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INCOME INEQUALITY AND THE CONDITION OF CHRONIC POVERTY



Although the adverse effects of financial crises on growth and poverty are well documented, the fact that financial crises also tend to worsen income distribution in developing economies is less frequently considered. As this happens and inequalities worsen, they create the very conditions that provoke the next crisis.



Photo: Kibae Park/ UN Bangladesh



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Introduction

By all accounts, income inequalities in advanced economies have surged since the 1980s. This trend is closely correlated with the increase in the incidence of financial crises that have rocked the global economy over the same period (Moss 2009, Stiglitz et al. 2009, Rajan 2010). “Worldwide, systemic banking crises have been ten times more likely during the 1990s than during the late 1970s, hardly a period of calm economic activity” (Ernst and Escudero 2008). As developing economies become ever more integrated into international financial markets, they are increasingly exposed to the negative effects that such shocks typically have on poverty and growth. Evidence from the financial crises in Asia in 1997, in Mexico in 1994, in the Russian Federation in 1998, and in Argentina and Brazil in 2001 and 2002 has amply documented this (Gonzalez-Hermosillo and Hesse 2009).

There is a similar pattern in many developing countries, where inequalities have risen sharply largely due to the adoption of financial liberalization and adjustment policies. Moreover, as in advanced economies, the rise in income inequality appears strongly associated with more frequent domestic financial crises (Cornia 2004, Vandemoortele 2009, Woo 2005, van der Hoeven 2008). In other words, there appears to be a strong link between the rise in income inequality and the increasing frequency of financial crises across the world.

Although the adverse effects of financial crises on growth and poverty are well documented, the fact that financial crises also tend to worsen income distribution in developing economies is less frequently considered. As this happens and inequalities worsen, they create the very conditions that provoke the next crisis. For these reasons, rising income inequality, be it in advanced or developing economies, has become a principal driver of vulnerability in recent times.

Furthermore, the persistence of inequality at high levels in many developing economies has made it more difficult to reduce poverty. It is well known by now that greater inequality makes it less likely that economic growth can reduce poverty—regardless of the rate of economic growth. Moreover, there is a growing consensus that excessive inequality can stunt growth itself (Birdsall 2005).¹

High inequality can also have undesirable political and social consequences (Alesina and Perotti 1996).² “Where the institutions of government are weak, inequality exacerbates the problem of creating and maintaining accountable government, increasing the probability of economic and social policies that inhibit growth, and poverty reduction and where social institutions are fragile, inequality further discourages the civic and social life that undergirds collective decision-making which is necessary to the functioning of healthy societies” (Birdsall 2005). Put differently, high inequality is associated with higher crime rates, lower life expectancy and conflict.

This relationship between high inequality and weak growth appears to be particularly strong in countries where a large part of the population is ‘trapped’ in poverty. One reason that poor countries find it so difficult to grow is that all income in an impoverished household goes for consumption. There are no taxes and no personal savings. “Yet, depreciation and population growth continue relentlessly. The result is a fall in capital per person and a negative growth rate of per capita income. That leads to still further impoverishment of the household in the future” (Johnston 2010).

Thus, at the macro-economic level, extensive poverty leads to low savings rates and, in the absence of external sources of finance, low rates of investment. Low investment results in low growth, which, in turn, is insufficient to make a dent in poverty. Put differently, high initial levels of poverty can set into motion a vicious cycle

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"through which the high incidence and severity of poverty act as constraints on economic growth, thus perpetuating all-pervasive poverty" (Gore 2002).

Chronic poverty and high and rising income inequality have important consequences for sustaining MDG progress:

- High and rising inequality can slow and even stall progress towards the reduction in poverty, given the growth, inequality and poverty linkages in a country.
- Rising inequality is a key driver of domestic financial instability that is typically associated with adverse growth, poverty and distribution impacts. As the conditions of the poor deteriorate and inequalities worsen amidst depressed growth, budgetary outlays to sustain MDG investments may be difficult to maintain.
- Income inequalities are linked to and can reinforce other inequalities. For instance, the supply of publicly subsidized education is likely to be limited where the rich resist a large tax burden to finance services they can purchase privately (Behrman and Birdsall 1983). Likewise, one of the key messages of the Commission on Sustainable Health was that there is a need to tackle the inequitable distribution of income, since a major determinant of health inequality is income inequality (van der Hoeven 2008).
- For countries with chronic and extensive poverty and long-term anaemic growth, policies that address poverty reduction at the margins will be grossly inadequate. If growth is unable to generate domestic resources or make a dent in poverty, the prospects for MDG progress will be very uncertain. Further, low growth is unlikely to generate the resources needed for measures that can protect economies against the effects of external or domestic shocks.
- High and rising inequality also reduce the likelihood that economic and social policies fostering inclusive growth and human development will be delivered and implemented. For instance, richer groups may secure economically inefficient advantages such as regressive taxes or an allocation of public funds for their own interest rather than for that of the country (Vandemoortele 2009).
- Finally, in developing countries, where the institutions of government are often weak, inequality exacerbates the problem of creating and maintaining accountable government, thereby increasing the probability of the adoption of economic and social policies that inhibit growth and poverty reduction (Birdsall 2005).

This relationship between high inequality and weak growth appears to be particularly strong in countries where a large part of the population is 'trapped' in poverty.

For the most part, policy measures to reduce income inequalities and poverty have mainly focused on the latter. Yet, given the centrality of income (and wealth) distribution for poverty reduction, it is essential that countries pursue an inclusive growth agenda and squarely address the issue of inequality and poverty reduction in tandem. Specifically, policy measures should focus on:

- Promoting inclusive growth and creating productive employment
- Redistributing assets and incomes
- Adopting pro-poor macro-economic policies



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Trends in Income Inequality

Income Inequality in Advanced Countries

In most advanced and emerging economies, the rise in income inequality during at least the past two decades has been unprecedented (IMF 2007, OECD 2008, Krueger et al. 2010). In most advanced economies, the average wage stagnated, while inequalities surged in favour of the upper quintile of the distribution.

Chart 6.1 shows a redistribution of income from the lowest earning 80 percent to the highest earning 20 percent of income earners in OECD countries as a whole.³ The real income of the lowest earning quintile in

OECD countries grew by 0.8 percent less than the average growth in income. This means that the share of the bottom quintile in total income fell from the mid-1980s to the mid-2000s. The middle three quintiles suffered a similar fate during the period: growth of the real income of the middle three quintiles was 0.2 percent less than the growth in average income. Only the real income of the top quintile grew faster than average income. In the OECD countries, the real income of the top quintile grew by 0.5 percent above the average growth in income. With the exception of France, the same patterns hold for individual OECD countries (Germany, Italy, United Kingdom, and the United States of America).

The increase in inequality within advanced countries fuels financial instability because inequality creates a political environment whereby procyclical investment policies (such as poor regulation and loose monetary policy) are more likely to be implemented with the objective of avoiding political instability and reductions in economic growth.

Rising Inequality in Advanced Economies and Global Financial Fragility

Sharply rising inequalities in advanced economies have come under greater scrutiny since the 2007/08 crisis and are increasingly seen as a primary determinant of global financial fragility. "Although the crisis may have emerged in the financial sector, its roots are much deeper and lie in a structural change in income distribution that had been going on for the past three decades." (Rajan 2010, Fitoussi and Saraceno 2010, Vandemoortele 2009, Stiglitz et al. 2009).

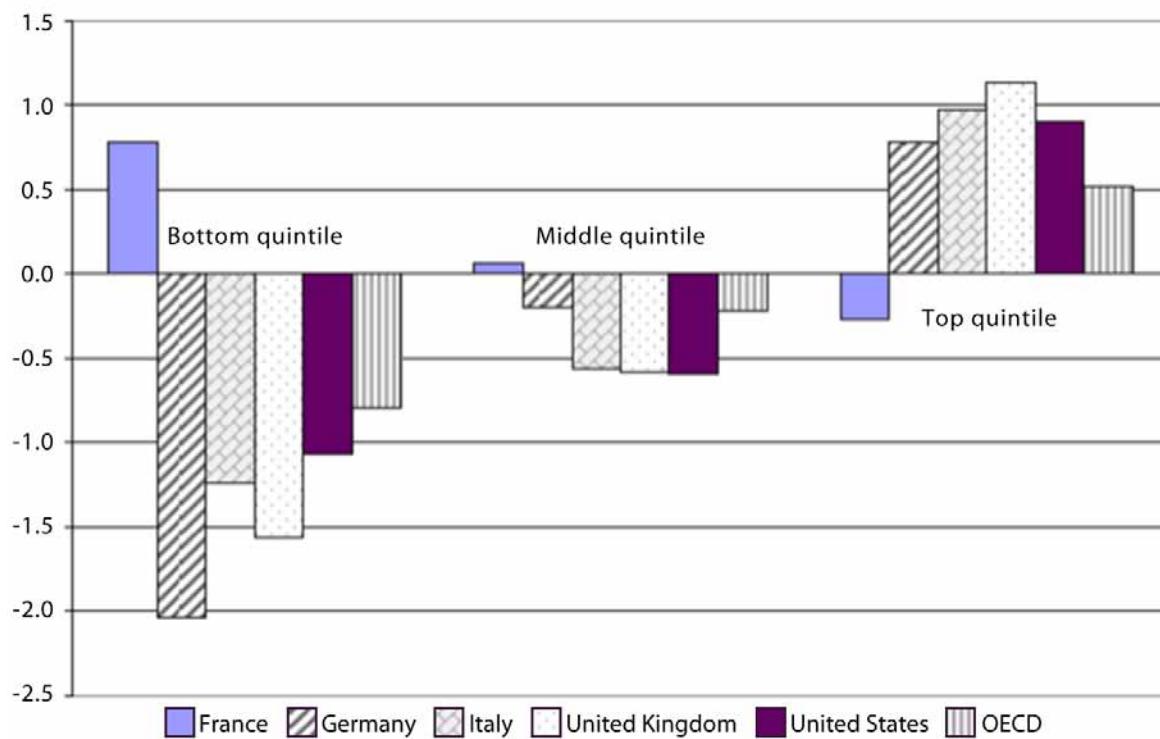
Inequality contributes to financial instability through several interrelated channels. Generally, a rise in income and wealth inequality reduces the purchasing power of middle- and low-income groups. From a macroeconomic perspective, this triggers a redistribution away from households with a higher propensity to consume to households with a lower propensity to consume. If propensities to consume differ, then income distribution affects the overall propensity to consume, and an increase in inequality causes it to decrease. The consumption demand then puts downward pressure on aggregate demand and on income (Kalecki 1942, Fitoussi and Saraceno 2010). Put simply, people who would spend money do not have it. "As inequality rose, money was transferred from those who would spend it to meet basic needs to those who had far more than they could easily spend. This created a tendency toward reduced levels of aggregate effective demand" (Stiglitz et al. 2009).

In other words, concentrations of wealth sap the overall demand for goods and services from the economic system, leading to a lack of aggregate effective demand. To circumvent the consequences of rising inequality, policy makers in the advanced countries allowed, even encouraged, policies that fuelled financial instability

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**Chart 6.1: Average annual growth of income minus growth of average wage,
mid-1980s to mid-2000s**



Source: Reproduced from Fitoussi and Saraceno 2010

(Vandemoortele 2009). These included lax legislation and loose monetary policy — manifest in the easy credit for poor consumers and complex financial instruments and practices to maximize profit, such as derivatives and swaps.⁴ Coupled with the search for high-return investments by those who benefited from the increase in inequalities, this led to the emergence of bubbles. “Net wealth became overvalued, and high asset prices gave the false impression that high levels of debt were sustainable.” (Fitoussi and Saraceno 2010).

