

2020 FOCUS BRIEF on the World's Poor and Hungry People

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ECONOMIC GROWTH AND POVERTY REDUCTION Do Poor Countries Need to Worry about Inequality?

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There is a seemingly widespread view that inequality should not be a concern in countries striving to fight absolute poverty. Although inequality may well be high or rising in some developing countries, this increase is seen as the unavoidable by-product of the economic growth needed to reduce poverty. The message for policy is that poor countries—including their poor—need not worry too much about inequality.

Does the evidence from country experience support this view? This brief first looks at the relationship between economic growth on the one hand and poverty and inequality on the other. It then examines how inequality influences the relationship between growth and poverty and distinguishes between different types of inequality. Finally, some thoughts are offered on appropriate policies.

Growth Is Not Necessarily Inequitable in Poor Countries

The classic argument for believing that inequality will rise, more or less inevitably, as poor economies grow is the Kuznets hypothesis (KH), based on pioneering research by Simon Kuznets in the 1950s. This hypothesis states that inequality increases during the early stages of growth in a developing country but begins to fall after some point.

Writing in the 1950s, Kuznets had very little survey data for developing countries to draw on. Since then, there has been a huge expansion in the collection of nationally representative household surveys for developing countries. These data suggest that most growing developing countries have not seen the trend increase in inequality predicted by the KH. Indeed, very few developing economies have seen a trend increase (or decrease) in overall inequality. Granted, many countries have experienced periods of rising inequality, but they have generally been followed by periods of falling inequality and have only rarely been sustained. (Box 1 examines one exception—China—although even there the reality is more complicated than implied by the KH.)

To re-examine the relationship between growth and changes in inequality, this brief relies on 290 observations of the change between two successive household surveys for a given country, with more than one observation for most countries (data are drawn from the World Bank's PovcalNet and *World*

Development Indicators). About 80 countries are represented, spanning the period from about 1980 to the early 2000s.

Box 1—China: Concerns about Rising Inequality

China is often cited as an example of an aggregate growth-equity trade-off. Probably no other country has had the steep rise in both mean income *and* income inequality that China has seen since the early 1980s. The evidence shows, however, that periods of more rapid growth did not bring more rapid increases in inequality. Indeed, the periods of falling inequality (1981–85 and 1995–98) had the highest growth in average household income. And the provinces that started the reform period with relatively high inequality had both lower subsequent growth *and* less sharing by the poor in the gains from that growth.

Although some of the policy reforms and institutional changes in China's economic transition simultaneously increased inequality and reduced poverty (such as allowing greater returns to schooling by opening labor markets, and restoring incentives to work by introducing the Household Responsibility System), other economic and political forces have been at work to generate less benign inequalities. These forces include geographic poverty traps (whereby prospects of escaping poverty depend causally on where one lives) and emerging inequalities in opportunities for enhancing human capital, obtaining credit and insurance, protecting one's rights under the law, and influencing public affairs. These "bad inequalities"—rooted in market failures, coordination failures, and governance failures—limit peoples' opportunities to take action that will help them escape poverty.

It will be harder for China to maintain its past rate of progress against poverty without addressing the problem of rising inequality. If recent history is any guide to the future, the historically high levels of inequality found in many provinces today are likely to inhibit future prospects of poverty reduction. Other factors point to the same conclusion. It appears that aggregate economic growth in China is increasingly coming from sources that bring more limited gains to the poorest. The "low-lying fruit" of efficiency-enhancing pro-poor reforms may be becoming scarce. Inequality is continuing to rise, and poverty measures are becoming more responsive to rising inequality.

At the outset of China's current transition period to a market economy, levels of poverty were so high that inequality was not an important concern. That situation has changed.

Taking this period as a whole, there is little or no correlation between changes in inequality and rates of economic growth. Comparing the changes in a measure of inequality, the Gini index, with changes in average real income shows that among growing economies, inequality increased about as often as it fell. That is also true of contracting economies.

If one focuses solely on the period since the early 1990s, there are signs that a positive correlation is emerging between rising inequality and economic growth. It appears that the recent growth processes seen in many reforming economies have put upward pressure on inequality. There are exceptions, however, in that growth since the early 1990s has accompanied falling inequality in some countries. Nor is the overall positive correlation in the data after 1990 robust to corrections for measurement errors. As a generalization across country experiences, it still appears that growth tends to be roughly distribution-neutral on average.

One should be cautious about the policy interpretation of this finding. The lack of a robust correlation between changes in inequality and growth does not imply that policymakers aiming to fight poverty in any given country can safely focus on growth alone. Putting measurement problems to one side, this empirical finding merely reveals that, on average, there was little effective redistribution in favor of the poor. It does not say that redistribution rarely happens, or that distribution is unimportant to the outcomes for poor people from economic growth, or that social protection policies are unnecessary.

