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Chapter II

INCOME INEQUALITY: THE MAIN ISSUES

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INCOME INEQUALITY: THE MAIN ISSUES

A. Inequality of incomes and market mechanisms

Economic inequality has re-emerged as a central policy concern in the wake of the global crisis, as the past three decades have witnessed rising global inequalities over periods of both growth and slump. Against this backdrop, this *Report* addresses an old question: whether rising (or high) income inequality is an inevitable outcome – or a necessary factor – of economic development; or whether it is possible, and even desirable, to reduce income inequality, in order to achieve more inclusive growth as well as to overcome the present economic challenges and create the conditions necessary for a more sustainable and rapid development process in the long run.

The issues of equality and equity have preoccupied thinkers, politicians and religions since ancient times. In contemporary debates, a distinction is often made between equality before the law (or formal equality), and equality in terms of income and wealth. The latter form of equality is affected by ownership structures as well as by market processes, social stratification and political systems which may deny true equality of opportunities to a large segment of a society. While there is broad agreement that equality before the law is desirable, there is an ongoing debate about how much "effective inequality" can be tolerated without seriously damaging social cohesion and trust and the overall functioning of an economy. Here, equality refers primarily to what can be considered relative equality in the distribution of incomes, rather than absolute equality in terms of civil rights.

> There is an ongoing debate on how much "effective inequality" can be tolerated without damaging social cohesion and the overall functioning of an economy.

One area in which the gap between formal and real equality seems particularly strong is in market operations. On the one hand, buyers and sellers in different markets are formally equal: they are free to accept or refuse a transaction at a given price. Consequently, a market transaction theoretically takes place only if it is beneficial to both parties. In addition, market institutions assure justice through the equivalence of exchanges (Habermas, 1973). On the other hand, inequality of resources is more clearly manifested in market transactions than anywhere else, owing to asymmetries in the purchasing power of different participants. From a formal point of view, markets are the sphere of personal and legal equality whereby all participants are equally free to buy and sell to their mutual benefit. But in reality, owing to disparities in wealth and incomes, market operations reflect the lack of real (or effective) equality in starting positions.

There is nothing in the pure market mechanism that tends to rebalance an initially unequal distribution of assets and resources. Agents with more resources or greater access to credit (the two being frequently related) can invest, innovate and expand production on a larger scale than others. Thus the process of economic development is normally unbalanced, with some firms and sectors gaining market shares at the expense of others, and new products and production processes replacing older ones in a process of "creative destruction" (Schumpeter, 1942/2003). In this process, the accumulation of capital and knowledge (including that acquired through learning by doing) tends to concentrate wealth and economic power even further.

There is nothing natural about rising inequality that requires society to allow or accept it, nor does it improve the efficiency of market outcomes.

Although the principle of formal equality is the basis for social and economic interaction in most modern societies, the social consensus on how much inequality of market outcomes is acceptable, differs considerably among societies. But irrespective of cross-country differences in the level of effective inequality, the increase in inequality over time has given rise to growing concerns in many countries about its social and economic repercussions.

Accelerated economic globalization and technological progress over the past 30 years is often seen as a major factor responsible for a widening of the income gap between wage earners and earners of capital incomes, as well as between different groups within these aggregates. It is important to bear in mind, however, that trade, financial and technological factors always operate within a framework of social and economic institutions, regulations and policies. In this *Trade and Development Report* (*TDR*), it is argued that although inequality has risen in most regions since the 1980s, when globalization began to accelerate and became increasingly "finance-led", there is nothing "natural" about this development that requires society to allow or accept it. Nor does an increase in inequality improve the efficiency of market outcomes in a rapidly changing world. Even worse, a significant rise in inequality can generate economic conflicts that lead to social tensions and, in the extreme, political violence, especially when overall income growth is slow or absent. This is why economists such as Tinbergen (1956/1964) included among the objectives of economic policy the need for a better distribution of real income and expenditure among social groups and countries.

The use of certain instruments to reduce the current level of inequality is not necessarily damaging to investment and growth. On the contrary, appropriate macroeconomic, tax and labour market policies can prevent an increase in inequality or reduce it in a way that is conducive to both faster overall income growth and sustainable development.

