

Redistribution for Growth?

Income Inequality
and Economic Recovery



**Redistribution for Growth?
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Rudolf Traub-Merz (ed.)

Impressum

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FOREWORD

Studies on income distribution usually point into one direction only: wages are stagnating or declining, rural-urban income differentials growing, Gini coefficients climbing and other indicators of income disparities are worsening as well. The gap between the rich and the poor is rapidly widening in most countries. Only a few countries appear to be able to withstand this trend or turn it back. Economic growth in emerging economies may have been important to finance the reduction of absolute poverty, but in developed and emerging economies alike, it is accompanied with an increase in inequality.

Today, a new world economic crisis is looming and there is growing concern that the world economy has entered a phase of structural stagnation and further growth is hampered by the existing level of inequality. Justice based criticism on income disparities is joined by macro-economic considerations calling for a new growth model based on balanced current accounts and an increase in household consumption.

Under the title »Redistribution for Growth? Income Inequality and Demand-led Economic Growth in Emerging Economies« the Shanghai Academy of Social Sciences (SASS) and the Friedrich-Ebert-Stiftung (Shanghai Office) jointly organized an international conference on May 10-11, 2011 to discuss the interplay between economic growth, income inequality and the need for redistribution policies. Country reports focused on emerging economies (Brazil, China, India, Mexico, South Africa) but for comparison, developed economies (Germany, South-Korea, USA) were included.

Encouraged by the acclaim which greeted the conference and the fascinating contributions to the debate the Friedrich-Ebert-Stiftung decided to publish the contributions – most of them revised – in two volumes, one in Chinese, the other in English.

The Shanghai Academy of Social Sciences (SASS) and the Friedrich-Ebert-Stiftung would like to thank the authors involved in this publication for their valuable contributions.

No bilingual book is possible without translators. Mrs Wu Xiaozhen translated the Chinese contributions into English, while Professor Zheng Chunrong, Dr. Zhang Haibing and Dr. Xue Lei translated the English-language articles into Chinese. James Patterson copyedited all the English texts for publication. We owe them our thanks for their professional work.

We hope that this publication will be of interest.

Shanghai January 2012

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I

INCOME INEQUALITY AND REDISTRIBUTION FOR GROWTH

Rudolf Traub-Merz

The extent of income inequality and the trend observable in many countries towards increasingly inequitable income distribution has become a key issue of political and social debates in many places. Since the outbreak of the global financial crisis in 2007–2008 the debate, long dominated by neoliberalism, has opened itself up. New views concerning the conditions of economic growth and income inequality coming to the fore and old debates on economic policy governance are revived. The social consequences of the most recent global economic crisis have left the defenders of the existing global economic order in something of a quandary. A public debate on growth and social justice not only appears urgent, but in many countries protest movements are gaining in political significance with their demands for a social and political change of course.

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Income inequality has many different connotations, three of which are of particular importance:

(1) The *moral dimension*, which leads into the discussion of human rights. What kinds of reason should a society accept for the emergence or existence of inequality and how much inequality between its members is reconcilable with the right of each individual to human dignity?

(2) The second dimension *links inequality to political stability*. How much inequality can a society endure before a significant number of its members begin to reject the existing pattern of distribution and demand fundamental changes? In societies with very rigid forms of income distribution, this may easily lead to pub-

lic protest, if not violence. Authorities are then faced with the option of reacting to protests with repression or reform. In societies with flexible tools of negotiation and bargaining on income, smoother mechanisms of adaptation may be available.

(3) The third dimension – in many cases the dominant pattern in social debate – links inequality to economic performance. Individuals who achieve more and perform better deserve a higher income. If everybody is treated the same, the overall willingness to work may decline. The argument includes the scarcity of skills. Societies have to provide incentives to ensure that talents and education are allocated to jobs where they are needed most. Not many people doubt the general accuracy of these arguments – but nobody has ever shown how to correctly measure performance and how to find an objective way of linking it to the prevailing level of income distribution. Inequality is needed – to some extent – but nobody knows how much of it is good.¹

A look at development trends in income distribution in industrialised and emerging countries is revealing. While inequality in a few countries has been on the decline, most have witnessed a step increase. In its recent report, the OECD notes that over the past two decades the Gini coefficient, a standard measure of income inequality »rose in 17 of the 22 OECD countries for which long-term data series are available« (OECD 2011: 22) and only two recorded small declines.

For emerging economies, the report finds similar results. While most succeeded in reducing the extent of absolute poverty during the two

decades to 2008 – the decline was particularly dramatic for Brazil, China and Indonesia – their high economic growth rates were mainly accompanied by ever more income inequality. Of the BRICS, South Africa stands out as the country whose already horrible income profile under the apartheid regime has further worsened under the new black government (see Hlope in this volume); China is a special case in that it has moved within three decades from being one of the most egalitarian to one of the most unequal societies today (see Li in this volume); and Brazil is the positive exception in that it is the only member of this group which has constantly reduced its Gini coefficient over the past decade, albeit from a high level (see Neri in this volume).

If trends in growing inequality are long-lasting and the dominant state of affairs in OECD countries as in emerging economies, why are we having a wide public discussion on the need to reduce inequality now? There are several reasons, but the main argument is that a change in the dominant discourse can best happen during a societal crisis when an existing pattern of explanations is seen as worn out. The global finance crisis and its aftermath have provided this new ground.

The global financial crisis was ignited in a sector which in previous years and decades – together with labour markets – has witnessed the most far-reaching market deregulation. Public discourse was dominated by statements such as »markets are the best way of allocating scarce resources« and »government intervention always leads to misallocation«. In labour economics paradigms dominated explaining wage differentials by the absence or ownership

¹ In a work process based on the division of labour it is never possible to quantify individual contributions to the aggregate outcome and to determine the difference between individual contributions. Pay differentials are ultimately only the result of historically developed negotiation processes and reflect power rather than capabilities.

of skills in demand and stock market analysts, financial economists or bank managers behaved like a new class of priests equipped with ultra-specialised knowledge of how markets work, justifying their often fabulously high pay on these grounds. The outbreak of the crisis, however, brought shame on much of the profession: few economists could claim to have predicted the coming of the 2007–2008 market collapse and the mess the world is now in. In a bid to save capitalism, politicians and economists alike shifted overnight to the solution that for the previous few decades had been regarded as the problem: Keynesianism. This shift in public policy opened the door (again) to a new discourse on the fundamentals of market economies and a recognition that markets without strong rules are – or at least can be – destructive, and that markets are blind with regard to the future and to income distribution. They may produce a Pareto optimum for resource allocation – but this should not be confused with justice or fairness in income distribution. It is down to society by political means to lay down the parameters of what it wants as its income profile.

But the major push for the new debate on income distribution appears to have come from macroeconomic arguments and the link to global economic imbalances. There is every reason to believe that the 2008 global financial crisis has shown that the prevailing neoliberal model of economic growth is exhausted. An untenable international trading system has emerged, in which one group of countries consumes more than it produces and covers the deficit (import surplus) with increasing debts on the part of private households and public budgets, while another group of countries produces

more than it consumes (export surplus) by keeping domestic consumption low, in particular with a low wage policy. The debt-led consumption group (United States, United Kingdom, Greece, Spain and others) must adjust its aggregate domestic expenditures to national income and shift from debt-financed consumption (both private and public) to more production and higher exports. The export-led mercantilist economies (Austria, Germany, the Netherlands, Sweden, Japan, China and others) have to do the opposite and shift from export production to more domestic consumption through a wage-led strategy and a general reduction of income inequality.

China and Germany have their share in this debate. Both are blamed – as is Japan – for contributing to global imbalances with their current account surpluses and are being asked to do the same: balance their external accounts by increasing domestic demand through measures to reduce income inequality. In other words, increase wages, increase taxes on profits, increase the supply of public goods and increase welfare spending. If the global economy is to return to a growth path income inequality must be reduced.

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The years between 1945 and 1973/75 are sometimes called the «golden age of capitalism», politically administered under the Keynesian Consensus. Unlike supply side-oriented economic theories and policies Keynesian macroeconomic planning targeted the level of effective demand corresponding to full (or near full) employment. As the market alone was not likely to achieve full employment governments

through public spending had to make up the difference and regulate market failures (see Kumar in this volume). The Keynesian Consensus was inward-looking and emphasised the dual nature of wages: they comprise production costs and consumer demand at the same time and a change on one side always impacts on the other. As the rich consume a smaller proportion of their incomes than the poor do, consumption propensity declines with higher income and overall consumption is slowed when inequality increases. During these Keynesian times wage policies in many industrialised countries were regulated through national agreements between trade unions, employers' associations and governments and the general line followed was to maintain the existing pattern of functional distribution of income in wages and profits by implementing productivity-oriented real wage increases.

All this is history. Since then we have witnessed in many OECD countries a retreat of the state from the economy, its withdrawal from regulating, a sliming down of its taxation capacities and a focus on fighting inflation instead of unemployment. Above all, we have seen redistribution-in-reverse and a vast reconcentration of wealth (OECD 2011; Atkinson, Piketty and Saez 2011). Labour's income share has fallen, profits and top management salaries (including bonuses and fringe benefits) have shot up and within the economy, financial corporations have come to dominate non-financial ones, in a development sometimes called the »financialisation of capital«.

The new discourse² emerging from today's global growth and inequality crisis emphasises three overriding principles that policies must embody: the financial sector must be re-regulated to prevent its focus on high-return speculative business and to realign it to its key task of providing funds to productive capital for investment; global imbalances have to be corrected by applying policies in large economies that balance foreign trade and avoid structural surpluses or deficits on their current accounts; and income inequality must be addressed through active redistribution policies.

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The sovereign debt crisis in the EU which exploded in Greece in spring 2010 and has encroached on Portugal, Spain and Italy thereafter is the second time within a few years that long-term structural imbalances have come to the surface. The crisis in public finances is profoundly connected to the trade imbalances between EU member countries and its main cause is the drifting apart of wage costs. Germany is at the centre of the problem due to its constant efforts to improve its price competitiveness with its European trading partners through a low wage policy.³ This dampened domestic inflation, led to the stagnation of private demand and kept imports well behind exports, which grew at record levels. The debt crisis evolved in countries which have seen the other side of this equation: mounting current account deficits and growing national debts.

² Variants of this discourse are called inclusive growth, inclusive development (see Nederveen Pieterse in this volume), decent capitalism (Dullien, Herr and Kellermann 2011) or the Keynesian New Deal (Hein 2011).

³ Between 2000 and 2010 Germany was the only European country that experienced a fall in real wages (minus 5 per cent). The development of unit labour costs (2000–2010), one of the strongest indicators for measuring the competitiveness of a national economy, shows a Eurozone divided into three groups: (i) France, the Netherlands, Belgium, Finland and Austria have developed according to the average; (ii) the foreign debt crisis countries Greece, Portugal, Ireland, Italy and Spain have seen unit labour cost increases above average; while (iii) only Germany has showed increases substantially below average (Niechoj, Stein, Stephan and Zwiener 2011: 12).

The EU's debate on solving the sovereign debt crisis with rigorous spending cuts takes the symptoms for the cause and ignores the urgent need to rebalance the current accounts. Premature fiscal consolidation and a collective austerity package⁴ will deepen the crisis, particularly in those countries that need export growth to pay back foreign debt. As countries of the Eurozone cannot use nominal depreciation, cutting wage costs is the only way to improve national competitiveness. This will not materialise, however, if labour costs in Germany do not increase. The key to overcoming the debt crisis is a policy package that stimulates domestic demand in Germany, in the first instance with higher wages (Niechoj & Stein & Stephan & Zwiener 2011).

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Policies directed towards income redistribution usually have three main levers for intervention. They can affect the bargaining powers of the social partners on labour markets, flatten differences in market incomes with progressive taxation and provide financial means for those who cannot engage in market activities or need support on low market incomes.

The power to tax is one of the central attributes of state sovereignty. It is not just essential for

the provision of public goods but it is **also** the main instrument of redistribution policy. Market incomes are usually distributed much more unequally than net incomes and taxation can be deployed to achieve a politically and socially acceptable income distribution.

Over the past two or three decades, the use of taxes for redistribution has been greatly weakened in many OECD countries. This is partly due to a voluntary policy of cutting taxes to broaden the tax base, a neoliberal policy strategy of reducing companies' overheads to create additional incentives for investment⁵ or a result of tax competition in the era of globalisation, within the framework of which reducing taxes in one country forces others to follow suit to avoid seeing their own tax base shrink.⁶

Total tax revenue as a percentage of GDP for OECD countries remained unchanged between 1995 and 2008 at around 35 per cent (OECD 2011: 62) but among the sources, several structural shifts took place, all of which contribute to undermining the redistributive character of taxes. When MNCs shift paper profits⁷ to low tax countries, even tax havens, the burden in the business sector falls more on nationally incorporated businesses; the tax burden **also** shifts from non-market to market income when taxes on assets and property are reduced.⁸ A

⁴ The agreement in November 2011 of 26 out of 27 EU members on an automatic mechanism for punishing countries which run a public deficit above 3 per cent is strange considering that – with the exception of small economies such as Luxembourg or Estonia – every member has higher debts and thus should be punished straight away, but would have no money to pay because they must institute spending cuts.

⁵ For companies at marginal profit levels and operating in market segments with sufficient demand, the argument may have some value. For the business sector overall facing excess capacity and low demand, lower taxes are unlikely to lead to higher investment in general (see Kumar in this volume).

⁶ During the »neoliberal cycle« when company profitability and the number of incorporated businesses increased »nominal corporate tax rates have indeed fallen globally from an average of around 50 per cent in 1975 to an average below 30 percent in 2005« (Rixen 2011: 449).

⁷ See Rixen (2011) for a proposal on international taxation of MNCs to stop them shifting paper profits to tax havens.

⁸ In Germany, the proportion of property taxes in total tax revenues fell from 3.3 per cent in 1980 to 2.3 per cent in 2008.

similar move happens from capital owners to labour when proportionately higher tax rates apply to salaries.

Of particular concern is the growing tendency to move the tax base from income to consumption. This is the case even within OECD countries but particularly marked in emerging economies. While many have seen their overall tax base strengthened over the years due to their high economic growth rates or were able to realise high revenues from oil rents and royalties, the composition of their tax revenues differs significantly from OECD countries in that consumption taxes are the main source (OECD 2011: 62). Consumption taxes have regressive effects, burden the poor more than the rich and, in interplay with flat capital taxes, a minor role for progressive personal income taxation can effectively neutralise redistribution policies or worse, turn the whole tax system into a regressive machinery for increasing inequality.

China is a case in point. Half of its tax revenue comes from consumer taxes (51 per cent in 2008; see OECD 2011: 63) and their regressive character is not fully compensated with progressive taxation on personal income. Before the agricultural tax was abolished in 2006 its rural tax system was even designed such that the lowest income decile was paying an average tax rate 6–10 times higher than the rates paid by the highest income decile (Wang and Piesse 2009: Table 1; see Li in this volume). Personal income tax for the urban population was introduced in 1980, but with tax-free allowances set at such a level that a mere 2 per cent of taxable income earners were covered. By keeping these thresholds constant for a long time (the first changes came in 1996) nominal

income increases moved a higher share of income earners into the taxable brackets and in 2008 personal income tax contributed 5 per cent to total tax revenue and covered 28 per cent of wage earners. The recent tax reform – following a public call for real wage increases – moved the tax-free allowance up from 2,000 RMB to 3,500 RMB and reduced the coverage of taxable wage earners to 7.7 per cent (China Daily, 1 July 2011). For redistribution purposes the reform may prove counter-productive. It has no positive effect on the majority of the population, relieves the tax burden on members of the mostly urban middle class⁹ and makes the tax system even more dependable on consumer taxes. Keeping the tax-free allowances unchanged, increasing tax progressivity, dealing with tax evasion by high-income persons and relieving the poor with reduced consumer taxes would have been a reform focusing on redistribution. In marginalising personal income tax, the government has given away one of the best instruments for reducing inequality.

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When taxes play a less important role or no role at all in reducing market-income inequality, public cash transfers and social security contributions become key instruments. Welfare states always redistribute on two fronts: over the lifecycle of the individual and between individuals. Social security schemes are in many cases composed to function as insurers to balance income differences within a lifecycle. With flat-rate contributions and payment of benefits linked to those contributions, their effect on redistribution between individuals becomes marginal (for Germany, see Bartels 2011).

⁹ The minimum wage in 2011 for most urban areas along the east coast is between 1,000 and 1,200 RMB per month.

Social insurance schemes can have a redistributive character in both directions, depending on their set-up. If coverage is high and returns are detached from contributions and uniform, it will distribute top-down. It has the opposite effect when it targets exclusively urban wage earners in the formal sector and calls on non-benefiting rural migrants to pay for it, as happened in China up to the social insurance reform in 2011.

Contributory social insurance programmes are the dominant form of social security in industrialised countries, but even in emerging economies they account for the bulk of public expenditure (OECD 2011). However, coverage is very different and usually fairly limited in emerging economies.¹⁰ People who have been poor throughout their lives cannot be expected to finance their own pensions through «social insurance». The only feasible option for social security provision is non-contributory schemes funded by general taxation.

Cash transfers, often conditional and means-tested, have become prominent in recent years in many emerging economies. The ILO is propagating a «Social Basic Floor for All» for all countries and argues strongly in favour of its positive effects on poverty alleviation and labour productivity gains for the economy (see Wodsak in this volume). One well-known project is the «Bolsa Família» run by Brazil, which now covers 11 million families and 44 million people in total. The effects of cash transfers on the reduction of inequality in Brazil are indeed substantial. Calculations show that they had a similar impact with social insurance schemes in reducing income inequality during the period 2001–2008 (17 per cent vs. 15 per cent), but

public expenditure on cash transfers were much lower and its cost–benefit ratio 384 per cent higher than expenses for social insurance benefits (see Neri in this volume). The message from «Bolsa Família» and similar programmes is straightforward: cash transfers can work. They can be targeted on vulnerable groups without being hijacked by local elites; they can build bridges for social groups to reengage with the productive economy; they are key intervention strategies in reducing inequality; and they are not too heavy a burden for public budgets (see Wodsak in this volume).

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The labour market is at the centre of any discussion on income inequality and explanations of the causes of growing disparities, as well as the design of policies to correct them must come to terms with the driving forces behind two main trends: a falling share of wages within total income in many countries and an increased wage spread which sees rapidly increasing wages at the top and stagnating or declining wages at the median and bottom of the distribution (ILO 2010; OECD 2011: 86–88).

«Globalisation» and the development of «labour-saving» or «skill-biased» technologies are often used to explain falling wage shares and growing disparities in wage earnings. As markets integrate globally the balance of demand and supply on labour is shifting such that highly educated and mobile workers are enjoying better income opportunities and workers with less education are facing declining employment prospects and stagnant incomes (Spence 2011: 29). There is no doubt that low skilled

¹⁰ The share of the workforce contributing to a pension and/or health insurance plan ranges from about 10 per cent in India and Indonesia to 50–60 per cent in Brazil and South Africa (OECD, 2011).

labour in tradable sectors of developed countries have been put in competition with workers in low-paying emerging countries and that many companies have relocated. But this does not explain why many low pay jobs are usually found in the nontradable sectors of the national economy where downward pressure on wages does not stem from globalisation.

Plausible as some of these arguments may seem at the first glance, they do not provide convincing answers to the question of why nearly all of the gains in income and wage rises are monopolised by a very small fraction at the very upper level of the income hierarchy, made up of top executives and bankers. It is not the top 30 per cent, top 20 per cent or top 10 per cent who are the winners from globalisation, technological progress or increased market integration: in many countries, university degree holders, experts or lower and middle management barely earn more – in relative terms – than they did decades ago.

In their fascinating studies on top incomes,¹¹ Atkinson, Piketty and Saez (2011) show that over the past thirty years the income share of the top 1 per cent has skyrocketed, in particular in the Western English-speaking countries (United States, Canada, United Kingdom, Ireland, Australia and New Zealand), as well as in China and India, whereas the gains in other countries, while still substantial, lag behind.¹²

Two more findings are particularly important: the concentration of income in the top 1 per cent leaves nothing (or close to nothing) to the top 2–10 per cent and »wages and salaries now

form a much greater fraction of top incomes than in the past« (Atkinson, Piketty and Saez 2011: 7). Theories which purport to explain the distribution of labour income in terms of demand and supply of skills cannot account for these extreme forms of monopolisation: explanations that use labour market institutions, changes in power relations and a new »winner takes all« mentality are more adequate.

The distribution between capital and labour and the extent to which competition for employment can be transformed into a larger wage spread depends on workers' relative bargaining power and the strength of trade unions. Many of the institutional changes of the neoliberal revolution of recent decades have targeted deregulation of labour markets and the weakening of workers' bargaining power (see Schmitt on the United States in this volume). The strictness of employment protection legislation decreased in many OECD countries and statutory minimum wages, where they exist, often fell relative to median wages. Governments worked actively to establish a low-wage sector and did not prevent precarious employment from becoming a fixed feature of their economies. Trade union densities have fallen and unions' organisational capacity has shrunk. Bargaining coverage may have been stabilised in many countries through extension agreements but bargaining patterns have become more decentralised and uncoordinated, shifting downwards from national or sectoral coverage to company agreements. The ILO wage reports clearly show that trade union strength is positively linked to the wage share and a narrower wage spread and their weak-

¹¹ See also the databank on top incomes, available at: Alvaredo, Facundo, Anthony B. Atkinson, Thomas Piketty and Emmanuel Saez, The World Top Incomes Database, <http://g-mond.parisschoolofeconomics.eu/topincomes> (accessed 24 December 2011).

¹² Concentration in the top 1 per cent went up by smaller rates in Southern and Northern Europe. Continental Europe lagged behind but for this group the data usually do not cover the years after 2000, which have seen inequality on the rise in countries such as Germany.

ness explains why they failed to push for productivity wages¹³ and stable household consumption.

In most countries, trade unions are not able to raise the wage share back to former levels and employers will certainly not come to their rescue to increase wages for the sake of higher consumption. Policy intervention is needed to support trade union bargaining power by reducing competition pressure from wages. Extension policies to increase bargaining coverage to more companies and sectors are important, as is active employment promotion. The single most important intervention may well be a statutory minimum wage, set at a level where it bites into the low-wage sector¹⁴ and is increased annually in accordance with productivity increases in overall income plus expected inflation.

Minimum wages are applied «in about 90 per cent of countries in the world» (ILO 2010: 64) but in many of them their potential for reducing low pay is not used due to low enforcement. Legislating on minimum wages is meaningless if a weak implementation machinery or wide exemption clauses allow undercutting on a large scale. The argument is made time and again that «minimum wages in developing countries will always be more effective in the formal than in the informal economy, where monitoring is difficult and where unregulated casual work is widespread» (ILO 2010: 70).

India, with an informal economy covering some 90 per cent of the total economy, may have

found an answer to many of these implementation problems with its new National Rural Employment Guarantee Scheme (MNREGA). MNREGA is the largest public employment creation scheme in rural areas, covering some 52.5 million households or 10 percent of its labor force. Its success stems not only from the magnitude of the programme but from its design, which makes it function as an effective wage anchor. It is rights-based and demand-driven, entitling every household in rural areas to a maximum 100 days of employment in public works with wages at an official minimum level, which is higher than what the private sector pays for casual labour (see Himanshu in this volume). The time span since its inauguration as a national project is still short, but there is already anecdotal evidence that MNREGA provides a firm wage foundation upon which upward pressure on wages can be exerted and workers are able to use it as a bargaining tool (see Himanshu).

A similar process appears to be under way in China, but there it is not based on an employment guarantee scheme but demographic factors. With the rapid aging of its population the unlimited supply of migrant workers for urban labour markets is coming to an end. Labour shortages are changing power relations and migrant workers are using their stronger negotiating position to push for higher wages. This is usually not done in an orderly collective bargaining process led by trade unions but through strikes as unions are not seen as legitimate representatives of workers' interests. A new

¹³ The ILO in its Global Wage Report 2008/09 calculated that for the period 1995–2007 «a 1 per cent increase in the annual GDP per capita translated into average wage growth of 0.87 per cent in countries with superior collective bargaining coverage, compared to wage growth of only 0.65 per cent in countries with weak coverage» (ILO 2010: 56). Strong unions still had a positive impact on distribution but in the period under research were no longer able to get a productivity wage.

¹⁴ Statutory minimum wages set at 50 per cent of the median wage may be regarded as reasonable for the purpose of reducing employment pressure on wages and allowing unions sufficient scope for collective bargaining.

mode of adjustment may have been set in motion, where wage development is driven by the dialectical interplay between labour conflicts and minimum wage increases. Whenever workers feel their wages to be too low they may push for wage strikes; whenever local governments who are in charge of fixing minimum wages feel the number of strikes is too high, they may increase minimum wages (Traub-Merz 2011). Conflicts or the fear of them become driving forces behind wage development.

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The crisis of 2007–2008 saw the G20 process gain momentum when governments accepted »the greatest challenge to the world economy in our generation« (Preamble of the G20 Pittsburgh Summit statement, September 2009) and in order to save their economies from collapsing set up »the largest and most coordinated fiscal and monetary stimulus ever undertaken« (Preamble). But their promise »to turn the page on an era of irresponsibility and to adopt a set of policies, regulations and reforms to meet the needs of the twenty-first century global economy« (Preamble) was not long-lasting.

Today, the world economy is again at a critical juncture and the G20 has largely become inactive. The momentum for global coordination appears to have faltered and has succumbed to opposing national interest agendas. There is growing concern about the sustainability of public debts, which have soared with the financing of the stimulus and in the US, as EU discussions on fiscal consolidation and debt reduction through austerity measures prevail again. Such measures will not get anybody out of the crisis:

countries with enough fiscal space should apply growth policies to help others from falling even more deeply into trouble (Fitoussi and Stiglitz 2011).

The EU is currently the most critical case. It does not have an external deficit and the monetary union has enough savings to resolve its members' debt problems. The key issues are two distribution problems: »the countries north of the Alps have excess savings, but northern European savers do not want to finance indebted southern European countries like Italy, Spain and Greece« (Gros 2011); and states are indebted to their rich citizens. They have borrowed from them and have built up public debts instead of taxing their wealth and income.

Re-regulating the financial markets back to their previous size, when they served the real economy, is one of the most urgent reforms facing the international community. However, it has failed to make much headway so far. Another is distribution policy. High levels of income inequality must be reduced to overcome weak global aggregate demand. The needs of the twenty-first century global economy demand new policies on income distribution to make recovery and growth economically and socially sustainable.

Redistribution as a programme for constantly reducing inequality can work only by empowering those who would benefit from it. It must be rights-based and grounded on the organisational power needed to defend those (newly won) legal rights whenever they are challenged again. Redistribution of income implies a rebalancing of political power. Cash transfers or other forms of donation are not enough, only empowerment in the legal and political sense,

providing workers with the opportunity and means to demand a higher share of the wealth they help to generate.

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II

GROWTH AND SOCIAL POLICIES: TOWARDS INCLUSIVE DEVELOPMENT

*Jan Nederveen Pieterse**

1. INTRODUCTION

In the second decade of the twenty-first century, many developing countries are more prosperous than in the past and are introducing social policies on a large scale. Welfare policies, which were absent or meagre in the past, are now becoming substantial. However, they are often disconnected from economic policies. Ministries of the economy and of social affairs do not speak to each other, or when they do they do not «speak the same language». Economists have mostly been trained in neoclassical economics, and in some cases in Chicago School supply-side economics, while social affairs ministries speak the language of social cohesion and political stability. Thus, the logics

of accumulation and welfare, of growth and social policy do not connect. This policy schizophrenia is not merely occasional, but reflects long-standing divides between the economic and social spheres. It mirrors the long-standing disconnect on a world scale between the international financial institutions, based in Washington, and the UN institutions.

Social policies played a central role as part of the Keynesian consensus of the post-war era. They have been marginalised during the period of neoliberal globalisation, but they are emerging to play a new role in the wake of the 2008 crisis. Social policies are further refracted by differences between developing and developed economies, and between social market and neoliberal economies.

* With thanks to Rudolf Traub-Merz for his comments.

The discussion in this chapter first takes up the question of the relationship between social policies and economic growth. Are social policies a benevolent afterthought based on growth, or are they part of growth strategies? In addition, is redistribution a viable policy framework? The chapter then turns to the impact of globalisation, IT, financialisation and export-led growth. Patterns are changing again in the emerging multipolar world and in the wake of the 2008 crisis. Given the slowing of world trade and high dependence on exports in many developing countries, a social turn in their growth strategies can serve as a key component in moving away from export-led toward domestic demand-led growth. The scope of the discussion is global, with an emphasis on developing countries and emerging societies.

2. GROWTH AND REDISTRIBUTION

Growth and social policies are often viewed either as unfolding on separate tracks or in the sequence »growth first, redistribution afterwards«. The idea is that without growth sharing would only produce shared poverty. While this may generally make sense it is also too vague to hold much water: as if any growth is welcome and the quality of growth does not matter. In effect, this recycles the idea of »growth above all« and does not count social and environmental costs. In any case, this sequence in effect means »trickle down« and it entrenches interest groups and policies that create their own path dependence. Most important, it glosses over the importance of human capital as a key factor in growth.

»Redistribution and growth« continues to be argued as a poverty reduction policy that is more effective than growth alone (Dagdeviren et al. 2002). This is true but it is also a facile argument. Is »growth and redistribution« a formula we can go back to or does it belong to a bygone era? The 1970s growth and redistribution literature (Chenery 1974) came during the waning years of the Keynesian consensus. As a concept and policy framework redistribution has a number of limitations. Redistribution assumes a stable political centre and effective fiscal and revenue raising policies. Note that in the United States none of these conditions apply: the political centre is not stable because there are elections every two and four years; fiscal policies are not effective because corporate lobbyists and lawyers create or find tax loopholes; and raising revenue is difficult with major political forces fiercely opposing tax increases.

Redistribution further assumes a stable social contract, a social consensus, which is not available in societies that are deeply divided – for example, in societies with structural conditions of »radical inequality«, such as India, Pakistan and much of Southeast Asia, and in heterogeneous immigrant societies, such as the United States. It also poses a problem in societies where immigration has increased amid economic constraints, as in parts of Europe. Thus, precisely where redistribution is most needed, the social basis and political coalition required to achieve it is least likely to materialise. In the United States, »redistribution« is a nonstarter and is generally taken to be an ugly word that smacks of »socialism« (and »big government«). What has taken place in the United States since the 1970s is redistribution-in-reverse, a vast

reconcentration of wealth and power, returning the country to the wealth disparities of the 1920s and undoing the reforms of the New Deal. In continental Europe, redistribution is generalised, but immigration exposes the limits of the social contract. In Mediterranean Europe, welfare has taken on forms of lax state patronage and the current crisis in the Eurozone has exposed its design problems and those of European Union more generally. In developing countries, large-scale welfare policies are a new trend and how they relate to growth is contentious. This is the focus of this discussion.

Redistribution assumes effective distribution policies and capable local government, which are problematic in many developing countries, China and India included. Social transfers may be subject to elite capture at the local level. As an issue, redistribution is elastic, subject to narrow or wide interpretations, has different meanings for different policymakers and is therefore unstable as a policy framework. Furthermore, redistribution per se ignores or holds constant the overall growth paradigm. Growth and redistribution are viewed as separate compartments, or alternatively, the implicit assumption is a Keynesian policy framework. In addition, redistribution ignores macroeconomic dynamics. It implies a Keynesian «national economy» bias – in other words, a lesser degree of globalisation – and is subject to imponderable economic fluctuations.

