

Warum interessieren wir uns für Ungleichheit? Ökonomische Perspektiven ... *or why inequality matters!*

Verein zur Entwicklungsökonomischen Forschungsförderung
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Schwerpunktthema
„Entwicklung und Verteilung“

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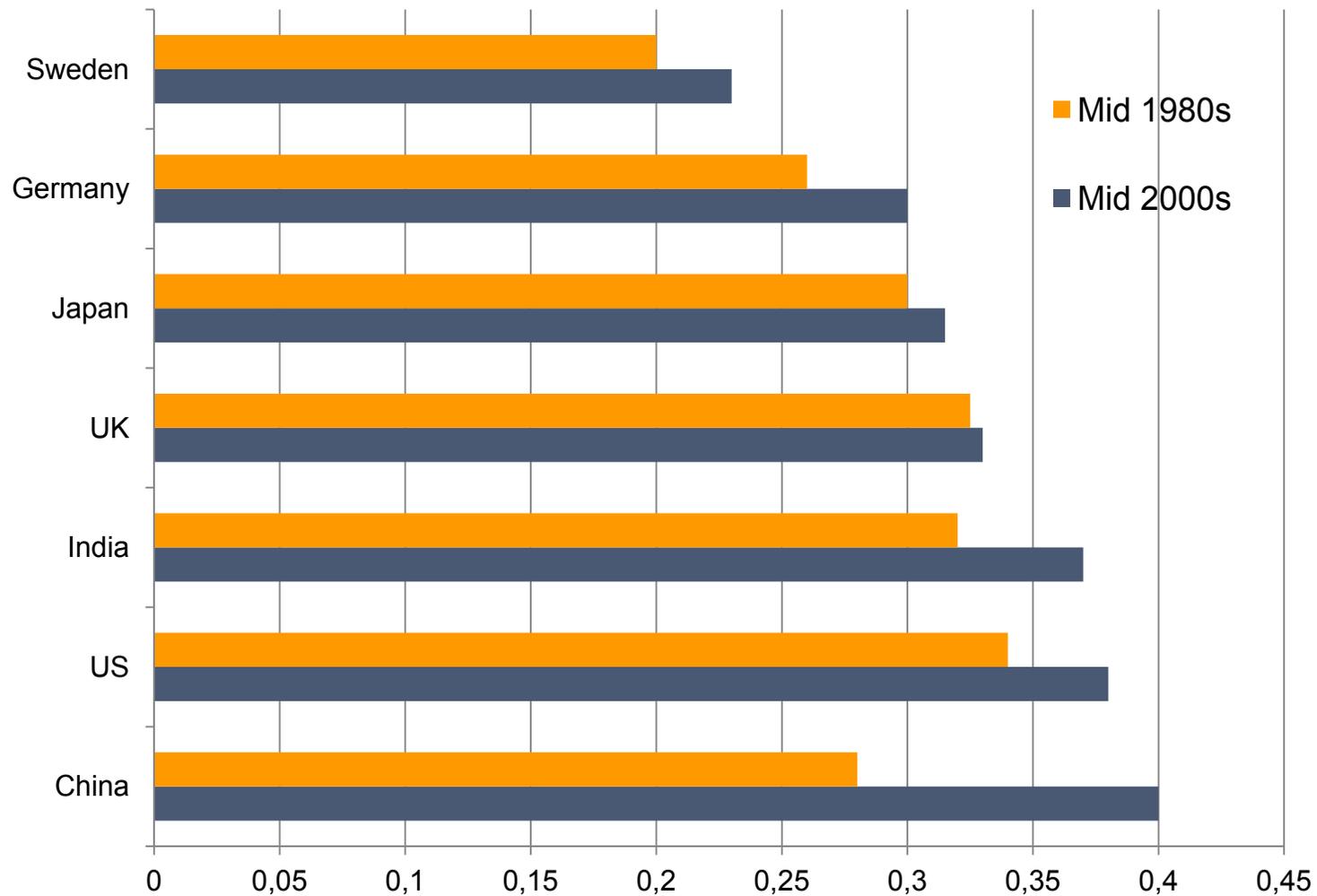
True Progressivism

A new form of radical centrist politics is needed to tackle inequality without hurting economic growth



Rising inequality ...

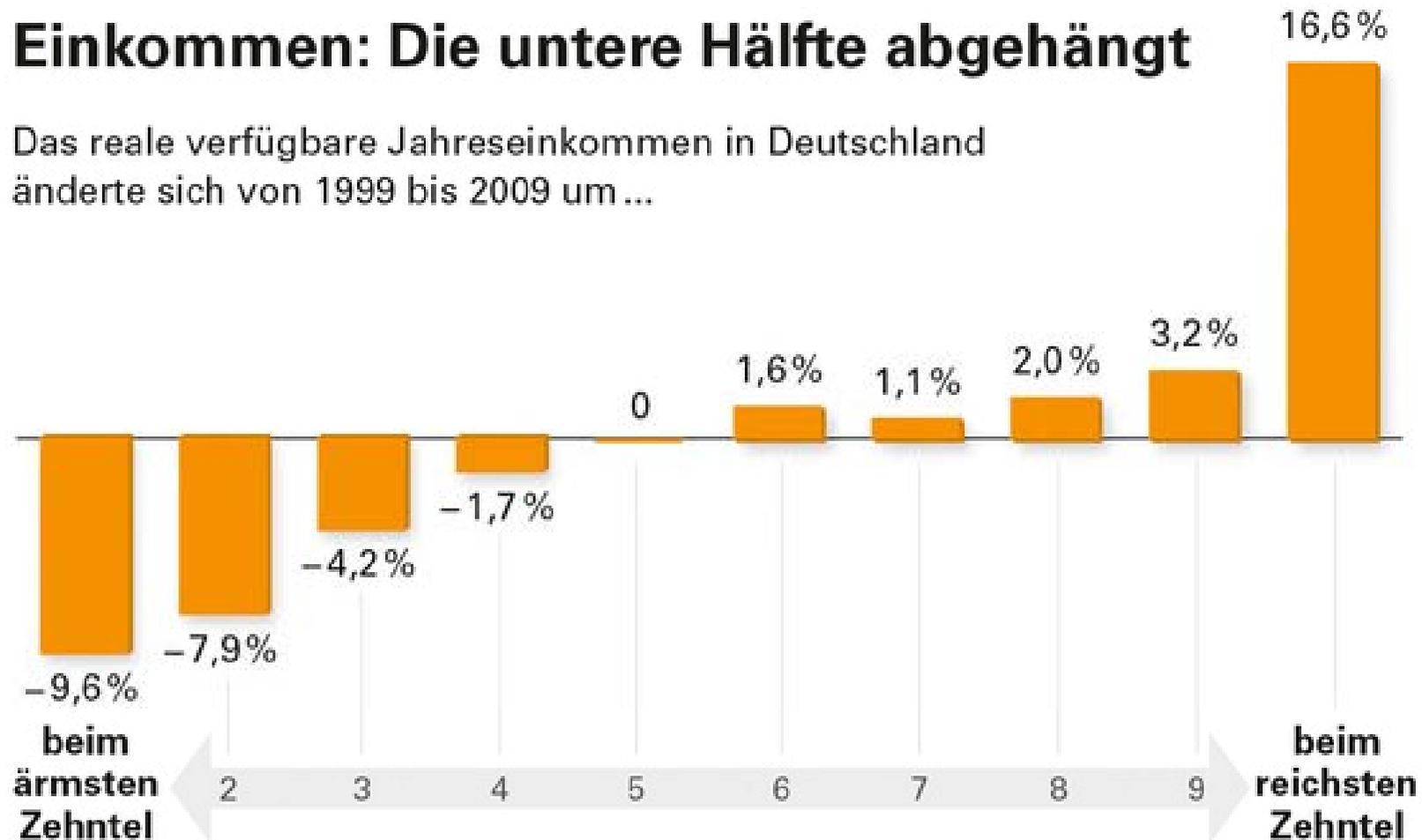
Gini coefficient



... in Germany too ...

