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Wonkblog

Why some billionaires are bad for growth, and others aren't

Not all inequality is created equal

By Ana Swanson August 20

Over the past few decades, wealth has become more concentrated in the hands of a few global elite. Billionaires like Microsoft founder Bill Gates, Mexican business magnate Carlos Slim Helú and investing phenomenon Warren Buffett play an outsized role in the global economy.

But what does that mean for everyone else? Is the concentration of wealth in the hands of a select group a good thing or a bad thing for the rest of us?

You might be used to hearing criticisms of inequality, but economists actually debate this point. Some argue that inequality can propel growth: They say that since the rich are able to save the most, they can actually afford to finance more business activity, or that the kinds of taxes and redistributive programs that are typically used to spread out wealth are inefficient.

Other economists argue that inequality is a drag on growth. They say it prevents the poor from acquiring the collateral necessary to take out loans to start businesses, or get the education and training necessary for a dynamic economy. Others say inequality leads to political instability that can be economically damaging.

A new study that has been accepted by the Journal of Comparative Economics helps resolve this debate. Using an inventive new way to measure billionaire wealth, Sutirtha Bagchi of Villanova University and Jan Svejnar of Columbia University find that it's not the level of inequality that matters for growth so much as the reason that inequality happened in the first place.

Specifically, when billionaires get their wealth because of political connections, that wealth inequality tends to drag on the broader economy, the study finds. But when billionaires get their wealth through the market — through business activities that are not related to the government — it does not.

This study is important in part because it's one of the first to find a way to study wealth inequality across a big group of countries. Strange as it may seem, economists have a hard time studying wealth, defined as all the assets someone owns minus their debt. A lot of countries around the world don't have good data on wealth, especially over a long period of time. Usually, economists look at income instead, since it's easier to ask someone how much they earned last week than calculate their total debt and assets.

The problem with this approach is that variations in income tend to be much smaller than variations in wealth. Because wealth represents all of someone's income and inheritance built up over time, wealth inequality is almost always a lot greater than income inequality.

In order to analyze wealth across a big group of countries, Bagchi and Svejnar created a novel measure using a well-known source — the Forbes magazine annual list of billionaires. In 1982, Forbes began curating a list of the 400 richest Americans, and in 1987 it expanded this list to global billionaires. The authors sum the wealth of all the billionaires on the Forbes list in a given country, and then divide that total by a country's GDP, population or physical capital stock to normalize billionaire wealth for the country's size.

The researchers found that wealth inequality was growing over time: Wealth inequality increased in 17 of the 23 countries they measured between 1987 and 2002, and fell in only six, Bagchi says. They also found that their measure of wealth inequality corresponded with a negative effect on economic growth. In other words, the higher the proportion of billionaire wealth in a country, the slower that country's growth. In contrast, they found that income inequality and poverty had little effect on growth.

The most fascinating finding came from the next step in their research, when they looked at the connection between wealth, growth and political connections.

