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## Liberalization, Globalization and Income Distribution

Giovanni Andrea Cornia

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# **Liberalization, Globalization and Income Distribution**

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UNU/WIDER, Helsinki

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## ABSTRACT

Recent mainstream analyses of changes in income distribution over the post World War II period have concluded that income inequality within countries tends to be stable, that there is no strong association between growth and inequality and that, therefore, poverty is best reduced through growth-oriented, rather than distributive, policies.

This paper challenges this view. It argues that while income inequality declined in several nations between the 1950s and 1970s, this trend has been reversed during the last twenty years in two-thirds of the countries with adequate data. This conclusion is based on an econometric analysis of inequality trends for 77 countries accounting for 82 per cent of world population and 95 per cent of world GDP-PPP. Weighing the results by these two variables further strengthens these conclusions, which are supported also by a host of country and regional studies.

This paper also suggests (without testing formally) that the traditional causes of income inequality (land concentration, unequal access to education, urban-rural gap, and so on) are unlikely to explain its rise over the last two decades. Such an increase is more likely to be related to shifts towards skill-intensive technologies and, even more so, to the adoption of the unfettered liberalization of domestic and international markets. Easy generalizations are obviously not possible, as the impact in each nation depends on specific policy mixes and country circumstances. Yet, recurrent factors associated with the recent increase in inequality include: the decline in the labour share during structural adjustment; trade liberalization (in both the North and South); the 'financialization' of the economy and the rise in the financial rent between 1982–96; erroneous approaches to the privatization of state assets; changes in labour institutions (reduced regulation, erosion of the minimum wage and of the trade unions, and higher labour mobility); and, in some countries, the erosion of the redistributive role of the state following the changes introduced over the last twenty years in the tax and transfer systems.

Since the early 1990s, the international community has made the eradication of poverty its foremost development objective. Yet, the decline of poverty in the years ahead depends also on trends in income inequality, a fact which still attracts little concern by the policymakers. Much of the recent rise in income inequality must thus be viewed with alarm, as it may well prove to be incompatible with poverty reduction objectives.

## I INTRODUCTION

The last two decades have seen the emergence, consolidation and diffusion of a new economic paradigm—often referred to as the 'Washington Consensus'—which emphasizes macroeconomic stability, the liberalization of domestic markets, privatization, the removal of barriers to international trade and financial flows, and the search for market-based solutions also in the provision of public goods or goods with large externalities. This paradigm aims at the creation of a global market in which competition among economic agents operates with limited government interference. This paradigm has deeply marked policy-making in both developed and developing countries and, most of all, in the former socialist economies of Europe.

The proponents of this approach have long claimed that these measures reduce rent-seeking, lead to increasing competition and efficiency, offer huge opportunities for export and growth to developing countries, promote the convergence of the incomes and living standards of poorer countries with those of the advanced ones and, thus, reduce the incidence of poverty worldwide. They claim also that the distributive impact of these policies is likely to be, on the whole, neutral (or positive in areas with a surplus of educated labour), that income inequality is broadly stable over the long-term (Deininger and Squire, 1996), that there is no strong association between growth and inequality and that, thus, poverty is best reduced through growth-oriented, rather than distributive, policies. In the last few years, however, the international financial institutions (e.g., the IMF and the World Bank) which have broadly supported the move towards greater liberalization and globalization have shown growing concern for the poverty impact of these measures, and have placed growing emphasis on social safety nets to safeguard the poor during structural adjustment and on how to protect budgetary allocations to health and education programmes (Tanzi and Chu, 1998).

The data on growth and income inequality seem to contradict the optimism of the proponents of globalization. The empirical evidence suggests in fact that, for most countries, the last two decades have brought about slow growth and rising inequality. The growth rate of the world economy fell moderately in relation to the 5 per cent recorded during the Golden Age (1950–73). Only a few East and South East Asian economies were able to grow fast enough to converge towards the income per capita of the industrialized countries (UNCTAD, 1997). For the majority of the developing and transitional



economies, the North-South and East-West income gap is bigger in the late 1990s than it was in the 1980s or 1960s.

Growing polarization among countries has been accompanied by a surge in inequality within countries. A large number of country or regional studies suggest that, over the last 15–20 years, income concentration has risen in many nations of Latin America (Altimir, 1996), Eastern Europe and the former Soviet Union (Milanovic, 1998), China (Ping, 1997), a few African and Southeast Asian economies and, since the early 1980s, almost two-thirds of the OECD countries (Atkinson, 1995). While not entirely uniform ('late liberalizers' such as India and Pakistan exhibited stable or slowly declining inequality indexes between 1960 and 1992), this trend towards an increase in inequality is perplexing and marks a clear departure from the move towards greater egalitarianism observed during the 1950s and 1960s.

TABLE 1 DECOMPOSITION OF CHANGES IN POVERTY OVER TIME INTO CHANGES IN MEAN INCOME AND CHANGES IN THE DISTRIBUTION OF INCOME (PERCENTAGE CHANGES OVER TIME)

	Total change in poverty	Poverty effect of changes in income/capita	Poverty effect of changes in income distribution	Residual
Brazil, 1981-8	0.0	-4.5	4.4	0.1
Cote d'Ivoire, 1985-8	15.9	16.9	-6.0	5.0
Bulgaria, 1991-3	8.1	0.9	6.6	0.6

Source: Author's calculations.

