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POLICY BRIEF

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Key points

- Rising income inequality has accompanied FDG over the last 30 years with a noticeable shift in the proportion of income going to the top 1 per cent.
- Vicious circles of inequality, instability, and crisis have damaged productive investment and slowed long-term growth.

BREAKING THE CYCLE OF EXCLUSION AND CRISIS

Unfettered capital movements, the deregulation of financial markets, regressive taxation and the retrenchment of social programmes – defining features of what UNCTAD has termed “finance-driven globalization” (FDG) – are also contributing factors to rising income inequality observed in both rich and poor countries over the past 30 years. Even leaving aside basic issues of social justice, experience shows that inequality often goes hand in hand with macroeconomic instability and crises, undermining growth prospects and, significantly, further augmenting inequality. Breaking this vicious circle will entail a concerted effort to foster inclusive and sustainable growth. Policy changes will be needed at national and international levels, together with strengthened multilateral support and coordination.

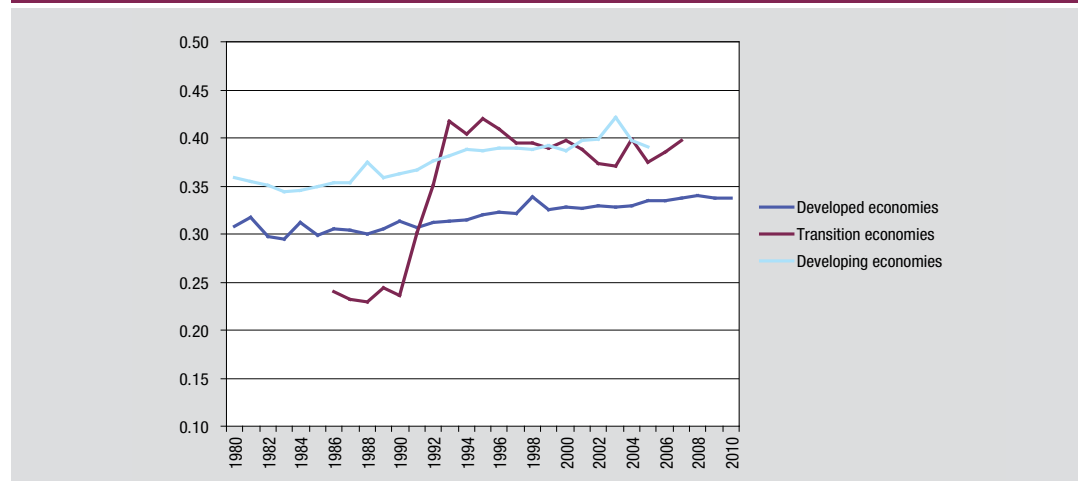
Forces driving inequality

Even before the 2008 financial crisis triggered the worst recession since the 1930s, it had become clear that the prevailing pattern of economic growth was deeply unbalanced. The share of profits and interest in national income had been increasing everywhere over the preceding decades, and the Gini coefficient had tended to rise in developed, developing and transition economies, albeit with some variations, especially in recent years (fig. 1). By 2007, the richest 20 per cent of the world's population was receiving 70 per

cent of global income, while the bottom 20 per cent was receiving only 2 per cent.

Trade openness and technological changes have been offered as possible causes, but these are, at best, partial explanations, because they ignore the dominant role of finance in shaping economic outcomes over recent decades. Several features of FDG have contributed to growing inequality. Firstly, the financial sector's share of national income has grown almost everywhere, channelling larger profits and ever more generous compensation packages to the wealthy.

Figure 1. Gini index, 1980–2010 (net income)

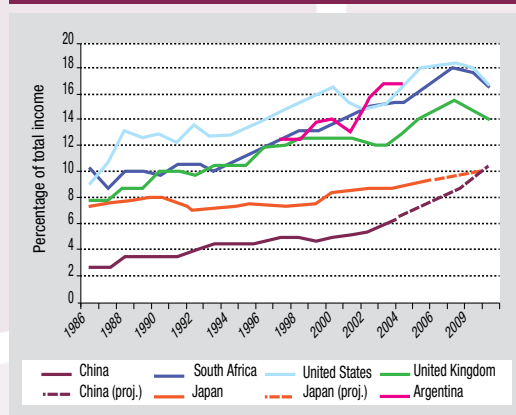


Source: UNCTAD secretariat, based on the *Standardized World Income Inequality Database*.

- A policy shift is needed to reignite growth, with renewed attention to employment, income distribution and social protection.
- Experiences of wage-led growth in Latin America can offer important lessons to other developing economies.

This helps to account for the increasing proportion of income going to the top 1 per cent of the population (fig. 2) and, even more markedly, to the top 0.1 per cent.

Figure 2. Top 1% income shares, 1986–2009



Source: UNCTAD secretariat, based on the *The World Top Incomes Database*.