The slumps of the 1970s and 1980s turned the tide and at the World Bank the Washington Consensus outflanked the redistribution and growth approach. In development studies, the human development approach overtook growth and redistribution. In the 1990s, debates fol-

lowed on tradeoffs between growth and equity. The human development approach argues not for growth but for quality growth, and not for redistribution but for «capacitation».

3. SOCIAL POLICIES

Thomas Pogge (1999) refers to conditions of «radical inequality»: those at the bottom are very badly off in absolute terms, but also in relative terms; the inequality is persistent, pervasive and avoidable. In several countries, some of the conditions of radical inequality have begun to unravel. With social forces and newly empowered strata emerging in emerging markets, they have become emerging societies. Political demands are stronger, government coffers fuller and social policies more ambitious. But what is the political economy of the ongoing transformations?

Social reforms such as cash transfers (as in Mexico's Oportunidades and Brazil's Bolsa Família), work programmes (such as India's NREGA), micro credit (as in Grameen) and social provisions (such as health care and pension schemes in Thailand and child care support in Nepal) share the limitations of redistribution policies. As long as they are conceived as set apart from the logic of growth itself they are vulnerable to political vicissitudes and economic fluctuations.

The July 2011 elections in Thailand illustrate the dilemma. The Pheu Thai party led by Yingluck Shinawatra (sister of the deposed and exiled former Prime Minister Thaksin Shinawatra) won a landslide victory on a major programme of social benefits,¹ which is as

¹ An increase in the minimum wage (to Bt300), salary increases for civil servants, a reduction in personal income tax (from 30 to 23 per cent), a Bt100 million allocation for each province to establish a fund for women, better incomes for the aged, credit cards for farmers, energy cards for taxi drivers and a tablet PC for all first grade students.

populist as Thaksin's policies had been. Economists and business leaders caution that these policies could lead to inflation, higher interest rates and higher costs for private companies (Bangkok Post 2011). The election victory represents a renegotiation of Thailand's social contract against the backdrop of political crisis with »warring political factions, five years of street protests and violent military crackdowns«. This includes the long neglected countryside, especially in the northeast. One report notes:

»Once passive and fatalistic, villagers are now better educated, more mobile, less deferential and ultimately more politically demanding. ... The old social contract, whereby power flowed from Bangkok and the political establishment could count on quiet acquiescence in the Thai countryside, has broken down. ... Villagers describe a sort of democratic awakening in recent years and say they are no longer willing to accept a Bangkok-knows-best patriarchal system« (Fuller 2011).

Thus, structural changes in the countryside and the »transformation from peasants to cosmopolitan villagers« (quoted in Fuller 2011) and mounting social pressure are fundamental to the ongoing political changes.

According to the Pheu Thai party, the social policies will stimulate domestic consumption and help lead the country away from export dependence. Its Vision 2020 refers to the ASEAN Vision 2020. Missing from the mix are land reform and broadening access to education. The general quandary concerns whether social policies are redistributive trickle-down or whether they are conceived as *part* of the growth model. Are social policies a bonus to poorer strata for overall growth, a low-cost way of buying social peace and cutting crime (as in

Brazil since FH Cardoso and President Lula)? Are social policies market-friendly (such as schemes that enable the poor to buy on credit), or are they embedded in expanded workers' rights, such as collective bargaining (as in Germany's coordinated social market economy; see Vaut in this volume)? Are they occasional redistribution or do they reflect a social perspective on growth and a different growth path? Obviously, these are as much political as economic questions.

Elite patronage and charity – such as the nineteenth-century soup kitchen – are social policies that are *disarticulated* from growth policies. They are typically short-term, depend on market and political fluctuations, and have a demobilising effect. Some social policies may serve to repair damage done, as in Spain, Portugal and Greece after the fall of the dictatorships, or in the »new South Africa« after 1994. As reparation policies they fall short of a new social contract. Nevertheless, some forms of charity stem from entitlements to food staples and food security that may go back to feudal lordly duties, or over time they may be transformed into rights. If social policies are entitlements and based on rights, as in India's right-to-work programme, they go beyond trickle-down. India's NREGA programme changes the village power structure and the sway of caste rule in the panchayats because they provide a revenue source outside the village. In sum, to be genuinely effective and sustainable social reforms should be part of the overall growth model and take into account macroeconomic imbalances. The main ways of integrating growth and social policies are demand-side and supply-side approaches. On the demand side, production without consumption, and steep

social inequality and wealth concentration are not sustainable. Growing inequality, as in Marx's classic pauperisation thesis, undercuts mass demand, the quandary emphasised by Keynes, Galbraith and, recently, by Robert Reich and Paul Krugman.

On the supply side, the key variable is so-called »capacitation«. Social policies enhance broad social participation in growth; growing human capabilities – sustained by education, health and housing policies – boost productivity and employability, widen the tax base and thus establish a virtuous circle. In the Nordic countries this is the productivist approach to welfare, or social productivism, as in Gunnar Myrdal's classic work (1968). In Germany's Rhineland model it is the combination of welfare policies, apprenticeship, codetermination in shopfloor affairs and boardrooms, and the partnership of government, employers and trade unions. In East Asia, similar policy combinations have inspired the human development approach. This goes much further than redistribution and involves restructuring growth models and changing the political equation. It also goes further than human development. It is not just a matter of individual attributes, as in the Human Development Index, but concerns building social institutions, so it is social development. As Wilkinson and Pickett

(2009) show in their impressive study, *The Spirit Level: Why More Equal Societies Almost Always Do Better*, all of society benefits from equality, also the rich, with less crime, less disease, greater security and social stability. The recent Spence Commission's case for shared growth and inclusive development takes this to another level (Commission on Growth 2010). Table 1 sums up ways of articulating social policies and growth.

Some of these relations have broken down in the setting of accelerated globalisation and IT growth. In developed countries they have been short-circuited by post-Fordism, offshoring and outsourcing, and the creation of low-paying jobs in the service sector. In the wake of the 2008 crisis the issue is how to rework and reconceptualise social policies.

4. GLOBALISATION, IT, FINANCIALISATION AND EXPORT-LED GROWTH

The Keynesian consensus broke down at the intersection of the slumps of the 1970s and 1980s, accelerated globalisation, technological change and financialisation. The Fordist approach matched productivity growth with wage increases plus inflation. In the 1980s, techno-

Table 1: Articulating social policies and growth

Demand side	Develop social demand and sustain domestic market
Supply-side	<p>Capacitation: Enhance broad social participation in growth; education, health and housing policies sustain growing capabilities, boost employability and widen the tax base</p> <p>Social investment: in productivity and social cohesion; education and empowerment of women, minorities. Social development: capacity and institution building</p>

Source: Author's compilation.

logical changes enabled post-Fordism, flexible production, automation, containerisation of ocean transport and 24/7 (24 hours, 7 days a week) global finance, and hence the further interweaving of firms and economies across national boundaries. Global competition, the need to invest in technology and marketing and gaining global market share, reinforced the trend towards offshoring to zones with lower labour costs. About the same time, Eastern Europe and China opening up to international markets, adding a vast pool of labour to the global labour market.

Together, these changes enabled a major shift in bargaining power from labour to capital along with a different understanding of growth, led by capital, hence the rise of shareholder capitalism. American society, steeped in a culture in which business occupies a larger place than in past hegemonies and in other societies, includes within it a vast zone – the American South – where tax, labour and regulation standards have lagged far behind the rest of the country. »Dixie capitalism« enabled the neoliberal turn in the United States (Nederveen Pieterse 2004). The international financial institutions based in Washington, the IMF and World Bank became instruments of this outlook, the Washington Consensus.

In the 1980s, the Washington institutions promoted export-led growth as the leading development model, combined with trade liberalisation, deregulation and privatisation, even though the success stories of this model – the Asian Tiger economies – all involved active government intervention. Export-led growth along with investment from American companies enabled the rapid industrialisation of some of the

Asian economies. The Cold War and American wars in the region (Korean War, Vietnam War) also provided stimuli. For Korea and Taiwan, the proximity of Japan mattered as well. Thus, export-led growth and industrialisation in some developing countries has been the mirror image of deindustrialisation in some OECD countries, in particular the United Kingdom and the United States.

What ensued is the complex interdependence of the Pacific economies. In brief, manufacturing and service jobs lost in the United States led to rising wages in Asia. In the United States, productivity has been rising steeply, as have corporate profits, but wages have broadly remained stagnant since the 1970s. Profits, the Dow Jones and CEO remuneration are up because American corporations reap high yields from rising productivity and from offshoring. Cheap Asian imports compensate somewhat for stagnant American wages, but over time rising wages and the skills-squeeze in emerging economies will raise the cost of imports and will make offshoring to such areas less attractive.

Since the 1980s, this growth model has been sustained by the United States as driver of the world economy, with private consumption as the main engine (rising from 64 per cent of US real GDP in 1980 to 72 per cent in 2007). With wages remaining stagnant, consumption was sustained by longer working hours, dual-earner households and credit expansion (deferred payments, credit cards, home equity financing), made possible by low interest rates and external borrowing. Credit expansion fuelled the financialisation of the economy; financial services became the largest sector of the US economy with 20 per cent of the workforce and 40

per cent of corporate profits. This further deepened inequality (with pay rates in finance much higher than in other sectors). Deregulation combined with new financial instruments, some arcane (credit default swaps, securitisation) and some virtually fraudulent (subprime mortgages), and growing white-collar crime, contributed to financial instability and crisis (peaking in 2008 and ongoing).

«Globalisation», then, is shorthand for a package of concurrent changes, a vortex of interacting forces. In the 1990s, «globalisation» became a buzzword to cut government intervention on the grounds of competition and capital flight to low-cost and low-regulation zones. Globalisation intertwined with turbo capitalism helped to transform social and stakeholder capitalism into «no-nonsense capitalism» (a term used in the Netherlands at the time). However, the *form* of globalisation during a particular phase is not the same as the *trend* of globalisation. Second, the momentum of globalisation is more complex and points in more directions than just the course orchestrated by the hegemon. Third, hegemons do not last. Fourth, in the wake of the 2008 crisis and the global imbalances it reveals, the neoliberal turn, while it has not gone away, is over its peak as an ideology and difficult to sustain institutionally.

5. TIPPING POINTS

These developments are now at a crossroads because of economic decline in the OECD and because of social forces, as in Thailand, which cannot be contained within this social constellation. These relations are unstable for American trade and current account deficits cannot rise

indefinitely. Tipping points include the limits on American purchasing power (in view of stagnant wages, steep inequality and crisis), US debt and the unstable dollar.

At this stage, the American model of import and borrow and the Chinese model of export and lend are both unsustainable. «If the import-and-consume business model is dead, so too is export-and-save» (Financial Times editorial 2009). According to Thomas Palley, «the possibility of global development via export-led growth is now exhausted». Key problems he notes are waning consumer markets in developed economies; emerging markets' exports hindering the recovery of industrialised economies, crowding out the exports of other emerging markets; increasing South-South competition; the declining prices of manufactured goods; and the ability of multinational corporations to shift production to lower cost countries (Palley 2011: 4–5).

In the United States, a key problem is private underinvestment. The rise of outward investment in the 1980s coincided with a peak period of American hegemony. American companies' offshoring and investing outward was facilitated by US government policies (the Department of Commerce and the Export-Import Bank) as part of the projection of American hegemony. While in Germany, the EU and Japan offshoring was generally *balanced* by inward investment and innovation, in the United States deindustrialisation and financialisation went much further (also in the United Kingdom because of its reliance on the City of London as a financial centre). Hence in the course of two decades US manufacturing exports became imports, at the expense of American jobs and growing trade and external deficits. Now that the United

States is attempting to bring about economic recovery, lagging inward investment and innovation are undermining the global competitiveness of American products, except in a few sectors (such as military industries and software). A case in point is green technologies in which US companies lag behind in every sphere, including wind turbines, solar panels, energy efficiency and bio fuels (Nederveen Pieterse 2010).

Exports have been substituted for domestic demand also in Europe:

«The solution to the problem of effective demand is seen as lying above all in a positive trade balance. ... This outlook on the part of capitalist institutions and firms ... relegates the domestic level of employment and of wages to a subordinate role compared with external expansion. Profits accruing from net exports reduce firms' dependence on a relatively small or slow-growing domestic market, and Europe's surplus countries are well aware that were it not for their export strategy domestic investment, profits and employment would be lower» (Bellefiore et al. 2011: 120).

Decoupling (emerging markets becoming independent of Western demand) has not materialised; weak growth in all the leading economies together poses a problem. Alternative markets for Asian and emerging markets' products – in Asia (ASEAN+6), East-South trade and domestic markets – are taking shape, but at a slower pace than OECD demand is falling. Thus, at this stage mercantilism poses a fundamental problem in the world economy. If all countries rely on export-led growth, who imports? Export-led growth together with steep inequality feeds the overall dynamics of overproduction- underconsumption.

Part of the quandary is dynamic financialisation unfolding on a global scale. Following the Asian crisis (1997–98) developing countries have accumulated financial reserves as a buffer against turbulence. Thus, several flows fuel financialisation on a global scale: credit expansion in import-dependent countries (especially the United States); savings, trade and financial surplus in exporting countries; developing countries' buffers to ward off financial turbulence; and developed economies' crisis management with bailouts, stimulus and «quantitative easing» (QE). QE also works as a policy of exporting inflation that has triggered higher commodity and food prices and increasing inflation risks in emerging markets. Brazil's finance minister has dubbed the policies of the US Federal Reserve a «currency war».

Financial investments in emerging markets' industries enable Western pension funds and institutional investors to secure financial returns that sustain the income of pensioners. Conversely, exporting economies' surplus and savings lent to the United States in Treasury bond purchases contribute to the financialisation of the world economy. The Chinese lending their hard-earned dollars to the United States thereby contribute to ballooning deficits in US dollars that are worth less. Thus, Chinese workers subsidise the American economy by providing low-wage labour, cheap products, treasury purchases that help keep US interest rates low and returns on investments that keep American pensioners going. Capital controls, safeguards against inflation and property bubbles, and restrictions on international finance are high on the agenda of emerging societies.

6. WELCOME TO THE MULTIPOLAR WORLD: SOCIAL POLICIES REVISITED

The 2008 crisis has ushered in a new phase in the interaction of capitalisms. The Washington Consensus survived the crises of the 1990s in tatters. In the wake of the 2008 crisis we are leaving what remains of it behind, but the question is, for what: for the Rhineland model, the German model, the East Asian model or the »Beijing consensus«? In the wake of the 2008 crisis, the question of social policies and growth is expressed in terms of different equations in each of the major zones of capitalism.

Emerging markets now drive the world economy and East Asia is widely regarded as the main »winner« in contemporary globalisation. During the period 2000–2007, which saw the fastest growth of world trade in history, Asian developing countries' ratio of exports to GDP rose from 36 per cent to 47 per cent. Thus, East Asia is in the lead, but tethered to a postbubble world economy.

East Asian developing countries' possible directions include engaging in global competition and emphasising science, innovation and design; shifting gear from price competition to quality and brand competition; or shifting from industry to services and from tradable to non-tradable goods. Going green and commodity-lite is another challenge. Replacing exports to the United States and EU with regional and South-South demand is something for the long haul. At this juncture, the risks for emerging markets and developing Asia are betting on export-led growth when global trade slows, entering global finance when Anglo-American megabanks rule and pursuing peaks while neglecting the social

base. For emerging societies, then, the trade-off is between global competitiveness and building the domestic market; too far a tilt in either direction jeopardises their balance. It is a matter of balancing peaks and valleys. Investing in peaks – science, technology, design, finance – is necessary to sustain global competition; investing in valleys (in social security, broadening access to education, reducing the need for savings, investing in agriculture and pro-consumption policies) is necessary to build domestic demand and to build or sustain democracy. Cutting dependence on exports and shifting gear from supply-driven to demand-led growth, driven by domestic consumption is essential.

This is where articulating growth models and social policies comes in. In emerging societies, social policies sustain broad effective demand and are in line with abandoning export-led growth. A social protection floor (as advocated by the ILO; see Wodsak in this volume) also tempers the effects of economic downturns. However, the continuing emphasis on global competition is an incentive to keep wages and prices low. Thus, in South Korea the central social issue is the growing dualisation between regular and irregular workers, with the latter receiving much lower pay and poorer labour conditions (Lee and Jeong 2011).

Among the BRIC and among emerging societies, China is most advanced in merging social policies with reorienting its growth path. Hu Jintao's »scientific outlook on development« and Wen Jiabao's »five imbalances« of the Chinese economy set the stage for the twelfth five-year plan (2011–2015). This aims at building broad social safety, reducing the need

for savings and thus boosting domestic consumption, reorienting the economy away from export dependence (Li 2012; Roach 2009). The aim is to eventually balance China's external accounts so China would import as much as it exports. In Wen Jiabao's words:

»We have made breakthroughs in building a social security system covering urban and rural areas. We have introduced a rural old-age insurance scheme which will cover 60 per cent of counties in China this year. The basic urban medical insurance scheme and rural cooperative medical care scheme now cover more than 90 per cent of the population« (Wen Jiabao 2011).

At issue is »shifting the development model«. For the world's second largest economy, much is at stake. Implementing this may slow growth rates and runs counter to powerful export interests, so it is a long process.

Turning to developed countries, they have been on a technological plateau for some time, as Cowen (2011) argues. The 1990s were a time of economic stagnation that was papered over by financial expansion, a period marked by overleveraging and the steep growth of inequality. The dikes broke in the 2008 crisis. The bailouts socialised bank debt, ushering in phase two of the crisis, the sovereign debt crisis. Instead of regulation there has been consolidation of the financial sector, leaving six megabanks standing in the United States.

In an age of deleveraging, when economies contract, politics stumbles. In the United States, this means political gridlock and a split Congress, as in the debt ceiling controversy. In the Eurozone, it exposes the design problems of the EU (monetary union but no alignment of fiscal policies; democratic deficit and a difficult voting

system). It also exposes the tensions between Europe's disparate economies, with Northwest Europe investing in industry, technology and infrastructure; Mediterranean Europe investing in real estate and speculative property (Spain) or extending state patronage (Greece); or the establishment of Wild West oases of finance (Iceland, Ireland).

Thomas Palley proposes a domestic demand-led strategy, along with social safety nets, raising wages, improved labour protection and collective bargaining by unions, public infrastructure investment, investing in health care and education and reforms to make taxes more progressive (Palley 2011: 5–6). But this is hardly feasible in economies in which neoliberalism is institutionally entrenched. Etzioni (2011) observes that moral capital and political capital are in limited supply, more limited than many imagine, so he argues for »policy minimalism« as a virtue. In some countries it may be a necessity. The dilemmas of balancing employment, fiscal soundness and equality (Iverson and Wren 1998) work out differently in different capitalisms. Neoliberal, social democratic and Christian Democratic societies face these dilemmas in different ways (Im 2007).

Inequality has been growing worldwide and particularly steeply in the United States and the United Kingdom. In the latter two countries, growth led by the financial sector prompts luxury consumption while the Main Street economy is slowly crumbling, producing an hourglass society. Worldwide, some 500 billionaires own as much as half the world population. As extreme capitalism produces radical inequality it gradually undermines its own sustainability. In the United States, giant corporations con-

tinue offshoring and outsourcing; financialisation continues and megabanks are the latest phase of American hegemony. The formula »billions for banks and austerity for people« has reached breaking point; witness the Occupy Wall Street (OWS) movement and the riots in England that some attribute to draconian austerity. The OWS movement is part of the globalisation of anger; impunity for white-collar crime and financial corruption has reached a tipping point. The bottom line is that countries that do not invest in the future will decline.

Social market economies that invest in manufacturing, technology, infrastructure and education may plough through the crisis; this may apply to Japan, Germany and Nordic Europe (for the latter, with the proviso that the problems of the Eurozone can be managed). They may experience less growth but with greying populations, growth is less important.

In conclusion, social policies are of crucial importance in emerging societies (to reduce dependence on exports), in developing countries (to build capacities towards inclusive development) and in the OECD to establish shared growth.

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III

INCOME DISTRIBUTION AND ECONOMIC GROWTH IN TIMES OF GLOBAL CRISIS: A MACROECONOMIC PERSPECTIVE WITH REFERENCE TO INDIA

Arun Kumar

1. THE EMERGING GLOBAL CRISIS IN 2011

Some of the rich in European countries have asked their governments to tax them more. This follows the call made by Warren Buffet in the United States that the rich should pay more taxes. The motive is self-interest: to save their economies from sliding further and going into a double-dip recession, and preventing challenges to the perpetuity of the existing model of enrichment by, for example, the kind of youth violence that has recently been witnessed in several countries in Europe. The recession looming on the horizon (if the world is not already in it) will be more difficult to deal with than in the earlier rounds. This time the cause is political rather than financial, as the case

was with the global recession that started in late 2007.

As pointed out in Kumar (2009), in 2007–2008, experts and analysts were «behind the curve» and in a state of denial about the start of the recession. The International Monetary Fund did not acknowledge the recession till late 2008, almost a year after it had started. Ben Bernanke, the head of the US Federal Reserve, only admitted problems in February 2008 when the first stimulus tranche of \$160 billion was announced. The US Treasury Secretary did not admit basic problems in the financial sector even in July 2008 when Freddie Mac and Fannie Mae, the two housing mortgage giants in the United States, faced imminent collapse.

Globally, governments facing a deep crisis were forced to boost demand using the Keynesian

device of creating deficits. The US budget deficit went from 3 per cent of GDP to 12 per cent. The same thing happened in India. China provided a \$600-billion infrastructure boost. Japan and much of Europe went in for budget deficits to boost demand in their economies. Nonetheless, globally unemployment rose sharply, as pointed out by the ILO. In the United States, it reached 9.6 per cent.¹ In India, exports, which were growing at 35 per cent in 2007, started plummeting in 2008, leading to large-scale unemployment in labour-intensive sectors, such as textiles, gems and jewellery and leather goods. Many industries and services, such as transport, finance and real estate, went into a tailspin.

The reason for the anaemic global recovery was that the stimulus was nowhere near as big as was needed to boost employment and revive economies decisively (with the exception of China). Thus, when the big economies started climbing out of the recession in early 2010, the impact on employment remained negligible.

Politics entered the picture globally soon thereafter. Conservative parties in particular in the Anglo-Saxon world started pushing the neo-classical paradigm of tax cuts for the rich and balancing the budget. The anaemic recovery was used as an excuse to argue that the Keynesian prescription to boost the economy does not work. The conservatives' programme of cutting taxes on the rich leads to a decline in tax revenue so that deficits tend to grow. But since the budget has to be balanced, expenditures have to be curtailed – the opposite of what the economy needed to climb out of the crisis. In the United Kingdom, the new Conservative government cut back budget expenditure

and proposed a reduction in public sector employment of half a million.

In the United States, after the Democrats' big losses in the 2010 elections, President Barack Obama could not push through his expenditure programme and had to reach a compromise with the Republicans. At the beginning of August 2011, the US government almost came to a grinding halt due to the logjam between the two political forces. This left the markets in a panic.

The world economy faces a deep crisis for political reasons. This is not palatable to the conservatives who once again have a grip on political power in the major economies of the world. India is no exception to this conservative mood, with the government talking about balancing the budget in stages.

2. DEFICIENT DEMAND AND CYCLES IN CAPITALIST ECONOMIES

2.1 KALECKI ON DEMAND IN CAPITALIST ECONOMIES

Kalecki (1971: 146–155) showed why demand in a capitalist economy tends to fall short in the normal course of events. He argued that capitalists are atomistic decision-makers so that their decisions to invest do not automatically equal the full employment level of investment. He criticises Luxemburg's argument that exports can help overcome internal demand deficiency by providing an additional market for capitalists. Furthermore, he negates Baranovski's argument that investment in machines for the sake of machines can generate demand and help overcome demand defi-

¹ Of all the big economies only Germany managed to stabilise its labour market due to its crisis intervention strategy involving «Kurzarbeit» (short-time working).

ciency. Kalecki argued that the external market to supplement the internal markets is created not by exports alone but by export surplus and also that investment in machines cannot increase endlessly.

He showed that the key growth impulses for a capitalist economy are investment, export surplus and government deficit. Of these, the first is limited globally by the atomistic decision-making of investors and the lack of coordination in the world for achieving the full employment level of investment globally. Regarding export surplus, one country's surplus will be another's deficit so the world as a whole cannot have a surplus. Thus, globally there cannot be a surplus and for the world as a whole no stimulus from export surplus is feasible. However, each individual government can have a budget deficit and through that each economy can work to increase demand. In open economies, demand will tend to leak to other countries but all nations can gain together. In brief, Kalecki's argument is that in times of global recession, creating demand through government deficits is a surer way than giving concessions to capitalists to invest. Given excess capacity and weak demand, the accelerator cannot act.

This prescription by Kalecki is not to the liking of capitalists since they do not like full employment (Kalecki 1971: 138–145). He points out that because of this dislike of full employment, economies now go through political business cycles and not the earlier kind of straight business cycles. The capitalists do not like increased government intervention as it has anti-capital implications.² The neo-classical ortho-

doxy reflects this, calling on the state to withdraw from the economy. This economic policy paradigm underlies the Washington Consensus³ since the 1980s and has been in operation in India as well since the launch of the New Economic Policy (NEP) in 1991 (Kelly and D'Souza 2010).

2.2 REAGANISM AND THATCHERISM SINCE THE LATE SEVENTIES, THE WASHINGTON CONSENSUS AND DEEPENING MARKETISATION

The world has been globalising for a long time, but the form it takes changes from time to time. It has been following a one-way pattern since the beginning of colonisation in 1750 (Kumar 2001: 24). Most influences have been going in one direction: from the West to the current developing world. This one-way globalisation has also gone through different phases. The latest began with Mrs Thatcher's period in office in the United Kingdom from 1979 and Ronald Reagan's Presidency from 1980. They pushed the world in the direction of marketisation. The global institutions of economic governance, such as the IMF and the World Bank, have toed this line (Kelly and D'Souza 2010).

Marketisation was also possible because of the global strategic changes for which political space opened with the weakening of the Soviet Union from the mid-1970s and the 180-degree turn in economic policy in China after Mao. The changes were also visible in the negotiating stance of the advanced capitalist countries in the GATT, which started pushing the developing world from the early 1980s to agree to the new issues: trade in agriculture, trade in services,

² A case in points is the EU debt crisis. Several big banks in the EU reacted strongly against propositions from politicians to strengthen their capital base and improve their capacity to resist the consequences of a possible default of Greece. The chair of the German Deutsche Bank even proposed to sell some of the banks asset before accepting state money.

³ John Williamson coined the term «Washington Consensus» (Williamson 2004).

TRIPS, TRIMS and so on. At the Uruguay Round of negotiations in 1986 they managed to introduce these issues into the GATT negotiations and managed to change GATT into the WTO in 1995, with all the new issues part and parcel of the new organisation.

Another significant change concerned aid. The developing countries received aid from the developed world on concessionary terms. The underlying idea was to help them to develop. From the early 1990s, this changed to capital flows at market interest rates. The developing countries had to attract capital by offering appropriate terms and concessions. The focus now shifted to FDI (foreign direct investment) and FII (foreign institutional investment) flows and the domination of multinationals.

The idea of marketisation is not just economic but also social. It has resulted in the penetration of the principles of the market into social and political institutions. People are increasingly treated as nothing more than individual instances of »homo oeconomicus«, solely determined by economic considerations of profit and loss. The social and political aspects of existence are becoming less and less relevant. People are taken to be »rational beings«, seeking to maximise gains. Even marriage or raising children are viewed in terms of individual gain and little else.

Within the framework of marketisation, economic growth is the growth of market-related human activity whether associated with human welfare or not. This has led nations to adopt the approach of »growth at any cost«. The burden of this blind growth mania has fallen on the environment and the marginalised sections of soci-

ety who have little or no voice. With this approach, distribution hardly matters and inequalities have dramatically increased throughout the world, including in the United States, Germany, South Korea, India and China.⁴ Investment is being recklessly carried on for the sake of it, without taking into account the long term. The limitations of this strategy for long-term growth due to its consequences for social welfare and growing social and political instability appear to be few people's concern today.

2.3 DISTRIBUTION, INEQUALITY AND GROWTH

As argued above, since the 1970s, income distribution has hardly been a consideration of economic policy and has led to rising inequality across the world. This affects consumption since the rich consume a much smaller proportion of their incomes than the poor do. Consequently, the consumption propensity declines, which adversely impacts investment. This results in a tendency for deficiency of demand within the economy. The economy tends to slow down unless external demand is generated, such as exports or by stimulating investment, as already discussed.

This has been visible in the case of, for example, Japan and China. Their savings rates have risen dramatically and their economies have become dependent on export markets and rapid increases in investment for maintaining growth. But the large export surpluses of both these countries have led to national and international imbalances and instabilities. Hence this kind of strategy has limitations and cannot be applied long term.

⁴ For these countries, see figures on inequality rise in the country studies in this publication.

2.4 FREE TRADE, GROWING DISPARITIES AND IMPACT ON DEMAND IN THE WORLD ECONOMY

The global economy has been under the WTO regime since 1 January 1995. As a result, competition among developing countries has increased in the sale of low and intermediate technology goods in international markets. The advanced countries maintain their monopoly over advanced technology goods and control prices. By competing with one another, the developing countries have lowered the prices of the goods they sell. Thus, the terms of trade have shifted against the developing countries and in favour of the advanced countries.

To maintain low prices, the developing countries have held back wages. The position of workers has weakened globally as international mobility of capital has enabled it to gain the upper hand. But the weakening has been even greater in the developing world. Labour has lost many of the rights it had gained through struggles since the Second World War. For instance, in India, courts have reversed some of the earlier judgments which had granted workers' rights. For instance, in call centres and the BPO (Business Process Outsourcing) sector in India, even trade unions are not allowed.

These two global trends (the monopoly on advanced technology and the weakening of workers' bargaining power) are aggravating income disparities across countries and within each country. As argued above, this is resulting in a tendency towards deficient global demand.

2.5 THE BLACK ECONOMY, GLOBAL ILLEGAL FLOWS AND INEQUALITY

Another important factor in the rising global inequalities is the growth of the black economy

in various countries and especially in the developing economies. Typically, the black economy is concentrated in the hands of the already rich, who try to increase their incomes by illegal means. They share a fraction of this, as in India, with the other elite sections of society, such as politicians, the bureaucracy, the police and the judiciary (Kumar 1999). This is at the expense of the marginalised sections of the population who constitute the majority in developing countries. Furthermore, as illegality has increased in the developing world, the size of the black economy has been growing. One effect of the growing black economy is the aggravation of inequality within countries and also across countries.

Globally, those generating such illicit («black») incomes use tax havens both to take their capital out of national territory and round-trip it back again (Baker 2005; Kumar 1999). Tax havens are also used by the corporate sector to siphon profits out of the developing countries via transfer pricing or under- and over-invoicing of exports and imports.

In India, the black economy has rapidly increased and now amounts to about 50 per cent of GDP. It is concentrated in the hands of at most 3 per cent of the population (Kumar 1999: 75–78). Thus, as the black economy has grown the income gap between the top 3 per cent on the income ladder and the rest has grown rapidly.

One result of the growing black economy is to aggravate the demand problem both nationally and globally (Kumar 2009).

