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Shared Prosperity in Emerging Economies

From Paradigm Shift to Reality Shift

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- Inequality is a cause of global imbalances, debt bubbles, and financial crises and undermines sustainable prosperity. Stable growth must be wage led and consumption oriented.

- Emerging economies—in particular Brazil, China, India, Mexico, and South Korea, which are the focus in this paper—display a diverse pattern of growth and inequality. While in China output and inequality have risen tremendously, Brazil and Mexico have achieved a more equal distribution of income. Meanwhile, higher inequality in India and South Korea has not led to stronger growth.

- Three policy areas are key to reducing inequality: fiscal policy and redistribution, social investment, and labor markets. Tax policy must incorporate truly progressive and more efficient taxation, and social policy must be better targeted at reducing inequality. Wages must increase in step with productivity, driven by strong trade unions and decent minimum wages.

Dialogue on Globalization

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Abstract

For a long time, the dominant paradigm of economic theory and policy has been that the more one shares prosperity, the less one creates. From a narrower perspective, it was assumed that inequality is good for growth. Since the financial crisis that began in 2008 and the great recessions that followed, this paradigm has shifted. Even the bastions of conventional economic wisdom—such as the International Monetary Fund, the Organisation for Economic Co-operation and Development, and the World Economic Forum—are increasingly concerned about the rise of inequality and its detrimental impact on sustainable growth. Rising debt levels and global imbalances endanger the world economy. New studies emphasize that long-term stable growth can only be wage led and consumption oriented, but the actual policies of many countries still advocate wage restraint and labor market reforms for the sake of competitiveness, which relies on export surpluses that other economies have to finance.

There never was general, empirical support for the old paradigm. Many countries achieved growth and prosperity without high or increasing inequality. Emerging economies experienced strong growth, in particular after 2000. At the same time, inequality increased in China and India and decreased in Brazil and Mexico. These countries have adopted different growth models, but might all become stuck in a middle-income trap. On the supply side, they must reduce their dependence on cheap labor, while on the demand side, they cannot indefinitely rely on investment or export surpluses, which cannot be sustained at a high level in the long run.

A shift in reality must now follow the paradigm shift. Policies that reduce inequality need to be implemented to guarantee prosperity. Contrary to the old paradigm, these measures can be designed to foster growth while at the same time spreading its gains to poorer groups. Three policy areas are key: labor market policies, fiscal policy and redistribution, and social investment. As a fundamental principle, labor market policies must ensure that real wages increase in line with productivity while minimum wages protect workers in situations without strong unions. Fiscal policy must become truly progressive and redistribution better targeted. Tax evasion needs to be reined in with greater effort and better international cooperation. In the end, social investment is the least controversial way to ensure prosperity for all. Better education and health care foster growth and equality by increasing productivity, employability, and social mobility.

1. Introduction

Inequality has increased in most countries over the last decades. For a long time, this was considered a necessary evil or even a good thing. Inequality was seen as a condition for growth and prosperity. With the 2008 global financial crisis and subsequent great recession, these views have lost some of their clout. One could even speak of a paradigm shift, as not only did Keynesian economists and the liberal left express their concerns about the risks of growing inequality, but so did major institutions of economic analysis and policy, including the International Monetary Fund (IMF), the Organisation for Economic Co-operation and Development (OECD), and the World Economic Forum, along with the U.S. government. Hence there is renewed focus on the relationship between prosperity and inequality.

New thinking about inequality is an important step forward, but alone it is by no means sufficient. New policies to correct the increasingly inequitable distribution of income are also necessary. A shift in reality must follow the paradigm shift. This paper reviews theories about growth and inequality and the historical evidence with special reference to wage inequality in large emerging economies because of their importance in the world economy and their special role in the core question of the relationship between prosperity and inequality.[1] Particular attention is paid to five emerging economy (5EE) countries, the analysis for which is based on country studies: Brazil (André Calixtre), China (Guo Jiannan), India (Arup Mitra), South Korea (Lee Joung-Woo), and Mexico (Gerardo Esquivel Hernandez).[2] It also explores opportunities to reduce inequality without harming prosperity. It primarily investigates income inequality and, to a lesser extent, the distribution of wealth.[3]

1. In small developing and resource-based economies, growth depends more on external factors, while advanced economies usually have functioning tax and welfare systems and regulated labor markets.

2. The studies resulted from a workshop held April 11, 2014 in Washington, D.C., sponsored by the Friedrich Ebert Stiftung.

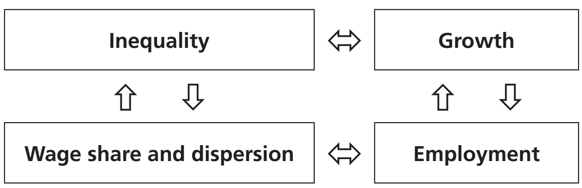
3. Special thanks are due to the participants of the Washington workshop (see footnote 2), to Hubert Schillinger, Rudolf Traub-Merz, and to the editor Robin Surratt.

2. Prosperity and Inequality: Some Theories

Prosperity is a concept that encompasses not only economic growth as its core, but also other important aspects of welfare that are neglected or excluded from gross domestic product (GDP), such as ecological sustainability, household work, leisure, and the quality of labor (decent work). To a large degree, prosperity results from unpaid labor within the family (i.e., cooking, cleaning, and care of children, the disabled, and the elderly, and so on), which comprises the bulk of hours worked in all societies and is mostly performed by women. Growth—which is often achieved by depleting natural resources and harming the ecological foundations of human life and work or permitting inhumane working conditions—might increase output, but not prosperity, which results also from work in households done mostly by women. Of particular importance in emerging economies is work in the rural subsistence sector and the mostly urban informal sector, whose output is usually not registered in national accounts. Prosperity also increases when rising productivity is translated into less work and more leisure time, not involuntary unemployment, although output growth will in this case be slower.

Nonetheless, in this paper growth is often used as a proxy for prosperity. When appropriate, it is indicated where growth has increased prosperity and at what cost to other aspects of human welfare. The other drawback of a focus on growth in GDP is neglect of its distribution. Averages such as GDP per capita always hide often-huge inequalities. Sharing prosperity implies a more equal distribution of income and decent working conditions and hours for all. It can be fairly assumed that a more equal distribution enhances the prosperity of a society. Wages and working conditions are key to the relationship between inequality and prosperity, as they strongly influence employment and productivity (and thus growth) and income distribution (see figure 1).

Figure 1: The relationships among inequality, wages, and growth



In the following two sections, we first consider the relationship between inequality and growth and then between wages and growth.

2.1 Inequality and Growth

The relationship between growth and inequality is a highly controversial issue of economic theory and has generated a huge body of studies (for an overview, see Benabou 1996). Traditionally, economists on the »left,« such as Karl Marx and John Maynard Keynes, have focused on the risks inequality poses to growth when lopsided capital accumulation and savings reduce consumption and demand. Classical economists have stressed the role of savings as a supposed condition for investment and assumed a trade-off between efficiency and equality (Okun 1975). Meanwhile, experimental economics has shown that many basic assumptions of the neoclassical model—the utility maximizing behavior of *homo oeconomicus*—do not describe reality, as individuals value justice and fairness more than money (Stiglitz 2012: 126f.)

In perfect capital markets, high savings in the wake of strong inequality would be channeled into growth-enhancing investment, such as promising business projects, physical infrastructure, and human capital. Alas, in the imperfect capital markets of the real world, speculation and limited access to capital by poor households and small businesses hamper growth. Trading in sophisticated financial instruments seems often to offer higher returns than investment in the real economy, while poor potential borrowers lack the collateral necessary to obtain loans. In particular, after the financial crisis of 2008/9, some economists pointed out that higher inequality might undermine the long-term prospects of growth by creating financial bubbles (Rajan 2010; Kumhof/Rancière 2010; Cynamo/Fazzari 2013). More recently, Piketty (2014) has raised the issue of lower rates of growth in the long run exacerbating the unequal distribution of wealth and income.

It is important to differentiate between the primary or market distribution (market inequality) of income and the secondary distribution of disposable income after taxes and subsidies (net inequality). Redistribution of income through public policies, which transforms primary distribution into secondary distribution, usually intends to reduce market inequality to a lower net inequality. Ostry, Berg, and Tsangarides (2014) have made a detailed survey of the literature and empirical analysis covering the interrelationship of inequality, redistribution, and growth. They find that societies with a high level of inequality usually apply public policies that lead to more redistribution, which has an ambiguous effect on growth. On the one hand, it distorts incentives for work and investment, but on the other hand, it should stabilize growth, as lower net inequality enhances human capital accumulation and political stability. In the end, they posit that redistribution, if it is not extreme, supports growth.

