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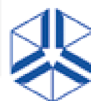
Inequality, Growth and Poverty in the Era of Liberalization and Globalization

Giovanni Andrea Cornia
and Julius Court



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Inequality, Growth and Poverty in the Era of Liberalization and Globalization

Giovanni Andrea Cornia and Julius Court

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Katajanokanlaituri 6 B
00160 Helsinki, Finland

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EXECUTIVE SUMMARY

Eradicating poverty has become the international community's number one development objective. The overriding target—endorsed at the recent United Nations Millennium Summit by virtually all world leaders—is to reduce the incidence of income-poverty in developing countries from 30 percent to 15 percent between 1990 and 2015. The problem is that that further progress has stalled and the number of people living in poverty has remained at around 1.2 billion people—a fifth of the world's population.

Accelerating rates of economic growth is an accepted priority for any anti-poverty strategy. But, policymakers have largely ignored the issue of inequality. This appears to be a very short sighted approach. Rising inequality threatens growth and poverty reduction targets. In order to meet the global targets for reducing poverty, it will be essential to make pro-growth policies more distributionally favourable.

This policy brief reports the main findings of the UNU/WIDER study on changes in within-country income inequality over the last two decades and on the links between poverty, inequality and growth. It focuses on inequality at the national level, i.e. the distribution of income among people within a country. As part of the project, UNU/WIDER compiled the World Income Inequality Database (WIID)—the most extensive database on inequality trends within countries. Analysis of the database and research papers highlights five main issues.

First, the recent trends in income inequality are sobering. Since the early-mid 1980s inequality has risen in most countries, and in many cases sharply.

Second, it is clear that there are some common factors causing the widespread surges in inequality around the world. 'Traditional causes' of inequality, such as land concentration, urban bias and inequality in education, do not appear to be responsible for the worsening situation. Rather it is 'new causes' that are crucial. These 'new causes' are linked to the excessively liberal economic policy regimes and the way in which economic reform policies have been carried out.

Third, the persistence of inequality at high levels or its further rise have made it much more difficult to reduce poverty. The higher the level of inequality, the less impact economic growth has in reducing poverty—for any rate of economic growth.

Fourth, high levels of inequality can depress the rate of growth. High levels of inequality can also have undesirable political and social impacts—on crime and political stability, for example.

Fifth, rising inequality is not inevitable in a world dominated by technological change and globalization. Countries can maintain low inequality and still grow fast—Canada and Taiwan provide two of the clearest examples.

Specific policy mixes will vary, depending on the extent of the problem and specific national characteristics. The higher the level of inequality, the stronger the measures to avoid or reduce it may need to be. Some of the main issues and different policy options to reduce inequality are outlined below.

Policies to address the 'traditional' causes of inequality

Land reform

Land ownership inequality helps explain high levels of income inequality in rural areas and contributes also to high income concentration in the urban areas by depressing minimum urban wages. Most of the poor in developing countries live in rural areas and are dependent on agriculture for their livelihoods. Land reform in an agriculture-dominated country could substantially reduce rural inequality and, indirectly, urban inequality. Agrarian reforms can now be implemented in a market and power compatible way, i.e. combining state policies in favour of the poor with the apportioning of part of the cost of the reform on the urban rich, the urban middle class and the beneficiaries of the reform themselves.

Expanding education

There should be strong emphasis on rapid and sustained expansion of equitable, broad-based and high-quality basic education, especially for girls and including in secondary education. Increasing average years of schooling will reduce inequality.

Active regional policy

The evidence points to the value of more active and direct policies towards marginalized, particularly rural, regions. The increase of inequality among regions in China is so significant that this is one of the most important factors in accounting for increases in global inequality. Investment in education and transport, power and water infrastructure are generally more effective in reducing regional inequality than welfare transfers.

Policies to address the 'new' causes of inequality

Offsetting the impacts of new technologies and trade

Trade and technology are far *less* important than publicly perceived. The impact of trade liberalization and new technologies has varied considerably depending on domestic policies. Particularly important, in both developed and developing

countries, are policies regarding public expenditure on education and strengthening financial markets.

Macroeconomic stability

While many of the macroeconomic policy fundamentals are well known, key elements of any anti-poverty strategy should be to minimise output volatility and to avoid sharp recession-induced rises in inequality. Such policies would contrast to the excessively (and unnecessarily) severe approach to stabilization and adjustment introduced by the IMF and the World Bank in the 1980s and 1990s.

Careful domestic and international financial liberalization and regulation

In addition to spurring financial crises, the liberalization of domestic banking and of international financial flows, including short term flows, have caused rises in income inequality due to the increase in financial rents, the rapid expansion of the high-wage financial sector and the adverse poverty and distributive impact of a growing number of international and currency crises. Policies regarding domestic financial liberalization and capital account liberalization need to be reconsidered.

Equitable labour market policies

Changes in labour market institutions have contributed significantly to rises in wage inequality and overall inequality, especially in medium and high income countries. In contrast to the current ideology, there is great scope to use labour market policies to enhance the dynamic efficiency and the equity functions of labour markets. Some key policy issues include minimum wages, centralized wage setting, investing in human capital and employment protection.

Innovative tax- and transfer policies

Through increasing tax revenues and progressive pro-poor expenditure, the government can have a direct and significant impact on income inequality. There remains great potential to generate increased revenue through tax reforms. While redistribution via the tax system could be considered, the emphasis on equity issues should be via transfers. The priorities here are to increase the efficiency of basic health and education programs and to enhance the targeting of such programs.

Policies the international community might consider

Include distribution issues in policy advice

International Financial Institutions (IFIs) should advocate policy frameworks and reform packages that account for distributional issues. Stabilization, structural adjustment and external openness are often helpful, but the extreme nature and speed of the liberalization approach, often in the absence of adequate

macroeconomic balance, regulatory capacity and safety nets, has a negative impact on distribution.

Support policies to reduce output volatility

International action to curb destabilizing short-term capital flows and mechanisms to dampen the volatility of commodity prices could reduce output volatility and help countries avoid sharp recession-induced increases in inequality and poverty.

Increase external budgetary support

Speeding up debt relief, reversing the decline of real aid flows and targeting development assistance more effectively would help protect vital social expenditures.

It is increasingly clear that the poor are systematically left behind by economic growth when there is high income inequality. A hopeful message of the research is that countries in the worst situation can benefit most. Policies to reduce inequality could also help provide a strong base for growth and faster poverty reduction. In short, if the potential of globalization is to be realised for the benefit of all people, reducing inequality as well as promoting growth will need to be at the heart of any strategy.

1. INTRODUCTION AND OVERVIEW

Eradicating poverty has become the international community's main development goal. The overriding target—endorsed at the recent United Nations Millennium Summit by virtually all world leaders—is to reduce the incidence of income-poverty in developing countries from 30 percent to 15 percent between 1990 and 2015.

The dominant anti-poverty strategy, as advocated by the International Financial Institutions (IFIs) and accepted in governments around the world, has put priority on accelerating rates of economic growth. Policymakers have largely ignored the issue of inequality, as they believe that the long-term distribution of income within countries is stable and that there is no clear association between inequality and growth. The main approach to promoting rapid growth has been based on a neoliberal policy package. It has included a stringent focus on macroeconomic stability, the liberalization of domestic markets, privatization, market solutions to the provision of public goods, and rapid external trade and financial liberalization. In an era of globalization, such a strategy was seen to be the only answer to the poverty challenge.

The problem is that progress has stalled. The 1990 World Development Report projected that the total number of poor would have fallen from 1,125 to 825 million between 1985 and 2000. Most recent figures for years both before and after the Asian crisis indicate the number of people living in poverty as somewhat above 1.2 billion, around one fifth of the world's population. The original target was missed by a wide margin. Indeed, if China is excluded, poverty appears to have declined in the developing and transitional world by a meagre 0.18 percentage points a year between 1987 and 1998. At this speed, it would take almost 60 years to reach the 15 percent poverty target mentioned above. At the same time, inequality at global and national levels is perceived to be rising. It is in this context that UNU/WIDER has undertaken a major research initiative on the changes in income inequality over the last decade and on the links between poverty, inequality and growth. In terms of policy, it is national level inequality that is most important. Given the lack of adequate data, particularly on trends for the last decade, UNU/WIDER compiled the most complete database of synthetic statistics on inequality trends within countries by extending substantially the World Bank database developed by Deininger and Squire. Analysis of the database and research papers prepared for the project highlight five key conclusions.

First, the trends in income inequality are sobering. Since the early-mid 1980s inequality has risen, and in many cases sharply, in most countries in the world for which we have data.

Second, it is clear that there are some common factors causing the widespread surges in inequality around the world. With the exception of worsening educational

inequality in Latin America and Sub Saharan Africa, worsening situations in the 'traditional causes' of inequality, such as land concentration, urban bias, abundance of natural resources and inequality in education, are NOT generally responsible. Rather it is 'new causes' that are crucial. These 'new causes' are linked to the excessively liberal economic policy regimes and the rushed manner in which economic reform policies have been carried out.

Third, the direct implications of the rise are worrying. The higher the level of inequality, the less impact economic growth has in reducing poverty—for any given rate of economic growth. Rising inequality makes it much more difficult to reduce poverty.

Fourth, very low and very high levels of inequality can depress the rate of growth itself. The turning point seems to be at Gini coefficients of around 0.40. Beyond this point, growth tends to suffer. High levels of inequality can also have undesirable political and social impacts—on crime and political stability, for example.

Fifth, the fact that countries can maintain fairly low inequality and still maintain strong growth performances—Canada and Taiwan provide two of the clearest examples—points to priorities for policy.

