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The Difference Inclusive Growth Makes

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The Difference Inclusive Growth Makes

Equity has come to the center of discussions in development, quite rightly, integrating the advances in development thinking on inclusive growth and the experience with results on the ground from growth and distribution. One policy concern springs from the obviously higher poverty levels that are associated with growth when it is accompanied by a highly unequal or worsening distribution. The other concern involves the negative impacts of high inequality on the capacity to generate growth and improve people's welfare.

Discussions of distribution are tied to trends in growth, employment generation and poverty. The primary goal of development is to improve living standards and reduce poverty. Economic growth has been the driving force in obtaining that goal. Estimates of poverty are based on the number of individuals living below a pre-determined limit – the poverty line, usually $1 a day – and are expressed as a proportion of the population.

Changes in poverty occur when either the mean income increases (growth effect) or when the distribution of income changes (distribution effect). Changes in the distribution of income or relative income effects measure the degree of income inequality. Relative inequality – generally represented by the Gini index – measures the disparity of income between individuals or countries relative to mean income. Income inequality falls when the average income of the poorest increases faster than the national average.

Striking is the difference more inclusive growth makes to poverty. Consider these:

- Increasing the growth for the poor (bottom 40 percent) in Asia by 5 percentage points over the average growth can reduce poverty from 18 percent in 2005 to 2 percent in 2020 – reducing the number of extreme poor from 600 million to 80 million people (a recent Asian Development Bank report).

- Brazil could reduce poverty by half in 10 years with a 3 percent growth rate and 5 percent improvement in the Gini coefficient of inequality – or 30 years with the 3 percent growth and no improvement in inequality (a recent World Bank review).

This paper reviews the worldwide trends in inequality, with a special focus on Latin America, with connections to growth, employment, poverty and welfare. The region is highly diverse in its economic and social configuration. Even inequality varies from the relative low of Costa Rica and Uruguay to the relative high of Brazil. And yet the region has a particular concern with high inequality and its own lessons and comparisons with other regions (especially middle income East Asia) are of great relevance.

Our interest is on the link income distribution has to growth prospects of the region and how cost effective policies for greater equality can make a difference to those prospects. Therefore, the implications we arrive at from this review relate to growth policies concerning infrastructure, the financial sector, rural- urban investments, as much as to social programs directly concerned with poverty. These implications are also especially informed by the changes in the global economy and the relentless opportunities and pressures of globalization.

1. Trends in Inequality

The past five years have seen robust economic growth worldwide, helped by a favorable global climate for trade and capital flows and supported by policy reforms in countries. Many nations enjoyed the benefits of institutional and investment reforms of previous years. East Asia remains the fastest growing region. Latin America and the Caribbean lags East Asia in growth markedly, but the gap in growth performance has come down notably as Latin American growth has picked up (Table 1).

Table 1. Regional Economic Growth Rates of Real GDP

Region	*1980-1989*	*1990-1999*	*2000*	*2001*	*2002*	*2003*	*2004*	*2005*	*2006*
East Asia & Pacific	9.8	11.2	7.7	6.9	8.1	9.0	9.2	9.2	9.6
Europe & Central Asia		-2.4	7.1	3.0	4.9	6.4	7.6	6.0	7.0
Latin America & Caribbean	1.3	3.3	3.9	0.4	0.1	2.2	5.9	4.5	5.4
Middle East & North Africa	2.8	3.6	4.1	4.0	4.9	5.4	4.9	4.3	5.5
South Asia	6.4	6.1	4.3	4.8	3.7	7.8	8.0	8.7	8.7
Sub-Saharan Africa	2.0	2.0	3.1	3.7	3.4	3.8	5.6	5.6	5.7
World	3.4	3.0	4.7	2.6	2.9	4.0	5.2	4.7	5.3

Note: GDP measured at PPP exchange rates. Percentages for 1980s and 1990s expressed as average annualized percentage change.

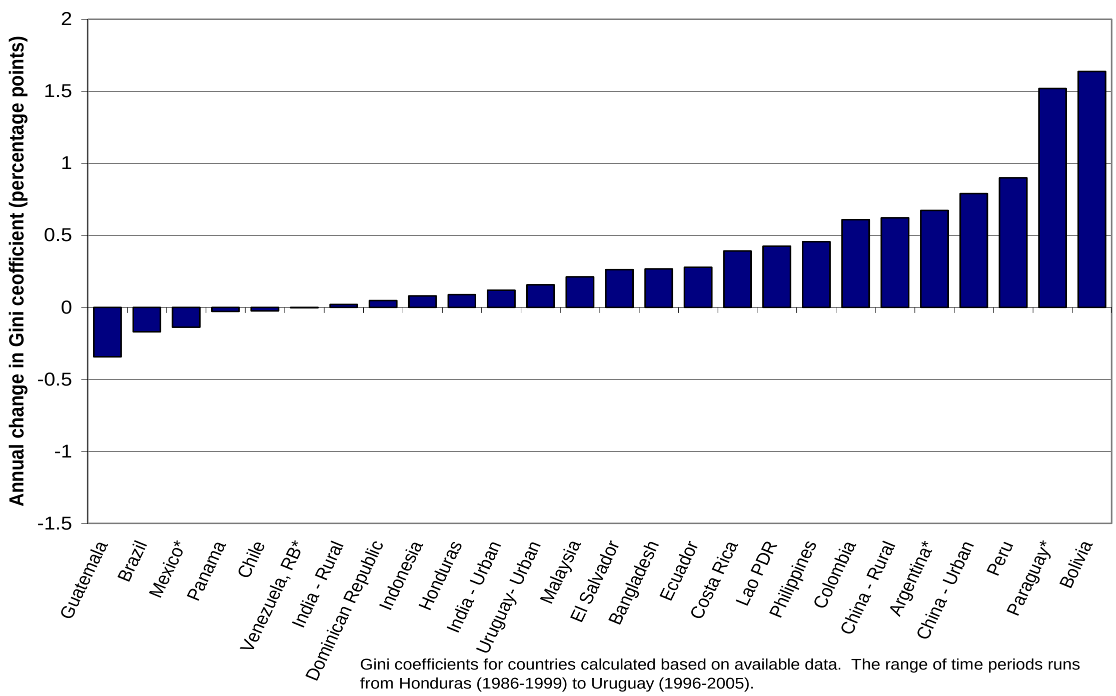
Source: World Development Indicators 2007

