

# Globalization, Growth and Distribution: Framing the Questions

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## **Abstract**

In the last two decades, across a range of countries high growth rates have reduced poverty but have been accompanied by rising inequality. This paper is motivated by this stylized fact, and by the strong distributional concerns that persist among populations and policy makers alike, despite the poverty reduction observed in official statistics where growth has been sufficiently high. This seeming disconnect frames the questions posed in this paper. Why the disconnect, and what to do about it? It is argued that official poverty statistics may be missing key elements of the ground level reality of distributional evolution, of which rising inequality may be an indirect indicator. Heterogeneity of population means that there may be significant numbers of poor losers from technical change, economic reform and global integration, even when overall measured poverty falls. In terms of actions, attention is drawn to the role of safety nets as generalized compensation mechanisms, to address the ethical and political economy dimensions of such a pattern of distributional evolution. Addressing structural inequalities is also a long term answer with payoffs in terms of equitable growth. In terms of future analysis, diminishing returns have set in to the inequality-growth cross-country regressions literature. Further work to help policy makers should focus on (i) new information to illuminate the disconnect, (ii) analysis and assessment of safety nets as generalized compensation mechanisms, and (iii) addressing specific forms of structural inequality related to assets, gender, and social groupings like caste or ethnicity.

## 1. Growth and Distribution: A Motivating Stylized Fact and Concern

The discourse on globalization, economic liberalization and growth is contentious partly, perhaps mainly, because of the distributional dimension. The “anti-globalizers”, if one is permitted that shorthand with all its problems, point to the negative distributional consequences of the conventional policy package of economic liberalization combined with trade and financial integration into the global economy, even if they accept (which many do not) that these policies are associated with higher growth rates. Some “globalizers”, while standing firm on the close link between the conventional policy package and growth, nevertheless worry about its distributional outcomes—others, however, argue that the package is good for both growth and distribution, at least in the long run.<sup>1</sup>

I will argue in this paper that this discourse is characterized by many misunderstandings, which arise because different questions are being asked and answered, different perspectives are brought to bear on economic processes, and because different analytical frameworks are being used to understand and interpret ostensibly the same phenomena. While these misunderstandings persist, it is difficult to make progress in the discourse. Implicit pejorative characterizations of one side or the other (as “good hearted but stupid”, or “clever but a tool of international capital”) will persist, even among people all of whom may, again ostensibly, share a common objective—for example, poverty reduction.

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<sup>1</sup> The literature is by now too vast to enumerate even partially. For publications targeted towards general audiences, see Stiglitz (2003) and Bhagwati (2004). Recent publications targeted towards an academic audience include Nissanke and Thorbecke (2006), and Harrison (2007).

My focus will be primarily on developing economies, rather than the rich countries (including the transition economies of Eastern Europe, although their experience will be alluded to). Further, I will focus primarily on economic growth and income distribution, leaving to one side the vast topic of non-economic dimensions of wellbeing. I will come presently to some detailed aspects of how income distribution data are generated, and their role in the debates referred to above. For now, suppose that we have an “ideal” income distribution—a distribution of individuals by real income with all the corrections for price differentials, household composition, etc, etc, that one is advised to do in the research manuals. Define poverty as a measure on the lower tail of the income distribution, below some cut off called the “poverty line”. For now, leave to one side the vast literature on poverty lines and poverty indices—think simply of the percentage of people below some nationally accepted cut off.

A few accounting properties of such income distributions will prove useful as an anchor. Speaking loosely, but I believe intuitively, an increase (a decrease) in the mean holding constant the inequality of the distribution will reduce (increase) poverty. A decrease (increase) in inequality holding the mean constant will decrease (increase) poverty.<sup>2</sup> So, of course, if the mean increases and inequality declines (a stylized representation of the East Asia miracle of the 1960s, 1970s and 1980s)), poverty will fall.

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<sup>2</sup> Of course these statements can be made precise. For example, if by decreasing inequality is meant an inward movement of the Lorenz curve (or, equivalently, a second order dominating shift in the income distribution), then all members of the FGT family of poverty indices (Foster, Greer and Thorbecke, 1984) for poverty aversion greater than or equal to one will decline. However, whether the head count ratio—the proportion of population below the poverty line—declines depends more intimately on the shape of the distribution and the position of the poverty line. For example, if the distribution is symmetric and the poverty line is less than the mean, then a decrease in inequality will reduce poverty (see Haddad and Kanbur, 1990).

If the mean decreases and inequality increases (a stylized representation of some transition economies in the 1990s), poverty will rise. I will refer to an increase in the mean of the income distribution as growth. Of course if growth is accompanied by an increase in inequality, the effect on poverty is ambiguous and depends on the relative strength of the two forces. Finally, notice that even if inequality does not change, the initial level of inequality will affect the impact of growth on poverty—intuitively, the more unequal the distribution to which a given growth rate is applied, the lower will be the impact on poverty reduction.<sup>3</sup>

To my mind the central stylized fact of distributional evolution in developing countries in the past twenty years is that in countries where there has been high growth it has been accompanied by inequality increase, but the growth effect has been sufficiently strong that poverty has fallen.<sup>4</sup> It is this constellation of outcomes—high growth, inequality increase and poverty reduction-- that forms the nexus of debate, not only for these countries, but also for those countries languishing at low growth rates and low poverty reduction. For the latter, the high growth countries offer a model—but of what sort?

In country after country where there has been significant growth, policy makers continue to worry about distributional outcomes. The statistics of poverty reduction do not seem to have registered with the population or the polity. The newspapers, and civil society at large, talk of “those left behind”. Growing gaps between rich and poor are the

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<sup>3</sup> For a formal statement of these relationships, see Ravallion (1997, 2000).

<sup>4</sup> Increasing inequality was already highlighted as an emerging phenomenon in my review paper written in the mid 1990s, Kanbur (2000).

basis of much social commentary, and also much social unrest. In China, despite spectacular growth and poverty reduction, policy attention is focused on growing protests not only in the vast hinterland, but also in the fast growing coastal provinces.<sup>5</sup> In India, the last election brought in a government with a commitment to address the distributional consequences of the high growth trajectory.<sup>6</sup> In Ghana, the North-South divide looms larger than ever in the political economy, despite a decade or more of growth which has reduced measured poverty significantly.<sup>7</sup> In South Africa, the first post-Apartheid decade was characterized by low growth, and increasing inequality and poverty.<sup>8</sup> In the last five years, despite a pick up in growth rates, inequality has continued to increase and income poverty reduction has languished, leading the government to start a discourse on a “second economy”, disconnected from the “first economy” which is reaping the benefits of growth. In Chile, spectacular growth and poverty reduction over the past quarter century have not allayed distributional concerns on growing inequality.<sup>9</sup> In Mexico, overall low growth rates have held back poverty reduction, but even when growth rates have been high, the impact on poverty reduction was diluted significantly by rising inequality.<sup>10</sup>

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<sup>5</sup> For evidence on the magnitude of growing spatial inequality in China, see Kanbur and Zhang (1995).

<sup>6</sup> For a recent account of the evolution of income distribution in India, see Deaton and Dreze (2002.).

<sup>7</sup> Aryeetey and McKay (2007.).

<sup>8</sup> see Borat and Kanbur (2006).

<sup>9</sup> Birdsall and Szekely (2003) note: “Between 1992 and 1996, Chilean GDP per capita expanded by more than 30 percent in real terms and moderate poverty (headcount ratio declined by 20 percent. But income inequality increased (the Gini index increased by 7 percentage points). Had the income distribution remained as in 1992, the proportion of poor would have actually declined much more, by 50 percent.”

