ANALYSIS

ECONOMY AND FINANCE

RISING INEQUALITY

What are the implications for policymaking at the World Bank?

Jürgen K. Zattler
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The long-term trend toward rising inequality in many countries raises major challenges for economic growth, social cohesion and financial stability.

Neither the drivers of inequality nor their policy implications have been adequately absorbed by policymakers or reflected in World Bank policies.

The World Bank should 1) enhance its analysis of inequality and policy impacts, 2) work toward an official »corporate view« on inequality, 3) better link analysis to operations, and 4) review its goal of shared prosperity and how that is measured.

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Content

The debate on inequality focuses on various dimensions, in particular »inequality between countries«, »inequality within countries« and »extreme poverty«. The latter two dimensions are reflected in the World Bank Group's (WBG) corporate goals, notably to end extreme poverty by decreasing the percentage of people living on less than 1.90 US dollars per day to no more than 3 per cent by 2030, and to promote shared prosperity by fostering the income growth of the bottom 40 per cent for every country.[1] Largely due to some fast growing developing countries, in particular China, there have been substantial reductions in both »extreme poverty« and »inequality between countries«. This paper focuses on »within-country inequality«, where progress seems to be more mixed.

The first part of this paper recalls the most important trends regarding within-country inequalities. Part 2 outlines the potential negative implications of high and growing inequality. Part 3 summarizes the main factors underlying the increase in inequalities in many countries. Part 4 draws conclusions for development strategies, and Part 5 offers a few suggestions on how the WBG can refine its approach to shared prosperity and better operationalize this corporate objective.

1 TRENDS REGARDING WITHIN-COUNTRY-INEQUALITIES

Inequalities have increased in recent decades in many countries, in particular in high-income countries (HICs): between the mid-1980s and the mid-2000s, income inequality rose in 16 out of 20 OECD countries (Milanovic 2011: 3). The situation seemed to have improved somewhat in the meantime due to the financial meltdown in 2008–09 and the subsequent economic boom, the longest in the postwar era.

Recent developments notwithstanding, most observers would agree that the majority of OECD countries have experienced a long-term trend toward increasing inequalities, starting in the 1970s or 1980s. Since there is an abundance of literature on those trends, here I will only highlight a few striking examples of the evolution of incomes in the US:

- Between 1980 and 2014 the bottom 50 per cent of post-tax incomes increased by 21 per cent, while the incomes of the top 10 per cent increased by 113 per cent, and those of the top 0.1 per cent increased by 617 per cent (Piketty et al. 2016).
- Between 1948 and 1973, the median family income increased at approximately 3 per cent per annum, compared to just 0.4 per cent subsequently (Furman and Orszag 2018).
- The median income of employed men has not increased since the early 1970s.[2]
- With the increase in incomes prior to 1973, there was a 96 per cent chance that a child would have a higher income than his or her parents. Today, 28 per cent of children have a lower income than their parents had (Furman and Orszag 2018).

While those long-term trends can be observed in most HICs, they are much more accentuated in Anglophone countries (Chancel, 2019). For example, the pretax incomes of the bottom 50 per cent of the income spectrum in Western Europe were slightly lower than the bottom 50 per cent in the US in 1980, but are now around 25 per cent higher.

Data availability on long-term trends regarding income inequality in developing countries is poor. However, the large emerging countries, such as India, Russia and China, display similar long-term trajectories to the advanced economies (Chancel 2019). Only a few years ago, the WBG started to systematically collect data on a broader sample of both industrialized and developing countries. According to its most recent *Poverty and Shared Prosperity* report, »Piecing Together the Poverty Puzzle« from 2018, the shared prosperity (SP) premium was negative in almost half of a sample of 91 countries monitored. In other words, the income share of the bottom 40 per cent is growing more slowly than the overall average in those countries. The regions with relatively high SP premiums are East Asia and Pacific, the Middle East, and Latin America and the Caribbean. However, due to the challenging economic development in many Latin American countries in recent years, there are indications that this positive trend might reverse itself. The SP premiums were negative in the other four regions. »In the four South Asian economies included in the sample, incomes among the bottom 40 are growing, but at a slower pace than in the mean. In addition, half the countries in Europe and Central Asia and more than half in Sub-Saharan Africa have negative shared prosperity premiums.«[3]