UNDERSTANDING INEQUALITY

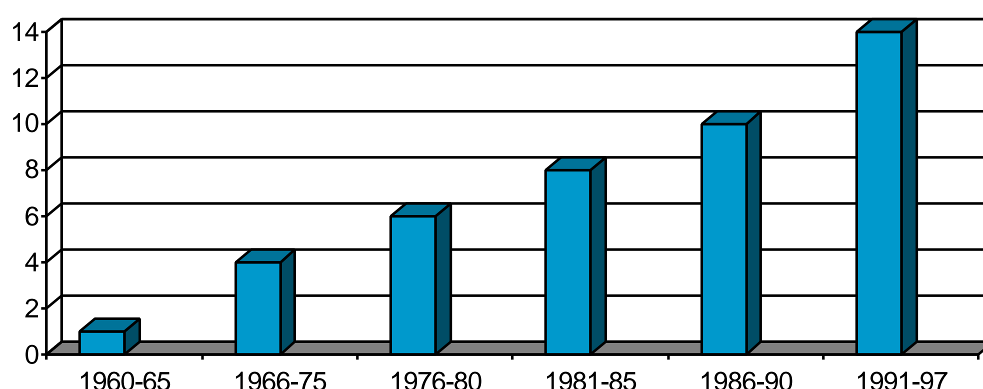
- Approaches to inequality: Inequality means different things to different people. To some it is an ethical issue and high levels of inequality should always be avoided. Here, we focus on why economic inequality matters for economic growth and poverty reduction, but also for other social and political reasons.
- Income inequality: The brief particularly focuses on income inequality; i.e. the inequality of the distribution of household income among the population of one country. The level of income inequality depends primarily on the distribution of wages and assets as well as on government policy.
- Measuring income inequality: The standard measure of income inequality is the Gini coefficient. It is measured on a scale of zero (perfect equality) to one. Above 0.4 is considered to be high.
- Levels: There are three 'levels' of inequality. Global inequality refers to differences between all individual people in the world. International inequality refers to the economic disparity between countries. We focus on inequality at the national level; i.e. the distribution of income among people within each country. The national level is important because global inequality stems in part from rising disparity at the national level and, most importantly, because national level inequality is more easily modifiable through policy interventions.

In sum, rising inequality threatens growth and poverty reduction targets. In order to meet the global targets for reducing poverty, it will be essential to make pro-growth policies more distributionally favourable and, to this end, structural reforms should be considered.

2. TRENDS IN INEQUALITY

The extensive evidence in the World Income Inequality Database and the analyses based on it highlight some important trends. The Golden Age, a period of stable global economic growth between the 1950s and early-mid 1970s, witnessed declines in income inequality in a number of countries (with some exceptions). This trend was reversed over the last two decades as country after country has experienced an upsurge in income inequality; see Chart 1 below for the number of countries in each period where the trend was reversed.

CHART 1
TIMING OF INEQUALITY TREND REVERSAL
(NUMBER OF COUNTRIES PER PERIOD)



Source: Giovanni Andrea Cornia with Sampsa Kiiski (2001) 'Trends in Income Distribution in the Post-World War II Period: Evidence and Interpretation', *WIDER Discussion Paper* No. 89, UNU/WIDER: Helsinki.

TABLE 1
TRENDS IN THE DISTRIBUTION OF INCOME (GINI COEFFICIENTS) FROM 1950s TO 1990s FOR 73 DEVELOPED, DEVELOPING AND TRANSITIONAL ECONOMIES

	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	48	59	47	78	71
of which U-shaped	29	55	44	73	66
Falling inequality	9	5	4	9	8
No trend	16	36	29	13	12
Not included in sample	...	...	20	...	9
Total	73	100	100	100	100

Source: Giovanni Andrea Cornia with Sampsa Kiiski (2001) 'Trends in Income Distribution in the Post-World War II Period: Evidence and Interpretation', *WIDER Discussion Paper* No. 89, UNU/WIDER: Helsinki.

Over the last two decades, inequality has risen in 48 out of the 73 countries for which sufficient 'high quality' data is available in the WIID. These 48 countries account for 59 percent of the population and 78 percent of the overall GDP-PPP of the sample countries (see Table 1). In contrast, inequality remained constant in 16 nations including Brazil, India, Bangladesh and Indonesia, although the data for the latter three countries show a rise in inequality over the last 2-3 years. Inequality fell only in 9 of the 73 sample countries which account for only 5 and 9 percent of the sample's population and GDP-PPP respectively. These include mainly small nations such as Honduras, Jamaica, Norway, Tunisia and medium-sized nations such as France, Germany, Malaysia and South Korea (please refer to Table 2 for details).

TABLE 2
INCOME INEQUALITY CHANGES IN 73 COUNTRIES FROM 1960s TO 1990s

Inequality	Developed countries	Developing countries	Transitional countries	Total
Rising	12: Australia, Canada, Denmark, Finland, Italy, Japan, Netherlands, New Zealand, Spain, Sweden, UK, USA	15: Argentina, Chile, China, Colombia, Costa Rica, Guatemala, Hong Kong, Mexico, Pakistan, Panama, South Africa, Sri Lanka, Taiwan, Thailand, Venezuela	21: Armenia, Azerbaijan, Bulgaria, Croatia, Czech Rep, Estonia, Georgia, Hungary, Kazakhstan, Kyrgyztan, Latvia, Lithuania, Macedonia, Moldova, Poland, Romania, Russia, Slovakia, Slovenia, Ukraine, Yugoslavia	48
Constant	3: Austria, Belgium Germany	12: Bangladesh, Brazil, Cote d'Ivoire, Dominican Rep., El Salvador, India, Indonesia, Puerto Rico, Senegal, Singapore, Tanzania Turkey	1:Belarus	16
Declining	2: France, Norway	7: Bahamas, Honduras, Jamaica, South Korea, Malaysia, Philippines, Tunisia	0	9
All	17	34	22	73

Source: Giovanni Andrea Cornia with Sampsa Kiiski (2001) 'Trends in Income Distribution in the Post-World War II Period: Evidence and Interpretation', *WIDER Discussion Paper* No. 89, UNU/WIDER: Helsinki.

Notes: The length of the time series and the number of observations about income inequality varies from country to country. In the countries underlined, very recent information (not yet included in the WIID) suggests that income inequality may have risen over from 1998-2000; i.e. in the wake of the recent wave of financial crises.

Table 2 provides a detailed account of the inequality changes for the 73 sample countries. The increase in inequality was universal, and often sharp, in the former Soviet bloc, where the number of people living in poverty jumped from 14 million in 1989 to 147 million in 1996. Inequality has also risen, and from already high levels, in most of Latin America and parts of Africa. China has experienced a sharp increase in inequality in recent years, though it has been able, so far, to sustain its growth. So have a number of South and East Asian countries, which in the past had been able to achieve growth with equity. India has had stable inequality over the long term although evidence points, as noted, to a recent increase as even a respectable growth has bypassed the rural areas where the large majority of the poor live. In addition, surges in income dispersion were observed in the majority of OECD countries. One of the exceptions is France, which has reduced inequality gradually over the long term. Examples of countries in the developing world that have reduced inequality include, as noted above, Jamaica, South Korea and the Philippines. Please refer to the Graphs in Chart 2 for an illustration of the different trends in specific countries around the world.

WORLD INCOME INEQUALITY DATABASE

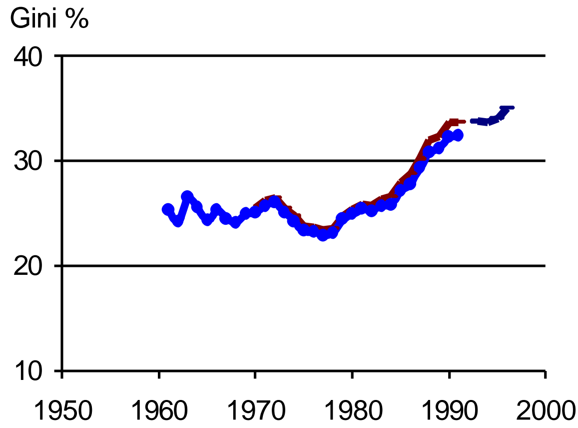
The *World Income Inequality Database* (WIID) collects and stores information on income inequality for developed, developing, and transitional economies in an easily retrievable, exportable, and analyzable format. The WIID includes over 5000 datapoints representing practically all the available national data on income inequality. The construction of WIID was undertaken by UNU/WIDER and was jointly supported by UNU/WIDER and United Nations Development Programme (UNDP). Some basic facts are:

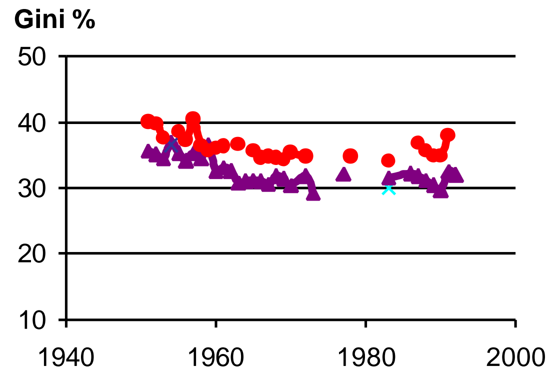
- Coverage: 151 countries (developed, developing and transitional economies)
- Data and timespan: over 5000 observations covering mainly 1950-1998
- Data sources include the Deininger-Squire database (World Bank), major regional databases (LIS, TRANSMONEE) as well as data obtained from selected studies or made available by Central Statistical Offices around the world.
- Quality: each data point is documented and its quality is controlled and rated.
- Continuity: the WIID is regularly updated.
- Availability: the WIID is freely available in order to facilitate further analysis and debate on inequality.

