Briefing Paper

December 2004

INEQUALITY IN MIDDLE INCOME COUNTRIES

International attention to poverty reduction often tends to focus on those low income and least developed countries (LICs and LDCs), mainly in sub-Saharan Africa and south Asia, in which poverty is both broad and deep. While this attention is fully warranted, there is a need also to examine the situation of the poor in Middle-Income Countries (MICs), currently defined by the World Bank as having per capita GNI of between $735 and $9,075. High levels of inequality in many MICs (including many MICs with large populations) mean that, despite higher average incomes, these countries also contain a significant proportion of the world's absolute poor. If the international community is to achieve the Millennium Development Goal targets by 2015, it will have to address the problems of inequality and poverty in MICs.

Although the importance of reducing inequality has been recognised (e.g. World Bank 2000), the conventional wisdom has been that levels of inequality are resistant to change, that tax-based approaches to redistribution entail a particular risk of slowing growth, and therefore that emphasis should be upon dynamic rather than static redistribution. This paper summarises the analysis and conclusions of a recent research project into the challenge of inequality in MICs. It draws together an overview concept paper with detailed analysis of three country case studies (Brazil, China and South Africa). The findings challenge the conventional wisdom and advance the agenda in certain key ways:

- more importance is now attached to equality as an intrinsic good;
- it is possible to reduce inequality through progressive taxation and pro-poor public expenditure;
- there is a need to look at inequalities in dimensions other than income;
- political structures are central to explaining inequality and identifying opportunities for redistribution;
- human rights provide a powerful tool in efforts to reduce inequalities between groups which have faced discrimination and social exclusion.

Poverty, inequality and growth

Levels of and trends in inequality in MICs

It is now commonly accepted that welfare (and its absence, poverty) is multidimensional in nature (World Bank 2000; OECD 2001). Although improvement in any one aspect of wellbeing (e.g. income) tends to be correlated with improvement in others (e.g. health), the strength of these connections can vary considerably. By extension, inequality in wellbeing also needs to be examined from a multidimensional perspective, involving analysis of differences in both opportunities and outcomes.

Unfortunately, data on many of these dimensions is either missing or defined in such diverse ways that it is hard to compare levels of inequality in different countries. What we are left with is a somewhat patchy and impressionistic picture of the nature of inequality in MICs. Nonetheless, some interesting findings do emerge.

- Contrary to common perception, MICs are not generically characterised by extreme inequality. Some MICs (including Brazil and South Africa) do indeed display very pronounced inequalities. On average, however, income Gini coefficients in MICs are no higher than the corresponding values for LICs, and in some MICs (the transition economies) are still quite low.
- Secondly – and once again in contradiction to the conventional wisdom – levels of inequality can change (either upwards, as in China, or downwards, as in South Africa) over time. Inequality is not, as previously thought, everywhere and always 'path dependent' (see Table 1).

Table 1: Levels of inequality can change: Gini coefficients in three MICs

	'88	'89	'90	'91	'92	'93	'94	'95	'96	'97	'98	'99	'00	'01	'02
Brazil			.62					.60				.60			
China	.38							.45							.43
South Africa				.67				.56					.57		

Sources: country case study papers.

- Finally, in many MICs inequality has a strong horizontal component: that is, inequality in outcomes is not merely due to the differences which might be expected within any market economy, but reflects also persistent differences in opportunity between groups defined on (for example) racial or gender lines.

Redistribution and pro-poor growth

On the links between inequality, growth and poverty, other aspects of the conventional wisdom are also increasingly open to question. In the past, the general position has been that success in poverty reduction will depend critically on economic growth, not the reduction of inequality. Increasingly, however, the consensus is that inequality does matter, and that redistribution is a legitimate policy option. This is because:

- high levels of inequality retard economic growth, either because high levels of inequality create imperfections in credit markets, or because they create the risk of social and political instability which deters investment;
- inequality weakens the linkage between growth and poverty reduction: a given rate of growth results in a lower corresponding drop in poverty in a highly unequal society than in a society characterised by low inequality;
- inequality matters in its own right, in that there is a strong ethical basis for ensuring a reasonable degree of equality between individuals.