Private wealth as a share of national income, after falling until after World War II, increased rapidly in the 1980s, while public wealth-income ratios have declined (Chancel 2019). In parallel, wealth inequality has increased in almost all advanced countries, but at a much faster rate in the US than in Europe. Wealth inequality was very much driven by the top 1 per cent, and in particular by the top 0.1 per cent, of the income spectrum (Chancel 2019).

1 The objective of reducing within-country inequality has also been incorporated into the Sustainable Development Goals (SDGs).

2 This example might help to explain the high share of "protest votes" in the last US general elections amongst male lower and middle class voters. The income evolution for women was more positive. Nevertheless, the income gap between males and females, after displaying a rapid decrease in the three post-war decades, underwent only a moderate reduction since the 1980s (Chancel 2019).

3 However, this result may paint a too rosy picture (see Zattler 2016: 2) since the WBG is using consumption data for most regions. Because rich people tend to consume only a relatively small part of their incomes, measuring income instead of consumption data would provide a more accurate picture of SP trends.

We have seen in many countries that income inequality has a locational dimension. Telling examples of regions left behind are the US Rust Belt[4] and some parts of Eastern Germany. More research needs to be done to analyze whether growing *regional disparities* represent a phenomenon that can be observed in HIC exclusively, or if they also occur in developing countries. Recent WBG Country Partnership Frameworks seem to support the latter scenario.

Another interesting variable is the *wage rate*, which has been falling steadily worldwide (Karabarbounis and Neumann 2013), and in the OECD by almost ten per cent since the beginning of the 1990s.[5] Overall, real wage growth has clearly lagged behind productivity growth since around 1980. This is in contrast to the post-war era when wage shares had been stable or increasing. It also 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 remain more or less constant over time. This »fact« does not seem to hold any longer. Reliable data are not available for most developing countries. However, where data exist they seem to mirror the long-term trend observed in HICs (Stockhammer 2013).

The growing inequality in advanced and Middle Income Countries (MICs) is at odds with another important economic theory, the »Kuznets-Curve«. Kuznets argued that in very poor developing countries inequality rises as people start moving from low-productivity agriculture to the more productive industrial sector, where incomes are 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. However, the growing inequality we see not only in advanced economies, but also in rising economies like those of China and India, is at variance with this theory.

2 ECONOMIC, POLITICAL AND SOCIAL IMPLICATIONS

2.1 Political Stability and Social Cohesion

In Europe and the US, the period after World War II was characterized by a narrowing of income distribution and a leveling out of wealth distribution. For the first time in modern economic history, a broad, property-owning middle class emerged. There is no doubt that this middle class has been a stabilizing force in politics and society. Many countries consider a broad and prosperous middle class to be a central building block of social cohesion and economic success.

Indeed, history provides painful lessons regarding the impacts of growing inequality, unemployment and widespread pauperization on political systems. Not only can these trends destroy the social cohesion of societies and spark social segregation and tensions, they can also destabilize societies and trigger populist and nationalist movements, leading to high levels of violence and increasing social fragility. According to the World Bank, excessive concentration of income or wealth has been associated with episodes of conflict. One can suppose that the political turmoil in such countries as Ukraine, Egypt, Syria and Venezuela is linked in part to growing inequality, high unemployment and a lack of inclusiveness of growth.

Besides, there is the risk that those in the upper echelon have access to significant influence over the political process. This »wealthification« of politics can undermine democracy by granting wealthy people disproportionate influence over 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« (Karabarbounis 2011). Viewed from this perspective, political systems have moved from a »one-person/one-vote« model to a »one-dollar/one-vote« model.