Has the world become more equal or more unequal with globalization? The answer is both. It depends on the measure of inequality is used. There has been rising inequality *among* countries. Trend estimates over the last two decades range from a .3 percent average annual increase for developing countries to .45 percent (measured by the Gini coefficient). Inequality has increased as the differences in average incomes have increased and growth rates have diverged. But the differences among the people of the world would have decreased. The reason is that the most populous nations China and India have had a far higher growth rate than the world average, thus reducing the disparities among people (as opposed to nations).

In-Country Differences Among People

What about inequalities within countries, which concerns policy makers the most? Within countries, inequality has improved in some but worsened in many countries (Figure 1). The Asian Development Bank reports that 14 out of 21 countries have experienced rising inequality during the late 1980s, late 1990s and early 2000s. Rising inequality was large in China, rising at one percent per year during 1993-2004. World Bank data confirm that 14 of 24 Asian, Latin American and Caribbean countries show rising inequality between 1986 and 2005. An evaluation of 85 middle income countries confirms 55 had growing disparities.

Figure 1. Rising inequality in many developing countries



Gini coefficients for countries calculated based on available data. The range of time periods runs from Honduras (1986-1999) to Uruguay (1996-2005).

The overall trend in inequality in Latin America and the Caribbean was downward in the 1970s. During the 1980s with generally high macroeconomic and political instability in the region, inequality rose sharply. During 1990-2004, relatively equal countries saw worsening income distributions while Brazil – historically the region's most unequal country – witnessed declines in inequality. The clearest pattern to emerge from Latin America and the Caribbean is not the direction of change in inequality but the persistent levels of high inequality.

Why is there excess inequality in Latin American? A comparison of the United States and Brazil across four institutions – labor markets, assets, household formation and public expenditures – sheds light. Brazil's labor market is characterized by especially high returns to education as a result of historical patterns of underinvestment in education and a higher demand for skilled workers than supply, especially driven by technological change. Technology was found to be the primary determinant of reductions in income inequality between 1980 – 2004, along with education and trade liberalization.

If Brazil's workforce had the educational distribution of the United States', inequality in Brazil would fall from 56.9 to 50.5 – 6.04 points or half the Gini-gap between the two countries. Adding returns to education, the combined effect is 7.5 points; adding government transfers, the gap between inequality in the United States and Brazil is all but closed (1.7 points remain).

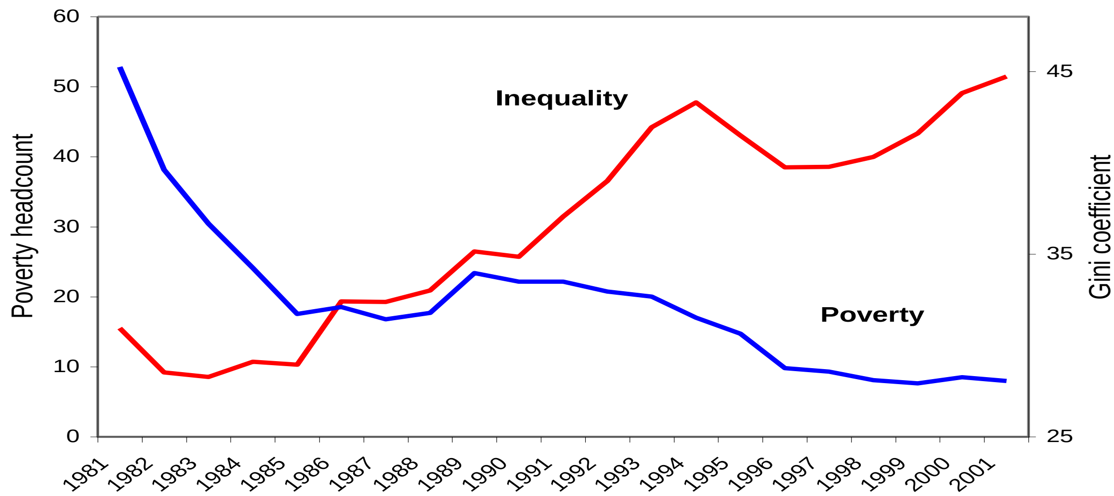
In-Country Differences Across Regions

With respect to inequality within countries, regional disparities and urban-rural differences deserve special note. Spatial differences across localities are generally perceived to account for the lion's share of overall inequality at the country-level. Inequalities represent long-standing power advantages, resource endowments, distance to markets, and weak institutions in lagging regions. Regional disparities also represent underutilized economic potential. Finally, when group-based inequalities are masked as regional inequalities, such as when economically disadvantaged or ethnic minorities are highly concentrated in a lagging region, stability and social cohesion suffer.

