Overcoming Economic Inequality:
What Role for the G20?

Draft Discussion Paper

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Has the world become more or less unequal over the last decades?

The answer to this question is not self-evident. The income gap between the richest and poorest countries is still growing, but income inequality between countries is falling due to faster economic growth in many developing countries than in OECD members. Conversely, inequality within countries has been growing in many parts of the world. In the long term, inequality both within and across countries can slow down national and global economic growth, as income concentration and unequal access to resources limit consumption and investment, as well as opportunities for employment generation. In addition, inequality limits the positive impact of economic growth on development goals like poverty reduction and food security.

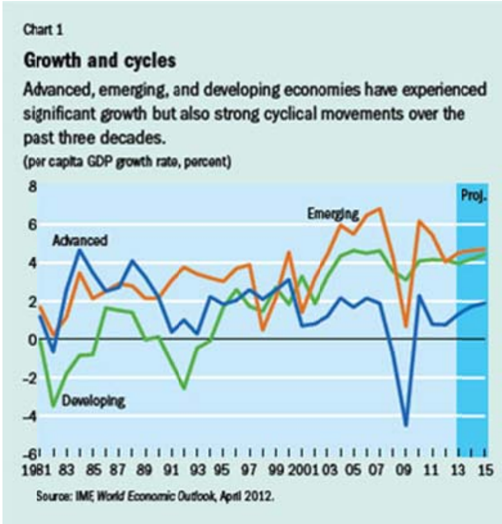
Therefore, promoting sustainable economic growth and reducing domestic inequalities and poverty within developing countries, and development gaps across countries should be at the centre of the future G20 development agenda.

1. The State of the World Economy: Convergence and Inequality

Two trends can be simultaneously observed in this increasingly interdependent world economy: convergence and divergence. This contrasting picture must be analyzed in depth.

Convergence in GDP per capita. The division between rich and poor countries that characterized the world since the industrial revolution is now weakening (Maddison, 2007). Over the last two decades the pace of per capita income growth in developing countries has dramatically accelerated. In spite of the Asian Crisis (1997-1998) per capita growth taken as a whole increased three times faster in developing and emerging economies than in advanced economies. This trajectory seems to be here to stay, and projections for the period 2013-2015 show economic trends resuming on a strong pace for developing and emerging economies (Chart 1).

[1] This paper draws upon the work of the UNDP Expert group on inequality at BDP in charge of drafting a UNDP Flagship report on inequality in developing countries. The opinions expressed and arguments employed herein do not necessarily reflect the official views of UNDP or of the governments of its member countries.



This is a major and essential shift in the structure and the dynamics of the world economy. Three developments (Dervis, 2012) explain that long term trend growths of emerging and developing economies: the globalization context, higher investment rate and demographic transition in emerging and developing countries that support greater capital intensity, diversification of their economy and faster per capita growth. This convergence process is likely to continue and will profoundly transform the world economy in the long run. By 2025-2030 many emerging economies' per capita incomes will be much closer to those to advanced economies and will more than quadruple in the poorest economies by 2060 (OECD, 2012). Then, the former division of the world into "advanced" and "poor" economies that began with the industrial revolution will fade, ceding to a much more differentiated multipolar economy. International development cooperation needs to take this new reality into account.

Divergence and Increasing Inequalities. A second fundamental trend appears to be higher inequality within countries and a wider gap between the world's richest and poorest citizens. Over the last decades, income has become concentrated at the very top in many countries, and a group of very poor countries unable to participate in the convergence process have not benefited of the per capita income growth.

- *Within countries*: the convergence process enabled a rapidly growing middle class to rise up in many emerging and developing countries. However, a variety of factors — including the nature of technological change, the increased skill premium, the mobility of capital in contrast to the relative immobility of labor, particularly unskilled labor — have all led to increased income concentration at the very top in many countries, advanced as well as emerging and developing. As the causes of the concentration are largely global and can be counteracted only partially by national policies, international cooperation on tax policy appears as a way forward if we don't want to see this top-heavy concentration increasing in the near future.
- *Across countries*: Meanwhile the income gap between the richest and poorest countries is still growing, and millions of people have real incomes that have not increased at all.