Inequality is mostly defined by the distribution of income between individuals and households. Another important dimension is the functional distribution of income between factors of production, such as capital and labor. Generally, the relative shares of wages and profits in national net income strongly influence the distribution of income. Rising inequality is often the result of, among other factors, declining wage share. The other link between functional and personal (household) distribution is the dispersion of wages and profits. With the rise of self-employment, functional distribution becomes more fuzzy, because it is difficult to identify capital or labor as the main source of value and income.

2.2 Wages and Growth

Another large body of literature examines the relationship between the level and structure of wages and economic growth with controversial positions similar to those involving growth and inequality. On the one hand, Keynesian and leftist economists focus on the purchasing power of wages, which increases consumption and demand; on the other hand, classical and conservative economists stress the cost dimension of wages, which might dampen investment and exports. A major intervening variable is employment. If the labor market worked like a goods market, a lower price of labor (i.e., lower wages) should increase the demand for labor while higher wages (or a legal minimum wage) are supposed to destroy jobs or prevent employment. Goods and labor markets, however, are different. Goods do not buy goods, while labor spends its wages, thus creating demand and securing and creating jobs. Employment depends not only on wages, but also on other labor market conditions, such as the level of employment protection. It is strongly debated whether better working conditions (decent work) harm employment and productivity.

Employment is linked directly to growth as GDP (labor input x labor productivity), but the direction of causality is disputed. On the one hand, output growth must exceed productivity growth to increase employment. On the other hand, new jobs and more hours worked (not necessarily identical) will lead to higher output as long as labor productivity does not decline. Higher wages and better working conditions might increase productivity (efficiency wage theory), but the received wisdom has been that growth requires structural (labor market) reforms, usually lower wages and less employment protection.

Bhaduri and Marglin (1990) have tried to differentiate wage-led and profit-led growth models. When higher wages increase output more via higher consumption than by reducing exports and investment, such an economy and its growth are wage-led. In the other model, growth is based on investment and exports and thus is profit-led. Small and less-developed economies are more likely to be profit-led due to their smaller domestic market.

Theoretically, low wages would not affect personal income distribution if capital were equally distributed among all people, let alone workers. In such an egalitarian society, all households would receive the same share of capital income. In reality, because capital ownership is highly concentrated, low wages and a decreasing wage share will increase inequality. In recent times, and particularly in certain countries,[4] wage dispersion has often had a stronger influence on income distribution than the wage share itself, as top earners (e.g., those in the financial sector) increased their salaries much faster than normal workers. Sectoral and regional differences influence the distribution of income as well. Urban incomes are usually higher than rural incomes.

Public policies affect both market inequality and net inequality of income:

- *Regarding market inequality:* Labor market policies and collective bargaining (union density) influence wage share and wage dispersion. Due to globalization, technological change, declining union power, and labor mar-

4. For instance, in comparison to other OECD countries, the United States had a relative stable or slowly declining wage share, while inequality greatly increased because of an explosion of top earnings.

ket liberalization, wage dispersion at the top end of the earnings hierarchy has increased dramatically. Industrial and trade policies affect the sectoral and regional distribution of income.

- *Regarding net inequality:* Fiscal and expenditure policies primarily affect the distribution of disposable income. The welfare state provides income to persons or households without market income due to sickness, unemployment, or age.

Actual change in the distribution of income might be smaller than expected when these policies benefit richer households more than poorer ones, because the policies are oriented more toward preserving income status in risky times than in redistributing income or wealth.

2.3 Emerging Economies: From Kuznets into the Middle-income Trap?

The locus classicus of the relationship between inequality and growth during economic development is the Kuznets curve. Kuznets (1955) posited that inequality would first rise and then decline as countries grew richer. Poor agricultural societies are relatively egalitarian but become much more unequal during industrialization. In many emerging economies, there are often a large number of households in the informal sector whose low monetary income (and its distribution) provides only a partial view of actual living standards due to subsistence production and other non-market activities. The shift of people (labor) from traditional agriculture into mostly urban manufacturing increases the national income but also increases income disparities. When the share of workers in the modern sectors (manufacturing and services) reaches a certain level, inequality is supposed to decline. In developed societies, increased power of organized labor and more redistributive public policies also contribute to this change.

Political economy indicates that democracies are prone to more redistribution and that authoritarian regimes, although perhaps more unequal, are better for growth as long as growth simply depends on a ruthless strategy of accumulation at the expense of consumption. Political economy claims as well, however, that this phase of development is transitory at best. In the long run, prosperity requires an economic and political system sensitive to the needs of the population. Many rentier economies, which know neither taxation nor representation, are stuck in a vicious circle of unequal distribution, patronage, and stagnation. Many emerging economies are relatively weak democracies. Even where formally free elections take place, rich elites often control the state and shape policies to fit their interests. Corruption and collusion between economic and political elites are rife. These structures sustain inequality at high levels as the benefits of structural change are appropriated by a small number of elites (Oxfam 2014).

Emerging economies usually have a large subsistence and informal sector consisting to some extent of the self-employed. As neither its output nor income is properly recorded by national statistics, the impact of this sector on inequality and growth is often hard to determine. In most cases, the living standards of the self-employed are lower than in the formal sector. People thus try to move from rural areas into the urban economy, to achieve higher income through higher productivity. If they succeed, the shift is a major source of growth. The wage share will usually be much lower in emerging economies than in fully capitalist societies, as self-employment and incomes in the rural and informal sector increase GDP (as far as they are recorded) but not the wage sum.

After reaching a certain level of development—when average annual per capita income is approximately above 4,000 USD—certain problems arise, often referred to as the »middle-income trap.« Productivity can no longer grow rapidly by shifting labor from traditional sectors to modern sectors. Foreign direct investment in the production and export of low-wage goods stagnate. The development of new competitive industries depends on innovation, flexibility, an ever better educated labor force, and expansion of the domestic market for more sophisticated goods and services (Agénor et al. 2012).

In short, economics or political economy does not unequivocally support the idea that inequality is necessary or good for growth in advanced or in emerging economies. On the contrary, in the long run, growth should reduce inequality and depends on lowering inequality to continue.

3. Growth and Inequality in Emerging Economies: Some Evidence

Emerging economies have become increasingly important in the world economy. In examining the evidence related to the development of inequality and growth in emerging economies over the last decades, the large emerging economies of Brazil, China, India, South Korea, and Mexico were selected for this study, because they include almost half of the world's population and have large domestic markets.[5] One could have included other big, middle-income countries—such as Indonesia, Russia, South Africa, or Turkey—but they were excluded here to keep the project manageable. Large natural resource-based economies were also excluded, because their growth and income distribution are less driven by domestic demand and factor markets. That said, Brazil and Mexico arguably are, to some extent, resource based, but they also have a sizeable manufacturing sector.

3.1 Overview of Country Studies: Prosperity, Growth, and Distribution

Brazil's development was characterized by high inequality and volatile growth until 2000. In 2003, the new Workers' Party government under President Luiz Inácio Lula da Silva began to focus on the Brazilian internal market by reducing unemployment and increasing wages, especially the minimum wage. The period 2003–2012 was marked by positive forces of economic prosperity. Not only were GDP and per capita GDP growth rates higher than in the first period (1995–1999) of the Real Plan—the economic policy program to stop inflation that included introducing a new currency, the real—but they also became more positively correlated, indicating that economic growth was spreading more broadly across the country's demographics; average household per capita income experienced amazing growth. The Brazilian pattern of economic growth is exceedingly based on consumption, with moderate volatility of gross capital formation (investment) determining cycles of growth.

After 2003, per capita income tended to increase faster at the lower-middle income and poor levels than at the upper-middle and rich income levels. Nevertheless, Brazilian income inequality is extremely high, and growth in wealth for the poorest segment of society is still not enough to move Brazil away from unacceptable levels of inequality.

Increasing prosperity and fighting inequality were pursued by people's integration into the labor market and by the expansion of public policies without progressive taxation reform. The first process consisted of creating large numbers of new and formal jobs combined with a minimum wage growth policy. Restructuring the labor market was the core of inequality reduction in Brazil, and this approach is far from exhaustion. Consistent household income growth with better distribution accelerated poverty reduction during 2003–2012, with more than 30 million people leaving poverty and another 16 million rising above extreme poverty, resulting in 2012 with much lower levels of poor (16%) and extremely poor (5.3%). Brazil created a cycle of development connecting the entire national economy by creating better jobs, reducing unemployment, increasing participation by the productive part of society at its demographical apex (15–64 year olds), and strengthening the welfare state. The distribution of wealth, however, has not been affected much and requires new policies for wealth and inheritance taxation.