2.2 Economic Growth and Poverty Reduction

In the past, economists argued that redistribution can hamper growth, for example, because inequality provides incentive for innovation and entrepreneurship. More recently, there is a growing awareness that rising inequality and insufficient redistribution can also affect economic growth. In the first place, it may deprive the poor of the ability to stay healthy and accumulate human capital. Secondly, inequality can generate political and economic instability and impede the formation of a social consensus. Empirically, countries with high levels of inequality suffered lower growth than those with a more even distribution of income (Ostry, Berg and Tsangarides 2014). The World Bank estimates that one Gini point increase in income inequality lowers annual GDP per capita growth by around 0.2 percentage points in advanced countries and by around 0.14 per cent for a larger set of countries (World Bank 2014a: 6). Finally, inequality can also make growth more volatile and create the unstable conditions for a sudden slowdown in GDP growth (IMF, 2014b). In conclusion, while there is not a clear-cut causal relationship between inequality and growth, high inequality entails risks for the sustainability of economic growth. Besides, the goals of poverty and inequality reduction seem to be interdependent: high inequality has a disproportionate negative effect on the income growth of the poor (Milanovic and van der

4 The Rust Belt, which was once the US's manufacturing "heartland", encompasses parts of the Midwest and Northeast regions where once-booming economies are now in decline, and rusted factories are a graphic symbol of decay.

5 Stockhammer, 2013. In the advanced economies the (adjusted) wage share has fallen on average from 73.4 per cent in 1980 to 64 per cent in 2007

Weide 2014). Therefore, inequality makes it more difficult to reduce absolute poverty.[6]

2.3 Financial Stability

We can observe that inequality increased sharply in the two decades preceding the financial crisis of 2007/08. In parallel, debt-to-income ratios increased in many countries before this crisis broke out. The same phenomena – rising inequality and debt – could be observed before the economic crisis in 1929. In the US, the ratio of household debt to GNP increased twofold between 1983 and 2007, similar to the rate observed between 1929 and 1932 (Kumhof and Rancière 2010: 4ff.).

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 (Kumhof and Rancière 2010: 4). This »recycling« of rich people's funds to the poor and middle-income households is reflected in the increasing size of the financial sector over the last decades (Zattler 2016: 4).

3 DRIVING FORCES OF GROWING INEQUALITY

Why is inequality on the rise over the long term in the vast majority of HICs, as well as in many developing countries? What are the driving forces behind this trend? The relevant literature focuses on the following three culprits:

3.1 Technology

The argument goes that new technologies are skill-biased, increasing the productivity of workers with certain more sophisticated skills. They substitute low-skilled labor, thus puting pressure on the low-skilled workforce. Both the World Bank and the IMF are strong supporters of this hypothesis, as reflected, for example, in last year's World Development Report on »The Future of Work.« The ongoing wave of digitization propels this development. The digitization of the economies, so the argument goes, leads to a »labor market divide«, in particular in HICs, which have good and improving labor market perspectives for the well-educated and worsening perspectives for lower-skilled workers and increasingly also for »middle-skilled« workers. Besides, digitization contributed to the rise of so-called superstar firms, which benefitted from network externalities and massive scale effects, resulting in substantial market dominance for the firms in question. Indeed, there is evidence that those firms have seen high profit margins (»rents«) while investment rates have been relatively low. Finally, big multinational corporations, in particular the platform companies that control digital infrastructures and marketplaces such as Google, Amazon, Uber and Airbnb, have managed to avoid and evade taxation. This in turn undermines the public finances of nation-states and their ability to maintain basic social and economic services and their fair funding.

3.2 Trade and investment

The growth in cross-border trade and investment has been linked with the offshoring of labor-intensive production. In particular, global value chains have been a major driver of outsourcing labor-intensive production to lower-wage locations. This has opened up development opportunities for poorer countries, but may also have contributed to putting pressure on low-skilled labor. Besides, there is some evidence that this development has increased the market power of companies and that the associated cost savings were not passed on to consumers and workers.[7] This is reflected in relatively high profit margins. Therefore, both downward pressure on wages, as well as the upward trend in some companies' markups, may have contributed to growing inequality.

