# INEQUALITY IN MIDDLE INCOME COUNTRIES:

## Synthesis Paper

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**Overseas Development Institute**

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**This paper is based on the DFID supported project on Inequality in Middle Income countries, in particular on the presentations and discussions at the project workshop in London on 4-5 December 2003.**

## Contents

# 1. Introduction: background and motivation

This paper is the final synthesis report produced as part of a DFID funded project focusing on the relationships between growth, inequality and poverty reduction in Middle Income Countries (MICs). The project was motivated by the high levels of absolute poverty in many MICs, despite their higher average income levels compared to Low Income Countries (LICs). These high absolute levels of poverty in MICs reflect high levels of inequality, which often has strong horizontal dimensions, in other words high levels of inequality between clearly defined groups, for instance along ethnic, gender or regional lines (or combinations of these).

The development performance of MICs over the next decade will be a very important contributory factor in the chances of meeting the Millennium Development Goals at the global level, especially so as levels of poverty and inequality have been very persistent in many instances. These high levels of inequality are also widely regarded as having adverse effects on growth and social stability, which in turn are key factors enabling more rapid poverty reduction. Finally the performance of MICs can often have strong favourable impacts on neighbouring countries, which in many instances include LICs (e.g. in the case of South Africa).

This project comprised an overall concept paper written by a multidisciplinary team at ODI, and three country case studies of Brazil, China and South Africa which were prepared building on the framework set out in the concept paper. The case study countries thus covered two high inequality MICs with relatively slow growth (Brazil and South Africa), and one rapidly growing country, in which inequality has increased significantly, albeit from an initially low level (China). Each of these papers was presented in a workshop on London on 4-5 December 2003, along with other closely related presentations reflecting a number of other important initiatives in this area at present, notably from key multilateral organisations (Inter American Development Bank, Asian Development Bank, World Bank, European Commission) and researchers working in this area. The programme for the workshop is included as Annex 1 to this paper.

The synthesis paper summarise key messages from this project, drawing both on the papers and on the presentations at the workshop. The papers and presentations from the workshop will shortly be available on the ODI website.

In seeking to synthesise the findings of this project, a useful starting point is to consider perspectives on inequality in a key international publication on poverty reduction: the World Bank's *World Development Report 2000/01* on poverty. The key features of the WDR position on inequality were summarised by Simon Maxwell at a presentation at the workshop as follows (see also Maxwell, 2001):

- The basic approach: opportunity, empowerment, security
- Inequality matters – but mostly for instrumental reasons
- The primacy of growth: emphasise openness
- Redistribution with growth
- Empowerment = open institutions, information

- Ginis are hard to shift: hence focus on education as a long term investment
- Reducing inequality by tax is difficult and distorting
- Hence little emphasis on social protection
- The answer to rural poverty is land reform
- Middle income countries can take care of themselves

Many if not all of these points can be regarded as forming a "conventional wisdom" on inequality. Of course perspectives have continued to develop since the publication of WDR 2000/01, but this summary forms a very useful starting point for considering the discussions of the workshop in this synthesis paper. The findings of this project complement or challenge some aspects of some of the above statements of a conventional wisdom, and discussing these forms a key focus of this synthesis paper.

The project emphasised three key themes: relations between poverty, inequality and growth; the political economy underlying inequality and attempts to tackle it; and the need for an explicit focus on rights, non-discrimination and social inclusion. These three themes form the substantive sections of this paper (sections 3 to 5 respectively). Before this section 2 provides a brief review of the nature of inequality in MICs, and afterwards section 6 discusses donor policies in relation to MICs. Each of these sections begins with a brief review of the issues, and then summarises a small number of key findings from the project. Finally, section 7 of this paper summarises and sets out some key issues to be considered in future work.

## 2. The nature of inequality in MICs

Middle Income Countries (MICs) are currently defined by the World Bank as countries whose GNI per capita in US$ in 2000 lay in the range $755 to $9265. In 2002 there were 93 MICs; among these China is classified as a lower Middle Income Country and Brazil and South Africa as upper Middle Income Countries.

To date inequality has most commonly been considered in terms of income, consumption or assets. But inequality, like poverty, is multidimensional in nature. Both inequalities in *outcomes* (e.g. income) and in the *opportunities* that typically underlie this (e.g. discrimination in access to key services or employment) are important. Horizontal inequality (Stewart presentation) is also important, that is inequalities between different groups of the population, for example by ethnicity or gender. Currently available data does not capture these different aspects of inequality adequately. Data is most widely available for individual inequality in monetary outcomes such as income or consumption, though for example the *Breaking with History* study reports evidence on inequality of opportunities in Brazil.

In this and the subsequent three sections, the key findings from the project and the workshop discussions are summarised as numbered points, relating them where appropriate to the WDR 2000/01 understanding of inequality set out above.

1. *Inequality levels are high in MICs, but with substantial variations. And there is evidence that Gini coefficients can change over even relatively short periods of time.*

Cross country comparisons of inequality are fraught with serious data comparability and reliability problems, but in fact indicate quite a lot of diversity in the levels of inequality in different MICs. Although many MICs do have high inequality, in fact levels of Gini coefficients in MICs are not higher on average than LICs, contrary to common perception. And education inequality seems to be lower in MICs than in LICs. Another important lesson from international data sets (combining cross country and time series aspects) is that levels of inequality can change over time, either upwards or downwards. This is important because even small changes in inequality can have an important impact on poverty (Naschold, 2002).

