Preface

Inequality and Growth: A Preamble[1]

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It was a part of the common wisdom of mainstream economics that, for developing countries, in the early stages of development, inequality would rise but, as growth persisted, inequality would, eventually, decline. Evidence gathered over the first three decades after World War II, seemed to suggest that this pattern would be borne out. But, as more time passed and growth persisted, inequality, as measured on several dimensions, has continued to grow. What this illustrates is the folly of trying to determine long-run future trends by extrapolating from a couple of decades of data. Looking at the past is an uncertain guide for the future: the innovations created at each stage of history may or may not make the next fundamentally different from those of the past. To peer into the future, we will not only need data but also analysis and theory. Our aim in this volume is more modest than peering into the distant future; but rather, to analyze the current state of global and regional inequality, to dissect the phenomenal increase in inequality that we have seen occur in recent times, and to better understand the relationship between inequality and development. But taking a cue from what was argued above, we have been mindful to bring analysis and economic theory to bear on data and statistics. This was one of the driving forces behind the conceptualization of this monograph, which eventually grew to being a two-volume set. But there were other driving forces.

As the world has continued to grow, the persistence of extreme poverty and the growing gap in the incomes and wellbeing between the world's poorest and the richest people have become unconscionably high. As is argued in one of the chapters, there is growing evidence that there is not just a glass ceiling for the very poor but a glass floor for those who are born very rich. That is, it is difficult for them to become poor. We should care not only about the average growth rates within the economy, but also about how those numbers translate into opportunities for individuals – all individuals, both those born to the rich and to the poor. The long-run relationship between growth and inequality is important to study but we also have to try to understand the contemporary patterns and regularities, including those relating income inequalities and inequalities of opportunity. And as we acquire better knowledge of these, we have to ask ourselves what are the accompanying policy challenges for growth that is not just rapid but also inclusive and sustainable, which is nothing but inclusive *over time*. Growth that benefits the current

generation at the expense of future generations is not, in a fundamental sense, inclusive.

It is possible that the growing income and welfare gaps are contributing to the growing political turmoil we see around the world, from the Arab Spring and growing refugee crisis to the Occupy movement. Each one of these developments has distinct proximate causes, but it is arguable that underlying them there is a deeper cause rooted in the sense of despair and deep feelings of injustice and inequity and the inability to exercise voice through normal political processes for a mass of people who have felt their relative positions deteriorate. Extreme inequality not only deprives masses from sharing the benefits of economic development but by robbing the disadvantaged of voice, it also has a propensity to erode democracy.

Fortunately, as the challenge of inequality and marginalization has grown, several new books and writings have appeared, from Stiglitz (2012), Galbraith (2012), Piketty (2014), through Milanovic (2014) and Bourguignon (2015), to most recently, Atkinson (2015). Of late, this is a topic in which there has also been welcome engagement both from unlikely institutions such as the International Monetary Fund (Berg and Ostry, 2011) and the OECD (2014) and from less-surprising ones, such as Oxfam (2015).

In 2013, the World Bank Group officially declared two mission goals for itself – the end of chronic, extreme poverty by 2030 and the promotion of shared prosperity in every society, the latter being defined (for the purpose of statistical computation) as the promotion of growth of the per capita real income of the poorest 40 percent of each society.[2] Implicit in this was the mission to help the poorest segment of society to grow faster than the rest, thereby mitigating inequality. This was the first time that the Bank set the curbing of inequality as a mission goal.[3]

The importance of a focus on inequality stems from the fact that the bulk of inequality is not a matter of individual choice – some people preferring leisure to work and so choosing to be poor. Indeed, the bulk of human inequality is determined by birth--by what a child inherits and the kind of schooling, education, and health care the child receives. Since there are no hardworking babies, this inequality cannot be driven by individual preferences over leisure and work.

Once it is agreed that the right direction to go from where we stand today is to strive to mitigate poverty and inequality, attention must turn to the drivers of poverty and inequality. This is where the relation between growth and inequality becomes significant. Growth is of course very important, especially for low-income countries and emerging economies. It is not possible for such countries to have significant across-the-board reductions in poverty without growth. But growth does not necessarily lead to the reduction of poverty.

More broadly, what does growth mean for the reduction in inequality, and what does inequality do for growth? These questions have led to a contentious

debate. There is an emerging consensus that inequality is bad for growth; and this is an idea that the reader will encounter in this two-volume book.

