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Economic Integration, Inequality and Growth: Latin America vs. the European economies in transition

Giovanni Andrea Cornia

Abstract

This paper presents a simple theoretical framework to explain variations in income inequality over time and between countries. It also analyses the factors responsible for the widespread rise in inequality during the neo-liberal reforms of 1980-2000 in the fields of trade, foreign direct investment (FDI) and capital flows, and the rise in migration. Finally, it compares the decline in inequality observed in most of Latin America over 2000-2008 with the steady increase of inequality in many European transition economies during this period despite their return to robust growth. The paper argues that such divergence is explained by differences in policies.

JEL Classification: D31, E24, E62, F20, F41, I20, O54, P27

Keywords: policy reforms, neo-liberalism, international economic integration, income inequality, Latin America, transition economies of Europe

Giovanni Andrea Cornia teaches economics at the University of Florence since 2000. Prior to that he was the Director of UNU-WIDER.

Comments should be addressed by e-mail to the author: giovanniandrea.cornia@unifi.it.

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United Nations
Department of Economic and Social Affairs
2 United Nations Plaza, Room DC2-1428
New York, N.Y. 10017, USA
Tel: (1-212) 963-4761 • Fax: (1-212) 963-4444
e-mail: esa@un.org
<http://www.un.org/en/development/desa/papers/2010>

Economic Integration, Inequality and Growth: Latin America vs. the European economies in transition

*Giovanni Andrea Cornia*¹

1. Introduction

The world economy is far more integrated in every respect today than in 1980, the year that conventionally marks the beginning of the current phase of globalization. This growing economic, social, political and cultural integration is to a large extent the result of endogenous changes in transportation, information and telecommunication technologies, and in demographic trends. Yet, policies (referred to in this paper, for convenience, as “neo-liberal policies”) that dominated the scene until the onset of the recent financial crisis did contribute to accelerating economic integration, except in the case of labour mobility. During these same three decades (1980-2010), there has also been a gradual spread of liberal democracy, particularly in the former socialist countries of Europe and in Latin America.

However, these technological, economic and political changes were accompanied by a widespread decline in gross domestic product (GDP) growth, except in China, Vietnam and a few other countries which developed home-grown approaches to economic liberalization. In a marked departure from the trends of the 1980s and 1990s, the current decade (that is to say, since 2000) has witnessed a recovery in practically all developing and transitional regions. During this period inequality declined markedly in Latin America, but it continued to increase in countries in other regions, albeit at a slower pace.

How can one explain these trends? What are the relationships between international economic integration, inequality and growth? Are there policies that can help progress towards an equitable and efficient model of economic integration? Is the recent experience of countries which followed home-grown approaches to development of any use to guide future policy making? These are the main issues discussed in the present paper. Section 2 briefly reviews what economic theory says about the causes of inequality in developing countries. Section 3 discusses the theory and empirical evidence of the impact of international trade, foreign direct investment (FDI), portfolio flows and migration. Section 4 analyses the trends in domestic income inequality during 1980-2000 and 2000-2008. Section 5 compares the different approaches to economic integration followed in Latin America and the European economies in transition. Finally, section 6 suggests domestic policies which could help countries to benefit from global economic integration while avoiding the problems of inequality and instability that have characterized the last three decades.

2. Theories of domestic income inequality

What are the main determinants of income inequality? Before answering this question, it is necessary to underscore three points that are relevant to the current debate on inequality. First, classical (for example,

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Ricardian) and neo-classical (for example, Solowian) theories focus on “positive” explanations of changes in the “factor shares” (that is to say, the shares of wages, profits and rents in total income) due to endogenous changes in factor endowments, ageing, migration and technology, given existing institutions. The main limitation of these models is their neglect of differentials within a particular social class. Thus Solow deals with a representative agent and Ricardo’s economy is populated by homogeneous groups of land owners, capitalists and wage earners who receive the same remuneration at the same rate. While it is important to pay attention to changes in factor shares, the empirical evidence shows that a large part of income inequality and of its evolution over time is explained by variations in the distribution of income among wage earners, rentiers and profit recipients. In many economies, wages account for between 50 to 80 per cent of total income and changes in wage inequality explain a large part of income inequality. It is therefore necessary to focus on wage polarization as well as the changes in the distribution of profits, rents and other capital incomes.² Secondly, while insightful, most “dualistic models” à la Lewis, characterized by a “modern” and “backward” sector or, in their modern reformulations, by “skilled” and “unskilled” workers, are of limited help in explaining the evolution of inequality over the last 30 years.³ Thirdly, these positive models of income inequality ignore the role of public policies and of changes in institutions which—as shown by many studies—can mitigate inequality (as in the case of egalitarian land, credit, educational and social security reforms) or exacerbate it (as in the case of financial deregulation) by affecting either the factor shares or the distribution of wages, capital incomes and public transfers. Explanation of changes in the distribution of the net disposable income therefore requires taking into consideration positive, normative as well as institutional factors.

2.1 *A framework to explain income inequality changes over time and across countries*

A general inequality framework able to take into account changes in both factorial and personal distributions of income with heterogeneous agents, decomposes the income of household “i” as the sum of the products of its factors endowments of unskilled labour (LF), human capital (HC), physical capital (K), and land and other non-reproducible assets (L) by their respective returns, namely “uw” (unskilled wage), “sw” (skilled wage), “rk” (return on capital), and “r” (the rent of the land, mines, etc.). In symbols:

$$y_i = uw LF_i + sw HK_i + rL_i + rk K_i$$

Assuming that the state taxes all incomes at different rates and that it redistributes some of the revenue so obtained in the form of income transfers to the households, the post-tax and post-transfer income of person “i” can be expressed as:

$$y_i = nw LF_i(1 - t_{uw}) + sw HK_i(1 - t_{sw}) + rL_i(1 - t_r) + rk K_i(1 - t_{re}) + TR_i$$

The evolution over time of the income share of household “i” (y_i/Y) (and—when considering all households—of the Gini coefficient of disposable income) thus depends on the:

-
- 2 Recent work by Piketty and Atkinson shows, for instance, that much of the recent increase in inequality in the United States of America and the United Kingdom of Great Britain and Northern Ireland is due to the polarization of the distribution of wages and salaries, with the emergence of a class of “working super-rich” rather than to changes in factor shares.
 - 3 Kanbur (1998, p. 12) notes on the basis of a review of the post-war literature on income distribution that “Despite the huge amount of resources devoted to the development-distribution relationship in the (cross-sectional) Kuznetsian approach, it has to be said that the harvest is meager”.

- evolution of the distribution of production factors (LF, HK, L, K) among households;
- changes in the remuneration of production factors (uw , sw , r , rc);
- changes in transfers (TR) received and taxes paid (“ t ”) by each household on different income types.

Generally, the bottom per centiles of households receive most of their incomes from unskilled labour and transfers and the top ones from skilled labour and capital income.

This simple framework can be used to explain cross-country differences in inequality as well as the evolution of inequality during the recent period of fast global economic integration since 1980. For instance, a high concentration of the distribution of L, HC and K traditionally explains the high levels of inequality observed in most developing countries. In turn, the dominant “North-Atlantic” explanation of the rise of inequality during the 1980s and 1990s focuses on the “skill premium” (that is to say, the ratio “ sw/uw ”) caused either by an increase in the demand for HK due to technological change, or migration of unskilled labour (which increases the supply of LF and may reduce “ uw ”). The increase in inequality during the Reagan era in the United States was explained by a rise in capital returns (rk) and decline of tax rates on capital income (t_r).

2.2 *Traditional determinants of domestic income inequality*

The above framework can be used to discuss the traditional determinants of income inequality in a developing economy with low international economic integration.

Before the onset of the second globalization of 1980-2007, differences in inequality levels and trends could be traced to three sets of causes: distribution of production factors (LF, HC, L, K), returns to each of them (uw , sw , r , rc) and redistribution by the state (t , TR).

Inequality and aggregate supply and distribution of endowments (LF, HC, K, L)

Aggregate supply and distribution of LF

The overall labour supply is mainly influenced by demographic factors. It increases rapidly—with a lag of about 15 years with the onset of the first demographic transition, then it stabilizes gradually, while it declines—also with a lag—with the onset of the second demographic transition, as shown by the recent experience of the European countries. The distribution of LF across households is not uniform, as it depends on their dependency ratio and activity rates. It is much lower in female-headed and incomplete households and in families with high dependency ratios and low female labour force participation (FLFP). Indeed, except for a handful of advanced economies, the latter is much lower than that of men. An increase in FLFP has ambiguous effects on income inequality. If the “assortative matching hypothesis” (according to which people marry a spouse with broadly the same level of education) is verified, the impact on the distribution of household income per capita is un-equalizing if the first women who enter the labour market are well educated, and equalizing if they belong to low-income strata.

Aggregate supply and distribution of HC

In the early stages of development, the supply of skilled labour is comparatively low due to the intrinsically slow expansion of education systems and human capital formation. The relationship between the average years of education of the LF and wage and income inequality is concave. During the initial phase of development, educational expansion increases the number of better paid skilled workers, thus generating a growing

wage gap in relation to unskilled workers. In addition, if the supply of skilled workers grows less rapidly than its demand, scarcity rents and income inequality rise. As the relative abundance of skilled workers grows, scarcity rents and the wage rate of skilled workers stabilize and then decline, and the “wage premium” (sw/uw) and earnings inequality drop. Empirically, inequality in education has been shown to rise until the workers’ average number of years of schooling reaches 7 to 8 years and to decline thereafter (Londono, 1996).

The rise of the skill premium (sw/uw) depends also on educational policies. Indeed, while most developing regions traditionally exhibited low public expenditure on education, low secondary and tertiary enrolments and high inequality in the distribution of human capital (HC) (see table 1), the East Asian educational strategy focused on a state-financed rapid expansion of secondary education which raised the number of skilled workers, reduced educational inequality and the concentration of labour income.

High concentration in the distribution of land and other non-reproducible assets

Because of historical factors, in many developing countries land has traditionally been distributed in a highly unequal way. The Agricultural Censuses of the Food and Agriculture Organization of the United Nations (FAO) indicate that in the 1960s-1970s, the Gini coefficient of land distribution ranged between 0.61 and 0.92 in Latin America, between 0.46 and 0.71 in sub-South-Eastern Africa, and 0.60 in semi-feudal South Asia. In several of such countries a small number of landowners appropriated up to 50 per cent of the agricultural output or 25 per cent of GDP (Carter, 2004). In addition, in view of the low labour absorption of *latifundia*, high land concentration and landlessness also depressed the wage of rural labourers and, through them, the unskilled wage in urban areas.

Also, countries well endowed with natural resources tend to have high asset and income inequality. The ownership of mines and other natural resources is traditionally concentrated in the hands of local capitalists and transnational corporations (TNCs), a fact that may cause political instability and “greed wars”. In addition, production in this sector generally requires a large amount of capital and not too much labour. Only when governments are able to capture the mining rent through nationalization and taxation and to redistribute it in ways which benefit the poor (as in Botswana) can an endowment of natural resources reduce income inequality.

Table 1: Human capital formation and research and development (R&D) in selected regions

Mid-1980s				
	<i>Latin America</i>	<i>Mediterranean Basin</i>	<i>East Asia</i>	<i>G-7</i>
Secondary school enrolment rate	45.6	77.7	65.0	90.0
University enrolment rate	17.8	22.2	18.4	41.0
University graduates per 100,000 inhabitants	1,560	1,910	4,780	5,920
Engineering and technology graduates/total graduates	17.2	17.6	20.2	15.5
Engineers and scientists per 100,000 working-age persons	690	1,190	1,450	5,810
R&D expenditure/GDP	0.6	0.9	1.3	2.7
Per capita R&D expenditure	120	240	180	3,460

Source: ECLAC (1990).

Note: The Mediterranean Basin includes Greece, Italy, Portugal and Spain.

High concentration of the distribution of industrial, housing and other reproducible assets

Initial concentrated distribution of land affects subsequent distribution of other assets too. Indeed, while the direct impact of concentrated land distribution diminishes with the decline in the weight of agriculture in GDP, its indirect impact on long-term inequality is propagated via a skewed accumulation of human capital and—in the presence of imperfect financial markets—of industrial and other assets as the poor are excluded from credit markets. Thus, in the absence of “financial innovation” (for example, micro-credit schemes, credit unions and cooperative banks) and government measures in the field of human capital formation and access to credit by low-income families, industrial assets, housing and other forms of reproducible wealth remain concentrated in the hands of comparatively few families. The popular portrayal of the economies of Central America (for example, El Salvador and Nicaragua) dominated by a few oligarchic families, who control both agricultural and industrial wealth, illustrates this correlation (Carter, 2004).

Differences in returns to endowments (uw , sw , r , rk)

As noted, in the early stages of economic development, low-income economies are characterized by an infinitely elastic supply of unskilled labour which—given the level of capital accumulation and existing economic institutions—reduces the unskilled wage “ uw ” and raise land rents (r) and capital incomes (rk). Under such circumstances, labour markets tend to become highly dualistic, and labour policies tend to have a modest impact because of lack of enforceability of labour norms and minimum wages. Nevertheless, “ sw ” tends to be high in comparison with “ uw ”, particularly if the demand for skilled labour rises (for example, due to capital accumulation and technological modernization), while its supply lags behind due to limited public and private expenditure on human capital. The returns to capital depend on many endogenous factors (such as the efficiency of assets and credit markets), contractual arrangements (for example, on sharecropping terms, which affect “ r ”) and interest rates policies (which affect “ rk ”).

Distributive impact of tax and transfers

Barring redistribution via inflation (which in most cases tends to be regressive) or land reform (which requires overwhelming political support) the extent of redistribution depends on the ability of the government to generate tax and non-tax revenue (t). This in turn depends on structural characteristics of the economy (the shares of agriculture and urban informal sector in GDP, the presence of high-value commodities and GDP per capita), as well as on the government’s tax effort. The success of the latter depends, in turn, on the existence of a representative democracy (“no taxation without representation”) and on how legitimate and responsive the state is perceived to be by its citizens. Improvements in tax administration and institutions are also key, as suggested by Lora (2008). Thus, improving governing institutions, reducing corruption and tax evasion, and increasing voice and accountability may go hand in hand with an expansion of tax handles and changes in economic structure. Finally, the extent of taxation and redistribution depends on the “demand for equality” in the society. The evidence indicates that homogeneous societies tend to have a high preference for equality and, therefore, for redistribution via the budget.

The extent of redistribution via the budget depends also on the volume, composition and incidence of various income transfers (Tr). The quintile shares and concentration coefficients reported in table 2 suggests that in Latin America (but similar results are obtained in other regions) all components of social expenditure are less concentrated than private income. Expenditures on primary education and social assistance are found to be strongly progressive, and those on secondary education and health care mildly progressive or proportional. Expenditure on tertiary education, by contrast, is found to be as concentrated as the income

Table 2: Incidence of government expenditure by quintile and concentration coefficients of public expenditure by country subgroups, 18 Latin American countries over 1997-2004

Expenditure sector	Shares of total public expenditure, by sector and income quintile					Concentration coefficients of public expenditure		
	I quintile	II quintile	III quintile	IV quintile	V quintile	Group 1	Group 2	Group 3
Education	7.4	6.5	6.3	5.9	5.6	-0.067	0.116	-0.138
Health	5.1	4.7	4.2	4.0	3.7	0.074	-0.073	-0.192
Social security	2.0	2.8	4.3	6.3	16.5	0.504	0.568	0.349
Social assistance	3.3	2.1	1.6	1.3	1.1	-0.089	-0.154	-0.484
Housing	0.8	0.9	1.1	1.4	0.9	0.206	0.067	-0.026
Total	19.6	17.0	17.5	18.9	27.8	0.143	0.042	0.044

Source: Cornia and Martorano (2009), based on CEPAL data.

