Equality and poverty reduction

Which is the best way of reducing poverty: more growth, more equality – or a bit of both?

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In the late 1990s, the bilateral and multilateral development agencies came to place increasing emphasis on poverty reduction in developing countries. As a consequence, financial support to low-income developing countries by the international financial institutions is now provided under the aegis of Poverty Reduction Strategies,[2] while the first of the Millennium Development Goals requires a halving, between 1990 and 2015, of the number of people living in extreme poverty.

Achieving targets requires policies, and policies are most effective within an overall, coherent strategy. A central strategy choice is between poverty reduction through faster economic growth and reduction through redistribution, though the two may be complementary. Here, we discuss which strategies would be the most effective for different groups of countries, given specific poverty targets, and the initial country conditions.

Growth and distribution

Of the many issues central to the development process, few have been characterized by the shifts, reversals and re-affirmations that have plagued the analysis of the interaction of growth, poverty and inequality. Evidence that inequality and poverty increased in many countries in the 1980s and 1990s, including some of the OECD countries, rekindled ever-smouldering controversies.[3]

From the 1950s to the 1970s, analytical emphasis was on probable trade-offs between growth and income distribution. This derived in part from the famous "inverted-U hypothesis" which postulated that inequality would rise in the initial phases of development, then decline after some crucial level was reached.[4] Growth theories could be cited in support of the hypothesis, such as the Lewis model of "economic development with unlimited supplies of labour".[5]

Kaldor's growth model, in which capitalists have a higher marginal propensity to save than workers, also implies that redistribution to profits raises the growth rate. This model is most appropriate for developed countries, in which the functional distribution of income largely consists of wages and profits, and of less relevance to developing countries, considered here.[6]

The Chenery and Ahluwalia model[7] of "distribution with growth", which came into fashion in the mid-1970s, distinguished social groups by asset ownership or mode of access to assets. The interaction between growth and distribution was modelled through "income linkages" between the groups – i.e. via the labour and commodity markets. In simulation experiments with this model, progressive redistribution of income and assets led to substantial improvements in the incomes of poverty households, and non-poverty households as well, via increases in aggregate productivity. As a consequence, in the 1970s emphasis shifted to the identification of redistributive mechanisms to reduce poverty without hampering growth.

This focus proved to be short-lived. It was abandoned with the rise of neo-liberalism and the Washington Consensus in the late 1980s. In the Washington Consensus approach,[8] growth itself is the vehicle for poverty reduction, achieved through "trickle-down" mechanisms not always clearly specified. The perceived ineffectiveness of redistributive measures under the Washington Consensus also led some to advocate targeting public expenditure to the poor, and to judge effectiveness by the accuracy of that targeting.

However, targeting of expenditures in developing countries is fraught with difficulty. Amartya Sen[9] argued against targeting public spending for several reasons:

- Information asymmetries reduce the effectiveness of targeting in the presence of "cheating".
- The prospect of losing targeted subsidies may reduce beneficiaries' economic activities.
- Targeting may negatively affect the self-respect of the poor.
- The sustainability of targeted programmes is doubtful, as the potential beneficiaries are politically weak.

To the list can be added the formidable measurement problem of identifying who qualifies – a serious issue in industrialized countries, and virtually intractable in most developing countries. Targeting public spending is more likely to be effective if the poor are a small proportion of the population – i.e. if poverty is not a major problem. For countries in which poverty is widespread, the administrative cost, identification, monitoring and delivery of programmes may outweigh benefits. This is particularly the case if a country is experiencing, or has recently experienced, conflict.

In the 1990s, both the neo-liberal analysis and the earlier view of a trade-off between growth and equity were challenged by a number of studies.[10] In particular, doubt was cast upon the sanguine view that orthodox macro policies were, by their nature, poverty-reducing. Much of the work on the relationship between growth and income distribution in the 1990s is basically empirical. It concluded that during recessions inequality rises, and that on average positive growth rates are distribution-neutral while lower initial inequality raises the likelihood that growth will reduce poverty.[11]

A recent strand of theoretical discussion involves so-called political economy arguments against inequality and, by implication, poverty.[12] This analysis predicts a negative relationship between income inequality and growth on the grounds that higher initial inequality would:

- lead to increased public expenditure, because it prompts a demand for redistributive policies
- incite political instability that undermines growth.

