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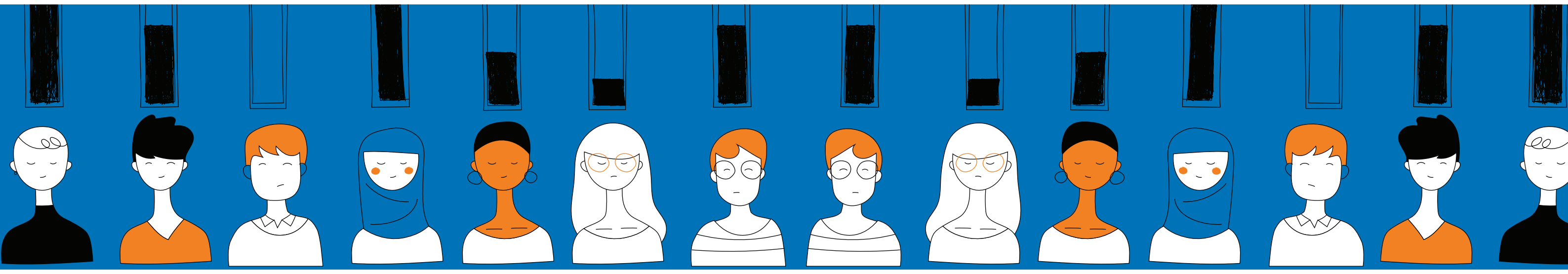

Addressing income inequalities through development cooperation

Volume 1: Concepts and definitions

Directorate-General for International Partnership

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Tools and Methods Series

Reference Document N° 29

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Volume 1:
Concepts and definitions

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This document is the 29th reference document in the EuropeAid Tools and Methods Series. The collection includes three subcollections: guidelines, reference documents and concept papers.

ABBREVIATIONS AND ACRONYMS

ECD	early childhood development
EU	European Union
GDP	gross domestic product
HDI	Human Development Index
IHDI	inequality-adjusted Human Development Index
IMF	International Monetary Fund
OECD	Organisation for Economic Co-operation and Development
SDG	Sustainable Development Goal
UCT	unconditional cash transfer
UHC	universal health coverage
UNDP	United Nations Development Programme
WASH	water, sanitation and hygiene
WIID	World Income Inequality Database

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INTRODUCTION

About the reference document

The objective of this reference document is to support the ongoing effort of the European Union (EU) to strengthen its approach to development cooperation to address inequalities in its partner countries. While recognising the importance of all forms of inequality, the document will focus primarily on income inequality, effective policy responses and how to address inequality in development cooperation.

This exercise reflects the commitment of the Directorate-General for International Partnerships (DG INTPA) to keep pace with the global reflection on inequalities and also to move beyond the objective of poverty reduction, as enshrined in the EU treaties, to that of inclusive growth – defined in the Agenda for Change as people's ability to participate in, and benefit from, wealth and job creation – and eventually to the new concept of equitable and sustainable growth, as proposed in the Addis Ababa Action Agenda and the 2030 Agenda for Sustainable Development.

Most important, the reference document is a direct follow-up on a major step forward made by the EU towards recognising the problem of inequality and addressing the risks it entails. In 2019, the European Commission staff working document 'Implementation of the new European consensus on development – addressing inequality in partner countries' (EC, 2019), and the subsequent Council conclusions (Council of the European Union, 2019a), recommended the development of an operational guidance document to mainstream reduction of inequalities into development cooperation.

This strategic study collects and builds on the knowledge produced in previous studies, and effectively contributes to making DG INTPA strategies, instruments and interventions more responsive to the challenge of reducing inequality and addressing its causes. It is structured in three complementary volumes, each dedicated to a specific part of the work.

This volume, Volume 1, presents the theoretical background to understanding inequality, including its trends. Chapter 1 is meant to help those who are not very familiar with the relevance of inequality to the fight against poverty, by offering a basic review of definitions and measurements. Chapter 2 will help readers to understand the importance of addressing inequality from an economic perspective and to become familiar with the main determinants of trends towards both lower and higher inequality. It will further illustrate what the main arguments for tackling economic inequality are and some of the main international responses.

Volume 2 presents 18 briefs on policies with a demonstrated impact on inequalities. The policy areas covered are health and nutrition, education, social protection, transport and mobility, energy, climate change, water and sanitation, land, urban development, territorial development, public finance (i.e. taxation), trade, growth, digitalisation, financial inclusion, labour and employment, governance and the rule of law, and gender. No particular priority is assigned to any of the policy areas covered, since all of them have effects on inequalities.

Volume 3 presents guidelines and tools to help EU staff mainstream reduction of inequality into all their development cooperation operations.

Each policy brief in Volume 2 can be linked to one of the macro areas identified by DG INTPA in its policy note on socioeconomic inequalities (Table 1). In that policy note, the EU objectives for the reduction of socioeconomic inequalities revolve around four building blocks: (1) Enabling people – Ensuring equal opportunities; (2) Supporting and Safeguarding Sustainable and Inclusive Growth; (3) Improving the Collection, Use and Distribution of Resources; and (4) Protecting People from Risks. Each building block represents a macro area for intervention.

Table 2 provides an overview of references that can be found in the policy briefs to other policy briefs (direct mentions are indicated in blue and indirect mentions in orange).

TABLE 1 Macro policy areas relevant to tackling inequalities, as defined by DG INTPA

POLICY AREAS	POLICY BRIEF AND POLICY INTERVENTIONS
Macro Area 1: Enabling people – ensuring equal opportunities	
Investing in education	• Education • Improve teaching and leadership • Promote early childhood development (ECD): early intervention to prepare children for school and avoid dropout • Identification of vulnerable groups facing inequality and increasing their opportunities • Practical opportunities and approaches to improve equity in education • Policy development and legislation • Community-level representatives of marginalised populations • Financing: conditional cash transfers (CCTs) and unconditional cash transfers (UCTs) • Protection and resilience building • Revised curricula and materials • Good management and governance
Facilitating access to assets	• Land policies • Land redistribution policies aimed at modifying skewed land distribution patterns • Address land tenure, control and ownership, with a focus on the most vulnerable • Review conditions for access to land and land adjudication processes (access, taxation, compensation) • Land registration and titling can be used to protect smallholders' rights of direct access to land, and awareness campaigns can be used to avoid commodification of property rights • Set up and enhance land governance participatory platforms • Support women owners • Enhance land valuation and taxation • Provide financial services to enable access and development • Financial inclusion • Financial sector policies tailored to target financial inclusion to support excluded populations • Digital financing: mobile money, online banking, etc. • Lifting credit constraints: credit and microcredit for micro, small and medium-sized enterprises (MSMEs) • Promote interoperability agreements to provide digital financial services in a convenient, affordable and fast way

TABLE 1 Macro policy areas relevant to tackling inequalities, as defined by DG INTPA (continued)

