Do consequences exist for developing countries experiencing significant growth which don't improve the welfare of their citizens in conjunction?

First Prize – Postgraduate Category

By Stefania Paredes Fuentes*

Abstract

In the last thirty years we assisted to several episodes of rapid economic growth in developing countries. This growth should provide an opportunity for these countries to lift out of poverty and improve the welfare of their citizens. The role of the government is crucial for the achievement of these goals. Government can intervene with policies that aim to reduce social inequality and improve welfare of the population, however some economic literature considers redistributive policies detrimental for economic efficiency and therefore bad for growth. According to this view, improvement in welfare has negative consequences for the future growth of these countries. This essay argues that income inequality can have serious negative effects on the economy, and that redistributive policies are not only going to improve citizens' welfare, but they also incite a sustainable path of steady growth.

1. Introduction

There is a strong correlation between gross domestic product (GDP) per capita and indicators of development such as life expectancy, infant mortality, adult literacy, political and civil rights, and indicators of environmental quality. For this reason, GDP growth is the main agenda in several countries, although economic growth alone does not guarantee human development. While

*PhD Economics

economic growth provides the resources needed to improve the welfare of the population, redistribution policies and other policies targeted to improve the standards of living of the whole population are fundamental for the process of development.

The last years have witnessed several episodes of rapid economic growth in developing countries with China being amongst the most discussed cases with a growth of GDP per capita in 2000s of 9.57%. But while economic growth is an important factor in reducing poverty and generating the resources necessary for human development, rapid growth poses some challenges to developing economies. If economic growth is centralised in the main cities, the rural-urban income gap will increase and this will generate an increase in the internal migration from rural to urban areas[1]. In addition to inequality between rural and urban areas, there is also the risk of increased inequality due to the division of factors of production. Income inequality has risen in China at such levels that this country is now the most unequal country in Asia [Knight and Ding, 2012]. There are also environmental issues related to this process[2].

These challenges recall for government intervention in order to alleviate the possible loss in welfare for the population. However, literature offers several arguments against redistribution and political intervention in general, due to the effects on efficiency in the allocation of resources as well as in terms of their implications for work effort and savings which will undermine the potential of further growth. The argument of the trade-off between economic equality and economic efficiency is deeply ingrained in the neo-classical analysis. For instance, Marshall [1907, p. 41] argues that distribution policies are detrimental for property rights, free enterprise, and it might even diminish aggregate wealth. Okun [1975, p. 48, 51] goes further and argues that economic equality and economic efficiency cannot be achieved together; he also argues the inefficiency of the welfare state in pursuing redistribution[3].

Of course there are dissenting voices on this view of no-intervention. Section 2 analyses this literature and offers a theoretical explanation behind the negative effects of lack of welfare policies during episodes of rapid economic growth mainly based on the increase in income inequality. Section 3 analyses the relationship between growth and inequality and the possible channels through which growth can increase the gap between rich and poor. Section 4 offers a brief analysis of some countries that have experienced rapid growth. This analysis will provide an empirical support to the need of government intervention on welfare of a country's whole

---

1 see Cashin and Sahay [1996]; Graham [1970]; Cai and Wang [2010]; Phan and Coxheah [2010] for internal migration analysis in different countries

2 on the relationship between growth and environmental degradation see Stern et al. [1996]; Sorrell [2010]; Narayan and Narayan [2010]. Some cases studies in Soytas and Sari [2009]; Zhang and Cheng [2009]; Menyah and Wolde Rufael [2010]; Ghosh [2010].

3 see also Lindbeck [1983]; Olson [1982] on the disincentives of redistribution policies.

population. Section 5 summarises and concludes.

2. To Intervene or Not to Intervene?

Economic growth maximisation has been the clear objective of economic policy. Increase of the total production increases income which in turn rises the opportunity to increase the material standard of living. Increased production is translated into an increase of job opportunities, reducing thus unemployment and the issues related. Therefore, economic growth is desirable as a mean to increase social welfare and enhancing welfare should be basic objective of governments.