Given that a relatively small reduction in inequality can have a significant effect on the poverty headcount, there is a strong case for combining growth (rising average incomes) with balanced measures to equalise incomes and assets (through redistribution).

Much of the controversy over these issues is internalised in a debate about the meaning of 'pro-poor growth' (see Box 1). The general conclusion for MICs is that the importance to be attached to containing or reducing inequality depends considerably on context. When initial levels of inequality are low and economic growth rates are high (as in China), rising levels of inequality may be a concern for intrinsic reasons, but can still be compatible with dramatic reductions in poverty. However, when inequalities are pronounced and growth is slow (as in Brazil and South Africa), addressing inequality is important not only for intrinsic reasons but is also central to reducing poverty. Unfortunately, it is in precisely those countries with entrenched inequalities and slow growth that redistributive policies will be politically hardest to achieve.

Box 1: 'Pro-poor growth' and inequality

There are, broadly speaking, two competing definitions of pro-poor growth in circulation. For Pernia (2003), growth is only pro-poor if it results in the incomes of the poor growing (proportionately) faster than the incomes of the non-poor: that is, it is growth that serves to effect a redistribution of income. According to this view, lower inequality carries some intrinsic value, and is a goal in itself. Others however define pro-poor growth simply as growth which contributes to a reduction in poverty (Ravallion and Chen 2003; DFID 2004) – which can, as in China, be compatible with widening income inequalities. According to this view, lower inequality has no intrinsic value in itself, although it may be important for instrumental reasons.

The role of taxation and public expenditure

Governments in MICs typically receive much greater revenues from domestic taxation than they do in LICs. This raises the possibility that MICs, like high-income countries, might use progressive taxation and pro-poor public expenditure to redress inequalities. In the past, conventional wisdom was that using the tax system to influence inequality risked creating growth-retarding market distortions. Experience over the last decade suggests that this is by no means inevitable. In South Africa, progressive taxation has reduced the Gini coefficient from 0.68 to 0.64; once subsidised or free receipt of state benefits is accounted for, the Gini falls further to 0.44. In cross-country data, post-tax income Ginis were on average 0.06 points below pre-tax Ginis. Furthermore, levels of taxation in MICs relative to GDP, while much higher than in say south Asian LICs, are still much lower than in developed countries. If, as many economists argue, there is an inverse-U relationship between taxation and economic growth, many MIC governments have the potential to increase taxation before they begin to retard growth.

At present, however, taxation and budgetary policies in many MICs are at best only weakly progressive, and in some cases actually regressive. In Brazil, for example, service delivery is skewed to the interests of the rich rather than the poor: of public expenditure on education and culture, 70% is allocated to higher education, and only 13% to basic education. Sometimes, regressive taxation and spending has its origins at least in part in deliberate state policies: in China, the higher rates of tax in rural areas relative to (richer) urban areas reflects the legacy of efforts to promote industrialisation. Typically, however, the failure of public financial management to address entrenched inequalities is the product of a political system which gives the rich more influence in setting policy and budget priorities.

Macroeconomic stabilisation and inequality

Macroeconomic crises are often particularly damaging to the poor, who are less able to manage income volatility; hold more of their assets in the form of cash; and receive much of their income in forms fixed in nominal terms (e.g. minimum wages or pensions) – and as such suffer badly from high inflation. Evidence from Latin America suggests that inequalities which widen during crises narrow again only slowly, if at all, once stability is restored.

However, governments have choices in how to establish macroeconomic stability. The impact of adjustment measures on the poor can be minimized by increasing revenue collection as well as reducing expenditure; by ensuring that pro-poor elements of public spending are protected (or, as in much of middle-income south-east Asia, expanded) during overall cuts; and by the prudent use of capital controls.