China's most rapid growth, mainly driven by investment and export, does not benefit all its citizens. Although social welfare has improved, most of the wealth created goes to government-controlled sectors, with rising income inequality indicated by its Gini coefficient based on official data and more reliable China Household Finance Survey data. The rural-urban dichotomy, regional disparities, and differences in human capital endowment as well as *guanxi* (personal relationships or networks) are the main contributors to inequality. China's rising inequality has led to an unexpected consequence: some 70% of all savings is in the top 10% income decile, and more than half of all families annually spend amounts equal to or more than their total income. Thus, the high rate of saving in China is not the result of insufficient consumption but income distribution patterns. If inequality continues to be high, stimulus tools are unlikely to be able to boost consumption.

Given this concern, along with the labor market having peaked and the labor supply now in decline, it appears that higher wages and less inequality are at the center of China's new development model. Minimum wages are

5. The analysis in this section is based on the country studies by André Calixtre, Guo Jiannan, Arup Mitra, Lee Joung-Woo and Gerardo Esquivel Hernandez.

being implemented, while security forces are rarely sent to end the growing number of workers strikes for higher wages. Traditional policy tools, however, are less effective in China. Personal income tax policy hardly reduces inequality, while the social welfare system exacerbates it because of its unequal coverage and regional differences in payments. New policies could be introduced. For example, in the short and medium term, transfers could reduce inequality, especially when channeled into education. In the long run, China needs to reform its institutional environment to decrease the importance of guanxi. Only then can inequality resulting from guanxi be eliminated (or at least reduced) and overall income distribution improved. A new growth model might then emerge in China.

South Korea's economic development after the 1997 Asian financial crisis is entirely different from its pre-crisis development. Economic growth was dampened while income inequality rose by about five percentage points. Low growth and high inequality are the two primary symptoms of its current economic ailment. Wage inequality, which had been declining for two decades, has rebounded. Wage gaps between different occupations show a similar pattern. Unsurprisingly, following the recession, the power of capital has gained strength at the cost of labor, whose relative position has definitely worsened. Segmentation between regular and contingent workers has widened and become more concrete. With declining unionization, labor cannot do much to mitigate this labor market segmentation.

The conservative ruling class in South Korea has stubbornly thwarted the welfare state such that fiscal policy has little redistribution effect. Social expenditures are minimal, and tax revenues are insufficient. The current conservative government seems to have forgotten what it promised during the last elections—promotion of economic democracy and the welfare state. South Korea's traditional export-led growth model appears to be constrained by current weak global demand. Debt-driven growth is unreliable as well, as household debt has already reached risky levels. The »creative economy« and deregulation proposed by the new government do not look promising. The most dependable source of growth may be found in a new model of inclusive growth with a focus on wages or income.

India's economic growth has been reasonably high in the last two decades, but it has been dominated by the service sector. The welfare implications of services-led growth are quite serious, as there is not much room for the productive absorption of unskilled and semiskilled workers. India's increase in economic growth has been associated with increasing inequality. An overwhelming proportion of Indian workers are engaged in the informal sector. Overall employment growth has remained sluggish, and nearly 50% of workers are still engaged in agricultural activities. Not enough attention has been paid to improving the quality of labor-intensive production in the manufacturing sector. The import of capital-intensive technology, even in labor-intensive industries, has led to sluggish growth in employment. Hence, innovation in labor-intensive methods is crucial to employment generation.

Although labor market reforms have not been carried out on a significant scale, several indirect routes have allowed firms to introduce labor market flexibility while not providing labor with safety nets. This seems to have aggravated wage inequality. The role of institutions is pertinent for setting minimum wages, which need to be linked to productivity and rapid inflation. Labor unions have to be empowered to bargain for their due share, which has been squeezed by labor intermediaries or labor contractors. Another issue relates to enrollment and skill development. While jobs are increasingly becoming skilled, the supply of labor far exceeds demand in the unskilled category. Skill development, on-the-job training, and investment in human capital formation are important policy implications.

Mexico's strong growth after 1950 came to an end in 1982. Since 1982 Mexico has experienced crises and short booms in spite of the North American Free Trade Agreement. The period 2000–2012 was characterized by low growth with macroeconomic stability. Growth was driven by oil revenues and foreign direct investment in the *maquiladora* industry, but in the 1980s it suffered from structural adjustment programs and depended excessively on growth of the US economy.

Mexico has been caught in a middle-income trap. Inequality, which had declined until 1982, began to climb again, until 1994. Between 1994 and 2000, poverty increased while inequality fell. Lower wage inequality has been one of the main drivers of increasing equality. While the rise of inequality can be explained by a sharp decline in the minimum wage and unionization rate between 1980 and 1998, its decline has coincided without visible changes in these two institutional factors. Poverty has been reduced by targeted public policies. Regardless, Mexico needs to stimulate domestic demand through a higher minimum wage and the expansion of social protections, such as the introduction of unemployment insurance.

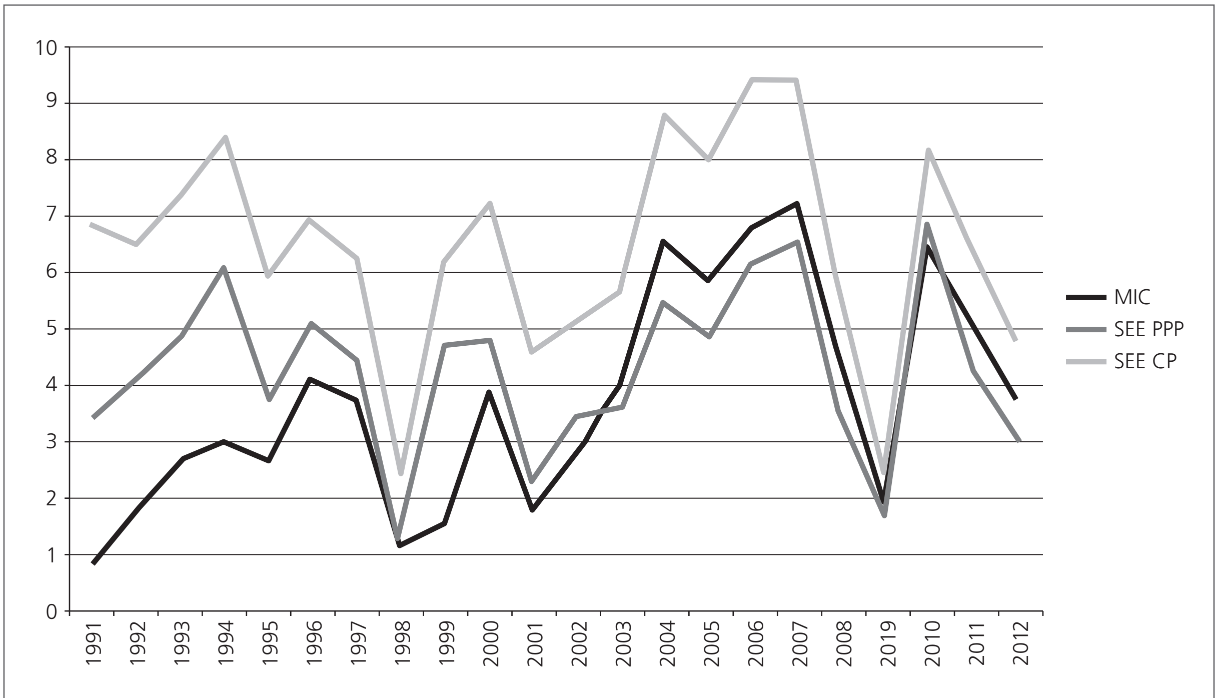
3.2 Development of Prosperity and Growth in Emerging Economies

Since 1990 growth has accelerated in middle-income countries, albeit with an interruption by the Asian crisis in 1998, before reaching a peak in 2008, before the great recession. This group recovered quickly after the most recent crisis. Figure 2 highlights its ups and downs. The group is defined by the World Bank and thus does not include South Korea (a high-income country). It is compared here with the five emerging economies featured in this report. As Figure 2 shows, the 5EE countries are relatively representative of middle-income countries.

The picture regarding growth and inequality is quite diverse for Brazil, China, India, South Korea, and Mexico. Growth was generally stronger in the Asian countries than in those in Latin America. The great recession hit each 5EE in 2009, albeit to different degrees (e.g., China the least, Mexico the worst).