This is not to deny that many MICs do have high levels of inequality; Table 1 presents data on inequality for the three country case studies along with growth statistics. This shows very high levels of inequality in both Brazil and South Africa, and somewhat lower levels in China. Throughout this period there have been important changes in inequality levels in China and South Africa, increasing sharply in the former (associated with economic liberalisation) and falling in the latter (associated with political transition and the end of apartheid). In both cases though inequality seems to have been more stable in later years. In Brazil inequality levels remained stubbornly high, such that the Gini coefficient has changed very little over the last 25 years.

**Table 1: Summary data on inequality & growth over the 1990s in case study countries**

| Country | Gini coefficient | Average per capita growth rate 1990-2000 (% p.a.) |
|---|---|---|
| Brazil | 0.62 (1990)<br>0.60 (1995)<br>0.60 (1999) | 1.3 |
| China | 0.38 (1988)<br>0.45 (1995)<br>0.43 (2002) | 8.6 |
| South Africa | 0.67 (1991)<br>0.56 (1995)<br>0.57 (2000) | -0.3 |

*Sources: inequality data from country case study papers; growth rates from World Development indicators 2002.*

Of these countries only China has experienced significant growth over this period, and this has translated into substantial poverty reduction despite the increase in inequality.

> *2. There are high levels of horizontal inequality in each of the case study countries.*

In China there are large differentials between urban and rural areas, and between the coastal and western regions; with the better off urban and coastal areas benefiting more from growth in each case. In South Africa the proportion of overall income inequality attributed to differences between racial groups is around 40%, a massive inter-group inequality by international standards. In Brazil there are sharp differentials in many different indicators by race, as well as vast differentials by gender and by region. The presentation by Velez shows for instance that some states in Brazil have social and income indicators comparable to HIPC countries in Latin America. This point about the importance of horizontal inequality or social exclusion applies more widely, with other presentations at the workshop (Stewart, Buvinic) giving several examples along ethnic, gender or regional lines from other countries.

## 3. Poverty, inequality and growth

This component of the project focused on the nature of growth and its relations with inequality, and on reviewing experiences with macroeconomic, fiscal and other measures to tackle inequality. The political conditions which shape or enable these policies are clearly of critical importance, but will be discussed in the subsequent section. Four key lessons are highlighted in this section.

> *3. There remains controversy about the underlying rationale for addressing inequality.*

Many continue to see the rationale in purely instrumental terms, whereas others see the rational in both instrumental and intrinsic terms. This controversy is reflected in different definitions of the term 'pro-poor growth' used by researchers, donors and multilateral agencies. Pernia (ADB) defines pro-poor growth as the extent to which the proportional income growth of the poor exceeds average income growth. This definition clearly places an intrinsic value to reductions in income inequality. By contrast, the World Bank (Ravallion and Chen, 2003), and DFID's Growth Team in a recent Briefing Paper (DFID Pro-Poor Growth Briefing Note 1, 2003), define pro-poor growth as simply growth that reduces poverty. This definition does not place intrinsic value on reductions in inequality, only an instrumental value, to the extent to which reductions in inequality can increase the growth of the average income of the poor.

The case of China highlights this distinction well, in that it has attained rapid poverty reduction, despite increasing inequality, mainly because of rapid economic growth

(Table 1). This is therefore not pro-poor growth in the Pernia sense. But it would be difficult to argue that poverty reduction could be even faster in China had more been done about the increase in income inequality – simply because current rates of poverty reduction are among the highest anywhere recorded. The instrumental reasons for addressing inequality seem less critical in this case, at least over this time horizon. However, there may be questions about the sustainability of China's economic growth and poverty reduction in the longer term if inequality levels continue to rise (due for instance to increasing social tensions, as at present).

In Brazil and South Africa, by contrast, poverty reduction has been much slower, because of slow economic growth combined with an initially very unequal distribution of income (Table 1). In these cases, it is almost certain that reductions in inequality would raise the rate of poverty reduction; in other words, there would be both intrinsic and instrumental reasons for addressing inequality.

To summarise, the importance of addressing inequality in achieving poverty reduction may depend not just on a country's initial level of inequality (positively) but also on its level of growth (negatively). Unfortunately however reductions in inequality may also be more difficult to achieve politically, precisely in countries which are growing less rapidly, in that short run redistribution is more of a zero sum game.

## *4. Reducing inequality through taxation, as well as public expenditure, is possible.*

Evidence from South Africa suggests that the combined impact of taxation and public expenditure is to reduce the (pre-tax) Gini coefficient from 68% to 44%, allowing for the estimated benefits of publicly provided health, education and other services on a subsidised or free basis (not incorporated in the Gini coefficient estimate in Table 1). This is a very large reduction, mostly achieved through public spending. But taxation still reduces the Gini coefficient from 68% to 64%, which will still have a large poverty reduction impact. Similar estimates for other countries are still significant: among the Dollar and Kraay (2001) dataset, Gini coefficients of pre-tax income are on average 4.5 percentage points higher than those for post-tax income (now not allowing for the imputed of public services provided on a subsidised or free basis).

