First draft, comments welcome

Policy reform and income distribution[1]

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1. BROAD TRENDS IN INCOME INEQUALITY.

Domestic income inequality declined steadily between the early 19th century and the mid 1970s (Bourguignon and Morisson 2002). Until the 1950s such decline was mainly evident in today's advanced nations and in the socialist countries of Europe, but between the 1950s and early 1970s it spread to several developing countries – such as the Asian Tigers, China and India - which, after achieving independence, introduced a few programs of land reform, educational enlargement, public health and income redistribution.

Despite such decline, in most developing countries, in the 1970s income inequality was still very high, mainly because of the interplay of a few recurrent factors – that we shall label 'the traditional causes of inequality' – including high land concentration, unequal access to education and other public services, selective acces to credit, the dominance of the mining and plantation sectors (in which rents absorb a large part of output), and the urban bias of public policy which alloweed city-based elites to capture a disproportionate share of public expenditure and productive opportunities. Racial and gender discrimination were also important contributors to inequality, and all this was rooted in social systems in which the poor and the lower-middle class had a limited ability to self organize, influence policy and fight for their interests.

Since the mid 1970s, income inequality started turning upwards in the OECD countries (Smeeding 2002) and Latin America (Szekely 2003). In turn, the 1990s witnessed a sharp income polarization in the economies in transition (Milanovic 1998). Meanwhile, in China inequality rose slowly over 1978-1985 and much faster since then (Riskin 2003). A trend reversal took place also – if later on, less markedly and from lower initial inequality levels - in the Asian Tigers that had achieved in the past 'growth with equity' (Jomo 2004), India (Deaton and Drèze 2002) and the remaining South Asian nations (Pal et al 2004). The limited data available for Sub-Saharan Africa suggest that following structural adjustment the urban-rural income gap was reduced by a process of "equalising downward" (as in Cote d'Ivoire), and that intra-urban inequality rose, intra-rural inequality rose in countries – such as Kenya - characterised by a high land concentration or where the recovery was peasant-based but failed to reach the remote areas due to inadequate infrastructure or the collapse of marketing arrangements - as in Zambia - while it improved in countries such as Mozambique and Uganda characterized by a peasant agriculture rebounding from years of civil strife (Mc Culloch et al 2000, Bigsten 2000). Data limitations do not allow to reach any conlcusions for the MENA region, though the fragmentary evidence available points to a substantial stability of Gini coefficients at around 37-40. As a result of all these trends, over the last 25 years, income inequality appears to have risen – if from different levels, by different extents and with

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different effects - in 70 percent of the countries with available data representing 80 percent of the world population and GDP (Cornia with Kiiski 2001, Cornia 2004)[2]. There were notable exceptions to this rule - such as France, Germany, Malaysia and Jamaica – but these did not affect the general trend[3].

The observed upsurge in the Gini coefficients in the 53 (out of 73) nations exhibiting growing inequality was moderate (i.e. of less than 5 points) or high (5-10 points) in about 35 countries though in 9 of them (mostly located in Latin America) the rise occurred from high initial levels. Rises of 10-20 points were recorded in 14 countries and of more than 20 points in three states of the former Soviet Union. While inequality upsurges of 3-5 points from low initial levels may spur economic growth, large increases (as in the former USSR) or moderate increases from already high levels (as in Latin America) possibly affected negatively poverty alleviation and economic growth.

The recent trend towards rising inequality could be attributed to a worsening of the traditional causes of inequality mentioned above. Yet, while high land concentration remains a major cause of rural and overall inequality, changes in this area cannot explain as a rule the trend in income inequality recorded during the last two decades. Indeed, the weight of agriculture in total output and employment fell everywhere, and highly disequalizing land rents declined both as a share of GDP and agricultural output. Likewise, while countries well endowed with mineral resources are known to exhibit a considerable income and asset inequality, such "curse of natural resources" hardly explains the upsurge in inequality of the last two decades, as the "rent/GDP ratio" has systematically declined since the late 1970s in most mining or plantation economies. Third, the same conclusion applies – with some qualification – to an hypothetical aggravation of the "urban bias". Indeed, a recent review of the extent of such bias in the globalised world (Eastwood and Lipton 2000) finds no evidence of its systematic aggravation: while it increased in post-1984 China, Thailand and Indonesia it declined in Latin America and parts of Africa. Finally, a worsening of inequality in education is also unlikely to offer a sufficiently general explanation of the recent widespread deterioration in the distribution of income. In fact, while an increasingly more unequal access to education contributed to the surge of income inequality during the last twenty years in Latin America, this does not seem to have been the case in the other regions (Checchi 2004). In Africa and, to a lesser extent, the former Soviet Union the difficulties experienced in sustaining primary and/or secondary education and the surge in private higher education will likely have a disequalizing impact on the future distribution of human capital, but did not affect the distribution of human capital in the 1980s and 1990s. In contrast, the East and Southeast Asian and Middle Eastern educational policy, focused on an expansion of universal secondary education and so helped – *ceteris paribus* - reducing educational inequality and wage concentration.

[2] Cornia and Kiiski (2001) carried out an empirical test of changes in trends in income inequality based on the November 1998 version of WIDER's World Income Inequality Database using 770 reliable Gini coefficients for the years spanning the mid 1950s to the mid 1990s for 73 countries (34 developing, 23 transitional and 16 OECD) accounting for 80 and 91 percent of the world population and GDP-PPP. Inequality was found to have risen in 48 countries, remained constant in 16 and declined in nine. Except for Africa and MENA, these countries account for 84 to 98 percent of the population and 82 to 98 percent of the GDP-PPP of their respective regions.

[3] Until 7-8 years ago, many analyses (Deininger and Squire 1996, Li et al. 1998) suggested that inequality indexes had remained relatively stable over time. As noted, this is no longer, the prevailing view in the literature, as new data and analyses point to a fairly general increase in domestic income inequality.

