Economic Growth, Equity, and Poverty

An Essay by

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ECONOMIC GROWTH, EQUITY, AND POVERTY

I. How do we define economic growth, equity and poverty?

A. Economic growth basically refers to an increase in the annual production of goods and services, and in the income associated with that production.

B. Economic equity refers to the distribution of real income, including access to essential goods, services and the intangibles that together determine the general "quality of life," in a way that is just, fair and impartial. The distribution of income is closely related to the distribution of wealth, especially income-earning assets. An equitable distribution of income will not be equal; and there is no fixed standard that separates equitable from inequitable. Economists would normally consider a pattern of income distribution equitable if it was based roughly on the market value of different levels in skill, experience, education, and marginal productivity, with an emphasis on the latter, and not on inherited, political or monopolistic status.

The measurement of relative <u>inequalities</u> in income distribution is a poor proxy for the measurement of <u>inequities</u>; but data does exist (in some countries) for the former, which is related to the latter, which can be compared across countries and for different time periods, and for which trends can be identified. Equality of income distribution is not a desired objective--our primary goal is alleviating poverty--and the question is how best to do that. **This paper concludes that economic growth, greater equity, and poverty reduction can all best be achieved by a broadly-based pattern of economic growth.**

C. Poverty refers to absolute levels of income and consumption that are inadequate to meet basic needs. The extent of poverty basically depends both on the aggregate level of output and income and on income distribution.

II. Ways to achieve economic growth.

There are essentially two basic ways to achieve economic growth: 1) by increasing the availability and productive use of land, capital and/or labor, and 2) by using these factor inputs more efficiently to produce the desired goods and services. Both are fostered by a relatively more open market economy.

The first primarily depends on capital accumulation, which can be embedded in improvements to a) land, buildings and other physical facilities on the land (such as roads, ports, and irrigation works), b) capital equipment and vehicles, or c) human skills, health and education. It is also affected by the growth of the labor force, by changes in the environment, and by changes in the availability of natural resources.

Greater efficiency is achieved by a) improved production technology, which usually accompanies new capital investment, and b) higher levels of specialization in production, which in turn depends on efficient markets.

III. **Ways to achieve greater equity.**

Income is determined by asset ownership and the return to assets. A farmer who owns two hectares of land near a road can earn a higher income (because he pays less to transport his goods) than a farmer who owns similar land far from a road. In most developing countries there are five key assets: 1) land, 2) labor, 3) human capital (vocational skills, technical training, experience and education), 4) physical capital, and 5) financial capital.

There are three basic ways to achieve greater equity: 1) the redistribution of existing land and non-human capital assets or the income derived from them, 2) changing the rates of return on (the income received from) existing assets, eliminating artificial disparities, and 3) creating new assets more broadly and fairly distributed among the population.

Redistribution is achieved by public taxation and expenditure policies, by public or private redistribution of assets, and by public and private transfers. Examples include: the redistribution of land, the taxation of land and capital assets or the income received from them, and, when financed from a constant revenue base, transfer payments (social security, welfare, unemployment compensation, etc.), public employment programs, and the expansion of social services (health, education, etc.). Redistribution is difficult politically and economically, and it may reduce incentives to accumulate capital; although it is sometimes necessary, on both, equity and efficiency grounds as well as political, in countries where distribution is extremely unequal (such as in the Latin American latifundia or the Asian landlord/tenancy systems).

The rates of return on existing assets are often distorted by government subsidies, minimum wage laws, price controls and/or other regulations, including tariffs, fixed foreign exchange rates and export/import controls. These can be changed accordingly. Government policies and development strategies can also affect the relative intensity of factor demand within the economy, and thereby the income accruing to factor ownership. A more labor-intensive pattern of growth, for example, will generate more employment and eventually, when the economy approaches full employment, raise the market wage rate and the average income of skilled and unskilled workers.

A broader, fairer distribution of new assets can be achieved by stimulating a pattern of economic growth based on factors of production owned by poor groups, by stimulating new investments by small holders and small entrepreneurs, and by the taxation of (higher level) growing incomes to finance expanded social and economic services, public works (especially economic infrastructure), education and skills training. The best long-term mechanism for creating more broadly distributed new assets is a mass educational system, which does not necessarily even require higher levels of funding, but simply a broader and employment-oriented use of existing educational funds.

