OCTOBER 28-30, 2018

TOKYO, JAPAN

EMERGING MARKETS FORUM

2018 GLOBAL MEETING

Inequality: What Policy Makers Should Know

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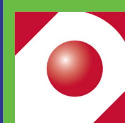
Background Paper



Emerging Markets Forum

A nonprofit initiative of the Centennial Group

Inequality: What Policy Makers Should Know

Montek S. Ahluwalia

The subject of income inequality has moved to the center stage of discussions on economic policy in recent years. In this paper, I look at four different aspects. **Part I** provides a brief commentary on how perceptions about the importance of inequality have changed in recent years. **Part II** presents a factual picture of what has happened to income distribution in a small group of industrialized and developing countries. **Part III** discusses some of the determinants of income distribution, which we need to understand if we want to reduce the degree of inequality. **Part IV** discusses the scope for corrective action in this area with special reference to emerging markets.

I. A Little Bit of Background

Income inequality has only recently become a subject of concern among policy makers in industrialized countries and in emerging markets. In the former, policy makers from the 1960s onwards, have focused on securing robust growth and low unemployment with modest rates of inflation. Economic performance in these dimensions was broadly satisfactory through the second half of the last century and the social welfare system created after the Second World War provided enough of a safety net for those left behind. The overall socio- economic and political environment was perceived to be “fair” and economic inequality was simply not seen as an issue.

Developing/emerging market countries in this period were also little concerned with inequality. The primary concern was accelerating growth to raise the general standard of living of the population. From the 1970s onwards, the pursuit of growth was modified by a distributional concern to ensure that the benefits of growth reached those in the lower income groups and led to a reduction in poverty. The World Bank sanctified this approach by focusing on poverty reduction as its principal objective. There was relatively little attention to income inequality.

Poverty reduction and inequality are obviously connected, since any given growth rate, would lead to a greater reduction in poverty if accompanied by an improvement in the share of income accruing to the lower percentiles of the income distribution. However, the focus of policy was more on accelerating growth and reducing poverty, and not on reducing inequality. If a faster rate of growth reduced poverty but increased inequality in the process, it was not seen as a problem. The Kuznets hypothesis, postulating an inherent tendency for inequality to increase in the early stages of development, was frequently invoked to put rising inequality into perspective.

It is after the global financial crisis of 2008 that inequality became the focus of discussion. It is worth noting that income inequality was rising in the United States for at least twenty years before the crisis, but as long as unemployment was not a problem, it did not have a major impact on policy making. The financial crisis of 2008 changed these perceptions because of the stark contrast in the experience of ordinary people, who were hit by the increase in unemployment, collapse in house prices leading to foreclosures of homes, and stagnant or even falling real wages, while the thin upper crust, which controlled the financial sector, and indeed was viewed as having caused the crisis, was little affected.

It should be noted that resentment towards certain aspects of globalization, notably liberal trade policies leading to “hollowing out” of manufacturing and consequent high unemployment in certain areas, was building up even before the crisis. However, this resentment was contained because there was a sufficient appearance of general prosperity in the economy at large. Some of this we now know was illusory. Easy credit policies in the US in the 2000s, especially for house purchases, fueled a boom in home prices, which gave poorer people an illusion of prosperity because of rising equity in homes against which they could borrow to finance higher levels of consumption.

When this bubble burst in 2008, it revealed profound asymmetries in the system. A small group of people controlling the financial sector, and earning huge salaries compared even to the upper end of other sectors in the real economy, were seen as having pushed globalization

and financial liberalization for their benefit. The sense of unfairness was magnified by the fact that while those in charge were seen as having caused massive losses to the economy, leading to much suffering by ordinary people, they got away with no punitive action. Even Christine Lagarde, MD of the IMF, lamented that no one went to jail for the systemic failings that inflicted so much loss on so many.

It is worth noting that although inequality was back in focus after 2008, the concern was not so much about overall inequality as measured by the Gini Coefficient. It was much more about the income share of the top 1 percent, and even the top one tenth of one percent! Joe Stiglitz has pointed out that in the United States, while the median income in real terms has stagnated or even fallen, a disproportionate share of total growth has been appropriated by the top one percent and this share has actually increased! This anger about unfairness morphed into a political movement against the elites who were seen as having managed the system to their benefit. We see evidence of this phenomenon in many industrialized countries.

