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## [Combating poverty and inequality] Income inequality and structural change

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# Income Inequality and Structural Change

Inequality is considered by some to be of little social concern. As long as poverty is minimized, it is argued, there should be no principled objection to the unbridled gains of the very rich. In some hands, this argument becomes one of active advocacy: that the concentration of wealth should be cultivated to generate savings, investment and growth.<sup>1</sup> Yet the fact that high levels of inequality are often found in the poorest countries exposes the weakness of this argument. Evidence suggests, in fact, a two-way causal relationship between poverty and inequality. There are additional important grounds for a concern with inequality. The international human rights framework commits governments to uphold equality in civil and political rights and to take steps progressively to achieve this. Furthermore, some notion of equity is central to the construction of socially inclusive states and the realization of substantive citizenship.<sup>2</sup>

*High levels of inequality are often found in the poorest countries, and evidence suggests a two-way causal relationship between poverty and inequality*

Easing inequality has, however, been marginal to the poverty reduction agenda of the international development community in recent years. Apart from a commitment to eliminate gender disparities in primary and secondary education, the Millennium Development Goals (MDGs) do not explicitly focus on inequalities, despite the affirmation of the principles of equality laid out in the Millennium Declaration. More recently, several reports<sup>3</sup> have underscored the intrinsic value of equality as well as its relevance for achieving growth and reducing poverty. But the view articulated in the World Bank's *World Development Report 2006*

emphasizes equality of *opportunities* as opposed to *outcomes*. This argument justifies unequal outcomes if the processes that generate them are “fair”,<sup>4</sup> and advocates interventions only to protect those who fall below an absolute threshold of need. Such a view results in a weak redistributive agenda that shies away from any serious consideration of wealth and income redistribution *now*, emphasizing instead investments in opportunities that might produce a more equitable *future*.<sup>5</sup>

This chapter examines the causes, patterns and dynamics of inequality, with a particular focus on inequalities of income and wealth, often referred to as vertical inequalities. Inequalities among groups (horizontal inequalities) or based on factors that determine identity, such as ethnicity and gender, will be dealt with in chapters 3 and 4. In this and subsequent chapters, emphasis is placed on both the *intrinsic* and *instrumental* value of redistributive policies and processes that lead to equitable outcomes.

Based on extensive analysis of country case studies, the chapter demonstrates that increases in inequality are linked to a range of economic policies that have dominated the development agenda in recent decades. These include financial liberalization, regressive taxation, privatization in the context of weak regulation, public expenditure policies that fail to protect the poor during crisis or adjustment periods, and labour market policies that lead to precarious forms of flexibility, informalization and an erosion of minimum wages and union bargaining power.<sup>6</sup> Other causes of rising inequality include disparities in educational attainment, technological change and employment policies that widen wage gaps between skilled and unskilled workers; rural-urban wage differentials in the process of structural change; inequality in asset ownership (including land); and unequal access to credit and basic production inputs, particularly in the agricultural sector.

*Increases in inequality are linked to a range of economic policies that have dominated the development agenda in recent decades*

Chapter 1 has argued that the overall structure of employment, and the distribution of employment across sectors, has significant implications for the well-being of a population and for poverty reduction. Continuing this line of reasoning, this chapter discusses the importance of structural change, changing global intersectoral terms of trade and macroeconomic policies for the evolution of inequality. It argues that despite the importance of structural change in determining levels of inequality, there is no single pattern that holds for all countries across time. Instead, as the case studies illustrate, (i) redistributive policies can moderate inequalities even at early stages of industrialization, and (ii) rapidly industrializing economies with a previously egalitarian income distribution may experience rising inequalities in the absence of corrective measures. Furthermore, (iii) most low-income agrarian societies that have not yet experienced sustained growth and industrialization, and whose public policies lack a redistributive focus, generally have high levels of inequality; and (iv) the growing dominance of the financial and technological sectors in national economies, especially in contexts where economic policies favour market liberalization and less redistribution, increases inequality.

This chapter also shows that structural change – in terms of the changing roles of agriculture, industry and services in an economy – and the global terms of trade among these sectors are closely related. In the short run, global terms of trade have a direct effect on inequality in a liberalized economy. For instance, a fall in global commodity prices tends to drive up inequality in agrarian economies by lowering the relative incomes of commodity producers. A technology bubble raises incomes at the top. High interest rates are, in general, bad for debtors and good for creditors; they thus raise inequality since the latter are almost invariably richer than the former. This underscores the importance of

global governance of financial and commodity markets and the management of global monetary policy.

Reducing inequality has value in its own right, and also yields substantial benefits in terms of both poverty reduction and growth. There are a number of mutually supportive redistributive policies that governments can adopt, including:

- land reform, especially in highly unequal economies where the poor depend substantially on land for their livelihoods;
- fiscal reforms that improve tax administration, prevent tax evasion and avoidance, and limit opposition to progressive taxation and redistribution (see also chapters 8 and 10);
- income-generating employment opportunities (as discussed in chapter 1); and
- expenditure-related policies that enhance the welfare of the poor (such as the range of social policies discussed in Section two of this report).

*Reducing inequality has value in its own right and also yields benefits in terms of both poverty reduction and growth*

In sum, four key messages are highlighted in this chapter.

- Income inequality is on the rise, partly as a result of neoliberal economic policies adopted in the 1980s and 1990s.
- Growth and equity can be mutually reinforcing, but only when supported by well-thought-out economic and social policies. Such policies should pay particular attention to the needs of small farmers.
- Successful implementation of redistributive policies calls for a stronger state role.
- Global forces are now a major factor in the movement of inequality within and between countries, and should be managed more deliberately to avoid negative repercussions for the poorest countries.

The chapter is organized as follows.

Section 1 discusses why inequality matters in the fight against poverty.

Section 2 reviews the evidence for trends in inequality globally.

Section 3 examines the links between structural change and global intersectoral terms of trade in contributing to inequality. It also discusses how both domestic structural change and external forces affect inequality in a number of countries representing different patterns and stages of development.

Section 4 concludes with a discussion of redistributive policies that governments can adopt to create wealthier, more equitable societies.

## 1. Income Equality and Poverty Reduction

As noted above, equity has intrinsic value and is central to the achievement of human rights and citizenship. One dimension of inequality – related to income and wealth – is closely linked to poverty. At the most basic level, the distribution of income within a country has a direct impact on the welfare of its people. A more equal distribution of national income means that aggregate welfare (where the welfare of each individual is given equal weight) is higher for any given level of average per capita income, and poverty is lower.

*While greater equality is often considered to come at the expense of growth, lower inequality can contribute to greater economic efficiency*

While greater equality is often considered to come at the expense of growth, there is also evidence that under some circumstances, and with appropriate institutional arrangements, lower inequality can contribute to greater economic efficiency. The development of the Scandinavian countries is illustrative here. Through a process known as the Meidner-Rehn mechanism,<sup>7</sup> political commitment to egalitarian economic outcomes constrained business from competing on the basis of wage costs, which were consequently higher than those of their international competitors. Companies were therefore forced to raise labour productivity in order to stay competitive.<sup>8</sup> This policy preceded the advance of the region from the middle to the top of the European (and world) income scales. A similar effect was seen in the United States during the New Deal of the 1930s and the golden age of economic growth. For the European region as a whole, there is evidence that countries with lower inequality have better employment performance.<sup>9</sup> In other words, business can absorb technological change at a faster pace in societies that systematically reduce disparities in pay structures, encouraging an increase in productivity and raising per capita incomes faster than the global average.

### High levels of inequality inhibit development

At the same time, a growing body of evidence points to the negative relationship between high levels of inequality (often considered to be a Gini coefficient more than 0.4) and improvements in economic and social well-being.<sup>10</sup> High levels of income inequality are dysfunctional for development for a number of reasons.<sup>11</sup>

- First, high levels of inequality make it harder to reduce poverty through growth. With high levels of inequality, growth tends to be concentrated in certain sectors, with those who are not linked to these growth sectors being excluded from the benefits. Such exclusion, in turn, lowers the potential for growth, particularly in a context of poverty, by constraining the productive capacity of the poor and thus their potential contribution to growth. Under such circumstances, a large proportion of the workforce (the poor) have

limited productive capacities for reasons that include inadequate nutrition and ill health, low levels of education or skills, a lack of employment opportunities or limited access to productive assets, such as land and credit. Furthermore, the economic exclusion of a significant proportion of the population contributes to their social and political exclusion through processes of disempowerment and lack of recognition or representation.