Nonetheless, the link between economic growth and social welfare is one of the hottest debates in economics. Interest in this topic grew rapidly in the 1970s when many analysts saw in the 1960s' rise in social welfare programmes the origins of the slowdown in growth in some economies. As previously explained, neoclassical economic theory argues that well functioning markets is the best way to fulfil the need of the people, leaving thus none (or very little) space to government intervention. According to this view, we would expect to see slow growth in states that pursue welfare policies. On the contrary, Lindert [2009] argues that this is not the case and that in fact, among the advance OECD countries (but the same results are observed within US states) the period between 1950 and 1980 matches with the fastest growing welfare states but also with the history's strongest growth period.

There exists an extent literature that supports government intervention and in particular welfare reforms. These reforms instead of being considered as costly for a society, they laid a basis for a more sustained economic growth[4]. Redistributive policies are related to improvements in human, health, and social capital which in turn are positive related to economic growth [Behrman, 1990, 1995; Birdsall and Sabot, 1994; Cohen and Soto, 2007].

Therefore, if we do not agree with the neoclassical theory of no intervention, and given the empirical evidence that literature offers this is the case, we can argue that there are negative consequences for developing countries that do not improve the welfare of their citizens during periods of economic growth. These negative consequences depend on the initial conditions of these countries, the distribution of wealth, and also on the source of the economic growth.
Rapid economic growth poses several challenges. Szreter [1999] considers market-led rapid economic growth *disruptive* due to the apace of growth in income and wealth inequalities through the process of capital accumulation and the migration from rural to urban areas in search of opportunities with the problems arising from the disorganised increase of urbanisation and lack of

4 Myrdal [1968, 1970] offers an extent criticism to this view.

basic services. These problems are particularly marked in developing countries where in fact, views of no-intervention have been very unsuccessful leaving these economies with poor welfare states.

3. Inequality and Economic Growth

One of the most common problems in developing countries is the high levels of inequality. Several rapid-growth developing countries experience rapid increase in inequality (e.g. China). Inequality can harm the economy in several ways. Studies have found that countries with higher inequality have worse health and social services and lower rates of social goods [Wilkinson, 2005; Wilkinson and Pickett, 2010].

However, there is no unanimous consensus in literature on the relationship between inequality and economic growth. Conventional economic wisdom on inequality and growth has been dominated by two arguments. The first is based on the trade-off between inequality and efficiency and in particular on the believe that inequality is necessary in order to offer incentives to economic actors and therefore inequality is good for growth (this is the theory behind the neoclassical approach that was discussed in the previous section). The second argument suggests that the impact of inequality on the process of growth depends on the stage of development (the Kuznets hypothesis). The conjecture is that inequality should necessarily increase during the early stages of development due to urbanisation and industrialisation and decrease later on as industries attract a large fraction of the rural labour force.

Alesina and Rodrik [1994]; Persson and Tabellini [1994] add a third argument on the relationship between inequality and growth: *inequality harms growth*. Alesina and Perotti [1996] go further and argue that highly unequal societies create incentives for individuals to engage in illegal activities which generate social instability and discourages accumulation due to current disruptions and future uncertainty. Galor and Zeira [1993]; Galor and Moav [2004] also argue that increases in inequality will lead to lower growth, but they investigate the credit-constraints channel. They notice how the process of development is characterised by complementarity between physical and human capital so that growth increases with the increase in investment in human capital, however credit constraints will prevent poorer individuals from investing in education, for this reason inequality will adversely affect growth prospects by reducing the number of individuals who are able to invest in human capital.

What we should keep in mind when analysing the role of inequality is that, economic growth is only a mean to improve the life of the population, and unless it raises general living standards, true development has not taken place. Large parts of the population in developing countries are still living in conditions of absolute poverty, and governments need to adopt policies in order to meet the basic needs (i.e. food, shelter, healthcare and education). Therefore, even if we accept the hypothesis that initial inequality is good for economic growth (because it provides the necessary incentives), we still need to evaluate the gains of future growth in terms of welfare of the whole population against the lack/loss of welfare now due to the high levels of inequality. Distributive policies should be considered in the light of reducing current levels of social inequality without damaging future welfare. Easterly and Rebelo [1993]; Perotti [1996], using different measures of redistribution (social spending, marginal and average tax rates), find that redistribution is likely to have a positive impact on growth. These results suggest that we can reduce levels of current inequality, and increase future economic growth, which in a less unequal society is going to benefit a larger share of the population.