Note: The total changes in poverty over the respective time periods are equal to the sum of the changes due to (i) falls/increases in average income per capita, (ii) improvements/deteriorations in the distribution of household income, and (iii) to a residual factor (interaction term).

Since the early 1990s, the international community and some national governments have made the eradication of poverty their foremost development objective. Yet, changes in the incidence of poverty depend also on shifts in income inequality (as indicated by Table 1), a fact which still attracts limited concern by the policymakers. In Cote d'Ivoire, for instance, the recession-induced steep rise in poverty of 1985–8 was partly compensated by a decline in inequality. In contrast in Brazil, poverty stagnated over the 1980s as a result of a rise in inequality which offset the increase in average income per capita.

The relation between income inequality and poverty reduction is further complicated by the fact that growth is also influenced by the past and current distribution of asset and incomes. For instance, disincentive effects may occur at very low levels of earnings inequality, as observed in some former socialist

countries of Europe. Likewise, high initial inequality of income or assets, or its further rise, are likely to generate a similar effect, i.e. slower growth and, through that, much slower poverty reduction (see section V). Too 'high' or too 'low' inequality would thus reduce growth, which might not be affected within an 'efficient inequality range'. If this is true, it follows that from a poverty alleviation perspective, it is desirable to target a growth pattern with the lowest inequality—within the above mentioned 'efficient inequality range'.

Much of the recent rise in income inequality must thus be viewed with alarm. Many of the developing countries with rising inequality already had high levels of income and asset concentration which have traditionally inhibited growth, poverty alleviation and human development in these regions. A further increase in inequality or its persistence at high levels may well prove to be incompatible with the poverty reduction objectives reaffirmed recently by many national authorities and the international community, may destabilise international trade and finance and impede growth.

## II PAST AND RECENT TRENDS IN INCOME DISTRIBUTION

### 2.1 The OECD countries

The developed market economies emerged from World War II with a relatively high inequality in the distribution of both primary and final incomes. However, inequality declined steadily between the 1950s and 1960s, and this trend continued during most of the 1970s (Sawyer, 1976). This fall was brought about by a steady decline in unemployment, stable earnings inequality and a rapid expansion of social security schemes (Boltho, 1997). Since the late 1970s this trend towards egalitarianism has been halted or reversed in most OECD countries. With considerable simplification, one could argue that inequality rose first in the USA, UK, Australia and New Zealand (Brandolini, 1998). The Scandinavian countries, the Netherlands, and Italy are part of a second wave of countries where inequality has started to rise again. A third group, including Finland and France, have experienced a gradual flattening of inequality indexes in the 1990s (ibid.).

To a considerable extent, the increase in *income inequality* is explained by a rise in *earnings inequality*. The three main explanations for this emphasize the erosion of labour institutions, skilled-biased technical progress, and the impact of trade liberalization. Countries with centralized wage-setting institutions (Germany, Italy), a high union density and adequate minimum wages (France) contained the pressure towards earnings inequality. At the other end of the spectrum, the UK, the US and other countries with

decentralized negotiations and flexible labour markets experienced the largest increases in inequality. In the US, respectively 30 and 20 per cent of the rise in earnings concentration is explained by the decline in the minimum wage and unionization (Gottschalk and Smeeding, 1997). A rise in the profit share and in interest rates, financial liberalization, and changes in tax and transfer programmes have also contributed to greater inequality. For instance, while the US tax and transfer system still redistributes in favour of the poor, its progressivity declined during the 1980s (ibid.).

## **2.2 The economies in transition of Europe**

Since 1989, income concentration rose moderately in Central Europe and markedly in the former Soviet Union (Cornia, 1996; Milanovic, 1998). In Central Europe, the comparatively modest rise in inequality was due to the preservation of a fairly efficient (though costly) welfare state and by a smaller than anticipated rise in wage inequality. This moderate increase in inequality may have a positive effect on incentives, growth and poverty reduction. The astounding rise in inequality observed in the countries of Southeast Europe and the former Soviet Union are likely, in contrast, to erode social cohesion and incentives, prevent the financing of public goods needed for long-term growth and human development, and lead to slow growth, persistent poverty and social instability.

Also in this region, the main factor in the surge in total inequality was a sharp rise in wage inequality. The latter has been attributed to the emergence of 'scarcities rents' for professions such as accountants, bankers and so on which were under supplied under the old system, as well as to a rise in returns to education following wage liberalization. But wage inequality appears to have risen also due to the fall in the minimum wage (relative to the average wage) and to a surge in inter-industrial wage dispersion unexplained by widening productivity differentials across sectors (Cornia, 1996).

## **2.3 China**

Also in China, the trends in inequality followed a U-shaped pattern, with the turn-around occurring about the mid 1980s. While the 1978 reforms induced a sharp acceleration of growth, until 1984, this was accompanied by only a modest upsurge in inequality which, in contrast, rose quickly between 1985 and 1990, and rapidly after 1990. The rise in income disparity in the second part of the 1980s can be traced to the fast expansion of the town and village enterprise (TVEs) which exacerbated regional differences among rural areas (World Bank, 1992; Ping, 1997). The 1990s have witnessed in particular a visible divergence between the relatively rich coastal provinces and the relatively poor interior regions. Public policy has accentuated this divergence.