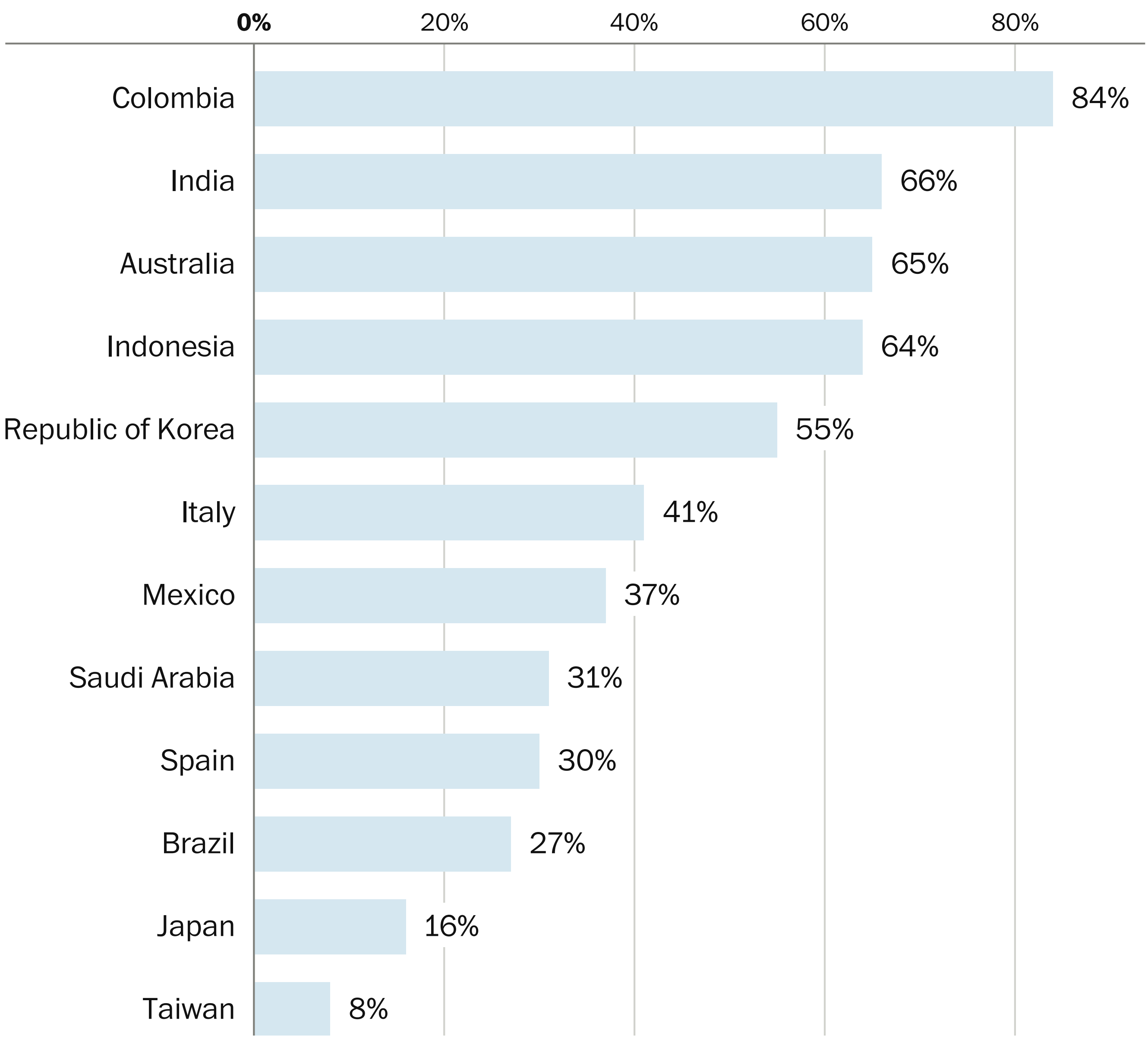
The researchers argue that past studies have looked at the level of inequality in a country, but not *why* inequality occurs — whether it's a product of structural inequality, like political power or racism, or simply a product of some people or companies faring better than others in the market. For example, Indonesia and the United Kingdom actually score similarly on a common measure of inequality called the Gini coefficient, say the authors. Yet clearly the political and business environments in those countries are very different.

