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"To combat poverty and increase growth in the world's poorest countries policy makers need to focus on decreasing world income inequality."

What is known as the developing world is the set of countries that are classified as having low to middle per capita income. It is argued that low per capita income is an important distinction when measuring economic development and there is little uncertainty that the distribution of wealth across the world is incredibly unbalanced. As found in the "World Development Report" by the World Bank (2003) the world produced approximately $32 trillion of output in 2001. A little less than $6 trillion of this, less than 20% came from low and middle-income developing countries, which amounts to around 85% of the world's population. Inequality therefore matters for multiple reasons ranging from factors as simple as productive potential to basic resource allocation. Based on the research presented in this essay it is clear that policy makers should worry about income inequality and its effects on growth and poverty.

Income inequality is generally referred to as a situation in which income within a given population is distributed unevenly, thus creating a large separation between the rich and the poor. Inequality can be graphically represented by plotting a Lorenz curve, which plots cumulative income and cumulative population in relation to a line that signifies perfect equality. The further away the curve lays from the perfect

equality line the more unequal the economy. On the down side when curves intersect an accurate conclusion cannot be made. This implication led to the creation of the Gini coefficient, which numerically represents a countries level of inequality, leading to effective comparison.

There has been much research regarding the link between inequality and growth, which has resulted in a variety of theories. In order to effectively manage policy aimed at growth by reducing inequality, an understanding of how the two factors interact must firstly be formed. The Kuznets's inverted ‘U’ hypothesis shows a relationship between inequality and income growth. The theory presented is that low-income countries have low levels of inequality, as income gradually increases inequality follows. Once a point is reached during the increase in income, inequality starts to fall as income rises suggesting that countries with high income have low levels of inequality, thus forming a ‘U’ shaped graph. The theory from a development standpoint states that benefits of income growth in highly unequal countries will be experienced by those with an already high income, which in turn leads to greater inequality.

There are many models in which inequality potentially can have some kind of effect on growth, but it is difficult to directly link it. It is largely argued by many that it can have a connection in some situations but cannot in others meaning a distinct answer has not yet been found. Consequently there have been three models created aiming to connect growth and inequality: Savings and inequality, Politics and inequality and

finally Human Capital and Capital Markets.

Firstly we can take into account the link between Savings and Inequality. As seen in the Solow Growth Model savings and growth are directly connected whereby savings is equal to investment S (t) = I (t) and capital required for growth in the following periods depend on investment today. It is largely discussed among economists, if in an economy that suffers from inequality and wealth is left to be controlled by those whom have it, will they save it or will they invest it?

People save differently for many reasons, many according to their level of income; we can assume those that have have low income have low savings rates due to subsistence concerns, those with high income also have low savings rates due to Conspicuous Consumption (consumers buy items to display wealth) and those with middle income that save the most, because they have future aspirations for better living standards for example. This gives rise to a skewed savings and income relationship, meaning that redistribution from the rich to the middle income could boost savings in the economy as a whole. Therefore this means that the size of each income group in comparison to the population will play a role in how effective a distribution of wealth would be. For example if an economy has a large proportion of rich and small proportion of middle income individuals a redistribution from rich to middle income would result in an increase in savings. In a developing country the distribution of wealth is at the extreme ends of the scale, there is a large proportion of those who are poor. This results in a poor distribution of savers because there are not as many middle-income individuals, whom are associated with saving,

compared to a developed country.

Secondly we can consider Politics with respect to Inequality, more specifically the limitations created by the need to redistribute wealth. Inequality can directly affect voting behavior (assuming a democracy is in place), which can potentially lead to some level of redistribution, but this affects incentives to accrue capital. *Persson and Tabellini* (1994) argue that high inequality sets up a clamour for redistributive taxation. If the government pursues the redistribution of wealth following a vote, the policy makers must be able to find out who holds the greatest amounts of wealth and how much, which can be difficult in developing countries with poor levels of infrastructure. An example of potential policy could include taxing returns earned from investment because the wealthy are the only people able to invest, but this has its downfalls; i.e. return on investment will fall due to the tax, this reduces incentives for the wealthy to invest which therefore reduces their investment and therefore can reduce growth. In a country where a large proportion of wealth is held by the rich this could potentially be damaging to the economy again, showing that the effect is dependant on the specific situation.