There is no firm and conclusive evidence of the extent to which redistribution of these magnitudes has adverse effects on incentives for savings, investment or work – and hence growth rates. But this does refute the view that Gini coefficients are difficult to change, as already seen above. Moreover, average levels of taxation are much lower in MICs than developed countries. In Latin America, for example, tax revenues averaged 15% of GDP in the 1990s, as compared with an average of around 30% in developed countries (*Breaking with History* presentation). If, as some economists believe, there is an inverse-U shaped relationship between taxation levels and economic growth, it is quite possible that most MICs have not yet reached the point at which higher taxation leads to lower growth.

At the same time, it is also clear that substantial barriers remain to redistribution through public expenditure and taxation in most MICs. In Brazil and China no comprehensive estimates exist for the overall impact of public expenditure and taxation on the distribution of income or consumption, but what evidence there is suggests only a weakly progressive impact and perhaps even a mildly regressive one

– in other words poorer groups are not benefiting more than richer groups. In China, average levels of taxation are higher in rural than urban areas, and for poorer groups within those regions, which is most likely a legacy of the urban bias pursued by Chinese authorities seeking to promote industrialisation. In Brazil, public expenditure has had only limited success in reducing inequality, despite a level of tax revenue which is relatively high given its per capita GNI (25% of GDP in 2000). This reflects the low priority given to expenditure on goods and services most important to the poor: for example, 70% of government expenditure on education and culture was allocated to higher education, compared to only 13% to basic education (Brazil case study paper, p.25). Estimates from the presentation by Velez show how regressive public spending on pensions is in Brazil.

The difficulties of achieving significant redistribution in practice are compounded in Brazil and China by the spatial nature of inequality. In particular, in both countries a substantial component of overall inequality is accounted for by high and increasing disparities between rapidly industrialising, more favoured, regions and less favoured, predominantly rural, regions. In China, for example, there has been very little redistribution of income or resources from richer states to poorer states via the Central Government, mainly because the richer state governments have become increasingly powerful relative to the Central government, and as a result increasingly able to retain their own resources for use within their own state.

*5. The most appropriate measures for addressing inequality in the long-term will depend on the sources of inequality, and are likely to differ between countries.*

Examination of the three case studies shows that the sources of inequality in income differ quite significantly.[1] In Brazil, the largest source of overall income inequality is arguably the differences in incomes and asset returns between racial groups, regions and interactions among these. The interlinked nature of these inequalities reflects historical context, but also makes it difficult to unpack their respective contributions and to identify appropriate policy responses; focusing for example on race alone is likely to be inadequate. In addition, there remains substantial scope for reducing inequality via public expenditure and taxation, given that the redistributive impact of the fiscal stance is currently low or negative.

In China, the largest source of overall inequality is undoubtedly the large differences in incomes and other measures of well-being which exist between regions. Tackling inequality in China will require first and foremost that something is done about these gaps. Current policy is aiming to reduce these gaps mainly by providing funds for large-scale infrastructure and transport investments in more remote areas. More could be achieved, however, if the government was to relax legal restrictions on inter-regional migration. Tackling fiscal regressivity is another key issue as noted above.

In South Africa, differentials in incomes and asset returns between racial groups continue to be a major issue. Responding to inequality in South Africa will clearly require a concerted attempt to continue reducing racial differentials, in other words,

[1] By the sources of inequality in income, we mean differences in the income-generating assets which people hold (in quantity and quality), differences the returns to those assets (both income received and probability of being employed), plus any income redistribution which occurs voluntarily or via the government. Underlying each of these sources will be a set of deeper determinants, which may be economic, political or socio-cultural.

addressing the divide between the "two nations". Extremely high levels of unemployment are another major factor underlying inequality, partly reflecting a capital-intensive development strategy and contractionary macro policies. There are large disparities in employment prospects between skilled and less-skilled labour. Addressing inequality will also require a reduction in these gaps: either by stimulating the relative demand for the less-skilled, or by reducing their relative supply (e.g. through adult training).

The impact of trade openness on inequality is a matter of some concern in both Brazil and South Africa, though the evidence for this in these cases needs to be developed further. Perspectives on openness are also complicated by the fact that there is quite a lot of evidence that it is an important factor influencing growth rates (see above discussion of pro-poor growth).

6. *Although macroeconomic stability is undoubtedly important for raising living standards and reducing poverty in the long-term, it can be achieved in different ways with different implications for inequality.*

Achieving macroeconomic stability, through the use of fiscal, monetary and exchange rate policies, is an essential component of a long-term strategy for economic growth. In Latin America macroeconomic crises have implied very large fiscal costs (*Breaking with History* presentation). Macroeconomic stability is also likely to be particularly beneficial to poor people, either because they hold a greater share of their assets in cash, or because a greater share of their income is fixed in nominal terms (e.g. minimum wages or state pensions), or because they are more vulnerable to income volatility.

However, achieving macroeconomic stability can often impose significant costs on a society, notably during periods of adjustment following adverse external shocks. Governments concerned with inequality (either for intrinsic or instrumental reasons) should make sure that the costs of such adjustment are not born predominantly by poorer groups. This could be achieved, for instance, by increasing taxes as well as cutting public expenditure, by ensuring that more 'pro-poor' elements of public expenditure are maintained, and through the prudent use of capital controls.