Fiscal decentralization substantially reduced the possibility of the central government to control regional inequality by means of resource transfers to poorer provinces. Industrial policy played an even more disequalizing role as it favoured explicitly the coastal provinces through the granting in special powers and privileges which facilitated the development of export industries and the inflow of foreign direct investment. Recent research suggests that greater income concentration within each region is due to, also in this case, an increase in wage inequality (McKinley and Brenner, 1998).

## **2.4 Latin America**

In the 1950s and 1960s, Gini coefficients in Latin America traditionally ranged between 45 and 60, i.e. among the highest in the world. In the 1970s, however, inequality declined moderately in most of the region with the exception of the 'southern cone' (Altimir, 1996). From 1980 to the mid 1990s, inequality in the region was deeply affected by large external shocks, the recessionary adjustment introduced to respond to them, the unstable growth pattern re-established in the mid-to-late 1980s and the subsequent moderate recovery. Altogether, the 1980s were characterized by regressive distributive outcomes. Greater income polarization does not seem to have been interrupted with the return to full capacity growth in the 1990s.

The income polarization of the 1980s was the result of fast inequality rises during recessionary spells and slow declines during periods of recovery. It has been estimated (Cornia, 1994) that the poverty rose by 1.8 per cent for every 1% fall in GDP during recessions, but that it declined by only 0.6 per cent for every 1% growth in GDP during recoveries. In particular, earnings inequality seems to have worsened rapidly during recessions, as suggested by the decline by 5-6 percentage points in the labour share between 1980 and the late 1980s in Argentina, Chile and Venezuela, and a 10 point decline in Mexico. Surges in earnings and income inequality can be traced to a slowdown in the number of jobs created during the decade, the rapid 'informalization' of the labour market, and the fall in minimum wages relative to average wages recorded in 70 per cent of the countries with available data (ECLAC, 1991).

## **2.5 Sub-Saharan Africa**

In Africa, the main sources of inequality have traditionally been a large 'urban-rural gap' and high land concentration in the countries of Southern and Eastern Africa. In the 1980s structural adjustment policies tried to reduce this gap and stimulate growth. Such policies however led to less satisfactory results than expected because of the institutional and infrastructural weaknesses of the African economies and continued worsening in commodity prices. By and large, GDP per capita in the region has stagnated since 1980,

with the exception of 1994–6. The impact was felt the hardest in the urban sector, while rural areas were less affected. In this way, the urban-rural gap was reduced by a process of 'equalizing downward' (UNCTAD, 1997). However, while the rural income gap has declined, intra-rural and intra-urban inequality rose in several countries, as policies that stimulate growth and exports under conditions of unequal distribution of assets tend to increase income concentration.

## 2.6 Summing up

The above evidence, studies on other regions (not shown here for reasons of space) and the trends analysis summarized in Table 2 below indicate that:

- Income inequality declined in many countries between the 1950s and 1970s, though with important differences from one region to the other. There were several exceptions to this rule: in many economies of sub-Saharan Africa the development of national states often brought an increase in the rural-urban income gap and in overall inequality. In Latin America, the decline in inequality began only in the 1970s—after two decades during which income concentration mostly rose. And in India, an initial decline in inequality between 1950–62 was followed by a stable trend.
- During the last twenty years, the trend towards falling income inequality was reversed in the majority of the countries with adequate information on the distribution of income for the entire national economy (and not only the urban, metropolitan or rural sectors). This conclusion is based also on an econometric analysis of inequality trends between the 1950s and the 1990s for 77 countries which account for 82 per cent of the world's population and 95 per cent of the world GDP-PPP. The data in Table 2 indicate that in 45 of such countries inequality has been rising (in 23 of them, including many large economies such as China and the USA, the Gini coefficients followed a U-shaped pattern). In four countries (including India) inequality stopped declining over the long-term, while in seven no statistically significant trend was observed. Only in 16 countries is there evidence of a clear decline in income concentration over the long-

TABLE 2 TRENDS<sup>1</sup> IN THE GINI COEFFICIENTS OF THE DISTRIBUTION OF INCOME<sup>2</sup> BETWEEN THE 1950S AND 1990S  
FOR 77 DEVELOPED, DEVELOPING AND TRANSITION ECONOMIES<sup>3</sup>

	Sample countries in each group	Share of population of sample countries	Share of world population	Share of GDP-PPP of sample countries	Share of world GDP-PPP
Rising inequality, of which:	45	56.6	46.2	71.4	67.8
continuously rising	15	...	...	...	...
U shaped	23	...	...	...	...
accelerating inequality(--/) <sup>4</sup>	7	...	...	...	...
Slowdown in inequality(\--) <sup>4</sup>	4	22.1	18.0	5.7	5.4
Falling inequality, of which:	16	15.6	12.7	20.7	19.7
continuously falling	13	...	...	...	...
inverted U shape	3	...	...	...	...
No trend	12	5.7	4.7	2.2	2.1
Not included in sample	...	...	18.3	...	5.0
Total	77	100.0	100.0	100.0	100.0

Source: Author's calculations on the November 1998 version of WIID (WIDER Income Inequality Database) which includes the 2,622 observations of the Deininger-Squire (1996) database and 1,131 observations collected by WIDER staff.

