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OVERVIEW

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OVERVIEW

The world economy, which continues to suffer from the fallout of the financial crisis that began in late 2007 and the meltdown in September 2008, has not been able to revive the growth conditions of the preceding decade. Those conditions had been particularly supportive of economic and social progress in the developing world, and the resulting momentum, especially in some of the larger developing countries, helped to stoke recovery in the world economy once the worst of the crisis had been contained. However, those countries are now losing that momentum and downside risks for the world economy are growing again.

The immediate problem is the inability of the developed countries to return to a normal growth pattern, but there is also an equally serious problem of contagion. Amidst their fragile recovery, an unreformed (and unrepentant) financial sector and macroeconomic policies that are timid at best, and counterproductive at worst, the developing countries will find it difficult to sustain their own growth dynamic, let alone that of the global economy.

In the United States, a sluggish recovery remains vulnerable to events in Europe given their strongly intertwined financial systems. Europe as a whole is on the brink of a deep recession, with some members having been stuck in reverse gear for several years. In both cases, attempts to overcome the present crisis are dominated by fiscal austerity, combined with calls to further "flexibilize" their labour markets. In practice, this means wage restraint and in some cases massive wage reductions. However, these policies are more likely to further weaken growth dynamics and increase unemployment instead of stimulating investment and job creation. At the same time, as has been demonstrated with similar structural reform policies in the developing world over the past 30 years, they will also serve to reinforce the trend towards greater inequality, *which has become a visibly damaging feature of finance-driven globalization.*

Therefore, a fundamental policy reorientation is needed, recognizing that healthy and inclusive growth will require a stable expansion of consumption and investment in productive capacity based on favourable income expectations of the working population and positive demand expectations of entrepreneurs. This requires a rethinking of the principles underlying the design of national economic policy and supportive international institutional arrangements.

In particular, while globalization and technological change, and their interplay, have created both winners and losers, their apparent adverse impacts on overall income distribution in many countries must be understood in the context of the macroeconomic, financial and labour market policies adopted. Those policies have caused unemployment to rise and remain high, and wages to lag behind productivity growth, and they have channelled rentier incomes towards the top 1 per cent of the income ladder. Neither globalization nor technological improvements inevitably require the kind of dramatic shift in the distribution of income that favours the very rich and deprives the poor and the middle-class of the means to improve their living standards. On the contrary, with more appropriate national and international policies that take into account the crucial importance of aggregate demand for capital formation, structural change and growth dynamics, job creation can be accelerated, inequality reduced and the requisite degree of economic and social stability guaranteed.

Global recovery: uneven and fragile

The recovery from the global financial and economic crisis, beginning in mid-2009, has been uneven and fragile. While growth has regained steam in some developing regions, it has sputtered in most developed countries, with ongoing deleveraging across the private sector, high unemployment spreading uncertainty among households and governments scrambling to consolidate their budgets prematurely. Global decision-makers, including at the level of the G-20, have lacked a clear idea of how to pierce through the thick fog of uncertainty enveloping the global economy and to "lift all boats" on to a more sustainable growth path.

The global economy weakened significantly towards the end of 2011 and further downside risks emerged in the first half of 2012. Growth of global gross domestic product (GDP), which had already decelerated in 2011, is expected to experience a further slowdown in 2012, to around 2.5 per cent.

Despite a very modest improvement of GDP growth in the United States and a more significant one in Japan, developed economies as a whole are likely to grow by only slightly more than 1 per cent in 2012 owing to the recession currently gripping the European Union (EU). That recession is concentrated in the euro zone where the authorities have so far failed to present a convincing solution to the area's internal imbalances and related debt overhangs. The chosen policy of unconditional austerity is suffocating the return to sustainable economic growth. Indeed, a further deterioration of economic conditions in Europe cannot be excluded.

Growth in developing and transition economies has been driven by domestic demand and high commodity prices

While developed countries are still struggling to reignite recovery, GDP growth in developing and transition economies is expected to remain relatively high, at around 5 per cent and 4 per cent respectively. Indeed, most developing countries have managed to regain the ground they had lost as a result of the crisis. This owes much to the adoption of expansionary demand-side policies. For example, China was able to absorb a dramatic fall in its current-account surplus with only a small reduction of its overall growth expectation and without restraining real wage growth. The contrast with Germany, which could not avoid economic stagnation despite its huge surplus, is striking.

Private consumption and wage growth have also played a crucial role in the superior performance of many developing countries. Although GDP growth is slowing down moderately in Latin America and the Caribbean, it is expected to remain in the order of 3.5 per cent in 2012. This growth stems from strong domestic demand, which is being sustained by rising real wages and credit to the private sector. Several countries have been responding to the deteriorating external environment with countercyclical policies, including higher public spending and a more accommodative monetary stance. They have been profiting from the policy space made possible by higher public revenues and active financial policies, including the management of foreign capital flows. As a result, investment rates are on the rise and the unemployment rate has fallen to its lowest level in decades.

Growth rates increased in Africa, owing to continuing expansion in sub-Saharan Africa and to economic recovery in the Northern African countries following an end to the internal conflicts in 2011. Relatively high prices for primary commodities benefited external and fiscal balances, enabling many countries to adopt fiscal stimulus measures. Investment in infrastructure and in natural resources also supported domestic expenditure and growth.