POLICY AREAS	POLICY BRIEF AND POLICY INTERVENTIONS
Addressing gender inequalities	• Collect data for gender mainstreaming: precondition for designing and implementing other policy options • Remove gender-based legal restrictions and promote equality before the law • Protecting women from violence: support regional and national bodies and gender strategies. • Supporting and protecting women human rights defenders, strengthening protection mechanisms and supporting their leadership role • Promote women's entrepreneurship • Revise tax policies to encourage women to join the labour force • Create space in government budgets for priority expenditures, such as on infrastructure, health and education, to close the gender gap • Promote universal health coverage (UHC), including sexual and reproductive health and rights • Deconstruct stereotypes and work on intersectionality • Promote equal participation and leadership
Digitalisation for all	• Digitalisation • Ensure accessibility and availability • Promote digital identity • Leverage existing infrastructures and capabilities within countries • Promote interoperability agreements to provide digital financial services in a convenient, affordable and fast way • Guarantee data security and privacy • Promote financial literacy • Digital education and health: e-health and e-education
Macro Area 2: Supporting and safeguarding sustainable and inclusive growth	
Promoting decent work conditions and fair wages	• Labour and employment • Minimum wage policies and collective bargaining • Active labour market policies and programmes • Labour market regulations
Targeting investments for the bottom 40 %	• Water and sanitation • Reduce inequalities through universal and equitable access to water, sanitation and hygiene (WASH) • Ensure clean water and decent sanitation and hygiene in schools • Guarantee WASH for workers • Climate change adaptation and resilience for WASH • Domestic resources, international public financing and increased accountability to ensure that no one is left behind • Prepare for emerging priorities, notably the rapid development of urban areas • Transport and mobility • Application of sound transport planning and programming • Building transport infrastructure can provide direct benefits • Promoting labour-intensive forms of investment • Assess social distributional effects of transport operation and management • Energy • Move from a financial rationale to a socioeconomic rationale • Promote innovation and technology

TABLE 1 Macro policy areas relevant to tackling inequalities, as defined by DG INTPA (continued)

POLICY AREAS	POLICY BRIEF AND POLICY INTERVENTIONS
Targeting investments for the bottom 40 % (continued)	• Promote sustainable, clean, secure and affordable energy production that is properly adjusted to need, including through the legal and regulatory framework should • Promote pro-poor tariff structures • Support programmes to create awareness and to facilitate adult education and learning, skills development and targeted mentoring for business development • Urban development • Inclusive urban development – access to basic infrastructures • Participatory slum upgrading programmes • Territorial development • National strategic commitment to territorial development • Development-friendly decentralisation process • National urban agenda and rural development strategy • Set of supportive national policies • Inspire an endogenous development process, involving regional and local governments
Maximising the employment potential of investment and trade	• Growth • Assess the employment impact of investments and industrial policy choices and prioritise employment-intensive investments • Target MSMEs in private sector development and support formalisation • Target vulnerable workers through specific labour market policies • Ensure the participation of workers' representatives in the design and monitoring of business environment reforms • Trade • Effectively apply labour rights provisions in EU trade agreements and promote responsible business conduct and fair and ethical trade principles • Increase national budget expenditures (through budget support measures) on key government institutions for labour standards enforcement • Support South–South cooperation and regional economic integration processes • Prioritise the targeting of small and medium-sized enterprises under the Aid for Trade initiative • Support developing countries to enhance competition policies and to enforce relevant legislation that contributes to restricting the abusive behaviour of large companies in international markets
Macro Area 3: Improving the collection and distribution of resources	
Supporting domestic resources mobilisation and progressive fiscal policies, and addressing tax evasion and illicit financial flows	• Public finance: taxation • Promote progressive tax systems combined with redistributive public expenditure policies • Raise tax effort and increase tax capacity • Enlarge the tax base • Rely more on direct taxes and transfers to achieve redistributive objectives, rather than on indirect taxes and subsidies • Avoid regressive indirect tax exemptions • Encourage individual tax credits and avoid individual tax deductions • Enhance the progressivity of personal income taxes • Promote international and regional efforts to discourage a race to the bottom on corporate income tax rates • Promote international cooperation to fight tax avoidance and tax evasion • Accompany progressive taxation with credible, transparent and redistributive expenditure policies

TABLE 1 Macro policy areas relevant to tackling inequalities, as defined by DG INTPA (continued)

POLICY AREAS	POLICY BRIEF AND POLICY INTERVENTIONS
Supporting domestic resources mobilisation and progressive fiscal policies, and addressing tax evasion and illicit financial flows (continued)	• Governance and the rule of law • Actions at project/programme level: • Promote inclusiveness and participation • Increase transparency – in particular in relation to the budget – communication and information provision • Reinforce accountability and external oversight • Support the design and implementation of reforms in priority areas, and approach them through political dialogue, policy dialogue and budget support, as well as through cooperation or trade agreements
Macro Area 4: Protecting people from risks	
Expanding universal social protection and UHC	• Social protection • Social assistance, including non-contributory UCT programme and CCT • Social insurance • Social protection for informal workers • Health and nutrition • Promote UHC through resilient and sustainable health systems • Ensure equitable access to essential health services, including sexual and reproductive health services • Increase support for primary healthcare • Promote ECD • Promote breastfeeding, provide nutritional supplements for young children and ensure access to sufficient amounts of safe and nutritious food for normal growth and development and an active and healthy life for all
Fighting climate change	• Climate change • Increase the local knowledge base on climate change and its impacts: • Climate risk and vulnerability assessment • Social and informal learning • Exchange with local authorities and actors on transdisciplinary ‘co-production’ • Implement climate measures: • Preventive planning and disaster risk reduction • Building and renovating infrastructure • Increasing resource efficiency • Increasing energy efficiency • Preserving ecosystems • Advancing women’s empowerment and gender equality • Develop an integrated approach for inclusive climate action: • Prioritise efforts towards mainstreaming climate change action, notably in local development planning • Understand the trade-offs, synergies and incompatibilities between the measures proposed in nationally determined contributions and in sector strategies • Assess capacity and the systems in place that are able to support inclusive climate action and capacity and institution building • Underline the added economic benefit of developing renewable energy sources • Explore domestic opportunities to mobilise climate finance with international support, where appropriate

TABLE 2 **Interlinkages between policy briefs**

POLICY BRIEF		1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18
1	Health and nutrition																		
2	Education																		
3	Social protection																		
4	Transport and mobility																		
5	Energy																		
6	Climate change																		
7	Water and sanitation																		
8	Land																		
9	Urban development																		
10	Territorial development																		
11	Public finance: taxation																		
12	Trade																		
13	Growth																		
14	Digitalisation																		
15	Financial inclusion																		
16	Labour & employment																		
17	Governance & rule of law																		
18	Gender																		

CHAPTER 1

WHAT IS ECONOMIC INEQUALITY?

KEY MESSAGES

- Inequality refers to the unequal distribution of goods, resources and rights.
- Unlike poverty, which focuses on the segment of the population for which living standards fall below a minimum level (i.e. a poverty line), inequality refers to differences in social and economic outcomes and opportunities across the whole population, as well as between and within its groups.
- Economic inequality is most commonly described in terms of the differences between individuals' or groups' positions within the economic distribution, with regard to income, consumption or wealth.
- Economic inequality data rely mostly on surveys. Surveys tend to be carried out less frequently in poorer countries.
- The Gini index and the bottom 40 per cent are the main indicators used to measure income inequality.

Defining inequality

Inequality refers to the unequal distribution of goods, resources and rights; it is inherently a relational concept.

Unlike poverty, which focuses on the segment of the population for which living standards fall below a minimum level (i.e. a poverty line), **inequality refers to differences in social and economic outcomes and opportunities across the whole population, as well as between and within groups**. Poverty and inequality are strongly interconnected through the distribution of income. High levels of inequality, however, may be observed in societies where poverty rates are relatively low because of large differences between the most disadvantaged individuals or groups and the rest of the population. In other words, average measures of poverty, even if low, may mask significant inequality between vulnerable groups. Poverty reduction strategies can leave the level of inequality unchanged if they are not well calibrated, and inequality hinders the effectiveness of these strategies. More, although economic growth can mechanically reduce poverty if equally distributed, it has been shown that the persistence of inequality can cancel out this effect. This is why poverty alleviation efforts have to be accompanied by inequality reduction strategies.

Diverse definitions and concepts have been developed to describe and analyse inequality. A primary distinction is made between **equity** and **equality**. Equity means that individuals' needs and requirements are taken into account and those individuals are treated accordingly. Equality refers to a situation in which every individual is granted the same rights and responsibilities, regardless of individual differences, in the absence of discrimination based on sex, age, ethnicity, disability, nationality, and so on. From this perspective, equity is a process and equality is an outcome: equity is the necessary condition to be fulfilled to achieve equality. In the Treaty on European Union, Article 21(1), equality is explicitly mentioned among the principles guiding the EU's external action.