The countries' growth models differ (and differed) strongly. China's stellar growth, which dominates the world economy, has been largely driven by investment and exports. A very high savings rate has kept domestic consumption relatively weak. This pattern is now changing, and at the same time growth rates are declining though still very high. On the supply side, a large migration from the countryside to coastal cities has provided a necessary labor force, often employed by foreign investors. South Korea's growth had been similarly strong in the past, but suffered during the Asian crisis. Its growth rates now are lower than between 1960 and 1995 as it approaches the productivity frontier and its population ages. In the wake of the 1998 crisis, South Korea shifted toward a stronger export orientation to build its currency reserves.

Figure 2: Growth in middle-income countries (GDP per capita) compared to five emerging economies (PPP, national currency, constant prices), 1991–2012



Sources: World Bank, World Development Indicators, and calculations by Michael Dauderstädt.

Note: MIC, Middle-Income Countries; PPP, Purchasing Power Parity; CP, Constant Prices.

Contrary to China and South Korea's growth, India's was weaker and less based on manufacturing. Its economy is strongly characterized by services, which are often increasingly productive. Growth in Brazil and Mexico has been more unstable, in part due to volatile commodity prices. Consumption has driven growth to a large extent, but domestic supply often did not match demand, leading (at least in the case of Mexico) to a middle-income trap. Savings rates have been lower. For a more detailed picture, see Figure 3 and Table 1.

Figure 3: Growth in five emerging economies (GDP per capita, constant prices, national currency), 1991–2014

Source: International Monetary Fund, World Economic Outlook Database.

Table 1: Growth patterns in five emerging economies

	Brazil	China	India	South Korea	Mexico
Growth	Volatile growth, with periods of stronger growth (1993–95 and after 1999)	Continuous high growth (more than 7%)	Strong growth since 1992, especially 2002–2008 (5%), and slow-down after 2011	Strong growth (5%), slowly declining after Asian crisis in 1998	Volatile growth after 1982 with declining growth rates
Drivers of Growth	Consumption	Investment Net exports	Productivity Service sector expansion	Consumption until 1998, then exports	Middle-income trap

Source: André Calixtre (Brazil), Guo Jiannan (China), Arup Mitra (India), Lee Joung-Woo (South Korea), and Gerardo Esquivel Hernandez (Mexico).

Prosperity has not increased similarly to GDP. Working conditions and hours have been harsh, with workers rights decreasing. As energy consumption and emissions from industry and households has increased, the environment has also suffered. China is a prime example of high growth achieved at the expense of the health of the country's population. Between 1980 and 2012, life expectancy in China increased by only 12.2%, while that for Brazil was 17.4%; India, 19.6% (albeit from a much lower level than all the other countries here); Korea, 23.6%; and Mexico, 15.9% (Figure 4).

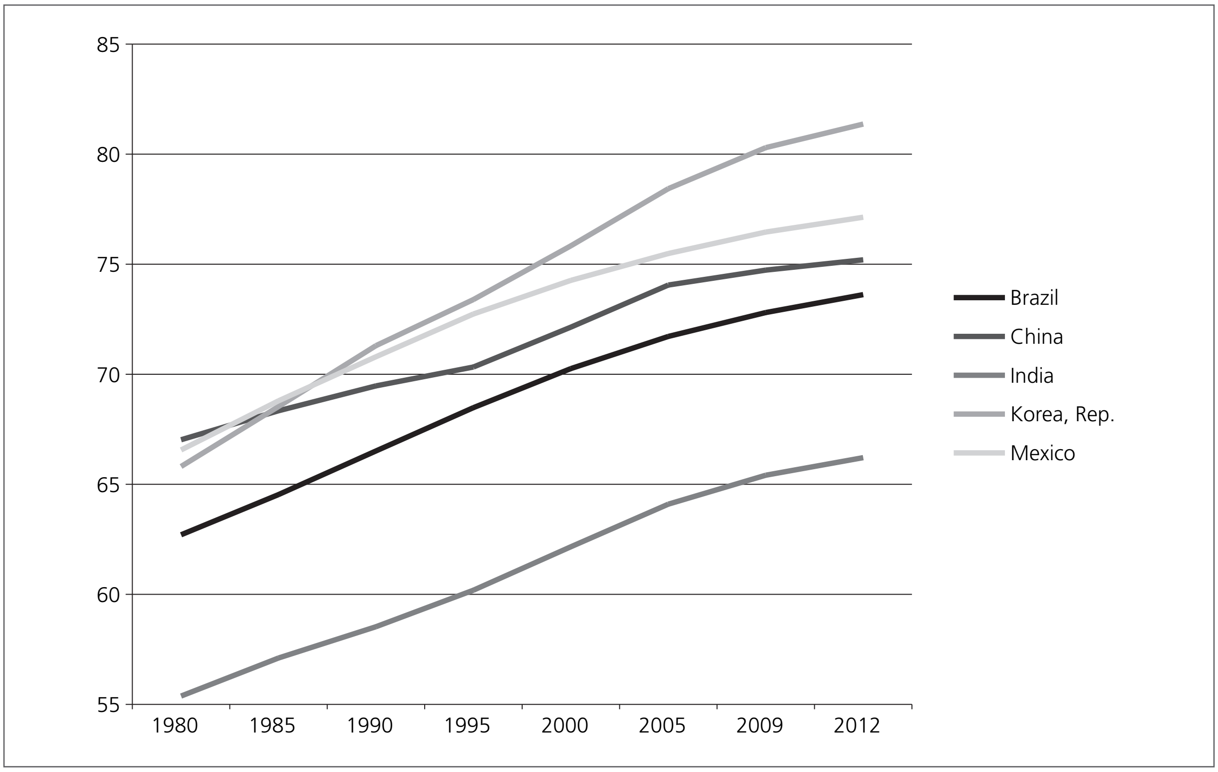
The development of prosperity and differences in it are closely linked to inequality.

3.3 Development of Inequality in Emerging Economies

Emerging economies are generally more unequal than advanced economies. Large informal sectors, broad regional disparities, and irregular access to education and health services are important causes of inequality in these economies. At the same time, the share of taxes and social spending in GDP are lower than in advanced economies. Emerging economies are also much less efficient in correcting market distribution of income, as they rely much more on consumption taxes than on personal income taxes (OECD 2011: 63). The high share of the informal sector and self-employment in the total economy makes it easier to avoid taxation (OECD 2011: 49).

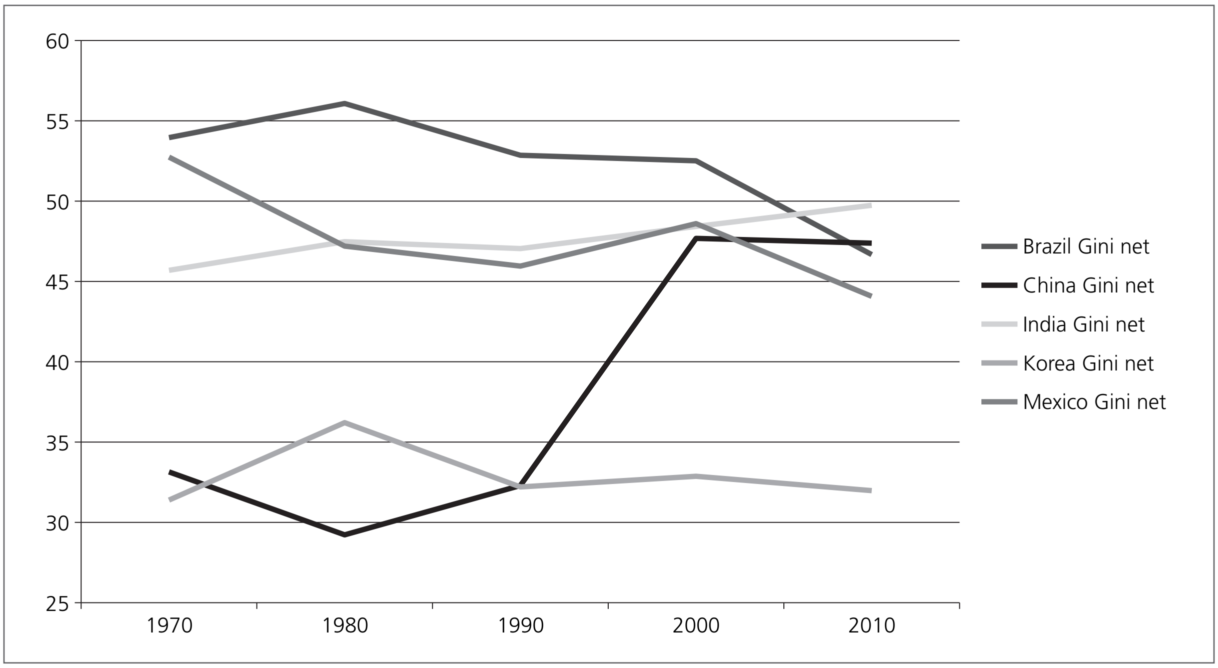
Inequality increased in the Asian countries, albeit slowly in South Korea, while it decreased in Brazil and Mexico. The official figures are not reliable. The Gini for China given in Figure 5 is likely to underestimate China's true inequality, as revealed by the extensive and careful household survey by Guo Jiannan. If one looks at the Palma ratio, another measure of inequality, which compares the top 10% with the bottom 40%, the picture changes slightly. Between 1990 and 2010, this indicator declined from 6.4% to 4.3% in Brazil, while it increased from 1.25% to 2.15% in China, from 1.25% to 1.35% in India, and from 0.8% to 2.8% in Mexico (Cobham and Sumner 2013: annex). There are no data for South Korea.