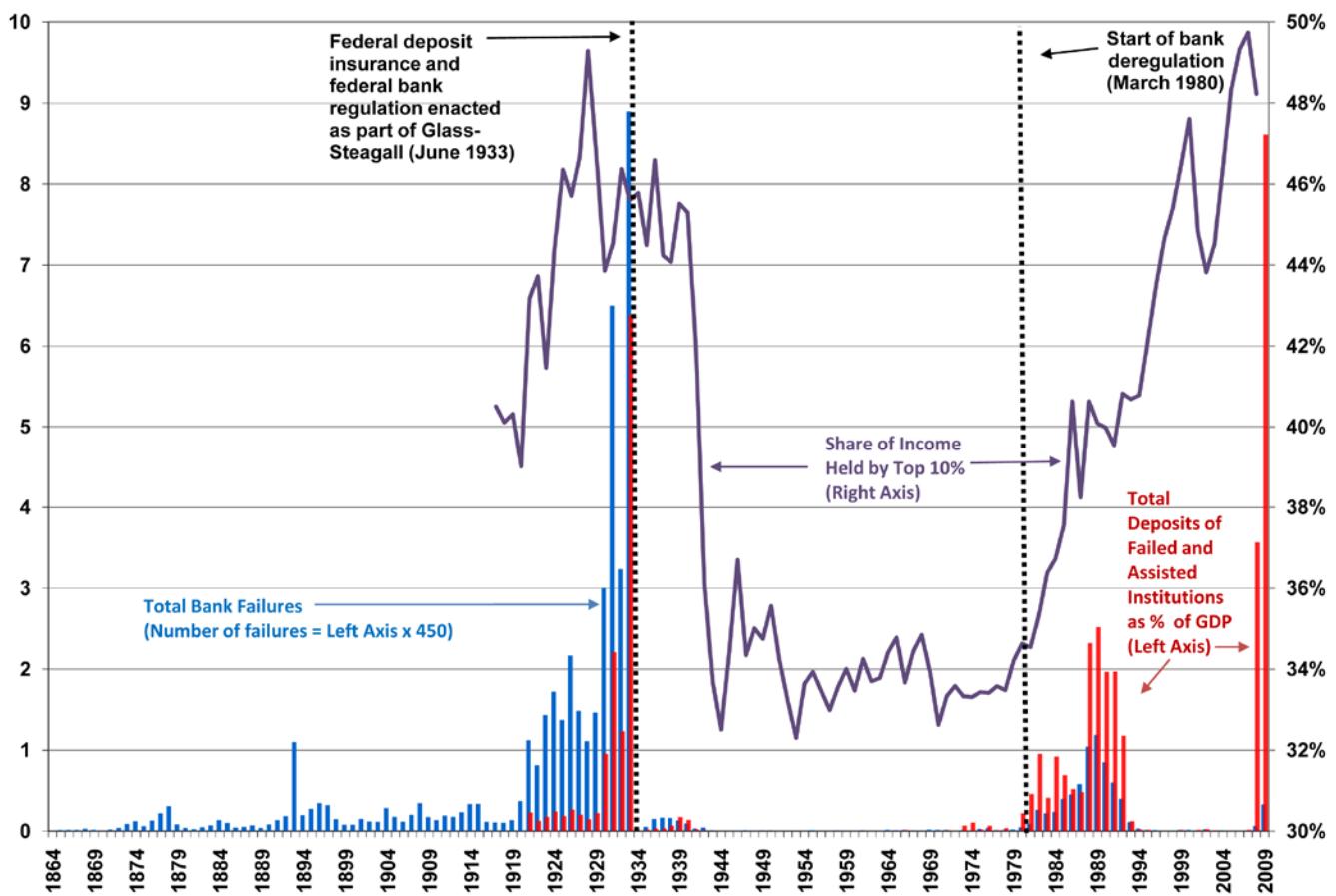
To sum up, the increase in inequality within advanced countries fuels financial instability because inequality creates a political environment whereby procyclical investment policies (such as poor regulation and loose monetary policy) are more likely to be implemented with the objective of avoiding political instability and reductions in economic growth.⁵ Concentrating wealth within a small portion of the population reduces risk aversion among investors and generates excessive risk-taking, particularly where regulation is weak. Together, these phenomena result in endogenous financial fragility. In other words, if wealth is concentrated within a small portion of the population, those at the top of the income distribution find themselves with a large pool of excess capital and search for profitable opportunities to invest. When these large investments enter the financial sector, they — in the absence of effective management and regulatory controls — have the potential to generate excessive risk-taking by market agents. Where this takes place, the result is endogenous financial fragility (Milanovic 2009, Minsky 1982).⁶



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The relationship between rising income inequality and financial fragility appears to be borne out by evidence for the United States (Chart 6.2), which shows that “disparities between rich and poor widened as government regulations eased and bank failures rose” (Moss 2010). It is also striking that the two peaks in inequality occurred in 1928 and 2007—in each case, immediately before a major financial crisis. “Although correlation is not causation, the patterns across American history are sufficiently striking that further investigation of possible connections seems merited” (Moss 2010).

Chart 6.2: Bank failures, regulation, and inequality in the United States



Source: Reproduced from Moss, 2010. Original source: *Historical Statistics of the United States: Colonial Times to 1970* (Washington, DC.: Government Printing Office, 1975), Series X-741,8 (p. 1038); “Federal Deposit Insurance Corporation Failures and Assistance Transactions United States and Other Areas,” Table BF01, FDIC website (<http://www2.fdic.gov/hsob>); Richard Sutch, “Gross domestic product: 1790–2002.” Table Ca9-19 in *Historical Statistics of the United States, Earliest Times to the Present: Millennial Edition*, eds. Susan B. Carter et al. (New York: Cambridge University Press, 2006); Bureau of Economic Analysis, “Gross Domestic Product.” NIPA Table 1.1.5. (<http://www.bea.gov/national/nipaweb>SelectTable.asp>); Thomas Piketty and Emmanuel Saez, “Income Inequality in the United States, 1913–1998,” *Quarterly Journal of Economics*, 118(1), 2003, pp. 1–39, with updated data available at: <http://elsa.berkeley.edu/~saez/TabFig2008.xls>. For an earlier version of this chart, without the inequality overlay, see David Moss, “An Ounce of Prevention,” *Harvard Magazine*, September–October 2009. Note: David Moss prepared this chart with the assistance of Darin Christensen and Arthur Kimball-Stanley and is deeply indebted to Mitchell Weiss for his insightful observation about the pattern of inequality.

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Rising Inequality in Advanced Countries and its Impact on Developing Economies

If the increase in income inequality in advanced economies is associated with more frequent financial crises, this has implications for developing economies, especially those that are more exposed to global financial markets. "Countries that have experienced banking and financial crises have also experienced an average reduction in GDP growth of 1.3% over the subsequent five years compared with countries that did not experience such crises" (Szekely 2003, as quoted in Cornia 2006).

As mentioned, the negative growth and poverty impacts of financial shocks in emerging and developing economies that are highly exposed to global financial markets have been extensively documented. More recently in the context of the 2007/08 financial meltdown, studies for Bangladesh, Mexico and the Philippines predict an increase in the level and depth of poverty for all three countries as a result of the crisis, with the extent of increase largely depending on the size of the macro-economic shock. "In Bangladesh and the Philippines, where the crisis led to a slowdown but not a reversal in GDP growth, poverty is expected to decline at a slower pace due to the crisis. In 2010, the poverty rate is expected to be 1.2% and 1.5% higher than what it would have been without the crisis in Bangladesh and the Philippines respectively, which translates to approximately 1.4 and 2 million additional poor" (Habib et al. 2010).

In Mexico, GDP actually contracted by nearly 9 percent in 2009 and is expected to grow by just 3 percent in 2010. As a result, the poverty rate is expected to rise by nearly 4 percent between 2008 and 2010 (Habib et al. 2010). Additional evidence shows that financial crises are associated with an increase in poverty in emerging and transition economies (Baldacci et al. 2002).

Financial crises adversely affect not only growth and poverty, but also typically income distribution. In developing countries, they do this through various channels, including by causing a slowdown in economic activity, relative price changes, fiscal retrenchment, and a change in assets (Balducci et al. 2002). Evidence from Mexico, Bangladesh, and the Philippines indicates that, in all three countries, the impacts are relatively large in the middle part of the income distribution. "Between 15% and 20% of households in the fourth to seventh decile of the income distribution group in Mexico and the Philippines, and 10% of this group in Bangladesh, suffer income losses that push them to a lower income decile. In Mexico, where the crisis has been more severe, significant impacts are also likely for the bottom of the distribution. The poorest 20% of Mexican households suffer an average per capita income loss of about 8% compared with 5% for the entire population — even after existing safety net transfers that benefit many of the extreme poor are taken into account. The impact on the middle of the distribution can be attributed to significant shocks to employment and labour earning in the manufacturing sector, which employs a large number of workers from middle-income households" (Habib et al. 2010).

Evidence from the financial crises of the late 1990s that affected the Republic of Korea, Mexico and Thailand also show that the income share of the bottom 80 percent of households fell compared to the top 20 percent (Table 6.1). In Mexico in 1995, many children of the poor dropped out of school — with many never returning (Szekely 1999).

To conclude, rising inequality in advanced countries is a key factor that accounts for heightened financial fragility in international markets. Financial shocks typically worsen inequality, growth and poverty in

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developing economies.⁷ Thus, addressing growing income inequalities in advanced countries is as important as addressing the same trend within developing nations.

Table 6.1: Financial Crises and Changes in Income Shares in East Asia and Latin America

Country	Pre-crisis		Post-crisis	
	Income share of poorest 80% of population (%)	Income share of richest 20% of population (%)	Income share of poorest 80% of population (%)	Income share of richest 20% of population (%)
Rep. of Korea	61.2	38.8	58.3	41.7
Philippines	48.0	51.9	45.2	54.8
Thailand	39.2	60.8	38.2	61.8
Brazil	35.1	64.8	34.4	65.6
Mexico	42.0	58.0	41.5	58.5
Country	Income share of poorest 80% of population (%)	Income share of richest 20% of population (%)	Income share of poorest 80% of population (%)	Income share of richest 20% of population (%)
Rep. of Korea	19.3	38.8	15.9	41.7
Philippines	13.7	51.9	12.3	54.8
Thailand	8.2	60.8	7.8	61.8
Brazil	8.2	64.8	8.0	65.6
Mexico	11.2	58.0	10.7	58.5

Source: WIDER WIID 2.0a (2005) and author's calculation – Reproduced from Birdsall (2005). Notes: East Asian Financial Crisis 1997/98, Brazil crisis 1999, and Mexico crisis 1994/95. Pre-crisis data for Thailand, the Republic of Korea, and Brazil are from 1996, for the Philippines from 1994 and Mexico 1992. Post-crisis data are from 1996 for Mexico, 1998 for the Republic of Korea, 1999 for Thailand, 2000 for the Philippines, and 2001 for Brazil

Trends in Income Inequality Within Developing Countries

Income inequality within the majority of developing countries has been rising—in some cases, sharply. “The last two decades have witnessed a widespread and symmetric rise in within-country inequality in developing countries” (Cornia 2004, Birdsall 2005, Van der Hoeven 2008).

Examining the change in the Gini coefficient of income distribution for a sample of 70 countries⁸ from the mid-1990s to the mid-2000s indicates that, although the trends in income inequality were not uniform across developing economies, income inequality rose in the majority of countries (38 of the 70 countries). Since these 38 countries represent 75 percent of the population covered by the sample, the rise in inequality affected the vast majority of households living in the developing world. For one country in the sample, there appears to have been no change in income inequality, while inequality declined in 31 of the 70 countries during the decade (Annex 6.A).

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By the mid-2000s, Latin America and the Caribbean remained the region with the highest levels of income inequality (Gini coefficient of 51), followed by Africa (Gini coefficient of 42). In Asia and the Pacific and the Arab States, the Gini was 37, and the lowest level of income inequality was found in the ECIS region, which had a Gini of 32.