## 4. The political economy of inequality in Middle Income Countries

The previous section concluded that it is in fact possible to identify public actions that are likely to be effective in containing inequality. Whether or not these policies are pursued is fundamentally an issue of political economy: that is, policy and budget decisions reflect the influence of political incentives and the differences that exist between groups within society in terms of the power they exercise over political processes. It is important to remember that inequalities in wealth and wellbeing are both a cause of and an outcome of inequalities in power. The poor, almost by definition, have less power and are less likely to have their interests reflected in public policy. The rich, by contrast, typically benefit from current policies, and are likely to resist efforts to redistribute wealth or redirect public spending away from items primarily of relevance to them and towards items primarily of relevance to the poor.

Identifying technical policy solutions to the problem of inequality is thus of little value if not complemented by a good understanding of national political realities and of the changes to the political system that will be necessary if these technical solutions are to be adopted. This understanding is not adequately acknowledged in the conventional wisdom set out above, and as such is a major omission. The project suggested the following key findings, as well as the need for further work in this area.

7. *There is no conclusive relationship, in either direction, between the broad nature of a political regime (democratic or authoritarian) and the level of inequality in society.*

At a crudely mechanical level, median voter theory suggests that where the poor are in a majority (as in most low income countries), democratic politics might be expected to yield pro-poor, inequality-reducing policies. In many MICs, of course, the poor are not in a majority. In some, however, they are: and even in countries where the poor are in a minority, it would appear that there is still a puzzle to solve, as public spending often clearly favours the rich majority, rather than policies which might benefit the majority (poor and lower-income non-poor alike). Indeed, two of the case study countries (Brazil and South Africa) continue to display levels of income inequality that are amongst the highest in the world, despite being multiparty democracies. The failure of democratic elections to result in government policies which reduce inequalities is thus a matter for some debate.

Against this, it is often observed that non-democratic countries frequently demonstrate relatively low Gini coefficients. This is unsurprising when the countries in question (e.g. China) have in the past adopted socialist command economy models (and to some extent continue to do so, even though most have by now substantially liberalised). However, there are also capitalist regimes (e.g. South Korea, Taiwan) which have under early authoritarian phases carried out significant land reform and continue to demonstrate relatively low levels of inequality.

There is a danger that this contrast becomes simplified to the extent that it is concluded that authoritarian regimes are better than democracies at containing inequality. 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 (apartheid in South Africa and military-bureaucratic rule in Brazil). While it may be fair to conclude that a decade of 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 (South Africa case study).

- Secondly, even within one country, there are important temporal and sub-national variations within the categories of “authoritarian” and “democratic”: and these different phases or regional variants of authoritarianism or democracy have had different effects on inequality. The relatively low level of inequality in contemporary China is largely a legacy of the decades of (authoritarian) command economy: it is now being eroded as the (still authoritarian) regime opens steadily more aspects of the economy to market competition[2].

- Democracy remains important as a political safety net (providing a guarantee that the poor will have some voice in the political process; and providing a check on the ability of political leaders to pursue clearly disastrous policies); and, apart from its intrinsic value, also plays an important indirect role in structuring (through debate) the direction of change in social and political values (Sen, 1999).

- 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 conclusion is that the variation in levels of inequality *within* the set of authoritarian political systems on the one hand and the set of democratic political systems on the other is as great as any differences between the two sets. If democracy is clearly not enough to guarantee a pro-poor or egalitarian bias to public policy, neither is it legitimate to generalise upon the East Asian experience to conclude that authoritarian regimes are inherently better at containing inequality.

This still leaves the question of *why* democracies often fail to address pronounced inequalities, when it might reasonably be expected that the voice of the poor, through elections and through debate in a free press, should influence policy.

*8. Political traditions and institutions play a critical role in empowering or disempowering the poor, and thus in shaping the possibilities for redistributive policies.*

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. What is needed is a more fine-grained political analysis that looks also at political traditions, configurations of political institutions (both formal and informal) and the social basis for political identities and organisation. Together, these help to 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 (as in most countries) the poor are divided by interwoven differences in identities (language, region, race, religion, culture, or sex) and material interests. These differences are often exacerbated by

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[2] It is also important to remember that when non-democratic regimes *have* proved successful at containing inequality, this has sometimes been at the expense of growth and poverty levels. China until 1978 (and, from the low-income camp, Vietnam until 1986) can both be reasonably characterised as having achieved equality in, if not poverty, then certainly very low incomes. While arguably these state socialist phases of asset redistribution and equalising human development provided the basis for rapid growth in later decades once the emphasis on equality was relaxed, they did not in themselves achieve resounding developmental success. The contemporary combination of relatively low inequality with rapidly-rising incomes in China can thus best be seen as a distinct historical moment in a long-run transition from low average, equal income distribution to a high average, unequal distribution.

traditions of clientalist or corporatist forms of vertical political alliances, by which individuals or the state as a whole mobilise fragments of the poor, preventing the formation of effective broad horizontal alliances between poor groups. The existence of such forms of adverse incorporation helps to explain why Latin American democracies have by and large failed to address issues of extreme inequality (see Box 1).

The concepts of corporatism and clientalism relate to another political phenomena, that of populism. When charismatic leaders (such as Peron in Argentina or Chavez in Venezuela) have gained and stayed in power through direct, personalized appeals to the poor, the politics of redistribution that have resulted 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 1 Corporatist and clientalist political traditions in Latin America**

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, 2003). Corporatism per se may not be an entirely negative phenomena: in advanced welfare states, it has provided a degree of stability and mutual discipline which has allowed the negotiation of political compacts between capital and labour. The Latin American model of corporatist politics, however, has involved the management of political mobilization from above through 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. Clientalist politics are distinguished from corporatism by the individualistic and informal nature of the relationships involved: 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 however various ways in which the poor in both democratic and non-democratic regimes can 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 heavily on the quality of leadership and organisation emerging from within poor groups and their non-poor allies: however, it will also be influenced by 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, then the prospects for redistributive policies are much greater (Hossain and Moore 2002; Crone 1993).

