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Tackling inequality through trade and development in the post-2015 development agenda

Note by the UNCTAD secretariat

Executive summary

As the international community discusses the post-2015 development agenda, it is now clear that inequality will form an integral part of the sustainable development goals. Empirical evidence shows that increasing income inequality has been a feature of the world economy since the early 1980s. The current pattern of global income distribution is extremely unequal, both between countries and within countries. Inequality between countries has recently declined somewhat due to the very rapid growth of China. If China is not taken into account, the inequality between countries is higher today than it was in 1980. Inequality within countries has deteriorated in most countries due to the persistent decline of the share of wages in total output and the move towards less progressive tax systems and less generous social transfers. Other forms of inequality such as wealth distribution, gender disparities and differences in access to education are also important, as they may significantly undermine equality of opportunities and social mobility.

While the relationship between growth and inequality is complex, recent research shows that high inequality may prevent societies form achieving inclusive and sustainable growth. The global financial crisis, in particular, has greatly increased awareness of the link between growing inequality, the rise of unregulated financial markets and the threat to economic and social security from shocks and crises. Rising inequality is neither a necessary condition for sound economic growth, nor its natural result, and thus could be altered by proactive economic and social policies. Inclusive and sustainable development cannot be achieved without an integrated policy framework, with growth-promoting and job-generating macroeconomic policies and developmental industrial policies as its main pillars. To increase the chances of developing countries catching up with developed ones and therefore reduce global inequality, coherent macroeconomic, industrial, trade, environmental and social policies that reinforce each other need to be implemented. Policy coherence at the national level should be complemented by policy coherence at the international level, providing countries with the policy space needed to implement their national development strategies and achieve sustainable development goals.

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I. Inequality is back on the agenda of the international community

1. After being mostly absent from the international community's agenda in recent decades, the issue of economic inequality has re-emerged as a major concern. Trends towards the increasing divergence of wealth and incomes, both within and across countries, have caught the attention not only of specialists, but also of broader segments of the society and, importantly, of policymakers. While previously the dominant concerns regarding inequality were moral and ethical, there is now an emerging consensus that existing levels of inequality are also potentially damaging in both economic and political terms.

2. The adoption of the Millennium Development Goals in 2000 galvanized political will and efforts of the international community in poverty eradication. Those efforts drew on a flourishing body of research on poverty-related topics, and the resulting goals focused the world's attention on extreme forms of social deprivation, primarily with regard to poverty, nutrition, health and education.

3. A similar shift in focus and policy stance seems to be taking place concerning inequality. As the international community discusses the post-2015 development agenda, it is now clear that inequality will form an integral part of the proposed sustainable development goals. Indeed, the current list of 17 goals to be attained by 2030 includes reducing inequality within and between countries.[1]

4. Tackling inequality through trade and development is thus an integral part of the quest for a more sustainable and inclusive development agenda beyond 2015. It involves, inter alia, a radical rethinking of the traditional view that inequality is good for growth. It also involves moving away from the business-as-usual approach to policymaking that has been dominant in the past three decades and has spurred tendencies towards higher levels of inequality. Finally, it involves a vision of the world in which national and international policies work in tandem to address pressing issues of concern to both developed and developing countries.

II. Recent trends in economic inequality between countries

5. The scale of global inequality and its evolution is not easy to measure due to major data deficits. Nevertheless, all studies indicate that the current pattern of global income distribution is extremely unequal. For example, measured by the most widespread indicator of inequality (the Gini coefficient), the distribution of income in the world, at around 0.67, is more unequal than in the most unequal country. A similar picture is produced by taking the Palma index as an alternative measure of income inequality measuring the ratio between the total income of the richest 10 per cent of the population and the poorest 40 per cent. For the world as a whole, the Palma index was 13.5 in 2005. In most countries, it is less than two, and it is higher than the world figure only in Jamaica.

6. Most studies also indicate that inequality across countries still explains the bulk – between 60 and 90 per cent – of total inequality. One recent study estimates that around 85 per cent of global inequality can be explained by differences in the mean incomes of the countries, while only 15 per cent can be attributed to variations within countries.[2] In statistical terms, location is more likely to determine the place of an individual in the global

[1] Open Working Group on Sustainable Development Goals, 2014, outcome document, 19 July.

[2] B Milanovic, 2012, Global inequality: From class to location, from proletarians to migrants, *Global Policy*, 3(2):125–134.

distribution of income than other factors. This stems from the fact that the spatial distribution of productive capacities in the world is very uneven and is still heavily skewed in favour of advanced industrial countries.