The recent inequality rise could also be due to ‘new non-policy causes of inequality’ including skill biased technical change, shifts in labour market participation, demographic effects and rising migrant remittances. Space limitations do not allow to review here the strengths and weaknesses of these hypotheses. Suffices it to mention that, while these factors do indeed affect the distribution of income in specific situations, none of them seems sufficiently general to explain the deterioration in income inequality observed over the last twenty years in very different types of countries.

While the explanations briefly mentioned above are either incomplete or misplaced, there is mounting evidence that the recent upsurge in inequality was associated to a rise in the “capital share”, and a fall in the “labour share” and “transfer share” caused by the unexpected effects of policies of liberalization and globalization that weakened labor institutions; rising interest rates and interest spreads; insider privatization; rising rents and asset concentration in the financial and real estate sector; lower redistribution via the budget; and distorted regional policies. In a number of cases the rise in the capital share was very pronounced. In the UK, for instance, the income share of the top 1% of the population (60 percent of whose earnings is constituted by capital incomes) rose over 1979-2001 from 21 to 34 %, suggesting in this way that the capital share rose by at least 8 percentage points (Atkinson 2003). Likewise, in South Africa the share of property incomes (profits, rents and other property incomes) rose from 18 to 30 percent over 1981-2000. And for India, Banerjee and Piketty (2001) show on tax returns data that in the 1990s the share of total income of the top one percent of income earners increased from just over 4 percent to almost 11 percent becasuse of the rise in capital incomes driven by the rapid growth of the urban-based service sector, and particularly of its FIRE component. Thus, though data about changes in these areas are still limited and fragmentary, the overall evidence suggests the distributive changes of the last two decades are associated to a shift in factor shares, rising spatial inequality and changes in the wage differentials unexplained by the human capital theory. Scattered but growing evidence in this regard is available in the literature for countries as different as Argentina, Canada, Chile, Japan, Mexico, Russia, Thailand, Turkey, the USA, Uzbekistan and Venezuela.

Thus, while the traditional causes of inequality still represent the main source of social polarisation, there is mounting evidence that – against the predictions of most received theory - the recent policy changes in the field of domestic liberalisation and external globalisation have often been associated with a rise in income inequality, an issue that is explored in greater detail in the next section. Thus, an understanding of the relation between ‘policy reform’ and ‘income inequality is crucial in any effort at reducing poverty over the long and medium term as in the case of the MDGs. This is all the more true in view of the possible pernicious interaction between the old causes of inequality and the new policy-related causes of inequality. For instance, devaluation or the liberalisation of the prices of agricultural exports in a country with high land concentration will raise inequality. The opposite is also true, as a wrong approach to liberalisation may exacerbate traditional inequality. For instance, botched financial liberalisation or the premature opening of the capital account can lead to crises that worsen the distribution of credit and income.

This paper reviews the changes in within-country income inequality that have accompanied the recent liberalisation of the domestic economy and of the external transactions. It argues that the conclusions of the standard theory about the ex-ante distributive impact of policy reform often collide with a substantial body of evidence indicating that inequality rose in several instances on occasion of the introduction of policies of liberalisation and globalisation. Finally, the paper explores the discrepancy between theoretical predictions and observed inequality trends, by emphasising in particular the distributive impact of liberalisation and globalisation under conditions of poorly sequenced macro policies, incomplete markets, weak institutions, asymmetric information, widespread protectionism and structural rigidities. Conscious of all this, the equity impact of each of the policy instruments and of the overall liberalisation-globalisation package are reviewed hereafter. For each instrument, the predictions of the received theory are first discussed. These are then compared with the observed inequality trends in different types of countries, while possible explanations of the discrepancy between theory and outcomes are discussed at the end of each section.

2. ESTERNAL LIBERALISATION AND INEQUALITY

2.1 Trade liberalisation. Trade theory based on the Hercksher-Ohlin (HO) theorem predicts that trade liberalisation leads to greater specialisation and a rise in national income in participating countries, following a more rational global allocation of production inspired by the principle of comparative advantage. In labour-abundant countries, trade liberalisation is expected to switch production from capital-intensive and inefficient import-substitutes towards efficient labour-intensive exportables. In turn, the Stolper-Samuelson theorem posits that such shift leads to the convergence in the prices of goods and factor remunerations. Because of this, domestic inequality is expected to decline in countries endowed with an abundant labour supply and to rise in those with an abundant endowment of capital, as the demand for and remuneration of the latter (that exhibits an unequal income distribution) will increase, while the demand and remuneration of labour (that is distributed more equitably) will fall.

The evidence on the impact of trade liberalisation on inequality is, however, mixed. On the one side, several studies point to a favourable effect. In the 19th century, trade liberalisation raised domestic inequality in the rich New World countries but reduced it in the poor Old World ones. Likewise, in an analysis of the determinants of inequality in 35 small developing countries Bourguignon and Morisson (1989) conclude that the removal of trade protection in manufacturing reduced the income of the richest 20 percent of the population and raised that of the bottom 60 percent. Similar conclusions are arrived at by Wood (1994) in the case of the East Asian exporters of labour-intensive manufactured goods. On the other side, an equally important literature points to opposite conclusions for a broad range of countries. For instance, wage inequality was found to have increased in six of seven Latin American countries that liberalized trade, as well as in the Philippines and Eastern Europe (Lindert and Williamson 2001). In turn, an analysis on 38 developing countries for the years 1965-1992 found that trade liberalisation benefited the top 40 percent of the population while affecting negatively the bottom 40 percent who were hit by the greater terms of trade fluctuations typical of an open economy (Lundberg and Squire, 1999). Another study (Savvides 1999) shows that the most open developing countries experienced a rise in inequality between the 1980s and the early 1990s and that there is a positive correlation between the income share of the poorest quintile and trade protection.