<sup>10</sup> See Birdsall and Szekely, 2003: “Between 1996 and 1998, GDP per capita increased in Mexico by 9.7 percent in real terms, a spectacular gain compared to the previous 16 years. However, poverty hardly declined...The huge increase in mean income was due entirely to the income gains among the richest 30%-particularly the richest 10%--of the population.”

The above country stories could be multiplied many times over. They raise the question: What is going on in those countries where growth has been high enough to reduce poverty, and yet there is popular discontent on distribution that policymakers feel they have to address? A second question is: What can and should be done to address these concerns without jeopardizing growth performance—what, if any, are the tradeoffs? Answers to these questions are important for the high growth countries, and for low growth countries looking to accelerate their growth rates.

In answering the first question, the possibility arises that our poverty numbers are misleadingly optimistic about wellbeing at the lower end of the income distribution because they miss out or misrepresent key trends that are relevant in terms of ground level realities. There is also the conceptual issue of whether the evolution of poverty captures the full dimensions of social welfare as seen by the population and policy makers, especially when inequality is on the rise. In answering the second question, we might first consider the possibility that the rising phase of inequality is temporary and will end soon enough—so the short run price will be worth paying from the long run perspective. If the increase in inequality is nevertheless a problem, the issue arises as to whether and how the increase in inequality can and should be curtailed. Finally, even if poverty were the only concern, and it were measured accurately by our numbers, the concern might be that rising inequality could threaten the growth trajectory and therefore future poverty reduction.

The following sections frame a series of specific questions on the issues identified above, starting with why rising inequality might be a concern, and following with what might be done about it. Even when answers to these questions are not easily available, I hope that framing the questions in this way serves to illuminate key features of the debate, and highlights what further analysis may be needed to arrive at a resolution.

## **2. If Poverty is Declining, What's the Worry About Rising Inequality?**

### **2.1 Is Something Missing from the Poverty Numbers?**

Policy makers are used to disbelief about official growth rates from civil society, who often argue that high growth rates are all very well but the beneficial impact on the population at large, in particular on the poor, is a different matter altogether. Poverty statistics, from nationally representative household survey data, should address this concern. Poverty data are now produced at regular intervals for most developing countries, by their national statistical agencies or by international agencies. The publication of these numbers is a major event. The recent controversy in India on poverty statistics is perhaps an extreme example,<sup>11</sup> but in most countries the publication of poverty numbers leads to a national debate on what the numbers represent, and what they imply about the efficacy of government policy.

And yet, it would be fair to say that there is considerable skepticism in civil society about these poverty numbers. Especially in countries where poverty statistics are showing declining poverty, these are challenged by many elements of civil society as not representing the reality on the ground which, they claim, shows a worsening of wellbeing at the lower end of the income distribution. Such claims are often dismissed by economists, official statisticians, and some in government, as the biased views of those with an interest in attacking economic liberalization policies. Sooner or later, those in government do pay attention to these views, because they often represent the views of

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<sup>11</sup> See Deaton and Kozel (2005)

voters at large, or when they spill over into violent protests. This is what explains policymakers' continued worries on the distributional front despite good poverty reduction figures. As analysts, however, we might ask whether the poverty figures conventionally published are missing out on key features of ground level reality and which might explain the disconnect between the official statistics and perceptions in the population.<sup>12</sup>

### **2.1.1 Population Normalization**

Consider an economy in which the incidence of poverty—the fraction of population below the poverty line—has been falling at 1 percentage point per annum. This is a pretty good rate of decline, especially for an African country. At this rate, depending on the initial level of poverty, an economy would be well on track for achieving the first Millennium Development Goal, on reduction of the incidence of income poverty. But suppose that population growth in this economy is 2 percentage points per annum. In this case, although the fraction of poor population is falling at 1 percentage point per annum, the absolute number of the poor is rising at 1 percentage point per annum. For an NGO working with the poor on the ground, the soup kitchens are fuller than ever, there are more street children than ever, there are more distressed farmers than ever—and yet the official statistics seem to proclaim a reduction in poverty. The disconnect is of course sharpest in relatively low poverty incidence reduction and relatively high population growth economies—like those in Africa. But the tendency is present in all economies. Even in the fast poverty reduction case of China—where the

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<sup>12</sup> Some of the points in this section are developed in Kanbur (2001).

incidence of poverty and the absolute number of poor have both fallen spectacularly, the rate decline of the latter is lower than the rate of decline of the former.

The practice of normalizing by total population goes back at least far as Sen's (1976) axiomatic treatment of poverty measurement. One of those axioms effectively states that replicating every individual in an economy—so that there are twice as many poor but twice as many rich as well—should leave the poverty measure unchanged. This leads to the characteristic form of all standard poverty measures, that they contain total population size in the denominator. Economists and poverty statisticians have clearly bought into this axiom, perhaps somewhat unthinkingly. Those working at the ground level with the poor, however, have not. Policymakers need to be aware of this, and look at figures for absolute numbers of the poor to better understand popular perceptions of poverty. The World Bank has started producing both sets of figures for its global poverty data, which is a good start. A formal analysis of poverty measurement without Sen's (1976) population axiom, see Chakravarty, Kanbur and Mukherjee (2006).

### **2.1.2 Public Services**

What household surveys are excellent at capturing is the value of market goods and services bought and sold. Expenditure data generated from respondents is the building block of poverty data in countries like India and Ghana.<sup>13</sup> Over the years these surveys have become better and better at capturing the value of a number of non-market

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<sup>13</sup> Although expenditure surveys are increasingly coming into Latin America, the primary sources of information are income surveys from the labor market. But the issue of neglect of public services is still present in these surveys as well.

activities like production for home consumption—for example through questions that try to ascertain how much it would have cost to purchase home grown maize from the market. Housing in rural areas is also not traded very much, so descriptive information on the house (type of construction, square footage etc) could in principle be used to construct hedonic estimates of the value of housing services, with information from what little trading there is in the sample. And so on.

However, what household surveys are not good at is capturing the value of public services such as health, education, transportation, etc. Conceptually there is no particular difficulty in incorporating these into the standard money metric measures of wellbeing. Empirically, however, there are severe difficulties in estimating the shadow value of these services for each household. In any event, this is simply not done in official statistics. Of course, the surveys do collect information on the availability, quality, etc of health, education, water, sanitation and other services. But there is no integration of the value of these into the income/expenditure measure of wellbeing from which the poverty rates are calculated.

Consider then an economy in which there is a reorientation from a heavily publicly provided services past to a more private sector oriented future, which is precisely what, as some may argue, is leading to the higher growth rates. The household survey data will capture transactions in the expanded private sphere, but it will not capture corresponding reduction in public services which, no matter how inefficiently and ineffectively provided, had at least some value to them. Since the value of public services

is not accounted for in standard household survey based money metric measures of wellbeing, standard official poverty statistics will overstate the improvement in wellbeing throughout the distribution, including at the lower tail. Hence, they will overstate reduction in poverty.<sup>14</sup>

It should be pointed out that this disconnect works in both directions. If for some reason there has been an expansion of basic public services, the monetary equivalent of these is not captured in household surveys, and poverty statistics based on them will understate improvement in wellbeing and thus understate improvement in poverty. This can be argued to have been the case for post-Apartheid South Africa, as documented in Borat and Kanbur (2006). It is a measure of sharp increases in income inequality in South Africa that they loom so large in the population's perceptions and evaluations of distributional evolution—so large that even sharp improvements in supply of public services to the previously deprived black population cannot make up for it. In any event, the way our standard poverty statistics are calculated is likely to mislead in a period of major changes in the provision of public services.