Although it remains the fastest growing region, Asia is experiencing an economic slowdown, with GDP growth expected to fall from 6.8 per cent in 2011 to slightly below 6 per cent in 2012. Several countries – including China, India and Turkey – have been adversely affected by weaker demand from developed countries and by the monetary tightening they applied in 2011 to prevent a rise in inflation and asset prices. Given the headwinds from the international economy, they have since relaxed their monetary conditions and many of them have applied countercyclical measures. Regional growth is based on a continuous expansion of household incomes and a shift from external to domestic demand, as well as on high levels of investment.

The transition economies are expected to maintain a growth rate exceeding 4 per cent in 2012. This is entirely due to the dynamism of members of the Commonwealth of Independent States (CIS). Growth in the CIS is based on strong domestic demand, spurred by gains from the terms of trade and/or strong workers' remittances, while on the supply side the recovery of the agricultural sector has also played a significant role.

Slow expansion of global trade

International trade expansion, after a strong rebound in 2010, slowed to only 5.5 per cent in 2011, and is likely to further decelerate in 2012. In most developed economies – particularly in the euro zone – trade volumes have not recovered to their pre-crisis levels, although in the first half of 2012 they did grow somewhat in Japan and the United States. Trade was comparatively more dynamic in developing countries, but its growth has slowed down significantly even in these countries to around 6–7 per cent in 2011. The exceptions are some commodity exporters, which were able to increase their imports at two-digit rates owing to gains from the terms of trade. These countries benefited from commodity prices that remained high by historical standards in 2011 and the first half of 2012. However, those prices continue to display strong volatility and have been exhibiting a declining trend after peaking during the first months of 2011.

Considerable downside risks to global recovery

The main obstacles to global recovery and a benign rebalancing are concentrated in developed countries. Among these countries, the United States, which continues to have the largest current-account deficit by far, saw its external deficit decline to around 3 per cent of GDP in 2009 due to a marked contraction of imports. Since then, its current-account deficit has remained stable, while domestic demand growth has been sluggish. Moreover, a major risk ahead is that premature and excessive fiscal austerity by early next year could choke growth dramatically. An even greater problem for global recovery is Europe's increasing dependence on exports. Germany's external surplus is only slightly smaller today than it was prior to the crisis. So far, much of the German surplus is offset by deficits mainly in the rest of Europe. However, the ongoing crisis is reducing incomes and imports, and with most countries seeking to improve their competitiveness, the EU's external position may be shifting towards a sizeable surplus. The whole region is, in effect, trying to export its way out of the crisis. This could exert an enormous drag on overall global growth and worsen the outlook for many developing countries.

The crisis in Europe is being widely referred to as a "sovereign debt crisis", as public finances have deteriorated markedly since the start of the global financial crisis and interest rates have soared in a number of countries. However, the situation with public finances is less dramatic in most countries in the euro zone than in other developed economies such as Japan, the United Kingdom and the United States, which have nevertheless seen their bond yields fall to historical lows. Overall, in developed countries the worsening of public finances is primarily due to the working of automatic stabilizers and to the bailouts of financial institutions after the shock of late 2008, though the latter were entirely justified by the gravity of the situation. Since 2010, however, calls for an "exit strategy" from fiscal stimulus and for quick fiscal consolidation have gained the upper hand. As a result, fiscal austerity has become the "golden rule" throughout the euro zone, entailing especially draconian fiscal retrenchment in the Southern European member States. Such a measure may prove to be not just counterproductive, but even lethal for the euro and dire for the rest of the world as well.

Rising fiscal deficits in Europe are but symptoms – not the root cause – of the euro-zone crisis. Underpinning the huge divergence of long-term interest rates in the Economic and Monetary Union (EMU) are the wide wage and price differentials and the related build-up of large regional trade imbalances among the members. These imbalances started to build up at the very juncture when the most important instrument to deal with such imbalances – namely changes in the exchange rate – was no longer available. With fiscal policy ideologically blocked in many key countries and the existing monetary policy toolkit clearly inadequate, unconventional policy instruments are now needed.

Structural reforms are no substitute for a growth strategy

In general, the role of fiscal policy in developed, developing and transition economies alike needs to be reassessed from a dynamic macroeconomic perspective. Fiscal space is largely an endogenous variable which depends on a combination of policy choices and institutional capabilities. In particular, macroeconomic policies that stabilize GDP growth and keep interest rates low can contribute to securing fiscal space and achieving a sustainable public debt. Clearly, fiscal space is not evenly distributed either globally or regionally, but slowing domestic demand and GDP growth has never been a viable option to help consolidate public finances. It is crucial for the world economy and for the prospects of developing countries that systemically important countries, in particular those with current-account surpluses, make wise use of their available fiscal space to restore growth and support current-account rebalancing.