3.3 Government policies

The wide variation in inequality trajectories in the group comprising US and European countries, which were all similarly affected by trends in technology, global trade and global investment, suggests that government policies may also have played an important role. Beginning in the 1980s and 1990s, many countries introduced policies that weakened workers and made fiscal policies less redistributive, for example, by cutting social benefits and lowering the progressivity of income taxes.[8] These changes in policy marked the end of a long period of pro-equality policies that began in the 1930s. After the Great Depression in 1929, and in the face of rising fascist movements, governments became aware of the destabilizing potential of high unemployment and mass pauperization. Some decided to introduce Keynesian policies and social security systems, most prominently in the US, with Roosevelt's »New Deal.« Similarly, after World War II fiscal policy played a significant role in reducing income inequality in other advanced countries, namely in Europe. According to IMF estimates, direct income taxes, and in particular transfers, led to a decrease in inequality in these countries by an average of one third (IMF 2014a: 15). However, it appears that more important than the cash redistribution effect are government policies impacting on pretax incomes, for exam-

6 Simulations by Lackner et al. 2019 show that the extent of poverty reduction until 2030 is highly dependent on how inequality within societies evolves.

7 The IMF (2019) examined markups over marginal costs charged by over 900,000 firms in 27 countries. It found that markups rose by 8 per cent on average between 2000 and 2015, in line with other findings that market power has risen notably in US and to a lesser extent in Europe, in part in industries other than manufacturing.

8 IMF, 2014a, p. 17. For example, in the US, the tax system has become less progressive over the past four decades. According to Saez and Zucman (2019), the 400 richest Americans paid an average income tax rate of about 23 per cent in 2018, while low-income Americans paid roughly 25 per cent.

ple, the public provision of higher education, health coverage and labor market policies and institutions, such as minimum wages (Chancel 2019).

Two comments on the above-mentioned forces driving increasing inequalities within countries:

Firstly, the three factors – higher education, health coverage and labor market institutions – should not be seen in isolation: they are interlinked in many ways. Most importantly, government policies have a strong impact on market incomes, for example, through access to education, as well as on post-tax incomes. It can also be argued that the wave of economic globalization was triggered by government policies that liberalized trade, investment and finance. Besides, there are dynamic effects; for example, Chinese exports to the US and Europe may have contributed to the decline of jobs in manufacturing in those countries; but they have also made consumer goods cheaper and more accessible for the poor. Additionally, they may have pushed HICs into more skill-intensive sectors, for example, the digital economy, thus opening up new employment and economic perspectives.

Secondly, one factor whose significance may have been underestimated in the debate is the impact on equality of the worldwide trend toward financial liberalization starting in the 1980s. Arguably, the liberalization of the financial sector and the removal of barriers to international capital flows have widened the investment options for companies and individuals. As a result, shareholders gained more power relative to workers and put pressure on salaries. Moreover, the explosion of relative earnings of financial professionals itself contributed to the concentration of income and wealth at the top. Most importantly, financial liberalization led to a »financialization« of economies in which the savings of the rich were largely invested in financial and other assets, such as real estate. This in turn led to extraordinary increases of stock valuations and real estate prices, thereby making the rich richer, exacerbating financial bubbles and undermining economic growth (as also reflected in the low investment rates).

4 IMPLICATIONS FOR ECONOMIC POLICIES

How can national governments combat trends toward growing inequalities, given that most economies are highly integrated internationally, which may limit their national policy space? The conventional advice is to invest in the education of the workforce and *human capital* (ranging from early childhood education and health care to tertiary education and vocational training), because this increases the supply of skilled labor, thereby mitigating or compensating for the relative decline in the demand for unskilled labor due to technology. This is probably the single most important piece of advice given by the World Bank, both in its flagship reports, such as the World Development Reports, and in its country strategies.

Besides, countries might mitigate income disparities (in particular regional ones) by applying so-called *place-based policies* or industrial policies aimed at both smoothing and promoting structural change. Until recently, the WBG was reluctant to recommend such policies but now seems to be more open to such recommendations (Hallward-Driemeier and Nayyar 2018).