Figure 4: Life expectancy in five emerging economies, 1980–2012



Source: World Bank, World Development Indicators.

Figure 5: Inequality in five emerging economies (Gini of net inequality after taxes and transfers), 1970–2010



Sources: Standardized World Income Inequality (SWIID) Database; Frederick Solt, »Standardizing the World Income Inequality Database,« *Social Science Quarterly* 90, no. 2 (2009): 231–42, SWIID version 4.0, September 2013.

Table 2: The development of inequality, wages, and redistribution in five emerging economies

	Brazil	China	India	South Korea	Mexico
Inequality	Almost continuous decline since 1993, particularly after 2003	Strong growth from highly egalitarian to very unequal; *guanxi*	Growth between 1994 and 2008	Low, slowly increasing since 1998	Strong increase between 1989 and 1994, almost continuous decline after 1994 until 2008
Labor market and wages	Stable wage share; slowly growing real minimum wage	Declining wage share until 2008, slight increase afterwards; higher dispersion of rural than urban wages	Low wage share; high wage dispersion between workers and other employees; contractual workers exploited	Increasing wage dispersion; more contingent workers; many self-employed; rising minimum wages (stronger between 1998 and 2008)	Decline in real wages and minimum wage until 1996, followed by slow real wage growth, stagnant minimum wage
Redistribution	Bolsa Familia and Fome Zero: Good for poverty reduction, little impact on inequality	Tax system hardly affects inequality	Low share of social spending	Lowest reduction of market inequality in OECD	Oportunidades: Inefficient redistribution

Sources: André Calixtre (Brazil), Guo Jiannan (China), Arup Mitra (India), Lee Joung-Woo (South Korea), and Gerardo Esquivel Hernandez (Mexico).

Note: Bolsa Familia, Fome Zero, and Oportunidades were designed as poverty reduction programs.

Inequality is caused not only by the unequal distribution of value added between labor and capital but also by wage dispersion between privileged workers in the formal sector, public sector and well-run big corporations, and precarious workers (limited contracts, temporary or leased work, informal sector). In China, for instance, migrant workers in cities have no legal residence rights (*hokou*) and are thus not entitled to health care and other social protections. Furthermore, informal networks of personal connections and mutual assistance, guanxi, are an important source of income in China. The share of informal employment is more than 80% in India and 50% in Brazil and Mexico (OECD 2011: 55).

In the five emerging economies, wage structures developed in a way similar to general inequality. In Brazil and Mexico, and to some extent South Korea, where inequality has declined or stagnated, wage shares and real minimum wages remained stable. In China and India, where inequality has increased, wage share and dispersion have deteriorated. Self-employment increased in Korea. For a detailed picture, see Table 2 and Figure 5.

Public social expenditure is relatively low. In the best-performing emerging economy, Brazil, it reached 16% of GDP in 2005—the OECD average is 19%—while in Korea (in 2007), Mexico (in 2007), and China (in 2008), the share was well below 10%. In India (in 2006/7), the level was less than 5% (OECD 2011: 59). The unemployed rarely receive benefits. The share of all unemployed who received benefits was about 38% in Korea—the OECD average is about 46%—31% in Brazil, 10% in China, and zero in India and Mexico. In Brazil, total tax revenue as a share of GDP was 33.6% in 2008, thus approaching the OECD average of 35%. The corresponding share was 22% in China, 17.3% in India, 20.9% in Mexico, and 26.5% in South Korea (OECD 2011: 62; OECD database for Mexico and Korea).

Unsurprisingly, redistribution and public policies had only a minor impact on inequality. The well-known Brazilian programs Bolsa Familia and Fome Zero did reduce poverty but hardly affected inequality because the amounts transferred have been too small. It was above all the changes in the labor market that reduced inequality in Brazil. The Oportunidades program in Mexico has also not effectively redistributed income. China has a progressive tax system that has little impact on inequality. Even in relatively rich and egalitarian South Korea, public policies hardly affect income distribution (difference between market and net inequality).

3.4 Prosperity and Inequality: A Global Perspective

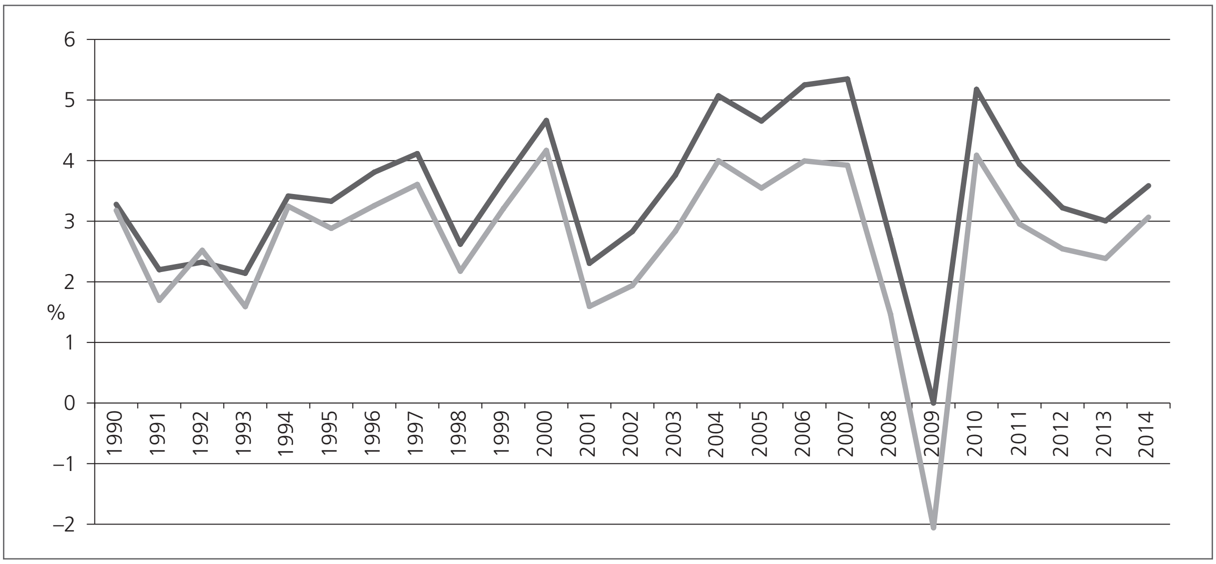
At a glance, the 5EE country studies present an ambiguous picture of the relationship between growth and inequality. On the one hand, inequality increased in the countries with the strongest growth (China and India), while Brazil and Mexico combined decreasing inequality and weaker growth. On the other hand, South Korea, with its relatively low inequality, had strong growth, and the recent rise in inequality did not accelerate growth. Brazil experienced phases of growth combined with declining inequality.

This mixed picture reflects the global experience. For the world economy, periods of high growth, particularly until 2008 (see Figure 6), have often coincided with increasing inequality. The financial market crisis of 2008 and the great recession, however, raise some doubts about the long-term sustainability of unequal growth. There are also many phases of growth cum equality, such as most of the growth in the postwar period (1945–75) and the catch-up growth in Japan, Taiwan, and South Korea (until 1998). Actually, the Fordist model (postwar period) had the historically highest global growth rate, and from a supranational or global perspective, growth has led to lower transnational inequality (Milanovic 2011; Dauderstädt and Keltek 2014).