Adding to the bleak prospects for global recovery is the problem that policymakers in developed countries, particularly in Europe, now appear to be pinning their hopes once again on "structural reforms". However, those reforms are all too often coded language for labour market liberalization including wage cuts, a weakening of collective bargaining and greater wage differentiation across sectors and firms. The reasoning behind such a structural reform agenda is flawed because it is based on purely *microeconomic* considerations and ignores the *macroeconomic* dimension of labour markets and wage determination. A fixation on reforms of this kind can be dangerous in the current situation of rising unemployment and falling private demand. Moreover, asymmetric rebalancing that places the burden of adjustment solely on crisis-stricken current-account deficit countries in the European periphery is bound to further undermine regional growth.

Reforms in global governance need to be reinvigorated

The G-20 process established in 2008 to enhance global macro-economic and financial coordination has lost momentum. It has made no progress towards reforming the international monetary system, even though exchange rate misalignments driven by currency speculation persist. International financial reform is another unresolved issue. While the crisis prompted the consideration of an agenda for placing the international financial system on a safer footing, policymakers' attention to it remains fragmentary and hesitant.

It now seems that the moment of opportunity has passed – the advice to never let "a serious crisis go to waste" has gone unheeded. The financial crisis and the bailouts have led to even greater concentration in the financial sector, which has largely regained its political clout. Short-term rewards rather than long-term productivity remain the guiding principle for collective behaviour in the financial industry, even today. There is a very real threat that financial institutions and shadow banking activities may again succeed in dodging the regulators, as vividly demonstrated by recent banking scandals.

Bank deleveraging in developed economies, even if warranted, may again have negative effects on developing countries. If the deleveraging does not occur in a gradual and orderly manner, but is forced by sudden stresses in banks' balance sheets as a result of new shocks, it may also affect international bank lending. In this regard, the availability of trade finance is of particular concern, and may require a new global initiative to make sure that developing countries are not adversely affected due to an external credit crunch.

Rising income inequality: a feature of the past three decades

Fiscal austerity, combined with wage restraint and further flexibilization of labour markets, not only causes an economy to contract, but also creates greater inequality in the distribution of income. The ensuing threat to social cohesion is already visible in several countries. However, rising inequality is by no means a recent phenomenon; it has been a ubiquitous feature of the world economy over the past 30 years, even if in some developing countries this trend appears to have come to a halt since the beginning of the new millennium.

After a long period of relatively stable distribution of income between profits and wages, the share of wages in total income has fallen since around 1980 in most developed and many developing countries. In several of the larger developed countries much of this decline already occurred between 1980 and 1995, when increasing unemployment started to exert pressure on workers and to weaken unions and average wages began to fall behind overall productivity growth. In some countries this trend continued for two decades. With wage compression pursued in many developed countries to overcome the current crisis and new records in unemployment, this trend is likely to be even reinforced. In several developed countries it has been accompanied by a dramatic gap between the top income groups and those at the bottom of the income ladder.

In developing countries the wage share has also tended to decline since the early 1980s. It has to be kept in mind, though, that in many of them data on functional income distribution are less indicative in this respect than in developed countries. Large segments of their active population are self-employed in low-productivity agriculture or retail commerce activities, and it would be misleading to consider all their revenue as capital income.

Inequality of personal income distribution increased in all regions after 1980

Personal income distribution, which reflects the distribution between profits and wages, disparities between income categories and redistribution by the State, had become more equal in most developed countries during the post-war period until the late 1970s. Subsequently the income gap widened. The Gini coefficient that measures income inequality across all income groups confirms this trend: in 15 out of 22 developed countries, personal income distribution deteriorated between 1980 and 2000, though in 8 of them this trend was reversed to some extent after 2000.

In developing countries, inequality of personal income distribution is generally more pronounced than in developed countries and transition economies. As in developed countries, the income gap narrowed during the first three decades after the Second World War, with the exception of countries in Latin America. But during the period 1980–2000 there was a general increase in inequality in all developing regions. Since the turn of the millennium, trends in income distribution have diverged among developing regions.

In Latin America and the Caribbean inequality rose during the 1980s and 1990s in 14 out of 18 countries for which relevant data are available. It reached a historical peak in the region as a whole by 2000, but has fallen since then in 15 of the 18 countries. However, overall, it remains higher than before the 1980s.

In Africa as a whole, between 1980 and 1995 inequality increased from an already high level, as in Latin America, but this increase began a few years later than in other regions. Out of 23 African countries for which relevant data are available, inequality increased in 10 countries (including several with large populations), but fell in another 10 and remained unchanged in the remaining 3 countries. After 1995, the income gap narrowed in 15 out of 25 countries, mainly in Southern Africa and West Africa, but sub-Saharan Africa still accounted for 6 of the 10 countries with the most unequal income distribution in the world.

In Asia, where inequality of personal income is generally lower than in other developing regions, it has increased since the early 1980s in terms of both income disparities across all income groups and the share of the top income groups in total income. Greater inequality is particularly evident in India, but it has also increased in East and South-East Asia, where 7 out of 9 countries for which relevant data are available saw an increase in personal income inequality between 1980 and 1995. Distinct from some countries in South-East Asia, inequality continued to rise in East Asia also after 2000, albeit at a slower pace. In many Asian economies, income from financial activities rose considerably faster than from other activities.