7. A comparison of the per capita income of the richest 15 countries with that of the poorest 15 countries over the past few decades highlights how wide the gap really is. The average income of those richest countries was 44 times that of the poorest in the 1980s, 52 times in the 1990s and 60 times in the 2000s. Rapid economic growth in many developing countries since the turn of the millennium has somewhat dented the gap, with the ratio declining from 62.3 in 2000 to 55.8 in 2009.

8. More generally, inequality between countries has followed the same trajectory over the past three decades. Measured by the gross domestic product (GDP) per capita of each country at purchasing power parity of United States dollars, the Gini coefficient of income inequality between nations increased steadily from the late 1970s to the early 2000s, when it reached 0.58. The major reason is the stagnation of growth in many Latin American and African countries caused by the debt crisis in the 1980s and the collapse of growth in most transition economies in the 1990s. As the growth rates of many developing and transition economies picked up significantly in the new millennium, the income gap between countries narrowed somewhat, with the Gini coefficient declining to 0.56.

9. An often encountered shortcoming in measuring global inequality is that it does not take into account the number of people living in different countries. If the data on inequality between countries are weighted by population, the picture changes significantly. First, it shows that population-weighted income inequality between countries was considerably higher than with the first definition until the final years of the previous decade. This reflects the fact that two populous countries (China and India) have long been low-income countries. Second, the evolution of population-weighted income inequality reflects more accurately the growth performance of these large countries. When these two countries started to record growth rates of GDP superior to those in the rest of the world, economic inequality between countries started to diminish.

10. The data show that the weighted Gini coefficient declined by more than 10 points from 1980 to 2010. Statistically, most of this decline is due to the very rapid growth of China. If China is not taken into account, the Gini coefficients of inequality between countries, both unweighted and weighted, were higher in 2010 than in 1980. Thus, despite some recent improvement, international inequality remains very high. Even while between-country inequality has fallen somewhat in relative terms, it has continued to grow in absolute terms, as the difference in average incomes between rich and poor countries increased from $18,525 in 1980 to $32,000 in 2010.

III. Recent trends in economic inequality within countries

11. A full picture of global inequality must consider income inequality both between and within countries. Economic inequality within countries results from the interplay of forces determining a primary and a secondary distribution of income. Primary distribution, also called functional distribution, refers to income formation among production factors (labour, land and capital). Secondary distribution, often called personal income distribution, results from the modification of the results of primary distribution through government policies (taxes, subsidies, social transfers and the like).

12. Recent trends have shaken the belief of mainstream economists in a long-term stable distribution of functional income distribution. Since 1980, there has been a significant and persistent decline in the share of wages in many countries, both in developed and developing countries. The share of labour income in world gross output fell from 62.5 per

cent in 1980 to 54 per cent in 2010. This indicates a slower pace of growth of labour incomes, compared with the growth of world output, and corresponds to a rise in profit share.

13. The trend is particularly clear in developed countries. According to the Organization for Economic Cooperation and Development (OECD), for example, between 1990 and 2009 the share of labour compensation in national income declined in 26 out of 30 developed economies for which data were available, and the median labour share of national income across these countries fell considerably, from 66.1 to 61.7 per cent. Since 1980 the decrease surpassed 10 percentage points in Austria, Germany, Ireland, New Zealand and Portugal. The breakdown of the post-war social consensus, when wage increases closely tracked increases in productivity, combined with the growing dominance of the financial sector over the real sector of the economy, have been among the main causes of the changes in the functional distribution of income in developed countries.[3]

14. Functional income distribution has also undergone some profound changes in developing and transition economies. The transition economies in particular experienced dramatic falls in the wage share in the wake of the collapse of the socialist central planning regime in the early 1990s. The share of wages tumbled between 15 and 23 percentage points in Armenia, Azerbaijan, Kyrgyzstan, the Republic of Moldova, the Russian Federation and Ukraine during that period. Notwithstanding some recovery in some of the transition economies in recent years, their share on average is still substantially lower than in the 1980s.

15. Functional income distribution has been volatile in many developing countries. In general, it has seen a declining trend of the share of wages, although with significant variations across countries. Recurrent recessions, periods of high inflation, external shocks and political changes have had a strong influence on employment and wages, sometimes resulting in large swings of these variables. In particular, the debt crisis of the 1980s resulted in reductions in the wage share in GDP of most Latin American countries. Despite some improvements in the 2000s, the wage share has not returned to its previous peaks.

16. In Asia and Africa, the self-employed continue to constitute a significant proportion of the labour force; therefore, changes in functional income distribution result from the interaction of sometimes opposing factors. For example, migration from rural to urban areas can increase the share of wage earners in total employment, while an excess of labour supply tends to keep real wages depressed. Thus, while the share of wages tends to increase with overall income growth, recently this linkage has been weakening. The wage share of income has increased more slowly than the growth of GDP per capita in some cases and has even decreased in others.