The distributional objective in developing countries has evolved in the past twenty-five years but it has not focused on inequality. Instead, the earlier objective of poverty reduction has been expanded into a new objective of broader sharing of the benefits of growth. Going beyond poverty reduction was almost inevitable as the incidence of poverty declined. It makes sense for political leaders to make elimination of poverty as the central plank of their development strategy when poverty affected 60 or 70 percent of the population, but not when it is down to 10 or 20 percent, as it now is in many countries. In India for example, the Eleventh Plan 2007-07 to 2011-12 reflected its development objective in the title “Inclusive Growth” and this was broadened to “Inclusive and Sustainable Growth” in the Twelfth Plan (2012-13 to 2016-17) reflecting the growing importance of environmental sustainability and climate change. Inclusive growth as defined in Indian plans went beyond poverty reduction by defining poverty to include inadequate access to essential public services especially in education, health, sanitation, and clean drinking water. It also incorporated considerations of gender equality and inter-regional inequality.

In line with these developments, the World Bank modified its objectives from the earlier exclusive concern with eliminating absolute poverty to a broader concept of reducing poverty and promoting “shared prosperity”. Inclusive growth or shared prosperity goes beyond poverty reduction, but it is not the same as reducing inequality. It only reflects the need to provide a broader spread of benefits not just to the poor, but also to the non-poor and the growing middle class.

Much work has been done in recent years to understand the impact of inequality on growth and on other aspects of social development. The notion that we need increased inequality to raise the savings rate in order to finance the investment needed for higher rates of growth does not find much support. Some studies have shown that lower inequality is associated with better health or educational outcomes, but this may only reflect the fact that for a given level of per capita income, lower inequality means a higher level of income for the poorer segments, and it may be the higher income levels that have the effects mentioned. It can be argued that the same outcome could be achieved by faster growth, as long as it leads to adequate growth in incomes of the poor, even if inequality increases in the process.

The real case for reduced inequality as an end in itself has to be made either as a moral imperative for individuals or because it generates greater social cohesion and a politics that is more participative and caring. In this context, it is especially important to avoid extreme concentrations of income since it effectively allows tiny elites to enjoy standards of living which cause envy and social turmoil. It also allows them to control the political decision-making process. Joe Stiglitz has worried about this for the United States, and it is obviously equally, if not even more, relevant for emerging market countries.

All this suggests that we need to be careful in determining how exactly income inequality should be fitted into the development agenda in emerging markets. The following approach seems to me to make a great deal of sense.

a. Rapid growth to raise the general level of per capita income is essential in countries at low levels of per capita income. However, they should also make sure that the growth is environmentally sustainable. Environmental sustainability can also be viewed as a distributional objective. Air pollution for example imposes externalities on the population at large, mainly because of the consumption of a few. Climate change is also a distributional problem where the lifestyle of a small portion of the current generation, accounting for most of the carbon emissions, is imposing a huge cost of the whole of future generations.

b. Reduction in poverty will remain a more compelling objective than reducing inequality. However, poverty reduction should be defined not just in terms

of bringing people above some fixed absolute level of income or consumption. Instead, the poverty line should be periodically adjusted in line with the rise in the general standards of living e.g. by defining poverty as 40 percent of the mean income or consumption level, which rises as the mean rises. Poverty should also be more broadly defined to include lack of access to minimum levels of public services in health and education.

c. Once growth and poverty reduction have been suitably addressed, it makes sense to try to curtail inequality to some level that is perceived to be "fair and acceptable". However, it is not possible to prescribe a universal level of inequality that is acceptable. This is inevitably a social or political choice. If it is possible to generate rapid growth which is both inclusive (i.e. poverty reducing) and environmentally sustainable but is also likely to involve some increase in inequality as measured by the Gini coefficient, the resulting increase in inequality may not be objectionable.