In China, a marked rise in inequality has accompanied fast economic growth since the 1980s, and this trend has continued beyond 2000. Despite rapid growth in the average real wage, the share of labour income in total income has declined and wage disparities have grown on several dimensions: between urban and rural areas, interior and coastal regions, and between skilled workers in certain occupations and low-skilled migrant workers. The share of the top 1 per cent incomes in total income has also increased since 1985, but it remains low by international comparisons.

In Central and Eastern Europe, income distribution was the most egalitarian among all country groupings until the early 1990s. Following their transition to a market economy, the wage share in GDP fell dramatically and inequality of personal income distribution in this region increased more sharply than in any other region, although it is still lower than in most developing countries.

In all regions growing income inequality since the early 1980s has been associated with an increase in the concentration of wealth in the higher income strata. Ownership of financial and real assets is not only a source of income but also facilitates access to credit and privileged participation in political decision-making. In many developing countries, the concentration of land ownership plays a particularly important role in this regard. It is especially high in Latin America, where income inequality is also the most pronounced, whereas it is relatively low in East and South-East Asia and in sub-Saharan Africa.

Is greater income inequality inevitable?

The shifts in income distribution over the past three decades occurred in parallel with accelerating trade and financial flows, the spread of international production networks and rapid technological change, owing in particular to progress in information and communication technologies (ICTs). This led to the widespread assumption that increasing income inequality is an inevitable by-product of structural changes brought about by globalization and technological change, or even a precondition for such change. However, structural change also occurred throughout the past century, including during periods when inequality of income distribution was considerably lower.

It is true that in the past few decades globalization has been spurred by trade and financial liberalization and the greater participation of developing countries in international production chains and in international trade of manufactures. Moreover, progress in the application of ICTs in recent decades may have been faster than technological change in earlier phases of economic development. But it is also true that there was rapid increase in productivity during the previous decades, and yet income disparities narrowed along with the simultaneous creation of a sufficient number of new jobs.

Structural change and corporate strategies in developed countries

In developed countries, which entered a period of normal "deindustrialization" in the 1970s and 1980s, structural change in recent decades has been shaped by fast growth of the financial sector, and to some extent by advances in ICTs and by increased competition from developing countries. In some countries, these have been accompanied by shifts in the demand for labour with different skills – i.e. a decline in the demand for moderately skilled workers relative to both the highly skilled and the low-skilled. The rise of imports from developing countries has accelerated since the mid-1990s largely as a result of offshoring of production.

The increasing frequency of such relocation of production is related not only to the liberalization of trade and increasing attempts by developing countries to attract foreign direct investment (FDI), but also to a change in corporate strategies of a growing number of firms in developed countries. Emphasis on the maximization of shareholder value has led managers to focus on short-term profitability and a higher stock market valuation of their companies. This approach has changed the way companies have been responding to competitive pressures under conditions of high unemployment. Instead of adopting a long-term perspective and trying to further upgrade their production technology and the product composition of output through productivity-enhancing investment and innovation, they have increasingly relied on offshoring production activities to low-wage locations in developing and transition economies, and on seeking to reduce domestic unit labour costs through wage compression. The pursuit of such strategies has been facilitated by the weaker bargaining position of workers faced with the persistent threat of becoming unemployed, which has strengthened the power of profit earners vis-à-vis wage earners. This trend has been associated with growing wage inequality between workers with different skills, and of those with similar skills in different occupations.

Structural and macroeconomic factors influencing inequality in developing countries

Widening inequality in the different developing regions and in the transition economies is associated with very different development paths. In some cases, as in a number of Asian economies, it has accompanied rapid economic growth. In others, it has taken place during periods of economic stagnation or depression, as in Latin America and Africa in the 1980s and 1990s, and in the transition economies in the 1990s.

In a number of developing countries, especially in Latin America, but also in some transition economies, the trend towards greater inequality in the 1980s and 1990s occurred in a context of "premature" deindustrialization. Labour moved from manufacturing activities in the formal sector towards lower productivity jobs with lower remuneration, such as in informal services and the production of primary commodities. Declining industrial employment, combined with large absolute falls in real wages, in the order of 20–30 per cent in some Latin American countries, led to increasing income gaps in conjunction with stagnating or declining average per capita incomes.

One explanation is that many countries with rich natural resource endowments and a nascent industrial sector found it difficult to sustain a dynamic process of structural change after opening up to global competition. Unlike developed countries, they had not yet acquired the capabilities for technological innovation that would have allowed them to seize the opportunities presented by globalization to upgrade to more capital- and technology-intensive activities. Moreover, unlike low-income countries at the initial stages of industrialization, they did not, or no longer, possess abundant cheap labour and thus could not benefit as much from the offshoring of labour-intensive activities by developed-country firms. Countries that possessed some industrial production capacity relatively early may also have been adversely affected by increasing imports of manufactured goods from other, lower-wage developing countries.

However, the main cause of deindustrialization in a number of developing countries in the 1980s and 1990s lies in their choice of macroeconomic and financial policies in the aftermath of the debt crises of the early 1980s. In the context of structural adjustment programmes implemented with the support of the international financial institutions, they undertook financial liberalization in parallel with trade liberalization, accompanied by high domestic interest rates to curb high inflation rates or to attract foreign capital. Frequently, this led to currency overvaluation, a loss of competitiveness of domestic producers and a fall in industrial production and fixed investment even when domestic producers tried to respond to the pressure on prices by wage compression or lay-offs.