3. INCREASING GLOBAL INSTABILITY SINCE THE 1970s

3.1 GROWING POLARIZATION BETWEEN SAVERS AND CONSUMERS GLOBALLY

Globally, income distribution has deteriorated in the past 40 years.⁵ Paradoxically, some countries – such as China and the group of newly industrialising countries (NIC) – have grown rapidly, narrowing the gap with the rich countries. Across nations, disparities may thus show a reduction but within nations, disparities have been on the rise. Thus, considered globally, disparities between the elite and rest appear to be growing.

This seems to be creating a global tendency for demand shortages. While for individual countries (for example, China), exports may generate additional demand, for the world as a whole exports cannot counter the demand deficiency since there cannot be a global trade surplus.

The tendency towards global demand deficiency has been countered by rising levels of investment in Asian economies and growing levels of consumption in the largest economy, the United States.

The United States has shown declining levels of savings since the mid-1980s. Its consumption levels have been driven by the wealth effect based on rising asset prices. Stock markets and other markets have risen with the result that paper wealth has increased and the rich and the middle classes who have benefited from this have been spurred to increasing levels of consumption. Consumption was also spurred by increasing availability of consumer credit. This fuelled demand in the rest of the world. Under Reagan, the United States massively increased

military expenditure, which also spurred a budget deficit and boosted global demand.

The result of the divergent national policies has been that savings and investments rates have risen in Japan, China, the NIC and India, while they have fallen in the United States. There have therefore been current account surpluses in China, Japan and the NIC, but deficits in the United States and other countries. In effect, the world has polarised between savers and consumers.

3.2 DOLLARISATION, DEMAND IN THE WORLD ECONOMY AND UNCERTAINTY

This global imbalance has been sustained since the 1980s by the dollarisation of (important parts of) the world economy. Big investors all over the world were willing to hold dollars and treasury bonds. The deficit in the US current account and budget could therefore be sustained by the return flow of capital from the surplus countries. The bulk of the rising reserves of China and Japan were in US treasury bills.

In addition to countries running a current account surplus with the United States, the outflow of dollars from the United States to Russia, the Central Asian Republics and Latin America was possible because it was considered to be stable. The dollar has become the global reserve currency – a safe currency that the rest of the world has been willing to hold. Thus, the United States could pay for its excess imports with dollars. No other country in the world could do this.

This circular flow of dollars in the world allowed the largest economy to sustain rising consumption which led to demand spillovers to the rest

⁵ For instance, see UNDP Human Development Report (2005).

of the world. This led to a demand boost in the world and also to rising investment in the export surplus economies, further boosting demand.

As already pointed out, demand globally was also fuelled by rising asset prices, including stocks, real estate and other financial instruments. These paper gains meant that people felt they were richer and spent more. However, the rise in asset prices constituted a bubble.

In brief, two kinds of instabilities were building up in the world economy: the global savings/investments imbalance between nations and the asset bubble. Both these imbalances were unsustainable over the long term. For instance, the rising exports of China and Japan could be sustained only if their currencies remained undervalued in relation to the dollar. Appropriate interventions ensured that their rising reserves did not increase the value of their currency.

The rising amount of dollars held abroad and the rising level of US treasury holdings by foreign entities was feasible only as long as faith in the US economy remained and the currency retained its status as reserve currency. Similarly, the rising asset bubble could be sustained only by its continued rise and the reinvestment of the profits made in such speculation back into the same assets. This became an increasingly unstable system over time and finally the bubble had to burst (Alternative Survey Group, 2009).⁶

3.3 NEW DEMAND PROBLEMS SINCE 2008

The crisis of 2008 changed the global macroeconomic situation. With the decline in asset prices, rising unemployment and the financial

crisis, the share of consumption in GDP in the United States declined. With rising unutilised capacity in industry, investment also declined and finally, crisis in the financial sector meant that loans were not being issued, so that small businesses found it difficult to operate. The US government reacted to the decline in private consumption by increasing its budget deficit from 3 per cent of GDP to 12 per cent (in 2008). The Federal Reserve provided a massive infusion of liquidity to shore up the financial markets and cut interest rates to almost zero to stimulate investment, but nothing worked. It was as if the economy had entered a liquidity trap. Thus, the major source of world demand, US consumption, fell.

The world over, this pattern was repeated: in the Eurozone, Japan, Britain, China and India. Demand declined despite the massive interventions by central banks and increased government deficits. Nations such as China and Japan, which had strong export surpluses, faced a decline in exports and their surpluses and this slowed down their economies further.

Currently, the Eurozone has its own sovereign debt crisis and a conservative mood prevails due to the poor performance of Europe's economies. Austerity measures have been imposed to bring debt-ridden and supposedly profligate economies into balance. This is further slowing demand and added to this is the fear of sovereign default. In brief, there is a vicious cycle of slowing demand and growing global crisis, leading to fears of double-dip recession.

Major countries facing crisis are likely to become protectionist since consensus eludes them. Furthermore, with rising fears of debt

⁶ Of course, as already pointed out, there were other reasons, too, such as the sub-prime crisis and commodity speculation, but all these were also linked to the global imbalance and growing disparities across the globe.

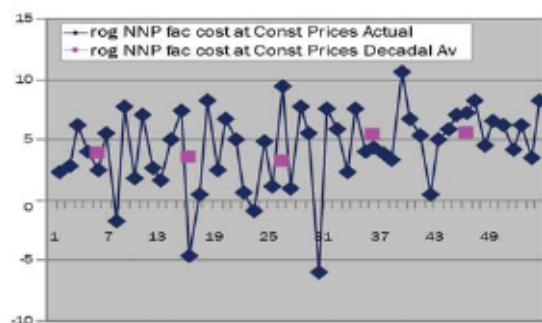
default, the financial sector is facing another crisis which will impact all the countries of the world. In this context, the Asian economies, to protect their interests, may have to depend on generating domestic demand.

4. THE INDIAN CONTEXT: RISING DISPARITIES AND INSTABILITY

The Indian economy started to open itself up strongly with the New Economic Policies (NEP) launched in 1991. While its exports and imports as a proportion of GDP in 1991 were around 7 per cent (roughly the figures for the United States, Japan and China at that time) now the numbers have risen to about 20 per cent.

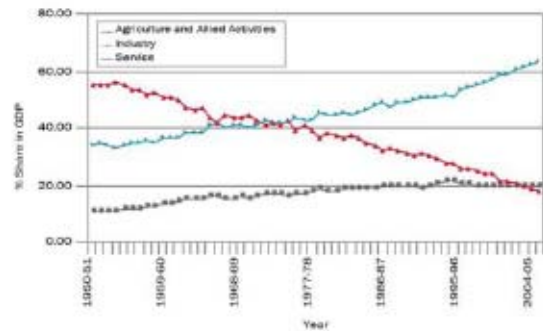
NEP led to a paradigm change in policies. While earlier the collective was taken to be responsible for the problems of individuals (such as poverty, illiteracy, health and unemployment), now the individual is held responsible for his or her problems and the state has partly retreated.

Figure 1: Annual and decadal rates of growth of national income, India, 1950/1951-2003/2004



Source: Data from Handbook of Statistics, RBI

Figure 2: Sectoral components of GDP (at 1999-2000 prices), India, 1950/1951-2008/2009



Source: Data from Handbook of Statistics, RBI

The market has taken over from the state and is playing a leading role in the growth process. This has meant giving concessions to private capital and ignoring the distributional consequences of market activities and policies.

In the 1990s, after the NEP were launched, the economic growth rate remained at roughly the same level as in the 1980s (Figure 1 shows that the rate of growth over the decade was unchanged). There has been a growing sectoral imbalance with growth dependent on the service sector whose share has risen to more than 60 per cent of GDP (see figure 2). This imbalance is based on the relatively slow growth of agriculture and rapid growth of the service sector. This is the source of rising disparities in the economy.

While agriculture still employs more than 50 per cent of the workforce, its GDP share is only 17 per cent. In contrast, the service sector employs 30 per cent of the workforce but contributes more than 60 per cent of GDP. Thus, those in agriculture are the majority but marginalised

with regard to national income. Since agriculture is concentrated in rural areas and services in urban areas, this disparity is leading to a growing urban/rural divide. Furthermore, since the backward states are predominantly agricultural, they are lagging behind the advanced states in which the service sector makes a decisive contribution. Finally, since agriculture employs largely unorganised workers there is a growing divide between the unorganised and the organised sectors.

The growing disparity is also based on the post-1991 concentration of resources in the hands of the private corporate sector which is investing in the organised sector, mainly in the advanced states. Thus, agriculture is receiving barely 2 per cent of investment (for 50 per cent of the workforce) and is lagging behind in productivity and wages. It is barely generating new jobs. In contrast, the corporate sector is investing but in capital intensive activities and is, therefore, shedding jobs in a kind of jobless growth. Consequently, overall few jobs are being generated and this is resulting in rising under-employment (Kumar 2006a).

Growing problems of employment generation and rising disparities have led to increased political and social instabilities in India. There have been violent protests against land acquisition for projects and the setting up of SEZs (Special Economic Zones). Other agitation for reservations and affirmative action has often turned violent since the government is seen as non-responsive and pro-corporations. Growing corruption has added to the government's poor image: it is seen to be working against the interests of the poor and in favour of the rich (Kumar 1999).

To improve its image, the government has been forced to go in for programmes to support the poor, such as rural employment generation (MGNREG)⁷, rights to food, rights to education, mid-day meal schemes in schools, loan waivers for poor farmers and so on. The launching of some of these schemes and increased expenditure on others coincided with the need for fiscal stimulus in 2007–2009. They pumped purchasing power into the rural areas of India and prevented demand from rapidly declining. That is why India's rate of growth fell much less than that of many other economies of the world. Furthermore, since this demand is not import-intensive, it did not leak out of the economy.

Another aspect of the rise in disparities and the black economy in India is the dramatic rise in the savings rate from 2000–2001 and a simultaneous rise in the direct tax/GDP ratio. Both these are an indication that the rich has obtained a much larger share of national income (Kumar 2007). However, as Figure 1 shows, spurts in growth in the past twenty years have been short lived. The lesson of these years is that internal demand in India has been very important. This is also likely to be the case for other developing countries.

HAS GROWTH BEEN REAL?

The rapid growth in some of the newly emerging market economies has been accompanied by large-scale destruction of the environment and hence needs to be reassessed (Kumar 2006b: 29–44). Economic growth should be accompanied by social welfare improvements, but the environmental destruction and associated pollution and climate change are leading to enormous negative consequences, especially for marginalised social groups who are least able

⁷ See Himanshu in this publication.

to cope with these changes. With climate change, cropping patterns become disturbed and lead to adverse consequences for agriculture in which the bulk of the poor are concentrated. This results in unstable food prices which, again, impacts the poor the most.

New chemicals are leading to new diseases and illnesses for which solutions do not exist and these, too, are affecting the poor the most since they are the most vulnerable. They are doing most of the hazardous jobs, such as spraying pesticides in the fields or recycling hazardous waste (computer components, ships, plastic or lead acid waste). The increased expenditure on health is sending families down the income ladder into poverty despite apparently increased incomes. Thus, such growth is not improving social welfare.

Similarly, growth is often based on destruction of assets created in the past. Factories, roads and airports are often springing up on previously productive agricultural land. Thus, new investment needs to be adjusted for the destruction of past assets. Similarly, new output from such investment needs to be adjusted for the old output that is not, as a consequence, produced. In other words, the more past assets are destroyed the less the economy is really growing. Thus, increased growth needs to be adjusted by providing for much greater depreciation.

In India, the effect of such adjustment could shave up to 25 per cent off the output and growth rate. In this sense, in much of the developing world, growth is partly spurious. Current growth is at the expense of future growth as the environment deteriorates and people's health is adversely affected.

5. CONCLUSION

The global economic problems starting in 2007 are continuing but had a brief period of respite in 2010. As we have seen, they are the result of the global imbalance in demand in the past thirty years, characterised by a divide between savers and consumers. This situation could continue for so long due to the dollarisation of the world economy and the wealth effect due to rises in asset prices driven by finance capital.

The problem of growing global imbalances was aggravated by the growing disparities within countries and across groups of countries due to the strategy of »growth at any cost« based on marketisation and growing consumerism amongst the better off. Globally, this was sustained by a shift in power towards capital and away from labour. The big changes in the former Soviet Union and China since the 1970s contributed to this shift.

Today, the world is facing the spectre of double-dip recession, with all major economies slowing down. This is affecting everyone, including China and India. How can the impact of this brewing crisis be minimised? The lesson that India offers from the period 2007–2010 is that government needs to intervene strongly in favour of the poor and the marginalised. This would generate local demand which would not leak out and would reduce inequity. Other developing countries also need to increase local demand and reduce inequalities. Clearly, increasing growth must be concentrated on the sectors that have fewer external linkages and a low possibility of demand leakage. In other words, globalisation must take a back seat to local needs. In this context, real wages must be

allowed to go up, even though that will affect exports.

It must be understood that markets do not have a solution to the current global problem since they cannot improve distribution. They have only provided higher growth rates at the expense of greater global instability and of the future. Furthermore, given the global crisis, lack of coordination among governments and a conservative mood in most advanced countries, individual governments have little control of the situation. The developing world alone cannot try to help the advanced countries come out of the crisis since, as a result, they would themselves go down. Thus, there is little choice for the developing world but to be more inward-looking and to protect its economies and especially its marginalised sectors. Today, government intervention has become the key to stable growth in the developing world.

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IV

REDUCING INEQUALITY AND PROMOTING GROWTH THROUGH A SOCIAL PROTECTION FLOOR FOR ALL

Veronika Wodsak

1. INTRODUCTION

The Social Protection Floor Initiative of the United Nations Chief Executives Board is a significant policy approach to reduce inequality and contribute to demand-led growth. Launched in April 2009 as one of nine UN initiatives in response to the financial and economic crisis, the Social Protection Floor Initiative, under the joint leadership of the International Labour Organization (ILO) and World Health Organization (WHO), has served as the catalyst for the mobilisation and coordination of expertise and resources to advocate and support governments in the development of national social protection floors (SPFs). National SPFs guarantee the population:

- A basic set of *essential social rights and transfers*, in cash and in kind, to provide a minimum income and livelihood security for poor and vulnerable people and to facilitate access to essential services, such as health care.
- Geographical and financial access to *essential services*, such as health care, water and sanitation, education, social work.

The ILO has long advocated such a basic package of social protection and in 2001 launched a related Campaign on the Extension of Social Security and Coverage for All. The International Labour Conference, at its 100th Session in June 2011, adopted a Resolution and Conclusions on social security (ILO 2011a), representing a global tripartite consensus on social security reached by governments and employers'

and workers' representatives of the ILO's 183 member states.

The Conclusions call for the extension of social security along two dimensions. Governments should aim:

- to achieve universal coverage, with at least a minimum protection floor (horizontal dimension); and
- to progressively ensure higher levels of protection guided by up-to-date ILO social security standards (vertical dimension).

The horizontal dimension should aim at the rapid implementation of national social protection floors that ensure that over the lifecycle all persons in need can afford and have access to essential health care and have income security at least at a nationally defined minimum level. Strong emphasis is being placed on the fact that a one-size-fits-all approach is not appropriate. Countries should design and implement their national social protection guarantees according to national circumstances and priorities defined with the participation of the social partners.

The Resolution and Conclusions further invite the International Labour Conference to discuss a possible Recommendation on the Social Protection Floor at its 101th Session in June 2012. Complementing the existing ILO social security standards,¹ such a Recommendation² would provide flexible but meaningful guidance to member states in building national social protection floors within comprehensive social secu-

urity systems. Guiding national social security extension strategies, such a Recommendation would also support national social, economic and employment policy strategies, and contribute to poverty reduction and the formalisation of informal employment.

2. SOCIAL PROTECTION FLOORS TO PROTECT PEOPLE AND ENSURE INCLUSIVE GROWTH

The social protection floor is a crisis management and socio-economic development concept. It creates a solid foundation for economic growth by putting people first in a sustainable development strategy.

The social protection floor concept is designed to promote guaranteed access to nationally defined baskets of essential goods, services and income transfers to ensure that people do not suffer from hunger and avoidable illnesses, do not remain uneducated, do not have to resort to unsafe water and do not remain homeless. People who have guaranteed access to a basic set of goods, services and transfers are protected from or lifted out of poverty and vulnerability and can become active citizens and more productive contributors to the economy.

The term »guarantees« implies that access to benefits is based on effective legal entitlements and that the concept is outcome-oriented but leaves maximum flexibility for national adapta-

¹ The most comprehensive ILO standard is the Social Security (Minimum Standard) Convention, 1952 (No. 102), which provides for minimum standards for all nine branches of social security with regard to coverage of the population, benefit levels, sustainability and good governance. Other social security conventions address specific issues (Equality of Treatment (Social Security) Convention, 1962 (No. 118); Employment Injury Benefits Convention, 1964 [Schedule I amended in 1980] (No. 121); Invalidity, Old-Age and Survivors' Benefits Convention, 1967 (No. 128); Medical Care and Sickness Benefits Convention, 1969 (No. 130); Maintenance of Social Security Rights Convention, 1982 (No. 157); Employment Promotion and Protection against Unemployment Convention, 1988 (No. 168), and the Maternity Protection Convention, 2000 (No. 183)). In addition, several Recommendations provide further guidance to member States.

² In contrast to Conventions, Recommendations are non-binding and cannot be ratified by member States.

tion. The level of benefits and the scope of population covered for each guarantee should be defined nationally, although the level of benefits and the actual combination of transfers in cash and in kind should not fall below a minimum that ensures access to a basic basket of food and other essential goods and services.

Defining the Floor as a coherent set of components opens up the possibility of a priority-based phased introduction in case of scarce resources without losing sight of the overall objective and the possible opportunity cost when prioritising one guarantee over another.

There are at least three good reasons why the social protection floor concept needs to be promoted: it is a (i) social, (ii) political and (iii) economic necessity. A minimum of income security is the material basis for the functioning of families and households which in turn provides the basis for social coherence, which is pivotal for the functioning of societies, states and markets.

3. A SOCIAL PROTECTION FLOOR FOR ALL AS A SOCIAL AND POLITICAL NECESSITY

There is ample evidence that national social protection systems effectively reduce poverty and inequality and thus foster social cohesion and peace, while reducing crime and instability. Social protection systems also enhance the perceived legitimacy of governments and citizens' identification with the state. Evidence comes from European countries, but also developing countries such as Brazil, Mexico and South Africa, which have already introduced elements of the social protection floor. For example, in Mexico, the poverty gap³ was reduced by 30 per cent and the headcount poverty rate⁴ by 17 per cent in the Progres/Oportunidades⁵ areas between 1997 and 1999. In Brazil, the Bolsa Família programme⁶ was found to account for 16 per cent of the recent fall in extreme poverty. Evidence from studies on the impact of basic social transfers in 30 developing countries has demonstrated not only substantial effects on poverty reduction and inequality, but also on the improvement of social development indicators such as school enrolment, health and nutritional status and child labour (ILO 2011b: 110). In some countries,

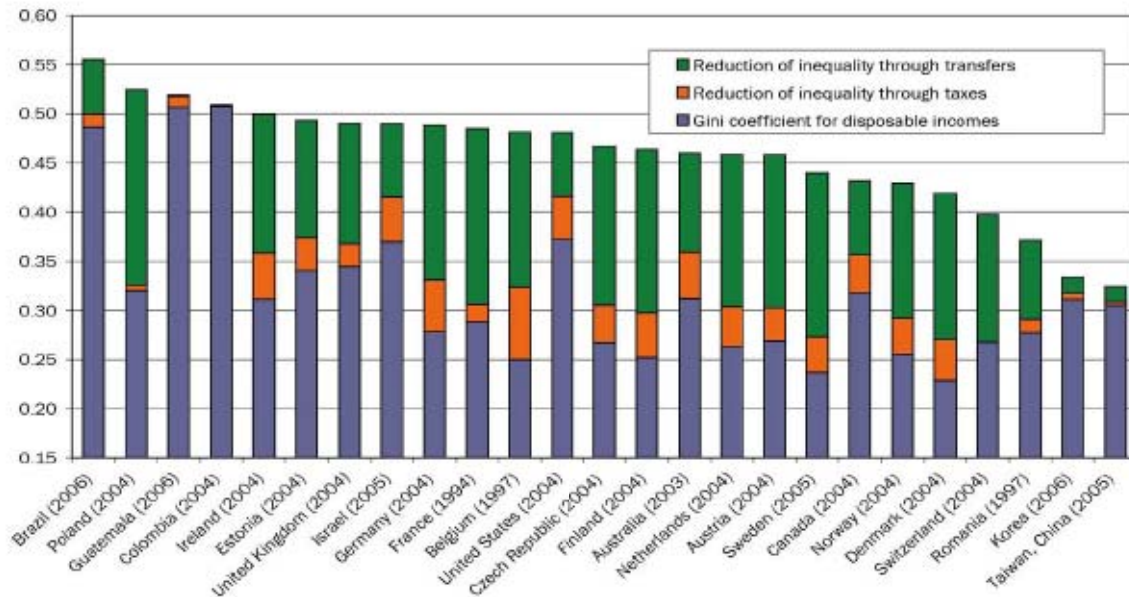
³ The poverty gap reflects the average distance of the poor population from the poverty line. This is a measure of the intensity of poverty.

⁴ Headcount poverty rate refers to the proportion of poor people among the total population, indicating how many people are poor.

⁵ Progres/Oportunidades is a conditional cash transfer for poor families launched in 1997 and continued under the name of Oportunidades since 2002. The receipt of the benefit is dependent on regular school attendance, health clinic visits and improved nutrition. In 2010, 5.8 million families, about 30 per cent of the population, received these benefits. The programme has a budget of 5.7 billion Pesos (MXN), equivalent to about US\$460 million.

⁶ The Brazilian Bolsa Família programme is one of the largest social assistance programmes in the world. In 2008, it covered 47 million people, corresponding to about one quarter of the Brazilian population, with a level of expenditure of 0.4 per cent of GDP, representing 1.8 per cent of the federal government budget. The programme aims at (a) reducing current poverty and inequality, by providing a minimum level of income for extremely poor families; and (b) to break the inter-generational transmission of poverty by making these transfers conditional on the compliance by beneficiaries with 'human development' requirements (children's school attendance, attendance at vaccination clinics, and arrangement of prenatal visits).

Figure 1: The impact of taxes and transfers on income inequality



Source: ILO 2011d.

cash transfers have also helped to promote gender equality by strengthening the social status of women in households and communities (ILO 2011c: 60). The importance of reducing inequality of transfers and of adequate tax regimes to finance the transfers is demonstrated in Figure 1.

4. A SOCIAL PROTECTION FLOOR FOR ALL IS AN ECONOMIC NECESSITY

Investment in a basic social protection floor is necessary to develop the full productive potential of a society and to achieve sustainable growth. Orthodox development and modernisation theories postulate that countries need to achieve a certain level of economic develop-

ment before they can afford to invest in their social protection systems. More recently, both the theoretical debate and also empirical evidence have shown that an initial investment in social protection may be necessary for countries to achieve economic growth (World Bank 2000: Chapter 8; Cichon and Scholz 2009).

The underlying development logic is as follows: investment in social protection will help to create a population that is sufficiently healthy, well nourished and educated to engage in entrepreneurial activities and gainful employment and to participate meaningfully in society. Ensuring that workers can realise their productive potential will allow people to escape poverty traps and migrate from the informal to the formal economy – that is, from low productivity and subsistence level activities to participation in

the economy as tax and contribution payers. As a result, the economy can grow and incomes can subsequently be taxed to finance social security systems, which can help to achieve higher levels of welfare and growth. A basic social protection floor is hence a necessary condition for a successful fight against persistent levels of low productivity and informality. Once people are in a position to enter the formal labour market, affiliated higher levels of social security provide the necessary incentives to remain in formal employment as well as the financial security that allow individuals to adapt to technological change and economic transformations through training and retraining measures.

Country experience supports this development logic of a virtuous cycle created by an initial investment in social protection and human development. In their study on the relationship between human development and economic growth, Suri et al. investigate the development patterns of 79 countries over 41 years (Suri et al. 2011). They conclude that human development and economic growth tend to move in tandem but that «there is clear evidence of a strong positive relationship between early human development levels and countries' growth trajectories, implying that promoting higher human development early on is an important element in creating an acceleration in growth» (Suri et al. 2011: 516). In terms of sequencing, they emphasise «the need for prior or at least simultaneous human development improvements to achieve above average improvements in economic growth» which «contradicts the neoclassical view that different inputs into the growth process are substitutable for investment in humans» (Suri et al. 2011: 512-513).

Of course, investment in human development is not a sufficient condition for achieving economic growth. However, some countries in the sample were able to sustain progress in human development even in the absence of economic growth while no country was able to sustain economic growth in the absence of human development. Many countries were stuck in vicious cycles of low human development and low economic growth but several countries were able to enter virtuous cycles of positive human development and economic growth. The analysis also shows that the Gini coefficient and poverty head count ratio are inversely related to economic growth, indicating that inequality and poverty can create impediments to economic development (Suri et al. 2011: 512).

More detailed analysis of individual country experiences and social transfer schemes have produced further evidence of the positive economic effects of redistribution and social protection policies, mainly related to improved risk management, investment in or protection of productive assets, access to credit, human capital development, access to labour markets as well as macroeconomic effects, such as stabilising aggregate demand during economic downturns.

In terms of improved risk management, research on low and middle incomes demonstrates that the vast majority of households are greatly affected by external shocks, such as floods or droughts, a death in the household or a serious illness. In light of the uncertainty of it and when these shocks occur, poor households often adopt risk-averse livelihood strategies and remain trapped in low risk-low return activities, forgoing potentially more profitable op-

portunities. A social protection floor that guarantees minimum income security could encourage households to take the risk of more profitable investments, guaranteeing their ability to satisfy their basic consumption needs in case of adverse outcomes. For example, farmers in India that participate in the Employment Guarantee Scheme in Maharashtra were found to invest in higher yielding varieties and fertilisers than farmers in neighbouring states not benefiting from the scheme (DFID 2011: 35).

There is vast evidence of social transfers enabling households to accumulate productive assets and avoid losing them in the face of short-term shocks. In Mexico, on average 12 per cent of transfers from Progresa/Oportunidades were invested in productive activities, such as microenterprises and agriculture, with an average rate of return of 18 per cent. In Paraguay, beneficiary households invested between 45 and 50 per cent more in agricultural production. In Zambia, the transfer scheme lifted the number of households owning goats from 8.5 per cent to 41.7 per cent (DFID 2011: 36). Cash transfers also have the potential to counterbalance market failures in capital markets. The poor are frequently highly credit constrained. In Brazil, the «Previdencia Rural» social pension programme allows beneficiaries to access loans from banks by showing their pension enrolment card, leading to an increase in entrepreneurship.

Studies showing improved school enrolment rates and access to health services abound. However, the evidence on outcomes in terms of improved learning and health status is more mixed, showing the need to invest also in quality of services and the importance of careful

benefit design (Fiszbein 2009). While the discussion of social transfer schemes in traditional welfare states in Europe is dominated by concerns about creating disincentives for labour market participation through social assistance programmes, evidence from middle and low income countries shows that social transfers create access to labour markets by allowing poor households to cover the cost of job seeking. In Brazil and South Africa, households receiving cash transfers looked for work significantly more extensively and intensively and found employment more successfully, resulting in higher labour force participation among recipient households (Samson 2009: 134).

Finally, the recent crisis has shown dramatically that countries with social protection systems were much better able to deal with the adverse social and economic consequences of the crisis. Unemployment benefits and job retention policies enabled countries to maintain a certain level of aggregate demand and to move more quickly into recovery. Low-income households spend relatively high proportions of their income on domestic foods and services, hence an increase in their income favours domestic production (Behrendt et al. 2011).

5. CONCLUSION

Overall, it cannot be expected that global society will be able to reap the potential benefits of globalising markets without providing a minimum of social returns in the form of higher levels of social protection. Otherwise, people might not accept the inevitable new levels of insecurity that structural change causes in the global production system and, consequently, labour

markets. The increased interconnectedness of globalised markets makes economic and financial crises more contagious and reduces individual capacities to cope with the related risks. As a result, there is a need for strengthened national, regional and global frameworks to protect people from external shocks, as well as lifecycle risks. The most important innovations in providing this protection effectively to as many people as possible – including workers in the informal economy – have recently been developed in emerging economies. Brazil, India, China, Korea, Thailand, South Africa, Mexico and Argentina have shown that building a national social protection floor – or elements thereof – is technically and financially feasible if the political will is there.

Increasingly, low-income countries are following these examples and Ghana, Zambia, Mozambique, Nepal and Rwanda, among others, are developing their own versions of conditional cash transfers, employment guarantee schemes, social pensions or health insurance schemes. The discussion of an ILO Recommendation on Social Protection Floors during the International Labour Conference in 2012 will provide timely input and guidance for these countries in progressively building national social protection floors. The concept has likewise met with great enthusiasm internationally: the small group of UN agencies, UN Regional Commissions and Bretton Woods institutions that signed up at the launch of the Initiative in April 2009, has developed into a broad coalition of members, including UN agencies, donor governments, NGOs, development banks, regional

partners (Asia, Africa and Latin and Central America) and other partners, including the International Trade Union Confederation (ITUC) to support countries in their endeavours to build national social protection floors.

A key point of debate has been the question of the affordability of such social protection policies. This contribution has argued that the cost of social protection floors is in fact an investment and not merely an item of expenditure in the government budget. Social protection floors as part of wider social security systems are a key contribution to promoting inclusive growth, fostering transitions from low productivity and subsistence level activities to more productive decent jobs and creating positive synergies with employment, financial and economic policies. At the same time, social unrest in some parts of the world shows that failing to curb unacceptable levels of poverty and inequality may also be extremely costly. However, it is equally evident that a sustainable social protection system is not possible without ensuring a sufficient level of financial resources. Low and middle income countries face particular challenges in finding and extending fiscal space for the extension of social security. However, experiences from various countries show that the progressive extension of national social protection floors within wider social security systems is possible, even in countries with tight fiscal constraints.⁷

⁷ Cost projections conducted by the ILO and others have demonstrated that the progressive development of national social protection floors is possible even in low income countries. For example, ILO costing studies estimated the cost of a basic social protection package (excluding health care) for 12 African and Asian countries at 2.2–5.7 per cent of GDP (ILO, 2008). UNICEF (2009) estimated the cost of various options of child benefits and social pensions for five West and Central African countries. WHO estimates show that the cost of ensuring access to key health services in 2015 would be about US\$60 per capita for low-income countries on average, and that the cost of scaling up health coverage would average around 0.8 per cent of GDP of low-income countries in East Asia and the Pacific (WHO 2010a, 2010b).

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V

INCOME DISTRIBUTION IN CHINA: PROBLEMS, CAUSES AND POLICY CHOICES

Li Shi

1. INTRODUCTION

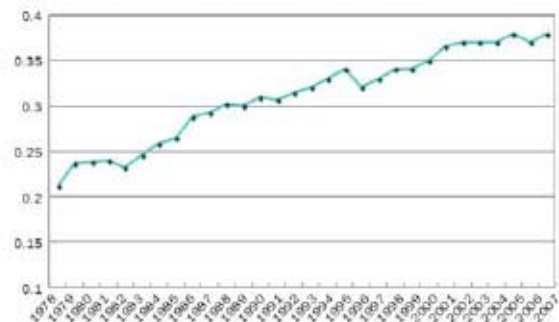
In this analysis of income distribution in China I first discuss some general trends in the development of income inequality. I give some basic facts, such as the extent of income inequality in China. There are several explanations for the widening income gap, one being economic growth. I also discuss significant drivers of income inequality and the major problems of income distribution in China. Finally, I touch on policies to address the income gap and unfair distribution.