II. Facts About Inequality in Developing Countries/ Emerging markets

We now turn to a brief review of what we know about income distribution in industrialized and developing countries.[1] Table 1 shows data for a select group of industrialized countries and emerging market/developing countries for 1990 and 2015. Two different Gini coefficients are reported for each year, one for market determined incomes, i.e. before any redistribution through fiscal transfers, and a second for disposable income after transfers. The following are some important conclusions that can be drawn from the data.

i. **Inequality based on disposable income is significantly lower than inequality in market incomes suggesting that fiscal transfers do affect inequality.** This is true in both the industrialized countries and also in emerging market countries, but the impact of the redistributive policies, in terms of the absolute reduction in the Gini Coefficient is much larger in industrialized countries. This is what one would expect, since equalizing transfers have been "baked into" the social security systems of industrialized countries and their fiscal capacity is also much larger. This has relevance for future policies in emerging market countries.

ii. **Inequality seems to have increased in 6 of the 7 industrialized countries over the twenty-five-year period, whether we look at market determined incomes, or incomes post fiscal transfers.** The exception is the UK where it seems to have been stable, both in terms of market income and disposable income. The increase in inequality in Japan is particularly strong. The Gini for Japan based on market incomes shows an increase from 30.4 in 1990 to 44.3 in 2015. This is not the highest Gini among industrialized countries, but the redistributive effect seems much weaker in Japan than in other industrialized countries as a result of which the Gini based on disposable incomes in Japan has increased from 28.2 in 1990 when it was among the lowest, to 40.2 in 2015. This makes Japan the most unequal society on a post fiscal transfers basis, among the industrialized countries in the Table. *(I am not entirely sure about the validity of this conclusion and would welcome comments from the audience.)*

iii. **Inequality has also increased in 3 of the 7 emerging market countries:** China, India, and South Africa. Both China and India have experienced high growth and also declines in absolute poverty. This process began much earlier in China, but it has also been seen in India in the past fifteen years or so. However, while high growth has brought a reduction in poverty in both countries, both have also seen a substantial increase in inequality. *(The Gini Coefficient for China reported in Table 1 is lower than reported in many other studies and I need to go into the reasons for this discrepancy*) The IMF has recently produced a study of inequality in China (Sonali Jain et al 2017) and the broad picture that emerges from this study can be summarized as follows. Inequality began to increase after 1990 but the increasing trend halted some years ago and began a very mild reversal. However, the extent of concentration of income in the top remains high, with a fairly large number of billionaires in the Forbes list. India too has a large number of billionaires in the Forbes list, and this is now widely publicized. Unlike China there is no evidence as yet that inequality is declining. However, in comparing India with China, we have to keep in mind that India is at least 20 years behind China

1. I must emphasize that data on income distribution in developing countries are very poor. In this section, I use data on the Gini coefficient for a representative group of industrialized and emerging market countries for the years 1990 and 2015 from the SWIID data base developed by Frederic Solt.

Table 1: Gini Coefficient of Income Distribution

	Before fiscal transfers		After Fiscal Transfers	
	1990	2015	1990	2015
Industrialized Countries				
1) USA	46.6	50.6	34.7	37.9
2) UK	51.2	51.7	33.7	33.0
3) France	47.8	49.2	29.1	29.5
4) Germany	44.3	52.3	25.7	29.3
5) Italy	43.5	50.0	30.7	33.5
6) Japan	30.4	44.3	28.2	41.2
7) Korea	29.5	33.1	27.1	30.1
Emerging Markets				
1) China	35.7	46.0	33.0	40.2
2) India	43.7	49.5	41.3	47.8
3) Brazil	62.0	53.7	53.2	47.7
4) South Africa	64.4	68.3	56.2	59.1
5) Mexico	47.3	46.7	44.1	40.3
6) Indonesia	38.0	44.3	34.2	39.3
7) Thailand	48.6	44.7	44.1	40.3

Source: SWIID

in terms of per capita income. If India continues to grow at say 7.5 percent per year, it will get to where China is today in 20 years. If inequality in India begins to decline in ten years or so, India could be seen to be mirroring China.