In other countries, such as India and many African countries, the manufacturing sector has not grown fast enough to generate sufficient employment and a much larger proportion of the labour force has been absorbed in informal and less remunerative employment, while price liberalization in agriculture has led to lower incomes of farmers, particularly in Africa. To the extent that liberalization has brought benefits, these have accrued mainly to traders rather than farmers. Moreover, where industrialization has largely relied on integration into international production networks, as in a number of countries in South-East Asia and parts of Africa, production activities and job creation have been mainly in labour-intensive activities without igniting or sustaining a dynamic process of industrial deepening. As a result, traditional patterns of specialization in primary commodities and natural-resource-intensive manufactures have been preserved, if not reinforced.

Some improvements in income distribution since the late 1990s

Reductions in income inequality over the past decade in Latin America and in parts of Africa and South-East Asia occurred in a context of improved external conditions, especially higher international commodity prices and lower debt service burdens. However, owing to different internal structures and domestic policies their effects on income inequality were not the same everywhere. In resource-rich developing and transition economies where the concentration of ownership of land and mineral resources is typically high, rising prices of oil and mineral products tend to increase income inequality. Nevertheless, some resource-rich countries, especially in Latin America, have succeeded in translating terms-of-trade gains into broad-based income growth in the economy as a whole since 2002 and thus in narrowing the income gap. They achieved this by augmenting their fiscal revenues and by targeted fiscal and industrial policies, which helped to create good-quality jobs outside the commodities sector. Higher fiscal spending created jobs directly in the public and services sectors, and indirectly in occupations related to infrastructure development and in manufacturing industry. Countercyclical fiscal policies and more progressive income taxes were also very important. Moreover, many countries used higher public revenues for increased social spending. Several countries also adopted managed exchange rate systems and capital controls with the aim of stemming speculative capital inflows and preventing currency overvaluation.

Rapid industrialization with growing inequality in Asia

In many East and South-East Asian economies, macroeconomic and industrial policies supportive of productive investment spurred rapid industrialization and buoyed economic growth in the context of increasing globalization. In these subregions, the shifts in income distribution over the past few decades have been strongly influenced by the creation of numerous employment opportunities in high-productivity activities, mainly in manufacturing. Thus labour was able to move from low-productivity jobs, often rural, towards higher productivity jobs. Wages in these occupations rose faster than average wages as the supply of better skilled workers fell short of demand. In addition, financial liberalization caused incomes from financial activities to rise faster than those from other activities. To the extent that income inequality hinders the development of domestic markets, a move to more equal income distribution would facilitate a productive upgrading away from low-wage and low-skill specialization within international and/or regional production networks.

In China, rising inequality has also taken the form of growing regional income disparities and a widening urban–rural income gap. This appears to be due to fiscal decentralization and trade and industrial policies, including investment in infrastructure, that have favoured coastal areas closer to international trade routes and large-scale capital-intensive production over small-scale production. At the same time, disparities among wage earners contributed to overall inequality, as the distribution of wages shifted in favour of skilled workers in the high-tech, financial and services sectors, and migrants from rural areas receive lower wages and social benefits than urban workers with formal residence.

The role of FDI and relocation of production

The global production and investment decisions of transnational corporations (TNCs) have played an important role in the globalization process. They integrate the output from production stages outsourced to a specific country seamlessly into the continuously evolving total production process. TNCs typically achieve this by offshoring specific slices of their technology to their foreign affiliates, combining their advanced technology developed at home with cheap labour abroad. Over the past two decades, albeit under the specific circumstances of rather high unemployment and possibly contrary to earlier periods with low unemployment, FDI outflows at times have had the effect of exerting downward pressure on wages and employment in manufacturing, which may have contributed to an increase in income inequality in the largest developed countries.

For developing countries the evidence is mixed. However, FDI alone has never been sufficient to change the balance in the labour markets in favour of labour on either side of the flow. Paradoxically, home and host countries have displayed similar responses to growing FDI in terms of labour market policy and wage setting: home countries attempted to curb the trend towards the relocation of production abroad by deregulating their labour markets and putting pressure on wages, while host countries also made efforts to create "flexible" labour markets to attract additional FDI. In the same vein, governments have often aimed at creating locational advantages or compensating for presumed locational disadvantages by lowering taxes, thereby boosting net profits of TNCs and limiting their potential to reduce inequality with fiscal instruments.

The turning point: financial liberalization and "market-friendly" policy reforms

In order to comprehend the causes of growing inequality, it should be borne in mind that the trend towards greater inequality has coincided with a broad reorientation of economic policy since the 1980s. In many countries trade liberalization was accompanied by deregulation of the domestic financial system and capital-account liberalization, giving rise to a rapid expansion of international capital flows. International finance gained a life of its own, increasingly moving away from financing for real investment or for the international flow of goods to trading in existing financial assets. Such trading often became a much more lucrative business than creating wealth through new investments.

