

## What to do about rising inequality in developing countries?

By Stephan Klasen

In recent years, debates about inequality have reached a renewed intensity in international policy debates. This is partly the result of much better data on the extent of inequality, where the work by Piketty on the top 1% has revealed much larger (and rising) inequality than previously known from household surveys. Similarly, work on global inequality in incomes and wealth have generated eye-catching results about the massive levels of global inequality in incomes, and even more so in wealth. Lastly, the renewed interest in inequality is also the result of rising inequality in many developing countries since the 1980s which has contributed in many places to social and political instability. In consequence, it is not surprising that the Sustainable Development Goals have included reducing inequality as a new goal.

When discussing inequality, one needs to distinguish between-country, within-country, and global inequality as they are affected by very different drivers and require actions by different actors. Between-country inequality is related to differences in economic growth, and therefore reducing inequality will require poorer countries to grow faster than richer ones.

This is primarily an issue of national growth strategies although the international economic environment can also play a role, as it might affect export opportunities, export prices, FDI, aid, and access to technologies.

Within-country inequality is about the distribution of assets within a population, the returns that different groups receive on those assets, and to what extent the state redistributes incomes through tax and transfer systems. Global inequality, lastly, can be the result of between as well as within-country inequality and thus is affected by all of these

determinants. For example, global inequality can be high because the average income of people in Sub-Saharan Africa is low compared to the rest of the world; or it can be high because the poorest in Sub-Saharan Africa are much poorer than the average incomes prevailing there. In this policy brief I will first talk briefly about global inequality and its relation to within- and between-country inequality and then focus primarily on the question what can be done to reduce within-country inequality in developing countries, and whether the international community can play a role here.

### Global Inequality: Trends and Drivers

There are many ways to look at global inequality. The one that appears most intuitive considers inequality between the citizens of the world where all receive equal weight and where purchasing power differences are corrected for. If one does this, an overview of different estimates provided in Klasen et al. (2016) shows that global inequality is very large, with a Gini coefficient of about 0.7. What about trends over time? Most estimates suggest slightly declining global income inequality since about the 1980s. But those numbers have to be treated with some caution. In particular, they are based on surveys which notoriously exclude the very rich. Depending on the assumptions about levels and trends in top incomes (which most observers believe to have increased as a share of global income), the decline in income inequality might have been rather modest or have vanished entirely. So we know that global inequality remains very high, has not been increasing, and might have decreased a little since the 1980s. What drove those changes?

### Key Points

- Rising within-country inequality accounts for a sharply rising share of global inequality. In the 1980s and 1990s, within-country inequality went up in all regions; since the mid-90s, regional trends are much more heterogeneous
- High and rising inequality slows down poverty reduction, while there is no significant interaction with economic growth
- Inequality reduction has to address country-specific priorities, which may relate to asset inequality, inequality in returns to assets, or insufficient redistribution by the state
- In most developing countries there is greater scope for redistribution by the state
- The international community can only play a supporting role in affecting inequality trends.

### Poverty Reduction, Equity and Growth Network (PEGNet)

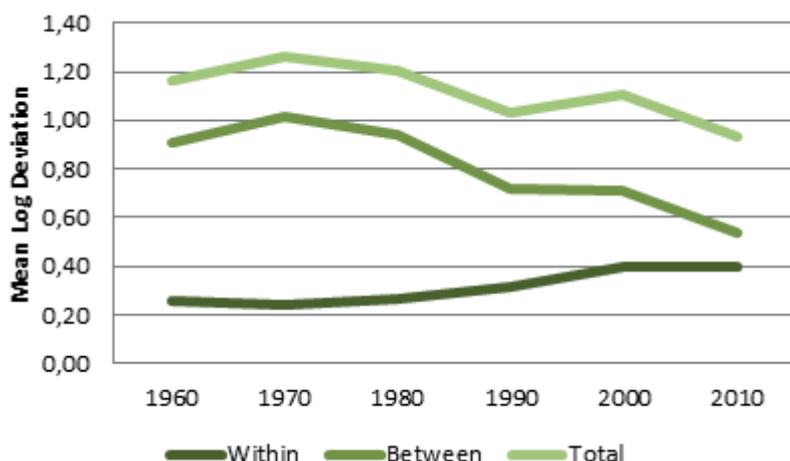
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As can be seen in **Figure 1**, when one uses a decomposable inequality measure such as the *Mean Logarithmic Deviation* (Gini coefficient is not decomposable), one can see a very interesting underlying trend: Between-country inequality has been falling substantially since the 1970s. This is, of course, related to the rapid growth rates in populous Asian countries, including China, India, Indonesia, Vietnam, etc which all grew much faster than world