2. GENERAL TRENDS IN INCOME INEQUALITY

Here I discuss three aspects: income inequality in rural China, income inequality in urban China

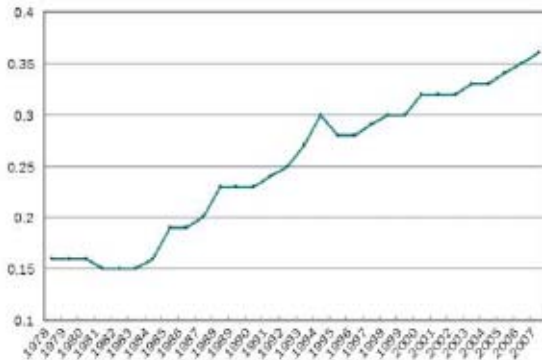
and income inequality in the country as a whole. First, let us look at income inequality in rural areas. Since China's adoption of the reform and opening-up policy after 1978, the income gap in rural China has been widening. In the initial stages, the rural Gini coefficient stood

Figure 1: Income inequality in rural China



Source: Zhang 2010.

Figure 2: Income gap development in urban China



Source: Zhang 2010.

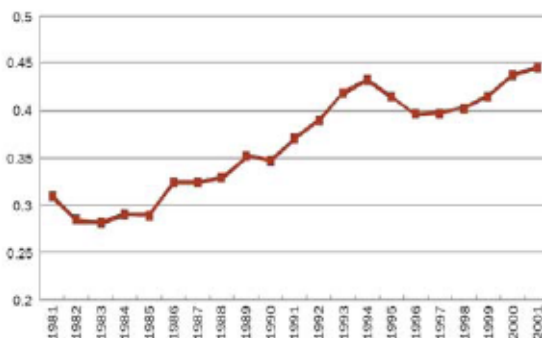
at approximately 0.22, rising gradually to around 0.38 in 2007 (see Figure 1).

With regard to income inequality in urban China, in the initial stage of reform and opening up, the Gini coefficient stood around 0.15, which was fairly narrow compared to many other countries. However, since the mid-1980s, the income gap in urban China has been rising steadily: by 2007 the Gini coefficient had reached 0.36 (see Figure 2). Many people believe that this figure underestimates inequality, however, because it is more difficult for a sam-

ple household survey to acquire information on the high-income population. As a result, there is insufficient representation of that group in the sample, leading to an underestimate of the urban income gap. After corrections over the sampling bias, the Gini coefficient in urban China climbs up 5–6 percentage points to around 0.42.

Concerning income inequality at the national level, Figure 3, which is a World Bank estimation based on rural and urban survey samples provided by the National Statistical Bureau of China, shows changes in the income gap at the national level between 1981 and 2001. The Gini coefficients were 0.30 in 1981 and 0.28 in 1982, but 0.45 in 2001. Since 2001 there have been few authoritative estimates. We estimate, on the basis of the latest data, that the Gini coefficient in 2007 was around 0.48. This estimate is fairly reliable and is often quoted in the media and research reports. In our estimation, we considered various variables and made adjustments to the sample in accordance with regional differences in living standards and weighting.

Figure 3: Gini coefficient at the national level



Source: Ravallion & Chen 2004.

3. LINKS BETWEEN INCOME INEQUALITY AND ECONOMIC DEVELOPMENT – NO CONFIRMATION OF KUZNETS'S HYPOTHESIS

The data seem to indicate that the income gap has been widening in China as the economy grows, but does economic growth result in a widening income gap? According to Simon Kuznets's hypothesis, economic inequality increases over time as a country develops until a

critical income level is attained, after which inequality begins to decrease. In other words, there is an inverted U-shaped relationship between income gap and economic growth. Some scholars believe that it will take another ten years or so for the critical income level to be attained in China, and that the deteriorating economic inequality is driven largely by economic growth. We tried to verify the hypothesis empirically to see whether it can explain income gap movements in China. According to this hypothesis, the income gap could be represented by the Gini coefficient, while the latter's relationship with income level, the square of the income level and some other related variables

can be expressed as follows:

$$I_i = b_0 + b_1 \log Y_i + b_2 (\log Y_i)^2 + b_3 \text{Unem}_i + b_4 \text{MIGR}_i + b_5 \text{MIGR}_i^2 + b_6 \text{MYR}_i + e_i$$

(I_i = Gini coefficient of the i th region (country), Y_i = income of the i th region (country), Unem_i = unemployment rate, MIGR_i = percentage of migrant population, MYR_i = ratio between the income of the migrant population and the income of the local population)

We used the abovementioned formula to carry out an empirical verification of the inverted U-shaped curve hypothesis. By drawing on data from the 2005 China 1% Population Sample

Table 1: Empirical verification of Kuznets's hypothesis

Dependent variable: Gini coefficient	Model 1	Model 2	Model 3	Model 4	Model 5
b_0	2.20*** (3.28)	0.95* (1.70)	2.04*** (3.06)	0.75 (1.35)	4.205*** (-3.57)
b_1	-0.54*** (-2.72)	-0.25 (-1.53)	-0.48** (-2.38)	-0.17 (-1.05)	-1.19*** (-3.57)
b_2	0.04*** (2.70)	0.02* (1.89)	0.03** (2.22)	0.02 (1.25)	0.09*** (3.67)
b_3		0.79*** (12.86)		0.79*** (13.15)	0.78*** (13.0)
b_4			0.18*** (3.30)	0.16*** (3.56)	0.20*** (4.43)
b_5			-0.19** (2.41)	-0.15** (2.32)	-0.20*** (-3.07)
b_6					0.02** (2.55)
Adj-R ²	0.016	0.336	0.049	0.369	0.401
Sample size	344	344	344	344	342

Notes: ***, **, * indicate, respectively, that the figure is statistically significant on the 1%, 5%, and 10% levels.

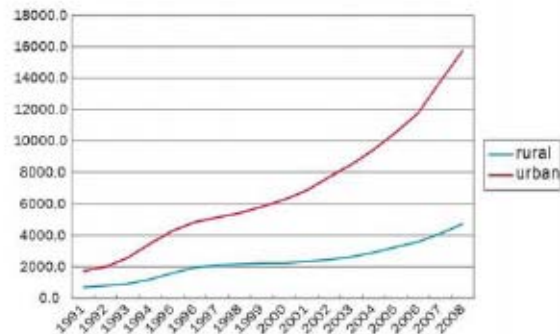
Source: Li & Li 2010.

Survey, we calculated the variables included in the formula of over 300 cities to create city-specific profiles. Then we compared the income levels of cities to see whether there is an inverted U-shaped relationship between income level and income gap, and whether income gaps widened before narrowing down. Our data showed that the hypothesis does not apply. Instead of widening before narrowing down, income gaps narrowed before widening up (see Table 1). We also found that urban unemployment had a significant impact on income gaps: that is, the higher unemployment is, the larger the income gap, regardless of the control variables we introduced.

4. CAUSES OF THE INCREASE IN INCOME INEQUALITY

There are a number of issues specific to China that help to explain the development of income inequality in China. For example, the urban-rural income gap reflects, to a large extent, problems in the system, policies and public services. The urban-rural income gap reflects differences in the levels of public services in urban and rural areas, as well as differences in the development strategies in urban and rural areas. The widening income gap also reflects the gap between monopolistic industries and competitive industries. It also indicates that the current tax regime has largely failed to adjust income distribution. There are also inequities in education.

Figure 4: Urban-rural income gap movements in China (absolute gap)



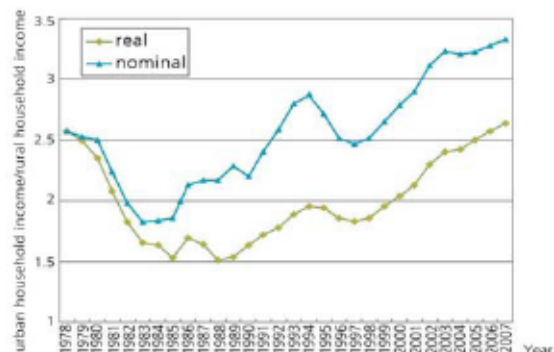
Source: Data on average income of urban and rural residents in *China Statistics Digest 2010*.

4.1 THE URBAN-RURAL DIMENSION

In this section we shall look at a number of causes of the widening income gap. For example, the urban-rural income gap in China has been widening since the 1990s. Figure 4 shows that the average absolute urban-rural income gap rose from about 900 Yuan in the early 1990s to about 11,000 Yuan in 2008.

Turning to the relative urban-rural income gap (Figure 5). There is a similarly substantial gap here and it has been widening since the mid-1990s. Various measures show that it reached

Figure 5: Income differentials between urban and rural households, 1978-2007



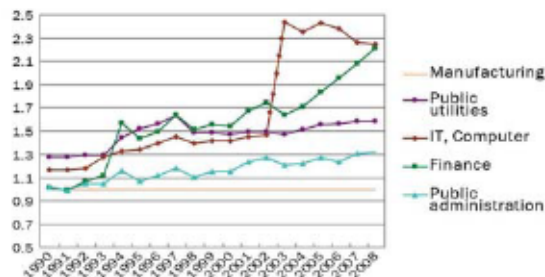
Source: Data on average income of urban and rural residents in *China Statistics Digest 2010*.

historical highs in 2007 and 2008. The urban-rural income gap dominated the income gap at the national level: decomposition analysis shows that the urban-rural income gap explains 37 per cent of the national income gap in 1988, 41 per cent in 1995 and 51 per cent in 2007. It is clearly an important factor.

4.2 MONOPOLISTIC VS. COMPETITIVE SECTORS

The income gap between sectors – mainly between monopolistic and competitive sectors – is also widening. In the early 1990s, there was a modest 30 per cent income differential between such monopolistic sectors as power, telecommunications, banking and financial services, and sectors based on competition, such as manufacturing. In other words, in 1990, the average wage in the power sector was 30 per cent higher than in manufacturing, while the average wage of the financial sector almost equaled that of manufacturing (see Figure 6). However, by 2008 the differential had risen to 200 or 300 per cent or even more. If we break down the sectors, we find that the highest average income (in monopolistic sectors) is over ten times higher than the lowest (in competitive

Figure 6: Wage differentials between monopolistic and competitive sectors



Source: Data on average income of urban and rural residents in China Statistics Digest 2010.

sectors). Some argue that greater human capital in monopolistic sectors leads to higher wages. However, our analysis shows that the factor of human capital could explain only one-third of the income gap, and the rest is attributed to a monopolistic position and subsequent supernormal profits.

4.3 TAXATION

Adjustment of incomes through taxation is also problematic in China. In many other countries, taxation – especially personal income tax – corrects income distribution and reduces inequality. But this is not the case in China. Instead of progressive taxation China applies regressive taxation and the tax rates for the poor are higher than for the rich: in other words, the tax rate decreases as income increases, which contributes to the widening income gap. Rural China is no exception. Especially in the 1990s, the tax burden was very high in rural areas: the tax rate for the bottom 10 per cent of the income population was 14 per cent, while for the top 10 per cent of earners it was only 3 per cent (Sato, Li and Yue 2008). Although in recent years, thanks to the gradual removal of agricultural tax, the situation has improved, it should be recognised that for a long time, the heavy tax burden in rural China contributed to the widening income gap. If we calculate the rural Gini coefficients for pre-tax and after-tax income separately at the end of the 1990s, we find that the latter is greater than the former (Sato, Li and Yue 2008). That is to say, the regressive nature of China’s taxation widens the income gap.

4.4 EDUCATION

Another important cause of the widening income gap is inequality of access to education.

Individual rates of return to education in China, and in urban China in particular, have been rising steadily in the past 20 years, which is quite natural as a market economy develops. The rate for urban China, which stood at less than 3 per cent in the early 1990s and 8 per cent in 2002, is 10 per cent at present. The rising rate of return to education certainly widens the income gap between highly-educated and less-educated people. However, as the extent of the rate of return on education expands, more people will enjoy equal access to education, which will to a certain extent offset the income gap widening effect brought about by the rising rate of return to education. Therefore, we took equal access to education into account in our research by calculating the years of education average citizens receive in different time periods. Calculations revealed that for a long time there was no improvement in equal access to education. For example, the number of years of education barely changed between 1995 and 2002. At the same time, we must note the increasingly apparent difference in the quality of education received by different segments of the population. In particular, the quality of compulsory education differs greatly from urban areas to rural areas, which is a major reason why the percentage of rural children going to college is now declining.

4.5 INCOME MOBILITY

There has been less income mobility in recent years than in the 1990s. Income for various social strata has stabilised, making it highly likely that a poor person this year will still be poor in ten years' time; the same applies to a rich person. With less income mobility the poor lose hope of a better future, leading to major social instability.

5. POLICIES TO TACKLE INCOME INEQUALITY

Income distribution in China should be addressed in a holistic manner, not by a single policy. A comprehensive set of policies for income distribution and redistribution is required to tackle income gaps and distribution inequality. There could be several categories of income distribution policy. The first category would deal with primary distribution. There are many policy options here, such as minimum wages, wage bargaining mechanisms and higher prices for farm produce. The latter are necessary because in the past 30 years, farm produce price hikes have narrowed the urban-rural income gap as well as the income gap within rural China on a number of occasions. The negative impact on urban residents could be mitigated by subsidies and similar policies.

A second policy category should aim at improving the quantity and quality of employment, so that wages could grow faster and subsequently the income gap could be narrowed. Job creation is a top priority, but improving the quality of workers is even more important. Low-skilled and unskilled workers, especially migrant workers from rural areas, should be provided with more training to enable them to compete better in the job market and obtain higher pay.

Policies should also be adopted to develop our mode of economic growth, inject more mobility into the labour market and eliminate discrimination against migrant workers and female workers. Competition should be introduced in monopolistic sectors. Income in monopolistic sectors is higher than that in many competitive sectors mainly because monopolistic sectors reap supernormal profits. It will be impossible to contain rapid wage increases in monopolistic

sectors if they are allowed to maintain their monopolistic position.

There are several issues concerning income redistribution. For one thing, personal income taxation should be reformed. The current practice of levying itemised income tax rather than composite income tax has limited impact on income adjustment. Moreover, a property tax and an inheritance tax should be introduced. Transfer payments to the low-income population, especially those in rural areas, should be strengthened. The social security system should be improved. More efforts should be made towards poverty reduction. Transfer payments to less developed regions should help to improve the quality of education there.

It should be noted that the policies suggested above may not be enough. Another phenomenon affecting income distribution in China is corruption. Therefore, further policies are called for. (i) We need policies to strengthen the surveillance of personal income, because at present the tax and statistical authorities leave much to desire with regard to the supervision of the high-income population. (ii) We also need a better tax regime: why is the tax rate for the high-income population lower than that of the low-income population? (iii) We need policies to keep government power in check. It is very important for government officials to declare their income and property, but despite assurances going back many years this is still not done. At present, government officials are required to report their income internally, not to the general public, which is not effective enough in curbing corruption and under-the-table income. Furthermore, reforms are needed in the pricing of resources and land use. All the

above-mentioned reforms and measures will help to address the widening of the income gap and of income inequality.

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VI

THE TWELFTH FIVE-YEAR PLAN IN CHINA: A NEW GROWTH MODEL ORIENTED TOWARDS POPULAR PROSPERITY

Chi Fulin

1. INTRODUCTION

A wide-ranging discussion is under way in China on the need to change the economic growth model from one driven by exports and investments to one led by consumption. The key to this pursuit of demand-driven economic growth lies in macroeconomic stability in the short term and sustainable development in the long term. It is critical to China's economy and reform process that it realise the transition from investment-driven to consumption-driven growth in the course of the Twelfth Five-Year Plan.

China is standing at a crossroads. It must switch its emphasis from transforming production and economic growth to transforming the structure of the economy and stimulating con-

sumption. This will be the major economic issue throughout the period of the Twelfth Five-Year Plan (2011–2015). The reform process will, for a second time, be of historic significance.

2. DEVELOPMENT TO INCREASE POPULAR PROSPERITY

A pre-eminent problem characterising China's economic development in recent years has been the steady decline of consumption despite rapid GDP growth. This is caused by our current model of government-led economic growth which aims at increasing GDP and the «wealth of the nation» and allows national production to grow faster than people's purchasing power. This model is also responsible for the widening

income gap. China needs to strike out on a new growth path, focused more on expanding household income than on expanding GDP: in other words, there should be more emphasis on the wealth of the people than on the wealth of the nation.

2.1 NATIONAL PROSPERITY AND DISPOSABLE INCOME

In recent years, GDP has been growing faster than per capita income. During the Eleventh Five-Year Plan period (2006–2010), China's GDP growth averaged 11.2 per cent a year, while the per capita disposable income of urban dwellers grew by 9.7 per cent per annum. Per capita income growth during the Twelfth Five-Year Plan period (2011–2015), although the highest in history, lags far behind GDP growth.

Fiscal revenue growth has outpaced GDP growth. In 2010, China's fiscal revenue grew by 20.88 per cent, while GDP grew by 10.3 per cent.

State-owned capital has also been expanding faster than GDP. Between 2005 and 2009, total assets of state-owned enterprises grew from RMB 25.4 trillion to RMB 53.5 trillion, averaging 20.5 per cent growth per year, outpacing both GDP growth and the expansion of private capital.

The government controls large quantities of resources and dominates economic growth.

2.2 UNRESOLVED CONFLICTS UNDER THE CURRENT DEVELOPMENT MODEL

In order to grow economic output rapidly and to address general poverty, China adopted the

model of prioritising the creation of more wealth for the nation. Given the shortage economy at the time, this was the right choice. Today, however, this model confronts unresolved conflicts:

Over-emphasis on economic output at the expense of balanced socio-economic development. The economy as a whole and fiscal strength have been developed continuously and rapidly. Social development lags behind and social conflict is simmering.

Over-emphasis on investment and exports at the expense of consumption. Consumption has been declining steadily and there is an obsession with investment. Despite the rapid economic growth in the past decade or so, the consumption rate is still falling. In 1978, China's national consumption rate stood at 62.1 per cent of GDP. In 2008, it dropped to 48.6 per cent, the lowest since China began its reform and opening up process. Household consumption has decreased more dramatically, from 48.8 per cent in 1978 to a historical low of 35.3 per cent in 2008. A mere 8 per cent of the latter came from the 700 million Chinese farmers.

The over-emphasis on investment in exports leads to an oversupply of money, which affects macroeconomic stability. Statistics show that money stock in China exceeds USD\$10 trillion, or double GDP. This underlies the macroeconomic fluctuations.

Economic growth driven by investment and export depends heavily on external markets and is vulnerable to external market fluctuations. In 2009, China's total imports and exports amounted to RMB 15 trillion, or 43.66 per cent of GDP.

Over-emphasis on the heavy chemical industry at the expense of a balanced industrial structure. Economic growth depends too much on investment in the heavy chemical industry. In 2009, new investment in this industry accounted for 46.6 per cent of new urban fixed-asset investment.

The share of the service industry in the economy has remained low. For a long time it has hovered around 40 per cent – the highest it has ever attained was 43.36 per cent in 2009 – which is 10 per cent lower than that in medium-income countries (53 per cent in 2008) or the average of low-income countries in 2000 (44 per cent).

Unbalanced income distribution. The share of primary distribution that goes to businesses and the government in China has risen from 16 per cent in the mid-1990s to above 20 per cent at present. Households' share has been declining steadily (from 65 per cent in the mid-1990s to below 60 per cent at present).

In 2009, China ranked ninety-ninth in the world in terms of per capita GDP, but one-hundred-and-fifty-eighth in terms of the minimum wage out of 183 countries and regions (Liu 2011). This unbalanced income distribution is one of the main reasons why consumption is not driving growth and why the income gap has widened.

2.3 TOWARDS A NEW DEVELOPMENT MODEL

The need to address socio-economic imbalance. If priority is given to household wealth, people will have more income and there will be more household spending on education, health care and housing, thereby enabling China to

pursue a more balanced path of socio-economic development.

The need to address overinvestment. The greatest challenge to the current development model is that production is growing faster than household consumption. If priority is given to household wealth, people will consume more, demand will go up and economic growth will be driven not only by exports and investment, but also by consumption, and therefore China's will be able to grow sustainably.

The need to address structural imbalances in industry. The most striking example of this is the low share of services in the economy. If priority is given to household wealth, consumer spending will flow into services and the imbalance will be corrected. For example, low consumption has severely hampered the leisure industry. If people are able to spend more on leisure and entertainment – and if the industry caters to people's needs better – value added from the leisure industry could probably grow from its current 2.5 per cent to more than 5 per cent.

The need to address the income distribution imbalance. More income for households will correct the current imbalance in income distribution.

In December 1990, Deng Xiaoping remarked: «We've been talking about common prosperity from day one of our reform. It will one day become a central issue» (Deng 1990: 364) In September 1993, he declared: «How to attain prosperity and how to distribute wealth when prosperity comes are big issues. These issues have emerged already. To address them will be even more challenging than to address develop-

ment issues» (Deng 1993). Transition and reform geared to household wealth has become a central theme in China today. Shifting focus from the wealth of the nation to the wealth of the people represents a strategic repositioning with regard to China's development. The emphasis should be switched from GDP growth to household income growth, so that people's aspirations can be satisfied. The Twelfth Five-year Plan (2011–2015) stresses a rational approach to development, reflecting both internal and external developments.

3. THE TWELFTH FIVE-YEAR PLAN: FROM INVESTMENT TO CONSUMPTION

The consumption rate is not only an indicator of the extent to which household wealth is prioritised and people enjoy a high living standard, but also a key to equitable and sustainable development. In the next five years, major changes will happen with regard to China's demand structure: first and foremost, demand will be driven more by consumption than by investment and exports, as in the past. Therefore, the preliminary transition from an investment to a consumption focus will be the key to the transition of China's economic growth model in the course of the Twelfth Five-year Plan.

3.1 IMBALANCE BETWEEN INVESTMENT AND CONSUMPTION

Reform of income distribution is lagging behind, constraining the purchasing power of the medium-to-low-income population. The development of public services is also not what it should be, forcing people to pay high prices for

education, health care and other things out of their own pockets, thereby leaving them less to spend less on private goods. Although during the Eleventh Five-year Plan period (2006–2010), total retail sales of consumer goods grew by an average 18.1 per cent a year, investment grew even faster, forcing the consumption rate down. The consumption rate has gone up in the past couple of years, but real consumption growth is falling again. People are still reluctant to spend. According to a survey of depositors carried out by the People's Bank of China in the first quarter of 2011, the willingness to spend of urban residents has fallen to its lowest level since the survey started in 1999. With the consumption rate declining, growth depends even more on investment and exports, thereby reinforcing the old growth model and aggravating the conflicts in our economy.

3.2 POLICY ADJUSTMENTS TO STIMULATE CONSUMPTION

With proper policies and reform, it would be possible for China to transition from investment-driven growth to consumption-driven growth during the period of the Twelfth Five-year Plan: in other words, in five years' time, the consumption rate could go up from 48 per cent to 55 per cent, and the household consumption rate could rise from 35 per cent to 45 per cent.

Enhance household purchasing power. The low real income level constrains household spending. The share of wage income in total income in China fell from 51.2 per cent in 1994 to 39.7 per cent in 2007. It is unusual for such a decline to continue for more than ten successive years.

Improve households' propensity to consume. For historical reasons public services in China have some way to go before they start to meet people's needs satisfactorily, although in recent years the government has made outstanding efforts to improving equal access to public services. As a result, people remain insecure with regard to their material situation and marginal consumption has fallen.

Improve the consumption structure. China's consumption structure is poised for a major change. Development-related demand is growing rapidly. Children's education expenditure is already one-third of household income in many medium-to-large cities; housing needs are urgent, but there is a supply shortage. Consequently, if we want to enhance household consumption expectations, increase household consumption and improve the consumption structure, we must guarantee basic public services to meet people's rising demand.

Optimise the consumption environment. In recent years, food scares have been frequent and the consumption environment generally has deteriorated considerably, which has adversely affected consumer confidence. Businesses should exercise more self-discipline. More importantly, supervision should be improved.

3.3 POLICY RECOMMENDATIONS TO STIMULATE CONSUMPTION

It is important to carry out reforms during the Twelfth Five-year Plan to stimulate household consumption. Policy recommendations include:

Income distribution reform scheme. This scheme should be introduced as soon as possible before the end of 2012. The public have high expectations, and it will be critical to stimulate consumption. We suggest that the authori-

ties concerned solicit public opinion and develop a concept for reforming income distribution within a year.

The share of wage income in total income in China has fallen to a critical low point. Wage bargaining between workers and employers should be further improved, aiming at a higher share of wage income in total income and minimum wage standards.

Targets should be set with regard to the urban-rural income gap and the industry-related income gap, as well as expansion of the share of the middle-income population.

There should be further regulation of income distribution, including measures to deal with under-the-table income and to make fiscal budgeting and the administration of state-owned assets more transparent, so as to lay a solid foundation for medium- to long-term income distribution adjustments.

Equal access to public services in urban and rural areas. Equal access should be available at a basic level during the Twelfth Five-year Plan. Since the Eleventh Five-year Plan (2006–2010), central government has increased spending on public services. Some provinces, such as Guangdong, have announced timetables for providing equal access to basic public services. The Twelfth Five-year Plan clearly states the goal of establishing and improving basic public services. Overall, this goal is attainable. It will help change consumption expectations and mitigate social conflicts.

The national plan for providing equal access to basic public services during the period of the Twelfth Five-year Plan should come out before the end of 2012.

The respective responsibilities of central and local government in providing equal access to basic public services should be clarified and there should be further increases in spending on basic public services. We estimate that RMB 15–20 trillion is needed from central and local government to reach this goal within five years.

Reforms in education and health care, including public hospitals, should be accelerated.

Public institutions require urgent reform so that they can serve the public better. Since public institutions are the major providers of public services, their reform should be aligned with the establishment of basic public services.

Migrant workers should be granted the status of urban residents. The process of turning migrant workers from rural areas into urban residents should be accelerated. The government work report of 2011 clearly stated that «migrant workers from rural areas who have stable employment and who have lived in urban areas for a designated number of years should be turned into urban residents step by step» (Government Work Report 2011). Headway has been made in the Yangtze River Delta, the Pearl River Delta, Chongqing and some other regions. Breakthroughs are expected in two to three years' time. There is a good opportunity to address this issue during the Twelfth Five-year Plan. We suggest that a national action plan should be issued as soon as possible to facilitate breakthroughs, which will be essential to stimulating consumption, narrowing the income gap, resolving social conflicts and promoting urban–rural integration.

Nationwide policies governing rural migrant workers' access to basic public services should

be promulgated at the earliest possible time, so that wherever they work they can enjoy basic public services similar to those enjoyed by local residents.

An effort should be made to include rural migrant workers in the urban housing support system. Part of government revenue from land use rights should be used to provide basic housing for rural migrant workers.

Development of the basic housing support system in urban areas should be stepped up. According to the government work report, in 2011, 10 million affordable housing units will be either built or refurbished in urban areas, and 1.5 million dilapidated houses in rural areas will be refurbished. During the period of the Twelfth Five-year Plan, the coverage of basic housing in urban areas will reach around 20 per cent. As commercial housing prices are fairly high right now, building more affordable housing would not only stimulate domestic consumption and speed up the transformation of the economic growth model, but also improve people's lives and maintain social stability.

When building basic housing, clear targets should be set for land use, government spending and so on. Supervision should also be strengthened. Measures should be taken to prevent the misappropriation of basic housing and the social tensions that would arise as a result. Research should be carried out with a view to establishing rules on the administration and supervision of basic housing.

4. MEDIUM-TO-LONG-TERM TRANSITION AND REFORM TO STIMULATE CONSUMPTION

When addressing the imbalance between investment and consumption and stimulating household consumption, some urgent issues must be resolved immediately, while other, more fundamental issues may require more consideration.

4.1 TAX SYSTEM REFORM TO STIMULATE CONSUMPTION

At the macro level, the current tax burden is too heavy and tax reform is proceeding too slowly to stimulate demand or speed up the transformation of the growth model. The current tax system, the result of the 1994 tax distribution reform, has been effective in increasing economic output, but not in adjusting income distribution. In order to prioritise household income, the tax system should play an important role in adjusting income distribution. We suggest that a new round of tax reform geared to boosting household income be carried out in the first two years of the Twelfth Five-year Plan. Tax distribution between central and local government should be aligned to the provision of equal access to basic public services. Hopefully by the end of the Twelfth Five-year Plan, governments at all levels will have fiscal resources commensurate with their responsibilities.

4.2 ALLOCATION OF STATE-OWNED RESOURCES

Previous reform of state-owned capital was guided by selective entry or exit.¹ During the Eleventh Five-year Plan, state-owned capital encroached upon competitive sectors of the economy, and state-owned monopolistic sec-

tors grew faster as a proportion of GDP. This is not conducive to improving people's lives: it crowds out the private sector, widens the income gap and makes it even more difficult to reform monopolistic industries.

The scarcity of public goods has replaced the scarcity of private goods as an outstanding problem in China's socio-economic development. State-owned resources should no longer be solely devoted to GDP growth. Part of them should be allocated to public services. During the first two years of the Twelfth Five-year Plan, well-grounded reform plans to further optimise the allocation of state-owned assets should be promulgated. At the same time, state-owned monopolistic sectors should be asked to pay more rent or dividends to the government to supplement spending on basic public services.

4.3 EDUCATION, HEALTH CARE AND LEISURE

The government should dominate these markets. However, in order to attract private investment and to better serve diverse needs for public services, we suggest that these markets be opened up to some extent. Market access should be made easier to expand supply from businesses and social organisations. The government should promote the establishment of a diversified supply system for basic public services by such measures as public service outsourcing. Pilot studies should be carried out in regions with the right conditions favouring the opening up of education, health care and leisure.

¹ State capital should be withdrawn from ordinary, competitive industries and injected into key industries that are central to the national economy.

4.4 ADMINISTRATIVE REFORM TO TRANSFORM GOVERNMENT

During the Eleventh Five-year Plan, progress was made with administrative reform, but there is still a long way to go before it can fully facilitate the transition towards a growth model driven by domestic demand and consumption.

First, the government's presence in the economy has grown and the role of the market in resource allocation has been weakened. This underlies the imbalance between investment and consumption. Second, reforms of market regulation, supervision and the circulation of goods are far from satisfactory. This has also contributed to the deterioration of the consumption environment. Third, the government is increasingly self-interested. Administrative costs have increased despite austerity efforts, which has adversely affected the imbalance in income distribution.

More rapid administrative reform is key to the transformation of the growth model and all other reforms. We recommend the following:

- (1) Accelerate the establishment of a system in which central and local government share responsibility for public services. The accountability of local government to central government should also be enhanced.
- (2) Implement resolutions passed at the Second Plenary Session of the Seventeenth CPC Central Committee and strive to set up a system of checks and balances between decision-making, implementation and supervision.
- (3) The government should improve its functioning, make substantial progress in reforming the use of official cars and cut administrative expenditure so that the public can have more confidence in administrative reform.