17. In India, the movement of factor incomes suggests a tendency towards greater inequality, since the share of wages fell from 40 per cent of total national income at the start of the 1990s to only 34 per cent by 2010. In China, the rapid growth of GDP has not been matched by a similar growth in wages. As a result, the wage share in GDP shrank from 62 per cent in 1990 to 47 per cent in 2008.

18. How these trends in functional income distribution have an impact on household disposable income depends to a large extent on redistributive measures taken by Governments. Thus, the primary distribution of income is modified to some extent by government policy, resulting in personal income distribution. The extent to which it is modified varies from one country to another, but in general is more widespread in

[3] OECD, 2012, *OECD Employment Outlook 2012,* OECD Publishing.

developed countries. Inequality is generally lower in countries with larger welfare programmes and more fiscal redistribution.

19. A particular feature of developed countries is the large difference between the inequality measures stemming from the functional and personal distribution of income. This difference amounted to 13 percentage points on average in developed countries during the 2000s. In developing and transition economies, government action modifies the primary distribution of income to a much lesser extent; the difference was thus only 2 and 4 percentage points, respectively. Hence, it is mainly because of their large public sectors that income inequalities are lower in many developed countries than in the rest of the world.

20. Over the past three decades, income inequality increased significantly in many developed countries and the transition economies, as well as in Asian developing countries. It also increased in Latin America and Africa in the 1980s and 1990s, but it declined sharply in the 2000s. Since these regional trends can be biased by changes in populous countries, it is necessary to examine the trends in individual country experiences to get a full picture.

21. Inequality in personal income distribution grew in most developed countries between 1980 and 2010. Capital income increased its share of total income at the expense of labour income, benefiting a small number of capital owners. In addition, there was growing inequality in the distribution of wages and salaries, since incomes of higher paid workers rose more than those of the lowest paid. Finally, redistribution measures became less effective in modifying the primary distribution of income, reflecting the move towards less progressive tax systems in many developed countries, coupled with less generous social transfers.

22. In the transition economies, the economic collapse of the early 1990s affected wage earners disproportionally, and the crisis in government finances caused a reduction in social transfers. Hasty and opaque privatizations of State assets led to the concentration of wealth in many countries, pushing the level of inequality even higher. As a result, many countries which had the lowest levels of inequality in the 1970s and 1980s were among the most unequal in the early 2000s.

23. In Latin America, the rise in inequality in the 1980s and 1990s coincided with a reduction of formal jobs in industry and the public sector, in most cases against a backdrop of slow growth and declining investment rates. By contrast, the income gap has narrowed since the early 2000s, partly due to a sustained economic recovery but also to the introduction of a series of progressive policy measures. Between 2002 and 2010, the average regional Gini coefficient declined by 4 percentage points and by even more in several countries in South America. The new policy orientation has included countercyclical fiscal policies, an increase in the progressivity of tax systems, minimum wage legislation and increased government expenditures on various social support programmes.

24. Africa, alongside Latin America, is the world’s most inequitable region. In 2010, 6 out of 10 countries with the most unequal income distribution in the world were in sub-Saharan Africa. However, the dispersion of income varies dramatically across countries. For example, the ratio of the income of the top decile to that of the bottom decile ranges from 10.5 times in the United Republic of Tanzania to 44.2 times in South Africa. Trends show increases in inequality in all the subregions except in North Africa in the 1980s and 1990s. In the 2000s, it decreased in Southern Africa and to a lesser extent in West Africa, but showed little change or even increased in the other subregions. One reason for these negative trends is that in many natural-resource rich countries, local elites, together with

foreign capital, have been able to appropriate most of the rising rents from natural resources.

25. In Asia, inequality trends have been less clear-cut, since inequality has been growing in some countries and declining in others. However, considering that the countries where the income gap has widened are the most highly populated, overall regional inequality has increased significantly since the 1980s. In South Asia, the process of globalization has been associated with greater inequalities in all countries, except in Pakistan, where it remained stable on the whole. In East and South-East Asia, several countries experienced structural transformations that increased inequality, as the acceleration of technological change generated new employment opportunities for better skilled workers in the higher income groups. In addition, economic and financial liberalization reduced the scope for redistributive policies and increased incomes from financial activities. However, following the Asian crisis, the Gini coefficient fell in Malaysia, the Philippines, the Republic of Korea and Thailand due to large investments in public education and strengthening of redistributive policies.

26. In China, the Gini coefficient increased from a low figure of 0.27 in 1984 to 0.47 in 2009. Policy reforms, especially since 1985, have accelerated the widening of the urban–rural income gap. They also contributed to a surge in the skills premium and a rise in corporate profits, increasing intra-rural and intra-urban inequalities. Trade and industrial policies favoured the creation of special economic zones in coastal areas, export-oriented firms and the capital-intensive sector over the small-scale ones. The worsening of the functional distribution of income could not be compensated by public policies since the national tax-to-GDP ratio fell to only 10.2 per cent in the mid-1990s because of a fiscal decentralization policy. Recently announced reorientation towards a domestic consumption-led model of growth is likely to reverse some of these trends in income distribution in China.

