

Income Inequality and Growth

Some people are of the view that income inequality is a necessary part of the growth process that it is generally unavoidable and that policy should focus on ensuring that everyone is doing better rather than focusing on narrowing the income gap. Other analysts argue that income inequality undermines growth and that policies aimed at reducing inequality will support growth too.

Based on international experience, economic theory and empirical evidence, what is your view of this important debate?

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Abstract

What is the relationship between income inequality and growth? Popular theory post-1950 suggests that income inequality and growth are necessary bedfellows; increased income inequality is a natural consequence of the growth process and is only temporary anyway. However, some evidence suggests otherwise. Modern thinkers question the necessity of income inequality as a consequence of growth and its possible negative effects, given the growth without rising income inequality in the far-east and stagnating growth in sub-Saharan Africa in the face of rising inequality. This paper seeks to evaluate these warring opinions and assess where South Africa stands in the pursuit of growth and the reactions to the effects of ever rising income inequality and what South Africa can do and is doing in the pursuit of long-term, sustainable growth.

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Growth as the Spur to Income Inequality

Why is Growth Important Anyway?

The term economic growth means the increase in the real gross domestic product (GDP) over a period of time (Goodwin, et al., 2007). Economic growth is purported to represent the overall increase in living standard of the population within a nation, although this claim is contentious and there is still some debate over the relevance of economic growth, in itself, as an adequate proxy for living standard measure. Theoretically, economic growth can reduce poverty and unemployment and improve the government's budget deficit and improve living standards

The reduction in poverty is more of a correlation than a causation effect, but it has been determined that without economic growth, a reduction in poverty is very difficult. The increase in production levels as a result of growth increases the amount of employment opportunities available. The increase in labour demand may not necessarily be meant for the labour in current supply. Increases in production are connected to an increase in income, which, in turn, increases tax income, without increasing the tax rate allowing budget deficits to fall. The improvement in living standards comes about as a result of this increase in government revenue, which enables the government to spend more on infrastructure development and service delivery.

Income Inequality and its Discontents

Income inequality is the degree of variation between the income levels amongst people in a country. Income inequality is a proxy for actual inequality within a nation. It is measured using the Gini index, which calculates the ratio of the area between the Lorenz curve and a 45° line from the origin to the area under the 45° line (Central Intelligence Agency). The Lorenz curve calculates the total income over the population ranging from poorest to wealthiest.

The internal economic issues associated with income inequality deal with political instability consequences of a high level of income inequality (Furman, et al., 1998). Income inequality also makes it difficult to predict the effects of policy reform, because of the differing effects of the different orders of society. The government is subject to the dictates of society and if the majority of the electorate is made up of the poorest members of society, growth policy that undermines the effects of income inequality will not be tolerated and governments hand will be forced to reject such proposals.

Growth's Nasty Little Habit

It has been theorised that growth can cause income inequality to increase, depending on the point of development (Kuznets, 1955). Basically, when a country is still at a low development level and growing, it will experience an increase in income inequality as it grows before it reaches a certain level of development at which point income inequality will start to fall. This implies that income inequality is a natural consequence of an initial growth

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spurt and that, in the long run, the change in income inequality is smaller than otherwise thought and the trade-off between growth and inequality is an initial short-term effect (Kuznets, 1955).

This phenomenon that had been theorised by Simon Kuznets can be illustrated diagrammatically with the Kuznets curve. The Kuznets curve is an inverted U-shape relationship curve between inequality and Income per capita. It is explained by the migration of labour from one sector to another more productive sector, namely agriculture and industry and the process of urbanisation (Kuznets, 1955). In the initial stages of migration, the gap between the rich and the poor is small but increasing, as there are still few people in the more productive sector relative to the highly saturated unproductive sector and the income per capita is still low due to under-utilisation of the more productive sector. Further increases in migration result in a larger income per capita, but with large divergences in the income to labour from the more productive sector versus the less productive sector, the income inequality is larger than before (Kuznets, 1955) and educational disparities have an offsetting affect on the level of migration. The increase in the wealth of the nation will cause an increase in the quality of infrastructure and education. This enables the labour from the less productive sector to move into the more productive sector and as the majority of the labour force becomes assimilated in the more productive sector, so the income inequality diminishes (Kuznets, 1955).

