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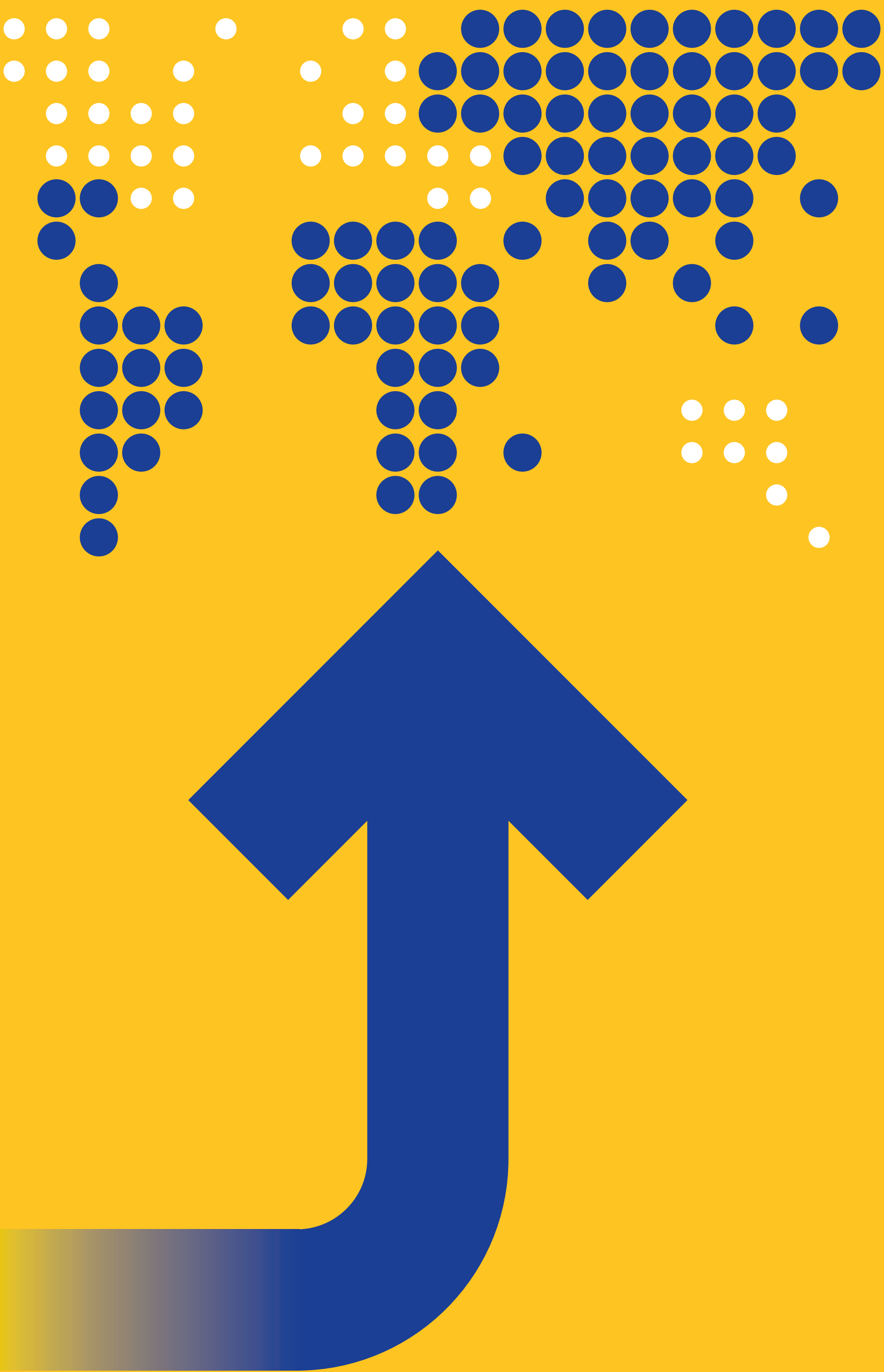
Background Paper



Emerging Markets Forum
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Growing Inequality: What Can We Do?

Michel Camdessus

The extent of the increase in inequality in the world is disturbing. It appears as one of the major, deeply rooted, plagues of our times. Paradoxically, little is known about this phenomenon mainly because countries are reticent to recognize what can be seen as a failure of their economic and social policies. Let us look at some well- established figures to build our thinking. The OECD (2018) estimates that the top 1 percent of the population holds 50 percent of total wealth while the bottom 40 percent only holds 3 percent. Moreover, during the past 30 years, the top 1 percent has significantly increased their incomes, thus widening the gap[1],[2]. The main driver of the growing inequality is the income gap between lower-income households—the bottom 40 percent of the distribution—and that of the rest of the population.