IV. Other forms of economic inequality are also important

27. Economic inequality has several interrelated dimensions, the most prominent of which is income inequality. Nevertheless, economic inequality is also the result of an uneven distribution of wealth and varying access to education and basic services, which in turn are frequently determined by social, racial and gender factors. These factors may significantly undermine equality of opportunities and social mobility, with severe economic, social and even political consequences. What is more, high economic inequality tends to be perpetuated by increasing wealth concentration that generates a dual society where one segment of the population is able to afford good-quality private education, health and basic services, while the rest has to settle for low-quality services due to their inadequate public provision.

28. Income and wealth distribution are closely interrelated. In general, wealth concentration tends to be higher than income concentration because wealth represents a stock of financial and real assets accumulated over years and transmitted through generations. A large proportion of total wealth is generally concentrated in the richest percentile. The top 1 per cent holds a much larger share of the total wealth than the bottom 50 per cent in countries where data are available. In the United States of America, for example, the top 1 per cent holds 33.8 per cent of the wealth, while the bottom 50 per cent holds only 2.5 per cent. The numbers for France are 24 per cent and 4 per cent, and for Indonesia, 28.7 per cent and 5.1 per cent, respectively.

29. The wealth-to-income ratio was relatively stable at around 4 during the post-war period in several developed countries for which data are available. It started to increase in

the 1980s to reach 7 at the end of the previous decade. This increase reflects a strong rise in asset prices and mainly creates financial wealth. The share of financial wealth in several developed countries (Canada, the Netherlands, Switzerland and the United States) actually exceeds that of real assets.

30. The wealth-to-income ratio in developing countries tends to be lower than in developed ones, generally only half of the figure for the latter. However, the share of non-financial wealth in total wealth is much higher than in developed countries, as land and housing are more important and financial markets are less developed. This makes the unequal distribution of land ownership a particularly important component of the inequality picture in many developing countries. Land concentration is the highest in Latin America with a Gini coefficient of 0.81, followed by West Asia and North Africa (0.66), Eastern Europe (0.62), South Asia (0.59), OECD countries (0.56), East Asia (0.51) and sub-Saharan Africa (0.49). As a result, inequality in land ownership is much higher than income inequality across the world.[4]

31. Gender inequality, an important and integral part of economic inequality, takes multiple shapes and forms. With regard to labour markets, women are generally paid less than men for similar jobs with similar qualifications. The relatively low proportion of women who own firms, work in top management or are engaged in full-time employment also provides an indication of the inferior position of most women in labour markets. Women are more likely to work in precarious, low-paid or unpaid jobs and tend to obtain less well-paid jobs, even with comparable qualifications. Finally, they perform the major part of unpaid household work. Although gender-related income inequality is one of the most widespread forms of economic inequality, it is one that is least visible in aggregate statistics.

32. Access to education is a key factor in generating equality of opportunities. Access limited to the upper income groups will perpetuate existing social stratification and income inequalities, and stymie social mobility. Access to education has improved substantially, in large part because of the concerted effort to achieve the Millennium Development Goals. As a result, more people have access to education today than ever before. However, low income remains a major barrier at all levels of education. In Latin America, for example, only one in five children from the lowest quintile complete secondary school. Only 17.5 per cent of children are enrolled in pre-school in sub-Saharan Africa, compared with 85 per cent in high-income countries. In general, the higher the direct costs of access to education, the more likely this will be to deter or pose a heavy burden on poorer households.

V. Inequality and globalization

33. According to available data, inequality increased strongly during the first phase of globalization in the late nineteenth century and the beginning of the twentieth. Subsequently, it decreased in all developed countries, first following the massive economic and political shocks between 1914 and 1945, and then with the rise of the welfare State. Based on these trends, Simon Kuznets concluded that inequality rises in the early phases of capitalist development and later tends to fall. This inverted U-shaped curve was subsequently accepted in economic circles as the universal pattern that all countries would follow. For developing countries, this seemed to imply that higher inequality was the price

[4] UNCTAD, 2012, *Trade and Development Report, 2012*: *Policies for Inclusive and Balanced Growth* (New York and Geneva, United Nations publication).

to be paid for an initial development push, before returning to more tolerable levels at higher incomes.