How can one explain these conflicting findings and the frequent discrepancy between empirical results and theoretical predictions? To start with, it must be underscored that the HO theorem holds under very restrictive assumptions that concern trade between two countries producing two goods with two factors (capital and labour) and using the same technology that remains constant over time. The model also assumes no economies of scale, efficient factors markets (characterized by no restrictions to factors mobility and full employment of all factors), balanced trade and symmetric trade liberalisation by all trading partners. Yet, in the real world, trade takes place in a multi-country, multi-factors and multi-goods context in which several or even most of the of the above assumptions do not hold. Indeed, a formal extension of the theoretical model shows that the predicted outcomes of efficiency and equity may not obtain if some of the basic assumptions are relaxed (Ethier 1984). Hereafter alternative explanations of why inequality may rise on occasion of trade liberalisation are tentatively provided:

(i) Changing relative endowments of countries participating in multi-country, multi-factor and multi-goods trade. The limitations of the 2x2x2 HO model are most obvious when considering the case of trade among countries whose relative comparative advantage evolve over time because of the decision of some of them to change their trade policy. Country A, for instance, may have a comparative advantage in terms of unskilled labour in relation to country B but not of C which has – however – not yet liberalized its trade regime. Thus, a decision to liberalize exports by the latter may generate distributional consequences for A. In particular, the prediction that A will experience a reduction in inequality due to greater trade with B is unlikely to be verified as her labour intensive exports will be displaced by those of C. It may even happen that – because of C's decision to liberalize trade - A will specialize instead in the production of goods with a medium-high skill and capital content with the effect of worsening her wage distribution. This is what happened in the 1990s on occasion of the entry into the world market for labour-intensive manufactures by China and other low-wage economies that affected the exports and comparative advantage of middle-income countries from Latin America, Eastern Europe and South East Asia in these sectors.

That of Mexico over 1985-90 is a well documented case of how trade liberalisation was accompanied by a widening in wage differential due to the intense competition caused by the entry into the world market for low skill manufactured exports by China and other exporters with substantially lower wages than Mexico (Alarcon and McKinley 1996). Also in countries such as Chile and later Costarica and Colombia (Wood, 1995) increasing openness implied rising inequality due to the contraction of the formerly import-substituting, high-skill intensive sectors (that were replaced by imports from developed economies), an expansion of the semi-skilled sector (including in agriculture), and a contraction of low-skill intensive sectors (replaced by imports from low-income countries).

(ii) Liberalisation in countries specialising in the export of primary commodities. This sector is subject to considerable price shocks – both because of sudden variations in global demand as well as because of the "fallacy of composition" problem caused by the growing number of suppliers entering saturated markets. Over the past two decades, these price shocks reduced the trade/GDP ratio in most commodity-producing countries despite the liberalisation of their trade regime (Birdsall and Hamoudi 2002). These price collapses reduced not only their export receipts but also their import capacity, inducing in this way a decline in employment and earnings in the import substituting sector without a corresponding rise in the export sector, with negative effects on the distribution of income.

(iii) Trade liberalisation in countries with an unequal distribution of the abundant factor. The standard model fails also in the case of countries exporting primary commodities

produced by means of an abundant factor that is unequally distributed. While an increase in land–intensive agricultural exports may reduce inequality in countries with egalitarian agrarian structures, it would raise it in countries dominated by *latifundia*. Indeed – due to the labour surplus prevalent in the rural labour market – it is unlikely that an increase in the demand for agricultural workers will raise the subsistence salary in line with or faster than the increase in export receipts.

(iv) Trade liberalisation and the import of skill-enhancing investment goods. One of the key assumption of the HO theorem is that the production technologies utilized by the trading countries are not affected by trade itself. Yet, trade liberalisation can enlarge the access to previously restricted technologies or, by relaxing foreign exchange rationing, raise the imports of capital intensive investment goods. Because of capital-skill complementarities, this "skill-enhancing trade" causes an increase in the demand for and wages of skilled workers and a fall in the demand for and wage of the unskilled ones.

(v) Asymmetric trade liberalisation and protectionism among the trading partners. Another assumption of the basic trade model is that trade liberalisation concerns all trading partners. However, in the case of low-tech African and Asian exporters, trade liberalisation has led to unsatisfactory export growth not only because of weak domestic conditions but also because of persistent protectionism in OECD countries. Furthermore, the latter countries have not abandoned the policy – forbidden under WTO rules – of subsidizing entire sectors of agriculture and of exporting its products at prices much lower than their cost of production. Thus, in most cases, unilateral liberalisation combined with restrictive trade practices in the trading partners can raise inequality and poverty in low tech exporters from developing countries (as employment and incomes in the formerly protecred sector decline while jobs and wages in the export sector stagnate)

(vi) Factors immobility. In a liberalized trade regime, it is essential that workers posses the ability to shift from the declining import substituting sector to the expanding export sector. Yet, developing and transitional countries are often characterized by structural rigidities and governance problems that hamper the relocation of resources towards the export sector. Such rigidities can be very different but most often include restrictions on internal migration (as in China and Uzbekistan), lack of infrastructure and/or housing in the areas where the traded sector is located (as insome Sub-Saharan countries), labour laws limiting the transfer of workers across industries (as in India), shortage of retraining programs to re-skill the workers made redundant in the formerly protected sector (as in some economies in transition), lack of social safety nets to assist the redundant workers til they find new employment, narrow credit markets and lack of new investments to absorb the labour mouving to the traded sector, and poor governance. For all these reason, trade liberalization can lead to a fall in employment and earnings in the import-substituting sector (most often traditional manufacturing and parts of the agricultural sectors) without generating a corresponding rise in jobs in the export-oriented sector. The impact on inequality is undetermined but that on poverty is clearly unfavourable.

In a detailed study of the impact of trade liberalisation in India, Topalova (2004) for instance found that the rural districts where the industries more exposed to liberalisation were concentrated experienced the sharpest increase in the incidence of poverty due to limited mobility of the factors of production across regions and industries. Poverty increased also in urban districts but less markedly so. The author suggests that the impact of trade liberalisation was particularly pronounced in the Indian states where rigid labour laws hampered the reallocation of labour across industries. However, the limited spatial mobility of the rural labourers who were most affected by liberalisation would suggest that other factors stand in the way of an enhanced factors mobility.

