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The Debate on Growing Inequality – Implications for Developing Countries and International Co-operation

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The Debate on Growing Inequality – Implications for Developing Countries and International Co-operation

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Abstract

A body of recent research is pointing to a growing inequality in many countries. The current debate focuses on high income countries. However, developing countries are an important element in understanding the full picture. First, evidence indicates that growing inequality can also be observed in many developing countries, in particular if top income and wealth evolution is taken into account, a phenomenon which is at variance with conventional economic theory. This has a multitude of economic, political and social implications for the respective countries. In particular, high inequality is linked with political instability, financial fragility and can undermine economic growth. Secondly, developing countries form an increasingly important part of the world economy. Therefore, options to combat inequality must take into account this broader picture.

For any solution, one has to understand the driving forces behind growing inequality. Piketty's central claim is that the free-market system has a natural tendency towards increasing the concentration of wealth. However, there are strong arguments that ever growing inequality is not sustainable in the long-term, in particular because it would eventually slow down economic growth, increase debt levels as well as social and political instability. It is argued in this article that the tendency to accumulate capital at the top seems to lead periodically to unsustainable situations, whereby "external factors" such as wars, technological innovations, government re-distribution and bail-outs can rebalance (and have in fact in the past rebalanced) the system for some time.

Governments of developing countries must act on two fronts to contain rising inequality: On the one hand, they have to scale-up domestic resource mobilisation in order to enhance social investments and re-distribution, as many Latin American countries did successfully in the last decade. On the other hand, they must foster the inclusiveness and resilience of their development strategies. Correspondingly, development institutions should go beyond their current focus on extreme poverty and take into account inequality – in terms of general approaches, country support and strategies as well as instruments. Finally, the issue should be adequately taken up within the new "Post-2015" framework.

Keywords: Inequality, financial stability, developing countries

JEL codes: E21, E24, H20, 020

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A body of recent research is pointing to a growing inequality in many countries. In particular, triggered by the publication of Thomas Piketty's *Capital in the Twenty-First Century,* there is a renewed interest in this issue. The current debate focuses on high income countries. The question raised in this article is, how the issue relates to developing countries. The first section highlights a few key facts regarding the evolution of inequality. The second session asks why equality matters. The third session focusses on the question: What are the driving forces behind the growing inequality in many countries? The last section outlines implications for developing countries and their development strategies as well as for international co-operation.

1. An Unequal World

Piketty documents the evolution of income and wealth over the past 300 years, particularly in Europe and the United States. He demonstrates that the period after the industrial revolution and until the World War I ("the long 19th century") was characterized by a growing concentration of wealth and income. A similar tendency can be observed in the last decades. Since the 1970s, both wealth and income gaps have been rising back towards to their pre-20th-centruy norms. According to Piketty, the period from about 1914 to the 1970s, in many advanced countries, was an historical outlier in which both income inequality and the stock of wealth (relative to annual national income) fell dramatically.

Let us look first on the evolution of income distribution in the last decades. Between the mid-1980s and the mid-2000s, inequality rose in 16 out of 20 rich OECD countries.[1] Where inequality increased, usually it was due to an unprecedented surge in top wage incomes. The trend is particularly strong in Anglophone countries. For example, in the US, the share of market income captured by the richest 10 percent surged from around 30 percent in 1980 to 48 percent by 2012. In the same period, the share of the richest one percent increased even more, from 8 percent to 19 percent, while the share of the richest 0.1 percent increased from 2.6 percent to 10.4 percent.[2]

What about developing countries? Inequality is on average higher in these countries than in high income countries. But, can we observe there a similar trend towards inequality? The World Bank claims in its 2014 Global Monitoring Report, that during the 2000s, the bottom 40 percent enjoyed more rapid income growth than the average of the population in 50 out of 78 countries. However, these figures tend to paint a too rosy picture.[3] First, the World Bank is using for most regions consumption data. As rich people tend to consume a relatively small part of their income, measuring income instead of consumption data would be more appropriate.[4] Besides, the World Bank approach - looking at income growth rates of the bottom 40 percent compared with overall income evolution - is ignoring the evolution of top incomes. As argued above, at least in advanced countries, growing inequality was very much linked to the exploding income of the highest 1 percent or even

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[1] Branko Milanovic (2011, p. 3)
[2] IMF (2014a, p. 9)
[3] According to the data presented in the paper, for the following countries, the average income performance was clearly better than the income performance of the bottom 40 percent: Malaysia, China, Uganda, Paraguay, Costa Rica, Bulgaria, Burkina Faso, Togo, Montenegro, India, Lao PDR, Malawi, Iraq, Senegal, Ethiopia, Armenia, Mauritania, Indonesia, Georgia, Macedonia, Serbia, Central African Republic, Zambia.
[4] See Kumhof and Rancière (2009, p. 28) for the US.