34. These ideas were formulated during the golden age of capitalism when output experienced its fastest and longest expansion. Developed and developing countries experienced average growth rates of around 5 per cent per annum, from the end of the Second World War to the first oil shock in the early 1970s. But rather than the result of unmanageable structural pressures and market forces, broad-based prosperity followed, thanks to reconstruction efforts to rebuild European economies after the war, deliberate policies of full employment growth and the strong regulation of financial markets at the domestic and international levels.

35. The turning of the ideological tide against these policies and regulations beginning in the mid-1970s and continuing through the recent financial crisis has coincided with a period of growing income inequality. Paradoxically, research on the issues of economic inequality went out of favour just when income distribution started to undergo marked changes. However, the trends described earlier have recently generated new research on the topic in both developed and developing countries.

36. While the Kuznets theory is inadequate to explain recent developments, several important questions beg to be answered. Was the decrease in inequality between the first and the second phase of globalization simply a temporary deviation from a general trend? Indeed, if such a general trend exists, is there a natural tendency of capitalist economies to lead to more and more unequal distributional outcomes?[5] What is causing this increase in inequality? What is the impact of heightened inequality on economic variables such as growth and employment, social variables such as social mobility and stability, and political outcomes in terms of concentration of power and democracy? Finally, if the effect of economic inequality is to worsen outcomes in economic, social and political areas, what is the scope of public policies to mitigate them? While there are presently no clear answers to many of these questions, recent research has shed some light on the impact of inequality on economic, social and political variables.

37. The textbook trade-off between growth and equality has paid much attention to whether trade or technology has been the principal link between globalization and rising income inequality, and whether the general (efficiency) gains outweigh local costs (in terms of income or employment losses), and if so, how best to compensate the “losers”. The discussion has not proved conclusive, however, in part because this trade-off is difficult to reconcile with the wide experience across countries in terms of the timing and scale of these different aspects of globalization.[6]

38. The traditional view that trade liberalization will promote greater income equality in developing countries is based on the assumption that with open markets a country will produce and trade goods that use its abundant factor of production most intensively. Since in developing countries the most abundant factor is unskilled labour, their production under free trade should concentrate on agricultural and manufactured products that require unskilled labour. This would consequently increase the relative demand for unskilled labour, leading to an improvement in the share of wages in domestic income, as well as a reduction in wage inequality worldwide.

[5] For example, T Piketty, 2014, *Capital in the Twenty-First Century*, Harvard University Press, Cambridge, Massachusetts, United States.

[6] UNCTAD, 1995, *Trade and Development Report, 1995* (New York and Geneva, United Nations publication).

39. However, the experience of many developing countries, especially in Africa and Latin America, with trade liberalization and inequality trends is different. Instead of specialization in the production of goods that require unskilled labour, many of these countries have specialized in the production of commodities, which generally is more capital intensive. That has resulted in the deindustrialization of economies on both continents. In Africa, for example, the share of manufacturing in GDP fluctuated at around 14 per cent from the 1970s to the late 1990s, when it started to decline. In 2012, manufacturing represented only 9.1 per cent of the total value added in Africa. As the number of formal sector jobs diminished with deindustrialization, and the specialization in production and exports of commodities did not create new ones, economic inequality increased. This contrasts with the experience of the newly industrialized economies of East Asia, where trade liberalization came after a successful implementation of industrial policies, and protection and support were removed in large part because they were no longer needed.

40. However, and as discussed in several UNCTAD studies, trade has not been the dominant economic force shaping the contemporary globalization process. The evidence that this has been a source of growing inequality appears to be more conclusive. Across most countries, the top income strata (in some cases only the top 1 per cent of the population) have seen the greatest – and in some cases the only – gains from boom conditions, capturing higher rentier incomes through capital gains and interest payments than would have been possible under more regulated financial structures or even conceivable barely a generation ago. Capital mobility has made it harder to tax, reducing the bargaining power of labour and increasing the State’s reliance upon regressive taxes and bond markets, further amplifying the adverse distributive impact of finance-led globalization.[7] A growing body of research has begun to tie the scale of the current crisis to these inequalities, pointing to their skewed impact on the composition of demand, incentives that promote financial over real investments and their links to an increasingly fragile debt-driven growth model.

41. Four channels have been identified through which income inequalities can have negative impacts on economic growth and stability. The first channel is the impact on the level and composition of aggregate demand, the second is the relationship between inequality and sociopolitical instability, the third is concerned with political economy implications of high inequality and the fourth is related to imperfect capital markets and investment in education.

42. The level and composition of demand are important determinants of growth. Typically, entrepreneurs base their investment and hiring decisions on their expectations of future demand for their products. If wages in one country are higher (inequality is lower), the future demand will be higher. Thus, lower levels of inequality will have a positive impact on the level and composition of demand, and thus stimulate investment, employment and growth. Conversely, wage compression will adversely affect these variables.