Growth Tends to Be Less Pro-Poor in Poor and Unequal Countries

Given that growth tends to be distribution-neutral on average, it is not surprising that many empirical studies have found that measures of absolute poverty tend to fall with growth. The same rate of growth, however, can bring very different rates of poverty reduction. In trying to understand why this is so, it should first be noted that the rate of poverty reduction is the growth rate times the growth elasticity of poverty reduction, or the "growth elasticity" (GE) for short—that is, the proportionate change in the measure of poverty that results from a given rate. A large negative GE reveals that even a modest growth rate can bring rapid poverty reduction. For the US\$1-a-day poverty rate, the average GE is about -2 , meaning that a growth rate of, say, 5 percent in mean household income per capita will reduce the share of the population living below the poverty line by 10 percent a year (in proportionate terms).

High initial inequality makes poverty less responsive to growth. This is intuitive; given that growth tends to be distribution-neutral on average, the higher the initial inequality, the less the poor will share in the gains from growth. Unless there is sufficient change in distribution, people who have a larger initial share of the pie will tend to gain a larger share in the pie's expansion.

Indeed, among the highest-inequality countries, poverty incidence tends to be quite unresponsive to economic growth. Consider a country with a 2 percent rate of growth and a headcount poverty rate of 40 percent. In a low-inequality country with a Gini index of 0.30, the poverty rate will fall by about 6 percent a year and be halved in 11 years, on average. By contrast, in a high-inequality country with a Gini index of 0.60, growing at the same rate and with the same initial poverty rate, it will take about 35 years to halve the poverty rate. Because poverty responds more slowly to growth in high-inequality countries, these countries need unusually high growth rates to achieve rapid poverty reduction.

Poverty incidence also tends to be less responsive to growth in poor countries. The combined effect of high poverty *and* high inequality greatly attenuates the growth elasticity of poverty reduction. Recall that the average GE for developing countries is about -2 . Among those countries with both high inequality (a Gini index over, say, 0.45) *and* a high incidence of poverty (a US\$1-a-day headcount index over, say, 25 percent), the median elasticity falls to about -1 , implying that twice the rate of growth will be needed to achieve the same rate of poverty reduction. Contrast this with the set of developing countries fortunate to have both low inequality (a Gini index less than 0.35) and low poverty (a headcount index less than 10 percent). For this group the median elasticity is an impressive -3.4 , and even modest growth can result in quite rapid poverty reduction.

How Inequality Changes over Time Also Matters

The empirical finding that growth is roughly distribution-neutral on average is consistent with the fact that during growth spells, inequality increases in roughly half the cases. Whether inequality increases or not can make a big difference to the rate of poverty reduction. Among growing economies, the median rate of decline in the US\$1-a-day headcount index is only about 1 percent a year for those countries for which growth came with rising inequality. By contrast, poverty declined about 10 percent a year among countries that combined growth with falling inequality. Either way, poverty tends to fall, but at very different rates.

Consider the growth process in Brazil (a high-inequality country) in the 1980s. If Brazil's growth had been distribution-neutral, it would have experienced a 4.5 percentage point decline in the headcount index of poverty. In fact, there was no change over the decade; distributional shifts working against the poor exactly offset the gains from growth. Conversely, even when initial inequality is high and the initial share held by the poor is low, their gains from growth can be sizable if that growth is accompanied by sufficient pro-poor redistribution. Falling inequality in Brazil beginning in the mid-1990s allowed a faster rate of poverty reduction than the level implied by growth alone.

What factors underlie the changes in distribution, as they affect poverty? A great many country-specific factors are involved, including shocks to agricultural incomes, changes in the trade regime, shifts in relative prices, tax reforms, welfare policy reforms, and demographic changes. Generalizations across country experiences are never easy, but one factor that is likely to matter in many developing countries is the geographic and sectoral pattern of growth. The greater availability of nationally representative household surveys has revealed marked and persistent concentrations of poor people in specific regions and sectors, even in countries with high growth. The extent to which growth favors the rural sector is often key to its impact on poverty, given that three-quarters of the poor in the developing world live in rural areas. The importance of agricultural growth to poverty reduction has been particularly striking in China, where relatively equitable access to agricultural land in rural areas has meant that poverty is very responsive to agricultural growth. Growth in aggregate farm output has had about four times greater impact on aggregate poverty in China than has growth in the manufacturing or services sectors. In other countries, however, including Brazil and India, the services sector has proved to be an important source of poverty-reducing growth.

There Are Both Good and Bad Inequalities

High initial inequality can also impede future growth and hence poverty reduction. Credit and risk market failures are one way this can happen. The credit-constrained poor tend to have high marginal products from investment given their low initial capital endowments, but they are unable to exploit opportunities for investment. High inequality can also foster social conflict and macroeconomic instability and impede efficiency-promoting reforms that require cooperation and trust. High inequality is thus a double blow to prospects for reducing poverty: it entails less growth, and it means that the growth is less pro-poor.

However, it is not particularly useful to talk about “inequality” as a homogenous concept in this context. To contribute to policy, one needs to focus on the specific dimensions of inequality that create or preserve unequal opportunities for participating in the gains from economic growth. There are both good and bad inequalities.

