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Income Inequality and Redistributive Policies

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prepared for the UNRISD project on
**UNRISD Flagship Report:
Combating Poverty and Inequality**

November 2009 ▪ Geneva



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Main Messages

This chapter argues that the reduction of income inequality should be a central issue of economic and social policies in developing countries. High inequality not only retards the reduction of poverty but is also inimical to economic growth and development. The issue is highly germane today because most developing countries are characterised by high levels of inequality and, worse, a majority of them have experienced rising inequality in the past two decades.

Given that the reduction of high levels of inequality will yield substantial benefits in terms of both poverty reduction and growth, it follows that a comprehensive and mutually supportive set of redistributive policies should be adopted. The scope of these policies should not be confined within the straitjacket of the prevailing neo-liberal conventional wisdom. Rather, they should be framed in the context of greater freedom for developing countries consider options that work best in the in specific circumstances of each country.

Redistributive policies should be premised on a strong role for the state and be framed in the context of an overall development strategy that will generate pro-poor growth. Furthermore, given the importance of labour-intensive growth for poverty reduction, development strategies should incorporate employment policies that support the attainment of this goal. The adoption of such strategies should not be constrained by multilateral rules and the reform of global governance should seek to ensure this.

Within this framework redistributive policies should seek to increase the redistributive impact of fiscal systems both on the taxation and expenditure sides. The highest priority should be given to redistributive policies directed at the rural sector given the pivotal role of increased rural incomes in reducing overall poverty. Land reform is a central issue that should be addressed with an open mind. Similarly the proposition that the state has a crucial role to play, through production-oriented investments and supportive policies, in promoting rural development should not be foolishly surrendered under ideological pressure. Only reasoned debate can settle the issue.

Outline

The chapter begins by marshalling arguments for the case that the reduction of high levels of inequality is a central issue for contemporary development policy. It then seeks to establish that there has been the alarming development of a pervasive rise in income inequalities across the world. It then attempts to refute the Panglossian neo-liberal position, notwithstanding limited concessions, that is all to the good. Finally, it seeks to make the case for comprehensive redistributive policies along the lines encapsulated in the main messages just presented.

Why Inequality Matters

There are important grounds for a concern with issues of income inequality and redistributive policies. At the most basic level the distribution of income within a country has a crucial impact on the welfare of its people. A more equal distribution of national income, other things being equal, means that aggregate welfare is higher when

the welfare of each individual is given equal weight. Poverty will also be lower at any given level of per capita income.

This is not a case for absolute equality since in a market economy it is essential to have a sufficient degree of inequality in order to provide the incentives for differential effort and to motivate investment and innovation. This is the basis for achieving economic efficiency and growth. But, even from a liberal perspective, this level of inequality should be no more than is justifiable in terms of differences in legitimate contributions to economic output. A precondition of this is that economic and social institutions provide a level playing field for all to participate in economic and social life. However, this condition is rarely met, especially in developing countries. The upshot is that observed inequalities are explained not only by legitimate differences in economic contributions but by unjustifiable economic and social privileges and practices of the rich. A clear consequence of this injustice is the marginalization and exclusion of the poor. Observed inequalities are thus often not justifiable even from a liberal perspective. They are even more unjustifiable from other political perspectives than see greater equality as an intrinsic value, one that also underpins other important values such as social cohesion and solidarity.

In addition to these ethical grounds for favouring a low level of inequality there are also a host of instrumental reasons. There is an accumulating body of evidence that points to the fact that a high level of inequality, of say a Gini of more than 0.4, has negative effects on important economic and social goals. While a moderate level of income inequality is essential, high levels of inequality are in fact dysfunctional.

First, since high inequality means a higher level of poverty, it lowers the rate of economic growth that is attainable by excluding a higher proportion of the workforce from contributing fully to economic growth. The poor are unable to contribute fully because their productive potential is impaired by inadequate nutrition and ill health as well as by low levels of access to education. In addition their ability to raise their productive contribution is further limited by a lack of access to productive assets such as land as well as to credit that would enable them to invest in physical and human capital. This economic exclusion of a significant proportion of the population is costly in terms of the loss of human resources that could contribute to higher growth. There is clear evidence of this effect in the finding that countries with higher levels of initial income inequality have experienced lower growth than those with lower levels of inequality.

Secondly, a high level of inequality can also retard growth in other ways. The economic exclusion of the poor also translates into lower effective aggregate demand in the economy. The poor are largely locked into a subsistence economy or have very little to spend on manufactured products. This limits the size of the domestic market and thus retards the potential for industrialization that is an important driver of growth. High inequality also breeds crime and social unrest which are inimical to growth. In extreme cases, especially where inequality is manifested along ethnic, tribal or religious lines, it can lead to social conflict and state failure which is economically destructive.

Thirdly, high inequality tends to be self-perpetuating. It leads to the growth of unequal political and economic institutions that work in favour of perpetuating the political, economic and social privileges of the rich. In highly unequal societies the poor have little effective political influence and are locked into poverty traps from which it is difficult to escape. They remain with very limited ability to share in new economic opportunities created by economic growth because of their limited access to basic

needs, assets and education. As a result high inequality also implies a significantly lower pace of poverty reduction.

For all these reasons the degree of inequality in the distribution of incomes is a central policy issue. It impinges not only on the prospects for economic development for poor countries but also, and more importantly, on achieving the goal of poverty reduction that the international community has subscribed to in the Millennium Development Goals. In this context the scope for deploying redistributive policies, especially in countries with high levels of inequality, should be central to the debate on development policy. Before addressing redistributive policies it would be instructive to first survey existing levels of inequality and how they have been evolving.