- Second, high levels of inequality can also retard growth by translating into lower effective aggregate demand in the economy. In highly unequal societies, the poor are more likely to be locked into a subsistence economy and have limited disposable income for the purchase of manufactured goods. This limits the size of the domestic market and hinders the potential for industrialization that is an important driver of growth.
- Third, high levels of inequality have negative implications for the building of inclusive states that have the capacity to implement redistributive and progressive economic and social policies. High levels of inequality may also undermine the realization of civil, political, economic and social rights, and the exercise of substantive citizenship. Inequality is often a factor in rising levels of crime and social unrest, which are inimical to growth. In extreme cases, especially where inequality is manifested along ethnic lines, it can lead to war and the failure of the state (see chapter 3).
- Fourth, without deliberate policy interventions, high levels of inequality tend to be self-perpetuating. They lead to the development of political and economic institutions that work to maintain the political, economic and social privileges of the elite. In highly unequal societies, the poor have little political influence; in the absence of meaningful representation to change underlying structures that perpetuate inequalities, they may become locked into poverty traps from which it is difficult to escape.
- Finally, even under conditions of rapid growth, inequality is likely to be reinforced by the distribution of the externalities of growth. For example, the poor are most likely to bear directly the burden of environmental degradation arising from rapid

industrialization. Only when the fruits of growth are distributed equitably – either directly as income or socially through the provision of infrastructure and other public goods – is the statistical fact of a rising gross domestic product (GDP) experienced as an improvement in overall living conditions and well-being.

*Only when the fruits of growth are distributed equitably is the statistical fact of a rising GDP experienced as an improvement in well-being*

## 2. Global Trends in Inequality

### The global income gap remains daunting

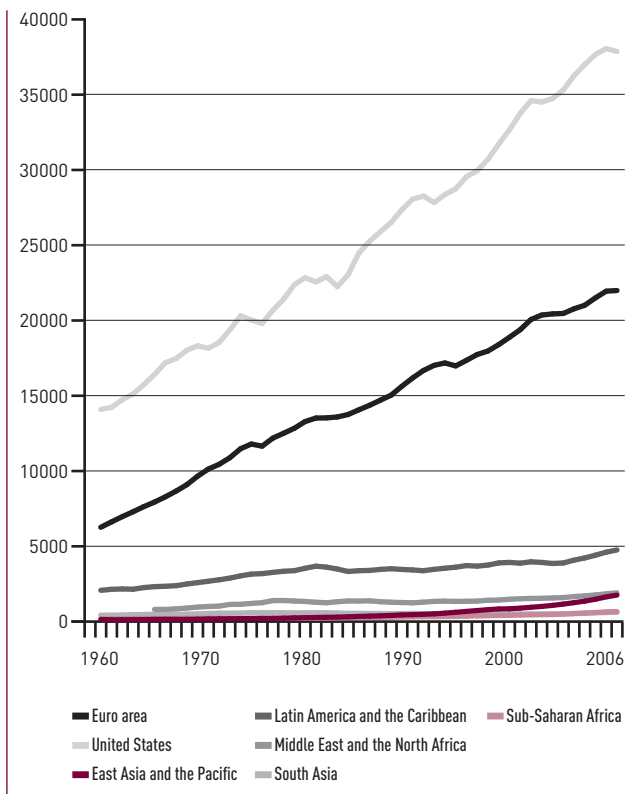
Economic growth is important in facilitating structural change that is poverty reducing.<sup>12</sup> An assessment of the per capita incomes of major regions and countries from 1960–2006 illustrates the persistence of the global income gap and how little real and sustained economic growth has occurred for most developing economies, in terms of substantially improved per capita GDP. Although most countries in the developing world experienced episodes of growth during this period,<sup>13</sup> that growth has not been sustained in most cases. Nor has it generated decent jobs. The income gap (in terms of per capita GDP) between rich and poor countries has not lessened.<sup>14</sup> Figure 2.1 provides evidence on real per capita incomes (in constant 2000 US dollars) across some major country groupings for 1960–2006, illustrating the persistently large income gap between rich and poor countries. Indeed, the differences in per capita incomes in 1960 were so large that even quite rapid growth in some regions over the subsequent four and half decades has not made the gap more respectable.

Thus, while the per capita income of the fastest growing developing region – East Asia – increased more than tenfold over this period (compared to an increase of less than threefold for the United States), in 2006, the average income in the United States was still 15 times that of East Asia. For other developing regions, per capita income gaps were even larger and are, in some cases, growing. Thus, the per capita GDP in 1960 of countries currently in the euro zone was 34 times that of South Asia; by 2006, this had increased slightly to 36 times. For sub-Saharan Africa, the widening gap is much starker. In 1960, the per capita income of countries now in the euro zone area was 15 times that of sub-Saharan Africa; by 2006, the difference was 38-fold.

### Income inequality has increased in the majority of countries around the world

Countries vary widely in the nature of their income distribution. The Gini coefficient – the most commonly used measure of income inequality – ranges from 0.20 in Slovakia to 0.74 in Namibia,<sup>15</sup> on a scale where 0 represents perfect equality and 1 represents total inequality. In general, the variance in income inequality among developing countries is much higher than that among rich countries. Countries with per capita incomes of \$20,000 or more have coefficients within the range of 0.25–0.45,<sup>16</sup> whereas for many low-income countries they are more than 0.50. High inequality is thus a feature of underdevelopment.

**FIGURE 2.1: Per capita income in 2000 US dollars**



Source: Calculated from World Bank World Development Indicators online.

*Most developing countries experienced little real and sustained economic growth, in terms of substantially improved per capita GDP, over the past 45 years*

In many developing countries, extreme inequalities are driven by highly skewed distribution in the ownership of land. A high level of inequality (see table 2.1), such as that found in many Latin American countries, is difficult to transform without radical land reform. Conversely, more egalitarian land distribution creates a strong base for maintaining lower levels of inequality in the process of development. The initial structure of an economy – whether based on capital-intensive extractive industries or labour-intensive manufacturing, for example – also affects the level of income inequality likely to be found as well as the ease with which policies for income redistribution can be implemented.

TABLE 2.1: Landholding patterns in selected countries and regions

Country	Year	Distribution of landholding by percentile groups of agricultural households					Landless population as % of rural population (1988)	
		Lowest 20%	Second 20%	Third 20%	Fourth 20%	Highest 20%		
<b>South America</b>								
Bolivia	1978	5.8	5.8	5.8	9.3	73.3	10	
Ecuador	1987	1.0	1.6	4.2	9.6	83.6	23	
Peru	1984	3.3	3.3	3.3	17.1	73.0	19	
<b>Central America and the Caribbean</b>								
El Salvador	1985	5.1	5.1	5.1	10.6	74.1	41	
Guatemala	1979	0.8	1.6	3.3	4.2	90.1	21	
Honduras	1980–81	2.9	2.9	3.8	11.4	79.0	26	
<b>South Asia</b>								
Bangladesh	1983–84	2.3	5.4	12.5	23.6	56.2	20	
India	1976–77	4.1	4.1	6.3	20.3	65.2	30	
Nepal	1982	2.6	2.6	7.7	19.8	67.3	18	
<b>Southeast Asia and the Pacific</b>								
Indonesia	1976–77	3.0	6.2	11.3	24.0	55.5	15	
Thailand	1978	4.0	8.3	16.3	24.2	47.2	15	
Philippines	1981	3.2	8.1	11.6	20.4	56.7	34	
<b>Near East</b>								
Egypt	1984	11.2	11.2	11.2	11.2	55.2	25	
Morocco	1981–82	6.8	6.8	6.8	21.6	58.0	15	
<b>West and Central Africa</b>								
Cameroon	1984	3.6	9.3	15.0	21.6	50.5		
Ghana	1984	7.8	8.7	7.8	18.6	58.0		
<b>Southern Africa</b>								
Mozambique	1998	Smallholders accounted for 95% of cultivated land, with the remaining 5% occupied by state farms, cooperatives, private farms and joint ventures						
South Africa	1994	Smallholders held 13% of the land area, with 67,000 commercial farmers owning 86% of the agricultural land						
Zimbabwe	1993	One million smallholders in communal lands owned 50% of agricultural land; 13,335 large and medium commercial farms controlled 37% of the best agricultural land						

Source: Ghimire 2001.

The development experience of the first wave of East Asian states demonstrates that rising inequality in the early stages of development is not inevitable. In the case of the Republic of Korea and Taiwan Province of China, radical land reforms that preceded industrialization, the use of labour-intensive technologies during the early stages of industrialization, and investments in human capital that helped balance out opportunities available in urban and rural settings and across income groups were important factors in preventing the growth of inequality. High levels of growth without rising inequality were also seen in Singapore and Hong Kong, China, both city-states where agriculture was insignificant but where governments implemented basic social (particularly housing) policies to support the growth process.