A secondary distinction is made between **economic inequality** and **social inequality**. In addition, **inequality of outcomes** is considered to be distinct from **inequality of opportunities**.

Although **the focus of this document is economic inequality**, it is worth mentioning that there are other forms of inequality, as this concept can refer to differences between individuals or groups through various dimensions. Two examples are given below.

- **Political inequality** refers to unequal influence over decisions made by political bodies and the unequal outcomes of those decisions. It is closely related to differences in the distribution of political resources, which can lead to the exclusion of particular groups from participation in political processes.
- **Environmental inequality** refers to unequal distribution of environmental risks and hazards (e.g. air or water pollution) and inequitable access to natural resources and other ecosystem services (e.g. land, parks and freshwater) between different social groups. Environmental inequality is also closely connected to social and economic inequality.

Economic inequality

Economic inequality is most commonly described in terms of the differences between individuals' or groups' positions within the economic distribution, with regard to income, consumption or wealth (Atkinson, 2015). Income is money received by an individual or a household from various sources, such as employment, investments, savings, welfare transfers, pensions or rent. Consumption refers to the purchase of goods and services for use by households. Wealth is the total amount of assets, financial assets or properties, held by individuals or households.

Social inequality relate to the unequal distribution of public and social goods, such as access to and achievement in education, health and nutrition, housing and employment, and security, power and rights (World Bank, 2006).

Like poverty, inequality goes beyond economic and material aspects: it is multidimensional.

Social inequality and economic inequality are strongly interrelated. One might act as a driver for the other, and the consequences of one can affect the other. Income distribution, for instance, is associated with access to health services and education. Individuals at the bottom of the income distribution are more likely to have lower life expectancy and educational attainments than those with higher incomes. Conversely, poor educational achievements may lead to a weaker position in the labour market, negatively influencing earning capacity (Dabla-Norris et al., 2015; Narayan et al., 2018).

Environmental inequality exacerbates social and economic inequality, notably by influencing people's resilience to natural disasters. Environmental inequality also influences economic wealth, income and consumption, in particular for those who are directly dependent on natural resources for their livelihood.

Inequality of outcomes relates to differences in outcomes such as those mentioned above, for example, income or educational achievements. **Inequality of opportunity** refers to differences in economic or social outcomes that are determined by circumstances beyond an individual's control or responsibility, such as age, gender, disability, ethnicity and religion, place of birth or family background (World Bank, 2006). Inequality in outcomes is driven partly by inequality in opportunities; it is also driven by differences in effort and aptitude, among other factors (Roemer, 1998).

The concept of equalising opportunities, also referred to as 'levelling the playing field'[1], means compensating individuals in some way for their disadvantageous circumstances; ideally, inequality in outcomes would be determined only by individual responsibility (Atkinson, 2015). However, when moving from theory to actual policies and practices, separating effort and its outcomes from opportunities is not an easy task. It is almost impossible to measure effort and separate it from other responsible factors, and therefore to establish what level of outcomes might be deemed fair (Kambur and Wagstaff, 2014). In addition, the outcomes of one generation shape the opportunities available to the next. The income level of parents, for example, represents a key circumstance driving opportunities for their children to access schooling and thus achieve a high level of education. High levels of income inequality among adults make equality of opportunity for children more difficult to achieve (Morabito, Vandenbroeck and Roose, 2013). Therefore, an effective strategy to tackle inequality

[1] Catchphrase used by the World Bank (2006).

must necessarily address differences in both outcomes and opportunities.

The concept of horizontal inequality refers to differences in economic or social outcomes between groups of individuals who have a 'shared identity' in a society (Stewart, 2008). These groups' categories might vary in relation to the object of distribution (e.g. income, education, health). The categories used when looking at horizontal inequality usually include those associated with circumstances, for instance gender, ethnicity, religion or geographical location. Women and girls, in particular, face more challenges, multidimensional barriers, human rights violations and discrimination than men, thus impeding their access to resources, services and opportunities – in particular access to the labour market – in society. This limits their autonomy and freedom to make their own choices and hampers their full enjoyment of their human rights, also preventing them from benefiting equally from development cooperation.

By contrast, vertical inequality refers to variations in outcomes among individuals (or households) within a particular group, country or region, or in the world as a whole. The concept of horizontal inequality is often associated with that of inequality of opportunity, as both concepts relate to groups with reduced access to opportunities, while strategies to address vertical inequality and outcome inequality share the objective of reducing gaps between individuals rather than between groups (Stewart, 2008).

Levels of income inequality

This document focuses on economic inequality, specifically income inequality. This choice is dictated by the characteristics of income itself, as income inequality is both the primary object of inequality of outcome and one of the main factors shaping inequality of opportunity. Indeed, income can often determine a household's access to health, education, housing and many other important elements of our social lives and their functioning.

There are three different levels at which personal (or household) income distribution can be considered and measured[2].

- Primary income distribution is the distribution of household income earned from economic activities before taxes and subsidies (also referred to as 'market income').
- Secondary income distribution is the distribution of household income after deduction of taxes and inclusion of transfer payments (also referred to as 'disposable income').
- Tertiary income distribution is the distribution of household income when imputed benefits from public expenditure are added to household income after taxes and subsidies.

Total income equality is not possible, just or desirable.

A key caveat is required in relation to the term 'equality'. Total income equality is not possible, just or desirable. Certain differences, especially in rewards, are fair and reasonable, and they provide key incentives for individuals. The objective of addressing inequality as that is meant in this reference document is not to establish complete social and economic equality but simply to 'operate a shift in the distribution towards less income inequality', given the high levels observed in the world today (Atkinson, 2015: 1). Income inequality, while it does not explain the entire range of inequality suffered by an individual, does enable a broad understanding of their constrained opportunities and outcomes.

Measuring income inequality

Unlike data from national accounts (e.g. gross domestic product), income inequality data rely mostly on

[2] Lustig and Higgins (2013) use an analytical framework based on five concepts of income: (1) market income, (2) net market income, (3) disposable income, (4) post-fiscal income, (5) final income. The purpose of their framework is to analyse the incidence of tax–benefit systems and public spending in low- and middle-income countries. Essentially, it constitutes a more disaggregated version of the three-level conceptual framework presented here.

surveys. Although national accounts data yield aggregates for the entire economy and per capita averages (by dividing the former by population), they do not provide insight into the distribution of incomes. **Surveys need to be conducted to capture distributional information; however, surveys have a number of well-established drawbacks that strongly affect the availability and quality of inequality estimates.**

Survey availability

The first difficulty with surveys is clear: **surveys must be nationally representative and are therefore costly**. This often means that they are not carried out with the required regularity to monitor some aspects of the economy or country in question. Cost, operational complexity and political economy considerations mean that surveys tend to be carried out less frequently in poorer countries than in wealthier ones.

In those countries that do have surveys, the surveys' periodicity decreases with income: **the lower the level of income, the lower the number of surveys within the reference period**. Among low-income countries, where surveys are fundamental to measure poverty and inequality, most either do not have poverty or inequality estimates or have only one set of estimates, which cannot show any changes within the period. It is necessary that countries have surveys run at **two points in time to allow monitoring and comparison of poverty and inequality**.