Although inequality has risen over the last decades in most countries (Milanovic 2011; OECD 2011; Gupta 2014; see also Figure 7), this development was by no means uniform. The rise of inequality was particularly dramatic in the post-communist countries in the wake of their transition to market economies. Most developed market economies experienced increased inequality as well. Latin America (Cornia 2012) and Sub-Saharan Africa have been exceptions, however, in that inequality has not increased there. At the same time, the world economy grew quite well until the 2008 global crisis (see Figure 6), although growth rates were lower than in the postwar period, when inequality was lower or declining.

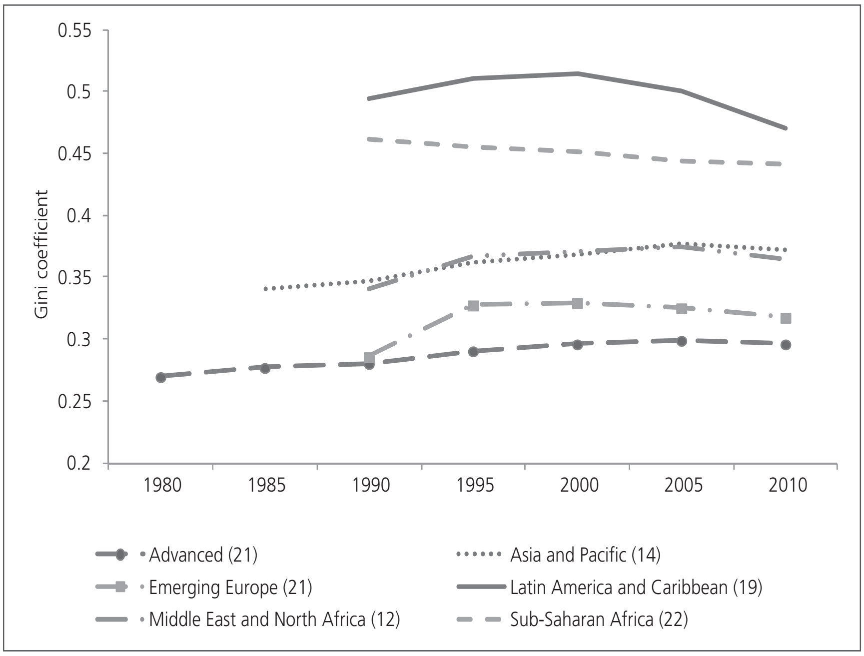
In the global economy, however, inequality has declined as poorer countries have grown faster than rich

Figure 6: Global growth (GDP at purchasing power parity and exchange rate), 1990–2014



Source: International Monetary Fund, World Economic Outlook Database.

Figure 7: Trends in disposable income inequality, 1980–2010



Sources: OECD; Luxembourg Income Study Database; Socio-Economic Database for Latin America and the Caribbean (SEDLAC); World Bank; Eurostat.

Note: Disposable income is income available to finance consumption once income taxes and public transfers have been netted out. Therefore, the distributional impacts of indirect taxes and in-kind transfers are not included. The Gini coefficient ranges between 0 (complete equality) and 1 (complete inequality). Number of countries in parentheses.

Figure reproduced from S. Gupta, »Fiscal Policy and Income Inequality,« IMF Policy Paper, International Monetary Fund, Washington, D.C., January 2014, 8.

economies. Still global inequality is much higher than any in-country inequality (Milanovic 2011). The relation between the incomes of the top 20% to the bottom 20% (S80/S20) in the world is about 50:1, while within countries this indicator usually ranges between 3:1 and 15:1 (Dauderstädt and Keltek 2011).

Multicountry studies (Barro 1999; Klasen 2009) on the relationship between growth and inequality do not provide a clear picture but clearly undermine the traditional idea that more equality is bad for growth. The locus classicus is Barro. To quote from his abstract (Barro 1999),

> Evidence from a broad panel of countries shows little overall relation between income inequality and rates of growth and investment. However, for growth, higher inequality tends to retard growth in poor countries and encourage growth in richer places. The Kuznets curve—whereby inequality first increases and later decreases during the process of economic development—emerges as a clear empirical regularity.

Barro updated his analysis in 2008. To quote from that abstract (Barro 2008),

> International data confirm the presence of the Kuznets curve—an inverse-U shape relationship between income inequality and per capita GDP—that is relatively stable from the 1960s into the 2000s. The direct effect of international openness on income inequality is also found to be positive. On the other hand, a cross-country-growth equation shows a negative effect of income inequality on economic growth, holding fixed a familiar set of other explanatory variables. This effect diminishes as per capita GDP rises and may be positive for the richest countries.

Klasen, a leading German researcher on inequality and welfare, put it this way (Klasen 2009):

> Regarding the impact of initial inequality on subsequent growth, the preponderance of empirical evidence from across the world suggests that high initial inequality serves to reduce subsequent growth. … Rising inequality, as observed in Brazil in the 1980s, and in China and India since the 1980s, can seriously reduce welfare, slow down poverty reduction, undermine social stability, and may ultimately undermine economic growth.

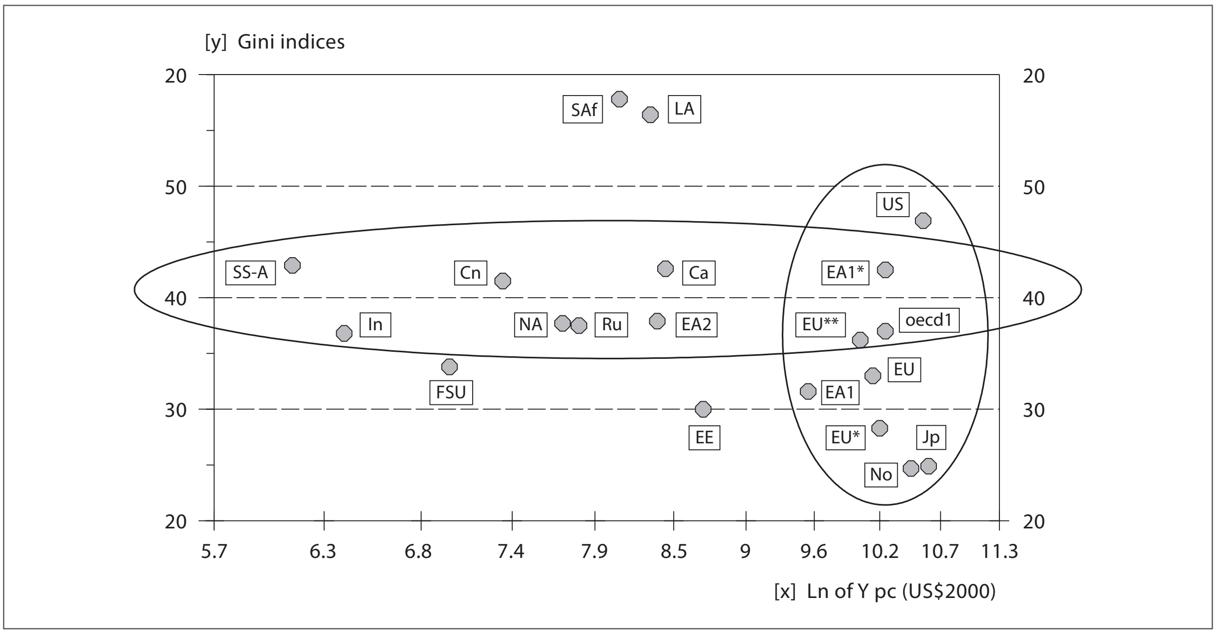
There is some doubt about the actual validity of Kuznets forecasts in today's economies. Palma (2011) shows that in 2005, there is no U-curve if one compares levels of income per capita and Gini coefficients (see Figure 8). In particular, there is, in his view, no clear indication that inequality has to increase to reach higher levels of income. Palma compares countries with different income levels, not the same country during its development. Thus, his findings do not imply that inequality in a given country will not increase in earlier phases and not decrease later. Rather, he shows that at a given income level, there are different levels of inequality. This indicates that political, societal, and institutional factors are important intervening variables.

Palma (2011) also shows that high levels of inequality are closely related to the high income shares of the richest decile (D10) and low shares of the bottom 40% (D1-4), while the share of the »middle class« (D5-9) hardly varies across country groups. Unequal societies are primarily unequal because the rich are very rich (D10 shares of around 45%), and the poor are very poor (D1-4 share less than 10%), while in more equal societies the respective figures are below 25% (D1) and above 20% (D1-4). The middle class (D5-9) always gets about half of total income (+/- 5%). The »Palma« (the ratio of D10 to D1-4) might actually be a better indicator of inequality than others, such as Gini and S80/S20 (Cobham and Sumner 2013; Doyle and Stiglitz 2014).