Poverty is becoming more urban but still remains a rural phenomenon in all regions but Latin America. From 1993 to 2002, urban poverty increased by 50 million people. Over the same time period, rural poverty was reduced by 150 million people. Still, some 75 percent of the developing world's poor live in rural areas. In Africa and South Asia, the sheer numbers of the rural poor is the overwhelming problem.

Meanwhile, absolute inequality has increased between rural and urban areas in China. That despite the fact that China has lifted more than 400 million people out of poverty in the past 25 years (Figure 2), the majority within rural areas due to agricultural productivity increases (as opposed to urban migration or remittances). Still the growing gap between urban and rural areas is a major policy concern in China.

Figure 2. Rising Inequality and Falling Poverty in China



In addition to China, India and Mexico too have seen a divergence in urban-rural differences. Yet there is no clear trend on this, nor an iron law governing it. Brazil's urban-rural inequality has recently begun to converge.

Turning to regional differences, income inequality in China between coastal and inland regions has been on the rise. This is due, in part, to policy. Development of heavy industry in certain provinces, trade openness and government investments in coastal regions are associated with widening interregional inequality. India too has seen the richer states grow faster than the poorer states, thus making regional or inter-state differences rise. Income inequality in India increased in between 1980-2004. Income inequality increased in urban areas with the Gini coefficient rising from 0.34 in 1983-84 to 0.38 in 2004-05.

Brazil's overall high rate of inequality is historically reflected in the income disparities between regions. Per capita income in the Federal District – Brazil's richest area – is seven times greater than in Maranhão – the poorest state. Per capita income disparity is greatest between the Southeastern and Northeastern region – where average income is less than half the national average. But in Brazil, the differences across states and regions have come down – in contrast to China and India – as the poorer Brazilian states have grown faster than the national average while the richer ones have grown slower than the average, as growth theory would suggest.

Access to infrastructure services is now seen as a fundamental reason for certain regional disparities. Differences in incomes between coastal and highland regions in Peru are a case in point. Several studies have found infrastructure significantly influences income and inequality. In Latin America, 25 percent of the variation in economic growth between 1981 and 2000 is explained by differences in the quantity of infrastructure stocks and both the quantity and quality of infrastructure is associated with lower inequality. Table 2 presents data on access to selected infrastructure services in several Latin American countries by income deciles.

Table 2. Inequalities in Access to Infrastructure by Income Deciles (in percent)

	Water		*Sewerage*		*Electricity*		*Telephones*	
Country	Top quintile	Bottom quintile	Top quintile	Bottom quintile	Top quintile	Bottom quintile	Top quintile	Bottom quintile
Uruguay (1989)	98	80	82	28	100	89	n/a	n/a
Brazil (1992)	n/a	n/a	87	17	99	60	61[a]	2[a]
Mexico (1992)	96	63	91	28	99	75	54	3
Colombia (1996)	96	60	92	35	98	81	71	12
Bolivia (1996)	86	26	49	4	93	21	59[b]	1[b]
Honduras (1990)	89	49	55	4	80	15	n/a	n/a

Notes: a: 1995; b: 1999.

Source: National household survey data analyzed for Inequalities in Latin America and the Caribbean: Breaking with History? World Bank 2003.

Social Indicators

A part of inequalities in income come from the distribution of social attributes. A recent study of developing countries found education to be a significant determinant in the reduction of income inequality. Social indicators in basic education and basic health have converged, both globally and between groups within countries. The rapid decline in disparities in education and access to health care increases the future impact of these factors in helping to eventually reduce income inequality.

The greater convergence of social indicators compared to income levels have several sources. First, some of the social indicators relating to health have technological sources, which in the age of globalization have a tendency to equalize. Vaccination for example helps to even out differences in basic health outcomes. The other reason is that some social indicators such as infant mortality have a floor and some like school enrollment have a ceiling – in contrast to income that is unbounded in principle. This allows social indicators to converge with greater ease.

That said, in Latin America and the Caribbean, strong evidence of inequality of access to services by region, race and ethnicity exits. There is a considerable distance to go.

Social indicators are important: for example, barriers to education opportunities lower income, lower overall health outcomes, which in turn contribute to lower education achievements. In Ecuador, parental education and family income, influence schooling outcomes at a very young age. Children three years old from all socioeconomic groups have similar test scores for vocabulary recognition and are close to the international reference group. By the time they are five, children from poor families or whose parents have limited education (which is highly correlated with income) have faltered relative to the international reference group and their richer peers.

It thus pays to work on improving social indicators and eventually they will feed into the distribution story. New evidence from Brazil suggests programs like Bolsa Familia account for up to one third of the recent declines in inequality.

2. Growth and Inequality

The association of strong growth and rising inequality is sometimes taken as supportive of a Kuznets curve. That is, inequality increases in the early stages of growth in a developing country but begins to fall after some point, i.e. the relationship between inequality and average income is predicted to approximate an inverted U shape.

China is often cited as an example of a country that achieved rapid growth with rising inequality. China has enjoyed a period of sustained and high economic growth, and inequality has been rising since the mid-1980s though not continuously. Over the last two decades of the twentieth century, the proportion of the population of China living under $1 a day fell by about two percentage points per year on average.