iv. The emerging market countries where inequality has declined are Thailand, Brazil and Mexico. In Brazil's case, the decline is from very high levels of inequality and the decline we have witnessed has brought Brazil down to the same level as in India. It is interesting to note that the decline in inequality in Brazil is evident in both the distribution of market determined incomes and also in post transfer incomes. Thus redistributive programs such as Bolsa Familia, are not the only factor accounting for an improvement in inequality. The underlying distribution generated by the market has also improved. It could be argued that this is a second order effect of the anti-poverty program improving income earning power of the next generation, but the time lag for that effect to show up is much longer.

v. The absolute difference in the Gini coefficient based on market incomes and post fiscal transfer incomes gives some indication of the effectiveness of transfer policies in reducing inequality. The difference is very large in the Western industrialized countries except for Japan and Korea. In the case of the emerging market countries, the redistributive effect is generally modest, except in the case of Brazil, South Africa and Mexico. The redistributive effect in the case of India is particularly small, possibly reflecting the fact that India has the lowest per capita income of all the countries and therefore also a correspondingly lower capacity for redistributive transfers. The redistributive effect in China was small in 1990 but seems to have increased considerably in 2015 according to these data.

The above description of changes in income distribution over time focuses only on the Gini coefficient, which is a measure of overall income inequality. However, movements in the Gini coefficient do not tell us about other aspects of income distribution that are also important. For example, it does not tell us about the extent of concentration of income in the very top of the distribution, such as the top 1 percent. As pointed out earlier, this may well be the relevant area of focus in certain circumstances. The overall Gini coefficient also does not tell us about the extent of regional inequality, which can often be politically important. One can imagine a situation in which inter regional differences in terms of mean incomes of different regions show widening inter regional inequality even though the overall Gini coefficient declines showing an improvement in the overall income distribution. This can happen if the worsening of inter-regional differences is swamped by improvements in inequality within regions. However, as pointed out above, in many situations it is the inter-regional aspect of inequality that matters.

Another limitation of the Gini coefficient is that it measures inequality at a point in time and does not indicate underlying dynamic trends. For example, the spread of education today has implications for changes in income inequality in future since it will determine the distribution of human capital. However, this also depends upon what is happening to the quality of education. We may be seeing a spread of education, but if the quality of education varies very substantially, access to good quality education may remain highly unequal thus perpetuating inequality over time.

A related issue is the degree of social mobility. Any given level of inequality today would be more acceptable if the system provided a potential for upward mobility over time, at least for the next generation. Unfortunately, there are almost no data bases that enable one to judge progress in this area, at least in emerging market countries. Some recent research in the United States points to the fact that social mobility is actually declining. Much of the optimism associated with the "American Dream " in the post war years was due to the belief that children of poorer, or lower middle class, families, often refugees from Europe, have a high probability of "making it". That seems to have changed over the past twenty years.

III. The Determinants of Inequality

Policy makers wanting to influence the distribution of income generated by the market need to understand what determines the distribution thrown up by the market, and then see what policy instruments can produce different results. Unfortunately, the traditional theoretical models on which much of economic theory is based do not focus too much on income distribution. The most elementary model of growth, on which most economists still cut their teeth, is the Solow model which in its Cobb Douglas Production function version generates a constant share of capital in total income even as capital accumulates. If rising income levels of labor lead to rising levels of savings, and therefore a wider diffusion of ownership of capital by labor, there is an inherent likelihood for incomes to become more equally distributed over time. There are of course many variations of this model that can produce rising shares of capital depending upon the nature of technological progress.

Thomas Picketty's *Capital in the 21st Century* is widely regarded as the definitive work that forced economists to start rethinking income inequality distribution. Picketty's book was published in 2014, six years after the crisis. He refers to the financial crisis as having been caused by the earlier rise in inequality, but the book presents a much broader sweep of the history of industrialized countries in which he argues that there is an inherent tendency in capitalism for income and wealth to become increasingly concentrated. He recognizes that inequality declined in these countries from the end of the First War to 1980, but he argues that this was an exceptional period, characterized by considerable destruction of capital in the wars and important structural changes in the post war years with the creation of the welfare state. Since the 1980s, inequality in industrialized countries has been rising and this, according to Picketty, is actually a return to the longer-term trend under capitalism as was evident before the First World War during the "Belle Epoque".