As of the mid-2000s, high-income developing economies and MICs had the highest level of inequality among development groups. Low-income economies followed and the lowest level of income inequality was found in transition economies (Table 6.2).

Table 6.2: Gini Coefficient of Income Distribution by Region and Development Status, mid-2000s

Region or Development Status	Gini Coefficient (*100)
LAC	51
Africa	42
A&P	37
Arab States	37
ECIS	32
High-Income Developing Economies	48
Low-Income Developing Economies	40
Middle-Income Developing Economies	48
Transition Economies	32

Calculated using data from World Bank, World Development Indicators 2009

Disaggregating trends in income distribution by region (Chart 6.3) shows that, in the Asia and Pacific region, ECIS, and Latin America and the Caribbean, more countries saw income inequality rise than fall. Africa was the exception to this pattern, with only four countries registering an increase in income inequality, whereas 12 countries showed a decrease in income inequality. In the Arab States, which are represented by only four countries in the sample, two countries saw income inequality rise and two saw inequality fall between the mid-1990s and mid-2000s.

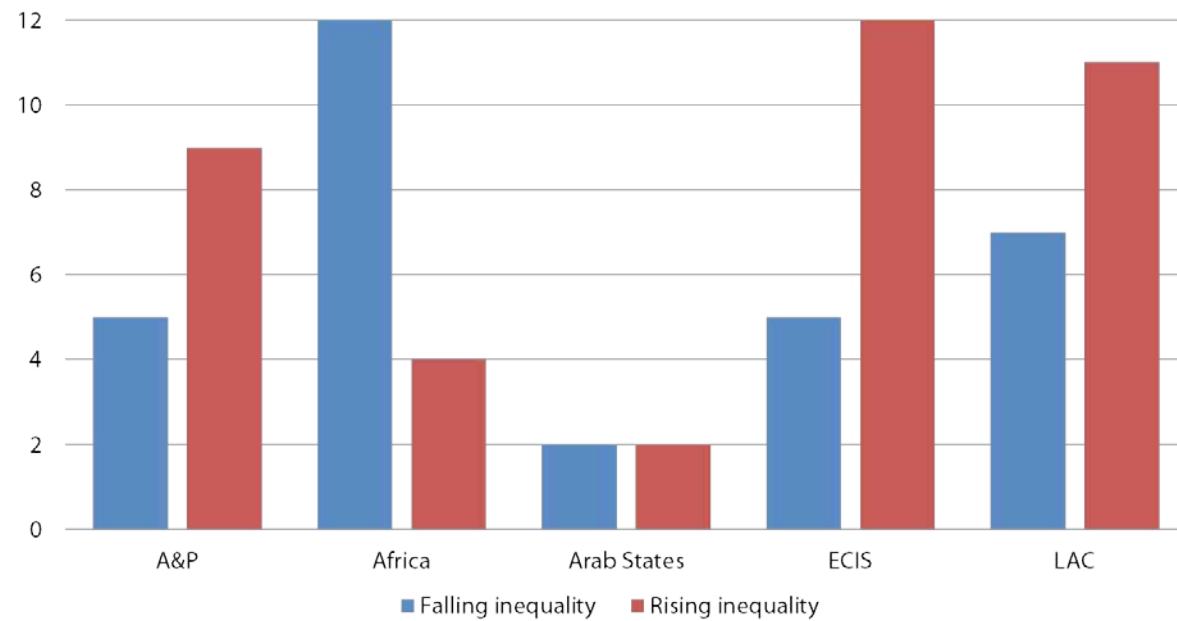
The ECIS saw the largest number of countries experience rising inequality. Income inequality rose in 12 of the 17 countries in the sample, with the average rate of increase in inequality standing at 14 percent during this period (Chart 6.4). In Latin America and the Caribbean, 11 of 18 countries experienced rising inequality, with the increase averaging 13 percent. A similar pattern was observed in Asia and the Pacific, with nine of 14 countries experiencing rising inequality, which averaged 13 percent. Included in the latter group are China, India and Indonesia, the three most populous countries in the developing world. Only two Arab countries (Egypt and Morocco) witnessed increasing inequality during the period. Income inequality increased by 4 percent in Morocco and by 0.4 percent in Egypt.

Although the trends in income inequality were not uniform across developing economies, income inequality rose in the majority of countries.



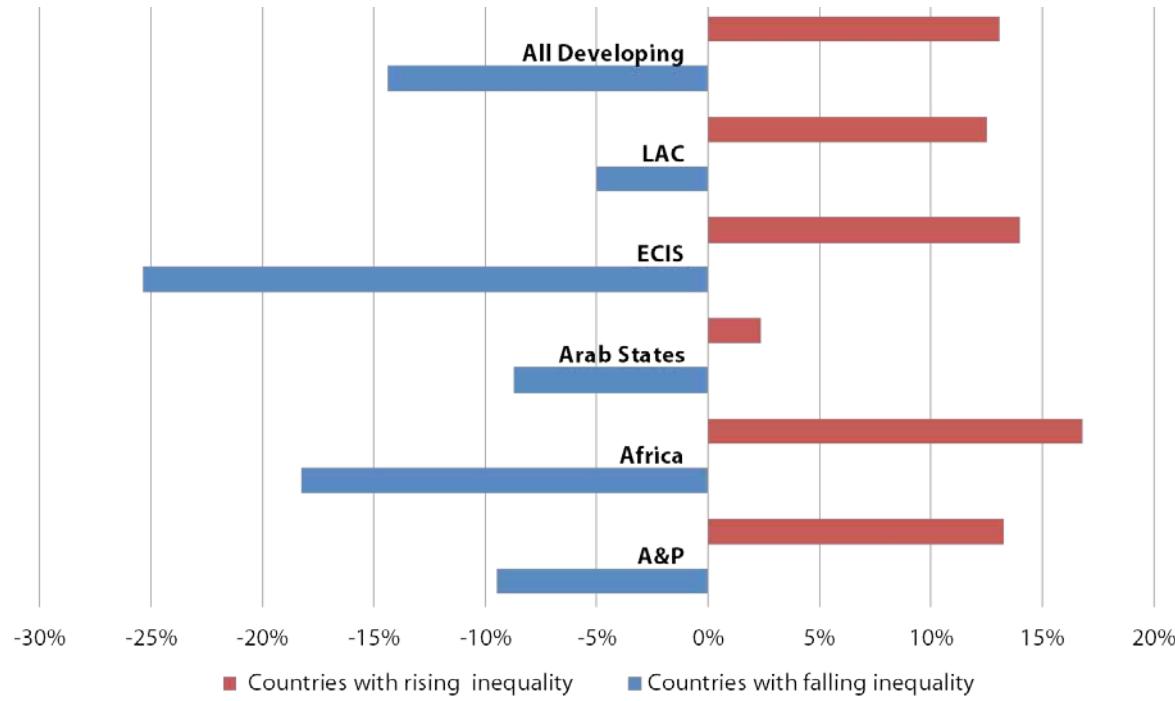
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Chart 6.3: Number of countries with rising and falling income inequality by region, mid-1990s to mid-2000s



Source: Calculated using data from World Bank, World Development Indicators 2009

Chart 6.4: Average change in income inequality by region, mid-1990s to mid-2000s



Source: Calculated using data from World Bank, World Development Indicators 2009

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Africa had the lion's share of the number of countries with falling inequality during the period. Twelve African nations of the 17 covered by the data had declining income inequality at an average rate of 18 percent during the period.⁹ Seven of the 18 Latin American and Caribbean countries in the sample experienced falling inequality, with an average rate of 5 percent. This group of countries includes countries that traditionally have had very high levels of inequality (Brazil, Chile, Nicaragua and Panama). The five countries (of 14) in the Asia and Pacific region with declining inequality managed to reduce inequality by 9 percent on average during this period. The most successful was Malaysia, where inequality fell by 20 percent.

The majority of countries in each development group (Chart 6.5) saw inequality rise, except for countries in the low-income development group. Nearly 70 percent of the transition economies in the sample experienced rising inequality, a trend true of high-income developing economies as well, although only five countries represent the group of high-income developing countries. Still, three of the five high-income developing economies had an increase in inequality. Middle-income developing economies, with a more representative sample of 19 countries, also display the same trend. Eleven of the 19 MICs in the sample had an increase in income inequality during the period.

Among countries with rising inequality (Chart 6.6), transition economies showed the greatest increase, with an average rate of increase of 15 percent during this period. Low-income economies followed closely, with a 14 percent average increase in inequality. For the MICs with rising inequality during the period, inequality

Chart 6.5: Number of countries with rising and falling income inequality by development status, mid-1990s to mid-2000s

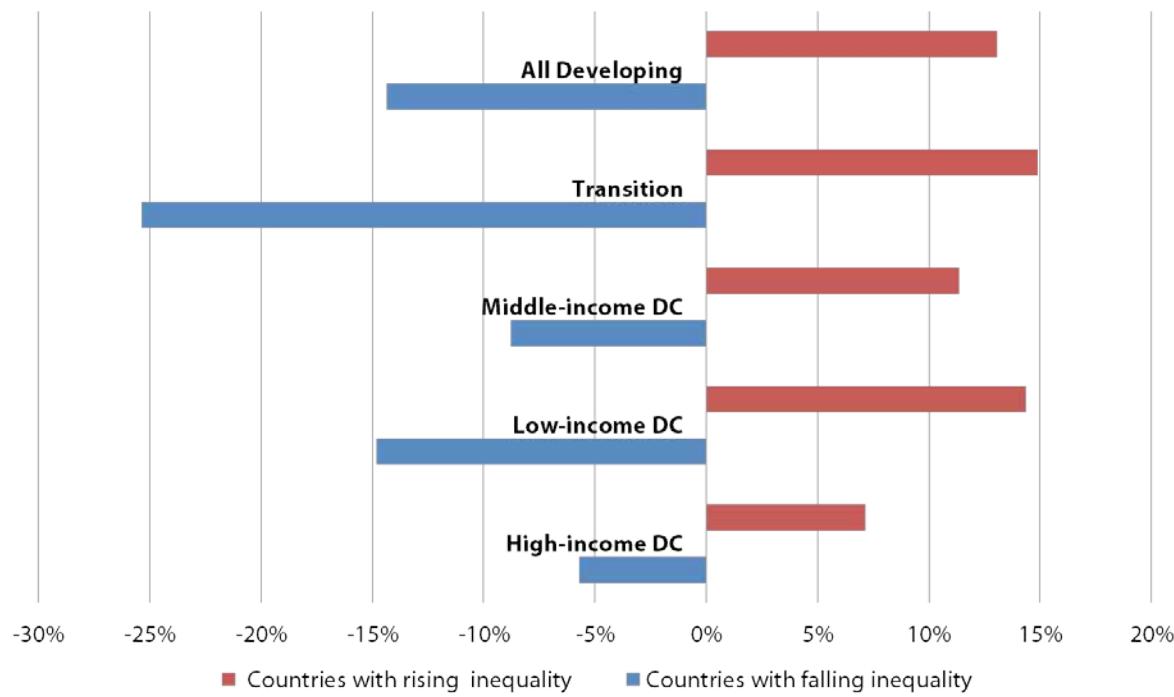


Source: Calculated using data from World Bank, *World Development Indicators 2009*



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Chart 6.6: Average change in income inequality by development status, mid-1990s to mid-2000s



Source: Calculated using data from World Bank, *World Development Indicators 2009*

rose by an average of 11 percent. Income inequality in the three high-income developing economies with rising inequality rose by 7 percent on average.

Significantly, the majority of countries with falling inequality were low-income economies. Sixteen of 29 low-income economies had an improvement in the distribution of income by an average of 15 percent. Only five of 16 transition economies had a decrease in income inequality, averaging 25 percent—the highest average decline among all development groups. In the MICs, eight of 19 countries had falling levels of income inequality, averaging 9 percent over the period. Only two high-income countries had a fall in inequality: Chile and Mexico both managed to reduce their levels of income inequality by 6 percent during the period.

