How Important is Directly Targeting Inequality for Economic Development?

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Inequality is perhaps the most topical and pressing issues in economics today. In this essay, Eilis O'Brien examines the relationship between inequality and growth. She first considers the contrasting evidence regarding the relationship between income inequality and growth, citing the wealth theoretical and empirical which have come to seemingly contradictory results. Eilis finds however, that if inequality of opportunity is distinguished from inequality of outcome, then the relationship becomes a little clearer. She shows inequality of opportunity certainly is inefficient and has negative effects on growth. However, a certain degree of income inequality is needed for an economy to function, although excessive income inequality is associated with less equality of opportunity and lower growth. She concludes that a balance is needed to maximise efficiency, and that policymakers should exercise caution in pursuing policies which are untested and based solely on theory.

Introduction

The issue of inequality is a pivotal element of development economics, with income inequality in particular at a significantly high level today (Oecd.org, 2017). This calls for an examination of the importance of inequality and development. This essay will focus on national economic development, defined as the deviation of actual observed economic growth from potential growth. Inequality can be divided into three concepts following the definition by Marrero and Rodriguez (2013), where the combination of inequalities of opportunity and effort result in inequality of outcome. Inequality of opportunity is structural, ingrained in the

fabric of society a result of the human, social, political and economic resources an individual has access to depending on their geographical and social place of birth. Inequality of outcome, on the other hand, is a consequential inequality characterised by differences in individual accumulation of economic capital.

The importance of directly targeting income inequality to achieve full development is difficult to measure due to differences in analytical methods and countries analysed, and the difficulty in establishing causal relationships. Nonetheless, it would appear that although inequality of income may provide incentives for production, there is empirical support for the reduction of income inequality leading to redistributive policies which hinder economic growth. On the other hand, there appears to be more agreement regarding the detrimental effects of inequality of opportunity on efficient resource distribution and subsequent economic growth. It would seem that in order to experience full potential growth, a country should focus on reducing inequality of opportunity and on implementing policies which seek to reduce income inequality in such a way that the incentives provided by income inequality are not affected. Moreover, the inconclusivity of results highlights the fact that the design of policies which target inequality should take into account the political and economic context.

Income Inequality and Development

If inequality is defined as disparities in income, then the relationship between inequality and economic growth is difficult to establish, as results vary depending on the method of analysis, or the countries analysed (World Bank, 2006). Nonetheless, it would seem that both direct and indirect targeting of inequality are not necessary to achieve economic growth. However, although there is evidence that a certain level of inequality may promote growth in more developed countries, it would appear that the disruptive redistributive policies, which are implemented in political economies as a result of disparities in income, may support directly reducing income inequality.

Central to this debate is the focus on direct targeting of inequality as opposed to indirect targeting. To claim that direct targeting of inequality is unnecessary is to assume either that inequality will decrease as a result of economic growth, or that there is no relationship between inequality and growth in the first place. In contrast, empirical observations imply that direct targeting may be useful for economic development.

Indirect Targeting

It has been theorised that direct targeting of inequality is not necessary for economic growth, but rather that inequality will be indirectly influenced as a result of growth. One of the most influential concepts regarding the relation-

ship between inequality and economic growth was formulated by Simon Kuznets (1955). According to Kuznets, as a country experiences growth, income inequality first rises as a result of industrialisation and urbanisation (Kuznets, 1955, p.17) before falling as efficiency increases, as a greater proportion of the population is born in urban areas and a set of welfare policies are implemented. Kuznets did note the lack of solid empirical evidence to support his theory, and although this relationship between inequality and growth has been noted empirically, the causal interpretation that he established has been contested (Barro, 2000).

Similarly, a large cross-country study by Dollar and Kraay (2002) found that direct targeting of inequality was not a necessary prerequisite for economic growth. Their research supports the implication of Kuznets theory whereby indirect targeting of inequality is unnecessary for development. However, their interpretation differs from Kuznets theory since they find that growth influences the income of the poor at a rate equal to the rest of the population. More importantly, their research finds that direct targeting of inequality has no more influence on income distribution than it does on overall growth. According to their research, economic development does not require direct targeting of inequality, but rather that income equality will rise proportionately with economic growth.

Direct Targeting

However, significant inconsistencies have been noted with Kuznets theory. Stiglitz (1996) argues that the rapid growth in East Asia starting in the 1970s was a result of policies promoting growth combined with ones specifically targeting inequality. This implies that, contrary to Kuznets theory, inequality is not indirectly reduced as a result of economic growth, but rather that specific policy implementation seeking to reduce inequality directly may be one of the driving factors of economic growth.