Income versus consumption

Income inequality can be measured in terms of either **income or consumption**. In principle, using income is preferable when measuring income inequality, as surveys should (ideally) be able to collect good information on incomes. In reality, however, this is not always the case: **in poorer areas, income tends to be less steady and thus more difficult to track or determine with precision in an interview**. A typical example of this is a survey trying to determine the income of a farming population. Depending on when the survey is taken relative to harvest, huge differences in incomes can be found. Lower-income farmers tend to have little or no income shortly before the harvest and then experience a peak after it. Even if the survey takes this effect into account, the concept of income is not very relevant in contexts where there are large fluctuations in income throughout the year and where self-consumption is predominant, as in the agricultural sector (see Box 1.1).

BOX 1.1 World Income Inequality Database

The United Nations University World Institute for Development Economics Research World Income Inequality Database (**WIID**) presents information on income inequality for developed, developing, and transition countries. It provides the most comprehensive set of income inequality statistics available.

The latest version of the WIID, released in May 2020, covers 200 countries (including historical entities), with over 11 000 data points in total. With the current version, the latest observations now reach the year 2018.

In poorer contexts, surveys tend to collect information on consumption instead of income[3]; income at low levels is not well captured by surveys, while consumption is smoother – more stable and less seasonal. People do not change their consumption patterns drastically, although their income may fluctuate significantly. Using consumption as a proxy for income assumes that households spend all that they earn, a realistic assumption for poorer households. Consumption does not include savings, while income does; the higher the country's income level, the more desirable it is to use income as a measure. In addition, surveys based on income may also receive a large number of 'zero income' responses, which does not happen with surveys based on consumption. This may affect the overall level of poverty and/or inequality measured.

Because savings are not accounted for in consumption aggregates and they increase along the line of income distribution, **inequality measurement based on consumption often produces lower estimates than if the measurement had been based**

[3] This is the case for much of the world, with the exceptions of high-income and Latin American and Caribbean countries, where income is the aggregate generally used to measure poverty and inequality.

on income. For some countries for which there are have inequality estimates based on both income and consumption the difference can be substantial, up to 10 Gini percentage points (see 'Inequality measures – Gini and the bottom 40 per cent,' below) (Word Bank, 2016).

Thus, countries have had to make a trade-off, and it is important to be aware of the conceptual difference between income and consumption. Because of a lack of income data, sub-Saharan Africa's inequality estimates are based on consumption. By contrast, those of Latin America are based on income. The former appear to be higher overall than the latter but if the same aggregate (either income or consumption) were available for both, this difference might well be significantly reduced. **Regional comparisons of inequality levels therefore need to be made carefully and with this in mind.** This is less the case for inequality trends, which appear to be roughly robust to using either measure (World Bank, 2016).

Top incomes

Regardless of whether surveys collect data on income or consumption, **information on richer individuals who absorb higher shares of resources tends to be of relatively poor quality**. This is partly addressed by using measures that are not sensitive to imprecision at the bottom and top of the distribution (e.g. the Gini index; see 'Inequality measures – Gini and the bottom 40 per cent,' below), but it prevents the detection of increasing concentration at very high income levels.

Surveys are not effective in gathering information for those on the upper tail of the income distribution for a number of related reasons:

1. **Those at the very top of the income distribution scale are, by definition, very rich and very few.** Because surveys gather information not on the entire population but on a sample of it, the small number of very rich individuals may not be included despite the fact that their incomes are a significant part of the total. The very rich tend to be under-represented in the sample.
2. **If the very rich are included in the sample, they frequently will not respond to a survey that may involve questions that make them uneasy** (high non-response rates).
3. **Even if they respond, they often will not provide information on all their income** for a variety of reasons, among which is a fear of mentioning income not declared to the tax authorities (under-reporting).

Resorting to tax data or other administrative records would not capture under-reporting but could address sampling issues and non-responsiveness. Unfortunately, the accessibility of these data remains very limited internationally. **Globally, tax record data are mostly available for high-income countries**.

Inequality measures – the Gini index and the bottom 40 per cent per cent

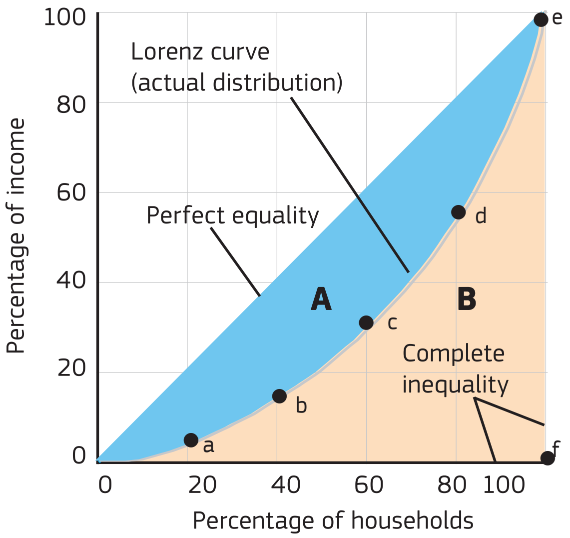
There is no single inequality measure that is able to capture all the complexity of an income distribution. The Gini index is the most widely used measure. It provides a straightforward tool to produce country rankings as well as to assess and monitor the level and evolution of inequality within a given population. This index corresponds to the area between the Lorenz curve[4] of an economy, a graphical representation of the actual distribution of income or of wealth, and that of a perfectly equal distribution where all people receive the same income (see Figure 1.1). Variations in the distribution of income around very low and very high percentiles hardly affect the shape of the Lorenz curve and therefore hardly affect the size of the total area[5]. Towards the middle of the distribution, however, the curve can differ substantially from the equidistributional 45-degree line.

The Gini index ranges between 0 and 1, or between 0 per cent and 100 per cent if it is expressed as a percentage, with **0 representing perfect equality and 1 representing perfect inequality. A** country in which every resident had the same income would have an income Gini coefficient of 0; a country in which one resident earned all the income, while everyone else earned nothing, would have an income Gini coefficient of 1.

[4] The Lorenz curve is the cumulative percentage total income of a cumulative percentage of the population.

[5] By definition, this area is contained between the origin of coordinates (0,0) and the point (1,1), because both these Lorenz curves start and finish at these two points.

FIGURE 1.1 The Lorenz curve



Source: McConnell, Brue and Flynn (2009).

Note: The Lorenz curve is a convenient way to show the degree of income inequality (here, household income by quintile in 2006). The area between the diagonal (the line of perfect equality) and the Lorenz curve represents the degree of inequality in the distribution of total income. This inequality is measured numerically by the Gini ratio – area A (shown in blue) divided by area A + B (the blue + orange areas).

The Gini index is more sensitive to changes in the middle of the distribution than to changes at the tails. The advantage is that, given that information from the tails – and particularly the richer one – is less reliable, Gini focuses on the part of the distribution for which higher-quality information is available.

The disadvantage is that important changes in the share of income accruing to the poorest and to the richest individuals are underestimated or go unnoticed altogether. Furthermore, a number of different shapes of the Lorenz curve can result in the same Gini coefficient, in the same way that the area of the shape remains unchanged when the same length of rope is used to form a square and a rectangle. This means that very different income distributions may have the same Gini index value. The result is that two countries, or a country trend, may be ranked differently in terms of inequality depending on what measure of inequality is being used (as measures differ in how they weigh income differences in different parts of the distribution). In addition, the Gini index is not decomposable and does not help to disentangle factors contributing to inequality changes.

To address the Gini index's lack of sensitivity at the tails, a complementary method can be used, one consisting of examining the shares of income accruing to the bottom (typically the bottom 20 per cent or 40 per cent) and the top of the distribution (typically the top 20 per cent, 10 per cent or 1 per cent). **In line with Sustainable Development Goal Target 10.1, it is advisable to focus on the bottom 40 per cent.** For the top of the income distribution, it is quite common to look at the shares of the richest 20 per cent, 10 per cent or 1 per cent, particularly because there are very important dynamics among these top groups.