IV. **Ways to diminish poverty.**

Changes in the extent of poverty basically depend on economic growth and on changes in income distribution, the latter depending in turn primarily on increasing the economic productivity of poor households and simultaneously assuring that the income they produce is equitably distributed.

V. **Linkages between growth and equity and poverty reduction.**

Economic growth is not valuable in and of itself, but only insofar as it improves the living standards of the population, particularly of those in the greatest misery. Having said that, it is clear that growth, not redistribution, is the best mechanism for reducing poverty.

Redistribution of existing assets is difficult politically, and it does not often contribute much to growth, whatever form it takes. Nationalization of industry, heavy taxation on higher incomes, and even some forms of land redistribution can seriously reduce incentives to use existing resources efficiently, as well as incentives to create new ones. Transfer payments and public employment programs can increase receipts at the lower end of the income scale, and expanded health and education services can contribute to a more productive work force, but these are difficult to finance from the existing income base without either taxation so heavy or inflation so high that the investment incentives required for more rapid and sustained economic growth are adversely affected. There are certain situations (i.e., in the Asian landlord/tenancy context) in which land redistribution can enhance investment incentives, and land taxation can be used to penalize those who leave productive land idle. Aside from special cases like these, however, <u>it is hard to stimulate economic growth by redistributing existing assets and income.</u>

On the growth side, the world is littered with countries that--in the name of faster economic growth--have tried to force investment (through tariff protection, duty free machinery and other inputs, subsidies, public investment and ownership, etc.), much of it borrowed from abroad, in urban-based industries. Many of these have become capital-intensive, import-dependent white elephants, wasting millions of scarce dollars and considerable (even scarcer) managerial talent while providing employment and income for very few people. Government regulation and control have often merely protected the economic privileges of a few at the expense of many. The rules and regulations have restricted producers' choice of buyers (often allowing sales only to a parastatal or the government) and their choice of suppliers (often allowing purchases only from a parastatal or the government). The first result has been to reduce the role of market prices in the allocation of inputs and outputs. A further result has been shortages allocated by political decisions. The final result has been inefficiency, inequity, and suppressed growth, as the politically powerful have helped themselves while neglecting the general welfare.

Greater equity was not achieved by these poorly advised growth strategies and, generally, the rich got richer and the poor either stayed poor or got poorer. Many of these same countries tried to respond to the demand for a more equal distribution of real income by expanding public works and social services, especially education, the recurrent financing of which, however, became increasingly difficult to sustain. The euphoria of rapid industrial growth soon gave way to larger government subsidies, balance of payments deficits and stagnation, since these industries were neither using domestic resources for inputs nor benefiting from a growing domestic market demand for their outputs, nor were they competitive in world export markets. Both the sources of economic growth and its circle of beneficiaries became more and more restricted, resulting in an increasing proportion of the educated, articulate elite and middle class finding themselves left out and inclined to foment and lead social discontent and revolt. The consequent political instability has itself stifled further economic growth in many countries. <u>In these all-too-common cases, neither greater equity nor sustained economic growth was achieved.</u>

On the other hand, there usually is a congruence, and indeed a synergistic relationship, between the creation of new assets and new income streams more broadly distributed and a pattern of economic growth that is more sustainable over the long run. Countries which have adopted a more broadly-based, market-oriented approach, usually emphasizing agriculture and an export orientation, have fared much better on both counts. More jobs were created and domestic demand kept pace with production, balance of payments deficits remained reasonable, and the growth process was sustained.

<u>"Broadly-based" economic growth is more likely to be successful and self-sustaining</u> over the longer run than other, more narrow growth patterns for several reasons: 1) it brings to bear the energy and initiative of poorer strata on production by providing them the tools--most notably education--that permit them to contribute directly to increased production; 2) it encourages an efficient use of domestic resources and labor instead of imported inputs, thereby reducing pressure on the balance of payments; 3) it develops domestic market demand for domestic products, enhancing the multiplier effect on overall growth; and 4) it develops the

country's natural comparative advantages vis-a-vis its trading partners in an efficient, competitive mode, spurring sustained growth in both traditional and non-traditional export industries.

