

## Inequality and Growth in Emerging Economies

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# The structure of this presentation



- The relevance of Inequality
- Inequality and growth: some theory
- Inequality of income and wealth: a vicious circle
- Inequality and growth: The global evidence
- A closer look at 5 emerging economies
- Policies to fight inequality

## Why inequality matters



- The financial and economic crisis has drawn the attention on the distribution of pre-crisis gains and post-crisis costs.
- A rebalancing of the global economy requires the adjustment of export-focused growth models driven by low wages.
- Inequality affects the general level of welfare in a society. (Wilkinson Pickett)
- Inequality will constrain consumer demand and thus possibly growth. (Stiglitz)
- Inequality might destabilize an economy (the case of pre-crisis USA) by rising debt levels. (Cynamon Fazzari)
- Inequality distorts democracy as the rich can influence political decisions. (Stiglitz)

# Inequality of income and wealth: causes



- Neoliberal turn 1975-1980 (end of Brettonwoods, Reagan, Thatcher)
- Globalization: labor supply shock due to China's opening and collapse of "real socialism"
- Technology (substituting labor, digital economy with zero marginal cost)
- Rising wage dispersion

### **Theory 1**



Microeconomic Theory	Okun: Income differences enhance the optimal allocation of work and capital, And create incentives to work and invest	<ul> <li>Behavioral economics:</li> <li>1. People are ready to forego income in order to achieve a fair distribution (dictator game)</li> <li>2. It is not performance that causes status, but status causes performance</li> </ul>
Macroeconomic Theory	Kuznets "Summit": High inequality after first phase of industrialization Savings are necessary for growth; inequality increases savings	Kuznets "starting point" and "terminus": low inequality in agricultural and highly developed societies Savings reduce demand and can cause deflation/recession

### **Theory 2**



Financial system	Under perfect capital markets inequality does not harm growth. Inequality provides the funds for new investment	Imperfect capital markets are harmful to growth, as poor entrepreneurs do not get credits Inequality produces more liquid funds searching for yield, possibly resulting in bubbles, which later cause financial crises.
Pattern of structural development	Inequality provides the high purchasing power for innovative (and costly) products, which are later available for all.	Equality leads to mass demand providing economies of scale.
Political economy	Authoritarian regimes, which concentrate income and wealth within the ruling elites provide stability and can overcome impediments to growth more easily.	Inequality leads to redistribution and/or social unrest, which are bad for growth. Rentier economies are bad for growth.

#### Global Evidence 1 (Multi-country study Barro 2008)



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

#### Global Evidence 2 (Multi-country study Klasen 2009)



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

### Inequality : Some stylized facts



- Global income inequality: 1:50 (S80/S20)
- European inequality: 1:10 (X), 1:7 (PPP)
- National inequality: diverse from 1:3 up
- Between-country inequality declining
- Within-country inequality rising
- Declining wage shares
- Rising wealth ratios (Piketty)

## High diversity of Gini



Gini indices of personal income distribution in 131 countries, c. 2012



#### Middle class shares almost constant



The homogeneous middle vs. the heterogeneous tails in 131 countries, c.2012



#### Palma ratio (D10/D1-4) steeper than Gini (due to LA and SA)



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 Sources: as in Figure 1. Highlighted countries are those of Latin America and (mineral rich) middle-income Southern Africa. The last two, Namibia and South Africa, are — literally — off the chart!<sup>22</sup>



### **Global inequality**



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

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

#### Global evidence: Income and inequality

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#### Global growth (in % p.a.)





# Growth and inequality in the world economy



- No clear picture
- Strong but volatile growth (The impact of inequality?)
- Rising inequality in many regions
- Declining inequality in Latin America and Africa
- High inequality with low growth in LA and SA
- Declining global inequality

#### Inequality widened in many EEs



Change in Gini coefficient, early 1990s-2010



Figures for the early 1990s generally refer to 1993, whereas figures refer to 2011 for OECD, 2009 for Argentina, China and Russia, 2010 for India and South Africa, 2012 for Brazil and 2013 for Indonesia.

### Earnings ratios show different trends across EEs



Earnings inequality, decile ratios



D9/D1: ratio of the wages of the 10% best-paid workers to those of the 10% least-paid workers. D9/D5 (D5/D1) ratio of the wages of the 10% best-paid (least-paid) workers to those at the median of the earnings distribution Source: IPEA for Brazil, Povcalnet for China, Milanovic for Indonesia, OECD-EU Database on Emerging Economies for India and South Africa

At the upper end, the share of very high incomes increased in many countries



Shares of top 1% incomes in total pre-tax incomertung 1980 – 2010 (or closest)



Source: World Top Income Database. Note: Incomes refer to pre-tax income.

# Coverage and generosity of social protection is low in

Public Social expenditure in OECD countries and EEs



Source: OECD (2014), OECD Social Expenditure database, (www.oecd.org/social/expenditure.htm).