To conclude, despite mixed trends, more countries are moving towards higher levels of income inequality than towards more equality.

Explaining the Rise in Income Inequality in Developing Countries

Making generalizations about the causes of income inequality in developing countries must be done with care. The situation in each nation depends on country-specific circumstances and policy mixes. Yet, it is clear that there are some common factors behind the widespread surges in inequality around the world. It has been noted that a worsening situation in the ‘traditional’ causes of inequality such as land concentration, urban bias and inequality in education has not caused the recent increases in inequality in developing countries,¹⁰

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although these factors still do explain most of the variation in cross-country inequality (Cornia 1994).¹¹ Rather, the evidence points to 'new' causes associated with neo-liberal policy reforms that have increasingly been adopted in transitional and developing countries (Cornia and Court 2001, Birdsall 2005, van der Hoeven 2008, UNRISD 2010). The most important of such policy reforms are macro-economic reforms including, *inter alia*, financial and labour market liberalization, privatization, and reforms in the tax and transfer systems.

Stabilization and Adjustment Programmes: The 1980s and 1990s witnessed a sharp increase in the number of stabilization and adjustment programmes. Since a key objective of stabilization is inflation targeting, "the sharp demand compression undertaken by such programmes to reduce inflation to single digits led to sharp recessions and poverty surges" (Cornia 1994). Furthermore, "in developing countries, the standard approach to stabilization has not been distributionally neutral" (Cornia 1994). This is because wages in LICs and MICs are downwardly flexible and social safety nets are much less developed. Thus, wages (especially wages for unskilled labour) fall faster than GDP per capita and profits, the wage share declines, and inequality of income distribution increases. The rise in wage share during recovery then tends to be smaller than the fall during the crisis period.

The evidence points to 'new' causes associated with neo-liberal policy reforms that have increasingly been adopted in transitional and developing countries.

Domestic Financial Liberalization: Many MICs in Asia and Latin America adopted financial liberalization policies in the 1990s. In addition to spurring financial crises, the liberalization of the domestic financial system has apparently "caused an increase in income inequality much greater than that caused by other policy changes such as trade and labour market liberalization" (Cornia and Court 2001). Increases in real interest rates, a result of the liberalization of domestic financial markets, benefited lenders and rentiers at the expense of borrowers, including governments. Consequently, interest payment on public debt has risen rapidly and a large part of the government budget in many MICs now goes for interest payments rather than for social expenditure.

Privatization and Distribution of Industrial Assets: The mass privatization of industrial assets in transition economies has almost invariably increased income inequality and created severe incentive problems. In some African countries like Guinea-Bissau and Mozambique, there has been some confusion in land titling following de-collectivization, with poor communities least able to protect their rights.

Changes in Labour Market Institutions: It seems likely that changes in labour market institutions have contributed significantly to rises in wage inequality and overall inequality, especially in middle-income and transition economies. "As employment became more informal, wage shares declined and the difference between skilled and unskilled wages increased in many countries" (Cornia and Court 2001).

The State Tax and Transfer Systems: Governments can significantly influence levels of income inequality through taxes and expenditures. Indeed, this is why it is important to look for changes in government budgets—particularly taxes and transfers—in order to help drive the distribution of disposable income towards greater equality. Progressive tax and pro-poor expenditure will reduce poverty.¹² Yet, over the past two decades, the main policy trend has been in the opposite direction: tax systems appear to have evolved towards greater use of indirect taxes (VAT) and lower progressivity in developing countries; very few tax systems in developing countries are progressive and, over time, the progressivity of tax systems has declined in most developing countries. More troubling, the level and composition of public expenditure in



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some countries appear to have become less redistributive. In other words, the tax and transfer policies in developing and transition economies were not effective in limiting the rise in inequality of the distribution of national incomes, while the declining progressivity of tax systems may have worsened inequality during the 1980s and 1990s (Roy and Heuty 2009).

Within-Country Inequality and Domestic Financial Fragility

Rising income inequality is associated with endogenous financial fragility in developing economies just as it is in advanced economies, although the transmission channels vary:

- Domestic financial liberalization in many developing countries has tended to raise the interest rate, which, in turn, has increased the cost of servicing the public debt. This, in turn, usually requires an increase in taxation. However, in many countries, the tax incidence is regressive or proportional, while ownership of financial assets is highly concentrated. And higher interest rates have rewarded the owners of financial assets, thus increasing income inequality. "Generally, financial deregulation has led to a substantial increase in the rate of return to financial capital, a rapid accumulation of public debt, an increase in the share of GDP accruing to non-wage incomes, the emergence of a new class of rentiers, and the redistribution via the budget of labour incomes to holders of state bonds" (Cornia and Court 2001).¹³
- If wealth is concentrated within a small portion of the population, those at the top of income distribution find themselves with a pool of excess capital and search for profitable opportunities to invest. In the absence of effective management and regulatory controls, these large investments have the potential to generate excessive risk-taking by market agents when they enter the financial sector. In other words, inequality generates procyclical investment behaviour.¹⁴ Where this occurs, the result is often endogenous financial fragility (Vandemoortele 2009). Indeed, such excessive risk-taking accounts for the emergence of asset bubbles in sectors such as real estate in developing economies, leading to financial fragility.
- Further, societies with higher degrees of income polarization will be more prone to fiscal instabilities because, when politicians disagree on how to use public funds, each will have an incentive to overexploit the common pool of resources, with negative effects on fiscal balance and the 'national project of development'. This behaviour is more likely to occur and be more severe in societies with higher degrees of polarization (Woo 2005).

Inequality, Economic Growth and Poverty Reduction

It is well known that economic growth and inequality play a major role in generating changes in poverty. Indeed, high, sustained growth is essential for poverty reduction if the distribution of income remains more or less constant (Deininger and Squire 1996, Ravallion 2002). Likewise, much evidence suggests that greater inequality tends to increase poverty (Bourguignon 2004, Birdsall 2005, UNRISD 2010, van der Hoeven 2008). For these reasons, "although poverty reduction is correlated to growth in per capita income, this effect appears low in countries where income inequality has been rising" (Jantii and Sandstrom 2005, Lopez 2006).

What, though, is the relationship between distribution and growth? Does faster growth in a country reduce or increase inequality? Or does excessive inequality in a given country slow or accelerate growth?

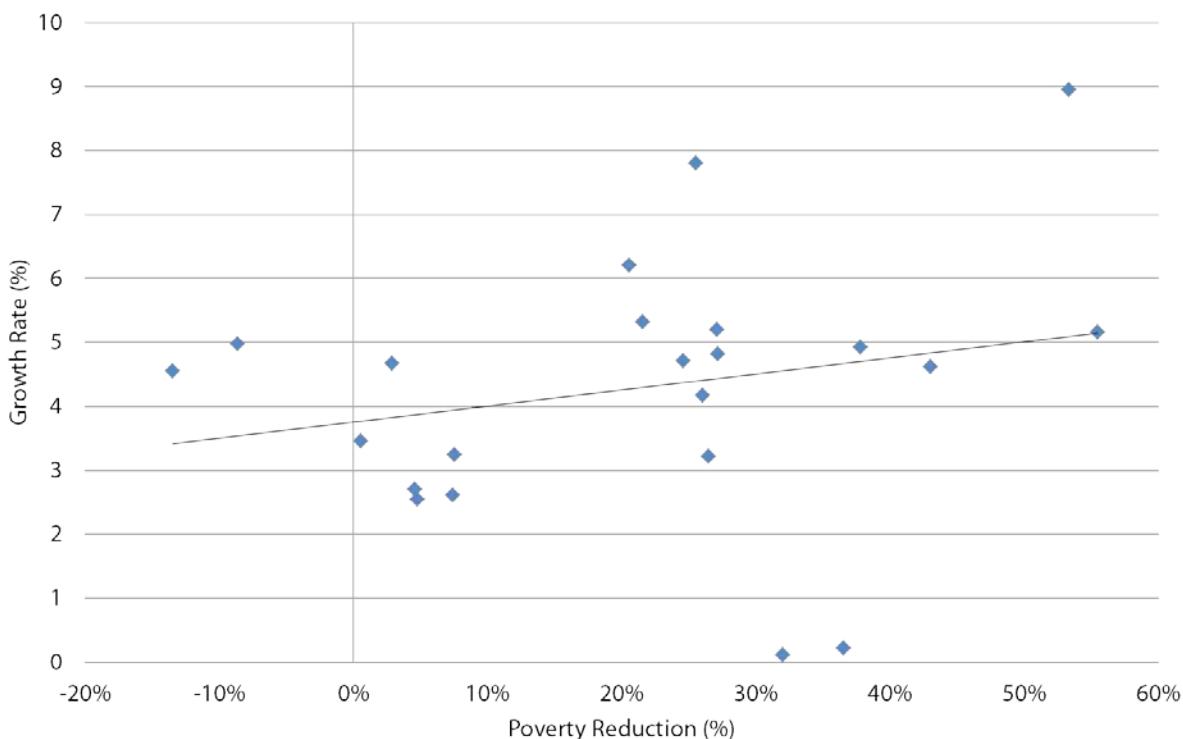
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The dominant perspective today is that inequality plays a central role in determining the rate and pattern of growth and that high initial levels of inequality seem to be associated with lower economic growth rates (Alesina and Rodrik 1994, Alesina and Perotti 1996, Birdsall 2007, Rodrik 1998).¹⁵ The evidence appears to support this perspective with cross-sectional studies showing that inequitable countries tended to grow more slowly over the last 20 to 30 years,¹⁶ whereas countries with an initially relatively egalitarian distribution of assets and incomes grew faster (Birdsall 2005).

If this is indeed generally the case, then its implication for policy is that progressive redistribution would enhance growth. In other words, it is possible to reduce inequality through redistribution or through promoting inclusive growth for a sustainable poverty reduction strategy. In short, a more equal distribution of assets matters. It can reduce poverty indirectly by accelerating economic growth and directly by enhancing income growth of the poorest groups. The long-standing inattention to the distribution of assets, both in terms of physical and human capital, has been costly as it otherwise would have called attention to a fundamental constraint on poverty reduction: the lack of access by the poor to the assets necessary for increased productivity and income (Birdsall 1997). Additionally, it is not only the lack of access to assets that holds the poor back; equally important is the fact that the poor's assets tend to be insecure, unprotected and less productive than they could be.