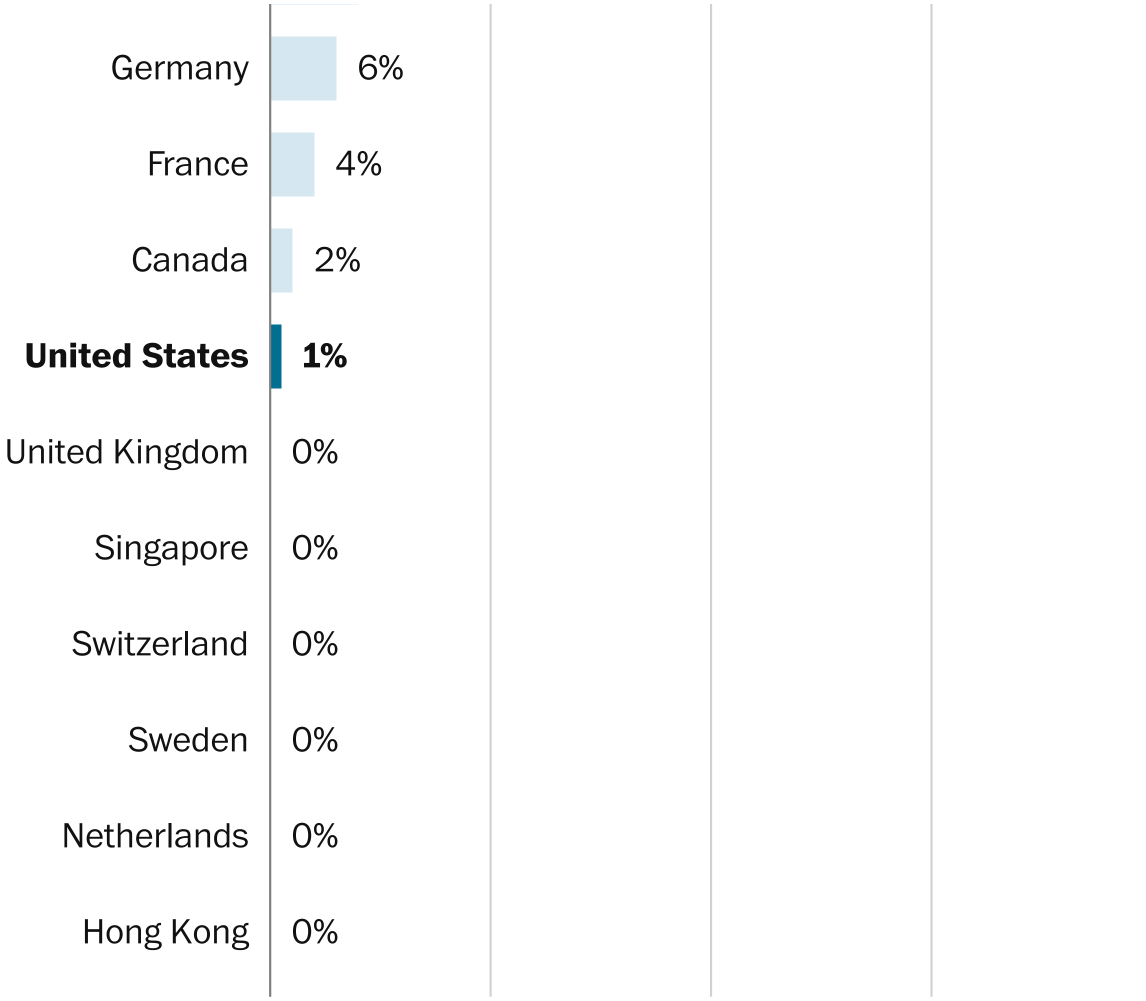
So Bagchi and Svejnar carefully went through the lists of all the Forbes billionaires, and divided them into those who had acquired their wealth due to political connections, and those who had not. This is kind of a slippery slope — almost all billionaires have probably benefited from government connections at one time or another. But the researchers used a very conservative standard for classifying people as politically connected, only assigning billionaires to this group when it was clear that their wealth was a product of government connections. Just benefiting from a government that was pro-business, like those in Singapore and Hong Kong, wasn't enough. Rather, the researchers were looking for a situation like Indonesia under Suharto, where political connections were usually needed to secure import licenses, or Russia in the mid-1990s, when some state employees made fortunes overnight as the state privatized assets.