*Over the past two decades of economic liberalization, it has been much harder for countries to achieve high growth rates without increases in inequality*

Over the past two decades of economic liberalization, it has been much harder for countries to achieve high growth rates without increases in inequality. Recent studies point to the fact that inequality has increased in the majority of countries throughout the world. One recent study<sup>17</sup> found that income inequality increased in 30 out of a sample of 49 countries between the 1990s and the 2000s. It remained unchanged in six countries and in only 13 countries did it decrease. A similar result has been presented in a recent study by the International Labour Organization (ILO). 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”.<sup>18</sup> 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 studied, patterns of change tend to vary by region. In Asia, inequality decreased in only

two out of eight countries. Significantly, India and China were among the countries that experienced an increase in inequality. In Latin America, inequality declined in six out of 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 though inequality decreased in these regions, the resulting level of inequality remained high (a Gini coefficient of more than 0.40) in most of the countries studied.

### **The gap is growing between wage earners and those who derive their income from profits**

A broad pattern of growing income inequality under economic liberalization, reflected in rising Gini coefficients, is supported by data on other dimensions of inequality. An important indicator in this regard is the functional distribution of income – that is, the distribution of income between wages (income from labour) and profits (income from capital). This provides a general indication of how well wage earners are faring relative to employers and others who derive their income from the ownership of capital, such as productive equipment and financial assets. Typically, industrialized countries have only a small sector of self-employed producers, and the bulk of total income derives from either wages or profits. As a result, the share of wages in GDP is closely correlated with changes in overall income inequality as determined by a summary measure such as the Gini coefficient. Thus a rise in the share of wages in GDP is likely to mean a reduction in overall inequality, since wage earners tend to be at the lower end of 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 the increased bargaining strength of workers.

In developing countries, the picture is less clear-cut, since there is often a large informal sector consisting of self-employed petty producers or service-providers whose meagre incomes place them at the bottom of the income

scale. Yet their incomes are usually recorded in national statistics as profit or a return on the assets used to engage in economic survival activities. In this context, there is no simple interpretation of what a change in the share of wages in GDP means in terms of 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 countries with high levels of informality, an analysis of the change in the wage shares that is confined to only the formal sector of the economy can provide useful information on trends in inequality. A change in wage shares within the formal sector can be interpreted in the same way as an overall change in the wage share of advanced economies. For instance, a decline in the wage share in the manufacturing sector of a developing country does tell us that the bargaining strength of workers is weakening, either because of an excess supply of labour relative to demand, the strengthened power of employers due to increased exit options as a result of globalization, or the suppression of labour unions or collective bargaining mechanisms.

*Between 1980 and 2000, the average wage share of national income fell by 10 points in the euro zone, a clear sign of redistribution from labour to capital*

A study commissioned by UNRISD,<sup>19</sup> based on panel data for 25 member countries of the Organisation for Economic Co-operation and Development (OECD) over the period 1973–2003, found that the wage share of national income fell or remained constant in 23 cases. These falls were quite large in some cases. Between 1980 and 2000, the average labour share fell by 10 points in the euro zone<sup>20</sup> – one of the largest decreases and a clear sign of redistribution

from labour to capital. The study also found evidence of a strong and persistent 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 appears to have been at work in some developing countries. Bearing in mind the difficulties 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.<sup>21</sup> The study, which covered 29 advanced, 33 developing and 11 transition economies, concluded that three-quarters of them witnessed a decline in the wage share of national income. The fastest decrease – of more than 13 per cent – was found in Latin America. The advanced economies and Asia also experienced significant declines. Wage shares fell in Asia by over nine percentage points during the period 1985–2002, and by the same amount in advanced economies over the period 1980–2005.

### **3. Inequality, Structural Change and Global Intersectoral Terms of Trade**

How should these changing patterns of inequality among and within countries in a globalized economy be explained? Is there a common global pattern and, if so, what does this tell us about global economic governance? To answer these questions, this section examines global, regional and national datasets on economic inequality developed by the University of Texas Inequality Project.<sup>22</sup> These datasets are a unique resource, providing consistent and reliable measures of pay inequality for a large number of countries from the early 1960s to the early years of the twenty-first century. These measures suggest certain broad patterns and relationships between economic inequality and structural change (see box 2.1).

**BOX 2.1: A methodology for measuring income inequality**

The measures of inequality derived from the University of Texas Inequality Project (UTIP) can be applied to many sources of data and do not require recourse to micro-level datasets derived from sample surveys. The resulting measures are often comparable both through time and across countries.<sup>a</sup> The method is summarized in Conceição et al. (2001) and is based on the work of Theil (1972), who argued that an inequality measure computed from grouped data provides a consistent lower-bound estimate of inequality for the entire population. Relatively coarse disaggregation is sufficient to capture the major movements of inequality in the whole distribution.

Income distributions are approximate statistical fractals (that is, they produce similar patterns at different scales and from different points of observation), so that observation of the entire distribution, or even of a statistically representative portion of it, is not necessary in order to observe change with reasonable accuracy most of the time. All that is required is to observe an important part of the distribution (say, the manufacturing sector) on a consistent basis over time. Since this part is linked organically to other parts that may not be observed, such as agriculture and services, movements in the observed part are usually – but not always – representative of movements in the shape of the entire distribution. Changes in the structure of incomes often occur because of changes in the relative positions of major industrial groupings (a rise of industry over agriculture, for instance, or of finance over industry) or in the relative position of different geographic areas, differentially affected by demographic change, climate or war. Thus, after a certain point, further disaggregation adds little useful information.

The inequality measures developed by the UTIP are also broadly consistent with conventional, survey-based income inequality measures, or can be made so by statistical adjustment after allowing for conceptual differences between pay and income and for the many different kinds of inequality that are reported in the survey-based literature (for example, income, expenditure, gross or net of tax, household or personal).<sup>b</sup> The dataset on which the UTIP measures are based covers more than a hundred countries over three or four decades. Measures of inequality may also be calculated both within and among regions inside many countries. In some countries, inequality measures can be computed on a monthly basis.

However, it is important to note that the UTIP approach has its limitations. Of these, perhaps the most important is that the work is statistical and comparative; it cannot be substituted for detailed case-by-case analysis. The UTIP data are also largely focused on pay, aggregated by sector and region. Pay is associated with jobs, not with households, and the datasets lack information on the characteristics of the workers or their families. For this reason, the UTIP studies are not well suited to an analysis of the social welfare consequences of political and economic change, nor of the effects of such change on gender or ethnicity, except where these attributes are associated with the distribution of jobs. Finally, the data are entirely pretransfer, and shed no light on the post-transfer distribution of income. However, transfer payments are very limited outside of the OECD region. Within that region, the scale of transfers is closely correlated with the equality or inequality of pay structures, so that the inequality rankings found in the UTIP data would not change much if post-transfer income were included.

Notes:<sup>a</sup> Galbraith and Kum 2005, 2003. <sup>b</sup> Galbraith and Kum 2005, 2003. Source: Galbraith 2008.

## Early development thinking held that inequality rose in the early stages of development, and then declined

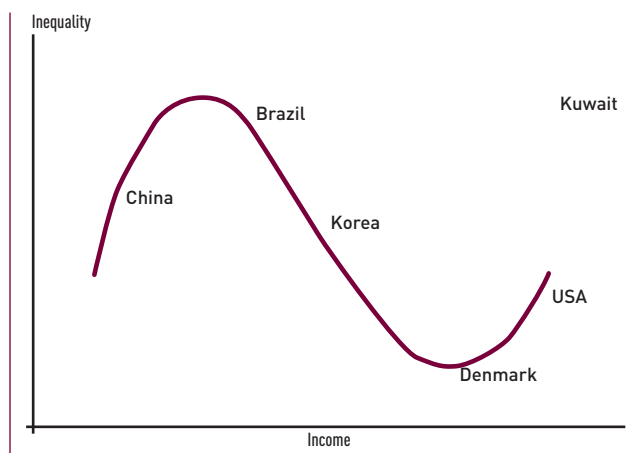
An important strand of early development thinking held that an inverted-U shaped curve described the relationship between the level of development and the degree of inequality in the distribution of income. The Kuznets curve<sup>23</sup> summarized a process whereby inequality increased in the initial stages of development but then reversed itself as development proceeded. Kuznets identified the transition from agriculture to industry as the prime mover of a process of increasing inequality in the early stages of economic development, simply because towns and cities are always richer on average than the countryside around them. However, as economic development matured, the weight of agriculture in the whole economy would shrink, and ultimately urban phenomena would come to dominate the evolution of inequality. At that point, Kuznets argued, the dynamics of factory life, including the rise of labour unions and democratic politics, would cause inequality to decline.