This excursion into political science is somewhat dubious.[13] For example, it is not at all clear how a society with the power relationships to generate inequality would, at the same time, produce an underclass with the political power to force redistributive policies upon a government.

On somewhat firmer analytical ground, it is also argued that inequality has a negative impact on growth through imperfect capital markets, to which the poor have limited access.[14] In other words, if capital markets discriminate against the poor, potentially profitable activities by the poor are constrained by lack of credit. However, the imperfect capital markets argument has practical limits, in that it assumes the poor to be self-employed, or to have the option to become so. While this may be applied to a portion of the households in poverty, empirical evidence suggests that, during the 1990s, those in the lowest income quintile in Latin America, at least, and perhaps elsewhere, were increasingly in waged employment. The idea that most low-income wage earners could escape poverty through self-employment is something of a challenge to the imagination, as well as to historical trends.

Overall, the literature of the 1990s was relatively limited in its theoretical contribution, and most striking in that it demonstrated, yet again, the ambivalence of economists towards the issues of inequality and poverty. On the one hand, the mainstream literature, with its emphasis on the efficiency of markets, had a predilection for viewing inequality and poverty as accidental or occasional outcomes of a deregulated growth process. On the other hand, the persistence and severity of poverty in many, if not most, developing countries brought forth periodic arguments for their alleviation. The shifts in emphasis in the literature reflect the difficulty of reconciling these two.

However, there seems to be a growing consensus that countries with an "initial condition" of relatively egalitarian distribution of assets and income tend to grow faster than countries with high initial inequality. This is an extremely important conclusion, because it means that reducing inequality strikes a double blow against poverty. On the one hand, a growth path characterized by greater equality at the margin directly benefits the poor in the short run. On the other hand, the resulting decrease in inequality creates in each period an "initial condition" for the future that is growth-enhancing. Thus, any growth path that reduces inequality reduces poverty through redistribution and via "trickle down".

Policies for redistribution with growth

The major element required to introduce and effectively implement a redistributive strategy in any country is the construction of a broad political coalition for poverty reduction. The task of this coalition would be the formidable one of pressuring governments for redistribution policies, on the one hand, while neutralizing opposition to those policies from groups whose self-interest rests with the status quo. How such a political coalition might come about is beyond the scope of the present article. We focus on a less fundamental, but crucially practical issue: the policies that could bring about a redistribution strategy. To be policy-relevant, our consideration of redistribution mechanisms must move beyond a listing of possibilities to an analysis of the likely effectiveness of these.

Perhaps the most important determinant of the effectiveness of the various measures and specifics of each redistribution strategy is the structure of an economy. This structure will depend on the level of development, which will to a great extent condition the country's production mix, the endowments of socio-economic groups, the remuneration to factors, direct and indirect taxes on income and assets, prices paid for goods and services, and transfer payments. These elements of the distribution system are initial conditions that delineate the scope for redistributive policies. In this analytical context, the implementation requirements of redistributive policies can be summarized in a simple theoretical framework (see next page).

The effectiveness of tax and expenditure policies (V and T) in generating secondary and tertiary distributions more equitable than the primary distribution depends upon the relative importance of the formal sector. This is for the obvious reason that governments can most effectively apply progressive income taxes to wage employees and corporations. All empirical evidence shows that the formal sector wage bill and profit shares increase with the level of development. Along with the importance of the formal sector goes a high degree of urbanization, and working-poor urban households are more easily targeted than either the rural poor or urban informal sector households. The experience of a number of middle-income countries has demonstrated the effectiveness of basic income payments for poverty reduction, an example being the basic pension paid to the elderly in South Africa.

Define the following terms: Y denotes the income of a household, V is transfer payments, T is taxes, k is a set of assets (including human capital), w is a set of rates of return (including wages), p is the price set of goods and services, q is the quantity of those goods and services, and S is household saving.