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VII

DECLINING INCOME INEQUALITY IN BRAZIL

Marcelo Neri

1. INTRODUCTION

Monitoring Brazilian inequality up to the beginning of the past decade was somewhat monotonous; it was like a constant of nature. Since 2001, however, inequality as measured by the Gini coefficient has fallen every year. This chapter analyses the evolution of poverty and inequality in Brazil in the past 10 years.

The main questions addressed in this chapter are as follows:

- What happened to poverty and inequality in Brazil during the 2000s?
- How did personal income distribution develop?
- Who has benefited most from economic growth?

- Is the reduction in income inequality linked to a general increase in welfare?
- Why did these changes occur?
- What role was played by education and labour market outcomes?

Answers to these questions matter not only for identifying the causes of change, but also for assessing the sustainability of income redistribution.

2. METHODOLOGY AND SCOPE OF ANALYSIS

Examination of inequality trends over the long, medium, short and very short terms requires the use of complementary databases. Popula-

tion statistics are obtained from the study by the IBGE (Brazilian Institute of Statistics) on the 2010 Demographic Census, with some data from the 1960 Census and others from the 1872 survey.¹ The data from the national household survey PNAD (Pesquisa Nacional de Amostras a Domicílio) are the main source for the analysis of income in Brazil, because it is conducted every year, contains a multitude of questions and, above all, the income questionnaire has remained constant since 1992. However, there were no PNAD surveys in the key years 1994, 2000 and 2010, which are crucial years for differentiating between the presidencies of Fernando Henrique Cardoso (1994–2002), Lula (2002–2010) and Dilma Rousseff (since 2011).

To fill in these gaps, the PNAD data are complemented with data from the monthly PME surveys (Pesquisa Mensal do Emprego). PME surveys are more restricted in their geographical coverage and use a different concept of income. PMEs collect data on labour income only in the six main metropolitan areas. Labour income, however, accounts for 75 per cent of people's income and the inequality that characterises it corresponds almost exactly to overall income inequality. To make PME and PNAD data comparable, the PNAD data, which are collected during the month of September, are compared to September data taken from the PME monthly surveys.

In using microdata from various household surveys, our analysis assesses the evolution of income distribution *lato senso*, including inequality and average income, as well as poverty.

Besides looking at vertical inequality – which covers the entire population – we look at horizontal inequality by assessing the income differences between various segments of Brazilian society, such as men and women, the illiterate and college students, black, brown or white people, urban and rural residence and so on.

Furthermore, what explains the differences in the mean income of these segments? Is income inequality linked to income arising from the state (such as transfer payments) or income from work? To what extent are income and inequality related to the labour market, unemployment and participation rates, working hours and demographic changes or express inequality of education between groups?

3. IS THE END OF POVERTY IN SIGHT?

The reduction of poverty² in Brazil during the period 1994–2010 was significant. The country underwent social transformation under both the Fernando Henrique Cardoso (1 January 1995 to 31 December 2002) and the Luis Inácio Lula da Silva governments (1 January 2003 to 31 December 2010). The Brazil of 2010 looks quite different from that of 1994.

Linking the beginning of the Cardoso period to its later years creates some difficulties as Brazil faced hyperinflation that ended with the introduction of the real as the new currency on 1 July 1994, during the presidency of Itamar Franco, when Fernando Henrique Cardoso was Minister of Finance.

¹ Brazil has conducted a periodical population census since 1872.

² The definition of poverty developed by Ferreira, Lanjouw and Neri (2003) and by the Center for Social Policies at Fundação Getúlio Vargas (CPS/FGV) is used here. It incorporates updated regional differences in costs of living that affect purchasing power. The income threshold for access to Bolsa Família in 2011 is BRL 137 (Brazilian real) per family per month, which is relatively close to the CPS/FGV regionally adjusted poverty line.

Comparing the September 1993 or 1994 PME data with the first PNAD income data collection in 1995 ignores seasonal factors and does not fully reflect the distributional impact of hyperinflation and the introduction of the real during these months.³

The biggest poverty decrease between 1993 and 1995 – 13.9 per cent – happened under Fernando Henrique Cardoso's government. This was followed by a period of international crisis during which poverty fell a further 7 per cent until the end of the Cardoso era, a 21 per cent decrease overall. If we calculate from the time the real was introduced (July 1994) until 2002, there was a 31.9 per cent decrease.

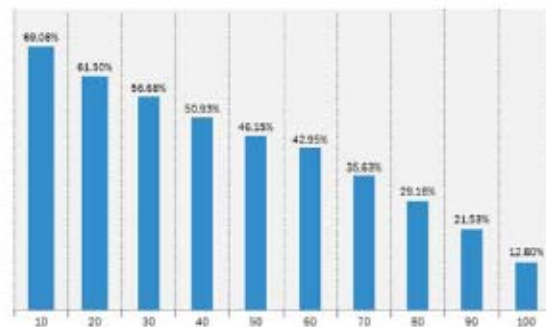
In order to assess the impact of Lula's government on poverty, we have to take the PME results from December 2002 to December 2009 – in accordance with which poverty decreased by 50.64 per cent – and add the findings of the PNAD surveys. Combining PME and PNAD results, poverty decreased by 51.9 per cent during the Lula era.⁴

4. THE MIRROR OF INEQUALITY

The 2000s can be referred to as the decade of falling inequality. After 2001, inequality as measured by the Gini coefficient decreased every year.

If we take per capita household income as measured by the PNAD, and group the house-

Figure 1: Variation in per capita average income, Brazil (Income deciles; PNAD 2009/2001)



Source: CPS/FGV based on microdata from PNAD/IBGE.

holds into deciles according to size of income and compare the changes in income over the years, we get a clear picture of the reduction of inequality. Between 2001 and 2009⁵, the per capita income of the 10 per cent poorest households increased by 69.08 per cent, whereas the income of the 10 per cent wealthiest people increased by only 12.8 per cent (see Figure 1).

If we compare income changes among the five poorest deciles with the top decile we find that between 2001 and 2009 the income of the poorest half of the population grew 311 per cent more than the slice of the 10 per cent wealthiest (52.59 per cent growth vs. 12.80 per cent). This is an intuitive measure of inequality evolution.

If we add the results of the monthly PMEs for December 2000–September 2001 and September 2009–December 2010 to the PNAD

³ According to PME data, poverty increased by 6.6 per cent from September 1993 to September 1994 and by 16.9 per cent from September 1994 to September 1995. If we incorporate the instant reduction effect imposed by the introduction of the real, in the form of an »inflation tax« that particularly affected the poor, poverty increased by as much as 22 per cent between September 1994 and September 1995.

⁴ It should be pointed out that the UN's first millennium goal of reducing poverty by 50 per cent in 25 years (between 1990 and 2015) was accomplished in Brazil in eight years.

⁵ PNAD did not make field trips in the census years 2000 and 2010. Therefore, PNAD data only allow us to know what happened in the other eight years of the decade.

data – which cover only September 2001 to September 2009 – we obtain an understanding of the changes in inequality for the whole decade. The series completed by PME data shows that for the whole decade 2000–2010 the accrued income growth rate for the 10 per cent wealthiest stood at 10.03 per cent, while for the 50 per cent poorest it was 67.93 per cent. The growth rate of the latter was 577 per cent higher than that of the 10 per cent wealthiest. With these different growth rates, the gap in average income between the two groups – an inequality measure – fell from a factor of 18.12 in December 2000 to one of 9.76 in December 2010.

How does income inequality development in the first decade of 2000 compare with previous decades? We have studies on income inequality in Brazil going back half a century. They started with the 1960 Census, the first representative household survey to ask direct questions about income. The data from the 1960 Census cannot be used directly as it is impossible to deduce per capita income from the in-

come of each household. Because of such limitations, we compare changes in different measures. The concept Carlos Langoni used in his seminal work in 1973 (Langoni, 1973) was individual income. Langoni's work is still surprisingly up-to-date, in terms of both methodology and conclusions,⁶ if they are inverted to cover the most recent data.

Figure 2 depicts the development of the Gini coefficient between 1960 and 2010. During the first decade (1960–1970) the 10 per cent wealthiest people saw their income increase by 66.87 per cent, while that of the poorest half increased by a mere 15.26 per cent. Remarkably, this is just the opposite of the development in the most recent decade (2000–2010): here, a similar income increase of 67.93 per cent accrued to the 50 per cent poorest people, while the top 10 per cent experienced only 10.03 per cent growth. At the end of the past decade, inequality development stood where it had been half a century beforehand.

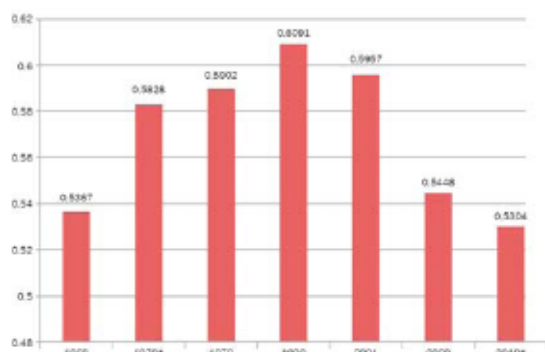
5. MOVING AWAY FROM THE PAST: INEQUALITY BETWEEN GROUPS

According to PNAD data, per capita income in real terms increased by 23.7 per cent between 2001 and 2009. If we net out the effects of inflation and population growth, Brazil's average growth performance was far from spectacular.

Using average per capita income, however, hides as much as it reveals, for two reasons:

- (1) it attaches statistically more weight to changes in the higher income brackets. The income of the 10 per cent poorest in Brazil in-

Figure 2: Long-term perspective on Inequality (Gini coefficient)



Note: * PME and Census/IBGE and Langoni 1973.

Source: CPS/FGV based on microdata from PNAD.

⁶ I had an opportunity to comment on this in the Preface to the third edition of Langoni's book, published by Fundação Getúlio Vargas in 2005.

creased by 69.08 per cent during this period. The gain slowly becomes smaller and smaller as we get closer to the top of the distribution, reaching 12.8 per cent for the 10 per cent richest. This growth rate of the rich is closer to the average than that of the poor.

(2) The concept of household per capita income eliminates, by definition, existing inequality among members of a household. For instance, it is assumed that, within a household, if the wife earns less than the husband, her loss will be offset by her husband's gain. When looking at per capita income, inequality between women and men is underestimated, as is inequality between any other groups or segments of society.

To get a better understanding of inequality in its horizontal dimension, we can compare per capita income of various groups with each other for 2001 and 2009.

Gender: female per capita real income grew by 38 per cent from 2001 to 2009. This is substantially higher than the growth of male income, which was only 16 per cent. The income ratio was reduced from 0.49 (in other words, women's income was 49 per cent of male income) to 0.58.

Ethnicity: the real income of those who identify themselves as black or *pardo* (official term for people of mixed African and Caucasian origin) increased by 43.1 per cent and 48.5 per cent, respectively, compared to an increase of 20.1 per cent in white people's income. The income ratio between Afro-Brazilian and Caucasian people improved from 0.53 to 0.62.

Education: the real income of those with no formal education increased by 46.7 per cent

against a 17.5 per cent decrease for those who had at least started college. In the case of households headed by an illiterate person, income increased by 53.5 per cent in comparison to a 9 per cent decrease for those with 12 or more years of formal education. Even though the gap in income between these two groups remains high, this opposing trend has reduced the income ratio from 0.1 to 0.17.

Territorial: income in the Northeast region of Brazil increased 41.8 per cent, compared to 15.8 per cent in the Southeast. The income ratios between the two regions increased from 0.43 to 0.53. In Maranhão, initially the poorest state, income increased by 46.8 per cent compared to São Paulo, initially the wealthiest state, which increased by 7.2 per cent. In Sergipe, income increased by 58 per cent.

Looking at the provincial capitals, the highest growth rate was recorded in Teresina, (56.2 per cent), whereas the winner among Brazilian metropolitan suburbs was Fortaleza (52.3 per cent). In contrast, income in the capital and suburbs of São Paulo metropolitan area increased by only 2.3 per cent and 13.1 per cent, respectively. This pattern, with the suburbs⁷ growing more than the capital, was observed in seven out of Brazil's nine great metropolitan areas. Likewise, income increased more in the poorer countryside areas (49.1 per cent), compared to the metropolitan areas (16 per cent) and in the remaining cities (26.8 per cent). Economic sectors performing above average include those in which the poorest work, such as domestic services, agriculture and construction.

Overall, the income of traditionally marginalised groups, such as Afro-Brazilians, illiterate people,

⁷ It should be added that, in Brazil, the «suburbs» (*periferias*) house poorer people rather than the well-to-do, as in some other countries.

women and people from the Northeast, as well as those living in the suburbs of larger cities, the countryside and building sites increased above average in the twenty-first century. This trend contrasts with what we see in developed countries or the other BRIC countries, where inequality is visibly increasing. More than as a country of the future entering the new millennium, Brazil – the last country in the Western world to abolish slavery – should be seen as a country beginning to set itself free from the heritage of the past.

6. REDUCING INCOME INEQUALITY: POLICIES AND INSTRUMENTS

What policies helped to reduce income inequality? In identifying factors in the reduction of income inequality we shall look at both non-labour income and labour income.

Regarding non-labour income, particular attention must be paid to incomes directly affected by social policies, such as social security benefits and other non-labour income, including cash transfers from social programmes and capital income.

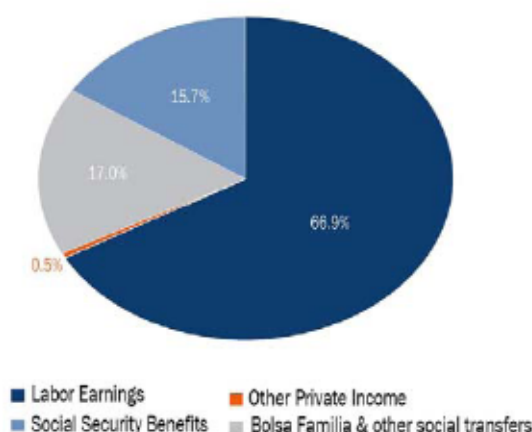
Social security is the main component of social income in Brazil, and second only to labour earnings among all income sources collected by PNAD. In 2008, it amounted to 19,64 per cent of all income sources. Social security benefits include a contributory Pay-as-You-Go old-age pension system and non-contributory benefits, both subject to discretionary income policies. Today, Brazil has the highest transfers of income to the elderly relative to GDP in Latin America. One key policy variable is the progres-

sive differentiation of social security adjustments, which means that higher income groups receive lower real gains.

Concerning the short-term aspect of fighting inequality, there is in Brazil a new generation of social policies which are better focused on and more capable of redistributing income than the policies implemented in the past. This includes state-sponsored income transfer policies such as 'Bolsa Família' and minimum wage adjustments. However, the problem is that Brazil maintains other, less effective official income transfer policies within the framework of its efforts to tackle inequality and to improve welfare. The government has opted to expand both new and old, targeted and less targeted policies.

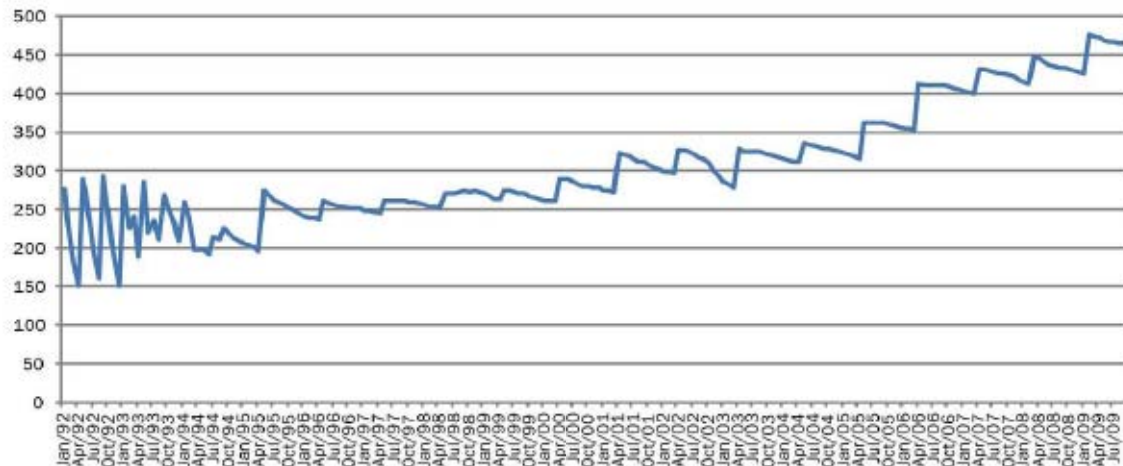
How was inequality reduced? With regard to the 2001–2008 period, using a methodology to decompose Gini variations into different income sources, we find that 66.86 per cent of the re-

Figure 3: Contribution of Income sources to the reduction in Inequality (Gini), Brazil, 2001–2008



Source: CPS/FGV based on microdata from PNAD/IBGE.

Figure 4: Real minimum wage trends since 1992, Brazil



Source: Labour Ministry & INPC/IBGE.

duction in inequality in that period is due to changes in labour incomes, followed by social programmes, especially Bolsa Família, Bolsa Escola and other social transfers (non-social security-related), with 17 per cent (see Figure 3). Then follow social security benefits with 15.7 per cent, with remaining incomes accounting for only 1 per cent.

From this analysis we can also calculate the differences in the cost-benefit rate between the two sets of programmes. While both policies had similar effects on the reduction of inequality, the effects of funding through public expenditure differed greatly. Public financing of Bolsa Família and other transfer programmes was 4–5 times lower than payments through social security schemes. This means that the additional cost for the fiscal budget of each percentage point that inequality fell was 384.4 per cent more expensive for social security benefits compared to Bolsa Família and other social transfers in 2001–2008.

The labour market provides the main means of reducing income inequality. This is due to various reasons, such as expanding employment, moving labour from informal to formal employment and reducing inequality within labour by increasing minimum wages (see Figure 4).

Neri (1997) shows that minimum wage rises had a major impact on labour market-based poverty and inequality measures in the mid-1990s. However, as minimum wage increases progressed these effects faded away (Neri 1997). The most important contribution of minimum wage increases in Brazil was their effect on non-labour income through the linkage to social security contributions.

7. CONCLUSIONS: SUSTAINABLE INCLUSIVE GROWTH?

Two Nobel prize winners for economics, Joseph Stiglitz and Amartya Sen, together with J.P. Fitoussi led a high-level commission appointed by

the President of France. The report has been published as a book, entitled *Mismeasuring Our Lives*. We can apply its main conclusions to recent developments in Brazil (Neri 2012).

GDP versus PNAD. The Stiglitz/Sen/Fitoussi report emphasises the need to improve the methods of measuring economic performance. Indicators based on GDP should be complemented by the income and household consumption approach to gauge average material living standards. While in the long term the evolution of aggregates such as GDP encompassing national accounts and income from the Brazilian National Household Survey (PNAD) may present similar tendencies, they diverged from one another significantly between 2003 and 2009, when PNAD's average income increased by 11.3 percentage points above GDP. This indicates that average living standards were improving more than GDP suggests. As the Stiglitz/Sen/Fitoussi report points out, in most other countries the opposite happened: their respective PNADs indicate lower growth than that of GDP.

Sustainability. Asset inventories and environmental considerations must be incorporated in the analysis to take into account the sustainability of performance indicators over time. Only then can we know whether current welfare levels can be maintained for the next generations. Environmental variables are outside the scope of this chapter, but one sustainability indicator based on data collected by PNAD should be mentioned. While public social transfers, such as social security benefits and the Family Grant (Bolsa Família) are significant factors in the income growth of the poor, the growth in education and formal employment (although still very

precarious) is comparably more relevant in explaining the ongoing transformations, suggesting sustainability in the growth process.

Inclusion. Income, consumption and wealth measurements must be accompanied by indicators reflecting their distribution. In a country such as Brazil – sometimes nicknamed Belindia (a combination of Belgium and India) – such considerations are essential, because averages hide more than they reveal. From 2001 to 2009, real per capita income growth, according to PNAD, was 69 per cent for the 10 per cent poorest people, and decreased monotonically as we approached the 10 per cent wealthiest people, to 12.8 per cent. This is a spectacular growth rate for the poor, 577 per cent higher than for the top decile. Brazil has experienced Chinese growth rates but only for the poor. In developed countries such as the United States or the United Kingdom, or emerging countries such as China and India, we observe the opposite: inequality is on the rise.

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VIII

INCOME DISTRIBUTION AND GROWTH: THE CASE OF MEXICO*

Rolando Cordera Campos

1. FROM THE »MEXICAN MIRACLE« TO STRUCTURAL ADJUSTMENT

Mexico's experience of growth and the distribution of wealth and income could serve as a case study on the »dissonances« of development. Thanks to the rapid and sustained economic growth that took place between the 1930s and the early 1980s, the country was able to cope with mass poverty and the acute income and wealth concentration that had accompanied its evolution since independence from Spain at the beginning of the nineteenth century. Redistribution occurred during the period, after a fashion, and general living standards improved significantly. The population and urbanisation also increased at a high rate.

These were the years of the so-called »Mexican miracle«, characterised by a development strategy based on stability implemented for almost twenty years from the mid-1950s to the end of the 1960s. These were also the years of »state-led industrialisation« that were declared at an end during the initial phases of the great international debt crisis that Mexico inaugurated in 1982.

The »Mexican miracle« was followed by a deep economic crisis, when the country attempted draconian external adjustment, suffered a severe decline in incomes and growth rates and at the end of the 1980s implemented a full overhaul of its whole political economy through an ambitious plan for structural change that eased Mexico's rapid insertion in the new con-

* In collaboration with Nahely Ortiz.

text of globalisation after the end of the Cold War and the collapse of the Soviet system.

Mexico underwent a «great transformation» from state-led industrialisation, with trade protection and generalised subsidies, to an export-led growth strategy. This pattern was and still is regulated by NAFTA and many other free trade agreements. In less than two decades, Mexico became a significant exporter of manufactured goods, mainly cars, auto parts and electronic equipment, which permitted the country to leave behind its image as a quasi-mono oil exporter. Notwithstanding these achievements, almost half of total exports are still basically produced under the old «maquila» regime, with a very low degree of domestic value added and no significant interlinkage with the domestic economy. There is still little correspondence between the remarkable growth in the export sector and the general rates of income and employment in the rest of the economy.

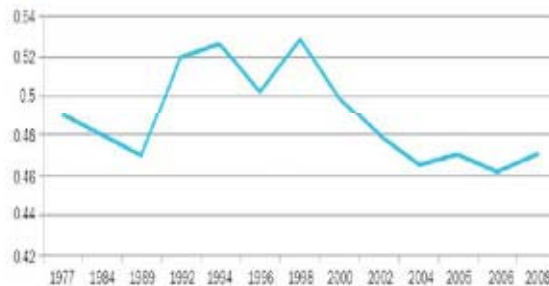
In the past thirty years, Mexico has transformed its entire political and economic system. Most of it has been the outcome of explicit revisions of previous development strategies for the purpose of easing entry into globalisation, mainly through trade liberalisation and privatisation of state-owned enterprises. The globalising strategy was accompanied by new social policies to deal with the harsh new social demands and challenges produced by the economic crises of the 1980s. It defined the Mexican «end of the century» and of the Mexican revolutionary cycle. The distribution question was not part of the new development agenda. Many changes took place, some of them radical and hopeful. But none of them, either alone or taken together, tackled the high economic inequality that has accompanied México's development.¹

2. INEQUALITY AND POVERTY

Mexico has a very skewed income distribution. Among the OECD countries, Mexico – with a Gini coefficient of 0.48 – is ranked second lowest, just ahead of Chile (0.5) (OECD 2011).

Figure 1 provides an overview of the distribution of monetary income between 1977 to 2008. Over the whole period, the Gini coefficient fluctuated within a narrow range between 0.46 and 0.53, showing a strong tendency towards stagnation at a very high level of inequality. The minor ups and downs

Figure 1: Gini coefficient, Mexico, 1977–2008



Source: Mexico National Institute of Statistics and Geography (INEGI).

reflect differences in the development model. The early years after 1977 were still part of the «Mexican miracle» when state-led industrialisation provided employment growth and secured wage development in the formal sector. The increase in the Gini coefficient thereafter corresponds to the shift to an export-led economy, in which low wages became the determinant of a higher share of export markets. From around 2000, public social expenditure on health care and education increased and social security spending on very poor households was higher.

¹ Baron von Humboldt described the Kingdom of New Spain in 1803 as «the land of inequality».

Table 1: Percentage share of money income by decile, Mexico, 1977–2008

Decile	1977	1984	1989	1992	1994	1996	1998	2000	2002	2004	2005	2006	2008
I	1	1.4	1.1	1	1	1.1	0.9	1.1	1.3	1.2	1.1	1.4	1.2
II	2	2.5	2.3	2.1	2.1	2.3	2	2.1	2.4	2.6	2.5	2.6	2.4
III	2.9	3.6	3.3	3.1	3	3.2	3	3.1	3.4	3.6	3.4	3.6	3.4
IV	4	4.6	4.4	4	3.9	4.1	4	4.1	4.4	4.5	4.4	4.5	4.4
V	5.2	5.8	5.5	5.1	4.9	5.2	5.2	5.2	5.5	5.6	5.6	5.6	5.5
VI	6.6	7.3	6.7	6.3	6.2	6.5	6.5	6.6	6.8	6.9	6.9	6.9	6.9
VII	8.5	9.2	8.5	8.1	8	8.2	8.2	8.3	8.5	8.6	8.6	8.5	8.7
VIII	11.6	12	11	10.8	10.5	10.9	10.9	10.8	11.1	11.1	11	10.9	11.2
IX	17.1	16.8	15.6	15.9	15.6	15.6	16	15.9	16.1	15.9	15.8	15.8	15.9
X	41.2	36.8	41.6	43.6	44.7	42.8	43.3	42.7	40.5	39.9	40.7	40.1	40.3

Source: Mexico National Institute of Statistics and Geography (INEGI).

Table 1 confirms the picture of a high level of income concentration by listing the relative share of money income for different households grouped in deciles. While there were some changes in the relative shares of poor and rich households in, for example, 1984 and 2004, the dominant trend is one of stagnation. The 10 per cent poorest households have less than 1.5 per cent of total income, while the 10 per cent richest households have more than 40 per cent of it.

The latest report by the United Nations Development Programme (UNDP) on the Human Development Index (HDI) in Mexico is a good summary of Mexico's social situation and its prospects after more than twenty years of structural market reforms (PNUD 2011: 43).

The HDI, which combines the three indicators on health, education and income, climbed from 0.742 in 2000 to 0.758 in 2008, indicating an improvement in social living standards and a reduction in inequality. However, from 2006 to

2008 the Index fell slightly, from 0.759 to 0.758, which implies no further progress thereafter.

The Income Index (which differs from the Gini coefficient) has had a similar evolution: in 2000 it stood at 0.714 and improved to 0.731 in 2006. In 2008, however, it fell back to 0.716, thus eroding the progress made in previous years.

The improvement of living standards between 2000 and 2006 is linked to expenditure on health and education, which registered steady increases due to the sustained growth of public social expenditure and growing conditional transfers to relieve extreme poverty. However, it is very difficult to associate these increases with an effective and lasting improvement in the general living conditions of the majority of Mexicans. We have to take into account that most of the basic needs of Mexican households are satisfied through the market and that within the system of policy setting and administration

of public expenditure strong mechanisms operate against significant redistribution from above.

The Report also states that the gap between the bottom and the top of the social pyramid has diminished in the past ten years: the richest 10 per cent of families had an HDI which was 49 per cent higher than that of the poorest in 2000. In 2008, this difference was reduced to 40 per cent. This reduction is basically explained again by significant increases in public social expenditure on health and basic education. However, the index for monetary income did not improve but actually fell in 2008, returning to 2000 levels, indicating no significant redistribution of income to the poorest segments of society.

POVERTY

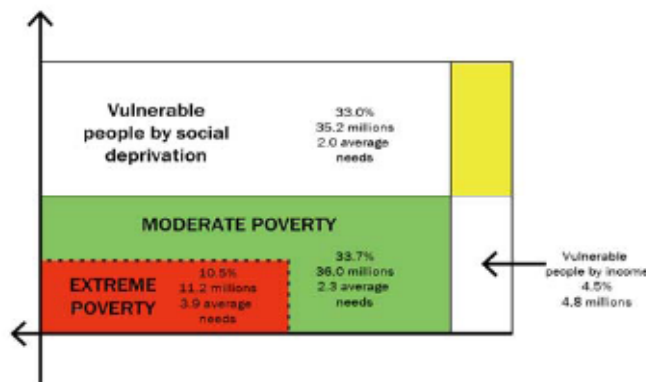
In Mexico, high inequality is combined with large segments of the population living in abject poverty. Recent data from the National Council for the Evaluation of Social Development Policy (CONEVAL 2011:1) report that approximately

52 million Mexicans lived in poverty, and about 20 million suffered from food poverty. Of the total population, 47.4 per cent did not have the income necessary to meet their basic needs.

3. LOW WAGES AND A WEAK DOMESTIC MARKET

Key reasons for poverty and inequality include the structure of the Mexican labour market and labour remuneration. The labour market is divided almost half and half between the informal and the formal sectors. The former lacks any kind of social and even legal protection, is highly precarious and on average reports very low income levels. In the latter, however, workers have access to social security and labour contracts, pensions, fringe benefits and so on. However, average wages have practically remained stagnant, registering only minor increases in real terms in recent years, while the minimum real wage has experienced a severe decrease since the 1980s. The combined effect of these trends resulted in the reduction of the wage share in GDP and consequently a very low rate of growth of consumer demand, which makes up between 70 per cent and 80 per cent of the domestic economy. The export-led growth model established at the end of the twentieth century turned the Mexican economy into a very vulnerable mechanism strongly dependent on the international cycle and especially the United States. With the global financial crisis, the fragility of the domestic market became evident and left the whole economy without internal defences. The immediate outcome was

Figure 2: Multidimensional poverty in Mexico, 2008



Source: CONEVAL 2011.

a drastic decline in the level of total output of about 6 per cent in 2009.

Economic growth from domestic markets is not likely without improvements in income distribution. The dependence on global markets alone can produce low rates of increase in total output, precarious and insecure employment and acute external vulnerability.

4. DEMOGRAPHIC CHANGE AND NO JOBS FOR YOUNG PEOPLE

Mexico is undergoing a demographic transformation into a country of young adults, in contrast to the «country of children» which it was in the second half of the twentieth century. This demographic transition is accompanied by a strong trend towards urbanisation. The population is concentrated in large metropolises and medium-sized cities, although a considerable proportion of the population still lives spread out in small rural villages, which poses a serious obstacle to social and development policies.

Urbanisation and demographic change are further influences on a labour market already suffering from the inability of a stagnant economy to provide the employment required by the new labour force. Neither the economy nor the state have been ready or able to generate the surpluses needed to improve and enlarge secondary and higher education. The population of young people neither in work nor studying (known as «Neets» in the United Kingdom: «not in education, employment or training») has turned into a time bomb that overshadows current political structures and threatens the sta-

bility of the whole social fabric that came into being with Mexico's structural change at the end of the twentieth century implemented to accelerate participation in globalisation.

Mexico is a poor country, but with a formidable stock of young people of working age and with more formal education than their parents. Its population is aging and without adequate funds for retirement, but there is the potential to substantially increase the occupied labour force, which would increase the necessary resources.

