in brief...

More inequality means higher inflation

All governments claim to want low inflation – but not all achieve it. While poorer countries generally fare worse, inflation rates can differ markedly even between equally wealthy countries. Turkey and Korea had similar levels of per capita income at the start of the 1980s. But while Turkey's inflation ran at an average of 60% a year over the next two decades, Korea's was only 6%.

One explanation is that policy-makers in countries like Turkey were simply unlucky or incompetent. But new evidence on the relationship between inequality and inflation uncovered by CEP researcher **Chris Crowe** suggests an alternative explanation.

Figure 1 illustrates the inequality-inflation relationship for 53 countries between 1981 and 2000. The vertical axis plots the average 'inflation tax rate' (a transformation of the inflation rate that prevents extremely high values dominating the data). The horizontal axis plots the most widely used measure of income inequality, the 'Gini coefficient'. More inequality is associated with higher inflation.

What explains this link? Crowe argues that politicians in high-inequality countries might face incentives to choose higher inflation. His story has two stages. The first shows why more wealthy groups might actually prefer higher inflation. The second shows how greater inequality can make their preferences more salient.

To demonstrate the first stage, note that inflation is a tax. Printing money raises revenue for the government, in the process expropriating a proportion of any wealth held in nominal assets such as cash. But not all people face the same inflation tax rate. Inflation is regressive, a tax that hits the poor and middle class hardest because they hold more nominal assets, as a fraction of total income, than the wealthy. This means that the wealthy – who can mostly avoid the inflation tax – might well prefer it to more progressive taxes such as income tax.

To demonstrate the second stage, note that where democratic institutions are less effective, some groups will carry more weight than others. To put it simply, money talks. But if political voice depends on income, then greater inequality means greater inequality in political participation. In turn, this increases the adoption of policies – such as inflation – more favourable to the wealthy.

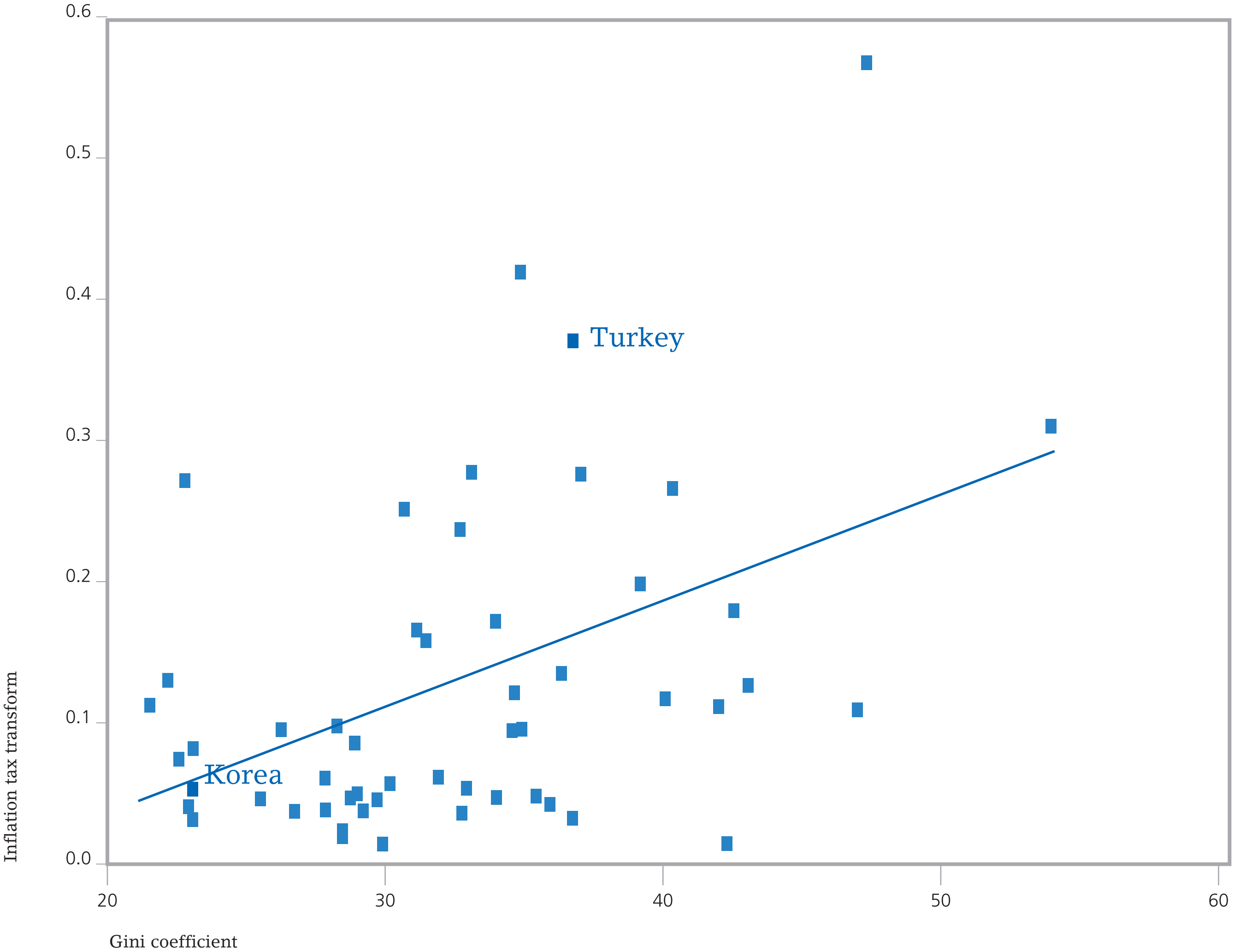
Analysis of the data shows that the positive relationship between inequality and inflation holds even when controlling for other factors like the overall level of development. On average, countries with the highest levels of inequality will face inflation at least 40% higher than countries with the lowest inequality. There is also evidence that inflation is higher in countries with less participative political systems.

Of course, this story provides only one explanation for inflation. Some policy-makers are simply incompetent. And inflation worldwide has shown clear common trends – higher in the 1970s and 1980s than in the 1990s – while inequality has not. But this research offers an explanation for the positive cross-sectional relationship between inequality and inflation. More generally, it shows how the distribution of income and wealth can affect policy performance.

Politicians in high-inequality countries might face incentives to choose higher inflation

Greater inequality means greater inequality in political participation – and policies more favourable to the wealthy

Figure 1:
The inequality-inflation relationship



This article summarises 'Inflation, Inequality and Social Conflict' by Christopher Crowe, CEP Discussion Paper No. 657 (http://cep.lse.ac.uk/pubs/download/dp0657.pdf).

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