Note: Group 1: Bolivia (Plurinational State of), Ecuador, El Salvador, Guatemala, Honduras, Nicaragua, Paraguay, Peru; Group 2: Colombia, Dominican Republic, Mexico, Panama, Venezuela (Bolivarian Republic of); Group 3: Argentina, Brazil, Chile, Costa Rica, Uruguay.

distribution. Similarly, social security outlays (for example, pensions and unemployment benefits) are not progressive as they focus on formal sector workers. However, these outlays can become progressive if non-contributory benefits are provided to informal sector workers and families.

3. Global economic integration and income inequality

From the outset of the 1980s, most developing countries abandoned the then dominant import-substituting industrialization development paradigm and introduced neo-liberal policies. The new approach aimed at stabilizing macroeconomic imbalances and reducing inflation by means of the monetary approach to the balance of payments. Public policies following from this approach focused on liberalization of domestic markets for goods, labour and finance, privatization of state companies and an overall reduction of the role of the state in the economy. These policies paved the way towards the liberalization of foreign trade, opening up to FDI, liberalization of portfolio flows, adoption of a standardized patent regime (embodied in the Agreement on Trade-related Aspects of Intellectual Property Rights (TRIPS)) regarding intellectual property, and the simplification of all forms of international exchange, except for the free mobility of labour.

The proponents of the monetary approach to the balance of payments have long claimed that this approach restores the conditions for growth, and that domestic and external liberalization generate more competition, reduce domestic prices, increase specialization and efficiency, improve inequality in nations exporting labour-intensive goods, channel world savings to developing countries with low capital accumulation but high rates of return on investment and accelerate the transfer of technology to backward regions. They also claimed that the distributive impact of internal and external liberalization was likely to be neutral (or positive in areas with a surplus of educated labour), that income inequality would remain stable over the long-term (Deininger and Squire, 1996),⁴ and that there was no strong association between inequality and growth. However, during the last few years, the International Monetary Fund (IMF) and the World Bank (which have traditionally promoted greater liberalization and globalization) have shown growing concern for the impact of these measures, placed growing emphasis on social safety nets to protect the poor

⁴ These authors argued that decadal regional averages of Gini coefficients over the 1960-2000 period showed hardly any variation, with the exception of the economies in transition over the 1990s.

and encouraged protection of health and education during structural adjustment. They have also strongly supported the achievement of the Millennium Development Goals (MDGs), without—however—changing their stance in favour of rapid internal and external liberalization. Yet, as will be shown in this section, this drive towards global economic integration coincided with an increase in domestic income inequality in some 70 per cent of the countries analysed.

3.1 *Distributive impact of trade liberalization*

The neoclassical trade theory embodied in Heckscher-Ohlin (HO) theorem predicts that trade liberalization leads to greater specialization and an increase in national income in participating countries, following an allocation of production based on comparative advantages. In labour-abundant countries, trade liberalization is expected to switch production from capital-intensive and inefficient import-substitutes towards labour-intensive exports. In addition, the Stolper-Samuelson (SS) corollary to HO posits that such a shift leads to the convergence in the prices of goods and remuneration of factors. Thus, domestic inequality is expected to decline in countries endowed with an abundant labour supply. By contrast, the inequality is expected to rise in capital-rich countries, as the demand for and remuneration of capital (which is unequally distributed) will increase, while the demand for and remuneration of labour will fall.

The empirical evidence on the distributive impact of trade liberalization on inequality is, however, mixed, at best. As predicted by HO-SS, the trade liberalization of the 19th century raised domestic inequality in the rich New World and reduced it in the poor Old World. Likewise, Bourguignon and Morisson (1989) found that in 35 small developing countries trade liberalization reduced the income of the richest 20 per cent of the population and raised that of the bottom 60 per cent. Similar conclusions are arrived at by Wood (1984) in the case of the East Asian exporters of labour-intensive manufactured goods during the 1960s and the 1970s. Yet, an equally important body of 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, a study of 38 developing countries for the years 1965-1992 found that trade liberalization benefited the top 40 per cent of the population while affecting negatively the bottom 40 per cent who were hit by more severe terms of trade fluctuations typical of an open economy (Lundberg and Squire, 1999). Similarly, 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. Finally, a recent review of the evidence for Argentina, Brazil, Chile, Colombia, Hong Kong Special Administrative Region of China, India and Mexico during the 1980s and the 1990s (Koujanou-Goldberg and Pavcnik, 2007) identifies a parallel increase in economic integration and income inequality. It also confirms that there is no evidence that trade openness favours the less fortunate, and attributes this finding to short-run factor immobility, trade-induced, skilled-biased technological change, the confounding effects of simultaneous capital flows and exchange rate fluctuations and some other factors.

How can we explain these conflicting findings and, most of all, the discrepancy between empirical results and theoretical predictions? To start with, it must be underscored that the HO-SS theorem holds under restrictive assumptions, that is to say, trade between two countries producing two goods with two factors (capital and labour) using a 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 their full employment), balanced trade and symmetric trade liberalization by all partners. Yet, in the real world, trade takes place in a multi-country, multi-factor and multi-goods context in which most of the above assumptions

do not hold. In the following, we provide explanations on how departures from these assumptions may lead to the rise in inequality on the occasion of trade liberalization:

Changing relative endowments of countries participating in multi-country, multi-factor and multi-goods trade

The limitations of the 2x2x2 HO-SS model are most obvious when considering the case of trade among countries whose relative comparative advantage and production structures evolve over time because of the decision of other countries to change their trade policy. For instance, country A may have a comparative advantage in terms of unskilled labour in relation to country B but not of country C, which has, however, not yet liberalized its trade. Thus, the decision to liberalize exports by C is likely to displace A's exports to B with adverse effects on equality. It may even happen that, because of C's decision to liberalize, A will shift to the production of goods with a medium-high skill and capital content with the effect of worsening its wage distribution. This is what happened in the 1990s, with the entry into the world market of labour-intensive manufactures by China and other low-wage economies affecting the exports and comparative advantage of the middle-income countries of Latin America, Eastern Europe and South-East Asia.

Trade liberalization in countries with an unequal distribution of the abundant factor

The standard model also fails in the case of countries exporting primary commodities produced using an abundant factor that is unequally distributed. While an increase in land- or mineral-intensive exports may reduce inequality in countries with an egalitarian distribution of assets, it would raise it in countries dominated by *latifundia* and a highly concentrated mining sector. Indeed, due to the labour surplus prevalent in their labour market, it is unlikely that an eventual rise in the demand of workers would raise their wages in line with the increase in export receipts.

Trade liberalization and the import of skill-enhancing investment goods

One of the key assumptions of the HO-SS theorem is that the production technologies utilized by the trading countries are not affected by trade itself. Yet, trade liberalization can enlarge the access to previously restricted technologies or, by relaxing foreign exchange constraints, 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 wages of the unskilled ones.

Asymmetric trade liberalization and protectionism among trading partners

Another assumption of the basic trade model is that trade liberalization concerns all trading partners. However, in the case of low-tech African and Asian exporters, trade liberalization has led to unsatisfactory export growth not only because of weak domestic conditions but also because of the persistent protectionism of agriculture in the Organization for Economic Cooperation and Development (OECD) countries. Thus, unilateral liberalization combined with restrictive trade practices by the trading partners can raise inequality and poverty in low-income developing countries.

Trade reorientation following capital account liberalization

Another explanation that has received little attention so far concerns the interaction between trade and capital account liberalization. Sudden inflows of foreign capital can bring about appreciation and increasing instability of the real 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).

These changes encourage the restructuring of production along with reduction in formal employment and wages and greater reliance on outsourcing that further reduces absorption of unskilled labour and raises wage inequality.

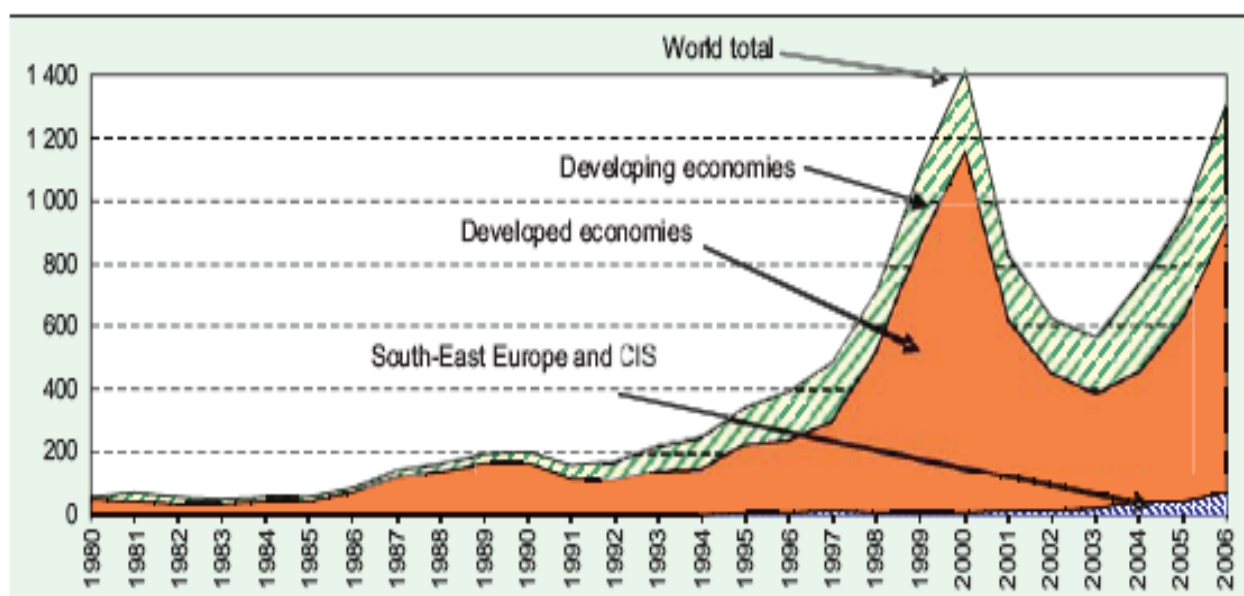
3.2 *Distributive impact of the liberalization of FDI*

During the last thirty years, FDI increased steadily, particularly on the wave of acquisitions of state enterprises in Latin America and in Eastern Europe and the former Soviet Union (EEFSU) in the 1980s and 1990s, and opened up investment opportunities in fast-growing East Asia. In contrast, between 2000 and 2004, foreign investments in developing countries stagnated and those in the OECD declined following the bursting of the dotcom bubble (Figure 1). Yet, between 2004 and 2006, FDI to developing economies rose faster than the total, following the introduction of legal changes allowing majority ownership by foreign investors, liberalization of profit remittances and gradual elimination of clauses on minimum domestic content, minimum export requirements, exclusion of strategic sectors and indigenization of management (UNCTAD, 2007, table 1.8).

Most theories of the distributive impact of FDI implicitly refer to the case of greenfield investments in labour-intensive manufacturing in new industries. This leads to the conclusion that FDI reduces income inequality in low-wage, labour-abundant countries by accelerating capital accumulation, raising the demand for unskilled workers and offering higher wages than those prevailing in the informal or domestic formal sectors. Furthermore, FDI is assumed to generate dynamic gains by contributing to technological and human capital upgrading in backward countries which otherwise would have to invest huge resources over decades to develop the technology transferred to them by the TNCs. Thus, according to this perspective, FDI would enhance medium-term manufacturing growth, export capacity and income distribution of the host countries.

Figure 1: FDI inflows, total and by groups of economies, 1980-2006

(Billions of United States dollars)



Source: UNCTAD, based on annex table B.1 and FDI/TNC database (www.unctad.org/fdistatistics).

Do the propositions above correspond to the empirical evidence? Evaluations of wage changes and employment conditions in TNC-controlled firms and export processing zones provide mixed results. Te Velde and Morrissey (2002) found that FDI raised the wages of all skill levels in four of the five East Asian countries analysed. In contrast, in Mexico, the increase in wages due to FDI was significantly lower for the unskilled than skilled workers (Alarcon and McKinley, 1996). With respect to equality in the economy as a whole, a study by Milanovic (2002) found no significant relation between the FDI/GDP ratio of the recipient countries and the income shares of various deciles. However, Benassy-Queré and Salins (2005) claim on the basis of both panel and cross-country regressions that opening up to FDI tends to favor the wealthiest quintile of the population even though FDI reduces the rural-urban income gap, as migrants working in urban-based TNCs remit money home to poorer rural areas. Finally, an analysis of a sample of 18 Latin American countries for the years 1990–2007 shows that the accumulated stock of FDI as a percentage of the current GDP correlates closely and significantly with income inequality (Cornia and Martorano, 2009). Thus the evidence with regard to the impact of FDI on inequality is inconclusive. The predictions of the simplistic theoretical model therefore need to be qualified in the following ways:

FDI composition

While the flow of FDI increased in all regions,⁵ their sectoral composition changed steadily, with a growing share of it going to resource- and capital-intensive mining and manufacturing (chemicals, metallurgy and machinery), and to capital and/or skilled-labour intensive services such as utilities, finance, telecommunications, transport, and business services. Comparatively, much less FDI was directed to unskilled-labour-intensive manufacturing such as textile, shoes, apparel, food processing, furniture, toys, beverages, simple assembly operations, motor vehicle construction, and services such as trade, restaurants, hotels and so on (see table 3). Thus, (unskilled) labour-abundant countries witnessing an FDI shift towards resource-, capital-, and skilled labour-intensive sectors experienced, *ceteris paribus*, an increase in income inequality both through labour market effects and, where democratic institutions are weak, via political economy mechanisms.

Greenfield FDI vs. Mergers and Acquisitions (M&A)

Particularly during the 1990s, the share of cross-border M&A in the total FDI grew steadily (see Table 4). M&A entail an improvement in foreign exchange availability but not in the stock of capital, employment and consumer welfare. Most often, the effect of M&A is negative, as foreign firms generally impose cuts in employment, increases in tariffs, and consolidations among firms leading to, *ceteris paribus*, adverse distributive effects (Baldwin, 1995). For instance, the equity effect of the acquisition of Latin American public utilities during the 1990s depended on the sale price of state assets, increase in price for services supplied by foreign-controlled utilities and the employment impact of restructuring. Morley (2000) argues that the impact was felt mainly by the middle class who was both the main user and producer of the subsidized services of the state enterprises.

Substitution effect and “business stealing”

Even when FDI flows to the unskilled-labour-intensive sector, its net effect on income distribution has to take into account the changes in employment and wages in the rest of the economy. This is particularly the case when the new FDI enters markets which are already supplied by domestic firms. To determine their

5 The ratio of the worldwide stock of inward FDI rose from 4.62 per cent of world GDP in 1980 to 24.7 in 2006, when such ratio ranged from a minimum of 23.5 per cent of GDP in Middle East and North Africa (MENA) to a maximum of 30.4 in Latin America (with all regions falling within this narrow range), as opposed to 1980 when the FDI/GDP stock ranged from 4.5 per cent in Latin America to 9.5 in sub-Saharan Africa.