Einkommen: Die untere Hälfte abgehängt

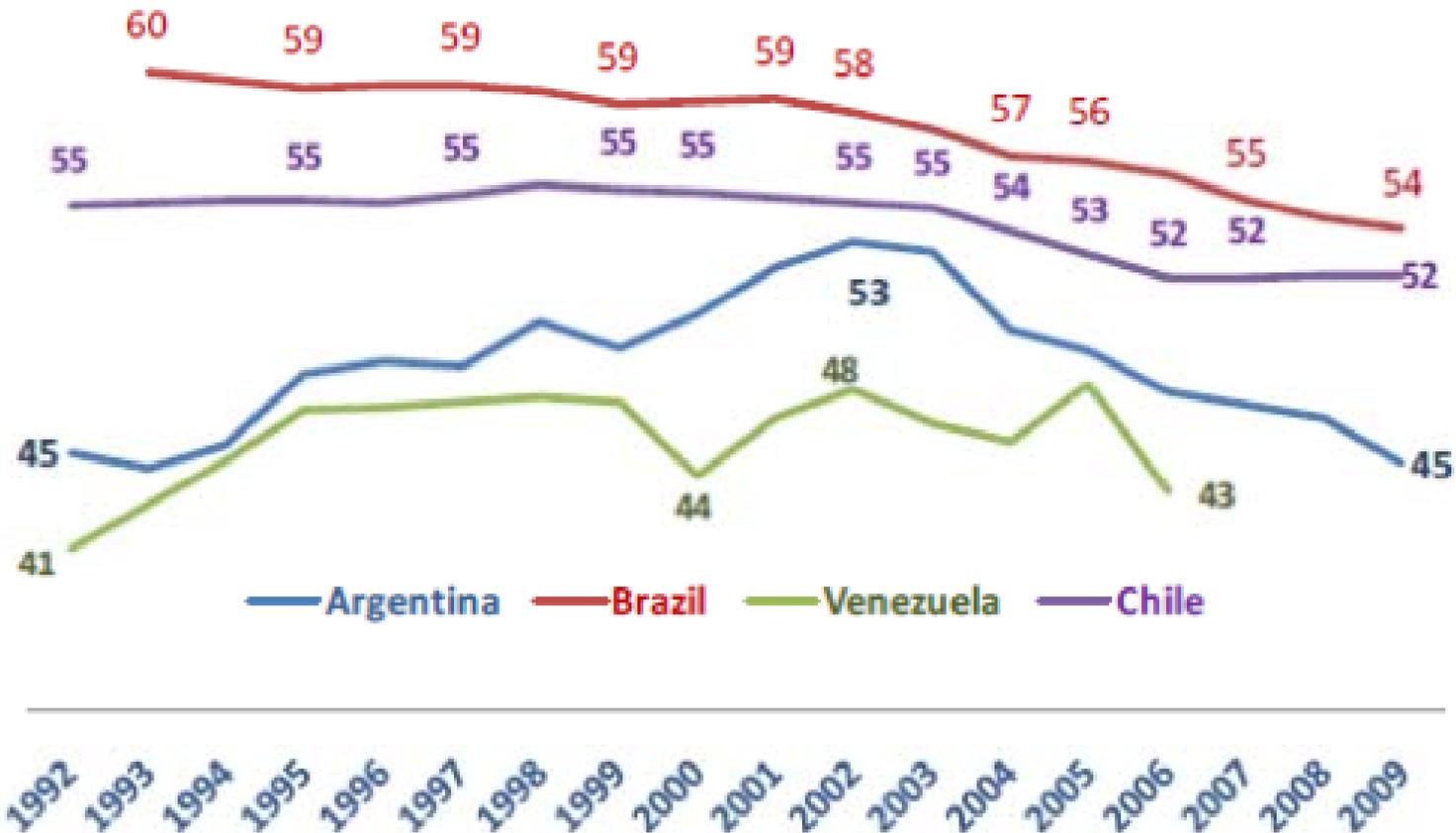
Das reale verfügbare Jahreseinkommen in Deutschland änderte sich von 1999 bis 2009 um ...



Quelle: Deutsches Institut für Wirtschaftsforschung 2011 | © Hans-Böckler-Stiftung 2012

... but also cases of falling inequality

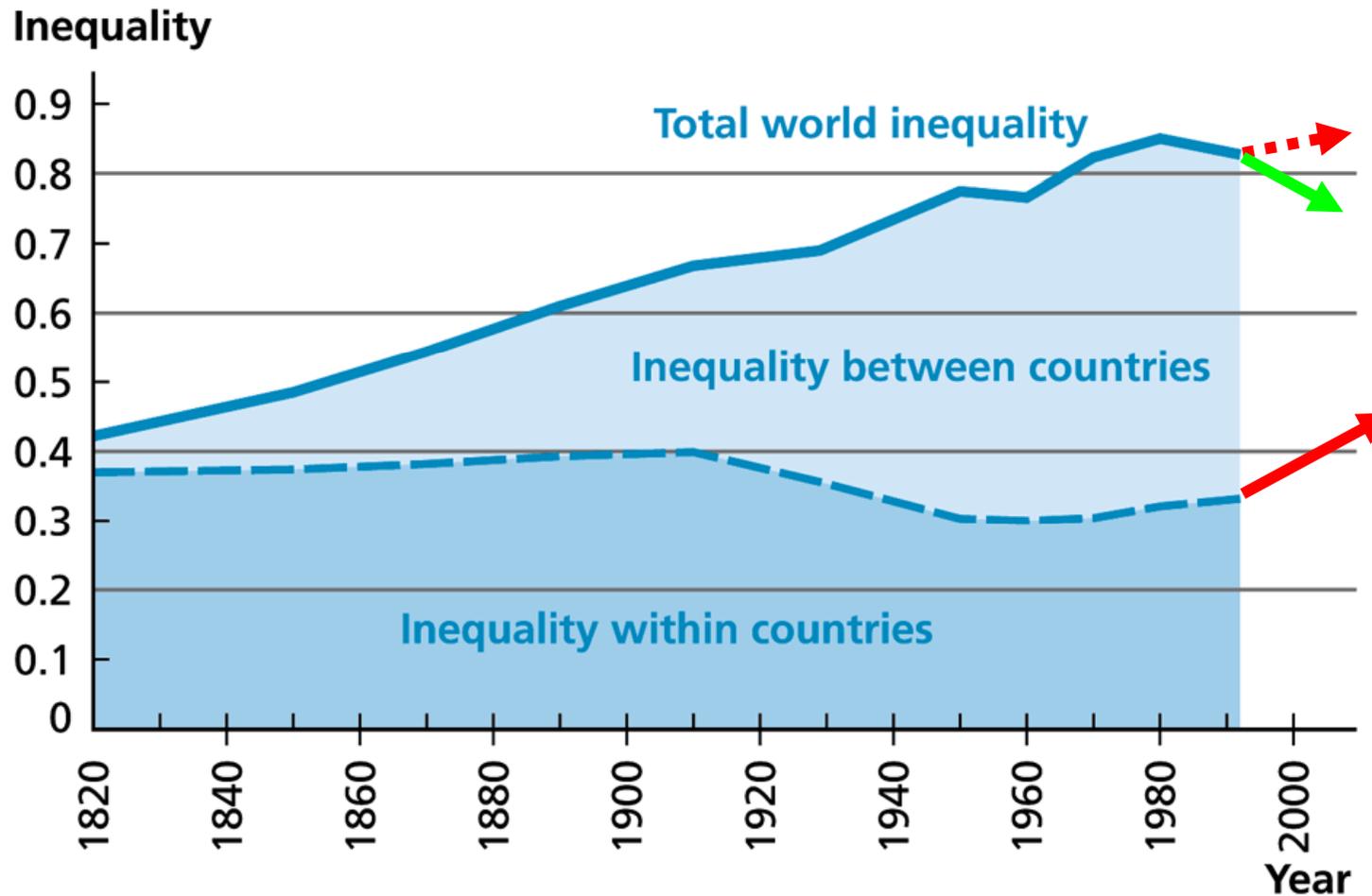
Figure 5: Inequality in Argentina, Brazil, Chile, and Venezuela (Gini coefficients, rounded)