(vii) Trade reorientation following capital account liberalisation. Another explanation that has received so far little attention concerns the interaction between trade and capital account liberalisation. Sudden inflows of foreign capital can entail the appreciation and increasing instability of the exchange rate, shifting in this way the composition of domestic demand towards cheap imports and away from domestic products while rendering exports less competitive (Taylor 2000). All this has the effect of cancelling out the supposed positive effects of trade liberalisation, as it encourages the restructuring of production via a reduction in formal employment and wages and greater reliance on outsourcing, i.e. measures that reduce the absorption of unskilled labour and increase wage inequality.

2.2. The liberalisation of Foreign Direct Investments (FDI).

The predictions of economic theory about the distributive impact of FDI are similar to those of international trade. In low-wage, labour-abundant countries, 'greenfield FDI' accelerate capital accumulation and in this way raise the demand for and (under certain conditions) the wage rate of unskilled workers. FDI may also offer better employment conditions and higher wages to all workers – regardless of their skill level – than in the informal or domestic formal sector. The distributive impact of 'brownfield FDI' is less straightforward, as the possible long term gains in efficiency have to be weighted by short term retrenchments in employment that may cause adverse distributive impact.

Evaluations of changes in wages and employment conditions in TNCs-controlled firms and export processing zones provide however mixed results about the impact of FDI. Te Velde and Morrissey (2002) found that FDI raised wages of different skill levels in four of the five East Asian countries analysed. In Mexico, in contrast, the increase in wages due to FDI was significantly lower for the unskilled than for the skilled workers (Alarcon and McKinley 1996). And a study of the distributive impact of FDI in developing countries (Milanovic 2002) found no significant relation between the FDI/GDP ratio of the recipient countries and the income shares of various deciles.

Also in this case, one is thus faced with the problem of reconciling the conclusions of the theory with those of an inconclusive evidence. Hereafter are provided some tentative explanations of the FDI-inequality relation that may understand these inconsistencies:

(i) Sectoral composition of FDI: The theoretical advantages mentioned above are most often observed in labour-intensive manufacturing branches such as textile, apparel, food processing, furniture, toys, beverages, assembly operations and so on but are less evident in capital-intensive manufacturing and in the utility and mining sectors. In these sectors, production requires a lot of capital, some unskilled labour and few skilled workers. This reduces the demand for and wages of unskilled labour. Second, the high volatility of commodity prices and employment conditions in the resource sector reduces the incentives to invest in education, thus affecting negatively the long term distribution of income. Third, income inequality in the mining sector is usually very high as the ownership of mines is usually highly concentrated and as the mining rent can be captured by the élites with considerable ease. Therefore, FDI in these sectors are likely to raise inequality both through labour market and political economy mechanisms. In addition,

when FDIs take the form of mergers-and-acquisitions (M&A), the immediate short term of FDI takes the form of labour shedding following firm restructuring and consolidations among firms with likely net job losses (Baldwin, 1995). While this might improve micro-economic efficiency of the firms concerned over the medium term, the immediate effect is likely to be disequalizing.

The overall distributive effect of FDIs obviosuly depends on their composition. In this regard, the evidence shows that while the ratio of the combined stock of inward and outward FDI rose from 19.2 per cent of world GDP in 1990 to 34.0 percent in 2000, the sectoral composition of FDI has shifted towards utilities, finance and trade-related services and away from mining and manufacturing. Third, a big share of FDI takes the shape of cross-border mergers and acquisitions (M&A) rather than greenfield projects, a trend that merely entailed the transfer of existing jobs from domestic to foreign owners.

(ii) Substitution effect and "business stealing". Even when greenfield FDIs go to the labour-intensive sector, their net effect on employment and income distribution has to take into account their impact on the local economy. This is especially important when the output of the FDI is sold on local markets that used to be supplied by domestic firms that risk in this way of being displaced by FDIs that would so cause losses of jobs in the labour-intensive informal sector. Because the latter is likely to have a lower labour productivity and higher employment coefficients per unit of output than the foreign firms, a full displacement of their output tends to worsen the distribution of income.

(iii) North-South plant relocation and skill-biased technical change. A further refinement of the basic model concerns the technology that a multinational seeking lower wages is likely to transfer to a developing country. While such technology may be considered of low-skills intensity for an advanced nations, it might be relatively skill-intensive in the developing country hosting the new FDI. For instance, the outsourcing of production through the FDI from the US to the *maquiladora* sector in Mexico generated a drop in the demand for unskilled labour in the US (and so contributed to the rise in the skilled/unskilled wage gap) and a simultaneous increase in the demand of what is considered skilled labour in Mexico, thus raising wage and overall income inequality in both countries (Feenstra and Hanson 1997). New evidence from China and India suggests that also in these countries well endowed with cheap, literate and well trained labour, FDI are becoming increasingly skill-biased.

(iv) regional distribution of FDI and spatial inequality. One of the possible adverse effects of FDI is to increase spatial inequality. This often depends on the industrial policy of the receiving country that tries to drive the FDIs towards the more developed and accessible areas. In China, for instance, the FDI policy pursued by the Chinese authorities between 1978 and the mid 1980s deliberately favored the Southern coastal provinces through the granting of special tax and duty exemptions, as well as freedom regarding labour laws which facilitated the development of export industries and the inflow of foreign direct investments. Only after 1992, the FDI preferential policy was extended to the whole of China. However, even now foreign investors continued to enjoy greater incentives in the coastal area. For instance, the average 'preferential policy index' computed by Demurger et al (2002) over 1996-99 was 3.0 for the three main metropolis, 2.4 for the typical coastal areas and only 1.3 central and nothwestern provinces. Also in India, the interstate distribution of FDI has been extremly skewed, with the top ten states (mostly from the Southern and Western regions) receiving 63 percent of total direct investments, while the bottom ten states received only 1 percent (Pal et al 2004). In many

cases, however, the spatial disequalizing effects of FDI may largely be endogenous, as foreign investments are attracted by the economies of scope and agglomeration and the externalities available in the already comparatively advanced areas of developing countries. Indeed, there is quite a bit of evidence that FDI naturally flow not so much to low-wage areas but to high wage areas well endowed with public infrastructure, transport facilities and industrial services.