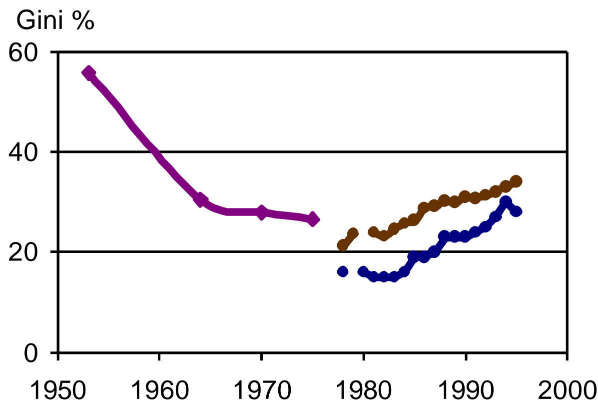
Access or download the database from the UNU/WIDER website:
http://www.wider.unu.edu/wiid/wiid.htm

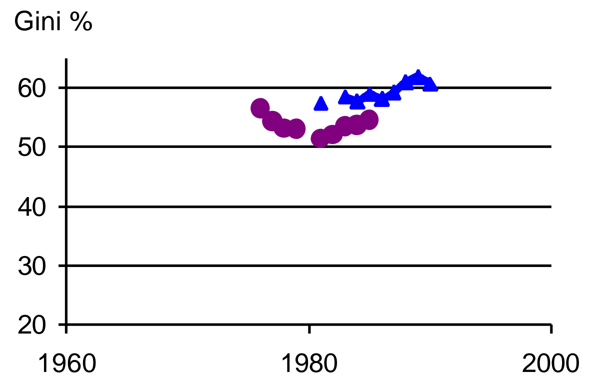
The extent of the increase in inequality recorded during the period under investigation was often substantial. Eastern Europe and the former Soviet Union witnessed the greatest spikes in inequality, sometimes with a 20-point increase in the Gini coefficient. Increases of more than 10 Gini points were even recorded in the OECD group, in the United Kingdom and New Zealand for example. By the mid-late 1990s, 46 out of 73 countries analyzed had Gini coefficients higher than 0.35-0.40, the threshold beyond which growth and poverty alleviation can be perceptibly affected. Only 29 countries had such high inequality in the early 1980s.

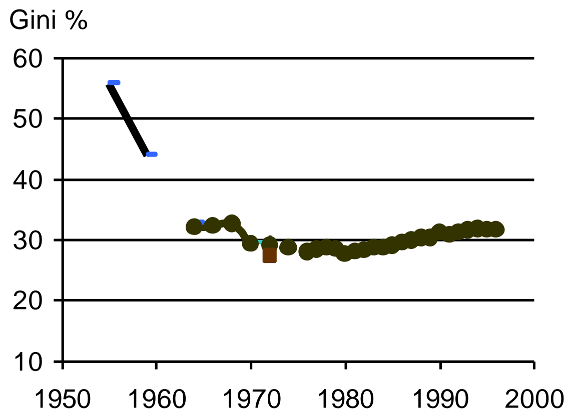
CHART 2
INEQUALITY IN SELECT COUNTRIES AROUND THE WORLD

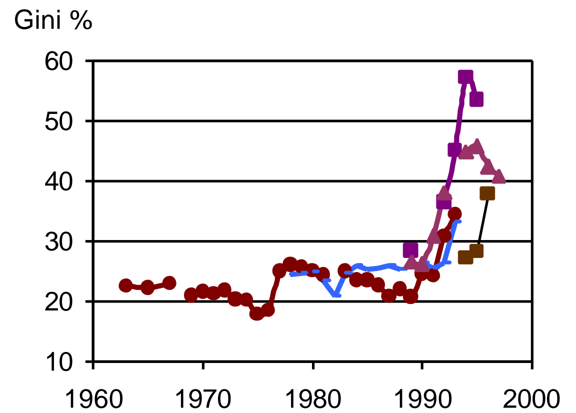












3. DECOMPOSITION AND EXPLANATION OF THE RISE IN INEQUALITY

3.1 Decomposition of the rises in inequality

In order to help explain the causes of rising inequality, it is useful to look at the different subcomponents of income inequality. Although it is not ideal to make broad generalizations, national inequality appears to have most frequently originated from: (i) a rise of capital's share in total income, (ii) a surge in wage inequality, and (iii) an increase in regional and rural-urban inequality.

Capital share in total income rises sharply

The analysis and the project case studies highlighted the rise of capital share (and fall of labour share) in total income as a key component of overall increases in inequality. There were a number of mechanisms driving this with different relative importance in different countries. These have particularly, but not exclusively, been associated with stabilization packages in developing countries and widespread financial liberalization.

The relationship between stabilization packages, recession and rising inequality is well known. While stabilization is often unavoidable, the standard approach has not been distributionally neutral. In low and middle-income countries, wages are downward flexible and social safety nets much less developed. Thus, wages (particularly unskilled wages) fall faster than GDP/capita and profits, the wage share declines and the inequality of the distribution of income increases. The rise in wage share during economic recovery then tends to be smaller than the fall during the crisis period.

Stabilization and domestic financial liberalization have also tended to lead to high interest rates which raise, among other things, the cost of servicing the public debt and which often requires an increase in taxation. In developing countries tax incidence is regressive or proportional while the ownership of financial assets is highly concentrated (in Turkey, in the late 1980s the Gini coefficient of bank deposits was 0.7). More generally, financial deregulation has led to a substantial increase in the rate of return to financial 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 the redistribution via the budget of labour income to holders of state bonds. Also, the rapid growth in recent years of the FIIRE sector (finance, insurance, internet and real estate)—in which financial rents and the wages for few highly skilled workers absorb most of the sectoral value added—was critical in many countries. This was not just in OECD countries, but the case studies also particularly highlighted the impact in Thailand and India.

A widespread rise in earnings inequality

Overall, income inequality depends to a large extent on earnings inequality as in many countries the latter account for 60-70 percent of the total income. This is the case for all developed and many developing countries. Although the extent has varied, the rise in inequality in earnings over the last few years is well charted in almost every country with a developed wage economy; this is shown by the data on the Latin American, transitional and OECD economies. In many cases, there has been a fall in minimum wages and a fast rise in the highest wages. Thus, rising earnings inequality is clearly an important contributor to increases in overall income inequality.

Earnings inequality is influenced by changes in returns to education and experience and the overall supply and demand of different types of labour as well as by the institutions regulating the labour market. However, there is disagreement on the relative importance of these factors in driving the increase in earnings inequality. Rises in earnings inequality may well be the result of inadequate educational policies of the past. Partly linked to this, many analysts emphasize technical change and increasing scarcity rents for skilled workers. For Eastern Europe and the Former Soviet Union the relative increase in the wages of skilled workers in short supply explains almost half of the overall rise in income inequality.

The decline in the importance of labour institutions is a contributing factor in many countries. Since the 1980s, there has been a widespread shift towards greater wage flexibility, reduced regulation, erosion of minimum wages, lower unionization, dilution of the wage bargaining power of trade unions and higher labour mobility. All these factors are correlated with the recent rises in overall inequality observed in the OECD and Latin American countries.

THE INEQUALITY CHALLENGE IN CHINA

The economic reforms initiated in China in 1978 and broadened in scope over the subsequent two decades led to a massive economic boom. This benefited large sections of the population with huge falls in the rates of poverty. While the growth of 1978-84 was accompanied by broadly stable inequality, growth became increasingly less egalitarian since 1985, and especially since 1990 (see Table 3). This trend threatens further advances in poverty reduction as well as the continuity of rapid rates of growth. There are now massive disparities between the coastal belt, a middle ‘rust belt’ home to many obsolete state-owned enterprises in need of radical restructuring, and the underdeveloped and under served western regions. In addition, even in the coastal area, rural-urban inequality is increasing as urban wages rise while rural incomes remain flat. Over the last 5 years, China has been characterized by ‘jobless growth’ with farmers and workers in state-owned enterprises losing out. China’s entry into the WTO is likely to exacerbate this situation, as agricultural tariffs will need to be halved by 2004 and manufacturing tariffs reduced even more, thus putting further pressure on the most vulnerable sectors.

Increase in regional and rural-urban inequality

Although the data are somewhat limited, they do point to a troubling stability, and in many cases increase, of rural-urban and regional inequality within developing countries. The rural-urban gap is *rising* in the four Asian countries for which we have detailed evidence for the 1990s. In three of them, including China, the rise is rapid. Indeed, the increase of inequality among regions in China is so significant that it accounts for half of the overall increase in income inequality observed in this country since 1985. Table 3 illustrates well this growing rural-urban and regional inequality. A similar tendency is observed in Thailand, due to the overwhelming growth of the Bangkok Metropolitan Area and the slow growth or stagnation of the rural areas and, more recently, in India. In contrast, there is evidence that a falling rural-urban income gap has offset rising intrasectoral inequality in Latin America. For Africa and the transitional economies, the lack of data means that no clear conclusions can be drawn.

TABLE 3
EVOLUTION OF GINI COEFFICIENTS AND INCOME GAP IN CHINA, 1953-98

Year	Overall Gini coefficient	Urban Gini coefficient	Rural Gini coefficient	Income gap, U/R[a]	Interprovincial income gap (rural)[b]	Interprovincial income gap (urban)[b]	Interprovincial income gap (total)[b]
1953	0.56 c	.....	...	...	.....	...	...
1964	0.31 c	.....	...	...	.....	...	...
1978	0.32	0.16	0.21	2.37	.....	...	...
1981	....	0.15	0.24	2.05	2.80	1.81	12.62
1984	0.28 d	0.16	0.26	1.71	3.16 e	1.59 e	9.22 e
1988	0.38	0.23	0.30	2.05	.....	.....	.....
1990	....	0.23	0.31	2.02	4.17	2.03	7.50
1995	0.43	0.28	0.34	2.47	4.82	2.34	9.79
1998	0.41 c	.....	...	...	.....	...	...

Source: State Bureau of Statistic and World Bank (2000).

Notes: [a] ratio between the average urban and rural average income; [b] ratio between the average income of the highest to the lowest province, by rural, urban and total area; [c] data for these years *are not strictly comparable* with those of the other years and are provided only for illustrative purposes; [d] refers to 1983; [e] refers to 1985.

