Rising income and wealth inequality in many countries around the world has been a long-term trend for three decades or more. But the attention devoted to it has increased substantially since the 2008 financial crisis: With slow growth, rising inequality bites harder. The "old" theory about inequality was that redistribution via the tax system weakened incentives and undermined economic growth. But the relationship between inequality and growth is far more complex and multi-dimensional than this simple trade-off suggests. Multiple channels of influence and feedback mechanisms make definitive conclusions difficult.

For example, the United States and China are the fastest-growing major economies today. Both have similarly high and rising levels of income inequality. Though one should not conclude from this that growth and inequality are either unrelated or positively correlated, the unqualified statement that inequality is bad for growth does not really accord with the facts.

Moreover, in global terms, inequality has been falling as developing countries prosper – even though it is increasing *within* many developed and developing countries. This may seem counterintuitive, but it makes sense. The dominant trend in the global economy is the convergence process that began after World War II. A substantial share of the 85% of the world's population living in developing countries experienced sustained rapid real growth for the first time.

This global trend overwhelms that of rising domestic inequality. Nonetheless, experience in a wide range of countries suggests that high and rising levels of inequality, especially inequality of opportunity, can indeed be detrimental to growth. One reason is that inequality undercuts the political and social consensus around growth-oriented strategies and policies. It can lead to gridlock, conflict, or poor policy choices. The evidence supports the view that the systematic exclusion of subgroups on any arbitrary basis (for example, ethnicity, race, or religion) is particularly damaging in this respect.

Intergenerational mobility is a key indicator of equality of opportunity. Rising inequality of outcomes need not lead to reduced intergenerational mobility. Whether it does depends heavily on

whether important instruments that support equality of opportunity, principally education and health care, are universally accessible. For example, if public education systems start to fail, they are often replaced at the upper end of the income distribution by a private system, with adverse consequences for intergenerational mobility.

There are other links between inequality and growth. High levels of income and wealth inequality (as in much of South America and parts of Africa) often lead to and reinforce unequal political influence. Rather than seeking to generate inclusive patterns of growth, policymakers seek to protect the wealth and rent-capturing advantage of the rich. Generally, this has meant less openness to trade and investment flows, because they lead to unwanted external competition.

This suggests that all inequality (of outcomes) should not be viewed in the same way. Inequality based on successful rent seeking and privileged access to resources and market opportunities is highly toxic with respect to social cohesion and stability – and hence growth-oriented policies. In a generally meritocratic environment, outcomes based on creativity, innovation, or extraordinary talent are usually viewed benignly and believed to have far less damaging effects.

That is partly why China's current "anti-corruption" campaign, for example, is so important. It is not so much China's relatively high income inequality, but the social tensions created by insiders' privileged access to markets and transactions, that threatens the Chinese Communist Party's legitimacy and the effectiveness of its governance.

In the US, how much of the increase in income inequality over the past three decades reflects technological change and globalization (both favoring those with higher levels of education and skills), and how much reflects privileged access to the policymaking process, is a complex and unsettled question. But it is important to ask for two reasons. First, the policy responses are different; second, the effects on social cohesion and the social contract's credibility are also different.

Rapid growth helps. In a high-growth environment, with rising incomes for almost everyone, people will accept rising inequality up to a point, particularly if it occurs in a context that is substantially meritocratic. But in a low-growth (or, worse, negative-growth) environment, rapidly rising inequality means that many people are experiencing no income growth or are losing ground in absolute as well as relative terms.

The consequences of rising income inequality can tempt policymakers down a dangerous path: the use of debt, sometimes combined with an asset bubble, to sustain consumption. This arguably occurred in the 1920s, prior to the Great Depression; it certainly occurred in the US (and Spain and the United Kingdom) in the decade prior to the 2008 crisis.

A variant, seen in Europe, is the use of government borrowing to fill a demand and employment gap created by deficient private domestic and external demand. To the extent that the latter is associated with productivity and competitiveness problems, and exacerbated by the common currency, this is an inappropriate policy response.
Similar concerns have been raised about the rapid increase in debt ratios in China. Perhaps debt seems like the path of least resistance in dealing with the effects of inequality or slow growth. But there are better and worse ways to deal with rising inequality. Leverage is one of the worst.

So where does that leave us? For me, the high-priority items are fairly clear. In the short run, the top priority is income support for the poor and the unemployed, who are the immediate victims of crises and the underlying imbalances and structural problems, which take time to remove. Second, especially with rising income inequality, universal access to high-quality public services, particularly education, is crucial.

Inclusion sustains social and political cohesion – and hence the very growth needed to help mitigate the effects of rising inequality. There are many ways for economies to fall short of their growth potential, but underinvestment, especially within the public sector, is one of the most potent and common.