The way in which growth translates into income distribution and poverty reduction depends on the nature of the growth process, in particular to the extent to which it is based on the generation of sources of employment and on diminishing the urban-rural gap. If the output mix is labour intensive and rural incomes rise rapidly, poverty reduction is more likely to occur and income is going to be more equally distributed than if growth is urban biased and capital intensive.

4. A Look to Some Country Experiences

In the last thirty years, several developing countries have experienced periods of rapid economic growth. This section briefly investigates the response of some socio-economic indicators to these episodes of significant economic expansion. Table 1 shows these indicators for the early 1980s and the most current figures available, in general 2011[5]. In this period we have the most significant growth miracles in developing countries.

China offers one of the most surprising growth miracles in recent history. Since initiating market reforms in 1978, China has experienced an average growth rate of 9% (this has peaked to 12 and 13 percent in 2006 and 2007). Nonetheless, between 1980 and 2011, China’s Human Development Index increased from 0.4 to 0.687, an average annual increase of about 1.7%, much lower than its increase in growth (Table 1). In addition, if we consider the Inequality-Adjusted HDI, which takes into account the levels of inequality, the HDI falls to 0.534 [UN Development Program, 2011]. In fact, inequality in China has risen to become the highest in Asia - from 29.11% in 1981 to 41.5% in 2011 -. While economic growth has lifted more than 600 million people out of poverty, over 170 million still live below the $1.25-per-day international poverty line. Rapid growth in China has also posed the problems of demographic pressure due to rapid urbanisation and ageing population.

5 The first column refers to the earliest data available (after 1980), while the second one shows the latest data available (in general 2011)

After over twenty years of Chinese rapid growth, policy adjustments aimed to redistribution and poverty reduction remains a crucial challenge. In March 2011, the National People's Congress endorsed the 12th Five-Year-Plan which aims to tackle Chinese energy problems. In fact, environmental protection and energy conservation are identified as investment priorities. This plan also targets to improve access to education and health care, and to expand social protection. The target of 7% growth of income per capita is lower than the current values and it is representative of China's efforts to rebalance its economy.

In Asia, we have several other growth miracles. One of them is Bhutan, one of the poorest countries in the world, has expanded at a robust pace with a GDP per capita growth of nearly 6% in average since 1981. Unlike China, this economy is characterised by good progress in human development and an increasing availability of public services throughout the country. In fact, Bhutanese society has undergone significant changes over the past decades with dramatic improvements in health and education and the ongoing development of a modern infrastructure [World Bank, 2013a]. Life expectancy, even if still low, has notably increased since 1980 (from 47 to 67 in 2011). The available data on income inequality (Gini index) shows a decrease from 46.83 in 2003 to 38.06 in 2007. The percentage of population under the threshold of $1.25 poverty-line is also decreased in the same period from 7 to less than 2 percent.

Countries such as Malaysia, Myanmar, Laos, and Indonesia have recently experienced sustained economic growth. Malaysia made admirable progresses on human development, in fact it has one of the highest HDI of the region (0.76 in 2011). One of the characteristics of the productive structure of Malaysia is the progress from being a producer of natural resources (tin and rubber), to being a diversified economy. This has benefited the creation of jobs and the development of human capital. On the other hand, Laos', Myanmar's, and Indonesia's economies are still strongly based on the exploitation of natural resources. These economies still have significant levels of absolute poverty and are doing poorly in a number of social indicators. All these economies, with the exception of Laos, have high levels of income inequality. This is related to the fact that employment growth has been slower than population growth [World Bank, 2013b]. As mentioned, these economies are based on the production of natural resources, which is a capital intensive activity and generates fewer sources of employment compared to manufacturing.