fortunately more favorable than in the case of income inequality. Global health inequality has experienced a drop and the episode of rising inequality due to the AIDS crisis in Africa has now come to an end as AIDS mortality is falling sharply. Global education inequality is also falling, partly related to the massive expansion of educational enrolments in poor countries in the last two decades. There is still work to be done as inequality in health within countries remains stubbornly high in many countries and inequality in educational outcomes such as test scores remain sizable. But in the following I will concentrate the discussion on income inequality where trends have been more adverse.

**Figure 1:** Within and Between Country Inequality Components of Global Inequality



Source: Global Income and Consumption Database.

average income. Since 2000, it is also related to the high growth rates in many poor African countries that contributed to falling inequality.

In contrast, within country inequality has been rising substantially, esp. since 1980. If we included estimates for the top 1%, that rise would be even faster. Now we live in a world where within-country inequality is nearly as large as between-country inequality. That is to say: it matters nearly as much for your economic fortune if you are born rich or poor within a country as it matters whether you are born in a rich or a poor country. As a result it is right to focus on this worrying rise in within-country inequality.

Before turning to trends and drivers of within-country income inequality, it is important to briefly discuss trends in inequality

**Within-Country Inequality Trends: Some Facts**

**Table 1** shows within-country inequality trends over time, for all countries, and by region. These are based on a new database that provides comparable inequality estimates, the Global Consumption and Income Project (Arjun et al. 2015). First it confirms that within-country inequality has been rising across the globe from the 1980s to the 2000s. This is also true for all regions. But since 2000, trends have been much more heterogeneous. While in East Asia, South Asia, and Europe and Central Asia, inequality has stabilized at substantially higher levels, it has fallen a little in the Middle East, and quite substantially in Latin America. In Africa, there is also no discernible trend but underlying data suggest that inequality has been rising in about half of the countries and falling in the other half. This suggests that inequality change can be very different across regions and time periods, suggesting that country-specific conditions and policies are likely to play a role. In particular, the experience of declining inequality in Latin America is interesting.

Further analyses in Klasen et al. (2016) as well as Hoy et al. (2016) suggest that inequality trends are not a consequence of growth trends. High growth has been accompanied by rising, stable and falling inequality, nor is there evidence of a Kuznets Curve which posited first rising and then falling inequality in the process of development. Recent worries about an inequality-induced middle income trap also are unfounded. As Hoy et al. (2016) show, poor countries that transitioned to middle-income status are not different in their inequality trajectory from other countries.

What about the reverse causality, i.e. does inequality reduce subsequent growth? Since Deininger and Squire (1998) we know that low initial inequality has been associated with

**Table 1:** Average (population-weighted) of within country Gini by regions

	World	East Asia and Pacific	Europe and Central Asia	Latin America & Caribbean	Middle East & North Africa	North America	South Asia	Sub-Saharan Africa
1980	0.386	0.336	0.312	0.520	0.487	0.343	0.408	0.514
1990	0.418	0.418	0.317	0.512	0.472	0.367	0.413	0.538
2000	0.471	0.504	0.354	0.537	0.492	0.394	0.464	0.526
2005	0.469	0.488	0.367	0.509	0.480	0.401	0.478	0.525
2010	0.459	0.492	0.353	0.488	0.475	0.402	0.444	0.523

Source: Global consumption and income project

in non-income dimensions of well-being such as health and education. Here the trends are



higher growth, a finding that is still true today. So South Korea and China benefited from their low initial inequality, and Brazil suffered from its high one. But the more interesting and policy-relevant question is whether reducing inequality in a country such as Brazil will lead to higher subsequent growth. After a careful review of the literature and detailed new estimations, Scholl and Klasen (2016) find that there is no relationship between inequality change and growth. Earlier results that found a positive effect were unduly affected by the unique experience of transition countries; and results that showed a negative effect have not been robust.