(v) Systemic effects in a world of mobile capital and immobile labour. The mobility of capital and immobility of labour may generate strong competition among developing countries simultaneously attempting to attract a fixed amount of FDI. All these countries may thus engage in a "race to the bottom" by which all of them make concessions to the multinational companies in the field of taxation, subsidies, labour and social security legislation, minimum wages and so on that – in the end – may affect either the distribution of private or public consumption or the welfare of workers. While wages in the multinational sector tend to be higher than in local firms, these wage and employment benefits will be felt only in the countries where FDI have finally taken place. In the countries bypassed by FDI, the ex-ante concessions made to attract them may have generated costs unmatched by benefits.

2.3. Capital account liberalisation.

Mainstream theory maintains that capital account liberalisation raises investments, employment, labour productivity and growth in countries with low capital accumulation but high rates of return on investments and an abundant supply of cheap labour. All this raises employment and - possibly - wages in the developing countries receiving these funds, with favourable effects on equity. In addition, the liberalisation of portfolio flows would permit the diversification of the financial assets of domestic investors leading to a balancing of the risk profile of their portfolios and thus affecting favourably the national saving rate. Finally, the opening of the capital account is supposed to exert a 'disciplining effect' on domestic policies in the fiscal and monetary area, thus contributing to macro stability and credibility.

Yet, contary to these predictions, the empirical evidence points to a widespread deterioration of income inequality on occasion of both inflows and outflows of these funds, as vividly documented by a growing number of examples in the 1990s. With rare exceptions, the liberalisation of portfolio flows generated a sharp social impact. How to account for this discrepancy ? Possible explanations include:

(i) Appreciation of the real exchange rate on occasion of large inflows. Large inflows of funds relative to domestic assets generally cause an appreciation of the real exchange rate that reduces employment in the tradeable sector, shifts resources from the tradeable to the non-tradeable sector and encourage subcontracting and wage cuts in the tradeable sector to preserve profit margins (Taylor 2000). Countries can attempt to control the appreciation of the exchange rate via a costly sterilisation of the inflows or through regulation, but both measures work up to a point.

(ii) *Intersectoral allocation of portfolio flows*. Portfolio flows do not directly benefit the poor, as they tend to be invested not so much in agriculture or labour intensive manufacturing but rather in those FIRE activities that have high short-term rates of return and a perceived low risk profile, while employing medium-to-highly skilled workers whose wages tend therefore to rise together with the skilled/unskilled wage differential. In addition, the credit boom associated with the inflow hardly reduces the segmentation of the credit market between those who can collaterilize their loans and those who cannot for lack of guarantees. In turn, during financial crises credit allocation becomes particulalrly skewed as decapitalized banks may reduce their lending and restrict its allocation to all but preferential borrowers (e.g. large firms in both the traded and non-traded sector). Given, the dominance and greater labour-intensity of small and medium enterprises in developing economies, this 'credit starvation' can have serious poverty and inequality consequences.

(iii) Sudden capital outflows and financial instability. The impact on inequality is also mediated by the tendency of capital account liberalisation to augment the frequency of destabilising financial crises with real effects (Caprio and Klingebiel 1997). Left to themselves, deregulated financial systems do not perform well owing to problems of incomplete information, markets and contracts, herd behaviour, panics, weak supervsion and speculation on asset prices. Indeed, as noted by a recent IMF paper (Prasad et al 2003) there is no evidence that international capital flows accelerate the rate of growth in recipient countries, while there is clear evidence that they raise the instability of private consumption, with clear effect short term and long term effcts on poverty as people in developing countries have no access to financial market and cannot smooth their stream of consumption over time.

The empirical evidence about the distributional impact of financial crises points to a negative impact, particularly in countries with weak labour institutions and social safety nets, as underscored by Galbraith and Lu (1999) who found that in Latin America and Asia financial crises raised inequality in 73 and 62 percent of the time while no impact was evident in Finland, Norway and Spain. Diwan (1999) arrives at similar conclusions on the basis of panel data showing that the labour share contracts markedly and permanently in the wake of financial crises. In an study on Latin America, Behrman et. al. (2000) find that the strongest wage disequalizing component of the overall reform package was the liberalisation of the capital account. Some analyses have argued that during the first phases of such crises, income inequality may fall as the first people to be affected are the comparatively better paid workers of the FIRE sector. Yet, analyses based on micro data show that the medium term impact on inequality - transmitted via differential employment, wages and price effects - affect the lower deciles especially hard (Levinshon et al 1999).

(iv) Bailouts of the banking system. Large financial crises induce a medium term worsening of inequality because of the huge cost borne for their resolution through the recapitalisation with public money, new taxes or foregone progressive expenditures of the banking sector, the provision of bailouts for depositors, and debt relief for borrowers which entail regressive redistributions from poor non participants to rich large participants of the financial sector. The average costs of such operations in emerging economies was equal to 14.7 percent of the GDP of the countries affected (Halac and Schmuckler, 2003). In addition, evidence shows that only a few priviledged participants receive these transfers – in particular large foreign and more informed depositors, as well as large and related borrowers. The analysis suggests that the transfers go from poorer to richer households, with clear disequalizing effects.