Secondly, as returns on capital have grown, the share of wages in national income has declined in most developed countries and has shown significant volatility in the developing world. Wages have lagged behind productivity growth almost everywhere, reflecting greater competition in labour markets, weaker employment protection legislation, and the weakening of labour unions. This has made it harder to sustain the expansion of domestic demand and, consequently, stable economic growth.

Thirdly, there have been huge increases in speculative financial flows in search of quick gains. These have been fuelled by rising debts contracted by governments, firms and individuals (see below), and by the liberalization of finance, capital movements and exchange rates in most countries under FDG, which signalled policy support for a financial free-for-all.

The features of FDG described above often reduced governments' policy space, particularly regarding taxation and distributive measures. In part to prevent capital flight through liberalized financial markets, many governments have cut tax rates on high earners and on capital gains, while relying on regressive measures, such as taxes on consumption, to make up the shortfall.

The growth of finance, the concentration of income and wealth, and the movement of capital within and across borders have also been linked to the increasing

frequency of crises and shocks. Financial, balance-of-payments and exchange-rate crises were common in developing countries in the 1980s and 1990s, particularly in Latin America and East Asia. In all these cases, the rapid liberalization of financial markets was an important trigger. But asset bubbles and crises also affected the United States, Scandinavia and Japan, culminating in the near-meltdown of the financial system in 2008, the impact of which continues to be felt, particularly in Western Europe. The pattern of accumulation under FDG, including declining investment, weak demand, and boom-and-bust cycles, helps to explain the uneven and generally slow economic growth rates in many countries over the past 30 years, especially in those most firmly committed to FDG. The contrast with much faster and more stable growth rates achieved in some countries, especially in Asia, can be traced to the different development strategies pursued in the latter (see UNCTAD XIII Policy Brief No. 1, produced in January 2012).

A vicious circle

Several channels establish a two-way causal relationship between FDG and inequality. After years of stagnating or slow-growing incomes, those at the middle and lower end of the income spectrum increasingly turned to "easy credit" to meet their aspirations for better housing and improved living standards, fuelling a credit bubble based on subprime loans, especially in the United States and the United Kingdom but also in parts of the eurozone. This was facilitated by the rising incomes of the well-off, whose frantic search for yield swelled the size of the financial sector and provided the liquidity for loans to those on lower incomes. In recent years, and principally in the advanced economies, these processes were accompanied by the proliferation of opaque financial instruments, such as mortgage-backed securities, which set up the conditions for the 2008 crisis.

A significant body of evidence indicates that, since those higher up the income ladder have a relatively low propensity to consume, the skewing of income distribution can reduce aggregate demand even as their spending habits prompt those on lower incomes to increase their own spending, thereby reinforcing the pattern of debt-driven growth. This, in turn, adds to the fragility of the financial system.

When financial crises spread to the wider economy, the inevitable rise in joblessness

can also serve to aggravate inequality. For example, rapid deleveraging by companies and households reduces tax receipts and consumption and fuels the public debt, and, in recent experience, triggers regressive shifts both in taxation and in social provision, further widening income inequality.

The outcome of these overlapping processes is a vicious circle in which FDG fosters inequality, which contributes to crises which, in turn, perpetuate or even heighten inequalities. Meanwhile, mounting evidence by the International Monetary Fund, the World Bank, UNICEF and others suggests that unequal societies are more unstable and less able to sustain long spells of growth.

Income gaps can also widen across regions within countries, as is evident in the growing rural–urban split in several fast-growing developing countries and in many developed countries, where the recession has widened regional inequalities. Given the proven track record of public policies in reducing regional disparities across countries and over time, today's austerity policies do not bode well for convergence within countries. At this level, too, the risk is that such inequalities become entrenched and self-perpetuating.

These vicious circles of financial instability, inequality and crisis have long-term implications and may store up difficult challenges for the future. Slow wage growth and insufficient aggregate demand increase the risk that the global economy will suffer a prolonged stagnation and deflation. Persistently low investment and employment creation, especially of full-time, permanent and decent jobs, wastes human resources and risks excluding many people, especially the young and women, from the benefits of economic growth. Finally, and despite the marginal tightening of financial regulations after the global crisis, if the disproportionate flow of income to the top is maintained, the conditions that triggered the crisis could be recreated.

Inclusive development

It is possible to break these cycles of inequality, economic instability and underperformance through a coordinated drive within and across countries to promote inclusive development. There is an important role for multilateral institutions in providing policy

advice supporting these efforts to ensure that national policies are mutually reinforcing and driven by those countries with stronger fiscal and balance-of-payments positions, rather than conflicting with each other or burdening the weakest countries disproportionately.

