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Income Inequality

Disparities have recently started to decline between countries as the global financial crisis has led to stagnant real incomes in advanced economies, while most developing countries and emerging markets continued to experience relatively strong growth. In contrast, inequality is growing within countries. What accounts for the latter increase and how to stem the rising tide of inequality? The articles by Mr. Milanovic and others in the recent issue of the IMF's Finance and Development issue looks at this in detail (available at: http://www.imf.org/external/pubs/ft/fandd/2011/09/index.htm). How to build more inclusive growth was also an important theme in the IMF's Regional Economic Outlook (REO) for Asia and the Pacific, which was launched in Manila on October 17 (available at http://www.imf.org/external/pubs/ft/reo/2011/apd/eng/areo1011.htm).

Income inequality, as measured from household surveys or by using fiscal data on reported pre-tax income, has been on the rise, or stagnant at best, in most countries since the early 1980s. Inequality has also increased in the Philippines, in line with other emerging markets. Disparities have also risen in China since 1980, which is surprising as economic theory would have predicted that as poor countries engage more in global trade, they tend to specialize in the production of lower skilled goods where they hold a comparative advantage. This would raise the wage of low skilled workers relative to skilled workers, reducing inequality.

The view that income inequality harms growth has become more widely held in recent years. Historically, the reverse position—that inequality is good for growth—held sway among economists. The main reason for this shift is the increasing importance of human capital in development. When physical capital mattered most, savings and investments were key. Then it was important to have a large contingent of rich people who could save a greater proportion of their income than the poor and invest it in physical capital. But now that human capital is scarcer than machines, widespread education has become the secret to growth. And broadly accessible education is difficult to achieve unless a society has a relatively even income distribution.

What causes inequality? In rich countries, some economists argue, technological change, resulting in increasing demand for highly educated workers, is the reason that inequality is again on the rise. But it is possible that an entirely unrelated force—for example, the reduced power of trade unions—is in fact responsible for the rising skilled-unskilled wage gap. A country's institutional framework also plays a role in determining the level of inequality. Governments can use higher taxes and social transfers to redistribute some of the higher incomes earned by skilled workers. A government's reluctance to take steps to minimize inequality may reflect its view that redistribution is wasteful and hurts market incentives (endorsing the argument that there is a strong trade-off between equality and growth, which

may not be the case in the longer term as greater equality appears to sustain growth by reducing the risk of financial crisis, domestic and foreign indebtedness, and political instability). But failure to redistribute income may also reflect a political reality—that the rich wield a disproportionate influence over policy because they are more politically active and contribute more to politicians than their less affluent counterparts. In other words, political systems have moved closer to "one dollar, one vote," from the more traditional "one person, one vote" model.

Globalization has also been blamed for the rising inequality in the rich world. Specialization in high-skilled exports leads to a rising gap between the skilled and unskilled wages. Moreover, cheap low-skill imports and outsourcing also reduce wages or increase unemployment among the lower skilled workers—further exacerbating inequality. Another explanation for increased inequality is changing social norms, although it is hard to pinpoint exactly which social norms have changed and why. It is likely that all four explanations—technological progress, institutional change, changing social norms, and globalization—have had something to do with rising inequality in advanced economies.

In major Latin American countries, by contrast, there has been a sustained decrease in inequality over the past decade. Brazil's decline is particularly striking given how much and how quickly relative incomes changed and how unique it was compared with the rest of the world. Inequality also declined in Mexico and Argentina. The improvements are often ascribed to social support programs, but were also the result of broader access to education, which increased the supply of skilled workers. But even with these improvements, Latin American countries still exhibit some of the highest levels of inequality in the world.

How to stem inequality? From the above, institutional reforms and investing in education and health care are obviously key as are targeted social support programs. Improving connectivity between rural and urban areas is also important. Land reform has also been associated with improved human development indicators. In addition and to the surprise of some, there is also mounting evidence that financial development does not merely enlarge the pie, but also divides it more evenly by offering better and cheaper services for saving money and making payments. Insurance services help firms and households cope with shocks and reduce their vulnerability to fall into poverty. Financial market development may particularly help poor and micro entrepreneurs by overcoming lack of collateral and weak credit histories and connections. Financial development can reduce poverty and income inequality directly, by disproportionately relaxing credit constraints on the poor, and indirectly, by improving the allocation of capital and accelerating growth.

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