Ravages of inequality

Inequality is even higher in emerging and developing economies, despite the diversity of situations, than in advanced countries. The global financial crisis and the subsequent downturn of the commodities cycle generated changes in the living standards of the poorest households in various aspects, increasing the divide. We also noticed that growing income inequality within countries is the main obstacle to improving those standards and, frequently, the cause of their deterioration.

Today, we have finally opened our eyes and no longer justify the "benign neglect" view of policy-makers—that growth will be sufficient to reduce the income and wealth gaps. But the "trickle down" theory still has its supporters. For sure, while growth and globalization have reduced inequality between countries, the evidence is showing that they have not prevented inequality to rise within most countries and regions.[3] This is a recognized fact but its causes and possible remedies are still under discussion.

The fact that inequality grows when an economy starts taking off is no longer a matter of debate. The more dynamic sectors are the first to benefit. The persistence of this process in the long run, however, is due to diverse causes—gender inequality, insufficient trade openness in the context of globalization, technological advances that benefit first users, and access to powerful positions. In addition, growing public debt burdens, compounded by tax evasion, puts the burden of public finance on the lower- and upper-middle classes and reduces governments' capacity to address income inequality. The digital revolution—which is progressing at a faster pace—will undoubtedly amplify these trends.

Moreover, at a time when countries, following the very limited results of the Bonn Conference, are invited to deepen their environmental thinking, the importance of growing inequality in the context of the environment must be highlighted. It ranges from access to natural resources and exposure to natural disaster to responsibilities in environmental degradation. The effects of these factors vary depending on the country and are assessed superficially, making it difficult to address the inequality problem.

Rising inequality in disposable income has, over the medium term, a negative impact on growth,[4] and adverse consequences on social order, to the extent that public opinion across countries is urgently expecting credible measures toward more equitable income levels. So far, the lack of progress in this regard and the likely worsening of the present income gap are undoubtedly contributing to the discredit of public authorities and the constant and

1. In the OECD countries, the income of the richest 10 percent of the population was 7 times the income of the poorest 10 percent in the 1980s. This ratio rose to 8:1 in the 1990s, 9:1 in the 2000s and 9.6:1 in the mid-2010s (OECD, "In it together: why less inequality benefits all," 2015).
2. Between 1980 and 2014, the income of the top 1 percent of Americans grew 204 percent compared to 61 percent for the total population (Alvaredo et al. 2017).
3. The October 2017 Fiscal Monitor of the IMF indicates that inequality has increased in 53 percent of all countries over the last three decades.
4. Berg, A. and Ostry, J., 2011. "Inequality and Unsustainable Growth: Two Sides of the Same Coin?" IMF Staff Discussion Note 11/08. The paper estimates that an increase of 1-Gini point reduces growth by an average of 0.5 percentage point a year. Similarly, OECD (2015) estimates that during 1985-2005 inequality rose more than 2 Gini points on average across 19 OECD countries and led to a cumulative loss of 4.7 percentage points of GDP during 1990-2010. Ostry, J., Berg, A. and Tsangarides, G., Redistribution, Inequality, and Growth, IMF Staff Discussion Note 14/02.

universal drop of their popularity. It is therefore all the more important that we assess and address the adverse consequences of this scourge.

Inequality has a multidimensional impact on people's living conditions—such as education, health, housing, life expectancy, etc.—with combining and amplifying effects among them. For example, university-educated 25-year-old men and women in OECD countries have life expectancies that are 8 and 5 years longer, respectively, than those of 25-year-old men and women who have never had upper-secondary schooling (Murtin et al. 2017). In advanced countries, children with parents who did not complete secondary education have only a 15 percent prospect to succeed at university. Prospects reach 60 percent if at least one of the parents has a degree. The same is true for young children's' access to education, including secondary-level. Gaps increase considerably when they reach the age of accessing the labor market. Obviously, perception of these realities by the poorest population is reinforcing their strong feelings of despair—including because of the prospects of inequality in future generations—and ultimately can lead to political and social turmoil.

In turn, endemic inequality contributes to the degradation of community and society cohesion, increased segregation, slowdown in social mobility, growing frustrations, instability and rising risks of all kinds.

Most researchers also emphasize inequality's severe consequences on country productivity and potential growth. A recent IMF study shows that the relationship between inequality and growth becomes negative once a country's net Gini[5] coefficient exceeds 0.27—a threshold that most countries have exceeded (Grigoli and Robles, 2017). The limited capacity of most poor countries to invest in education and professional formation are typically the most cited cause of insufficient labor productivity. This phenomenon is further aggravated by inequality in access to credit, i.e., poor financial inclusion, as credit is largely concentrated on the wealthy population at the expense of the poor and economic development, which requires sufficient access to credit for the population as a whole.