Thirdly Human capital, capital markets and inequality can be contemplated. In economies where large proportions of the population are poor, their ability to invest is hindered by a lack of access to capital markets. For example for individual' s to earn more than the average per capita wage they must become educated, but for them to become educated they must pay a given amount. In a developed world if an

individual cannot afford to pay for something they have the option to receive a loan and pay back in interest once they are educated, but in developing countries the poor may not have the option of receiving a loan due to a lack of collateral for example, meaning that they cannot become educated, forcing this individual into low skilled work. If this occurs on a larger scale because of a large proportion of poor, this means that future generations are likely to experience the same problem, meaning that the poor are likely to remain poor. This relationship proves that a lack of capital markets can in turn affect inequality.

On the other hand it is argued that increased inequality can actually result in a greater level of growth. For example when taking into account setup costs with extreme levels of poverty. In countries with a very poor society, where a large amount of the population has an income so low that it cannot afford the setup costs to start a business, then that sector is likely to be incomplete. In its place, if wealth was distributed more unequally, some may be able to raise sufficient funds to undergo this potentially profitable business venture, which could result in potentially high levels of growth, resulting in new jobs being created therefore affecting society as a whole. The obvious down side to this being that this additional level of inequality may be intolerable and inhumane leading to increasing poverty.

Because there are many conflicting points with regards to the link between income inequality and growth maybe we should be concentrating on alternate factors. The connection between poverty and growth for example is clear whereas the influence of

income distribution on growth is not clear as mentioned already, more specifically we need to find out whether higher levels of inequality lessen the effects generated by growth.

Following a study carried out by *Ravallion* (2007) initial levels of income inequality were important in determining exactly how powerful an effect growth has in reducing poverty. It was estimated that a one per cent increase in income levels could result in a 4.3 per cent decline in poverty in countries with very low inequality or as little as a 0.6 per cent decline in poverty in highly unequal countries. But these calculations must be interpreted carefully given the specific variables that were set in place, while this type of research has shown some causal relationship the general consensus is that there is not a consistent relationship. "The experiences of developing countries in the 1980s and 1990s suggest that there is a roughly equal chance of growth being accompanied by increasing or decreasing inequality" *Ravallion* (2001), this shows that inequality can potentially be linked to decreased poverty, in the sense that a lower level of inequality boosts the effect that growth has on reducing poverty but growth itself may not have a distinct effect on altering income inequality.

Due to the complicated relationship between growth and inequality, controlling for inequality of assets such as land and education becomes more important than income inequality with respect to opportunity for growth, *Birdsall, N et al* (1997). Asset inequality can be important because owning assets that can be used as collateral can

greatly extend the level of access that people have to financial markets, meaning that policy makers could focus more on this issue rather than income inequality to facilitate growth and a reduction in poverty. Following this it is likely that income inequality would fall.

So what should policy makers decide to do with regards to reducing poverty and maximizing growth? Should Policy makers concentrate directly on increasing growth in order to reduce poverty or should they concentrate on tackling income to try and spark a change in poverty?

Many argue that in order to facilitate sustainable growth a country must strive for equality, in particular inequality could potentially impede growth because it puts pressures on policy makers to redistribute wealth through the fiscal system, which could undermine growth. Therefore giving rise to a method that can be used. In this situation some argue that taxes and transfers are the wrong way to go about a re-distribution of wealth. This very issue is the central point of *Arthur Okun's* (1975) book on tradeoffs between efficiency and equity. When considering a policy regarding re-distribution it must be asked whether these types of intervention will lead to a loss of economic efficiency and if so will the benefits that come from this outweigh the potential loss. A couple examples of this kind of policy could include taxing activities with negative externalities that are largely paid by the wealthy, for example taxing overly risky investment in the financial sector and aiming public sector spending to encourage attendance in school or improving capital for the poor.

Although taxing this kind of investment may sound effective there is a clear issue of how to calculate and measure what classifies as a risky investment. Determining this requires knowledge and resources that a developing countries government may not hold. Alternatively a progressive taxation system could be implemented, meaning that the higher an individuals income the greater the level of tax. Potentially this could be beneficial once re-distributed but it is very difficult to implement in developing countries as income can be easily hidden.