Good inequalities are those that reflect and reinforce the market-based incentives that are needed to foster innovation, entrepreneurship, and growth. For example, a control regime may keep inequality low by compressing the labor-market returns to schooling or the returns to other forms of investment. Reforms in such a regime can increase inequality in a way that facilitates more rapid poverty reduction by allowing poor people to take up new economic opportunities.

Bad inequalities, however, not only generate higher poverty now, but also impede future growth and poverty reduction. Social exclusion,

discrimination, restrictions on migration, constraints on human development, lack of access to finance and insurance, corruption, and uneven influence over public actions are all sources of inequality that limit the prospects for economic advancement among certain segments of the population, thereby perpetuating poverty in the future.

Recent research has pointed to the importance of certain geographic inequalities. Living in a well-endowed area will sometimes mean that a poor household can eventually escape poverty, whereas an otherwise identical household living in a poor area experiences stagnation or even absolute decline. Such geographic poverty traps are one reason why some poor areas have often seen lower-than-average growth and hence stay poor.

Bad inequality also stems from disparities in human resource development. By increasing the returns to schooling, freeing up labor markets increases the incentives for work and skill acquisition. People with relatively little schooling, few assets, or little access to credit, however, are less able to respond to these incentives. The disadvantages they face in these other areas mean that they are less well positioned to take advantage of the opportunities unleashed by market-oriented reforms.

For example, although India has relatively low overall inequality of consumption, it has high inequality in human resource development and access to markets. These inequalities have interacted powerfully with the sectoral and geographic pattern of economic growth to influence India’s progress against poverty, which was disappointing in recent times, particularly given the country’s relatively high aggregate growth rates.

Policies Need to Reduce Bad Inequalities While Promoting Growth

Accepting that poverty reduction is the overall goal, policies that reduce inequality at the cost of lower long-term living standards for poor people should clearly be avoided. Reducing inequality by adding further distortions to an economy will have ambiguous effects on growth and poverty reduction. It should not be presumed, however, that all redistributive policies will result in such a trade-off. The potential for win-win policies stems from the fact that there are bad inequalities, which come at a cost to overall growth *and* entail that the poor share less in the opportunities unleashed by growth.

More rapid poverty reduction requires more growth, a more pro-poor pattern of growth, and success in reducing the antecedent inequalities that limit poor people’s economic opportunities. What types of policies are needed? Some examples of the types of policies that can promote poverty reduction by reducing the bad inequalities follow:

- *Increase agricultural productivity.* Higher agricultural productivity promotes growth in other sectors, including services, and higher farm productivity can be expected to reduce overall inequality and poverty within a typical developing

economy (where food producers tend to be poor and poor consumers have high budget shares devoted to food). Achieving higher farm yields in rain-fed, drought-prone settings will require both more research on appropriate farm technologies (including technologies appropriate to labor-abundant settings) and policy reforms and public investments to help assure successful adoption of those technologies.

- *Address geographic poverty traps.* Spatial concentrations of extreme poverty remain, even in the more rapidly growing developing economies. A recurrent issue is striking the right balance between investing in poor areas and reducing the cost of out-migration from those areas. Does it make more sense to move jobs to people, or people to jobs? There is fertile ground here for future research. The right sorts of investments in poor areas (such as in education and managing risks) are also necessary conditions for successful out-migration to begin. Rural infrastructure development can also play a decisive role. For example, research has revealed the importance of rural roads to achieving more pro-poor growth processes in poor lagging areas of rural China. Some research has also suggested important complementarities between human and physical infrastructure investments.
- *Make markets and governments work better for the poor.* Policies can also focus on correcting the underlying market and governmental failures that create high costs of inequality, such as by restricting the accumulation of physical and human assets by poor people. A wide range of policies are potentially important, including sound public investments in rural infrastructure

to support market development, better policies for delivering high-quality health and education services to poor people, and policies that allow key product and factor markets (for land, labor, and credit) to work better from the point of view of poor people. In rural economies, security of access to land through tenancy reform and titling programs will often be important. Better instruments for credit and insurance can also help, both in smoothing consumption and in underpinning otherwise risky growth-promoting strategies. Affirmative action policies can help open opportunities for the poor. Removing biases against the poor in taxation, spending, and regulatory policies (including policies on migration) can also play an important role in certain settings. Again taking an example from China, reducing the government's taxation of farmers through its underpriced food grain procurement quotas has been a powerful instrument against poverty. The right combination of interventions will naturally depend on country and regional circumstances.

The challenge for policy is to combine growth-promoting policies with the right policies for assuring that the poor can participate fully in the opportunities unleashed and so contribute to that growth. If a country gets the combination of policies right, then both growth and poverty reduction will be rapid. Get it wrong, and both will be stalled.

For Further Reading: World Bank, *World Development Report: Equity and Development* (New York: Oxford University Press, 2006).

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