CHAPTER 2

ADDRESSING INEQUALITY

KEY MESSAGES

- Global income inequality has declined as a result of a reduction in inequality between countries. However, within-country inequality has increased as a result of an increase in top incomes.
- Income inequality trends vary substantially between regions. Countries with Gini coefficients above 40 per cent are mostly developing countries in Latin America and sub-Saharan Africa.
- Main determinants: Although trade globalisation, progressive taxation, rising migrant remittances, a decline in dependency rates, education, improved infrastructure and institutions, and gender policies have lowered income inequality, financial globalisation, technological changes, the ratchet effect, dependency on natural resources, corruption and ethnic fractionalisation have tended to increase income inequality worldwide.
- The EU, being the largest contributor to development cooperation, has a strong a crucial role to play to reduce inequality

Trends in economic inequality

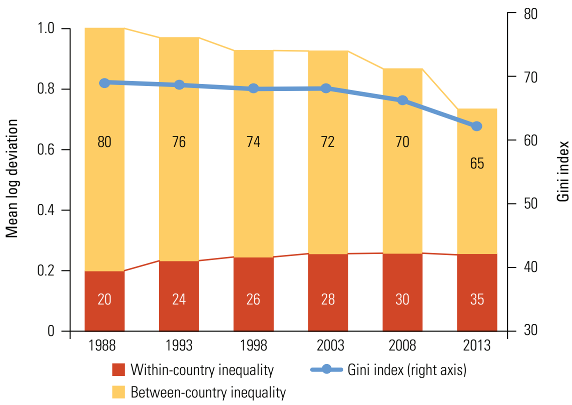
Global inequality

The Gini coefficient of the world as a whole (interpersonal inequality[1]) has steadily increased since 1820, with the exceptions of a short period around the Second World War and, more recently, in the past few decades.

Global income inequality declined between 1988 and 2013 (see Figure 2.1). A reduction in inequality between countries appears to have been the main factor driving the downward trend. This resulted, in particular, from the rapid income growth and poverty reduction experienced by populous emerging countries (particularly in Asia); the gap in income per capita between these countries and richer countries has narrowed significantly. Inequality within countries increased during the late 1980s and 1990s and then stabilised in the 2000s and 2010s. Yet post-2013 data appear to indicate that this slight fall may not be sustainable and that average national levels of inequality may be increasing again.

Income inequality trends vary substantially between regions (see Figure 2.2). Inequality levels

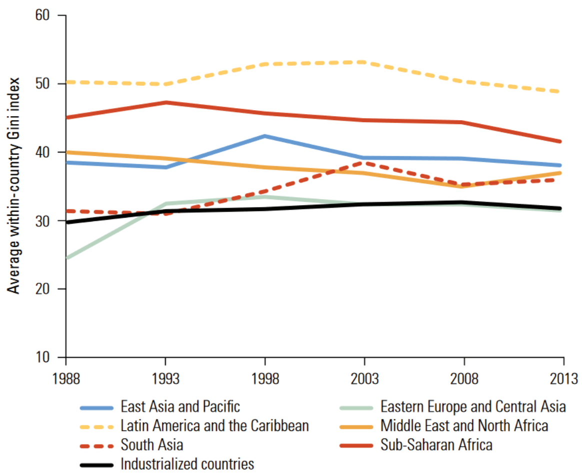
FIGURE 2.1 Global income inequality, 1988–2013



Source: World Bank (2016), Figure O.10. Based on Lakner and Milanović (2016); Milanović (2016); and PovcalNet.

[1] Global interpersonal inequality calculates inequality among the world's citizens regardless of where they live and their country's average income, using national surveys and comparing purchasing power across nations.

FIGURE 2.2 Trends in the average Gini index by region, 1988–2013



Source: World Bank (2016), 11.

increased in Latin America and the Caribbean in the 1990s, followed by a remarkable reduction in the 2000s and early 2010s. South Asia and industrialised countries showed a significant increase in inequality levels throughout most of the period, whereas the Middle East, north Africa and sub-Saharan Africa experienced a slight decrease. Poor growth and even economic contractions in these countries tended to hit the poorer hardest, negatively affecting their income not only in absolute terms but also in relative ones, thus increasing overall inequality.

Despite these decreases, the levels of inequality observed in many countries today are still very high. Among countries with a population of more than 10 million, **those with Gini coefficients above 40 per cent are mostly developing countries in Latin America and sub-Saharan Africa** (see Figure 2.3). The list includes a large number of upper-middle-income countries (12 out of 34), lower-middle-income countries (8 out of 34) and low-income countries (11 out of 34).

In contrast to the trends in global income inequality as measured by the Gini index, inequality as measured by the share of income held by the top 10 per cent of the population has increased almost everywhere, although at different paces (see Figures 2.4 and 2.5). Countries that experienced drastic changes in the distribution of income in favour of the top decile include China and India; in Europe the increase in income of the top decile was more moderate. The trends observed are similar if the focus is on wealth rather than income. Further, the countries with the highest per capita gross domestic product (GDP) present levels of inequality below 42 per cent. Hardly any large country has managed to reach high income levels without keeping inequality (as measured by the Gini index) in check to a certain extent.

Figure 2.5 provides a good overview of inequality across regions. Inequality is generally low in the high-income group and very high in Latin America, the Caribbean and sub-Saharan Africa. The high-income countries, with lower income inequality levels, are all in the lower part of the diagram. This is particularly the case if certain high-income countries – the United States, Israel, Argentina, Uruguay, Panama and Chile – are excluded: all the remaining high-income countries have a Gini index of less than 38 per cent. This seems to point in the same direction as the empirical evidence (see 'Trends in economic inequality', above) on the beneficial developmental effects of tackling high levels of inequality.