Choice of strategy will depend upon context

The factors that create and perpetuate inequality clearly vary considerably from one middle-income country to the next. In China, inter-regional differences account for the largest share of total inequality; although regional differences are also pronounced in Brazil, investigation suggests that these are more fundamentally a spatial reflection of underlying differences in incomes and asset returns between racial groups. Racial inequalities are clearly critical in South Africa, with inter-racial differences in levels of education resulting, through differences in the demand for low-skilled and high-skilled labour, in pronounced contrasts between the employment rates and wages of blacks and whites.

Logically, then, attempts to address inequality will require a different mix and prioritisation of policy instruments – transport infrastructure in remote regions, job training, anti-discrimination measures – from one country to the next. In practice, however, the choice of policies will be influenced as much by political feasibility and incentives as by objective analysis of policy options.

The political economy of inequality

Inequalities in wealth both cause and are caused by inequalities in power. Political arrangements are central in determining whether technically feasible policies to reduce inequality can be enacted and then implemented.

Inequality under democratic and authoritarian regimes

One somewhat controversial issue concerns the link between democratic politics and the success – or even existence – of policies to address inequality and poverty. The evidence suggests that while democracy is a useful safety net (providing a guarantee that the poor will have some voice in the political process) - and not only has an intrinsic value, but also plays an important indirect role in structuring (through debate) the direction of change in social and political values.- the mere fact of regular multiparty elections is often not enough to ensure policies that reduce poverty. Indeed, in some cases (China, for instance), non-democratic regimes may prove more successful than democracies in containing inequality (Moore and Putzel 1999).

A balanced position on this issue needs to take account of the following. Firstly, it is important to acknowledge the role of historical legacies: inequality in currently-democratic South Africa and Brazil is to a large extent an inheritance from previous periods of authoritarianism. While it may be fair to conclude that democracy in these countries has to date had little success in reversing trends towards growing inequality, these inequalities clearly have their origins in a non-democratic past. Secondly, even within one country, there are important temporal and sub-national variations within the categories of 'authoritarian' and 'democratic' and their effect on inequality. The relatively low levels of inequality in contemporary China is largely a legacy of the decades of (authoritarian) command economy, and is being eroded as the (still authoritarian) regime opens steadily more aspects of the economy to market competition. Finally, while some authoritarian regimes (such as China) have demonstrated relatively low levels of inequality, many others (e.g. most of Latin America under bureaucratic-military rule) have not.

The role of political traditions and institutions

It seems that the labels of democratic and authoritarian are generally too broad to tell us much about the likelihood that a political regime will implement policies to address inequality. A more fine-grained political analysis would need to look also at the political traditions and configurations of political institutions (both formal and informal) that determine how the identity and voice of the poor is structured and how they do or do not exercise influence on policies.

In both democracies and non-democracies, the ability of the poor to form horizontal alliances is highly important. In many MICs the poor are divided by identities and material interests: this is often exacerbated by traditions of corporatist or clientelist forms of vertical political alliances. The existence of such forms of adverse incorporation helps to explain the failure, by and large, of Latin American democracies to address issues of extreme inequality (see Box 2). Charismatic leaders (such as Peron in Argentina or Chavez in Venezuela) have gained and stayed in power through populism - direct, personalized appeals to the poor. The politics of redistribution under populist governments are often confrontational, fiscally unsustainable, focused upon static rather than dynamic approaches, and risk provoking – as in Latin America – an elite backlash which imposes non-democratic, often military government.

Box 2: Corporatist and clientelist political traditions

The apparent inability of democratic governments in Latin America to make significant sustainable impact on inequality is often explained by reference to a deep-rooted corporatist or clientelist character to the region's political institutions (World Bank 2004). The Latin American model of corporatist politics has involved the management of political mobilization from above. Formal state or party organizations represent specific segments of the population (e.g. indigenous peoples, peasants) in terms that favour the interests of political elites. Clientelist politics, by contrast, are individualistic and informal: they involve 'lop-sided friendships' in which powerful 'patrons' provide immediate material benefits to defined 'clients' in return for loyalty and service (as when politicians buy off fragments of the poor – e.g. poor neighbourhoods – with 'gifts' of state investments, receiving votes in return). Both types of relationship prevent the development of broad horizontal alliances that might address the underlying causes of inequality.