Other relationships between income inequality and economic growth have been observed. Banerjee and Duflo (2000) found a non-linear relationship between inequality and growth where a change in inequality is associated with reduced growth in the short-run. They base their model on a political economy where redistributive policies are implemented when inequality arises. They note that their results may be due to the disruptive effects of a hold up (increased inequality) or redistributive policies (lower inequality) in the short-run, though they impress upon the difficulty in establishing a causal relationship. Barro (2000) states that the distortionary effect of redistributive policies is often considered to be an explanatory theory for the decrease in growth for less developed countries when high inequality is present. Marrero and Rodriguez (2013) also comment upon the potential detrimental effects of income-based redistributive policies on

growth. Considering the fact that pre-existing inequality is the reason for such disruptive policies, these findings could indicate the benefit of directly targeting income inequality, even if it leads to a short-term reduction in growth.

This notion is supported by Persson and Tabellini (1994) who claim that there is a negative relationship between inequality of income and economic growth as a result of decreased investment and reduced returns from investment due to disruptive redistributive policies. Moreover, they state that this is specifically the case in democratic countries, perhaps due to the higher concern with redistribution in democracies. These findings imply that direct targeting of inequality in democracies may be necessary to reduce the impact of redistribution and achieve greater economic development. Their research highlights the importance of taking the political context of a country into account when assessing the importance of inequality.

Barro (2000) further argues that there may be a negative relationship between inequality and economic growth, and in particular that variations in economic context should be taken into account. He finds that inequality prevents economic growth in developing countries but promotes growth in more developed countries. This has been noted in other research (Shin, 2012), which implies that policies seeking to promote economic development should take into account the current level of development of a country, and focus on reduction of inequality if they are less developed.

Although there seems to be support for the direct reduction of income inequality in order to promote economic development, it is important to note that a certain level of inequality of outcome may promote economic growth. Considering the importance of private property for the capitalist model, property rights can incentivise production and stimulate growth by creating a temporary monopoly which provides profits in order to promote innovation, production and growth if appropriately implemented (Kumar, 2003). Growth may therefore benefit from a certain level of inequality of outcome, and direct targeting of income inequality should be tailored to accommodate for this.

Overall, it would seem that inequality of income may be damaging for economic growth, although the extent to which this is the case is ambiguous. In a political economy or democracy, higher inequality often leads to redistributive policies which decrease capital accumulation and as a result decrease incentives for production. This change in inequality has been shown to lead to a short-term decrease in growth, and thus democracies may be more negatively affected by income inequality than more autocratic political economies. Income inequality has also been found to be a hindrance for growth in countries with lower levels

of development. Therefore, direct targeting of inequality may be necessary to promote economic growth as this would reduce the need for redistributive policies which diminish incentives for production, and this may be particularly important for less developed countries. However, property rights which guarantee inequality of outcome may also incentivise economic growth. The lack of a solid conclusion regarding this issue highlights the importance of taking current levels of development and political context into account when assessing the importance of inequality for development.

Equality as Participation in Economic Life

The difficulty of coming to a significant conclusion about the relationship between income inequality and economic development has not gone unnoticed. Marrero and Rodriguez (2013) argue that this is due to the use of disparities in income as a measure of inequality. They find that focusing on inequality of opportunity and effort as factors of income inequality provides a more complete understanding of the effects of inequality on development.

It would seem that full development can only be achieved if there is a reduction of inequality of opportunity with equal possibility for all individuals to participate in economic life. Inequality of opportunity is considerably more difficult to measure empirically than income inequality (World Bank, 2006). However, there is greater consensus regarding the importance of inequality of opportunity for development. Equality of opportunity promotes an efficient distribution of resources and enhanced institutional development which, combined, is a driving force for development.

Efficient Resource Distribution

There is much theoretical support for the importance of reduction of inequality of opportunity. The main reason is that of efficient resource distribution. The World Development Report (World Bank, 2006) highlights the fact that access to markets (and in particular credit markets) is often not as efficient as it is considered to be in economic theory. In theory, whether individuals invest or not is a function of the rental price of capital, potential returns and an investor s risk adversity. However, in practice, individual access to credit is dictated by moral hazards and imperfect information, and thus actors with higher return prospects, collateral insurance or political affiliations often have easier and cheaper access to credit. The report also notes that pre-existing stereotypes about certain individuals may lead to discrimination by lenders. This inequality of opportunity leads to capital being available to individuals on the basis of their economic, political or social background, rather than their expected social contribution. This leads to a certain amount of underinvestment. This inefficient distribution of resources

which is rooted in inequality of opportunity may therefore be translated as lost economic growth.

