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Dismantling the Myth of the Growth–Inequality Trade-Off

Summary

Conventional economic wisdom has long maintained that there is a necessary trade-off between pursuit of the efficiency of a system and any attempts to improve equity between participants within that system. Economist Robert Lucas demonstrated the implications of this common economic axiom when he wrote: "Of the tendencies that are harmful to sound economics, the most seductive, and in my opinion the most poisonous, is to focus on questions of distribution [...] the potential for improving the lives of poor people by finding different ways of distributing current production is nothing compared to the apparently limitless potential of increasing production." (Lucas, 2004)

Indeed, many economists have suggested that too little inequality or too generous a distribution of benefits may undermine the individual's incentive to work hard and take risks. Setting aside the harsh rhetoric used by Lucas, the practical and ethical acceptability of such a trade-off is debatable. Moreover, evidence from recent decades suggests that the trade-off itself is, in many cases, entirely avoidable.

A large body of research has shown that improved competition and economic efficiency are indeed compatible with government efforts to address inequality and reduce poverty, as assessed in a World Bank report (World Bank, 2016). Contrary to another common belief about economic interventions, this research indicates that such policy interventions can be tailored to succeed in all countries and at all times; even low- and middle-income countries in times of economic crisis can successfully pursue policies to improve economic distribution, with negligible negative impacts on efficiency and, in many cases, even positive ones. Some examples of such pro-equity and pro-efficiency measures include those promoting early childhood development, universal health care, quality education, conditional cash transfers, rural infrastructure investment, and well-designed tax policy.

Overall, four critical policy points stand out:

(1) A trade-off is not inevitable. Policymakers do not need to give up on reducing inequality for the sake of growth. A good choice of policies can achieve both.

(2) In the last two decades, research has generated substantive evidence about which policies work to foster growth *and* reduce inequalities.

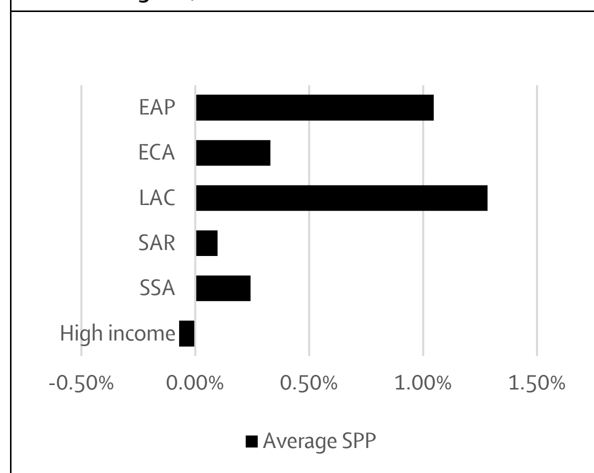
(3) Policies can redress the inequalities children are born into while fostering growth. But the wrong sets of policies can magnify inequalities early in life and thereafter.

(4) All countries can, under most circumstances, implement policies that are both pro-equity *and* pro-efficiency.

Inequality globally

In the last 15 years, many developing countries managed to grow quickly and to do so inclusively – in ways that benefitted the poor at least as much as the rich. This has helped reduce inequality. One way to measure the extent to which growth is shared is through the shared prosperity premium, which is defined as the difference between the rate of growth in incomes of the poorest 40 per cent in a country and the overall average rate of growth in incomes in that country. A high positive value means that the poor benefit disproportionately from growth. Figure 1 shows average shared prosperity premiums in different world regions. While regional average values conceal variation among individual countries, Figure 1 shows that the gap in prosperity between the poor and the average person in developing countries has been shrinking. However, the weakest performers – South Asia (SAR) and Sub-Saharan Africa (SSA) – are home to the majority of the global poor. In high-income countries, the gap has actually increased. Clearly, there is a pressing need in these regions for stronger efforts to make growth more inclusive.

Figure 1: Average shared prosperity premium across world regions, 2008–2013



Source: World Bank, 2016. Note: EAP: East Asia and Pacific; ECA: Europe and Central Asia; LAC: Latin America and the Caribbean; SAR: South Asian Region; SSA: Sub-Saharan Africa.

To achieve this, largely drawing from World Bank (2016) and Cuesta et al. (2018), we highlight six policy areas that, according to latest research, are simultaneously pro-growth and inequality reducing. They cover four distinct approaches: reducing gaps in opportunities for human capital development, starting at a very early age; reducing gaps in opportunities for income generation; smoothing consumption among the poor and disadvantaged; and directly reducing income inequality.

