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Redistribution is part of the toolkit to promote growth

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A recent IMF study of several countries provides robust evidence that a high level of income inequality weakens the prospects of sustained economic growth and reduces the duration of growth spells. Redistributive steps, by contrast, do not have a noticeable negative effect on growth. Therefore, a reduction in inequality that is achieved through redistributive steps could have a net pro-growth effect. The policy challenge for South Africa is to find the best policy mix to achieve that.

Introduction

In recent decades the agenda for global development has focused strongly on poverty reduction associated with growth – as articulated in the 2001 *World Development Report* on ‘Attacking Poverty’ (World Bank 2001), for example. In emerging market economies, gains in industrialisation, urbanisation and employment have substantially reduced absolute poverty and contributed to a global convergence in average incomes and some rebalancing of economic power. A decline in poverty has also occurred in South Africa since 1993 (see Finn *et al*, *Econ3x3*, July 2013).

But convergence between countries has been accompanied by rising inequality within many advanced and developing countries. Whereas inequality was portrayed as a transition feature of the path towards growth and development in the past, it now appears to be more deeply entrenched. In South Africa, inequality has deteriorated since the early 1990s despite the substantial growth of GDP – with the Gini coefficient rising from 0.68 in 1991 to 0.72 in 2006, before it declined somewhat to approximately 0.70 after that. Income gains appear to have been concentrated at the top end of the distribution of South African income since 1993 (see Visagie, *Econ3x3*, July 2013).

Rising inequality has raised questions about the social and political sustainability of the dominant policy paradigm. In some analyses it is identified as a factor that contributes to the

financial fragility and economic imbalances exposed by the 2008 recession and its aftermath (see Stiglitz 2012).

The evidence that inequality has increased in many countries – and that it has increased particularly in the top percentiles of the distribution – has brought a new intensity to distributional economics as a research topic. Internationally, the debate on inequality has been given impetus by the publication of Thomas Piketty's *Capital in the Twenty-First Century* (Piketty 2014). Where the subject seemed almost taboo 25 years ago, inequality and the effectiveness of redistributive policy and programmes are now at the forefront of academic and policy discourses.

It has been known for at least the past two decades that inequality may weaken the prospects of rapid and sustained economic growth (see, for example, Persson & Tabellini 1994). This is an awkward finding for countries like South Africa, where the level of inequality is very high. It is sometimes argued that growth is the primary policy imperative since a high-growth path makes the reduction poverty and inequality possible (Bhagwati & Panagariya 2013). However, if inequality holds growth back, then highly unequal societies may get caught in a development trap in which neither rapid growth nor the reduction of inequality can be achieved. Accordingly, a key question is whether inequality-reducing policies hinder or support the growth process – in other words, whether or not there is a trade-off between promoting growth and pursuing equity.

The interaction of inequality and growth

It is important to understand the channels through which inequality and growth interact, and what mechanisms of redistribution are available and effective. A recent IMF staff paper provides interesting perspectives on the growth-and-inequality question.

Ostry, Berg & Tsangarides (2014) use the 'standardised world income inequality' cross-country dataset to examine the links between growth, inequality and redistribution.¹ They perform a comprehensive statistical and econometric analysis of data from 153 developed and developing countries. Their findings confirm earlier findings by demonstrating that lower inequality is correlated with faster growth in all countries (more detail is provided below). Moreover, a lower level of inequality contributes to more durable growth – growth episodes are likely to be longer if inequality in a country is lower.

¹ The dataset was developed by Solt F. 2009. Standardizing the World Income Inequality Database. *Social Science Quarterly* 90(2): 231-42.

The authors of the IMF study also find that more unequal societies tend to redistribute more than less unequal societies. This leads to the important question: whether the redistributive interventions of unequal societies contribute to their tendency to grow more slowly – or whether it is the underlying inequality itself that constrains growth.

The analysis indicates that '*redistribution appears generally benign in terms of its impact on growth; only in extreme cases is there some evidence that it may have direct negative effects on growth*'. Thus the combined direct and indirect effects of redistribution – including the growth effects of the resulting lower inequality – are on average pro-growth' (Ostry *et al.* 2014: 4; italics original).

The international dataset provides time-series measures for each country of its 'market distribution' (i.e. its income distribution before direct taxes and transfers) and its 'net distribution' (i.e. the distribution of disposable income or expenditure of individuals or households after paying taxes and receiving transfers such as social grants).² These enable the researchers to compare the inequality of monetary income *before* and *after* direct taxes and subsidies. (Therefore, specific redistributive policy steps and the provision of in-kind services, such as education, health, housing and welfare services, are not part of this redistribution calculus.)

The extent of redistribution that occurs in a country can then be measured as the difference between the Gini coefficients of the market and net distributions respectively.

In OECD countries, the median *market*-distribution Gini – which has increased somewhat over the past thirty years – is currently about 0.45. The median *net*-distribution Gini is about 0.30, indicating extensive redistribution, mainly through social security transfers and progressive tax structures. Amongst non-OECD countries, the median market-distribution Gini now is also about 0.45, having declined since the 1970s. However, in many non-OECD countries, *net* inequality is quite close to market inequality, mainly because social security arrangements are limited.