The importance of equal access to capital markets is supported by Barro (2000), who notes that profitable ventures are often not undertaken by individuals if they are poor. Indeed, the most profitable investments also tend to be the most risky ones. If an individual has limited access to credit then they will most likely not have access to capital for risky ventures, and thus a country will forego not just any investment, but a proportion of its most productive investment potential as a result of inequality of opportunity in the credit market. Inefficient resource distribution can also arise as a result of gender inequality. In some countries, female economic participation in the household is unequal to that of men (Duflo, 2003). In the case of what Sen calls missing women (Sen, 1992) there is a considerable proportion of women who, due to neglect in the early stages of their lives relative to their male siblings, undocumented female births, or selective abortion, never have the full opportunity of life to begin with. This discrepancy represents a reduction of the potential labour force, which entails a reduction of innovation, production and economic growth. Sen highlights the fact that policy implementation specifically targeting gender inequality could help reduce this inequality of opportunity, which implies that directly reducing gender-based inequality of opportunity may be necessary in order to achieve full economic development. Thus it would seem that, considering the inefficient resource distribution which arises as a result of inequality of opportunity to capital markets, education and full participation in economic life for women, directly targeting such areas may help promote full development.

Institutional Development

A thorough examination of development includes not only efficient access to markets, but equally non-market institutional development (World Bank, 2006). This too can be limited by inequality of opportunity. Indeed, the World Bank Report (2006) states that political, judicial and social institutions underpin the efficiency of markets, and that these are influenced by inequality of opportunity. The main concern regarding inequality of opportunity and institutions is that of unequal representation in the legal system. The World Bank provides notable examples such as slavery and apartheid, but this could also be applied to recent racial tensions and police brutality in the United States, for example. As long as there exists an imbalance of power in a society, there will be unequal opportunity of access to markets and resources such as capital or property rights, which leads to inefficient growth. This inequality of opportunity may become internalised by individuals and persist in the long run if policies seeking to tackle it are not

devised (World Bank, 2006).

Marrero and Rodriguez (2013) note the importance of evaluating not only inequality of opportunity, but also inequality of effort. If opportunity is to be held constant, then the main factor which influences outcome is effort. They argue that inequality of outcome as a result of effort rather than opportunity may be beneficial for an economy. This leads them to conclude that specifically targeting inequality of opportunity through tailored policy design may increase the possibility of individual effort without harming incentives for productivity.

Conclusion

Establishing the influence of inequality reduction on economic development is a complicated task. Much of the empirical data provides conflicting answers due to the varying nature of each model used. Nonetheless, the question can be assessed in two different manners. Firstly, there is conflicting evidence regarding income inequality and economic development. In theory, inequality of outcome may provide incentives for productivity and thus stimulate economic growth. Upon empirical examination, certain models find little evidence for any substantial relationship between income inequality and growth. Others observe a negative correlation between the two in the short run. However, there is some empirical evidence that income inequality may hinder economic development, in particular for less developed countries. This may be the result of the disruptive effects of redistributive policies which seek to reduce pre-existing income inequality.

Secondly, once the definition of inequality is nuanced, the answer becomes considerably clearer. Inequality of opportunity seems to be negatively correlated with economic development for countries regardless of their level of development. Theoretical arguments highlight the importance of equality of opportunity and efficient resource distribution for economic development. Therefore, it would seem that policies which seek to reduce inequality of opportunity may be necessary in order to achieve full development, and that this may be more important the further away from steady state growth a country is. A reduction of inequality of opportunity as a result of specifically tailored policies may enhance economic growth without damaging the incentives provided by outcome, since this would allow variations in effort to be the determining factor of outcome rather than opportunity.

Overall, it seems that directly targeting inequality may not be necessary in order for a country to experience economic growth, but that a certain discrepancy may exist between actual growth and potential economic growth if inequality of opportunity is not specifically targeted. Considering the conflicting data which

emanates from research depending on the research model and the political and economic context of the country under examination, it would seem unwise to implement policies that have been informed solely by generalised research. Differences in the structural context of individual economies, societies and political regimes should be taken into account, and specific research based upon tailored data and models should inform policies which seek to promote development.

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