Picketty focuses on the role of capital, and the observed empirical regularity (based on his extensive trawling through historical data) that the rate or return on capital seems to exceed the rate of growth. Combined with a steady increase in the ratio of capital stock to GDP, this leads to a rising share of the earnings of capital in total GDP. That, combined with initial inequality in ownership of capital, perpetuated by inheritance, is a recipe for constantly increasing inequality. A possible equalizing element in this system could be the accumulation of human capital in terms of labor skills, which can in principle be widely spread. However, as Picketty points out, labor income has also become highly unequal. Picketty warns against extracting any simplistic policy conclusions from his analysis. Commenting on his own work recently, he summarized its central message in the following sentences from the Introduction to his book. "One should be wary of any economic determinism in regard to inequalities of wealth and income. The history of the distribution of wealth has always been deeply political and it cannot be reduced to purely economic mechanisms...The history of inequality is shaped by the way economic, social and political actors view what is just and what is not, as well as by the relative powers of those actors and the collective choices that result. It is the joint product of all relative actors combined."[2]

In addition to capital and its concentration, another important influence on income distribution, is the role of technology and the nature of technological change. The special importance of technology at the present stage is persuasively brought out in "*The Second Machine Age: Work, Progress and Prosperity in a time of Brilliant Technologies"* by and Eric Brynjolfsson and Andrew McAffee published in 2014. They point out that the new disruptive digital technologies which constitute the Industrial Revolution 4.0 have the potential to increase productivity, but

2. Picketty (2014) page 20

they will also be highly disruptive leading to a massive displacement of labor in industrialized economies. Following this line of thinking, the McKinsey Global Institute has estimated that about half the activities/ jobs that exist today in the US are likely to be automated within the next fifteen years. These projections obviously have profound implications for employment, and therefore social stability, in industrialized countries in the years ahead.

Technological change has always generated the fear of loss of jobs, but in the past it has been possible to argue that while technological change may eliminate some jobs, it generally produces new and higher productivity jobs in the economy. The question being raised now is whether the new digital and AI revolution will also do the same, i.e. produce more but different jobs, or will it lead to a significant net decline in the demand for labor. The McKinsey Global Institute study has clarified that there will be many new jobs created, but they will be different jobs, and what is even more important the nature of jobs may also change.

One immediate consequence is that the work force will have to be retrained and redeployed to meet these new needs. The work force of the future must also accept that the nature of jobs may also change with far fewer long-term jobs and much more frequent changes of jobs and even professions. In other words, we are in for a period of massive labor market disruption. This may show up as an increase in inequality in the short run, but the real challenge is not how to prevent inequality from rising, but how to manage the labor market transitions involved, including not only frequent retraining, but also accepting new paradigms for employment.

The technological changes taking place in industrialized countries are responding to conditions in industrialized countries. The economic rationale in substituting capital for labor may be less evident in developing countries where labor is much cheaper but global integration of value chains and adoption of global standards will force employers in developing countries to follow suit even if the relative economics do not justify it. The implications for emerging market countries are not well studied or even understood.

Globalization is the third factor that is having an impact on inequality. It is now generally conceded that freer trade and capital flows reduce inequality between countries—an entirely desirable outcome—but it is often pointed out that it increases income inequality within countries. Here again, the nature of the change imposed by globalization is different in the industrialized countries compared with emerging market countries, and as a consequence the perception of the impact of globalization is also different.

In industrialized countries, a clear anti-globalization narrative has emerged that runs something as follows. Free trade leads to import of products requiring middle level skills, which are easily acquired by workers in emerging market countries. Domestic production of these products therefore shifts out of industrialized countries to foreign shores, to be performed by workers at much lower wages, which makes them "unfairly" competitive. This leads to unemployment and falling real wages for middle skill categories in industrialized countries. Jobs requiring high skill levels in industrialized countries, which contribute to advancing the technology frontier and generating new IPR, are not affected by this process. These jobs will remain in industrialized countries, and wages of this category of workers are expected to rise as these technologies are in demand worldwide, generating royalties for the IPR owners even when production shifts offshore. Low skill jobs in industrialized countries are not likely to be affected for two reasons (i) By their very nature, they have to be performed on site i.e. cleaning services, short order cooks, shop assistants, taxi drivers etc. (ii) Immigration restrictions prevent low wage labor in developing countries from competing for these jobs.

