EG Technical Briefings
Volume IV No. 2, Feb. 2007

Effects of Initial Inequality of Incomes on Speed of Economic Growth and Poverty Reduction

Background: In the ongoing debate about the relationships among economic growth, inequality, and poverty, a strong consensus has emerged that sustained rapid growth is essential for rapid poverty reduction. However, important voices also raise appropriate concerns that attention be paid to the impact of initial inequality on growth and poverty reduction.

The Recent Literature on Growth, Inequality, and Poverty: In the 1980s and 1990s, analysts subjected newly available cross-country data to rigorous empirical analysis, in order to quantify the links among growth, inequality, and poverty. The central conclusion was that *no* systematic correlation was observed between the rate of economic growth and changes in income inequality. Rather, these studies showed that on average across countries, economic growth leaves the distribution of income among households or individuals roughly unchanged. This finding strongly suggests that for the "average" country, the gains from increasing per capita income are enjoyed not only by the wealthy, but by households across the income distribution. As a result, rapid macroeconomic growth tends to be accompanied by rapid poverty reduction.

Caution must be exercised in drawing policy conclusions from these results, however. These empirical findings do not imply that policy makers can choose rapid economic growth with the certain knowledge that inequality will not increase. First, economic growth is not a direct choice variable: policy makers cannot simply wave a magic wand to decree faster growth. Rather, they choose policy instruments they expect will lead to faster growth, but in doing so should recognize that such policy choices can have important impacts on income distribution. Data show that the particular policy mix chosen by any given country need not be distribution-neutral – country experiences include cases where inequality has increased with faster growth, as well as other cases where faster growth has been accompanied by a reduction in inequality.

An accounting exercise known as "decomposition analysis" has advanced our understanding of the relative roles of inequality and growth in reducing poverty. Decomposition analysis allows us to separate observed changes in poverty into growth- and redistribution-related components. The growth component is the change in poverty that would have occurred as a result of the actual change in per capita income, if income distribution had remained unchanged. The redistribution component is the change in poverty that would have occurred if per capita income had remained unchanged. In "what if" exercises of this type, by far the greater portion of the observed reduction in poverty – often up to 80% - results from the growth component. Economic growth is clearly good for the poor in this sense. But it turns out that inequality also affects *how* good growth is for the poor: the initial level of inequality and changes in distribution will determine the share of the gains from growth accruing to the poor.

The arithmetic of the accounting exercise is very informative because it shows the power of growth; but caution must be exercised in drawing policy conclusions. Decomposition analysis does not imply that the growth and redistribution components can be separated for policy purposes the way they are in the decomposition exercise. There is a danger that policy makers may artificially classify some policy instruments as purely pro-growth (liberalizing trade, increasing FDI, privatizing state enterprises), and others as purely redistributive (food subsidies, transfers, public works, programs.) In reality, as emphasized above, every policy will have both growth and redistributive effects. The net effect of particular combinations may or may not be distribution-neutral.

EG Technical Briefings is published by USAID/EGAT Office of Economic Growth (EG) in Washington, D.C. This publication aims to share technical and analytical information with USAID field missions, especially with economic, private sector, and agricultural development officers. Any views, interpretations expressed in *EG Technical Briefings* are those of the author(s) alone and do not represent any official view of USAID or the U.S. government. If you have feedback, suggestion or ideas about *Technical Briefings*, please contact Jim Elliott (jelliott@usaid.gov). Draft technical briefs of no more than two pages in length from readers will be considered. This Technical Briefing was authored by Tom Kelly while serving as an economist in the EG Office. This technical briefing has benefited from editorial input by economist Don Sillers of EGAT/PR.

Inequality and Poverty as Determinants of Growth: The analyses above make clear that the speed with which a given rate of growth reduces poverty depends on the initial distribution of income. It also raises the question of whether, at least in some cases, the causality may also run in the other direction -- from a greater or lesser degree of initial inequality to the prospects for subsequent economic growth. The most commonly proposed channels through which inequality might dampen growth are liquidity constraints and lumpiness of investment. These factors discourage the poor from exploiting growth-promoting and productivity-enhancing investment opportunities. An opposite point of view – a contrary theory of long standing - claims that higher inequality results in higher savings and investment and hence in faster economic growth. This argument depends on the assumption that the marginal propensity to save out of income rises with per capita income. Given plausible theories pointing in opposite directions, much empirical effort has gone into assessing the net impact of initial inequality on growth.

The existing evidence from cross country regressions is not conclusive, but on balance "appears to offer more support for the view that inequality is harmful to growth than the opposite view" (Ravallion, 2001). The evidence from country studies is much stronger, suggesting that high inequality does dampen growth. Lower initial inequality would then appear to be doubly beneficial for the poor: per-capita income will tend to grow more quickly, and the poor will enjoy a larger share of the benefits of that growth. Factors associated with greater inequality that also impede growth at the same time reduce the benefits accruing to the poor. Win-win policy changes may arise. Such win-win gains from policy reforms are much preferred to awkward discussions of tradeoffs. It is important to stress that the empirical results suggesting that greater initial inequality is harmful to economic growth do *not* imply that a particular set of policy changes aimed at *reducing* inequality in a particular country will necessarily lead to faster economic growth. As emphasized above, policies that redistribute income in favor of the poorer groups will also tend to impact aggregate economic growth, and some of those inequality-reducing redistributive efforts come at the expense of overall growth.

The Growth Elasticity of Poverty: A growing number of empirical studies estimate the percentage reduction in poverty associated with a one-per cent increase in average income -- the so-called growth elasticity of poverty. These studies have demonstrated that a given rate of growth has been more effective in reducing poverty in some countries than in others. Differences in initial degree of income inequality have already been mentioned as one source of differences in speed of poverty reduction. But the literature also highlights other key determinants of the growth elasticity of poverty. The labor intensity of growth matters a lot. In many cases, the sectoral and geographic pattern of growth also matter. In many countries, agricultural growth has had the biggest direct impact on poverty in the medium term because of the high concentration of poor households in rural areas. There are also important examples of growth episodes where regional disparities have increased, with some regions benefiting much more from national income growth than others.

In Conclusion, Policy Concerns: For the policy maker, two key conclusions emerge: first, the importance of understanding the net effects of particular policies on both growth and distribution, and second the need to identify "win-win" policies that promote such improvements. Broad tendencies related to the expected factor intensity and geographic and sectoral concentrations of growth are also helpful starting points, but there is much that is not known with confidence about the timing and impacts of specific policies. Finally, the importance of paying attention to the constraints that prevent the poor from fully participating in and contributing to growth cannot be overstressed. Growth reduces poverty more where policies are in place to enhance the capacity of the poor to participate in the growth. Generally, policies that should be stressed are those that allow poor households to participate more fully in product and factor markets and to increase the quality and quantity of their productive assets.

References: The interested reader may contact the editor of this series for a short bibliography supplied by the author.