> Many of these very poor countries experience conflict and government failure. In that sense, there is a huge new divergence in the world economy. The distance between the extremes of the income distribution of the world as a whole has increased, and needs to be addressed.

Evan though we need to distinguish between regions, the majority of the people on the planet now live in countries where income disparities are bigger than they were a generation ago. Rising income inequality has been a feature of the past three decades in many regions of the world (UNCTAD, 2012). After a long period of relatively stable distribution of income between profits and wages, the share of wages in total income has fallen since around 1980 in most developed and many developing countries. In several of the larger developed countries much of this decline already occurred between 1980 and 1995, when increasing unemployment started to exert pressure on workers and to weaken unions and average wages began to fall behind overall productivity growth. In some countries this trend continued for two decades.

Personal income distribution, which reflects the distribution between profits and wages, disparities between income categories and redistribution by the State, had become more equal in most developed countries during the post-war period until the late 1970s. Subsequently the income gap widened.

In all regions of the world, economic inequality remains higher than it was in the late 1970s. Though trends are not the same in Latin America and Asia for instance, but everywhere growing income inequality since the early 1980s has been associated with an increase in the concentration of wealth in the higher income strata. Ownership of financial and real assets is not only a source of income but also facilitates access to credit and privileged participation in political decision-making. In many developing countries, the concentration of land ownership plays a particularly important role in this regard.

2. The Importance of Tackling Economic Inequality

Globalization is often blamed for growing inequality as the benefits of greater trade and capital flows across countries have often benefited high-skilled and highly-educated workers more than low-skilled and less-educated workers and driven up the wage and income inequality between the rich and the poor. This led to the widespread assumption that increasing income inequality is an inevitable by-product of structural changes brought about globalization and technological change, or even a precondition of such change.

As the international community begins reflecting on a post 2015 development agenda the urgency of addressing such persistent and growing inequalities will be at the front and center of deliberations. And policies addressing both the inequality of outcomes and opportunities will be needed. In developing countries, inequality of personal income distribution is generally more pronounced than in developed countries and transition economies. The majority of the poor today, what Paul Collier called the Bottom Billion, live in middle income countries and face very high level of inequality.

2.1. Distinguish between inequality, equity, and poverty

Inequality, poverty and equity have been often discussed together:

- Inequality is a relative concept, and often referred to in the form of money inequality such as inequality of income, consumption, or wealth.
- Poverty often refers to the condition of people who are poor in absolute terms. Across countries there is at best a weak association between absolute poverty and inequality.
- Equity often refers to justice or fairness in the processes that lead to outcomes such as income, and in contrast to outcomes or income per se.

A society with relatively high income inequality might be to a certain extend an equitable society if the observed inequality were the outcome of an entirely fair process—in which some worked harder or took more economic risks with resultant greater economic gains than others. Equity is sensibly thought of as equality of opportunity and is a more satisfactory concept from a normative point of view; but it is harder to measure.

Up to recently conceptual frameworks analyzing inequality have mainly been concerned with analyzing “the inequality of what” or “inequality between whom”. The former encompasses income inequalities as well as in the non-income aspects of well-being (Equity perspective, Human development, right-based approach…) while the latter focuses more “horizontally” on the income and non-income aspects of inequalities (such as social and cultural status dimensions) between culturally defined groups.

More recently, the issue of inequality has been framed in terms of inequality in outcomes and inequality in opportunity (Asian Development Outlook, 2012). While the inequality in outcomes (e.g. income levels) suggests the end point of a process, the inequality of opportunity is that part of the inequality in outcome that can be attributed to differences in “individual circumstances” (such as gender, race or ethnicity).It is worthy stressing that inequality of income and outcome are inexorably interrelated and it is impossible to address one without addressing the other.

2.2. What drives Income Inequality in developing countries?

Widening inequality in the different developing regions is usually associated with very different development paths. In some cases, as in a number of Asian economies, it has accompanied rapid economic growth. In others, it has taken place during periods of economic stagnation or depression, as in Latin America and Africa in the 1980s and 1990s.

The driving forces of economic inequalities in developing countries can be linked to the increasing recourse to markets, and thus enlarging consumption inequality across households, without sufficient intervention by governments to ensure that the poor are not left behind. Conversely, in many developing countries fiscal and monetary policies that placed priority on macroeconomic stabilization over job creation in the last two decades have led to wage inequality in manufacturing.

