Chapter 3

The impact of inequality

The previous chapters showed that, both within and across countries, the rich have gained disproportionately from the economic growth of the past two decades. This rising inequality matters, not only for its effect on economic development processes, but also for its impact on poverty reduction, social mobility, social cohesion, political stability, and other aspects of social development. However, as highlighted in previous chapters, the arguments and evidence against inequality as an unavoidable by-product of development are growing. While some level of inequality can be incentivizing, there is growing recognition that too much inequality, and sustained periods of it, can derail economic progress and deepen—or create—the social and economic exclusion of large pockets of society.

This chapter discusses the real and potential impacts of inequality on socioeconomic development. While it accepts that moderate levels of inequality can have a constructive influence, it illustrates the—mostly constraining—impact of inequality in relation to economic growth, poverty, social mobility, social stability and cohesion.

I. Inequality and economic growth

The relationship between inequality and growth is complex. Ongoing efforts to understand this relationship in the development literature are yielding mixed results. Some studies have found a positive relationship between the two phenomena, while others have found either a negative relationship or no relationship at all. Consequently, a number of important policy questions have emerged. These include whether inequality is harmful to economic growth, whether growth is good for the poor, and whether highly unequal societies experience slower economic growth than more egalitarian ones.

Inequality has shown itself to be useful, to some degree, in ensuring the efficiency of the economy, which enhances growth. Okun (1975) argued that pursuing equality could reduce economic efficiency. This scenario sees some level of inequality as constructive, stimulating capital accumulation and technological innovation and creating incentives to invest in education and health. This suggests that more equal distribution of incomes could reduce incentives to work and invest. This argument also points out that efforts to redistribute incomes through minimum wages, taxation and other public policies can be costly. However, with the onset, and lasting effects, of the recent global financial and economic crisis, greater attention is being given to the negative long-term impact of rising inequality, and to the role of fiscal and social policy in shaping and curbing these effects.

High levels of inequality can be a serious impediment to future economic growth and a potential cause of underdevelopment (Berg, Ostry, and Zettelmeyer, 2012; Easterly 2002; Bruno, Ravallion and Squire, 1996; Alesina and Rodrik, 1994). Berg and Ostry (2011) examined the relationship between income inequality and economic growth across 174 countries, to reveal that income inequality was a strong determinant of the quality of growth, even when market structure and other institutional factors were taken into account. Countries with low levels of inequality tend to sustain high rates of growth for longer durations, while growth spurts tend to fade more quickly in more unequal countries. Similarly, growth in more unequal countries can be much slower than that in countries with low initial levels of inequality (Bénabou, 1996).

In addition to inhibiting economic growth over time, inequality can also generate greater market volatility and instability. One of the important ways in which inequality has created economic instability is through its impact on the generation of finance-driven business cycles (Galbraith, 2012). Some evidence of this has been seen in the much-debated relationship between inequality and the onset of economic recession. Both the Great Depression of the 1930s and the 2007-2008 Great Recession were preceded by sharp increases in income and wealth inequality and by a rapid rise in debt-to-income ratios among lower- and middle-income households (Kumhof and Rancière, 2010)

While the relationship is not clear-cut, there are persuasive arguments that it was the combination of growing inequality, wage stagnation and financial deregulation that fuelled the global financial crisis of 2008-2009 (Foster and Magdoff, 2009; Galbraith, 2012; Stiglitz, 2012; Stockhammer, 2012; Rohit, 2013). In the years prior to the crisis, the poor (who consume a relatively greater share of their income) had falling shares of national income. Rising inequality reduced aggregate demand and slowed economic growth. The financial sector and economic stimulus policies sought to counter reduced spending and economic stagnation with so-called financial innovations and easy credit, which led to increased debt-driven consumption, particularly among poor and middle-income households in the advanced economies of the United States of America and Europe. As a result, poor and middle-class households accumulated unsustainable debt. Household debt in the United States rose from around 50 per cent of gross domestic product (GDP) in the early 1980s to nearly 100 per cent in 2007, and to 130 per cent of disposable income (Papadimitriou, Hannsgen and Zezza, 2008; Krugman, 2010). Not surprisingly, with this increased debt came a decline in savings among the poor and middle classes, feeding further demand for, and supply of, credit to these same households. As rich households tend to hold riskier financial assets than other income groups, there was a further concentration of income and wealth at the top of the income distribution ranking. The expansion of hedge funds and subprime derivatives, associated with the rising demand for credit increased, not only the incomes of the super-rich but also, aggregate speculation (Stiglitz, 2012; Lucchino and Morelli, 2012; Rajan, 2010; Reich, 2010). This combination of forces created the unsustainable process of expansion in the United States and other developed countries in Europe that culminated in the financial crisis.