### **2.1.3 Gender and Intrahousehold Inequality**

Another defining feature of standard household income/expenditure surveys is that all money metric information is collected at the household level. The usual way of converting this into individual levels of wellbeing is to divide by household size and to

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<sup>14</sup> Some of these ground level realities may be better captured in smaller scale qualitative assessments based on in depth unstructured interviews with respondents. See Kanbur and Shaffer (2007).

assign the per capita household income or consumption of the household to each individual in the household. Sometimes in analytical work an adjustment is made for household composition by using adult equivalent conversions, but it would be fair to say that this is almost never done in official poverty statistics. In any event, even if this correction were to be done, to account for differing consumption needs, the assumption is still that consumption is allocated in proportion to need, in other words, that there is no intra-household inequality in real terms.

Some of the strongest critics of official government narratives of poverty decline tend to be women's groups. One possible explanation for this disconnect is the above fact that household survey based methods do not allow for intrahousehold inequality in consumption, especially between the genders. Of course, there are many non-consumption based indicators of gender inequality, such as anthropometric measures for babies, educational and health access for children and adults, differential mortality rates, and so on. Analyses of these give a strong indication that gender inequality is present.<sup>15</sup> But our focus is on the disconnect with standard income/consumption based measure of poverty and inequality. How big might intrahousehold inequality in consumption be, and what difference can it make to measured poverty and inequality? This is a difficult question to answer, since by definition we do not have individual level consumption data from standard sources—and if we had the information as a matter of routine, we would use it and there would not be a disconnect problem to start with. In an analysis of a specially designed survey in the Philippines, Haddad and Kanbur (1990) used information on individual calorie intakes within households to calculate food

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<sup>15</sup> For an early example of this type of work, see Kynch and Sen (1983).

consumption based measures of poverty and inequality. Since they had individual level data, they could simulate the standard situation where only household level data is available and household equality is assumed. The results are striking. Ignoring intrahousehold inequality understates true inequality and poverty by as much as 30%.

Gender inequality is a deep structural phenomenon, and amenable only to equally deep structural changes over the long term. How might the fact of gender inequality within households play into the disconnect between official poverty statistics and ground level reality over the relatively short period of a decade? In particular, how might the disconnect play out in periods of rapid growth? The accounting framework in the introduction to this paper can provide one answer. There it was pointed out that if we take two distributions with different degrees of inequality, and then apply the same growth rate to each without a change in inequality in either, the poverty reduction will tend to be lower in the distribution with the greater inequality. With intrahousehold inequality the true income distribution is more unequal than the standard income distributions produced by official statistical agencies. Thus, even if there were no increase in inequality in the true distribution, the poverty reduction would be scored as being greater in the official statistics than the true income distribution would show—if only we had the data to calculate it. But since we do not have this data, we are left with a disconnect between the (more optimistic) official poverty reduction narrative and the true situation on the ground.

There is a second reason why a disconnect might appear in a rapidly transforming economy, especially one that is opening out to the outside world. Consider an economy

that is moving to one where tradable activities are earning relatively higher returns compared to the past, and non-tradable activities are earning lower returns than in the past—a standard adjustment that is a feature of global integration, one that is argued to be the basis of faster growth. Clearly, then, individuals whose incomes come from participating in tradable activities will benefit, and those whose incomes come from participating in non-tradable activities will lose. If there is full mobility among the activities, then in the long run those factors used intensively in non-tradable activities will lose out relatively. If structurally women are more restricted to non-tradable activities then their incomes from this source would decline. This would not matter if there was full income pooling within the household. If each household was a microcosm of the economy as a whole, and there was perfect income sharing within the household, then growth in the economy following greater global integration should be reflected in household incomes and in individual consumption of men and women. But there is a fair amount of evidence that there is not income pooling within the household—that, in the short run at least, consumption of men and women reflects the income they bring to the household.<sup>16</sup> Then, to the extent that women are structurally tied to non-tradable activities, the average improvement will not be reflected in their wellbeing to the same extent and will lead to the disconnect. The extent and nature of the disconnect through this channel will be context specific. In many parts of West Africa, for example, men traditionally tend the internationally traded cash crop (eg coffee or cocoa) and control the income from it, while women traditionally tend the root crops (cassava, yam) and dispose of the income from these. Furthermore, if child bearing and child rearing can be argued to

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<sup>16</sup> There is a large literature on this. Already by the mid 1990s the evidence against income pooling was strong, which led Alderman et. al. (1995) to argue that the burden of proof should shift to those who would argue that there was such pooling. Since then, the evidence has continued to mount.

be quintessentially international non-tradable—at least in rural areas of poor countries—then the structural nature of gender roles in most countries would suggest a decline in the wellbeing of women from a general policy shift that increases returns to tradable activities over non-tradable activities, if income pooling is not perfect within the household.

Of course the above explanations, for a possible disconnect between official poverty figures and the experience reality of wellbeing by women, cannot be tested directly through our household survey data—if we had the information to do so, we would have the information to identify the disconnect directly in the first place. However, the body of evidence on intrahousehold inequality gives a reasonable indication that policymakers should be aware of this as a reason why the population’s response to official poverty statistics is not the same as that of the economists or the statisticians who produce those figures.

#### **2.1.4 Poor Winners and Poor Losers**

The official poverty statistics are snapshots at different points in time. They do not follow the same individuals over time to track their fortunes. If they did, they might find considerable churning into and out of poverty between two points in time. Certainly, specialized panel surveys that do follow households and individuals over time seem to find this as a systematic phenomenon. This evidence has spawned a growing literature on

risk, vulnerability and poverty. The focus in this literature is that even around a given steady state of average outcomes, there are shocks and these affect the time path of wellbeing around a given average.<sup>17</sup>

The stylized fact that I am focusing on is not a steady state, but rather decreasing poverty with increasing inequality when there are high growth rates. However, the basic lesson from the risk and vulnerability literature, that tracking individual wellbeing matters, is perhaps relevant in understanding why declining official poverty figures do not elicit as positive a response in the population as they might be expected to. Consider a country where major structural changes are under way. These will, in general, create winners and losers, in the short run and in the long run. If the poor are all winners, or if there are some poor winners and no poor losers, poverty will of course decline. But measured poverty may also decline even if a significant number of the losers are poor, because their losses are outweighed by the gains of the other poor. The anguish of increasing poverty among some, perhaps a sizeable number, of the poor, will not be captured by the national level decline in poverty. There will be a disconnect between those who focus on these official statistics, and those whose focus is on poor losers.