Then, by definition, it follows that:

Y = (V – T)	+ wk	= pq	+ S
Transfer payments (unemployment compensation, pensions, child benefits, aid to disabled) and progressive taxes (on income and wealth)	Minimum wages, low-wage subsidies, other labour market regulations, public employment schemes (w); credit programmes for the poor, land reform, education (k)	Subsidies for basic needs goods, public sector infrastructure investment (p); child nutrition programmes (q)	Facilitate future asset acquisition: 'village banks' and other financial services for the poor
Effective in middle-income countries	Effective in middle-income and some low-income countries	Effective in most countries	Effective in most countries

A tax- and expenditure-based redistribution strategy is most appropriate for middle-income countries, because their per capita incomes are high relative to the absolute poverty line. These are also the countries whose economic structures make taxation and expenditure instruments effective for redistribution. Such countries would include the larger ones in Latin America (Argentina, Brazil, Chile, Mexico and Venezuela), several Asian countries (the Republic of Korea, Malaysia and Thailand), and virtually all former socialist countries of Central and Eastern Europe.

To a certain extent, specific economic structures allow for effective use of taxation for redistribution in a few low-income countries, although this would typically be relevant only for middle-income countries. If the economy of a low-income country is dominated by petroleum or mineral production, then a large portion of national income may be generated by modern sector corporations. This allows for effective taxation even though the administrative capacity of the public sector may be limited. The tax revenue can be redistributed through poverty reduction programmes, though not through transfer payments if the labour force is predominantly rural. Examples of mineral-rich low-income countries with the potential – albeit unrealized – to do this are Liberia, Nigeria and Zambia.

Interventions to change the distribution of earned income (wk in the equation above), which alter market outcomes, will also tend to be more effective in middle-income countries. The most common intervention is a minimum wage, though there are many other policies to improve earnings from work. Further mechanisms include public employment schemes and tax subsidies to enterprises to hire low-wage labour. Some of these would be effective in low-income countries (employment schemes), but others might be still less effective because of enforcement problems (minimum wage), targeting difficulties and the narrowness of impact (wage subsidies).

Land reform might achieve poverty reduction for rural households, but the relationship between land redistribution and the level of development is a complex one. On the one hand, low-income countries are predominantly rural, so if land ownership is concentrated, its redistribution could have a substantial impact on poverty. Furthermore, the more underdeveloped a country, the less commercialized tend to be its poor rural households. Therefore, the benefits to the poor from land redistribution in low-income countries are less likely to be contingent on support services. On the other hand, lack of administrative capacity and so-called traditional tenure systems represent substantial constraints on land redistribution in many low-income countries, and especially in the sub-Saharan countries.

The usual approach to land redistribution presupposes private ownership, such that it is clear from whom the land will be taken and to whom it will be given. There are few sub-Saharan countries in which private ownership is widespread, making redistribution difficult or impossible without prior clarification of ownership claims. While land redistribution is probably not an effective poverty-reducing measure for most low-income countries, a few notable exceptions in Asia (e.g. India and Vietnam) suggest that it should not be ruled out in all cases.

For middle-income countries, experience in Latin America has shown that governments can effectively implement land redistribution. However, the high degree of commercialization of agriculture in middle-income countries requires that redistribution be complemented by a range of rural support services, including agricultural extension, marketing facilities and other measures. Perhaps more serious, the relevance of land reform for poverty reduction tends to decline as countries develop and the rural population shrinks relatively and absolutely. For example, at the end of the twentieth century in the five most populous Latin American countries, 20 per cent or less of the labour force was in agriculture. Minimum wages may be more relevant than land redistribution in reducing poverty among the landless and near-landless in such countries.

Interventions that directly affect the prices and access to goods and services (pq) could potentially be quite powerful instruments for poverty reduction. Subsidies to selected commodities have the administrative advantage of not requiring targeting, only identification of those items that carry a large weight in the expenditure of the poor. While multilateral adjustment programmes typically require an end to such subsidies on grounds of allocative efficiency or excessive budgetary cost, the rules of the World Trade Organization do not – as long as subsidies do not discriminate between domestic production and imports. Whether subsidies would generate excessive fiscal strain would depend on the products covered and financing. Again, the level of development of a country is of central importance for the effectiveness of subsidies. In low-income countries, with the majority of the poor in the countryside, consumer subsidies are unlikely to have a significant impact on the poor outside urban areas. Basic goods provision in kind can be an effective instrument for poverty reduction even in very low-income countries, by delivering such items as milk to schoolchildren. To do so with a non-targeted programme would require a progressive tax system. This would be more likely in a middle-income country.

In all countries, the poor suffer from poor health and inadequate education in comparison with the non-poor. Expenditures on education and health have the practical advantage that programmes that would help the poor are easily identified, though the specifics would vary by country. However, providing these services to the poor may, in some countries, be as politically difficult as more obviously controversial measures such as asset redistribution. The same point applies to infrastructure programmes directed to poverty reduction. To the extent that these would reduce public investment in projects favoured by the non-poor, especially the wealthy, they may be no easier to implement than measures that appear superficially to be more radical.