However, China does not offer much support for the view that rising relative inequality has facilitated the country's rapid poverty reduction. First, the relationship between growth and inequality was negative: inequality declined during the periods with the highest rates of growth (1981-1985 and 1995-1998). Second, the provinces that saw a more rapid rise in rural inequality saw less progress against poverty, not more.

There is also support from the literature that greater equality may be good for growth (Table 3).

Table 3. Empirical evidence on the effects of distribution on growth

Sub-discipline	*Channels*	*Key publications*	*Main insights*
Industrial organization	Investment	Loury (1981); Perotti (1992); Aghion and Bolton (1997)	Capital market imperfections imply that poor but talented individuals cannot take advantage due to inability to borrow and invest.
Political economy	Incentives		Higher inequality leads to pressure for more redistribution higher taxes, and lower growth
	Insecurity	Benabou (1996)	Inequality leads to socio-political conflict and hence less secure property rights that reduce investment

Source: Gill, Kharas et al. (2006) from Gill, Hariharan, and Kharas (2006).

Inequality, Growth and Poverty Reduction

Economists have sometimes held the view that inequality can provide incentives for work and investment in the economy. Even if true for a time, at what point do good inequalities turn bad? Higher inequality means higher poverty, lower poverty reduction from growth, social tensions and lower potential for all to contribute to the growth process. The flip-side of the economics argument is that inequality represents underutilization of resources especially labor and lost economic potential when all opportunities from growth are not fully exploited. East Asia's early growth was built on the gains from relative income equality compared to other regions.

The opposite might be said of some of the Latin American experience. Inequality in Latin America has been far more pronounced than in Asia. This by various accounts has served as a constraint, not an aid, to growth. Progress in bringing down the LAC region's disturbingly high levels of poverty (and extreme poverty) has proved slow at best and subject to reversals when the overall macro picture has turned cloudy. More encouragingly, most countries in the region have managed to achieve sustained improvements in human development indicators, even during periods of mediocre macroeconomic performance.

A comparison of Brazil, China and India illustrates the case that growth is good for poverty reduction. At Brazil's level of inequality, economic growth of 1 percent is estimated to reduce poverty by less than 1 percent. In India and China, countries with greater equality, 1 percent growth reduces poverty by more than 3 percent. In China and India, high rates of economic growth, coupled with their greater equality, have resulted in strong reductions in poverty.

In Brazil, slower growth and greater inequality have meant less poverty reduction over the past two decades. Put another way, reducing poverty by half in Brazil would take ten years to accomplish with a 3 percent growth rate and a 5 percent improvement in the Gini coefficient and 3 times as long – 30 years – without an improvement in income inequality.

Reversals in Inequality between Asia and Latin America?

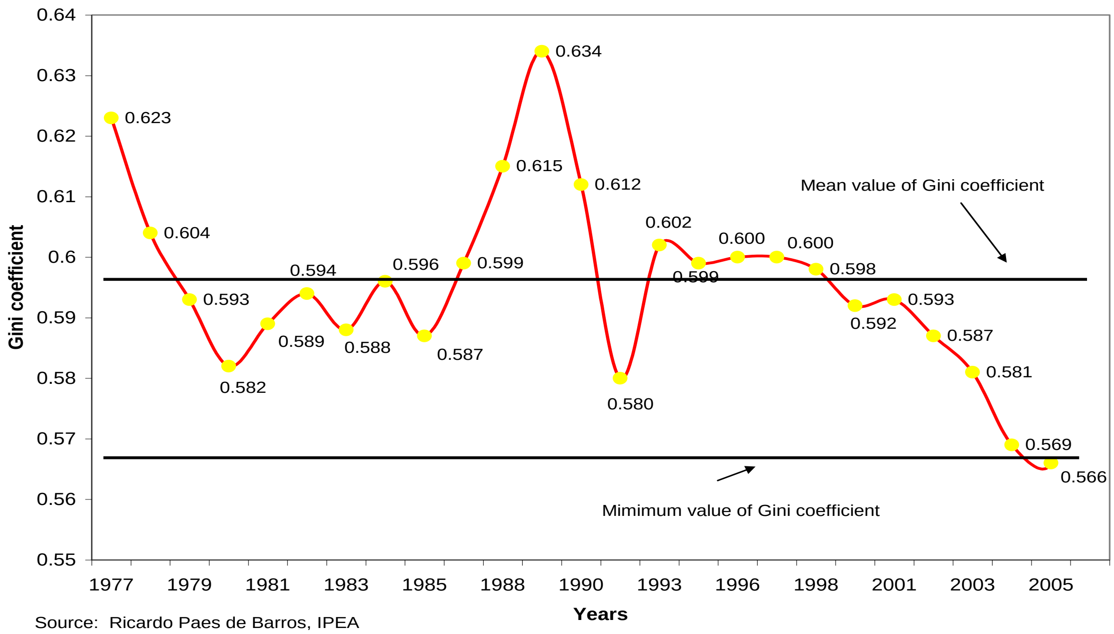
The conventional wisdom is that the levels of inequality in developing Asia have been far below those of Latin America. Broad comparisons have borne out much of this impression. However, these differences partly reflect the fact that inequality estimates for Latin America invariably refer to incomes, while for many Asian countries they are based on expenditures. So the inequality in Latin America is somewhat over stated and those in Asia underestimated in relative terms.

There are also difficult questions of the distribution of other attributes on inequality. If education, health, social services, crime, violence, and environmental damages were captured in the measures, how might inequality between the two regions compare?