The Kuznets curve describes a process of structural change (or intersectoral transition) specific to the history of economic development in the United States, the United Kingdom, much of Europe, and Japan. The process has been repeated elsewhere – but not everywhere. In mineral-rich countries dominated by extractive industries, or in post-industrial societies dominated by services such as technology and finance, different patterns would be expected. Kuznets' enduring message is not that a single curve should be found in the history of all countries in all periods, but that the essence of understanding inequality lies in understanding the intersectoral transitions, or structural changes, that produce it.

Figure 2.2 shows an augmented Kuznets curve,<sup>24</sup> which suggests that for large agrarian societies in the process of industrialization, of which China is the leading example today, the rural-to-urban transition still drives the rise in inequality. In only a few other industrializing countries does the agrarian population remain sufficiently large for the intersectoral transition out of agriculture to dominate

the picture; most developing countries, especially outside Africa, are over the hump of the inverted-U (if the hump exists) and on the downward-sloping portion of the curve.

**FIGURE 2.2: Stylized augmented Kuznets curve**



Source: Galbraith 2008.

Among the highest income countries, notably the United States, the United Kingdom and Japan, a different dynamic takes over.<sup>25</sup> The most advanced economies have procyclical movements of inequality, because their highest income sectors, services in technology and finance, enjoy their greatest income growth in boom times, whether driven by domestic investment or by exports. This is also true of small economies dominated by services such as finance and real estate, of which Hong Kong, China is a prominent modern example. Meanwhile, the world is speckled with mono-line producers (that is, countries dependent on a single commodity, such as oil) where distribution is driven by the peculiar characteristics of an extractive economy. They are characterized by high per capita income, a low-wage (often immigrant) manual workforce and high inequality.

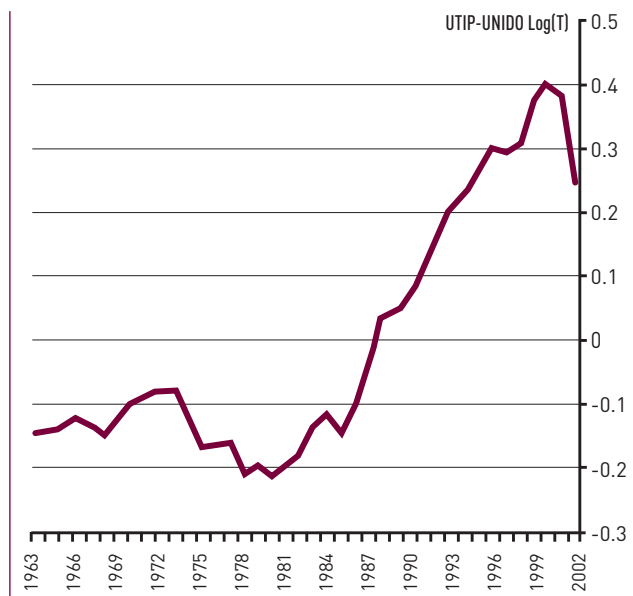
## Global intersectoral terms of trade are a key determinant of inequality

Intersectoral transitions (structural changes between agriculture, industry and services) within countries, and the global

terms of trade between these sectors, are closely connected. We would therefore expect global intersectoral terms of trade to influence inequality within countries, even in the absence of significant structural change. Thus, a boom in commodity prices will tend to reduce inequality in a country with an important agricultural sector, simply because it tends to raise the relative income of farmers; whereas a fall in commodity prices will depress incomes in such a country. A cartel action to increase the price of oil gives producers resources to redistribute or invest (for example, into construction); meanwhile, it may raise the cost of production and consumption in other countries, increasing unemployment among industrial workers and squeezing the incomes of the middle classes in wealthier countries.

In a world of globalized financial and commodities markets, these effects will be global: they should show up everywhere (or almost everywhere) at once, and they do.<sup>26</sup> From the early 1960s onwards, patterns in the expansion or contraction in the level of inequality have tended to be found during the same time period within countries around the world. These patterns have four phases, as illustrated in figure 2.3.

**FIGURE 2.3: Global patterns of inequality over time, 1963–2002**



Source: Kum 2008.

### Four phases of inequality

The first phase, which occurred from the first observed year (1963) until around 1971, was a period of relative stability, with no common movement in the measures of inequality.

The second phase, from 1972 until around 1980, was a period of moderate decline in inequality in much of the world. 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 bank lending at negative real interest rates.

The third phase is one of sharply rising inequality, beginning around 1982 and continuing to the end of the century. It was associated with the calamity of the global debt crisis, initially most severe in Latin America and Africa, followed by the collapse of communist governments in Central and Eastern Europe, and finally by a wave of deregulation and liberalization in Asia in the 1990s. The specific experience of countries and regions varies, but they share several common characteristics: collapsing imports; a shrinking fiscal base and therefore public sector retrenchment; trade liberalization; de-industrialization; and the simultaneous decline of both the civil service and the industrial working class. Globalization eventually brought financial investment to some countries, stimulating the rise of new sectors – most notably real estate, insurance and banking – accompanied by global pay scales and a rise in speculation. The overall pattern almost exactly resembles that found in another major study<sup>27</sup> that examined inequality among countries, unweighted by population. This should not come as a surprise: events that increase the gap between rich and poor people within countries should also, in principle, broaden the gap between rich and poor countries, since the latter are just unbalanced collections of the former.

The pattern has exceptions. India and China, for example, avoided the global rise in inequality in the 1980s, arguably because they had not liberalized their financial markets, and were therefore relatively unaffected by the debt crisis. While inequality in China had started to rise from low levels during the 1980s, the sharp and problematic rise in inequality dates from the crisis of 1989. In India, the rise in

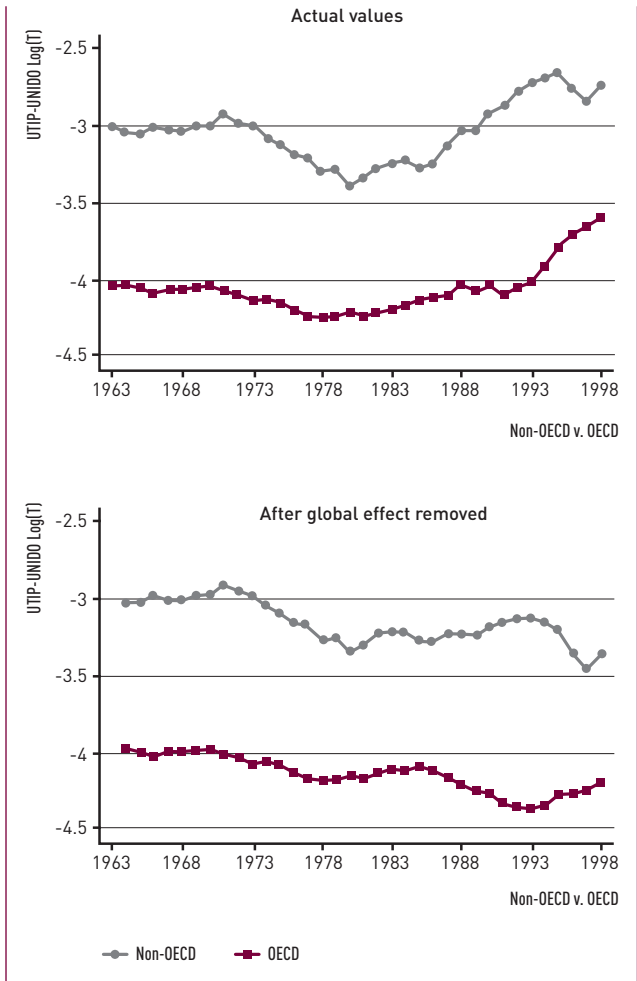
inequality started with the liberalization reforms of 1992.<sup>28</sup> These exceptions help to confirm the hypothesis that a major driver in the movement of inequality in the age of globalization is not idiosyncratic national policy or even structural change within countries, but global forces affecting intersectoral terms of trade.

The fourth phase, beginning in 2001, is again one of declining inequality. It coincides with the marked relaxation of credit conditions that followed the attacks of 11 September 2001 in the United States and a repudiation of the Washington consensus policies (the reform package promoted by Washington, DC-based institutions such as the International Monetary Fund/IMF, the World Bank and the United States Treasury Department) associated with adverse growth and social development in many countries. These changes appear to have permitted both higher growth and some abatement of the extreme increases in inequality that had afflicted the developing world for the previous 20 years. The commodities boom during this period also benefited low-income agrarian countries. The dramatic onset of the global economic crisis in 2008 has undoubtedly brought an abrupt end to this brief period of declining inequality. Low-income agrarian economies now face sharply reduced growth, a contraction of output, rising unemployment and a renewed rise in poverty.