Overall, market oriented reforms, technical change and globalization can be seen as three factors driving income inequality through three channels: shifts in income distribution between skilled and unskilled labor; returns to human capital and the skills premium; returns to labor and capital. In other words, these drivers determine in the first instance, the primary distribution of income, and redistribution policies (e.g. cash transfers, minimum wages, etc.) impact this primary distribution of income. Therefore, redistribution policies targeting poorer households, but also structural policies that aim to address the horizontal distribution of income, can have a significant impact on inequality reduction, and the inequality/poverty trade-offs appears to be a critical issue.

From this perspective, UNDP as a development agency is well placed to help nations address this challenge given that the very mission of the organization is human development. Human development itself is based on the understanding that equalizing people's capabilities must be a fundamental objective of development. The 2010 Human Development Report (HDR) finds that countries with lower human development tend to be the most unequal. This flagship Report introduced new indices that specifically are designed to monitor progress on equity and the distribution of wealth: the Inequality-Adjusted Human Development Index (IAHDI) adjusts HDI achievements to reflect disparities in income, health and education; and the Gender Inequality Index (GII) captures gender inequality.

Building on the organization's long-standing experience and also on knowledge of the drivers and dynamics of inequality, UNDP comes up with four sets of policies that can be especially critical for reducing inequalities.

3. Four Sets of Policies against Inequality

How to tackle inequalities we are facing today? National and international stakeholders can put a focus on four sets of policies in the fight against inequality.

3.1. Promoting Inclusive Growth

Inclusive growth (i.e. growth that reduces both poverty and inequality) is the cornerstone for achieving social equity and a redistribution of wealth while reducing poverty. Evidence indicates that countries with low or falling levels of inequality experience higher rates of economic growth and poverty reduction on average compared to countries with high or increasing levels of inequality. Hence, broadly spread growth, where the poor and socially excluded households are included in the benefits and opportunities provided by the growth process, will be a key factor in achieving more equitable outcomes with respect to income distribution. Inclusive growth can be promoted through two major channels:

- **Employment creation.** The poor share the benefits of growth when their incomes are increased through ***quality*** employment opportunities. At present, the global employment portfolio of UNDP consists of over 500 projects and programmes that focus on initiatives to support macroeconomic and sector policy reforms for employment led-growth, entrepreneurship development to promote self-employment, vocational education and training initiatives and temporary public employment programs and employment guarantee schemes. Although gainful employment remains a challenge for many segments of the population, it is even more so for socially excluded groups. For this reason, we must pay specific attention to the structural barriers that women and youth, as well as vulnerable groups (such as persons with disabilities or minorities) face in the labour market.

- **Social protection.** Social protection is important for social equity and the distribution of wealth because it provides the poor with income support but also supports poor households to better cope with shocks. Social protection has also shown that it can have inequality reducing impacts as measured by the Gini coefficient. For instance, it has been established that the Bolsa Familia Programme in Brazil is responsible for between 21 and 16 percent of the reduction in inequality since 2001.

3.2. Fostering Transparency

Promoting transparency in public institutions is critical for achieving more equitable and pro-poor development outcomes. All too often, resources do not reach actual beneficiaries because of a lack of transparency in the distribution and/or use of funds. Responsive and accountable governments can surely benefit the poor by ensuring that society's resources are equitably distributed. This however requires additional efforts such as making sure that corruption is rooted out and that accountability is embodied in structures that are transparent to all people:

- **Anti-corruption. C**orruption undermines human development by diverting public resources to private gain and reducing access to public services. Corruption also hinders economic development by distorting markets and damaging private sector integrity. Achieving social equity will largely depend on the quality of governance and level of effectiveness, efficiency, and equity in the generation, allocation and management of resources. Therefore a major focus needs to be put on strengthening preventive capacities to stop leakages of public resources, in working for example on the implementation of the United Nations Convention on Anti-Corruption (UNCAC) especially in sectors such as health, education and water to help fight corruption where the poor are most affected.
- **Illicit financial flows.** Illicit financial flows from the Least Developed Countries (LDCs) increased from US$9.7 billion in 1990 to US$26.3 billion in 2008 which is roughly equivalent to the amount of ODA received by the LDCs that same year. The ratio of illicit outflows to Gross Domestic Product (GDP) averages about 4.8 percent and in some LDCs, losses through illicit capital flows outpace monies received in official development assistance (ODA). Illicit financial flows that reflect the cross-border transfer of the proceeds of corruption and tax evasion undermine the efforts of government to fight corruption and promote transparency, and lead to the loss of substantial revenues that are critical for development progress.

