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How and why economic inequality matters for inclusive development

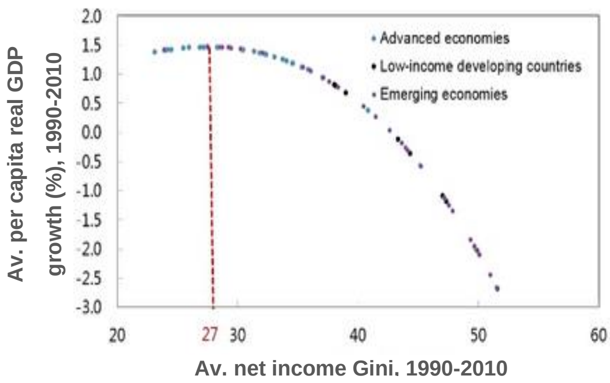
The failure of sustained growth to translate into the anticipated reduction in poverty (the so-called trickle-down effect) in Sub-Saharan Africa has led to inequality being treated more proactively in development agendas. Africa hosts 10 of the world's 19 most unequal countries, with income Gini coefficients ranging from 0.50 in Rwanda to 0.63 in South Africa. The richest 0.0001% own 40% of the continent's wealth. The true cost of such extreme inequality is increasingly being acknowledged, with inequality reduction occupying one whole Sustainable Development Goal on its own and being fundamental to achieving multiple Agenda 2063 targets. High levels of inequality hinder inclusive development through various interrelated channels. The evidence on the four most important channels is presented here.

1. Inequality, macroeconomic growth and stability

The relationship between inequality and growth has long been debated without consensus. On the one hand, a skewed income distribution is said to induce greater competition, risk taking, efficiency and innovation, which drive performance. On the other hand, inequality is claimed to waste resources and weaken overall productivity and investment, creating shorter and less intense spells of output growth and job creation in the medium-term and preventing longer-term structural change and industrialization.

Recent literature reveals a non-linear relationship. One study found that positive impacts occur only in the short-term, while the long-term impact is usually negative. Other studies have established tipping points ranging from an income Gini index of 24.5 to 36, below which inequality stimulates growth and above which it hinders growth. Importantly, the threshold where the costs of inequality outweigh its benefits is not universal, but depends contextually on the initial level, nature and drivers of inequality, the stage of development and the policy and institutional environment.

Figure 1. Inequality and GDP growth



Source: Grigoli and Robles (2017)

The bottom line is that income inequality in Sub-Saharan Africa lies above every proposed threshold. This implies that at current extreme levels inequality is detrimental to the region's ability to resume a high-growth path and realise its demographic dividend.

High inequality further harms economic progress through rising vulnerability and low resilience against adversity. Instability is problematic when facing large-scale economic and political uncertainty, through the following mechanisms:

- **Bounce back:** Africa's prolonged recovery from the global recession has been partly attributed to high inequality due to weak consumer demand and under-investment, which have resulted from a declining labour-share of income, growing wage disparities, financial exclusion and low business confidence.
- **Debt:** The expansion of household borrowing and social protection to meet basic needs has increased debt beyond sustainable levels, exposing over half of Africa's low-income countries to credit crises and hurting future social spending.

- **Adaptability:** Gaps in opportunities for decent work and small business development create untapped potential and reduce the market's ability to respond to changing conditions through innovation and transition. Structural barriers and rigidities weaken domestic competitiveness and global integration.

2. Inequality, poverty and human development

Inequality is considered a key intermediary in the link between growth and poverty reduction. In the absence of trickle-down or effective redistribution, widening income inequality has been shown to undermine the poverty-reducing capacity of high growth and exacerbate poverty during low-growth periods. Oxfam estimates that, had inequality within countries not grown between 1990 and 2010, an extra 200 million people would have escaped poverty. According to the UN, Sub-Saharan Africa has suffered a 33% drop in its Human Development Index as a result of inequality, reflecting impacts on overall wellbeing which extend beyond income. The general conclusion is that aggregate growth alone is inadequate to fight poverty, and that targets for poverty reduction will remain hypothetical if certain gaps are not closed. As with growth, the relationship depends on the intensity of certain channels and the capacity of governance to mitigate them, including:

- **Savings channel:** Savings gluts of the rich can increase asset prices and affect consumption by the poor, while low wages of the poor suppress their ability to save and invest, reinforcing poverty traps.
- **Public spending channel**: Having a small portion of taxpayers reduces revenue and stretches social safety nets and public services, making them less effective at lifting households out of poverty.
- **Dependency channel:** Economic exclusion prevents the poor from reaping the benefits of growth and becoming self-sufficient, rather than reliant on credit and social protection. Households who do escape poverty often struggle with low and unstable wages, food insecurity and few opportunities for mobility, so remain vulnerable to slipping back into poverty, especially during downturns.

3. Inequality, governance and democracy

Persistent, excessive inequality threatens to disrupt the political stability that many countries have worked hard to build. Unequal patterns of wealth and power increase the risk of lobbying, cronyism, rent-seeking and corruption in order to preserve elite interests, and weaken the voice and participation of minority and marginalized groups. Polarization, combined with unmet promises and the restricted bargaining power of the poor, has been shown to lower the legitimacy of governments and erode trust in formal institutions. Research has also found strong links between increased gender equality and greater peace and security. Essentially, strong inequality weakens the functioning of civil structures and processes. Failure to grasp the political economy of inequality has been cited as one of the main obstacles to solving it.

4. Inequality, social cohesion and conflict

Growing inequality in a time of plenty, especially when visible along racial, ethnic or religious lines, can create rising group tensions and weaken the broader social fabric. Evidence suggests that economic exclusion heightens the likelihood of crime and violence. Inequality is also linked to low trust and interaction between citizens, which stalls collective action on wider problems. Protest movements have been rising in many countries among rural and youth communities, particularly around issues of identity, land reform and employment (which are tightly bound to the distribution of wealth and income). The social pressure resulting from growing inequality tends to worsen the longer it goes unchecked and exaggerates the economic outcomes of inequality, therefore urging immediate action.