The complex relationship between inequality and growth is also illustrated by the potential of economic crises to create, or deepen, inequalities. The financial and economic crisis impacted many countries by increasing their fiscal deficits, limiting their policy space and their capacity to respond to future shocks. In particular, the crisis also spurred the sovereign debt crisis in Europe, to which policymakers have responded by implementing austerity measures. This has not only decreased growth rates in Europe but has affected other economies through reduced trade and aid.

With the declining revenues fuelled by the crisis, many Governments have been unable to maintain, or increase, public spending in critical areas, including those that affect livelihoods and living conditions. The less well off have been disproportionately affected, hit heavily by job losses and income declines (ILO, 2013a).

In many countries, the increase in part-time work in comparison with full-time work, and reductions in overtime, has resulted in fewer total working hours, exacerbating a phenomenon that existed before the crisis. In Europe, temporary workers have felt the brunt of labour-market adjustments. Ninety per cent of employment losses in Spain were among temporary workers (Vaughan-Whitehead, 2012). Across the region, and in many other advanced economies, rising unemployment has put downward pressure on real wages, reducing consumption further. Bulgaria, Hungary and the United Kingdom have experienced increases in wage differentials between the top and bottom of the wage scale. Aggregate statistics may hide the actual depth of the effect of the crisis on income-inequality, as lower-waged, low-skilled and temporary workers may be laid off first, leaving better-paid workers employed at higher aggregate wages (ILO,2013b). In emerging and developing economies, structural change has slowed since the crisis, as jobs are not moving from low- to higher-productivity sectors as fast as they had before. This has slowed progress in reducing vulnerable employment and the number of working poor.

The mixed impact of the recent crisis on inequality and growth highlights further the importance of social and fiscal policy in shaping the effects of growth on poverty reduction, social mobility and social cohesion. Chapter 1 showed that many countries in Latin America, several in Africa and a few in Asia experienced declines in income inequality between 2003 and 2010. In most of those countries, proactive public policies played a critical role in ensuring that the crisis did not harm the population in the bottom half of the distribution disproportionately. The following sections discuss some of the social impacts of inequality, and show that policy matters, critically.