The discourse on economic liberalization, globalization and distribution is often cast as a battle between rich and poor. Those in favor of liberalization argue that the old controls in any case favored the rich and powerful. Those against, point to the gains made

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<sup>17</sup> Here are some recent items from his growing literature: Grootaert, Kanbur and Oh (1997), Baulch and Hoddinott (2000), Dercon and Krishnan (2000), Jalan and Ravallion (2000), Ligon and Schecter (2003), Dercon (2004), Agüero, Carter and May (forthcoming).

by the rich during liberalization and the losses incurred by the poor. What is missing from this discourse is a recognition that the blunt instruments of economic reform often pit one group of poor against another group of poor. Thus while it may be true that on average households whose incomes come primarily from the non-tradable sector (eg government employees) have lower poverty than households in the tradable sector, so that global integration of the standard sort in favor of tradables should reduce poverty, there are nevertheless poor people in the non-tradable sector as well. These people will be negatively affected by adjustment, at least in the short run. Even if overall poverty comes down, the poverty of many, not the majority but still a significant number, will increase.<sup>18</sup>

Since national level poverty data are calculated from snapshot surveys, we cannot of course test the above logic directly. The available panel data do show a significant amount of worsening of wellbeing for significant portions of the population, which provides some weak support for the hypothesis, but the literature has not used these to identify the effects of liberalization or global integration. However, the observed increasing inequality, in the periodic surveys that underpin national poverty data, may also give an indication that the logic above may be playing out. Certainly, there is a wide variation in the rates of poverty reduction across regions within a country. In Ghana, for example, during the decade of the 1990s national poverty declined but poverty in the North remained stagnant or, for some measures, actually increased. In Mexico in the late 1980s and early 1990s, poverty declines at the national level were not reflected in the

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<sup>18</sup> The technical specifics of this, for decomposable poverty measures, were developed in Kanbur (1987b).

poor South of the country.<sup>19</sup> In other countries, poverty measures that emphasize the depth of poverty more, decreased less, indicating a problem in the depths of the income distribution as compared to close to the poverty line.<sup>20</sup> Thus rising inequality could be an indirect indicator, though not conclusive of course, of a significant number of people being made worse off even during a period of overall poverty reduction.

## **2.2 Should Rising Inequality Matter for Evaluation of Outcomes?**

### **2.2.1 The Welfare Function**

I have considered a number of reasons why the poverty numbers used to evaluate distributional outcomes might be missing key features of ground level reality. I have also argued that rising inequality might be an indirect indicator that this type of phenomenon is in play. But suppose that the poverty numbers were not missing anything—that they actually did capture the true snapshot picture of the evolution of wellbeing at the lower tail of the distribution. Then why should rising inequality matter if poverty is falling?

The answer depends of course on what sort of welfare function we have in mind. The standard Bergson-Samuelson Social Welfare Function, where the wellbeing of each individual in the snapshot counts positively, but at a diminishing rate at the margin, would justify concern with inequality. All else equal, it would be better to have a more equal distribution for a given mean. Further, if the social welfare function were

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<sup>19</sup> For a comprehensive compilation of information on increasing spatial inequality from around the world, see Kanbur and Venables (2005).

<sup>20</sup> For example, Deaton and Dreze (2003) for India and Aryeetey and Mckay (2007) for Ghana.

particularly inequality averse, it would emphasize improvement and worsening of wellbeing in the lower tail of the distribution, which is what poverty measures do. In the extreme, only poverty of the poorest would matter—it would be the centerpiece of evaluation and overall inequality would fade away as a policy relevant phenomenon. The gaps between rich and poor would not matter—only the wellbeing of the poorest would count. If this is the case then (assuming the data are not missing anything as discussed previously), the central stylized fact I have been exploring would be a cause for unalloyed celebration—policymakers should not be concerned at all about rising inequality.

But of course policymakers are concerned, and that is the motivation for much of the discourse. Why might this be? One argument is that they are indeed concerned about inequality in its own right as a normative assessment, separately from poverty. They are concerned about both. Despite the technical difficulties of giving an independent role to both poverty and inequality as a reduced form of a general social welfare function of individual wellbeings, analysts may just have to accept that this is what policy makers care about, and carry both elements in their evaluations—although the lack of a formal foundation makes it difficult to discuss the relative weighting of the two components.<sup>21</sup>

### **2.2.2 Groups and Inequality**

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<sup>21</sup> Fields (2006) refers to such a reduced form welfare function, with poverty and inequality appearing independently, as BLEND. He says (p71), “You might also try to axiomatize BLEND. I have been singularly unsuccessful in getting anywhere with it; I think this is because it is unclear to me what the primitive concept of BLEND is.”

The standard measures of inequality, like the Gini coefficient or the Theil measures, are individualistic. They calculate the inequality in the distribution of income by persons. These are the measures the rise of which is the focus of so much discussion and concern. As detailed above, for some analysts a change in such inequality is of second order importance in evaluation compared to a change in poverty in the individualistic social welfare function framework. But consider now a society divided into broadly defined groups—ethnic, racial, religious, regional, etc. A given change in overall interpersonal inequality, or even no change at all, can go hand in hand with many different patterns of change in distribution between these groups.

For certain inequality measures, overall inequality can be decomposed into a between-group component and a within-group component. The former is the inequality that would remain if all incomes in each group were equal to the mean income of that group. The latter is the inequality that would remain if all group means were equalized to the national mean. This is the empirical technique that is commonly used to gauge the quantitative contribution of group mean differences to overall inequality. For most actual exercises, with between half a dozen or a dozen groups, it turns out that the between group component is between 10 to 30 percent.<sup>22</sup>

I would like to propose that an increase in the between-group component of inequality, reflecting growing average differences between salient groupings within the country, is much more significant in a population's perceptions of inequality than an

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<sup>22</sup> See references in Kanbur (2006).

equivalent increase in the overall national measure of inequality.<sup>23</sup> And, to the extent that policy makers reflect this, their concerns are often about divisions across groups—whose evolution can be more exaggerated than the evolution of national level inequality. To take an extreme example for illustrative purposes, suppose there is an increase in the between-group component of inequality that is exactly matched by a decrease in within group inequality, leaving national inequality unchanged. It is easy to see that the stable national level of inequality may not capture key elements of rising tension in the society, which policymakers will pick up but distributional analysts and national level inequality indices will miss.

The reasoning behind the importance of group differences can be related to the recent economic literature on identity, which characterizes individual well being not only in terms of standard consumption inputs but also in terms of an exogenously given feature of individuals defining their belonging to a group.<sup>24</sup> From this it is a short step to make the average consumption of an individual's group an input into the wellbeing of that individual. A more direct way is to simply think in terms of forms of income sharing within a group that are not captured very well in our household survey data. Thus, for example, free food at the temple or the mosque, provided by rich Hindus or rich Muslims but largely consumed by poor Hindus or poor Muslims, should in principle be captured in our household survey data. To the extent it is not, we are missing the effect of group means on individual wellbeing.

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<sup>23</sup> This argument is developed in Kanbur (2006).

<sup>24</sup> Akerlof and Kranton (2000), Basu (2005)

I am not aware of any direct empirical studies to substantiate the above possible explanation of why rising inequality might be a concern over and above the simple national inequality measure. But a growing economics literature provides indirect support for the mechanisms suggested. For example, the theoretical propositions in Dasgupta and Kanbur (2007) formalize group antagonism in a model of contribution to group specific public goods; Miguel (2004) and Gugerty and Miguel (2005) examine the role of ethnic divisions in the under provision of public goods in Africa; Alesina, Baqir and Easterly (1999) argue that ethnic divisions explain the undersupply of local public goods in the U.S.

### **2.2.3 Equality of Opportunity**

If the argument about groups points towards concern for (certain types of) distributional change greater than that captured by standard national inequality measures, there is another line of argument that in fact this concern should be less. What is important normatively, it is argued, is equality of opportunity--and measured interpersonal inequality does not necessarily capture this well. Indeed, measured inequality may overstate the true degree of inequality of opportunity. Perhaps the most famous statement of a disconnect in this direction was by Milton Friedman (1962):

“Another kind of inequality arising through the operation of the market is also required, in a somewhat more subtle sense, to produce equality of treatment, or, to put it differently, to satisfy men’s tastes. It can be illustrated most simply by a lottery. Consider

a group of individuals who initially have equal endowments and who agree voluntarily to enter a lottery with very unequal prizes. The resultant inequality of income is surely required to permit the individuals in question to make the most of their initial equality...Much of the inequality of income produced by payment in accordance with the product reflects 'equalizing' difference or the satisfaction of men's tastes for uncertainty...Redistribution of income after the event is equivalent to denying them the opportunity to enter the lottery."