Chart 6.7: Relationship between economic growth and poverty reduction, mid-1990s to mid-2000s



Source: Calculated using data from World Bank, World Development Indicators 2009



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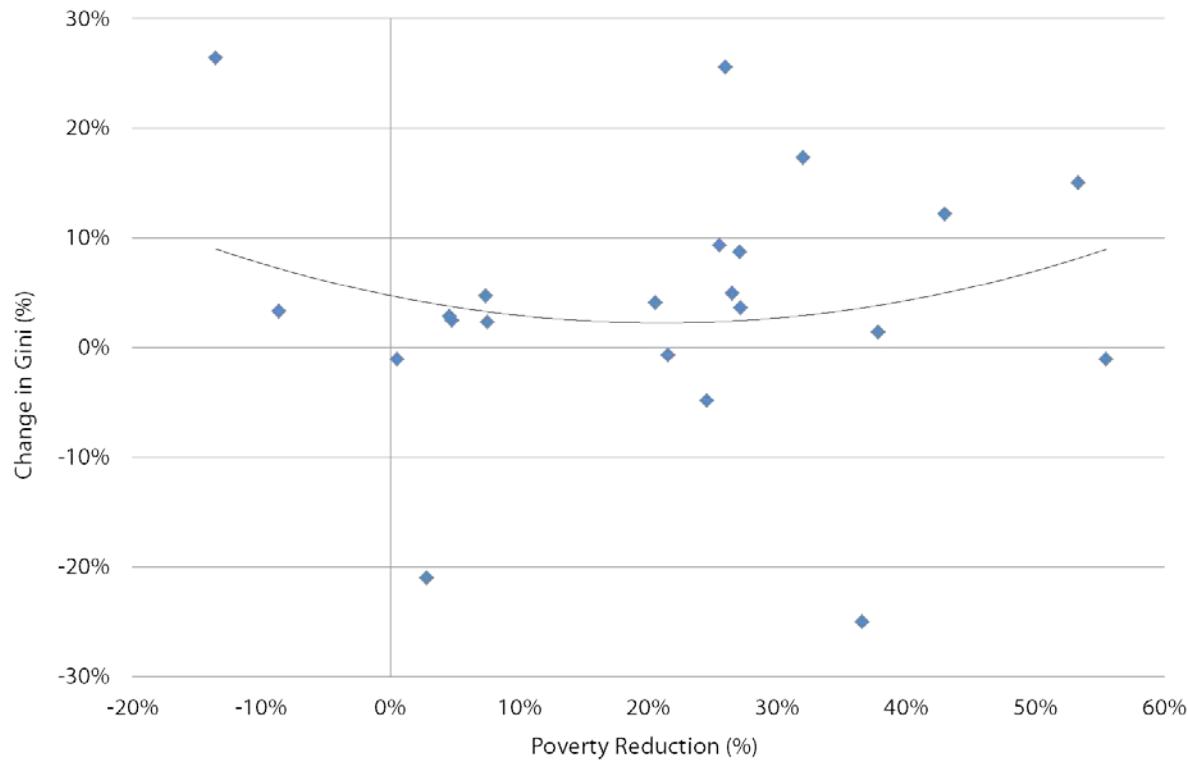
In summary, it is important to consider both growth and income (wealth) distribution simultaneously and to recognize that distribution matters as much as growth for poverty reduction. However, the impact of these phenomena depends on the initial level of income and inequality, and the relative effects of both phenomena may differ quite significantly across countries.

Evidence on poverty reduction, economic growth and inequality for a sample of 22 countries from the mid-1990s to the mid-2000s (Annex 6.B) indicates that, although there is a direct correlation between economic growth and poverty reduction, specific countries nonetheless demonstrate great variance in the precise nature of this correlation (Chart 6.7).

Some countries, despite low growth rates, appeared to have lowered their poverty incidence significantly. For instance, El Salvador reduced poverty by 26 percent, with an average rate of growth of 3.2 percent, whereas, in Indonesia, with relatively low rates of growth (2.5 percent), poverty was reduced by only 5 percent. Clearly, country-specific conditions explain some of these results: El Salvador emerged from conflict, while Indonesia suffered from the East Asian crisis in 1997.

On the other end, high-growth countries, like China and India, significantly lowered their poverty incidence, whereas Costa Rica, Ethiopia and Sri Lanka, despite high growth, saw an increase in poverty (Costa Rica's poverty rose by 9 percent, Sri Lanka's poverty rose by 14 percent) or a negligible reduction in poverty

Chart 6.8: Relationship between change in poverty and change in income inequality, mid-1990s to mid-2000s



Source: Calculated using data from World Bank, World Development Indicators 2009

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(Ethiopia's poverty fell by 3 percent). Many other countries with moderate rates of growth showed minimal reduction in poverty (Mongolia, the United Republic of Tanzania).

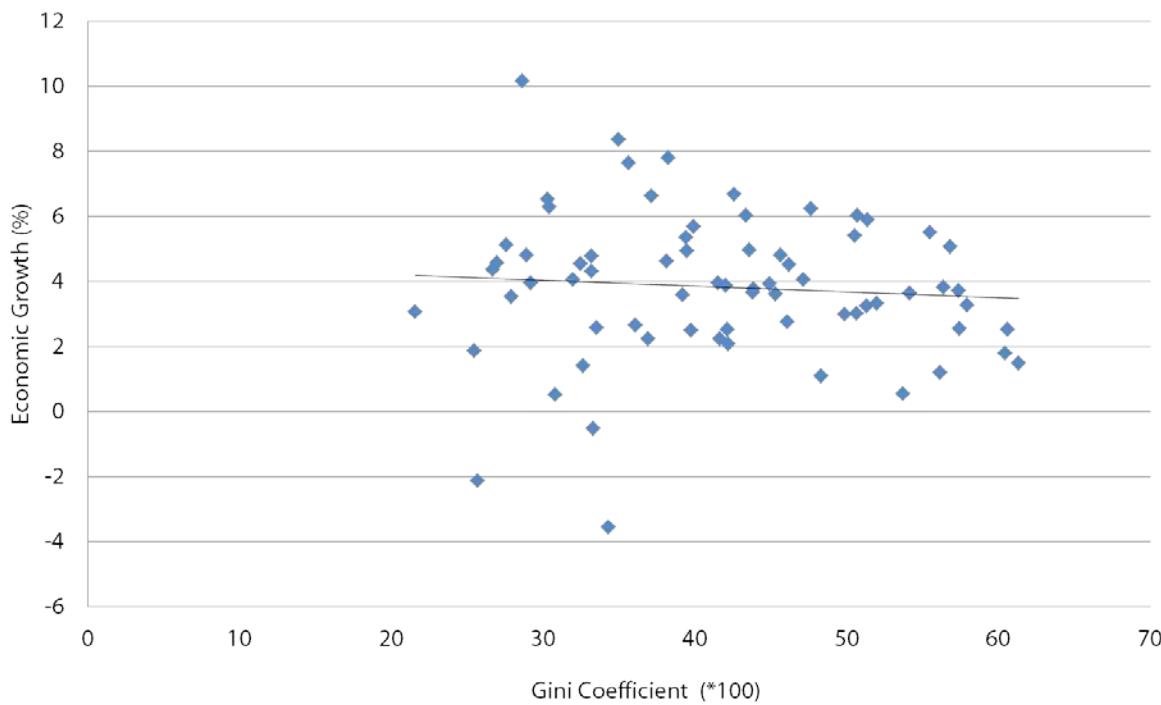
Earlier, it was noted that, though growth has the potential to reduce poverty, this potential is more strongly realized when it is accompanied by falling inequality. Indeed, the sample of 22 countries shows not a single case where reductions in income inequality were associated with an increase in poverty.

The relationship between changes in poverty and changes in inequality (Chart 6.8) shows that, although the relationship is not linear, a worsening of income inequality is typically associated with a lesser reduction in poverty. Moreover, the relationship between changes in inequality and changes in poverty generally appear to be significantly weaker at very high rates of poverty reduction.¹⁷

Apart from the impact of changes in income inequality on poverty, the initial levels of income inequality also matter for growth and poverty reduction. Countries with higher initial levels of inequality tend to have a lower growth path than countries with low initial inequality. Chart 6.9 shows the relationship between growth from the mid-1990s to mid-2000s and the initial level of inequality in the mid-1990s for a group of 70 developing countries. The evidence shows that countries with a lower initial Gini coefficient were generally able to achieve higher levels of growth.

To sum up, countries that had the most success with poverty reduction were those where income inequality fell and growth remained robust.

Chart 6.9: Relationship between initial level of income inequality and economic growth, mid-1990s



Source: Calculated using data from World Bank, *World Development Indicators 2009*



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Poverty Traps

The concept of poverty traps has long been used to explain the persistence of chronic poverty and long-term growth failure (i.e., growth with low levels of income per capita) in the poorest of economies. "The persistent failure to break the cycle of stagnation and poverty in the poorest countries is perhaps the most striking exception to the otherwise remarkable economic achievements of the twentieth century" (IMF 2000, OECD/World Bank 2001).

The trap¹⁸ stems from the fact that the condition of poverty itself has effects that cause poverty. In other words, not only does economic growth affect the incidence of poverty, but, where the majority of the population is very poor, the incidence of poverty also affects economic growth. "In societies where the majority of the population live at or below income levels sufficient to meet their basic needs, and the available resources even where equally distributed are barely sufficient to meet the basic needs of the population, this all-pervasive poverty itself acts as a major constraint on economic growth" (Gore 2002).¹⁹ For instance, between 1995 and 1999, the average per capita income in LDCs, when measured in terms of current prices and official exchange rates (rather than in 1985 PPP dollars) was \$0.72 a day and the average per capita consumption was \$0.57 per day. This implies that, on average, there was only \$0.15 a day per person to spend on private capital formation, public investment in infrastructure and the running of vital public services, including health, education, administration, and law and order. The low rate of per capita expenditure on essential public services, such as health and education, in the LDCs results not from different expenditure priorities, but from the extremely low overall resource availability amidst all-pervasive poverty.

When poverty is extant, low income leads to low savings, low savings leads to low investment, and low investment leads to low productivity and low incomes.

It has been pointed out that the extreme poor lack six kinds of capital: human capital, business capital, infrastructure capital, natural capital, public institutional capital, and knowledge capital.²⁰ So "the poor start with a very low level of capital per person, and then find themselves trapped in poverty because the ratio of capital per person actually falls from generation to generation. The amount of capital per person declines when the population is growing faster than capital is being accumulated" (Sachs 2005).

In short, poor nations remain poor because of a vicious circle of low savings and few investment opportunities. When poverty is extant, low income leads to low savings, low savings lead to low investment, and low investment leads to low productivity and low incomes.

Policies for Reducing Chronic Poverty and Inequality

Although policies to address poverty reduction have been around for a long while, policies to address inequality have received much less attention. Yet, addressing both in tandem will be critical for sustaining MDG progress. Specifically, policy measures in three areas will be critical:

- Inclusive growth and the expansion of productive employment
- Redistribution of incomes and assets
- Pro-poor macro-economic policies



Promoting Inclusive Growth and the Expansion of Productive Employment

Although rapid growth is necessary for substantial poverty reduction, it should, in order to be sustainable over the long run, be broad-based across sectors and include²¹ much of a country's labour force, where 'inclusiveness' refers to equality of opportunity of access to markets and resources and an unbiased regulatory environment for businesses and individuals (The Commission on Growth and Development 2008).²²

More specifically, growth that raises average household incomes and household consumption is necessary. "Increases in overall GDP per capita will not necessarily do the trick" (Gore 2002). Indeed, evidence indicates that there is a major opportunity for the rapid reduction of extreme poverty through a form of economic growth that raises average household incomes. This, of course, requires an expansion of employment opportunities and increasing output per worker (World Bank 2009b).

In other words, sustained high growth rates and poverty reduction can only be realized when the sources of growth are expanding and an increasing share of the labour force is efficiently included in the growth process. Thus, the main instruments for inclusive growth are growth in productive employment and growth in productivity (OECD 2009).

Although policies to address poverty reduction have been around for a long while, policies to address inequality have received much less attention. Yet, addressing both in tandem will be critical for sustaining MDG progress.

Employment growth creates new jobs and income for the individual—from wages in all types of firms, or from self-employment—while productivity growth has the potential to lift the wages of those employed and the returns to those who are self-employed.²³ However, the ability of individuals to be productively employed depends on the opportunities to make full use of available resources as the economy evolves. This is why it is important to also look at ways to strengthen the capacity of the individual on the labour-supply side as well as ways to open up new opportunities for productive employment on the labour-demand side.

Thus, specific policy measures to promote inclusive growth will need to:

Identify the sources of growth and employment-intensive investments affecting different sectors and types of firms and also the bottlenecks to economic transformation in the long run. For instance, although it is well known that SMEs and cooperatives can be important sources of growth and employment creation, the growth and productivity of these firms are often constrained by their lack of access to finance, markets and inputs (Birchal and Ketilson 2009).