More generally, the previous more interventionist approach of public policy, which strongly focused on reducing high unemployment and income inequality, was abandoned. This shift was based on the belief that the earlier approach could not solve the problem of stagflation that had emerged in many developed countries in the second half of the 1970s. It was therefore replaced by a more "market-friendly" approach, which emphasized the removal of presumed market distortions and was grounded in the strong belief in a superior *static* efficiency of markets. This general reorientation involved a change in macroeconomic policies; monetary policy gave almost exclusive priority to fighting inflation, while the introduction of greater flexibility in wage formation and in "hiring and firing" conditions was intended to reduce unemployment. The idea behind this approach, based on static neoclassical economic reasoning, was that flexible wages and greater inequality of income distribution would enhance investment by boosting net profits and/or aggregate savings.

In the context of expanding financial activities, greater inequality often led to higher indebtedness, as low- and middle-income groups were unable to increase or maintain their consumption without resorting to credit. This in turn tended to exacerbate inequality by increasing the revenues of owners of financial assets. Moreover, when excessive debts eventually led to financial crises, inequality frequently rose because the costs of the crises generally had a disproportionate impact on the poorest.

While this shift in policy orientation occurred in most developed countries from the late 1970s onwards, the new thinking also began to shape policies in developing countries in the subsequent decades. In particular, a large number of countries were forced to comply with the conditionalities attached to assistance from the international financial institutions or followed their policy advice in line with the "Washington Consensus" for other reasons.

Deregulation of labour markets and tax reforms

With regard to labour markets, this new policy orientation meant deregulation and the introduction of greater flexibility. The unwillingness of workers to accept lower wages was considered the main reason for unemployment inertia. In an environment of high and persistent unemployment, the influence of trade unions was weakened in countries where they had previously been influential, and in countries where they were initially weak, they could not be strengthened. As a result, the power in wage negotiations shifted towards employers, and wage increases were kept low in comparison with overall productivity gains, leading to a widespread increase in the shares of profits in total income.

The new spike of unemployment in the context of the financial crisis in 2008–2009, rather than motivating a rethinking of this approach, has, curiously, led to a reiteration of the presumed superiority of flexible labour markets in most developed countries. Only a few governments, notably in Latin America, have not followed such an orientation. Instead, they have focused on policies that improve the economic situation of the poor and the bargaining power of workers without hampering growth and global economic integration.

In terms of fiscal policy, the reorientation of economic policy since the early 1980s towards the principle of minimizing State intervention and strengthening market forces entailed the elimination of "market distortions" resulting from taxation. According to this view, the distribution of the tax burden and the allocation of public expenditure should primarily be determined by efficiency criteria and not by distributive considerations. Lower taxation of corporate profits and lower marginal income tax rates at the top of the income scale were expected to strengthen incentives and increase companies' own financial resources for investment. Another argument in support of lower taxation of high-income groups and profits was that the resulting shift in income distribution would increase aggregate savings, since these income groups have a higher-than-average propensity to save. Supposedly, this in turn would also cause investment to rise.

In many developed and developing countries such liberal tax reforms reduced the tax-to-GDP ratio, lowered marginal tax rates and contributed to strengthening those elements of the public revenue system that had regressive effects on income distribution (i.e. a tax burden that falls disproportionately on lower income groups). In developed countries this was associated with a considerable decline in revenues from direct taxation as a share of GDP.

Reduced fiscal space in developing countries

Fiscal reforms in developing countries in the 1980s, together with the loss of tariff revenues resulting from trade liberalization also led to a reduction of public revenue, or prevented it from rising to an extent that would have enlarged the scope for governments to enhance the development process and to act to improve income distribution. This problem was aggravated by the stagnation of per capita flows of official development assistance (ODA) in the 1980s and their dramatic fall in absolute terms in the 1990s. As a result, in many countries the provision of public services was reduced or user fees for public services were introduced, often with regressive effects or leading to the exclusion of low-income groups from access to such services, especially in Africa and Latin America.

ODA disbursements recovered from a historically low level from the mid-1990s until recently. However, a large proportion of this increase went to only a few countries emerging from several years of conflict, or it was provided in the form of debt relief to a number of countries that were accumulating debt arrears, so that it had a limited effect on the current budgets of most recipient countries. An increasing proportion of ODA was also directed towards health, education and other social purposes, with positive effects on income distribution in the recipient countries. But since the increasing share of ODA for these purposes meant a decline in the share allocated to growth-enhancing investment in economic infrastructure and productive capacities, its effects on structural change and the creation of new employment and wage opportunities were limited.

The failure of labour market and fiscal reforms

Insufficient growth of average real wages, coupled with inappropriate tax reforms, constitute the root causes of rising inequality in most countries, but they have not led to the promised outcomes of faster growth and lower unemployment. This is because any policy approach that dismisses the important contribution of income distribution to demand growth and employment creation is destined to fail. A shift in income distribution to high income groups with a higher savings rate implies falling demand for the goods produced by companies. When productivity grows without a commensurate increase in wages, demand will eventually fall short of the production potential, thereby reducing capacity utilization and profits. This in turn will typically lead to cuts – and not to an increase – in investments.