In the present context, and in the frame of our central stylized fact of growth with rising inequality, the argument might run as follows. Consider a scenario where, after a long period of being denied the opportunity to enter the lotteries of economic entrepreneurship and risk taking, economic liberalization opens up these opportunities. Some people take up these lotteries, others do not. Those who do will, on average, do better than those who do not. But even among those who do, there will of course be winners and losers. The economic opening up will increase the size of the pie and will introduce inequality of outcome where there was none. But there will be no inequality of opportunity.

In the extreme example given by Friedman (1962), there is no inequality that should cause concern. The inequality that is observed is the result of decisions freely taken by initially equal individuals. In reality, of course, individuals are not initially equal. If this inequality affects their decisions, then the further inequality caused by these decisions is, to some extent, influenced by the initial inequality.<sup>25</sup> But the basic argument remains— part of the increase in inequality can be attributed to decisions taken freely by

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<sup>25</sup> Sen (1980), for an early discussion of what it is that we should be concerned about the inequality of.

individuals in accordance with their tastes in response to new opportunities, and this increase in inequality should not cause normative concern.

To get at the level and evolution of inequality of opportunity, we would have to allow for the decisions made by the initially unequal people. More generally, we can separate out the factors outside the individual's control and the decisions under the individual's control, such as the effort they expend in economic activity according to their tastes. This is the line of argument developed by Roemer (1998). In particular, for example, if the distributions of income were identical within each category of individuals with identical exogenous conditions, we might describe this as equality of opportunity—differences are caused by effort or luck, not by initial exogenous circumstances. More narrowly, we might require only that the means of the distributions by type are the same for equality of opportunity. As recognized by Bourguignon, Ferrerira and Walton (2007), “[T]hese are the definitions of equal opportunities implicit in the [World Development Report, 2006].”

But Bourguignon, Ferreira and Walton (2007), who are among the principal authors of the World Bank's (2005) World Development Report 2006, find that they need to go beyond equality of opportunity to capture their value judgments since, in principle, a policy to equalize opportunity might be consistent with severe deprivation of actual outcomes for some. They handle this by keeping (a Rawlsian maxi-min version of ) opportunity in the objective function, but introducing a constraint that the actual wellbeing of any individual not be allowed to fall below a critical value:

“We find the above formulation appealing in that it makes “poverty reduction” (understood in this context as enforcing a minimum level of [wellbeing] for all, regardless of *both* circumstance *and* efforts) a necessary *requirement* for equitable policy, but not its ultimate *objective*. The ultimate objective goes beyond the elimination of absolute deprivation, and is the pursuit of ‘equal opportunities’ in the Rawls-Roemer sense.”

I am not sure that the separation the authors intend is as clean as they wish it to be, since the constraint comes from the government preferences, not from technology. If we were to take the formulation literally, then almost no recent distributional evolution could pass the constraint, since, as argued earlier, significant new poverty has been created under the aggregate umbrella of an overall improvement. If we were to get around this by allowing some increase in poverty at the individual level, then we are back to having some combination of poverty and equality. In any event, Bourguignon, Ferreira and Walton (2007) seem to have brought us full circle. We began by noting the arguments of those who would not be as concerned with rising inequality over the past 20 years, because this is an increase in inequality of outcomes brought about by new opportunities that are differentially accessed because of individual preferences—it is not an increase in inequality of opportunity. This is a move away from the focus on outcomes. But Bourguignon, Ferreira and Walton (2007), are not willing to abandon an outcomes based approach. So they reintroduce poverty, requiring, I would argue, a weighing up of poverty outcomes against the increase in inequality. Albeit in the context

of a definition of equality of opportunity, we are effectively in the BLEND scenario of Fields (2006), and all of the conceptual problems it raises.

But I want to go further. I want to argue that the idea of equality of opportunity, while persuasive and elegant in the abstract, may not have cutting power in practice. This is because of the difficulty, in my view, of separating out those factors that are under the individual's control, and those that are truly exogenous. A child's home circumstances are exogenous to the child, but are a consequence of the choices made by its parents. Those choices, in turn, were influenced by the home background of their parents. Where exactly are we going to draw the line? Where is the original position from which we start to define equality of opportunity? Put another way, parents' free choices create the circumstances for their children. Equalizing these circumstances for the children surely goes against the principle of not taking into account inequality in the outcomes of the parents' free choices? By the same token, when I see information about the life chances of babies born into different racial and ethnic caste groups, or information about differing wages for the same educational achievement across racial groups, I see these as being important because they affect the distribution of outcomes.

Finally, it is not at all clear which way moral intuition runs on bad luck from an equal starting point. The equality of opportunity view would say that this should not count in our assessment. But an equally strong intuition, I would argue, is that the one who is down must be helped precisely because he had bad luck despite all his efforts.<sup>26</sup> Thus I wish to argue that the palpable concern among populations and their policy

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<sup>26</sup> This argument is developed in Kanbur (1987a).

makers about increasing inequality of outcomes cannot be easily assuaged by equality of opportunity arguments. Opportunity is abstract. It is the translation into actual outcomes that matters.

### **3. What Can and Should be Done?**

The palpable concern among populations and policy makers over increasing inequality despite poverty reduction because of high growth, which I have tried to dissect in this paper, worries some economists and policy advisors, because they fear this will lead to measures that may hold back the rise in inequality but will reduce growth and hence poverty reduction. Two questions then arise. First, might it all blow over with the passage of time, with inequality declining after a period, and if so, why not wait? Second, if redistributive measures have to be taken, what are their growth consequences?

#### **3.1 Will it All Blow Over, And So What if It Does?**

What if increasing inequality is a phase, and will eventually begin to decline? The best known hypothesis in this regard is of course that of Kuznets (1955), which posits that as development proceeds and mean income grows, inequality first increases and then decreases. Kuznets himself supported this hypothesis with time series data for England, Germany and the United States over periods of decades. But from the 1970s onwards testing of the “Kuznets inverse-U shape” for developing countries has been conducted on cross-country data. The most famous test of the Kuznets hypothesis on cross-country data (Ahluwalia, 1976) spawned a large literature, much of which supported the hypothesis. Surveying the literature a quarter of a century ago, Fields (1980, p122) concluded: “Research studies suggest that the relationship between relative inequality and per capita GNP tends to have an inverted-U shape.”

According to the empirical literature of a quarter century ago, then, increasing inequality would be followed by decreasing inequality. Characteristically, the policy conclusions drawn from this were diametrically opposite to each other. One group (including some at the World Bank, see Chenery et. al. 1974) focused on the initial increasing inequality phase and how to make growth more equitable. A second group, however, focused on the declining phase to argue that increasing inequality was not inevitable but a phase—policy makers should continue to pursue growth and wait it out till the declining inequality set in, since to address distribution early on might jeopardize the growth itself.