9. *There are some good examples of successful alliances, both between poor groups and between them and non-poor, which have influenced public policies and budgets in favour of reduced inequalities.*

There are numerous positive examples of successful alliances, both horizontal and vertical, which have generated political pressure for redistribution. Several of these were highlighted in the country case studies (see Box 2). It is important however to be realistic about the conditions under which civil society demand can be effective, and to recognise that often it is a change in state orientation that creates the possibility for grassroots action. Having noted above the limitations on what should be expected of democratic governments, it is important to remember that a liberal democratic political superstructure has at least the advantage of allowing the formation of civil society groups which might challenge the state – and of encouraging the state to promote and use these opportunities. 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 (Box 2). In this way the Lula administration hopes to strengthen the political support base for its own, inequality-reducing agenda (though see Box 2 on the non-representative composition of these fora). In China by contrast the one-party state, by closing off opportunities for the formation of autonomous civil society organisations, is forced to rely upon its own analysis and corporatist structures in order to understand and manage social concerns about inequality.

**Box 2 Pressure from below and openings from above**

In South Africa, the National Economic, Development and Labour Council (NEDLAC), 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 proposed policy initiatives. (Even this, however, is a contested process, as illustrated by the fact that blacks are severely under-represented.) In Brazil, the administration elected in October 2002 has created a number of fora through which to involve civil society groups representing the poor in setting government policy. These include the Economic and Social Development Council (CDES), and the National Food Security Council (CONSEA), both set up by the current administration. The former brings together representatives of businesses, trade unions, NGOs and intellectuals, in order to come to agreement on domestic policy issues, including tax and social security reform. The latter has a similar composition, and is designed to submit decisions and propose projects for the *Fome Zero* (Zero Hunger) Program. However, while attempting to be representative, these councils are often not; thus there is only one black representative on CONSEA despite the fact that the overwhelming number of beneficiaries are from the black population. This simply helps to perpetuate existing horizontal inequality.

*10. The political processes giving rise to policies designed to address inequality are complex, often protracted, and require the ability to manage compromises.*

The political possibilities available to those seeking to reduce inequalities depend heavily upon context. In other words, political strategies for a more egalitarian society will be shaped by history, the current health and future prospects of the economy, and the changing capacities of political institutions to manage conflicts of interest. 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.

The importance of specificity notwithstanding, dynamic redistribution (i.e. ensuring that the poor gain an increasing share of national wealth through participation in economic growth) is generally considered to be much more politically feasible than static redistribution (involving zero-sum redistribution of an existing stock of assets). Even when adopting this approach, however, governments that are inclined to act in the interests of the poor will almost always need to form pacts, and make compromises, with non-poor groups. This is most clearly evident in the case of South Africa. From the outset – in particular, from the first public meeting inside South Africa between representatives of big business and the newly-unbanned ANC in 1990 – it was clear that a future ANC government would offer a deal: macroeconomic stability and openness to international trade, in return for support from business for black economic empowerment (Gelb 2003: 26). The negotiated nature of this process meant that reform in South Africa would necessarily involve an incremental, market-focused process, rather than a more radical, static redistribution.

Economic and political transitions – for example, from a closed command economy to a more open mixed economy in China, and from apartheid to multi-racial democracy in South Africa – often involve changes in both the degree but also the causes and nature of inequality. During such transitions, political and social institutions may be hard pressed to adapt. In China, the broad inequalities that existed between urban and rural and coastal and inland under the centrally planned economy have been exacerbated by growth under liberalization – and complicated by growing inequalities *within* rural and urban sectors of society. Combining policies to contain inequalities with those designed to promote growth requires a delicate balancing act, and one that is deeply political.

## 5. Discrimination, rights and inequality

The extent of differentials in outcomes and opportunities between clearly defined groups of people has been repeatedly stressed in this synthesis paper. The concept paper and workshop discussions presented a number of related concepts used to examine this problem: a human rights approach, which posits equality and non-discrimination as fundamental principles which should be respected by development processes (rights background paper); horizontal inequality, which is useful as a tool to measure difference between groups, recognising that definition of groups can be relatively fluid (Stewart presentation); and social exclusion, which refers to the processes and social dimensions (Buvinic presentation). Horizontal inequality may be explained as a consequence of discrimination against, or social exclusion of, the group in question, though it is important to recognise that differential outcomes do not by themselves prove discrimination (e.g. differences in wages between two individuals may reflect different levels of education – although of course there may have been prior discrimination in access to education).

Evidence suggests that inequalities within groups are generally much larger than inequalities between groups (World Bank *Breaking with History* study), which is sometimes used to justify focusing attention on the former rather than the latter. However, WDR 2000/01 does recognise as one key aspect of its empowerment theme the importance of focusing specifically on disadvantaged groups, such as indigenous peoples in Latin America, often specifically in terms of access to services or to information. In practice, though, this has not been regarded as a central theme in tackling inequality. The arguments and evidence reviewed in this project imply this is a major issue in tackling inequality, which needs to be given much higher priority.