Notes: (1) The results of the econometric trend analysis summarized above were obtained on the basis of 832 'high quality observations' concerning the entire national economy of 77 countries (data for other nations could not be used either because they did not concern the entire economy or because too few observations were available). The trend in the Gini coefficients were interpolated on a country by country basis by means of linear, quadratic and hyperbolic functional forms. The best results of these three interpolations were chosen on the basis of the combination of the best 't' and 'corrected R2' statistics. Where the t statistics of the estimated parameters of all three functional forms were not significant at the 5 per cent level (and, for about ten countries, at the 10 per cent level), the country analyzed was assigned to the group 'no trend'. (2) In 54 cases out of 77, the income concept used refers to 'per capita household disposable income' (gross in 29 cases, net in 17, unknown in 8), in 9 to 'per capita household consumption expenditure'; and in 14 (mostly economies in transition) to 'gross earnings'. (3) Out of a total of 77 countries, 36 are developing, 19 from the OECD and 22 transitional economies. Except for Africa, these countries account for between 84 and 98 per cent of the population of all main regions, and between 82 and 98 per cent of their GDP-PPP. For Africa, the six countries included in the analysis account for 18 and 32 per cent of its population and GDP-PPP. (4) A country is assigned to the group 'accelerating inequality' or 'slowdown in inequality' when the best fit and 't' statistics of its trend data are respectively obtained by hyperbolic and quadratic functions of the type  $Y = a - bX + cX^2$  and  $Y = a - b/X$ .

term. If one weighs the relative importance of these inequality changes by the population size and GDP-PPP of the countries concerned, the conclusions reached above are strengthened. Indeed, Table 2 shows that, over the last two decades, inequality rose or stopped declining in nations accounting for 79 per cent of the population and 77 per cent of the GDP-PPP of the countries analyzed in Table 2. While, as noted above, inequality fell in 16 countries, these include mainly small and medium size nations whose total population and GDP-PPP comprise only than 16 and 20 per cent of the sample countries.

- The year of reversal in the inequality trend varies. An upsurge in the trends in Gini coefficients was observed in the mid 1970s in Sri Lanka and Thailand, in the late 1970s and early 1980s in four Anglo-Saxon countries introducing neoliberal policies (UK, US, New Zealand, and Australia), the early-to-mid 1980s in several Latin American countries, 1984 in China, 1985–90 in several Central-Northern European countries, 1989 in all Eastern European and former members of the USSR, and 1992–3 in Italy and, to some extent, Finland.
- In countries with a large wage economy, the upsurge in total inequality tends to be driven by a fall in the labour share and a surge in earnings inequality (explained in part by the fall in the minimum wage), and (in several Western countries) by a very fast rise in high level wages, as shown by the data on the Latin American, transitional and OECD economies. Other public policies which seems to have affected inequality include fiscal decentralization and the regional industrial policy (as in China), changes in the tax and transfer system and financial liberalization.
- The results in Table 2 differ substantially from the 'mainstream view about inequality' which can possibly be summarized by a recent paper by Li, Squire and Zou (1998) (see also Deininger and Squire, 1996). The first paper, which carries out a trend analysis of Gini coefficients for 49 developed and developing countries over the 1947–94 period, concludes that there is no evidence of a significant time trend in income inequality in 65 per cent of the countries examined. From this, the authors conclude that the long-term distribution of income within countries is basically stable, and that growth is therefore the only realistic option for poverty alleviation. Their study, however, includes fewer countries (e.g. the European economies in transition) than our analysis, and fewer observations for the more recent years (especially for the OECD and the developing countries). In addition, the study by Li *et al.* (1998) interpolated the time trends on income inequality only by means of linear functions, a procedure ill suited to capture the trend reversals which are the

focus of this paper. As shown by the data in Table 2, these trend turnarounds are better represented by hyperbolic or quadratic functional forms.

- This reversal in inequality trend most likely reflects changes in policy regime (see later) which normally has taken place over a decade or so. Rather than implying a continuous rise in inequality in the future, it is possible the trend may stabilize in the future at a higher level than prior to the shift in policy regime.

### **III EXPLAINING THE RECENT RISE IN INEQUALITY: 'OLD' STRUCTURAL CAUSES**

Traditionally, inequality in developing and industrialized countries has depended on the following factors:

- Dispossession of peasant communities by the colonial authorities (in Latin America, the Philippines, and Eastern and Southern Africa) and the ensuing high land concentration created considerable inequality in the rural areas. High land concentration increases inequality and poverty because of the appropriation of a large share of agricultural output by the landlords. In addition, it depresses the wage of rural labourers and, through them, the minimum wage. Over the long-term, high land concentration leads to an agricultural growth that is slower than that achievable under smallholder agriculture, and thus contributes to the persistence of poverty and inequality.
- Countries well endowed with natural resources tend to grow slower and have a higher income and asset concentration than other economies (Sachs and Warner, 1995). Explanation of this 'curse of natural resources' has traditionally focused on the 'unequal exchange', the long-term decline in prices of primary commodities, and rising protectionism. Yet, other explanations may be more relevant. First, in mineral economies the production process is relatively simple, requires a lot of capital but little skilled labour. This compresses the labour share and discourages investments in education. Second, the high volatility of commodity prices can reduce the opportunities for and incentives to invest in education: falling incomes may force poor families to pull their children out of school, thus causing permanent damage to their educational opportunities. Third, the ownership of mineral resources is usually highly concentrated due to the greater ease with which the mineral rent (originating from few



locations) can be 'captured' by predatory national elites for their own wealth accumulation.