0.1 percent of the population. It is therefore not surprising that other indicators – such as the Gini coefficient or even more the Palma ratio[5] - paint a more negative picture about the evolution of inequality in developing countries. Since 1990 the Gini coefficient for disposable income[6] has increased not only in nearly all advanced countries, but also in many developing countries, in particular in Asia, the Pacific, the Middle East and North Africa.[7] Based on the calculation of Gini coefficients, seven out of 10 people live in countries where the gap between rich and poor is greater today than it was 30 years ago.[8]

The growing income inequality can also be observed when looking at the share of wages in total income ("the wage rate"). Since 1990, real wages in advanced countries has been flat or increasing very slowly. In contrast to the evolution of real wages profit rates are historically high in many countries and also corporate savings has risen across the rich world in recent years. East Asia is an extreme case. Japanese firms hold 2.1 trillion dollar in cash, a massive 44 percent of GDP. Their South Korean counterparts hold 440 billion dollar or 34 percent of GDP.[9] Accordingly, the wage rate has fallen steadily the world over.[10] This is somewhat surprising as it contradicts conventional wisdom. Kaldor (1957) set out six so-called "stylized facts" about economic growth, one of which was that the shares of national income flowing to labor and capital held roughly constant over time. This "fact" does not hold any longer. The falling wage rate seems to hold also true at least for some important developing countries, such as China.

Wealth is even more concentrated than income.[11] In the US, the bottom 90% of the population holds just 22 % of wealth, about the same than the wealth held by the top 0.1%.[12] The top one percent controls one-third of the assets in the United States and 40 percent around the world. Today, the world's 85 wealthiest citizens own more than its bottom three and a half billion. There are 1645 billionaires worldwide, more than double the number compared to before the financial crises.[13] Many of those "High Net Wealth Individuals" are from developing countries.

The growing inequality in advanced and middle income countries is at variance with another important economic building block, the "Kuznets-Curve". Kuznets argues that in very poor developing countries inequality rise as people start moving from low-productivity agriculture to the more productive industrial sector, where income is higher. But as a society matures and becomes richer, the urban-rural gap is reduced and old-age pensions, unemployment benefits, and other social transfers lower inequality. The documented exacerbating inequality in advanced economies, but also in China and India contradicts this theory. The development in China, India and many other developing countries also contradicts another economic theory, the *Heckscher-Ohlin-Samuelson Theorem*. This theorem posits that as poor countries engage more in global trade, they tend to specialize in the production of goods in which they hold a comparative advantage, namely low-skill

[5] For a comparison, see Cobham 2013
[6] I.e. market incomes minus direct taxes plus cash transfers.
[7] IMF (2014a, p. 7)
[8] Oxfam (2014, p. 8)
[9] The Economist (Sept. 27, 2014)
[10] Karabarbounis and Neiman (2013)
[11] It does not come as a surprise that income and wealth concentration increased simultaneously. Higher incomes of the rich are partly invested in assets. Rising shares of non-wage income from capital for richer households in turn fuel income inequality.
[12] The Economist (November 8, 2014)
[13] Forbes magazine (2014)

goods. Doing so should increase domestic demand for low-skilled labor and raise the wages of low-skilled workers relative to that of skilled workers. Inequality should decline.

2. Why Equality Matters for Development?

Inequality is not only a moral issue in the narrow sense. Rather, it is an issue with a multitude of economic, political and social implications for the respective countries and for the world economy as a whole.

(a) Political Stability and Social Coherence

The period after the after World War II was characterized by a narrowing income distribution and by a leveling out of the wealth distribution. For the first time in modern economic history a broad, property-owning middle class emerged. Doubtless, that middle class has been a stabilizing force in politics and society. Many countries, such as Germany are considering a broad and prosperous middle class as a central building block of their social fabric and economic success.