3.3. Strengthening Democratic Institutions

Democratic institutions are fundamental for the promotion of social equity and a fair distribution of wealth in particular. Without effective, responsive and accountable political institutions, systems, processes and political will, economic gains are not automatically translated into development outcomes (UNDP 2010). In the same vein, without truly democratic institutions, i.e. beyond the electoral aspect, inequalities can survive in democratic regimes. Governance weaknesses can have a detrimental effect on service delivery, for example, and this might be particularly true for those groups that are poor or disadvantaged if there are no effective mechanisms to have their voices heard. That is why effective and equitable participation is important for addressing inequality. Likewise, it is important for people to be able to hold their authorities accountable for the services and benefits they are supposed to deliver. Once again, this requires the existence of mechanisms through which people can monitor the performance of governments and ultimately be able to expose gaps and have them addressed:

- **Strengthening Accountability Mechanisms** through which civil society organizations and citizen groups monitor the delivery and quality of social services as well as the effectiveness of public expenditures through a variety of different instruments such as Public Hearings, Social Audits, Community Score Cards, Citizen Report Cards, Participatory Public Expenditure and Budget Reviews.
- **Strengthening Civic Engagement and Participation.** Empowering the poor and vulnerable communities with information and tools to engage in civic activity is particularly important since it is these very groups that are often at the margins of decision making, in part due to lack of information.

3.4. Reducing Horizontal Inequalities

Horizontal inequalities or inequalities in opportunity are inequalities in economic and political resources as well as social and cultural status between culturally defined groups such as gender, ethnic, racial, caste-based or religious. Such inequalities matter for social equity and wealth distribution because by disenfranchising certain groups vis-à-vis others, the concentration of wealth can be sustained. Horizontal inequalities weaken social cohesion and can even lead to civil unrest as in the case of exclusion based on ethnicity, for example, or in the case of the exclusion of major sectors of the population such as youth.

Even if the economy undergoes a structural transformation, would specific groups (women, the poor, socially excluded) be able to participate and benefit from this growth process? Horizontal inequality (or inequality in opportunity) is intrinsically linked to inequality in outcome. In other words, "the inequality of opportunity can amplify the distributional consequences of these driving factors". For instance, inequality in education is a major contributor to the inequality of income, and the same is true for health.

Addressing inequalities in outcomes without addressing inequalities in opportunities will be meaningless: an economy that generates productive, and well-paid jobs but does not have people that can join the work-force on account of chronic health or education deficits or because they do not have the appropriate skill set will be as meaningless as the case where people have the capacity and training and skills but the economy cannot benefit from this on account of its structure. Therefore, policies that ensure equitable access and coverage to social services for socially excluded or marginal groups of the population must be proposed. Put differently, developing and building human capabilities of the poor so as to close the gap in opportunities will be critical.

Gender inequalities in particular are persistent and merit special attention. Another group that is experiencing a difficult time accessing the benefits of growth is the youth. There are now 75 million unemployed young people in the world (ILO 2012). Unemployment stints during youth can have lasting pernicious effects on economic opportunities later in a person's life and can reinforce a vicious circle of intergenerational poverty and vulnerability.

4. Possible G20's Action against Inequality

In the short term, the fragile global economy is recovering from the latest economic crisis. There is an immediate need for giving priority to the reduction of inequalities as a component of more balanced economic recovery strategies. In the longer term, there is much more we need to think debate and act upon. For example, it might be worthy to consider inserting the reduction of inequalities as an integral and central part of into the development agenda and establishing it as an explicit public policy objective because inequalities are not only the outcome of, but also drivers of vulnerability and poverty.

4.1. Global Economic Rebalancing and the Fight against Inequality

Since the G20 inception at the leaders' level, and in a context of persistent worries on the global economic front, the G20 aimed to focus on global economic recovery and rebalancing, including through the implementation of the Framework for Strong, Sustainable and Balanced Growth adopted at the Pittsburgh Summit and the Action Plan for Growth and Jobs.