- Low and unequal access to education has also traditionally been an important source of inequality in both developed and, especially, developing countries. The relationship between investments in education and inequality are well established. For instance, it has been shown that a decrease in illiteracy has a positive effect on the incomes of the bottom 40 per cent of the population, while a rise in enrolment rates enhances the income position of the middle class (Ahluwalia, 1976). Education affects inequality through four channels. First, education enhances productivity and efficiency. In urban areas, low productivity, low earnings and a high risk of poverty still are closely related to the level of education of the head of household. A study on nine Latin American countries found that differences in education explained in the 1970s a greater share of inequality and risk of poverty than employment category, sector, age and gender (Altimir and Pinera, 1979). Second, education facilitates technological diffusion and industrial diversification. Third, education reduces fertility, poverty, population growth, environmental pressures and the supply of labour over the medium-term (the latter in turn prevents a fall in the wage rate in the medium-term). Fourth, parental education is inversely correlated with child mortality and the mortality rates of other family members.
- In many countries inequality was exacerbated by the 'urban bias' of public policy, i.e. the overvaluation of the exchange rates, pricing policies adverse to agriculture, overtaxation of export crops, an allocation of public expenditure privileging the urban sector, and drainage of rural saving. The 'urban bias' was compounded by institutional distortions and market failures, particularly pronounced in the case of credit, insurance and technology. Small farmers and informal sector enterprises typically functioned in conditions of more limited access to and substantially higher costs of credit, intermediate inputs and support services (training, R&D and commercialization) than large farmers and modern sector enterprises. For instance, small urban-based businesses were subject to average real interest rates (on informal credit markets) which were two to three times higher, or even eight times higher, than those prevailing in the modern sector.

Are these 'old causes of inequality' still relevant? Despite the changes intervened over the last 20-30 years (for instance, urbanisation has reduced the impact of land concentration, educational efforts should have reduced earnings inequality, and so on), several of these factors still explain the

persistence of high inequality at the end of the 20th century. While the increase in enrolments of the last decades had a large impact on productivity and poverty, it is not clear whether it has reduced differentials in educational achievement. A study on Brazil showed that the importance of differences in educational achievements in explaining income inequality rose from 35 per cent of in 1960 to 46 per cent in 1970 (Langoni, 1973). In addition, enrolments in primary education have declined in some African countries (Tanzania is a prominent case) while the opening up of education to private providers increased the number of privately financed enrolments at the secondary and higher level. All this may have had a disequalizing long-term impact. However, this paper argues that it is likely that the traditional causes of inequality are unlikely to explain the surge in inequality observed in many countries over the last twenty years. Other more recent factors, discussed in the next section, are likely to be more relevant.

#### **IV EXPLAINING THE RECENT RISE IN INEQUALITY: RECENT POLICY CHANGES**

Some of the new causes of rising inequality, such as technology, are endogenous, i.e., beyond the immediate control of policymakers. First and foremost, many 'new technologies' generate a demand for skills which is more skewed than that emanating from 'old technologies'. Second, information technologies allow to diminish the cost of monitoring the performance of unskilled workers, minimize labour shirking, and reduce the wage premia to be paid to this class of labourers to ensure adequate efficiency. Wage dispersion in the sectors using the new technologies tends therefore to grow. Third, particularly in the service sector, new information technologies increasingly replace labour and push up unemployment. Fourth, advances in information technologies are turning formerly non-tradable services into international tradeables; for example data processing and accounting. This creates new jobs in low-income countries with an educated workforce but may increase unemployment in the advanced countries.

Much of the recent surge in inequality, however, seems to be related to changes in economic policies and ideology which reflect a shift towards liberalization and globalization. Easy generalizations on their effect are not possible, as the direction of the impact depends on specific policy mixes and country circumstances. Some facts are already evident however.

## **4.1 Stabilization and structural adjustment**

The 1980s and 1990s have witnessed a sharp increase in the number of adjustment programmes introduced with the assistance of the IMF and the World Bank. The impact of some of these measures are discussed hereafter.

### *4.1.1 Deflation and factor shares*

In recent years, stabilization has been attained mainly through demand management measures. Measures to stimulate supply have also been introduced but these generally require more time and resources to produce results, and have fewer chances to succeed in poor economies with weak institutions and infrastructure. Stabilization has therefore often entailed the reduction of subsidies on food, fuel and other goods, retrenchments in public employment, cuts in public sector wages and other deflationary measures.