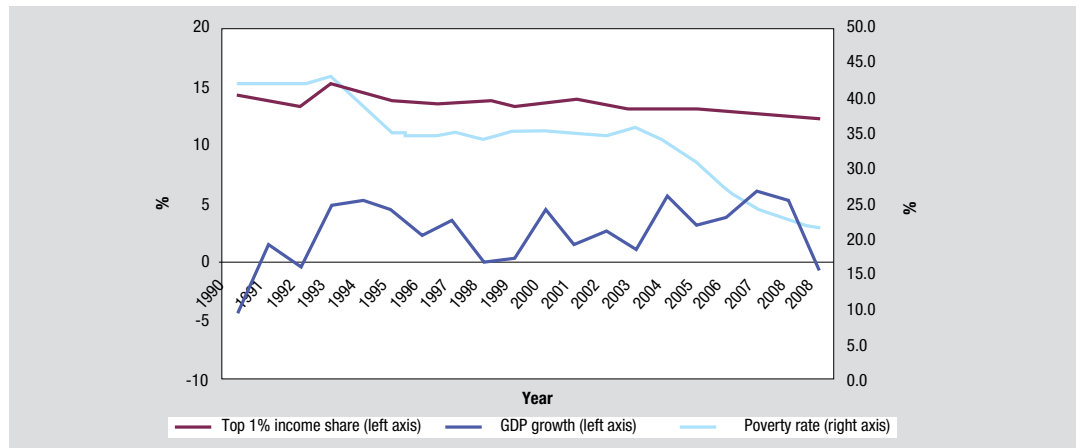
A more balanced, inclusive and stable pattern of growth will require boosting demand in a sustainable manner, through real wage increases and improved social security provision, rather than through speculation or bubbles in credit and asset markets. This should be the bedrock sustaining a virtuous circle of long-term sustainable investment, rising productivity, higher wages and consumption, and job creation. While no single policy prescription can secure the transition onto this trajectory, several economic and social policies can work together to make growth more sustainable and inclusive, fostering a form of globalization that is development-centred rather than finance-driven.

This policy shift will require paying as much attention to employment, income distribution, social protection and environmental sustainability as to inflation, efficiency, and the interests of creditors. In this respect, the experience in Latin America during the last decade is encouraging. Since the start of the new millennium, several countries have managed to reduce inequality and sustain faster and more inclusive growth through the deployment of more equitable social, taxation and economic policies. These include countercyclical fiscal policies, lower interest rates, and higher public investment and social spending, supported by more progressive taxation, and labour-market policies that help to raise wages and improve social protection. In turn, enhanced income support, higher pensions and improved healthcare have helped to ensure that disposable income is channelled back into the economy, especially in poorer regions, alleviating poverty and boosting regional convergence.

In Brazil, for example, inequality has declined sharply since the new millennium, with the Gini index falling by more than 5 points since 2000. This has been associated with a significant reduction in poverty and in the share of income going to the wealthiest 1 per cent (fig. 3). Between 2000 and 2009, average annual GDP growth accelerated by two



Figure 3. Poverty, inequality and growth in Brazil, 1990–2009



Source: UNCTAD secretariat, based on *Ipeadata*.

percentage points compared with the previous decade. This break with the past reflects a policy mix that has included substantial growth in the minimum wage, increased spending on education and a range of innovative social programmes, the best known of which is Bolsa Família, and a rising share of taxes as a percentage of GDP, which are subsequently channelled back into the economy.

Experiences of wage-led growth in Latin America can offer important lessons for those developing economies where creeping financialization and precarious social protection have driven household savings to excessive levels, fostering a distorted and, ultimately, unsustainable modality of growth.

Efforts are also needed to encourage investment in fixed capital, developing and incorporating sustainable technologies, and to strengthen the employment component of growth. Linked to these priorities is the need to address the failure of wages to grow in tandem with productivity. Several policy instruments are available in this regard, including industrial policies, income and labour-market policies, and public-sector investment.

Other structural and self-reinforcing aspects of inequality must also be addressed, including unequal access to education and technology, and exclusion due to gender, ethnicity and age. Investment in education has been particularly successful in reducing inequality, and it needs to be a top priority in both developing and developed countries, with an emphasis on ensuring the full participation of girls as well as boys. This should be accompanied by wider policies investing in the health and skills of women and young people, which have

been shown to bring about more inclusive development at a relatively low cost.

Without such policies, and a decisive break with FDG, developing countries risk replicating the regressive and destabilizing growth pattern of the developed countries. This danger is especially evident in fast-growing Asia, where income inequality has widened markedly in the last 20 years. A recent report by the Asian Development Bank estimates that, if inequality had remained stable in those Asian economies where it has increased, the growth rates achieved in 1990–2010 would have taken 240 million more people out of poverty. Unsurprisingly, the Asian Development Bank also warns that future growth in this region may be undermined unless this unequating trend is reversed.

Conclusion

The rising trend in inequality under FDG, and its economic and social implications, is increasingly of concern to policymakers, researchers and international bodies. Growing realization of the dangers of inequality should elicit policy analyses and recommendations tailored to the needs of individual countries. However, if such policies are to succeed in breaking the cycle of inequality and creating inclusive development, they must be part of an integrated approach combining economic and social goals, with effective support and coordination at the international level.

UNCTAD's 2012 Trade and Development Report, to be published later this year, will focus on the linkages between income distribution, growth and development.

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