If things go on as they are, without an adequate institutional infrastructure and with a public health system that is scarcely prepared to cope with the accumulation of new needs brought about by demographic aging, Mexico's future could be summarised as follows: transition from being a poor but young country, to a poor but old one, and without even minimum protection for the majority.

5. CONCLUSIONS

Mexico needs to address the institutional reconstruction of the state and to develop and promote new forms of social protection, moving towards a universalist regime based on fundamental welfare rights. It must also obtain from its population the political and social support necessary for a strategy of growth recovery and productive expansion, based on an ambitious vision of equality and social cohesion through economic and social redistribution.

The sheer magnitude of the working population (68 per cent of the total population) provides an opportunity to pursue a new path of change based on equity and democracy. However, this

opportunity may be realised only to the extent that the Mexican economy is able to generate the necessary jobs. Otherwise, the opportunity will be squandered and deteriorate into conflict, social unrest and an active challenge to democracy: discontent not only within democracy but against it. This is the worst political outlook that could be imagined for Mexico.

Striking a new course for development, promptly leaving the recessionary swamp, innovating and renewing institutions should be the central task of a plural democratic polity based on inclusivity and social cohesion.

This outcome is not yet in sight, but Mexico can realistically aim to use democratic politics, even in their current state, as a means to abandon the dogma that has tended to dominate public debate in these years of global reversal.

Reinventing credible forms of social cooperation for the sake of fairness; establishing imaginative relations between the state and the market in order to safeguard the human, physical and institutional capacities that nevertheless continue to exist; and fostering the emergence of new activities with higher added value, capable of realising the benefits of economic openness domestically: these could be the main vectors of a new political economy based on fundamental compromises making it possible to redistribute the fruits of economic effort more fairly.

The main development issue is no longer whether we need inequality in order to have growth. The big question now is: how much inequality can one part of our people live with and for how long, while at the same time the other part is enjoying economic growth and development.

In this view, development must be the result of a complex and dynamic combination of growth with income redistribution.

This is the realm in which productivity and structural heterogeneity confront one another, and in which the main axioms and theorems of conventional economics tend to collapse. Without raising the question of power and the state it is not possible to go further than the time horizons envisaged by Kuznets and Lewis. We therefore have no choice.

The level of income and wealth concentration in Mexico is extremely adverse and must be changed. But how do we obtain the desired combination of capital accumulation and income redistribution without stymieing economic growth? This is the main challenge for social and employment policy, such as there is at present.

Mexico is a good illustration of the saying that pursuing the best can be the enemy of the good. While some continue to insist on wasting time on partial, too narrowly focused and, ultimately, futile programmes, the populations of the large emerging countries seek out the best approach to redistribution while still maintaining steady and rapid growth.

Rather than looking for illusory ways out from globalisation, we should try to nationalise it, subjecting it to evaluation criteria consistent with a national project worthy of the name. Rather than seeking to regain lost time, we need to rebuild the future.

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IX

GROWTH AND REDISTRIBUTION: THE RURAL PUBLIC EMPLOYMENT PROGRAMME IN INDIA

Himanshu

1. INTRODUCTION

The Indian economy has grown an average of 7 per cent a year over the past decade, second only to China. This growth has attracted considerable international attention. However, it is worth looking not only at the sustainability of growth in the Indian economy in the long run but also at how growth has been shared among various occupational, social and regional groups. Recent evidence clearly underpins a growing concern that growth may have led to increases in inequality, in almost every dimension. Not only has urban growth outpaced rural growth, but even within rural areas, cultivator and agricultural labourer households seem to have benefited much less than other occupational groups. Measures of household inequal-

ity such as the Gini coefficient of consumption expenditure across households have also shown an increasing trend since 1993. Income growth of casual labourers slowed down between 1999/2000 and 2004/2005 and the real wages of regular workers even declined.

Inequalities with regard to gains from economic growth have also been acknowledged in the policy arena, where the focus has shifted from simple economic growth to 'inclusive growth'. Given the vast magnitude of poverty and the modest increases in per capita income in India, a more effective system of redistribution or, still less, a reliance on some sort of trickle-down effect would not suffice. Since population growth is largely exogenous, a development policy is needed that will lead to higher long-

term growth. A balance between these two objectives would be achieved more easily by a pattern of economic growth with a higher employment content. Rapidly expanding employment and output reduce the state's redistributive burden and, if such employment is 'gainful', it contributes to GNP.

Recognition that employment generation is the best form of redistributive growth is not new in the Indian context. India has a long history of public employment programmes and they are acknowledged to have had a significant impact on poverty and inequality. A large literature (Sen and Ghosh 1993; Sen 1996; Bhalla 1997; Fan, Hazell and Thorat 2000) has documented the major role of public expenditure – particularly that geared towards employment generation – in reducing poverty in the 1980s. However, since 1991 public expenditure-led employment creation has diminished, which has manifested itself in increasing inequalities. Rural growth has fallen behind urban growth and agricultural labourers – among the most vulnerable occupational groups – have not shared in India's economic growth.

It was this that led to the enactment of the Mahatma Gandhi National Rural Employment Guarantee Act (MGNREGA) by the Indian parliament. What distinguishes MGNREGA from previous attempts to boost employment through public expenditure was the statutory guarantee of 100 days of employment for all households requiring it. The act was passed in September 2005 and implemented initially in 200 of the poorest districts (sub-state administrative unit), starting in February 2006. However, the programme's success led to its expansion to the entire country within three years (by 2008). Its

effects on rural incomes and distribution have been recognised as crucial to the growth of the Indian economy. However, it has also been criticised for defects in programme delivery and its impact on agriculture in the countryside.

At a time when India is debating the outlines of similar landmark legislation on food security (National Food Security Act), it is time to evaluate the working of the employment guarantee act. This chapter analyses the performance of MGNREGA over the past four years. Section 2 provides an overview of the growth and distributional aspects of the Indian economy; Section 3 looks at trends in wages and earnings; and the final section evaluates MGNREGA.

2. RECENT TRENDS IN GROWTH, EMPLOYMENT AND POVERTY

Recent estimates of India's GDP suggest that the economy grew by more than 8 per cent per year between 2004 and 2010. The growth rate has slowed somewhat over the past two years because of the global recession and domestic factors such as inflation. However, this high rate of economic growth has been unequally distributed in sectoral terms. Table 1 (see next page) gives a sectoral breakdown of growth rates over the past three decades.

Agriculture – which still employs close to 50 per cent of India's total workforce and almost two-thirds of the rural workforce – has not seen a major acceleration of growth, although there has been some recovery from the low growth rates of 1999–2000 to 2004–2005. However, GDP growth is significantly higher compared to previous periods. The weakening of the impact

Table 1: GDP growth, India (constant prices)

	1983–1994	1993–2000	1999–2005	2004–2010
Agriculture	3.76	3.31	1.59	3.05
Mining	6.44	5.20	4.67	4.11
Manufacturing	5.97	6.90	6.46	9.50
Electricity etc	9.43	6.98	4.14	7.18
Construction	5.43	6.36	8.79	9.23
Trade & hotels	6.12	9.29	8.05	9.07
Transport & communications	6.54	8.66	12.63	12.77
Real estate & business services	10.10	7.78	6.71	12.04
Community & personal services	6.25	7.83	5.22	8.19
Secondary	6.17	6.62	6.63	8.75
Tertiary	7.16	8.35	7.65	10.31
Total non-farm	6.79	7.74	7.31	9.78
Total GDP	5.78	6.51	5.99	8.62
Population	2.34	1.94	1.72	1.45
Per-capita GDP	3.36	4.48	4.20	7.08

Source: National Accounts Statistics, Central Statistical Organisation, various issues.

of agricultural growth on total GDP growth is primarily a result of the falling share of agriculture in total GDP: it fell from around 55 per cent in 1950–51 to 37 per cent in 1983–84 and around 20 per cent in 2004–2005. However, the share of agriculture in employment has fallen more slowly than in GDP. As a result, the per capita productivity gap between agriculture and other sectors has increased sharply.

The Planning Commission recently released the latest estimates concerning poverty in India (Ahluwalia 2011), based on the new poverty lines.¹ The most recent round of the consumption expenditure survey (2009–2010) by the National Sample Survey Organisation (NSSO

report number KI (66/1.0)) also allows us to track inequality in household expenditure over the years. Inequality has increased in rural areas but much more quickly in urban areas. However, despite accelerating growth rates and an increase in inequality to its highest level

Table 2: Poverty head count ratio (based on official poverty lines)

	Rural	Urban	Total
1993–94	50.1	31.8	45.3
2004–05	41.8	25.7	37.2
2009–10	36.0	22.3	32.1

Source: Planning Commission 2010 & Ahluwalia 2011.

¹ The Planning Commission appointed an Expert Group under the chairmanship of Suresh Tendulkar to suggest a methodology for the revision of the poverty lines used by the Indian government. The Expert Group's report was accepted by the Planning Commission and proposed the Urban Poverty estimate based on the existing official poverty line as the starting anchor, recalculating price indices to correct for territorial price differentials. The new poverty lines are not linked to any specific basket of commodities but an effort was made by the Expert Group to justify the poverty lines in accordance with minimum norms for education, health care and food.

Table 3: Gini coefficients for rural and urban

	Rural	Urban	Total
1993-94	25.8	31.9	30.1
2004-05	28.1	36.4	34.6
2009-10	28.8	38.3	36.2

Source: NSSO, Consumption Expenditure Survey.

since the 1980s (see Table 3), the most recent period appears to be one of moderate poverty reduction (see Table 2) after a setback in the first 10 years of the reform process starting in 1991.

Along with the poverty and inequality estimates, estimates on employment and unemployment are also available. As is clear from Table 4, the high GDP growth rate in the past five years has failed to boost employment. Whereas 60 million additional jobs were created between 1999-2000 and 2004-2005, only two million additional jobs were created in the past five years for which data are available. This is particularly

Table 4: Employment growth

Year	Rural		Urban		Total
	Male	Female	Male	Female	
<i>Workers in employment (in millions)</i>					
93-94	188	105	65	17	374
99-00	199	106	75	18	398
04-05	219	124	90	25	458
09-10	232	105	100	23	460
<i>Growth Rates</i>					
93-00	0.94	0.15	2.61	0.94	1.02
99-04	1.96	3.24	3.71	6.23	2.85
04-10	1.20	-3.30	2.07	-1.42	0.10

Source: NSSO, Report on Employment and Unemployment.

worrisome given that the period between 1999-2000 and 2004-2005 saw employment growth which was not only higher than the growth of the labour force but also the highest seen in the past four decades.

Compared to the period between 1999-2000 and 2004-2005, the period between 2004-2005 and 2009-2010 shows employment growth of only 0.1 per cent per annum by usual status, but 1 per cent per annum by daily status. While confirming the trend of slow employment growth reported by the 2007-2008 employment survey, these also confirm other trends noted earlier on changes in the status of employment and industrial distribution. The bulk of the employment generated in the past five years has been in the low productivity construction sector. Furthermore, the data also suggest an increasing casualisation of the workforce, with employment swelling in the informal sector. The trend towards non-farming diversification also shows no acceleration compared to previous periods.

A preliminary reading of the recent employment estimates suggests that the slow employment growth is largely due to a sharp decline in female labour force participation, while the number of male workers actually increased by a respectable 22 million between 2005 and 2010. It has been argued that the drought and the global recession have been partially responsible for the slow growth of employment in the Indian economy. The third factor - at least since March 2008 - has been the double-digit inflation, particularly for food items.

Despite low employment growth, the 2009-2010 data also show casual real wage rates growing at 4 per cent per annum for rural males

and at 5 per cent for rural females between 2005 and 2010, suggesting that those most vulnerable to inflation, drought and recession were now much better protected. For example, with the 2009–2010 data showing an eightfold increase in participation in public works over the 2004–2005 data, the impact of MGNREGA is clearly evident. More generally, the effects of the financial crisis were muted because of the fiscal stimulus, which involved both a significant stepping-up of construction activity in the public sector and debt relief for farmers. Taking into account that rural areas also witnessed a significant flow of resources in the run-up to the general election in 2009, the external shocks, although important, were not so severe as to recreate the earlier situation of sustained distress. Nonetheless, while these were seen as crucial interventions to lessen the impact of external shocks, they were less successful in addressing the structural factors which have contributed to jobless growth and rising inequality in recent decades.

Nonetheless, while the data are consistent with a considerable reduction in rural distress since 2005, they do not offer any grounds to reject the argument that this period has been one of jobless growth. The acceleration of GDP growth from an average of 6 per cent to 8 per cent after 2005 has not been accompanied by a corresponding generation of decent jobs. In fact, the pace of creation of regular employment which was about 2 million annually between 1993 and 2005 nearly halved between 2005 and 2010, with fewer than 1 million such jobs created after 2007–2008. Of course, there has been some employment upturn in the private sector which has led the growth boom (and the 2009–2010 survey figures for urban males

reflect this), but this is swamped completely by the stagnation or even decline in regular employment in all other segments, mainly the unorganised sector. Furthermore, with over 80 per cent of all new jobs created being casual – overwhelmingly in construction – there are serious questions about the ability of economic growth to offer sustained employment creation as a cornerstone of inclusive growth.

3. WAGES AND EARNINGS

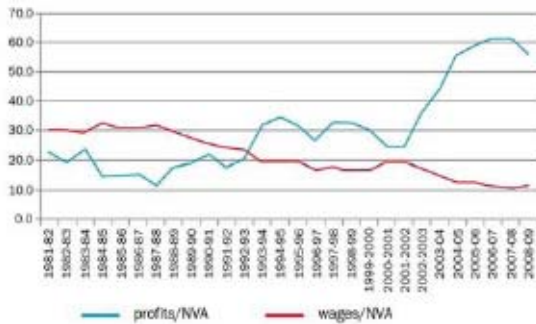
However, matters are complicated by the fact that the surge in employment growth after 1999 was accompanied not by higher growth in wage rates but by their stagnation. Table 5 summarises all-India trends in wages at constant 1999–2000 prices. The trend is clearly a deceleration in the real wages of casual workers, although they revived somewhat in the most recent period: that is, real wages decelerated for all workers significantly during 1999–2000 to 2004–2005 and then accelerated again to the previous level. This was true for rural and urban, agricultural and non-agricultural, male and female workers and at all levels of education.

Table 5: Growth rate of real wages for casual workers (age 15–59), (1999–2000 prices)

	93–94 to 99–00	99–00 to 04–05	04–05 to 09–10
Male	4.06	1.80	3.65
Female	3.66	1.44	4.97
Persons	4.03	1.89	4.18

Source: NSSO, Report on Employment and Unemployment.

Figure 1: Share of wages and profits in net value added



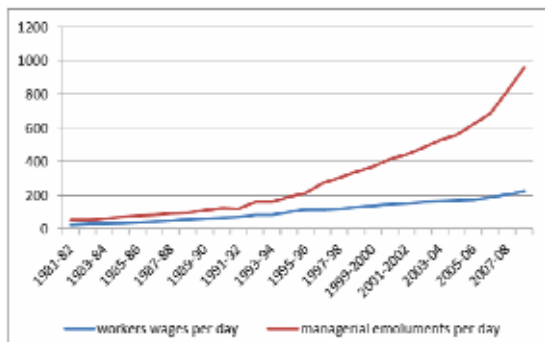
Source: Government of India.

However, although the wages of casual workers returned to a respectable rate of growth, the deceleration in employment growth during the same period meant that casual workers as a category benefited less than in previous years. Preliminary evidence from the national accounts also confirms the decline in the share of wages in the national economy. This, incidentally, is also confirmed by the Annual Survey of Industry data which show a consistent decline of the wage share in net value added. Figure 1 gives the share of wages and profits in net value added in industry. The share of wages,

which was 30 per cent in the early 1980s, declined to 20 per cent by the end of 1990s and further declined to around 10 per cent by the end of the past decade. On the other hand, the share of profits in net value added rocketed during the same period. Furthermore, while the share of profits was lower than the share of wages until 1993–94 it is now almost six times that of wages. The fact that this happened during a period in which wage growth revived is not inconsistent with the overall trend of wage share decline. It is also clear from Figure 2 that most of the increase in wages has been received by white-collar workers with managerial salaries increasing much faster than workers' wages. The fact that the most recent period has seen little employment creation has also meant a worsening of workers' bargaining power as well as their well-being during the period in which the Indian economy has experienced its fastest growth.

4. EMPLOYMENT GUARANTEES AS SOCIAL POLICY

Figure 2: Workers' wages and management salaries



Source: Government of India.

It is now evident that the acceleration of economic growth in recent years has neither helped to reduce inequality nor to increase the incomes of the most vulnerable section of society, casual labourers. A large part of this development was attributed to the sluggish response of the labour market. While there has been valid criticism of the validity of employment-output linkages in the developing-country context, particularly in an economy with large-scale agricultural employment, India's experience does point to the role of employment creation as a redistributive tool. This recognition of em-

employment creation as the cornerstone of inclusive growth was instrumental in the enactment of MGNREGA in 2006.

Employment creation through public employment is not new in the Indian context. This was recognised as an important tool of redistribution with growth as early as the 1970s. Even though the role of public employment as a redistributive measure was recognised in the literature (Sen and Ghosh 1993; Sen 1996; Bhalla 1997; Fan, Hazell and Thorat 2000), these largely remained relief measures to be invoked during crises and emergencies. Much of the literature had already noted that the large poverty reduction seen during the 1980s was in effect a result of increased public expenditure-led employment creation in rural areas. However, MGNREGA is the first such official recognition of the potential of public employment as a redistributive mechanism as part of economic policy.

The basic feature which separates MGNREGA from other employment generation programmes is the fact that it is backed by legislative authority and is closer to a right to employment than a scheme for public employment. It essentially entitles every household in rural areas to a maximum 100 days of employment in public works. However, it gives households the right to avail themselves of work whenever they feel the need for it. The demand-driven nature of MGNREGA is an essential differentiating feature compared to previous such schemes which depended on the willingness of the state to provide employment. However, it also puts the onus of implementation on households. The third distinguishing feature is the nature of the transparency and monitoring safe-

guards built into the programme. The fourth feature is the provision of unemployment benefits, including penalties and fines if the government fails to provide employment within a stipulated period of time. Last but not least, wages paid for MGNREGA employment are official minimum wages (which are generally higher than private sector casual wages).

The act came into force in February 2006 initially covering the 200 poorest districts of the country and has been expanded to cover all rural areas since April 2008. Going by the statistics available from the Ministry of Rural Development, MGNREGA is the largest programme of its kind in the world for providing employment to rural areas. According to the official statistics, 52.5 million households benefitted from MGNREGA in April 2009–March 2010 out of the 113.2 million households issued with job cards. A total of 2.83 billion person-days of employment was generated in 2009–2010. Of these, 51.2 per cent was accounted for by Schedule Caste and Schedule Tribe households.² The percentage of women in total person-days generated was 49 per cent. These are impressive statistics by any standards. Nonetheless, they need to be verified and cross-checked with independent evidence.

Although numerous field studies and micro-studies are available, few large-scale surveys exist on the functioning of MGNREGA. However, the National Sample Survey Organisation (NSSO) decided to include it as part of its official employment-unemployment surveys (EUS). The NSSO has now introduced a separate activity code 42 for all those working as wage labourers under MGNREGA. Recent estimates by the NSSO are available for 2007–2008 and

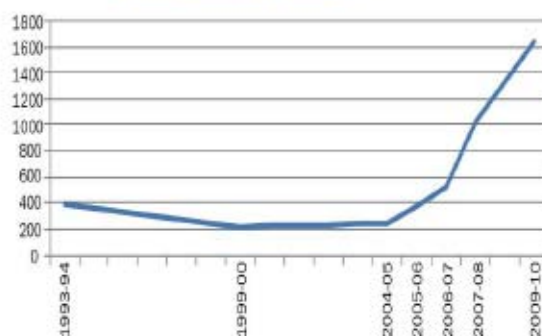
² Schedule Castes and Schedule Tribes are the poorest caste groups and tribal groups which have been identified by the Indian Constitution as beneficiaries of affirmative action. These are the most vulnerable households in rural areas with significantly higher poverty compared to other castes and tribes.

2009–2010. The 2007–2008 survey round is large enough to provide reliable estimates of work under MGNREGA not only at the national level but also at state level. These are fully comparable to the last quinquennial round of 2004–2005, the year immediately preceding MGNREGA.

First, the broad results. According to the NSSO, total employment generated by public employment programmes in 2007–2008 was 1.02 billion person-days compared to the official statistics of employment generation of 1.436 billion person-days. At an average wage rate of Rs 78.91 per day, it also implies that the total wage bill was Rs 80.40 billion as against the official estimate of Rs 107.38 billion. In terms of person-days employment, the NSSO's estimated person-days are 71 per cent of the official estimates and 74 per cent of the estimated wage expenditure on MGNREGA. These are definitely an improvement on the usual claim that only some 15 per cent of government money reaches the people. But even a 25 per cent leakage in MGNREGA wage payments (against official records) is a cause for concern. Total employment created in 2009–2010 according to the NSSO was 1.64 billion person-days as against the official claim of 2.8 billion person-days.

But how does it compare with pre-MGNREGA days? Employment generated by public employment programmes in 2004–2005 was 240 million person-days: that is, employment generated increased by 4.2 times in 2007–2008 compared to 2004–2005. By 2009–2010 it had increased to almost seven times. Figure 3 gives the person-days of employment generated

Figure 3: Person-days employment created in public works (million)



Source: NSSO, Report on Employment and Unemployment.

by public employment programmes. However, the increase varies across states and districts.

It also varies depending on how long the act has been in operation in a particular district. As expected, the districts which first began implementation – which are also the poorest districts – also saw highest increase in employment generated compared to districts which were added in the last phase. Person-days employment increased in the first phase districts (poorest 200 districts) and in the next phase (130 further districts in 2007) by more than 5.4 times. On the other hand, the expansion in public employment generation was only 1.9 times in the third phase (districts added in the last phase).³ Considering that the first and second phase districts were among the poorest, this also suggests that the largest expansion in employment generation happened in these poorest districts. Since these districts are also the ones in which the programme started, it may also represent a strengthening of the delivery system over time.

However, there is considerable variation by gender and across states in terms of performance.

³ As mentioned earlier, MGNREGA was initially implemented in the 200 poorest districts of the country in 2006. This was later expanded in April 2007 to cover an additional 130 districts. In April 2008, the coverage was expanded to include all districts (580).

As against official claims of a female share of total employment of 43 per cent, the NSSO shows that women have only 38 per cent of total employment. However, women's employment share in the poorest 200 districts increased from 28 per cent in 2004–2005 to 36 per cent in 2007–2008, although it declined in phase-three districts. However, the share of SC/ST households in total households that have availed themselves of jobs reported by the NSSO is similar to the shares reported by the official statistics.

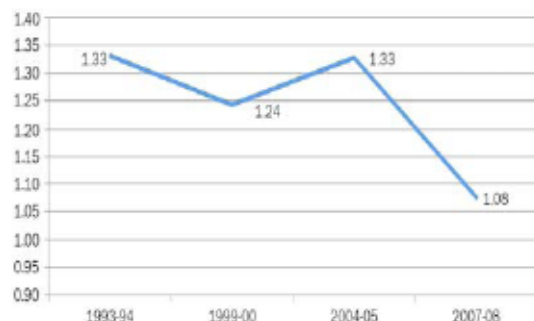
Moreover, as expected, there is also a spillover into other areas, notably wages in rural areas. Not only did casual wages increase by 4.5 per cent per year in real terms between 2004–2005 and 2009–2010, but there has also been a narrowing of the gender gap in casual wages. As reported by the NSSO, there is a negligible gender gap in public employment, but also in casual employment in other sectors: male wages were only 50 per cent higher in 2007–2008 compared to 58 per cent higher in 2004–2005. Figure 4 presents the gender gap in public works wages. Part of the reason for

upward pressure on wages and the decline in the gender gap has been the fact that MGNREGA guarantees wages at the specified minimum wage rates, which are generally higher than private wages and also the same for men and women.

It is obvious that MGNREGA has performed much better than the sceptics predicted in its short lifespan of less than five years. This is not only in terms of the level of leakages but also in terms of access to the programmes on the part of disadvantaged groups, such as women, SC/ST households and also in poorer districts. While this highlights the huge potential of the programme, it also highlights the programme's dependence on institutional structures and innovations in programme delivery, as shown by Andhra Pradesh.⁴ The huge gap in implementation across states is partly a result of governance but also a reflection of political will. But even the sceptics agree that part of the reason that inflation and drought in recent years did not lead to massive protests was because the rural population was insulated from negative effects by access to MGNREGA as a safety net.

However, the importance of MGNREGA in rural areas goes beyond its success in creating public employment and its impact on wages. MGNREGA has played a much bigger role in revitalising the labour market in rural areas. This is evident not only in the success outlined earlier on the basis of secondary data, such as increases in wage rates for casual wage labourers, and reductions in the gender wage gap and between public employment wages and private casual employment wages, but also in the anecdotal evidence generated through field surveys (see Khosla 2011; Adhikari and Bhatia 2010;

Figure 4: Gender gap in public works wages (male/female wage ratio)



Source: NSSO, Report on Employment and Unemployment.

⁴ Several innovations were introduced by the Andhra Pradesh government, such as the institutionalisation of regular social audits, payment of wages through banks and post offices and the introduction of information technology for real-time monitoring of the works undertaken.

Khera and Nayak 2009). Not only has it led to the creation of a class of workers who are using MGNREGA as a safety net but these workers are also able to use it as a bargaining tool for higher wages. Although the evidence so far is too limited to allow us to infer that the general upturn in rural wages has been led by MGNREGA, there is at least acceptance that it may have played a role, directly through upward pressure on wages and tightening of the supply of casual labour to the market and indirectly through the pressure on state governments to increase minimum wages. The fact that the success of MGNREGA has also led to a large section of farmers organising politically against the act is additional proof of the ability of the programme to generate pressure on private wages. Similar evidence of a slowdown in rural-urban migration and of its impact on urban wages is yet to be clearly established.

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X

INEQUALITY AND GROWTH IN SOUTH AFRICA

Josephilda Nokukhuthala Hlope

1. INTRODUCTION

When South Africa adopted the universal franchise in 1994 the country was confronted by a stagnant economy, growing at a rate of 0.1 per cent per annum, high debt levels (44 per cent of GDP) and a very skewed income distribution along racial lines (Hirsch 2005).

The period 2000 to 2008 was one of good GDP growth rates of between 3 and 5 per cent. Then South Africa was hit by the global and financial crisis of 2008/2009 which affected all sectors, but especially export. GDP declined by 1.8 per cent. South Africa emerged from recession in the third quarter of 2009 with growth for the second quarter of 2010 of 3.2 per cent. GNP per capita was R50,000 in 2010, having risen

from R39,400 in 1995 (2010 prices) (The Presidency 2010).

While South Africa is ranked as an upper middle income country, GNP per capita figures are meaningless because the country has the highest levels of income inequality in the world.

2. INEQUALITY

2.1 INEQUALITY ON THE INCREASE

In 1995, the poorest 20 per cent of the population earned just 2.3 per cent of national income, while the richest 20 per cent earned 72 per cent. The Gini coefficient stood at 0.672. By 2005, the richest 20 per cent of South Africans received almost 80 per cent of

the national income and the Gini coefficient had increased to 0,72 (The Presidency 2010). Indeed, various studies have shown that economic growth in South Africa has contributed to a decrease in poverty, but has produced sharp increases in inequality. Borhat and others have proved that the rich are experiencing faster growth in their per capita incomes than the poor. The fact that there have been huge increases in the Gini coefficient also testifies to a pattern of growth that is particularly inequitable (Bhorat et al. 2009).

2.2 INEQUALITY, TRUST AND DEVELOPMENT

Beyond other negative repercussions for a society's social and political reproduction, high inequality – especially if coupled with poverty – impacts negatively on public policy, business behaviour and economic growth in general, in various ways. For example, with high inequality:

(1) The few rich are able to opt out of the public provision of services, such as health care, education and security and pay for private provision of these services. This removes resources and voice from public provision. For example, in relation to health care, 85 per cent of all health care resources are consumed by 15 per cent of the population. This is so because private medical insurance is not affordable by the poor.

(2) Crime, including corruption, thrives in countries with massive inequality and where citizens feel they need not practice good citizenship. In South Africa, the fear of crime has led to the phenomenal growth of gated communities. This has led to social exclusion, creating a barrier to interaction among people of different races, cultures and classes. Corruption according to the National Planning Diagnostic document is also on the rise after falling in 1994.

(3) South Africa's trust index is a low 20 per cent (Kotze and Harris 2007). Cross-country studies, within-country studies and so on all suggest that economic inequality has a negative influence on trust. In the absence of trust, consumption is preferred to investment as leaders cannot credibly promise future benefits from worthwhile long-term investments (Knack and Keefer 1997). In addition, without trust: (i) it becomes very expensive to enforce property rights/agreements (everything has to be written down and contingency plans crafted); (ii) increased resources are needed for protection against corruption as fewer resources will be diverted to protect individuals due to, for example, bribes, private security systems, huge bureaucracy, pilferage; (iii) there is a reduction in innovation as entrepreneurs devote time to monitoring possible malfeasance; (iv) growth is stifled as hiring decisions will be influenced by »connections« rather than excellence.

(4) Polarisation impedes the formation of a consensus to develop, change or even implement policy. Failure to achieve consensus is due to asymmetric information on costs and benefits between groups regarding policy promulgation/non-promulgation and the implementation or non-implementation of certain policies (Knack and Keefer 1997).

2.3 INEQUALITY BY RACE

In South Africa, the inequality problem is compounded by the fact that apartheid for decades concentrated wealth and resources at one end and poverty, exclusion, marginalisation and social alienation at the other.¹ Black people crossed over to the democratic era with little or no assets, skills and so on. Because of apartheid policies, inequality was and to a large extent still is racial in nature.

The effect of these laws (see footnote 1) and other related ones was to:

(1) Skew developmental outcomes against African males. For example, life expectancy for white males is about 17 years more than that of African males (StatsSA 2010a).

(2) Cement poverty and inequality along racial lines; to illustrate this in 2005, white households earned on average R69,680 per year, compared to R6,979 for Africans, R13,213 for Coloureds and R24,707 for Asians (Bhorat and Van der Westhuizen 2011). The unemployment rate in 2010 for whites was 5.1 per cent, 29.8 per cent for Africans, 22.3 per cent for Coloureds and 8.6 per cent for Asians (StatsSA 2010b).

(3) De-agrarianise black people and create a rural periphery – a labour reserve – by forcing people off the land and into urban labour markets and thus today only 4 per cent of the rural poorest derive their income from agriculture.

(4) Limit human capital formation: 5.2 per cent of blacks completed higher education compared to 28.8 per cent of whites (StatsSA 2008b). So huge are the education backlogs that even with massive investment post-1994, only 1 per cent of African schools perform at

the top level with regard to high school certificate results (The Presidency 2011).

2.4 SERVICE DELIVERY AND INEQUALITY OF OPPORTUNITY

Generally, Africans still lag behind in terms of service delivery and equality of opportunity (see Figure 1 on the next page).

The data from the same survey also reveal that infrastructure in urban areas is superior to infrastructure in rural areas. For example, only 1 per cent of households in the Ekurhuleni Metropolitan area in Gauteng were without basic water services compared with 95.5 per cent for the rural Mbizana municipal area in the Eastern Cape. In general, the backlogs are greatest in the previous homeland areas in the Eastern Cape and Limpopo, although there are scattered problems elsewhere as well (2007 Household Survey).

