There is a crescent body of literature linking inequality to weaker growth and macroeconomic instability. In fact, the increasing inequality observed in most advanced economies and many emerging markets and developing countries (EMDCs) is generating worries about the prospects for the global economy. Among EMDCs, however, some countries have been able to combine economic growth and rising equality. Pro-growth policies associated with pro-poor and pro-middle-class programs seem to be in the heart of the matter.

For a long period, the IMF publications and policies have focused on pro-growth measures, neglecting their impacts on income distribution – a tendency that seems to be finally changing. In recent publications, the Fund has focused on what links economic growth to inequality and labor market conditions\(^1\), and the wage gender gap\(^2\). Other publications have focused on the role of financial inclusion and appropriate fiscal policies to fight poverty and income inequality.

In an effort to operationalize its work on inequality, the IMF is launching a series of pilot studies to better understand the links between income inequality and macroeconomic stability. Most important, the Fund is interested in understanding how long-standing IMF pro-growth policy recommendations affect income inequality. The first of such studies was published last November focusing on Ethiopia.

To boost economic growth in Ethiopia, the IMF has recommended the adoption of reforms – some of which are expected to result in increasing inequality. Along with the awareness of the unwanted distributional impacts of the recommended reforms comes the necessity to recognize that, when promoting economic growth, policymakers should focus on the poor and middle-class – as they matter the most for growth. What follows is a brief summary of the pilot study on Ethiopia. Pilots for Colombia and Guatemala are expected soon to be released.

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1 See [Inequality and Labor Market Institutions](#) and [Causes and Consequences of Income Inequality: A Global Perspective](#)  
2 See [Fair Play: More Equal Laws Boost Female Labor Force Participation](#) and [Women, Work, and the Economy: Macroeconomic Gains From Gender Equity](#)
Introduction

In the last decade, a combination of economic growth, poverty reduction and rising inequality has been observed in many countries, including those in Sub-Saharan Africa. Ethiopia has diverged from this trend, presenting a reasonably stable Gini coefficient while rapidly growing and reducing poverty.

The IMF Selected Issues paper aimed at analyzing what makes Ethiopia different regarding the links between income inequality and economic growth. It reviews the evolution of inequality in that country and presents a dynamic general equilibrium model to quantify the impact of certain growth enhancing policy measures, including some traditional IMF recommendations, on distributional variables.

Equitable Growth and Poverty Reduction in Ethiopia

Large public investment and growing services have contributed to robust economic growth and poverty reduction in Ethiopia in the last decade. From 2004 to 2013, real GDP has increased an average of 10.8% yearly. From 1995 to 2010, absolute poverty has declined, and the share of the population living below the poverty line decreased from 60.5% to 29.6%.

The Ethiopian Gini is remarkably low, driven by egalitarian consumption patterns among the countryside population – the majority in Ethiopia. In the cities, however, the income gap is widening again after a period of declining inequality between 2004 and 2010. Food security is the main threat to sustainable development as a big (and growing) share of the population remains vulnerable to food price shocks.
Impact of Fiscal and Social Policies on Income Distribution

Fiscal policy is a powerful tool to affect income distribution and inequality. In Ethiopia, fiscal instruments have been relatively successful in influencing distributional variables, but some policy adjustments are indispensable. For instance, tax collection needs to be strengthened and tax exemptions eliminated. Also, the tax base needs to be broadened and tax revenue increased.

Direct transfers should replace indirect subsidies to better target the poor population. Energy subsidies, for instance, absorb around 2.6% of general government spending, a very large disbursement that benefit mainly the relatively better-off. Direct taxes can also help to make taxation more progressive, and the tax brackets should be revised to accompany the economic transitions observed in Ethiopia in the last decades.

With growing urban inequality and growing rural-to-urban migration, social policies should now pay special attention to the urban population. The Productive Safety Net Program, that combines cash transfers and public-work employment, could prove very useful to assist the urban poor. In fact, it has been critical for poverty reduction in rural areas.

Financial Inclusion

Financial development has strong positive links with economic growth and income equality. In fact, by making saving instruments available, financial development increases access to credit, and smooths income, consumption, and investment. In Ethiopia, despite robust economic growth in the last decades, the financial sector still lacks the vivacity observed in other sectors of the economy.

The majority of Ethiopia’s population, living in the rural area, lacks access to basic financial services. The population per bank branch and per ATM machine ratios are very high, and credit remains the lowest among the Sub-Saharan countries. Improvements on the financial services for the poor are crucial, and the government should work to improve the outreach of Microfinance Institutions and Saving and Credit Cooperatives (SACCOs).

Access to credit, however, is a problem not only for the poor population. The private sector also faces strong constraints on credit, as most of the available credit is channeled to state-owned enterprises. The government should eliminate the constraints on credit to the private sector, as private savings can be a critical resource for financing economic development.
Macroeconomic and Distributional Implications of Reform: A Model-Based Approach

Through a dynamic general equilibrium model based on Ethiopian household data and calibrated to reflect the main features of the Ethiopian economy, the IMF tried to establish a formal framework to analyze the macroeconomic and distributional implications of reforms. The study focused on two policies recommended by the Fund to enhance Ethiopian growth: Streamlining tax incentives, and reforming the Development Bank of Ethiopia’s (DBE) funding policy.

The Development Bank of Ethiopia (DBE) funding policy requires commercial banks to invest 27% of their new loans in five-year bonds issued by the National Bank of Ethiopia, the proceeds of which are used to finance the DBE. The model indicated that such requirement is an implicit tax on the returns to investment, and thus the IMF recommended its elimination. The end of such requirement would be associated with a 3% increase in private investment.

The results also show that streamlining tax incentives and expenditures would increase revenue mobilization, generating revenue to fund DBE’s policies. For instance, the tax incentives granted to export-oriented firms are estimated to reduce tax revenue by 2.8% of GDP per year. The elimination of such incentives would benefit not only tax revenue, but also economic growth.

Changing the DBE’s funding policy and streamlining tax incentives would promote structural transformation, with the manufacturing sector receiving a larger stimulus when compared to agriculture. Urban households would therefore benefit more than rural households as the price of agricultural goods would fall. To deal with the increases in inequality, the reforms would require simultaneous distributional policies. The IMF recommends three of such policies: Expanding cash transfers through the Productive Safety Net Program, deepening access to financial services and fostering rural to urban migration.

The simulation results show that cash transfers targeting the rural poor would reduce inequality and offset the negative effects of the proposed reform. Financial deepening, especially in rural areas, would also help reduce income inequality and smooth consumption over time. The IMF also estimates that financial development would boost private investment and output.

The IMF also recommends policies to promote rural-to-urban migration, as it would equalize the labor returns in the urban and rural areas. Increasing labor supply for the emerging manufacturing and services sectors would contribute to a structural transformation in Ethiopia towards a more urban and modern society. With the proper policies Ethiopia should be able to make such transition and maintain its high growth levels, while still reducing poverty and inequality.