For instance, by imposing a progressive tax on income or by taxing accumulated wealth, governments can reduce income inequality without undermining the incentive of economic agents to create and implement new ideas and projects. Taxing high incomes on the basis of progressive scales does not take away the absolute advantage of the richer individuals or the incentive for others to try out new ideas and move up the income ladder. Diamond and Saez (2011) estimate that in the United States the marginal tax rate on top incomes can be as high as 50–70 per cent without creating substantial incentive problems. Taxing wealth and inherited fortunes may even be seen as a means to providing incentives to the next generation to also engage in economic activities in a manner that maximizes outcomes for the society as a whole instead of relying on inherited fortunes. In resource-rich (mainly developing) countries, government policies aimed at capturing a significant share of the natural rents are vital for using the commodity bonanzas to improve domestic income and demand and generate a more broad-based growth of the economy, instead of allowing a few domestic and foreign actors, mainly in geographically concentrated enclaves, to take much of the windfall benefits. An incomes policy, a social safety net for unemployment and other hardships, and the provision of basic services, such as a good education for all, are instruments that simultaneously strengthen growth and reduce inequality.

These alternative views, by challenging the conventional wisdom that rising inequality is the normal result of development within market economies, may contribute to a new understanding of the functioning of a market economy, and can lead to a paradigm shift towards a pattern of economic development that is both more equitable and more efficient.

B. Inequality and economic theory

Traditionally, economists' views on inequality have diverged. Some do not see it as a problem, arguing that, in the absence of artificial impediments to social mobility, inequality basically reflects differences in talents and choices. They believe that the most talented, thrifty and industrious prosper, even when handicapped by initially adverse social conditions. In a world in which market participants receive a compensation which is in line with their contribution to society (their marginal productivity), the prosperity of the "fittest" cannot be deemed to be unjust and should not be a policy concern. According to this view, strategies to reduce inequality would undermine the power of the market mechanism to generate the most efficient outcomes, because they would reduce incentives to engage in the economic process. This would slow down economic growth, stymieing the chance to reduce absolute poverty "by lifting all boats" (Friedman and Friedman, 1980).

Some economists believe public policies to reduce income inequality might undermine economic efficiency and growth.

According to Hayek (1960 and 1978), income distribution in a market society results from an impersonal process that nobody manages and conducts, and since justice is a human attribute, impersonal markets cannot be just or unjust. Government intervention aimed at ensuring more equality or social justice would, paradoxically, lead to an unfair result by delinking the distribution of rewards from individuals' contributions to the generation of global income. Public authorities should provide "equality of opportunities", particularly in the sense that rules should be the same for all individuals, with no barriers or advantages artificially created or distributed. Equality of opportunities would also require a universal access to elementary education, to be provided by governments, while advanced education should be left in private hands, and the public authorities should not have the power to decide who may access it for the sake of equality (Hayek 1960: 384–385). More generally, governments that try to generate "equality of results" would be discouraging more capable people and encouraging the less capable. This, according to Hayek, would not only be unfair, but it would also be costly from an economic point of view.

A long-term structural view of how economies develop has led to a different perception of the relationship between inequality and economic growth. The seminal contribution of Kuznets identified a long-term relationship between income inequality and the development process based on sectoral changes in the economic structure: during the early stages of industrialization and urbanization, inequality increases as gains in productivity and income concentrate in the cities and workers migrate from rural areas (characterized by relatively uniform low-productivity activities and income) to seek better paid occupations in urban areas. In later stages, inequality diminishes because the mechanization of agriculture and the declining proportion of the population engaged in the agricultural sector tend to close the gap between rural and urban areas, and because urban workers eventually have the social and political power to reduce income inequality (Kuznets, 1955; Galbraith, 2012). In this analysis, "the long swing in income inequality must be viewed as part of a wider process of economic growth, and interrelated with similar movements in other elements" (Kuznets, 1955: 20), without a clear causality between them; changes in the levels of income and

inequality respond to structural changes inherent in the economic development process. Hence, at least in the first stages of development, inequality does not appear to be either a driving factor for, or an obstacle to, development.