At the outset it is important to note that countries vary widely in the extent of inequality in the distribution of income. 'The range of inequality measures across the 130 countries is very large indeed. The Gini index ranges from 0.20 in the Slovak Republic to 0.74 in Namibia.' This has arisen because of differences in the level of development, the economic structure, the political and economic institutions that have been adopted and the economic and social policies that have implemented in different countries. In general the variance in income inequality among developing countries is much higher than that among rich countries. 'Above 20,000 per capita per annum, all Gini indices lie in the relatively narrow interval of 0.25 to 0.45' whereas high inequality (a Gini of above 0.50) is a feature of underdevelopment.' In many developing countries the inherited initial distribution in land ownership is a key factor behind extreme inequality. A high level of inequality such as that that still characterises many Latin American countries locks an economy into a high level of income, social, and political inequality that is difficult to shift without a radical land reform. Conversely more egalitarian land distributions create a strong initial base for maintaining lower inequality in the process of economic development. The initial structure of an economy such as whether it is based on capital-intensive extractive industries or labour-intensive manufacturing also conditions the initial level of income inequality as well as the ease or otherwise of implementing policies for income redistribution.

Trends in Overall Income Inequality

An important strand of early development thinking held that an 'inverted-U' shaped curve described the relationship between the level of development and the degree of inequality in the distribution of income. This Kuznets curve summarised a process where inequality increased in the initial stages of development but would then reverse itself at higher stages of development. The underlying explanation was believed to be the process of structural change that was the essence of development. This involved a shift from a predominantly agricultural to a more diversified structure of production as new, higher-productivity activities, usually spearheaded by industrialization, began to take off. Since there was typically a large gap between the levels of productivity and incomes between the new and the 'traditional' activities, there would be an initial rise in inter-sectoral inequality that would drive an increase in inequality in the overall distribution of income. However, with continued expansion of the high-productivity activities their weight in determining the overall distribution would also grow, leading eventually to a reduction in income inequality.

Within this framework there was an element of inevitability about rising inequality in the early stages of development, leaving relatively little scope for avoiding this through institutional reform and redistributive policies. However, this view has since been

revised. 'Work in the 1980s..argued that there was no Kuznets curve to found in the cross-country data. This became the conventional wisdom, and has been found to be largely corroborated by the literature of the 1990s and the 2000s.' In addition, the development experience of the first wave of Asian NICs demonstrated that there was no inevitability about rising inequality in the early stages of development. These countries were able achieve very rapid growth without a rise in income inequality. In the cases of the Republic of Korea and Taiwan, China radical land reforms prior to take-off into high growth was undoubtedly an important factor in preventing a rise in inequality. The growth process started from a more egalitarian base of asset distribution, pointing to the importance of the link between asset and income distribution. But the same process of high growth without rising inequality had also been true of Singapore and Hong Kong, both city states where agriculture was insignificant. This suggests that the critical explanatory factor for the equitable growth that was achieved lay in the rapid growth of labour-intensive manufacture exports that was the common cornerstone of the development strategy followed by all four countries.

This benign relationship between growth and inequality has, however, proved to be a rare phenomenon. In the past two decades 'no country seems to have managed to achieve high growth without increases in inequality.' And it does not appear to be only high growth that has driven increasing inequality. In fact rising inequality has been a common feature across countries with differing growth experiences. Recent studies of income inequality point to the fact that inequality has increased in a majority of countries across the world. A recent study by the World Bank found that in a sample of 49 countries income inequality increased in 30 of them between the 1990s and the 2000s. It remained unchanged in six and in only 13 countries did it decrease. A similar result has been presented in a recent ILO study. It found that between 1990 and 2000 'more than two-thirds of the 85 countries for which data are available experienced an increase in income inequality, as measured by the Gini index.' Of the 20 advanced countries in the sample inequality decreased in only four, while of the 21 transition countries in the sample inequality decreased in only three. Among the developing countries in the sample, there were regional variations in the pattern of change. In Asia only 2 out of the 8 countries did inequality decrease. Significantly, India and China were among the countries that experienced an increase in inequality. In Latin America, inequality declined in 6 out of the 15 countries for which data were available. It was only in the Middle East and North Africa and in Sub-Saharan Africa that more countries experienced a decline rather than an increase in inequality. However, even after the decrease, the resulting level of inequality still remained high (a Gini ratio of more than 0.40) in most of these countries.

Trends in the Functional Distribution of Income

This broad pattern of rising inequality reflected in rising Gini ratios is supported by information on other dimensions of inequality. An important indicator is the functional; distribution of income or the distribution of income between Wages and Profits (or income from assets). This measure provides an overall indication of how well wage earners are faring in relation to employers and others who derive their income from the ownership of assets such as productive equipment and financial assets. In the industrialised countries the share of Wages in GDP is closely correlated with changes in overall income inequality as measured by a summary measure such as the Gini ratio. This is because there is typically only a small sector of self-employed producers and the bulk of total income comes from either Wages or Profits. Thus a rise in the share of Wages in GDP is likely to mean a reduction in overall inequality since wage earners are

at the lower end of the income distribution while the opposite is true of those who derive their incomes from profits. A rise in the share of Wages also usually reflects a tight labour market and increased bargaining strength of workers.

In the case of developing countries, however, the picture is less clear-cut because of the presence of a large informal sector consisting of self-employed petty producers whose meagre incomes typically place them at the bottom of the income scale. Yet their incomes are usually recorded as profits or a return on the meagre assets with which they engage in some activity for economic survival because they are not able to obtain wage employment. In such a context there is no simple interpretation of what a change in the share of Wages in GDP means in terms of the impact on overall inequality. For example, if an increase in the share of non-wage income is largely due to an increase in average incomes in the informal sector then this would be a desirable change from a distributional standpoint. Nevertheless, even in these countries an analysis of the change in the wage shares that is confined to just the modern sectors of the economy can provide useful information on trends in inequality. A change in wage shares within the modern sector can be interpreted in the same way as an overall change in the wage share in the case of advanced economies. For instance, a decline in the wage share in the modern manufacturing sector in a developing country does tell us that the bargaining strength of workers is weakening because of either a continuing labour surplus problem, the strengthened power of employers due to increased exit options as a result of globalization or simply increased repression of labour unions.