Perhaps even more importantly, even with the caveat of underestimation of inequality in Asia, some of the recent estimates of inequality for developing Asia indicate levels approaching those of Latin America. The comparisons between China and India on the one side and Brazil on the other provide a case illustration of this trend. But the broader data also suggest that Asia’s inequality may be approaching that of Latin America.

Inequality in per capita household income reached a 30 year low in Brazil in 2004, falling continuously over the 2001-2004 period (Figure 3). Over the entire period beginning in the 1990s, less 25 out of 75 countries with comparable data had inequality reduction rates higher than Brazil’s. However, poverty has been decreasing slowly. According to estimates using regional poverty lines, poverty incidence decreased from 38 percent to 34.5 percent between 1995 and 2004.

Figure 3. Income Inequality in Brazil Falling but Remains High



Average per capita household income in Brazil did not grow during 2001-2004. But the poorest 10 percent of the population experienced average income growth of 7 percent while the national average income fell by 1 percent. The reduction in Brazil's poverty rates can be attributed to the reductions in inequality. The 4 percent decrease in relative inequality reduced the number of Brazilian's living in extreme poverty by 3.2 percent -- 5 million Brazilian's were lifted out of extreme poverty. Achieving similar results without any redistribution of income would have required sustained rates of economic growth of 6 percent per year.

With inequality on the rise in Asia, policies that affect the distribution of income will have very different effects on poverty reduction. With the average growth rate during 2002-2006 and pro-poor policies that increase the average consumption growth of the bottom 40 percent of the income distribution in Asia 5 percentage points over mean growth, poverty would be reduced from 18 percent in 2005 to an estimated 2 percent in 2020 – from 604 million to 78 million people living in extreme poverty. Lower than average growth and pro-rich policies, i.e., increasing inequality dampens the poverty reducing effects of growth; increasing mean consumption expenditure of the richest (top

40 percent of the distribution) would reduce poverty from 604 million to 391 million leaving 9.9 percent of Asia’s population living in extreme poverty in 2020.

Brazil's inequality has decreased; and will Brazil grow fast now because of a more equitable distribution? China and India's inequality has increased; will the growth of these developing giants slow due to a less equitable distribution?

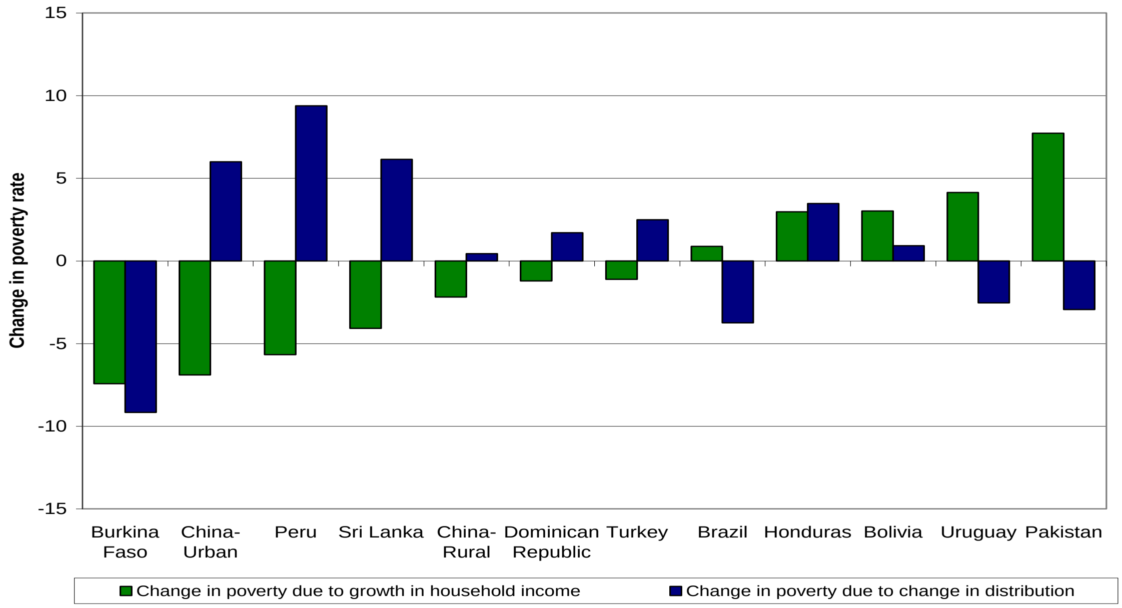
Is Growth Enough for Poverty Reduction?

Many studies have shown that not only the pace of growth but also the patterns of growth matter for poverty reduction. However, there is still inadequate attention to how to make growth more pro-poor, equitable and sustainable. A recent evaluation found that World Bank strategies designed solely to boost overall growth often missed opportunities to reduce poverty most effectively. In the countries where growth did not result in poverty reduction, growth was concentrated in sub-sectors with low labor intensity and where few of the poor could work. The ability of the poor to participate in growth depends on how much growth is driven by productivity increases in sectors where the poor work, how much growth translates into job creation, and how equipped the poor are to take advantage of the resulting job growth.

Developing countries have had five consecutive years of relatively good economic growth with average growth rate of 5-6 percent in 2004-06 even excluding China and India. However, growth is distributed unevenly. Many countries have grown, including the 12 African cheetahs, but others have seen peaks and valleys. In some countries, growth did not translate efficiently into poverty reduction because growth and changes in distribution did not work in the same direction (Figure 4).