Subsequently, this view was modified by other development economists who examined how income distribution could affect investment and growth. Kaldor (1957) presented an economic model in which GDP growth was limited by available resources and not by effective demand: capital accumulation, the flow of innovation and the growth of the population determined economic expansion. In the model, savings propensities of the community determine the rate of capital accumulation, but they are also linked to the distribution of income between profits and wages, since profit earners tend to save a higher share of their income than wage earners. Consequently, higher (functional) income inequality would be associated with higher savings and capital accumulation and higher economic growth. Kaldor did not imply that this should form the basis of any policy recommendation, since in his model income distribution was endogenous; but for many years a widespread interpretation of his model was that growth could be boosted by increasing the share of capital in income distribution (box 2.1).

Development economists focus on how income inequality affects aggregate demand, investment and growth.

Studies by the Economic Commission for Latin America and the Caribbean (ECLAC) in the 1960s followed a different approach, as they identified the highly unequal Latin American social structure as a major obstacle to development. They believed it hindered social mobility, in that it prevented the rise of the most dynamic individuals in the society, and that it weakened economic incentives for an efficient use of labour, land and machinery.[1] They also saw it as generating excessive consumption by the upper classes, contrasting with the precarious conditions of the popular masses. In their view, income inequality does not translate into stronger capital accumulation, as ostentatious consumption by the rich reduces savings. Moreover, because such consumption consists of a high proportion of imports and of goods produced by capital-intensive industries, it has little impact on domestic growth and employment, and does not provide the necessary basis for a sustainable process of industrialization. Consequently, State-led redistribution policies must seek to reduce consumption by the upper income groups in order to increase savings and direct them to capital accumulation (Prebisch, 1963; Pinto, 1970).

Theoretical work on the macroeconomic effects of income inequality was sidelined in the mid-1970s, partly because of the dominant role of representative agent models in mainstream macroeconomics.[2] The financial turmoil and the debt crisis in developing countries in the 1980s focused attention on short-term economic management, pushing development concerns to the background. From the early 1990s, however, interest in the relationship between inequality and development resurfaced. The contrast between rapid growth in a number of Asian economies and the "lost decade" for development in Latin America raised questions about their diverging growth paths. Relatively low inequality in East Asia contrasted with historically high inequality in Latin America, which was further aggravated by the debt crisis and the policy responses. Some authors suggested that this was an important factor in explaining these regions' widely different development experiences (e.g. Fajnzylber, 1989; ECLAC, 1990).

The renewed interest in the links between growth and distribution in the early 1990s was reflected in several theoretical works, which identified four possible channels through which income inequalities can have negative impacts on economic growth. The first channel is the impact of inequality on the level and composition of aggregate demand. The second is the relationship between inequality and socio-political instability. The third concerns the political economy implications of high inequality. Finally, the fourth channel through which inequality affects the pace of output growth is related to imperfect capital markets and investment in education.

Regarding the first channel, it is argued that since entrepreneurs make their investment and hiring decisions based on their expectations of future demand for their products, higher wages (and lower inequality) can stimulate investment, employment and economic growth by increasing expected demand. Murphy, Shleifer and Vishny (1989a and b) formalize

Box 2.1

INEQUALITY, SAVINGS AND INVESTMENT

Rising income inequality is often seen as a means to increase the investment ratio, as the higher incomes of the rich or more income appropriated by profit earners tend to augment aggregate savings at any given level of income. And it is assumed that their higher savings will quasi automatically lead to greater investments. As discussed in previous *TDRs* (see, in particular *TDR 2006*, Annex 2 to chap. I, and *TDR 2008*, chap. III), the theory of savings and investment which underlies this view (as well as the related policies to revive growth and employment creation) is highly questionable. It is even deeply flawed, because its core is a simple ex post identity.

The national product generated in an economy (plus the net capital flows) can be used either immediately (for consumption during the period of production) or at a later stage. If used at a later stage, it is counted as the savings or the investment of that economy. Hence, by simple definition, the savings (national and foreign) in any economy always equal its investments.

However, the identity is silent about causality. It is therefore highly problematic to attribute to any of its terms a specific or even a leading role in the macroeconomic process, as long as the factors that determine either of them are not taken into account. A theory is constituted only when the plans of one group of actors are analysed in conjunction with the plans of other actors. Specifically, it is necessary to identify the functional relationships which determine the consumption and investment decisions taken by the different actors in an economy. In doing so, the real income of all actors cannot be treated as an exogenous factor, but as a variable which itself is influenced by the decisions of the economic agents regarding their consumption and investment plans, as well as by policy decisions and by exogenous shocks.

