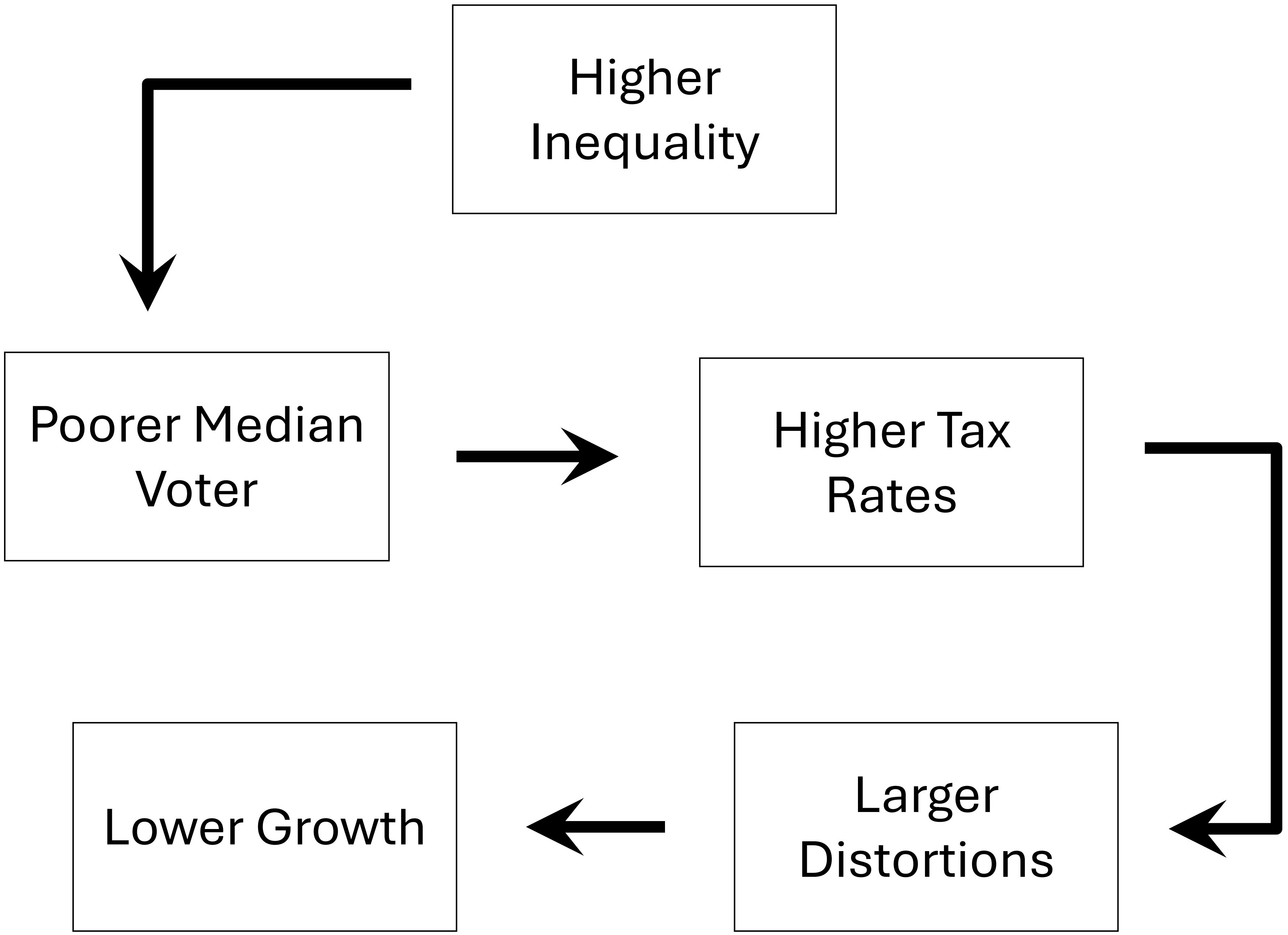
- Now, if the government is such that the net effect of its taxation and expenditure policies is redistributive,

- Then, preferences for the value of τ decline monotonically with income.

- And if we measure inequality as the distance between the median and the mean voter, then for a given mean income, it follows that greater inequality (i.e. a lower income for the median) leads to the choice of a higher tax rate.

- Add to this any distortionary effect of taxation, such as a disincentive to save, and we easily find that greater inequality may lead to lower growth.


t
f(y)
t = g(y)
t_2
t_1
Median
Mean = Media
y


Higher Inequality
Poorer Median Voter
Higher Tax Rates
Larger Distortions
Lower Growth

Inequality and Political Rents

- Citizens often have heterogenous preferences over public policies.
- At the same time, they all share a common interest in controlling the persons in charge of implementing those public policies.
- The relationship between horizontal conflicts of interest (different citizens support different policies) and vertical conflicts of interest (those in charge of implementing policies extract rents from the rest of the society) is one of the fundamental issues in political economy.

Inequality and Political Rents

- Although a great deal of progress has been made by focusing on one or the other of these dimensions, the exact nature of the connections between the two is still one of the hardest nuts that, both theoretically and empirically, has yet to be cracked in the realm of political economy.
- At the theoretical level, electoral models typically stress horizontal conflict, while principal-agent models typically stress vertical conflict.
- Polo (1998) and Dixit, Grossman and Helpman (1997) are two notable exceptions. Polo (1998) extends Downs' electoral competition model to incorporate endogenous rents. Dixit, Grossman and Helpman (1997) extend the principal-agent model by introducing multiple principals who try to influence a common agent.
- For both models, in Galiani et al. (2018). we show that that higher inequality leads to higher political rents and provide laboratory evidence supporting these results.

The case of Venezuela

- 60s – High quality democracy for Latin American Standards.
- 70s – Oil rents increase substantially. Inequality increases. Redistribution and corruption increases.
- 80s/90s – Redistribution unsustainable. Adjustment fails. Democracy deteriorates even further.
- 00s – Oil rents increase again. Populism and corruption skyrocket and democracy collapses.
- The interplay of horizontal and vertical conflicts of interest play a key role in explaining this case, as well as many other historical and current cases.