In Bolivia and Georgia poverty increased; negative household consumption growth was accompanied by an increase in inequality. In Armenia, Moldova, and Ukraine there was poverty reduction reinforced by reduction in inequality. In China, Lithuania, Sri Lanka and Romania and several Latin American countries the positive effects of growth were dampened by worsening income distribution. An exception to this pattern, Brazil’s improvements in distribution translated into poverty reduction despite a lack of growth.

Figure 4. Distribution Can Dampen the Effect of Growth



Burkina Faso is an example where both growth and a better income distribution simultaneously helped to reduce poverty. With a modest average per capita growth rate of about 1.6%, Burkina Faso still reduced the share of its people in poverty by about half over five years, making it one of Africa's strongest performers in this respect. This result was largely driven by reductions in rural poverty. This was made possible by increased cotton production which was stimulated by earlier price and trade liberalization reforms.

3. How to Grow with Greater Equality?

Even if the worldwide patterns do not pronounce definitively on the link between growth and distribution, we find aspects of policy that have positive implications for growth, employment and equality. Here we consider three -- productivity; labor markets; and human capital.

Productivity and Reforms

The development paths of both India and China have been influenced by, and have generated, two types of inequalities. Good inequalities – most notable those that reflect the role of economic incentives – may have helped their growth experience thus far. But there is a risk that bad inequalities – those that prevent individuals from connecting to markets and limit investment and accumulation of human capital and physical capital – may undermine the sustainability of growth in the coming years.

Policies are needed to create incentives for innovation and investment but at the same time reduce the scope for inequalities with detrimental effects. Growth with equality requires trade, infrastructure and financial sector reform policies, equality of opportunities especially health and education, through investments in human capital, and public investments in rural infrastructure that help poor connect to markets and at the same time promote the sustainable use of natural resources.

The concept of total factor productivity often captures many of the positive elements in the growth process – especially the impact of reforms on efficiency and sustainability. China, India and Brazil witnessed especially high shares of total factor productivity in total growth in periods when they grew the most (see Table 4 and Table 5). So improving productivity would seem to be key to growth. Productivity in turn relies on better practices in trade and investments as well as the build up human capital.

These countries gained in productivity from gradual liberalization of trade and the financial sector and de-regulation of industry for productivity. Private sector emerged more productive from restructuring under competitive pressure in India. Trade allowed China to improve efficiency through vertical specialization and scale economies. Brazil has seen an increase in productivity since mid 1990s when it started reforms. But are these features also really good for greater equality?

Table 4. Contribution of Total Factor Productivity to GDP Growth (%)

Country	**Growth episode**	**1978-1993**	**1993-2004**	**1978-2004**	**2003-2005**
China[1]	Percentage point contribution	3.6	4	3.8	--
	Share of contribution	40	41	41	--
India[1]	Percentage point contribution	1.1	2.3	1.6	3.5
	Share of contribution	24	35	30	43.5
Country	**Growth Episode**	**1960s**	**1970s**	**1980s**	**1990s**
Brazil[2]	Percentage point contribution	2.15	2.33	-3.74	
	Share of contribution	37	29	-260	

Note: TFP derived from the education-augmented Solow residual.
Sources: Bosworth and Collins (2007) and Poddar and Yi (2007), Thomas (2006).

The same observation can be generalized from a much larger set of country cases: productivity is the driver of high growth episodes.

Table 5. High GDP Growth Positively Related to TFP

	1989-1995 (%)		*1995-2003 (%)*	
Country	GDP Growth Rate	TFP	GDP Growth Rate	TFP
Cambodia	7.48	3.21		
China	9.94	6.33	7.13	2.49*
Malaysia	8.45	3.40		
Singapore	7.95	3.69		
Korea	7.48	3.13		
Thailand	8.58	4.74		
Ireland			7.99	3.52
Israel	7.03	2.11		
Chile	7.24	3.55		
Lebanon	13.51	12.27		
Syria	7.97	4.87		
Developing Asia	7.35	3.88		

Note: * Estimate could be 0.5% higher due to an upward revision in GDP during the time period according to Srinivasa, T.N. (2006)

Source: Jorgenson and Vu (2005). OF the 110 economies or 220 growth episodes studied by Jorgenson and Vu, only these 12 episodes had a growth rate over 7 percent.

In particular, relative productivity increases in agricultural from increases in agricultural exports related to trade liberalization have significantly reduced inequality in developing countries over the last two decades. In Latin America, Brazil and Nicaragua are examples of countries with rising shares of agricultural exports and falling inequality.

Labor Markets, Employment and the Investment Climate

Labor markets are generally not competitive – employers may have more market power than employees and information asymmetries and discrimination impede the mobility of workers. Labor markets are highly regulated. The challenge is to design government interventions which balance equity and efficiency and that work within governments' institutional capacity to increase access to the labor market and increase the flexibility of the labor market – which is good for investment, innovation and economic growth. Policies to reform labor markets may require a trade-off between equity and efficiency in the short-term.

More efficient and flexible labor markets increase the ease of doing business and job creation (Table 6), and are good for employment generation. Rigidities in the labor market create incentives for businesses to hire workers informally – paying lower wages, providing no insurance or social benefits. Ironically, those most likely to be hired informally are the poor, women and children. In 2006, the *Doing Business* survey results ranked Brazil 11th most restrictive labor market and 121st for overall ease of conducting business in Brazil (Figure 5). Following theory, Brazil's informal labor market is some 50-60 percent of the total and recent estimates of Brazil show informal workers earn 30 to 40 percent less than workers in the formal labor market.

