

# Growth and inequality : a trade-off?

Remarks by Iyanatul Islam, Adjunct Professor, Griffith Asia Institute, Griffith University, Brisbane, Australia and former Branch Chief, ILO, Geneva

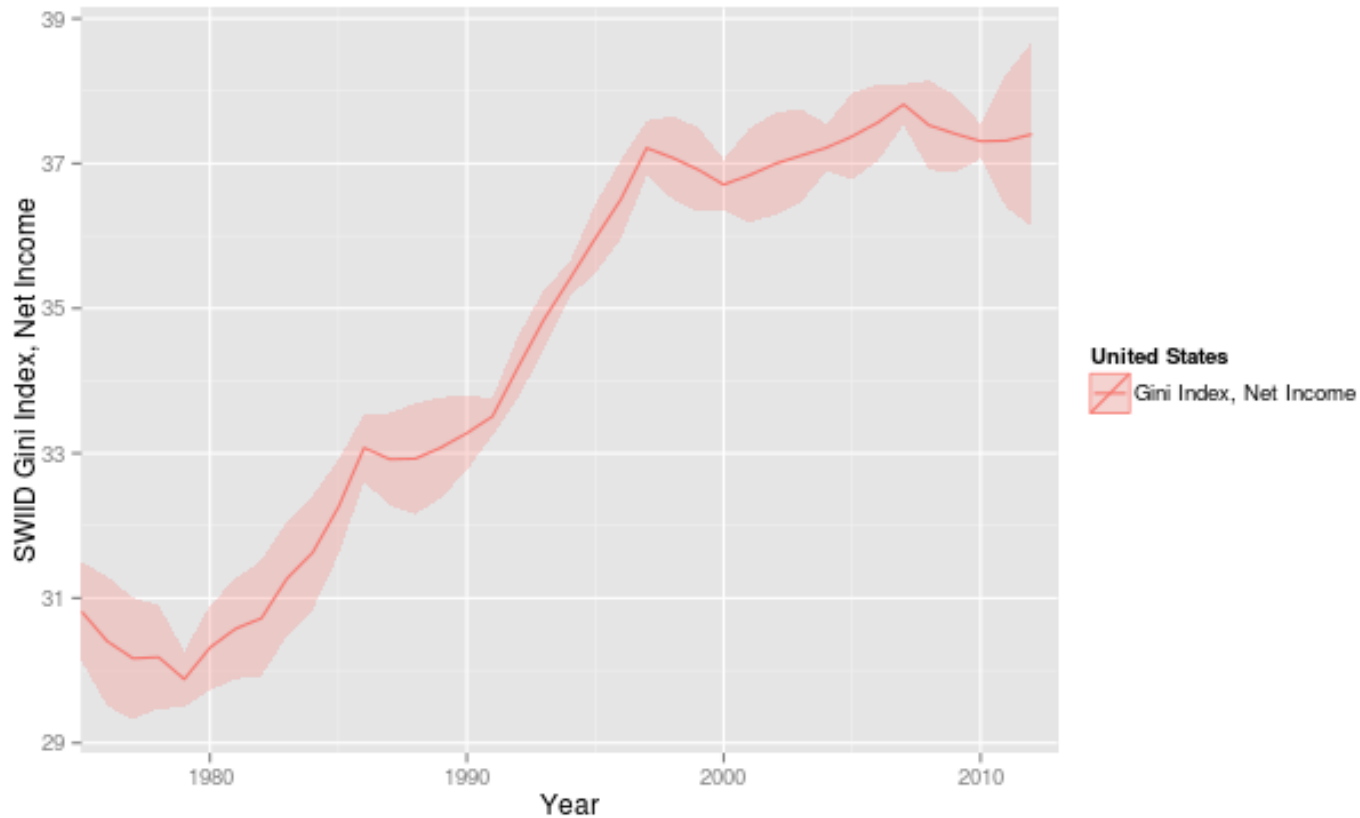
Email: [i.islam@griffith.edu.au](mailto:i.islam@griffith.edu.au) and [yanislam53@gmail.com](mailto:yanislam53@gmail.com)

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# Growth and inequality: preamble