**Most low-income agrarian economies are highly unequal**

If the global element in rising inequality in the 1980s and 1990s had not existed, there would have been no increase in economic inequality on average around the world. Indeed, given the Kuznets forces affecting inequality in the process of economic development, inequality in most countries and on average would have declined. Figure 2.4 illustrates this calculation, separating out member countries of the OECD and non-OECD countries to show how global forces affect each group. The figure also illustrates a core fact: high-income industrialized countries enjoy markedly more equality, on average, than low-income developing countries.

**FIGURE 2.4: Inequality within countries, with and without the global effect**



Source: Galbraith and Kum 2003.

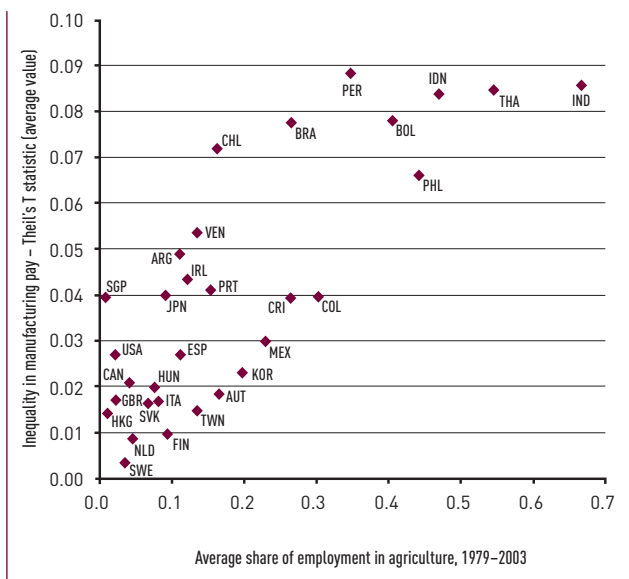
The high inequality of most low-income agrarian societies may be puzzling. However, particularly in the tropics, agricultural arrangements are frequently descended directly from feudal land tenure systems or from slavery. Such arrangements differ from the historical cases examined by Kuznets, such as the United Kingdom and nineteenth-century North America, or from the East Asian economies after land reform, where small freeholders predominated. Except in some parts of Africa, low-income agrarian economies with egalitarian income structures are rare, and in the past century have tended to emerge only after violent

revolution, as in China (1949), Cuba (1959) and Viet Nam. Even in these countries, however, inequality is rising (albeit from very low levels) with more liberal economic reforms.

*High-income industrialized countries enjoy markedly more equality, on average, than low-income developing countries*

Without these countries, it is doubtful whether the inverted-U shaped curve would have a low-income upward-sloping component at all in recent decades. Figure 2.5 illustrates the relationship between the share of agriculture in total employment and inequality in manufacturing pay for a selection of developed and developing countries. The positive relationship is strong and consistent: the higher the population in agriculture, the higher the level of inequality.

**FIGURE 2.5: Inequality in manufacturing pay and the share of agriculture in employment in selected countries, 1979–2003**



Source: Galbraith 2008, from data in Kum (2008).

### Global forces now shape the movement of inequality within countries

Taken together, the issues outlined above paint a complex picture, yet one with regular features. For any given country, the movement of inequality can be said to depend on three factors:

- the position of the country on an augmented Kuznets curve, reflecting previous processes of structural change;
- the current process of structural change and growth in income; and
- the country's integration into the global economy, and thus the external impact of changes in intersectoral terms of trade.

In sum, in most cases, structural change in the process of economic development tends to reduce inequality. Exceptions exist, two of which are:

- low-income post-revolutionary agrarian societies in the process of urbanization, industrialization and transition to market capitalism; and
- high-income post-industrial societies as they move towards economies dominated by services in technology and finance.

Likewise, crises and shocks that periodically disrupt the processes of economic development tend to raise inequality. Structural change in the process of economic development is relatively slow, whereas the impact of shock and crisis is rapid and highly visible in the data (although such events have been relatively rare to date, at least at a global level).

For this reason, changes in relative prices (or the terms of trade) between sectors tend to dominate the actual movement of economic inequality. Commodity booms generally benefit lower income developing countries, while financial bubbles and interest rate shocks generally benefit high-income groups within financialized economies, at least in relative terms. Since oil and grain prices and interest rates are set in global markets, it is not surprising that the movement of economic inequality should now be largely a common global phenomenon, operating in much the same way (though certainly not symmetrically) in most of the world.

### How structural change and global forces affect inequality: Country examples

Based on the arguments and framework developed above, the remainder of this section highlights key features of the development experience of a number of countries. These cases illustrate the relationship between different stages and patterns of structural change, exposure to external economic forces and inequality.

#### Rapid industrialization: The case of China

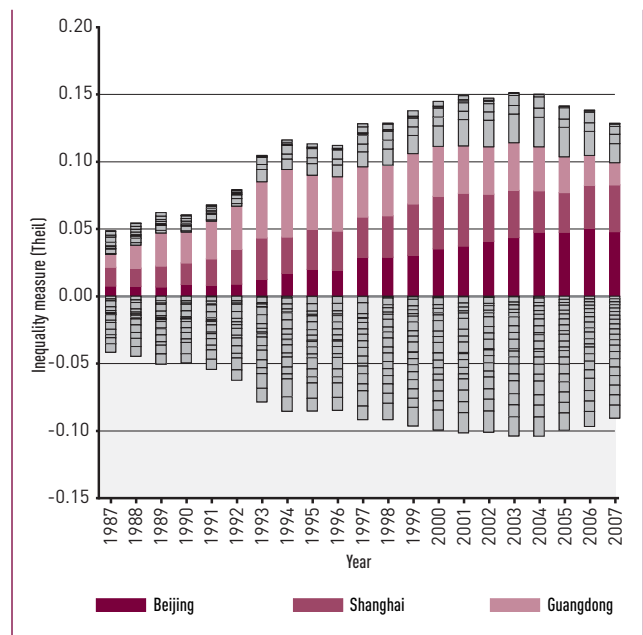
China provides a classic example of the evolution of inequality dominated by internal structural change, at least until very recently. In the 1980s and 1990s, the country was largely insulated from external relative price changes. Although it is now well integrated into international food and fuel markets, it still enjoys an internal price level for most labour-intensive wage goods, such as food, clothing and housing, that is far lower than the external prices of these goods. Rapid growth starting from the point of an agrarian economy that had undergone major reforms after the egalitarian practices of communism implied rising inequality, accelerated by urbanization as growing urban-rural differentials prompted greater migration from the countryside into the cities. This dynamic constitutes China’s greatest social challenge, and authorities are locked in an ongoing effort to balance control over internal migration with a construction programme sufficiently vast to accommodate the urban inflows that cannot be prevented.

*China provides a classic example of the evolution of inequality dominated by internal structural change*

In recent years, China’s picture has been complicated by large inflows of speculative capital. Some of it is moving through the current account in the trail of an enormous export boom, which has, in turn, fuelled an epic real-estate boom in Beijing, Shanghai and a few other locations. These factors exacerbate inequalities between rural and urban areas, as well as between different regions or provinces.

Figure 2.6 illustrates the changing contribution of various Chinese provinces to the country’s inequality up to 2007. Each segment of each bar represents the contribution to overall inequality of a particular province in a particular year. Those provinces with incomes above the national average show positive values, and those with incomes below the national average show negative values. The figure provides a succinct measure of the rise and fall in relative terms of Chinese provinces relative to each other. Of particular note is the contribution of Beijing, neither a coastal city nor a primary centre for the production of goods for export, which continued to rise even after the diffusion of economic growth caused the relative shares of Guangdong and Shanghai to tail off in the late 1990s and early 2000s. This is at least in part related to the construction boom that preceded the 2008 Olympics and illustrates the extent to which financial forces may be coming to dominate and to destabilize the pattern of relative incomes inside China.

**FIGURE 2.6: Contribution of provinces to interprovincial inequality in China, 1987–2007**



Note: The bar segments represent elements of the Theil index, specifically the population weight times the ratio of average sector pay to country pay (times the log of the same ratio). Thus above-average pay sectors show positive values, those with below-average pay show negative values. The Theil measure for each year is the sum of the bar values for that year. Source: Galbraith et al. 2008.