43. Income inequality may also affect a country’s social and political stability. Economic inequality may result in higher crime rates, strengthened organized crime, higher corruption, eroded property rights and increased transaction and security costs, all of which creates uncertainty for investors and reduces economic growth. In extreme cases, increasing inequality may reach a point where it leads to social and political upheavals.

[7] A Jayadev, 2007, Capital account openness and the labour share of income, *Cambridge Journal of Economics*, 31 (3): 423–443.

44. Political economy models emphasize the link between inequality and growth in the political sphere. Depending on how models are specified, median voters will either want more or less redistribution to change the results of the functional distribution caused by the market. However, as the concentration of income and wealth increases, richer individuals can acquire more possibilities to influence political outcomes and in that way, bias policies in their favour. If richer members of a society have more influence on economic policies, the outcome could be adverse for growth by, for example, policies favouring investment in the financial sector, instead of the real sector. Thus, growing inequality, if unchecked, could eventually undermine democracy.[8]

45. The fourth channel emphasizes the interactions between income inequality, imperfect capital markets and investment in education. Since education is costly, poorer members of a society are prevented from getting the education level that would be optimal from the society's point of view. Hence, inequality may have a negative effect on economic growth when human capital is the main driver of such growth because credit constraints can limit aggregate human capital accumulation. In addition, capital market imperfections result in the inability of the poor to invest, even if their projects have high rates of return. Since high inequality deprives many people of access to education and credit, it prevents the expansion of domestic markets. In other words, lack of access to credit arising from capital market imperfections lowers the rate of growth of the economy.

46. The last two channels may have also contributed to the global financial crisis that erupted in 2008. Extremely high compensations paid to corporate executives and financial agents in some developed countries have led to excessive risk taking in search of short-term profits and shareholder dividends. This has resulted in a flourishing of opaque financial transactions that were at the heart of the crisis. In contrast, stagnant wages meant that wage earners were forced to go into debt to maintain their living standards. Hence, excessive concentration of income was one of the factors leading to the global crisis, as it was linked to perverse incentives for the top income earners and high indebtedness in other income groups.

47. The government response to the global financial crisis has further heightened economic inequalities. Publicly financed bank bailouts of private financial institutions amounted to a transfer of income from the poorer to the richer parts of society since the fiscal cost of crisis resolution was borne by the society at large through a process of socialization of private losses. These regressive transfers were financed by a combination of higher taxes and lower public spending that had a direct impacted on those less well off. The subsequent imposition of conventional stabilization programmes through fiscal austerity, labour-market deregulation and privatization amplified inequality further. The large underutilization of existing resources in the form of high unemployment has been one of the most enduring characteristics of the period since the eruption of the crisis in 2008.

48. The global financial crisis has greatly increased awareness of the close association between growing inequality, the rise in unregulated financial markets and the threat to economic and social security from shocks and crises. That means high inequality not only prevents societies from achieving inclusive growth – it may prevent them from achieving sustainable economic growth as well.

49. In addition, there may be other channels through which economic inequality adversely affects economic growth. For a capitalist economy to function efficiently, it is necessary to provide public goods in sufficient quantity and of sufficient quality. Given that they are characterized by externalities, the socially optimal supply of these goods is

[8] J Stiglitz, 2012, *The Price of Inequality*, W.W. Norton and Company, New York and London.

possible only through government involvement. However, the more divided a society becomes in terms of income and wealth, the more reluctant the wealthy are to spend money on common needs. The result is underinvestment in infrastructure, basic research, education and other public goods, making the economy less efficient.

50. Rent seeking is another channel through which economic inequality adversely affects the efficient functioning of the economy. In its simplest form, rents are redistributions of income from the rest of the society to the rent seekers. They involve a real waste of resources that lowers a country's productivity, distorts resource allocation and weakens the economy. Monopoly power and preferential tax treatment for special interests are some forms of rent seeking that have negative effects on the economy. When rents are generated by monopoly power, prices are too high, resulting in a shift of incomes from the rest to the monopolist. The higher the concentration of income and wealth, the more likely it is that monopoly power and other forms of rent seeking will occur.

VI. Policies to tackle inequalities

51. Rising inequalities, uneven development and erratic growth have become permanent features of the global economy in the past 30 years. This is becoming more and more recognized and is raising concerns not only of an economic nature, but also of a social and political nature. These trends could potentially become threats not only to the social contract on which capitalism is based, but also to democracy itself. As such, economic inequality and what to do about it is becoming one of the central challenges of our time.