Source: SEDLAC (CEDLAS and the World Bank) as downloaded December 2010.

Source: McLeod and Lustig (2010).

... rising within, declining between ...



Source: Bourguignon and Morrison (2002).

Does inequality impede economic growth and poverty reduction?

If so, inequality of what?

And does economic growth affect inequality?

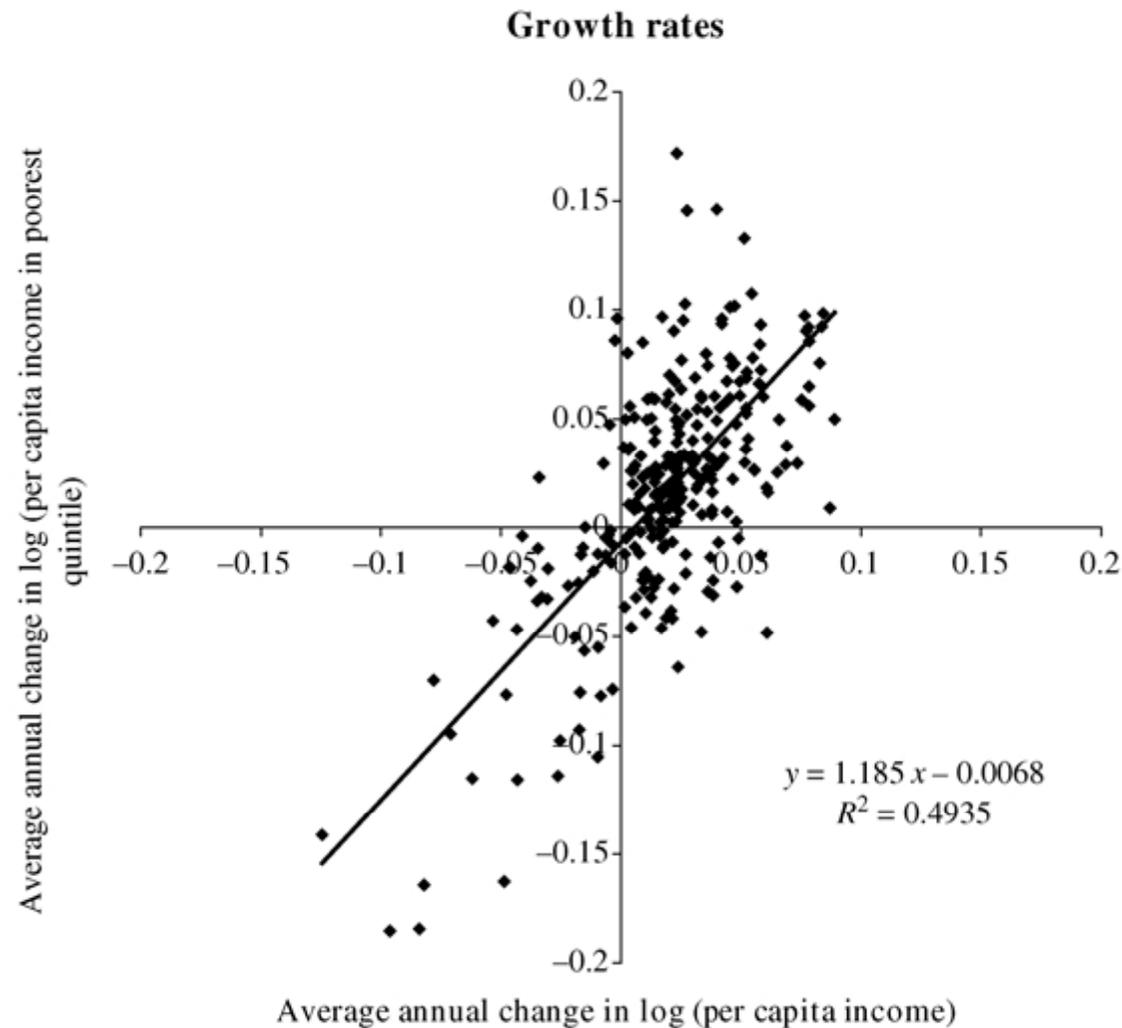
Outline

- The arithmetic link between growth, inequality and poverty
- Does development always come with higher inequality?
- Does inequality affect growth?
- Inequality of opportunities and growth
- Micro evidence and pro-poor growth: When is growth pro-poor?