Early childhood development (ECD)

Interventions to improve ECD, particularly in the first 1,000 days of life, are some of the easiest and most efficient ways to reduce inequality and poverty in low- and middle-income countries while boosting life-long economic returns. The goal is to minimise gaps in human capital development before they can become manifest later in life. This can be done by promoting early physical and cognitive development. Across the world, the poor have relatively limited access to early education opportunities such as preschool, and limited access to adequate nutrition, health care, water and sanitation infrastructure, childcare, intellectually stimulating environments, etc. These disparities are significantly more pronounced in the developing world and the effects seen later in life can be dramatic. Some important potential goals for ECD interventions are to encourage breastfeeding, to improve nutrition, to improve parenting skills, to expand access to quality preschool, and to make access to health care in early life easier. By reducing inequalities in human capital development before they start driving disparities, these interventions have been shown to increase educational achievement and incomes later in life, leading to a host of other indirect outcomes that can enhance economic efficiency. Even something as simple as exclusive breastfeeding for the first year of life has been estimated to have a positive potential economic impact of USD 302 billion, or 0.5% of the world's gross income. ECD interventions are highly effective in reducing inequality; they function as an investment in human capital development, promoting efficiency rather than harming it.

Universal health care

While low- and middle-income countries experienced extraordinary improvements in lowered rates of illness, mortality rates, and increased life expectancy over the last half of the 20th century, major within-country inequalities still exist. The poor suffer from much higher rates of adult and child illness and mortality, which stems from a persistent lack of access to health care and health services. Such inequalities are not only deeply unfair but are also economically inefficient as they undermine a country's human capital and waste talent. Universal access to quality health care can improve early childhood outcomes, increase school participation and learning, and lead to higher labour productivity and higher incomes for the poor, but the benefits are even broader than that. Healthier and more equal societies are also likely to exhibit greater social cohesion, more innovation, and higher economic growth. Large gains can be realised here through investments in improving and expanding existing health care systems. Such systems should be expected to reasonably provide quality services, have meaningful coverage, and be capable of responding to increased demand during shocks and crises. With large and broad beneficial impacts, ensuring universal health care is one of the most promising and fair strategies for reducing inequality.

Quality education

Ensuring universal availability of quality education has been a goal of the international community for more than two decades now (Millennium Development Goals and Sustainable Development Goals). However, much work remains to be done on that front. While there are millions more children

enrolled in school than just a few years ago, the poor continue to have much lower rates of school enrolment and, as a result, experience much higher rates of illiteracy and lower educational achievement. This disparity enlarges within-country inequality and perpetuates the inter-generational transmission of poverty. Learning disparities and educational quality constitute a second fundamental concern. Studies show that higher average test scores are correlated with higher per capita GDP growth. Educated farmers and entrepreneurs adapt to and adopt new technologies and techniques at a higher rate, while educated parents have better health outcomes and cope with economic shocks more effectively. Given the obvious benefits of quality education, the gaps in test performance that exist within countries between rich and poor are unacceptably large, rising as high as 50 percentage points or more in some countries. Although we focus here on the challenges faced by the global poor, it is worth remembering that women and rural communities are also disproportionately affected by a lack of access to quality education. Providing incentives for students and/or teachers has proven to be very effective in both increasing enrolment and increasing educational quality and outcomes. Cash incentives for poor students and incentives to increase teacher engagement are two particularly strong examples. With direct implications for human capital development, interventions to improve educational access and learning outcomes have a clear dual benefit for equity and efficiency.

Cash transfers

Low and fluctuating income is not the only problem faced by the poor. The unreliability of income presents additional challenges. The combination of these factors deepens and perpetuates poverty by restricting freedom of choice and opportunity. Simply supplementing the incomes of the poor can be a powerful solution to address these issues. Conditional cash transfer programmes, in particular, have gained popularity among developing countries because, through careful design geared towards well-defined policy objectives, they can simultaneously supplement incomes and encourage positive pro-efficiency behaviour, such as improving health-service use or school enrolment. Mexico's Oportunidades/ Propensa programme, Brazil's Bolsa Familia, and Bangladesh's stipend for female secondary school students are just a few examples of many such programmes throughout the developing world. Even *un*conditional cash transfers have been found to be just as successful under certain circumstances. In fact, a large number of Sub-Saharan African countries make use of unconditional transfers to great effect. When a country is plagued by poor service delivery, or when targeting is too difficult, unconditional transfers may outperform conditional transfers. Cash transfer programmes improve school attendance, school performance, nutrition, health, and much more. When transfers are given specifically to women in the household, they can also promote gender equality.

It is important to note that the feared side effects of cash transfers (e.g. loss of labour supply, increased alcohol and tobacco consumption, rising fertility, etc.) have generally not been observed. Conversely, the observed positive side effects have been numerous and impactful, from increased investment to increased dietary diversity. Indeed, the concept of cash transfers has been tried and tested more thoroughly than any other intervention on this list. Cash transfer interventions do face serious difficulties when it comes to efficient programme targeting and a need for constant programme evaluation and adjustment, but they have proven to be capable of truly impressive reductions in poverty and inequality.