### *11. A human rights based approach provides a strong argument for being concerned with inequality for intrinsic reasons, and a framework for tackling discrimination.*

Equality and non-discrimination are fundamental human rights, enshrined in international declarations and treaties, which governments have signed up to and which set a number of standards, for example in terms of access to services. A human rights-based approach to development is thus committed to tackling inequality and focusing on the needs of marginalised and vulnerable groups for intrinsic reasons, so as to equally promote their human dignity.

It offers a framework to analyse inequality from the perspective of discrimination, which may be official and direct (e.g. racism of apartheid South Africa), indirect (disadvantages of the black and indigenous communities in Brazil as a result of historical events), or informal (e.g. generalised racism in society and amongst government employees against blacks or indigenous people). It also provides a legal and policy framework to tackle discrimination, for example by providing civil society groups access to international fora to raise concerns over domestic discriminatory practices; providing standards for constitutional, legal or policy reforms and informing budget allocations; or suggesting that 'special measures', such as affirmative action policies, may be required in order to redress historical imbalances.

Challenges include the resistance of some governments to the human rights framework, the lack of international enforcement mechanisms, and the need not just to reform laws and policies, but to ensure that they are implemented and are effective in addressing discrimination and enhancing equality of opportunity and outcomes for all but in particular vulnerable or excluded groups.

### *12. Discrimination and social exclusion are important contributors to horizontal inequality.*

As already stressed, the extent to which horizontal inequality contributes to overall inequality is particularly striking in South Africa, here on racial lines (Gelb, 2003). Social exclusion is also a major issue in Latin America with those from indigenous groups experiencing higher levels of poverty, earning lower wages, and being more likely to drop out of school (Buvinic presentation). This often leads to a vicious circle of intergenerational transmission of poverty, in which adolescents with low levels of education and limited prospects in the labour market are more likely to have children at a younger age without the resources to support them adequately, or to engage in antisocial behaviour. Either of these is likely to perpetuate disadvantage.

While not all horizontal inequality reflects discrimination, discrimination is often an important factor directly or indirectly. For instance, in Brazil average income and poverty levels differ sharply between the white and black population. In part this reflects lower education levels among the black population (which itself appears to be an outcome of discrimination). But even for a given level of education, there is a large and systematic difference between the average income received by each racial group (Brazil case study). There are many factors underlying discrimination in Brazil, which has deep historical origins, and institutional racism (government, private sector, civil society) is a major issue. The unwillingness to recognise discrimination as one important factor (the myth of racial democracy) enables the persistence of patterns of discrimination over time.

*13. There is considerable scope for policy actions to tackle discrimination and social exclusion.*

A key starting point for policy responses is to recognise that discrimination and social exclusion are problems which need to be addressed, and then to adopt/revise constitutional or legal frameworks so that discrimination is outlawed. This needs to be accompanied by appropriate policies, such as a guarantee of equal access to services, which to be effective may also require measures to make these services more relevant for excluded groups, such as bi-lingual education. It is also important to put in place independent monitoring mechanisms, such as a National Human Rights or Equal Opportunities Commission, which can monitor state and social practices, as well as facilitating the activities of the media and advocacy groups. Whilst adequate economic and social policies are necessary, civil and political rights can be also be important to address inequalities: in China, restrictions on freedom of movement are part of the story of regional inequalities (China case study). Finally, it is essential that adequate disaggregated data are available to that inequalities and discriminatory outcome of policies can be identified and addressed. For example, ethnically-based inequalities in China could not be examined because of the difficulty of obtaining data.

Government provision of services that are in principle universal may not effectively reach disadvantaged groups, as for example with the public health system in Brazil (where for instance the mortality rates of black children remain high while those for white children are falling sharply). More generally the failure of public spending in many MICs to be significantly redistributive, especially in Latin America, is effectively demonstrated in several of the workshop presentations. The importance of pensions in public spending is one key aspect of this given that such spending often does not benefit disadvantaged groups, who are less likely to have worked in the public sector and hence be pension recipients (Velez presentation). Intentionally or unintentionally, public spending often does not provide adequate benefits to disadvantaged groups. This is a key issue in reviewing patterns (and levels) of public expenditures.

This raises the (controversial) issue of the need for affirmative action policies, such as the introduction of racial quotas for access to government run universities in Brazil (so far adopted in only one institution). Such measures are likely to be important in tackling entrenched discrimination, but do raise the issue of whether the policies benefit only the elites of disadvantaged groups, or whether they benefit others as well directly or through the beneficiaries being able to be more effective advocates for the disadvantaged group as a whole (as for example in South Africa). Further research would be valuable to strengthen the evidence-base for such affirmative action policies, as well as more broadly on the impact of explicitly rights-based approaches to addressing inequality.

## 6. MICs and the role of donors

Given the internationally agreed objective of global poverty reduction, as set out in the MDGs, it is commonly argued that donors should focus their attentions on LICs rather than MICs. The incidence of poverty and social indicators are substantially worse in LICs compared to MICs (although to counterbalance that the absolute numbers of those that are deprived remain very high in MICs, and not only because of the size of the population of China). In addition it is argued that, unlike LICs, MICs have domestic resources and access to financial markets which enable them to address poverty and deprivation.