Since changes in the behaviour of economic agents in an economy are subject to objective uncertainty, the determination of consumption and investment is a complex process, and the results are much less straightforward than they may appear by looking only at the ex post identity. If inequality increases, the planned savings of all households taken together will indeed rise, because the savings rates of the rich is higher than the savings rates of the poor. However, in this case producers are immediately faced with falling demand for their products and falling profits. In such a situation, they will typically react by cutting their investment in new productive capacity. On the other hand, when savings plans are based on the expectation of incomes that depend on a rise in investment but in actual fact investment falls, aggregate income will be lower than what was expected by households when they originally made their savings plans. Hence the planned rise in overall household savings may not materialize, since the total income is lower than what was expected at the time when the savings plans were made. Moreover, firms' savings (i.e. retained profits) are likely to fall. The ex post identity of savings and investments holds, but the mechanism to trigger the equalization is the unexpected fall in real income that neutralized the planned increase in savings.

The traditional theory of savings and investment ignores this latter mechanism and the fact that savings are an endogenous variable. It assumes that after an increase in the household savings rate, companies will invest more than before, despite a fall in consumption, which is the inevitable counterpart to higher savings. In the orthodox model, the economy is exclusively driven by autonomous consumer decisions. It assumes totally reactive entrepreneurs who never take into account the deterioration of actual business conditions and falling profits when making their investment plans.

Aggregate consumption and the incentive for private firms to undertake fixed investment are greater when a given national income is distributed more equally, because lower income groups spend a larger portion of their income on consumption than higher income groups. This is of particular importance in situations of high or rising unemployment. As Keynes (1936/1973: 372–373) put it: "... up to the point where full employment prevails, the growth of capital depends not at all on a low propensity to consume but is, on the contrary, held back by it ..." because "... an increase in the habitual propensity to consume will in general serve to increase at the same time the inducement to invest ..."

Rosenstein-Rodan's (1943) intuition that the simultaneous creation of many industries can be profitable even in a situation in which each industry would be individually unprofitable. They show that such a "big push" requires that the new industries pay wages that are higher than the wages in the traditional sector. With lower wages, simultaneous industrialization would not be profitable because of a lack of aggregate demand. In their model, the rich demand high-quality goods, the production of which offers little scope for increasing productivity; by contrast, the middle class demands standardized goods produced through mass manufacturing, where most productivity gains occur. Hence, a reduction of income inequality has positive effects on economic growth because it increases demand for products with growth-enhancing properties.

Recent theoretical work finds a negative correlation between income inequality and economic growth.

Another set of arguments (the second channel referred to above) emphasizes that, even if a high degree of income inequality does not have a direct adverse impact on economic growth, it has an indirect impact resulting from the social and political consequences of inequality. For example, a high level of inequality may lead to social upheaval and increase the crime rate, which create uncertainty among investors, erode property rights, raise transaction and security costs, and reduce growth (Venieris and Gupta, 1986; Benhabib and Rustichini, 1996; Grossman and Kim, 1996; Bourguignon, 1998).

The third channel is examined by different models that build a political economy link between inequality and growth. Models by Alesina and Rodrik (1994) and Persson and Tabellini (1994) suggest that high inequality in primary income distribution (i.e. distribution of incomes resulting from market outcomes alone) hampers growth. They argue that in less equal societies a majority of the population seeks more redistribution, and redistributive policies reduce growth by introducing economic distortions. In particular, taxes on capital result in lower private investment and growth. Another group of models (Bénabou, 2000, 2002; Saint-Paul and Verdier, 1996; Perotti, 1996; Bartels, 2008) gets the same result of lower growth with higher inequality, but with opposite mechanisms. They assume a positive correlation between redistribution and growth. According to them, the pivotal voter (i.e. a voter who can change his choices in successive elections and, acting in a group, can play a decisive role) is often richer than the median voter, and therefore would not benefit from redistributive policies. Thus, in less equal societies, characterized by low participation of the poor in elections, and/or by a disproportionately greater influence of the more wealthy in elections, there is an insufficient level of growth-enhancing redistributive policies.