As recognized by the IMF itself, while yielding rapid results in terms of macroeconomic balance, this approach tends to generate recessions of varying duration (IMF, 1998) and, because of this, to generate adverse distributional outcomes. Unlike in the advanced countries, inequality in developing countries rises during recessions and falls during recoveries. Economic slumps in industrialized countries have a greater impact on profits than wages because of the stickiness of the latter, and because well developed social safety nets cushion most of the loss of wage income. In contrast, in middle-income countries, wages are downward flexible and social safety nets much less developed. Thus, wages fall faster than GDP/capita and profits, the wage share declines and the inequality of the size distribution of income increases. The impact may be different, however, in economies where the informal sector and the peasant economy are important sources of wage earnings. The empirical evidence on the distributive worsening linked to recessions are well-known to the IMF itself which has noted that stabilization may entail changes in factor payments that are undesirable from an egalitarian perspective, but can be justified to attain given growth and balance of payment objectives (Johnson and Salop, 1980).

### *4.1.2 Devaluation, urban-rural inequality, and income distribution within the urban and rural sectors*

Adjustment programmes have aimed at correcting the urban bias by introducing measures (price incentives, devaluation of the real exchange rate, trade liberalization) attempting to raise farm incomes relative to urban incomes. Yet, it is not self-evident that these measures always succeed in improving the terms of trade of agriculture: this depends on extent of the 'pass through' to the producers of the gains from devaluation, the efficiency of private trading, the removal of input subsidies which often accompanies an

improvement in the terms of trade of agriculture, and changes in international prices. In addition, under conditions of high land concentration and incomplete markets for credit and insurance, an improvement in agricultural prices amplifies rural inequality and produces modest results in terms of poverty reduction. This is what happened in the 1980s in Brazil, Venezuela, Ethiopia, Kenya, and Tanzania. Policies aiming at closing the urban-rural gap would have a more favourable impact if the distribution of land were more equitable, rural markets more efficient and dependence on exports of traditional raw materials less pronounced. Lacking this, policy reform has a lower chance to improve distribution in rural areas, may accentuate overall inequality and generate a negative impact on the urban poor producing non-tradable goods who are affected by the rise in the price of basic goods, the removal of subsidies, and the recession of the non-tradable sector.

## **4.2 Globalization and trade liberalization**

According to a few authors (Wood, 1994), globalization accounts for between a third and a half of the increase in inequality in the OECD countries since the 1970s, and for its supposed decline in the fast growing exporters of manufactured goods (the evidence on this is, however, contradictory; see Jong-Il, 1998). According to this explanation, an expansion of manufactured exports in 'poor' countries raises the demand for unskilled (but literate) labour relative to that of other types of labour (skilled and illiterate) and, thus, reduces the wage differential between skilled and unskilled labour—though it widens that between the unskilled and illiterate workers.

The explanatory power of this approach is partial, particularly for the developing countries. While old trade theory predicts that inequality will fall in developing countries which liberalize, new theory, and some new evidence, suggests that income inequality now rises post-liberalization. One of the ways this increase occurs is through the import of world class technology which raises the returns to skilled labour and reduces the demand for the (locally abundant) unskilled labour. For instance, the distributive impact of trade liberalization in middle income countries is mixed. Recent reforms in this area in Latin America have been associated with increased wage inequality, as the adoption of imported new technologies renders the tradable sector less intensive in unskilled labour. In addition, a big difference between Latin America in the 1990s and East Asia in the 1960s is the competitive pressure arising out of the opening up of Asia's large low-income exporters such as China, India, Indonesia, and Pakistan. Their manufactured exports have grown rapidly since their opening up to trade. As a result, Latin American countries no longer have a comparative advantage in many labour-intensive exports, and they have been forced to shift towards skill-intensive exports where, however, they face stiff competition from the OECD countries. This is

a major policy issue for countries which see opening up as a way of reducing high initial inequality and avoiding politically difficult redistributive measures.

### **4.3 Interest rate policy, financial liberalization and the rise of financial rents**

While prior to the explosion of the Latin American debt problem in 1982, an important part of the borrowing by developing countries was external, after that governments increasingly borrowed from domestic bond markets. This shift forced interest rates up, a change which was reinforced by large increases in interest rates in crisis countries, the liberalization of the domestic financial sector and the shift of the financing of budget deficits from the central bank to internal bond markets. Domestic financial liberalization raised real rates from a long-term trend value of 2-3 per cent (or from negative values) to much higher, often two digit, levels during the 1980s and 1990s. In this way, interest payments on the public debt absorbed an increasing share of public expenditure, while the return on privately borrowed capital rose as well. For instance, in Canada, US and the UK real interest rates rose from an average of -1 per cent in 1976 to around 5-6 per cent over the 1982-4 period (Atkinson, 1998a). In the case of Italy, the increase in the real interest rate was of no less than 13 points, i.e. from -6 per cent in 1976 to 7 per cent in 1993 (ibid.) In developing countries having to pay high-risk premia, the rise in interest rates was much more pronounced. As a result, interest payments on public and private domestic debt rose rapidly. In addition, public bailouts of domestic and international banks due to a growing number of banking crises caused considerable 'moral hazard' and transferred scarce public revenue generated by the taxation of labour income or of consumption to the financial elites.