Recent IMF papers shows that more equal economies have longer spells of growth than those characterized by strong inequality and that redistribution thus indirectly sustains growth (Berg and Ostry 2011; Ostry, Berg, and Tsangarides 2014). When growth is driven primarily by consumption, it tends to be accompanied by declining inequality. When it is based on investment and net exports, inequality is likely to increase. This demand-side pattern fits the distinction between profit-led and wage-led growth. Domestic consumption results to an overwhelming extent from wages (Onaran and Galanis 2012) while an increasing capital stock leads to a higher profit share (Piketty 2014). High savings, which correspond to a high investment share or a current account surplus, are usually the result of an unequal distribution of income. In China, the most prominent case of an investment-driven growth model, the richest 10% account for 70% of total savings.

The labor market is key in explaining inequality. In countries where the labor market is unregulated (or existing rules are not enforced), inequality is relatively high, and precarious work (using contingent and contract laborers) makes up an increasing share of employment. This does

Figure 8: Income levels based on per capita GDP and inequality (Gini), 2005



Source: José G. Palma, »Homogeneous Middles vs. Heterogeneous Tails, and the End of the 'Inverted-U': The Share of the Rich Is What It's All About,« Cambridge Working Papers in Economics (CWPE) 111, Cambridge University, January 2011, http://www.econ.cam.ac.uk/dae/repec/cam/pdf/cwpe1111.pdf.

Notes: Ln of Y pc is the natural logarithm of per capita GDP; SAf – Southern Africa; LA – Latin America; SS-A – Sub-Saharan Africa; In – India; Cn – China; FSU – former Soviet Union; NA – North Africa; Ru – Russia; EE – Eastern Europe; EU** – Mediterranean countries; EU* – EU with Gini below 30 (Germany, Austria); Ca – Caribbean; EA1 – East Asia 1 (Korea, Taiwan); EA1* – Singapore, Hong Kong; EA2 – Indonesia, Malaysia, Thailand; EU – continental Europe, including Switzerland; OECD-1 – Anglophone OECD + EA1*; Jp – Japan; No – Nordic countries; US – United States.

not necessarily lead, however, to more employment. India is an example of a country where decent work standards are seldom enforced, but nonetheless growth has been jobless.

Redistribution has increased with inequality (Gupta 2014; Ostry, Berg, and Tsangarides 2014), but the effect of progressive taxes and social policies on inequality is less strong than expected (Gupta 2014). Taxes have become less progressive as top income tax rates, corporate taxes, and wealth taxes were reduced to prevent tax evasion, which had become increasingly easy in a more globalized, open economy. The tax base shifted toward consumption, sales, and value added taxes, which are rather regressive. Transfers (social spending) often did not target the poor, or they missed the target. The biggest transfer systems—health insurance and pensions—usually transfer funds within income groups rather than between them if one looks at lifetime inequality. Emerging economies, in particular in Latin America, are much less efficient in reducing market inequality via taxes and social spending (Gupta 2014).

4. The Risks of Unequal Growth

To assess the risks of unequal growth to sustainable prosperity it is useful to differentiate between three growth models according to their main drivers on the demand side:

1. *Consumption:* Economies with high inequality but low investment and trade deficits (for example, the U.S. economy) are basically consumption driven. This consumption, however, is debt financed, as other sectors, such as government and poorer households, have to absorb the savings of the rich. Such debt-financed growth relies on the patience of the debtors (capital markets) and eventually requires an adjustment and deleveraging (Krumhof and Rancière 2010; Cynamo and Fazzari 2013). The deleveraging process will harm growth if it

is not turned into the exports growth model (see below), which is the usual advice given to indebted deficit countries.

2. *Exports:* Inequality often results from a growth model driven by net exports. This growth pattern often requires low wages and savings (again mostly by rich households) to be lent to foreign borrowers, thus increasing the net foreign investment position resulting from export surpluses.

3. *Investment:* Investment-led growth and inequality are compatible, at least over a certain period when the rich who save more invest their savings in real capital. Without growing demand for the output of these investments, however, the propensity to invest will decline.

How sustainable is the exports growth model, of which China and Germany are the most prominent examples? From a global perspective, net exports obviously make no sense because the world economy is closed. This implies that any export-led growth relies on other countries readiness to import more than they export and finance the difference by debt. Such global imbalances are not sustainable. In the end, they require either debt restructuring or reversion of current account balances. The first option has taken place several times in the past. Germany lost about 20% of its accumulated surpluses in the financial crisis. The latter option requires the former surplus countries to run deficits and to switch to a consumption-led or an investment-led growth model.

This leaves the third, the investment-led growth model. Indeed, making the accumulation of capital the basic objective of economic activity is the core principle of capitalism. Critics such as Marx and Keynes have pointed out the contradictions of this growth model, as the returns on capital are likely to decrease in the long run—according to Marx, the decline of the profit rate, and Keynes, the declining marginal productivity of capital. Piketty (2014) shows empirically, however, that the long-term the historical rate of return on capital has been between 4% and 5%, implying an ever-increasing inequality of wealth and income, in particular in the absence of high growth and strong redistributive policies. Reconciling Piketty with Marx and Keynes, it can be argued that the stabilizing of the profit rate requires an ever-increasing inequality or strong devaluations of the capital stock, usually during economic crises.

What is the purpose of this continuously growing capital stock? Basically, it is supposed to increase the quantity and quality of output and the productivity of labor by making production more capital intensive. If this output and the productivity gains are not distributed in an equitable manner, the demand for this supply is bound to fall behind. Theoretically, a super-rich minority could try to consume an ever-increasing share of output by changing its composition and price so that luxury and positional goods make up an always-larger share of the value added. In reality, however, such a system is not only unacceptable for political, social, and moral reasons (Wilkinson and Pickett 2009), but also not likely to work economically as the utility of further consumption declines and savings increase. There are also huge differences among the investment behaviors of different countries. While in Latin America, with its high inequality, private investment is about 35% of the income share of the top decile, while the respective shares in South Korea are about 100% and in China and India about 80% (Palma 2011: 33).

In the end, the basic aim of economic activity is not only consumption, but also leisure if and when the desired level of consumption can be achieved with less and less labor. The prosperity resulting from labor, a growing capital stock, and rising productivity should be shared among all people in a fair way. A reduction in working time (e.g., less hours per day, a shorter working week, more paid holidays) is one way to use productivity gains, which ensured full employment in the advanced economies of Europe and the United States during the postwar growth period. It makes increasing sense as soon as more material consumption needs are fulfilled and ecological limits to growth are approached.

Poorer societies, including emerging market economies, however, will still prefer more output to more leisure time, at least for some time to come. This means that in these countries, real wages must increase with productivity; nominal wages should increase with productivity plus the target inflation rate of the central bank. This is a fundamental principle for balanced and sustained growth largely forgotten in the era of neoliberal globalization and export-orientated growth policies.

For the world as a whole, growth makes sense only if it is wage-led growth. Today's lopsided distribution of value added between capital and labor must be reversed.

An increasing level of prosperity allows not only decent wages, but also decent benefits for those no longer able to work or needed to work. In a more equitable society, this need not imply soaking the rich, as wage earners can support the old and weak without impoverishing themselves thanks to decent wages. This redistribution would take place primarily »within the working class.«

A global race to the bottom in wages and working conditions makes no sense. In a competitive environment, it will lead to lower prices and deflation. This will eventually raise real wages again, but at the price of recession and slow growth, as deflation will make further investment less attractive when the expected nominal returns decline. In a globalized economy without a common understanding of the problem and proper macroeconomic coordination, however, there is always the danger that countries will try or be forced to gain competitiveness by reducing wages, pursuing competitive disinflation, or undervaluing their currency.

High inequality also threatens long-term growth, as there is too little investment in human capital (i.e., education, health). If the young poor do not have access to these social services, there employability and productivity suffer at a high cost to the whole economy and future growth. Inequality also tends to reduce social mobility (Gupta 2014: 14) and can threaten social and political stability and security, thus requiring more public and private spending on crime control and prevention. These expenditures crowd out other more productive and growth-enhancing spending.

5. Policies for Shared Prosperity

Although the paradigm of inequality fostering growth is in retreat, reality has still to follow. In this final section, we will try to identify policies to reduce inequality, which will increase prosperity and are unlikely to harm growth. We start with policies that affect the distribution of market income and continue with redistributive and social policies.

5.1 Sharing Prosperity in Emerging Economies

As shown above, progress toward a better-shared prosperity has been slow and unequal within the five emerging economies examined. The policies adopted to improve or correct market outcomes often have failed (see Table 2). The policy changes suggested in light of this can be divided into labor market policy, fiscal policy and redistribution, and social investment (Table 3).