Indeed, history has given us painful lessons regarding the impact of growing inequality, unemployment and widespread pauperization on political systems. It can destroy social cohesion of societies, spark social segregation and tension. It can also destabilize societies and trigger populist and nationalist movements as well as lead to high level of violence. According to the World Bank, excessive concentration of income or wealth has been associated with episodes of conflict. Doubtless, the political turmoil in such countries like Ukraine, Egypt, Syria and Venezuela is partly linked to growing inequality, high unemployment and a lack of inclusiveness of growth.

Besides, with the "wealthification" of politics, those in the upper echelon have access to significant influence over the political process. This can undermine democracy by giving wealthy people inadequate influence on political decisions. Recent political economy models of inequality assume that the "decisive voter" – one whose preferences tilt a decision one way or another – is much richer than the "median income voter". Political decisions would then coincide much more with the preferences of the rich. In this analysis political systems have moved closer to "one dollar, one vote" from the more traditional "one person, one vote" model.[14] Moreover, there is a growing lobby defending the vested interest of wealthy people and the financial sector. E.g. it is estimated that financial institutions spend more than 120 millions € annually for lobbyists to influence EU policies[15], about the same amount the World is spending on Official Development Assistance.

Similar things are happening globally. Billionaires have run for office in Australia, Austria, France, Georgia, India, Italy, Lebanon, the Philippines, Russia, Thailand, Ukraine, the United Kingdom and the United States. Oligarchs in Russia, so-called "princelings" in China and tycoons in many other countries are becoming politically active and affecting public policy. Their political involvement raises important questions about excessive influence, especially in places where there is weak rule of law,

[14] Karabarbounis (2011)
[15] Wolf et al (2014) according to Oxfam (2014)

overt corruption and limited opportunities for social or economic advancement.

(b) Financial Stability

Since Keynes, we know that decreasing wage rates are a problem for the entire economy. Wage earners, in particular in the lower bracket, do have a higher propensity to consume. This means that if wages of low- and medium skilled workers do not hold up, the economy tends to suffer from insufficient demand. Insufficient consumption demand can be dealt with in two ways. The first possibility is that the system rebalances by shifting production towards investment goods. The lack of consumption demand is then compensated by higher investment demand.[16] As a second option, income earned by the wealthy rich can be spent on "investment" in the form of financial assets. However, if the income of the majority of citizens stagnate or decline, consumption levels are often not adjusted accordingly. As a consequence, household debt levels would increase.

For an "open economy" with a free flow of goods, services and capital there is a third option. In this case the surplus goods and services can be exported and income can be spent for buying financial assets abroad. For a country with insufficient domestic demand (and excess savings over investments), this opens up the possibility to sustain high production levels, at least for a while. However, it is obvious that this is not an option for all countries, as this option is associated with current account deficits and indebtedness by partner countries.

What we have seen before the financial crisis in 2007 is a combination of options 2 and 3. A big part of rich people's income as been invested into financial assets – domestic and abroad. Income inequality experienced a sharp increase in the two decades preceding the financial crisis in 2007. Parallelly, debt-to income levels increased in many countries before the outbreak of the financial crisis, in particular in the anglo-saxon countries. The same phenomena – rising inequality and debt - could be observed before the crisis in 1929. In the US, the ratio of household debt to GNP increased twofold between 1983 and 2007 (and also between 1920 and 1932).[17] It has been suggested that the surge in borrowing has been a way for the poor and the middle-class to maintain or increase their level of consumption at times when their real earnings were stalling.[18] The period before the financial crisis was also characterized by high and growing current account imbalances, i.e. indebtedness between the countries, both within Europe and globally. The recycling of rich people's funds to the poor and middle income households as well as to other countries is reflected in the growing size of the financial sector.

Policy also plays a role. A boom in financial investments is usually fuelled by loose monetary policies, as it was the case before 2007, and again in recent years. The major objective is to stimulate growth. Before the 2007 crisis, government incentives for housing credits helped to keep up the economy. After the crisis, central banks tried to improve access to credit by SMEs and the real sector. However, in particular in Europe expansive monetary policy has not been very effective in stimulating spending. The money pumped into the economies either ended up back in the central banks, as

[16] This option might not be sustainable in the long-run, as growing investment leads to growing supply and the mismatch would break up sooner or later.
[17] Kumhof and Rancière (2010, p. 4ff)
[18] Kumhof and Rancière (2010, p. 4)

excess reserves of the banking system, or went into speculative activities, into the stock markets. It hasn't really very much stimulated real sector investment, spending in general and generated jobs.