Since the outset of the Financial and economic crisis in 2008, prospects for developing economies have also deteriorated, threatening the important development gains of recent decades and the convergence process in the world economy. The reason is that the economic woes in developed economies spill over to developing countries. Actually economic policy changes in large economies like the G20 have spill-over effects on smaller developing countries as well. It is therefore important to assess these spill-over effects and help developing economies to cope with such shocks, and as a component of the Framework Assessment, the World Bank has been requested at the Los Cabos Summit to "continue to assess the growth and development agenda in developing countries", and to "continue to monitor the progress towards fulfilling commitments in this area".

Imbalances of the global economy remain a key factor of instability. Both surplus and deficit-current account countries need to make significant policy changes at home in order to reduce imbalances. But smaller developing economies are largely kept out of the rebalancing debate, and what deserves more attention is the role that smaller developing countries could play when the global economy is striking a new equilibrium. More work is needed for global rebalancing, which is not only a macroeconomic issue but also a development one.

With the right policies and incentives put in place, excess savings and foreign exchange reserves of surplus economies could flow to poorer developing economies as a new form of cooperation for development. These savings, instead of flowing to big deficit economies to finance excessive consumption and borrowing, could be used to support more productive investments in those developing countries that are short of financial resources. Invested wisely, this could not only help reduce the global imbalances but also reduce poverty and inequality, narrow development gaps across countries, and promote sustainable human development in the long run.

From this point of view, the G20 action for global economic rebalancing might be helpful in reducing inequality. The reflection is going on. For example, it is worth noting the wish of the Russian presidency of the G20 to initiate a discussion on the use of international reserves for investment financing and, in general for stimulating economic growth. Likewise, even though all of them are not surplus economies, the BRICS (Brazil, Russia, India, China and South Africa) plan to set up a Multilateral Development Bank aiming at "mobilizing resources for infrastructure and sustainable development projects in BRICS, and other emerging economies and developing countries" highlights the new momentum in linking development and global rebalancing to strike a new equilibrium.

4.2. Four Guiding Principles for the new G20 Development Action Plan

The Russian Presidency of the G20 wishes to adopt a new Development action plan at the Saint-Petersburg Summit. The UN proposes that the future development agenda of the G20 is to be based on four key guiding principles intended to capture the key characteristics of the G20 policies in the development field. The fight against poverty and inequality is part of this comprehensive approach.

Along with the poverty and inequality reduction principle, and intertwined with them, the following three principles should be guiding the G20 actions and policies in the development area:

- **Removing bottlenecks to economic growth.** The overall approach of the Seoul Development Consensus for Shared Growth remains valid. It recognizes that a crucial part of international economic cooperation aimed at finding new drivers of aggregate demand and more enduring sources of global growth relies on the strengthened role of developing countries. The G20 should continue to support Low Income Countries (LICs) to improve and maintain the levels, quality and inclusiveness of economic growth, remove bottlenecks, and reduce poverty and food insecurity, improve human rights and create decent jobs for both women and men. This principle – aimed at increasing the economic growth potential in developing countries as an underlying condition to development -- should be adapted and tailored to nations' individual needs and circumstances.
- **Promoting inclusive and green growth.** Inclusive Green Growth (IGG) has been the G20 DWG overarching priority over the Mexican Presidency of 2012. The G20 should pursue this agenda as an overarching principle guiding G20 development policies, rather than a pillar in and of itself. Following on from the Rio+20 Summit, the G20 could remain committed to supporting efforts to advance a 'triple-win' approach to development, which would result in integrated economic, social and environmental dividends, and set out a vision for a single, unified framework that responds to the challenge of sustainable development.
- **Policy Coherence and Knowledge Sharing.** As the global economy becomes increasingly interconnected, economic policy changes in large economies such as G20

economies have an important impact on developing countries. A joint and harmonized approach to development between the financial and sherpa tracks would be very valuable in enhancing policy coherence for development within the G20 agenda. Indeed this principle should guide future work of the G20. So too should knowledge sharing, where all stakeholders have the opportunity and mechanisms to exchange best practices, and where developing countries have the information they need to take the lead in designing and implementing development strategies tailored to their individual needs.

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