### Dualism and industrial crisis: Brazil and Mexico

In most of Latin America, by contrast, large-scale urbanization, globalization and, specifically, the internationalization of finance occurred decades ago. In the 1980s and 1990s, countries found themselves afflicted by the (closely related) scourges of negative growth and adverse terms-of-trade shocks as well as by the debt crisis, all of which increased inequality. In Mexico and Brazil, the debt crisis and resulting industrial slump were associated with a sharp rise in inequality,<sup>29</sup> as the collapse of import-substituting industries diminished the unionized working class. It is reasonable to infer that import-substituting industrialization had worked to reduce the (very high) inequalities associated with traditional Latin American economic dualism, and that the later shift towards an export-oriented growth model would again be characterized by a more unequal income structure. However the short-term movement of inequality during the transition between these two models was clearly governed by the same forces that generated macroeconomic and industrial crises in the first place.

*In the 1980s and 1990s, Latin American countries found themselves afflicted by negative growth and adverse terms of trade as well as by the debt crisis, all of which increased inequality*

The experience of Mexico and Brazil during this period also illustrates the simple relationship between wage inequality in industry and the rate of economic growth. As long as economic growth is sufficiently rapid to absorb the natural rise in the labour force, inequality in pay structures tends to be stable or decline. When growth falls short of that threshold, inequality tends to increase.<sup>30</sup> For countries in the latter situation, combating rising inequality is, in large part, a matter of restoring stable internal growth and thus absorbing the growing labour force into productive employment. But as long as such countries remain exposed

to external financial shocks, more stable global financial governance must also be part of the solution.

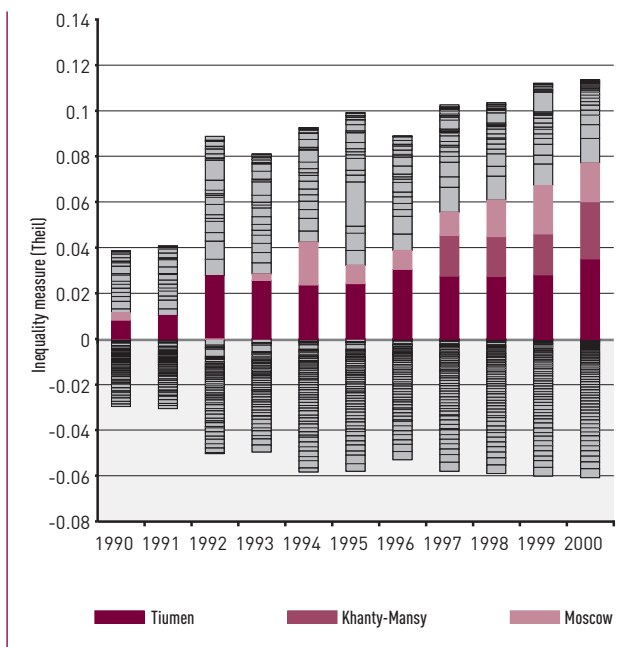
The experience of Mexico during the peso crisis in 1995 demonstrates the connection between external finance and economic inequality for many developing countries. A position on the periphery of the global economy implies important trading relations with much richer countries, and therefore a duality in the productive economy at home – between producers who sell to the external market and those who sell to domestic consumers. Workers in the former tend to be better paid than those in the latter, simply because industries with rich customers who earn hard currency can afford to pay a premium for labour. The former are also much better insulated against a currency crisis. When the peso crisis hit Mexico in 1995, export sectors were able, for the most part, to simply translate their dollar earnings into peso wages at the new exchange rate. Those who produced for the domestic economy, as manufacturers or as service providers, could not do this, and their relative wages fell instantly as the peso collapsed. In addition, their markets subsequently dried up, since consumers were forced to pay more for imported staples (such as corn) that were now available only at a dramatically higher peso price. There was a sharp rise in inequality in pay in the Mexican manufacturing sector following the 1995 peso crisis.<sup>31</sup>

### Transition economies

In the industrialized economies of Central and Eastern Europe, the combination of a large manufacturing sector and a communist political regime produced low inequality until the system collapsed in 1989. It is worth noting, however, that the collapse of communist regimes in Hungary, Poland, Yugoslavia and the Soviet Union was not unrelated to economic pressure. All were deeply indebted to the West at a time of depressed prices for primary commodities and exceptionally high real interest rates. These pressures exacerbated the underlying inefficiencies of the communist system, prompting efforts at reform that eventually opened the door to regime change. At that point, de-industrialization and price liberalization, leading to a very rapid move towards world price levels, combined to drive inequality up dramatically.

The case of the Russian Federation has been analysed using data for the years 1990–2000.<sup>32</sup> The dramatic increase in inequality came in 1992, with the implementation of shock therapy, starting with price liberalization. This resulted in the sudden collapse in the real wages of both agricultural and manufacturing workers as well as of non-commercial sectors, such as health and education, previously supported by the state. Energy and finance consequently became the leading sectors of the new Russian Federation, with Moscow rising as a world city in a country otherwise mired in post-communist stagnation. The situation became so extreme by the end of the century that the lightly populated western Siberian oil and gas regions of Tiumen and Khanty-Mansy had become major drivers of the inequality of Russian incomes overall. Meanwhile, the conflict-affected regions of the southern Caucasus had fallen far below the rest of the country in reported relative income. Figure 2.7 provides a schematic view of the interprovincial shifts in the Russian Federation during the disastrous transition decade.

**FIGURE 2.7: Contributions of three provinces to interprovincial inequality in the Russian Federation, 1990–2000**

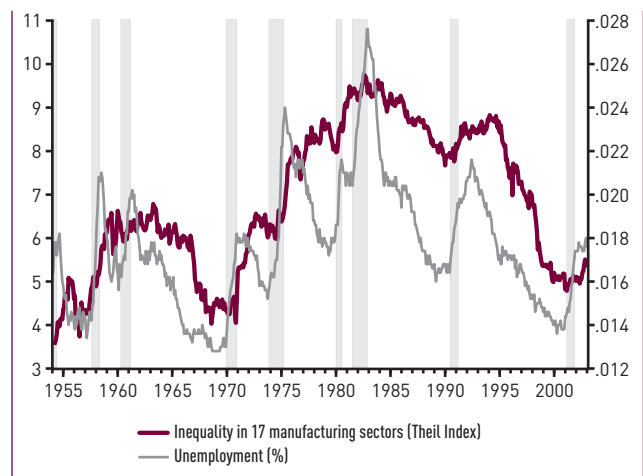


Source: Galbraith, Krytynskaia and Wang 2004.

**Financialized economies**

In the United States, inequality rose from the early 1980s under the demand shock of tight monetary policy and a high dollar – a backward movement on a downward sloping Kuznets curve. This movement was repeated in the recession of the late 1980s. Inequality in pay, particularly in manufacturing, then declined through much of the following decade as the economy recovered and eventually produced very high levels of employment. Figure 2.8 illustrates the close relationship between inequality in the structure of manufacturing pay in the United States and the rate of unemployment.

**FIGURE 2.8: Monthly manufacturing pay inequality and unemployment in the United States, 1953–2003**

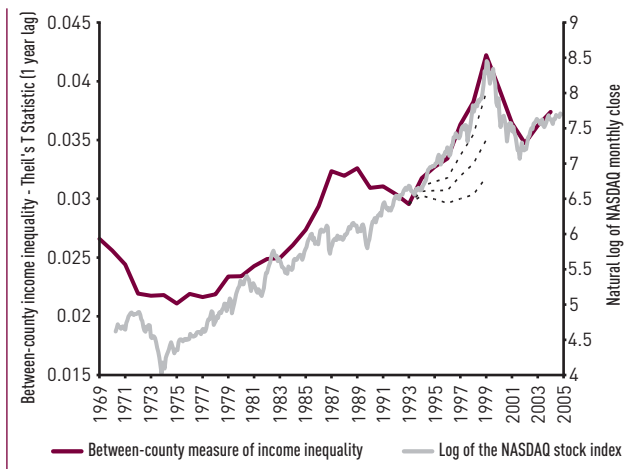


Note: Recessions indicated by grey lines. Source: Galbraith 2009.

In the last years of the decade of the 1990s, rapid growth in the United States was driven by a technology bubble. This produced increasing inequality – represented as a move up an upward-sloping segment of the Kuznets curve – as the country moved through the transition from an industrial economy to one largely centred on technology and finance.<sup>33</sup> The effect of this increase in inequality on household incomes was greatly exacerbated by the dramatic appreciation of capital asset valuations on the reported income of a very small number of very rich people. If the effects of rising income in just five counties – New York (Manhattan), New York; Santa Clara, San Francisco and San Mateo counties in California; and King County in Washington – are removed

from the data, about half of the rise in between-county inequality in household incomes in the United States in the last years of the 1990s would not have occurred.<sup>34</sup> Removing the income growth of just 15 counties neutralizes the entire increase in between-county inequality. Figure 2.9 illustrates this finding, and shows that the rise (and occasional decline) in income inequality in the United States is substantially due to changing valuations on the stock market, specifically the technology-rich NASDAQ.