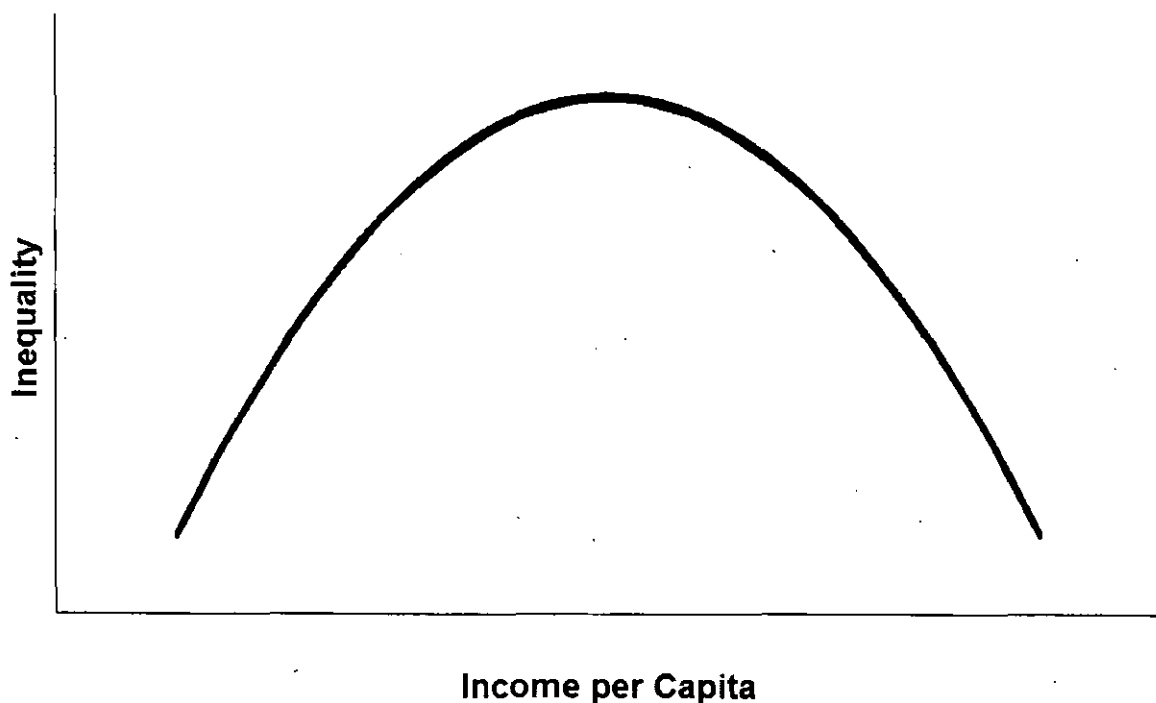


Fig. 1: The Diagrammatic Representation of the Kuznets Curve (Frazer, 2006)

The implications of Kuznets' findings were that income inequality is justifiable given that it is a short-run phenomenon and will be mitigated in the normal growth process through "the dynamism of a growing and free economic society" (Kuznets, 1955). Therefore, rising inequality became justifiable by policy-makers by invoking the power of the Kuznets Curve and concerns raised with regard to inequality became dismissible.

But who does it Hurt, Really?

According to Kuznets' hypothesis, no one will be hurt, because income inequality is a necessary and inevitable consequence of growth (Furman, et al., 1998). While there will be an initial divergence of incomes, the incomes of the poorest members of society will not necessarily decrease. The theory explains that overall growth will improve the overall welfare of society by marginally improving the lot of the lowest echelons of society (Moran, 2005). This, in turn, leads to strong mechanisms through the use of bargaining power of the larger part of the electorate, namely the poor. Their increased political relevance allows them to steer legislation to their favour thereby equalising economic positions (Moran, 2005).

Income Inequality pulls the Breaks

Growth Gets Stabbed in the Back

There exists alternate evidence which suggests the relationship between growth and income inequality is not the positive correlation that had been hypothesized. The suggestion is that income inequality actually has a negative impact on growth, can, in fact, undermine the growth process and is not necessarily a natural consequence of the growth process, but is merely the Cain to growth's Abel.

It was argued earlier that the distributional turnaround occurs as a result of the increased bargaining power of the poor and the shifting welfare expenditure that causes a further shift to the more productive industry, thereby normalising wealth distribution. The alternate relationship between growth and inequality is explained in this effect. Some would argue that this opportunity for redistribution undermines growth, due to the strong strain on the growth-promoting aspects of the economy it imposes. Growth-promoting aspects include investment (Furman, et al., 1998), specifically investment in human capital and aggregate demand (Galor, et al., 1993).