Real wage increases below productivity growth and greater job uncertainty systematically destabilize domestic demand and serve to increase unemployment rather than reducing it. This suggests that relying on the simple market mechanism cannot prevent disequilibrium on the labour markets. Indeed, just ahead of the new jump in unemployment in developed countries − from an average of less than 6 per cent in 2007 to close to 9 per cent in 2011 − the share of wages in GDP had fallen to the lowest level in the post-war era. Due to their negative effect on consumer demand, neither lower average wages nor greater wage differentiation at the sector or firm level can be expected to lead to a substitution of labour for capital and reduce unemployment in the economy as a whole. In addition, greater wage differentiation among firms to overcome the current crisis in developed countries is not a solution either, because it reduces the differentiation of profits among firms. Yet it is precisely the profit differentials which drive the investment and innovation dynamics of a market economy. If less efficient firms cannot compensate for their lower profits by cutting wages, they must increase their productivity and innovate to survive.

Equally, a possible initial improvement of international competitiveness that may result from translating productivity gains into lower export prices is not sustainable, because it adversely affects growth and employment generation in other countries. Moreover, when such a strategy is pursued simultaneously in many countries whose producers compete internationally, it will tend to trigger a downward spiral in wages. Such practices may deprive a large proportion of their populations of a share in the productivity gains. The same holds for international tax competition, especially with regard to corporate taxation.

A reorientation of wage and labour market policies is essential

Influencing the pattern of income distribution in a way that society as a whole shares in the overall progress of the economy has to be a leading policy objective. That is why, in addition to employment- and growth-supporting monetary and fiscal policies, an appropriate incomes policy can play an important role in achieving a socially acceptable degree of income inequality while generating employment-creating demand growth. 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 also take account of an inflation target. When, as a rule, wages in an economy rise 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. This way an economy can avoid the danger of rising and persistent unemployment or the need to repeatedly adopt a "beggar-thy-neighbour" policy stance in order to create demand for its supply surplus.

In applying this rule, wage adjustment should be forward-looking. This means that it should be undertaken in accordance with the productivity *trend* and with the inflation *target* set by the government or the central bank for the next period, rather than according to actual rates of productivity growth and inflation in the preceding period (i.e. backward-looking). The latter would only serve to perpetuate inflation without securing the desired level of real wages. Linking wages to both productivity growth and the central bank's official inflation target would also facilitate the task of the central bank in preventing inflation, while giving it greater scope to stimulate investment and growth. Collective bargaining mechanisms can contribute to a successful incomes policy.

Wage increases in line with overall productivity growth and an inflation target would primarily serve to keep the wage share from falling and prevent the emergence of large differences in wages for similar occupations. Still, when the wage share falls and inequality of personal income increases, as has been the case in most countries over the past few decades, governments may try to restore the wage share and reduce inequality. Achieving this requires an *a priori* social consensus, which may be reached through a process of collective bargaining between employers' and workers' associations, complemented by government recommendations or general guidelines for wage adjustments.

There are also other instruments that can be used to correct the market outcome in favour of those with weak negotiating power. These include creating additional public employment opportunities, establishing legal minimum wages, and progressive taxation, the proceeds from which could be used for increased social transfers. Public spending designed to improve the provision of essential goods and services and make them more affordable may also be increased.

Income supporting measures in developing countries

These latter instruments are of particular relevance in developing countries, which generally may need to achieve a more drastic reduction of income inequalities than developed countries. There is considerable potential for enhancing productivity growth in these countries by increasing the division of labour and exploiting opportunities to draw on advanced technologies. This means that there is also considerable scope for these countries to reduce inequality by distributing productivity gains more equally, thereby also fostering demand growth.

No doubt, in developing countries, which are still highly dependent on the production and export of primary commodities, the link between growth and employment creation is less direct than in developed countries. Their growth performance is often strongly influenced by movements in internationally determined prices of primary commodities. Moreover, in many developing countries the informal sector is quite large, and small-scale self-employment is rather common. In many of them, formal employment in the manufacturing sector accounts for a relatively small share of total remunerative occupations, and labour unions and collective bargaining typically play a much smaller role than in most developed countries. It is therefore important to complement an incomes policy for the formal sector with measures to increase the incomes and purchasing power of the informally employed and self-employed.

Mechanisms that link agricultural producer prices to overall productivity growth in the economy would gradually improve the living conditions of rural populations. The introduction of legal minimum wages, and their regular adjustment in line with the trend of productivity growth of the economy and the targeted rate of inflation, can have a positive effect on the investment-productivity-growth dynamic. Apart from reducing poverty among those who earn the minimum wage, this can also generate additional employment in response to higher demand, which is likely to be mainly for domestically produced goods and services. Moreover, the level of the legal minimum wage and its adjustment over time can provide an important reference for wage setting in the economy more generally. It is true that implementation of legal minimum wages is difficult in economies with large informal sectors. In those economies, it is necessary to complement such legislation with enhanced public employment, and with strategies to improve the viability of small-scale production.

Influencing income distribution through taxation

In addition to labour market and wage policies, taxation of income and accumulated wealth on the revenue side, and social transfers and the free and universal provision of public services on the expenditure side, play a central role in influencing distributional outcomes.

Progressive taxation can lower inequality among disposable incomes more than among gross incomes. The net demand effect of an increase in taxation and higher government spending is stronger when the distribution of the additional tax burden is more progressive, since part of the additional tax payments is at the expense of the savings of the taxpayers in the higher income groups, where the propensity to save is higher than in the lower income groups.