Some believers in "growth alone" (the view that the World Bank and other development agencies should focus just on growth) argue that growth will trickle down to the poor, unmindful of the fact that the word "trickle" itself gives away the hand of these commentators. This has been a contentious area of debate with a plethora of fallacies and misstatements. Consider, for instance, the finding, based on the study of large data sets, that over three quarters of poverty mitigation in recent decades can be attributed to plain and simple economic growth. From this, some people have deduced that growth therefore is the best cure for poverty and that we simply need to press on the growth accelerator and poverty will be taken care of.[4]

This, however, turns out to be a classic case of faulty deduction from arguably correct data. The fact that the bulk of the poverty eradicated in recent decades was because of growth does not mean growth is the best cure for poverty. All depends on what else was tried. If hardly any other relevant policies were tried, whatever poverty is eradicated would be because of growth, but that says little. It is like a Soviet economist studying job creation in the USSR in the 60s, 70s and 80s, and concluding that the government is the best creator of jobs, since almost all jobs were created by the state.

Indeed, even if growth by itself led to poverty reduction, given our poor record of eradicating poverty – in 2011, 14.5 percent of the world population lived below the poverty line of 1.25 dollars, Purchasing Power Parity (PPP)-adjusted),[5] per day – there is clearly a need to do much more and to look for appropriate policy interventions that go beyond "just" promoting growth.

This two-volume collection, *Inequality and Growth: Patterns and Policy*, is an effort to assemble the best of contemporary thinking on the subject. It is based on a roundtable convened by the International Economic Association (IEA) and the World Bank on "Shared Prosperity and Growth," and organized as part of the IEA 17th World Congress held at Dead Sea, Jordan, on June 10–11, 2014. In the roundtable that we organized, we tried to assemble an outstanding group of scholars, many of whom have grappled with the issues for many years, and from various perspectives.

The topics include conceptual issues and measurements, the state of global inequality, regional experiences, inequality of opportunity, consequences of inequality, and also some special areas that go beyond the traditional inequality discourse. The insights generated at the roundtable are critical in policy debates on economic development. The collection includes a total of sixteen full-length papers, and fifteen commentaries on those papers.[6]

The first volume, *Concepts and Analysis*, is a collection of papers on the conceptual and theoretical issues on inequality and its measurements. In chapter 1 of this volume entitled "New Theoretical Perspectives on the Distribution of

Income and Wealth Among Individuals," Joseph Stiglitz lays out five new stylized facts. First, there is growing inequality in both wages and capital income (wealth) and growing inequality overall. Second, wealth is more unequally distributed than wages. Third, average wages have stagnated, even as productivity has increased, and so the share of capital has increased. Fourth, there have been significant increases in the wealth-income ratio, and last, the return to capital has not declined, even as the wealth-income ratio has increased.

Section 1 of this chapter provides an overview of the key anomalies presented by the new stylized facts. It explains why they are inconsistent with the standard neoclassical models long used by economists, and explains how a focus on rents (ignored in the standard neoclassical models) helps to resolve the inconsistencies. It explains the central confusion between "wealth" as a measure of control over resources and "capital" (or more broadly, an aggregate measure of productive capital), and shows that the former can be increasing while the latter is decreasing (at least relative to income or effective labor supply). Land values can increase, but the productive capacities of the economy decrease. An increase in wealth as a result of exploitation (monopoly) rents can even result in a decrease in productive capacities as measured wealth increases. For instance, savings data from the National Income Accounts for the United States account for only a fraction of the observed increase in wealth; the rest is associated with an increased in the capitalized value of rents. Section 2 of the first chapter re-examines the equilibrium wealth distribution within the context of a standard neoclassical model of growth without land, showing that (contrary to Piketty's assertions) there is not ever increasing wealth and income inequality. Equilibrium inequality is related to underlying behavioral and technology parameters. Section 3 introduces land and rents into the model, analyzes the long-run determinants of land rents and the price of land, and explains how the credit system plays an important role in both the increase in the wealth-income ratio and the increase in wealth inequality. The chapter explains that in designing policies to mitigate inequality, one has to be sensitive to the possibility of tax shifting, but shows how capital taxes with revenues devoted to investment as well as land taxes can lead to reduced inequality and higher steady-state income levels.

In the chapter "Reflections on the 'Equity and Development': World Development Report Ten Years Later," Francois Bourguignon reflects on the 2006 *World Development Report* (WDR). While the report represented a major step forward in the Bank's broadening its focus beyond poverty and growth as the main poverty reduction tool, it fell short in putting the issues of inequality front and center stage. Besides political considerations, this choice was dictated by the recognition that the analytical link between inequality and development was more complex than a direct negative impact of income inequality on growth. Instead, the report focused on the inequality of opportunities as the major direct impediment to development and the ways of reducing it by "leveling the

playing field", including among other measures of income redistribution. The increased attention to inequality of opportunity was a significant contribution to the development policy debate.