The net result of globalization according to this narrative is that inequality in industrialized countries will increase. Capital moves globally to earn the highest rate of return it can, and high skill workers benefit from rising real wages. Middle skill workers experience a decline in their incomes and face unemployment. Low skill workers remain unaffected. This narrative almost certainly exaggerates the role of globalization in aggregate job losses in industrialized countries and understates the impact of technology. Much of the increase in unemployment that is feared is likely to happen in any case because of technological change. However, whatever the cause, high unemployment for middle skill workers is a political problem and will lead to a political response.

The political response thus far in the US has turned out to be a backlash against free trade with a real danger of a trade war. It is to be hoped that this backlash is contained and reversed. If it is not, it would adversely affect developing countries and compromise the objective of reducing inter country inequality. It may also rebound on the industrialized countries themselves, since their ability to sell sophisticated products produced by high end labor, will be adversely affected by any setback to the growth of emerging market countries. Unfortunately, this synergy of interests is not as well appreciated as it should be.

Globalization probably also increases inequality within emerging markets, but this increase has produced much less concern, and has certainly not led to any backlash in developing countries. The increase in inequality in developing countries is more often viewed as a benign increase, with a broad spread of benefits but some increase in inequality. Trade integration is expected to increase exports of simpler manufactures which can raise the wage of higher skilled labor in these countries (which corresponds to middle skill levels in industrialized countries). It may not increase low skill wages to the same extent, but to the extent to which it facilitates a shift of labor out of agriculture to non-agriculture, it contributes to increasing income levels of those that remain in the in the agricultural sector, which is where most of the poor are located. Rising income levels in emerging market countries as a result of globalization will also create expanding demand for domestic goods which could translate into rising real wages even for low skill workers.

Inequality in emerging market countries may well increase in this process if the increase in incomes at the lower end of the income spectrum is lower than at the upper end. However, such an increase in inequality is less likely to present a problem because it will certainly be accompanied by a reduction in poverty and greater shared prosperity.

IV. What Can Emerging Markets Do?

In this section I present a brief outline of the policy options from which governments in emerging markets can choose to achieve distributional objectives. There are two broad areas for intervention. The first is to attempt to alter the distribution of income as it is generated in the market and the second is to look at the scope for altering this market determined outcome by fiscal transfers. These are discussed separately below.

(a) Influencing Market Determined Distributional Outcomes

Any strategy for improving distributional outcomes generated by the markets must keep in mind Picketty's warning that the concentration of both income and wealth is ultimately determined by deeply political and social forces and it is the combined effect of all these forces that can make a difference. However, emerging market countries are going through structural transformations in which the government's typically play a leading role. This opens up the possibility of taking action in critical areas, which could promote a more inclusive growth process.

The scope for action can only be spelled out for an individual country depending upon the circumstances of the country concerned, but some generalizations are possible and some of the policy issues are listed below.

(i) Improving the Economic Conditions of the Agricultural Sector.

This is the where policy makers can make the biggest contribution to reducing poverty and containing, if not actually reducing, inequality in the lower middle-income range of countries where agriculture still accounts for a large part of the workforce. These countries need to shift labor from low productivity agricultural activity to higher productivity non-agriculture. India for example is now a lower middle-income country but still has 49 percent of its labor engaged in agriculture which accounts for only 16 percent of GDP. India's biggest challenge today is to reduce the population dependent upon agriculture to say 25 percent in a ten-year period while simultaneously increasing land productivity by at least 50 percent in the same period. This is technically feasible, but it will require a complete reorientation of agricultural sector policies away from the current dependence upon input subsidies towards improved agricultural marketing and associated logistics, greater investment in water management, and more focused agricultural research and extension. These sectoral policies would certainly make a major difference to the degree of rural poverty in India.

(ii) Providing an Adequate Flow of Good Quality Jobs.