Table 3: Structure of the stock of mergers and acquisitions (1990-2006) and total FDI (1990-2005) by sector

	<i>Mergers and acquisitions stock</i>		<i>Total FDI stock</i>	
	1990	2006	1990	2005
PRIMARY (of which)	6.6	9.8	8.2	8.7
Mining, quarrying and petroleum	6.5	9.5	6.4	7.8
SECONDARY (of which)	46.5	31.0	43.0	31.0
Food, beverages and tobacco	8.4	2.8	2.9	1.7
Chemicals and chemical products	8.1	6.7	13.1	3.6
Metal and metal products	2.9	5.5	4.3	1.5
Machinery	1.2	2.2	2.8	1.2
Electrical and electronic equipment	4.1	4.5	5.0	3.6
Motor vehicles and other transport equipment	4.9	1.8	2.1	1.7
TERTIARY (of which)	46.4	59.0	46.0	58.0
Electricity, gas and water distribution	0.4	2.6	0.8	2.3
Trade	5.1	2.6	7.2	7.9
Transport, storage and communications	9.6	16.0	3.6	5.7
Finance	14.4	14.9	26.0	14.7
Telecommunications and business activities	7.9	12.4	4.1	22.4
UNSPECIFIED	0.5	0.2	2.8	2.3
TOTAL	100.0	100.0	100.0	100.0

Source: Author's elaboration based on UNCTAD's database and UNCTAD (2009), table A.I.9.

Table 4: Share of mergers and acquisitions on total FDI, 1995-2006

	1995	2000	2006
World	0.54	0.81	0.67
Developed economies	0.76	0.94	0.83
Developing economies	0.14	0.26	0.34
Middle East and North Africa (MENA)	0.06	0.28	0.29
Sub-Saharan Africa (SSA)	0.19	0.36	0.92
Latin American and the Caribbean (LAC)	0.28	0.43	0.45
South East and East Asia (SEEA)	0.08	0.15	0.27
Eastern Europe and the former Soviet Union (EEFSU)	0.39	0.50	0.68

Source: Author's calculation based on UNCTAD (2007).

final distributive impact, one must therefore consider the effect on jobs and wages in competing unskilled-labour-intensive domestic firms. These problems do not arise if the goods produced by the TNCs were previously imported or if they satisfy a new demand.

N-S plant relocation and skill-biased technical change

A further refinement of the basic model concerns the kind of technology that FDI brings with it. This point is well illustrated by Feenstra and Hanson (1997) who consider the case in which, in order to cut costs, a multinational company shifts parts of its production to a developing country where wages are lower. Though

the skill-intensity of these production operations may be low from the point of view of a developed country, it may be high for the developing country hosting the new FDI. For instance, the outsourcing of production from the United States to the *maquiladoras* in Mexico generated a drop in the demand for unskilled labour in the United States (which contributed to a rise in the skilled/unskilled wage gap) and a simultaneous increase in the demand for what is considered skilled labour in the Mexican context, thus raising wage and overall income inequality in Mexico too.

Systemic effects

The mobility of capital and immobility of labour may lead to a competition among developing countries trying to attract FDI. These countries may thus engage in a “*race to the bottom*” in which all of them make ex-ante concessions with regard to taxation, subsidies, labour and social security legislation, and so forth, which, in the end, affect the distribution of private and public consumption. While wages in the multinationals tend to be higher than those offered by local employers, these benefits will be felt only in the countries where FDI have finally decided to go. In those bypassed by them, the ex-ante concessions made in the field of taxation and the like will have generated a cost unmatched by any benefit. However, actual evidence of “*race to the bottom*” is contradictory. For instance, in Latin America tax/GDP ratios rose steadily during periods of both stagnant and growing FDIs (Cornia and Martorano, 2009).

In any case, though total FDI reached US\$1.3 trillion in 2006, only 29 per cent of it were directed to the developing world (see table 5). While this percentage has been rising steadily, the share of FDI directed to the OECD countries and few large middle-income countries remains dominant, and the share of FDI directed to low-income countries, particularly to SSA, remains marginal. This pattern has a negative effect on the distribution of income among countries. Second, among developing countries, only a few of them get the lion’s share of FDI. The top ten recipient countries absorb about three quarters of the total FDI directed to developing countries. Finally, the historical evidence shows that FDI generally “follow” rather than “lead” domestic capital accumulation, as demonstrated by the Chinese and Vietnamese experience. In other words, FDI seldom acts as the main driver of capital accumulation in poor countries. Even in China, FDI accounts for less than a tenth of overall accumulation, though it plays a main role in transferring know-how and management experience to key sectors.

Table 5: FDI shares by regions, 1980-2006

	Inward FDI in reporting countries							
	Flow				Stock			
	1980	1990	2000	2006	1980	1990	2000	2006
World	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00
OECD	86.09	82.17	81.36	66.94	74.54	79.47	69.55	70.97
Developing economies	13.87	17.80	18.15	29.03	25.46	20.50	29.39	26.30
EEFSU	0.04	0.04	0.49	4.04	0.00	0.04	1.06	2.73
SSA	0.45	0.84	0.44	0.94	5.27	2.03	1.85	1.66
LAC	11.73	4.83	6.93	6.41	6.36	5.88	8.28	7.57
SEEA	7.22	10.83	10.26	15.35	9.57	8.67	17.26	14.08
MENA	-5.75	0.96	0.49	6.30	4.04	3.78	1.93	2.95

Source: Author’s elaborations based on the UNCTAD investment database.

3.3 Distributive impact of the liberalization of the capital account

Capital inflows of the non-FDI variety—often called portfolio investment (PFI)—generally consist of purchases of bonds, shares and securities by non-residents in local stock markets, lending by foreign to domestic banks, and borrowing abroad by domestic firms, families and the state. Mainstream theory has until recently maintained that capital account liberalization raises investment, growth, employment, labour productivity, and equity in countries with low savings but high rates of return on capital and an abundant supply of cheap labour. Capital inflows have also been credited with lessening the balance of payments constraint of developing countries, enhancing their ability to import investment goods, generate employment, and even reduce inequality. Other supposedly positive effects of PFI include decline in domestic interest rates, faster accumulation of currency reserves (which reduce country spreads on international loans), and “disciplining effect” on domestic macro policy. Finally, liberalization of portfolio flows would permit diversification of assets of domestic investors, leading to a better balance of the risk profile of their portfolios, thus affecting favorably the saving rate of developing countries.

However, contrary to the above predictions, the evidence points to a consistent deterioration of income inequality associated with PFI inflow and especially with its outflow. The distributional impact of PFI was found to be particularly negative in countries with weak labour institutions and social safety nets. For instance, Galbraith and Lu (1999) found that in Latin America and Asia, PFI-induced financial crises raised inequality in 73 per cent and 62 per cent of the time, respectively, while no impact was evident in Finland, Norway and Spain. Diwan (1999) arrived at similar conclusions on the basis of panel data showing that the labour share contracts markedly and permanently in the wake of financial crises. Behrman and others (2000) also found that in Latin America the strongest un-equalizing component of the overall neo-liberal reform package was liberalization of the capital account. How to account for this discrepancy between theory and evidence? Possible explanations include:

Appreciation of the real exchange rate due to large capital inflows

Large inflows of funds can cause an appreciation of the real exchange rate, reducing employment in the export sector, shifting resources from the tradable to the non-tradable sector and encouraging subcontracting and wage cuts in the tradable sector to preserve profit margins (Taylor, 2000). Countries can control appreciation of the exchange rate via costly sterilization of part of the capital inflows or through regulation. However, both measures work only up to a point.

Credit booms and inter-sectoral allocation of portfolio flows

Large inflows of portfolio investment tend to be directed not so much to agriculture or labour-intensive manufacturing but to capital- and skill-intensive companies in the finance, insurance and real estate (FIRE) sectors that have higher short-term rates of return and a perceived low risk profile. These sectors, however, tend to employ medium-to-high skilled workers whose wages rise in parallel with the skilled/unskilled wage gap. Meanwhile, the financing problems of labour-intensive small and medium enterprises remain unaddressed.

Sudden capital outflows and financial instability

Income inequality is also affected by the tendency of capital account liberalization to augment the frequency of destabilizing financial crises with real effects (Caprio and Klingebiel, 2003). Left to themselves, deregulated financial systems do not perform well owing to problems of incomplete information, markets and contracts,

herd behavior, panics, weak supervision and assets price speculation. Indeed, it is now generally agreed that financial liberalization raises economic instability, especially in relation to middle-income (emerging) economies (see table 6). Since 2003, the IMF, which in the past promoted capital account liberalization, published analyses indicating that capital account liberalization raises the instability of private consumption without generating any effect on growth (Prasad and others, 2003). Indeed, much of the recent instability (including that observed during 2008-2010) derives from the domestic and external financial deregulation carried out in the last 30 years. Even in the absence of full-fledged financial crises, capital market imperfections and incomplete safety nets generate negative effects on the income of the poor and on income inequality.

Table 6: Standard deviation of per capita GDP growth rate by country groups, 1960-2005

	1960-1970	1970-1981	1982-1990	1990-2005
Low income	4.69	6.32	4.95	4.58
Middle income	2.77	3.48	4.44	5.62

Source: Author's calculation based on the World Bank's World Development Indicators database.

Inequality effects of bank bailouts

An often-ignored pathway through which financial crises affect income distribution are bank bailouts, as observed during the current crisis too. Honohan (2005) shows that the average financial cost of solving a banking crisis was 9 per cent of GDP spread over 4.4 years in developed countries and 31 per cent over 3.8 years in the emerging economies. To find out the distribution of such huge bailout costs, Halac and Smuckler (2003) analyse the financial transfers that occurred during the solution of five financial crises, namely Chile (1981-1983), Mexico (1994-1995), Ecuador (1998-2000), Argentina (2001-2002) and Uruguay (2002). They found that the fiscal cost of crisis resolution implied a transfer from (poor) non-participants to (middle and upper class) participants in the financial sector, including depositors, borrowers and financial institutions. Furthermore, only a few privileged, large, more informed depositors benefited from the financial transfers from the state, while small and less informed depositors bore significant losses. These transfers were un-equalizing as they were financed through higher taxes, lower spending, and inflation, that is to say, through approaches that penalize mainly the poor.

3.4 Distributive impact of migration

The last 30 years have witnessed a surge in the number of migrants, exceeding 200 million by 2005. Much of this migration is not the result of agreements between states but reflects (often illegal) decisions of individuals, families and firms in the countries of origin and destination. The importance of migration has increased in parallel with the increase in remittances, whose volume, according to IMF, has reached US\$ 300 billion by 2008, exceeding official development assistance (ODA) and FDI to developing countries taken together. In about 30 countries, remittances account for 10 per cent to 40 per cent of national income, so that distribution of remittances has a major impact on inequality.

The recent increase in migration is reminiscent of what occurred during the globalization of the 1870-1914 period, when 60 million of mostly unskilled workers migrated from the European periphery to the New World (Lindert and Williamson, 2001). Migration and liberalization of agricultural imports of that period had a noticeable impact on income inequality, which rose in the New World (as wages fell and land rents rose) and fell in Europe where the ratio of unskilled wages to farm rents rose following a drop in labour supply due to migration.

However, given its new pattern, migration tends to increase inequality in the countries of origin. Indeed, contrary to the case of the “state organized unskilled migration” of the last century, currently the unskilled poor are less likely to migrate than the middle-income people whose families are better able to finance the high costs (between US\$ 3,000 and US\$ 20,000 per person) of “individual informal migration”. In addition, a migrant with a higher level of education is more likely to function better and find a job in the country of destination. Remittances are therefore received generally by people in the 40th to 80th percentile of the income distribution, bypassing the people of the lowest rung. At the same time, outmigration of skilled workers may raise their wages in the countries of origin, leading to a rise in the wage premium and overall inequality.

Here, too, there are some discrepancies between theoretical predictions and the empirical evidence. A review of the empirical literature does not offer conclusive evidence as to whether international migration increased or decreased economic inequality in the countries of origin, suggesting that actual outcome depends on some other factors, to be discussed below (see Docquier and Rapoport, 2003).

Migrant networks and redistribution

Recent evidence shows that migration may be less un-equalizing in source countries when it is state-sponsored or when sufficiently dense migrant networks emerge. These networks tend to reduce some of the costs of migration (for example, costs faced upon arriving in a new country), thus making migration affordable to low-income people too. In addition, inequality may decline whenever a sizeable redistribution takes place among members of the villages from which migration originated.

Long-term growth effects

Remittances may stimulate overall long-term growth in source countries⁶ by lessening the balance of payments constraint and allowing the import of capital goods, by facilitating formation of human capital (as children staying behind have a greater chance to graduate from schools, as observed in Mexico), by allowing poorer households to acquire and access productive assets (land) and complementary inputs. Returning migrants who acquired technical and entrepreneurial skills in advanced countries may also contribute to this growth acceleration (as observed for Turkey and Egypt by McCormick and Wahba, 2001).

With regard to the impact of migration on the countries of destination, IMF (2007) argues that the effective global labour supply in OECD countries increased four times during the last two decades through imports of labour-intensive manufactured goods, outsourcing of production and immigration of unskilled and skilled workers. Except in some specific cases, this increase in unskilled and semi-skilled labour supply does not appear to have displaced domestic workers. Instead immigrants appear to have generally replaced domestic workers in jobs left vacant due to a decline of the local labour force, higher education of local workers and expectations of finding employment in higher paid jobs. Migration may therefore have contributed to the observed rise in the skilled/unskilled wage ratio by causing a stagnation in the unskilled labour wages in countries of destination (as observed, for instance, in Italy). However, the literature offers other explanations of the deterioration in the skilled/unskilled wage ratio, including limited supply of skilled workers relative to a fast technology-driven increase in its demand (though this is less true countries where college education is by and large state-financed), unfavorable changes in labour institutions (concerning collective

⁶ The evidence in this regard is contradictory: Faini (2002) finds a positive but weak relation between migration and growth, Chami and others (2003) finds a negative relation, while the IMF (2005, table 2.1) finds no relation and shows that the investment rate does not increase in countries with high remittances/GDP ratios.