However, careful data and econometric work in the 1980s and 1990s, after the initial burst of research in the 1970s, raised serious questions about the empirical basis of the Kuznets relationship in the cross country data. Using the same data set as Ahluwalia (1976), work in the 1980s by Anand and Kanbur (1993a and 1993b) argued that an inverse-U could not easily be confirmed. Then in the 1990s came a new and more comprehensive data set put together by Deininger and Squire (1996), which in turn led to an explosion of attempts to test for the Kuznets hypothesis empirically. While there are of course variations in the findings of the many papers in this literature. I think it would be fair to say that by and large the inverse-U shape has not been found in cross sectional analysis, including by Deininger and Squire (1998) themselves. The difficulties of convincingly finding such a relationship are partly related to the usual problems of cross-country econometric analysis, but to the extent that the cross section is thought to

represent the long run outcome, a summary of the current literature is that there is no long run relationship between economic growth and inequality in the data.

We have plenty of time series evidence that inequality has increased in countries with high growth rates in the past two decades. Of course, if the cross-country empirical finding of a Kuznets curve, or of no curve at all, were to be believed as the long run outcome, the prescription of holding on to the growth path despite the current increases in inequality could still have some force. But there are two important challenges to such a conclusion, one normative, the other analytical.

The normative challenge is to do with balancing the losses of today vis a vis the gains of tomorrow. Supposing there is indeed an iron law that distributional changes will in the long run reverse themselves, how long is the long run? Kuznets's original data were over several decades, and several decades may be considered too long to wait. This can be a straightforward political economy issue—asking policymakers to stick to policies that are increasing inequality may be tantamount to asking them to sign their own exit from office. But it is also an issue about the nature of the social welfare function. How are we to compare the welfare of two populations across half a century, say, with most likely a considerably different set of individuals? Sacrifices on the part of some individuals at the start of the half century could in principle be aggregated with the benefits to them if they were still alive fifty years hence, with an appropriate discount rate; their sacrifices could perhaps also be aggregated with the gains of their descendants fifty years hence, again applying a suitable discount rate; aggregating the sacrifices of

some today with the benefits to unrelated individuals tomorrow is more problematic, but could nevertheless be forced through the social welfare function.<sup>27</sup>

The key normative question then, turns on the choice of discount rate and how benefits are aggregated and compared across unrelated individuals. A high discount rate obviously justifies a greater concern about sacrifices today. At the same time, if future generations are going to be wealthier than the present generation because of exogenous trends in technology, say, then sacrificing in the present in return for future gains will appeal less the more egalitarian are the normative sentiments. Many of the disputes in the globalization, growth and distribution discourse, while seemingly about the efficacy of this or that policy instrument, are really about such tradeoffs.

The second, analytical, challenge is simply this—treating the evolution of distribution as an iron law does not make sense. While Kuznets (1955) did indeed have a specific model in mind which generated an inverse-U shape<sup>28</sup>, he recognized that much of the force behind distributional change, for example the decline in inequality in the first half of the 20<sup>th</sup> century, was to do with politics and then policy. Specific and purposive redistributive policy had played the central role in declining inequality. This view is summarized well by Piketty (2006) in his recent overview:

“...there exists a myriad of country-specific institutions (from educational and labor

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<sup>27</sup> The problem becomes particularly acute when there are deaths because of increasing poverty, and these deaths serve to reduce measured poverty by taking the poor out of the count. See Kanbur and Mukherjee (forthcoming).

<sup>28</sup> see Anand and Kanbur, 1993a, for a formalization of this “Kuznets Process”

market institutions to corporate governance and social norms) that play a key role to shape the interplay between development and inequality. Rising dispersion of income is not the mechanical and largely unavoidable consequence of technical change. Nor is the trend going to reverse in a spontaneous fashion. Inequality dynamics depend primarily on the policies and institutions adopted by governments and societies as a whole.”

### **3.2 Are Growth Enhancing Policies Bad for Equality?**

So we come then to the central policy questions. Will measures to stem the rise in inequality that has accompanied high rates of economic growth invariably be detrimental to economic growth? Will rising inequality by itself act as an impediment to economic growth? What, if any, are the policies and interventions that help growth without harming equality, and help equality without harming growth? For practical policy making, all of these questions should be seen as being asked over a relevant policy horizon of at most a generation, more likely a decade, perhaps even less. Beyond this horizon, the predictive value of analysis based on previous history can be questioned, and the interest of current policy makers may wane.

The following representation of the questions might be helpful. Think of an instrument panel on which there are a number of buttons, each representing a particular type of policy or intervention—monetary policy, exchange rate policy, trade policy, tax policy, government expenditures of different types, laws and regulations, etc. The

instrument panel works in conjunction with a box representing the economy to produce various outcomes—in particular the distribution of wellbeing for individuals in society. The model of the economy in the box has features that describe structural aspects of the economy and society, including social norms that govern behavior, the factor endowments, infrastructure, etc. Some of these features can be changed over the relevant time horizon, others change so slowly that they can be taken as given for the present discussion. With this set up, we can ask, instrument by instrument, whether its application will lead to a trade off between growth and equity over the relevant time horizon, or not. After this we can ask whether there are packages of instruments such that the trade off is avoided.

The classic policy instrument debated and discussed has of course been global integration in trade, and I will focus on this for concreteness and illustration. There is now a substantial literature on the impact of such “openness” on growth and on distribution. A key technical question has been how to measure openness, since trade flow based measures suffer from being endogenous. Using genuine policy variables like tariffs weakens the results considerably. On trade liberalization, the recent study by Harrison (2006) concludes as follows (pp 38-40):

“The evidence suggests that there is no significant relationship between globalization (measured using average import tariffs) and poverty. Poverty is measured as the percentage of households in a country living on less than a \$1 a day, measured in 1993 PPP dollars. ...One strong possibility, which is clearly revealed in the country case

studies that make use of micro data using households or firms, is that there is too much heterogeneity in the effects of trade reforms on the poor...The lack of any robust positive association between trade and poverty reduction could indicate that the growth gains from trade have failed to trickle down to the poor because they simply do not participate in the benefits. This interpretation of results is consistent with the fact that a number of studies find that globalization is associated with increasing inequality.”

Goldberg and Pavcnik (2004) find that trade liberalization has a negative effect on unskilled workers in the short and medium run since (p40) “[T]he most heavily protected sectors in many developing countries tend to be sectors that employ a high proportion of unskilled workers earning low wages.” Of course the topic of openness and distribution is controversial, and results counter to these have also been propounded. Perhaps the best known of these recently are those by Dollar and Kraay (2001), who argue that since openness leads to growth, and since growth does not lead to much distributional change, openness benefits the poor.<sup>29</sup> A critique of the Dollar-Kraay paper is in turn provided by Rodrik (2000).

Where do I come down in on the question of trade, growth and distribution?

While there are technical problems with measuring openness using trade flows, it does seem clear to me that there are strong growth benefits to be had from integrating into the global economy, but that these come at a short run cost of worsening distribution—either in the sense that inequality increases, or in the sense that a significant number of people are made worse off even if an equivalent or greater number are made better off, or both. I

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<sup>29</sup> For an earlier analysis of openness and distribution, see Bourguignon and Morrison (1990).

find myself not too far from the middle ground proposed by in the review by Winters (2000, p 53)):

“Open economies fare better in aggregate than do closed ones, and there is no evidence that, overall, they experience worse poverty than closed ones...On the other hand, it is absurd to pretend that liberalization never pushes anyone into poverty, nor even that liberalization cannot increase the extent or depth of poverty in some circumstances. Thus in contemplating and managing a liberalization care is required to minimize adverse poverty impacts (care that has not always been taken in the past), and, wherever possible, to tailoring the program to play a positive role in poverty alleviation.”