3.2 Explaining the rises in inequality—traditional and new causes

Making easy generalizations is not appropriate—the situation depends on specific country circumstances and policy mixes. 'Traditional' causes of inequality such as land concentration, urban bias, the dominance of a highly concentrated mining sector and inequality in education do explain most of the variation in cross-country inequality. But the project analyses indicate that, with the exception of inequality in education in Africa and Latin America, they do *not* explain the recent surges within countries. The UNU/WIDER project identifies some common 'new' factors that are associated with the recent rise in inequality. These are strongly linked to the

neoliberal policy reforms that have been increasingly adopted in industrialized, transitional and developing countries.

Traditional causes of inequality

There is little argument that, even today, the 'traditional' causes of inequality such as land concentration, urban bias and inequality in education explain a large part of the variation in inequality between countries. However, it is important to assess whether these traditional causes were responsible for the rapid rise in inequality over the last two decades, i.e. to assess whether the impact of these 'traditional' causes of inequality had become significantly worse.

Land concentration

Land ownership inequality is widely considered to explain high *levels* of income inequality in agriculture-dominated developing economies. But the key issue here is whether land ownership inequality can help explain recent *trends,* i.e. the widespread rises in income inequality. For many countries, there is unlikely to be a direct link. Agriculture was already of minor importance in OECD countries and industrialization has led to a decline in the relative importance of the agricultural sector in the emerging economies of Asia and Latin America. Even for countries that remain agriculture-dominated, there have been few major changes in agrarian structure that could directly explain the rises in income inequality. Indirectly, however, land inequality may help explain current rises in income inequality by depressing minimum wages in both the urban and rural sector. The relatively egalitarian growth paths of the East Asian economies can be partially understood as the result of their relatively equal initial distribution of land. In contrast, the continuing reproduction of inequality has characterized agrarian growth throughout much of Latin America.

Increasing influence of the mineral sector on GDP

Countries well endowed with natural resources—especially mineral resources such as oil, diamonds, copper and so on—tend to have a higher income and asset inequality than other types of economies. This is often due to the capital-intensive nature of the production processes and the concentration of ownership in this sector. It is also due to the greater facility with which the elites are able to appropriate the mineral rent. However, the dominance of natural resources hardly explains the widespread surge in inequality observed over the last two decades (even for resource rich countries). The resource rent/GDP ratio has generally fallen in resource-rich economies and was lower in 1994 than in 1970 in every case. Also, changes in the resource rent/GDP ratio could clearly not explain the rise in inequality in many resource-poor economies.

Rising inequality due to changes in access to education

The key question here is whether education changes over the last decades help explain the trends of rising inequality. The project findings do indicate that there is a

strong negative linkage between average years of education and measured income inequality. Increases in average years of schooling should lead to reduced inequality.

However, an interesting finding is that the relationship between income inequality and average years of schooling appears like an inverted U, with the turning point at 6.5 years. Thus, increases in average levels of schooling from very low levels may actually exacerbate inequality. The most likely explanation involves the interaction between the educational choices of the population and jobs creation by firms. When the average educational level of the population is low, the few highly educated people are likely to obtain very high salaries. But, as more educated people enter the labour market, the speed of technological innovation goes up, followed by skilled job creation. More people earn higher wages, and as a consequence income inequality starts declining.

In sum, with the exception of East Asia and Eastern Europe, the average years of education of the new cohorts entering the labour force in many developing countries since 1980 remained below or around the critical threshold of 6.5 years. Increases in average education attainment in this context, while beneficial in their own right, could potentially add to increases in inequality. But, more worrying is the slow progress (or outright deterioration) in enrolment and retention rates during the 1980s linked to stabilization and adjustment programmes observed in Africa and, to an extent, in the countries in transition, as well as the rising in inequality in education in all regions. In Latin America, for instance, over he last two decades, inequality in education has risen as most governments have given priority to primary education for all and accelerated university education among a minority, while neglecting the promotion of broad-based secondary education. These developments have had a negative impact on the long-term distribution of human capital and are likely to continue to spur further increases in earnings inequality over the medium term.

Increasing urban bias

The question here is whether the urban bias had an impact on overall levels of inequality. It is a tough question to answer definitively given the range of issues that are relevant and the limitations of the data.

Many developing countries implemented adjustment programmes in the 1980s and 1990s that were not only intended to enhance efficiency and growth, but implicitly to raise farm incomes relative to urban incomes. Urban-rural inequality should have fallen and therefore have tended to reduce overall national inequality (and poverty). But, factors associated with liberalization or adjustment may have led to increases in rural-urban inequality. Urban populations, due to higher standards of education, are better placed to exploit new economic opportunities in the wake of price liberalization. While some evidence points to a persistent urban bias, the data show no *overall* tendency for within-country rural-urban inequality to increase or decrease since the 1980s in developing and transitional countries. While this

evidence is important from a policy perspective, it does indicate that, on balance, increasing urban bias was not responsible for the increases in inequality.

New causes of inequality

Trade liberalization and technology issues have been put forward as the major new factors driving the rises in income inequality. However, inequality is subject to many influences other than just technology and trade. The most important of the additional variables include macroeconomic conditions, financial liberalization, labour market liberalization, privatisation and the tax and transfer system. The widespread nature of rises in inequality and their timing as well as econometric analysis and case study evidence suggest that there are some common trends at work across countries.

Technological change

Rising wage inequality has often been ascribed to technological change. New technologies generate a demand for skills and an earnings distribution more skewed than that emanating from existing technologies. This favours higher-skilled workers over lower-skilled ones and leads to increasing wage differentials between skilled and unskilled workers. New technologies also tend to replace labour and affect in this way the functional distribution of income. In developing countries, this is evident in the shift from agriculture and labour intensive manufacturing to skill intensive manufacturing—the case study on Thailand provides a powerful illustration. In developed nations, this is now increasingly visible in the service sector.

The balance of evidence indicates that new technology is a determinant of rising income inequality in developing countries. But this evidence is not strong. The technology factor cannot explain some other striking facts regarding the trends in income distribution in developing countries where such technological shift has hardly occurred during the recent period. In addition, the impact of the new technologies has varied considerably depending on domestic policies, particularly regarding public expenditure on education and financial markets, for both developed and developing countries. Countries that have expanded rapidly the public and private education of high skilled workers—such as Canada and South Korea—have experienced no increases in wage differentials by skill levels, a phenomenon which is evident, in contrast, in the United States and in Brazil.

Trade liberalization

Globalization in general and trade liberalization in particular are publicly perceived to have had a negative impact on income inequality. This has been indicated by labour protests and political pressure in the US and Europe. The impact of globalization on poor countries has acquired particular significance too because of the popular demonstrations that have occurred at the recent meetings of the WTO,

the IMF and the World Bank and the G8. There is also an increasingly contentious debate between researchers on how exactly to measure the impact of trade on labour markets. Despite the methodological challenges, however, there is now increasing consensus that trade has only a small impact on wages and income inequality.

Trade liberalization was thought to account for the decline in inequality in the fast growing developing country exporters of manufactured goods. According to this explanation, an expansion of labour intensive manufactured exports in 'poor' countries raises the demand for unskilled (but literate) labour relative to that of other types of labour and thus reduces the wage differential between skilled and unskilled workers. Although the available data and analyses on the South are less available, the explanatory power of this approach too is partial at best. There has been a rise in inequality in the Asian countries that rapidly expanded their manufacturing exports in the 1980s. Also, trade does not explain the surge in inequality in the many developing and transitional economies, in which manufactured imports and exports hardly changed.

Rather it seems that the distributive impact of trade liberalization in middle-income countries is mixed. Contrary to the experience of East Asia, recent trade liberalization in Latin America has been associated with increased wage inequality. One of the ways this increase occurs is through the import of world class technology—or the shift to high tech exports requiring highly educated labour—which raises the returns to skilled labour and reduces the demand for the locally abundant unskilled (if literate) labour. In sum, it seems very unlikely that trade is the most important factor in causing increased income inequality in the recent period.

Stabilization and adjustment programmes in developing countries

The 1980s and 1990s have witnessed a sharp increase in the number of stabilization and adjustment programmes introduced with the assistance of the IMF and the World Bank. Stabilization is in most cases necessary, unavoidable and beneficial. Yet, when brought about through conventional instruments, stabilization generates large recessions and poverty surges. A first issue concerns the ‘stabilization targets’ for inflation and the budget deficit. The sharp demand compression undertaken by orthodox programmes to reduce inflation to single digit leads to sharp recessions in spite of evidence showing that driving inflation below 40 percent produces no discernible growth benefits. Second, the standard deficit reduction targets often err on the side of excessive fiscal prudence, for instance when foreign aid is not included in the computation of the deficit. Third, too rapid deficit reduction is also often a source of deflation, and experience shows that gradual, but irreversible, cuts (accompanied if needed by import controls and export subsidies to improve the balance of payments) are technically and politically more viable than more ambitious but unsustainable ones. Fourth, the reduction of the fiscal deficit has at times been achieved by means of means of pro-poor expenditure cuts rather than through higher taxation. Finally, as highlighted by the recent debate on the East

Asian crisis, stabilization may be better achieved through greater reliance on devaluation than on large interest rate hikes. But this is not yet the standard practice.

The adjustment in India provides an interesting case; there is compelling evidence that the reforms have exacerbated inequality. In response to controlled liberalization, there was a modest rise in rural inequality and a more significant rise in urban inequality in the 1990s. There was also an increase in regional inequality and in the incidence of poverty among rural labourers. Despite healthy growth, poverty levels remained high because of the increase in inequality and the near stagnation or decline in agricultural wages, as well as the rise in food prices and, especially, in the subsidized food prices in the Public Distribution System.

Financial liberalization

A large number of middle-income countries in Asia and Latin America, with encouragement from the Bretton Woods institutions, undertook the liberalization of international capital flows in the 1990s. The liberalization of the domestic banking and financial sector preceded the opening up to international capital movements as it was implemented in the majority of the developing countries starting from the mid-late 1980s.