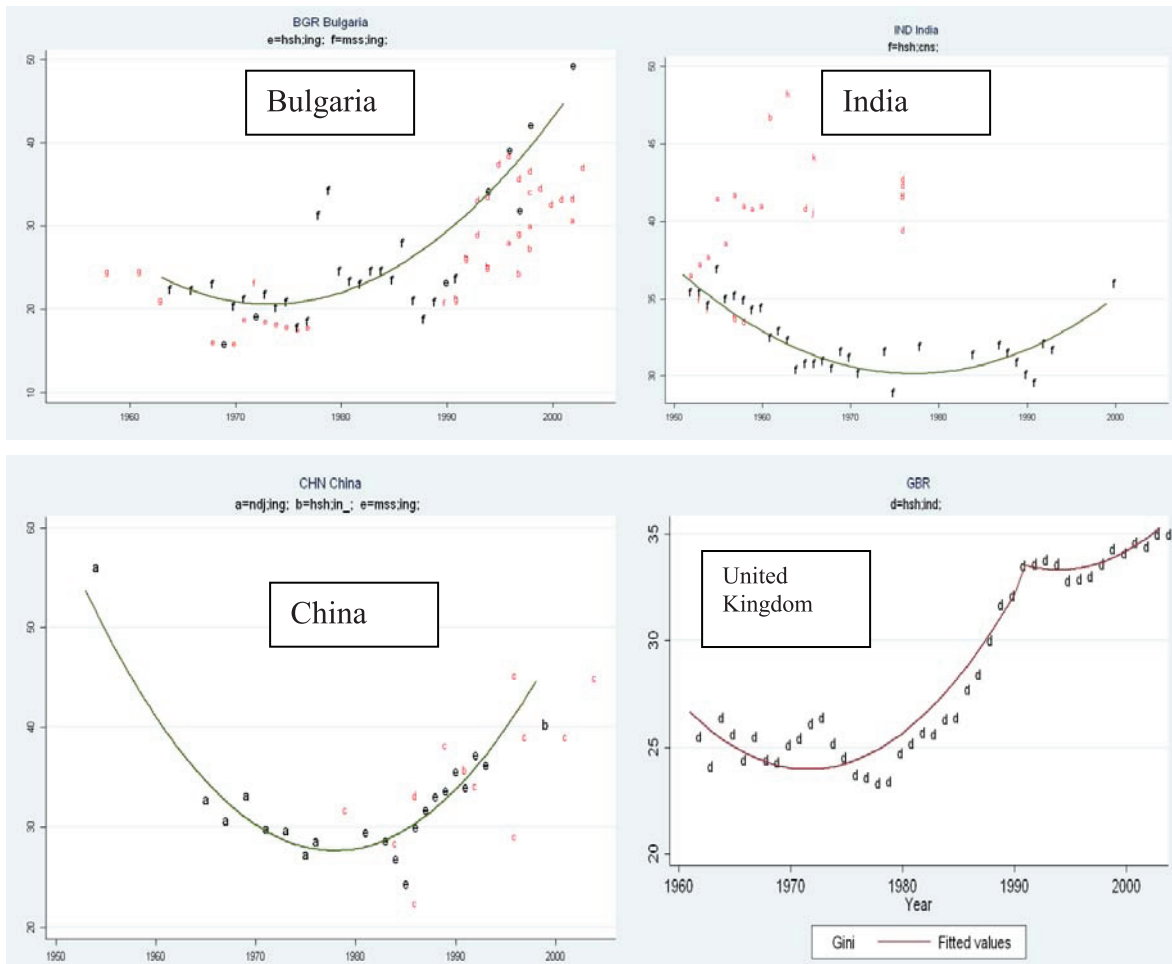
bargaining, minimum wages, hiring-firing costs, greater flexibility, and so on), and changes in social norms (explained by “winner takes all” theories) as manifested by large increases in the salaries of top managers and performers.

4. Observed inequality changes over 1980-2000, and 2000-2008

4.1 Trends during the period 1960-2000: widespread U-shaped increases in inequality

It is now broadly accepted that income inequality declined in several countries between the 1950s and the mid-late 1970s as a result of the rapid growth of employment following postwar reconstruction, the development of the welfare state in OECD and socialist countries, and institutional reforms (for example, land and social security reform) in a number of developing countries (Cornia, 2004). In contrast, inequality rose in the majority of the developed, developing and transitional countries between 1980 and 2000. With an initial decline and subsequent increase, income inequality between 1960 and 2000 followed in several countries a more or less symmetric and pronounced U-trend, with the inequality rise stabilizing in some cases during the 1990s, as in the case of the United Kingdom (figure 2).

Figure 2: Inequality dynamics in various countries as measured by the Gini coefficient of income distribution, 1960-2000



Source: Author's calculation based on WIDER's WIID2a data.

The data in table 7 document in detail this broad trend over 1960-2000 on the basis of WIDER's WIID2a database (dated 28 June 2005). WIID2a included 4,464 Gini coefficients for 154 countries. Out of these, 1,165 (deemed to be based on "high quality" data for 85 countries) were selected, eliminating observations for the years prior to 1950 and for countries with fewer than six well-spaced data-points or highly bunched data, or for which the surveys had an incomplete territorial coverage. The countries included in the study account for between 89 per cent and 99 per cent of the population and 95 per cent to 99 per cent of the GDP (measured using purchasing power parity (PPP) exchange rates) of the respective regions, except for SSA and MENA, which have a much lower coverage (see table 7).

Table 7: Trends in inequality (as measured by Gini coefficient of income distribution) from the 1950s to around 2000, in 85 developed, developing and transition economies

Inequality trends	OECD	Transition economies	Total	Developing economies				World
				LAC	MENA	SEEA	SSA	
A. Number of countries experiencing different inequality trends								
Rising inequality	13	24	22	8	2	8	4	59
U-shaped increase	10	11	14	3	1	8	2	35
Linear increase	3	13	8	5	1	0	2	24
No change	1	1	15	5	3	4	3	17
Falling inequality	6	0	3	2	0	1	0	9
Total	20	25	40	15	5	13	7	85
Sample countries (as a percentage of countries with population greater than 0.5 million people)	91	93	35	60	24	54	16	52
B. Percentage of population living in countries experiencing different inequality trends								
Rising inequality	61	98	77	64	40	84	39	76
U-shaped increase	55	43	70	18	36	84	25	66
Linear increase	6	55	7	46	4	0	14	10
No change	15	2	21	25	60	15	61	19
Falling inequality	23	0	2	11	0	1	0	5
Total	100	100	100	100	100	100	100	100
Population sample (countries as a percentage of regional population of countries with greater than 0.5 million people)	98	98	81	89	50	94	35	85
C. Percentage of GDP-PPP produced in countries affected by different inequality trends								
Rising inequality	67	97	73	64	34	79	79	71
U-shaped increase	61	44	62	23	22	78	73	60
Linear increase	6	54	11	41	12	0	6	11
No change	15	3	24	28	66	19	21	18
Falling inequality	19	0	3	8	0	2	0	12
Total	100	100	100	100	100	100	100	100
GDP-PPP sample (countries as a percentage of countries with population greater than 0.5 million people)	98	99	89	95	47	98	55	94

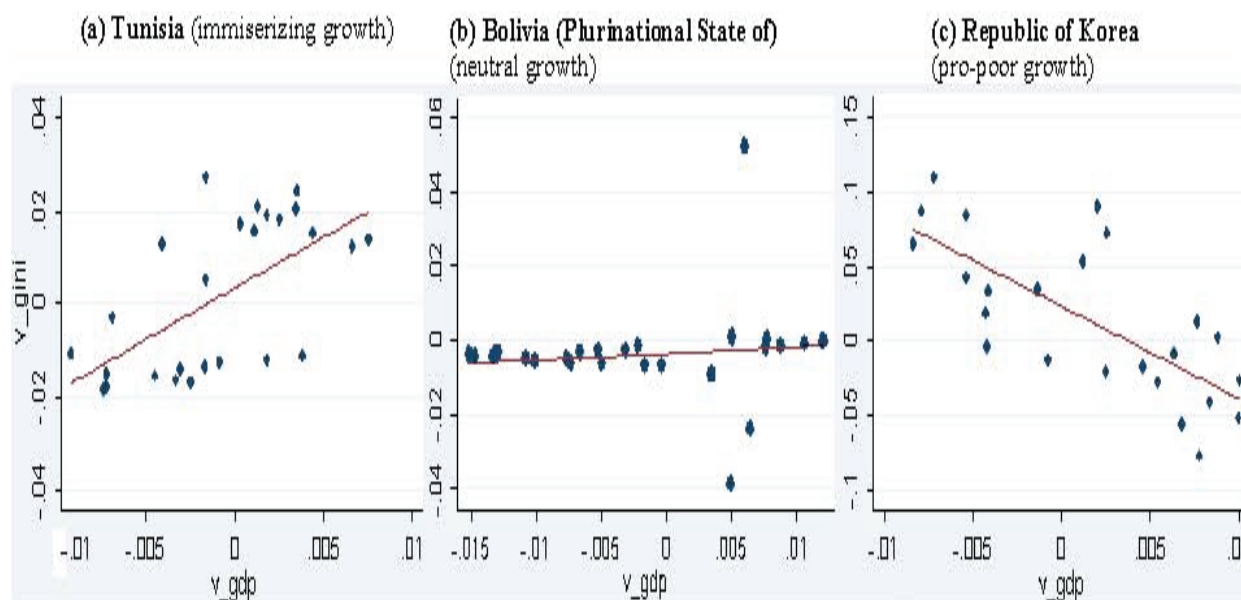
Source: Author's calculations based on WIDER's WIID2a database.

Note: (A) Trends in Gini coefficients were obtained by interpolating the data with linear, quadratic and hyperbolic functions. The best results were chosen on the basis of the highest F, t and R2 values. (B) The income concept used refers to disposable income in the case of 35 countries (mainly for OECD and Latin America), gross household income in the case of 24, gross earnings in the case of 13 transition countries and net earnings in the case of 2 transition countries, and consumption expenditure in the case of 11 countries. (C) Of the 1,165 Gini coefficient values, 389 pertain to 20 OECD countries, 300 to 25 transition economies and 476 to 40 developing countries.

This trend analysis (as well as analysis of several country studies and regional reviews) indicates that income inequality rose over 1980–2000 in 59 of the 85 countries for which time series data on inequality were available. These include most of the large economies such as Argentina, Brazil, China, Russian Federation, United States and United Kingdom. In 16 of these countries, the rising trend of inequality stabilized in the late 1990s. In 17 of the remaining countries, inequality remained, by and large, unchanged and in 9, it fell. These include large countries such as Bangladesh, Indonesia, Japan, Mexico, Nigeria, Thailand and Turkey. Inequality declined in nine countries, including some small European countries and a few medium ones. Inequality increase was near universal in the transition economies and very common in OECD countries, but less general in the developing countries, particularly in SSA and MENA, for which however, the data were limited and not of high quality.

It may be argued that the worsening of income inequality over 1980–2000 was due to the poor GDP growth performance that characterized the “lost decade” of the 1980s and in some regions (such as SSA, Latin America, Japan and the transition economies) the 1990s. In other words, rising inequality might have been caused by a slow or negative growth rather than other factors such as greater global economic integration. Indeed, a look at the GDP-growth relationship suggests that in 40 per cent of the 85 countries, changes in GDP growth and changes in inequality were inversely related (as expected on the basis of labour market changes) with changes in GDP growth (see figure 3(c), displaying the relationship concerning the Republic of Korea). Thus, in some countries, inequality might have risen due to poor growth. However, in 38 per cent of the countries, changes in inequality and GDP were not found to be unrelated (see figure 3(b)), suggesting that other factors are responsible for the rise of inequality in these countries. Finally, in 22 per cent of countries, inequality rose during years of rapid growth (see figure 3(a)). Thus, in about 60 per cent of the cases, inequality was due to other than cyclical factors.

Figure 3: Relation between yearly percentage changes in GDP (x-axis) and percentage changes in the Gini coefficient of the distribution of household income (y-axis), 1980–2000



Source: Author's calculations based on WIDER's WIID2a database.

4.2 Bifurcation of inequality trends across regions during the 2000s

Between 2000 and 2008, most transitional and developing regions (including the laggard countries of SSA and Latin America) experienced a return to growth. The decade since 2000 marks also a clear bifurcation of inequality trends across regions. On the one side, Latin America, and to a much lesser extent SSA⁷, recorded a *decline* in income inequality (see table 8), while in other regions inequality rose more frequently than it declined, though the extent of the rise was generally more moderate than in the past. This is evident in OECD, transition, MENA and SEEA countries. Outside Latin America and SSA, inequality fell in 19 countries, while it rose in 33 and stagnated in 20, as confirmed by several recent studies (OECD, 2008; Mitra and Yemtsov, 2006; Koujanou-Goldberg and Pavcnik, 2007). The reasons for this trend in bifurcation will be explored in section 5, which compares the policy experience of Latin America with that of EEFSU.

Table 8: Trends in inequality (measured by the Gini coefficient of income distribution) since 2000 in 114 developed, developing and transition economies

Inequality trends	OECD	Transition economies	Total	Developing economies				World
				LAC	MENA	SEEA	SSA	
A. Number of countries experiencing different inequality trends								
Rising inequality	8	12	21	3	4	7	7	41
No change	10	7	15	3	1	2	9	32
Falling inequality	5	7	29	12	2	5	10	41
Total	23	26	65	18	7	14	26	114
B. Percentage of population living in countries experiencing different inequality trends								
Rising inequality	21	36	70	29	45	88	21	60
No change	70	22	6	8	4	3	26	17
Falling inequality	9	42	24	63	51	9	53	23
Total	100	100	100	100	100	100	100	100
C. Percentage of GDP-PPP produced in countries affected by different inequality trends								
Rising inequality	19	33	63	35	48	79	46	36
No change	73	20	7	7	3	6	15	45
Falling inequality	8	47	30	58	49	15	39	19
Total	100	100	100	100	100	100	100	100

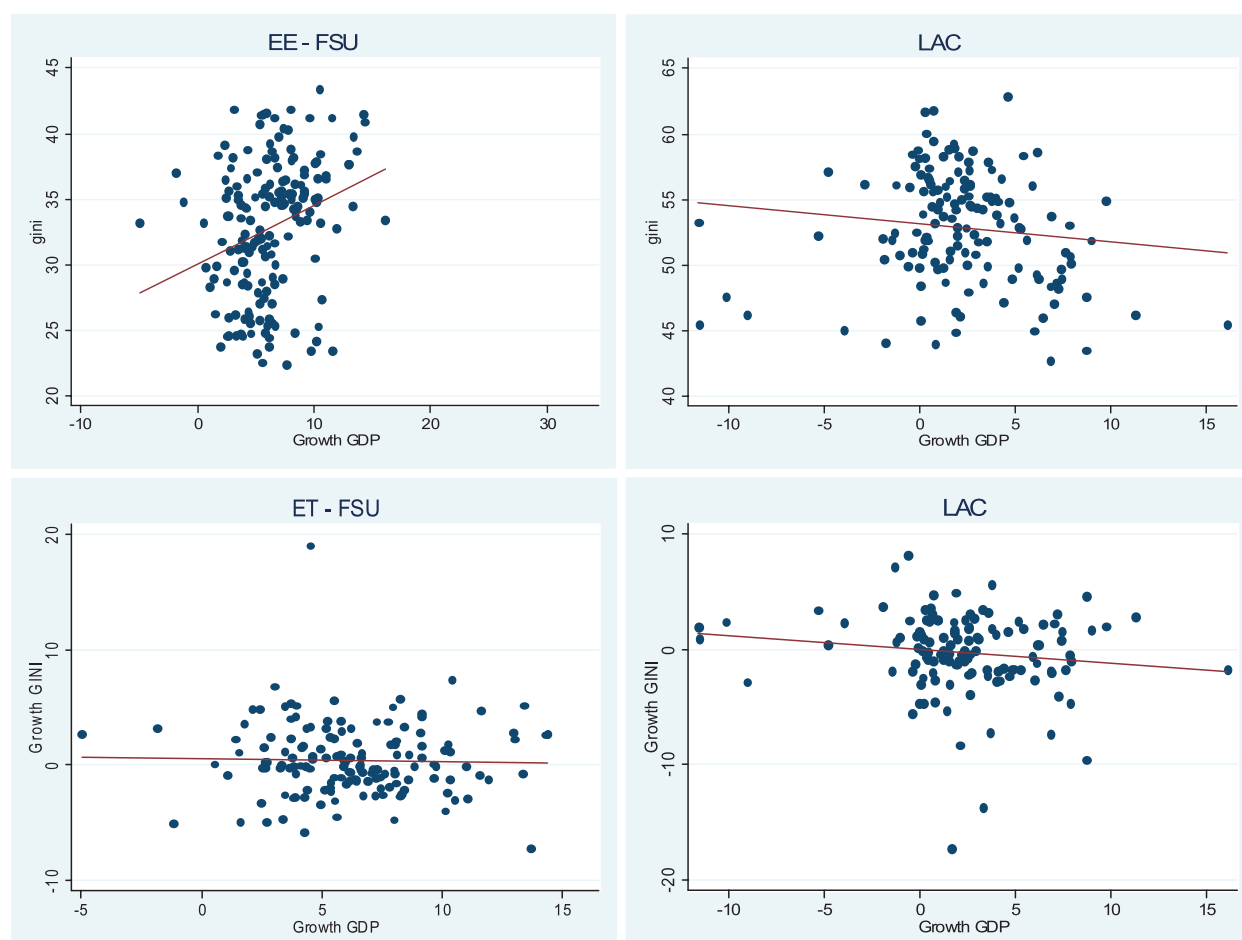
Source: Author's computation based on data reported in Cornia and Martorano (2009) for Latin America and Solt (2009), and on the basis of WIDER's WIID database, version 2.0, July 2009.