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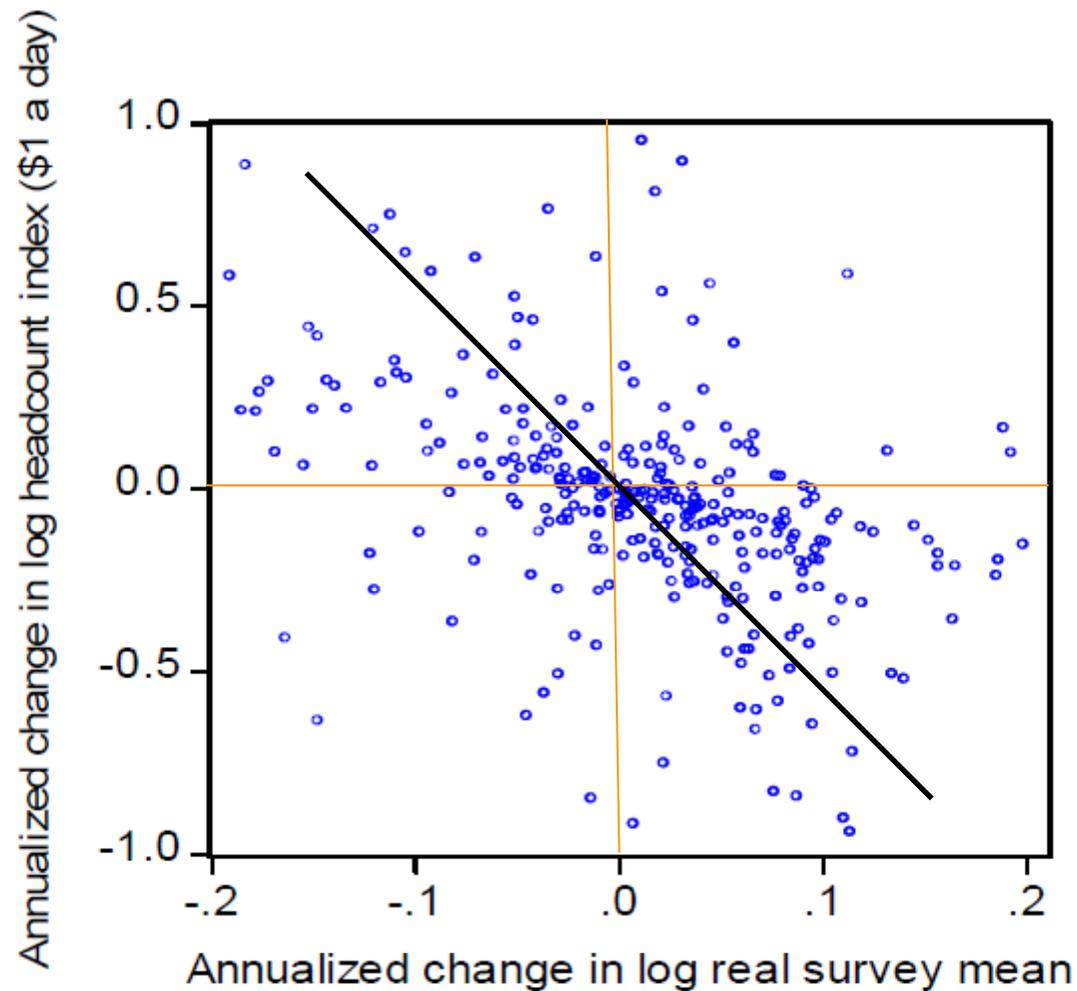
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Growth reduces poverty on average ...

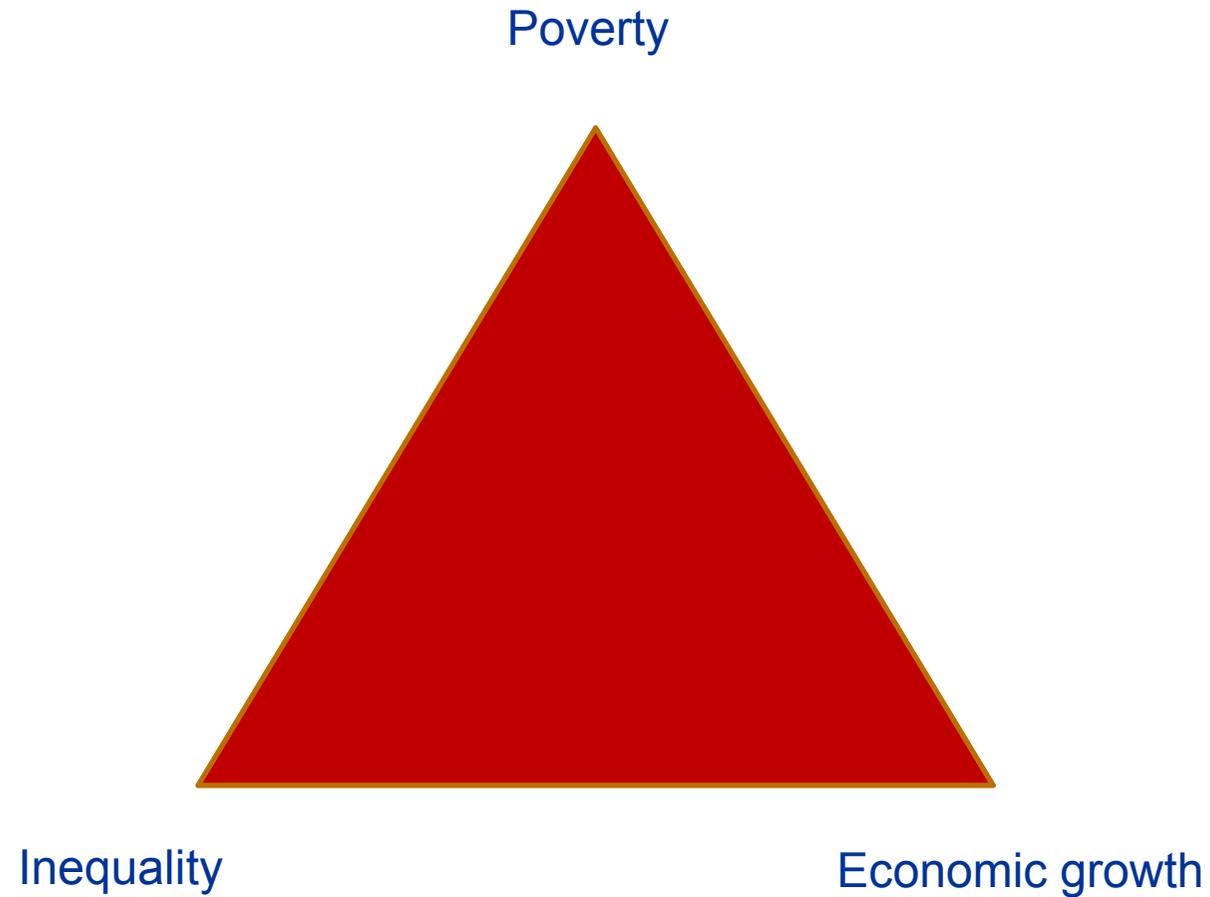


... but a huge variance in the growth-elasticity of poverty

Figure 7: Growth in poverty headcount against growth in survey mean consumption or income in LDCS, 1981-2004