Therefore, the existence of income inequality, which may be a product of growth due to the initial skills bias, can undermine growth.

Should Growth Kick the Habit?

The theory and intuition suggests that if there is a negative effect on growth due to income inequality, there needs to be some form of compensation made to affected groups. The

compensation need not be drastic or even monetary. The only necessary criteria of the compensation are that it be observable and that it be credible.

The association between growth and inequality may not be able to be eliminated, but it may be offset by a compensation mechanism. This does not change the fact that income inequality does arise from growth, but it recognises and combats the self-destructive aspect of growth arising from its stimulation of income inequality.

What does the Real World say?

Evidence

The evidence tells us that there is little to no correlation between growth and income inequality and the little correlation is negative anyway. This sample has been taken across a pool of countries, however, who display different tendencies.

When looking closer at specific country dynamics, a clearer picture is provided. While there is

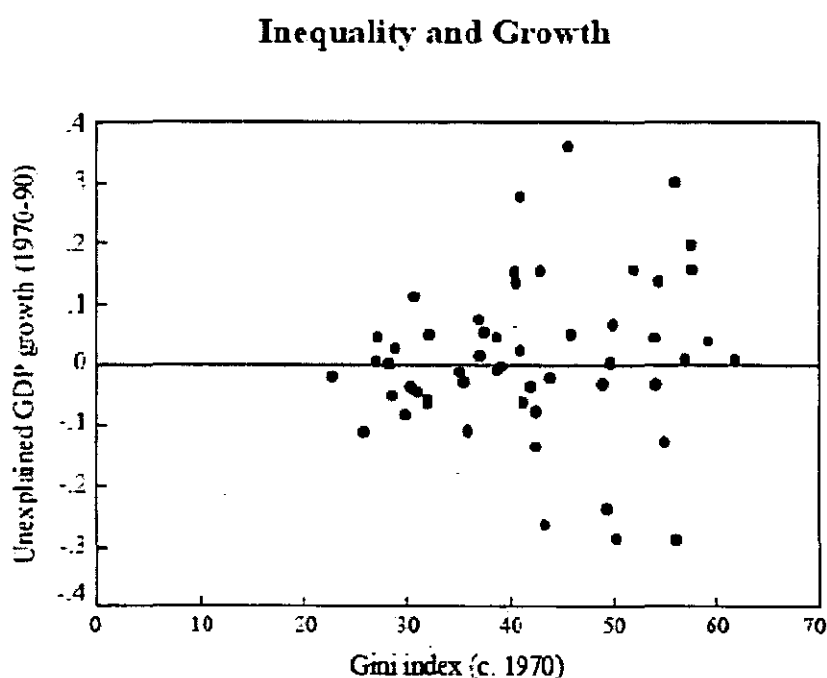


Fig. 2: Scatter plot of the relationship between growth and income inequality (Furman, et al., 1998)

no clear overall correlation between growth and income inequality, the reaction of growth to income inequality could be dependent on the type of country that is being dealt with.