52. In particular, the notion that there might be an unavoidable trade-off between efficiency and growth has been firmly shaken, and its cruder extension, the trickle-down theory, has been proven to be wrong. If anything, recent research, as well as the experience of economic growth and trends in inequality in both developing and developed countries, is pointing to the opposite conclusion: high inequality is detrimental to growth and may also have adverse effects on social and political stability. The notion that more equal societies are also more economically stable, inclusive, sustainable and democratic is gaining ground. The relatively equal distribution of income and wealth in several Asian "tiger" economies, and before them in the Scandinavian countries, demonstrates that equality is compatible with strong economic performance.[9]

53. The channels linking inequality and growth are many and complex. However, as the policy changes introduced in the 1980s helped to increase inequality, there is no reason why a different set of policies could not alleviate or even reverse these adverse effects. If the costs of inequality outweigh their benefits to the society at large, reducing inequalities should be a legitimate goal of public policies.

54. The experience of the last 15 years suggests that there is a macroeconomic approach compatible with the reduction of inequality. In a policy framework that aims at linking the development of productive capacities with employment creation in order to reduce inequality, fiscal policies acquire a central position. Public spending and taxation are key instruments for shaping the distribution of purchasing power in an economy and, with it, strengthening the process of capital accumulation, thereby placing the economy on a jobs-rich growth path. They are also effective instruments that could help establish linkages between enterprises in modern sectors and the rest of the economy, thus making the process

[9] UNCTAD, 2011, *Report of the Secretary-General of UNCTAD to UNCTAD XIII, Development-led globalization: Towards sustainable and inclusive development paths* (New York and Geneva, United Nations publication, UNCTAD (XIII)/1).

of structural change more dynamic and turned in the right direction. They can help accelerate the diversification of economic activities and develop sectors that are of strategic importance for national development.

55. Widening the available fiscal space requires diversifying public sector financing sources and strengthening domestic resource mobilization by broadening the tax base, improving the collection system and making the tax system more progressive. Reducing or eliminating exemptions and loopholes, as well as enticing more businesses to join the formal sector, would go a long way towards broadening the tax base.

56. In the case of developing countries rich in energy and mineral resources, domestic resource mobilization may be achieved particularly through improvements in the capture and redistribution of resource rents. Resource-rich countries can increase fiscal revenue by reversing their current practice of offering extremely favourable terms to foreign investors in agriculture and mining. With regard to agriculture, this means imposing a tax on land leased for large-scale investment projects or raising the existing tax on land, as well as revising the taxation on the activity undertaken by those projects. In the case of mining, Governments can raise their revenues by adopting higher levies, royalties, income taxes or, in specific cases, export taxes. These can be usefully directed towards strengthening human capital formation and expanding infrastructure, which provide the long-term basis for economic diversification, which is especially critical because the resources generating these rents are exhaustible.

57. One of the recent lessons for developing countries is that there is a need to avoid the financialization of their economies. In addition, it is necessary to limit foreign indebtedness and mobilize domestic resources. The recourse to foreign sources should be selective and sustainable to avoid high foreign indebtedness, which strongly limits policy space. Capital accumulation should be financed by mobilizing domestic resources through the development of well-regulated banking networks. It also means assigning a greater role to development banks that can behave countercyclically and provide credit to sectors of strategic importance to the national economy.

58. Large inflows of speculative foreign capital can have damaging effects on the national economy. This renders the local currency overvalued, thus penalizing exports and incentivizing imports. It also results in the appreciation of local assets, creating bubbles that sooner or later will burst. This boom-and-bust pattern, fuelled by the inflow and outflow of foreign capital, is detrimental to the national economy and should be avoided at all costs. It directly increases inequality by leaving economies in prolonged recessions with long-lasting consequences for the poor. Different kinds of capital controls should be used to restrict the harmful effects of large inflows and outflows of speculative capital.

59. In parallel with capital controls, developing countries should choose intermediate exchange-rate regimes to minimize the risk of currency crises. These regimes could also target a stable and competitive exchange rate, a key factor in kick-starting growth, diversifying the economy and keeping inequality within a reasonable range.

60. Trade liberalization should be managed so as to prevent a collapse of import-competing sectors. Indiscriminate and large-scale trade liberalization has resulted in premature deindustrialization in many developing countries, particularly in Africa and Latin America. That has eliminated thousands of decent jobs in the formal sector and contributed to rising economic inequality. When trade liberalization promotes growth through technological modernization, it should be accompanied whenever possible by compensatory programmes and active labour market policies to reduce the impact on wage inequality.

61. Monetary policy could also contribute to lessening economic inequalities by aiming not only at low inflation, but also full employment of resources. An alternative to a

monetary policy fixated on attaining an inflation rate in low single digits is a macroeconomic strategy that targets those real variables that are important for a particular country. These can include aggregate growth, productive investment, employment generation or poverty reduction. Monetary policy must be part of the overall macroeconomic policy directed towards these targets, rather than operating on a separate track of solely addressing monetary variables. It should be coordinated and aligned with fiscal and exchange rate policies. Since the chosen target must be met within other constraints, interest rate management will not suffice, and other instruments should be used by the central bank, including directed credit. Policymakers should avoid excessive rigidity over any one target and be prepared to be flexible in adjusting targets and instruments depending upon the requirements of changing situations.