Developing countries have played an increasingly important role in absorbing surplus savings. With rapidly integrating financial sectors these countries were more and more exposed to volatile capital flows. In search for higher yields and due to the low interest rates, substantial liquidity flowed from advanced to developing countries after the financial crisis. This inflow of capital supported the consumption boom in developing countries, the appreciation of the respective currencies as well as widening of current account deficits. Only recently, these flows slowed down and partly reversed. Those volatile capital flows have increased the vulnerability of those recipient countries' financial systems and added to the vulnerability of the world financial system.

(c) Economic Growth

In the past, economists used to argue that redistribution can hamper growth, e.g. because inequality is providing an incentive for innovation and entrepreneurship. More recently, there seem to be a growing awareness that, on the contrary, growing inequality and insufficient redistribution can affect economic growth. The IMF argues in a recent study[19] that inequality may be harmful for growth because it deprives the poor of the ability to stay healthy and accumulate human capital, generates political and economic instability as well as impedes the social consensus. Empirically, countries with high levels of inequality suffered lower growth than nations that distributed incomes more evenly. The World Bank estimates that one Gini point increase in income inequality is estimated to lower annual GDP per capita growth by around 0.2 percentage points in advanced countries and by around 0,14 percent for a larger set of countries.[20] Besides, inequality can also make growth more volatile and create the unstable conditions for a sudden slowdown in GDP growth.[21] If ordinary people do not benefit from economic growth, there is a high risk that the growth process itself being undermined.

3. Driving Forces of Growing Inequality

Why is inequality on the rise in the vast majority of high income countries as well as in many developing countries? What are the driving forces behind this trend? Piketty's central claim is that the free-market system has a natural tendency towards increasing the concentration of wealth. This is confirmed by his empirical findings, according to which inequality increased most of the time since the birth of modern capitalism. The period between 1914 and the 1970s is characterized as an outlier, because two world wars and the Great Depression pushed down the return on wealth, while rapid productivity and population rises pushed up growth.

Besides, it is argued that changes in government policies played an important role. After the world wars, many Governments used taxes and social transfers to redistribute some of the higher incomes. After the Great Depression and in the face of rising fascist movements governments became aware of the destabilizing potential of high unemployment and mass pauperization. Some decided to

[19] Ostry et al (2014, p. 4)
[20] World Bank (2014a, p. 6)
[21] IMF (2014b)

introduce Keynesian policies and social security systems, like Roosevelt's "Big Deal". Similarly, after World War II fiscal policy has played a significant role in reducing income inequality in advanced countries. According to IMF estimates direct income taxes and in particular transfers have decreased inequality in these countries by an average of one-third.[22] However, beginning in the nineties many countries cut social benefits and lessened the progressivity of income taxes making fiscal policy less redistributive.[23] Re-distributional policies also play a role in explaining differences between countries and regions, in particular why inequality increased much less in continental Europe than in English-speaking countries.[24]

Piketty's claim that the free-market system has a "natural tendency" towards increasing the concentration of wealth and higher degrees of inequality raises a few questions. It is largely based on the assumption, that the rate of return on capital (in normal times) is outstripping the rate of growth of the economy leading to an increasing share of capital income in total income, and therefore inequality. The more that capital is accumulated at the top, the more the economic structure is likely to be shaped to favor rents and profits over wage income, which then reduces the reliance of the owners of capital on faster GDP growth.

This assumption is backed by historic data, confirming rising inequality for most of the advanced countries, with the exception of the above mentioned "outlier period". The question arises, how such a high return on capital can be maintained and how such a system can be sustainable over the longer term. Why would do the marginal returns to capital not diminish over time?[25] If the capital earners received an ever growing part of the national product and invested it into new wealth whereas the wage earners received an ever diminishing part, where would the demand for the goods and services produced come from? The result would be an ever growing weakness of private sector demand relative to potential incomes – an unsustainable situation. Besides, the claim of the increasing rate of return on capital seems to be at variance with other theories, including the one outlined in Karl Marx' "Das Kapital". Marx argues that capitalism is inherently linked with a long-term fall in the profit rate. This tendency would eventually lead to a crisis of the capitalist system itself (the "inherent contradiction" of capitalism).

In my view, Piketty is right to argue that there is a mechanism leading to increasing returns on capital, notably because high income owners invest a big part of their income into capital assets thus securing them an increasing claim on future income. However, this mechanism does not bring about a sustainable long-term situation, in particular because the associated rising inequality would eventually slow down economic growth, increase debt levels as well as social and political instability.