Another option is to actively use fiscal policies. Whereas most development institutions, including the World Bank, traditionally focus on equity implications of expenditure policies, such as those for social security, health or education, less attention is given to tax systems. This is unfortunate because, in many countries, there is great potential to make tax policies more pro-poor and to mobilize additional resources, which could be used to promote greater equality. In this context, a number of economists have recommended reforms to increase taxes paid by platform-based businesses and the introduction of a wealth tax.

The standard argument against a wealth tax is that it would discourage income-generating activities, in particular investment, because »today's wealth is yesterday's income«. However, given that income is increasingly flowing into financial assets, it must be acknowledged that one investment is not as good as the next. In terms of economic impact, for example, there is a difference between investments in startups compared to those in bonds or shares. Another argument is more convincing, that a wealth tax might deter individuals with high incomes and large amounts of wealth from investing funds domestically, and it might incentivize them to transfer assets abroad. Therefore, it might be advisable to focus on immovable assets, such as taxes on land, or inheritance taxes, and to enhance international tax cooperation. In any case, the WBG was not very vocal on tax issues in the past, which has left the issue largely to the IMF. However, more recently the World Bank has argued for an enhanced effort to combat tax evasion, in particular with regard to digital platforms (World Bank Group, 2019 and 2020).

While the potential of fiscal policies for the promotion of shared prosperity is well discussed and understood, this is not the case for monetary policies. This is surprising, since there is little doubt that the loose monetary policy that prevailed in most countries after the financial crisis contributed to significant increases in asset prices, and thus increased income and wealth generation for those already better off. This is not to say that more restrictive monetary policy would have been better for the poor, since it could have further undermined economic growth and stability. But it can be argued that, while quantitative easing was necessary to avoid deflation, it was not effective in stimulating investment and consumption.

Therefore the key question is whether there are monetary policy alternatives that are good for both economic growth as well as for the incomes of the poor and middle class. One of those alternatives could be to more directly »channel« central bank money toward investments and consumption. This could, for example, be done by opening central bank accounts to provide liquidity directly to citizens through (progressive) lump sum payments. Another option could be that central banks apply climate protection criteria in their asset purchase programs, which would also boost investment and growth.

Finally, governments could enhance antitrust and competition policies. There is evidence of increased market concentration, a lower rate of entry for new firms and a lower share of young firms in economies, which affects competition and market power (network externalities).[9] This, in turn, could explain the high profit markups, in particular in sectors with high concentrations of wealth and market power, such as in the platform firms.

Development Challenges in the Age of Digitization

The most important question for developing countries is how to promote development in a context in which, in terms of international competitiveness, cheap labor is becoming a less important factor. Even relatively sophisticated production lines, such as sneakers, are becoming increasingly automated. Therefore, the jobs of the past that provided a path to industrialization, notably in apparel and assembly line operations, are rapidly being replaced by robots and artificial intelligence. Automation reduces the demand for low-skilled labor, the one production factor available in abundance in poorer countries.

Against this backdrop, one might argue that the traditional »flying geese« pathway to development is blocked and that we need an entirely new development model, one which is not based on the export of labor-intensive manufacturing. What such a pathway could look like remains unclear and linked to a vague hope of leapfrogging into a service economy. Alternatively, it might be argued that old development strategies still remain some value. However, they must be adapted to present circumstances; and while it is increasingly difficult to build up export industries, light resource-based and labor-intensive manufacturing remains a viable path to development. In order to pursue it, countries must take advantage of the new opportunities offered by digital technology, such as precision agriculture, e-commerce, e-payment systems, online education and e-governance. The WBG's International Finance Corporation reform agenda and its »making markets« strategy is to a large extent based on this recommendation.

5 IMPLICATIONS FOR THE WBG

What conclusions can be drawn from the above discussion for the WBG and its mission to promote shared prosperity? Are the WBG's current business model, strategies, policies and operations efficient and effective when it comes to achieving this objective? The results of a recent evaluation of the WBG's support for shared prosperity (Independent Evaluation Group, 2017), suggest that the WBG should comprehensively incorporate its second corporate goal, the promotion of shared prosperity, into its business model in much the same way as has been done for its first corporate goal, to combat extreme poverty. This would have the following three implications.