Turning first to the advanced countries, an UNRISD study based on panel data for 25 countries for the period between 1973 and 2003 found that ‘the labour share fell or remained constant in 23 cases.’ These falls have been quite large in some cases. ‘Between 1980 and 2000, the average labour share fell by 10 points in the Eurozone..this is one of the largest drops and a clear sign of redistribution from labour to capital.’ The study also found evidence of a ‘strong, persistent and international link between functional and personal income distribution.’ In the sample of 25 countries, 17 of the 18 countries that experienced an increase in inequality in the functional distribution of income also experienced a simultaneous increase in inequality in the personal distribution of income.

The same phenomenon also appears to have been at work in some developing countries. Bearing in mind the caveats set out earlier about the difficulties involved in interpreting changes in the functional distribution of income in developing countries, it is still significant to note the findings from a recent ILO study. Covering 29 advanced, 33 developing, and 11 transition economies the study concluded that ‘an analysis of the data collected –for advanced economies, newly industrialized and developing nations alike–reveals that the wage (or labour) share of total income has declined in three quarters of the countries considered. The decline occurred in most regions. The fastest decrease occurred in Latin America (over 13 percentage points)..but significant declines were also found in the advanced economies and Asia, where wage shares fell over 9 percentage points during the periods 1980-2005 and 1985-2002 respectively.

Other Dimensions of Inequality

Apart from these general indicators, there have been other measures that point to how pervasive the rise in income inequality has been. For instance, not only has the share of wages tended to fall but there has also been clear evidence that the distribution of this

reduced wage share has also tended to become more unequal. The ILO study referred to earlier showed that ‘the wage gap between the highest and the lowest 10 percent earners has also tended to increase in 18 of the 27 countries since the early 1990s for which data are available...Over the past two decades, large increases have occurred in Hungary, Poland, Portugal and the United States, where the ratio is near or above 4 but also, interestingly in developing countries and in countries that have low inequality overall such as the Nordic countries.’ In the case of developing countries this is a surprising development since this is contrary to theoretical predictions about how the growing trade with the industrialised countries during this period should have affected wage inequality. According to the Heckscher-Olin theorem such trade should raise the relative demand for their abundant factor which is unskilled labour. This should thus lead to reduced inequality between the wages of skilled and unskilled workers. Instead of this, the gap between the wages of skilled and unskilled workers has in fact increased in a majority of developing countries.

A key aspect of the rise in wage inequality in some advanced countries that has come into sharp focus in the wake of the current economic crisis has been the sharp increases that have occurred between the earnings of executives and average employees. A recent study of executive pay in the 15 largest companies in six countries found that chief executive officers earned on average between 71 and 183 times more than the average employee. Much of this increase has been fuelled by the introduction of high-powered incentives in the form of bonuses based on the maximization of the value of a company’s shares. Apart from contributing to an obscene rise in earnings inequality the serious flaws in such a system has been amply exposed by the current economic crisis. They created a strong incentive to favour high risk options that could yield high and quick returns over more prudent strategies that would be more productive over the longer term. There was also a massive negative social externality in the form of the current global economic crisis that was totally ignored.

This rise in executive pay was part of a wider phenomenon where the incomes of top earners increased substantially across the world. Apart from the deserved returns to productive and socially useful innovation and entrepreneurship, obscenely high incomes were also obtained through activities of more dubious social value such as financial speculation and procuring media attention and celebrity status. Part of the rise in top income in fields such as sports and entertainment was due the operation of the ‘economics of the superstar’, whereby earnings become increasingly concentrated in the hands of a few top performers.

In all, the period until the onset on the current crisis was one where there was not only a pervasive rise in inequality in personal but also a broad social acceptance if not also approval of this process.

Factors behind the Rise in Inequality

Global Structural Change

There are in all likelihood many factors that have contributed to the pervasive rise in inequality that has been described above. Sorting out which of these has been the most important is a crucial challenge for future research as well as for the design of policies than can contain or reverse these trends. While there is as yet no widely accepted and definitive answer at this stage few are likely to disagree that the dramatic

transformations that have occurred in the world economy through globalization must be an important part of the explanation.

A recent study carried out for UNRISD makes a bold attempt to provide a comprehensive theoretical and empirically-supported explanation of how increasingly globalization has assumed growing importance as a common factor behind much of the observed rise in inequality that has been observed.

The starting point was to find a large data set that would be comprehensive enough to cover broad trends in equality across most countries the world. As noted earlier, survey data on the household distribution of income that are comparable over time exist for at most 85 countries as analysed in the ILO study. The World Bank study had considered that there was adequate data for only 49 countries. The study undertaken for UNRISD by the University of Texas gets round this problem by using far more widely available data on inter-sectoral differences in pay and earnings. These data sets bring a unique resource to bear in the form of dense, consistent and reliable measures of inequality in the structure of pay and earnings, for a large number of countries during the period from the early 1960s to the early years of the new century. While far from perfect these data permit the recognition of patterns and relationships, broadly between economic inequality and structural change that might otherwise remain obscure.

The methodology used is to compute inequality as the between-groups component of a Theil T-statistic. This method does not require recourse to micro data sets derived from sample surveys and the result is a plethora of new measures of the evolution of economic inequality, capturing many different aspects of the phenomenon and revealing the complexity of the story to be told. Such inequality measures, although computed from grouped data, do nevertheless provide a consistent lower-bound estimate of inequality for the entire population and is sufficient to capture major movements of inequality in the whole distribution. There are limitations to this approach in that it does not provide information on the characteristics of workers or their families and the data are pre-transfer and thus shed no light on the post-transfer distribution of income. The latter however does not change the inequality rankings in the case of non-OECD countries since transfer payments are of little practical significance in these countries.