**FIGURE 2.9: Between-county measure of income inequality and the log of the NASDAQ stock index in the United States, 1969–2005**

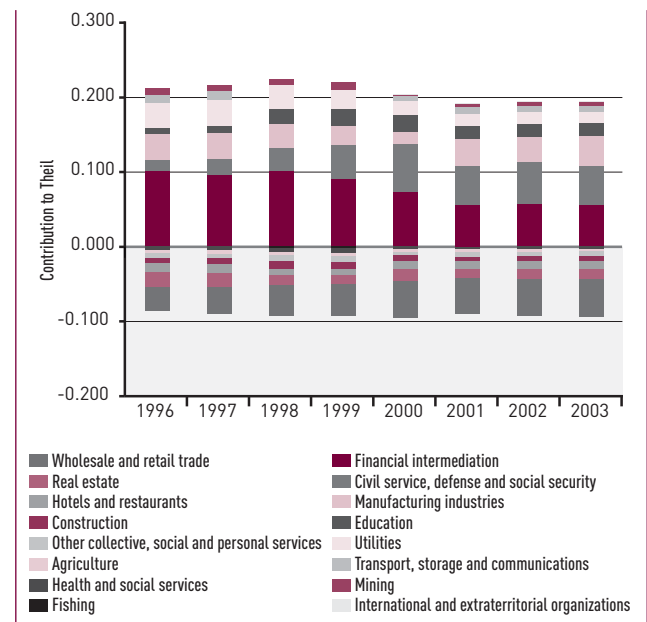


Note: Dotted line indicates hypothetical change in inequality 1993–1999 under the counterfactual of average national income growth in five counties: New York (Manhattan), New York; Santa Clara, San Mateo, and San Francisco counties in California; and King County in Washington. Source: Galbraith and Hale 2008.

Financialization, or the growing dominance of the financial sector in national economies, is strongly linked to neoliberal economic policy reform, which gained strength in the 1980s and 1990s and tended to favour national financial and political centres (Buenos Aires, Moscow, São Paulo, Shanghai and Beijing) at the expense of the hinterlands. In the wake of a financial crisis or stabilization policies, such as Brazil's Real Plan, the share of the financial sector in an economy is likely to shrink and overall inequality among sectors and regions to fall. Figure 2.10 illustrates this pattern for the case of Brazil, which at the peak of neoliberal policies channelled an extraordinary share of national income into the financial sector. Notwithstanding the small absolute size of the sector,

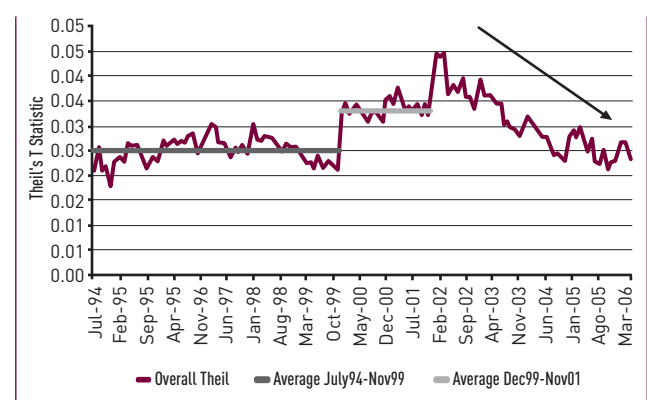
it would be reasonable to see the diversion of resources into banking as a principal motor of total income inequality in Brazil. Using monthly data for the case of Argentina, figure 2.11 shows that the financial crisis in 2002 triggered a process in which inequality – at least within the formal sector – was reduced in the post-crisis years.

**FIGURE 2.10: Contribution of sectors to economic inequality in Brazil, 1996–2003**



Source: Galbraith et al. 2007.

**FIGURE 2.11: Monthly measure of interprovincial inequality in Argentina, 1994–2006**



Source: Galbraith et al. 2007.

### Some countries have avoided rising inequality

Even though rising inequality was characteristic of the period under discussion (the 1980s and 1990s), it was not observed everywhere. In Northern Europe, notably in Scandinavia, historically among the most egalitarian regions in the world, measures of inequality remained steady throughout the 1980s and at least into the early 1990s. The Nordic experience relates in part to the strong tradition of unionization, centralized pay bargaining, and (in the case of Norway) the collective management of resources gleaned from the oil boom. Meanwhile, in parts of Southeast Asia, especially Singapore and Indonesia, inequality appears to have declined throughout the early 1990s. In parts of Latin America, notably Brazil and Argentina, inequality appears to have peaked with the crises of 1993 and 2002, respectively, and to have declined with the stabilizing growth experienced in subsequent years.<sup>35</sup>

## 4. Redistributing Wealth and Income: Implications for Policy

Poverty is far more than relative deprivation of material goods; it may be accompanied by hunger, malnutrition, ill-health and morbidity, shortened life expectancy, illiteracy, social exclusion and a constant struggle for survival.<sup>36</sup> Given the relationship between poverty and inequality presented in this chapter, policies to reduce inequality are important instruments for reducing poverty. Moreover, higher levels of income inequality tend to undermine civil, political, economic and social rights, as well as the realization of substantive citizenship and inclusive states.

### Make deliberate policy choices to ensure that growth and equity reinforce one another

In the 1990s, the view gained ground among some in the international development community that high growth rates were sufficient to alleviate poverty, especially if there were no changes in income distribution.

One highly publicized World Bank paper<sup>37</sup> argued that growth was good for the poor and that countries pursuing Washington consensus policies enjoyed faster growth in average incomes. This argument implies that governments need not follow deliberately pro-poor growth policies and that what matters most is the income level of the poor, rather than equality. However, there is a growing body of evidence suggesting that:

- there is no trade-off between equity and growth;
- an unequal income distribution is not immutable and can be affected by economic and social policies;
- equity can make growth more inclusive and pro-poor; and
- equity can also serve as an important agent of economic growth.<sup>38</sup>

Recognition that equity and growth can be mutually reinforcing still leaves open the question about the necessary economic and social policies to produce such an outcome. While current research disputes the simplistic view of trade-offs between equity and growth, it does not suggest that the virtual cycle of growth and equity is automatic. The possibility of a negative impact of one on the other suggests a need for deliberate policy choices and design to ensure that equity has a positive impact on growth, and vice versa.

*Deliberate policy choices and design are needed to ensure that equity has a positive impact on growth, and vice versa*

Research has shown 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 disparities. A recent study<sup>39</sup> shows that one-sixth of the 285 cases (consisting of different periods of time in different countries) used in a World Bank study<sup>40</sup> that downplayed the role of redistributive policies in poverty reduction in favour of growth, proved to be exceptions to the rule.

These were cases in which growth failed to reduce poverty or where poverty decreased without significant growth. An examination of these cases highlights the central role played by redistributive policies. At different periods of time in the Nordic countries, as well as in developing countries such as Colombia, El Salvador and Peru, strong redistributive policies meant that poverty decreased by more than was predicted in the study. In the case of developing countries, land reform was a prominent aspect of these policies. Conversely, in cases where poverty either increased or decreased less than predicted, there was a reversal or weakening of these same redistributive policies. Other studies,<sup>41</sup> including some from the World Bank itself, have shown that in countries with high levels of inequality, poverty is reduced more slowly in response to higher growth. Similarly, periods of highest growth were not necessarily the ones in which poverty reduction was the greatest. Even in countries with fast growth and poverty reduction, regional pockets of poverty and deprivation have persisted. This suggests that growth alone is insufficient to reduce poverty and that redistributive policies to change the distribution of income and assets are important.

Redistributive policies that countries can adopt include those that:

- provide the poor with greater access to productive assets, such as land, and reform inequitable tenancy arrangements;
- stimulate investment in irrigation and rural roads, create public works programmes for infrastructure development and increase access to credit;
- initiate fiscal reforms to improve tax administration, prevent tax evasion and avoidance, and limit opposition to progressive taxation and redistribution;
- generate employment opportunities;
- enhance the welfare of the poor through sound social policies; and
- help create a stable global economic environment that responds to the needs of poor countries.

Chapter 1 has discussed strategies for improving employment opportunities, and Section two of the report will examine social policies and tax strategies for redistributive

and socially inclusive outcomes. The remainder of this chapter will highlight a number of issues related to fiscal redistribution, land reform, improving the livelihoods of small farmers, and global economic governance.