The ability to shift labor out of agriculture, which is a critical element of the strategy, depends critically upon the ability to generate a sufficient growth of good quality non-agricultural jobs. Job creation in the nonagricultural sector is therefore the most important instrument for achieving distributional objectives. Providing good quality jobs, especially for younger people, is the key factor that will mitigate what could otherwise become explosive revolts against inequality. In the absence of such jobs, attention will inevitably focus on the unfairness of the social system, as we saw in industrialized countries following the crisis of 2008.

Providing jobs in non-agriculture is a function of the growth that can be achieved in this sector and its employment generating capacity. Rapid growth calls for many things on the supply side, which is what a growth strategy is supposed to deliver. What helped in East Asia was that the demand side of this growth was export led. This allowed for the development of capacity in employment intensive simple manufactures which generated very large

employment. This demand side feature is not likely to be as powerful a factor as it was for the East Asian countries. This is not only because of the threat of protectionism, but also because the market for these products in the industrialized countries is going to grow at only a modest pace, and there are many more developing countries competing for this market.

However, developing countries should not be discouraged from pursuing outward oriented strategies. The emerging market and developing countries together now constitute about 45 percent of world trade and this share is growing. If these countries continue to grow faster than the industrialized countries as is generally expected, their market share in world trade will increase. Fortunately, the emerging market countries have so far not relapsed into protectionist policies. A healthy export performance is therefore still a feasible target, though it is probably true that exports will not play the role they did for East Asian countries twenty years ago. A great deal more employment will therefore have to be generated by production to meet the needs of the domestic economy. However, openness remains an important objective to ensure competitiveness.

(iii) Small and Middle scale enterprises.

These enterprises generally provide the bulk of the employment in most countries and therefore have a big role to play in job creation. However, their ability to perform this role will depend upon access to good quality infrastructure, especially power and transport, a well-functioning financial system which does not discriminate against small scale enterprises, access to venture capital funding, and a regulatory environment which minimizes the cost of doing business. Developing countries would be well advised to ensure that these supply side preconditions for a successful growth in smaller businesses, and therefore growth in employment, are in place.

(iv) Skill Development and Training.

Inadequate skill development is widely recognized to be a major problem in many developing countries. Most of them are engaged in providing basic education to the population and although serious gaps in quality remain, this part of the effort is well on the way. However, there is relatively less progress in devising means of skill development in relevant areas especially given the changes taking place in technology. A major effort at upgrading the system of skill development, with the private sector actively involved in the process, should have high priority in most developing countries.

(v) Supporting Research that is Likely to be Promote Innovation

This is a very difficult, potentially controversial, area. It is clear that technological change is being driven by developments in industrialized countries and the broad directions of research are driven by their perceived priorities. These countries have a seamless web of research from government financed defense driven research at one end to commercial applications at the other. The Apple iPhone for example rides on fundamental scientific breakthroughs such as GPS, multi touch screens, LCD displays, lithium ion batteries and cellular networks all of which came from research supported by the government much of it linked originally to defense objectives.

Antony Atkinson in his book *Inequality: What can be done?* suggests that governments should proactively push research in areas that will help innovation and employability. This is an interesting suggestion though one that is also fraught with all kinds of dangers of government failure in most emerging markets contexts. Two areas however are particularly important where government could play an active role in promoting research. One is research in agriculture, aimed at raising productivity in the specific conditions that developing countries face. Climate change in particular is likely to create new threats to crops which will be very country and location specific justifying substantial government support. The other area is research in health related to diseases that are most prevalent in developing countries and the search for low cost diagnostic and curative medicine.

There is also scope for directing more resources to research from the corporate sector. Except in the case of China, industrial corporations in emerging market countries are not doing nearly as much research as they need. There is a good case for more generous tax benefits for research expenditure and also government grants to support research in critical areas.