The main merit of the approach is that it focuses attention on the main global driver of economic change and inequality in the present era of globalization. Structural change or the process of transition from agriculture to industry and then to modern services is the essence of economic development. This in turn is the main force than shapes the evolution of inequality. Although, as mentioned earlier, the Kuznets curve- an inverted 'U' relationship between inequality and income- no longer uniformly describes the relationship between growth and inequality in all countries, the essence of understanding inequality still lies in understanding the inter-sectoral transitions that produce it. For large agrarian societies in the process of industrialization, of which China is the leading example, urbanization still drives the rise in inequality. However, in only a few other industrializing countries does the the agrarian population remain sufficiently large for the inter-sectoral transition out of agriculture to so dominate the picture. Most developing countries, especially outside Africa, are over the hump of the inverted-U Kuznets curve.

Instead of a deterministic Kuznets curve it is the inter-sectoral transitions –in agriculture, industry, technology and finance-together with the changes in the global terms of trade between these sectors that are the main drivers of change in inequality.

Thus a commodities boom will tend to reduce inequality in a country with an important agricultural sector, simply because it tends to raise the relative income of farmers. A rise in the price of oil deprives industrial workers in consuming countries of their employment and incomes thus tending to increase inequality. Similarly a technology bubble raises top incomes and tends to raise inequality. Changes in interest rates also have an important impact on inequality; an increase tends to raise inequality since it favours rich creditors while a decrease has the opposite effect. The important point to note is that these effects are global and increasingly so in the context of increasing globalization. In today's globalized financial and commodity markets such changes in the terms of trade between sectors are felt almost everywhere at once.

The results of this approach show that there is a common time pattern of the movement of inequality within-countries in the world economy from the early 1960s onward. This moves in four phases. The first is a phase of relative stability, with no common movement in the inequality measures which dates from 1963 until around 1971. The second is a period of moderately declining inequality in much of the world from 1972 until around 1980. This period coincided with the collapse of the global financial framework of the Bretton Woods era, and the subsequent inflationary boom, abetted by large-scale commercial lending at negative real interest rates.

The third phase is of sharply rising inequality. It began around 1982 and continued through the end of the century, and is associated with the calamity of the global debt crisis. This was initially most severe in Latin America and Africa and was followed by the collapse of the communist governments of central and eastern Europe, and finally by the wave of the wave of deregulation and liberalization in Asia in the 1990s. The specific experience of countries and regions varies, but with much in common: collapsing imports, a collapsing fiscal base and public sector, trade liberalization, deindustrialization and the simultaneous decline of both the civil service and the industrial working class. Meanwhile globalization in many cases eventually brought financial investment from the West and the rise of new sectors-real estate, insurance, and banking notably- with global pay scales and speculative characteristics. The overall pattern resembles almost exactly that found by Milanovic (2007) for a measure of inequality between countries, unweighted by population. This is not surprising: events which raise the gap between rich and poor people within countries should also, in principle, raise the gap between rich and poor countries, since the latter are just unbalanced collections of the former.

The pattern has exceptions, because there are exceptions to globalization. Notably India and China, avoided the global rise in inequality in the 1980s, arguably because they held themselves aloof from the commercial lending going on everywhere else and therefore unaffected by the debt crisis. China's rise of inequality dates from the crisis of 1989, while India's starts with the reforms of 1992. These exceptions help to confirm the hypothesis: a major force driving the movement of inequality in the age of globalization was not idiosyncratic national policies or even structural change within countries, but global forces affecting the inter-sectoral terms of trade.

The fourth phase, beginning in 2001, is again one of declining inequality. It coincides with the marked relaxation of credit conditions in the United States after the attacks of September 11 2001, and the retreat from neo-liberal policies after the Asian crisis of 1997, the Russian crisis of 1998, and the Argentine crisis in 2002. These changes appear to have to have permitted both higher growth and some abatement of the extreme increases in inequality that afflicted the developing world for the previous 20 years.

For developing countries the dramatic onset of the global financial crisis in 2008 has undoubtedly brought an abrupt end to this brief period of declining inequality. The events are too recent for there to be data to confirm this but the crisis has clearly reversed trends that favoured declining inequality such as a boom in commodity prices, increasing FDI and other financial flows, increasing exports to industrialized countries. These countries now face sharply reduced growth and even contraction of output, rising unemployment, increasing inequality and a renewed rise in poverty. This development provides further confirmation of how vulnerable developing countries are to global economic forces beyond their control. It also underscores the fact that the governance of world financial and commodity markets and the conduct of global monetary policy are critical issues in the struggle to build a fair, tolerable and sustainable world.

Adverse Developments in Labour Markets

The impact of globalization on inequality can also be seen through the lens of developments in labour markets across the world. Significantly, globalization has coincided with a decline in the employment-elasticity of output growth, that is, a given rate of economic growth now generates significantly fewer jobs than hitherto. At the same time wage inequalities between skilled and unskilled workers have also been widening in many developing countries. There is still no generally accepted explanation of why this has happened but all the explanations that have been advanced are linked to the phenomenon of growing globalization. They focus on the rise in wage inequality because this is clearly at odds with a central prediction of the theory of international trade. From the perspective of the employment-intensity of growth, it should be noted that a rise in the relative wages of skilled workers means that the demand for these workers has increased more rapidly than that for unskilled workers. This is equivalent to a relative decline in the demand for unskilled workers and hence the likely cause of the decline in the employment intensity of growth.

One explanation that has been advanced is that increasing competition for export markets pushes exporters to adopt more skill-intensive technologies. Similarly increasing pressure from imports forces import-competing firms to adopt a similar strategy to preserve their position in domestic markets. Increasing inflows of foreign investment has also been seen as a contributing factor since they tend to introduce more skill-intensive technologies. The production that is relocated to developing countries consist of the least skill-intensive jobs in the advanced countries yet such jobs are likely to be skill-intensive in the context of the developing country that now hosts them.