It is also important to review whether employment-intensive investments can be effectively adopted and the trade-offs are involved. Although the idea of employment-intensive investment evokes a perceived trade-off with productivity and efficiency, there is evidence that this need not be the case with respect to every investment decision. Choosing an employment-intensive option for a given investment could be cost-effective while also generating much-needed employment opportunities (Islam and Majeres 2001). Infrastructure and construction are common investments that can be made employment-intensive, but there are other options such as agriculture, forestry, environmental services and protection or even the provision of social services (Islam and Majeres 2001, Lieuw-Kie Song and Philip 2010).

Devise strategies to raise the pace of growth by more fully using parts of the labour force trapped in low-productivity activities or completely excluded from the growth process. Integrating the poor



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and excluded into the growth process can be undertaken through various measures. For instance, public employment schemes and employment guarantee programmes have been identified as initiatives by which underemployed, marginal and vulnerable populations can be included in local economic growth processes while receiving income support and skills training. Cash-for-work and temporary employment programmes could also fit into this category, provided they contain skills-building components and they focus on the creation or rehabilitation of basic infrastructure.

Adopt policies that build the human capital and productivity of labour. As has been noted so often, policies in education, health and nutrition make a difference in the possibilities and conditions of entry into the labour market (McKinley 2008).

- Skills training can help enhance productivity and earnings of workers in the informal economy (OECD 2009, Dreschler et al. 2008).
- Enabling access to basic education and health services across regions and socio-economic groups can "not only stimulate economic growth and reduce inequality simultaneously, but also play an important role in determining a country's ability to cope with technological and economic changes" (Vandemoortele 2009).

Box 6.1: South Africa's Expanded Public Works Programme

The Expanded Public Works Programme (EPWP) is one of numerous government programmes to provide poverty and income relief through temporary work for the unemployed to carry out socially useful activities. It was launched in April 2004 to promote economic growth and create sustainable development. The immediate goal of the EPWP Phase 1 was to help alleviate unemployment by creating at least 1 million work opportunities, of which at least 40 percent of beneficiaries will be women, 30 percent youth and 2 percent people with disabilities. As part of the contribution to the income of the poor, the target for 1 million work opportunities through the Expanded Public Works Programme was reached in 2008, a year earlier than envisaged in the 2004 electoral mandate.

The Expanded Public Works Programme Phase 2 was launched in April 2009 at the University of the Western Cape. The goal of EPWP Phase 2 is to create 2 million full-time equivalent (FTE) jobs for poor and unemployed

people in South Africa to help halve unemployment by 2014 through the delivery of public and community services. (This will scale up from 210,000 FTE jobs per year in 2009/10 to 610,000 FTE jobs in 2013/14.) This translates to 4.5 million (short and ongoing) work opportunities. The average duration of employment is assumed to be 100 days. This will scale up from 500,000 work opportunities in 2009 to 1.5 million in 2014.

Public bodies from all spheres of government (in terms of their normal mandates and budgets) and the non-state sector (supported by government incentives) are expected to deliberately optimize the creation of work opportunities for unemployed and poor people in South Africa through the delivery of public and community services. Training and enterprise development will be implemented in sector specific programmes to enhance service delivery and beneficiary well-being.

Source: Adapted from Department of Public Works, Republic of South Africa, *Welcome to the Expanded Public Works Programme (EPWP): Phase 2*, available at www.epwp.gov.za

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The Redistribution of Incomes and Assets

Although the focus of inclusive growth is generally on productive employment rather than on direct income distribution as a means of increasing incomes for excluded groups, it is also clear that employment, by raising the incomes of workers, can contribute to reductions in inequality. "High employment levels reduce inequality and, especially, high employment levels in the industrial sector reduce inequality" (Angeles-Castro 2006). Thus, targeting for employment and for reduction of income inequality can be combined objectives in policy making.

Still, given the vast numbers of 'working poor' households,²⁴ additional and more direct interventions such as social protection and access to assets are needed to reduce poverty and inequality. Providing social protection and social services to those who cannot work can also shoehorn many of those who care for them—usually women—into the labour market.

Social Protection

Social protection has been conceptualized in many ways, from safety net approaches that help households respond to sudden shocks in their incomes, to a set of policies that support the poor to find an exit from poverty. More comprehensive approaches include transformative or promotional aspects aimed at helping the poor to enhance their income and capabilities and transforming enabling environments in regulatory and cultural dimensions (Lal et al. 2010). Whatever the approach, they all try to ensure a minimum level of consumption so that the poor are sufficiently nourished and have enough health care even when their income is compromised.

Social protection encompasses a wide variety of interventions. These include cash transfers such as conditional cash transfers (CCTs), non-contributory old age pensions, child-care pensions, social insurance or in-kind transfers such as school feeding programmes, nutritional supplements or subsidized foods. They can also include workfare programmes such as cash-for-work (common in post-crisis or post-disaster settings) and temporary public employment programmes. In more comprehensive systems, social protection can also include support for child and elder care and unemployment benefits (Table 6.3).

Table 6.3: Social Protection in the Developing World

Programme	Country	Type	Coverage	Impact
Progresas-Oportunidades	Mexico	Conditional cash transfer	25% of the population	Reduced poverty gap in rural areas by 19% and contributed 18% to the decline in Mexico's income inequality between 1996 and 2006. Educational attainment of beneficiaries: estimated increase 0.7–1.0% per year.
Bolsa Familia	Brazil	Conditional cash transfer	26% of the population	Reduced the poverty gap by 12% between 2001 and 2005 and contributed one third to the decline in income inequality over the last decade.

Source: European Communities, 2010



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Table 6.3: Social Protection in the Developing World

Programme	Country	Type	Coverage	Impact
Plan Jefes y Jefas	Argentina	Conditional cash transfer (public works)		Poverty among participants dropped from 80% to 72%; an extra 10% of participants would have fallen into extreme poverty in the absence of the programme.
Red de Protección Social	Nicaragua	Cash transfer	3% of the population	Contributed to an 18% decline in poverty gap among beneficiaries.
Old Age Pension	South Africa	Social Pension	80% of elderly	Combined direct effects of both programmes are to reduce poverty incidence by 6 percentage points, and a much larger effect on poverty depth.
Child Support Grant	South Africa	Social Grant	70% of children	
Productive Safety Net Programme	Ethiopia	In cash and in kind transfer	10% of the population	Modest but relevant average impacts, improving food security (by 11%), livestock holdings (by about 7%) and households' ability to cope with emergency. Larger effects on asset accumulation for those receiving substantial and complimentary support.
National Health Insurance Scheme	Ghana	Social insurance	67% of the population	Reduced out-of-pocket expenditures for health up to 50%.
Vision 2020 Umurenge Programme	Rwanda	Public works and cash transfers	About 36,000 households	Ongoing evaluations. The programme has contributed to the fall of the percentage of extreme poor among beneficiaries from 40.6% to 9%.

Source: European Communities, 2010

Although there is evidence of success of certain social protection interventions aimed at the poorest (such as CCTs or employment guarantee schemes), the sustainability of the results of these programmes will depend largely on how social protection strategies interact and intersect, *inter alia*, with labour market policies and the ability of the economy to absorb 'graduates' of social protection programmes into the labour market. Particular care must be taken to ensure that social protection interventions do not generate perverse incentives for the poor to avoid earning income or accumulating assets. Obviously, the ultimate success of these interventions in helping people get and stay out of poverty will also depend on the sustainability of financing and the priority given to this policy area in budgetary allocations (European Communities 2010).

Asset-Building and Protection

Asset-building and protection are important mechanisms for poor households to address vulnerability and generate and protect their incomes. The poor have limited access to formal insurance mechanisms to protect their income when faced with a shock. Thus, assets can help the poor to engage in productive activity, invest in human capital development and stabilize their income more sustainably.



Box 6.2: Assessing and Establishing a Social Protection Floor

Despite the benefits of a comprehensive and well-articulated system of social protection at the micro and macro levels, according to the latest estimates, up to 80 percent of the world's population is without any sort of social security protection. Since 2009, the UN system agreed on a set of initiatives in response to the global economic crisis. The Social Protection Floor Initiative (SPFI), led by ILO and WHO, is an integrated approach to social protection that minimally includes:

A basic set of essential social rights and transfers, in cash and in kind, to provide a minimum income and livelihood security for all and to facilitate effective demand for and access to essential goods and services.

The supply of an essential level of goods and social services such as health, water and sanitation, education, food, housing, life- and asset-saving information that is accessible for all (UN 2010).

In this way, the SPFI seeks to address the demand and supply sides of social protection. The specific characteristics of this social protection floor and the subsequent building blocks towards more comprehensive protection systems will depend on the specific context at the country level in terms of the initial levels of poverty and inequality, vulnerabilities, demographic trends and structure of the economy.

There is some evidence that establishing such a floor is an affordable enterprise for many countries. According to ILO calculations based on two regional studies in Africa and Asia, as little as 2 percent of the global Gross Domestic Product (GDP) would be enough to provide a social security floor to all of the world's poor and 6 percent would cover all individuals that currently have no access to social protection. Domestically, the initial annual cost of a basic social protection package could be between 3.7 percent and 10.6 percent of GDP.

Source: ILO, 2010, *Global Employment Trends*, ILO, Geneva.

Many social protection programmes can harm or foster asset-building even if they do not explicitly seek to do either. Therefore, it is important to consider how social protection and asset-building interact. For example, social protection programmes could conceivably dissuade programme beneficiaries from accumulating assets because beneficiaries might fear that, by having assets, they might no longer be eligible for the programme. There is some encouraging evidence, though, that some social protection interventions, such as CCTs, can encourage savings, as in the cases of Mexico and Paraguay (Zimmerman and Moury 2009), and they can open the door for the financial inclusion of the poor if transfers make use of the banking system or other models for setting up accounts for the beneficiaries. There is also evidence that the cash transfer given to CCT beneficiaries in Mexico has been used for productive investments. Beneficiaries use 88 cents of every peso they receive for household consumption and they invest the remaining 12 cents (Gertler et al. 2006). CCTs, or cash transfers in general, are meant to smooth consumption and, therefore, the transfer should ideally be spent to satisfy the basic needs of the household. Nonetheless, the potential to facilitate savings or other types of asset-building could be an interesting area to explore (de los Rios and Tivelli 2011).

Social protection can also play a critical role for the accumulation and use of assets. If poor households have predictable consumption-smoothening mechanisms, they do not have to resort to undesirable strategies to cope with shocks. For example, poor households, in an attempt to 'self-insure', could forgo more productive, but less liquid, investments in favour of more liquid assets that they can quickly sell if necessary. This generates a loss of efficiency and affects potential for future income (Dercon 2003).



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Box 6.3: Five Emerging Success Stories

Ghana's National Health Insurance Scheme is an intermediate form of health insurance involving social insurance financed by contributions from formal (and to a lesser extent informal) sector employees and by government coverage for those unable to contribute. The programme, now covering about 67 percent of the population, successfully includes informal workers by building on elements of community-based health insurance, thanks to the strong government commitment to guarantee health care for everyone.

Lesotho's Old Age Pension is a universal non-contributory scheme including all registered citizens over 70 not receiving any other form of pension benefit. The programme shows that, with strong political commitment, building a universal pension to reduce household vulnerability and enhance health and human capital might be feasible and affordable under certain preconditions, even in low-income countries.

Rwanda's Vision 2020 Umurenge Programme consists of three core initiatives to redirect social protection programmes to vulnerable populations: (1) public works; (2) the Ubudehe credit scheme; and (3) direct support

through an unconditional cash transfer. The programme underlines the importance of framing social protection as part of national development strategies and shows that decentralized administrative structures can improve targeting, avoid resource mismanagement, and increase local ownership and accountability.

Ethiopia's Productivity Safety Net Programme is a conditional transfer in cash and/or in kind based on public works. It also includes a small component of unconditional direct transfers to those unable to work. It is Africa's largest public works programme and one of the most effective social protection programmes in sub-Saharan Africa, reducing poverty and increasing food security in the short run while offering the potential for asset growth in the long run.