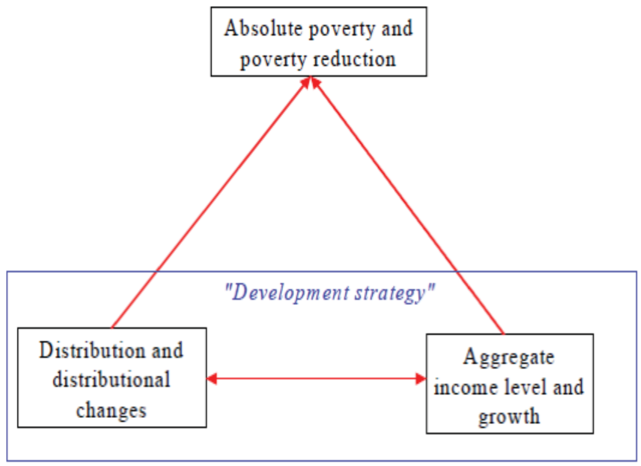
II. Inequality and poverty

Inequality, and its relationship with growth, have marked implications for poverty reduction, and vice versa. Income and non-income inequalities shape the responsiveness of poverty to income growth. Inequalities also undermine the growth process by excluding people living in poverty from sharing the benefits of growth (Ravallion, 2011; Adigun, Awoyemi and Omonona, 2011; Adams, 2003; Easterly, 2000; Kakwani, 1993). Lack of opportunities for building human capabilities, such as limited access to quality education and health care, can contribute to rising inequality, and limit social and economic mobility. Similarly, unequal access to other tangible productive assets, such as agricultural land, contributes to rising, or persistently high, inequality, by limiting the ability of some to share fully in the benefits of growth. In turn, these developments can lower growth rates, as argued in the preceding section. The quality of institutions and the nature of social policies pursued by countries are, therefore, important in determining the ultimate level and direction of both inequalities of opportunity and of income.

As illustrated by figure III.1, the inequality-poverty-growth nexus is one of co-dependence. While accelerated economic growth is a primary factor in reducing poverty, inequalities can constrain poverty reduction significantly. Without a change in the distribution of income, poverty reduction is only possible with growth. However, growth is less effective in reducing poverty in high-inequality countries, even when the distribution does not worsen; and, low levels of initial inequality, or modest reductions, can have relatively large poverty-reducing effects (Bourguignon, 2004). Grammy and Assane (2006) showed that improvement in income distribution was the key channel for poverty reduction. Using data on sixty-six developing countries over the periods 1970-1979, 1980-1989 and 1990-1998, they noted that growth accompanied by improved distribution worked better than either growth or distribution alone, and that provision of civil liberties and political rights enabled people to participate more actively in reducing poverty.

The pace of poverty reduction also tends to be much faster in more egalitarian countries and in countries in which lower initial levels of inequality have been followed by sustained growth spurts. Conversely, poverty-reduction efforts have been observed to falter in countries with large inequalities, weak growth or inadequate social protection programmes (Fosu, 2011; Besley and Burgess, 2003; White and Anderson, 2001; Bruno, Ravallion and Squire 1996). Yet, as highlighted earlier, redistribution without competitive economic incentives can undermine productivity and economic growth. The relationship between inequality, growth and poverty thus strikes a delicate balance. Prioritizing growth alone is not sufficient for poverty reduction. In order to reduce poverty effectively and sustainably, growth must be combined with sustained investments in human capital, such as education and health, and food and nutrition security, that keep income and non-income inequalities at constructive levels.

Figure III.1. The growth-inequality-poverty triangle



Source: Bourguignon (2004)

The experience of poverty reduction in East Asia is often cited as a counter-argument to the need for curbing inequalities. Over the past 30 to 40 years, some East Asian countries have managed to achieve rapid poverty reduction despite rising inequality. In China, for example, very rapid output growth (at an annual rate of around 9 per cent - 10 per cent between 1981 and 2005) was associated with dramatic declines in poverty (at an estimated annual rate of 6.6 per cent over the same period), even though inequality measured by the Gini index rose from 0.16 in 1980 to about 0.48 in 2011. However, inequality in both assets and incomes in China was extremely low at the start of the high growth phase, and this was probably critical to enabling rapid income growth. Further, poverty declined most sharply in the early 1980s and the mid-1990s, both of which were periods of falling inequality (particularly rural-urban income inequality). Increased income to farmers was crucial in reducing aggregate poverty at these points (Ghosh, 2010). Without rising inequality, the high rates of growth in China would have translated into even higher poverty reduction (Ravallion, 2011; Fosu, 2011).

The cross-country variations in growth and inequality presented in Chapter 1 underscore the complex linkages between growth, inequality and poverty reduction. They are a reflection of the different macroeconomic and social policies that countries have (or have not) implemented in order to stimulate growth, foster structural transformation, create employment opportunities, widen access to basic opportunities in education, health and job training, and deepen social provisioning. Addressing inequalities requires a combination of growth-enhancing, employment-generating macroeconomic policies and redistributive social policies. A focus on only one set of policies is likely to maximize impact on either poverty reduction or lowering inequalities, but not, necessarily, on both. However, tying redistributive policies too tightly to growth policies, or equity objectives too closely to growth objectives, would be a major mistake (McKinley, 2009). Greater equity should be valued as an end in itself—not primarily as a means that could advance the cause of growth. Redistributive policies, therefore, need to be addressed in their own right.