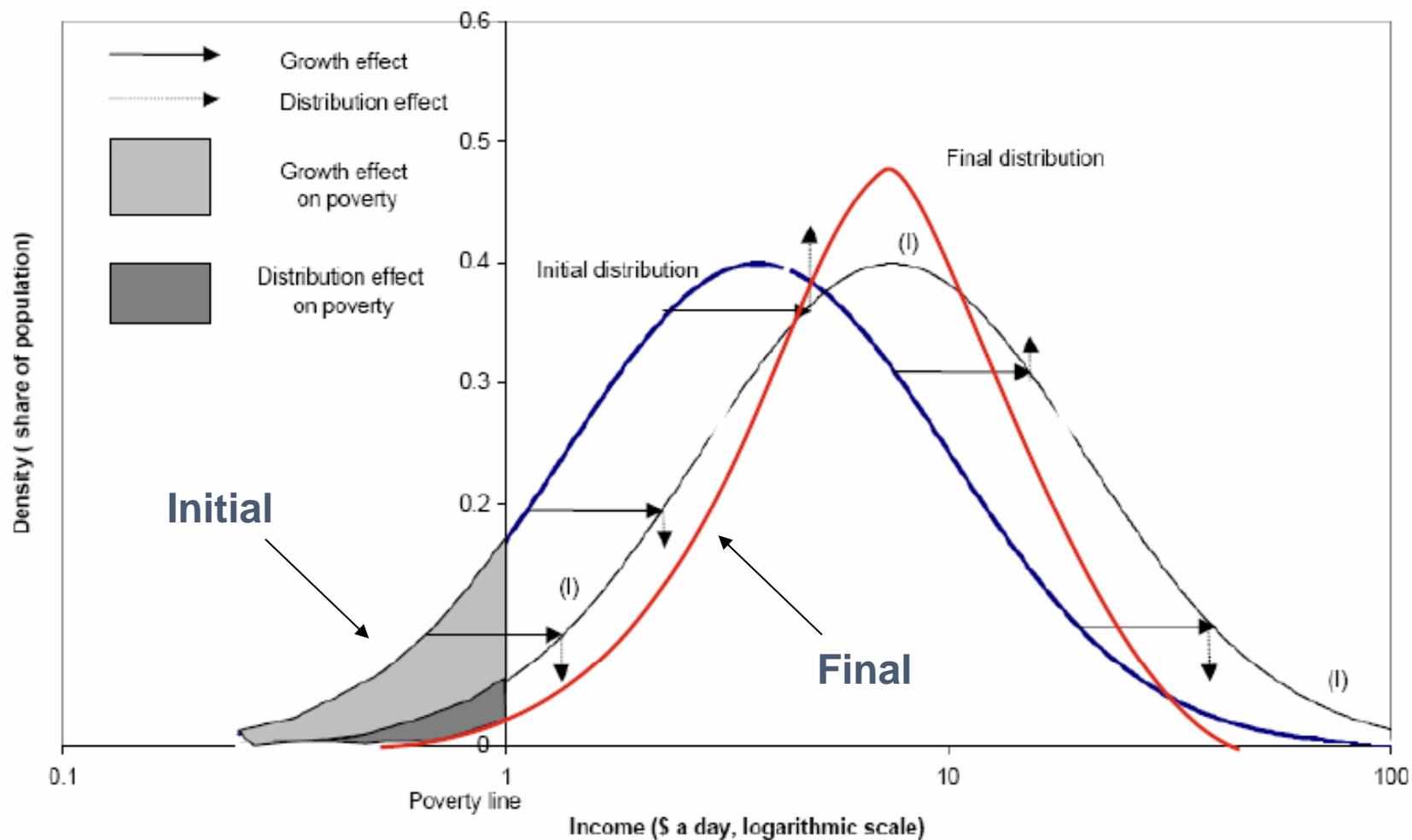


The Growth-Poverty-Inequality triangle



The Growth-Poverty-Inequality triangle

Figure 2. Decomposition of change in distribution and poverty into growth and distributional effects



The Growth-Poverty-Inequality triangle

$$\Delta \text{Poverty} = f(\Delta \text{Growth}, \\ \Delta \text{Inequality}, \\ \text{initial inequality}, \\ \text{initial income, } u)$$

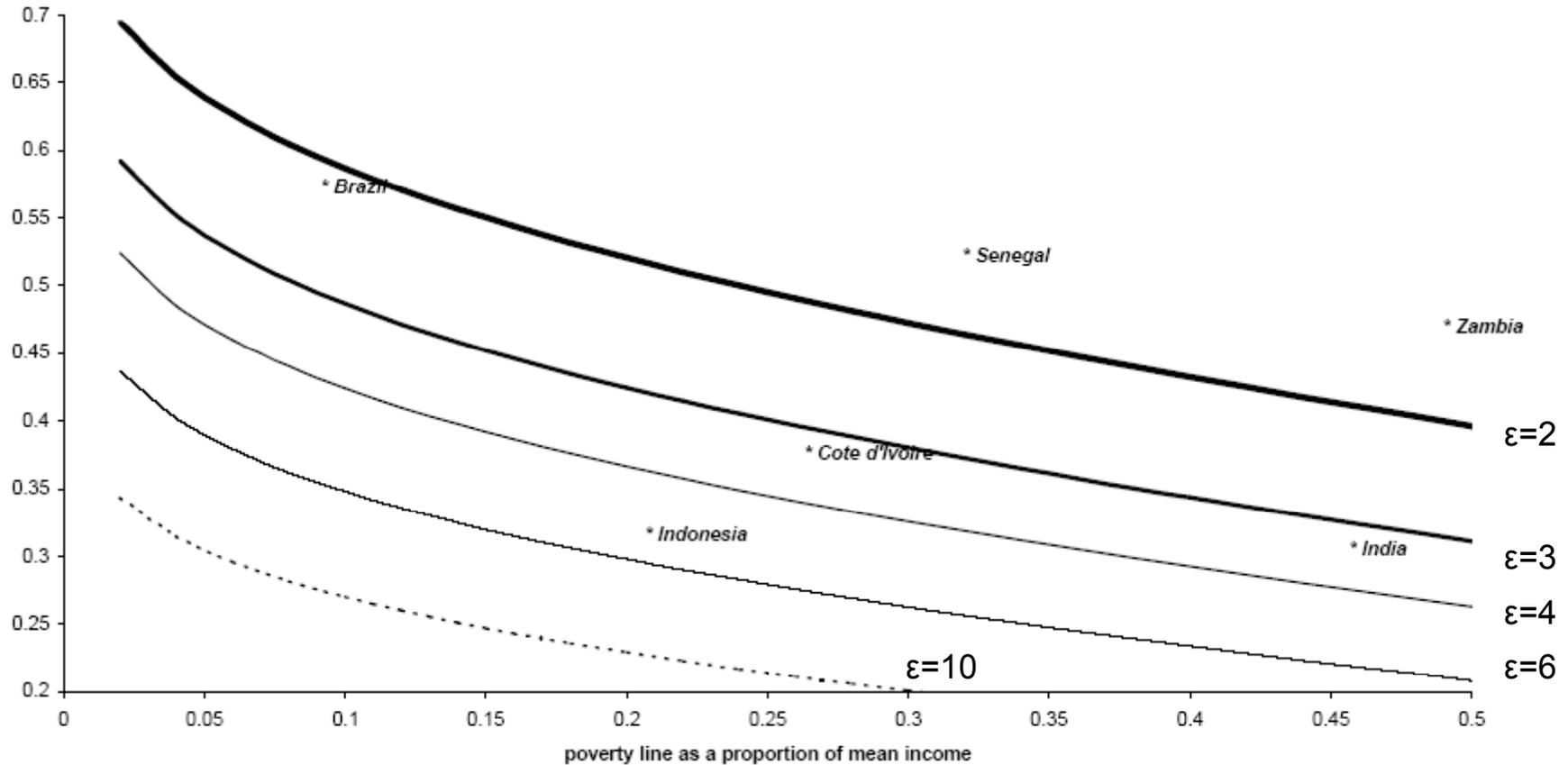
A higher Initial inequality reduces the growth-elasticity of poverty reduction.

Hence, there is a double dividend to reductions in inequality!