2.4 The limited liberalisation of migrant flows.

One of the peculiarities of policy reform during the last twenty years has been the much more limited liberalisation of migrant flows between the developing and transitional countries on the one hand and the developed countries on the other. A related point is the nature that migrant flows have taken place during the last twenty years. While over 1870-1914 migration was largely state-sponsored, -controlled and -assisted, the same cannot be said these days when immigration policies remain quite tight while much of the immigration is illegal or semilegal. Illegal migration, however, is very inefficient as it imposes large costs on the migrants themselves while enriching organized crime, increases expenditure on repression and deportation in the countries of destination, depresses the wage rate of illegal workers in the countries of destination who for fear of being reported to the police and being deported. A more open migration policy would therefore reduce income inequality between countries and – under certain conditions concerning the skill level of the migrants – within countries.

The limited efficiency and equity gains deriving from the current bout of migration differ considerably with those observed during that of 1870-1914. During this period 60 million mostly unskilled people migrated from the European periphery to the New World. The inequality impact of such migration broadly conformed with the predictions of standard theory. To start with, the increase in migration led to a substantial reduction in the wage and income gap between the countries of the Old and New World, as globalisation increased the relative demand for and the remuneration of the abundant factors and reduced that of the scarce factors (Williamson 1996, Andersen 1999). Mass migration from the periphery of Europe to the New World appears to explain most (some eighty-percent) of the drop in the New World-Old World wage gap between 1870 and 1914 (*ibid.*).

Secondly, globalisation caused a rise in within-country inequality in the rich countries of the New World and a fall in the poor ones of the Old World (Anderson 1999). In Great Britain, Ireland and Sweden, the ratio of unskilled wages to farm rents per acre rose following a drop in the supply of unskilled labour due to migration, growing labour demand in the export-led manufacturing sector and a fall in the prices of agricultural products due to cheap imports. The opposite effects were observed in the New World. Likewise, migration drove up unskilled wages and down the rental-wage ratio in the Old World but caused the opposite effect in the New World. In addition, as migrants were mostly unskilled, migration caused a reduction in the skilled–unskilled wage differential in the Old World but a rise of the same ratio in the New World. In turn, the flow of European investments to the New World partially offset the local fall in unskilled wages, as they moderated the decline in returns to a growing supply of unskilled labour, and so retarded the rise in wage inequality, while having the opposite effects in the Old World countries that exported capital.

3. DOMESTIC LIBERALISATION AND INEQUALITY

3.1 Domestic financial liberalisation.

Domestic financial liberalisation inspired by the “financial de-repression hypothesis” was one of the first policies introduced in many developing countries since the middle-late 1970s. The theoretical arguments in support of this reform are that it leads to financial deepening, greater competition, private credit expansion and the creation of bond and stock markets, i.e. measures that by increasing financial intermediation raise the saving, investment and employment rate, with likely positive effects on the distribution of income. Yet, the empirical evidence points to favourable effects in the OECD and a few developing country but to negative ones in most low income nations. How does one explain this contradiction between theory and empirical evidence?

(i) Policy sequencing problems: financial liberalisation in the presence of large budget deficits. In many cases, financial de-repression was introduced in the presence of large budget deficits that could no longer be financed by forcing commercial banks to absorb government debt at artificially low interest rates. To finance their deficit, governments were therefore obliged to create domestic bond markets on which to sell large amounts of treasury bills. Because of their lack of credibility and the considerable volume of the bond issues, interests rates often rose markedly in both nominal and real terms, with this increase being quickly transmitted to the rest of the financial sector. This shifted the distribution of income in favour of lenders who generally belonged to high income groups and against borrowers who belonged to the low-medium income group (Cornia and Lipumba 1999 and the cases studies reviewed therein).

(ii) Failure to create competition in the domestic financial sector. Contrary to expectations, the liberalisation and privatisation failed – especially in the 1980s – to raise competition in the financial sector. While the balance sheets of banks improved, in most cases the industry was transformed from a public to a private oligopoly, as signalled by highly disequalizing rises in real rates and spreads after liberalisation. Even the entry of foreign banks did not raise competition, as the these concentrated on a few low-risk customers while neglecting most other potential small borrowers (*ibid*). All this meant that the expected credit expansion was much lower than expected and that the poor continued to be excluded from the formal credit market.

(iii) Weak regulatory capacity, financial instability and mounting banking crises. Financial liberalisation was introduced without a prior strengthening of the regulatory and supervisory capacity of public institutions, Central Bank included. In several cases, the norms on the opening of new banks were relaxed beyond the usual prudential standard. In Latvia, for instance, a bank could be established in the early 1990s with only 20.000 US$. In Nigeria, domestic financial liberalisation coincided with the resignation of part of the Central Bank staff who moved to the private sector to open new – and difficult to regulate – financial institutions. In sum, financial deregulation led in many cases to a highly disequalizing increase in financial instability, as signalled by the rise in the frequency and severity of financial crises in recent years (Caprio and Klingebiel 1996).

(iv) Discrimination of small and medium entreprises. While repressed financial systems often allocated credit in a highly inefficient way, the distributive effects of financial liberalisation was also often negative. One of the most obvious channel through which this occured is the elimination of directed (and often subsidized) credit to small and medium entreprises and to the agricultural sector. In addition, these reforms exhibited an anti-rural bias, as the adoption of the principle of risk-minimisation by banks led to a fall in the volume of credit assigned to the agricultural sector. For instance, the financial reform in China led to a fall in the number of rural credit cooperatives from over 58.000 in 1995 to 41.000 in 2001 (Pal et al. 2004). Cornia and Lipumba (2001) noted the same phenomenon in Kenya and Uganda. And in India, financial liberalisation eased the lending norms according to which the national banks have to assign a a certain share of credit to agriculture and the SME. As a result, most banks now avoid lending to small farmers and small scale industries that are perceived to be less creditworthy, though evidence shows that this is not the case (Pal et al. 2004). The resulting credit crunch

deprived the poor of the possibility of investing in their businness. While such policies might not cause negative effects in countries with vibrant private credit markets, the closure of rural bank branches and abolition of dedicated credit lines pushed the small entrepreneurs and the peasants into the harms of informal moneylenders who charge exorbitant interest rates.