Another contributing factor has probably been the retreat of development planning in developing countries in the face of the growing sway of neo-liberal economic policies. Under the development planning framework an increase in the capacity of the economy to create productive jobs was usually an important explicit target. The employment impact of investment programmes and the promotion of particular industries informed policy-making. Thus issues such as the labour-intensity of different economic sectors and of the alternative techniques of production that could produce a given targeted output featured in the decision-making process. The upshot was that there was a conscious effort to ensure that public investment and industrial promotion policies, including the screening of Foreign Direct Investment proposals, maximised the employment-intensity of growth. Under a neo-liberal regime this concern for employment has been significantly attenuated. The new view is that the best way of dealing with the employment problem would be to liberalize markets, especially the labour market. Thus employment policy was reduced to the removal of labour market

regulations that were all believed to barriers to the flexible and efficient functioning of labour markets. More flexible markets supplemented by skill development policies to increase the 'employability' of the labour force were the best means of increasing the rate of employment creation. While not conclusive, the widespread decline in the employment-intensity of growth is a broad indication that neo-liberal policies have not so far delivered on the promise of increased employment growth.

It is also important to note that labour market deregulation that weakens workers rights also weakens the bargaining position of labour. This is especially important to avoid in the context of growing globalization where the bargaining position of employers is being strengthened through increasing capital mobility and the fact that production is now more footloose. These trends contribute to the adverse shift in the functional distribution of income that was discussed earlier.

Inequality and Poverty

In a developing country the degree of inequality also has a serious impact on the dire issue of absolute poverty. Poverty in low-income countries is far more than just an issue of relative deprivation. It means hunger, malnutrition, ill-health and morbidity, shortened life-expectancy, illiteracy, social exclusion and a constant struggle for bare survival. This is a gross violation of the most basic human right, that to life itself.

As pointed out earlier higher inequality, other things being equal, implies a higher level of poverty. Thus policies to reduce inequality in developing countries are an important instrument for the reduction of poverty. In spite of this there is no consensus that income redistribution should be the primary focus of economic policy. This is primarily because of the potential trade-off between growth and inequality. From a neo-liberal perspective redistribution would not be desirable since it is likely to reduce the growth potential of an economy. This is based on the belief that redistribution reduces economic efficiency because it blunts economic incentives (by reducing the rewards to entrepreneurship, innovation and effort) and distorts the optimal market-determined allocation of resources since it can only be achieved through the fiscal and regulatory interventions of the State. The key argument is that over a given time-horizon of say a decade higher growth can do more to reduce poverty if inequality remains constant or even increases when compared to the alternative of static redistribution that leads to economic stagnation or significantly lower growth. Thus the World Bank has argued that 'growth is good for the poor' based on the empirical claim that poverty reduction has been faster in countries that have experienced higher growth. Thus even if high growth is associated with growing inequality this is acceptable if the net result of both processes is a reduction of poverty.

This sanguine view has since been revised by the World Bank itself in its 2006 World Development Report entitled *Equity and Development*. This recognises that income inequality matters in its own right and is highly relevant to the overarching goal of poverty reduction. It couches this in terms of the need for greater equity which it defines as a state where 'individuals should have equal opportunities to pursue a life of their choosing and be spared from extreme deprivation in outcomes.' The underlying reasoning behind this position is that greater equity is 'doubly good for poverty reduction: through potential beneficial effects on aggregate long-run development and through greater opportunities for poorer groups within any society.'

Part of the reason for this change is the fact is that the empirical basis for the claim that growth is always good for the poor has turned out to be less robust than thought. New research began to show that the posited positive relationship between growth and poverty reduction based on cross-section regressions across countries merely described an average relationship around which there were significant dispersions. A recent study shows that in one sixth of the 285 the cases (consisting of different periods in different countries) used in the Dollar and Kray study proved to be such deviations. These were cases where growth did not reduce poverty or where poverty decreased without there being significant growth. The examination of these cases highlighted the central role that was played by redistributive policies. In several cases that included episodes in the Nordic countries as well as in developing countries such as Colombia, Peru and El Salvador poverty decreased by more than the predicted relationship between growth and poverty reduction because of strong redistributive policies. In the case of developing countries land reform was a prominent part of these policies. Conversely in cases where poverty either increased or decreased by less than the predicted relationship this was due to reversal or weakening of these same redistributive policies.

Other studies, including some from the World Bank itself, have shown that in countries with high levels of inequality poverty reduction responds more slowly to higher growth. Similarly the periods of highest growth were not necessarily the ones where poverty reduction was the greatest.

This suggests that growth alone is not sufficient for reducing poverty and that redistributive policies to change the distribution of income do matter. Moreover, redistributive policies, especially direct poverty reduction measures, can also be growth-enhancing. Unlike tax and transfer measures prevalent in the advanced countries poverty reduction measures such as providing the poor with increased access to productive assets and increasing the productivity of the assets they already have will generate higher growth. Properly designed and targeted measures such as land and tenancy reform, investing in irrigation and rural roads, public works for infrastructure development, and increased access of the poor to credit can all raise output and economic efficiency and productivity while simultaneously reducing income inequality and poverty. Similarly, providing the poor with increased access to health services and education are sound investments in human resources with a high pay-off in terms of both economic growth and improved life chances for the poor. With this type of production-oriented redistributive measures there is, contrary to the neo-liberal view, no trade-off between redistribution and growth.

It should also be noted that the inter-temporal rationale for growth as a means for poverty reduction also faces several objections. An important one is that given the acute human suffering that is associated with poverty in a developing country there is a strong moral imperative to alleviate it as fast as possible. Waiting for the benefits of growth to 'trickle down' indirectly to the poor seems callous from this perspective. Besides, there is a high degree of uncertainty as to the extent and the pace at which this would occur, if at all. In addition, there is the real possibility, as argued at the outset, that continued high inequality or rising inequality may itself prove to be inimical to sustained growth.