South Africa, with an approximate net³ Gini coefficient of about 0.70, is in a league of its own. The high inequality appears to be mainly due to high levels of unemployment, which result in an unusually high level of inequality with regard to labour market earnings. The

² An important limitation of this 'standardisation' of comparative international data on income inequality is that, in order to achieve comparable data, extensive adjustments to original country estimates are made through imputation procedures.

³ South African Gini coefficients normally are *approximate* net distribution figures that are based on *after-tax* wages and earnings as well as social grants; however, they are not fully net figures, since capital and 'other' income are pre-tax values, for example. The fully net Gini is likely to be a bit lower than the available figures.

redistribution impact in South Africa appears to be approximately six Gini points, as indicated in the dataset used by Ostry *et al.*⁴

How large is the likely impact of inequality on growth?

The authors of the IMF report explicitly distinguish the effects of inequality and redistribution on growth. In their statistical estimation of the effect of net inequality and the extent of existing redistribution on the growth rate of per capita GDP, they find the following:

- First, higher inequality appears to have a statistically significant negative impact on growth. Using the USA as an illustration, an increase in the net Gini coefficient of 5 points from its current value of 0.37 (to 0.42) would be expected to reduce the medium-term growth rate of per capita GDP by 0.5% per annum.
- Secondly, redistribution has a tiny negative but statistically insignificant effect – it appears to have an all but zero effect on growth.

These findings imply that ‘the average result across the sample is a win-win situation, in which redistribution has an overall pro-growth effect’ – counting both the potential negative direct effects of redistributive steps and the growth-enhancing effects of the resulting lower inequality (Ostry *et al.* 2014:17).

These results cast doubt on the notion that there is a trade-off between reducing inequality and economic growth – or that growth should be pursued first, followed by redistribution of its ‘fruits’.

With respect to the duration of growth, Ostry *et al.* find that higher inequality decreases the length of growth spells: a one Gini-point increase in net inequality is associated with a decrease of about 7% in the expected length of growth spells (2014:23). And redistribution as such has no noticeable effect on the duration of growth spells, except in extreme cases when very large redistributive steps are undertaken. (These would be, for example, attempts to reduce the Gini coefficient relatively rapidly by 13 points or more.)

Importantly, the analysis shows that the overall pro-growth effect does not result from the redistribution itself – it is due to the lower inequality achieved (in part through redistributive measures).

⁴ In the ‘standardised’ Solt dataset, used by Ostry *et al.*, South Africa’s 2005 market Gini comes to 0.70 and its net Gini is 0.635.

As with any multi-country analysis, there are several difficulties with these measures, based as they are on incomplete and sometimes inconsistent data series, and there is considerable complexity in the linkages and relationships under examination. For example, there are many possible channels through which redistribution might influence growth, either positively or negatively; the Gini coefficient may not be the most suitable measure of inequality for policy purposes, and there are likely to be at least some feedback effects of tax and transfer programmes on market distributions; in-kind redistributive programmes may be more important than monetary instruments; moreover, an analysis at this level of aggregation does not provide information about the top 5% or 1% of the distribution of income, which is where much of the rise in incomes in many countries has been seen in recent decades.

Whilst recognising such difficulties, the IMF paper's authors conclude (Ostry *et al.* 2014: 25-6) that:

'(Income) inequality continues to be a robust and powerful determinant both of the pace of medium-term growth and of the duration of growth spells, even controlling for the size of redistributive transfers. ...

It would ... be a mistake to focus on growth and let inequality take care of itself, not only because inequality may be ethically undesirable but also because the resulting growth may be low and unsustainable. ...

(T)here is surprisingly little evidence for the growth-destroying effects of fiscal redistribution at a macroeconomic level. ...

On average, across countries and over time, the things that government have typically done to redistribute do not seem to have led to bad growth outcomes, unless they were extreme. And the resulting narrowing of inequality helped support faster and more durable growth, apart from ethical, political, or broader social considerations.'

No trade-off? Towards policy implications

These results suggest that economists' conventional belief in a trade-off between efficiency and equity – implied in Arthur Okun's well-known analysis of the 'big trade-off' (Okun 1975) – is misguided. (The existence of such a trade-off would mean that more equity through redistribution could only be had at the expense of a reduced economic growth rate.)

In any case, there are many strands of public finance and development economics that support redistributive policies as growth-enhancing: investment in human capital, risk reduction through social security arrangements, land reform, or the promotion of small business development, for example. Even Okun's analysis suggests many ways in which redistributive social investment might be growth- and productivity-enhancing.

The implications of these findings for South Africa are potentially important. It is not just that inequality is unusually high in South Africa, or that there is a compelling need to find a policy mix that yields both faster growth and redistribution. *The analysis suggests that redistribution should be thought of as itself part of the toolkit for promoting faster growth*, and not just a desirable outcome to be sought through an inclusive or redistributive growth path.

The policy challenge is not to find the right trade-off between growth and redistribution, but to identify and design the specific policies and interventions that support inclusive, faster growth – in the context of a country's economic structure, its labour market features and institutional dynamics. If inequality is high, some of these measures are likely to be redistributive. In the sequencing of structural reforms to support enduring, inclusive growth, redistributive measures might warrant early prioritisation.

In exploring these policy choices, evidence on specific policies and their effectiveness in local circumstances needs to be sought. This will be discussed in a follow-up article.

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