In addition to spurring financial crises, the findings in the UNU/WIDER project suggest that liberalization of the domestic and international financial system has caused an increase in income inequality much greater than that caused by other policy changes such as trade and labour market liberalization and privatisation. Increases in real interest rates, a result of the liberalization of domestic financial markets, benefited lenders and rentiers at the expense of borrowers, including governments. Interest payments on public debt has risen rapidly and a large part of the government budget in many middle-income countries now goes towards interest payments rather than being used for social expenditure. In Turkey, domestic financial deregulation pushed upwards the share of interest income in total domestic income from virtually nil in 1980 to around 15.2 percent in 1998. In this way, the financial rent is now practically equivalent to the total value added of agriculture—a sector which houses 45 percent of the civilian labour force.

International financial deregulation in turn has caused growing instability, as signalled by the rise in the frequency and severity of financial crises in recent years. Left to themselves, deregulated financial systems cannot perform well owing to problems of incomplete information, markets and contracts, herd behaviour and weak regulatory institutions. In addition, international financial liberalization of the capital account, affects earnings inequality, particularly in countries with weak labour institutions and social safety nets. In Latin America and Asia, for instance, financial crises raised inequality 73 and 62 percent of the time respectively, while Finland, Norway and Spain experienced a sequence of banking and financial crises without experiencing increased inequality thereafter.

Privatization and the distribution of industrial assets

The empirical evidence in this regard is fraught with measurement problems. In many developing countries, furthermore, privatization has been less wide-ranging and its impact difficult to ascertain. And there are several examples of distributionally favourable privatization programmes in agriculture, as in the case of the distribution of collective herds in Mongolia, of the communal land in China and of state land in Armenia. Yet, the mass privatisation of industrial assets in transitional economies has almost invariably augmented income inequality and created severe incentive problems. This has 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 small financial elite, as exemplified most powerfully by the case of Russia. In some African countries, such as Guinea-Bissau and Mozambique for example, there has also been confusion in land titling following decollectivization, with poor communities least able to protect their rights.

Changes in labour market institutions

It does seem likely that changes in labour market institutions have contributed significantly to rises in wage inequality and overall inequality, especially in medium income developing and transitional economies and in the OECD countries. The project found substantial evidence that employment became more informal, wage shares declined and the difference between skilled and unskilled wages increased in many countries.

The reform process in many countries has caused a decline in the wage share and thus weakened the position of workers. For 20 of 26 countries with available data, the wage share in manufacturing industries declined between the early 1980s and the early 1990s, and in those countries where the share increased the increase was slight. The East and Southeast Asian countries were the best performing in terms of unchanged wage share. Another related phenomenon of the period of economic reforms is the increase in wage inequality. Evidence indicates that in most countries that underwent structural adjustment programmes in the 1980s, wage dispersion increased as real wages fell.

Although the conclusion remains tentative, it does seem likely that these trends are the consequence of reform policies. During the ‘second golden age of capitalism’ (a period spanning the early-mid 1950s to the early-mid 1970s), the policy focus on full employment and the creation of social insurance, a strategy that contributed in the majority of places to declining wage and income inequality. During the 1980s and 1990s, there was a widespread shift in policy orientation, particularly in developing countries as part of structural adjustment. The emphasis was increasingly towards greater wage flexibility, reduced regulation, erosion of minimum wages, reduction of employment protection, dilution or breaking up of bargaining power, reduction in public sector employment and reduced government outlays in human capital formation.

The state tax and transfer system

Through the combined effects of taxes and expenditure, the government can have a significant impact on levels of income inequality. Progressive tax and pro-poor expenditure policies will reduce inequality. Thus, in many developing countries, it is important to look for changes in the government budget—particularly taxes and transfers—in order to help drive the distribution of disposable income towards greater equality.

However, over the last two decades, the main policy trend has broadly been in the opposite direction. Indeed, a reduction in the role of the state has been a key element of the policy consensus in the 1980s and 1990s. Tax systems appear to have evolved towards greater use of indirect taxes (above all Value Added Tax-VAT) and lower progressivity in both developed and developing countries. More worryingly, perhaps, the level and composition of public expenditure in a number of countries have become less redistributive.

Unfortunately, the limited availability of high-quality data for developing countries prevents a clear conclusion on the impact of changes in transfer systems. However, the limited existing evidence on tax systems generated in the course of the project is worrying. Very few tax systems in developing countries were found to be progressive. And, over time, the progressivity of tax systems has declined in a majority of developing countries. The tax and transfer policies in developing and transition economies were not effective in limiting the rise in inequality of the distribution of market incomes while the declining progressivity of tax systems may have contributed to the increase in inequality in the 1980s and 1990s.

WILL INEQUALITY CONTINUE TO RISE?

Inequality has risen in the USA for 25 years and UK for 20 years respectively and subsequently in many other OECD and developing countries. Some rises in inequality are one-off shifts due to privatization-liberalization and with the full implementation of the new policy regime for already some years, the level of inequality has now stabilized and—in the absence of other major changes—is likely to fluctuate around a stable trend in the future. In contrast, inequality might continue rising in those countries where the neoliberal economic policy regime is still being implemented. The discussion in the brief indicates that, unless checked, inequality may thus still creep up in many countries. Some of the key factors are highlighted below:

- Overall, the current policy consensus in most developed and developing countries is not yet towards curbing the rise—there is increasing emphasis on public spending for education but capital incomes are increasing in importance and tax and transfer mechanisms are becoming less progressive.
- There is no evidence of any immediate intention to regulate or control the international financial system.
- Technical advances might have a greater impact on inequality in the future by turning formerly non-tradable services into international tradables—for example data processing and accounting. This may help reduce inequality for low-income countries with an educated workforce but may negatively affect employment and inequality in developed countries.

- There is still scope—and pressure, through the WTO and IMF in particular—for further privatization and liberalization in developing country markets. This is the case for the two giants, especially India but also China, and is also likely in many other developing countries.
- Societies tend to get used to higher levels of inequality. Research indicates the ways inequality can also become entrenched through the political system.
- On the other hand, however, there is also increasing evidence of shifts and backlashes at the national level (for example the ousting of conservative governments in Europe) and international level (indicated by the massive protests against the WTO, World Bank, IMF and G8).

In sum: making generalizations about the causes of increasing inequality must be done with care. The situation in each nation depends on specific country circumstances and policy mixes. It is clear, however, that there are some common factors that appear to be behind the widespread surges in inequality around the world. It is important to note that the increases have not been caused by a worsening situation in the 'traditional causes' of inequality such as land concentration, urban bias and inequality in education—although these do still explain most of the variation in cross-country inequality. Rather, the evidence in the UNU/WIDER study points to 'new causes' associated with the recent widespread surges in inequality. These 'new causes' are linked to the neoliberal economic policy packages and the rushed manner in which economic reform policies have been carried out. Stabilization, structural adjustment and external openness are often helpful, but the extreme nature, scope and speed of the liberalization approach, often in the absence of adequate regulatory capacity, have had a negative impact on distribution.

4. IMPLICATIONS FOR GROWTH AND POVERTY LEVELS

4.1 Inequality and growth

The analysis in the project suggests that there may be an inequality range that is most efficient for growth. This 'efficient inequality range' varies obviously with the main types of economic structure but the principle remains the same. There are a number of aspects here. At very low levels of inequality (as in some socialist economies in the 1980s), growth is affected negatively because an overly compressed wage distribution may not adequately reward different capabilities and efforts, erode work incentives and increase labour shirking and free-riding behaviour. Loss of incentives can also occur if workers are subject to very high marginal tax rates, either via the state or within-community mechanisms.

The impact on growth may also be negative when the gap between the rich and the poor widens excessively. Rent-seeking and predatory activities tend to rise and the work incentives of the asset-less poor wane. For instance, it is well known that rural economies with very high land concentration in a few hands and landlessness for the majority face very high shirking and supervision costs and the erosion of ecologically fragile lands occupied by the landless poor. For these reasons, these economies tend to be less efficient (e.g. to have lower yields per hectare) than more equitable agrarian systems, even when accounting for the economies of scale in marketing, processing and shipping which benefit larger farms.

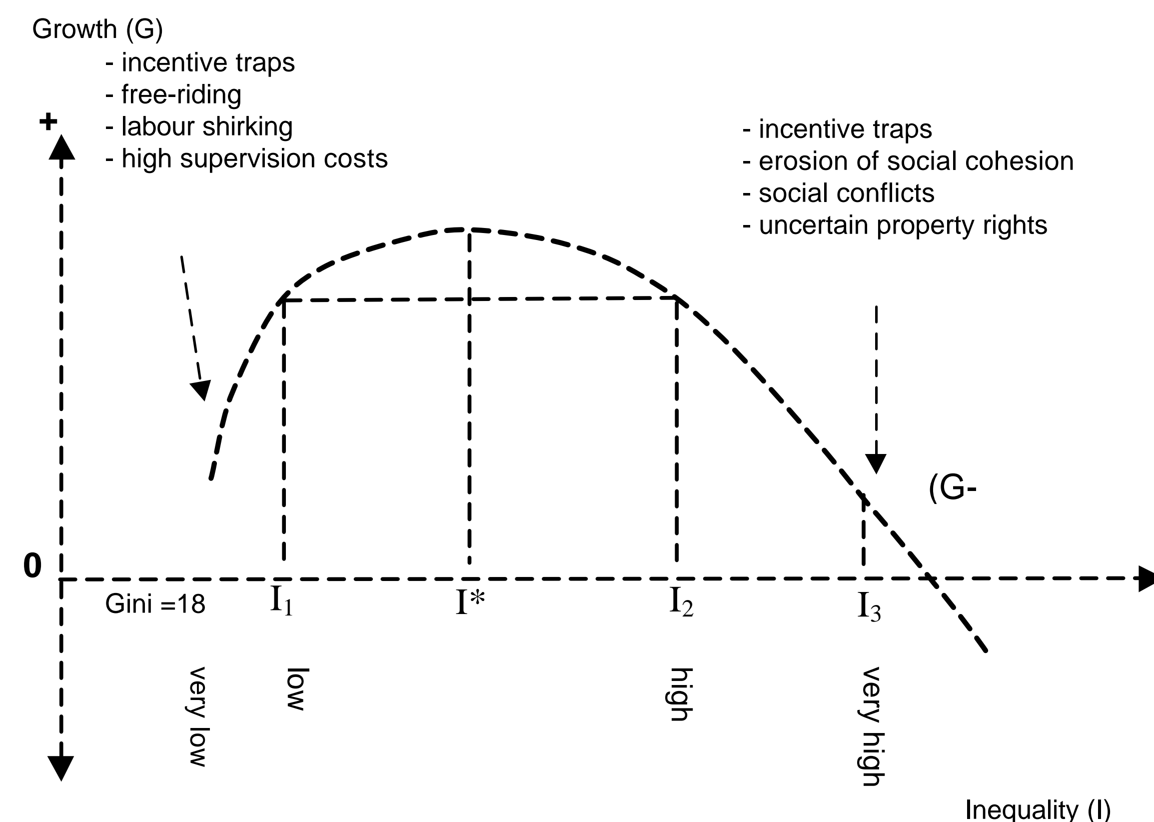
High inequality in the distribution of assets (e.g. land) can be detrimental to growth in other ways as well. High inequality has been shown to limit progress in education and accumulation of human capital. It also reduces progress in fertility control. There may also be implications through political channels leading to policy choices that are sub-optimal. Inequality in a democracy can lead to populist measures with negative implications for economic efficiency, macroeconomic stability and growth.