Thus Winters (2000), as well as Harrison (2006) seem to be advocating a *package* of policy measures to make the most of the benefits of trade liberalization while addressing the negative distributional consequences. What might these measures be? A key choice is between what Winters (2000) calls specific compensatory policies and general compensatory policies. The difficulty with specific compensatory policies is that they are difficult and costly to design and tailor to each circumstance—by trade reform and by sub-sector, for example. General compensatory policies avoid this problem. To quote Winters (2000, p 44):

“These policies – often referred to as safety nets – are designed to alleviate poverty from any source directly. They replace the problem of identifying the shock with one of identifying the poor. Ideally, countries should already have such programmes in

place. Indeed, a major part of their effect arises from their mere existence rather than their use: they facilitate adjustment by assuring the poor that there is a minimum (albeit barely acceptable) below which they will not be allowed to fall. If trade-adjusting countries do already have these schemes, they have the advantages over tailor-made schemes of automaticity, immediacy and a degree of ‘road-testing’, and they also avoid the problems of targeted trade adjustment assistance. Sensibly constructed, they need not entail huge expenditure; there is rather little chance of moral hazard problems if the thresholds are set low enough; and, since relieving poverty is more or less universally recognised as a responsibility of the state, there is little argument about the legitimacy of such interventions.”

Example of such general compensatory schemes include various public works schemes, such as the famous Employment Guarantee Scheme of Maharashtra in India (Ravallion, 1991), which has now been strengthened and introduced as a national level scheme by the government elected in 2004 on a platform to address the distributional consequences of the India’s high growth trajectory (Basu, Chau and Kanbur, 2007). Although some may disagree with this classification, the recent crop of Conditional Cash Transfer Schemes, such as Oportunidades-Progreso in Mexico (Levy, 2006), can also be put into the general compensatory schemes category—albeit that through their conditionalities they attempt to achieve other objectives as well, including keeping children in school or increasing visits to health centers by pregnant women.

There are, of course a large number of questions about such general compensatory programs or safety nets. Issues arise of targeting, implementation and monitoring (see, for example, Besley and Kanbur, 1988; Ravallion, 1991; Coady, Grosh and Hoddinott, 2004). However, the evaluation of these schemes has always been on their own terms—whether they target the poor, whether they make efficient use of resources, etc. What the argument above suggests is that such schemes have a value over and above the direct value of poverty alleviation from a given starting point. Importantly, they also assist in mitigating the negative distributional consequences of broad based economic reform which, alongside the average growth benefits, do tend to create winners and losers given the great heterogeneity of the population, especially the poor. Apart from this direct impact on the social welfare function, they can also ease the political economy of economic reform and liberalization (in general, not just trade liberalization) by reducing the incentives of the losers to band together and resist the reforms (Kanbur, 2005).<sup>30</sup>

### **3.3 Are Equality Enhancing Policies Good for Growth?**

This brings us then to the debate on the causal link from equity to growth. In the above discussion, we started off from the empirical observation that in the last decade or two, greater openness to trade has led to more growth, but also to more inequality. If inequality is a concern, policy makers may be moved to address it. Clearly, addressing it by reversing the trade openness sacrifices the growth—hence the compensation argument. If the compensation could be given in a way so as to not jeopardize growth, at least not

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<sup>30</sup> Rodrik (1999) has put forward the argument that since efficient adjustment to shocks almost invariably involves distributional consequences, those societies that resolve these distributional issues, or at least minimize them will be better placed to make efficient adjustments and hence to grow faster.

too much, then the policy package of openness plus compensation could be recommended. Some worry that compensation schemes may lead to excessive fiscal exposure, lead to corruption, and have adverse incentive effects on effort, thereby lowering growth rates. But without compensation schemes, the only advice on offer to policy makers is to wait out the increasing inequality, and the poverty increase of which it might be an indicator. This is not very helpful, and in any event the backlash from the population may force a closing down of trade. This is one sense in which equality enhancing policies, like general compensation mechanisms or safety nets, could help the growth process itself.

There are other theoretical arguments as to why equality per se could enhance growth, and these counter the classical argument that because of the shape of the savings function, the saving rate is higher with a more unequal distribution of income.<sup>31</sup> There is no shortage of theoretical models to counter the classical argument. They all rely on some form of market failure, which interacts with an unequal distribution of income, to produce a break on growth. Thus, for example, if a threshold level of investment is required for human capital investment, if credit market failures mean that the amount that can be invested is determined by own wealth, then those with low wealth will not invest in their own human capital. If human capital investment by the wealthy is diminishing at the margin, a redistribution of wealth will increase overall investment in human capital and, where this mechanism is tacked on to an endogenous growth model, the steady state growth rate as well. There are many other types of mechanism, including political

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<sup>31</sup> The classical savings assumption that capitalists save their incomes but workers do not is what drives growth in the famous Lewis (1954) model. Surplus labor holds wages down, while investment creates ever more profits to be invested.

economy ones such as that in Alesina and Rodrik (1994) where, in a voting model, more inequality induces more inefficient policies (specifically, a higher level of a distortionary tax) to be chosen.<sup>32</sup>

The real difficulties lie not so much in developing models that demonstrate a causal connection between equality and growth, but in actually showing this causal connection empirically. Certainly this has not proved easy in the cross section data, as might be expected from the Kuznets curve literature. A recent review by Birdsall and Szekely (2003, p 6) concludes as follows:

“ Empirical evidence from cross-country studies supports the general proposition for the case of developing countries that those with high levels of income inequality have experienced lower levels of growth. Best known but problematic are the early studies of Persson and Tabellini (1994) and Alesina and Rodrik (1994). These relied on cross-sectional estimates without controlling for fixed effects...More recent studies including developed as well as developing countries and controlling for fixed effects tend to come to the opposite conclusion (Forbes, 2000). But Barro (2000) shows that...[i]n developing but not developed countries, inequality does seem to reduce growth.”

Much as I am convinced by the theoretical models, I am not sure that I would endorse Birdsall and Szekely's opening sentence so far as the “cross-country regressions” literature on income inequality and is concerned. All the well known problems of drawing inferences from cross-country regressions will continue to bedevil these

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<sup>32</sup> For reviews, see Aghion et. al, (1999), and Kanbur and Lustig (1999).

analyses. In an added twist, Banerjee and Duflo (2003) argue that in their analysis of the cross-country data “[c]hanges in inequality (in any direction) are associated with reduced growth in the next period.”

But perhaps the most striking argument against any systematic relationship between inequality at the national level and growth at the national level is the very same stylized fact that motivates this paper. We now have a significant number of countries that have experience increasing inequality over the past decade or two, but this does not seem to have negatively influenced their growth performance. Of course the counterfactual is important—had they not had the increase in inequality, perhaps their growth might have been higher. Establishing such counterfactuals is difficult, but for 20 years now China has had ever increasing inequality with spectacular growth rates, the same is true for a decade or more for India, Bangladesh, Vietnam, Ghana, etc. This might also indicate that any simple relationship between overall inequality and growth may be difficult to establish. Further, Voitchovsky (2005) argues that the effects are different at either end of the distribution, with inequality at the top end positively associated with growth, and inequality at the bottom end negatively associated with growth.

The evidence is perhaps somewhat stronger when we move from inequality defined as income inequality to inequality defined in broader terms—inequality in physical and human capital, or gender inequality. For example, Birdsall and Londono (1997) argue this for Latin America for land and education, while Klasen (1999) argues this for gender inequality. Klasen concludes (p1):

“Point estimates suggest that between 0.4-0.9 % of the differences in growth rates between East Asia and Sub Saharan Africa, South Asia, and the Middle East can be accounted for by the larger gender gaps in education prevailing in the latter regions.”