On the other hand, Cambodia, Vietnam and Thailand are poor in natural resources but with highly diversified economies and successful human development (in particular Cambodia and Vietnam). These economies based their development on attention to structural reforms, environmental sustainability, social equity, and macroeconomic stability. These policies have promoted human skills development and infrastructure development.

Despite of the universally pessimistic consensus about Africa's economic prospects, there are some countries in the region that have performed well. In fact, there have been some periods of rapid growth in at least sixteen African countries at various points in time[6], although many of these episodes have not been sustained enough to improve the population living standards.
Botswana is the most famous example with one of the fastest growing economies in the world. Since its independence from Britain in 1966, this country shows an average growth rate of 6.30%, with peaks of 20% in 1970s. However this growth stands in contrast to the country's high levels of poverty and inequality and generally low human development indicators. Table 1 shows some of these indicators. The last figure of Gini index in Botswana is for 1994 – 60.96: this high value is a consequence of the high levels of unemployment rate (close to 20%). This economy is highly vulnerable to the external shocks in its main export sector - diamonds. Diversification into sectors beyond diamonds, that can ensure the welfare of the population, is the major challenge as improving the quality of growth to address high levels of unemployment. A surprising fact is the decrease in life expectancy since 1981. Botswana has one of the highest AIDS adult incidences in the world with around a quarter of the adult population being HIV positive. These statistical facts represent a serious public policy failure.

Another African miracle is Mauritius, which however managed to increase its income per capita hand by hand with the welfare of the population. Table 1 shows that while HDI has increased since 1980, income inequality has decreased. This is the result of a mix of good economic policies, diversification of the economy and strong social safety net.

From these country experiences we can distil few points. First, without right policies that aim to improve social conditions, rapid growth might actually harm certain sectors of the population in general the most vulnerable ones. Second, without policies that reduce the gap between rural and urban areas and promote the creation of employment, inequality levels are likely to increase. This is the case of China, Bhutan, Indonesia, and Botswana that show a massive increase in urban population with significant increases in inequality. However, more successful societies such as Mauritius, Thailand, and to less extent Vietnam, have suffered of less rural-urban differences and therefore the gap is much smaller. Third, it seems there is a positive relationship between economic growth and the damage of the environment. Carbon emissions per capita have increased in all these economies, with China being a notable case. Finally, policy-makers need to consider the origin of the rapid economic growth. If this arises from one high-specialised capital-intensive sector subject to volatility of the international market (such as natural resources), it is

6 In 1960s-early 1970s, Botswana, South Africa, Namibia, Gabon, Cote d'Ivoire, Togo, Kenya, Ethiopia Malawi and Tanzania experienced high growth rates. While in 1970s-1980s we have Mauritius, Ghana,Lesotho, Uganda, and Mozambique. However, few of these countries are in the top-50 list in terms of GDP per capita [Subramanian and Roy, 2003].

likely that this growth will bring less benefits to the economy than expected. Governments should channel the resources arisen from this growth into the diversification of the economy to other sectors that also prompt the development of the labour force.

5. Concluding Remarks

This essay shows theoretical and empirical support to government intervention in developing countries. This intervention should aim the improvement of the welfare for the whole population but it also needs to tackle the possible challenges that rapid growth pose to these economies. Through the use of various cases studies, it shows the possible consequences for development for those countries that do not improve the welfare of their citizens. Specifically, this work argues that economic growth is desirable as long as it is accompanied by improvements in living standards. In addition, episodes of rapid economic growth pose serious challenges that cannot be ignored otherwise they can harm the most vulnerable sectors of the population.

This work does not does not argue that governments should not pursue growth. Economic growth may have limitations, but it still matters for several reasons. First, even if growth *per se* does not reduce poverty, it is very difficult to make any meaningful and sustained reduction in poverty without an increase of the available economic resources, especially in developing economies. Second, a stagnant economy leads to higher rates of unemployment and the consequent social problems. Finally, if managed correctly, economic growth enables an increase in resources for important public services like education and health care.