5. Public policy, distribution and growth: Comparative experience of Latin America and Eastern Europe and the Former Soviet Union (EEFSU)

It has been argued in section 3 that during the recent decade of rapid economic integration, inequality dropped significantly in Latin America and increased further (if in fewer countries and at a slower pace) in EEFSU. How can we reconcile these divergent trends in the light of the findings in section 4 which suggest that economic integration (via trade, FDI, portfolio flows and migration) is likely to be un-equalizing? A first answer to this question is that during 2000-2008, the EEFSU growth pattern was un-equalizing while that of Latin America was equalizing (see figure 4). A second observation is that EEFSU is the region that was most

⁷ Data for this region refer however to a short period and, in addition, may have quality problems.

Figure 4: Relationship of GDP growth rate with level and growth (change) in inequality (measured by the Gini coefficient of income distribution) in EEFSU and Latin America, 2000-2008



Source: Author's calculation based on WIDER's WID2a database and World Bank's World Development Indicators database.

affected by the current financial crisis, while Latin America was less affected. What factors explain these differences? To answer these questions and to draw some lessons for future policymaking, this section compares the sources of decrease in inequality recorded in Latin America with those that led to its increase in EEFSU.

5.1 *Similarities and differences in the economic and political structures of the two regions*

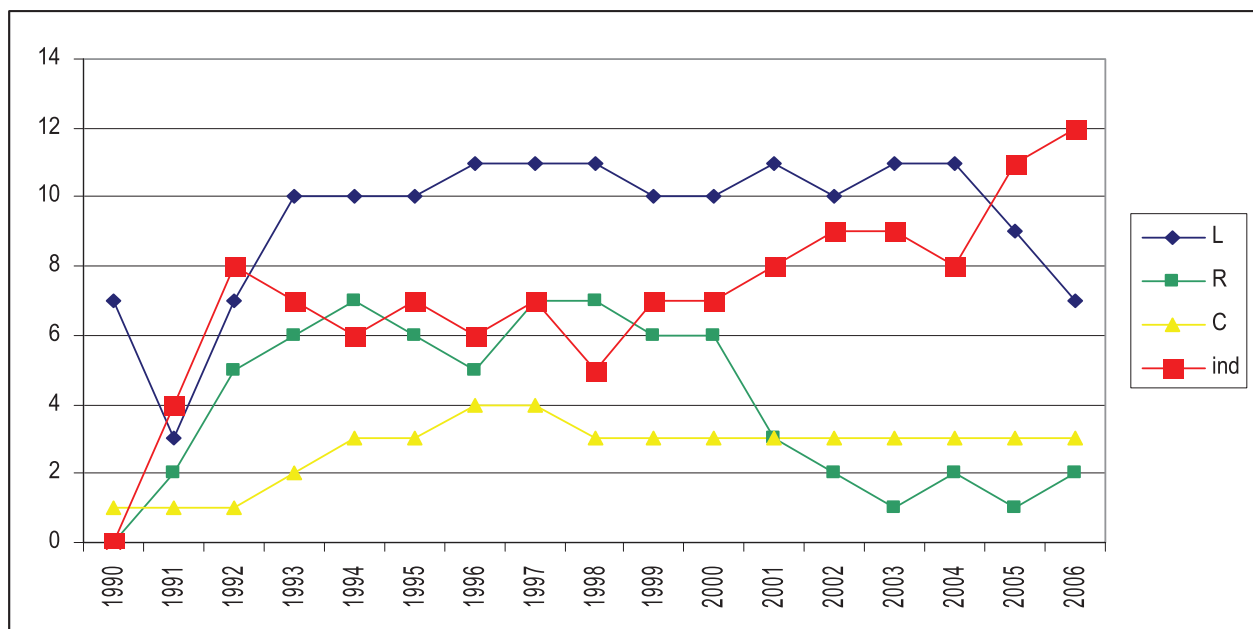
EEFSU and Latin America are both middle income regions, except for a few Central American, Caribbean, Balkan and Central Asian countries which have lower per capita income. Both regions are also highly heterogeneous in terms of economic structures. Latin America includes a group of semi-industrialized countries (the Southern Cone and Mexico), a group of commodity exporters (the Andean countries), another group depending on migrant remittances (most Central American and Caribbean countries, Ecuador and Peru), and only Haiti depending on aid. Likewise, EEFSU comprises a cluster of industrialized countries (the Central European countries, Bulgaria and Romania), another group of commodity exporters (Azerbaijan, Kazakhstan, Russian Federation, Turkmenistan, Uzbekistan), a third group where high- and low-tech services (transit fees, tourism, and others) play a key economic role, and a fourth group of countries (Albania, Armenia, Bosnia, Kyrgyzstan, Republic of Moldova, Tajikistan) which are dependent on remittances. Since

the two regions are “similarly heterogeneous”, structural differences cannot explain the observed differences with regard to growth, inequality and volatility during the last decade. Indeed, until mid-2008, both regions benefited from favourable trends in commodity prices and access to global finance and remittances, and both suffered from major reversals that occurred in these respects in 2008-2009.

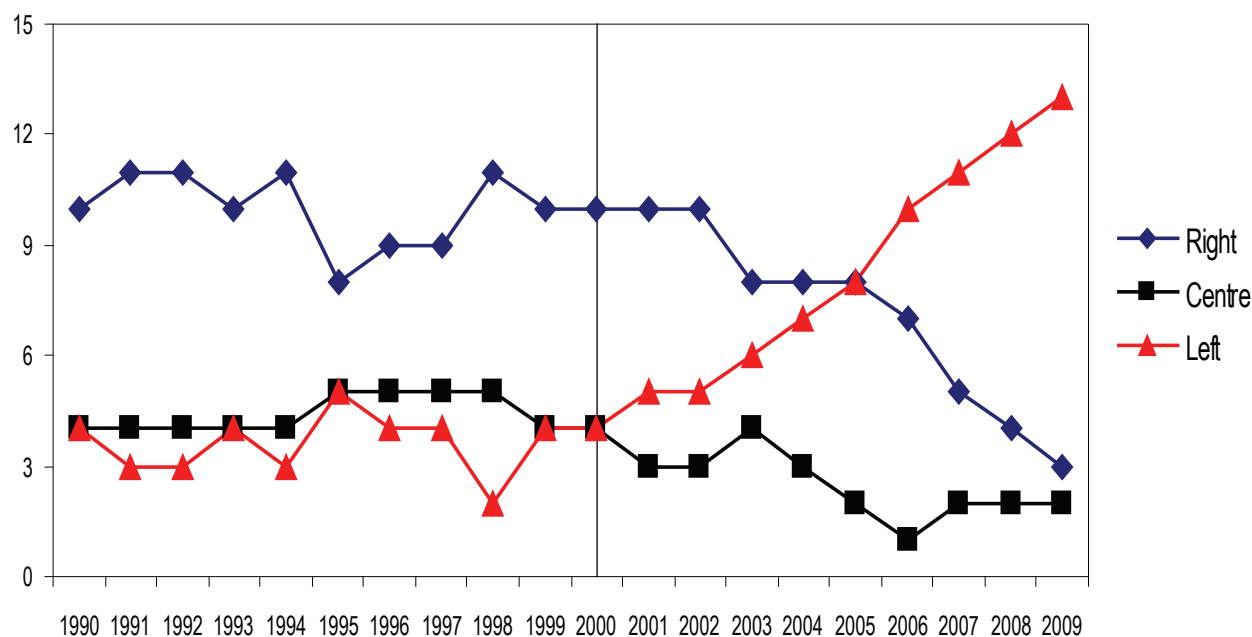
In contrast, the political history of the two regions has been very different. The EEFSU countries emerged in 1989 from decades of communist rule, state dominance in every sphere of life, and an overly compressed income distribution. Though important transformations had been achieved between 1989 and 2000 (though at a cost of greater than expected recessions and rise in inequality), it is possible that the political and economic decisions since 2000 were influenced by the perceived need for reducing further the role of the state in the economy, introducing more incentives and moderating the spirit of egalitarianism inherited from the past. One may see the reflection of such perceived needs in the decline of the number of left-of-centre (L) and nationalist, right-of-centre (R) regimes and the parallel rise of pragmatic “independent” regimes (Ind) focusing on sound macroeconomic policies, joining the European Union (EU), domestic liberalization and global economic integration while lacking a clear distributive agenda (Central Europe is an exception) (see figure 5).

The political trajectory of Latin America has been quite different. For long, the region has been a symbol of authoritarianism, unequal distribution of assets and income, and limited or no redistribution by the state. However, during the last 20 years, the political landscape has been dominated by a steady drive towards democratization and, starting from the mid-to-late 1990s, by a steady shift in political orientation towards left-of-centre (LOC) regimes, either social democratic or national-populist (see figure 6). Matters of social justice and economic development are at the core of the new LOC parties’ identity. However, in the pursuit of such objectives, the LOC parties avoided the ill-conceived approach to budget deficits and inflation typical of the populist regimes of the 1980s. In fact, the LOC economic model incorporates “liberal” elements

Figure 5: Changes in political orientation in 24 EEFSU countries, 1990-2009



Source: Author's compilation based on Keefer (2007) and national data reported by Wikipedia for the years 2006-2009.

Figure 6: Changes in political orientation in 18 Latin American countries, 1990-2009

Source: Cornia and Martorano (2009).

such as a prudent fiscal policy and low inflation, awareness of the inefficiencies associated with some types of state intervention, the primacy of the market in price formation, regional trade integration, and openness to foreign investment. At the same time, the LOC economic model's concern for poverty and inequality, recognition of market failures, and attachment of importance to strengthening of state institutions are in stark contrast with the neo-liberal emphasis on shrinking the state and the self-sustained role of markets (Panizza, 2005).

5.2 Differences in policy models

The two regions adopted some common policies but differed clearly in other areas, which are discussed below.

Budget deficit, public debt, inflation and current-account balance

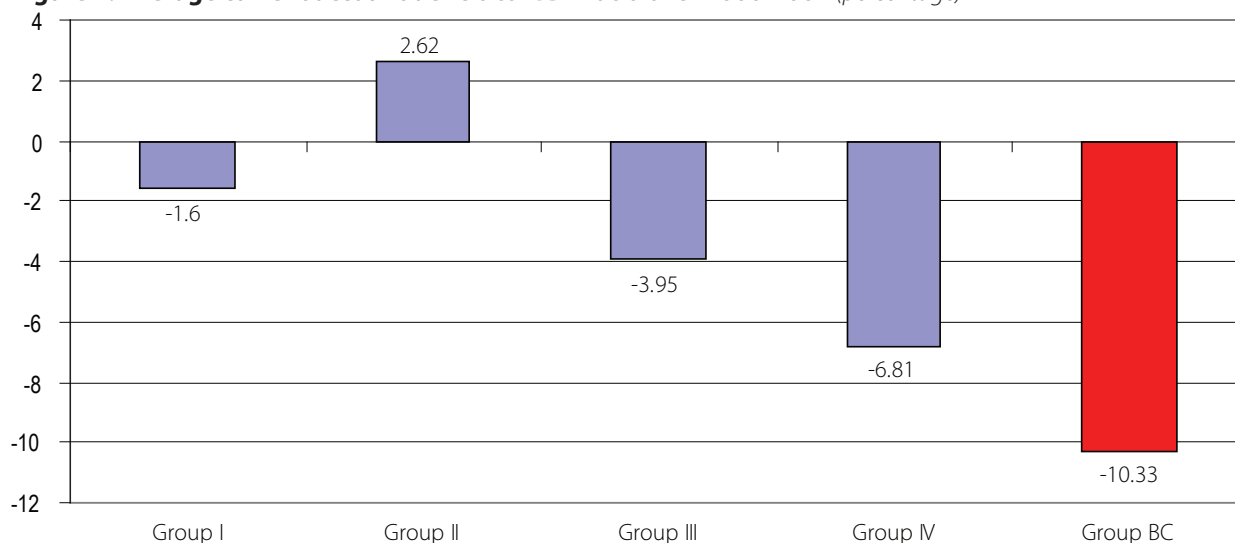
During the last decade, Latin America abandoned to some extent its traditional pro-cyclical fiscal and monetary policies.⁸ In all Latin American countries there was a sharp decline in budget deficits which typically fell below one per cent of GDP. In many cases deficits were turned into surpluses. LOC governments attempted also to reduce their dependence on foreign borrowing. Argentina and Brazil prepaid their outstanding IMF debt; a few others restructured their foreign debt, securing considerable discount in the process, and yet others benefited from the Heavily Indebted Poor Countries (HIPC) program. As a result, the gross public foreign debt net of fast growing currency reserves fell from 33 per cent to 8 per cent of GDP. Meanwhile, inflation fell to between 4 and 9 per cent except in the Bolivarian Republic of Venezuela.

The EEFSU followed a similar prudent and cautious approach with regard to public finance, but not to current-account balances. Since the mid-1990s, convergence in fiscal and monetary policies within the

⁸ Ocampo (2009) argues, however, that the improvements in budget deficits recorded during this period do not fully reflect a shift to countercyclical fiscal policy, which would have required the realization of larger fiscal surpluses.

region led to a reversal from a budget deficit (of about 3 per cent) in 2000 to a balanced budget by 2007.⁹ Similarly, public debt-to-GDP ratio fell from 47 per cent to 25 per cent, and the inflation rate fell from 18 per cent to 7 per cent (Cornia, 2009). In contrast, the current-account deficit rose sharply, reaching between 10 and 25 per cent of GDP, particularly in the Baltics, Belarus, Bulgaria, Hungary, Republic of Moldova, Romania and Ukraine.¹⁰ By comparison, current-account deficits remained between 3 and 6 per cent in Central Europe and at 1.6 per cent in Latin America (see figure 7).¹¹

Figure 7: Average current account deficit-to-GDP ratio over 2000-2007 (percentage)



Source: Author's calculation based on official data.