This terrible legacy means that the huge inequality further perpetuates divisions along racial lines. There has been some change, however. Since 1994, thanks largely to policies such as the Employment Equity Act of 2000, the Black Economic Empowerment Act of 2003 and others, the black middle class had grown by 30 per cent by 2005. This added another

¹ This was done through a variety of laws such as:

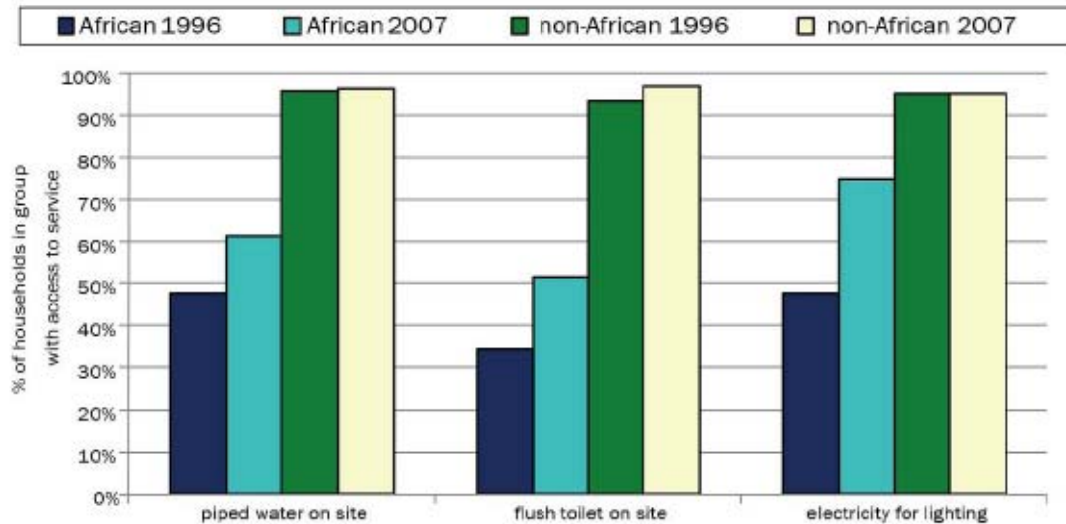
Land Act of 1913: set aside 13 per cent of land for the 87 per cent Black African majority. This was coupled with large state subsidisation of commercial agriculture for white farmers who received tax subsidies, rail transport subsidies, special credit facilities and grants and extension services, such as veterinary and horticulture services.

Group Areas Act of 1950: restricted firm ownership by blacks to specified areas in cities and towns, and later regulations prevented black entrepreneurs from owning more than one business, establishing companies or partnerships, or owning business premises even in 'black' areas.

Bantu Authorities Act of 1951: provided for the establishment of black homelands and regional authorities and, with the aim of creating greater self-government in the homelands, abolished the Native Representative Council. The 1958 Promotion of Black Self-Government Act then set up the 'homelands' – a patchwork of mini-states created on some of the country's most barren land, with borders generally drawn to leave out any viable economic areas. The 1971 Black Homeland Citizenship Act changed the status of the inhabitants of the homelands, so that they ceased to be citizens of South Africa or to have any of the rights of citizenship.

Bantu Education Act of 1953: ensured that Black African children received an inferior education. The democratic state inherited an education system in which the state spent four times more on education for white children than for black children.

Figure 1: Household Infrastructure by race



Source: StatsSA 1996 & 2008.

421,000 black adults to South Africa's middle-income layer, increasing the black population's share of the middle class to almost a third (The Presidency 2011).

3. REDUCING POVERTY

The democratic state has been able to make some inroads into the reduction of poverty, across all races. Between 1995 and 2005, the poverty gap ratio² was reduced from 32 per cent to 25 per cent for Africans, 15 per cent to 14 per cent for coloured, and 0,2 per cent to 0.1 per cent for whites (Bhorat et al. 2009).

The reduction in poverty is largely due to the building up of a relatively comprehensive social wage and social security system, that is, provisions for free basic water and electricity, free

health care for pregnant women and children under the age of seven, free houses, child support grant, foster care grant, disability grant, the state old age pension and war veterans grants.

The Constitution anchors the social security system in Section 27: »Everyone has the right to access to social security, including, if they are unable to support themselves and their dependants, appropriate social assistance« (Constitution of the Republic of South Africa 1966: Section 27, 1c). South Africa has developed two concepts of social security:

- a social insurance scheme based on contributions: contributory schemes, statutory ones include the Unemployment Insurance Fund, the Compensation Funds and the Road Accident Fund;³ non-compulsory ones are the Medical Aid fund and retirement funds; and
- a tax-funded scheme for redistribution.

² The poverty gap (PG) is defined as the amount by which the average expenditure of poor households lies below the poverty line.

³ The benefit period for the Unemployment Insurance Fund is no more than six months after loss of employment. The latter two work on the basis of one-off payments.

Table 1: The grant system⁴ in South Africa

Name of grant	Eligibility (all means tested)	Amount per month (calculated at US\$1=R7)
State old age pension	Men and women over the age of 60 who live in households with income of less than about US\$500	US\$ 130
Child support grant	Children under the age of 18 who live in households with income of less than about US\$500	US\$ 30 per child in a poor household
Disability grant	Adults with disabilities who live in households with income less than about US\$500	US\$ 130
Foster child grant (not means tested)	Fostered children below the age of 18	US\$ 90 per fostered child in a poor household
Care dependency grant	Families with children below the age of 18 with disabilities who live in households with income of less than about US\$500	US\$ 130 per disabled child in a poor household

Source: Department of Social Development 2011.

The mainly means tested grant system aims to assist the vulnerable and those not expected to participate in the labour market, namely, the aged, the disabled and those too young to work. Coverage for those eligible for these grants is almost universal. There are 13,026,104 beneficiaries of the social assistance system and this costs the state about US\$7.8 billion per annum. The Department of Social Development estimates that the government spends about US\$100 per month/per household on the poorest 40 per cent of households on the social wage, including social grants. Social assistance spending (excluding administration) now consumes 3.2 per cent of GDP, up from 1.9 per cent in 2000/2001.

The grant system has to some extent contributed to the reduction of inequality. It is esti-

mated that the 2005 Gini coefficient without grants would have measured 0.77 (Bhorat et al. 2009). The grant system is indeed redistributive, but impacts more on poverty than it does on inequality. For a developing country, South Africa's social security system is generous, but it could be argued that it has enabled the inequitable high growth model to be sustained. Seekings and Nattrass (2005) argue that in the years since the establishment of democracy an implicit contract has emerged between the poor, labour and big business whereby a high-growth/low-employment model of development is pursued, with part of tax revenues from growth used by the state to fund a relatively generous body of social grants.

The major criticism of the grant system, however, is that it assumes that there are jobs

⁴ «Non-contributory social pensions were instituted in 1928 for Whites and Coloureds who were not covered by occupational retirement insurance... In 1944, the Smuts government extended social old-age pensions to Africans, though benefit levels were less than one tenth of those for Whites... The 1992 Social Assistance Act finally did away with all discriminatory provisions. Thus the social pensions and grants which were set up to protect the white population gradually expanded their eligibility rules to include all South Africans» (Woolard and Leibbrandt 2011: 6).

available such that able-bodied people will be able work for a living, so able-bodied individuals over the age of 18 but under the age of 60 do not receive any form of social assistance from the state, unless they participate in public employment programmes.

4. WHY HAS THE DEMOCRATIC GOVERNMENT NOT BEEN ABLE TO REDUCE INEQUALITY?

Wage income is the main contributor to the high income inequality. Income inequality with regard to wages rose from 61 per cent in 1995 to almost 76 per cent in 2006. Highly skilled workers are rewarded with high wages, while lower and unskilled workers are either poorly paid or unable to find employment (see Borhat et al. 2009). This is mainly due to two reasons: (i) the lack of skills means a skills premium for those that have them; (ii) the economy is not creating jobs in adequate numbers and not for the current labour force (largely unskilled or semi-skilled), and thus too few people are employed in South Africa.

There are several reason for the emergence of this employment pattern:

On the supply side: The working age population (the number of persons aged 16 to 64) increased from 23 million people in 1995 to 29 million in 2008. At the same time, the labour force participation rate increased from 49 per cent to 55 per cent (The Presidency 2010). Participation rates rose most dramatically for the less-skilled as African females began to engage with the post-apartheid labour market and increase their very low participation rates of the

apartheid years. These two reinforcing factors resulted in an additional 5 million people entering the labour market over this period.

On the demand side: The economy has become skills oriented. High skilled employment rose by 50 per cent while low skilled employment fell by 20 per cent. This can largely be explained by the fact that increased international trade has allowed access to new technologies and enabled the adoption of unskilled labour-saving technology (Wood and Ridao 1994), as well as the fact that government policies and investment subsidies between 1993 and 1997 exacerbated an already capital intensive production structure. The legacy of the 1953 Bantu Education Act, which was designed to reduce the level of education attainable by black people, meant that the labour market became technology oriented and many African unskilled workers could not be employed. This could be why post-1994 average incomes increased more for white South Africans than for Africans. In real terms the average income increased by 41 per cent for white people and decreased by about 2 per cent for Africans between 1995 and 2005 (Bhorat et al. 2009).

The economy is not creating the quantity, quality and type of jobs required because:

- (1) There is a high dependence on minerals and energy-intensive activities which are still not vertically integrated into the economy.
- (2) South Africa has small markets due to the low incomes of the majority of the population. Basically, poor people buy a limited basket of consumer goods and most of these are (still) mass-produced in the core economy, on a scale that makes it hard to compete on price, even taking into account the cost of distance. Exist-

ing distribution systems in the formal economy are efficient enough to reach even remote areas.

(3) There is no thriving layer of small and medium-sized enterprises, especially black-owned ones.⁵

(4) There are high levels of concentration and high barriers to entry. In many economic sectors, the apartheid government gave monopoly concessions encouraging the »demise« of destructive competition/rationalisation when conditions were deemed not suitable for competition. Firms were allowed to allocate markets, to operate legal cartels and so on.

(5) The traditional approach to rural development and improving farm incomes in poor countries is to assist farmers to rise up the value chain by supporting forms of agro-processing. However, in South Africa a highly-centralised, vertically-integrated agro-processing sector already exists for every key staple and these value chains tend to exclude small/new/black producers.

(6) The big farm model is becoming increasingly capital intensive. This model, largely responsible for enabling food security at national level, is responsible for more than 99 per cent of South Africa's formal marketed agricultural output. Despite the decrease in the number of farming units, output from commercial agriculture has continued to grow, implying an increase in production efficiency.

In addition, there are high job search costs due to spatial apartheid.⁶ There is evidence that

travel costs severely limit job search in terms of both scope and length of search. Networks play a major role in finding work. About one-third of people get jobs through a family member or a friend and in communities with very high unemployment rates, many unemployed people know very few employed people and so networks break down.

5. DEVELOPING A MORE INCLUSIVE AND MORE EQUITABLE AGENDA

It is important to note that having an inclusive agenda begins by trying to equalise opportunities. Equality of opportunity is about levelling the playing field so that achievements in life depend on people's choices, efforts and talents, not on their circumstances at birth in relation to race, space and gender. The discrimination suffered by black people in the past crucially influences their life chances in the present (Habib and Bentley 2010: 337).

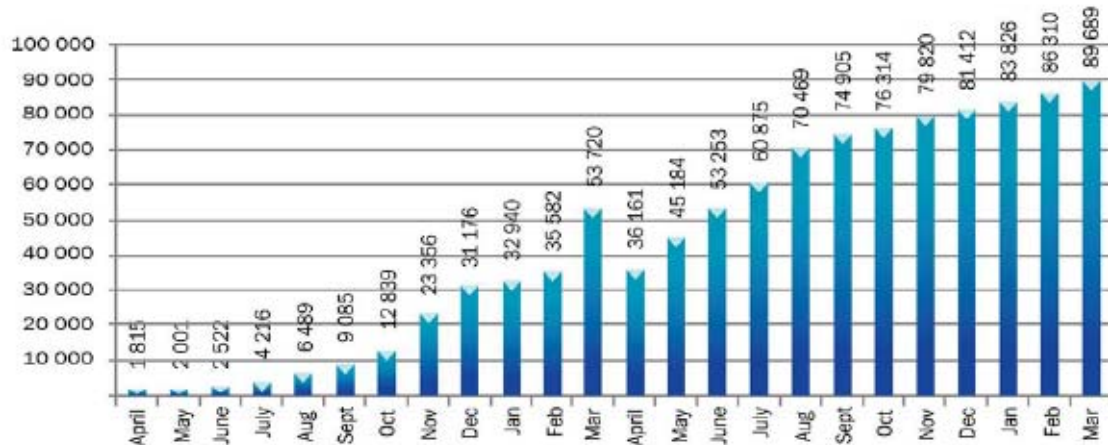
5.1 SOCIAL WAGE

Equalising opportunity in the context of South Africa must begin with ensuring that whoever one is, and wherever one is, it should be possible to access quality basic services and quality education. Fortunately, the Constitution lays the basis for equalising life chances in particular through the Bill of Responsibilities. Section 26 states that everyone has the right to access to adequate housing; Section 27 states that everyone has the right to access to health care services and continues: 'The State must take rea-

⁵ The black entrepreneurial class is virtually non-existent due largely to the 1950 Group Areas Act which explicitly restricted firm ownership by blacks to specified areas in cities and towns. Later regulations prevented black entrepreneurs from owning more than one business, establishing companies or partnerships, or owning business premises, even in 'black' areas.

⁶ African workers spend about 5 per cent of their income on transport compared to white families who spend 0.5 per cent on transport.

Figure 2: Community Work Programme – participation April 2009 - March 2011



Source: Department of Social Development 2011.

sonable legislative and other measures, within its available resources, to achieve the progressive realisation of each of these rights'; and Section 29 states that everyone has the right to a basic education.

This means that the government must continue to provide a basic or social wage.⁷

5.2 EXPANDING THE COMMUNITY WORK PROGRAMME TO INCLUDE A MILLION PEOPLE

Together with the social wage, the government should provide means to enable able-bodied unemployed/unemployable persons to be productive. One such means is the Community Work Programme. Flowing from the interim findings of the Presidency's second economic strategy project, a pilot project called the Community Work Programme (CWP) was started in late 2007. The project aims to be a safety net for the marginalised and is an adaptation of the concept of a »minimum employment guaran-

tee«. The CWP is an area-based local programme that offers a minimum level of regular employment to unemployed or underemployed people in a given local area, usually operating at the ward or municipal level, targeted at marginalised areas that are unlikely to generate market-based employment opportunities on the required scale in the near future. It is an employment safety net, not a permanent employment solution for participants. Its purpose is to ensure a minimum level of regular work for those who have no alternatives: two days' work per week, or the equivalent over a month. This is meant to complement and not replace the existing livelihood strategies of unemployed people. The CWP operates at the local level, with participants moving in and out of the programme as their needs change, but with the programme providing a constant safety-net at the local level, offering a baseline in terms of income security. The CWP identifies opportunities for »useful work« on an ongoing and sus-

⁷ The social wage comprises transfers to the poor from government in the form of free basic water (6,000 litres of water per month per household), free basic electricity (50kWh per household per month for a grid-energy system connected through the national electrification programme), free health services offered at public primary health care clinics and community health care centres, introduction of no-fee schools and school fee exemptions on a sliding scale, depending on level of income and roughly 35 per cent of all public commuting costs are subsidised by the government.

tained basis at the local level. This allows it to target spatial poverty traps, and provide a source of income security over time. The work performed is identified and prioritised through community consultation processes and must contribute to the public good. Useful work usually identified by communities includes road maintenance, soil erosion and degradation repair, spring/river protection, fixing classrooms, fencing food gardens, building water tanks, mapping orphans and vulnerable children, providing labour support to maintain food security for vulnerable households, as well as responding to social challenges such as reducing violence against women – converted to «work» by providing street guards in rape hotspots, and cutting the long grass adjacent to pathways, for example. The CWP has expanded exponentially, exceeding its targets: in the 12 months to March 2011, 89,689 people participated in the programme putting in 5,449,376 workdays, achieving 141 per cent of the originally set targeted 63,720 (see Figure 2).

The work undertaken is multi-sectoral. A typical CWP site is expected to operate at a scale able to provide regular work to a minimum target of 1,000 people per week/per cycle. There is massive demand for participation. The CWP is now in all nine provinces, and the beneficiaries are mostly young women (during 2010/11, 73 per cent of participants were women). From its inception the community work programme has always had proportionately more female participants.

By March 2011 about 90,000 people were participating in the programme. Cabinet has ordered that it be increased to about a million participants by creating additional work oppor-

tunities over and above the useful work already identified above. This will include:

- (1) a schools support strategy, placing 12 education assistants in every school in the country, in partnership with school governing bodies, creating opportunities for a target of 322,400 unemployed young graduates, with scope for an exciting support programme to go with this;
- (2) a partnership between the Natural Resource Management Programme and the CWP to roll out a programme of watershed services in 14 river catchment areas, with significant public good implications for water quality as well as water flows.

5.3 IMPLEMENTING THE NEW GROWTH PATH

In the new growth path, the government has proposed a broad development pact to strategic groups in society. One of the key issues is to reduce wage inequality and provide more employment for low wage earners. The government has proposed to include in the agreement:

- moderate real wage increases for workers earning R3,000 to R20,000 a month with inflation-level increases for those earning over R20,000 a month;
- cap pay and bonuses for senior managers and executives earning over R550,000 a year;
- moderate price increases, especially on inputs and wage goods;
- agree on ways to ensure a measurable improvement in employment creation.

The details of the new growth path are being debated in the social dialogue forum, the National Economic Development and Labour Council (NEDLAC).

6. CONCLUSION

With an estimated Gini coefficient of around 0.72, South Africa has the highest income inequality in the world. The labour market situation and wage income largely explain income inequality for all race groups: highly skilled workers are rewarded with high wages, while lower and unskilled workers are either poorly paid or unable to find employment.

Strategies to reduce inequality need a multifaceted approach. These strategies must enable all South Africans to realise their potential.

The economy must have jobs. Meanwhile, it should be possible to get South Africans working and improving their communities through public works programmes such as the Community Work Programme.

The National Planning Commission has identified reducing inequality and eliminating poverty as the two main objectives for the government and all economic agents. It is about turning around the legacy of apartheid, equalising opportunities, building capabilities and realising the vision embodied in the Constitution of the Republic of South Africa: the establishment of a non-racist, non-sexist, democratic and prosperous society.

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XI

ECONOMIC DEVELOPMENT AND INEQUALITY IN THE UNITED STATES SINCE 1979: INEQUALITY AS POLICY *

John Schmitt

1. INTRODUCTION

Since the end of the 1970s, the United States has seen a dramatic increase in economic inequality. While the United States has long been among the most unequal of the world's rich economies, the economic and social upheaval that began in the 1970s was a striking departure from the movement toward greater equality that began in the Great Depression, continued through World War II, and was a central feature of the first 30 years of the postwar period.

This short essay seeks to provide an analysis of the postwar period in the United States, particu-

larly of the last three decades. My argument is that the high and rising inequality in the United States is the direct result of a set of policies designed first and foremost to increase inequality. These policies, in turn, have their roots in a significant shift in political power against workers and in favor of their employers, a shift that began in the 1970s and continues through today.

The first section of the paper briefly documents the size of the rise in U.S. inequality and puts this change into historical context. The second section sketches an explanation for rising inequality, one that differs from the deeply rooted, but poorly articulated vision that lurks just be-

* Acknowledgments: This paper adapts and updates «Inequality as Policy: The United States Since 1979», originally published as a CEPR briefing paper and reprinted in the *real-world economics review*. The author thanks the Friedrich Ebert Foundation and participants in the FES-Shanghai Academy of Social Sciences symposium on «Redistribution for Growth» for many helpful comments.

Figure 1: Share of total income to top 1 %, US, 1913-2008



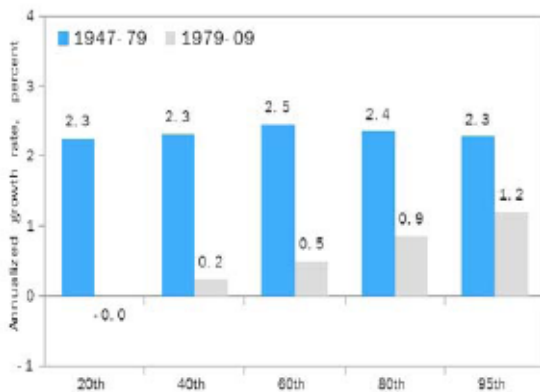
Source: Piketty and Saez 2003.

low the surface of the standard political discourse in the United States.

2. RISE OF INEQUALITY

As economists Thomas Piketty and Emmanuel Saez have documented meticulously, for most

Figure 2: Real family income growth, US, 1947-2010



Source: Census Bureau.

of the 20th century, economic inequality in the United States was falling or flat.¹ (See Figure 1.) The last 30 years of increasing economic concentration are the exception, not the rule, of the last century of economic development in the United States.

From a peak just before the 1929 stock market crash through the early 1950s, wage and income inequality, broadly measured, were declining. From the early 1950s through the late 1970s, inequality was flat, or even falling slightly. Since the late 1970s, however, inequality has skyrocketed, climbing back to levels last seen in the 1920s. In 1979, for example, the top one percent of all U.S. taxpayers received about 8 percent of national income; by 2007, the top one percent received over 18 percent. If we include income from capital gains in the calculation, the increase in inequality is even sharper, with the top one percent capturing 10 percent of all income in 1979, but over 23 percent in 2007.

The Piketty and Saez data are only the simplest way to demonstrate the rise in economic inequality in the United States over the last thirty years. Separate survey data, for example, show that even as family income inequality increased sharply in recent decades, the rate of growth in family incomes has declined at almost all levels (see Figure 2). A full discussion of the many dimensions of increasing polarization across (and within) education levels, gender, race, and region are well documented in *The State of Working America*, produced every other year by the Economic Policy Institute.² The Piketty and Saez data, however, are sufficient to show an enormous increase in economic concentration that is unprecedented in modern U.S. history,

¹ See Emmanuel Saez's homepage <http://elsa.berkeley.edu/~saez/> and <http://elsa.berkeley.edu/~saez/TabFig2008.xls> and Piketty and Saez 2003; updated to 2008 in 2011.

² See <http://www.stateofworkingamerica.org>.

roughly double in size and duration of the run-up in inequality in the 1920s.

3. INEQUALITY AS POLICY: CHANGING POWER RELATIONS

Early on, many conservative analysts in the United States went to great lengths to deny the increase in inequality, a particularly difficult task given that a host of survey and administrative data sets covering wages, compensation, incomes, and even net worth all showed sharp increases in inequality. From the late-1980s, however, the mainstream of the economics profession had turned its attention instead to explaining the rising inequality. The bulk of the profession fairly quickly settled on two likely suspects: «skills-biased technical change» and, to a lesser degree, «globalization».

According to the first explanation, the diffusion of computers and related technology in the early 1980s steadily increased the demand for skilled workers relative to less-skilled workers, driving up the wages and incomes of more-educated workers and depressing the wages and incomes of less-educated workers. From a political perspective, the skills-biased technical change view had several convenient features. At face value, it appeared to be broadly consistent with the data (even though economists on the left, such as David Howell (1999) and Lawrence Mishel (2009), and more mainstream economists including David Card and John DiNardo (2002), Alan Manning (Goos and Manning 2007), and others have presented strong critiques). At least as importantly, however, the technological explanation removed policy, poli-

tics, and power from the discussion of inequality, by attributing rising economic concentration to «technological progress», a force that could be resisted only at our peril. The skills-biased technical change explanation also put significant limits on the terms of policy debates: the problems of the three-fourths of the U.S. workforce without a university degree were either the result of the poor personal decision not to pursue enough education, or, at most, a sign that, as a society, we needed to invest more in education.

The second standard, though less favored, explanation for rising inequality was the elusive idea of «globalization» (Bivens 2008). In the most common view, globalization is supposed to have lowered the earnings of less-educated workers by putting them in direct competition with low-wage workers around the world. This competition put pressure on wages through international trade in goods and services; through the relocation or threat of relocation of production facilities to overseas locations; through competition with immigrants in local labor markets; and through other channels.

Globalization is the less favored explanation in the standard political discourse not because it does not offer what is at face value a coherent explanation of the rise in inequality, but because, by acknowledging the social costs of the increased integration of markets, the globalization explanation threatens to derail an important economic project of the elite. Economists and politicians in the United States spent much of the 1980s and 1990s arguing that the expansion of trade was the only path to national prosperity. In this context, blaming widening inequality on the same process of globalization

that was supposed to be making us richer became quite awkward.

But the main problem with globalization as an explanation for rising inequality is that the typical ways in which the discussion is framed obscure the underlying process through which globalization actually acts on inequality. The standard framing presents globalization, like technological process, as an exogenous force, something that happens to us. In reality, globalization is a complex process of integrating capital, product, and labor markets, where almost every characteristic of those newly integrated markets is the subject of, or should be the subject of, political and regulatory debate.

Contrary to the standard framing, which presents globalization as something that no nation can escape or even attempt to shape, we can choose the terms under which we integrate capital, product, and labor markets across countries. Over the last 30 years we have indeed “chosen” a particular form of globalization in the United States – a form that benefits corporations and their owners at the expense of workers and their communities. If we had chosen globalization on different terms, however, economic integration would not have required rising inequality. Another globalization is possible.

In opposition to these two standard explanations for the recent rise in inequality, I want to offer an alternative view, one that explains inequality as a function of power, sustained by politics, and implemented as policy. In this alternative view, it is not technological progress nor the inevitable march of globalization, but rather the sharp shift in the strength of capital and employers relative to workers that explains

the increasing concentration of wages, income, and wealth over the last three decades.

The decline in inequality from the end of the 1920s through the end of the 1970s – evident in the Piketty and Saez graph – was a function of a series of social movements over that same period that worked to reduce economic and social inequality. The 1930s saw the ascendancy of the U.S. labor movement, which went from a small force scattered across the national geography and industrial structure to an institution representing over one-third of U.S. private-sector workers by the mid-1950s. The civil rights movement of the 1950s and 1960s pressed for political, social, and economic equality for blacks. The women’s movement of the 1960s and 1970s fought for social and economic equality for women. The labor movement, the civil rights movement, and the women’s movement separately, but especially together, changed the way U.S. corporations did business.

Wages and benefits rose for all workers, union and non-union. Employers were legally and socially prohibited from paying minority and women workers less than white men for the same work. Together with the environmental and consumer movements of the 1960s and 1970s, which sought to constrain U.S. businesses engaged in endangering the environment and consumers, these social movements had the effect of increasing incomes for those at the bottom and lowering incomes for those at the top (by raising the cost of doing business).

Throughout the entire period, employers resisted each of these movements (labor, civil rights, feminist, environmental, and consumer).

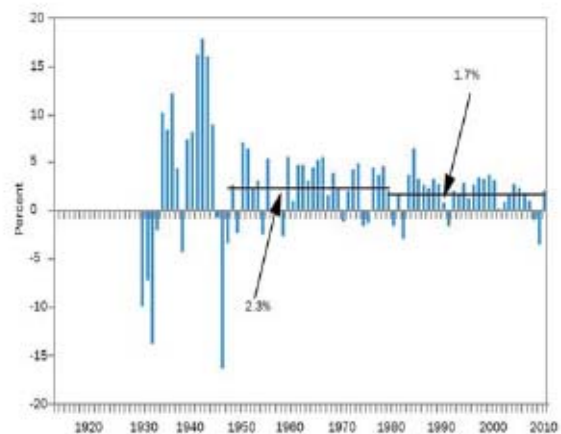
The economic elite, while eventually comfortable with the social aims of all of these movements, almost uniformly opposed the accompanying legislation, including: making union organizing easier; guaranteeing workers' health and safety; prohibiting discrimination against racial minorities and women in labor markets and in other markets such as housing and credit; protecting the nation's air and water; and ensuring the safety of consumer products. From the 1930s through the 1970s, capital generally fought a losing battle, able to shape and contain the specific policies that grew out of the various social movements, but ultimately unable to prevent the enactment and enforcement of a host of policies that worked strongly against employers' immediate economic interests.

By the end of the 1970s, however, employer opposition coalesced and the economic disruption caused by two oil crises in the 1970s gave capital and employers a political opening. Even while Jimmy Carter, a Democrat, was in the White House, a subtle but important shift in U.S. politics occurred – a shift away from the core constituency of the Democratic party (labor, women, racial minorities, and environmentalists)– and toward employer interests (see Hacker and Pierson 2010; Bowles et al 1984; Baker 2007). By the time Carter lost the presidency to Ronald Reagan in 1980, the corporate backlash against almost fifty years of social progress was in full swing.

The backlash was sold as a response to the economic crisis of the 1970s and the emphasis was overwhelmingly on improving the efficiency of the U.S. economy, which was described (and is still described today by many on the right) as

sclerotic, overly unionized, and overly regulated. (A great irony here, which Figure 3 illustrates, is that economic growth was more rapid in the early postwar period than it has been since the mid-1970s.) Each of the major policy initiatives of the last three decades claimed to offer important efficiency advantages. The long decline in the inflation-adjusted value of the minimum wage was supposed to correct a distortion in the low-wage labor market. The deregulation (more accurately, re-regulation) of the airline, trucking, railway, financial, and telecommunica-

Figure 3: Change in real GDP per person, US, 1930-2010



Source: BEA and Census data.

tions industries was supposed to lower consumer prices in those markets. The liberalization of foreign trade through a plethora of bilateral and multilateral trade agreements was similarly supposed to lower consumer prices on imported goods. The privatization of many federal, state, and local government functions – from school bus drivers to the administration of welfare policy and even much of the U.S. war in

Iraq and Afghanistan – was supposed to lower the cost of government. The steady, policy-enabled, deterioration of unionization in the private sector – from over one-third of workers in the 1950s to about eight percent today – was supposed to improve the competitiveness of U.S. firms.

These policies, sold as ways to enhance national efficiency, however, also had another common thread. They all worked to lower the bargaining power of workers relative to their employers. In many cases, the alleged efficiency gains have not materialized. In every case, however, the negative impact on workers has been obvious and substantial. The inflation-adjusted value of the minimum wage is now about 30 percent lower than it was at its peak in the 1960s. Workers in deregulated industries – airlines and trucking, most obviously – have seen their wages and benefits stagnate and fall. Even many mainstream economists acknowledge an important role for corporate-oriented international trade and commercial agreements in depressing the wages of less-educated workers, who have been forced to compete directly on world markets with workers often making only a small fraction of U.S. manufacturing wages. Privatization has been a windfall for the companies who win government contracts, while their main efficiency gains hinge on their ability to pay non-unionized, private-sector workers less than more unionized public-sector employees. The huge decline in unionization in the private sector has decimated the U.S. working class, which depends on the union wages and benefit premium to secure a middle-class standard of living.

Taken together, these policies – a low and falling minimum wage; the de- or re-regulation of major industries; the corporate-directed liberalization of international capital, product, and labor markets; the privatization of many government services; the decline in unionization; and other closely related policies – are the proximate cause of the rise in inequality. Of course, the underlying cause is a shift at the end of the 1970s in the balance of economic and political power following almost five decades of ascendancy of labor and other social movements.