The Growth Elasticity of Poverty

Gini

Figure 3. Poverty (headcount)/growth elasticity as a function of mean income and income inequality, under the assumption of constant (Lognormal) distribution

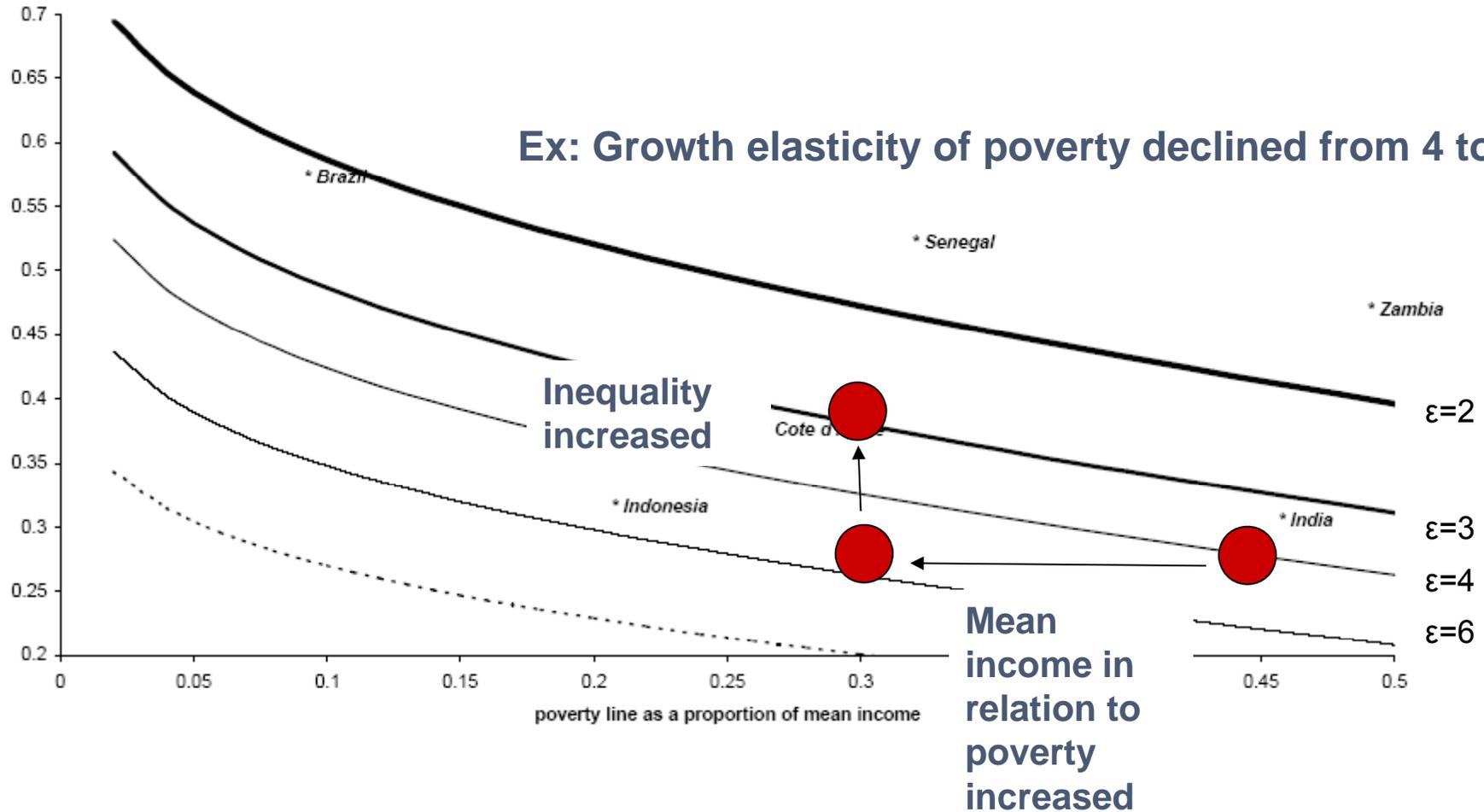


(Bourguignon, 2003).

The Growth Elasticity of Poverty

Figure 3. Poverty (headcount)/growth elasticity as a function of mean income and income inequality, under the assumption of constant (Lognormal) distribution

Gini



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Economic growth and income inequality

Simon S. Kuznets (1901 – 1985)

*„Does inequality increase or decrease
in the course of a country's economic
development?“*



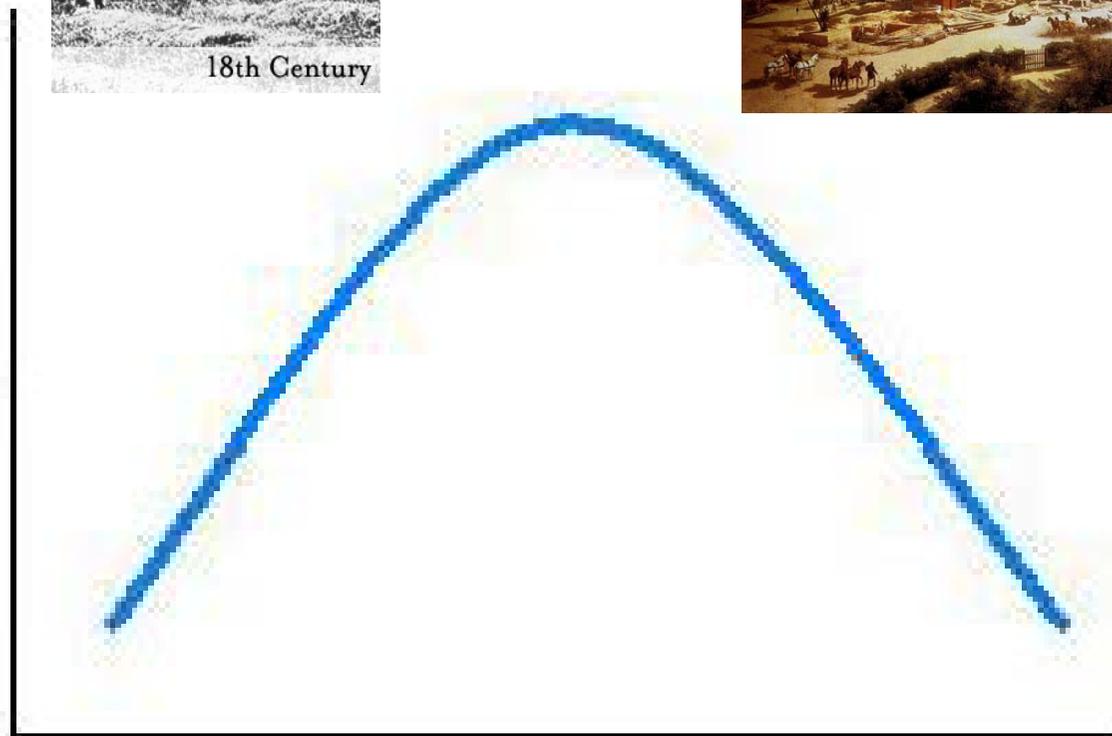
Trends in income inequality

US		1929	1945/50
Share of two lowest quintiles		13,5%	18%
Share of top quintile		55%	44%
UK	1880	1910/13	1947
Share of lower 85%	41%	43%	55%
Share of top 5%	46%	43%	24%
Prussia	1875	1913	
Share of top quintile	48%	50%	
Share of top 5%	26%	30%	
Saxony	1875	1913	
Two lowest quintiles	15%	14,5%	
Third quintile	12%	13%	
Top 5%	56,5%	54,5%	

A stylized Kuznets curve



Inequality



Income per Capita

An attempt at explanation

- Reallocation of workers across sectors.
- Kuznets assumed that inequality between the sectors was substantially greater than inequality within them.
- Process reinforced by growing political power of the urban lower-income groups.