The researchers found that some countries had a much higher proportion of billionaire wealth that was due to political connections than others did. As the graph below, which ranks only countries that appeared in all four of the Forbes billionaire lists they analyzed, shows, Colombia, India, Australia and Indonesia ranked high on the list, while the U.S. and U.K. ranked very low.

How much wealth comes from political connections?

A new measure of wealth inequality adds together the wealth of all the billionaires in a country and divides that by the country's GDP. The figures below show what percentage of that wealth is due to political connections.





Data is for countries with billionaires appearing in the Forbes magazine annual list of billionaires in each of the years studied (1987, 1992, 1996, 2002)

Source: Sutirtha Bagchi and Jan Svejnar

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Looking at all the data, the researchers found that Russia, Argentina, Colombia, Malaysia, India, Australia, Indonesia, Thailand, South Korea and Italy had relatively more politically connected wealth. Hong Kong, the Netherlands, Singapore, Sweden, Switzerland and the U.K. all had zero politically connected billionaires. The U.S. also had very low levels of politically connected wealth inequality, falling just outside the top 10 at number 11.

When the researchers compared these figures to economic growth, the findings were clear: These politically connected billionaires weighed on economic growth. In fact, wealth inequality that came from political connections was responsible for nearly all the negative effect on economic growth that the researchers had observed from wealth inequality overall. Wealth inequality that wasn't due to political connections, income inequality and poverty all had little effect on growth.

“The negative effects of wealth inequality are largely being driven by politically connected wealth inequality. That seems to be the primary channel that drives this relationship,” Bagchi said in an interview.

The researchers estimate that a 3.72 percent increase in the level of wealth inequality would cost a country about half a percent of real GDP per capita growth. That's a big impact, given that average GDP growth is in the neighborhood of two percent per year, Bagchi said.

Why is politically connected wealth inequality so bad for a country? The researchers suggest that when wealth and power becomes concentrated in the hands of a few, those business and political elites often influence government policy in a way that hurts the broader interest.

For example, politically connected business elites can charge consumers higher prices for services, control access to bank loans and other funding, and prevent outsiders from starting competing businesses. “One of the things that shocked us is that once the billionaires had a significant amount of wealth, they would often take steps to try to limit the amount of competition,” Bagchi said.

Bagchi points to the example of Carlos Slim Helú, a Mexican billionaire who started in telecommunications. Slim made his fortune when Mexico privatized its telecom sector, and sold a chunk of it to Slim's company at a cheap price. The Mexican government did this with the expectation that Slim's Grupo Carso would reduce its prices and expand coverage, says Bagchi. “That really didn’t pan out."

Today, prices for telecom services continue to be significantly higher in Mexico than in other countries, and investment in the sector is lower. And Slim has used the wealth he gained from telecom to expand into other sectors of the economy.

Bagchi cites Russia's oligarchs as another example. Russia did not have any billionaires on the Forbes list until the 1990s, when the country began to privatize state-owned oil and gas companies. Certain government employees “were in the right place at the right time, and they acquired control of these natural resource companies at bargain-basement prices,” Bagchi says.

For example, the study mentions Russian billionaire Mikhail Fridman, who financed Boris Yeltsin’s re-election campaign in 1996 and was able to buy state-owned oil and metals companies at very cheap prices, the Wall Street Journal reported in 2001. Over the next 20 years, crony capitalism made Russian society more unequal and reduced its economic potential, Bagchi says.

According to Bagchi, one takeaway of the research is that developing countries should limit how much businesses have to interact with the state to get things done — those interactions rarely turn out well for average people. The other lesson is that it's not just inequality, but the source of inequality that really matters.

While the U.S. scored relatively well in this ranking, it's worth asking how the connection between wealth and politics might have changed since 2002, the last year that the researchers studied. Post-financial crisis bailouts and the rise of Super PACs that can raise unlimited money may be creating a closer connection between the wealthy and the politically powerful than ever — perhaps with negative implications for economic growth.

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