"Broadly-based" economic growth is more equitable, reducing, in the long run, both relative income differentials and absolute poverty, mostly because it provides jobs for ever larger numbers of workers and higher incomes for large numbers of small farmers, with multiplier effects in both rural and urban areas, than either 1) a no-growth constant-pie situation where heredity and/or political power protect privilege and restrict the ownership of productive assets and other sources of income or 2) a more narrow, artificially engendered growth path that relies heavily on government protection and controls to sustain industries of questionable economic viability and those privileged to benefit from them. Sustained, broadly-based economic growth also provides the growing revenue base required for the government to support higher levels of social services such as education and health, which are themselves important ways to achieve a more acceptable distribution of real income.

In most countries, market liberalization, the centerpiece of the A.I.D. policy reform effort, is both growth and equity enhancing. The existing structure of government policies--which ration credit, subsidize urban consumers, tax farmers, subsidize capital use, and build bloated bureaucracies--is often designed to funnel income to a privileged few. Reversing these policies economizes on scarce resources and encourages the use of abundant resources, particularly labor. As a result, there is greater utilization of the assets that are owned by the poor, and their income increases. Thus, the first step to renewed growth, market liberalization, will result in improved income levels for the poor.

Growth, of course, changes individuals' incomes unequally. Those who first introduce more productive or cost-saving technology can raise their incomes above the laggards. Those who first obtain marketable skills or know-how command premium wages and salaries. Such inequalities are essential to the process of growth, since it is the possibility of higher incomes that induces more people to make the extra effort and investments to increase their own productivity and thus continue the growth process. As more skills are acquired, more labor is employed, and the incomes of more and more people are increased, both the incidence of poverty and relative income inequalities are reduced.

VI. **The empirical evidence.**

The point of departure for looking at empirical evidence on the relationship between growth and equity is Simon Kuznets's 1955 article on "Economic Growth and Income Inequality," which looked at a cross-section of countries and observed a "U-shaped" relationship between per capita income and inequality. As per capita income increased, income inequality first tended to increase and then decrease, the turning point occurring at what we would now call lower-middle per capita income levels.

Many observers hypothesized that the same relationship would hold within countries over time--in particular, that for low-income countries, growth would entail a worsening income distribution, which would undercut or perhaps even nullify the positive effects of growth on poverty.

By the end of the 1970's, usable time series data on income inequality were available for over twenty developing countries. These data, reviewed in AID Discussion Paper #39, indicated <u>no systematic tendency for income inequality to increase with growth:</u> in 8 cases inequality decreased; in 5 cases there was essentially no change; and in 7 cases inequality increased. Further, the pattern did not fit the Kuznets curve at all. In only one low-income country (El Salvador) did income distribution clearly worsen with growth. In other low-income countries distribution improved, remained unchanged, or the evidence was mixed. For the upper-income countries income distribution worsened in four, was unchanged in one, and improved in three. Geographically, most of the cases where income distribution deteriorated with growth were in Latin America, and most of the cases where income distribution improved or remained unchanged were in Asia.

The same AID Discussion Paper econometrically tested the relationship between the incidence of poverty and levels of per capita income for a sample of 36 developing countries. It found that as per capita income increased, the incidence of poverty tended to decline sharply for low-income and middle-income countries, with the declines tapering off as countries reached upper-middle income levels. Thus, <u>even if income distribution tended to worsen across countries with increases in per capita income, the incidence of poverty still declined.</u>

A more recent paper (financed by AID), by Papanek and Kyn, tests the Kuznets curve using a broader sample of observations, including a combination of cross-section and time-series data. The results indicate that the Kuznets curve <u>might</u> exist (depending on the variables used to measure income inequality and on whether or not several controversial observations are included); but if it does, it is relatively "flat," which means that income distribution doesn't change much as per capita income changes. <u>**This implies that rapid economic growth can be expected to result in significant declines in the incidence of poverty.**</u>

Finally, a quick glance at the IBRD's Social Indicators of Development 1987 reveals 35 observations of changes in income distribution over time, specifically the share of the lowest 40 percent of income recipients. In 19 cases this share did not change by more than one percentage point in either direction. In 7 cases the share improved by more than one percentage point, and in 8 cases the share declined by more than one percentage point. In one other case the share declined significantly, but no growth took place.

In conclusion, the empirical evidence indicates no systematic tendency for income distribution to worsen with growth in low-income countries, nor in LDC's as a group. The data also indicate that it would be normal (but not inevitable) for rapid growth in an AID-recipient country to lead to a significant decline in the incidence of poverty.

This is consistent with the general experience described earlier that broadly-based economic growth is more equitable, reducing both relative income differentials and absolute poverty, as well as more likely to be successful and self-sustaining.

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