### **Strengthen the role of the state in fiscal redistribution**

Successful implementation of redistributive policies calls for a stronger state role. Fiscal redistribution, which entails both progressive taxation and patterns of expenditure that improve the welfare of the poor, has occurred only to a very limited extent in developing countries. In contrast to many industrialized countries where fiscal redistribution brings about a drop in the Gini coefficient of 10–15 per cent, it is at most a few percentage points in most developing countries. As chapter 8 argues, the main obstacle to fiscal redistribution is the low tax base, due to the large proportion of the population with 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. The first is a weakness in tax administration and consequent tax evasion and avoidance, which tends to be widespread. The second is the presence of generous tax concessions. And a third 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 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 more regressive forms of taxation.

Turning to the expenditure side, the picture is less bleak. An increasing number of countries are introducing social programmes for the poor, such as cash transfer schemes and public works programmes. Despite their limitations, some of these programmes have been large enough in scale to have a perceptible impact on poverty reduction, as chapter 5 will show. In this regard, universal social protection

programmes tend to have a greater potential for redistribution and quality control than targeted programmes. Improving the poor's access to education, health care and other social services, as described in chapter 6, also helps to reduce inequalities and poverty. It enhances the capabilities of the poor and the efficiency or skill levels of the labour force in general, in addition to reducing the burden of disease. Public works programmes, which have gained prominence in many low-income countries as strategies for tackling poverty, should be focused not only on job creation, but also on the building of local infrastructure, since this will yield significant positive externalities for the affected local communities.

### **Refocus on land reform**

The primary target for production-oriented public expenditures should be agricultural and rural development, since they 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 concomitant high landlessness – well-implemented redistributive land reforms can yield gains in terms of reduced poverty and inequality as well as increased output. The redistributive benefits of land reform will come not only from the increased asset base and incomes of previously landless and marginal farmers, but also from ending exploitation based on market and non-market power previously wielded by landlords. In addition, the more balanced level of land ownership that will emerge will yield external benefits to local communities, since cooperative communal projects to strengthen the local economy are 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 programmes of support to small farmers, these productivity gains can be very significant. Smallholders in agrarian economies where land is not a severe constraint can benefit from investments in rural infrastructure and seedlings, extension services and credit.

Despite the success of land reforms in Japan, the Republic of Korea and Taiwan Province of China in the early

post-war period, and in several other countries since then, land reform largely disappeared from the national and international policy agenda in the 1980s. There was a revival of interest in the issue in the mid-1990s, sparked by the emergence of land-based conflicts in countries such as Brazil, Mexico and Zimbabwe, as well as by the salience of the issue in the aftermath of the overthrow of dictatorships in Bolivia, Indonesia, the Philippines and South Africa. Although it has reappeared on the policy agenda, the substance of discussions on land reform has taken a very different form. In line with neoliberal thinking, the focus has been on market-based reform and no longer on the redistribution of land ownership. A key aspect of this approach dictates that any transfers of ownership should be market-based (willing seller, willing buyer), ruling out expropriation or compulsory purchase. In addition, it focuses on increasing access to land through tenancy reform rather than through ownership. Some of these tenancy reforms reverse the outcomes of previous land reforms by removing ceilings on land ownership and tenancy. A driving force is the promotion of capitalist agriculture, as 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 potential benefits, despite the obvious significance of this issue for redistributive policies. It would be timely and beneficial to open such a debate.

### **Look after the best interests of small farmers**

Globalization has led to the growth of worldwide 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 state role in increasing the capacity of small farmers to respond to these new opportunities. Emerging global production chains are dominated by large multinational corporations that enjoy considerable market power; this opens up the possibility of unfair contracts with low returns and wages for the small farmers and workers involved.

It also creates a new responsibility for governments to regulate the terms under which poor farmers are incorporated into these production systems. In addition, some of these new export opportunities are in specialized niche markets that are very demanding in terms of the quality standards that must be met. This severely curtails 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 multinational corporations in global agriculture is also shifting research priorities away from harnessing advances in biotechnology for the development of crops with higher yields that are better adapted to local ecological conditions, which 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 crop research programmes of the type that produced the green revolution have been declining both internationally and nationally. It is important from the standpoint of redistributive and poverty reduction policies that these issues be faced seriously with a view to framing counter-measures.

### **Advocate for reforms in the governance of the global economy**

Not only should all possible redistributive policies be considered on their own merit; they should also be placed in the context of globalization and overall development strategies. As explained earlier, income distribution and poverty reduction are as much the outcome of a chosen development strategy and global dynamics as of deliberate decisions about how much redistribution and what type of redistributive policies a country adopts. Given the importance of global economic forces in determining both growth and income inequality in developing countries, and in the wake of the economic crisis, special attention must be given to reform in the governance of globalization. The goal must include the creation of a global economic environment that is compatible with growth and poverty reduction in poor countries.

Key elements of this reform should include greater stability in the international monetary system and in global commodity markets; stronger support for the development of least developed countries; and the restoration of greater policy space and autonomy to developing countries<sup>42</sup> (see chapter 10). Greater stability is required to avert a replay of the scenario in which developing countries have seen their development and poverty reduction efforts periodically nullified by financial crises and extreme fluctuations in commodity prices, including those of food. Stronger support for the least developed countries is required, entailing the reduction of vulnerability to commodity price and interest rate shocks, more access to rich country markets, increased financial assistance, and phasing out of agricultural subsidies in rich countries that impact adversely on poor countries. Similarly, greater policy space and autonomy are essential because the combined straightjacket of restrictive multilateral rules, neoliberal policy conditionality, and global financial market discipline has clearly blocked the adoption of more promising paths to development.

Chapter 1 has shown that deeper economic liberalization and restrictive monetary policy have not always been the optimal path. Several of the countries that have benefited from globalization, such as those in East Asia, and now China, India and Viet Nam, 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 policies and retained controls over foreign direct investment flows and the capital account. In fact, there are few examples of countries that have prospered from unfettered liberalization.

Developing countries need alternative monetary policies to expand domestic markets, maintain competitive exchange rates and improve access to credit. They also need fiscal policies that will support greater public investment, which is essential for improving private sector productivity and market access by building new roads and providing better transportation. Unskilled labour is the most abundant factor of production in developing countries, so making maximum use of it, through labour-intensive production strategies, is an efficient strategy to raise growth and reduce inequalities.

## Notes

- 1 Forbes's (2000) econometric study concludes that inequality is good for growth.
- 2 Maxwell 2001; Thomson 2003; Anderson and O'Neil 2006.
- 3 World Bank 2006; UNDP 2005; UNDESA 2005; UNRISD 2005.
- 4 Anderson and O'Neil 2006.
- 5 Razavi 2006.
- 6 Cornia 2004.
- 7 Meidner and Rehn 1951.
- 8 Huber and Stephens 2001.
- 9 Galbraith and Garcilazo 2004.
- 10 Cornia 2004; Shorrocks and van der Hoeven 2005.
- 11 This section draws on Lee (2009).
- 12 This section is based on Ghosh (2008).
- 13 Hausmann et al. 2004.
- 14 Ghosh 2008.
- 15 Ferreira and Ravallion 2008.
- 16 Ferreira and Ravallion 2008.
- 17 Ferreira and Ravallion 2008.
- 18 ILO 2008b:9.
- 19 Giovannoni 2008.
- 20 Euro zone refers to member countries of the European Union which use the euro as their national currency.
- 21 ILO 2008b.
- 22 Galbraith (2009) and Atkinson and Brandolini (2001) are critical of widely used datasets on inequality, which are based on limited sample surveys.
- 23 Kuznets 1955.
- 24 Galbraith 2009. The essential features of this curve were first discussed by Conceição (2001).
- 25 Galbraith 1998, 1989.
- 26 Galbraith and Kum 2003.
- 27 Milanovic 2007.
- 28 Galbraith, Roy Chowdhury and Shrivastava 2004.
- 29 Calmon et al. 2000.
- 30 Calmon et al. 2000.
- 31 Calmon et al. 2000.
- 32 This dataset was developed by Krytynskaia from original sources in Goskomstat, and reported in Galbraith, Krytynskaia and Wang (2004).
- 33 Galbraith 1998, 1989.
- 34 Galbraith and Hale 2008.
- 35 Galbraith et al. 2007.
- 36 This section draws on Lee (2009).
- 37 Dollar and Kraay 2002.
- 38 The World Bank strongly supported this position in its *World Development Report 2006*.
- 39 Donaldson 2008.
- 40 Dollar and Kraay 2002.
- 41 Cornia 2004; Shorrocks and van der Hoeven 2005.
- 42 UNCTAD 2004.