Notes: **Group I:** Latin America; **Group II:** Kazakhstan, Kyrgyzstan, Russian Federation, Tajikistan, Turkmenistan, Uzbekistan.

Group III: Armenia, Azerbaijan, Georgia, Ukraine. **Group IV:** Albania, Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, the former Yugoslav Republic of Macedonia, Poland, Republic of Moldova, Romania, the Slovak Republic, Slovenia.

Group BC: Estonia, Latvia, Lithuania.

The huge current-account deficits of the EEFSU countries were not due to public profligacy but were made possible by a surge in private foreign debt financed by a massive inflow of FDI and easy access to “cheap money”, that is to say, hard-currency loans (both corporate loans and household mortgages) at low interest rates provided by local subsidiaries of foreign banks. In the Baltics, Bulgaria, Hungary and Romania, between 50 and 85 per cent of bank loans were made in foreign currency, thus giving rise to currency mismatch, strong dependence on decisions of global players, and high external indebtedness (Aslund, 2009). By 2008, five countries (Bulgaria, Estonia, Hungary, Latvia and Slovenia) had foreign debts in excess of 100 per cent of GDP.

While it has been argued that current-account deficits do not pose a problem as long as they are financed by FDI, in the case of EEFSU a high reliance on FDI turned out to be not only a source of growth but also a cause of fragility. Indeed, a very high proportion of the output of the foreign investments was exported to Western Europe, that is to say, the same region from which most FDI originated. This made the external accounts of EEFSU excessively dependent on the business cycle of Western Europe. Table 9 confirms that during the period 2000-2008, EEFSU received on average 6.5 per cent of its GDP per year in foreign financing (with peaks of 14 per cent in Bulgaria) as opposed to about 4 per cent in Latin America.

⁹ Only Hungary incurred an average deficit-to-GDP ratio of over 7 per cent over 2005-2007.

¹⁰ In Bulgaria, the deficit of the current-account balance exceeded 25 per cent of GDP in 2007 and 2008.

¹¹ Except for the crisis years of 2001-2002 the current-account balance has always been positive.

Table 9: FDI/GDP flows, 2000-2008 in the economies in transition

	2000-2006	2007	2008
Eastern Europe and the Former Soviet Union (EEFSU)			
Central Europe and the Baltics (of which)	5.7	6.6	4.8
Estonia	9.8	12.9	8.3
Latvia	4.2	8.3	4.5
South-Eastern Europe	5.4	11.6	8.1
Bulgaria	11.8	29.6	18.4
Eastern Europe and the Caucasus (of which)	7.9	5.4	7.9
Republic of Moldova	5.6	11.2	11.6
Russian Federation	1.7	4.3	4.2
Central Asia	4.6	8.1	6.6
EEFSU Total	5.7	7.7	6.5
Latin America and the Caribbean (LAC)			
Central America and the Caribbean (of which)	3.9	5.8	5.9
Panama	6.3	9.7	10.3
South America (of which)	3.1	3.4	3.9
Chile	5.8	7.7	9.9
LAC Total	3.5	4.5	4.8

Source: UNCTAD's investment database.

Excessive reliance on foreign loans and FDI turned out to be an element of fragility. During the boom years, the impact of foreign capital on inequality was positive in the case of Greenfield FDI in manufacturing, and negative in the case of mergers and acquisitions and bank-to-bank loans. During the crisis years, excessive dependence on loans from foreign banks made EEFSU vulnerable to a sudden stop in capital inflows which had a clear un-equalizing effect.

Exchange rate policy

The crises of the fixed-peg regimes of the 1980s and the 1990s epitomized by the collapse of the Argentinean currency board in 2001-2002, encouraged the Latin American countries (with the exception of fixed-peg Bolivarian Republic of Venezuela and dollarized Ecuador, El Salvador and Panama) to opt for crawling pegs or managed floats aimed at prevention of real exchange rate appreciation. The goal was to shift economic activity towards the labour-intensive traded sector (for example, manufacturing and agriculture) with favorable effects on income distribution. To support their currency exchange rates, Argentina, Brazil, Chile and Colombia introduced temporary capital controls, and allowed Central Banks to intervene in the currency markets, especially during the years of financial bonanza (2005-2007) so as to avoid an excessive real appreciation and likely increase of inequality.

In contrast, many EEFSU countries anchored their currencies, instead of letting them float. For example, Slovakia and Slovenia formally adopted the euro; Macedonia and Montenegro *de facto* adopted the euro; the three Baltic countries and Bulgaria established a currency board; Ukraine, Belarus, Kazakhstan and the Republic of Moldova adopted a dollar peg (Aslund, 2009). On the other hand, three other countries allowed a free float, and the rest (mostly from Central Europe) went for a managed float. The literature suggests that countries with currency boards or fixed pegs attract short-term capitals which expand domestic

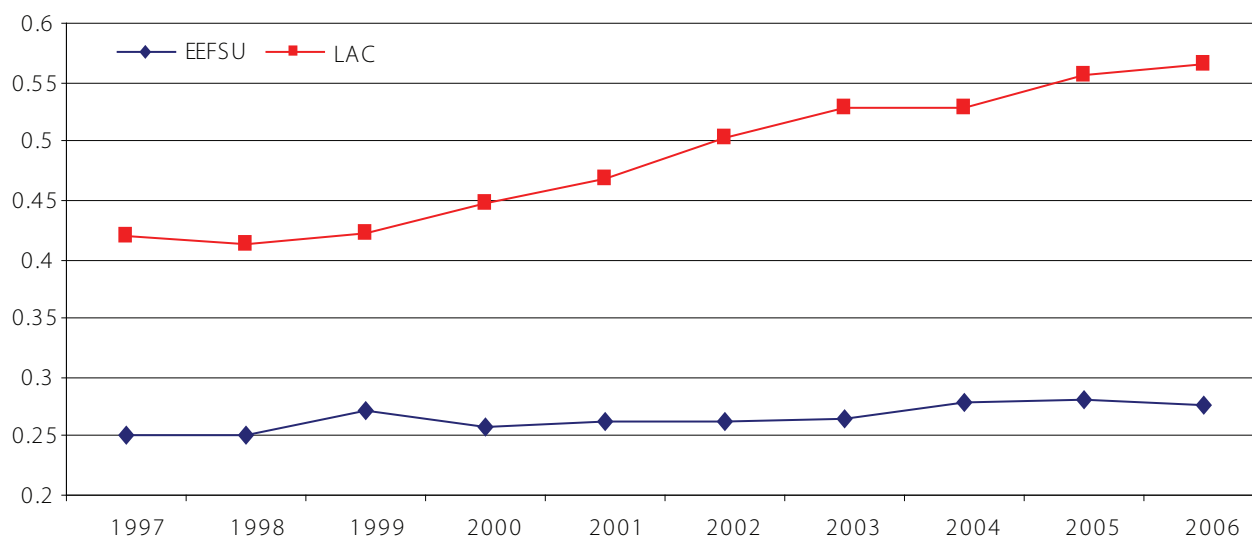
money supply and boost inflation, appreciate the real exchange rate and worsen income inequality by shifting capital and labour towards capital- and skill-intensive non-traded finance, insurance and real estate sector (Taylor, 2000). In addition, with a fixed peg, a deterioration of the balance of payments cannot be counteracted through devaluation, requiring instead large increases in interest rates and fiscal surpluses which cause marked and un-equalizing contractions of GDP while further attracting foreign capital. The countries most affected by the current crisis are precisely those which adopted fixed-peg type exchange rate (see table 11).

Labour market policies

Most Latin American countries addressed explicitly the problems of unemployment, job informalization, falling unskilled wages and the weakening of institutions for wage negotiations. Many countries introduced large-scale public work programmes, attempted to extend the coverage of formal employment and strengthened the institutions necessary for wage bargaining. They also decreed minimum wage hikes (see figure 8), which were generally found to be associated with lower earnings dispersion in both formal and informal sectors (Cornia and Martorano, 2009, and references therein). Despite the revival of unions, average wages rose slowly (Ibid.), possibly signaling the greater concern of policymakers for creating jobs than for raising wages.

The introduction of these policies in Latin America and the growth recorded between 2003 and 2008 led to a drop in the unemployment rate by 5.5 points in LOC and 2 points in non-LOC countries, and a fall in informal and self-employment, while the wage premium (sw/uw) declined in most cases (see table 10) due to a growing supply of educated workers (see below) and a shift in production towards the unskilled labour-intensive tradable sector, with positive effects on inequality.

Figure 8: Trends in minimum wage/average wage ratio, 1997-2006, in LAC and EEFSU



Source: International Labour Organization.

Notes: LAC countries: Argentina, Brazil, Chile, Colombia, Costa Rica, Honduras, Mexico, Panama, Paraguay, Peru, Uruguay and Bolivarian Republic of Venezuela. EEFSU countries: Albania, Armenia, Azerbaijan, Belarus, Bulgaria, Croatia, Czech Republic, Estonia, Georgia, Hungary, Kazakhstan, Kyrgyzstan, Latvia, Lithuania, Poland, Romania, Russian Federation, Slovakia, Tajikistan, Ukraine, Uzbekistan.

Table 10: Ratio of hourly wage by high/medium educational groups

	1992	2002	2007
Argentina	1.86	2.08	1.73
Bolivia (Plurinational State of)	..	2.71	2.14
Brazil	1.74	2.78	2.37
Chile	1.72	..	2.54
Colombia	2.52	..	2.85
Costa Rica	1.93	2.16	2.44
El Salvador	2.03	2.22	2.13
Panama	2.14	2.44	2.41
Paraguay	..	2.03	1.79
Peru	..	2.16	2.00
Dominican Republic	..	1.96	1.89
Uruguay	1.65	2.20	2.09
Venezuela (Bolivarian Republic of)	1.84	1.82	1.57

Source: Author's elaboration based on the CEDLAS database.

In EEFSU the rapid growth of 2000-2007 sharply cut unemployment which declined by between 3 points (in the Czech Republic) and 10 in Poland—though Georgia, Hungary, Macedonia, Romania and Serbia exhibited a rise in joblessness (UNICEF, 2009a). In almost half the countries, including the top performer, Poland, the decline in unemployment was facilitated by large-scale out-migration. In contrast, minimum/average wage ratio in EEFSU countries stagnated at a low level (see figure 8), suggesting that the skill premium (sw/uw) has risen because of wage liberalization and the decline in human capital formation during the 1990s (see below). Finally, the liberal reforms adopted during the transition in EEFSU countries did not aim at developing those institutions (such as collective bargaining, unemployment insurance, public works) and safety nets that moderate earnings inequality, particularly in periods of crisis.¹²

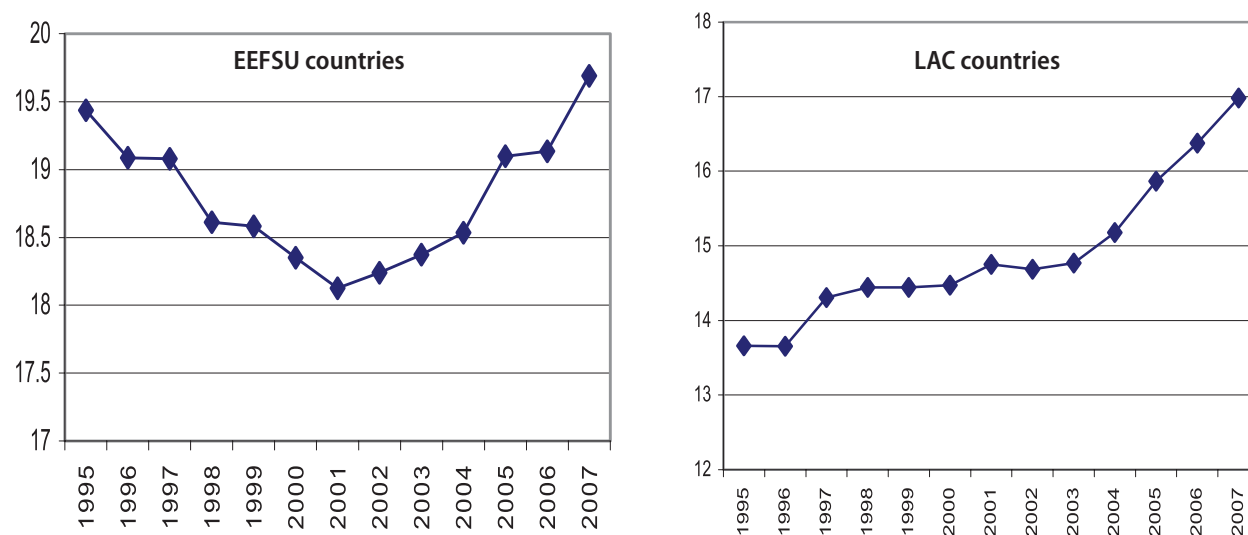
Tax policy and redistribution

Both regions improved revenue collection during the last decade. In Latin America, tax-to-GDP ratios started rising in 1995, accelerating further since 2003 (see figure 8).¹³ The tax-to-GDP ratio increased by 6 to 10 percentage points in Argentina, Brazil, Bolivia (Plurinational State of), Colombia and Venezuela (Bolivarian Republic of), which reached a level of taxation similar to that of the United States. The increase in tax-to-GDP ratio observed above is of structural nature and reflects improved tax administration and collection. Of the additional tax revenue collected since 2002 more than half came from direct taxes, a third from TVA, and the rest from other taxes. Overall, while tax reform still has a long way to go, these changes rendered the tax system a bit more equitable. In addition, countries benefiting from gains in terms of trade appropriated part of these windfall gains in the form of non-tax revenue (half a point of GDP on average, and by 3 to 4 points in the key commodity exporters (CEPAL, 2007).

The evolution of tax-to-GDP ratio in EEFSU was affected by an initial decline that coincided with the deep and long transformational recession that these countries suffered. In their effort to raise tax revenue

¹² Between 2000 and 2007, earnings inequality rose in one third of the countries, stagnated in another third and fell in the rest (UNICEF, 2009a). Detailed research shows that returns to education rose following wage liberalization, technological modernization and growing informalization (Mitra and Yemtsov, 2006).

¹³ Regression analysis (Cornia and Martorano, 2009) confirms that tax-to-GDP ratio rose on average by 0.20 to 0.22 GDP points a year due to greater tax effort, a formalization of the economy, and tax buoyancy.

Figure 9: Tax-to-GDP ratios in EEFSU and Latin America, 1995-2007

Source: Author's calculations based on IMF Government of Finance Statistics.

Notes: **EEFSU countries:** Armenia, Azerbaijan, Bulgaria, Czech Republic, Estonia, Georgia, Hungary, Kazakhstan, Kyrgyzstan, Latvia, Poland, Romania, Slovakia, Slovenia, Tajikistan, Uzbekistan. **LAC countries:** Argentina, Bolivia (Plurinational State of), Brazil, Chile, Colombia, Costa Rica, Dominican Republic, Ecuador, El Salvador, Guatemala, Honduras, Mexico, Nicaragua, Panama, Paraguay, Peru, Uruguay, Venezuela (Bolivarian Republic of).