High inequality may dampen aggregate demand, deprive many people of access to education and credit, and generate social upheavals, undermining productive investment and growth.

The fourth channel focuses on the relationship between income inequality, imperfect capital markets and investment in education. Models that emphasize the interactions between income inequality, imperfect capital markets and investment decisions suggest that risk-aversion and moral hazard are sources of capital market imperfection. They find that inequality reduces growth because it prevents some agents from investing in physical and/or human capital (Banerjee and Newman, 1991). Galor and Zeira (1993) postulate that access to education is costly, and even the poor need to pay a minimum fixed cost for it (possibly the opportunity cost of not having their children work). They show that fixed costs in education lead to persistent inequality as poor households are caught in a poverty trap.[3] Galor and Moav (2004) examine the dynamic effects of income inequality on economic growth. In their model, inequality may be good for growth when physical capital accumulation is the main driver of economic development, when such accumulation depends on savings and when high-income individuals have a higher marginal propensity to save. However, inequality may have a negative effect on economic growth when human capital is the main driver of such growth because credit constraints can limit aggregate human capital accumulation. This theory concludes that models that emphasized the positive effects of inequality on savings were an appropriate reflection of reality in the early stages

of industrialization, but are no longer relevant for developed economies today. Finally, high inequality also has a direct negative impact on growth in the "capital-market imperfections" model of Aghion, Caroli and García-Peñalosa (1999). They argue that it slows down human capital formation, as the rich tend to confine their investments to relatively low-return activities, while the poor, even if they have projects with high rates of return, cannot invest more than their limited endowments permit due to their lack of access to credit arising from capital market imperfections.

This theoretical work did not always attract the attention of policymakers, especially as economic growth tended to improve during the 1990s (until 1997) in several regions, with the exception of Africa and the economies in transition. In several countries, growth seemed to be compatible with rising inequality, and the policy responses were frequently oriented towards generating safety nets for those who were marginalized from the benefits of growth. However, some international organizations that adopted a larger historical perspective were less optimistic. UNCTAD (*TDR 1997*) observed that since the early 1980s there had been rising inequalities and slow growth, which were becoming permanent features of the global economy. It also warned that this could lead to a political backlash that might undermine several of the benefits of global integration. At the same time, the Latin American Institute for Economic and Social Planning (ILPES, 1998) highlighted the shortcomings and fragility of economic growth in Latin America, owing partly to its limited social impact and its inability to reduce income inequality. It observed that compensatory social policies had not been able to contain the widening social and economic gaps, and that a reorientation of the economic policy stance was needed.

The World Bank (2006) also analysed the negative social and economic consequences of high inequality. It noted that the distribution of wealth and power affects the allocation of investment opportunities often in socially undesirable ways, because "high levels of economic and political inequality tend to lead to economic institutions and social arrangements that systematically favour the interests of those with more influence. Such inequitable institutions can generate economic costs ... [and] the inequality of opportunity that arises is wasteful and inimical to sustainable development and poverty reduction" (World Bank, 2006: 2–3).

C. Some empirical evidence on inequality, employment and growth

Most of the recent literature reviewed in section B proposes empirical tests for the relationship between inequality and growth, which, as explained in this section, generally point to a negative correlation between the two. This is consistent with some basic stylized facts that are discussed in the subsequent chapters of this *Report*. There was strong global growth during the decades immediately following the Second World War, with low or declining inequality in industrialized countries and also in many developing countries. However, over the past three decades, income inequality increased dramatically, particularly in developed countries, reaching levels not observed since the 1920s (discussed in chapter III). It coincided with slower global growth and rising imbalances within and between countries, which eventually led to the global financial crisis that erupted in late 2008.

Recent empirical work on the link between inequality and growth can be divided into three groups. The first group uses cross-country data to study the long-term relationship between inequality and growth, the second uses longitudinal panel

data (still at the cross-country level) to study the medium-term relationship between the two, and the third studies this relationship by focusing on both cross-sectional and longitudinal state-level data for the United States.