Financial deregulation and the enlargement of the financial sector (the so called 'financialization' of the economy) have thus led to a substantial increase in the return to capital, a rapid accumulation of public debt, an increase in the share of GDP accruing to non-wage incomes, the emergence of a new class of *rentiers* and, as a result of that, an overall increase in inequality. Since 1980, there has been a shift to non-labor incomes in 5 out of 7 of the G7 countries, with rises of 5 percentage points or more in Italy, Japan and West Germany and 10 in France (Atkinson, 1998b).

### **4.4 Privatization and the distribution of industrial assets**

In transitional and other economies, income inequality may have been influenced also by a sharp rise in asset concentration. The empirical evidence in this regard is fraught with a lot of measurement problems, but it still seems

to be pointing in this direction (Cornia, 1996; Honkkila, 1997). The increase in asset inequality in these countries has often resulted from ill-designed privatization programmes—which result in the concentration of former state assets in the hands of the former managers and of a new non-deserving financial elite, as exemplified most typically by the case of Russia—and confusion with land titles following decollectivization, with poor communities least able to protect their rights (Guinea-Bissau and Mozambique). But asset privatization appears to have had similar, if less marked results, in several other countries. Also in this case, however, there are examples of distributionally-favourable privatization programmes, as in the case of the distribution of the collective cattle herds in Mongolia and of state land in Armenia and Romania.

#### **4.5 Changes in labour market institutions**

Earnings inequality has risen recently almost everywhere. This may well be the result of inadequate educational policies of the past, or of increasing returns to education. During the 1980s and 1990s, however, there was also a widespread change in labour institutions. The general tendency has been towards greater wage flexibility, reduced regulation, erosion of the minimum wage, dilution of the power of the trade union and higher labour mobility. In the USA, the fall in unionization explain about 20 per cent of the increase in earnings inequality (Gottschalck and Smeeding, 1997). And, the downward flotation of the minimum wage relative to the average in Eastern Europe, Latin America and the USA is closely associated with the rise in inequality. In the USA, for instance, the erosion of the minimum wage accounted for about 30 per cent of the rise in earnings concentration (ibid.). The impact of the deregulation of the labour market is less clear in countries with labour market rules and social security systems covering only the workers of the formal sector, and with already high wage inequality (Argentina and India, for instance). In these countries, the overall employment effect due to the downsizing of the capital-intensive formal sector might be distributionally beneficial.

#### **4.6 Changes in the tax and transfer systems: the erosion of the redistributive role of the state**

Past studies of the net fiscal incidence of government tax and expenditure operations in a large number of developing countries showed that the state played a positive, though generally limited, role in redistributing income from the upper to the lower income groups (Tanzi, 1974; De Wulf, 1975). Recent assessments for industrialized countries arrive at the same conclusions. In low-income economies with a narrow tax base (even worse if with predatory elites), the scope for income redistribution via the budget are extremely

limited. The scope for redistribution is, in contrast, greater in middle and higher income economies with a pro-poor political economy. However, during the last two decades, tax and transfer systems have evolved not only towards (an efficient) greater simplification, but also towards a lower degree of redistribution, and a sharp targeting of the benefits of public expenditure. While such approach to targeting may improve the distribution of subsidies, it generally worsens overall income distribution because of the large number of deserving poor often excluded by the implementation of this policy. For instance, the elimination of the (usually poorly targeted) generalized food subsidies is well known to worsen distribution, as the subsidies represent a greater share of the total income of the poor than of the non-poor. Though no comprehensive empirical analysis of the changes in the tax and transfer system is available for the 1980s and the 1990s, in several countries changes in the level, composition and incidence of public expenditure have probably reduced, or even reversed, the redistributive role of the state, thus contributing to the worsening of the distribution of income after taxes and transfers.

## **V INEQUALITY, GROWTH AND POVERTY REDUCTION**

Is inequality good for economic growth and poverty alleviation? While past growth theories predicted a positive relation between inequality and growth (Harrod, 1948; Pasinetti, 1962), research carried out over the last 10 years or so suggests that the relation between inequality and growth must be recast completely, and that excessive inequality can be detrimental to growth. Hereafter are briefly mentioned the channels through which inequality affects growth and poverty reduction:

- High land concentration leads to a slow growth of agriculture. There is substantial evidence that in labour surplus developing countries yields per hectare decline as farm size increases, as smallholders use greater amounts of family labour and home produced inputs per hectare than large farmers do. Economies of scale do exist in marketing, processing and shipping, but these can be captured by effectively linking smallholders to appropriate (market or co-operative) institutions. High land concentration is usually the product of the historic dispossession of peasant communities, or of failed collectivisation experiments, rather than the outcome of market processes.
- High land concentration can lead to adverse environmental outcomes and affect sustainable development. A high degree of asset concentration and landlessness may force the poor to irrational economic behaviour (over

exploitation of the forests, land erosion and overgrazing) and to a reduction in overall long-term growth.