Income Inequality and Growth of GDP, 1965-89

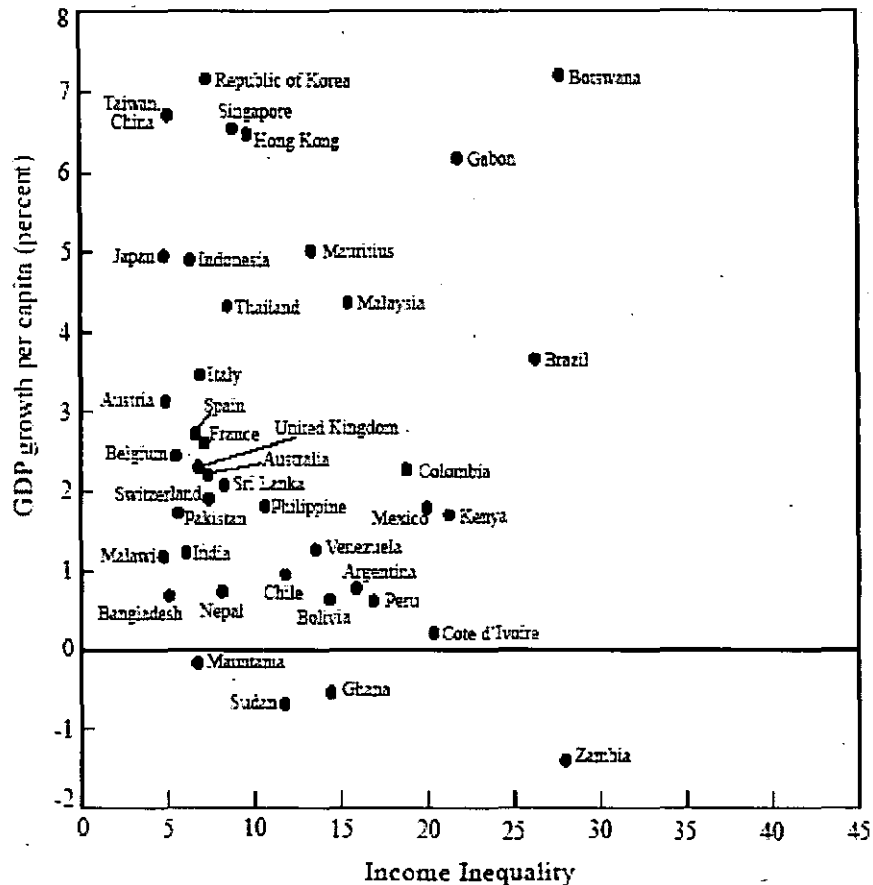


Fig. 3: The relationship between per capita growth and income inequality across a selection of countries (Furman, et al., 1998)

Things are Not Always as they Seem

Some countries do favour the Kuznets' theory of increased inequality with increased growth, such as Botswana, whereas the Asian nations, such as Taiwan and China display the opposite effect of high growth with low income-inequality. The explanation for these differences could be that the different effects of inequality on growth have an offsetting affect at the aggregate level (Barro, 1999).

This means that depending on the predominant affect of income inequality within a country, the relationship between inequality and growth will differ depending on the country and its relative wealth (Barro, 1999). Growth in Sub-Saharan Africa, for example, (with the notable exception of Botswana) is generally significantly negatively affected by

income inequality (Nel, 2003). Relative effects of income inequality need to be evaluated in accordance with the type of country being dealt with. Inequality, it seems, is bad for poor countries, but promotes growth in rich countries, or the reduction in income inequality (greater equality) promotes growth in poor countries (Chang, et al., 2000).

To whom should South Africa defer?

One Size does not Fit All

This presents something of a conundrum for South Africa, as a developing country. Is South Africa a poor country? Is South Africa a rich country? Countries such as Taiwan and South Korea have managed to maintain low inequality levels and at the same time achieve substantial growth providing definite evidence that growth can be spurred by decreasing income inequality.

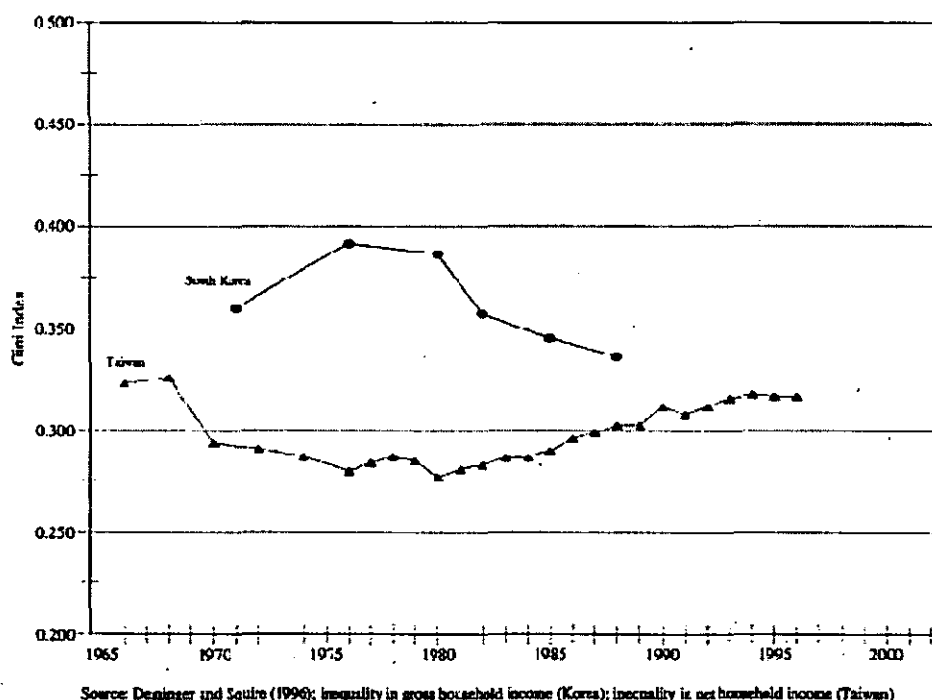


Fig. 4: Income inequality of South Korea and Taiwan from 1965 to 1997. (Korzeniewicz, et al., 2005)