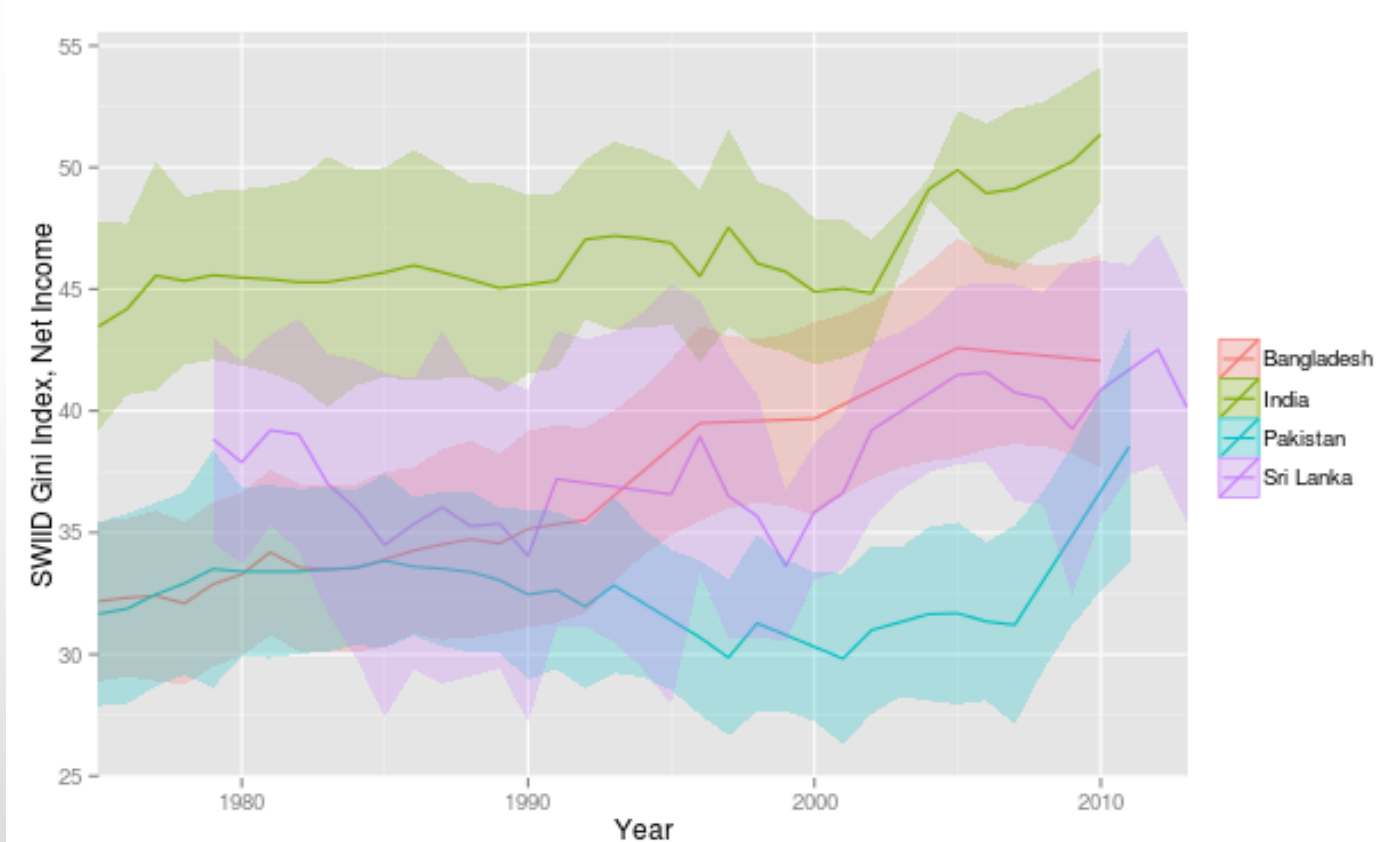
- Increasing inequality is a global phenomenon (Solt, 2014)
- Rising inequality in USA is well known
- In OECD, 16 out of 21 countries experienced growing inequality between 1985 and 2011
- In South Asia, the major economies of the region have witnessed growing inequality in the 2000s
- Inequality in the region in 2010 is significantly higher than 1975
- Graphs>>>>>

# Inequality trends: USA (net income)



Note: Solid lines indicate mean estimates; shaded regions indicate the associated 95% confidence intervals.  
Source: Standardized World Income Inequality Database v5.0 (Solt 2014).