- High inequality reduces progress in education. When inequality is high, governments are normally unwilling to tax the elites, public expenditure is low and fewer people have the resources to finance their investment in education and health. If so, the rate of human capital formation and economic growth is lower than under a more egalitarian income distribution.
- High income inequality entails higher luxury exports and is unfavourable to growth. As shown by Latin America and Africa during the 1960s, the wealthy have a higher propensity to consume expensive imports, a fact which aggravates the balance of payments position of a country. The growth pattern associated with an egalitarian income distribution has therefore a lower import intensity than an unequal growth pattern.
- High wage disparity erodes the incentives to work and pushes up the cost of supervision. While excessive egalitarianism in enterprises of the former socialist countries led to labour productivity losses, wage differentials not justified by differences in educational levels and personal ability can erode work incentives and reduce microeconomic efficiency.
- High inequality might hinder the reduction of fertility. High income concentration is associated with slower declines in fertility, possibly as a result of its negative impact on the education of women, or because of less active policies in the field of family planning.
- High inequality creates macroeconomic instability and debt-servicing problems which deters foreign investment. Finally, governments unwilling to finance social programmes by taxing higher income groups may resort to inflationary financing or borrow excessively from the capital markets. Evidence indicates that these countries are more likely to default on their international debts than more egalitarian countries. Latin America and the Philippines provide evidence of this phenomenon in the 1970s and 1980s. This in turn creates problems of political credibility and instability which drives away domestic and foreign investment and reduces economic growth. Political instability may work its way through the economy in several different ways including actual or threatened expropriation of property.

## VI CONCLUSIONS



The preceding discussion has suggested that the excessive egalitarianism of the former socialist system led to a decline of growth and a stagnation in living standards. Yet, the high concentration of asset and income traditionally observed in many developing countries have also been shown to impede growth and human development, while the policy-related surges in income dispersion observed during the last twenty years in many types of economies are likely to be anti-growth, and are certainly anti-poverty. It is necessary therefore to identify an 'efficient inequality range' within which growth is invariant in relation to inequality, so as to maximise both growth and poverty reduction. It is equally necessary to identify policies which can help keep inequality within the desired range. In this search for optimal policies, it is important to focus not only on 'traditional' redistributive policies, such as land reform, revision of tenancy contract, and enlargement of the access to education. While important, especially for the rural poor and the informal sector workers, these policies would not be able to control some of the new sources of inequality (which appear to be related to the policy changes promoted by the 'Washington Consensus'), such as the systematic compression of the labour share, the erosion of labour institutions, insider privatization, the rise in financial rents, reduced redistributive role of the tax and transfer system, and lopsided fiscal decentralization and regional development policies.

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TABLE 2 TRENDS<sup>1</sup> IN THE GINI COEFFICIENTS OF THE DISTRIBUTION OF INCOME<sup>2</sup> BETWEEN THE 1950S AND 1990S FOR 77 DEVELOPED, DEVELOPING AND TRANSITION ECONOMIES<sup>3</sup>

	Sample countries in each group	Share of population of sample countries	Share of world population	Share of GDP-PPP of sample countries	Share of world GDP-PPP
Rising inequality, of which:	45	56.6	46.2	71.4	67.8
continuously rising	15	...	...	...	...
U shaped	23	...	...	...	...
accelerating inequality <sup>(--/)</sup> <sup>4</sup>	7	...	...	...	...
Slowdown in inequality <sup>(\--)</sup> <sup>4</sup>	4	22.1	18.0	5.7	5.4
Falling inequality, of which:	16	15.6	12.7	20.7	19.7
continuously falling	13	...	...	...	...
inverted U shape	3	...	...	...	...
No trend	12	5.7	4.7	2.2	2.1
Not included in sample	...	...	18.3	...	5.0
Total	77	100.0	100.0	100.0	100.0

Source: Author's calculations on the November 1998 version of WIID (WIDER Income Inequality Database) which includes the 2,622 observations of the Deininger-Squire (1996) database and 1,131 observations collected by WIDER staff.

Notes: (1) The results of the econometric trend analysis summarized above were obtained on the basis of 832 'high quality observations' concerning the entire national economy of 77 countries (data for other nations could not be used either because they did not concern the entire economy or because too few observations were available). The trend in the Gini coefficients were interpolated on a country by country basis by means of linear, quadratic and hyperbolic functional forms. The best results of these three interpolations were chosen on the basis of the combination of the best 't' and 'corrected R2' statistics. Where the t statistics of the estimated parameters of all three functional forms were not significant at the 5 per cent level (and, for about ten countries, at the 10 per cent level), the country analyzed was assigned to the group 'no trend'. (2) In 54 cases out of 77, the income concept used refers to 'per capita household disposable income' (gross in 29 cases, net in 17, unknown in 8), in 9 to 'per capita household consumption expenditure'; and in 14 (mostly economies in transition) to 'gross earnings'. (3) Out of a total of 77 countries, 36 are developing, 19 from the OECD and 22 transitional economies. Except for Africa, these countries account for between 84 and 98 per cent of the population of all main regions, and between 82 and 98 per cent of their GDP-PPP. For Africa, the six countries included in the analysis account for 18 and 32 per cent of its population and GDP-PPP. (4) A country is assigned to the group 'accelerating inequality' or 'slowdown in inequality' when the best fit and 't' statistics of its trend data are respectively obtained by hyperbolic and quadratic functions of the type  $Y = a - bX + cX^2$  and  $Y = a - b/X$ .