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Income Inequality and Redistributive Policies

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Contents

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 t0 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 stated 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 1900s 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 a 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 form 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 the 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