Ravi Kanbur and Adam Wagstaff's chapter, "How Useful is Inequality of Opportunity as a Policy Construct?" acknowledges that the empirical analysis of equality of opportunity has contributed significantly to our understanding of the determinants of inequality of outcomes and have become an important part of the analysis of policy. At the same time, as the authors point out, there are limitations, both conceptual and empirical, of the practical usefulness of the concept for policymaking. Drawing on applications in the education and health sector, they argue, as Francois Bourguignon does in the previous chapter, that the focus on inequality of opportunity is often used to delegitimize concerns over inequality of outcomes, including those arising from luck, risk and the distribution of talent (which is also luck, one step removed).

In "The Effects of Fiscal Redistribution," Michele Battisti and Joseph Zeira use cross-country, pooled, and panel regressions to examine the role of fiscal policy in reducing income inequality. They test for the possibility of any reverse causality, namely that public spending increase is driven by pressure to redistribute and which type of fiscal policy is most strongly related to the redistribution of income. They find that a one percent increase in public expenditure as a percent of GDP reduces income inequality in both cross-country and pooled regressions by 0.3–0.4 percent. Fiscal policy is also significant in reducing poverty, in particular labor market subsidies. Due to data constraints, their analysis on poverty is limited to OECD countries.

The papers by Hai-Anh Dang and Peter Lanjouw, Tony Castleman, James Foster and Stephen Smith, and by John Ifcher and Homa Zarghamee propose alternative ways of conceptualizing and measuring inequality, poverty and vulnerability. The simplicity of poverty headcount measures have made them the most widely used measure for monitoring poverty. However, in their chapter, "Person Equivalent Headcount Measures of Poverty," Tony Castleman, James Foster and Stephen Smith argue that the headcount measures ignore the intensity of poverty and this incentivizes policymakers to focus their efforts on the least deprived segments of the poor, since it costs the least to help this group to cross over the poverty line. They contend that other conceptually robust measures are often dismissed from the policy discourse as being too complex and not intuitive. The "person equivalent headcount" measures they propose uses a monetary, benchmark measure of the average depth of poverty to count up the number of "person equivalent" poor. They calculate the person equivalent headcount for eighty countries using the World Bank's $1.25 per day poverty line, which shows a more rapid decline in global poverty and significant redistribution across regions and countries.[7]

In "Towards a Definition of Shared Prosperity: A Dynamic Perspective from Three Countries," Hai-Anh Dang and Peter Lanjouw present a complementary

measure to the shared prosperity measure employed by the World Bank which considers not only the currently poor, but incorporates the vulnerable population, the segment of the population that is currently non-poor but face a heightened risk of falling back into poverty. Using illustrations from India, the United States and Vietnam for the mid- to late-2000s, they find that the two approaches are qualitatively consistent, with Vietnam enjoying the greatest boost in shared prosperity, followed by India and lastly, the United States.

John Ifcher and Homa Zarghamee's chapter on "Evidence of the Compression of the Subjective Wellbeing Distribution with Economic Growth" looks at inequality from the subjective wellbeing perspective. To date, the existing literature has focused mainly on the mean of subjective wellbeing. The chapter expands the body of work to looking at inequality of subjective wellbeing, its changes and the relationship to growth. Using data from the World Values Survey and World Development Indicators, Ifcher and Zarghamee find that per capita income is inversely related to subjective wellbeing inequality in cross-sectional and time series (excluding the two fastest growing economies). The latter is an interesting corollary to the "Easterlin Paradox" – that, though as income increases, happiness increases, in the long run, increased income is not correlated with increased happiness.

Karla Hoff broadens the inequality discourse by looking at social exclusion from the perspective of behavioral economics. In her paper, "Behavioral Economics and Social Exclusion: Can Interventions Overcome Prejudice?" she demonstrates that mental models – intuitive, socially learned sets of ideas about how things work – can bias an individual's perceptions of himself and the world. She argues that government programs should attempt to look at both structural and behavioral factors in addressing social exclusion. Group deliberation changed perceptions and overcame biases in ways that led to the abandonment of female genital mutilation in many villages in Senegal. In the West Bengal state in India, political affirmative action for women improved the way men perceived women, parents perceived their daughters, and women perceived themselves. However, political affirmative action for low castes (the Scheduled Castes) appear to have had no impact on broadly shared mental models. In the Indian state of Uttar Pradesh, affirmative action for Scheduled Caste did not appear to change the perceptions that the high-castes held of the Scheduled Castes and may have led to worse performance by high-caste teachers in public education, which Scheduled Castes unlike high castes disproportionately depend on. In India and China, experiments showed the impact of activating existing mental models, rather than of trying to change them. Making salient (by publicly revelation) the social identities of students in dominant and stigmatized social groups created a gap between their average performance, with the stigmatized groups performing significantly worse.