Finally, high levels of income inequality—both vertical and horizontal (that is among social, ethnic, religious and occupational groups)—can also create political instability and social problems and affect very negatively growth over both the short and long term. There is increasing evidence of strong relation between inequality and the crime rate. Previous UNU/WIDER research suggests that high horizontal inequality increases the risk of social tensions and conflicts. Social tensions, in turn, erode the security of property rights, augment the threat of expropriation, drive away domestic and foreign investment and increase the cost of business security and contract enforcement.

While the balance of evidence strongly indicates the negative impact of high income inequality, it is important to note that different types of inequality have different (even opposite) effects on growth. Inequality of earnings that rewards effort is likely to be pro-growth, at least up to a point. Inequality of ascribed income or income due

to ascribed wealth—that is income or wealth accruing because of inheritance, priestly status, or positioning to seize monopoly rent or to undertake political lobbying for example—is likely to be anti-growth. Rural-urban or other spatial inequality is likely to be ascribed rather than attained. Thus, as rural-urban (and farm-nonfarm) inequalities are generally far higher in developing than in the OECD countries, reducing them might well accelerate development.

CHART 3
INEQUALITY AND GROWTH



For policy, it is most important to avoid the extremes—very low and especially very high inequality reduce growth—and target an 'efficient inequality range'. Such efficiency range roughly lies between the values of the Gini coefficients of 25 (the inequality value of a typical Northern European country) and 40 (that of countries such as China and the USA). The precise shape of the inequality-growth relationship depicted in Chart 3 obviously varies across countries depending upon their resource endowment, history, past policies on the distribution of physical and human capital and other factors. Nevertheless, the implication is that, given the attainable growth rate of output compatible with macroeconomic and environmental constraints, any country that intends to maximize poverty reduction should choose the lowest level of inequality (I_1) within the efficient inequality range (I_1-I_2). Aiming for the lower end of range is important because one obtains the same level of growth at lower levels of inequality, but it allows the reduction of poverty at a faster rate.

4.2 Inequality and poverty reduction

Reducing poverty strongly depends on the level and nature of growth; faster growth is certainly necessary for many countries to meet the poverty targets. But growth alone does not guarantee reduction of poverty, as illustrated in Table 4 which shows the changes in poverty during 117 growth episodes in developing countries in the 1980s and 1990s. Despite the growth in household income per capita, there was little impact on poverty in 30 percent of the episodes due to deteriorating distribution. The level of inequality is also important because higher levels of inequality are associated with lower rates of poverty reduction at any given rate of growth.

TABLE 4
CHANGES IN POVERTY RATES IN 117 GROWTH SPELLS COVERING 47 DEVELOPING COUNTRIES OVER THE 1980s AND 1990s

		Average Household Income Per Capita	
		Falling	Rising
Inequality	Rising	(17% of cases) poverty *rising* at 14.3% per year	(30% of cases) poverty falling at 1.3% a year
	Falling	(26% of cases) poverty rising at 1.7 % a year	(27% of cases) poverty *falling* at 9.6% a year

Source: Ravallion, Martin, ‘Growth, Inequality and Poverty: Looking Beyond Averages’, paper presented at the UNU/WIDER Conference on Growth and Poverty, 25-27 May 2001, Helsinki.

There is increasing evidence that the international poverty targets will *not* be met at the projected growth rates and given current levels of inequality. It is only through reducing levels of inequality that the projected levels of growth would reduce poverty to the extent necessary to meet the international targets. However, given that inequality is actually increasing in many countries, there is even less chance that the poverty targets will be met. This is particularly the case in countries where such increases occurred from already high levels or where the surge was very large. Most of the former Soviet bloc, much of Latin America (especially Brazil), a number of southern African countries and others such as Pakistan have levels of inequality that will make it very difficult for growth to be translated into rapid poverty reduction (or to sustain necessary rates of growth). However, meeting the global targets depends very much on the performance of China and India. Inequality has been rising rapidly in China and poverty reduction has virtually stalled despite rapid growth. There is increasing evidence that inequality is also now on the rise in India.

5. POLICIES TO REDUCE INEQUALITY

The evidence is clear that inequality is rising in many countries. It is also clear that inequality should be an important issue to all governments and the international community. Inequality can affect growth and poverty as well as social and political stability. It is also important to note that avoiding increases in levels of inequality is much easier than subsequently trying to reduce them. But what can governments do? And how can international organizations help?

Governments can have a significant impact on inequality and still grow fast! For example, if we compare growth performance and level of inequality in the Taiwan and Brazil. Taiwan had impressive growth in GDP/capita during the 1980-1998 period accompanied by only a modest increase in income inequality. In contrast, inequality in Brazil grew significantly from already high levels and economic growth was only 0.33 percent per annum over the same period. All countries essentially want to aim for a system that progressively distributes the fruits of growth without affecting the rate of growth. But specific policy mixes will vary, depending on the extent of the problem and specific national characteristics. The higher the level of inequality, the stronger the measures to avoid or reduce it may need to be.

Developing countries with high inequality should put more emphasis on directly reducing inequality, with stronger structural measures. A hopeful message of the research is that countries in the worst situation can benefit most. For countries with high income concentration, policies to reduce inequality could also help provide a strong base for growth and faster poverty reduction. Such policies could also help to lessen social problems and even to avoid conflict. There are clearly many different government policies that affect inequality and the overall level and nature of income distribution will depend on the combination of these. This section, however, outlines the different *policy options* for specific interventions to reduce inequality. It focuses both on the 'traditional' causes of inequality such as land concentration, urban bias and inequality in education and the 'new' causes associated with technological change and shifts towards neoliberal economic policy packages. In fact, any strategy aiming at promoting acceptable and pro-growth levels of income inequality must be two pronged, and deal simultaneously with the 'old' and 'new' causes of inequality.

5.1 Policies affecting traditional causes of inequality

Land concentration

Unequal land ownership helps explain different levels of income inequality among countries. The project highlights that reducing the concentration of land ownership can have a direct impact on income inequality, especially in agriculture-dominated developing economies. Based on the analysis of the pathways between agrarian structure and income inequality, the project led to two main policy suggestions.

First, it is clear that land reform would directly influence the distribution of agricultural income and overall income inequality. It is estimated that land reform in a still largely agrarian economy would reduce the Gini coefficient by 8 points. However, no such large impacts would be expected in more industrialized economies. In addition to affecting agricultural income, land reform would also affect overall income inequality by enhancing the human capital accumulation of rural households and by pushing upward the minimum wage in urban areas.

Major land reform programmes (as occurred in China, South Korea, Taiwan and Vietnam) have shown to be able to sharply curtail inequality, raise productivity and trigger rapid growth (i.e. both equity and efficiency impacts). Major redistribution measures to reduce structural inequality could be particularly useful for poor agrarian economies with high land concentration. Such reforms could be considered in many countries in Latin America, some in southern Africa and South Asia and also the Philippines. For example, in Central and South America one third of rural households remain landless. Also India and Indonesia could consider such reforms.

But it is important to proceed with caution. Many land reform efforts in the past have been badly planned and implemented without paying much attention to the incentives of all actors involved and to the functioning of the input and credit markets. Agrarian reforms ought to be implemented in a market and power compatible way, i.e. combining state coercion in favour of the poor with the apportioning of part of the cost of the reform on the urban rich (via taxation), the urban middle class (through higher food prices) and the beneficiaries of the reform themselves (via reimbursable long term credits). New ways of reducing rural inequality also pivot around an improved access to common-pool land, more equitable agrarian contracts, and a reform of the land market, including the taxation of land.

The *second* key policy is not directly related to land concentration but rather regarding the need to modify the conditions that make the asset distribution matter, i.e. reforming financial markets. High land concentration can lock-in inequality by affecting the way that the agricultural sector develops and by leading to unequal human capital accumulation. It is financial markets that create a linkage between the assets that a household already has and the new investments that they can undertake. Policies that make financial markets function well for the rural poor (or that subsidize education) could actually break the linkage between agrarian structure and income distribution.

Finally, it is worth noting that in some ways these two policy approaches are linked if we focus on land reform that is market-based. Redistributing agrarian assets through market-based methods is only likely to work if financial market access problems for the rural poor are resolved. Therefore, for many developing countries, the policy priority must be to make markets work better for the less well-off in rural

areas. This would enable the rural poor to position both themselves and their children to benefit from future economic growth.

