From Physical to Human Capital Accumulation: 
Inequality in the Process of Development

By

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Abstract

This paper presents a unified approach for the dynamic implications of income inequality 
on the process of development. The proposed theory provides an intertemporal 
reconciliation for conflicting viewpoints about the effect of inequality on economic growth. 
It argues that the replacement of physical capital accumulation by human capital 
accumulation as a prime engine of economic growth has changed the qualitative impact of 
iequality on the process of development. In early stages of industrialization as physical 
capital accumulation is a prime source of economic growth, inequality enhances the process 
of development by channeling resources towards individuals whose marginal propensity to 
save is higher. In later stages of development, however, as the return to human capital 
increases due to capital-skill complementarity, human capital becomes the prime engine of 
growth and equality, in the presence of credit constraints, stimulates investment in human 
capital and promotes economic growth. As wages increase, however, credit constraints 
become less binding, the adverse effect of inequality on human capital accumulation and 
growth subsides, and the overall effect of inequality becomes insignificant.

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