In view of all the reasons above one should be wary of reading too much into claims that growth is good for the poor or that inequality does not matter much. As noted earlier, high growth in recent decades has invariably been associated with rising inequality. Even though poverty may have been reduced in spite of this it remains true that this would have been faster without the rise in inequality. Moreover, the sustainability of

this path of poverty-reduction is constantly threatened by the growth-retarding effects of high inequality. An added consideration is the fact that high growth itself has proved to be an elusive target. As shown earlier in this report very, few countries have in fact been able to achieve high growth for a sustained period. There are thus strong grounds for considering alternative strategies to that of seeking to maximise growth through adopting neo-liberal policies that eschew all but the most minimal redistributive policies.

Redistributive policies

As stated earlier, even the World Bank has come round to the position that greater equity and redistributive policies to achieve this do matter. It must be noted, however, that this shift still remains a limited one since it is circumscribed by a narrow conception of the objectives and scope of redistributive policies. The objective of redistributive policies is to promote greater equality of opportunities but not of outcomes. This is based on the view that the many market failures that are to be found in developing countries, notably in the markets for credit, insurance, land, and human capital, are the main cause of the inequality of opportunities that lead to inequality of incomes. It thus maintains that 'correcting the market failures is the ideal response' although it also concedes that 'where this is not feasible, or far too costly, some forms of redistribution-of access to services, assets or political influence- can increase economic efficiency.' This concession is, however, also carefully circumscribed; note that the redistribution it refers to is a redistribution of 'access to' and not of what is to be distributed. Thus in the case of assets it is the 'access' to assets and not the assets themselves that should be redistributed. This has important implications for policy in an area such as land reform where it is clear from the report that what it has in mind is confined to tenancy reform and deregulation of land markets rather than expropriation or compulsory purchase of land to redistribute to the landless.

Critics of the report have pointed out that confining redistributive policies to only achieving greater equality of opportunities is too limiting. If outcomes in terms of the distribution of are the result only of fair process that allocate rewards in proportion to hard work and talent then it would be valid to focus only of making opportunities more equal. But this is clearly not the case in most developing countries. Similarly, the bad effects of inequality on poverty and growth flow from outcomes and not from opportunities. The practical significance of this is that options for redistributive policy should not be confined within the straitjacket of only dealing only with equalising opportunities. To accept the straitjacket would be to prioritize only market-based reforms and rule out other potentially effective tools for redistribution such as radical land reform, more progressive taxation systems, and a more pro-poor pattern of government expenditures.

Thus the position adopted here is that not only should we consider all possible redistributive policies on their own merit but that we should also place these options in the context of globalization and overall development strategies. As set out earlier income distribution and poverty reduction are as much the outcome of the choice of development strategy as of specific choices of how much and what type of redistribution a country chooses to adopt.

Given the importance of global economic forces in determining both growth and income inequality in developing countries it is clear than the reform of the governance of globalization in the wake of the current crisis has to give special attention to the

creation of a global economic environment that enhances the growth and poverty reduction prospect for developing countries. A reinstatement of the pre-crisis process of neo-liberal globalization will clearly not suffice. While increased access to developed country markets and FDI will remain important sources for growth in developing countries, this will have to be achieved within a new framework of global governance.

Key elements of this include the ensuring of greater stability in the international monetary system and in global commodity markets, stronger affirmative action to promote the development of the least developed countries, and the restoration of greater policy space and autonomy to developing countries. Greater stability is required in order to avert a replay of the scenario where developing countries have seen their development and poverty reduction efforts periodically being nullified by financial crises and extreme fluctuations in commodity prices, including that of food. Stronger affirmative for the least developed countries is required because they have been unable to compete with the small leading pack of developing countries that have captured most of the benefits generated by globalization thus far. Finally, greater policy space and autonomy is essential because the combined straightjacket of restrictive multilateral rules, neo-liberal policy conditionality, and global financial market discipline has clearly blocked the adoption of more promising paths to development.

In terms of development paths, the starting point is to draw the lesson that the default prescription of the international financial institutions that deeper economic liberalization is the optimal path has not worked. Several of the key countries that have benefitted from globalization such as China, India, and Vietnam have followed heterodox policies that involved controlled rather than all-out liberalization of trade and investment policies and of capital markets. These countries maintained a measure of import protection, adopted selective industrial promotion policies and retained controls over FDI flows and the capital account. Conversely, there are few examples of countries that have prospered through full-blooded liberalization.

The freedom to adopt policies to correct the many market failures that characterise a developing country is a prerequisite of an alternative development path. A key market failure relates to that which retards pioneering entrepreneurship directed at developing promising new lines of economic activity that are the engines of economic growth. This arises because the returns to the pioneers will be lowered by 'followers' who do not have to compensate them for the high risk they initially took in developing the new activity. This problem can only be overcome when the state adopts a strategic role in promoting new activities through some combination of measures such as subsidies, incentives, and public investments. This will be particularly important in cases where local producers are seeking entry into emerging global production markets, whether this is in manufacturing, modern services, or agriculture. In spite of the force of these arguments, present multilateral rules are increasingly encroaching on the autonomy of developing countries to promote new economic activities through such measures.