Using natural resources equitably

Despite the higher growth potential of resource-rich economies, these countries have had the worst distribution of income, human capital formation and growth performance since the 1960s. Resource-abundance is more likely to lead to states in which vested interests compete to capture resource surpluses at the expense of policy coherence. The economy tends to become increasingly distorted and manufacturing is often protected so that development depends upon commodities with declining competitiveness. Income inequality remains high and skills accumulate slowly.

However, low growth is not inevitable in resource-abundant economies. It is clear that economic policy counts and indeed is more important than natural resources in driving economic growth. Some of the key policy issues are that resource-abundant countries need a capital development fund to rationalise the allocation of resource surpluses, a commodity revenue stabilization fund to smooth government revenues, and a project evaluation unit to ensure efficient public investment.[1]

Education and training

It is well known that there are important relationships between education and the distribution of income in a population. On one hand, income inequality may prevent access to education when education is too costly for poor families. In this respect, there may be a self-perpetuating poverty trap that can only be avoided by easing access to education. On the other hand, improved access to education raises the earning opportunity of the lowest strata and, other things being constant, reduces earnings inequality.

Expanding basic education is seen as having many other social and economic benefits, but a key finding of the project is that expanding educational attainment is also vital for reducing inequality. A general lesson that emerges from our evidence is that increased access to education reduces income inequality only if two conditions are met. First, the initial level of educational attainment must be sufficiently low; second, the average educational attainment must be raised sufficiently rapidly and gradually be extended also to secondary education and, in the advanced economies, to higher education. The second condition implies policy recommendations within and outside the education sector. This is because educational choices are not only affected by the public provision of schools, but also by issues such as the generally available opportunities in the labour market, the prohibition of child labour, markets for education financing and cultural norms.

[1] Ideas based on the work of Richard Auty.

Nevertheless, we cannot stress enough the importance of strong, sustained emphasis on the expansion of equitable, broad-based and quality basic education, especially for girls. The gap between rhetoric and reality remains large, though gender differentials in education have fallen in most countries, including in North Africa, the Middle East and South Asia during the 1990s. Many developing countries still spend more on defence than health and education combined. Education reversals were also one of the most unfortunate outcomes of the fiscal crises and the severe stabilization and adjustment programs in the 1980s and 1990s. It will be vital for governments and the international community to prioritize education spending and better protect education budgets in periods of fiscal crisis.

Urban/regional bias

An important finding of the UNU/WIDER project is that the adjustment processes of the 1980s and 1990s have not resulted in the expected reduction in the rural-urban income gap. These measures did reduce some anti-rural price distortions, but may have actually increased bias against rural areas in other ways, especially given the finding that the urban bias in public investment has persisted, and that other reforms may have, *de facto,* favoured the urban sector over the rural sector. However, to reduce rural-urban disparities, it is clear that the creation of new market opportunities will need to be accompanied by measures that help rural people to exploit them.

Why is it important to address rural-urban inequalities directly? First, rural people still tend to be poorer, even allowing for differences in characteristics. Second, high inequality itself can be inefficient—for growth and public expenditure investments. Also as rural-urban (and farm-nonfarm) inequalities are ascribed inequalities, reducing them might well accelerate development. Third, the current situation in developing and transitional countries—the high level of inequality between rural and urban areas and the absence of any general downward trend in urban/rural ratios of welfare indicators—is contrary to expectations. Finally, regional and ethnic bias in economic opportunity and public spending can exacerbate both horizontal and vertical inequality. Ultimately, such inequality can cause political unrest and in extreme cases can contribute to violence and genocide (e.g. Rwanda). In addition, some large countries often combine a well-developed modern sector with remote and poor backward areas, often inhabited by people of a specific ethnic origin (such as in Brazil's north-east or Xinkiang in China). In Mexico, for example, 80 percent of the indigenous population is poor, while only 18 percent of Caucasians are poor. Specific targeting may be helpful in such cases.

Thailand provides one of the clearest example of increasing regional inequality and the need for planning. In 1960, the per capita income of the Central region (including Bangkok) was about three times that of the poorest region, the Northeast. By 1996, Bangkok accounted for more than 51 percent of Thailand’s GDP, and its per capita income was approximately 8.5 times that of the Northeast. Recent Thai experience highlights the positive impact that policies to promote industrial

decentralization, small-scale industries and agro-industries can have. This has reduced inequality among individuals living in different communities and regions and working in different sectors of production.

Tax and pricing policies as well as public expenditure policies can have significant impacts on the distribution of opportunities and income between rural and urban areas. A clear conclusion from this work is the need for a more active and direct policy towards rural areas. Infrastructure and education investment in poor regions is generally more effective in reducing urban bias and regional inequality than welfare transfers or fiscal incentives. This would require a reversal of existing policies which have been shifting towards a more intensified urban bias.

5.2 Policies affecting new causes of inequality

While measures to deal with the traditional causes are essential, especially for countries with a large number of rural poor, in most cases they are not sufficient to deal with the rises in inequality observed during the last two decades. In many countries, the rush to implement ill-designed privatization and premature liberalization of financial markets in the presence of weak regulatory capacity has contributed to rising income and asset inequality. Thus, a second essential ingredient in the effort to contain the rise in inequality and to accelerate poverty reduction is to make policy frameworks more distributionally favourable.

Technological change

Technological change presents a major challenge for a growth strategy aiming at maintaining inequality within an efficient range. New technologies have many positive elements but they also tend to generate a demand for skills—and thus a potential dispersion of wages—which is far more skewed than that emanating from 'old technologies.' Advances in telecommunications and information technologies are turning formerly non-tradable services into international tradables—for example data processing and accounting. This creates a new comparative advantage for low-income countries with an educated workforce (the growth of software development in Bangalore is a well-known example). Furthermore, as more developed countries move up the technological ladder, opportunities may also open up for developing countries. Indirect actions seem to be the most appropriate in responding to the inequality implications of technological change. The most important policy concerns the need for government to facilitate educational progress and skills formation as widely as possible and thus to increase the supply of skilled labour. This would enable countries to avoid inflated wage rents due to the scarcity of skilled workers, as well as to maintain and enhance competitiveness. This has been highlighted as a key difference in explaining the different inequality educational policies followed in the USA (where scarcity rents drove upwards wage differentials) and Canada (where wage differentials did not increase thanks to a rapid expansion in publicly supported secondary and higher education). In addition, institutional changes in labour markets and labour market policies towards lower unemployment are most relevant.

However, as social norms, unions, growth of employment and macroeconomic conditions are regarded as important determinants of income inequality (as well as other current labour market deficits), education and training can only go so far.

Macroeconomic stability

The excessively severe approach to stabilization and adjustment in the 1980s and 1990s has tended to spur rises in inequality. Severe adjustment policies have major impacts on the poor and, more generally, the benefits of reducing output volatility are considerable. A key element of a strategy focussing on poverty reduction should be to run a macroeconomic policy that minimises output volatility and in particular avoids sharp recession-induced rises in inequality. Once the crisis has emerged, the protection of the poor and of an equitable distribution may require a distributionally-sensitive measures as well as fiscal policies (including social safety nets) to smooth consumption over time. However, low international-credit ratings and thin domestic debt markets, limit the ability of poor countries to use this option. Increased external budgetary support can expand their room for manoeuvre—implying a reversal in the decline of real aid flows and more official debt relief—together with international mechanisms to dampen the volatility of commodity prices and short-term portfolio flows.

Sectoral Policies

In low-income societies, promoting growth in agriculture and labour-intensive industry (i.e., sectors with a high labour absorption) is also a key priority. The performance of the primary sector will be crucial because most of the poor in developing countries live in rural areas and are dependent on the agricultural sector for their livelihoods. The Indian and Thai cases in particular point to the crucial role of agricultural development in actual income distribution. A vital consideration is that the primary sector should not be penalised. Also, more supply side measures could be considered. Creating or supporting institutions for research and development as well as education and training in this sector should be given priority. Infrastructural investments to overcome power failures, water shortages and poor rural road networks are also essential.

Trade liberalization

The relationship between income, trade and inequality is certainly complex and remains disputed. However, it is clear from the project analysis that trade is far *less* important than publicly perceived. Trade liberalization seems to have exacerbated inequality in some cases but there is no systematic evidence. Thus, while certain countries, particularly in Latin America, should be aware of the distributional impact of trade liberalization, it seems that other broader policy responses are rather more important. These include macroeconomic conditions, social norms and economic institutions as well as growth of employment and education and training of the workforce.

INTERNATIONAL DIMENSIONS—IMF AND WORLD BANK POLICY PACKAGES

There is increasing sensitivity to inequality issues in the international financial institutions and, if the IFIs are to have a significant impact on poverty, inequality will need to be at the heart of any strategy. The key approach must be to advocate in stabilization and structural adjustment frameworks that are more distributionally favourable. For stabilization, this would involve, among other things, efforts to:

(i) choose reasonable 'stabilization targets' for the budget deficit and inflation;
(ii) choose a reasonable pace of adjustment; often, gradual—but irreversible—measures are technically and politically more viable than more ambitious but unsustainable ones;
(iii) achieve the deficit reduction through increasing progressive taxation rather than through cuts of pro-poor public expenditures;
(iv) generate sufficient external financing to smooth consumption;
(v) establish—ahead of time—adequate and affordable social insurance mechanisms;
(vi) whenever possible, rely more on devaluation and other export promotion measures rather than on fiscal and monetary expansion.