First, the WBG should improve its understanding of the various dimensions of inequality. For example, what impact do technology, trade and the financial system have on inequality? How can the various policies outlined in part 4 above be applied to foster economic inclusion? It is important to better understand the »theory of change« behind different policies and their impact on inequality. In that context, more attention should be given to neglected areas, such as the design of pro-poor tax policies.

Secondly, the Bank should work towards a consistent approach on the above issues. While it is good to have a diversity of views within one organization, the objective should be to get the facts clear, working towards a shared institutional understanding – a kind of »corporate view« – which is common practice in other organizations such as the IMF. An example of problematic inconsistency is how trends in inequality are assessed in the Bank's latest *World Development Reports*. Whereas the *World Development Report* 2019 seems to downplay the issue of inequality, this year's *World Development Report* clearly highlights the worrying trends and the challenges associated with global value chains, as well as the digital revolution, when it comes to their impact on inequalities on a country level. In doing so, it is important to take into account the various dimensions of inequality, including regional inequalities and the concentration of wealth and income at the top. In order to enhance its understanding and policy advice, the Bank needs to invest more in data collection.

Thirdly, the above general analysis should systematically inform country programs and projects and should be complemented by country specific assessments. The documents should systematically build on this enhanced analysis, presenting results-chains that link interventions to outcomes and consistent results-frameworks. This is particularly relevant for middle income countries: the number of their residents who live in absolute poverty has been declining, but their middle classes are small and always at risk of falling back into poverty. This issue is also relevant for low income countries, but to a lesser extent, because their residents in absolute poverty largely overlap with the »bottom 40%«.

9 See Furman and Orszag 2018 (focusing on the US).

Finally, the WBG must ask whether the way it currently measures the shared prosperity goal appropriately reflects the key challenges developing countries are facing. The corporate goal focuses on fostering the income growth of the bottom 40 per cent. As has been outlined above, however, there are many more dimensions of inequality that are relevant for developing countries, such as regional disparities and the concentration of wealth and income at the top. The Bank should more systematically assess and monitor those other dimensions. Besides, the Bank could adapt its corporate goal by aiming at a positive shared prosperity premium, in other words, a relatively higher income growth rate of the bottom 40 per cent. Admittedly, the Bank already monitors the shared prosperity premium to some extent, but if it were to adopt this officially as a corporate goal, the action would signal that the institution is taking a more ambitious approach.

Summing up, the Bank should (1) enhance its analysis and understanding of the various dimensions of inequality and of what impact policies have on them, (2) work toward a consistent understanding across the institution that would represent an official »corporate view«, (3) better link its analysis to operations (in terms of country programs and projects), and (4) review its corporate goal regarding shared prosperity and how this is measured.

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RISING INEQUALITY

What are the implications for policymaking at the World Bank?

The long-term trend toward rising inequality in many countries, particularly high-income countries, raises major challenges for economic growth, social cohesion and financial stability. Complicating the challenge, availability is poor for data on long-term trends in developing countries, although large emerging countries like India, Russia and China display long-term trajectories similar to the advanced economies. Unfortunately, neither the drivers of inequality nor their policy implications have been adequately absorbed by World Bank policymakers or reflected in their policies.

Why is this so? The Kuznets Curve – which predicts that inequality will initially rise as poor developing countries move away from low-productivity agriculture and toward the more productive industrial sector and that eventually, as the society matures and become richer, inequality will begin to decrease – remains an important mainstream theory, even though rising inequality in both advanced economies and rising economies like those of China or India is at variance with it.

To get beyond this difficulty, the World Bank should incorporate its goal on shared prosperity into its business model in much the same way as it has done for the goal on extreme poverty. This would help the Bank work toward a shared institutional understanding, or official »corporate view« on inequality. Once that is established, it will be possible to better link the enhanced analysis to country programs and projects. Finally, the Bank must ask whether the way it currently measures its shared prosperity goal appropriately reflects the key challenges developing countries are facing.

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