With that perspective, the historic data on inequality can be interpreted differently: The wars destroyed wealth and shifted (bargaining) power to workers. This increased demand and rebalanced in some sense the societies and the economies. Government re-distribution and intervention (e.g. after the Great Depression) had a similar effect. Also the financial crises in 2007/8 had in some way such a "purifying" impact as debt levels where reduced, albeit essentially not by writing-down private claims: the burst of the credit and asset bubble would have brought the rate of return down and

[22] IMF (2014a, p. 15)
[23] IMF (2014a, p. 17)
[24] Piketty and Saez (2006)
[25] Milanovic (2014, p. 9ff)

equality up; but as the Governments had to save the banks and bail out the investors, the rate of return was held up and inequality further increased. Similarly, the extension of the free-market system into other regions and areas, not yet subsumed under capitalist mechanisms, opening up cheap labor, land and other resources, can have the effect of a "fountain of youth", associated with increasing profits. This might contribute to explaining the evolution of income and wealth before World War I, but also after the World War II, characterized by accelerated economic globalization.

Are there other factors, which can explain the evolution of key economic variables, such as the rate of return on capital, the inclusiveness of the economic model and the degree of inequality? One important issue is technological innovation, as it can boost the rate of return (e.g. by diminishing the cost of capital and/or by new products, opening up the possibility of "extra-profits" etc.), alter the income distribution and substantially impact on growth perspectives.

A particular strand of discussion points to the digital revolution that has in the last two decades increased wage dispersion in favor of higher-skilled workers. The information and communication technology has destroyed, so the argument, many "old" jobs whereas it so far generated little "new" employment. The new technology enabled firms to reduce the number of workers engaged in routine tasks, which are comparatively easy to program and automate. Thereby, technological advances are more and more encroaching on tasks that were previously considered too brainy to be automated, including some legal and accounting work.[26] This has led to a rapid increase of income by people at the top of their profession. At the same time, white-collar workers with lower qualifications find themselves increasingly displaced. The resulting fierce competition puts pressure on wages, driving down the wage share of the economic pie. The result is a kind of labor – force polarization, a "great divide", characterized by soaring employment of least-skilled and low paid workers and a declining share auf middle-skilled workers.

It is argued that the new technology not only impacts negatively on the distribution of wealth and income in industrialized countries, but has also far-reaching implications for developing countries and their prospects to integrate into the global economy. For a long time, developing countries' governments have been looking at China and other successful East Asian countries and trying to copy at least elements of their development strategies. The key pillar of those strategies was to build up manufacturing export capacity, moving from low-margin, labor-intensive goods such as clothing to electronics assembly and to advanced manufacturing. Due to new technology, it might be more difficult for developing countries today to boost manufacturing capacity, thus absorbing unskilled labor from rural areas. More manufacturing work can be automated, leading to what has been coined "premature deindustrialization". At any given level of income, countries today are less reliant on manufacturing, than they were in the past and the level of income per person at which the size of the manufacturing sector peaks has declined steadily.[27]

The challenge might be greatest for low income countries (LICs), which have not yet built up a sizeable manufacturing sector with productivity spillovers to the entire economy. The IMF observes that, despite of relatively high growth rates in LICs in the last 15 years, growth has generally not been very deep or transformative.[28] It was largely driven by factor accumulation (physical and human

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[26] The Economist (October 4, 2014)
[27] ibid
[28] IMF (2014 b, p.15)

capital) rather than by productivity gains. The manufacturing base has remained narrow in the majority of LICs, in particular in Sub-Saharan Africa. The share of manufacturing in total value added has even declined over the past two decades, falling from an average of 14 percent in the period 1990-1999 to 11 percent in the period 2000-2012.[29]

To conclude, it is questionable that there is an "iron law" in the sense that inequality, except in very special circumstances, rises over time. Rather, the tendency to accumulate capital at the top seems periodically to lead to unsustainable situations whereas "external factors" such as wars, technological innovations, government re-distribution and bail-outs can rebalance the system for some time.

4. Implications for Development Strategies and International Co-operation

In the last years, the issue of inequality has also been taken up by development institutions, and in the meantime has moved quite high on the development agenda. The World Bank Group has adopted a new strategy with two goals: "eradication of extreme poverty" (by 2030) and "boosting shared prosperity". The second goal is understood by the World Bank to mean fostering the well-being of the bottom 40 percent of the population in every country. This will be assessed by measuring the income or consumption growth of the bottom 40 percent.