Kenya's Home Grown School Feeding programme is a conditional cash transfer to schools for local purchase of food, involving half a million children of primary school age. The programme shows that home-grown school feeding can spread the benefits of social protection to children while boosting local agricultural productivity.

Source: European Communities, 2010, *Social Protection for Inclusive Development: A New Perspective in EU Co-Operation With Africa*, The 2010 European Report on Development, Robert Schuman Centre for Advanced Studies, European University Institute, San Domenico di Fiesole.

Supporting Micro-finance Services

Beyond micro-credits for micro and small enterprises, other micro-finance services, particularly savings and micro-insurance (Zimmerman and Moury 2009), can promote the acquisition and protection of assets. Developed countries have long had financial instruments that promote savings among the poor, such as individual development accounts in the United States and Canada. These accounts are set up to receive deposits from the beneficiary that are then matched by public or private subsidies (OECD 2003). The uses of the funds of these accounts are normally restricted to investments in human capital, such as education, or the acquisition of assets such as land or housing. Recently in Mexico, the Oportunidades CCT programme included a similar approach for young people reaching the age at which they are no longer eligible for the educational benefits of the programme. Oportunidades established accounts for these young people and gave them financial help to pursue technical or higher education (Mexican Federal Government 2010).

Pro-poor Macro-economic Policies

A sound macro-economic framework is the basis for supporting growth and employment creation. Macro-economic policies can contribute to raising domestic productive activities and thus create new employment

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opportunities, but they also need to be sustained by structural and institutional changes in order to be effective. While many developing economies have achieved macro-economic stability in the recent past, major challenges in facilitating a more robust and pro-employment growth pattern remain.

In this context, coordinated macro-economic policies are key instruments for a structural anti-cyclical fiscal policy, since they can help smooth out economic fluctuations, raise investors' confidence, and contribute to growth and employment creation in periods of economic downturn. However, in many developing countries, monetary policies only include inflation targets. More attention should be given to growth and employment, without jeopardizing macro-economic stability.

Macro-economic Stability and Growth and Employment Creation

It has been noted that the key goals of any anti-poverty strategy should be the minimization of output volatility and the avoidance of sharp recession-induced rises in inequality. However, the typical focus of macro-economic policies remains stabilization, not economic growth. "At a time when the boundary between monetary and fiscal policy becomes fuzzy, when the control of asset prices becomes a major objective for macro-economic stability, we have to accept the sheer fact that monetary policy should also have several objectives and instruments and should strengthen its cooperation with fiscal policy" (Fitoussi and Saraceno 2010).

Careful Domestic and International Financial Liberalization and Regulation

In addition to spurring financial crises, the liberalization of domestic banking and international financial flows, including short-term flows, has also allowed income inequality to rise. Policies regarding domestic financial liberalization and capital account liberalization thus need to be reconsidered. "Capital controls can be, under certain conditions, an effective mechanism to insulate developing countries from the contagion effects of a financial crisis and can help reduce financial fragility" (Cozzi and Nissanke 2009). Further, institutional reforms, stronger regulation and an early warning system signalling financial distress can help mitigate the impact of such shocks.

Indeed, given the increased openness of most developing economies, exchange rate policy can also powerfully influence the competitiveness of the domestic economy, with all its consequences for employment.

Tax and Transfer Policies

By increasing tax revenues and progressive pro-poor expenditure, governments can directly and significantly affect income inequality. A progressive income tax system, in which tax rates increase as an individual's income increases, is a traditional way of redistributing income. Those with higher incomes pay taxes that are then used to finance government priorities, among which poverty reduction is often included. This is redistribution through the expenditure side of the public finance equation. However, on the revenue side, there are also ways to address inequalities. Specific policy options can include:

Prioritizing Poverty Reduction Expenditures

Given the overrepresentation of the poor in the informal labour market and their income levels, they often fall outside the tax net, so redistributing income through social expenditure often makes sense. Social expenditure can be directed at those in the formal and informal labour markets through, for example, spending on education, health, pensions, cash transfers and subsidies, for example.



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Extending tax exemptions and zero tax rates for basic products

Many developing countries are not able to effectively collect direct income taxes. They thus rely heavily on indirect taxation, which tends to be regressive, since it is not related to a person's income level. However, there are also ways of addressing inequality through indirect taxation, such as zero-rating or exempting basic products such as certain foods, edible oils, fuels for cooking and heating, and clothing that are often consumed by the poor. At this level, there are important opportunities for promoting gender equality, since women are not only overrepresented among the poor, but are also the ultimate consumers of these types of goods in their roles as caregivers (UNDP 2010).

Policies conducive to employment creation

Taxation systems are also relevant for the promotion of employment and income generation. Taxation should not be so onerous that it discourages investment and the creation and formalization of firms that can offer better quality employment. Likewise, at the household level, they should not discourage the entry and retention in the formal labour market. If taxation systems are such that the added income from a family member leads to a higher, unaffordable tax rate, that family member will often exit the formal labour market (Grown and Valodia 2010). In this sense, countries can analyse their tax codes and try to minimize the tax costs for poor households to engage in paid employment.

Include social expenditures in fiscal stimulus packages in times of crisis

During times of crisis, such as the recent global economic crisis, governments also rely on fiscal stimulus packages; this is a good opportunity to invest in often-needed social protection measures. As discussed above, social protection can have positive macro-economic effects, such as protecting domestic aggregate demand. During the recent crisis, at least 48 countries (developed and developing) announced fiscal stimulus packages (Zhang et al. 2010). However, the content of these stimulus packages is important in terms of their relevance for reducing poverty, vulnerability and inequality. An analysis of 48 countries by the Office of Development Studies at UNDP in 2010 (Zhang et al. 2010) revealed that at least 35 of those countries included some measures related to social protection (broadly understood). The percentage of the package devoted to social protection measures varied considerably, ranging from 1.5 percent in Turkey to 55.7 percent in South Africa. The social protection measures included spending in public housing construction and maintenance, as in China, Honduras, Malaysia and Viet Nam. There were also fee waivers for education and health services and a lowering of VAT for medications. Some also included some labour market measures such as investing in job-creating infrastructure projects, increasing vocational training options, or generating temporary employment. Aside from the macro-economic benefits, including such measures can help avoid the poor from bearing a disproportionate burden during economic downturns.



Notes

1. According to Cornia (2004), very low and very high levels of inequality can depress the rate of economic growth. The turning point seems to be at a Gini coefficient of 40. Beyond this point, growth seems to suffer.
2. High inequality is linked with conflict and political instability because it creates incentives for people to engage in activities outside the market (e.g., illegal drug trafficking, crime) that contribute to political and social instability. Such instability generates disruptions in the current economy and uncertainty about the future, thereby discouraging the accumulation of wealth, savings and investment (Alesina and Perotti 1996).
3. Chart 6.1 examines the difference between the growth of real income by quintile (or group of quintiles) and the growth in average income from the mid-1980s to the mid-2000s. Less-than-average growth of a given quintile (or group of quintiles) indicates a decrease in the share of that quintile in total income. And if a quintile's income is growing above average, then that quintile's share in total income must be growing.
4. As Rajan (2010) notes, "The political response to increasing inequality — whether carefully planned or the path of least resistance — was to expand lending to households, especially low-income households."
5. Procyclicality is accelerated in more unequal societies because, during economic booms, investors' net wealth increases. As net wealth rises, so does the borrowing capacity in the economy. "Greater availability of credit (perpetuated by policy makers and complex financial instruments) led to higher asset prices, which in turn served as collateral for more borrowing. Investors therefore accumulated debt during the boom, increasing demand for investible funds. As the interest rate rose (as it tends to during the boom), the credit-fuelled boom enabled the middle class to continue consuming, and temporarily offset potential tensions arising from increasing inequality. It collapsed, however, when ordinary borrowers started defaulting on their debts" (Vandemoortele 2009).
6. According to Minsky (1982), endogenous financial fragility is more likely to develop in a situation of rising inequality, where it becomes necessary for borrowers to increase indebtedness in order to face previously undertaken financial commitments (largely because expected income is insufficient to service the debt). In such a situation, borrowers and lenders are both speculating that it will be possible to finance the debt in the future. In the context of a growing economy, borrowers and lenders are rational in that their expectations are continually fulfilled. Thus, financial agents looking for larger profits will undertake riskier decisions as long as prosperity continues engendering endogenous financial instability in the market (See also Mendonca and Deos 2009).
7. "International financial deregulation in turn has caused growing instability as signalled by the rise in the frequency and severity of crises in recent years. In Latin America and Asia, for instance, financial crises raised inequality 73% and 62% of the time respectively" (Cornia and Court 2001).
8. Country level on Gini data is not available for every country in each year. To overcome this issue, we have selected countries that have Gini information for two years approximately a decade apart from the World Bank's World Development Indicators database (World Bank 2009a). Specifically, only countries that had Gini data for any year from 1991 to 1996 (the earliest year if there is more than one reported) and data for any year from 2002 to 2007 (the latest of years reported) were included in the sample. Also, countries with inequality data that covers less than a 10-year span were excluded. Moreover, the income definition used to compute the Gini coefficient can also vary by country. Most income distribution data in developing economies were calculated using household expenditure studies/surveys.
9. This impressive decline in income inequality recorded by countries in Africa is only exceeded by the group of five ECIS countries where inequality declined (Azerbaijan, Bulgaria, Estonia, Kyrgyzstan and the Russian Federation). These five countries managed to reduce income inequality by 25 percent on average during this period.
10. Land concentration: Land ownership inequality is widely considered to be the reason for high levels of income inequality in agriculture-dominated countries. However, even for countries that remain agriculture-dominated, there have been few major changes in the agrarian structure of developing countries that could directly explain the recent



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rises in income inequality. Evidence also shows that countries well endowed with mineral resources (oil, diamonds, etc.) tend to have a higher asset and income inequality than other types of economies. This is due to the capital-intensive nature of the production process and concentration of ownership in this sector. Yet, dominance of natural resources does not appear to explain the recent rise in inequality in resource-rich countries (Cornia 2004).

11. According to Cornia (1994), traditional causes of inequality (land concentration, urban bias, dominance of a highly concentrated mining sector, inequality of education) do explain most of the variation in cross-country inequality (i.e., these factors explain the level of inequality between regions), but, with the exception of inequality in education in Latin America, they do not explain the recent surges in inequality within countries.
12. This is why it is important to look for changes in government budgets—particularly taxes and transfers—in order to help drive the distribution of disposable income towards greater equality.
13. The rapid growth in the FIIRE sector (finance, insurance, internet and real estate)—in which financial rents and the wages for a few highly skilled workers absorb most of the value added—has been critical in many countries.
14. It has also been noted that procyclical policies and lax regulation of the financial sector are more likely to occur in more unequal societies. Typically politicians will seek to avoid implementing policies to address structural failures where they are controversial, and will support policies that both expand the purchasing power of the middle class and sustain growth, whether or not they are sustainable in the longer term (Vandemoortele 2009).
15. Alesina and Rodrik (1994) were the first to point out that initial inequality seemed to be empirically associated with lower growth rates. The literature has proposed several hypotheses to explain why progressive redistribution may be growth-enhancing: for instance, redistributing capital from capital-rich enterprises or individuals to capital-poor or credit-constrained people increases efficiency, investment and growth; too much inequality may lead to social tensions, which, in turn, adversely impact growth (Rodrik 1998).
16. It has been noted that these results depend very much on the sample and quality of data being used (Bourguignon 2004). Still, recent models focus on the likelihood that inequality exacerbates the effect of capital and other market failures on growth. “When credit-worthy borrowers cannot borrow because they lack collateral to comfort lenders, then their lack of income or wealth limits their ability to invest—in their own farms, small businesses, and in the health and education of their children” (Birdsall 2005).
17. However, some developing countries were able to reduce poverty considerably, despite rising inequality consequent to persistently high economic growth, which more than compensated for the rise in inequality in these countries (for instance, China and Ghana).
18. It is important to note that poverty traps do not explain why poor people remain poor in countries with sustained economic growth. That is a different kind of chronic poverty than that found in countries where poor people stay poor because of long-term growth failure. The former type of poverty is not irrelevant to LDCs, but it becomes important only once a process of economic growth is started and sustained (Gore 2002).
19. One mechanism through which this occurs is the negative feedback effects of generalized poverty on domestic resources available to finance investment and public goods, including governance.
20. Additional factors that contribute to a poverty trap include: limited access to credit and capital markets, extreme environmental degradation (which depletes an area’s agricultural production potential), corrupt governance, capital flight, poor education systems, disease ecology, lack of public health care, war or poor infrastructure.
21. The relationship between concepts of inclusive growth and pro-poor growth are explored in the note on Inclusive Growth, World Bank, 2009. “IG is in line with the absolute definition of pro-poor growth, not the relative one” (Ianchovichina et al. 2009).