(which rose by 1.5 GDP point during the 2000s, against 2.5 for Latin America), the EEFSU countries relied on administrative simplifications, a lowering of tax rates, and the introduction of VAT and a personal/corporate income tax of the “flat tax”-type. While the three Baltic countries retained the highest pre-reform tax rate and generally increased the no-tax area (thus making the tax schedule relatively more progressive), the remaining EEFSU countries adopted very low rates (for example, 10 per cent to 15 per cent for the personal income tax, and 9 per cent to 25 per cent for the corporate income tax) that were equal to the lowest pre-reform tax rates (see table 10). In the latter case, the *ex-ante* effect of the tax reform is un-equalizing, even though there is no evidence that Laffer-type responses have generated revenue increases (Keen and others, 2008). While it is important to avoid generalizations, and while the effects of flat taxes are not necessarily regressive, it appears that tax changes in EEFSU countries most likely reduced tax progressivity, except in the Baltic countries.

In Latin America, the last decade has seen improvements in the field of social transfers (T_r), with favorable redistributive effects. During the 2000s, public expenditure on social security and social assistance rose, and there is evidence that its incidence became more progressive, thanks to a shift away from less progressive social insurance for the relatively few employed in the formal sector and towards a better financed social assistance (CEPAL, 2005 and Barrientos and Santibanez, 2009). This new emphasis entailed the development of large-scale poverty reduction programmes pivoting around unconditional cash transfers, conditional cash transfers, and integrated anti-poverty programmes which absorbed between 0.5 to 1 per cent of GDP and covered a high share of the population at risk. Several studies document the favorable impact of these programmes on human capital formation, while a study by Instituto de Pesquisa Economica Aplicada (IPEA) (cited in ECLAC, 2006) found that non-contributory pensions and *Bolsa Família* explained one third of the inequality decline observed in Brazil during 2000-2006.

In EEFSU, social protection systems are highly heterogeneous and the related outlays range between 4 and 20 per cent of GDP (UNICEF, 2009). Except in Central Europe, social protection remained heavily

Table 10: Countries adopting the flat tax in EEFSU

Country	Year of adoption	Personal income tax rate		Corporate income tax rate		Basic allowance
		Before	After	Before	After	
Estonia	1994	16-33	26	35	26	Increase
Lithuania	1994	18-33	33	29	29	Increase
Latvia	1997	25 and 10	25	25	25	Reduction
Russian Federation	2001	12-30	13	30	35	Increase
Ukraine	2004	10-40	13	30	25	Increase
Slovak Republic	2004	10-38	19	25	19	Increase
Georgia	2005	12-20	12	20	20	Eliminated
Romania	2005	18-40	16	25	16	Increase
Kyrgyzstan	2006	10-20	10	20	10	Unchanged
Macedonia	2007	15-24	12	15	12	Unchanged
Kazakhstan	2007	5-20	10	30	30	Increase
Albania	2007	1-20	10	20	20	Increase
Montenegro	2007	15-23	15	15-20	9	Increase
Czech Republic	2008	12-25	15	24	22	Increase
Bulgaria	2008	10-24	10	10	10	Eliminated

Source: Keen, Kim and Varsano (2008).

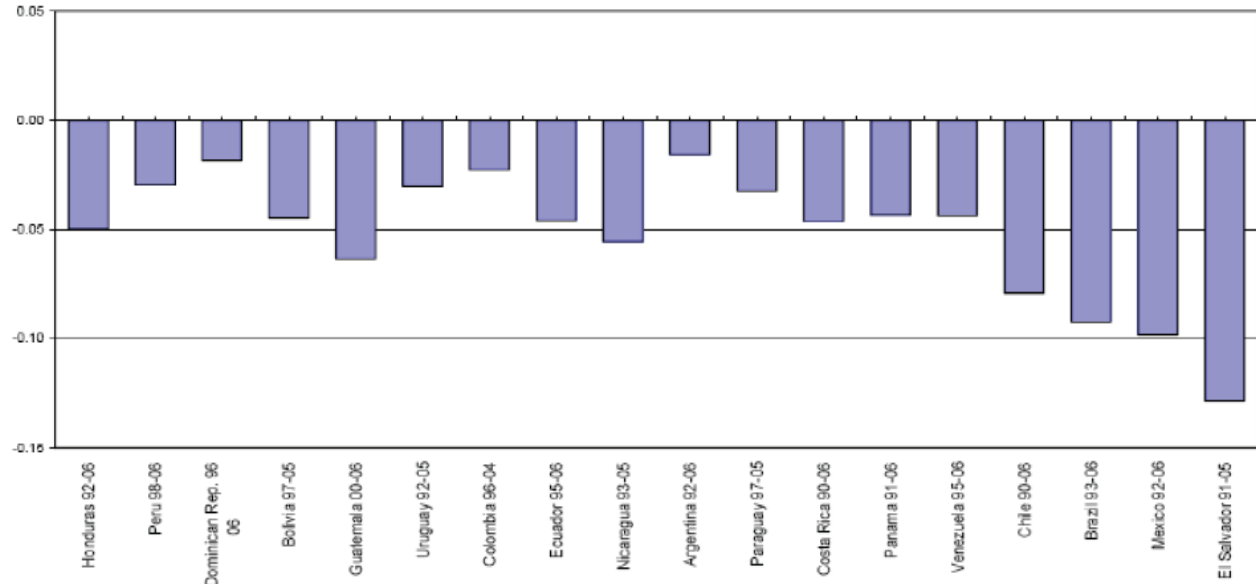
biased towards modestly progressive pension systems. Other benefits, such as unemployment benefit, sick pay and child allowances, all of which are much better targeted than pensions, have remained underfunded. Progress in the field of social assistance was less marked than in Latin America, as social protection had an entirely different meaning and modus operandi under central planning. As a result, these countries initially lacked the administrative infrastructure to manage social assistance programmes prevalent in market economies. For instance, in the early years of transition, many EEFSU countries introduced universal child allowances, but later on transformed them into means-tested programmes. Of the 12 countries for which data are available, child benefits absorb between 0.1 and 0.9 per cent of GDP. However, in six of them this ratio declined between 2000 and 2004-2006 (UNICEF, 2009). Thus, while the communist social protection systems had a far greater impact on income inequality than in Latin America, the last decade has seen a steady erosion of this initial advantage.

Investment in education and distribution of human capital among workers

A factor that contributed to the recent fall in income inequality in Latin America is the rise in enrolment rates recorded at all educational levels since the early-mid 1990s (Gasparini and others, 2009), and the subsequent reduction in enrolment inequality in primary and secondary education. For instance, the probability that a child from the bottom decile completes secondary education in relation to that of a child of the top decile rose on average from 36.7 per cent to 50 per cent between 1990 and 2005. Over time this reduction in enrolment inequality led to an increase in the average number of years of education of the working population, and a reduction in the Gini coefficient of the distribution of human capital among workers (see figure 10), thus contributing, *ceteris paribus*, to the decline in skill premium “sw/uw” (see table 11). An IPEA study (cited in ECLAC, 2006) concluded that two thirds of the inequality observed in Brazil between 2000 and 2006 was due to a fall in earnings inequality due to a drop in educational inequality among workers.

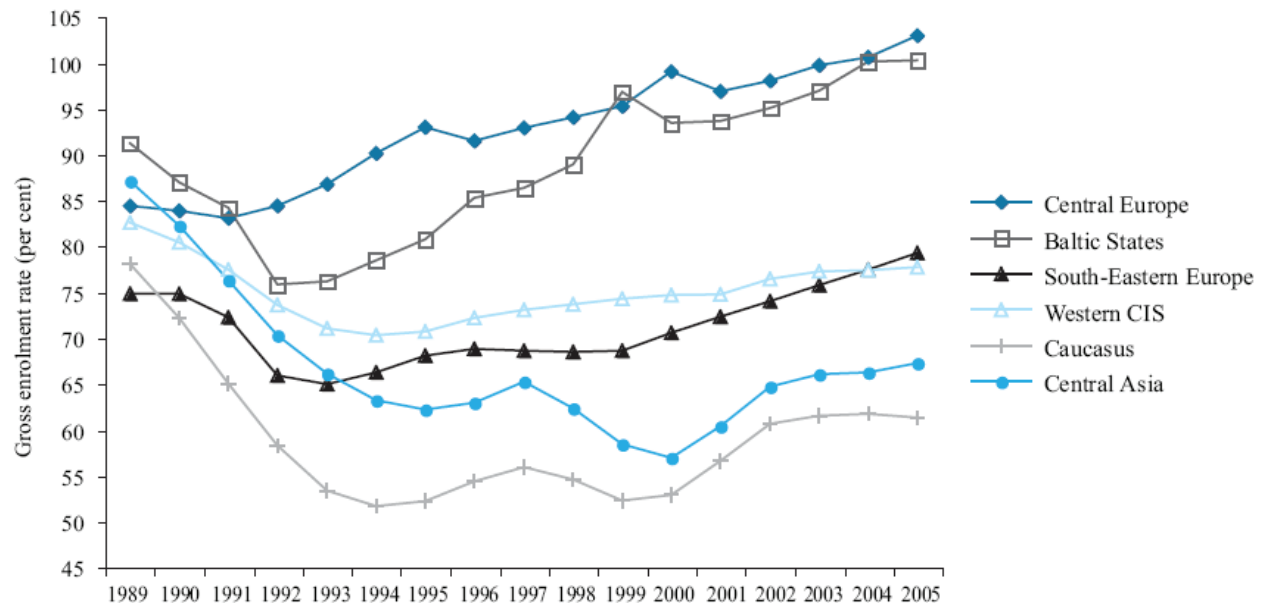
In contrast, in EEFSU, the 1990s were characterized by a fall in enrolment rates in upper secondary education catering to pupils of 15 to 18 years of age. This fall lasted until the mid-2000s, except in Central Europe and, to some extent, the Baltic countries (see figure 11). The enrolment decline was very marked among pupils of vocational schools from low and middle income groups but was also true (until the mid-1990s) for general public secondary and tertiary education. Enrolment in the latter have since recovered steadily (except in Bulgaria and a few Central Asian and Caucasus countries), mostly because of an expansion

Figure 10: Per cent change in the Gini coefficient of the distribution of years of education among the workforce, between mid-1990s and mid-2000s in 18 Latin American countries



Source: Gasparini and others (2009).

Figure 11: Trends in gross enrolment rates in upper secondary education in sub-regions of EEFSU (as a percentage of the population 15 to 18 years of age)



Source: UNICEF (2009).

of comparatively costly private universities affordable only to well-off families. The decline in enrolment was mostly due to the introduction of school fees, a fall in family incomes, the perceived low returns to technical education, and the deteriorating quality of educational institutions.

This trend suggests that a growing number of youth did not enrol in secondary education, and that the supply of skilled and semi-skilled workers declined with time. In other words, the average level of education of the labour force in many EEFSU countries stagnated or declined during the 2000s, precisely when fast growth and modernization raised the demand for skilled labour. All these changes possibly pushed skilled wages upward and exacerbated inequality, as measured by the Gini coefficient of the human capital distribution among the workforce.

5.3 Differential impact of policies on growth, inequality and instability

The hyper-liberal reforms (including early liberalization of trade, FDI, capital flows and migration, fixed nominal pegs, flat tax, targeted social security, user fees in public services, rapid privatization and so on) introduced in EEFSU countries during the transition, and deepened during the decade since 2000, generated during 2000-2007 a GDP growth that was faster than in Latin America. FDI and foreign lending were a welcome addition to domestic savings and helped to enhance the growth performance (see table 11). In

Table 11: GDP growth in EEFSU, Latin America and the countries most affected by the 2009 crisis, 2000-2010

	2000-2006	2007	2008	2009	2010
Eastern Europe and the Former Soviet Union (EEFSU)					
Central Europe and the Baltics (of which)	5.6	7.0	1.7	-8.3	-0.4
Estonia	8.5	7.2	-3.6	-14.0	-2.6
Hungary	4.3	1.2	0.6	-6.7	-0.9
Latvia	8.6	10.0	-4.6	-18.0	-4.0
Lithuania	7.3	8.9	3.0	-18.5	-4.0
South-Eastern Europe (of which)	5.1	7.2	6.6	-3.6	0.5
Bulgaria	5.4	6.2	6.0	-6.5	-2.5
Romania	5.6	6.2	7.1	-8.4	0.5
Eastern Europe and the Caucasus (of which)	9.1	12.1	5.9	-7.0	2.6
Republic of Moldova	6.0	3.0	7.2	-9.0	0.0
Ukraine	7.4	7.9	2.1	-14.0	2.7
Russian Federation	6.9	8.1	5.6	-7.5	1.5
Central Asia	8.9	9.3	7.6	2.5	6.0
Total EEFSU	7.1	8.7	5.5	-4.8	2.1
Latin America and the Caribbean (LAC)					
Central America and the Caribbean (of which)	3.9	6.5	4.2	-1.4	3.0
Mexico	3.0	3.4	1.3	-6.7	3.5
South America (of which)	3.5	6.5	5.9	-0.1	4.7
Chile	4.3	4.7	3.2	-1.8	4.5
Paraguay	2.0	6.8	5.8	-3.5	3.0
Venezuela (Bolivarian Republic of)	4.1	8.2	4.8	-2.3	2.0
Total LAC	3.7	6.5	5.2	-0.7	4.3

Source: IMF, World Economic Outlook database, October 2009, and CEPALSTAT database.

addition, the EEFSU, and particularly the countries of Central Europe and the Baltic, became much more integrated into the global economy than any other region.

Yet, this policy model has run into four main problems. First, while the external economic integration of the region increased, its diversification remained limited. In fact, the growing integration with Western Europe, which accounts for 60 per cent to 90 per cent of the trade and financial transactions (Nutti, 2009), increased the vulnerability of EEFSU countries to shocks originating from Western Europe. In contrast, in Latin America, exports destination became more diversified, thanks to increasing trade links with the Asia-Pacific region and away from the United States. Second, EEFSU was the only emerging region to run collectively a persistent and large current account deficit, when, by contrast, Latin America consistently ran a surplus during 2003-2008 (see figure 7). Persistent deficits and rising indebtedness increased EEFSU's susceptibility to capital flow reversals.¹⁴ As a result of these two factors, though EEFSU grew as a whole by 7.1 per cent over 2000-2006, as opposed to 3.7 per cent in Latin America over the same period (5.4 over 2003-2006), this superior growth performance disappeared in 2008 and was reversed sharply in 2009-2010. This was particularly true for the Baltic countries, Hungary, Russian Federation and Ukraine. In Latin America, only Mexico (whose trade relations remained less diversified) recorded a large GDP decline in 2009. In this sense, the recent EEFSU crisis is a repeat of the Latin American debt-led growth and debt accumulation of the 1970s that ended with the crisis in the 1980s.