The need for a stronger role of the state is also critical for the successful implementation of redistributive policies. In the case of fiscal redistribution it is clear that this occurs only to a very limited extent in developing countries. In contrast to many industrialised countries where fiscal redistribution brings about a drop of the Gini ratio by 10 to 15 percent, in most developing countries this is at most a few percentage points. The main obstacle is the low tax base due to the fact that a large proportion of the population have low incomes and to the presence of a large informal sector that is outside the tax net. Nevertheless, it remains true that tax revenues are typically even below this structurally-

determined level for several reasons. One is the weakness of the tax administration and the consequent existence of widespread tax evasion and avoidance. Another is the presence of generous tax concessions. Yet another is the trend in the era of increasing globalization towards lowering rates of income and corporate taxation. This together with a parallel trend towards reliance on indirect taxes such as a value-added tax reduces the progressivity of the tax system. Given these facts there appears to be room to increase both the yield and the progressivity of the tax system through fiscal reforms such as tightening tax administration and resisting trends towards reducing the progressivity of the tax system.

Turning to the expenditure side, the picture is less bleak. An increasing number of countries are introducing transfer programmes targeted on the poor and some of these that have been on a large enough scale to have had a perceptible impact on poverty reduction. The impacts have been largest in cases where they have been well-designed. A key feature of good design is to ensure that a high proportion of the benefits actually reach the poor. This is a formidable challenge given the typical dearth of information on the economic profiles of households and individuals. Self-targeting of programmes have proved to be a viable way round this problem. This involves screening out potential non-needy claimants through devices such as setting a low wage in public works schemes or providing goods of the quality that is typically consumed by the poor in food distribution schemes. Another feature of good programme design is that public works programmes should be strongly focussed on the creation of local infrastructure since this will yield significant positive externalities for local communities where the programmes operate. The use of conditional cash transfer programmes to increase the consumption of merit goods such as basic education and health care has also proved to be a useful innovation. In addition to the growth of transfer programmes, the impact of donor preferences and the commitment to the MDGs is also directing more expenditure towards primary education and basic health service. Both these positive trends need to be reinforced.

Nevertheless significant problems remain. One is the continuing bias in public expenditures towards the urban modern sector. The urban bias in expenditures on education and health is a well known problem. Similarly, in many countries educational expenditures remain biased towards tertiary education and health expenditures towards curative needs of the better-off. Another common bias is that a high proportion of social expenditures is often taken up by the provision of pensions and other benefits for public sector and other workers in the modern sector. This problem is particularly acute in Latin America where it has been estimated that transfer payments amounted to 7.3 percent of GDP. Within this total 6.0 percent of GDP goes towards pensions and other social benefits that predominantly benefit workers in the modern sector. There is thus considerable scope for increasing the progressivity of the fiscal system through a reduction of current biases in the pattern of social expenditures.

The need for a stronger role of the state is also critical for the successful implementation of production-oriented redistributive measures targeted at the poor. As pointed out earlier such measures have a win-win character since they would be simultaneously growth-enhancing and poverty-reducing. The attention and resources devoted to such measures as increasing redistribution through the fiscal system, land and tenancy reform, investment in research to develop higher-yielding varieties of crops cultivated by poor farmers, investment in agriculture and rural infrastructure, and the expansion of

agricultural extension services and rural credit have diminished in the past two decades with the ascendancy of the neo-liberal policy agenda.

The primary target for production-oriented public expenditures should be agricultural and rural development since these have the greatest impact on poverty reduction. A central redistributive issue here is land reform. In countries with a high degree of inequality in land ownership and its concomitant of high landlessness, well-implemented redistributive land reforms can yield gains in terms of reduced poverty and inequality as well of increased output. The redistributive benefits of land reform will come not only from the increased asset base and incomes of the previously landless and marginal farmers but also from the ending of exploitation based on the market and non-market power previously enjoyed by landlords. In addition the more equal land ownership that will emerge will yield external benefits to local communities since cooperative communal projects to strengthen the local economy are now more likely to develop. Potential gains in production will also come from the well-known inverse relationship between farm size and productivity. Provided land reforms are accompanied by effective programs of support to small farmers these production gains can be very significant.

Despite the success of land reforms in Korea, Taiwan, and Japan in early post-war period and in several other countries since then, land reform largely disappeared from the national and international policy agenda since the 1980s. There has since been a revival of interest in the issue from the mid-1990s sparked by the emergence of land-based conflict in several countries such as Mexico, Zimbabwe, and Brazil as well as by the salience of the issue in the aftermath of the overthrow of dictatorships in the Philippines, Indonesia, South Africa, Bolivia, and Honduras.

Although it has reappeared on the policy agenda the substance of discussions of land reform has taken a very different form. In line with neo-liberal thinking the focus now is on market-based reform and no longer on the redistribution of land ownership. The key elements of the market-based approach include the following. Any transfers of ownership should be market-based ('willing seller, willing buyer'), ruling out expropriation or compulsory purchase. An overwhelming focus on increasing access to land through tenancy reform rather than through ownership. Some of these tenancy reforms include undoing the outcomes of previous land reforms through removing ceilings on land ownership and tenancy. A basic driving force is the promotion of capitalist agriculture. This is reflected in moves towards the privatization of communal land and the encouragement of large-scale farming spearheaded by multinationals. There has been surprisingly little debate on how this new approach compares to earlier approaches in terms of their potential benefits despite the obvious significance of this issue for redistributive policies. It would be timely and beneficial to open such a debate.

One of the key planks in the case for the new approach is that the globalization of agriculture is opening vast new opportunities for small farmers in the developing world. It is true that globalization has led to the growth global production chains for traditional export crops as well as a range of floricultural and horticultural products that have increased export opportunities for smallholders in developing countries. But this development does not obviate the need for a strong role of the state in increasing the capacity of small farmers to be able to respond to these new opportunities.