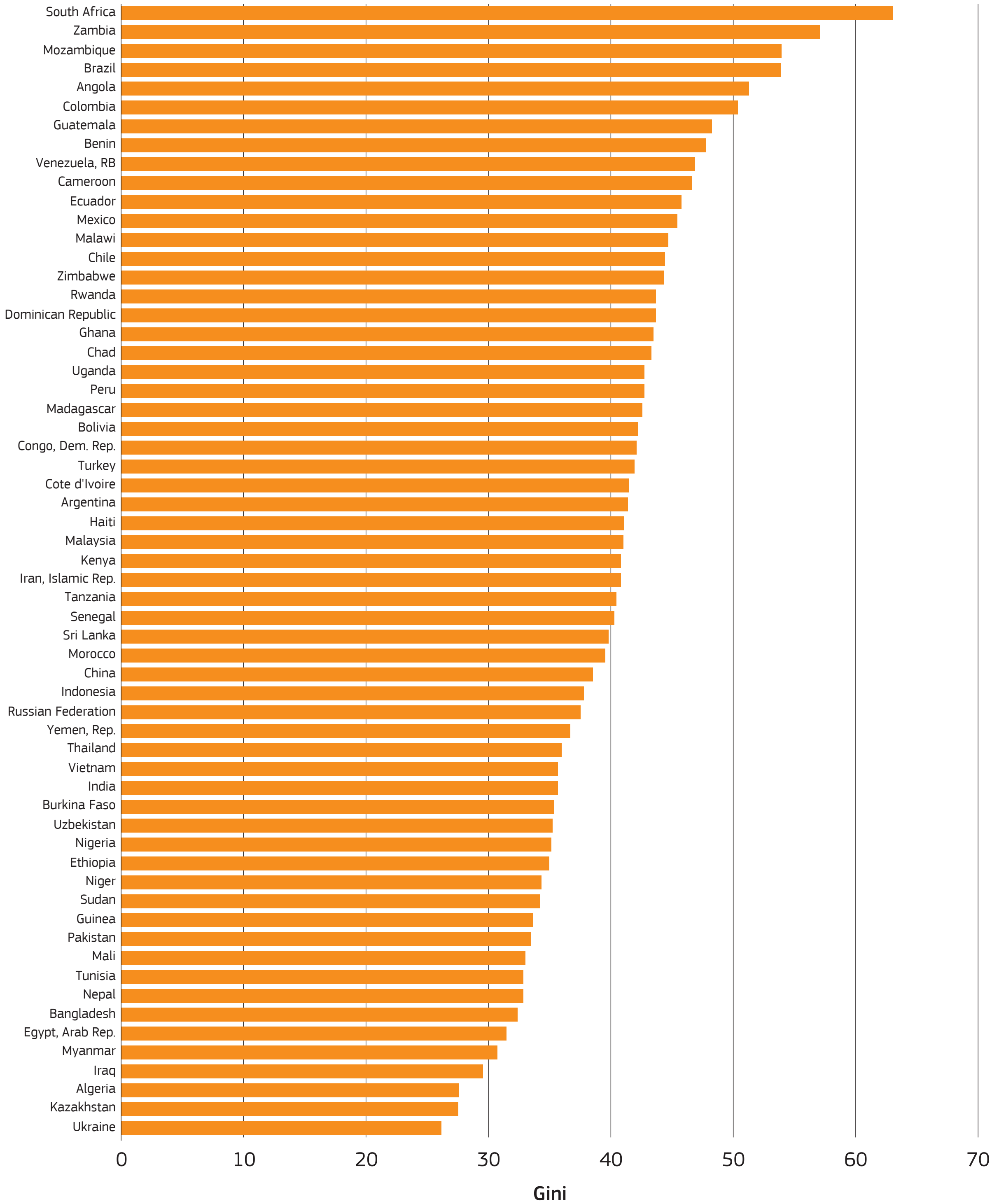
The bottom 40 per cent

The World Bank's estimations of the shared prosperity premium (Lakner, Negre and Prydz, 2014; World Bank, 2015b, 2016 and 2018b), which is an indicator of progress towards Sustainable Development Goal (SDG) Target 10.1, monitor the performance of the poorest **bottom 40 per cent of the income distribution** relative to the mean for all countries with available data over a 5-year period. **The shared prosperity premium**[2] assesses whether the incomes of the bottom 40 per cent have grown by rates above or below average, thus leading to decreases or increases in inequality, respectively.

Overall, the income of the bottom 40 per cent increased in most of the countries with available data for this period. In a majority of those countries, that income grew by more than the average rate, thus narrowing income gaps (Figure 2.6). The best-performing regions were South Asia, East Asia and the Pacific,

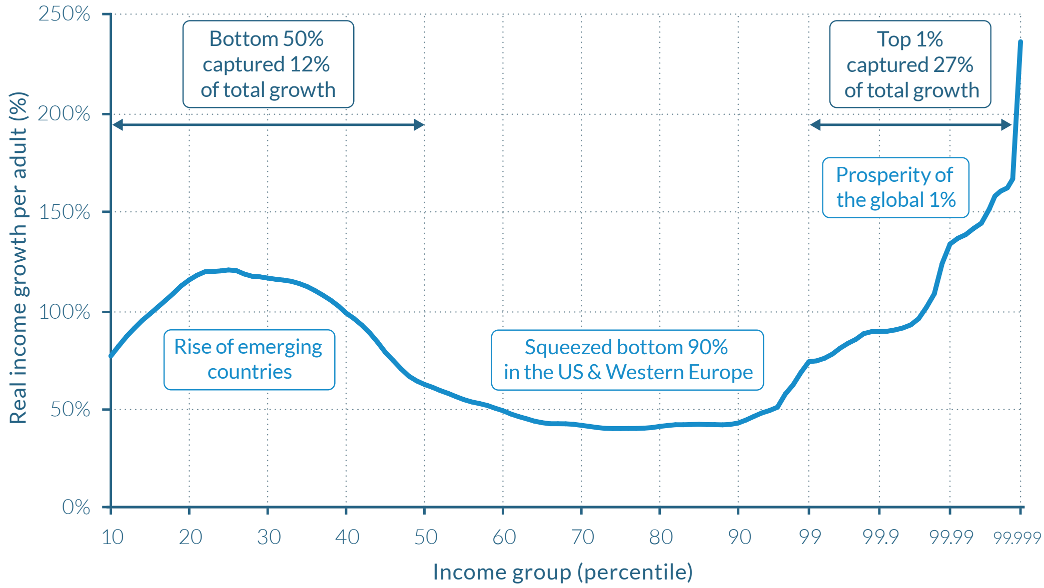
[2] The shared prosperity premiums equals the average income growth rate of the bottom 40 per cent minus that of the country's average.

FIGURE 2.3 Gini index for selected countries with populations greater than 10 million



Source: Created by the authors, based on the World Bank's World Development Indicators database and latest available surveys for each country.

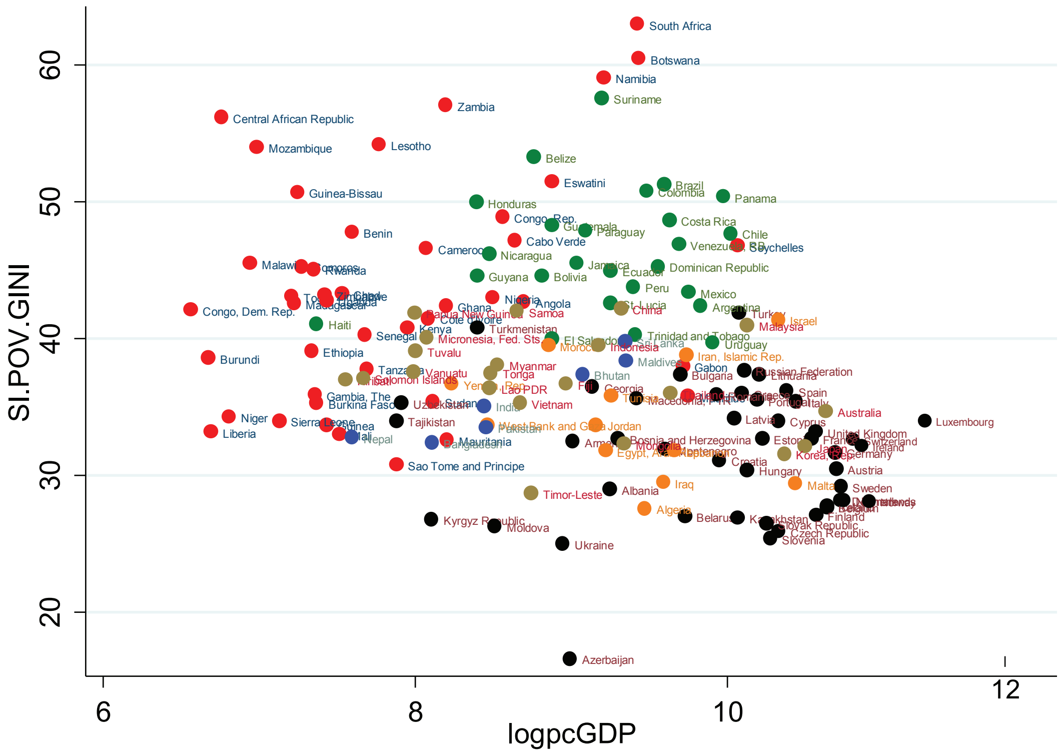
FIGURE 2.4 The elephant curve of global inequality and growth, 1980–2016



Source: Alvaredo et al. (2017), Figure 2.1.4. Based on WID.world (2017). See wir2018.wid.world for data series and notes.