There are various ways in which the poor in non-democratic regimes exert pressure upon governments for actions to address poverty and inequality. Riots or general strikes – or the fear of them – may encourage a redistributive policy response, ranging from ameliorative to genuinely transformative. The potential power of collective action by the poor will depend considerably on the values and perceptions of those in power. If political and social elites are persuaded of the moral case for helping the poor, see extreme inequalities as threatening to themselves (through rising crime, communicable disease or political violence) or have a strategic vision of the need for welfare policies to foster socio-economic transformation, the prospects for redistributive policies are much greater (Crone 1993; Hossain and Moore 2002).

There are also numerous positive examples of successful alliances, both horizontal and vertical, which have generated political pressure for redistribution. The South African National Economic, Development and Labour Council, established in 1995, has helped to provide a united voice for civil society: its most significant achievement has been the institutionalisation of open debate and bargaining about the costs and benefits of policy. It is important however to be realistic about the conditions under which civil society demand can be effective: in Brazil, the current administration has deliberately sought to empower from above, creating openings into the political process in the form of national councils which bring together representatives of business, trades unions, NGOs and intellectuals.

Both South Africa and Brazil highlight the importance of political incentives and power, and the need for political institutions which can contain and channel conflicts of interest. Redistribution always involves political compromise: success comes from institutions (whether created from above or below) which can manage this process of bargaining, preventing it from degenerating into either confrontational stalemate or elite capture.

Discrimination, rights and social exclusion

Discrimination and social exclusion play a significant role in the generation of horizontal inequalities (e.g. between men and women, or different ethnic groups). Groups that are marginalised or discriminated against may suffer poverty as a result of multiple, mutually reinforcing forms of inequality in both opportunity and outcome, which are transmitted from one generation to the next. While a focus on rights – including human rights - can be used to tackle vertical inequalities too (for example, by making access to basic social services – and the realisation economic and social human rights – a citizenship right), it has particular utility in framing approaches to tackle the social and political processes that underlie horizontal inequalities.

A human rights approach helps to establish the responsibility of the state not merely not to discriminate in its own actions (e.g. in the provision of public services), but also to protect marginalised groups against discrimination by third parties in social and economic relations (e.g. in terms of access to employment, credit, housing, etc.). The language of international human rights can be a powerful tool for civil society and reform-minded elements of the political system seeking to tackle structural inequalities in opportunities: it has proved useful, for example, in establishing better treatment for indigenous groups in a number of Latin American MICs. In some cases, it may be used to argue for special measures (such as affirmative action) to address the perpetuation of historical inequalities in access to education, employment or political position.

What role for donors?

With limited resources, donors clearly need to focus their efforts. Governments in MICs have larger and more diverse revenue bases than those in LICs, and higher levels of per capita expenditure. In Brazil, it is estimated that the government could eradicate poverty by transferring a mere 3% of GDP; in Mexico, the figure is 1%. What then is the case for international aid to these countries?

There are three main reasons. First, MICs account for a large share (19% in the case of China) of the global total number of people living on less than one dollar or two dollars a day. Second, rates of economic growth in several MICs have important consequences (in terms of FDI, trade, migrant jobs and remittances) for levels of poverty and political stability amongst their poorer neighbours (South Africa is a case in point). Thirdly, many MICs suffer from considerable instability, and several former MICs have slipped back into low-income status. There is therefore considerable potential for rapid and simultaneous reversals in the level of poverty in countries currently classified as MICs.

If there is thus a case for donor engagement with MICs on issues of poverty and inequality, it nonetheless seems clear that this role will be different from that played by donors in LICs and LDCs. Simple resource transfer will be less effective and less important: rather, the role of donors will be to work with governments, civil society and business in order to facilitate the formation of alliances in favour of redistributive and anti-poverty policies; promote the development of more appropriate institutions; and, possibly, help MICs to learn from each other.