Rural infrastructure investment

An unacceptable portion of the world's rural population remains unserved or underserved by modern infrastructure such as paved roads and access to electricity. A third of the global rural population (1 billion people) still live more than 2 km from the nearest paved road. Access to electricity also continues to elude 1 billion people. This lack of basic modern infrastructure severely hinders transportation and business operation for those affected. It is a major obstacle to the potential economic efficiency of underserved communities. We know that investment in rural roads can heavily reduce transportation costs and travel time; it can reduce barriers to labour reallocation towards new markets, and it can reduce credit constraints by increasing land values and, therefore, available collateral. All of this lowers costs for rural producers, reduces barriers to entrepreneurship and increases economic opportunity. Some of the biggest beneficiaries of these infrastructure improvements are women, for whom mobility constraints are often more binding than for men. Additionally, electrification has been shown to increase labour supply and shift labour towards formal employment. It also removes barriers to the formation of small businesses and can increase school enrolment and attendance. The high cost of connecting distant rural communities creates a trade-off between the financial viability of a project and the ability of a project to reach those most in need. Alternatively, increasing cost-effectiveness of decentralised energy systems on the basis of renewables can minimise the trade-off while also providing new sources of income locally.

Taxation

Tax policy is one of the most powerful instruments for reducing inequality. Because tax revenue funds many of the programmes and interventions that promote equality of opportunity, the specific design of tax policy can be considered, to a certain degree, to determine how the cost of such measures is distributed. Progressive tax systems (i.e. those that impose higher burdens on the wealthy and lower burdens on the poor) have the most direct inequality-reducing impacts, but this may come at a cost. Higher tax rates on higher incomes consume the profits and incomes of the wealthy and this may reduce incentives for additional

investment. The potential for taxes to play an important role in building inclusive and prosperous societies, however, cannot be ignored. While the trade-off between progressivity and economic incentives may be real, a tax policy that favours the poor can potentially boost the economic activity of lower-income households. Ultimately, the cumulative investment of the poor may result in excess growth over and above anything lost in terms of investment by rich households and firms.

A well-crafted tax and transfer system can reduce inequality, as can be seen in some European Union countries, where an average 20-point reduction in the Gini index can be attributed to such systems. The fact that so many low-income countries fail to make effective use of progressive taxation is unfortunate, but it does not need to be that way. When it comes to reducing inequality through taxation, there is ample evidence of effective taxation systems that do not negatively affect economic growth.

Conclusions

Through a combination of various policy interventions, such as those mentioned here, that have been shown to reduce inequality directly or indirectly, income distribution and economic efficiency can be harmonised. Contrary to the claims of some influential schools of economic thought such as that of Robert Lucas at the University of Chicago, it is now clear that focusing on distribution is not "poisonous" to sound economics. In fact, the opposite appears to be the case, as numerous rigorous studies have demonstrated the ability of inequality-reducing interventions to address questions of distribution through direct transfers, behavioural incentives, and prioritising the benefit and participation of the poor, all while improving economic efficiency, sustaining or increasing labour participation, and bolstering personal freedoms through expanded individual opportunities. Ultimately, such policy interventions are an important aspect of the ideal set of circumstances to encourage economic growth.

Much more important than the equity–efficiency trade-off are the risks of bad implementation of these interventions. Thus, the details of policy design are vital in determining the success or failure of specific policy goals. A vast array of policies, pilot programmes, and studies exist to provide examples of policy design, but more rigorous study of, and information about, their impacts is essential and will help to make future attempts at implementation more successful.

The key policy-relevant messages that emerge from this are: (1) economic growth and reductions in inequality can happen at the same time; (2) substantial evidence exists to show us how to achieve both simultaneously; (3) the fine details of policy design will make the difference between success and failure in striking this balance; (4) evidence has shown us that policy options to reduce poverty and inequality are available to all countries and under all circumstances.

The currently available evidence strongly suggests that there is no reason *not* to pursue some of the policy interventions discussed here. However, because elite capture is one of the most serious causes *and* effects of high inequality, we should expect to see resistance to such inequality-reducing measures in some cases. As a result, true commitment to global poverty and inequality reduction in accordance with the internationally agreed upon Sustainable Development Goals for 2030 necessitates a degree of political will and determination such that these policies can be introduced and maintained even against the potential opposition of powerful actors. Donors, governments, and international institutions would be well advised to prioritise those policies that have shown to contribute to achieving both growth and better distribution.

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