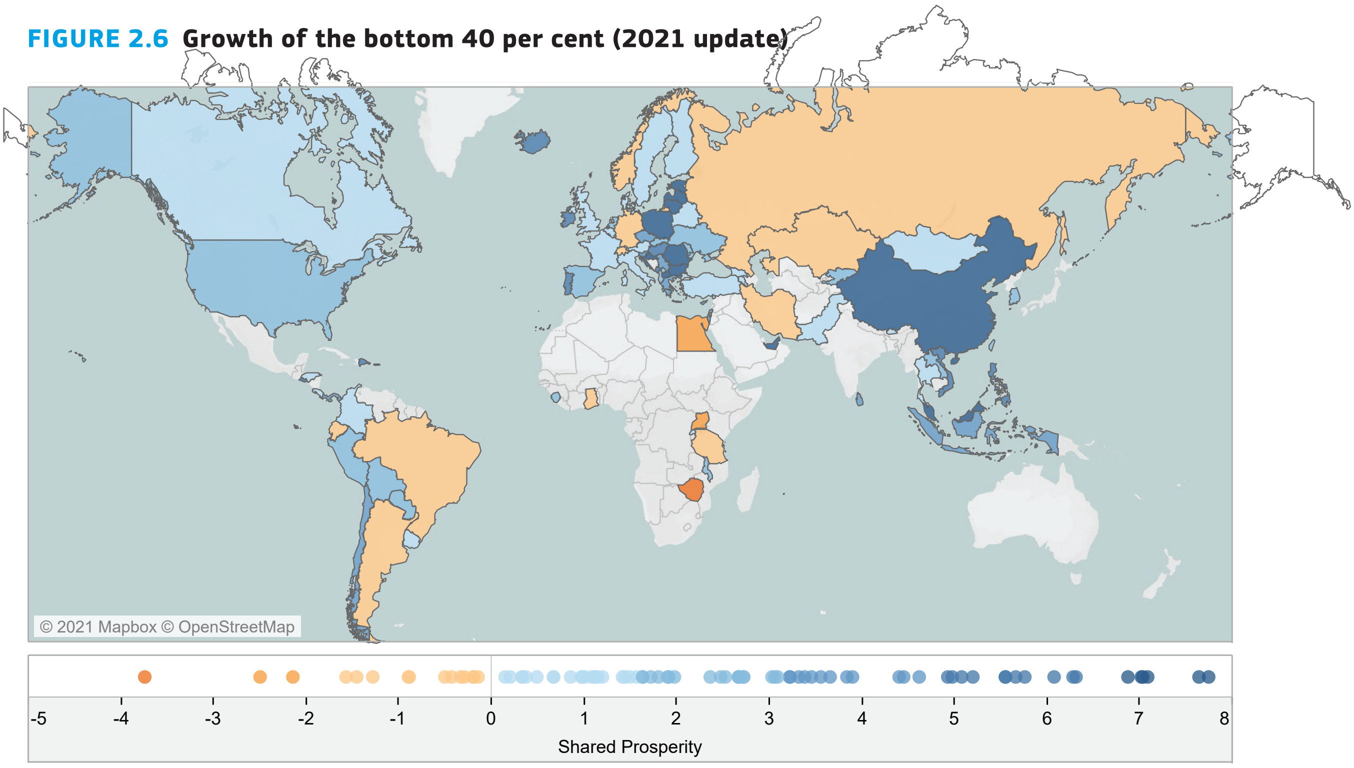
Note: On the horizontal axis, the world population is divided into 100 groups of equal population size and sorted in ascending order from left to right, according to each group's income level. The top 1 per cent group is divided into 10 groups; the richest of these groups is also divided into 10 groups, and the topmost group is again divided into 10 groups of equal population size. The vertical axis shows the total income growth of an average individual in each group between 1980 and 2016. For the poorest 10 per cent among the world's richest 1 per cent, growth was 74 per cent between 1980 and 2016. The top 1 per cent captured 27 per cent of total growth over this period. Income estimates account for differences in the cost of living between countries. Values are net of inflation.

FIGURE 2.5 Countries by inequality and log per capita GDP levels



Source: Created by the authors, based on World Development Indicators database, accessed 7 November 2018.

FIGURE 2.6 **Growth of the bottom 40 per cent (2021 update)**



Source: Global Database of Shared Prosperity (8th edition, circa 2013–18), World Bank, Washington, DC. 2021. https://www.worldbank.org/en/topic/poverty/brief/global-database-of-shared-prosperity.

Note: The map shows annualised growth in mean household per capita consumption or income.

and Latin America and the Caribbean. On average, the incomes of the bottom 40 per cent in these regions grew by 4.7 per cent, 2.6 per cent, and 3.2 per cent per year, respectively. In other regions, such as eastern Europe, and in highly industrialised countries in western Europe and the United States, there was hardly any expansion of the incomes of the bottom 40 per cent; there were even contractions because of sluggish economic growth. In the rest of the world, on average, the incomes of the bottom 40 per cent contracted by 0.3 per cent per year between 2010 and 2015. The income growth of the poorer sections of the population was considerably lower in regions with high poverty rates. On average, the incomes of the bottom 40 per cent in sub-Saharan Africa grew at 1.8 per cent per year, a pace slightly lower than in the rest of the world. The monitoring of these regions, however, remains partially incomplete as a result of limited data availability.

Top incomes

Income inequality as measured by the share that accrues to top earners shows similar stark differences across countries and deep gaps between rich and poor in many countries.[3]

A word of caution is necessary regarding top incomes: the very rich are often under-represented in surveys, meaning there is a downward bias in the estimation of inequality levels of as much as 15 per cent to 42 per cent. Missing information on top earners also affects information on trends, with different effects across regions. The poorest countries in sub-Saharan Africa are the most affected by this omission.

Inequality measured by the income share of the top 10 per cent has increased almost everywhere, although at different paces. Europe presents the lowest inequality at 37 per cent; the Middle East stands out with the highest absorption of income by the top 10 per cent at 61 per cent. This shockingly large share is closely replicated in sub-Saharan Africa, Brazil and India, each at around 55 per cent. Canada, Russia and

[3] This section draws heavily on Alvaredo et al. (2017). Statistics without attribution come from that report.

the United States follow, with shares between 46 per cent and 47 per cent, while China (41 per cent) and Europe (37 per cent) are at the lower end.

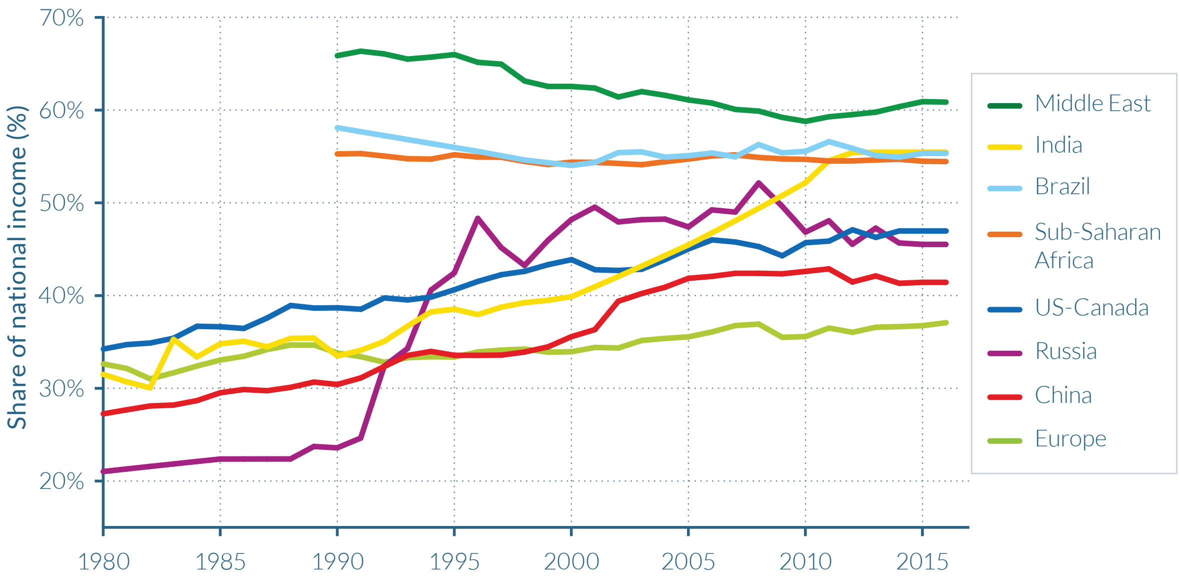
This finding that inequality has increased almost everywhere is in stark contrast to what inequality data by Gini and the bottom 40 per cent show. Although this may indicate the importance of domestic institutional and policy arrangements, it may also partially explain the current confusion about inequality trends: **substantial in-country reductions have been made over the past two decades, and yet a widespread perception that inequality is increasing remains.** What appears to be happening is that decreases in inequality, reported by measures sensitive to changes to the centre and lower part of the distribution, may indeed be capturing dynamics within these groups. Yet, concomitantly, the gap between these groups and the top earners is substantially expanding. These levels indicate that **within-country inequality between bottom and middle segments has decreased:**