Table 6. Flexibility of Employment

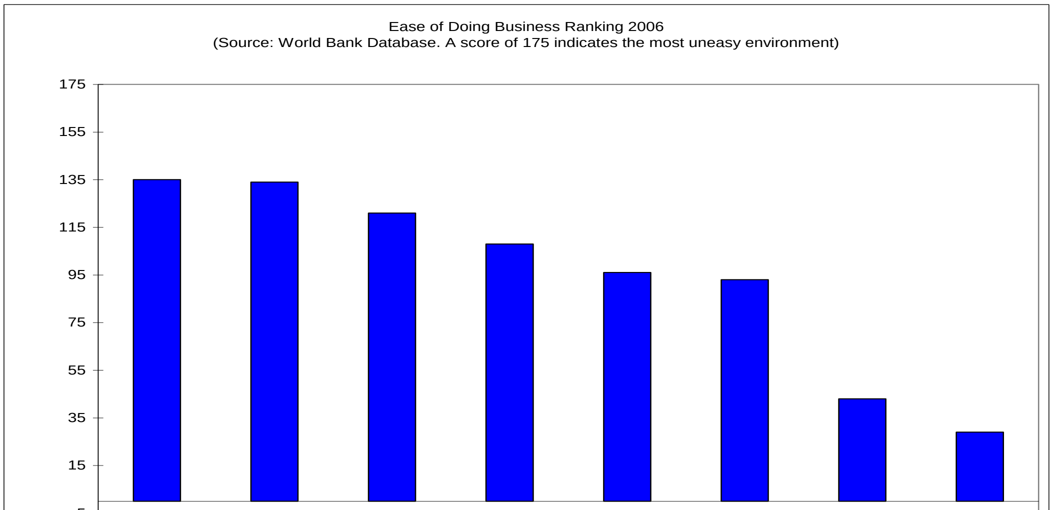
	Difficulty of Hiring Index	*Rigidity of Hours Index*	*Difficulty of Firing Index*	*Rigidity of Employment Index*	*Hiring cost (% of salary)*	*Firing costs (weeks of wages)*
Sao Paulo	67	80	20	56	26.8	165.3
Latin America	41	51	30	40	15.9	62.9
Mumbai	56	40	90	62	12.3	79.0
South Asia	42	35	43	40	5.1	75.0
Johannesburg	56	40	60	52	2.6	37.5
Sub-Saharan Africa	48	63	48	53	11.8	53.4
OECD	30	50	28	36	20.7	35.1

Note: Higher values of the indexes indicate greater difficulty to hire and fire and greater rigidity in hours of work and employment.
Source: (Beath 2006).

In 1990 Colombia introduced a labor market reform that substantially reduced the costs of dismissing workers. The reform reduced severance payments, widened the definition of just dismissals, extended the use of temporary contracts, and speeded up the process of mass dismissals. The joint effects of these reforms were to reduce the costs associated with firing workers in firms covered by the legislation. Note that the reforms did not affect informal sector firms, which did not comply with the legislation and which could have caused a shift to increased informality in Colombia's labor market.

However, an analysis of the effects of the reforms suggests that they did increase the flexibility of the Colombian labor market. There was an increase in worker turnover for formal sector workers, greatest among young workers, more educated workers, and workers employed in larger firms. The reforms may have also contributed to increasing compliance with labor legislation by reducing the costs of formality.

Figure 5. Ease of Doing Business in 2006



	Indonesia	India	Brazil	Nigeria	Russia	China	Mexico	South Africa
Ranking	135	134	121	108	96	93	43	29

Access to Opportunities and Human Capital Investment

Cross-country regression suggests that for a given level of income and inequality, growth translates more efficiently into poverty reduction in countries with high literacy rates, low regulatory burdens, and broad access to credit for the private sector. Higher literacy facilitates poverty reduction because it increases the share of the population that can take advantage of better employment opportunities created by growth, while at the same time providing entrepreneurs with a larger pool of skilled labor.

Education is an important determinant of income inequality and inequality of opportunities and therefore, overall well-being. Both within and between countries, large inequalities exist in educational attainment. Educational inequality is correlated with income, region, gender, and ethnicity.

Efforts to reduce access inequalities have been successful. Conditional cash transfer programs in many Latin American countries provide cash assistance to poor families in exchange for beneficiary compliance with human development actions, such as school attendance or participation in health programs. These programs have demonstrated positive impacts on education, health, and poverty reduction.

Programs such as *Opportunidades* in Mexico, which has increased secondary enrollment for girls by 14 percent and boys by 8 percent; reduced the probability of children ages 8-17 working by 10-14 percent; increased child growth by 16 percent among participating children ages 1-3 years; it reduced child illness by 12 percent, while also reducing the incapacitation rate of participating adults by 17 percent. As a result, there was a 10 percent reduction in poverty and a 45 percent reduction in severe poverty among the target population. In Columbia, school attendance for children between 12 and 17 increased by 10 percentage points in rural areas and helped reduce extreme poverty by 6 percent in one year.

Education has the potential to reduce income inequality through its effect on labor market results. Increasing the overall education level raises the average education level of the poorest, reducing educational inequality in the workforce, in the longer term, labor income inequality. Wage differentials are reduced by decreasing the education differences of the labor force and the premium on qualifications.

Evidence from Latin America suggests the set of initial conditions and policies that interact at the country-level require country-specific assessments. Controlling for experience, gender and locality, improvements in education in Brazil were associated with declining income inequality in Brazil and increases in educational opportunities in Mexico were accompanied with rising income inequality.