There also seems to be a change in the way development institutions look at that issue. Whereas in the past, the focus was on possible negative impacts of re-distributional policies on growth, there is growing concern now that inequality will put at risk hard earned development successes. Today, the IMF and the World Bank are stressing that high inequality may dampen economic growth over the long run. Besides, both institutions argue that inequality can cause political and economic instability, and undercut the social consensus required to adjust in the face of shocks, and thus that it tends to reduce the pace and durability of growth.

It becomes also clear that reducing inequality would contribute substantially to the fight against extreme poverty. Oxfam estimates that if India stopped inequality from rising, it could end extreme poverty for 90 million people by 2019.[30] Inequality seems to be the missing link explaining how the same rate of growth can lead to different rates of poverty reduction. This shift of focus from the reduction of extreme poverty to encompass broader inequality has huge potential implications, including for policies for poverty reduction.

4.1 What Can Developing Countries Do to Combat Inequalities?

Broadly, governments can act on two fronts: social investments and re-distribution as well as fostering the inclusiveness and vulnerability of their development strategies.

(a) Social Investments and Re-Distribution

[29] UNCTAD (2014 b, p. 78)
[30] Oxfam (2014, p. 9)

As outlined above, re-distribution played an important role in reducing income inequality in many countries. With rising income levels in developing countries, these societies must strengthen their redistributive systems. As most Latin American countries were quite successful in the last years in reducing inequality, these countries could offer some inspiration for other developing countries, in particular as tax policies and social investments played a key role.[31]

Tax policies are essential. Low levels of taxes limit the redistributive impact of fiscal policy, in particular as the fiscal space vanished in the years after the financial crisis in most developing countries. While average tax ratios for OECD countries exceed 30 percent of GDP, very few developing countries have tax ratios above 15 percent. However, some developing countries in particular in Latin America improved their tax take substantially in the last years, e.g. Ecuador from 11,4 percent (2004) to 20,2 percent (2012) and Bolivia from 15,5 to 28,1 percent in the same period.[32]

There is a number of promising options developing countries could explore to increase domestic resource mobilization. E.g., there is ample room to improve personal income taxes in most developing countries, both for increasing overall rates and for introducing more progression at the top. In most developing countries, personal income taxes raise only between 1 and 3 percent of GDP, compared to between 9 and 11 percent in advanced economies. The situation even got worse in recent years, as in particular governments in Central Asia and Eastern Europe introduced flat systems.[33]

Another option is the introduction of taxes on capital income and on wealth. In most developing countries, there is scope to extend property taxes and taxes on economic rents, like land, natural resources and the financial sector. However, given the increasing international tax competition and evasion, taxing capital income and financial wealth are not an easy option to implement. Greater capital mobility has made it harder to tax firms, thus increasing the State's reliance on more regressive taxes and on bond markets. Tax practices of multinational companies have been in the focus of public attention in the last years. Clearly, national tax efforts in these areas have to be complemented by enhanced international co-operation.

To abolish harmful subsidies and to introduce environmental taxes is another promising avenue for developing countries. The World Bank estimates that annual global energy subsidies (including the costs of negative externalities) are about $ 2 trillion.[34] In low- and middle-income countries on average, blanket subsidies for energy (except for kerosene in low-income countries) benefits the richest 20 percent of households six times more than the poorest 20 percent.[35] Reducing these subsidies would allow greater resources to be directed to social investments. Besides, it is well documented that the poor often rely disproportionately on access to natural resources to meet their immediate needs; the degradation of natural resources can have profound impacts on the health and

[31] This has been facilitated by high economic growth rates, partly due to the commodity boom. With the end of the commodity boom and reduced growth, there are signs that the decrease in inequality already came to a stall in many Latin American countries.
[32] OECD (2014)
[33] IMF (2014a, p. 36f)
[34] World Bank (2014a, p.8)
[35] ibid

livelihoods of the poor. If properly designed, abolishing energy subsidies and taxing the emission of carbon would raise revenue, protect the environment and reduce inequality.