The second volume, *Regions and Regularities,* examines the state of global inequality and inequality in different regions; and analyzes other kinds of inequality and discrimination.

In the first chapter, "The Inheritance of Employers and Nonlinearities in Intergenerational Earnings Mobility," Miles Corak and Patrizio Piraino examine intergenerational earnings mobility by looking at the role of parents on a child's interface with the labor market using a rich data set from Canada. They show that this explains nonlinearities in the intergenerational transmission of earnings. Getting a job in the father's firm plays a major role in preserving wealth and income advantages across generations.

In his chapter, "Do Nations Just Get the Inequality They Deserve?" José Gabriel Palma analyzes the contrasting centripetal and centrifugal forces at work within the distribution of income across countries. He argues that as a result of a process of convergence, the population located in the middle and Upper-middle (i.e., within deciles 5 to 9) tends to appropriate a share of about 50 percent of the national income. As a result, he proposes an alternative inequality measure to the Gini which is often referred to as the "Palma ratio". The Palma ratio defined as the ratio of the income share of the top 10 percent over that of the bottom 40 percent, tries to capture inequality where it currently exists (the top and bottom of the income distribution). The chapter suggests that the huge diversity of distributional outcomes across the globe is not just the result of abstract economic forces, but rather the consequence of differences in economic structure and political settlements.

The chapter by Nora Lustig, Luis Felipe Lopez-Calva and Eduardo Ortiz-Juarez examines the state of inequality in the Latin America and the Caribbean region In "Deconstructing the Decline in Inequality in Latin America" they show that inequality, as measured by the Gini coefficient and other indicators (including all variations of the Kuznets ratio), declined in sixteen of the eighteen countries in Latin America and the Caribbean during the period 2000 to 2012. They attribute the decline to the decrease in hourly labor income inequality and progressive government transfers. This is a study that clearly has lessons for other parts of the world and other economies at similar stages of development.

The Arab countries are the focus of Radwan Shaban's chapter, "Inequality in Arab Countries." He observed a similar general declining trend in the Arab countries, in the period leading up to the Arab Spring. Furthermore, the median Gini coefficient for the Arab countries, at 36 percent, was lower compared to 38 percent for the world and 40 percent for all emerging market economies and developing countries. He concludes by offering some plausible explanations of the difference between the measurement of inequality from household surveys and the perceived inequality as evidenced by the increased demand for fairness and social justice in the Arab countries.

In their chapter, James Galbraith, Beatrice Halbach, Aleksandra Malinowska, Amin Shams and Wenjie Zhang summarize a comprehensive revision and update of the University of Texas Inequality Project (UTIP) work on the

inequality of pay and incomes around the world for the period 1963–2008. Their new data set on industrial pay inequality (UTIP-UNIDO) based on the Industrial Statistics of the United Nations Industrial Development Organization covers 4,054 observations for 167 countries, and the revised Estimated Household Income Inequality (EHII) database of gross household income inequality covers 3,871 observations for 149 countries. Their paper "The UTIP Global Inequality Data Sets 1963–2008: Updates, Revisions and Quality Checks" provides a fairly comprehensive quality check of the database against other available measures. They conclude that the EHII data set is reliable in estimating trends and reasonably reliable in estimating the level of gross income inequality observed in household surveys, but provides the advantage of dense and consistent coverage across the global economy, and is therefore useful for comparative and historical analyses.

In "Inequality and the Fragility of Growth," Jonathan Ostry attempts to address two questions. To what extent does inequality render growth more fragile? And, if inequality makes growth less stable, what are the possible implications as far as redistributive policies are concerned? Ostry examines the relationship between the duration of growth spells and a number of determinants, including inequality. He focuses on spells rather than standard panel growth regressions because growth, especially for developing countries, is not a smooth process, and drawing inferences from panel growth regressions in such circumstances may be misleading. He finds that more equal societies have more durable growth spells. He then asks the question whether redistributive policies should be used to bring about less fragile growth. Ostry finds that except in extreme cases, there is no trade-off between growth and redistribution – a marked departure from the perspective that was dominant until recently, but consistent with the analysis of Stiglitz (2012) and other more recent studies.