Among the first group of studies, Persson and Tabellini (1994) and Alesina and Rodrik (1994) test the reduced form equations of their models, and show that there is a negative empirical relationship between income distribution and growth. Easterly (2007) uses an instrumental variable approach to show that income inequality has a negative causal effect on economic development. Perotti (1996) attempts to differentiate between the various theoretical channels discussed above. His main results can be summarized as follows: (i) there is a robust negative relationship between income inequality and growth; (ii) there is no evidence that the relationship between inequality and growth is stronger in democracies; (iii) the structural estimations support the hypothesis that inequality hinders growth by causing socio-political instability and by its impact on education and decisions relating to fertility;[4] and (iv) there is no evidence to support the political economy argument that inequality leads to higher redistribution, which in turn leads to lower growth. Indeed, Perotti finds a positive correlation between redistribution and growth.

Excessive concentration of income was one of the factors leading to the global crisis as it was linked to perverse incentives for the top income earners and to high indebtedness in other income groups.

The second group of studies includes those by Li and Zou (1998) and Forbes (2000) who use five-year growth periods to show that regressions which control for country-specific factors yield a positive relationship between inequality and growth. These results seem to contrast with the results of the theoretical models discussed above. However, there are at least two problems with their empirical approaches. The first problem has to do with the fact that, while most theoretical models emphasize the relationship between inequality and long-term growth, these studies analyse the link between inequality and medium- or short-term growth. The second problem (which also affects the cross-country regressions discussed above) relates to the fact that the linear structure imposed in standard growth regressions may lead to biased results. In addressing these issues, Banerjee and Duflo (2003) find that changes in inequality (in either direction) are negatively correlated with growth, and that lagged inequality is also negatively correlated with growth.

The third group of studies suggests that there is no clear relationship between different measures of income inequality and economic growth in different states of the United States. For instance, Partridge (1997) finds a negative relationship between inequality and growth when inequality is measured using the income share of the third quintile of the income distribution, and a positive relationship when inequality is measured using the Gini index. However, Panizza (2002) shows that there is a negative, but not very robust, relationship between state-level income inequality and economic growth in the United States.

Although not always conclusive, and sometimes based on opposite hypotheses, recent empirical and analytical work reviewed here mostly shows a negative correlation between inequality and growth. This growing academic consensus is consistent with the stylized fact already mentioned, that in many countries economic growth was strong in the post-war decades, when inequality was relatively low or declining, and has weakened markedly since the 1980s, when inequality has been rising. For the group of developed countries, the share of employee compensation in GDP (at factor cost) has reached its lowest level since the end of the Second World War, and yet open unemployment has reached its highest level recorded for the same period.

As the subsequent chapters of this *Report* show, in the last three decades macroeconomic policies and changes in institutional arrangements that followed the new paradigm of "labour market flexibility" played a major role in the trend of rising inequality, thereby contributing to the build-up of the global crisis. Labour market and tax policies exacerbated income inequality, as they placed the burden of adjustment to globalization and technological progress on wage earners and on the middle and lower income groups. In the United States, for example, tax cuts have favoured the wealthy, who are paying some of the lowest tax rates in the history of the country. There is evidence that the reduction in the progressive

tax in the 2000s did not result in higher growth and employment generation than in the previous decade, although tax rates on top incomes were increased in the early 1990s (Krueger, 2012).

In addition, several recent analyses suggest that some of the main causes of the global financial crisis – including private overindebtedness and the dominance of an unregulated financial sector over the real sector of the economy – are linked to growing income inequality.[5] In particular, rising private debt-to-income ratios in some developed countries – most notably the United States – were partly attributed to stagnating real wages, which reduced the purchasing power of households. With stagnating wages, households could increase their expenditure, or even just maintain it, only by incurring debt. The increase in such debt, in turn, boosted the activities and profits of the financial sector, resulting in a further concentration of wealth and income. The credit bubble thus created eventually burst with the subprime crisis that triggered the global economic crisis.

Developing countries must increasingly rely on domestic markets and South-South trade …

The predominance of the financial sector in the economy is reflected in the compensation paid to corporate executives, managers and financial agents. Extremely high wages in this sector are mainly responsible for the huge differences between the top income earners and the rest. Compensation packages often include stock or stock options, which create perverse incentives and lead to excessive risk taking. In this context, the changes in corporate behaviour that have accompanied finance-led globalization have given strong emphasis to short-term profits and shareholder dividends, while wage earners have borne the greatest burden of adjustment to economic shocks.

