

Inequality and Investment

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At the heart of this chapter is the theory and the body of evidence that argues people do not invest optimally, and that the amount they end up investing is a function of their economic and social status.

The theory section involves first laying out the various models of underinvestment (models based on credit constraints, risk aversion, insecurity of property, lack of information, lack of connections, intra-family conflicts, etc.). In particular we will argue that the people who under-invest tend to be poorer and social more marginal. Then we look at how the fact that some people under-invest distorts the overall pattern of investment (for example, some people, typically those who have lots of their own money, over-invest and people have strong preference for keeping control within the family).

The empirical section begins by looking at evidence for the channels that the theory documents. For example, we look at the evidence for imperfect financial markets and then the evidence that these imperfections have effects on the choices that different types of individuals make and likewise for imperfect property rights and the other theories. Finally we present evidence that the aggregate distortions predicted by the theory do show up in the data and review some recent work arguing that the productivity effects of these distortions are likely to be very large indeed.

The last section of the paper then turns to the issue of inequality. The fact that people who under-invest tend to be economically and socially disadvantaged, suggests an intimate connection between inequality and investment. However the evidence we present in the previous section suggests that the biggest distortions may not come from the very poor under-investing but rather from the fact the medium sized firms never grow to the optimal scale. If this is the case, the most productivity enhancing redistributions may not be the ones that directly help the very poor. It may be better to help the medium-sized firms grow so that they can create employment which will allow the owners of the smallest and least efficient firms to shut down their businesses and become workers. However there may also be a role for a program that helps the poorest invest more, at least as a part of the transition.