Again in a broader sense, group inequalities have been argued to hold back growth. The empirical evidence for ethnic and other forms of fractionalization and growth has been presented in the literature, including by Easterly and Levine (1997) and by Collier (2001), but questioned by Arcand (2000) and Temple (1998). Temple asks and answers his questions as follows: “Should the origins of slow growth be traced to Africa's social arrangements, high inequality, and ethnic diversity? Based on cross-country empirical work, this paper argues that the best answers are yes, no, and maybe.”

Overall, then, the macroeconomic evidence for a causal connection between equity and equity and growth is not particularly strong. Almost a decade ago, Kanbur and Lustig (1999) concluded their review by saying that “the jury is still out.” Here is how the best known recent overview, by the World Bank (2005) in their World Development Report 2006, summarizes the current state of play (p 103):

“Most studies that look at the cross-sectional relationship between inequality and subsequent growth over a relatively long period in cross-country data, and especially those that use measures of asset inequality, find a negative relationship, often significant. By contrast, most studies that look at the relationship between changes in inequality and

growth, including several studies that do analysis at the sub-national level within the same country, find a positive effect....Most important among the many reasons for both cross-sectional and the time series evidence to be misleading are the following: the possibility of a non-linear relationship between inequality and growth, problems with comparability of cross-country data, and the difficulty of identifying the direction of causality when both variables are likely to influence one another...Despite great attention devoted to the question of a systematic relationship between overall inequality and growth at the country level, the body of evidence remains unconvincing. But there is clearly a strong presumption that reducing a specific inequality would promote better investment.’

What are left with, at the end? Managing the distributional consequences of economic reform, as discussed in the previous section, has a strong imperative on ethical and political economy grounds. Proactive addressing of inequality has an ethical imperative, since the same growth rate applied to a more equal distribution will lead to greater poverty reduction, and further if inequality is a factor in the social welfare function over and above poverty. However, the argument for inequity being a drag on growth cannot be made in general with confidence. The theoretical and empirical arguments are stronger for specific forms of inequality—inequality of assets such as human capital, and inequality between salient socio-economic groups such as those defined by gender or ethnicity.

#### **4. Conclusion: Where to Focus Future Analysis to Best Help Policy Makers**

This paper provides an overview of globalization, growth and distribution motivated by the stylized fact that in most countries where there has been high growth, there has been rising inequality, but the growth has been fast enough to reduce poverty in the official statistics. However, despite the reduction in poverty, strong distributional concerns persist in the population at large and among policymakers. Some economist and policy analysts dismiss these concerns as irrelevant or overstated. But they frame the discourse on globalization, and this paper in turn frames a series of questions motivated by the stylized fact and the concerns it raises. First, the paper asks why rising inequality should be a concern if poverty is falling. One possible answer is that the official poverty statistics are missing key feature of ground level reality, which are captured, albeit indirectly and imperfectly, in the rising inequality. Another answer is that rising inequality is a matter of normative concern over and above falling poverty. Secondly, the paper asks: if the concern is accepted, what can and should be done? It argues that waiting for the rise in inequality to blow over is not an option ethically or in terms of political economy. Economic reform and global integration creates winners and losers, and addressing the losers' concerns is an ethical as well as a political economy imperative. Generalized compensation mechanisms embodied in safety nets, suitably designed, seem the best option for addressing these concerns. Finally, while the evidence is weak on a causal link from overall income inequality to growth, there is some evidence that addressing specific forms of inequality—in assets, between genders and between ethnicities and other salient groups—can lay the foundations for higher growth.

Based on the above, where might further analysis most fruitfully focus to help policy makers address the concerns raised by rising inequality in a high growth environment? Fairly clearly, the marginal social value of yet another cross-country regression between inequality and growth is by now pretty low. Rather, I would suggest three areas of focus: (i) improvement of official statistics to reduce the disconnect between them and the ground level realities of distributional evolution, (ii) analysis and exploration of a range of compensation mechanisms for addressing the distributional consequences of economic reform, technical change, and global integration, and (iii) how to address the specific structural inequalities that constrain growth and development.

I have discussed a number of possible explanations for the disconnect between official poverty statistics and perceived ground level realities. The evidence for these channels of disconnect is mostly indirect, or even anecdotal, since by their very nature the official statistics cannot be further organized to reduce the disconnect. For example, it is difficult to see how within the current framework the standard large national level household income and expenditure surveys could be easily modified to explore individual level consumption. It could be done in principle, but it would be prohibitively expensive. But smaller scale specialized surveys could be launched, like the one analyzed in Haddad and Kanbur (1990), the results of which could be used to provide policy makers with at least an estimate of the impact on official statistics of ignoring intrahousehold inequality in consumption. The same is true for public services. Specialized surveys and analyses that attempt to bring the consumption of publicly provided services into the same frame

as money metric measures of wellbeing could again give policy makers an adjustment to the official statistics on poverty taking into account the evolution of these non-market sources of consumption. Panel data could help to keep track of the patterns of winners and losers as the distribution evolves, helping policy makers and analysts to resolve whether the aggregate poverty reduction (if that is the trend) shown in official statistics hides a significant number of poor people (and even some just above the poverty line) being made worse off. Panel data have become much more prevalent in developing countries in the last two decades, but we are some way from their institutionalization as a standard a part of the monitoring mechanisms of government.<sup>33</sup> Finally, and this does not necessarily need new data, analysts and policy makers should pay much greater attention to the evolution of mean differences between salient socio-economic groups as opposed to a measure of overall income inequality at the national level.

If the concern about poor losers from economic reform, technical change and global integration is strong enough to need addressing, and I would argue that it is, then compensation mechanisms need to be considered. I have argued that this perspective brings us to look at generalized compensation schemes of different types—public works schemes, food subsidies, conditional cash transfers, etc—in a new light, not just as redistributive mechanism in their own right, but also as mechanisms that address the wellbeing of losers from policy changes at the macro level. There is already a large literature on the evaluation and design of these types of interventions as income transfer mechanisms—the efficacy of their targeting, their administrative and fiscal costs, and

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<sup>33</sup> For all of these, economist' standard fixed response survey methods can be complemented by the qualitative methods of other disciplines—indeed, some of the disconnect has been highlighted by such methods as “participatory poverty appraisal.” See, for example, Kanbur and Shaffer (2007).

their incentive effects—are analyzed. However, what might help policymakers is to analyze the operation of these mechanisms in the context of broad economic policy changes, such as greater global integration—how successful are they in compensating the losers from such reforms? This will require, among other things, the collection of more detailed information about participants in these schemes, and to examine these schemes in detail over time. Finally, policy makers would be helped by an assessment not just of each scheme separately, but whether the schemes as a whole are working to compensate the losers from efficient policy changes, thereby addressing political economy as well as ethical concerns.

Finally, while in my view the inequality-growth cross-country regressions literature has hit a plateau, investigation of the return to specific interventions to reduce inequality in assets and across groups will continue to have a high pay off. This takes us, whether it is land inequality, gender inequality, caste inequality, or ethnic inequality, into a deeply structural and often cultural domain, where economic analysis and economic interventions can play only a partial role, and the analysis and the prescriptions will have to be highly context specific. But if reducing such inequalities can increase the poverty reducing impact of a given growth rate, and perhaps even increase that growth rate, then it is a strategy worth pursuing.

Thus the nexus of high growth with falling poverty but rising inequality not only frames the questions for current debate, but it also frames the future research and policy analysis agenda.

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