(v) High US interest rate policy. In many countries, the financial sector was deregulated in the period 1982-1993 during which the US Federal Reserve followed a policy of high interest rates. Such policy and the IMF habit of demanding large increases in interest rates in adjusting countries fuelled a worldwide rise in real rates to well above the secular trend of 2-3 percent. All this had the effect of pushing several governments into a vicious circle in which the rate increases augmented the cost of debt servicing, which further pushed upward deficits and indebtedness. In a number of middle income and industrialized countries with large stocks of debt, this policy raised the cost of servicing the public debt to almost 15 per cent of GDP (UNCTAD 1997). The net effect of all this was disequalizing as in developing countries tax incidence is broadly proportional while ownership of financial assets is highly concentrated. Financial deregulation appears therefore to have raised the rate of return on financial assets and the share of GDP accruing to non-wage incomes and fuelled the redistribution of labor income to holders of state bonds via the budget.

3.2 The liberalisation of the labour market.

Neoclassical labour theory suggests that the liberalisation of wage formation is likely to generate a rise in both employment (as enterprises are more willing to hire workers at lower wages) and wage dispersion (as workers with higher human capital receive higher salaries than in the past). The net distributive impact of these mutually offsetting effects is indeterminate and depends on their relative significance. A second prediction of the neoclassical theory applied to dualistic labour markets is that the abolition of the minimum wage and other regulations in the formal sector raises employment therein and reduces the formal-informal wage gap, a beneficial outcome in countries with a small labour élite employed in a capital-intensive sector and a large low-wage informal sector.

Yet, with few exceptions in some East Asian countries, the evidence of the last twenty years points to a dominance of the negative over the positive effects. For instance, the liberalisation of the labour market in Latin America was accompanied by slow employment creation, growing informalisation, an erosion of minimum wages and mounting overall wage inequality. This findings are confirmed by Behrman et al. (2000) who show that wage differentials rose in 18 Latin American countries after the liberalisation of the labour market. Similar patterns were observed in the OECD and transitional countries and, lately, South Korea. In Eastern Europe, the fall of minimum wages relative to the average correlated closely with the rise in earnings inequality (Cornia 1996). In contrast, earnings concentration did not increase in the OECD and other countries such as Colombia which preserved collective bargaining institutions, adequate minimum wages and social protection systems. Possible explanations of the gap between facts and theory include:

(i) Adverse effects of changes in labour institutions. A first problem with the received theory is that the abolition of minimum wages might not stimulate labour demand, as the the demand curve in a particular range can be completly rigid, while the wage decline increases poverty and inequality. A second problem is that, while the control of trade

unions may be seen as a way to reduce labour market rigidities, a low rate of unionisation may also affect social cohesion, incentives and industrial relations.

(ii) Erosion of 'reference norm' and the rise of the P90/P10 ratio. Mounting wage inequality following liberalisation was also found to be associated with a rapid surge in the highest wages, rather than by falls in the bottom wages (Atkinson 2003), a fact unexplained by the human capital theory but possibly related to the expansion of the finance, insurance and real estate (FIRE) sector and to changes in social norms on the remuneration of highly skilled people. For instance, recent rises in wage inequality in the US and UK might be explained by the spread of 'the winner takes all' remuneration packages for top professionals and greater recourse to stock options for executive compensation.

(iii) *Labour market liberalisation with an open trade and capital account*. In Latin America and the former Soviet bloc, the liberalisation of the labour market coincided with the opening up of foreign trade and capital movements. As noted earlier, the difficulties caused by this on the export front led to wage compression and the shift of labour either towards the high-wage non-tradeable FIRE sector or to low-wage informal subcontracting, with the effect of increasing wage inequality.

3.3. Tax reforms.

The tax reforms introduced over the last twenty years were mainly motivated by the desire to reduce trade taxes, so as to promote a more efficient international allocation of resources, and simplify unnecessarily complex and inefficient tax regimes characterized by a large number of taxes, deductions and exemptions. In addition, the progressivity of wealth taxes and direct tax rates was to be reduced – so as to minimise efficiency costs and stimulate supply responses, as suggested by the Laffer curve. At the same time, a greater accent was placed on horizontal equity by eliminating exemptions and improving collection. In this new tax regime, the revenue decline caused by the reduction in trade and direct taxes on corporations was to be compensated by the broadening tax base resulting from the elimination of exemptions and the introduction of the VAT.

The impact of these reforms varied from country to country but the general trend is towards lower yields and progressivity, i.e. trends that affect inequality. In an analysis of whether tax changes contributed to the rise of income inequality in the United Kingdom, USA, Sweden, Canada, Germany and Finland during the last fifteen years, Atkinson (2000) notes that the tax schedule became less progressive in all countries, though in Germany, Finland and Canada this was accompanied by a broadening of the tax base which offset the negative effect of lower progressivity. As for the developing countries, the net impact of recent tax reforms also varied from country to country. Yet, a recent comprehensive study of tax reforms since the mid 1970s by Chu et al.(2000) points to an average drop of one percentage point in the tax/GDP ratio over the 1980s-1990s period (as opposed to a rise by 1.6 points between the 1970s and 1980s), a decline in the importance of direct taxes in the total and a fall in overall tax progressivity that correlates closely with the rises in inequality. In reviewing the impact of tax changes in Latin America, for instance, Morley (2000) notes that the effect of these changes were to shift the burden of taxation away from the wealthy and towards the middle and lower classes. Similar evidence is available for Pakistan where following the introduction of a tax reform, the tax burden on the poor increased by 7.4 percent between 1987-88 and 1997-8, while that on the richest households declined by 15.9 percent (Kemal 2001, cited in Pal et al. 2004).

What are the explanations of these trends that conflict at least in part with the results expected on the basis of the tax theory summarized above? No detailed analysis is available in this field but the following hypothesis can plausibly be advanced:

(i) The eleimination of trade taxes. In many countries, trade liberalisation led to considerable losses of comparatively easy-to–collect import duties and export taxes. The decline in revenue from trade taxes was not compensated in most cases by a rapid increased in revenue generation from other taxes. In India the reduction of import duties following trade liberalisation led to a permanent reduction of the revenue/GDP by almost two points. The revenue decline that was compensated by reducing subsidies on agricultural inputs and rural credit as well as food subsidies.