...which lowers the scope for redistribution

## Consumption taxes instead of PIT are the main source of revenues

Total tax revenue as % of GDP for major non-OECD economies

	Tax/GDP ratio		% of total tax revenus <sup>1</sup>				Top statutory	Top corporate	Ctos dord
			Personal income tax	Corporate tax	Social security contribution	Consumption taxes	income tax rate <sup>2</sup>	tax rate <sup>3</sup> on 1 January	VAT rate
	2009 (Provisional)	2008	2008	2008	2008	2008	2010	2011	2010
Argentina	31.4	30.7	6.0	11.0	15.0	54.0	35.0		21.0
Brazil	32.6	33.6	n.a.	n.a.	24.0	46.0	27.5	34.0	20(7)
China <sup>4</sup>	n.a.	22.0	5.0	16.0	15.0	51.0	45.0	25.0	17 <sup>(8)</sup>
India	15.7	17.3	12.0	21.0	0.0	58.0	30.0	30.0	10 <sup>(9)</sup>
Russian Federation <sup>5</sup>	n.a.	37.0	10.0	18.0	15.0	51.0	13.0	20(10)	18.0
South Africa	27.6	29.8	29.0	28.0	2.0	34.0	40(11)	28(11)	14.0
OECD average <sup>6</sup>	n.a.	34.8	25	10	25	32	41.7	25.4	18.0

Source: Brys et al. (2011)

## **Distribution of Wealth**



Country	Share of adult	Share of	Share of	Gini of woolth
		giobai wealth	giobai GDI	distribution
USA	5,13	29,91	22,1	85,1
Germany	1,44	5,35	4,75	77,1
Russia	2,37	0,50	2,85	93,1
Japan	2,24	9,38	8,05	63,5
China	21,40	9,21	11,25	69,5
India	16,45	1,50	2,58	81,3
Brazil	2,90	1,31	3,39	82,1
Nigeria	1,72	0,12	0,38	80,0
South Africa	0,67	0,25	0,57	83,6

### Inequality and Growth: The 5EE



- Our selection of emerging economies: Brazil, China, India, Korea, Mexico (5EE)
- Large share of global population and gdp
- Representative for middle income countries
- Different policies and development



## Different growth pattern



# Stylized facts on 5EE growth



	Brazil	China	India	Korea	Mexico
Growth	Volatile growth with periods of stronger growth (1993-95; after 1999)	Continuous high growth (over 7%)	Strong growth since 1992, in particular 2002-2008 (5%), slow- down after 2011	Strong growth (5%), slowly declining; Asian crisis in 1998	Volatile growth after 1982; declining growth rates
Drivers of Growth	Consumpti on	Investment, Net exports	Productivity; Service sector expansion	Consumption until 1998, exports afterwards	"middle income trap"

#### Different development of inequality



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### Stylized facts on 5EE inequality



	Brazil	China	India	Korea	Mexico
Inequality	Almost continuous decline since 1993, in particular after 2003	Strong growth of inequality from highly egalitarian to very unequal; Guanxi	Growth between 1994 and 2008	Low inequality, slowly increasing since 1998	Strong increase between 1989 and 1994, almost continuous decline after 1994 until 2008
Labor market; Wages	Stable wage share, Slowly growing real minimum wage	Declining wage share until 2008; slight increase afterwards; Higher dispersion of rural than urban wages	Low wage share; high wage dispersion; Contractual workers exploited	Increasing wage dispersion; more contingent workers; many self-employed; rising minimum wages	Decline of real wages and minimum wage until 1996; afterwards: slow real wage growth, stagnant minimum wage
Redistributi on	Bolsa familia Fome zero Good for poverty reduction; Little impact on inequality	Tax system hardly affects inequality	Low share of social spending	Lowest reduction of market inequality in OECD	Oportunidades Inefficient redistribution

## **Fighting inequality**



- Labor market is key
- Wage growth = Productivity growth
- Decent minimum wages
- Regulating contingent work
- Better targeted social spending
- Reforming tax systems
- Improving tax collection

# Suggested policies in 5EE



	Brazil	China	India	Korea	Mexico
Labor market policy	Higher minimum wage	Reforming Hukou Control of "Guanxi"	Labor market regulation Promoting manufacturing industry	Better protection of workers; higher participation rate	Higher minimum wage
Fiscal policy and redistribution	More progressive tax system	More efficient tax system	Taxing real estate, inheritance and capital gains	More efficient redistribution	More progressive tax system
Social investment	More social spending, less debt service	Investment in education and human capital	Higher spending on education and health	Investment in social service rather than infrastructure	Universal pension system and health coverage; Unemployment insurance



#### Thank you for your attention!

# Inequality of income and wealth: Piketty



- $\alpha = r \times \beta$  ( $\alpha$  profit share P/Y; r profit rate P/K:  $\beta$  capital or wealth share K/Y)  $\beta = s/g$  (g growth rate; s savings rate) Low growth  $\rightarrow$  higher  $\beta \rightarrow$  higher  $\alpha \rightarrow$ lower wage share r empirically around 4%; no decline!  $r_{superrich} > r_{rich} \rightarrow$
- concentration of wealth

# Inequality of income and wealth: a vicious circle



- If only the rich save out of profits:
- s = savings/profits

$$K_{t+1} = K_t + s \times P_t$$

r= 4% (Piketty)

 $\alpha$  and  $\beta$  remain constant, if s=g/r (=25g)

- If  $s > g/r \rightarrow \alpha$  and  $\beta$  grow
- If  $s < g/r \rightarrow \alpha$  and  $\beta$  decline
- $\alpha$  profit share;
- β capital or wealth share K/Y