The experience of the first three post-war decades in developed countries, when marginal and corporate tax rates were higher but investment was also higher, suggests that the willingness of entrepreneurs to invest in new productive capacity does not depend primarily on net profits at a given point in time; rather, it depends on their expectations of future demand for the goods and services they can produce with that additional capacity. These expectations are stabilized or even improve when public expenditures rise, and, through their income effects, boost private demand.

Indeed, the scope for using taxation and government spending for purposes of reducing inequality without compromising economic growth is likely to be much larger than is commonly assumed. Taxing high incomes, in particular in the top income groups, through greater progressivity of the tax scale does not remove the absolute advantage of the high income earners nor the incentive for others to move up the income ladder. Taxing rentier incomes and incomes from capital gains at a higher rate than profit incomes from entrepreneurial activity – rather than at a lower rate as practiced so far in many countries – appears to be an increasingly justifiable option given the excessive expansion of largely unproductive financial activities.

There is also scope for taxation in developing countries

Tackling income inequality effectively through progressive taxation requires a relatively high degree of formal employment in the economy and considerable administrative capacity, which many developing countries do not possess at present. However, these countries (including low-income countries) have a number of potential sources of revenue that can contribute to improving equality while increasing government revenues.

Greater taxation of wealth and inheritance is a potential source of public revenue that can be tapped in many developed and developing countries to reduce inequality of both income and wealth distribution and enlarge the government's fiscal space. For example, taxes on real estate, large landholdings, luxury durable goods and financial assets are normally easier to collect than taxes on personal income, and can represent an important source of revenue in countries that have high inequality of income and wealth distribution.

In resource-rich developing countries, incomes from the exploitation of natural resources and gains resulting from rising international commodity prices are another important source of public revenue. By appropriating their fair share of commodity rents, especially in the oil and mining sectors, governments in such developing countries can ensure that their natural resource wealth benefits the entire population, and not just a few domestic and foreign actors. This is particularly important, as the revenue potential from natural resources has grown significantly over the past decade owing to higher commodity prices.

There also appears to be considerable scope for modifying the tax treatment of TNCs, and FDI more generally. Developing countries often try to attract additional FDI by offering fiscal concessions. However, competing with other potential host countries by offering lower taxes is problematic since it triggers a downward spiral in taxation that reduces fiscal space in all the countries concerned, while initial locational advantages based on taxation tend to erode over time.

Public expenditures to reduce inequality

Well targeted social transfers and the public provision of social services can serve to reduce inequality of disposable income. For example, higher spending on education may contribute to more equitable income distribution, especially in the poorer countries, but only if job opportunities are provided to those who have received such education. However, employment creation depends on overall growth dynamics and especially on the expansion of the formal manufacturing and services sectors.

Public employment schemes, such as those launched in a number of developing countries in recent years, may have a positive effect on income distribution by reducing unemployment, establishing a wage floor, and generating demand for locally produced goods and services. These can be implemented even in low-income countries with low administrative capacity, and can be combined with projects to improve infrastructure and the provision of public services. If well conceived, they may also help to attract workers into the formal sector.

Proceeds from higher tax revenues may also be used for different forms of concessional lending and technical support to small producers in both the urban industrial and rural sectors. Apart from supporting productivity and income growth in these activities, the provision of such financing can also serve as a vehicle to attract small-scale entrepreneurs and workers into the formal sector.

The international dimension

In a world of increasingly interdependent, open economies, a country's macroeconomic performance is more and more influenced by external developments and policies in other countries. Sharp fluctuations in international prices of traded goods and currency misalignments can lead to distortions in international competition between producers in different countries.

The macroeconomic shocks that arise from such mispricing in currency markets affect an economy as a whole, and therefore cannot be tackled at the level of the firm. The appropriate way to deal with such shocks is by revaluation or devaluation of the currencies concerned, rather than by wage cuts in countries whose producers are losing international competitiveness. Movements of nominal exchange rates should reflect changes in inflation rate differentials or in the growth of unit labour costs. This would also prevent beggar-thy-neighbour behaviour in international trade.

Another important aspect of the international framework is the way in which countries deal with the relocation of fixed capital. Greater coordination among developing countries may be necessary to avoid wage and tax competition among them. Such coordination should aim at obliging foreign firms to conform to two principles: to fully accept national taxation schemes; and to adjust real wages to an increase in national productivity plus the national inflation target. Both these principles would set a standard for domestic firms. The latter would not deprive the foreign investors of their – often huge − extra profits arising from the combination of advanced technologies with low wages in the host country, because their labour costs would not rise in line with their own productivity but in line with the average productivity increase in the host economy as a whole.

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All these considerations serve to show that an efficient outcome of market processes in an increasingly globalized economy does not require greater inequality between capital and labour incomes and a greater dispersion of personal incomes. Inclusive growth and development requires active employment and redistribution measures, as well as supportive macroeconomic, exchange rate and industrial policies that foster productive investment and create decent jobs. A better income distribution would strengthen aggregate demand, investment and growth. This in turn would accelerate employment creation, including in high-productivity activities that offer better remuneration and social benefits, thereby further reducing inequality.

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