III. Inequality and social mobility

The relationship between inequality, poverty and growth can also manifest itself through the ease—or difficulty—with which individuals are able to move up the socioeconomic ladder, and live better lives in relation to their parents. This intergenerational socioeconomic mobility reflects the dynamic impact of inequality. The degree of mobility within a country is an indicator of the distribution of access to opportunities for building human capabilities, and of the extent to which people can move ahead based on their abilities and efforts.

One measure of socioeconomic mobility is the relationship between the incomes of parents and children. Limited income mobility would mean that all children born to poor parents would be poor as adults, and all children born to rich parents would become rich adults, regardless of their innate potential or efforts. The intergenerational earnings elasticity (IEE) of a given society is a measure of the fluidity or rigidity of this relationship. IEE ranges from 0 (total mobility) to 1 (no mobility) and, as illustrated by the phenomenon known as 'the Great Gatsby Curve' (Kreuger, 2012), is affected significantly by initial levels of inequality (Corak, 2013, figure 2). Although data differences make inter-country comparisons tenuous, Corak (2013) shows that higher levels of inequality are associated with less intergenerational mobility. Developing countries also show less income mobility than developed countries, a trend that may be related to the comparatively fewer opportunities for improving human capacity in developing countries, such as access to quality education, health care and decent work.

Recent studies find some support for a link between rising inequality and declining mobility in the United States and the United Kingdom (Blanden, Gregg and Machin, 2005; Bradbury, 2011). As income inequality in the United States has increased, family income mobility has declined, and the link has become stronger with time (Bradbury, 2011). A similar situation was found in Britain, when comparing income mobility of children born in 1958, versus a group born in 1970 (Blanden, Gregg and Machin, 2005). While less is known about intergenerational income mobility in developing countries, studies in Latin America have shown strong links between the socioeconomic status of parents and that of their children (Grawe, 2004; Dunn, 2007; Nunez and Miranda, 2010). In many countries, parental wealth has a substantial effect on children's education, occupational status, consumption, and wealth later in life (Torche and Costa-Ribeiro, 2012).

The structure of inequality in terms of the varying concentration of households along the income distribution also affects the degree of income mobility in a given country. There are fewer opportunities for mobility in those countries characterized by smaller middle classes, more people concentrated at the bottom of the income distribution and fewer at the top. There tends to be less mobility at the very top and bottom of the income distribution, as the very poor are less likely to move up while the extremely wealthy are less vulnerable to downward mobility and more likely hold on to their positions (d'Addio, 2007).

Education is an important channel for socioeconomic mobility. Countries with higher overall levels of education tend to have higher intergenerational mobility (Filmer and Pritchett, 1999; Behrman, Birdsall and Szekely, 2000; Dahan and Gaviria, 2001). In Latin America, a region with otherwise very high inequalities, a main determinant of the fall in wage inequality over the 2000s was the increase in secondary enrolment and completion rates that began in the early 1990s and accelerated during the 2000s. This trend benefited children from low-income families in particular (Cruces, Domench and Gasparini, forthcoming). In the Republic of Korea, rapid educational expansion led by public spending contributed to high educational mobility. Forty-five per cent of the 1970-to-1985 birth cohort whose fathers did not achieve high-school diplomas received at least some college education, and 59 per cent of women had received some college education by 2005 (Kye, 2011).

In turn, socioeconomic background influences educational attainment in several ways. Children from disadvantaged families may receive less parental and domestic support and cognitive stimulation, live in poorer neighbourhoods, experience worse health outcomes, and have other conflicting pressures such as contributing to family income or housework-related tasks. Studies have found that, even by the age of five, substantive gaps have emerged in the cognitive and non-cognitive skills of children from different socioeconomic backgrounds. These gaps have a tendency to widen over time as less advantaged children encounter more barriers to choice, such as: the need to opt out of school and join the workforce to contribute to the household, inability to pay school fees, and lack of access to quality schools (Bradbury and others, 2012; Heckman, 2006).