(b) Fiscal Interventions and Transfers

Our review of country experience in Part II shows that redistributive fiscal transfers play a major role in moderating the market determined inequality of income in industrialized countries. Most emerging market countries have much less redistributive intervention of this type. One reason for this is that fiscal capacity is much more limited. Industrialized economies, with mature tax systems and a very large organized formal sector can finance large social sector expenditures based on a combination of payroll taxes supplemented by matching contributions from the

government. Governments in developing countries do not have this luxury since the organized sector where payroll taxes can be applied is very small. They also have large demands for public expenditure on development of basic infrastructure and also essential social services which are essential to build the foundations of inclusive growth. This presents a potential conflict between what can be done in terms of redistributive transfers and what can be done to promote inclusive growth.

Subject to these qualifications, some broad conclusions can be offered.

1) Progressive Taxation

Whatever resources have to be mobilized for developmental objectives, should be mobilized through a progressive tax system to ensure fairness. It is generally acknowledged that income taxes have the greatest potential for progressivity but there is considerable difference across countries in what is regarded as an acceptable degree of progressivity. Several factors that have eroded the degree of progressivity in taxation in developing countries. These include especially the influence of low taxation rates in some jurisdictions. It would be useful to evolve a public consensus on what constitutes a reasonable rate of progressive taxation of personal income in terms of (a) the entry point where tax is levied as multiple of per capita national income (b) the initial rate of tax (c) the maximum marginal rate to which taxes should rise and (c) the point in terms of multiples of per capita income at which the maximum marginal rate will become applicable.

At times, it may be necessary to depart from conventional wisdom and introduce progressivity where it is normally not recommended. For example, the conventional view is that a Value Added Tax should be levied at a single rate, with very few exemptions. Political considerations may force (a) exclusion of a larger than desirable number of items and (b) may also force adoption of too many rates. The argument in favor of a single rate is that progressivity objectives are best met by progressive income taxation. However, many emerging market countries have too small a coverage of direct tax payers in the tax net. As long as that remains the case, the pressure to achieve greater progressivity through indirect taxes will be difficult to resist.

2) Inheritance taxes

Anyone worried about inequality must also be in favor of inheritance taxes. Practice in this regard varies considerably across countries with many countries (including India) having no inheritance tax. This is clearly an area where a consensus on good practices needs to be evolved.

3) Property taxes

Property taxes are in some ways the easiest taxes to impose, with a relatively easy way of enforcing progressivity. However, they are highly underutilized in most countries. As emerging market countries urbanize, urban local governments will need more substantial resources to finance the infrastructure they have to provide, and property taxes are an obvious source of such revenue. This is generally an under taxed source in most emerging market countries.

4) Progressivity of Benefits Through Public Expenditure

In a mature economy, public expenditure is usually structured to achieve progressivity, so that the post fiscal intervention income distribution is more equal. The usual benefits are (i) access to public schools of good quality at zero costs and public universities at very low coats (ii) access to good quality medical care either thorough public hospitals that are free, or government supported medical insurance plans, with a built-in subsidy for minimum access (iii) old age pensions for senior citizens and (iv) unemployment benefits based on contributions etc. and (v) child benefits which are either in the form of tax deductions or could be in the form of actual payments per child which would be reportable as taxable income.

Most emerging market countries have a set of programs in each of these areas which are aimed at helping the poor. Food subsidies are common and so are energy subsidies. Some countries run employment programs offering to employ individuals at the minimum wage on public works programs as a way of providing a minimum income support. These programs have an important role but are often poorly designed with large leakages. What is needed is a periodical comprehensive review of these programs to determine their effectiveness and a longer-term plan to shift from these ad hoc programs to a multidimensional social support program covering (i) to (v) above. A major problem in achieving this rationalization is that each of the existing programs are run by different Ministries and there is enormous resistance to folding them into a better designed comprehensive program.

The Emerging Markets Forum was created by the Centennial Group as a not-for-profit initiative to bring together high-level government and corporate leaders from around the world to engage in dialogue on the key economic, financial and social issues facing emerging market countries.

The Forum is focused on some 70 market economies in East and South Asia, Eurasia, Latin America and Africa that share prospects of superior economic performance, already have or seek to create a conducive business environment and are of near-term interest to private investors, both domestic and international. Our current list of EMCs is shown on the back cover. We expect this list to eveolve over time, as countries' policies and prospects change.

Further details on the Forum and its meetings may be seen on our website at http://www.emergingmarketsforum.org

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