If increasing inequality has been one of the factors leading to the financial crisis, the subsequent global recession and the policies devised to handle it are also having a significant impact on income inequality (UNCTAD, 2012). The social consequences of the economic and financial crisis have been record levels of unemployment in many countries, as well as increased poverty and higher inequality. In developed countries, particularly in Europe, most proposals to overcome the current crisis, such as cutting wages and downsizing social services, would tend to increase inequality. Cuts in public spending are largely focused on reducing social expenditure on education, health, pensions, and social services and transfers, as well as on cutting public sector salaries and employment. They also include reductions in public investment, which have a negative impact on employment and on private investment. When fiscal tightening takes the form of higher tax rates, this typically involves an increase of – regressive – indirect taxes rather than progressive taxes on wealth and on higher income groups. Hence, fiscal austerity typically has negative distributional effects, as it results in a reduction of the disposable income of lower income groups, and, since these are precisely the groups with a higher propensity to consume, this exerts further downward pressure on aggregate demand.

… but the size and composition of domestic and regional markets depend largely on income distribution.

The crisis has taken a heavy toll on society in terms of employment losses, particularly among the youth. In order to restore pre-crisis employment and absorb the new labour entrants, an employment deficit, estimated at 48 million jobs in 2011, would need to be eliminated (UN/DESA, 2012).[6] Apart from the immediate loss of wage income, long-term high unemployment tends to weaken the bargaining power of workers, with severe impacts on wages and labour conditions. It also leads to a loss of qualifications and reduced employability. In addition, the poorest and middle segments of the population are most likely to suffer a significant loss of assets, such as housing and savings, while their access to basic social services is further impaired. The ILO (2012b) provides compelling evidence on how the crisis has deepened inequalities in Europe.

Contrary to what happened in most developed countries and transition economies, over the last decade a number of developing countries have recorded significant improvements in income distribution. To a large extent, these improvements have been the result of redistributive fiscal policies and incomes policies which have linked wage

increases to productivity increases. The record of declining inequality in Latin America during the 2000s provides proof of the effectiveness of these policies in improving income distribution. However, in absolute terms inequality tends to be considerably higher in developing countries than in developed countries.

Restrictive policies and increased inequality in developed countries not only harm domestic economic activity, but also generate negative spillovers to other countries. In the current context of slow growth in developed countries, it has become evident that developing countries will not be able to depend on exports for growth as much as in the past, and must increasingly rely on domestic markets and South-South trade (*TDR 2010*). But the size and composition of such markets depend to a large extent on income distribution. Therefore, these countries will need to progress further in reducing income inequality and find the appropriate balance between external and domestic demand.

D. Looking ahead

The gap between formal and real equality of opportunities has deep economic roots and far-reaching economic consequences. Inequality that begins in the cradle is not easily redressed through social mobility. It tends to pass from one generation to the next and is generally compounded, in particular by unequal access to education and health services, and inertia on the part of existing power structures in different groups of society. Effective equality of opportunities requires more than just ridding a system of legal impediments to social mobility, such as those that existed in feudal times. It requires providing all social groups with access to an acceptable minimum level of living standards and to adequate public services, including education and health; otherwise, formal equality is little more than an empty shell. It is, in the words of Anatole France (1894/2007: 75), the "majestic equality of the laws, which forbid rich and poor alike to sleep under the bridges, to beg in the streets, and to steal their bread". The absence of equal opportunities in practice implies an enormous waste of development potential, since a large segment of the population is excluded from modern productive activities and consumption, which negatively affects the potential for the creation of value added and the development of strong domestic markets.

The greater the inequality, the less possible it becomes to separate outcomes and opportunities. Outcome determines opportunity through access to health, education and influence. This relates not only to opportunity among the lower income groups; it also concerns the distribution of profits (e.g. between rents and entrepreneurial profits, and between profits of innovative and declining sectors and firms). The extent to which profits feed back into investment and the overall dynamics of the economy has implications for the generation of employment.

Inequality, growth and structural change interact in different ways, as discussed in subsequent chapters. It is therefore necessary to examine if – and how – reducing inequality and increasing degrees of inclusiveness can lead to a process of strong and sustained growth. Revising the policy approach to inequality is all the more urgent in the light of the continuing impact of the global financial crises and the negative distributional effects of the fiscal and wage policy responses experienced in many developed countries today. In developing countries, a greater participation of workers of all occupations in overall productivity growth and more social protection for the poor are essential not only for alleviating poverty, but also for strengthening the dynamics of domestic markets.

