24. Economic growth and poverty reduction: the inequality connection

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Global trends in technology and trade are pushing towards greater inequality within countries. The policy responses to rising inequality have varied, and explain differing outcomes in inequality around the world. Policy in China and some other Asian countries has internalized these trends, while policy in the USA and the UK has exacerbated global tendencies. But policy in Latin America has mitigated global forces of rising inequality. High and rising inequality needs to be addressed by policy-makers because it dissipates the impact of growth on poverty, it can act as an impediment to growth, and it is ethically objectionable in itself.

Income inequality is directly objectionable from an ethical point of view. But my focus here is on inequality as being instrumentally relevant to economic growth and poverty. Take any distribution of income across individuals (or a distribution of consumption or expenditure) and specify three summary statistics: the average (or mean), a measure of spread, and a measure which aggregates information on incomes below a specified poverty line. The rate of change of the first (average income) is of course what is commonly known as the rate of economic growth. The second can be captured through a range of inequality indices such as the Gini coefficient. The most commonly used summary measure of the third is the fraction of individuals below the poverty line, or the head count ratio, although there are a suite of indices which weight depth of poverty to different degrees. How does inequality come into the picture in the connection between economic growth and poverty reduction?

It should be clear intuitively that an increase in the average holding inequality constant will reduce poverty. This is the case of 'distribution neutral growth' which is a benchmark in many poverty projection exercises, and leads to the often cited 'growth elasticity of poverty reduction': put simply, the responsiveness of poverty to growth. On the other hand, increasing inequality while holding the mean constant will usually increase poverty. Thus, if a rising mean is accompanied by rising inequality, the poverty reduction impact from growth will be attenuated. But if growth is accompanied by reduced inequality, the impact of growth on poverty reduction will be heightened. These effects constitute the first channel through which inequality mediates the impact of growth on poverty.

The above scenarios are not merely statistical artefacts, but correspond to real phases of history for many countries. Thus the 'East Asia miracle' in the 1960s and 1970s was one where countries such as the Republic of Korea had both growth and falling inequality, leading to a 'double blessing' for poverty reduction. During the period of 'shock therapy' in the 1990s, some East European transition economies experienced a declining average income and rising inequality at the same time, with disastrous consequences for poverty. From the late 1990s onwards, a group of large Latin American economies have seen growth along with falling inequality. According to one estimate, economic growth would have had to be 4 percentage points higher to achieve the same rate of poverty reduction for Brazil over this period without the fall in inequality (Barros et al., 2010). But for many other countries, especially in Asia, growth has been accompanied by rising inequality. It has been estimated that had rising inequality not accompanied high growth in developing Asia in the 1990s and 2000s, that growth would have lifted 250 million more people out of poverty (Kanbur and Zhuang, 2012).

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Even when inequality does not change with growth, its overall level can affect the relationship between growth and poverty reduction. It is well established that distribution-neutral growth starting at a higher level of inequality will reduce poverty by less. In other words, the responsiveness of poverty reduction to growth is lower when initial inequality is higher. This is the second channel through which inequality connects growth and poverty reduction, even if inequality stays constant with growth.

There is a third inequality channel through which growth and poverty reduction are connected, and which follows from those mentioned above. In fact it is a channel through which the impact of growth on poverty reduction can be overestimated. Standard national statistical sources usually do not, and cannot, produce information on intra-household inequality. In effect, it is assumed that there is no inequality within households and that inequality between individuals is purely the result of inequality in household per capita income or consumption. But there is considerable corroborative evidence that resources within the household are themselves distributed unequally, for example between men and women. Thus standard income and expenditure distributions understate inequality. And for this reason they overstate the responsiveness of poverty reduction to growth, with the overstatement being greater the larger is the degree of intra-household inequality.

These three channels can explain why poverty can persist as the result of inequality despite sustained economic growth. To gain more insight into inequality and its evolution, we can think of income as the returns on assets. The assets can be physical, financial or human. The return on human capital, for example, could be thought of as the wage premium for every additional year of schooling. From this perspective, overall inequality is composed of the inequality of assets and the inequality of returns on assets. The evolution of inequality is a combination of the evolution of these two types of inequality.

Differential rates of return from assets can be the result of technological or market forces, for example when technological change leads to increased demand for skilled labour relative to unskilled labour. They can also be the result of market imperfections, or of discrimination and social norms, for example when men and women are paid different wages for the same work. Social norms are more likely to explain the level of inequality, since they change slowly.

As already noted, gender inequality and intra-household inequality are well corroborated empirically. Technology and trade, however, are more likely to explain short to medium-term changes in inequality. Indeed, it has been argued that the forces of labour-displacing technical change are behind much of the increasing share of capital income, and are the cause of rising income inequality between skilled and unskilled labour (Autor, 2014).

If technical change is causing a global trend to rising inequality in the rate of return on assets, particularly human capital, one response is to reduce the inequality of assets. Clearly this would mitigate the impact on overall inequality of income for any given increase in the inequality of rates of return. For human capital, the impact on inequality of increasing wage premiums for more skilled workers would be mitigated by reducing inequality in skill levels. But it would also increase the supply of skilled labour. So reducing inequality in skills would hold back the premiums for skill offered by the demand side of technical change. Indeed, this effect is argued to have been a key mechanism through which Latin American inequality was held in check from the late 1990s onwards.