(ii) Limited impact of tax broadening. A first explanation is that the broadening of the tax base (via reduced exemptions and greater efforts at tax collection) yielded limited effects on revenue generation and horizontal equity, possibly because of institutional weakness and political economic factors. Under these circumstances, the expected negative effect of the reduced progressivity of direct taxation prevailed.

(iii) Dominance of non-graduated VAT. In many countries indirect taxes now generate the greatest share of total revenue. When applied at a unified rate to all transactions, such taxes are known to generate regressive outcomes, while when differential rates are used for inferior goods an elements of tax progressivity is preserved. This approach was however applied only seldom.

3.4. Impact of the overall liberalisation-globalisation package.

Mainstream theory predicts that the overall reform package – made up of policy components generally expected to generate favourable effects – generates a positive impact on inequality.

While limited to only few studies, the empirical evidence about the impact of the overall packages provides however a fairly different picture. In an analysis of 18 Latin American countries over 1980-98, for instance, Behrman et al (2000) found that the overall reform package had a significant short-term disequalizing effect on wage differentials, the intensity of which, however, declined over time. They also found that the strongest impact was due to domestic financial reform, capital account liberalisation and tax reform. Trade openness had, on balance, no effect on the wage spread, possibly because many effects cancelled each other out.

Similar results were obtained by Székely (2003) who analysed the relation between policy reform and inequality on a panel of 19 Latin American countries over the period 1977-2000. The study finds that while trade reform does not affect the income share of the bottom three deciles, financial liberalisation reduces them significantly. In turn, reforms in the field of taxation, labour market and privatisation did not appear to impact the income share of the poor. Yet, when analysing the impact of the reforms on the Gini coefficient, the disequalizing impact of financial and other reforms stood out clearly while, at the same time, trade openness appeared to reduce inequality significantly.

A third overall evaluation of the overall package is provided by a review of 21 reform episodes in 18 countries (13 from Latin America plus India, South Korea, Turkey, Russia and Zimbabwe) during the last two decades (Taylor 2000). Income inequality was found to rise in 13 cases, remain constant in 6 and improve in two. Virtually without exception, wage differentials by skill level rose following liberalisation, as a result of a reduction of employment in the modern sector, a rise in productivity and wage concentration by skill within the same, the reallocation of excess labour to the low-paying non-traded sector (informal trade, services and traditional agriculture) and a rise of inequality within the latter. In turn, Cornia with Kiiski (2001) evaluated the impact of liberalisation on an overall reform index developed by the World Bank on a sample of 32 developing and transitional economies for the years 1980- 95. The study suggests that while the reform package had an overall disequalizing effect, this was more pronounced in the economies of the former Soviet bloc, probably on account of their institutional weakness, but less marked in the countries with a high initial levels of inequality.

Finally, an analysis of the poverty impact of IMF-World Bank stabilisation and structural adjustment programs (Easterly 2001) found that these moderated the rise of poverty during output contractions, possibly because of the cushioning of the crisis through Bank-sponsored, adjustment-related social safety nets. However, the study found also that, during spells of economic expansion, Fund-Bank programs reduced the poverty alleviation elasticity of growth in relation to those of "home-grown" programs, suggesting in this way that Fund-Bank programs entail a worsening of income inequality during this phase of the business cycle (Table 8). For instance, in China – a country with medium inequality and no Fund-Bank program - poverty incidence fell over 1990-2 by 3.8 percent for every point of GDP growth, while in 1995-6 Colombia - a country with high inequality and a Fund-Bank adjustment loan – experienced zero poverty reduction for every point of GDP growth (Table 1).

Table 1. Poverty elasticity of growth for different Gini coefficients and IMF- World Bank adjustment loans per year

	Average number of IMF-World Bank adjustment loans per year During survey spell		
Gini coefficient	0	0.5	1.0
30	-3.8	-2.7	-1.7
45	-2.9	-1.9	-0.9
60	-2.1	-1.0	0.0

Source: Easterly (2001), Table 3

It must be emphasized that the above studies provide reduced form estimates of the "policy reform–inequality nexus" that do not permit to trace the causal linkages between liberalisation, globalisation and income distribution. Yet, the limited evidence reviewed above and other evidence that cannot be presented here for reasons of space (Atkinson and Brandolini 2003) suggest that – especially in economies with weak domestic institutions – the overall liberalisation package may lead to a deterioration in domestic income inequality owing to the incomplete switching of resources from the non-tradable to the tradable sector, an event that entails a fall in modern sector employment, a rise in wage differential within the same and a swelling of the informal sector, as well as a decline in the wage share and a parallel rise in the capital share linked to increasing banking and financial instability and changes in the labour market and taxation. Of the six components of the liberal package, capital account liberalisation appears to have the strongest disequalizing effect, followed by domestic financial liberalisation, labor market deregulation and tax reform. The equity effects of privatisation and trade liberalisation appear to have varied, with favourable effects in some types of countries and negative ones in others.

6. CONCLUSIONS

The basic theoretical models used to promote policies of liberalistaion and globalisation are often unable to predict accurately the inequality impact of internal and external liberalisation, as they are based on simple relations and highly restrictive assumptions that do not take into account the impact of institutional weaknesses, structural rigidities, incomplete markets, asymmetric information, persistent protectionism and the complexity of liberalisation of trade, finance, labour markets and taxation in a real life environment. This theoretical weakness comes at a high cost. Indeed, while liberalisation and globalisation policies may generate positive effects in countries with strong markets and institutions and a favourable position on world markets, their theoretically-inspired but premature and poorly-sequenced implementation under conditions of incomplete market and institutions and a dependent position may generate adverse distributive outcomes.

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