To what extent does inequality in the control over a society's resources facilitate or hinder growth? This is one of the key questions in the growth and inequality debate. However, empirical studies to date have tended to use the distribution of income as a proxy for distribution of wealth. In "Does Wealth Distribution and the Source of Wealth Matter for Economic Growth? Inherited v. Uninherited Billionaire Wealth and Billionaires' Political Connections," Sutirtha Bagchi and Jan Svejnar attempt to answer the question posed by the title of their paper, using a derived global measure of wealth inequality from *Forbes* magazine's list of billionaire and decomposing wealth into three components: wealth obtained through political connections (cronyism), wealth generated from entrepreneurship, and inherited wealth. In their sample, inherited billionaires, the largest group account for about 54–72 percent of the total (depending on the year under consideration) and politically connected billionaires represent the smallest 4–13 percent of total billionaire wealth. They find that politically connected wealth and inherited wealth have a significant

negative effect on growth, while the effects on growth of wealth generated from entrepreneurship are insignificant.

Ashwini Deshpande's chapter on "Caste Discrimination in Contemporary India" examines the state of caste disparities and discrimination in India, and notes how discrimination is very much a part of modern Indian society and also across the world with different kinds of systems, which seem to suggest that discrimination based on social identities is compatible with freely functioning markets. She finds that the persistence of caste inequalities results in both inequality of opportunities and inequality of outcomes. To rectify intergroup discrimination, such as those based on caste, will require purposive multi-pronged interventions.

The chapters are followed by interesting commentaries and in some cases, vigorous challenges by the discussants: Martin Ravallion, Bhaskar Dutta, Aristomene Varoudakis, Sudhir Anand, Paola Giuliano, James Foster and Murray Leibbrandt in volume 1 and Francisco Ferreira, Joseph Stiglitz, Edward Wolff, Francois Bourguignon, Kendra Bischoff, Shantayanan Devarajan, Celestin Monga, and William Darity, Jr. in volume 2. The work in these two volumes illustrates the complexity of the processes that determine the level of inequality in society and the importance of understanding them. The chapters have drawn attention to the many dimensions of inequality and the difficulties of measuring them, and the importance of both the inequality of outcomes and inequality of opportunity. The chapters have shown that inequalities, both in income and opportunity, can be affected by policy; and that policies that reduce these inequalities tend to promote development and enhance growth.

Some of the subjects addressed in this book have long been neglected. We see this two-volume monograph as opening up a debate, while being aware that there is much more to be said about each of the questions that have been addressed here. The aim of this volume is to put the discourse on a more sound scientific footing by marshalling some of the leading experts to contribute to our understanding of the main patterns of, and interconnections between, inequality and growth, and to nudge us towards the design of more effective policies for creating a better and a more inclusive global economy.

Notes

1. The authors would like to thank Karla Hoff for her extensive comments.
2. The twin goals were adopted by the World Bank's Governors at the Development Committee meeting on April 20, 2013.
3. It is worth clarifying that prior to the newly enunciated goals, many in the World Bank had written and spoken about the excesses of inequality; what is new is the formal adoption of the mitigation of inequality as a goal. Some commentators argued

that the "bottom 40 percent" focus is not an inequality measure because it does not speak comparatively with the rest of the income distribution. While this is technically true, since the overall growth rate of each economy is so widely known, making the data available for the growth of the bottom 40 percent immediately shows whether the poorest 40 percent is catching up or falling behind. Making this data available is a prompt to policymakers to curb the growth of inequality, to make sure that the bottom 40 percent grows faster than the top 60 percent. To say that this is not an inequality measure because we do not say what the policymakers should do with the new data is like saying that providing the Gini coefficient is not an aid to curbing inequality unless we make it explicit each time that the aim is to minimize the Gini and not maximize it.

4. Here we overlook a number of complex statistical issues. If, as reflected in the emerging consensus, countries with lower inequality grow better and are more stable, and if (as is surely the case), lower inequality and greater stability are associated with lower poverty, there are difficult problems of identification that are not addressed by most of the statistical studies: policies that led to poverty and inequality reduction may have led to higher growth.
5. For those unfamiliar with purchasing power parity (PPP) numbers, we may point out that in most developing countries 1.25 dollars PPP-adjusted translates to 35 to 45 cents. The fact that nearly one-seventh of the world lives below this line is a serious indictment of our effort at poverty mitigation thus far.
6. Stiglitz's paper was planned as a standalone presentation for general discussion without a designated discussant.
7. Or $1.90 per day, which is the updated poverty line in 2011 based on new PPP data, but constant in real terms to $1.25 per day poverty line based on 2015 PPP data.

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