A session in the workshop discussed the role of multilateral and bilateral institutions in relation to MICs, and this issue was also covered in other presentations as well as in the country case studies. This discussion can be summarised as follows.

> *14. The arguments for diverting donor attention away from MICs need qualifying.*

There is widespread agreement that the operations of donors must be different in MICs as compared with LICs. The operations of donors in MICs should be focused much more on attempting to persuade national governments to use more of the resources at their disposal for reducing poverty: a very different task to their work in LICs. This is supported by recent calculations showing that the fiscal cost of eradicating extreme poverty, measured as a % of GDP, is small in MICs: roughly 3% of GDP in Brazil, and 1% of GDP in Mexico (Velez).[3] This idea that the role of donors was more about contributing ideas and technical assistance to help build institutions as opposed to transfer of resources was strongly made in the South Africa case study (Gelb, 2003). In addition, there is also considerable scope for MICs to learn from each other, not just from donors and multilateral organisations. However, it is not always easy for donors to work together well in MICs: there is usually no PRSP or national frameworks around which to coordinate their assistance (DFID presentation) and regional or security interests may dominate poverty reduction considerations (EC presentation).

However, the arguments for diverting donor attention away from MICs were generally not accepted. Three main concerns were expressed. First, the dividing line between LICs and MICs is somewhat arbitrary. In reality, there is a continuum of countries with different amounts of internal resources available for reducing poverty, and

[3] This assumes that poverty reduction programmes could be perfectly targeted, which of course is not the case in practice. The point is rather to illustrate that the total shortfall is very small relative to the level of resources measured by GDP.

different levels of access to external resources. Donors need to adjust the volume and form of assistance according to these variables in a graduated way, which avoids the prospect of countries 'falling off the cliff' when they cross the dividing line between low-income and middle-income status.

Second, as already argued above, there may be important spillovers from the economic performance of MICs to the rate of poverty reduction in LICs. MICs are often important regional players and are important for neighbouring LICs, either in terms of providing markets for exports, or a destination for labour migration, or as a source of foreign investment. Moreover, the more MICs there are which 'slip back' (for one reason or another) into low income status, the less aid and concessional lending there will be available for each LIC. Once one takes into account these effects, the 'effectiveness' of aid in reducing poverty may be much larger in some MICs than conventionally recognised. One might even imagine a hypothetical scenario in which poverty is reduced by more in a poorly-governed LIC through aid given to a well-governed neighbouring MIC than it would be through aid given to its own government.

Finally, there is a view that MICs may be fragile countries, in the sense that "neither their institutions, nor their social structures, nor their economies, can easily withstand external and indeed internal shocks" (Green presentation). This means that, although a particular MIC may have the potential to continue growing and eventually become high-income, it remains at a risk of regressing and becoming a LIC. If this is the case, it provides another reason for believing that the effectiveness of aid in MICs is larger than conventionally measured. In particular, if aid can be used to reduce the chance of an MIC slipping back, and increase the chance of it continuing forward, the return to that assistance will be substantial.

# 7. Key issues and next steps

While it is clear from the above synthesis of the project that many issues relating to inequality in MICs and especially how to tackle it remain unresolved, it is also clear that discussions have moved on somewhat from the "conventional wisdom" presented at the beginning of this paper based on the WDR 2000/01. The latter already made a strong case for "inequality being back on the agenda" but the studies and discussions in this project suggest that the case is stronger still. There are convincing intrinsic reasons for addressing inequality, especially adopting a rights approach, and the importance of horizontal inequality, discrimination, social exclusion and the underlying processes seem to have been somewhat underemphasized in WDR 2000/01 (one aspect of this is the need to know much more about how discrimination operates and why it is so difficult to eliminate). Finally there is a need for much more focus on non-income dimensions of inequality. This will require more effort to collect data on these dimensions, although it is also the case that much more can be done with existing sources of information.

Moreover, WDR 2000/01 was incorrect about the difficulty of changing Gini coefficients and probably too cautious on the scope for redistribution – especially through taxes – as a means of addressing inequality. The latter point is illustrated by South Africa where a change in taxes alone would reduce the Gini coefficient by 4 percentage points, an amount which could have a potentially large impact on poverty. There are however two important gaps in our knowledge here. First, we need to understand more of the political economy of what makes redistribution (by taxes or public spending) possible, an issue being addressed to some extent in recent DFID work on drivers of change. Second, we need to understand much more about the extent to which redistribution does – or does not – have an adverse impact on growth.[4]

Another important issue about the WDR 2000/01 discussion of inequality was its inadequate discussion of the political economy issues involved in tackling inequality (a criticism which applies less to the recent *Breaking with History* study). In thinking about tackling inequality in middle income countries, the issue is not just the technical questions about the appropriate policies, but also about identifying the political economy factors which make such policies feasible and effective. This calls for an understanding of the factors that perpetuate inequality and frustrate attempts to tackle it. The extent to which inequality can be tackled will ultimately depend on the political compromises that can be agreed between key parties. The extent to which this process can deliver a consensus or social contract focused on poverty reduction will depend on the capacity of the different parties to these discussions. Helping with capacity development of these key partners may be another important role for donors, analogous to some forms of support for civil society organisations to participate in discussions of Poverty Reduction Strategies in low income countries. Note that many of the same issues may also be important in promoting growth in slow growing MICs such as Brazil and South Africa.