Lack of welfare improvements for the population can be translated in high levels of income inequality and related social problems. This is going to harm future growth and therefore future welfare is going to be reduced.

Table 1: Economic and Social Indicators in Rapid-Growth Economies

	growth (%)		HDI		Gini Index		$1.25 poverty line		life expectancy		urban population (%)		CO2 emissions	
	1980-2010	2000s	1980	2011	1981	2011	1981	2011	1981	2011	1981	2011	1981	2009
China	8.88	9.57	0.40	0.69	29.11	41.5	39.26	15.9	67.3	73.3	20.06	50.5	1.46	5.77
India	4.28	5.53	0.34	0.55	35.09	33.38[a]	17.24	7.49	55.74	65.48	23.35	31.30	0.52	1.64
Bhutan	6.00	5.80	n.a	0.52	n.a.	38.06	n.a.	1.81	46.98	67.28	10.69	35.57	0.06	0.59
Malaysia	3.49	2.99	0.56	0.76	48.63[b]	46.21[c]	0.66[b]	0	67.70	74.26	42.81	72.68	2.17	7.10
Myanmar	4.32	12.14	0.28	0.48	n.a.	n.a.	n.a.	n.a.	55.17	65.15	32.65	23.99	0.17	0.23
Laos	4.02	5.45	0.38[d]	0.52	31.00[e]	36.74[f]	316.24[e]	8.95[f]	49.13	67.43	12.66	34.22	0.05	0.30
Indonesia	3.87	4.09	0.42	0.62	30.47	34.01[a]	21.36[b]	3.31	58.09	69.32	22.90	50.69	0.65	1.90
Cambodia	5.96	6.63	0.44[g]	0.52	43.73	37.85[f]	11.95[h]	4.87[f]	41.94	62.98	9.96	20.00	0.05	0.33
Vietnam	5.10	5.89	0.44[d]	0.59	35.68[i]	35.57[f]	23.57[i]	3.75[f]	56.94	74.83	19.31	31.04	0.32	1.65
Thailand	4.12	3.11	0.49	0.68	45.22	40.02[c]	5.51	0.05[c]	66.36	74.09	27.05	34.11	0.79	3.95
Botswana	4.57	3.03	0.45	0.63	55.72	60.96[j]	13.81[b]	11.04[j]	60.97	53.01	18.53	61.61	0.98	2.24
Mauritius	3.58	3.47	0.55	0.73	50.22	39.18[h]	n.a.	n.a.	67.42	72.97	42.35	41.80	0.55	3.00

Notes:
a. data for 2005 - lastest data available
b. data for 1984 - earliest data available
c. data for 2009
d. data for 1990
e. data for 1992
f. data for 2008
g. data for 2000
h. data for 2004
i. data for 1993
j. data for 1994
h. data for 2006

References

Alesina, A. and Perotti, R. (1996). Income Distribution, Political Instability, and Investment. European Economic Review, 40(6):1203–28.

Alesina, A. and Rodrik, D. (1994). Distributive Politics and Economic Growth. Quarterly Journal of Economics, 109(2):465–90.

Behrman, J. R. (1990). The Action of Human Resources and Poverty on One Another: What We Have Yet to Learn? Working Paper 74, World Bank.

Behrman, J. R. (1995). The Impact of Distributive Policies, Governmental Expenditure Patterns and Decentralisation on Human Resources. mimeo, University of Pennsylvania.

Birdsall, N. and Sabot, R. (1994). Virtuos Circles: Human Capital Growth and Equity in East Asia. mimeo, World Bank.

Cai, F. and Wang, M. (2010). Growth and Structural Changes in Employment in Transition China. Journal of Comparative Economics, 38(1):71–81.

Cashin, P. and Sahay, R. (1996). Internal Migration, Center-State Grants, and Economic Growth in the States of India. IMF Staff Papers 43, International Monetary Fund.

Cohen, D. and Soto, M. (2007). Growth and Human Capital: Good Data, Good Results. Journal of Economic Growth, 12(1):51–76.