Even if not all countries are affected in the same way, income inequalities of the current extent remain unacceptable. One of the major tasks of countries, particularly those with a high inequality index, is to tackle this problem urgently, taking into account the most successful experiences in recent years.

What can be done?

The characteristics of inequality vary across countries and therefore require differentiated and rigorous efforts that promote inclusive growth and thus create opportunities and advancement for all. Investing in human capital will help raise the poor's income potential and foster upward social mobility. Improving health and education have proven to be strongly progressive and thus help address income inequality and inequality of opportunity (see below). To this end, governments will need to provide the low-income population with, particularly, better health services and stronger education, without overlooking the positive contribution that the private sector can make to reduce inequality to a tolerable level. Means-tested transfers will also help lower inequality[6] and, depending on their design, could also help in the efforts to improve health and education. For governments, these efforts will require increased fiscal space, by raising revenue and improving the efficiency of expenditure in order to ensure fiscal sustainability. For instance, efficiency would also be improved by reallocating education spending toward the disadvantaged students and schools. Implementing these measures over an extended period of time may prove difficult. But given their necessary scope, the support of multilateral actions, which have made a modest start, would be needed.[7]

At the national level—without ignoring the multiple factors, which contribute to inequality[8]-strengthening[9] the tax system and making it more progressive is critical to address the inequality in disposable (post-tax-and-transfers) income. Thus, these efforts would be the first steps—progressivity is widely used, with proven results. The IMF (2017) shows no effect of progressivity on growth, but does not rule out negative effects of extreme progressive tax systems. Thus, it is important not to interfere excessively with work incentives and savings. Other progressive taxes may also be used, such as real estate, inheritance and donations taxes. In some countries, the

5. The net Gini coefficient (the market Gini adjusted for taxes and transfers) measures disposable income inequalities appropriately, as it reflects income redistribution policies. For example, in 2015 the average net Gini coefficient for disposable income in advanced economies was .31 compared with .49 for market income (IMF Fiscal Monitor, 2017).

6. A system of Universal Basic Income has been proposed as an alternative for countries with very weak administrative capacity to implement means-tested transfers, but the fiscal cost of such a system could be prohibitive for many countries.

7. Reducing inequality through these measures will increase productivity and therefore growth, which may also benefit from the higher propensity to consume by the poor.

8. We need to mention, in this respect, the institutional environment, the rule of law, market efficiency, development of collective infrastructure, supporting agricultural productivity or internal and external competitiveness, the fight against tax evasion, state of social insurances, combatting the informal economy, etc.

9. Weaknesses of tax authorities have hampered governments in their strategies to fight inequality.

efficacy of these taxes, as well as taxes on companies and capital is limited because of the competition to attract foreign capital. However, it is important to focus on the net distributional effects of fiscal policy: regressive but efficient taxes (such as the VAT) can be used to fund progressive spending. Raising taxes on unhealthy behavior should also be considered. Today states are pushed to give priority to tax labor over capital, risking intensifying inequality. They seem to be experiencing difficulty in escaping from this vicious circle.

Measures also need to focus on the environment. For instance, taxing contaminants, such as carbon, could be justified and their revenue could help reduce inequality. Australia, Sweden, and Germany present interesting experiences. The more such a tax is applied with a realistic rate, the better it serves the purpose of COP21, thus enabling more targeted options for social contribution in order to curb social inequality.

Effectiveness in reducing inequality requires carefully designing social spending and giving priority to expenditures related to young children. It is well known that the damaging effects of poor health and education at an early age are difficult to reverse, thereby creating deep social injustice—an intergenerational or vicious cycle of poverty and inequality. Much more remains to be done. According to the World Bank, achievement of children at preschool in the poorest 20 percent of the population is just one third of the achievement of children in the richest 20 percent. In the 40 poorest countries, mothers in the lowest income level have 50 percent less opportunities to get pre-natal care. Only a quarter of the poorest quintile have some social protection. Recent studies show that these disparities are an obstacle to sustainable and strong growth (Berg et al 2011, Ostry et al 2014). And they affect not only the poor but also the welfare of more privileged members of society. Studies demonstrate that poor and rich children in more egalitarian societies have better achievement levels than in less egalitarian societies.

It is worth mentioning that countries with social programs focusing on young children have often achieved convincing results in the reduction of inequality by achieving more equitable health and education outcomes. In Latin America, for example, the Gini coefficient in Brazil was reduced from 63.3 in 1989 to 51.3 in 2015 (World Bank, 2018); moreover, from 2001 to 2007, the income of the poor rose at a faster pace than those of the rich and the national average. These improvements can be explained by a decline in remuneration inequalities, increased social transfers (especially Beneficio de prestação continuada and the conditional transfers through Bolsa Familia), and educational efforts at all levels. Similarly, reducing inequality in education outcomes between 1990 and 2005 led to drops of 4.8 Gini points in the Middle East and North Africa and 2.8 points in Latin America and the Caribbean (IMF 2017).