New agenda

Poverty reduction has always been a priority of development policy, albeit sometimes only at the rhetorical level. The end of the 1990s saw an increased emphasis on bringing the benefits of growth to the poor. However, growth policies alone are a rather blunt instrument for poverty reduction, since the consensus of empirical work suggests that it is distribution-neutral at best. Along with an emphasis on poverty reduction, a shift occurred in the policy literature towards a more favourable view of policies to redistribution income and assets. An integration of distributional concerns and a priority on poverty reduction could be the basis for a new policy agenda to foster both growth and equity.

This new agenda would be based on three analytical generalizations:

- that greater distributional equality provides a favourable "initial condition" for rapid and sustainable growth
- that redistribution of current income and assets, or redistribution of an economy's growth increment, is the most effective form of poverty reduction for most countries
- that the mechanisms to achieve the redistributions are as feasible as other policies for most countries.

The last of these points perhaps deserves greater elaboration. As we have shown, implementing an agenda of redistribution is often a major challenge and can pose problems, but these should not be exaggerated. In many countries, they may prove no more intractable than the problems associated with the implementation of other economic policies. An effective orthodox monetary policy is difficult to implement if a country is too small or underdeveloped to have a bond market. For example, the absence of a bond market leaves the monetary authorities unable to "sterilize" foreign exchange flows. Similarly, replacing tariffs by a value added tax would be a daunting task in a country whose commerce was primarily through small traders. Lack of public sector capacity would limit the ability to execute a range of so-called supply side policies: privatization, "transparency" mechanisms and decentralization of central government service delivery.

The multilateral agencies have recognized these constraints on adjustment programmes, and have typically made the decision that constrained implementation is preferable to non-implementation.

The same argument can be made for a redistributive growth strategy: to achieve poverty reduction, it might be preferable to implement redistributive growth imperfectly, rather than to implement the status quo imperfectly!

Notes

[1] This article is a highly abbreviated and reworked version of a longer text: Dagdevieren, H.; van der Hoeven, R.; Weeks, J. 2004. "Redistribution Does Matter: Growth and Redistribution for Poverty Reduction", in Shorrocks, T. and van der Hoeven, R. (eds.): *Growth, Inequality and Poverty – Prospects for Pro-poor Economic Development.* Oxford, Oxford University Press.

[2] IMF and World Bank. 1999. *Poverty Reduction Strategy Papers: Operational Issues,* Washington, DC, World Bank.

[3] Cornia, G. A. 1999. *Liberalization, Globalization and Income Distribution,* WIDER Working Paper Series, No. 157, March; and van der Hoeven, R. 2002. "Poverty and Structural Adjustment. Some Remarks on the Trade-off between Equity and Growth", in P. Mosley and A. Booth (eds.): *New Poverty Strategies, What have they achieved, What have we learned?* London, Macmillan.

[4] Kuznets, S. 1955. "Economic Growth and Income Inequality", in *American Economic Review,* No. 45, pp. 1-28.

[5] Lewis, W. A. 1954. *Economic Development with Unlimited Supplies of Labour,* Manchester School of Economics and Social Studies, No. 22, pp. 139-181.

[6] See for a discussion: Aghion, P.; Caroli, E.; Garcia-Penalosa, C. 1999. "Inequality and Economic Growth: The Perspective of the New Growth Theories", in *Journal of Economic Literature,* Vol. XXXVII, December, pp. 1615-1660.

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[8] See van der Hoeven, R.; Saget, C. 2004. "Labour Markets and Income Inequality: what are the new insights after the Washington Consensus?", in A. Cornia (ed.): *Inequality, growth and poverty in an era of liberalization and globalization,* Oxford, Oxford University Press.

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[12] Alesina, A; Rodrik, D. 1994. "Distributive Politics and Economic Growth", in *Quarterly Journal of Economics*, Vol. 109, No. 2, pp. 465-490.

[13] Cramer, Chris. 2000. "Inequality, Development and Economic Correctness", in *The Cambridge Journal of Economics.*

[14] Aghion, P.; Caroli, E.; Garcia-Penalosa, C., op. cit.