WIDER Angle

"Reflections on Launching Three Books about Poverty, Inequality, and Economic Growth"

C. Peter Timmer and Ashley S. Timmer*

It is always exciting to be present when new and provocative ideas are launched, especially when they are in the concrete form of books addressed to the scholarly and policy communities. The intersecting themes of poverty, inequality and economic growth are at the top of the policy agenda in Washington, especially under the mantra of "pro-poor growth," so it was no coincidence that the launch site for these three books from WIDER was the World Bank. But there was also a heady sense of challenging the "Washington Consensus" in its den, because the three responsible editors of the books, Giovanni Andrea Cornia, Anthony Shorrocks, and Roelph van der Hoeven, each attacked the bias in Washington toward economic growth as the primary vehicle for reducing poverty, at the expense of ambitious approaches to dealing with inequality.

In organizing the policy agenda proposed by these three volumes, it is useful to stress two definitional points. First is the distinction is between "constructive" inequality—which provides the needed incentives to move resources to their most efficient uses--and "destructive" inequality—which generates envy and socially unproductive redistribution. This distinction complicates analytical and empirical investigations: not only is the relationship between inequality and other variables of interest--such as economic growth and poverty reduction--not linear, it likely changes sign over its full range. In his chapter in the Cornia volume, Michael Carter makes the same distinction. Second is the distinction between inequality in outcomes, which are inevitable and (to some extent) desirable for their incentive effects, and inequality in opportunities or capabilities, which societies should strive to make as equal as possible if they are to reach their fullest potential, a point Nancy Birdsall stresses. Both definitional points help frame the research agenda that seeks to understand the relationship between economic growth and inequality. The three volumes just launched by WIDER should be important voices in shaping this new agenda.

It is already clear that future research must break new ground in several directions. First, much of the research must be at the country, or even sub-national, level. There are diminishing returns to further global studies using cross-section data sets if the goal is to understand how policy choices can impact inequality and poverty. Economic historians understand the country-specific institutional changes needed to sustain economic development, but they see country specificity through a very long-term lens of path dependency. At the same time, policy advisors are impressed by the uniqueness of the day-to-day constraints on policy making; many of these constraints are political. There are underlying commonalities to the development process, and the degrees of freedom on basic macro and trade policies are not large if rapid economic growth is the goal. But one size does *not* fit all, and the options hinge crucially on the existing (and potential) economic institutions the country has. This institutional variance is much wider than many in Washington want to recognize.

Second, there is important research to be done on the distributive foundations of economic growth, especially with attention to the political economy of income distribution and the behavioral foundations thereof. The three books just launched stress the two-way connection between economic growth and income distribution. But the distributive dimensions of economic growth go deeper than simultaneous causation and, as noted above, are mediated at the country or regional level. Exploring the different institutional contexts that link inequality and growth will be central to a full understanding of the relationship between them.

In particular, a future research agenda must pay new attention to the linkages between inequality and the politics of economic policy. It is entirely plausible that without political-economy feedback loops, growth-maximizing policies may generate the greatest growth at the upper ends of the distribution. But the historical record suggests that—perhaps with the exception of the United States in recent decades—even reasonably widespread rapid growth will generate political crises if the very wealthy are allowed to visibly increase their lead too much. The policies resulting from the backlash may end up not only slowing growth, but making the poor worse off in absolute terms. Further, the instability of such episodes may exacerbate the distributive impacts, because the lower ends of the distribution are more vulnerable to economic risks.

An important component of this research will be measuring income inequality in ways that are congruent with the political process. For this, a focus on income *gaps* rather than income *distribution* will be crucial (who has ever heard a politician refer to a Gini coefficient, much less the Watts Index?). There has been virtually no serious analysis done of income gaps by development economists, although income gaps are the stock in trade of economic historians interested in long-run trends in income distribution (admittedly in large part because distribution data do not exist, but income gaps can be approximated).

Income gaps correlate with the politics of distribution for behavioral reasons. In the political economy of growth, perceptions of inequality and other-regarding behavior are the central mechanisms through which economic trends translate into political issues, as Ravi Kanbur argued in an earlier *WIDER Angle*. Gaps measure the distance between rich and poor, a distance that is highly visible in the face of conspicuous consumption. The globalization debate itself demonstrates the salience of relative outcomes over absolute ones, not only because of distributional concerns but because *relative* income seems to be more tangible than absolute income. How individuals perceive well-being, and government beliefs about those perceptions, are central to understanding the importance of distributive questions. In particular, rapid growth that raises everyone's absolute incomes, but also exacerbates inequality, is surprisingly problematic in terms of political stability. Even highly unequal but distributively stable societies seem to fare better, suggesting that both relative position and positional *change* have to be taken into account. Economists in particular have been slow to investigate how increased structural volatility and economic change generate disutility.

The political economy of growth depends highly on distributive *outcomes*--such as income--but exploring the distribution of *inputs* to economic well-being should be even more revealing about the underlying relationships between economic growth and inequality. In particular, the variance of transactions costs and institutional structures that mediate economic outcomes, though usually ignored, may prove central to understanding distributive patterns. The development community now sees transaction costs as a key factor limiting development and growth, but the analysis rarely addresses how these costs are differentially distributed or differentially binding across groups or economic activities. Similarly, although there is renewed attention to economic institutions and their role in development, the way these institutions are shaped across sectors, across groups, and especially across income classes, seems critical to understanding how the inputs of well-being are mapped into the outputs. We argue that the distribution of outputs is partially driven by the differential functioning of these economic institutions. Further, with increasing demand for decentralization of government services and oversight, regional disparities in governance can drive the spatial character of development and of distribution.

A clear example grows out of the consensus in the development profession that credit markets are a central institution for growth. From new Basel standards to the boom in support for micro-credit programs, there has been demand at every level to reduce credit market failures and alleviate credit rationing and risk. But there are distributional dimensions to these failures and risks. For example, where credit markets function poorly, often certain ethnic groups, by accessing credit through transnational ethnic networks, have come to dominate capital-intensive activities. These groups are in effect side-stepping formal institutions in favor of those that reduce their transactions costs, and in doing so reduce the cost of capital and gain economic advantage. The implications for the distribution of income are clear, but there is almost no research to show how these processes drive regional and national distributive outcomes. These processes likely feed into the political economy dynamics discussed above, as wealth becomes concentrated among identifiable groups.

What is needed as a next step is an exploration of these less understood micro- and meso-level foundations of the relationship between economic growth and inequality. These foundations are invisible in cross-section data that pool highly disparate countries, but even country-level Gini statistics and quantified indices of policy measures probably obscure as much as they reveal. Understanding group- and location-specific trends and institutions should help pinpoint the mechanisms and processes that underlie the macro empirical relationships.

* Respectively, Senior Research Scholar, Center for Global Development, Washington, DC, and Director of the Program in Applied Economics, Social Science Research Council, New York. Peter Timmer delivered an early version of these the comments at the WIDER book launch on April 14, 2004. Previously, he was on the faculties of Stanford, Cornell and Harvard Universities, and served as Dean of the Graduate School of International Relations and Pacific Studies at the University of California, San Diego.