I am not simply arguing that the explosion of inequality was a side-effect of these policies. I am arguing, rather, that the explosion of inequality – what is, effectively, the upward redistribution of the large majority of the benefits of economic growth since the late 1970s – was the purpose of these policies. The purported efficiency gains, which were realized in some cases but not in others, were merely a political distraction.

4. BEYOND WAGES AND INCOME

So far, I have focused on the rise of wage and income inequality and the explanations for it. But the main problems that U.S. workers face cannot be solved simply with faster or even more equal real wage growth.

One key challenge for U.S. workers is job security. In the United States, with rare exceptions, workers are what our legal code refers to as «at-will employees» – that is, employees work at the will of the employer, with no legal claim to their job or to severance pay in the case of layoff.³ To be clear, in the overwhelming majority of cases,

³ For a review of relevant U.S. labor law, see International Labor Organization, <http://www.ilo.int/public/english/dialogue/ifpdial/info/termination/countries/usa.htm>.

U.S. employers can fire a worker without reason or advanced notice and without any legal obligation to provide severance pay. The major exceptions to this arrangement are the 13 percent of the workforce that is unionized and a small share of high-end workers such as company officers who negotiate individual contracts with their employers. One remnant of the civil rights and women's movement is that employers cannot fire workers for reasons of race, ethnicity, gender, religion, or certain other characteristics; but an employer can fire a worker without notice for almost any other reason: for arriving late to work, for refusing to work overtime, for arguing with the boss about a schedule change, or essentially any reason, reasonable or not, that does not involve discrimination. The "employment at will" doctrine creates a profound structural imbalance of power between the overwhelmingly non-unionized workforce and their employers.

Another challenge is the lack of a comprehensive and reliable social safety net. Historically, for example, only about 40 percent of unemployed workers receive unemployment insurance benefits and these are stingy by international standards (see Greenstein and Stone 2007).

The large majority of U.S. workers also depend on their job (or their spouse's job) for health insurance. With the typical employer-provided health insurance plan costing about \$5,000 per year for individual coverage and about \$13,000 per year for family coverage, higher wages alone will not go far in providing quality health insurance, particularly for lower- and middle-income workers (Kaiser Family Foundation and Health Research & Educational Trust, 2009: 24).

All of these non-wage issues – the lack of legal job protections, the lack of a safety net for most of the unemployed, the strong dependence of workers on their employers for health insurance, and others including the lack of any legally mandated paid time off – are major challenges for workers at almost all levels of wage distribution. But these problems are particularly acute for low-wage workers, who are not just the worst paid, but also the least likely to have union-representation, the least likely to have employer-provided health insurance (or insurance of any kind), and the least likely to have any form of paid time off.

5. CONCLUSION

The increase in inequality has given rise to a tremendous jump in household indebtedness. With workers' wages and their families' incomes under increasing pressure, many households have turned to ever-higher levels of debt to finance their consumption. In 1979, debt held by householders equaled about 75 percent of household income. At the peak of the last business cycle, debt had risen to over 135 percent of household income. The housing bubble was an integral part of this rise in indebtedness and it was precisely the collapse of the housing market that set off the Great Recession. The relatively rapid loss of about \$6 trillion in housing wealth had a devastating impact on household consumption.

In the standard neoclassical economics framework, low wages are simply a symptom of low levels of skill. Wage levels, however, are also a function of unionization rates; the level of the minimum wage; the entire regulatory frame-

work governing the terms and conditions of employment, from job security legislation to paid time off; the size and scope of the public sector; the degree of competition in national and international product markets; and other fundamentally political issues, all of which have little or nothing to do with workers' skills.

The sharp and sustained increase in economic inequality in the United States over the last 30 years is not a reflection of a national preference for inequality (discussed more blandly as «flexibility»), and not the continuation of an inexorable increase in inequality from 1776 to the present. The last 30 years, in fact, mark a significant departure from a five-decade trend toward greater economic and social equality. What changed was not the demand for skilled workers, but the balance of power between workers and their employers.

The way forward is clear, but appears largely blocked on the political front. In the short run, the federal government must use fiscal policy to make up for the collapse in private consumption and investment. In the medium- and long-term, economic policy must lay the groundwork for wage- and income-led growth. Doing so will require a substantial policy reversal. Policies that restore the connection between productivity growth and real-wage increases are probably the most important way forward, including: raising the minimum wage; expanding union representation; building a modern social insurance system that addresses the needs of the contemporary workforce, including universal child-care, guarantees of paid sick days, socially funded paid family leave, and legally mandated paid vacation and holidays; expanding existing social insurance, such as unemployment insurance, health care, and pensions; and improving access to quality education at the primary, secondary, and post-secondary levels.

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XII

REDISTRIBUTION FOR GROWTH? INCOME INEQUALITY AND DEMAND-LED ECONOMIC GROWTH - THE GERMAN EXPERIENCE

Simon Vaut

»I think the social market economy and the welfare state are among the greatest achievements in Europe during this otherwise terrible 20th century. But both require maintenance and repair. This is one of most urgent tasks of our time.«

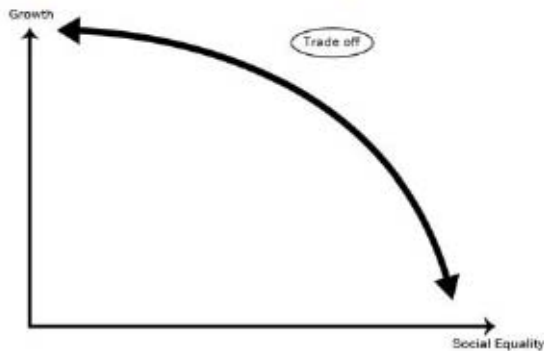
(Helmut Schmidt, Former Chancellor of Germany)

1. A SOCIAL DEMOCRATIC FRAMEWORK – WHY SOCIAL EQUALITY IS BACK ON THE AGENDA

What do the President of China Hu Jintao, the leader of Germany's Social Democratic Party Sigmar Gabriel, British Prime Minister David Cameron and US investor Warren Buffett all

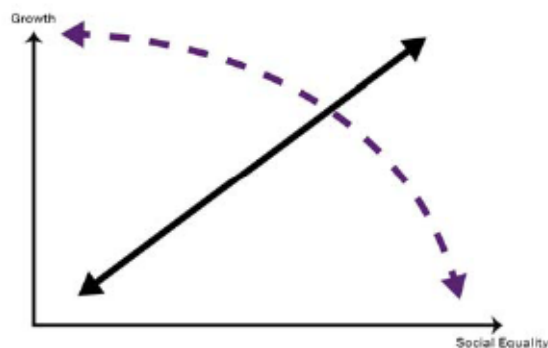
have in common? They are all worried about growing inequality in societies all over the world. These political leaders were all recently quoted in *The Economist* voicing their concerns about the dangers of rising inequality and the gap between rich and poor.¹ The recent world economic crisis contributed further to bringing awareness of social inequality back into focus

¹ »Mr. Hu puts the reduction of income disparities, particularly between China's urban elites and its rural poor, at the centre of his pledge to create a »harmonious society«, Mr. Cameron has said that more unequal societies do worse »according to almost every quality-of-life indicator«. Mr. Buffett has become a crusader for a higher inheritance tax, arguing that America risks an entrenched plutocracy without it.« (THE ECONOMIST: Jan 20th 2011: p. 6) Mr. Gabriel puts more social mobility and equality in the centre of his strategy to win back the government that the Social Democratic Party lost in Germany in 2009.

Figure 1: Conservative paradigm

Source: Author's illustration.

among policymakers. More and more, social justice is seen not only as a matter of fairness but as vital for steady, stable and sustainable economic growth. This perception marks a fundamental change in the public debate that was previously dominated by a relaxed attitude to increasing social inequality. Tony Blair, Britain's former prime minister, said he did not care how much bank managers earned so long as he could reduce child poverty. For the past two decades, dominated by the so-called Washington Consensus and neoliberal economic thought, social equality has been seen mainly as a trade-off for growth.

Figure 2: Social democratic paradigm

Source: Author's illustration.

Now, more and more researchers and policymakers are convinced that social equality provides a vital basis for sustainable and steady economic growth. As Figure 2 illustrates, growth and social equality can be seen as reinforcing each other.

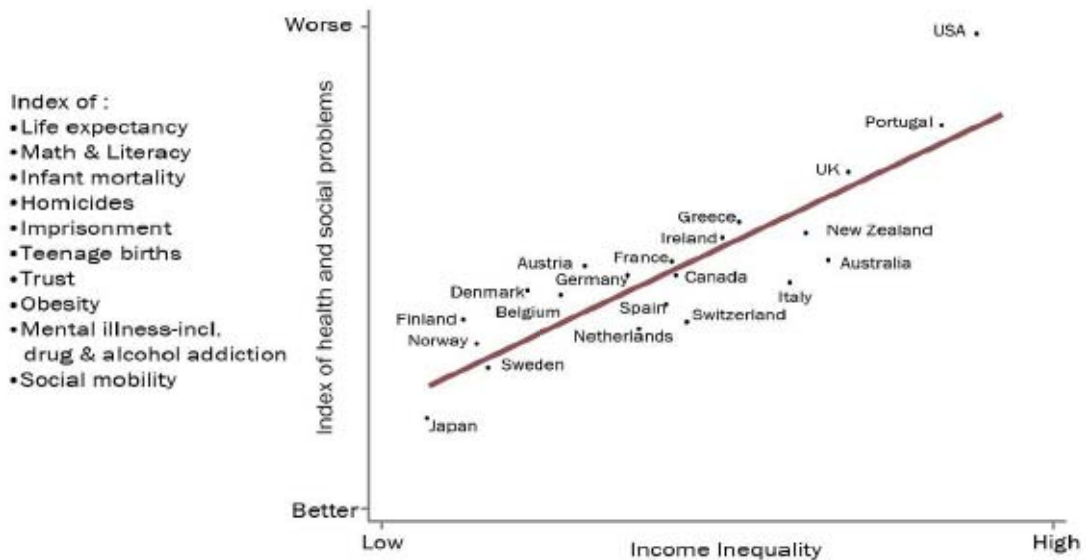
2. WHY SOCIAL BALANCE MATTERS

The case for social balance was recently emphasised on the basis of a wide range of data analysed by the researchers Richard Wilkinson and Kate Pickett in their landmark study *The Spirit Level – Why More Equal Societies Almost Always Do Better* (2009). Wilkinson and Pickett argue that inequality has pernicious effects on societies, such as eroding trust in public institutions, as well as increasing crime and illness. They show a strong positive correlation between greater equality and a number of social indicators, such as social mobility, life expectancy and literacy in OECD countries. Germany (and soon China) finds itself at a turning point, having reached a level at which further increases in per capita income do not automatically lead to an increase in general well-being. Progress depends more and more on fair income distribution and economic equality. Therefore, politics should now be less about maximising GDP and more about income distribution, social balance and sustainability for a harmonious society. (See Figure 3 on the next page.)

3. GROWING SOCIAL IMBALANCE IN GERMANY

What is the German experience of social equality and growth? For decades in the post-war

Figure 3: Health problems are worse in more unequal countries



Source: Wilkinson & Pickett 2009

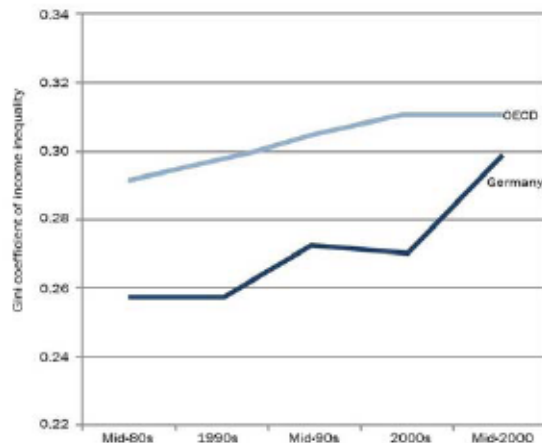
period, the German social market economy combined steady GDP growth with a high degree of social balance and equality. The »magic square« of Germany's coordinated social market economy was as follows:

- dynamic market forces in an open economy that are well integrated in the world market;
- strong welfare state institutions and social regulation to reduce poverty, create stable demand and ensure a harmonious society;
- collective bargaining by unions, employee participation and codetermination to enable employees to benefit from growing productivity with higher wages and to ensure a consensus in corporate governance between shareholder interests and human capital;
- macroeconomic regulation to prevent economic crisis and ensure stable demand.

Germany was more egalitarian than the OECD average until the 1980s. Although not as quickly as the UK under Margaret Thatcher or

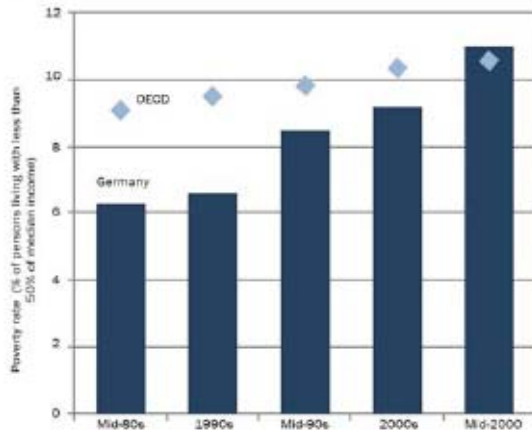
the USA under Ronald Reagan, Germany began to transform slowly in accordance with the Washington Consensus ideology. In the wake of global capitalism, shareholder value began to dominate corporate governance. The welfare

Figure 4: Development of the Gini coefficient



Source: OECD 2008.

Figure 5: Development of the poverty rate



Source: OECD 2008.

state was weakened and the bargaining power of trade unions deteriorated in many sectors – for example, services – and the welfare state was reformed and reduced. While net incomes remained stagnant for the middle class, the rich benefited from several tax reforms: the top income tax rate was lowered from 53 per cent to 42 per cent, inheritance tax was reduced and the wealth tax was abolished. Macroeconomic regulation was diminished by transferring power to the European Central Bank and the Keynesian policies that served Germany so well in the post-war period were abandoned.

What were the results of this transformation from the »golden age of welfare capitalism« to

an economic policy that increasingly followed the neoliberal agenda of the Washington Consensus? According to the OECD report *Growing Unequal* (2008), the gap between rich and poor has increased in Germany over the past two decades (see figure 4 and 5). In fact, German income inequality began to widen at a rate faster than in any other European country because the consensus of a coordinated social market economy had been weakened since the 1980s. Since 1985, the poverty rate (defined as a percentage of the population that has less than 50 per cent of the median income) almost doubled, from 6 per cent to 11 per cent. The Gini coefficient (an index of income inequality) rose in the same period from 0.25 to 0.29, which is slightly below the OECD average of 0.32. A growing number of poor fell behind those in the middle. There is an ever faster growing low-income sector in Germany that grew between 1995 and 2009 from 15 to 23 per cent (Vaut and Schroeder 2011).

As in many other countries, a significant rise in income going to the highest 1 per cent of earners can be observed. While the incomes of top managers have risen over the past two decades by 650 per cent, average workers have seen their living standards stagnate more and more and their income has increased by only 50 per cent since the 1980s (Vaut and Schroeder 2011: 9).

Table 1: Average growth and unemployment rates in Germany, 1951–73 and 1981–2008

	»Golden Age« 1951–1973	Period of Washington Consensus 1981–08
Average annual growth rate	4.8 %	3.2 %
Average unemployment rate	3.1 %	7.5 %

Source: Skidelsky 2009.

Getting back to the conservative paradigm (trade off between growth and social equality) and the social democratic paradigm (growth and social equality reinforce each other), the German experience gives some evidence

to support the *social democratic paradigm*. During this time of growing inequality, the average growth rate of GDP was 3.2 per cent compared to an average of 4.8 per cent during the years when Germany was more socially balanced.

4. WEAK DOMESTIC DEMAND, POORLY INVESTED EXTERNAL SURPLUS

What is the current situation in Germany regarding growth and equality? In 2011, Germany is growing at its fastest pace in two decades. A growth rate of 3.5 per cent puts it ahead of most other OECD countries. The unemployment rate in 2011 is just 6.6 per cent, the second-lowest among the G7 countries (Economist 2011).

However, this rosy picture is spoiled by Germany's export dependency: the country ran a current-account surplus of 5 per cent of GDP in 2010. The majority of the high growth was export-driven and thus is fragile in the unstable, contemporary world economy. The increase in net exports has accounted for no less than two-thirds of Germany's total GDP growth over the past decade, far more than in any other OECD country. Internal demand, however, has been shrinking for over a decade in Germany. The Global Wage Report 2010/2011 by the International Labour Organization revealed that real wages declined by 4.5 per cent between 2000 and 2009. In comparison, real wages went up by 25 per cent in Norway during the same period (ILO 2011).

This is not a sustainable engine for growth. To contribute to GDP as it has in the past, Germany's trade surplus would have to keep rising

every year. That would leave Germany increasingly vulnerable to recessions elsewhere, as well as to the risk of a protectionist backlash. Germany's trade surplus has swollen only partly at the expense of other rich countries: two-fifths of the increase over the past decade was with emerging economies. Indeed, its surplus with America has shrunk as a share of America's GDP over the past decade. But Germany does run a large surplus with the rest of the EU, where demand will be much weaker over the coming years, partly due to the Euro crisis (Economist 2011).

Germany's external surplus reflects chronically weak domestic demand as much as it does external strength. Consumer spending has grown by an annual average of only 0.3 per cent over the past decade, depressed by prolonged wage restraint and high household savings. The external surplus of Germany has been poorly invested, in everything from American subprime bonds to Greek government bonds.

To maintain growth over the coming years, Germany needs to boost domestic demand. The good news is that there recently seems to be a trend for more domestic spending: business investment has picked up and, in the fourth quarter of 2010, consumer spending was almost 2 per cent higher than in 2009. There is some reason for optimism that the lowest unemployment rate since 1992 will push up wages and encourage more consumer spending.

5. AN AGENDA FOR MORE SOCIAL BALANCE

It has been argued that social balance is not only normatively good (Wilkinson and Pickett), but is vital to create more domestic demand in order to stimulate growth and reduce export dependency. Policymakers therefore need to keep their focus on closing the growing gap between rich and poor. Here are some suggestions from the German experience that might be applicable to other countries as well.

Minimum wages, welfare benefits and progressive taxes. Some 800,000 employees in Germany have to claim welfare benefits in addition to their salary because the income from their full-time jobs does not provide a living wage. However, work must pay; that is a question of fairness but also economic sense. Therefore, a minimum wage has to ensure that somebody who works full time can make a living. While some welfare reforms helped to bring unemployed people back to work, some welfare cuts should be revised. Taxes are increasingly a burden for middle income earners, while in Germany and other OECD countries there have been massive tax cuts for top incomes in recent years. A fairer, more progressive tax system with fewer loopholes should therefore be considered.

Strengthening trade union bargaining power, codetermination and employee participation. German companies that are strongly unionised, such as carmakers (BMW, Volkswagen, Daimler and so on) are highly competitive because of their productive, innovative and flexible workforce. At the same time, they pay their workers good salaries. Codetermination and works

councils make sure that the experience and knowledge of the employees are considered in corporate governance. During the crisis, codetermination and works councils were particularly valuable, enabling management and employees to quickly come to a consensus to adapt to the crisis, for example, by cutting hours and reducing salaries for a limited time during the downturn of global demand. That was a major reason why Germany rebounded much more quickly from the world economic crisis in 2010 than other countries. However, in other sectors of the Germany economy – for example, the service sector – unions are weak and have to be strengthened to ensure productivity and fair salaries.

Measure economic success not only in GDP but with an indicator that also includes social (and environmental) sustainability. Last but not least, it should be discussed how economic and social progress can be measured in a way that goes beyond GDP using indicators that also include social balance and sustainability. The well known economists Joseph Stiglitz and Amartya Sen developed an indicator for the French government that measures economic and social progress. The German Bundestag (parliament) has been consulted since 2010 by an expert commission (so-called Enquete-Kommission) that researches social balance and sustainability and will develop indicators to measure progress in this area.

With these policies, social and economic growth in Germany and other countries could be fostered sustainably.

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XIII

INCOME DISTRIBUTION AND GROWTH IN SOUTH KOREA

Ky Won Kim

1. IS KOREA AN ADVANCED COUNTRY?

South Korea is now an advanced country in terms of per capita GDP (purchasing power parity), estimated to be about \$30,000 for 2010. The corresponding figures for the USA, Sweden, Germany, France, Japan, Italy and New Zealand, are \$47,000, \$39,000, \$36,000,

\$34,000, \$33,000, \$30,000 and \$28,000 respectively. According to IMF statistics, South Korea ranks twenty-fifth out of 183 countries in terms of per capita GDP.

With regard to industrial structure, South Korea has changed dramatically during the past five decades (Table 1): its present industrial struc-

Table 1: South Korea's Industrial structure, 1956–2009 (by value added; %)

	1956	1970	1979	1986	1997	2009
Agriculture and fishery	49	33	21	11	5	3
Manufacturing and mining	7	17	31	24	25	28
SOC and services	44	50	48	65	69	69

Source: The Bank of Korea.

ture differs little from that of other advanced countries. Moreover, South Korea enjoys a large world market share in some important industrial products, such as memory chips, cellular phones, automobiles, ships, petrochemicals and so on. Therefore, it is not surprising that South Korea has become a member of the G20.

However, in terms of quality of life, South Korea still suffers from numerous problems. There are still many violent incidents in South Korea, usually associated with income inequalities.

2. ECONOMIC GROWTH

Korea was emancipated from 35 years of Japanese colonial rule in 1945 but divided into South and North Korea. The conflicts between them led to the Korean War of 1950–53, which dealt a severe blow to the South Korean economy. After the war, South Korea sought to reconstruct its economy through import substitution industrialisation with foreign aid.

Since the 1960s, South Korea has experienced a high rate of economic growth, as shown in Table 2. In the 1960s and 1970s, the annual average growth rate was 8 per cent. This continued in the 1980s and 1990s, until the 1997 financial crisis. Subsequently, the growth rate fell below 5 per cent, but South Korea has been

one of the fastest growing countries since the 1960s.

In 1961, a military coup took place in South Korea and the subsequent military government promoted state-led industrialisation, implementing economic planning and nationalising some important banks. The government controlled the distribution of money to finance large industrial investment. Furthermore, export-oriented and labour-intensive industrialisation was initiated.

During the 1970s, the government sought to upgrade the industrial structure by putting more emphasis on heavy industry and chemicals rather than on labour-intensive industries, while it strengthened its dictatorship and repressed the growing student and labour movement. With regard to agriculture the government tried to improve the situation of peasants by raising the grain price and through the so-called *Saemaul* movement (new community development programme).

The overinvestment in heavy industry and chemicals resulted in investment readjustment in the 1980s. The new military government attempted to force the merger of large firms with excess capacity. It also introduced some legislation for restraining the power of the *chaebol* (South Korean conglomerates) which became the dominant player in the Korean economy.

The South Korean government's »growth first and distribution later« strategy met with increas-

Table 2: Annual average growth rate, South Korea (%)

	1954–60	1961–70	1971–80	1981–90	1991–2000	2001–2010
Growth rate	3.8	8.4	7.2	8.7	6.2	4.2

Source: KDI 1997: 129.

Table 3: Composition of GDP, 1973–2009: expenditure structure (%)

	1973	1986	1996	2009
Private consumption	70	55	60	53
Capital formation	24	28	39	24
Export	30	38	15	40

Source: <http://kosis.kr>.

ing opposition from the 1960s. The Korean people's discontent with the dictatorship erupted in 1987, ended the military regime and brought about rapid democratisation.

Along with political democratisation, workers demanded economic democratisation. Massive labour strikes took place in 1987 and many democratic labour unions were organised. As a result, real wages increased considerably, doubling in the decade after 1987. This, in turn, changed the composition of expenditure. Table 3 shows that the significance of domestic consumption rose in comparison to exports in the 1990s.

This expenditure structure was transformed abruptly with the outbreak of the financial crisis in 1997. The crisis was caused by the bankruptcy of some major *chaebols* and financial institutions. As the crisis went on, the unemployment rate rose drastically from 2.5 per cent in 1997 to 6.8 per cent in 1998. Real wages declined by 9 per cent in 1998. The proportion of regular workers out of total wage earners also declined.

South Korea recovered from the crisis relatively quickly by means of large-scale restructuring and reintroduced an export-oriented growth strategy. As demonstrated in Table 3, exports regained their importance, while consumption

lost its former significance. The growth rate decreased to below 5 per cent and the earlier high growth finally came to a halt.

3. INCOME DISTRIBUTION

First, it is important to note that reliable comprehensive data are lacking. Most income distribution statistics are based on household surveys, which exclude income earners in the high-income and low-income classes up to 1977. Since the 1980s, the survey sample has been widened to include both classes, but still not to a satisfactory degree. With this limitation in mind, we describe how income distribution has changed since the industrialisation of the 1960s.

Table 4 points to two trends between 1965 and 1976. Income distribution first improved in the

Table 4: Income Inequalities in Korea: Gini coefficient, 1965, 1970 and 1976

	National	Farm	Non-farm
1965	0.344	0.285	0.417
1970	0.332	0.295	0.346
1976	0.391	0.327	0.412

Source: KDI 2000: 285.

1960s, but deteriorated again in the 1970s (Table 4). This may be attributed to the fact that in the 1970s the government promoted capital intensive industrialisation and policies favouring large firms. Inflation, which accelerated during the 1970s, was another reason for the deterioration of income distribution.

During the 1980s and 1990s, income distribution improved, according to some studies. However, other studies show different results. Nevertheless, it can be agreed that income inequality among workers has decreased since the 1987 democratisation.

This trend changed suddenly after the 1997 crisis (see Table 5). The restructuring forced by the economic crisis exacerbated income inequality. Income distribution did not improve even after the financial crisis was resolved. The end of high growth was one determining factor. Economic recovery through export promotion also meant that there was a divide between the export-oriented and the domestic economy in South Korea. The trickle-down effect was

weaker. Globalisation and the IT revolution had a negative influence on income distribution. Some people adapted well, but others did not.

4. REDISTRIBUTION THROUGH PUBLIC FINANCE

In many countries, the state acts as a redistributive agent and through progressive taxation and social policy reduces income inequality. In 2007, the use of public finance reduced income inequality in OECD countries by more than 30 per cent, whereas in South Korea the effect was a mere 8 per cent (OECD 2008). One reason for this gap is the difference in the proportion of old people. Even when this factor is excluded, however, there remains a large gap between OECD countries and South Korea. This points to the need for increasing the role of public finance in order to alleviate income inequality in Korea.

With regard to taxation, the proportion of tax revenue compared to GDP in South Korea is about 20 per cent, which is 8 per cent below the OECD average. Direct taxes such as income tax are especially low, which makes it difficult to improve income distribution through public finance. Furthermore, tax evasion is rampant and there are tax concessions for large firms.

In connection with social spending, Korean government has pursued welfare policies whose importance has varied over time. During the high growth period of the 1960s and 1970s, little emphasis was put on welfare expenditure for coping with income distribution problems. The government tried to alleviate absolute poverty and to reduce unemployment by means of

Table 5: Change of Income Inequality (before and after the crisis 1997)

	Proportion of poor people	Gini coefficient
1982	11.0	0.316
1985	11.2	0.312
1990	7.6	0.273
1997	9.9	0.274
1998	12.4	0.310
2003	12.3	0.299
2007	14.4	0.325

Source: Lee 2010: 478.

the continuous creation of jobs through high economic growth.

Nonetheless, some minor social security programmes were introduced in part during the 1960s. The public assistance system was launched to boost the livelihoods of the poor. This comprised subsidies for operational costs, grain supplies and orphanages. Some social insurance schemes, such as government employees' pensions, military pensions and industrial accident insurance, were also put in place during this period.

The national welfare pension was scheduled to come into effect from 1974, but its enforcement was deferred due to political instability and the oil shock. Instead, medical insurance for businesses with 500 or more employees was launched. A medical assistance programme for extremely poor people was also introduced.

Since the 1980s, the social welfare issue has received increasing attention as discontent about widening income inequality has risen among the underprivileged. Accordingly, the government formulated the Fifth Five-year Economic and Social Development Plan of 1982–1986, clearly outlining the concept of social development differently from the previous Five-year plans. The objective of social development was to mitigate the undesired effects accumulated during the past high economic growth and to cope efficiently with rising public demand for social welfare.

However, nothing new was actually implemented before the 1987 democratisation. The slogan of social development was little more than lip service, for the government was still a military dictatorship following the previous dic-

tatorial regime. Only after political democratisation did the government initiate and expand several important welfare programmes.

The structure of the social welfare system went through three ground-breaking changes: implementation of the national pension plan; enforcement of nationwide health insurance; and enactment of the minimum wage law. The introduction of these three schemes was a major step forward for social welfare.

In the 1990s, up to the 1997 crisis, the government enacted the employment insurance law. The law guarantees some income over a fixed period for workers when they are unemployed. By introducing the employment insurance system, Korea came to possess all the core elements of social welfare – at least formally – except for child allowance. Of course, the quantity and quality of each social welfare element was insufficient compared to other advanced countries.

After the economic crisis broke out in 1997, Korea had to deal with its deleterious social consequences: rapidly increasing unemployment, declining wages and income, growing absolute poverty, worsening income distribution, and rising crime and violence. Therefore, the government initiated active policy measures to mitigate the harmful social consequences. Those included the expansion of unemployment insurance, the public works programme, the legislation of the Minimum Living Standards Security Act and so forth.

Unemployment insurance underwent a series of expansions after the 1997 financial crisis. Initially covering firms with 30 and more regular employees, it was expanded to companies with 10 or more regular employees. Later, all work-

places, including firms with fewer than five regular employees and irregular workers became liable for unemployment insurance. The amount and period of benefits for unemployed workers were increased.

As the unemployment rate soared in 1998, the government implemented a wide variety of public works programmes for the poor unemployed. Local governments provided temporary jobs which included street cleaning, traffic guides, tree trimming and so on. Public works suitable for women and white-collar workers, such as computerisation and information technology projects, were later added.

The Minimum Living Standards Security Act was adopted in 1999 in response to social demand for reform of the former Livelihood Protection Act. The latter was not intended for the unemployed who by definition were capable of working. This restriction on eligibility resulted in a gap in the social safety net. With the new law the government sought to ensure that basic needs such as food, clothing, housing, education and health care were met for all people living below the subsistence minimum.

At present, social security in Korea comprises social insurance, public assistance and social welfare services. Social insurance includes the public pension scheme, national health insurance and industrial accident insurance. Public assistance consists of minimum living standards security, medical aid and disaster relief. Social welfare services include services for the elderly, the disabled and children.

5. FUTURE TASKS

Formally, the core systems of social security are now implemented in Korea, except for child allowance. In terms of contents, however, Korean social security systems are still insufficient and have numerous gaps. Korea has a long way to go before it catches up with the welfare level of Western countries.

In order to improve income inequality and welfare, Korea has to reduce the gap between large and small and medium-sized firms. The gap between regular and irregular workers must also be reduced. Korea must expand welfare expenditure and close the various gaps.

In Korea, the proportion of exports in GDP was 10–20 per cent in the 1980s and 1990s, before the 1997 crisis. It increased dramatically after the crisis and now stands at about 40 per cent. In contrast, the proportion of private consumption has declined from about 60 per cent to about 50 per cent. This means that Korea's economic growth is now induced by foreign demand rather than by domestic demand. The deterioration of income distribution derives from this demand structure. Therefore, tackling this deterioration will change the demand structure and growth strategy.

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