On the other hand, Botswana, a neighbour to South Africa, paints a different picture. Botswana has experienced high levels of growth, but has a significantly high level of income inequality (Acemoglu, et al., 2001). It can be argued that Botswana has a lot in common with South Africa, given its location and legacy, but there are significant differences between the two countries. Botswana had been colonized for a relatively short period of time and had institutions in place prior to colonisation that allowed growth to flourish (Acemoglu, et al., 2001). South Africa, on the other hand, had been colonised for a very long period and was subsequently still under an oppressive regime.

South Africa's Size

Earlier in this paper, the benefits of economic growth were discussed. One of the benefits of economic growth is poverty reduction. The evidence in South Africa shows that economic growth has been benefiting the wealthy by a much larger extent than the poor have been benefited (Bhorat, et al., 2009). Economic growth is unable to provide its proposed benefit unless substantially higher levels of growth is achieved (Bhorat, et al., 2009), which is unsustainable. South Africa will need to reduce the income inequality in order to achieve the benefits from economic growth and thereby achieve substantially higher growth.

The Right Policy

Improving the distribution of income in South Africa can be undertaken in several ways. One can relax the restrictions on borrowing in the country; increasing social spending; invest more in education and stimulate job creation. The first would possibly not be the best idea. It was the stance taken by the United States of America in response to rising income inequality in order to maintain political stability (Milanovic, 2009). The result was an unprecedented increase in lending to risky persons with no collateral. These persons defaulted on the loans that they could not afford and so began the story of the financial crisis (Milanovic, 2009).

Social spending in the form of grants has been a necessary provision in order to allow for even the minimal growth that has been experienced by the poorest in South Africa and its absence would result in a dramatic decrease in the growth level for the country (Bhorat, et al., 2009). Therefore, maintenance of current social spending and future increases in social spending would be a necessary policy stance.

Investment in education and stimulating job creation go hand-in-hand. One cannot ignore the relationship between income inequality and wage inequality. The wage share of the Gini coefficient has increased from 60.9% to 75.6% from 1995 to 2005 (Bhorat, et al., 2009). This reflects South Africa's structural unemployment problem (Bhorat, et al., 2009) and the purpose of education is to eliminate to eliminate the gap between demand and supply for specific forms of labour. The investment in education is essential in providing the requisite skills to the South African labour force. However, there is a trade-off between social spending and investment in education and, given that social spending is a proven income inequality mitigator, there cannot be a large diversion from social spending without serious consequences in terms of growth. This is where job creation also plays a part. In creating jobs in those sectors where South African labour is best employed, the structural unemployment can be tackled from the demand side (Bhorat, et al., 2009).

In order for there to be a significant dampening effect on inequality, a policy mix of all but the first possible recourse should be developed. A strong emphasis on social spending, however, (as the proven tool) should be maintained and on job creation due to the close

association between income inequality and wages and the lack of conflict between job creation and social spending.

Is South Africa on the Right Track?

According to the 2010 Budget Speech, South Africa's goals seem to be on the right track and the method being employed is consistent with the suggestions made here. In the minister's statement on working towards a new growth path, he mentioned the implementation of measures to combat youth unemployment through the potential use of a wage subsidy and training opportunities and he also mentioned the support of labour-intensive industries, which should boost employment in those sectors to which skills are biased, thereby combating unemployment from the demand-side (Gordhan, 2010). In addition, the government is creating short-term job opportunities in the public sector for various public works projects.

Education is still the largest expenditure of the budget, which aims to improve the skills of the labour force and, thereby reduce structural unemployment from the supply-side. Social spending is also a very large portion of the national budget and has been extended and increased, however the increase in the child support grant was below the inflation rate (Gordhan, 2010). The trade-off between the large spending in education and that of social spending can be seen by the restricting factor on social spending. Education will only return on this investment in the long-run, whereas social spending returns in the short-run. Therefore, the long-run benefits of education investment need to be weighed up against the proven benefits of social spending. South Africa has pursued the long-term approach, as is evidenced by the greater spending in education, which bodes well for the pursuit of long-term sustainable growth.

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