Easterly, W. and Rebelo, S. (1993). Marginal Income Tax Rates and Economic Growth in Developing Countries. European Economic Review, 37(2-3):409–17.

Galor, O. and Moav, O. (2004). From Physical to Human Capital Accumulation: Inequality and the Process of Development. Review of Economic Studies, 71(4):1001–26.

Galor, O. and Zeira, J. (1993). Income Distribution and Macroeconomics. Review of Economic Studies, 60(1):35–52.

Ghosh, S. (2010). Examining Carbon Emissions Economic Growth Nexus for India: A Multivariate Cointegration Approach. Energy Policy, 38(6):3008–14.

Graham, D. H. (1970). Divergent and Convergent Regional Economic Growth and Internal Migration in Brazil: 1940-1960. Economic Development and Cultural Change, 18(3):362–82.

Knight, J. and Ding, S. (2012). China’s Remarkable Economic Growth. Oxford University Press.

Lindbeck, A. (1983). Budget Expansion and Cost Inflation. American Economic Review, 73:286–96.

Lindert, P. H. (2009). Growing Public. Cambridge University Press, second edition.

Marshall, A. (1907). Principles of Economics. MacMillan, London.

Menyah, K. and Wolde Rufael, Y. (2010). Energy Consumption, Pollutant Emissions, and Economic Growth in South Africa. Energy Economics, 32(6):1374–82.

Myrdal, G. (1968). Asian Drama. An Inquiry into the Poverty of Nations. Pantheon, New York.

Myrdal, G. (1970). The Challenge of World Poverty. Pantheon, New York.

Narayan, P. K. and Narayan, S. (2010). Carbon Dioxide Emissions and Economic Growth: Panel Evidence from Developing Countries. Energy Policy, 38(1):661–6.

Okun, M. (1975). Equality and Efficiency: The Big Trade-Off. The Brookings institution, washington d.c. edition.

Olson, M. (1982). The Rise and the Decline of Nations. Yale University Press.

Perotti, R. (1996). Growth, Income Distribution, and Democracy: What the Data Say. Journal of Economic Growth, 1(2):149–87.

Persson, T. and Tabellini, G. (1994). Is Inequality Harmful for Growth? American Economic Review,

84(3):600–21.
Phan, D. and Coxhead, I. (2010). Inter-Provincial Migration and Inequality During Vietnam's Transition. Journal of Development Economics, 91(1):100–12.
Sorrell, S. (2010). Energy, Economic Growth, and Environmentally Sustainability: Five Propositions. Sustainability, 2(6):1784–1809.
Soytas, U. and Sari, R. (2009). Energy Consumption, Economic Growth, and Carbon Emissions: Challenges faced by an EU candidate member. Ecological Economics, 68(6):1667–75.
Stern, D. I., Common, M. S., and Barbier, E. B. (1996). The Environmental Kuznets Curve and Sustainable Development. World Development, 24(7):1151–60.
Subramanian and Roy (2003). Who Can Explain the Mauritian Miracle: Meade, Romer, Sachs, or Rodrik? In Rodrik, D., editor, In Search of Prosperity: Analytic Narratives on Economic Growth. Princeton University Press.
Szreter, S. (1999). Rapid Economic Growth and 'the four Ds' of Disruption, Deprivation, Disease, and Death: Public Health Lessons from Nineteeth-Century Britain for Twenty-First-Century China? Tropical Medicine and International Health, 4(2):146–52.
UN Development Program (2011). Human Development Report 2011. Report, United Nations.
Wilkinson, R. G. (2005). The Impact of Inequality: How to Make Sick Societies Healthier. Routledge.
Wilkinson, R. G. and Pickett, K. (2010). The Spirit Level: Why Equality is Better for Everyone. Penguin.
World Bank (2013a). Bhutan.
World Bank (2013b). East asia and pacific: Regional strategy update.
Zhang, X. and Cheng, X. (2009). Energy Consumption, Carbon Emissions, and Economic Growth in China. Ecological Economics, 68(10):2706–12.