# Inequality trends: South Asia (net income)



Note: Solid lines indicate mean estimates; shaded regions indicate the associated 95% confidence intervals.  
Source: Standardized World Income Inequality Database v5.0 (Solt 2014).

# Growth and inequality: competing perspectives

- One view – associated with the early post-Keynesian literature– suggests that higher inequality promotes growth (Rodriguez, 2000 drawing on Kaldor, 1960 and Kalecki, 1971)
- The most commonly used justification is that the rich save more than the poor
- Hence, asset concentration leads to more saving, more investment and more growth

# Growth and inequality: competing perspectives

- One could also invoke political economy arguments
- A high degree of inequality motivates demands for redistribution that distorts work incentives through higher taxes and transfer payments
- Reduced work incentives can retard growth

# Growth and inequality: competing perspectives

- These pro-inequality arguments can be contested
- One could argue that inequality breeds political and social instability and can retard growth
- Lower inequality seems to be associated with lower fertility which increases growth in a conventional neoclassical model
- Inequality in the presence of credit market imperfections can retard growth
- This happens because the poor are deprived from opportunities to accumulate human and physical capital

# Growth and inequality: empirical evidence

- Kuznets (1955) and his pioneering empirical work led to the notion of a short-run trade off between growth and inequality
- Inequality first rises and then declines as economic development takes place
- Widely accepted in the 1970s, validated by Barro in the 1990s (Barro, 1999)
- Hence...inequality retards growth in poor countries, but encourages growth in rich countries



# Growth and inequality: empirical evidence

- New empirical evidence supports the view that more unequal societies grow less rapidly (The Economist, 2014)
- This evidence is influenced by a series of papers, such as Berg *et al* (2011, 2014)
- Latin America, for example, has a Gini ratio of 50 vs Asia whose average is 40
- If Latin America could close half this gap, its typical growth spell would be twice as long

# Growth and inequality: empirical evidence

- OECD (2014) contends that an increase in the Gini of three points reduces annual growth by 0.35 percentage points over a period of 25 years
- The net impact is a cumulative loss of GDP of 8.5 per cent
- Berg et al (2014), using global data, find a similar result: a rise in Gini of five points can retard annual growth by 0.5 percentage points

# Growth and inequality: Policy issues

- The growth-inequality nexus is policy-contingent
- Some policies can promote both growth and equity
- Others can promote growth, but this can be offset by an increase in inequality
- Examples?
- Suppose a government engages in tax reform by cutting income and corporate taxes in a bid to boost growth and employment.
- What is the likely outcome?

# Growth and inequality: Policy issues

- Studies show that, while there might be a modest increase in growth and employment, the impact on income distribution is deleterious
- OECD data suggest that a 1% cut in corporate and income taxes will boost employment by only 0.05 per cent at best (Bova et al 2014)
- If Gini goes up by 1 point as a result growth in the next round is expected to drop by 0.1 per cent (OECD 2014)
- Hence, initial growth gains are more than fully offset

# Growth and inequality: Policy issues

- If a country engages in fiscal consolidation regardless of the state of the business cycle, growth will decline and inequality will go up
- Recent experience of Euro Area is consistent with this interpretation (Ranenberg, 2015)
- Fiscal consolidation of approx. 4 per cent of GDP between 2011 and 2013 reduced growth by up to 3.5 per cent

# Growth and inequality: policy issues

- Data from 17 OECD countries (1978-2009) period suggest that following fiscal consolidation episodes (Ball et al 2013):
  - (a) long run inequality goes up by 3.4 per cent
  - (b) wage share declines in long run by of 0.8 percentage points
  - (c) long run unemployment goes up by 0.5 per cent

# Growth and inequality: Policy issues

- What policies are likely to promote both growth and equity?
- A sustainable domestic resource mobilization strategy that supports investment in health, education, infrastructure and social protection can help the cause of equitable and inclusive growth
- If well-designed environmental taxes are used as part of harnessing sustainable fiscal space to promote equitable growth, they can also support the goal of environmental protection
- This can be complemented by a financial inclusion strategy

# Growth and inequality: policy issues

- Such a policy framework can also promote jobs through direct employment effects and by boosting employability
- In sum, there need not be a trade-off between growth and inequality
- Policies can be designed to promote a ‘better world’



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