It should be noted, however, that to increase their effectiveness, programs focusing on young children need to be accompanied by efforts to enhance the potential of poor workers of taking advantage of better opportunities, such as lifetime programs to promote improvements in their competency, thereby allowing an increase of their earnings and a better social integration. Such programs combined with increased access to microcredit could help them in their self-employment efforts and stimulate entrepreneurship. Indeed, a lot can be said about the contribution Muhammad Yunus has made to reduce worldwide inequalities. Many institutions in this area have made important contributions in Zambia, Ethiopia, Burkina Faso, etc. Similarly, outstanding results were made by La Caixa in Spain, L'Adie in France, PerMicro in Italy. and other institutions in other parts of the world.

At the same time, the efforts mentioned above need to be accompanied by policies to encourage school attendance (provision of meals, equipment, and stipends if older children stay in school); increased child-care facilities, as these facilitate mothers' participation in the labor force and increase family income; policies focused on equity in education; and efforts to upgrade skills to avoid obsolescence and to align the supply of skills to the demand.

We should not hide the difficulty to raise the tax progressivity rate of higher incomes in many countries, nor lower the exorbitant and shocking remunerations of unscrupulous executives. The probability of success of inclusion programs and the fight against inequality would increase if these efforts were associated with a permanent revision of budgetary allocations and an end to inefficient and unproductive expenditures, which generally raise inequality. There are many examples of such spending, including excessive prestige outlays, unnecessary armament expenditure, unsuitable economic exposure, subsidies on fuel which benefit the most privileged. In Africa, US$21 billion were used to compensate inefficient public electricity companies and to subsidize gasoline.

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Programs to reduce inequality at the national level should be reinforced by a multilateral program, whereby the countries mutually support each other by comparing and sharing experiences. This is why Objective 10 of the Sustainable Development Goals for 2030 focuses on reducing inequalities within countries and between them.

Achievement of Objective 10 is based on several intermediate goals. The first goal is that governments should adopt the necessary measures (as described above) aimed at raising the incomes of the population with the lowest 40 percent of incomes faster than the national median. Other goals include special efforts to favor general policies of inclusion and promotion of equal opportunities.

Unfortunately, most countries have not yet started implementing these measures. They do not seem to endeavor to introduce the fiscal reforms inspired by Thomas Piketty in his book Capital in the XXIst Century. The successful sales of the book demonstrate the universal concern about growing inequalities. It should be recognized, however, that support for the implementation of the proposed progressive global tax on capital cannot be expected from day one. In this regard, the objective of enabling democracy to recover the control on globalized financial capitalism in this century is of such importance that one should ask whether a multilateral approach to stress the relevance of Objective 10 is not needed.

The plan would be to adhere to a global program under which countries would commit to implement their own-designed measures to achieve by 2020, or 2030 at the latest, a faster increase of the income of the poorest 40 percent than that of the national median.[10] The multilateral organizations (United Nations, International Monetary Fund, the World Bank, etc.) would be invited to help countries design their policies. They would follow up on the national objectives and initiatives through a periodic dialogue, such as the Article IV consultation of the IMF. A conference with the participation of nearly all the countries, to be held in 2023 and in 2028, would examine progress, identify obstacles, and note the most effective policies to achieve Objective 10.

Monitoring progress towards reducing disposable income inequality would be based on the indicators identified by the UN for Objective 10, as well as for Objectives 3 and 4 (health and education). These indicators should be supplemented by the indicators recently identified by the OECD, which focus on inequalities in economic, health and education outcomes in its member countries. In turn, guidelines would be formulated to encourage the harmonious evolution of intermediate outcomes.

In fact, it is all about inviting all the countries around the world to implement in a coherent way the objectives taken by unanimity when they sit at the United Nations. Nobody ignores the difficulties involved. All the more reason therefore to ask oneself if we can do something to reduce the income or wealth gap with our families and neighbors, before getting upset by the inability of the government to combat this global scourge.

10. By 2030, making sure that all girls and boys would equally benefit from free and quality primary and secondary education with useful professional training and that each of them would get universal health coverage including protection against financial risks and giving access to basic health of quality with secure, efficient and affordable medications and vaccines. Means-tested subsidies could help the disadvantaged access tertiary education and thus broaden the set of opportunities available to them; these subsidies could be financed in part by charging the better-off for such education. This policy is important for both developing and advanced countries.

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