As will be discussed in Chapter 4, membership in a particular ethnic group, class, gender, or having other social characteristics can heighten educational disadvantage and upward mobility. For example, Majumder (2010) found intergenerational educational mobility in India to be much lower for disadvantaged and excluded groups than for advanced classes. Similarly, in South Africa, Nimubona and Vencatachellum (2007) found that the intergenerational educational mobility of black Africans was lower than of white Africans, with the poorest groups experiencing the lowest levels of mobility.

Educational attainment and social and economic mobility are clearly interrelated, and policies to address disparities in education need to bear this in mind. Education can mediate the association between the socioeconomic status of parents and that of their children, a persistence present in many country settings (Hertz, 2008). As Chapter 5 highlights, policies to promote universal quality education are important. However, in order for educational access to translate into improved social and economic outcomes across generations, attention to household support structures is important, as well as attention to the discrimination and social exclusion creating the socioeconomic traps in which some families are caught.

Health outcomes are also integral to intergenerational upward mobility. Good health is an important precondition for the development of other capabilities that can enable socioeconomic mobility, such as education and labour productivity. Poor health can limit individual socioeconomic prospects and, ultimately, perpetuate—or even contribute to—increases in income and non-income inequality. Children in poor health may have greater difficulty learning, leave school earlier than healthy children, and tend to become less healthy adults. Adults in poor health may have difficulty finding, or holding, good jobs. They may not be able to work as many hours, or at the same productivity level, as their healthier peers, resulting in lower wages (Case and Paxson, 2006). Conversely, there is a clear relationship between poverty and the increased likelihood of poor health (Adamson, 2010). Policies to promote investment in health thus form an important component of any strategy to facilitate socioeconomic mobility.

IV. Social and political cohesion, social tolerance of inequality

Besides its close relationship with social mobility, inequality also matters for social and political cohesion and social tolerance. Under certain conditions, inequality can contribute to social instability and undermine trust. This is particularly the case where the gap between rich and poor is large and continuing to grow.

The upsurge in inequality in many parts of the world is generating divergent life experiences and societal expectations between the affluent and other social groups. The result has been greater social stratification and residential segregation. As the wealthy retreat from broad civic engagement and insulate themselves from the social and economic costs imposed by rising inequality on the broader society, they are less likely to be concerned about the plight of the less fortunate. The rich, individually or in associations such as business lobbies and other groups, may also engage in unproductive or predatory activities that add to inequality, and may be further detrimental to growth and economic and financial stability. This includes political lobbying to increase further their share of existing wealth through regulatory capture and by influencing the formulation and application of rules to their own advantage. Such behaviour weakens social trust and the social compact between groups further, and makes it much more difficult to forge common political solutions and social policies that promote investment in areas such as education, health and social protection (Oxendine, 2009; Costa and Kahn, 2002; Kawachi and others, 1997; Massey, 1996).

The denial of political voice or influence among those at the lower end of the inequality spectrum can cause social tensions, political instability, and even, violent conflict. People grow frustrated when they perceive that opportunities to improve their own lives are inaccessible, and the resultant protests can also lead to social unrest. This has shown itself in the wave of demonstrations seen around the world in response to the economic and financial crises and austerity measures, and in the social and political protests in the Middle East and North Africa. The discontent has not necessarily been always related to the absolute level of inequality, but to a combination of rising expectations and limited opportunities. For example, in Tunisia, high levels of educational attainment coupled with the lack of employment and decent work opportunities were critical factors fuelling the tensions (Campante and Chor, 2012). Similarly, the recent public protests in Brazil that involved workers, students, middle-class professionals and others, not only reflected continued inequalities, but expressed a wide range of demands about public service provision and corruption, reflecting the rapid growth of expectations in a dynamic country (Saad-Filho, 2013).