Empirical evidence

- Recent tests based on large data sets have consistently rejected this stylized fact (although many tested the “wrong” thing!).
- In particular Deininger-Squire (DS) data base for 108 countries, hh-survey based (panel).

Empirical evidence

- DS (1998) find little support for an inverted-U relationship between levels of income and inequality, when tested on a country-by-country basis.
- Only for five countries (about 10% of the sample) evolution seems to follow an inverted “U”.
- Also no evidence for a significant rising trend in inequality for poorer countries and significant falling trend in inequality for richer countries.
- DS do also not find any evidence that economic growth would systematically be accompanied by a widening of the income distribution.

Empirical evidence

- Even where a Kuznets curve can be observed (e.g. UK, US) inter-sectoral migration accounts for only a minuscule part of changes in overall inequality.
- Rather, inter-occupational inequality is found to be the driving force; induced by skill-biased technological progress ...
- ... and reductions of inequality emerging as “skill accumulation” finally began to catch up.

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Does initial inequality reduce long-run growth?

- Kaldor (1960) thought there is a trade-off between growth and inequality.
- Theorists provide three reasons, why initial inequality might be *detrimental* to long-run growth:
 - Political economy channel
 - Capital market imperfections channel
 - Social conflict channel.

The Political Economy Channel

- Alesina, A. and D. Rodrik (1994), Distributive Politics and Economic Growth. *Quarterly Journal of Economics*, 109: 465-90.



Question:

„How an economy's initial configuration of resources shapes the political struggle for income and wealth distribution, and how that, in turn, affects long run growth“.

The Political Economy Channel

- The focus is on a **tax on capital**.
- The distribution consists of workers with different endowments of capital and labour.
- Population decides via majority rule on tax on capital.
- The revenue from the tax is improving the earnings potential for all.
- ***Key-effect:*** The more *the labour-capital-ratio* of the median voter above the average ratio, the higher the voted tax on capital and the lower is the rate of growth of the economy.

The capital market imperfections channel

- Basic idea: In the presence of credit market imperfections desirable investments do not take place and hence reduce long run growth.
- Banerjee and Newman (*JPE*, 1993): poor workers are in the presence of imperfect capital markets and convex returns prevented from investing and are hence bound to be poor.
- Galor and Zaira (*RES*, 1993): The impossibility to borrow against future returns to human capital prevents poor people to invest in education, lowering the growth potential of the economy.

The social conflict channel

- Basic idea: (Extensive) inequality leads to less political stability, and this in turn can lead to sub-optimal investment levels (e.g. Alesina and Perotti, *EER*, 1996).
- Robust empirical evidence that inequality leads to social unrest and violence (e.g. Fajnzylber et al., 1998).
- and that violence generates high costs in the short and long run (Bourguignon, 1998).
- Experimental games show, that most people are averse against excessive inequality.

Empirical evidence – the effect of inequality on growth

- Alesina and Rodrik and some others find negative effect of inequality on growth.
- Kristin J. Forbes challenges this finding.
- Her main points of critique:
 - Previous estimates often not robust.
 - Measurement error in inequality.
 - Omitted variable bias (e.g. degree of capitalism, level of corruption).
 - Almost all previous studies focus on cross-sections of countries.
- She finds a positive or at least insignificant relationship.

Empirical evidence – the effect of inequality on growth

But Forbes uses also a ...

- small data set,
- which is not representative of all countries (over-emphasis on OECD countries) and

and she rather measures short term effects.

Empirical evidence – the effect of inequality on growth

- **Deininger and Squire (1998)** show that
 - Not (initial) income inequality, but asset inequality (in particular land) has a negative effect on (long term) growth.
- „Only two of the 15 developing countries with a Gini coefficient for the distribution of land in excess of 0.7 managed to grow at more than 2.5% over the 1960–1992 period”.
- Moreover, they find that inequality reduces growth for the poor but not for the rich.
- DS argue that redistributing existing assets (land) is less effective than creating new assets through investment.

General problems with this type of analysis

- Link is – plausibly - time and context specific
- Non-linearities
- Initial conditions matter
- „Single-cause“ relationship rather unlikely

Hence,

- ... additional insights can be gained from country case studies.

Another important question is,

- ... inequality of what (income, land, opportunities) ??

-
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Inequality of opportunity

Concept:

- Total inequality in an outcome can be decomposed into two parts: one resulting from **circumstances beyond individual control** and a second part resulting from *unequal individual effort and luck*.
- Unequal outcomes resulting from circumstances are generally considered socially unacceptable or, at the very least, undesirable.

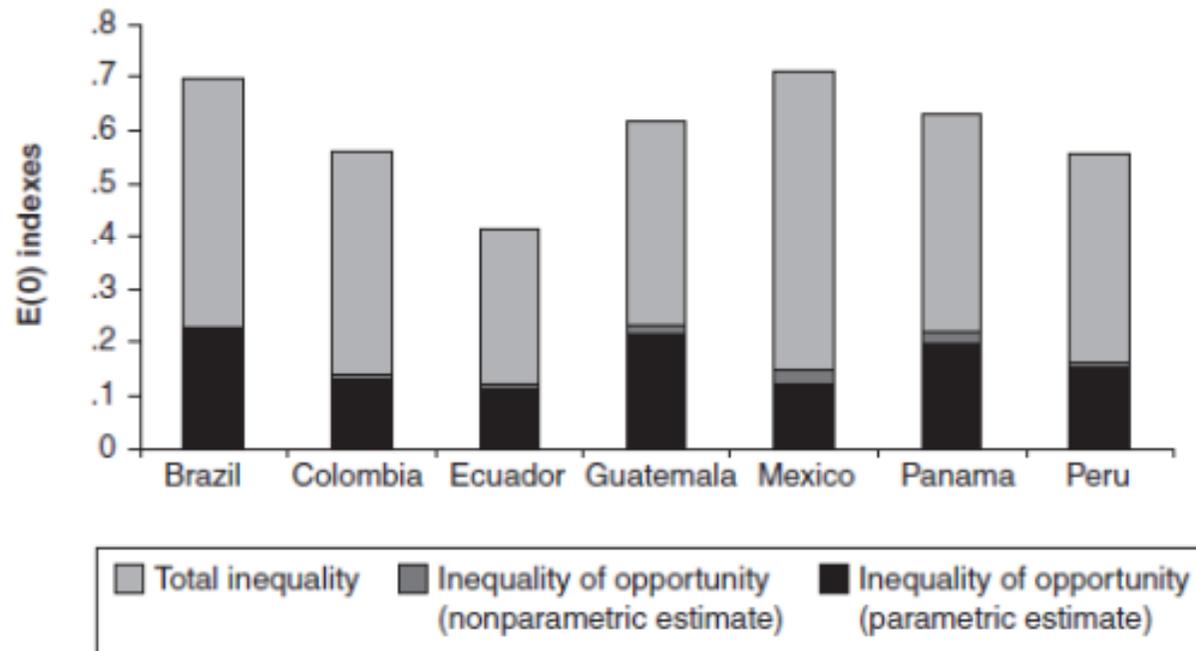
Example Latin America

Six circumstance characteristics considered:

- Gender,
- ethnicity,
- parental education levels,
- father's occupation,
- and birthplace

Example Latin America

Figure 4.3 Decomposing Total Inequality: Household per Capita Income

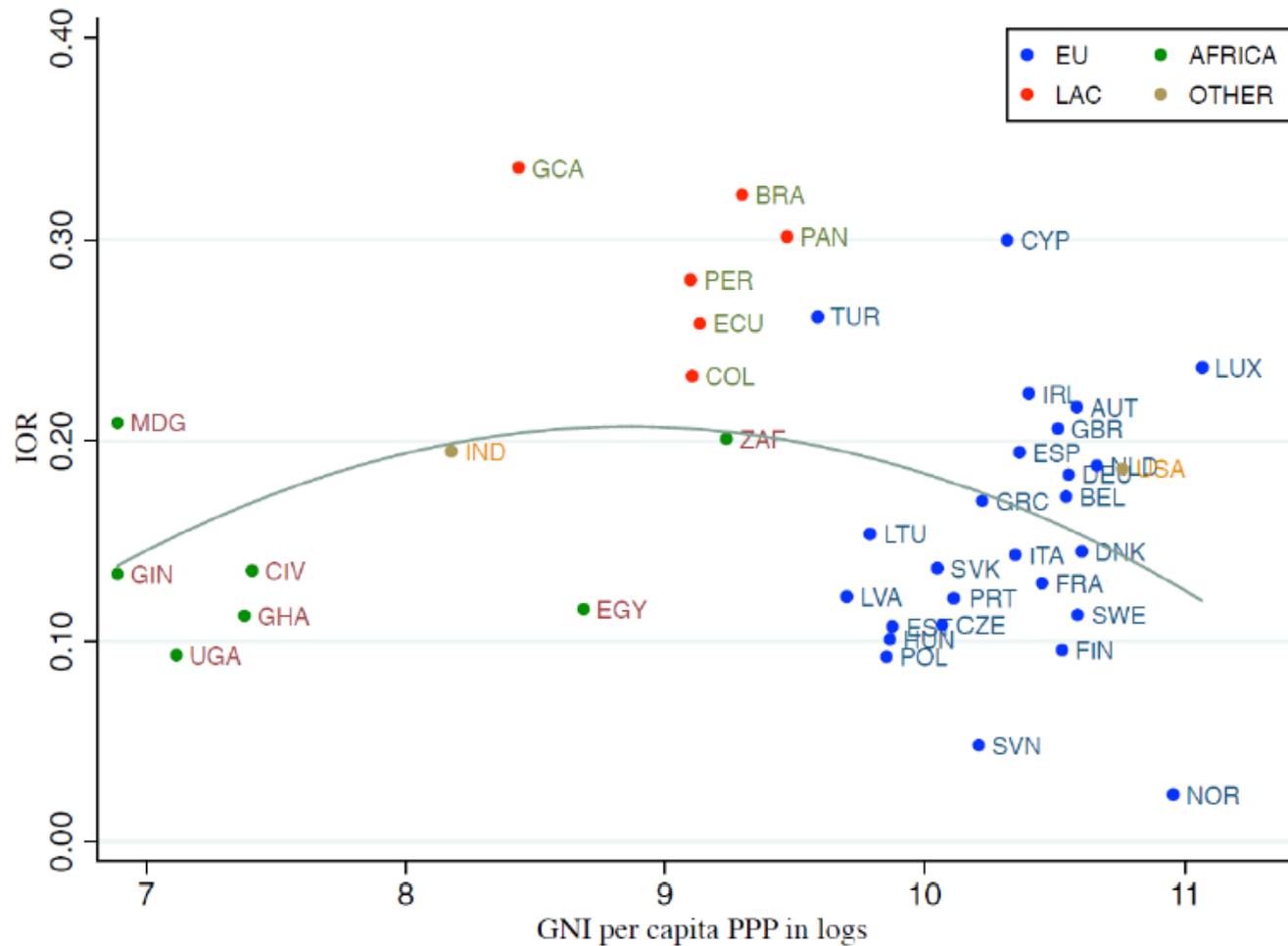


Sources: Authors' computations.

Paes de Barros et al. (2009).

International comparison and link with GNI

Figure 3: Inequality of economic opportunity and the level of development



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Example: Indonesia (1965-1996)

Table 2.3 Factors Affecting Changes in the Headcount Index of Poverty

	<i>Annual % change in per capita income</i>	<i>Annual % change in poverty index</i>	<i>Growth elasticity of poverty</i>	<i>Annual % change in real rice prices</i>
1967-76	5.48	-6.0	-1.09	2.5
1976-80	6.37	-8.1	-1.27	-3.5
1980-84	4.23	-6.8	-1.61	3.0
1984-87	2.69	-7.0	-2.60	-2.5
1987-90	5.66	-4.6	-0.81	5.5
1990-93	5.41	-4.6	-0.85	-1.6
1993-96	5.23	-6.2	-1.19	5.8
1996-99	-3.25	9.9	-3.05 (+)	19.2
1999-2002	2.49	-8.2	-3.29	-7.1

Source: Timmer 2005b.

Note: The growth elasticity of poverty (GEP) is calculated as the ratio of the percentage reduction in the headcount poverty index relative to the percentage change in per capita incomes (in \$PPP) from the World Bank Database on Pro-Poor Growth. An OLS regression of GEP on the change in the real rice price (DRRP) explains 80 percent of the variance in GEP, with highly significant coefficients. The results are as follows (*t*-statistics in parentheses):

Example: Indonesia (1965-1996)

- Policy prioritised subsidies to the agricultural sector instead of subsidizing the use of capital.
- Investment in agriculture increased incomes of the poor (*redistribution*) which in turn increased domestic demand (*for agricultural goods, manufactured goods and services*) ...
- ...and enhanced investment in the manufactured sector.
- Controlled rice prices stabilized further the food economy.
- Much of the rural infrastructure was built using labour-intensive techniques creating further employment and income for the poor.

Example: Indonesia (1965-1996)

- Relative unorthodox exchange rate management
- Macroeconomic stability.
- Political stability, thus low risk (*but authoritarian regime*).
- Investment in agricultural productivity (*irrigation, fertiliser, pesticides, improved seeds, rural infrastructure*).
- Cheap agricultural credits
- Investments in health and education
- Investment in transport infrastructure
- Open trade and investment policy

What key factors determine pro-poor growth more generally?

Growth is likely to be pro-poor if it ...

- strengthens the productive resources and the capacity of the entire population.
- opens up new opportunities and uses the full potential of the population.
- is based on policies that are backed by an active state and a committed government with a longer term perspective.

Conclusion

- No systematic positive or negative effect of growth on inequality.
- But plausible theoretical channels and empirical evidence for adverse effects of inequality on growth ... *even if not always and everywhere.*
- Exzessive inequality particularly harmful for (sustainable) growth.
- Likewise inequality in opportunities.
- Growth *can* be pro-poor, but often it is not.
- Pro-poor growth strategies are more effective if they are accompanied by inequality-reducing policies ... and with lower levels of initial inequality.