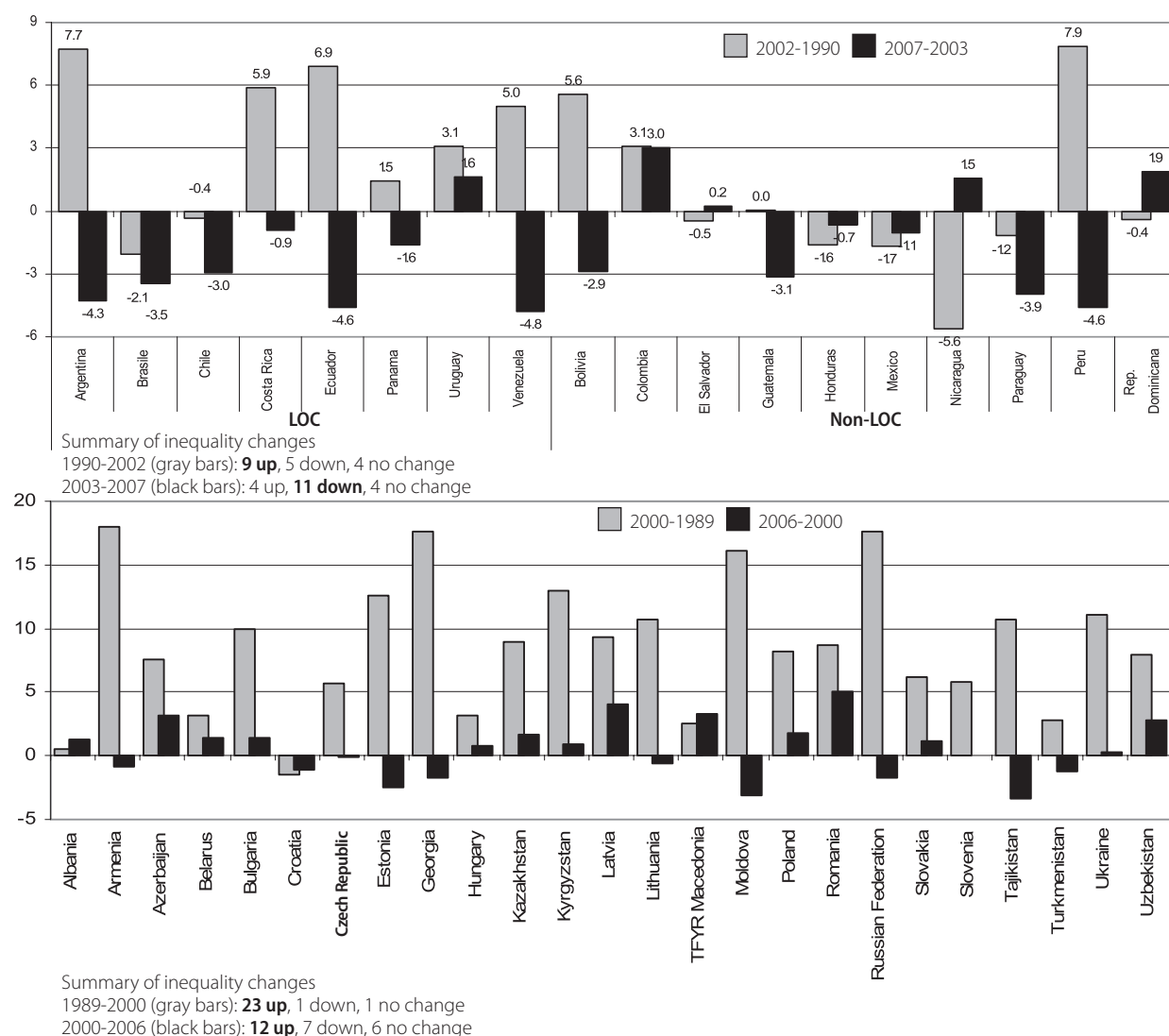
Third, the rigid neo-liberal policies adopted in much of the EEFSU region reduced the policy space (in the fiscal, monetary and exchange rate areas) for responding to external shocks that hit the region since late 2008. Finally, the neo-liberal policies of EEFSU have given rise to a pattern of growth that was often anti-poor, not only during the transformational recession of 1989-2000 but also during the roaring years of 2000-2007 (see figure 4). Yet, the worsening of inequality in the region during the recent period was comparatively small (see figure 12) so that, taking the combined effect of rapid growth and moderately rising inequality, the real incomes of the bottom deciles nevertheless increased.

The rise in inequality witnessed since 2000 in 12 countries of the EEFSU region was due to the factors examined in section 5 and, in particular, to the adopted controversial macro and tax policies, the distorting effects of a lopsided economic integration (that, as discussed in section 4, tends to raise inequality), the hands-off policy approach in the field of labour and educational policies, and to the limited interventions in the field of social transfers (here, again, with the exception of the Central European countries). Other factors not discussed in this paper that are often cited as having contributed to the inequality increase concern privatization and the introduction of user fees to formerly free public utilities. The rise in inequality in EEFSU in the last decade, however, needs to be seen in relative terms, because, despite this rise, inequality in this region (particularly in Central Europe and the Baltic) still remains well below the Latin American levels, largely due to a still much larger redistributive impact of direct taxes and public transfers (Zaidi, 2009).

Latin America introduced—thanks also to favourable external conditions—economic reforms broadly inspired by a “prudent redistribution with growth” model committed to reducing the social debt inherited from the colonial past and exacerbated by the liberal policies of the 1980s and 1990s. With few exceptions, the new policy model did not introduce a radical redistribution. Rather, it emphasized orthodox objectives, such as macro-stability, fiscal prudence, and the preservation of free trade and capital movements. Yet, in a clear departure from the 1990s, most Latin American governments opted for

¹⁴ Auer and Wehrmuller (quoted in Nutti 2009) estimate in 250 \$ billion the foreign debt of the region, much of which became sub-prime as many local currencies were devalued.

Figure 12: Changes in the Gini coefficient of the distribution of income in Latin America, 1990-2002 vs. 2003-2007 (top panel) and in EEFUSU, 1990-2000 vs. 2000-2006 (bottom panel)



Source: Author's compilation based on WIDER's WIID2 database, July 2009.

managed exchange rates, a prudent fiscal policy, reduced dependence on foreign capital, rapid accumulation of currency reserves, and a more active role of the state in the fields of taxation, labour market and social policies.

6. Policies to control inequality and promote growth in an open economy

What policy lessons can be drawn from the evidence on the inequality impact of international economic integration, and the comparison between the recent development experiences of Latin America and the EEFUSU? Leaving aside the issue of stabilization measures to be adopted to overcome the current crisis (beginning 2008), which development policies should be adopted in an increasingly open economy, in which, as the literature reviewed in section 4 suggests, economic integration may increase instability and raise the probability of crises and generate adverse distributional effects? The suggestions provided below—inspired in

good part by the above regional comparison—are of a general nature. Specific measures will have to reflect the different size, economic specialization, level of development and institutions of the countries considered. Yet, the common aim of the suggested measures is to avoid crises, promote growth and reduce inequality.

Limiting foreign indebtedness and mobilizing domestic savings

The comparison between Latin America and EEFSU confirms once more that while liberalization of the capital account offers an opportunity to access a global pool of savings, this policy entails several risks if it is accompanied by large and persistent capital account deficits financed with rising public or private foreign indebtedness. Such risk declines but does not disappear if the capital inflows take the form of mainly FDI. Thus, the recourse to foreign resources should be sustainable and selective. In fact, countries with a large foreign debt should gradually reduce it, as illustrated recently by the successful experience of several Latin American countries. This means that capital accumulation should be funded mainly by mobilizing domestic private and public savings through the development of the domestic banking network, as also shown by the experience of such countries of other regions as China, Malaysia and Viet Nam and, more recently, by a number of Latin American countries. Overall, the empirical evidence shows that open economies with larger domestic banking systems have smaller portfolio inflows than those with smaller domestic banking systems. A policy of moderate financial restraint could also be used to raise domestic savings and capital accumulation.

Controlling capital inflows and harnessing their sectoral allocation

Capital inflows can increase capital accumulation and (under certain conditions) exports, but can also cause a number of perverse effects. In countries with a large labour supply, an opening to green-field FDI in manufacturing is likely to generate positive growth and distributional effects, as shown by the past experience of Malaysia, Mauritius and a few Central American countries which attracted FDI to export-oriented manufacturing sectors employing unskilled and semi-skilled labour. The impact of FDI in other sectors needs closer assessment (see section 3) as its effect may generate trade-offs and require compensatory measures, for example, public work schemes for the people made redundant. In contrast, even in the presence of sound macroeconomic policies and strong regulatory institutions, countries should be free to impose market-based and administrative controls on portfolio inflows and outflows if these are likely to cause large swings in the real exchange rate and affect negatively the distribution of income (section 4). Such types of measures have been introduced recently in Argentina, Brazil and Colombia and, in the 1990s, in Chile, Colombia, Spain, and other countries. In addition, the central bank can set limits on the foreign exposure of domestic banks and the volume of hard currency loans in the domestic sector, forbid banks to borrow internationally or to extend loans to the non-tradable sector. The IMF now supports the introduction of temporary controls during crisis periods, but countries may consider extending such measures as long as they are needed, as China appears to be doing.

Choosing an appropriate exchange-rate regime

Such an exchange-rate regime should minimize the risk of currency crises, and at the same time provide adequate incentives for expansion of the traded sector, where the majority of the poor is often (but not always) employed. This means rejecting the views about the superiority of “two corner solutions” over intermediate regimes. Indeed, as shown in table 11, the EEFSU countries that suffered the largest GDP falls in 2009 and 2010 are those with currency boards and fixed pegs. It is obviously difficult to generalize, but in small- and medium-sized developing countries an intermediate regime aiming at credibly stabilizing

the real exchange rate and its expectations seems to be the best option. An example of such an exchange-rate regime is the BBC (basket, band and crawl) regime, adopted in Chile in the 1990s and in Argentina during the 2000s. Empirical research has shown that a stable and competitive exchange rate has been a key factor in kick-starting growth and improving the long-term performance of the economy (Rodrik, 2003). This approach leads to a slower decline of inflation, and needs to be supported by countercyclical fiscal and monetary policies and measures to control capital inflows. In addition, the BBC exchange rate may not help to improve income distribution in countries where the poor are located in the non-traded sector (for example, the urban informal sector) and the traded sector is skilled-labour intensive, or where the benefits of nominal devaluation are only in part passed on to the people employed in the traded sector. Yet, the BBC exchange-rate regime may be inappropriate in very small economies with highly volatile terms of trade and difficulties in diversifying their exports. Under these circumstances, dollarization may be an option. Finally, in large developing economies, a competitive exchange rate is less necessary for growth, poverty alleviation and reducing inequality as these objectives can equally be pursued through an expansion of domestic consumption and investment.

Counter-cyclical fiscal policy and stabilization funds

In many developing countries, government revenue oscillates widely because of fluctuations in the demand for and prices of their exports and weather shocks. Capital markets behave pro-cyclically and so reduce the possibility of stabilizing consumption in bad years. All this leads to large public expenditure cuts that exacerbate the shocks and worsen inequality. As the recent experience of a few Latin American countries shows, these problems can be tackled with prudent, counter-cyclical fiscal policies. Indeed, during the current crisis these countries were in a position to follow a more flexible monetary and fiscal policy entailing a sizeable fiscal stimulus and substantial deficits. This was possible because of budget surpluses, the low level of public debt, large accumulation of currency reserves, and decline in inflation achieved during the previous boom years. In countries with valuable commodities, counter-cyclical policies can be achieved via the creation of “stabilization funds” as done in Azerbaijan, Chile, Kazakhstan, Russian Federation and Venezuela (Bolivarian Republic of). Countries which can count on such funds and are able to make good use of them can control the rise of inequality during crises and large currency inflows and capital flights. The good use of such stabilization funds is not, however, to be taken for granted, as indicated by the recent Kazakhstan experience where large portions of the funds drawn down were used to recapitalize failing domestic banks.

Trade measures

As noted in section 4, in many cases trade liberalization has unexpectedly led to increases in inequality mainly due to short-run factors’ immobility, trade-induced skilled biased technological change, the confounding effects of simultaneous capital flows and exchange rate fluctuations, and other factors. Any further liberalization must therefore consider both the growth and inequality impact of these measures and avoid any further opening when the expected results in both areas appear negative or highly uncertain. In contrast, if trade liberalization promotes growth (for example, via technological modernization) but affects inequality (for example, by making redundant unskilled workers) it must be accompanied by compensatory programmes (for example, active labour market policies) to reduce the impact on inequality.

Supportive domestic policies

Supportive domestic policy measures have to be introduced for two reasons: first, to compensate for the adverse distributive effects of some international measures that may be desirable in terms of growth but not

in terms of their distributive impact; second, these equality-enhancing measures can generate positive effects on growth (see section 2) while reducing the un-equalizing effect of some measures (as, for example, when a substantial increase in the supply of skilled workers offsets the un-equalizing effects of a trade liberalization which increases the skill bias of production).

Among the domestic measures, those impacting the distribution of income more directly are policies pertaining to taxation and income transfers and human capital formation. Space limitation forbids a detailed illustration of the rationale and impact of these policies which are briefly reviewed below.

Tax policy must aim at gradually increasing tax-to-GDP ratios so as to be able to provide public goods, carry out social transfers that are considered “socially desirable”, and finance compensatory programmes required to offset the adverse effects of greater economic integration. Several countries in both Latin America and EEFSU have already moved in this direction, but in most cases there is a continued need to increase the progressivity of the tax instruments and to enhance the horizontal equity of taxation. This can be done not only with traditional progressive income and wealth tax but also with a flat tax, with a sufficiently high rate and sizeable no tax areas, with graduated value-added tax (VAT) rates, as well as with the appropriate taxation of mining rents and windfall profits. Greater taxation is important also to avoid the large accumulation of public debt or inflation due to monetization.

Income transfers generally generate strong redistributive effects, as already observed in Central Europe and a few Latin American countries. An intensification of income transfers can be carried out through both social insurance and social assistance. In this regard, the recent evidence suggests that the best approach may consist in “walking on two legs”. In a country with a limited formal sector, social security expenditure is not progressive, as it mainly covers a limited number of comparatively well-off formal sector workers. Focusing only on its expansion would be regressive. This raises the question of how best a government can expand social security coverage, whether by actively extending the formal sector (the evolution of which depends on many factors) or by setting up solidarity-based, non-contributory, universal or targeted funds providing basic benefits to informal sector workers and their families, including also conditional and non-conditional cash transfers. In middle-income countries, both approaches should be pursued at once.

Labour market (or income) policies are also required, and in both Latin America and EEFSU regions there is a need to strengthen the “labour institutions”, which help regulate the distribution of earnings, by addressing the problems of unemployment, informalization of labour, minimum wages, and the weakening of institutions for wage negotiations and dispute settlements. Specific programmes in this area include passive and active labour market policies, such as unemployment insurance, re-training programmes, reduced working hours, and self-targeting public-work schemes. Minimum wages—which most of the literature shows reduce inequality—need also to be raised to adequate levels. Finally, wage-bargaining institutions, which have been weakened substantially in most countries during the last three decades of liberal policies, now need to be strengthened. Efforts at “formalizing employment”, even at the cost of greater employment flexibility, may also be needed.

Finally, recent evidence suggests that an improvement in the distribution of educational achievements among the members of the workforce has a strong impact on the distribution of income, as it increases the supply of skilled workers and reduces the rise of the skill premium. In many developing countries this means raising enrolment and completion rates in secondary education and broadening the

access to subsidized tertiary education. The effects on inequality of rising secondary enrolments are lagged by several years (at least 5 to 10), but the long-term effects are quite powerful. The impact on inequality of the increased supply of skilled labour is not automatic, however, as an increase in employment and drop in wage inequality can come about only if additional jobs are created.

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