Finally, this project has focused specifically on MICs and some of the issues it covers apply specifically to MICs. However, many of the same issues arise in LICs, in many of which – as discussed above and shown in the concept paper – inequality levels are just as high. The domestic resources available for redistribution in LICs are clearly much more limited, but precisely because of the low average income, the issue of inequality is just as urgent in LICs, especially in sub Saharan Africa (where inequality levels are rising in several countries). While outside the immediate scope of this project, this needs to be a key priority for future work on inequality.

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[4] This latter point touches on a more general and centrally important issue; despite the large amount of writing in this area, we need to develop our understanding on the relationships between growth and inequality. This arises particularly in relation to the debate on pro-poor growth. Is there a trade off (in some countries or in general) between higher economic growth and lower inequality? Is rapid growth (as in China) likely to be accompanied by increases in inequality (e.g. because it is based on spatial concentration or increased openness)? Is there any evidence that attempts to pursue patterns of growth that are distributionally neutral in the short term mean that the resulting rate of growth will be slower (such that the poverty impact *might* be less)? There may not be a general answer to these questions across all countries, but the questions are important for the growth and poverty reduction strategy for all countries.

## References (other than project papers)


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## Annex 1: Workshop Programme

### Addressing Inequality in Middle Income Countries

### Workshop, 4-5 December 2003
### The Globe Theatre, London

*The objective of the workshop is to review evidence on the linkages between inequality, growth and poverty reduction in Middle Income Countries, and discuss appropriate policy responses, including for donors.*

**Key Papers:**
ODI Concept Paper with summary
Brazil Case Study Paper
China Case Study Paper
South Africa Case Study Paper

### Inequality, Economic Growth and Poverty Reduction

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|---|---|
| 09.30 – 09.45 | Welcome and introduction to workshop by Carolyn Miller, Director Europe, Middle East and Americas Division, DFID |
| 09.45 – 10.45 | "**Inequality in Middle Income Countries: Key Conceptual Issues**", presented by Dr Andy McKay, Research Fellow ODI<br><br>Chair: Bridget Dillon, Social Development Advisor, DFID SA<br>Discussant: Dr Andrew Norton, Acting Chief Social Development Adviser, DFID |

### Learning from Country Case Studies

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|---|---|
| 11.00 – 12.00 | Case study 1 presentation: **Policy Initiatives on Inequality in China**, by Dr. Lina Song, University of Nottingham<br>Chair: Dr Tim Conway, ODI<br>Discussant: Prof Bai Nansheng, Institute for Restructuring of Rural China, Beijing |
| 12.00 – 13.00 | Case study 2 presentation: **Inequality in Brazil**, by Luiza Bairros, Marcelo Paixao and Silvio Humberto Cunha<br>Discussant: Luiz Alberto Goncalves, Government of Brazil |

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|---|---|
| 14.00 – 15.00 | Case Study 3 presentation: **Inequality in South Africa**, by Dr Stephen Gelb, EDGE Institute, Johannesburg<br>Chair: Dr Alison Tierney, Senior Social Development Consultant, DFID<br>Discussant: Firoz Cachalia, Speaker of the Gauteng Legislature, South Africa |

## Lessons on Inequality

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|---|---|
| 15.30 – 16.45 | Panel Presentation:<br>Presentation One: '**The divergence between the degree of poverty and the distribution of the poor in Latin America and the Caribbean: policy implications for MICs with high inequality'**, by Carlos Eduardo Velez, Inter-American Development Bank (IADB)<br><br>Presentation Two: '**Pro-poor growth: what is it and does it matter?**' by Ernesto Pernia, Asian Development Bank<br><br>Chair: Simon Maxwell, Director, ODI<br>Discussants: Dr Rosalind Eyben, Research Fellow, Institute of Development Studies, University of Sussex; and Professor Adrian Wood, Chief Economist, DFID |

Friday 5 December

## Policy implications; and Multilateral/bilateral agency approaches

09.30 – 10.00 **Lessons on Inequality from the three country case studies**: presentation by Edward Anderson, ODI

Chair: Andy McKay, ODI
Discussion

10.00 – 11.15 *Panel Presentation: Addressing Horizontal Inequality and Discrimination*
Presentation One: '**Horizontal Inequalities**' by Prof Frances Stewart, Queen Elizabeth House, Oxford

Presentation Two: '**Policy Responses to Discrimination**' by Mayra Buvinic, Inter-American Development Bank

Chair: Laure-Hélène Piron, ODI
Discussant: Sue Unsworth, Chief Governance Adviser, DFID

11.45 – 13.00 **Approaches of Multilateral and Bilateral Agencies to Inequality in MICs**
Chair: Andy McKay, ODI
Panel Presentations followed by discussion
Michael Green, EU
David Peretz, World Bank
Ann Keeling, Deputy Head, Europe, Middle East and Americas Policy Dept, DFID

## Next steps

14.00 – 15.00 **Responding to inequality: next steps**
Discussion facilitated by Simon Maxwell, Director, ODI

15.00 – 15.15 Summing up and close by Andy McKay, ODI

## Additional documents

**ODI Rights & Discrimination Background Paper**

**Inequality, Exclusion and Poverty in Latin America and the Caribbean: Implications for Development**, by Mayra Buvinic

**Horizontal Inequalities: A Neglected Dimension of Development**, by Frances Stewart

**Pro-poor Growth: What is It and How is It Important?**, by Ernesto Pernia