In this framework, then, the level of inequality can be lowered through asset redistribution, which can be done all at one time as in the case of land reform in the Republic of Korea or Taiwan, China, or over time as was done through the more equitable spread of education in East Asia in the 1960s and 1970s, and in Latin America from the 1990s onwards. Addressing other structural factors such as gender disparities can also lower the level of inequality. But trends in inequality are affected by trends in relative demand for factors of production, such as the disparity between demand for skilled labour versus unskilled labour as the result of technical change. These forces can be mitigated by counteracting expanding demand with expanding supply, which is what Latin American education policies did. Other interventions such as minimum wage policies can also shore up the bargaining power of workers. But they have to be applied with caution, taking into account their possible unemployment consequences. Finally, redistribution of market income through taxation and transfers may also be needed. All of these strands of intervention came together in Latin America in the 1990s and 2000s, not just to hold inequality in check but to reduce it – an unprecedented outcome (López-Calva and Lustig, 2010).

So far we have looked at inequality as the connector between growth and poverty, but have taken growth itself as being unconnected to inequality. However, there is vigorous debate on whether rising inequality is a necessary condition for higher growth, or whether in fact higher inequality is causally linked to lower growth. There are good theoretical arguments on either side. Arthur Lewis, the father of modern development economics, wrote that 'Development must be inegalitarian because it does not start in every part of an economy at the same time' (Lewis, 1976). The rural–urban migration aspect of increasing inequality was emphasized by Kuznets (1955). A standard argument also bases itself on the empirical regularity which the share of savings out of income rises with income, so that greater inequality will raise the aggregate share of saving and thus make more resources available for investment.

The counters to these arguments are more recent. One strand is based on the role of credit constraints in limiting the capacity of the less wealthy to invest, in their own human capital or in enterprises, together with a minimum size requirement for investment (Banerjee, 2010). In this scenario it is intuitive that greater inequality will inhibit a greater number at the bottom from investing, and that this will impede growth. A second strand is oriented towards political economy. The simplest framework is one where greater inequality in income leads to a divergence between median and mean income. The median voter theorem in political economy would then suggest that policies would be chosen to raise median income, whereas those that raised mean income would be growth-enhancing by definition (Alesina and Rodrik, 1994).

Another entry point is via the following sequence of arguments. All economies are hit by shocks. Economies that change policies to present the most efficient response to these shocks will show the greatest growth of total income. But if the policy response involves major losses as well as gains, the losers can block the efficient outcome unless redistribution provides adequate compensation. Once again, then, distribution and growth are intricately connected.

So much for the theoretical argument. Empirical support for the thesis that greater inequality is detrimental to growth has always been sketchy. Kanbur and Lustig (2000) in their survey concluded that 'the jury is still out'. However, strong support has recently come from an IMF study. In a remarkable piece of ongoing analysis, the authors draw three major conclusions:

> First, *more unequal societies tend to redistribute more* … Second, *lower net inequality is robustly correlated with faster and more durable growth, for a given level of redistribution* … And third, *redistribution appears generally benign in terms of its impact on growth; only in extreme cases is there some evidence that it may have direct negative effects on growth*.
> (Ostry et al., 2014, emphasis in the original)

There are of course econometric questions to be raised on these results, which are based on cross-country regression analysis. But it does seem as though the pendulum is swinging in the direction of an assessment of inequality as a causal factor impeding growth, or at least towards the position that redistribution in the direction of greater equality is not necessarily an impediment to economic growth.

What then explains different policies on inequality? The answer is not easy, and lies deep in the political economy and history of a society. An interesting case in point is China. Here, inequality fell in the early phase of post-1978 reform, as rural incomes were expanded through the policy allowing peasants to keep a larger and larger share of the output they produced. After a few years, however, China entered into a two-decade-long period of rising inequality, associated particularly with the opening-up and rapid growth of the coastal regions relative to the inland provinces. However, inequality has plateaued since the mid to late 2000s, and by some estimates has begun to turn down.

Each of these phases is associated with specific policy choices. An intriguing historical explanation is provided by Bin Wong (2011). He identifies the historical roots of Chinese rulers' concerns with inequality, particularly regional inequality, in the setting of a large land empire whose outermost provinces were always vulnerable to temptation from competing polities. In this view the seeming lack of concern with inequality over a quarter of a century spanning the 1980s, 1990s and early 2000s was the aberration rather than the rule, and the traditional concern with inequality, which predated communist rule and was in some sense 'hardwired' into Chinese rulers, would assert itself sooner or later.

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This it did from the second half of the 2000s onwards through investment in the inland provinces, the development of health insurance, and a range of other measures.

Thus high and rising inequality dissipates the impact of growth on poverty; it can act as an impediment to growth; and it is ethically objectionable in itself. Global trends in technology and trade are pushing for greater inequality within countries, but whether these will elicit policy responses to mitigate rising inequality remains to be seen on a country-by-country basis.

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