With the additional revenues governments would have more funds to increase spending for *social investments*. More investments in health and education systems and a better targeting on the poor population not only improve income equality but can at the same time promote equality of opportunity. There are many options countries could explore and extend, such as the often cited "conditional cash transfers" (e.g. for encouraging better attendance at primary schools). These policies have been successfully applied in many developing, in particular in Latin American countries as well as in advanced economies to target the disadvantaged population. In general, more investments in primary and secondary education and skills are needed. Today, many developing countries lack the basic educational infrastructure to produce a more effective labor force. Here the recent technological development might help, as modern information and communication technology is making it easier and cheaper to obtain new skills. Information, courses and education programmes are more and more available online at low costs.

(b) Fostering Inclusiveness and Resilience

On the background of the digital revolution and the growing economic and financial interconnectedness developing countries are faced with new opportunities and new challenges. There are many implications for development strategies, no blueprint for success but a few areas of particular relevance. The technological innovations are opening up new development opportunities by lowering the logistical hurdles to entrepreneurship, e.g. through e-commerce.[36] However, there is no automatism; opening up the economy and thus integrating into global value chains does not guarantee productivity increases and sustainable growth. There is the risk that the economy gets trapped in low skilled production with little spillovers and inclusiveness. Governments must assess how to create jobs and foster productivity. They must provide the basic (including the digital) infrastructure, invest in education (taking advantage of new digital opportunities) and set up policy frameworks to ensure that investments move up to higher skilled productions. Allowing and fostering unionization can help to push for productivity increases and more inclusiveness.

The financial sector is another area where strong government intervention is pivotal. Not only middle income but also low income countries are getting more and more vulnerable vis-à-vis international capital flows, as their financial sectors are integrating rapidly. Developing countries have few instruments to fight boom and bust cycles. As past experience has shown, monetary policies have a very limited impact in developing countries, in if particular exposed to volatile short-term capital flows and / or following a fixed exchange rate. In these cases, monetary policy instruments must be accompanied by an appropriate macro-prudential regulatory policy. The main objective of the latter is to curb booms, in particular with regard to asset prices. Countercyclical capital requirements[37] and

[36] There are more and more mostly craft-based entrepreneurs using e-commerce to sell housewares, artwork, clothing and many other creative items. According to The Economist (2014, p. 14) sales last year amounted at 1.35 billion, an increase of 50 percent compared to the year before.

[37] A. Persaud (2014) has rightly stressed the point that counter-cyclical capital requirements could lead banks to concentrate their lending in the booming and overheating sectors (e.g. housing) and away from others. As risks are concentrating in these overheating sectors, capital requirements could be raised only in the booming sectors.

capital controls , such as taxes on short-term foreign borrowing or minimum stay requirements for foreign investments would be a reasonable starting point.

Finally, it is key to open up economic opportunities to poor and disadvantaged parts of the population. The economic empowerment of women has the greatest potential. Abolishing discriminatory laws against women and practices around asset ownership, e.g. land rights and inheritance laws as well as a better access to credit should stand at the top of the agenda. Workers' rights and labor law is another important issue – both for improving labor standards and for increasing salaries in line with productivity gains.

4.2 How Can International Co-operation Contribute?

First, the issue should be kept high at the international agenda. Containing inequality must be considered as a global public good where all countries having a joint interest, as it can hamper growth, as well as undermine political and financial stability beyond borders. In 2015, the international community will negotiate a new sustainable development framework. The goal to increase equality in all countries should be given a prominent role in this context. An appropriate indicator should reflect income concentration on the top. The „Open Working Group on Sustainable Development Goals" (OWG) has suggested in its report (under the goal 10 with aims at reducing inequality within and among countries) an indicator which reads: "by 2030 progressively achieve and sustain income growth of the bottom 40% of the population at a rate higher than the national average".[38] With this formulation the OWG takes over the approach the World Bank applies to measure its second corporate goal "shared prosperity". As outlined above, this objective does not take into account the growing income and wealth concentration on the top. It would be more appropriate to focus on other approaches such as the Gini coefficient or, even better, the Palma ratio[39], as e.g. suggested by Oxfam.[40] If it is not possible to commit to such quantitative targets, the publication of the related data could be a first step. Besides, a commitment to shift the effective tax burden to higher income brackets and to improve on international tax co-operation would be important.