A basic consideration is that these emerging global production chains are dominated by large MNCs which enjoy considerable market power and this opens the possibility to unfair contracts with low returns and wages for the small farmers and workers involved. This creates a new responsibility for governments to monitor and regulate the terms on which poor farmers are incorporated in these production systems. In addition, some of these new export opportunities are in niche markets for high-quality specialist markets that are very demanding in terms of the standards of product quality that have to be met. This severely limits the number of developing countries that can find a foothold in these markets without extension and marketing services provided by the state. The growing dominance of MNCs in global agriculture is also shifting research priorities away from harnessing advances in biotechnology for the development of transgenic crops, with higher yields and better adapted to local ecological conditions, that could be of immense benefit to poor farmers. Instead attention has shifted to biotech applications that could raise profits in large-scale commercialized agriculture. At the same time publicly-funded programmes of crop research of the type that produced the green revolution have been declining at both the international and national level. It is clearly important from the standpoint of redistributive and poverty reduction policies these issues be faced seriously with a view to framing countervailing measures.

Employment and Poverty

Apart the core redistributive issues discussed above it would also be important to frame employment policies that would be supportive of the goals of reducing inequality and poverty. A key option for achieving growth that is more pro-poor is to raise the employment-intensity of growth. This is so because of the clear link between a higher rate of growth of productive employment and the reduction of poverty. Labour is the most important productive asset owned by the poor in many developing countries and hence the most important source of income for them. A process of employment-intensive growth in the dynamic new sectors, such as manufacturing, that typically spearhead growth would increase the aggregate opportunities for the poor to obtain a modern sector job. These jobs are more productive and pay more than the activities in peasant agriculture and the informal sector in which the poor are currently trapped. For a poor person, obtaining such a job would be a significant step out of poverty both for himself or herself as well as his or her dependents. The greater the scale on which this can happen, the greater would be impact of growth on the reduction of poverty. Through this process the generation of employment acts as a powerful instrument for the distribution of income to the poor and hence for poverty reduction.

Such a strategy would also make eminent economic sense. From a macroeconomic perspective unskilled labour is the most abundant factor of production in a developing country, so making maximum use of it is an efficient strategy to raise growth. While it is possible, as discussed in the early development economics literature on the choice of techniques in production, that a more capital-intensive strategy may yield higher growth under some circumstances, this is likely to be associated with growing inequality and less reduction in poverty. Given the weakness of mechanisms and policies for redistributing income in a developing country, the moral imperative of swift poverty reduction must trump whatever marginal growth advantage such a strategy might yield. It is also important to note that in the context of growing globalization, and hence of competitiveness and comparative advantage as a driver of growth, a labour-intensive growth strategy is also to be preferred on these grounds. As mentioned earlier such a strategy of labour-intensive growth, based on the rapid growth of the export of labour-

intensive manufactured goods, was the key factor behind the ability of the first Asian NICs to achieve high growth without increasing inequality and hence rapid poverty-reduction. .

The overarching objective of employment policy should be to bring about an upward shift in the demand curve for labour within a given range of targeted growth rates. The condition about growth rates is important because the goal should not be to simply maximise employment at any cost in terms of productivity and growth. Thus static strategies to distribute employment more widely such as unproductive ‘make-work’ schemes should be avoided. The essential point is that employment growth should always be productive and growth-enhancing. For any given growth target the most employment-intensive among the feasible options for achieving it should be chosen. In some cases the more employment-intensive path may entail some sacrifice in terms of growth but this option may still be desirable so long as the trade-off is not very steep.

The policy instruments for achieving an upward shift in the demand for labour consist of measures to influence the sectoral composition of new industries and the choice of technique to be used in them.. In practice this boils down to measures such as the use of project-evaluation techniques to screen investment proposals (both local and foreign), tax and other incentives to promote particular activities and the correction of distortions in relative prices than bias the choice of technique in a capital-intensive direction. While such policies have fallen out of favour in the neo-liberal era, it needs to be recalled that most developed countries and the Asian NICs used targeted policies to kick-start the process of industrialization.

Over and above this, economic policies including macroeconomic management must support the maintenance of a high level of demand for labour. For example, restrictive monetary policies that target low inflation rates reduce the growth of domestic demand, raise real interest rates and lead to an over-valued exchange rate. These are all harmful for growth and employment creation. High real interest rates restrict domestic investment and the access of small enterprises to credit while an over-valued exchange rate restricts the potential growth of exports. Therefore an alternative monetary framework may be essential for expanding domestic markets, maintaining a competitive exchange rate and improving access to credit for on affordable terms. Similarly, fiscal policies may need to be reoriented to support greater public investment that is essential for improving productivity in the private sector and ensuring access to markets. Macroeconomic policies should also facilitate the raising of the overall rate of real productive investment by maintaining a favourable investment climate.

The successful pursuit of such policies will generate both growth and an increase in the overall demand for labour, thus providing a favourable environment for the reduction of income inequality and poverty. But this in itself will not be sufficient because additional policies will be required to ensure that the poor are endowed with the necessary capabilities to take advantage of these new opportunities. In the case of wage employment the expansion of educational opportunities to the poor is of cardinal importance since many of the new jobs in manufacturing and services, although officially classified as ‘unskilled’, nowadays require a basic education that imparts literacy, numeracy and habits of discipline. Needless to say, there also require an adequate level of health. Many of the poor do not currently possess these attributes and are thus ruled out of the competition for the new jobs that will be generated unless remedial measures are implemented. Similarly barriers to mobility, including labour

market segmentation, which work against the poor need to be removed since they limit the impact of an employment-centred development strategy.

An employment-centred strategy will yield not only increased wage-employment but also potential opportunities for the poor who are self-employed in the informal sector to move into more productive and remunerative lines of activity as well as to expand and increase productivity in current activities. This potential cannot be realised fully without measures to ensure increased for informal sector producers to credit, productive assets, skills, and knowledge on production techniques and market potential. Specific infrastructure investment to support poor producers such as electrification schemes for residential areas that will enhance the productivity of home-based workers and the provision of production and marketing sites will also be important. In addition, measures such as the formation of producer and marketing cooperatives, the creation of marketing boards and introducing regulation to prevent exploitative sub-contracting arrangements with micro-enterprises and home –based workers can all help to improve the terms of trade faced by poor producers.