The analysis of the relationship between inequality and growth and development is a complex task because inequality involves many dimensions. It is

compounded by the difficulties in measuring inequality and problems of data availability. This *Report* focuses mainly on income inequality within countries. However, it must be emphasized that inequality between countries also remains a major concern, as global inequality results from both intra- and intercountry inequality. Indeed, it is income differences between countries that is the major determinant of global income inequality. Assuming a stable income distribution within a country, narrowing the gap in per capita GDP among countries will reduce global income inequality, and vice versa. Thus continuing efforts at the national and international levels aimed at increasing the per capita GDP in developing countries and helping them catch up with the more advanced countries therefore remain crucial.

Chapter III of this *Trade and Development Report* presents some empirical evidence of the magnitude and evolution of inequality. It focuses on income inequality within countries, although it also examines how inequality has evolved at the global level. It suggests that policymakers need to target inequality within their countries with policies aimed at reducing the income gap, which in turn will influence overall economic and social outcomes. The chapter also briefly examines some other aspects of inequality, such as gender, access to education and the distribution of wealth. All of these are also relevant for income distribution and require specific policy actions.

Chapter IV discusses what are widely perceived to be the main structural causes of recent changes in income distribution, including trade, technological change and finance-led globalization. It argues that the impacts of globalization and technological change on domestic income distribution are not necessarily uniform. Rather, they depend on initial conditions as well as on how macroeconomic, financial and labour market policies interact with the forces of globalization and technological development. Structural changes do not necessarily lead to greater inequality if appropriate employment, wage and income distribution policies are in place. This issue is further elaborated in chapters V and VI of this *Report*.

Revising the policy approach to inequality is all the more urgent in the light of the continuing impact of the global financial crisis and the negative distributional effects of the policy responses.

Chapter V discusses how income distribution has been and may be modified by proactive public policies, including the use of fiscal instruments aimed at redistribution. It argues that the use of such instruments does not necessarily reduce incentives to invest in fixed capital, innovation and skills acquisition. On the contrary, the reduction of inequality that can be achieved with such instruments is more likely to accelerate growth and employment creation than the past trend towards less progressive taxation and lower social transfers, which aimed at eliminating distortions in market outcomes.

Finally, chapter VI examines how labour market institutions and policies, together with an appropriate macroeconomic framework, can respond to the present challenges and lead to both sustained growth and more inclusive development. The chapter starts with the proposition that slow growth has a strong impact on inequality due to rising and high unemployment. The latter increases inequality both as a result of income losses incurred by the unemployed, and, more fundamentally, by weakening the bargaining power of labour. It argues that the paradigm of labour market flexibility has not just failed to reduce unemployment, but has even tended to exacerbate it, because the unemployed are prone to accept lower wages. It asserts that the economic model underlying this paradigm is fundamentally flawed, and suggests an alternative approach based on the recognition that wage growth in line with productivity growth prevents a rise in inequality and supports the process of economic growth and employment creation in a dynamic economy.

Notes

1 For instance, Prebisch (1963) believed that extreme inequality in the ownership of agricultural land hampered the use of modern techniques of intensive production because large properties obtain huge rents even without having to resort to such production, and very small units, owing to extreme poverty, cannot afford to use the modern techniques.

2 These models are based on the assumption that the economy as a whole behaves like an individual economic unit – the "representative agent". Due to the way in which they are constructed, they exclude consideration of distributive issues among several agents or groups of agents.

3 However, this model does not always arrive at the conclusion that inequality is bad for growth. There is a set of parameters and initial conditions under which inequality allows some agents to invest in education, while under fully egalitarian distribution, where average income per capita is lower than the fixed cost of education, nobody would invest in education.

4 Alesina and Perotti (1996) also find evidence of a negative correlation between inequality and growth owing to the socio-political instability caused by high inequality.

5 See, for instance, Attali, 2009; *TDR 2010*, chap. II; Kumhof and Rancière, 2010; and Galbraith, 2012.

6 The International Labour Office also estimated a deficit of 50 million jobs as a result of the crisis (ILO, 2012a).

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