Additionally, government spending on education can supply the necessary infrastructure and inputs, especially for the rural poor who more than likely under-invest in education due to credit constraints or high discount rates. However, an adequate supply of educational inputs does not necessarily translate into outcomes. Unequal educational quality should not replace unequal access to educational opportunities.

Sustainable Use of Natural Resources

In addition, the pattern of national economic growth is crucially important to the accumulation or depletion of the global assets for long term human welfare. For example, the rising developing giants, Brazil, China, India, Mexico, Russia and Indonesia are becoming the engine of global economic growth but their strong demand for natural resources are also being felt everywhere. The energy intensity of their growth and the greenness of their policies have strong implications for global welfare.

Some three fourths of the assets of the poor come in the form of natural resources. Protecting these assets therefore is both good for growth and distribution. Such an approach is also progressive in its distributive effect across generations. And yet policies for the sustainable use of natural resources represent the weakest link in the economic policies both in Latin America and Asia.

4. Policy Implications

Distribution matters in many ways, but the impact on employment and poverty is the most tangible. In Brazil, the recent improvement in distribution meant that the poorest 10 percent of the population experienced average income growth of seven percent; the national average income fell by one percent. Put another way, the experience of Brazil's poorest was that of living in a high economic growth country while the richest was of living in a stagnating economy. The four percent decrease in relative inequality reduced the number of Brazilian's living in extreme poverty by 3.2 percent -- 5 million Brazilian's were lifted out of extreme poverty. Achieving similar results without any redistribution of income would require sustained rates of growth of six percent per year.

It is often argued that rising income inequality is a natural bi-product of economic growth. At first look China might be seen as an example of a country that experienced high rates of growth with rising inequality. True, but a more careful disaggregation suggests relatively better growth performance in provinces or time periods with relatively less inequality.

Furthermore, the persistently high inequality in Latin America and the Caribbean and low rates of growth have led to slowed progress in growth and poverty reduction. Brazil's long standing difficulty in generating growth had roots in high inequality. The key test now is whether the turnaround in inequality can now be followed by high growth.

The policy implication would be to seek combinations of approaches that are good for growth and greater equality – especially given the importance of distributional changes to reducing poverty. And so, more attention must be paid to the distributional impacts of reforms. Policies directed at both supporting growth and removing the barriers that constrain the poor from participating in the growth process would have the highest payoffs.

Employment Generation

All said and done, jobs are the most sustainable way to reduce poverty and job creation is the key to inclusive growth. On the other side, unemployment is economically problematic and socio-politically troubling. Latin America with a near 10 percent unemployment rate is only below Middle East and North Africa (15%) in unemployment across regions. The focus on the sources of unequal distribution needs to especially target the aspects that would generate employment.

This has implications for education policy: not only is greater access to secondary and higher education vital, but so is the relevance of the education and learning outcomes. Also important are labor market policies and the support for greater mobility. Greater flexibility in labor market may hurt certain segments, but is better for workers as a whole. The same can be said for actions to help the freer flow of people across sectors and regions.

The emphasis on productivity and reforms should be good for employment generation over time. But there is the question whether certain aspect of this approach – for example, technological improvements and innovations driven say by trade liberalization – may create short term losses, as opposed to gains, in employment. There is evidence that such instances are common especially in the wake of globalization. The challenge is to work through this dilemma, explicitly implementing education, labor market and safety net programs to deal with it.

Nature of Growth Policies

Related is the nature of the growth process. What matters is not only how much a country grows but also how it grows. Many countries including in Latin America have relied on capital subsidies of one sort or another, such as tax breaks for capital, subsidized interest rates or urban biases in investment policies. But these are unhelpful for employment generation and are not that good for long term growth anyway.

Instead, reforms of the financial sector would have important gains for distribution. Of particular importance would be a deepening of the financial sector with actions that facilitate greater access to all segments of the population. Coupled with supportive infrastructural investments, financial sector reforms have shown to be not only growth enhancing but also beneficial for distribution.

Support for trade opening is a related area of importance. Latin American countries have done a great deal of trade liberalization, and are arguably more open than their East Asian counterparts when it comes to measures of trade openness such as quantitative restrictions and tariffs. At the same time, effectiveness of trade polices also depend crucially on supportive infrastructure and institutional development. These are areas of complementary attention.

Rural Infrastructure and Natural Resource Use

Worldwide, rural poverty and the gaps in rural incomes are the largest challenges. Even as Latin America is far more urbanized than other regions (77 percent urban compared to the average of 44 percent for developing regions and 78 percent for high income regions), rural poverty remains intractable and tough to deal with. Development of rural infrastructure and increases in rural productivity therefore are high priorities.

Also conducive to a better pattern of growth are policies for greater sustainability in the use of natural resources. The biases against the sustainable use of natural capital – for example policies that encourage deforestation, soil erosion, water pollution – are particularly harmful to the poorer segments of the population who are mostly likely to be in harm's way. They also rely on natural capital for their livelihood much more than the richer segments.

5. Issues for Discussion

1. What are the crucial linkages among distribution, employment generation and poverty reduction that growth policies can ill afford to ignore?

2. How best might growth policies for infrastructure development, the financial sector and trade policies address the imperatives of improving distribution?

3. What are the lessons from social programs such as *Bolsa Familia* or *Opportunidades* for the efforts to improve distribution?

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