The case of Brazil is of special relevance as it shows how a combination of progressive labor market policies (raising the minimum wage) and conditional cash transfers (for example through Bolsa Familia) have led to more growth and employment. At the same time, Brazil reduced in-

Table 3: Proposed policy measures in five emerging economies

	Brazil	**China**	**India**	**South Korea**	**Mexico**
Labor market policy	Higher minimum wage	Reform *hukou* Reduce influence of *guanxi*	Labor market regulation Promote manufacturing industry	Better protection of workers Higher participation rate	Higher minimum wage
Fiscal policy and redistribution	More progressive tax system	More efficient tax system	Taxing real estate, inheritance, and capital gains	More efficient redistribution	More progressive tax system
Social investment	More social spending, less debt service	Investment in education and human capital	Higher spending on education and health	Investment in social services rather than infrastructure	Universal pension system and health coverage Unemployment insurance

Sources: André Calixtre (Brazil), Guo Jiannan (China), Arup Mitra (India), Lee Joung-Woo (South Korea), and Gerardo Esquivel Hernandez (Mexico).

equality. The impact of labor market policy on income distribution was significantly stronger than that of social policy.

5.2 Labor Market Policies

Wage policy is probably the most important instrument for redressing market inequality. Real wage growth should not lag behind productivity growth. Nominal wages should increase with overall productivity plus inflation. (Target inflation is usually about 2%.) The benchmark should be the rise of productivity in the total economy, not in respective sectors, as those employed in industries with little or no real productivity growth (e.g., teaching, health care, hair dressing, and performing arts) should benefit from the overall rise in prosperity.

As wages are often determined by collective negotiations between trade unions and employer associations, it is important to strengthen unions. Legislation should protect the rights of workers to organize, to strike, and to bargain collectively. The government can influence the wage-setting process without violating the autonomy of collective bargaining by using wage policy in the public sector or setting a legal minimum wage at an appropriate level (such as a certain percentage of the average or median wage). Wage settlements between unions and employer federations can be extended by decree to all enterprises in a given region or industry to prevent a race to the bottom by non-organized competitors. The implementation of all International Labour Organization standards should be guaranteed.

Competition policy can force industries with strong productivity growth to translate these gains into lower prices, which benefit consumers, rather than increasing profits. The state can also regulate labor markets in a way that reduces fragmentation of the labor force due to workers' different social, contractual, or legal status (such as the extent of contract work or the hukou system in China). Unions should be careful not to privilege and featherbed core, permanent workers at the expense of peripheral, contract employees. Instead, reforms should try to extend decent working conditions—which currently seem to be a privilege for a few—to all workers rather than trying to abolish privileges.

As long as wage growth does not exceed productivity growth, neither competitiveness nor profitability nor price stability is harmed. The wage share remains as stable as the profit share. If a society or country thinks that it needs higher savings to finance more investment, it does not have to reduce wages. A fairer approach would be for wage earners to save a certain share of their income, for instance, in the form of pension funds. Thus, they become the owners of the capital stock financed through these savings and will be entitled to receive the earnings from this capital stock. Singapore has used such policies to finance its growth. A more equally distributed capital ownership could mitigate the dangerous long-term trends described by Piketty (2014). To enable painless savings, however, wages must be substantially higher than the minimum necessary to survive in a decent manner.

5.3 Fiscal Policy and Redistribution

The tax system and public spending are the central redistributive policies. Ideally, the rich should pay a larger share of taxes and benefit less from public spending than the poor. In actuality, however, tax systems have often been reformed to reduce the tax burden of the rich and business sector while reorienting spending toward the needs of the middle classes and other powerful lobbies. As economic power becomes more concentrated, it translates into political power shaping public policies at the expense of the poor and less powerful. Top marginal tax rates have been reduced in many developed countries while the share of VAT has increased (UNCTAD 2012: 116–21).

Tax deduction loopholes and tax incentives for corporations and rich households should be reduced or eliminated. Evidence from rich countries shows that the lowering of corporate tax rates has not increased investment (UNCTAD 2012: 131). Emerging economies should not join the race to the bottom by trying to attract foreign direct investment with low taxes.

A shifting of the tax burden from the rich and corporations to consumption and wages can be seen in many countries, but it is particularly strong in emerging economies, where redistribution through fiscal and public expenditure policies rarely works. Although reforms of these policies are difficult given the political situation and the constraints set by globalization, they are far from impossible. Efficient redistribution (measured as the difference between the Gini of market and disposable income) in many advanced countries (e.g., Scandinavia, Ireland) proves that better performance can be achieved with effective administrative capacities and political will.

More attention should be paid to wealth (property) and inheritance taxes. Taxing capital will force its owners to use it productively or sell it to owners who can and do, thus supporting economic growth. Less income through inheritance strengthens the role of meritocratic values in a society, which should also improve economic efforts and growth. More international coordination and more transparency of the capital markets and the banking system are needed to implement such a policy and to fight tax evasion. In Sweden, for instance, income and tax records are open and public.

Redistribution will strengthen demand, albeit only to the extent it takes money from households with a high propensity to save and gives it to those with a higher propensity to consume. Otherwise the total level of income and spending remains unchanged. In times of recession, it is important to maintain spending and consumption levels, if necessary by government borrowing and spending. The »automatic stabilizers,« such as unemployment insurance, can smooth the cyclical behavior of markets and prevent a vicious circle of shrinking demand and rising unemployment.

Other systems of social insurance redistribute money between specific groups, such as from the healthy to the sick or from the young to the old. In so far as the benefits reflect prior (or later in the case of health insurance) payments, the redistributive effect over the lifetime of the insured is small. At any given time, the redistributed total amount is great, particularly in regard to pensions in aging societies. To the extent that retired people do not have market income, pay-as-you-go pension systems contribute massively to the reduction of market inequality, while in a capital-funded system, annuities would count as (capital) market income.

Which system is better for growth? Funded systems accumulate savings, which can be invested. When these investments take place in a productive way, they foster growth. A savings glut due to a lack of ready borrowers and investors, however, might lead to a recession or speculative bubbles. In the long run with a more stable demography, there would be continuous turnover of assets between the retired, who want to sell them, and active savers, who have to buy them. This steady exchange of assets against money, which is then used for consumption by the old, is virtually equivalent to a pay-as-you-go system. The functioning and sustainability of the system depends in any case on the readiness of the active population to forgo consumption to support the old by either buying their assets or paying contributions into the pay-as-you-go system. The higher the income, the easier this »sacrifice« is, which depends on the wage level and productivity. Investments in earlier times by the retired in physical and intangible capital stock determine that productivity.

Such social programs as Bolsa Familia and Fome Zero in Brazil, Oportunidades in Mexico, and the Mahatma Gandhi National Rural Employment Guarantee Act in India might not make a big dent in the reduction of inequality, but they increase prosperity and reduce poverty. When combined with requiring recipient households to send children to school and for regular health checks to prevent disease, they can increase employability and productivity.

5.4 Social Investment

The welfare state has contributed much to reducing inequality and poverty in the advanced economies. It has replaced systems of protection against risk based on family or neighborhood relations—on which most people had to rely in the absence of sufficient wealth—and it has also provided public goods and services, such as education and health, which are a precondition of growth and prosperity. This kind of social spending is not a luxury only rich societies can afford, but is necessary and best policy to foster growth and prosperity and to reduce inequality. Social spending often has a Keynesian multiplier greater than one leading to higher growth. Access to these basic services should be seen as human and civil rights similar to voting rights and equality before the law.

Social mobility and employability depend primarily on levels of education. The skill premium tends to increase in modern economies. The unemployment rate is usually much higher for unskilled than for skilled workers. With the progress of technology and the condition of globalized labor markets, the disadvantages of the less skilled are bound to increase. Investing in qualification and training of the young (and increasingly over the lifetime of all workers) will deliver higher productivity and more jobs and thus stronger growth and prosperity. A similar case can and must be made for health care systems. Lack of treatment and prevention reduces people's capacity and leads to a vicious circle of poverty and illness.

The provision of these services is itself a component of growth. More people working in these industries will earn money and spend it on various other goods and services. The expansion of social protection and investment is driven by two key factors: the preferences of the population, which wants more public goods and services, and the slower productivity growth in these sectors, which makes them relatively more expensive (Baumol 2012). It is not a burden on the economy as long as there is no full employment, which would force society to choose between the higher output of other goods and services on the one hand and better education and health care on the other. Higher productivity growth in industries such as agriculture or manufacturing actually allows for the better provision of social services without reducing other consumption.

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