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22. According to the Report of the Commission, “persistent, determined focus on inclusive long-term growth by governments is one of the ingredients of a successful growth strategy. Yet, there is limited analytical work integrating the literature on growth and productive employment” (Ianchovichina et al. 2009).
23. Since the problem in many LICs is not unemployment, but underemployment, inclusive growth requires not only employment growth, but also productivity growth. Further, it concerns not only wage employment, but also self-employment, so that returns to capital, labour, land and assets matter to the income potential of the focus group. Here, it should be noted that there is no preconception or bias in favour of labour-intensive industry policy. Indeed, the self-employed poor need improvements in productivity and leveling of the business environment in order to raise their incomes (see World Bank 2009b).
24. According to the ILO (2010), approximately 850 million workers might have been living in extreme poverty—i.e., below \$1.25 a day—in 2009.



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Annex 6.A: Change in Inequality

Country	Beginning Year	End Year	Years	Region	Development Status	Gini*100 (1991–1996)	Gini*100 (2002–2007)	Change in Gini (%)
Argentina	1992	2006	15	LAC	High-income DC	45.4	48.8	0.1
Azerbaijan	1995	2005	11	ECIS	Transition	35.0	16.8	-0.5
Bangladesh	1992	2005	14	A&P	Low-income DC	27.6	33.2	0.2
Belarus	1993	2005	13	ECIS	Transition	21.6	27.9	0.3
Bolivia	1991	2005	15	LAC	Middle-income DC	42.0	58.2	0.4
Brazil	1990	2007	18	LAC	Middle-income DC	60.6	55.0	-0.1
Bulgaria	1992	2003	12	ECIS	Transition	30.8	29.2	-0.1
Burkina Faso	1994	2003	10	Africa	Low-income DC	50.7	39.6	-0.2
Burundi	1992	2006	15	Africa	Low-income DC	33.3	33.3	0.0
Cambodia	1994	2004	11	A&P	Low-income DC	38.3	41.9	0.1
Central African Rep.	1993	2003	11	Africa	Low-income DC	61.3	43.6	-0.3
Chile	1990	2006	17	LAC	High-income DC	55.5	52.0	-0.1
China	1991	2002	12	A&P	Low-income DC	28.7	37.1	0.3
Colombia	1991	2006	16	LAC	Middle-income DC	51.3	58.5	0.1
Costa Rica	1990	2005	16	LAC	Middle-income DC	45.7	47.2	0.0
Côte d'Ivoire	1993	2002	10	Africa	Low-income DC	36.9	48.4	0.3
Dominican Republic	1992	2006	15	LAC	Middle-income DC	51.4	51.9	0.0
Ecuador	1994	2007	14	LAC	Middle-income DC	52.0	54.4	0.0
Egypt	1991	2005	15	Arab States	Middle-income DC	32.0	32.1	0.0
El Salvador	1995	2005	11	LAC	Middle-income DC	49.9	49.7	0.0
Estonia	1993	2004	12	ECIS	Transition	39.5	36.0	-0.1
Ethiopia	1995	2005	11	Africa	Low-income DC	40.0	29.8	-0.3
Georgia	1996	2005	10	ECIS	Transition	37.1	40.8	0.1
Ghana	1992	2006	15	Africa	Low-income DC	38.1	42.8	0.1
Guinea	1991	2003	13	Africa	Low-income DC	47.2	43.3	-0.1
Guinea-Bissau	1991	2002	12	Africa	Low-income DC	56.2	35.5	-0.4
Honduras	1990	2006	17	LAC	Middle-income DC	57.4	55.3	0.0
Hungary	1993	2004	12	ECIS	Transition	27.9	30.0	0.1
India	1994	2005	12	A&P	Low-income DC	30.3	32.6	0.1
Indonesia	1990	2005	16	A&P	Low-income DC	28.9	32.6	0.1
Iran	1990	2005	16	A&P	Middle-income DC	43.6	38.3	-0.1
Jamaica	1990	2004	15	LAC	Middle-income DC	42.2	45.5	0.1
Jordan	1992	2006	15	Arab States	Middle-income DC	43.4	37.7	-0.1
Kazakhstan	1993	2003	11	ECIS	Transition	32.7	33.9	0.0
Kenya	1992	2005	14	Africa	Low-income DC	57.5	47.7	-0.2

Source: Calculated using data from World Bank, World Development Indicators 2009

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Country	Beginning Year	End Year	Years	Region	Development Status	Gini*100 (1991–1996)	Gini*100 (2002–2007)	Change in Gini (%)
Kyrgyzstan	1993	2004	12	ECIS	Transition	53.7	32.9	-0.4
Lao PDR	1992	2002	11	A&P	Low-income DC	30.4	32.6	0.1
Latvia	1993	2004	12	ECIS	Transition	27.0	35.7	0.3
Lesotho	1993	2003	11	Africa	Low-income DC	57.9	52.5	-0.1
Lithuania	1993	2004	12	ECIS	Transition	33.6	35.8	0.1
Madagascar	1993	2005	13	Africa	Low-income DC	46.1	47.2	0.0
Malaysia	1992	2004	13	A&P	Middle-income DC	47.7	37.9	-0.2
Mali	1994	2006	13	Africa	Low-income DC	50.6	39.0	-0.2
Mexico	1992	2006	15	LAC	High-income DC	50.7	48.1	-0.1
Moldova	1992	2004	13	ECIS	Transition	34.3	35.6	0.0
Mongolia	1995	2005	11	A&P	Low-income DC	33.2	33.0	0.0
Morocco	1991	2007	17	Arab States	Middle-income DC	39.2	40.9	0.0
Nicaragua	1993	2005	13	LAC	Low-income DC	56.4	52.3	-0.1
Niger	1992	2005	14	Africa	Low-income DC	36.1	43.9	0.2
Nigeria	1993	2004	12	Africa	Low-income DC	45.0	42.9	0.0
Pakistan	1991	2005	15	A&P	Low-income DC	33.2	31.2	-0.1
Panama	1991	2006	16	LAC	Middle-income DC	56.8	54.9	0.0
Paraguay	1990	2007	18	LAC	Middle-income DC	39.7	53.2	0.3
Peru	1990	2006	17	LAC	Middle-income DC	43.9	49.6	0.1
Philippines	1991	2006	16	A&P	Low-income DC	43.8	44.0	0.0
Poland	1992	2005	14	ECIS	Transition	26.7	34.9	0.3
Romania	1992	2005	14	ECIS	Transition	25.5	31.5	0.2
Russian Federation	1993	2005	13	ECIS	Transition	48.3	37.5	-0.2
Senegal	1991	2005	15	Africa	Low-income DC	54.1	39.2	-0.3
Slovenia	1993	2004	12	ECIS	Transition	29.2	31.2	0.1
Sri Lanka	1991	2002	12	A&P	Low-income DC	32.5	41.1	0.3
Thailand	1992	2004	13	A&P	Middle-income DC	46.2	42.5	-0.1
Turkey	1994	2005	12	ECIS	Middle-income DC	41.5	43.2	0.0
Uganda	1992	2005	14	Africa	Low-income DC	42.6	42.6	0.0
Ukraine	1992	2005	14	ECIS	Transition	25.7	28.2	0.1
Uruguay	1992	2006	15	LAC	High-income DC	42.2	46.2	0.1
Venezuela	1993	2006	14	LAC	High-income DC	41.7	43.4	0.0
Viet Nam	1993	2006	14	A&P	Low-income DC	35.7	37.8	0.1
Yemen	1992	2005	14	Arab States	Low-income DC	39.5	37.7	0.0
Zambia	1991	2004	14	Africa	Low-income DC	60.5	50.7	-0.2

Source: Calculated using data from World Bank, World Development Indicators 2009



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Annex 6.B: Poverty Reduction, Growth and Inequality (mid-1990s to mid-2000s)

Country	Region	Development Status	Beginning Year	End Year	Poverty Rate (mid-1990s)	Poverty Reduction	Gini (mid-1990s)	Gini (mid-2000s)	Change in Gini (%)	Growth
Azerbaijan	ECIS	Transition	1996	2001	68.1	49.6	27%	35.22	36.50	4%
Bangladesh	A&P	Low-income DC	1996	2005	51.0	40.0	22%	33.46	33.22	-1%
Cambodia	A&P	Low-income DC	1994	2004	47.0	35.0	26%	38.28	41.85	9%
Cameroon	Africa	Low-income DC	1996	2001	53.3	40.2	25%	46.82	44.56	-5%
China *	A&P	Low-income DC	1996	2004	6.0	2.8	53%	32.34	37.05	15%
Costa Rica	LAC	Middle-income DC	1992	2004	22.0	23.9	-9%	46.95	48.50	3%
Egypt	Arab States	Middle-income DC	1996	2000	22.9	16.7	27%	30.13	32.76	9%
El Salvador	LAC	Middle-income DC	1995	2002	50.6	37.2	26%	49.86	52.32	5%
Ethiopia	Africa	Low-income DC	1996	2000	45.5	44.2	3%	37.97	30.00	-21%
Ghana	Africa	Low-income DC	1992	2006	50.0	28.5	43%	38.13	42.76	12%
India	A&P	Low-income DC	1994	2000	36.0	28.6	21%	30.32	31.56	4%
Indonesia	A&P	Low-income DC	1996	2004	17.5	16.7	5%	30.55	31.31	2%
Jamaica	LAC	Middle-income DC	1995	2000	27.5	18.7	32%	38.87	45.59	17%
Kazakhstan	ECIS	Transition	1996	2002	34.6	15.4	55%	35.32	34.95	-1%
Mauritania	Arab States	Low-income DC	1996	2000	50.0	46.3	7%	37.29	39.04	5%
Mongolia	A&P	Low-income DC	1995	2002	36.3	36.1	1%	33.20	32.84	-1%
Nepal	A&P	Low-income DC	1996	2004	41.8	30.9	26%	37.67	47.30	26%
Poland	ECIS	Transition	1993	2001	23.8	14.8	38%	32.39	32.84	1%
Russian Federation	ECIS	Transition	1994	2002	30.9	19.6	37%	47.61	35.70	-25%
Sri Lanka	A&P	Low-income DC	1991	2002	20.0	22.7	-14%	32.48	41.06	26%
Tanzania **	Africa	Low-income DC	1991	2001	38.6	35.7	8%	33.84	34.62	2%
Turkey	ECIS	Middle-income DC	1994	2002	28.3	27.0	5%	41.53	42.71	3%

Poverty rate measured as the poverty headcount ratio (using the national poverty line)

* China poverty data for 2002

** United Republic of Tanzania Gini data are for 1992 and 2000

Source: Calculated using data from World Bank, World Development Indicators 2009



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