Policy's such as the above are regarded by some as a 'win win' because they both tackle income inequality and therefore poverty as well as resulting in a level of growth. In theory these policies sound very positive but when tested empirically there are many conflicting outcomes. Many papers such as *Benabou,* (2000, 2002) and *Bleaney, Gemmell,* and *Kneller,* (2001) argue that this kind of public investment in education and infrastructure may benefit equality and growth in OECD countries, but others such as *Okun* (1975) imply that there is possibility of a trade off between the improvement in equality and growth. Therefore policy makers must tread carefully when tackling equality through fiscal measures depending on the specific situation that the specific country is in. For example in a country where there is a large amount of rich and a large amount of poor, taxing the wealthy increasingly could lead to a large fall in investment spending attributed to a reduction of income; this in turn could cause a decrease in growth even though it has its benefits from an equality and poverty reducing side.

Testing this kind of policy empirically *Alesina and Rodrik* (1994) regress per capita

income growth over the period 1960–85 against many other variables. Their results indicate a clear negative relationship between inequality and subsequent growth created from this. Their results suggested that an increase in the land Gini coefficient by 1 standard deviation (which is only an increase of 0.16 in this case) would decrease subsequent economic growth by as much as 0.8 percentage points per year. Their findings are strengthened further because following this as it was used in subsequent papers, which resulted in similar outcomes.

Alternatively it has been argued that raising the amount of assets that the poor hold could be a more effective way in tackling poverty. Policy regarding capital accumulation may result in a large increase in productivity, which in turn would result in higher investment in the future. Because OECD countries generally depend on the agricultural sector for growth, investment in machinery and irrigation for example could be what allows poorer people to increase production by maximising productivity. This method is effective because it generates growth, which in turn increases wages and reduces poverty. By allowing sectors like this to thrive, poverty rates are likely to fall allowing increasing amounts of people to be able to invest into their future through education and technological advancement. Comparing this kind of public sector spending to redistributive fiscal policy the possible reduction in growth generated from the redistribution could be reduced. This kind of policy is more sustainable because it allows people to ‘help themselves’ without causing disruptions in the financial sector;

It seems that there is not a ‘one size fits all’ policy that would be beneficial for all

developing countries. The general consensus is that a good level of guidance from developed countries is key to help implement appropriate economy specific policy and prevent corruption and moral hazard from occurring. *Sokoloff and Engerman* (2000) have argued that an inefficient elite, once installed in power, might attempt to do all it can to keep the non-elite at bay; setting fiscal policy to generate revenue from the non-elite in order to make it more difficult for them to conduct business. This kind of theory more concentrates on how inequality in the access of political power could curb growth.

It can be concluded that inequality has a loose effect on medium term growth, meaning that conclusions from *Berg and Ostry* (2011) for example are relevant. This means that it would be a mistake to focus directly on growth and allow inequality to take care of itself, for one its largely unethical but also the possible reduced growth that can stem from it is undesirable. As seen in a paper published by the IMF relating to inequality and growth there is surprisingly little evidence arguing that fiscal redistribution has a negative effect on growth. Especially in non-extreme situations the average redistribution of wealth is strongly followed by a reduction in inequality and also high and sustainable growth. Although redistribution must be undertaken with extreme caution "the things that governments have typically done to redistribute do not seem to have led to bad growth outcomes" *IMF (*2014) which in turn resulted in a narrowing of inequality and the building blocks to sustainable economic growth.

Even though Income inequality has not formally been linked to sustainable growth, drawing reference to theories such as Kuznets's hypothesis we can see that inequality

falls over time as income rises. Although the theory has been widely scrutinised, it has proven to hold when cross-sectional data is used. Yes, inequality should be on the forefront of government policy, loosely it has been found in many cases that once income inequality has been reduced the economy as a whole has benefited and poverty rates have been reduced; the theory behind this being that income inequality is harmful for growth because it leads to substandard policies that don't protect property rights and don't allow full private adoption of returns from investment. Policy focusing on redistribution of wealth is viable and an important tool but must be done in great efficiency in order to minimise any possible trade-offs that it can cause resulting in reductions in the growth level. Other policy such as increasing the accumulation of assets of poorer individuals can also be effective as it provides people an outlet to make themselves more productive. It can be concluded from past research that income inequality isn't quite fully understood in a development setting, once a strong link is found effective policy can be pioneered in order to solve the issue at hand without the potential repercussions that redistributive policies currently hold.

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