62. In addition, credit might be a more important variable than monetary supply. From that perspective, the volume of credit is a more effective monetary policy instrument than other instruments. This might be especially important in developing countries, where money markets and capital markets are underdeveloped. The consequence of that underdevelopment is that few households and enterprises would be able to borrow for consumption and investment. This is especially critical for microenterprises and small enterprises and farms that cannot provide collateral for a credit and thus are deemed not to be creditworthy by the banking sector. To remedy that situation, central banks could facilitate access to credit to sectors and activities of great importance for the economy. Policy instruments that could be used include interest subsidies, guarantees for certain types of credit, direct provision of credit by public financial institutions (development banks, for example) or refinancing of commercial loans.

63. Banking and financial sector regulation is particularly important to avoid the repetition of the damage that the global financial crisis inflicted on growth, employment and public finances, thereby exacerbating inequality. Some of the possible measures include increasing the capitalization of banks and strengthening their supervision, introducing stricter prudential regulation, enhancing risk-assessment mechanisms in large banks and assigning a greater role to national development banks in the mobilization of domestic resources and financing of economic activity.

64. Efforts aimed at strengthening labour institutions generally tend to reduce income inequality. Inclusive growth can be promoted through steadily rising minimum wages in line with the growth of productivity, coupled with measures to reduce wage dispersion. Measures such as unemployment insurance, retraining programmes and self-targeting public-work schemes could also be effective in reducing inequality. Wage bargaining institutions, which have been weakened substantially in most countries during the past three decades, need to be strengthened. Formalizing employment by helping small and medium-sized enterprises to grow and develop, especially in least developed countries where the informal sector provides up to 80 per cent of total employment, is a measure that may substantially increase the availability of decent jobs and thus reduce inequality.

65. Given that the functional distribution of income has been deteriorating continually in the past three decades, tackling inequality cannot be confined to measures to improve personal income distribution. In effect, reversing the trend towards growing inequality requires tackling the issue of the functional distribution of income. There are three elements of the aggregate wage share that are relevant in this regard, and policies must address all of them. These are the level of employment, the relationship of wages to productivity growth and the remuneration of self-employed workers, who constitute an increasing share of workers in many countries.

66. The inability of economic growth in many developing and developed countries to create jobs in sufficient quantity and quality (decent jobs) to meet the needs of the labour force is a major part of the problem. Reducing inequality requires policies that foster

dynamic structural change, especially in the least developed countries, where that process has stagnated.[10] Putting job creation and full employment at the centre of economic policies is only the first, but necessary, step to address that problem.

67. One of the significant reasons for falling wage share in GDP is that wages in many economies have not increased in line with labour productivity increases. That is why, in addition to employment- and growth-supporting macroeconomic policies, an appropriate incomes policy can play an important role in achieving a socially acceptable degree of income inequality, while also generating employment-creating demand growth.

68. A central feature of any incomes policy should be to ensure that average real wages rise at the same rate as average productivity. Nominal wage adjustment should in addition take into account an inflation target. If wages in an economy increase in line with average productivity growth plus an inflation target, the share of wages in GDP remains constant, and the economy as a whole creates a sufficient amount of demand to fully employ its productive capacities. Collective bargaining mechanisms can contribute to a successful incomes policy.

69. To address the issues of inequality between countries, the development prospects of developing countries should be strengthened. Faster convergence presupposes more development-friendly rules of the game at the international level. In particular, the re-regulation of international financial flows should be addressed. Moreover, the mobility of capital should be balanced by the mobility of labour to promote forces that would lead to convergence in incomes across countries. For the least developed countries to reverse trends towards marginalization in the world economy, a new international development architecture is needed.[11]

70. In sum, inclusive and sustainable development cannot be achieved without an integrated policy framework with growth-promoting and job-generating macroeconomic policies and developmental industrial policies as its main pillars. More broadly, to increase the chances of developing countries catching up with developed countries, coherent macroeconomic, industrial, trade, environmental and social policies that reinforce each other should be implemented. Policy coherence at the national level has to be complemented by policy coherence at the international level, providing countries with the policy space needed to implement their national development strategies and achieve sustainable development goals.

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[10] UNCTAD, 2013, *The Least Developed Countries Report 2013*: *Growth with Employment for Inclusive and Sustainable Development* (New York and Geneva, United Nations publication).

[11] See, in particular, UNCTAD, 2010, *The Least Developed Countries Report 2010: Towards a New International Development Architecture for LDCs* (New York and Geneva, United Nations publication).