Secondly, development institutions should reinforce their efforts in supporting developing countries to combat inequality. They should enhance their support for basic health care, education and the building up of social security systems as well as for the mobilization of domestic resources, both in terms of capacity building[41] as well as in terms of general approaches and policy recommendations (e.g. budget support could be linked to tax efforts). They should also systematically assess the distributional impact of projects, programs and related policy recommendations. To push this agenda, advanced countries need to invest a substantial amount of concessional funds and go

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[38] http://sustainabledevelopment.un.org/focussdgs.html

[39] The Palma ratio addresses the Gini coefficient's over-sensitivity to changes in the middle of the distribution. It is defined as the ratio of the richest 10% of the population's share of gross national income divided by the poorest 40%'s share.

[40] Oxfam (2014, p. 113). Oxfam has also suggested to commit to the setting up of national inequality commissions.

[41] According to Oxfam (2014, p. 84), no more than 0.1 percent of total ODA is channeled into reforming or modernizing tax administrations and related capacity building.

beyond the amount of Official Development Assistance, currently made available: just about five times more than the bonus Goldman Sachs paid itself during one crisis year![42]

Thirdly, advanced countries must - beyond traditional development co-operation - focus attention on their domestic policies ("policy coherence for development"). There are many things rich countries can do "at home" to help poor countries reduce poverty and promote shared prosperity. Working with "their" companies, e.g. in the textile and garment sector, to increase social and ecological standards in the global value chains is one important example. Another key area is tax co-operation. The G7, the G20 and the OECD have discussed and partly agreed on measures to combat multinationals' strategies aiming to reduce their global tax liabilities via profit shifting and base erosion. In particular, developing countries are suffering from those practices: the Global Financial Integrity Institute estimates that due to illegal money laundering and tax evasion developing countries loose more than a billion dollars annually. It is key to pursue these efforts towards strengthening international tax co-operation and thereby making sure that global rules also reflect the interest and specific situation of developing, in particular low income countries.[43] It has rightly been proposed to include enhanced tax co-operation into the Post-2015 framework, e.g. by adopting the objective to make public all ownerships of companies (also to developing countries), to commit to an automatic exchange of tax information[44] and to oblige multilateral companies to decompose the country origin of their revenues. It has also been proposed setting a target to reduce all trade-related illicit flows by 2030.[45]

A last comment: As has been stressed above, for political and economic reasons it is in the common interest of all countries to combat inequality. Many countries as well as the global economy are suffering from a chronic demand deficiency syndrome, a phenomenon which is intimately linked with high inequality levels. At the same time, there is a huge need for investments worldwide. Net investment is close to its lowest as a share of the total capital stock since World War II. Growth of capital stock slowed from 3.1 percent a year in 1994 to 2003 to 1,6 percent in the subsequent decade.[46] In emerging market economies and low-income countries there are huge infrastructure bottlenecks while infrastructure provision per capita is still a fraction of that in advanced economies. Scaling-up investments could help boost medium-term output, as higher infrastructure capital stocks expand productive capacity. And, properly done, it could help to transform economies towards a low-carbon development path and thus contain climate change and contribute to the achievement of

[42] See Milanovic (2012, p. 26f)

[43] E.g. developing countries can only benefit from an automatic exchange of information between national tax authorities or from "unitary taxation", as proposed by Picotto (2012), if they have the appropriate capacity for implementation and follow-up.

[44] Exemptions for low income countries should be granted as building up of the respective capacity is not feasible for them in the short run.

[45] Global Financial Integrity (2014), http://www.gfintegrity.org/press-release/new-study-crime-corruption-tax-evasion-drained-a-record-us991-2-billion-in-illicit-financial-flows-from-developing-economies-in-2012/

[46] See The Economist (November 22, 2014, p. 72), citing Eugénio Pinto and Stacey Tevlin.

the forthcoming new Sustainable Development Goals.[47] It would be important to agree on a concerted international effort to boost the relevant investments.[48]

Whereas there is a joint interest to stimulate investments in developing countries, in particular those countries with an aging society, such as Germany, should be particularly interested. With more and more retired people to "feed" and a shrinking labor force these societies must "save for the future". Using part of their savings to invest in poor but "young" economies (in particular in Africa) would secure future flows of income and could at the same time promote sustainability worldwide.

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[47] UNCTAD (2014c, p. XXVI) estimates that total investments to reach the SDGs in the range from 3.3 trillion to 4.5 trillion dollar per year are needed in developing countries alone, mainly for basic infrastructure, food security climate change mitigation and adaptation, health and education.

[48] One particular proposal has been made which might be an „elegant" contribution to tackle the challenge. A regular emission of Special Drawing Rights (SDRs) could at the same time boost global demand and foster the transformation towards low carbon development.

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