The relationship between income inequality and conflict is complex. Poorer countries tend to have more conflict than wealthier countries (Collier, 2007), and in highly unequal societies, both rich and poor groups are in conflict more often than groups whose wealth lies closer to the country average. Furthermore, horizontal inequalities between ethnic groups and States can promote conflict (Cederman, Weidmann and Gleditsch, 2011). Local economic characteristics also matter for conflict: civil conflicts are more likely to erupt in areas with low absolute income, even if a country's gross domestic product per capita is not necessarily low, and in areas with large deviations from national averages (Buhaug and others, 2011).

Inequality is more likely to be perceived as acceptable where all individuals have equal opportunity to improve their socioeconomic position, and where those at the upper end of the income continuum have achieved their position through merit rather than inherited advantage. As a result, when the level of Government investment in education, health, public transport and social security increases, the likelihood of the onset of civil conflict declines significantly (Taydas and Peksen, 2012).When privileged elites use institutions, public resources and access to assets, such as land, to maintain their status, they impose tremendous social and economic costs on society – creating conditions which not only weaken economic growth, constrain the financial development of countries and foster long-term inequality, but also contribute to social exclusion and political instability (Acemoglu and Robinson, 2012; Roe and Siegel, 2011; Sokoloff and Engerman, 2000). Furthermore, social and economic inequalities reinforce disparities in political participation and, as a result, ethnic minorities, women, indigenous people, youth and other affected social groups tend to have significantly lower rates of political participation. However, ethnic-minority participation and representation has been increasing in many liberal democracies (Bird, Saalfeld and Wüst, 2010). Similarly, gender inequality in political participation is declining, albeit slowly, worldwide (Coffé and Bolzendahl, 2011). Despite such improvements however, all regions are still well below equality in the engagement of all social and economic groups in activities intended to influence Government decision-making.

The media play an important role in shaping how inequality is seen and addressed. There is evidence that the extent of media freedom in democracies is positively associated with spending on health and education, net of the overall level of development (Petrova, 2008). Media control can also lead to manipulation of public opinion in ways that perpetuate, or increase, inequalities. High inequality is associated with elite capture of media and lower media freedom, particularly in democracies. A study on the way in which tax cuts in the United States were presented to the public in the early 2000s showed how media framing of the issue may have led to support for the cuts by the majority of citizens. This occurred even though the benefits were heavily concentrated at the very top of the income and wealth distributions, and although the implications – in terms of reduced public spending in other areas–were often against individuals' own economic interests and widely-shared collective values (Bell and Entman, 2011). Another study on the United States found that media outlets largely ignored economic inequality in discussions about the overall economy, despite mounting evidence suggesting that the problem had increased in recent years (Kleine, 2013).

Social media play a new role in this context, and the rapidly changing nature of media business and coverage suggests that traditional forms of elite capture can be both undermined and reinforced by the new social media. It is harder to influence the content and perspectives of major media providers amidst so many alternative sources of information. It is also harder to prevent different—and more pluralistic—forms of expression that can inform those who would otherwise remain unaware of actual trends, including in inequalities, and how policies can affect them. However, the digital divide remains large, albeit narrowing, even in developing countries where mobile telephony is fulfilling many of the earlier functions of personal computers. Moreover, blogging and similar forms of media interaction are still strongly class-driven (Schradie 2012), even as race and ethnicity become less important as determinants.

V. Conclusion

The many adverse consequences of inequality affect not only those at the lower end of the distribution, but also those who would seem to be benefiting from it. The onset—and continued impact—of the recent financial and economic crisis highlights the damage that inequalities can do to social and economic development. Inequality leads to less stable, inefficient economic systems that restrain economic growth and pose a serious barrier to the eradication of poverty. This, in turn, reduces the contribution of economic growth to social development and reduces social mobility.

Given the complex linkages between inequality, growth and poverty reduction, macroeconomic and social policies must aim at stimulating growth, fostering structural transformation and deepening social provisioning. All individuals, irrespective of their background, should have a fair shot at economic success. Accessing those opportunities that nurture their talents and abilities is critical.

Rising inequality can have a particularly profound impact on specific groups within societies. Various social groups – such as youth, older persons, persons with disabilities, indigenous peoples and rural populations – suffer disproportionally from inequality. Chapter 4 elaborates on how the disparities associated with these social groups intersect with, and reinforce, each other.