And it is still the case that reducing inequality will immediately lower absolute poverty and increase the poverty-reducing impact of economic growth. Thus there remains a strong case for inequality reduction if one is concerned about poverty: it reduces poverty immediately, it increases the poverty-reducing impact of growth, and it does not adversely affect growth. And of course, lower inequality will promote fairness and equality of opportunities which has received increasing attention in academic and policy circles.

### **Determinants of Within-Country Inequality**

To study trends in inequality, it is useful to think of a framework where income inequality is related to inequality in assets (land, labor, human capital, and physical capital), return to these assets (e.g. returns to land or human capital for different groups of people), inequality in private transfers (national and international remittances by income groups), and redistribution by the state. Trends in inequality are tied to these different drivers which differ greatly by country and over time.

For example, in quite a few countries in Africa and poorer countries in Latin America, asset inequalities related to land and human capital are the critical drivers of inequality; but returns to assets can also be a big problem, often related to remoteness and poor infrastructure (in the case of returns to land) or discrimination (in the case of labor); in many middle-income countries, differential returns to assets can be an important driver of inequality, often linked to poorly functioning markets, unequal access to markets (e.g. capital markets, or unequal labor market opportunities linked to location or background). Private transfers can also affect inequality levels and trends and are related to the ability of different income groups to migrate and send remittances. While the scope for redistribution by the state is more limited in most developing countries due to

large informal sectors and low administrative capacity, there is substantial scope for more redistribution than currently practised in many countries.

In particular, a broadening of the tax base, improvements in tax collections, more use of resource taxes, and expanded targeted transfer programs can all play a role in reducing inequality. In fact, these measures are among the key drivers of declining inequality in Latin America since the mid-1990s. Other factors that contributed were a pro-poor expansion of education as well as rising labor earnings supported by favorable economic conditions and rising minimum wages.

### **Policy Options**

This framework also generates opportunities for policy interventions to tackle inequality. This will, however, vary greatly by country. As a result, it is useful to start a policy framework with an inequality diagnostics to identify the most important drivers of levels and changes in inequality in a particular country; this is also an activity where bilateral development partners can play an important supporting role. When it comes to particular policy reforms, some of the issues that have been discussed for a long time remain highly relevant, including land reform (where land is still an important asset), pro-poor educational policies, rural infrastructure, and a focus on improving agricultural productivity of poor farmers. At the same time, increasing the redistributive role of the state through a higher tax take (to be achieved via broadening the tax base, increasing tax compliance, increased resource taxes), and increasing pro-poor social transfers is a viable option. Such changes cannot be implemented overnight- And they must be accompanied by the build-up of administrative capacity (such as building up revenue authorities that are shielded from political interference and onerous public service rules), must be based on a societal consensus surrounding these policies, and be phased in gradually.

As far as the international dimension is concerned, there should be a greater emphasis on assisting developing countries with fighting tax evasion and tax avoidance of firms and individuals which can substantially increase the fiscal space in developing countries. The current initiatives under way in this regard at the OECD and the IMF need to ensure that the interests of developing countries are considered and they are able to fully benefit from the implementation of new rules and regulations.

While within-country inequality is a multisectoral issue that does not lend itself



easily to individual donor-funded investment projects, aid can play a supporting role in some cases in supporting national initiatives. In principle, the potential is there for significantly affecting inequality via technical cooperation assisting states (and potentially non-state actors) in implementing an inequality-reducing agenda. This can range from assistance in implementing asset redistribution programs, to improving tax administration or the design and implementation of pro-poor spending programs. Budget support can be a particularly appropriate tool to support such a cross-sectoral national inequality reduction agenda, as can targeted investment projects if they focus on the policy-areas for inequality reduction outlined here.

## Conclusions

Rising within-country inequality seriously tears at the social fabric of societies. It is considered unfair, it leads to social and political instability, and it slows down poverty reduction. As the discussion above suggests, inequality trends are not related to unchangeable economic forces but depend to a great extent on policy choices by governments. As a result, there is substantial scope for a more pro-active inequality reducing agenda. Such an agenda in this sensitive area must be developed and led by the countries themselves, while the international community and donors can (and should) only play a supporting role.

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## PEGNet Policy Briefs

provide information and key policy recommendations on the poverty-equity-growth nexus. The views presented are those of the authors and do not necessarily reflect the views of PEGNet. In case of questions or comments, please directly contact the authors.