One specific way in which donors could contribute would be through a more stepped deployment of assistance to countries at different income levels. There is a danger of drawing a sharp demarcation between low- and middle-income countries: if graduating into middle-income status entails a sudden decline in aid receipts or treatment by international institutions, it may induce a country to fall backwards and become trapped in a long-term oscillation between low- and middle-income status.

Conclusion

At the turn of the century, it would have been possible to identify a broad consensus on the role of inequality in development (Maxwell 2001). This conventional wisdom acknowledged that inequality mattered but argued that levels of inequality were resistant to change; that tax-based approaches to redistribution entailed a particular risk of slowing growth; and thus that emphasis should be upon dynamic redistribution (ensuring the poor received an increasing share of the gains from growth, for example by improving their level of education) rather than static redistribution (transfer of existing income from rich to poor).

Findings and policy development since then challenge the conventional wisdom and advance the agenda in the following ways:

- More importance is now attached to equality as an intrinsic good, not only as an influence on growth and on the poverty elasticity of growth;
- It is possible to induce changes in the level of inequality; taxation and pro-poor public expenditure in particular may be effective instruments for redistribution
- There is a need to look at inequalities in dimensions other than income, and to understand the relationships between these different aspects of poverty;
- Political structures are central to explaining inequality and identifying opportunities for redistribution. Democracy provides some checks, but its effects can be severely constrained by vertical incorporation of the poor in clientelist or corporatist structures. There are however good examples of how both horizontal and vertical alliances can be developed in favour of redistributive policies;
- Rights may provide a powerful tool, particularly in efforts to reduce horizontal inequalities between groups which have and have not historically faced discrimination and social exclusion
- There is a particular rationale (for both governments and donors) to address inequality in the MICs, reflecting the large proportion of the world's poor who live in these countries, the spillover effects of MIC poverty or poverty reduction on other developing countries, and the vulnerability of many MICs to slipping back into high poverty (and low income status) in the face of economic or political crises.

References

Crone, D.K. (1993). States, elites, and social welfare in southeast Asia. World Development 21: 55-66.

Department for International Development (2004). What is pro-poor growth and what do we need to know? Pro-Poor Growth Briefing Note 1, February.

Hossain, N and Moore, M. (2002). Arguing for the poor: elites and poverty in developing countries. IDS Working Paper 148, Institute of Development Studies, University of Sussex.

Maxwell, S. (2001). Innovative and important, yes, but also instrumental and incomplete: the treatment of redistribution in the 'New Poverty Agenda. Journal of International Development 13: 331-341.

Moore, M. and Putzel, J. (1999). Thinking strategically about politics and poverty. IDS Working Paper 101, Institute of Development Studies, University of Sussex.

OECD (2001). Poverty Reduction: The DAC Guidelines. OECD: Paris.

Pernia, E.M. (2003). Pro-poor growth: what is it and how is it important? ERD Policy Brief 17, Asian Development Bank.

Ravallion, M. and Chen, S. (2003). Measuring pro-poor growth. Economics Letters 78: 93-99.

World Bank (2000). Attacking poverty: World Development Report 2000/01. Oxford University Press: Oxford.

World Bank (2004). Inequality in Latin America and the Caribbean: breaking with history? World Bank: Washington D.C..

This paper is based on work carried out at ODI by Edward Anderson, Tim Conway, Andy McKay, Joy Moncrieffe, Tammie O'Neil, and Laure-Hélène Piron. For further information contact the team leader Andy McKay (a.mckay@odi.org.uk) or visit: www.odi.org.uk/PPPG/activities/country_level/mic/

Overseas Development Institute, 111 Westminster Bridge Road, London SE1 7JD
Telephone: +44 (0)20 7922 0300 Fax: +44 (0)20 7922 0399 Email: publications@odi.org.uk