For the structural adjustment programs, this would involve efforts to:

(i) allow more time for institutional development ahead of reforms;
(ii) adopt a pragmatic policy in the field of labour market and trade liberalization;
(iii) include distributional concerns in the design and regulation of privatization and domestic financial liberalization, and include them in tool-kits for World Bank teams using PRSPs;
(iv) support policies (including capital controls) to reduce the output volatility caused by financial shocks;
(v) set up new, permanent mechanisms that would support the poor during periods of structural reform; social funds have not been satisfactory in this regard.[2]

Financial liberalization

Capital account liberalization is increasingly perceived to have caused increasing income inequality in many developing countries, particularly in Asia and Latin America. In emerging economies the main problem is to reduce the output volatility associated with financial contagion. Recent events have shown that exchange rate policy and financial regulation are the weak points in emerging economies. Yet, there is no consensus in this area. Assigning monetary and fiscal policy to defend the exchange rate raises the cost of public-debt service (via higher interest rates). To offset the impact on the overall fiscal deficit, countries are urged to raise their primary fiscal surplus—as advised by the IMF to Brazil in 1998. But this is not conducive to raising pro-poor social spending. A currency board ended hyperinflation in Argentina, but post-stabilization employment growth is disappointing and has not offset the rise in the concentration of wealth associated with recent privatizations.

International action to curb destabilizing short-term capital flows could reduce output volatility and would enhance the scope for avoiding sharp recession-induced

[2] The case study of India suggests that this should involve lasting, flexible organizations to protect the poor from the effects of macroeconomic shocks; workfare programme; and the building up pressure groups of the poor to ensure that enough funds are made available for social programmes.

increases in inequality and poverty. In the meantime, a reversion to capital controls seems inevitable if countries wish to assign monetary and fiscal policy to achieving growth. For instance, capital controls to support the currency have enabled China to reflate its economy, create new employment opportunities and offset in this way part of the social costs of privatization.

The UNU/WIDER project, particularly the evidence from the Thailand, India and Turkey case studies, strongly indicates that policies regarding domestic financial liberalization and capital account liberalization need to be reconsidered. Also, since it is widely believed that the rapid expansion of the FIIRE sector was caused by the inflow of foreign capital, more research on the distributional effect of foreign investment is needed.

Privatization and the distribution of industrial assets

The distributive impact of privatization needs to be addressed, particularly in transition economies. In addition to leading to a highly regressive asset redistribution, insider privatization failed to raise economic efficiency. Greater attention to the institutional design of privatization, and greater caution in its use, is now important for the future. However, as privatization is now a ‘done deal’ in many countries, regulation is increasingly the key entry point for equity concerns. Various regulatory mechanisms and subsidies to ensure service delivery to the poor can be deployed, though the relative effectiveness of privatized utilities remains uncertain.

Labour market institutions

The exact role of labour market policies to reduce income inequality as well as in overall economic and reform strategies remains controversial. This brief previously outlined the significant change in approach to labour market policies over the last two decades and their likely impact in increasing earnings inequality and overall inequality in medium and high income countries. As a framework, it is important to initially outline the main goals of labour policy: improving allocative efficiency (matching supply and demand), improving dynamic efficiency (increasing the quality of the labour force) and improving a sense of equity and social justice among labour force participants.

The current consensus emphasizes solely the function of the labour market of increasing allocative efficiency. However, well-organized and well-functioning labour markets can also contribute to the overall development goal of reducing poverty in other ways. The current consensus ignores options to enhance the dynamic efficiency or the equity / social-cohesion functions of labour markets. The project outlined some key policy issues with particular reference to developing countries.

There are a number of ways to increase the dynamic function of the labour market. Greater investment in human capital is critical; key issues are the development of

more innovative skills at lower school levels and of complex problem-solving techniques at higher school levels as well as more workplace training and lifelong learning. This contrasts with the current policy consensus, which has led to the squeezing of education budgets. Similarly, subjecting workers to precarious contracts does not help improve the dynamic function of the labour market. Longer term contracts and established and well-negotiated roles for employment protection can provide a better climate for improvements in productivity.

The UNU/WIDER project found that, in medium and high income countries, equity can be enhanced through two mechanisms, namely the establishment of well-functioning minimum wage mechanisms and centralized wage-setting. Minimum wages can provide stability, foster the commitment of workers, represent an incentive to raise productivity and help reduce poverty. Thus, policymakers should regard minimum wages as a tool rather than a bottleneck in the operation of the labour market. The evidence is overwhelming that centralized wage-setting has favoured lower inequality and lower inflation rates and improved industrial relations—as long as it is the outcome of a genuine collective bargaining process. Pay co-ordinating mechanisms would also be essential for increasing the real demand required to spur faster rates of growth. Here policymakers should seek to strengthen of the relevant institutions rather than abolish or block the creation of centralized wage-setting.

Finally, it is important to highlight issues related to the adjustment reforms since these called for changes in the labour market policies. If macroeconomic policies are not able to generate growth and demand for labour, labour-market policies cannot improve the overall situation. Macro problems may have to be resolved first to expect labour market reforms to succeed. Indeed, in many cases reform packages have resulted in marginal increases in growth yet resulted in greater inequality in the labour market. One can therefore conclude that an emphasis on the allocative function of the labour market during the reform process should not be the preferred policy instrument for fostering growth and reducing poverty.

The state tax and transfer system

The state can play a role in reducing income inequality and preventing further rises through expenditure policies that favour the poor and through progressive tax policies. Many, if not all, OECD countries have seen a rise in the inequality of market income between 1980 and the mid 1990s. But the differences with regard to the distribution of disposable income and overall inequality indicate that policy choices do matter. It is impossible to do justice here to the options available. It is worthwhile, however, to emphasize the extent of the impact the different approaches can have. More rigorous policies in Germany, France or Finland offset the rise in market income inequality and there was no apparent increase in the inequality of disposable income. The same was true in the United Kingdom until 1984. After this point, a significant policy shift reduced the redistributive contribution of transfers and taxes leading to a sharp spike in the level of income inequality (of over 10 Gini points).

Existing studies on tax and transfer incidence in developing countries indicate that their redistributive effects are not as large as in industrial countries. Developing countries tend to be fiscally weak in comparison—with low tax-GDP ratios, a limited menu of direct taxes options and weak transfer systems. Corruption and poor governance can also limit the effectiveness of taxes and transfers as redistributive instruments. Some, particularly the IMF, argue that these features cast doubt on the ability of tax and transfer policies in developing countries to redistribute income effectively.

This project points to a very different conclusion. In developing countries, there is scope for increasing taxes moderately and better distributing transfers to the poor as well as for having more progressive tax systems. There are a number of successful cases in developing countries that can be highlighted for more general use. Countries that pursued sound social policies (e.g., Jamaica, Turkey, and Indonesia) improved their income distribution in spite of the limited equity objectives of their tax reforms. But there is also need for much more innovative work in developing effective tax and transfer approaches to help reduce poverty and inequality.

In many developing countries public spending on education, health and transfers is insufficient. The evidence indicates that 14 of the 15 public education and health programs in developing countries studied in the project were progressive, but 9 of them could improve their targeting. Health and education targeting has been particularly weak in Africa and often biased towards the non-poor. Other transfers that affect the poor, for example for food, fuel and fertilizers, have largely been untargeted. The reforms of health, education, and other social programs should be aimed at increasing their efficiency, improving their targeting, and preventing an excessive 'middle-class capture' of their benefits. Developing countries have a tax structure dominated by indirect taxes and with a limited menu of capital and wealth taxes. In general, their weak tax administration gives rise to tax evasion, and a marked difference between *de jure* and *de facto* tax regimes, resulting in a low tax-to-GDP ratio. Nevertheless, the use of tax instruments for redistribution remains an issue that could be further explored in many countries.

First, there is great scope to increase tax returns. At the moment, wealth and property taxes account for a mere 1-3 percent of total tax revenue in most developing countries, while income tax generates only slight revenue. This would only help, however, if the resulting revenue was used for pro-poor expenditures. Second, there is scope to make tax systems more progressive. Only 13 of the 36 overall tax systems studied were found to be progressive, the rest were either proportional or regressive. Indeed, over time the progressivity has declined in several developing countries in parallel with the introduction of recent tax reforms which have explicitly neglected any distributive objective.

Overall, although socially desirable, it must be noted that tax reforms and the reallocation of public expenditure in periods of stagnant budgets may face a difficult political economy. If the political power of the wealthy can be overcome, then taxation of land, urban property, capital-gains and financial rents can raise additional revenue to be allocated to educational expansion and other pro-poor activities.

6. CONCLUSION

While the UNU/WIDER research project on income inequality has also highlighted a number of areas where further work is required, this policy brief is intended to provide information, analysis and some recommendations for a number of constituencies to which inequality matters. More specifically, it targets the following groups:

Researchers:	• it provides a new data set for assessing the relationship between growth, inequality and poverty reduction;
	• it provides a comprehensive analysis of the current state of knowledge on income distribution within countries.
Policymakers:	• it identifies key inequality issues that may need attention to make the economy more effective in reducing poverty as well as to make society more cohesive.
Civil Society:	• the database might enable civic groups to quantitatively track changes in inequality and could serve as an advocacy tool for improving income distribution in their country.
UN System: *(and donors)*	• it provides an assessment of inequality that can be used in shaping support strategies for countries around the world.

High and rising income inequality is one of the most pressing problems facing countries around the world, and the international community. It is increasingly clear that, in the presence of high levels of inequality, the poor are systematically left behind by economic growth. The project also finds that high inequality (as well as very low inequality) can also be detrimental to economic growth itself. There is also evidence that high inequality can have adverse social and political impacts too.

Rising inequality is not inevitable in a world dominated by technological change and globalization. Technological change and globalization are factors driving rises in inequality, but they are less important than is generally perceived. Income distribution is subject to many influences. The most important factors depend on public policies in the field of asset distribution, taxation, expenditure on human capital, structural adjustment, stabilization, liberalization and so on and thus are amenable to policy change. Also, the extent and nature of the impact that globalization and technical change have on inequality depends very much on other policies, especially those concerning education and the labour market for skilled workers.

The efforts underway to reform the mainstream neoliberal approach to economic policy must thus be intensified. These policies have led to a comparatively weak growth performance and have been one of the key causes of the widespread increases in within-country inequality observed during the last two decades. There is

considerable scope to maintain a moderate level of inequality, within a sound policy framework. If the potential of globalization and technological innovation is to benefit all people, it will be vital to move to an approach that places the distributional, as well as the growth issues, at the centre of the policy agenda.

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