- because the bottom has been catching up with the middle; or
- because the middle has fallen closer to the bottom; or
- there is a combination of both.

Inequality has also increased because the richest segment's share of total income has been steadily increasing.

From a policy perspective, the stark contrast between western European countries and other regions demonstrates how policy choices can have a substantial effect on outcomes. Europe, Russia, North America, India and China presented similar levels of inequality around 1980 but have evolved radically differently since. For instance, 'while the top 1 per cent's income share was close to 10 per cent in both the United States and Western Europe in 1980, it had risen only slightly to 12 per cent in 2016 in western Europe, while it had shot up to 20 per cent in the United States. Meanwhile, in the United States, the bottom 50 per cent's income share decreased from more than 20 per cent in 1980 to 13 per cent in 2016' (Figure 2.7).

FIGURE 2.7 Income shares of the top 10 per cent across the world, 1980–2016



Source: Alvaredo et al. (2017), Figure E.3. Based on WID.world (2017). See wir2018.wid.world for data series and notes.

Note: In 2016, 55 per cent of national income was received by the top 10 per cent earners in India, against 31 per cent in 1980.

Main determinants of trends

This section discusses the main potential determinants explaining recent trends in income inequality.

DETERMINANTS ASSOCIATED WITH LOWER INEQUALITY

Trade globalisation

The relationship between trade and inequality is mixed. On the one hand, in both advanced and developing countries, trade openness has been associated with lower inequality (IMF, 2015). Some reasons for this are that increased trade openness results in an increase in the wages of low-skilled workers and a reduction in the compensation of high-skilled workers, leading to a reduction in income inequality (Robbins, 2003). Lowering import prices through trade liberalisation can also lead to an increase in real wages.

However, it should be noted that trade liberalisation has resulted in a redistribution of income towards capital, thus accentuating inequality of wealth (Basco and Mestieri, 2019). Trade liberalisation can also increase income inequality through offshoring, when the reallocation of tasks increases the average skill intensity in skills-poor countries, increasing the demand for skilled labour – a demand that is not met – and, therefore, income inequality (Feenstra and Hanson, 1996). A fall in transport costs entailed by trade liberalisation can also have a negative impact on income inequality: as transport costs fall, the most productive producers grow and take over market share, with less productive manufacturers exiting the market altogether.

Opening up trade also fosters regional inequality (David, 2019). Dix-Carneiro and Kovak (2015) showed that negative effects persist because workers generally have low spatial and sectoral mobility. Low worker mobility is also put forward by Goldberg and Pavcnik (2007) to explain why no regional reallocation of labour has taken place after the liberalisation of trade, which has led to an increase in inequality. The unequal effects of trade liberalisation are not unique to high-income countries: Székely and Mendoza (2016) uncovered such negative effects for Latin American countries in the 1980s and 1990s. Financial liberalisation has also had negative effects on income distribution, especially in countries with weak labour market institutions and a lack of social protection systems. And as Wright and Zucman (2018) point out, the high level of inequality is also due to the fact that globalisation has led multinational companies to seek new arrangements to reduce their tax burdens and shield profits in low-tax countries, causing countries to compete by lowering their tax rates. In a similar vein, rich households transfer their assets to perceived tax havens.

If trade liberalisation is to reduce inequality, it is important that the gains in terms of trade be taxed and then redistributed in a progressive way.

Progressive taxation and redistributive policies

Progressive taxation can have redistributive effects if it increases the income of the bottom 40 per cent in relation to the average or top income earners (Clements et al., 2015; Ostry, Berg and Tsangarides, 2014). By increasing the income capacities of the poor, progressivity can contribute to inequality reduction by increasing investments in children's education and health, and in general human capital (Fatas and Mihov, 2001).

One of the main causes of the decline in income inequality from 2002 to 2009 in Latin America was the implementation of progressive taxation and redistributive policies (Cornia, 2012). Public social expenditure (social assistance, social security, education) started rising in the early to mid-1990s and this upward trend accelerated in the early 2000s.

Migration

Migration reduces inequality by allowing individuals to increase their productivity. International and internal migration offer individuals one of the few ways to escape poverty – moving to higher wages. As Pritchett (2006) points out, wage differences create pressures for labour mobility to the extent that they reflect differences in earning potential for the same individual, reducing inequality once the individual migrates.

Migrant remittances grew rapidly in Central America, Bolivia, Mexico and Ecuador between the 1990s and 2007–2008, tripling in absolute terms to nearly USD 70 billion between 2001 and 2008 (Cornia, 2012). In Latin America, remittances have been an equalising force, and they became even more so in the 2000s because they narrowed the rural–urban income gap and moved millions of low-income families further away from poverty and closer to the global middle class (López-Calva and Lustig, 2010).

Demography: a decline in dependency rates

Part of the recent reduction in inequality experienced by Latin America during the past decades and in Asia during the 'Asian miracle' was caused by the 'demographic dividend', consisting in a decline in dependency rates (Bloom and Williamson, 1998). The dependency rate is a measure of the number of dependents 0 to 14 years of age and more than 65 years of age, compared with the total population who are 15 to 64 years of age.

The *ceteris paribus* effects of a decline in dependency rates are acceleration of growth (because of an abundant supply of labour at low wages) and an increase in consumption per capita. Both have favourable distributive effects.

Education

Another underlying cause of the recent fall in income inequality in Latin America and Africa could be the redistribution of human capital stock among households because of a rise in enrolment rates in educational institutions recorded since the early 1990s (Gasparini et al., 2009).

Education plays an important role in reducing income inequality. It determines occupational choice, access to jobs and level of pay. It also plays a pivotal role as a signal of ability and productivity in the job market. Available evidence suggests that the strength of education's impact on inequality depends on a variety of factors, such as the size of individual and government investments in education and the rate of return on these investments (Rajan, 2015).

Infrastructure and health services

A key factor exacerbating economic inequality is unequal access to community and regional infrastructure and services. Urban and rural populations alike benefit from transport (and digital) networks that make it possible to partake in economic activities. Ready and affordable access to community services for water and sanitation, electricity, heating and waste disposal foster public health, clean living environments, community resilience and, for individuals and families, time savings (from no longer having to fetch water and firewood). These benefits lay a foundation for maximum participation in the educational and economic systems, which fosters greater income equality.

Institutions – the spread of democracy

During the past 20 years, Latin America has witnessed a return to and consolidation of democracy, which has affected income inequality through the introduction of more progressive policies. Institutions that guarantee democracy, civil liberties, rule of law, property rights and uniform political rights help prevent the exploitation of the poor by wealthy elites in economic bargaining and can generate pressures for redistributive policies (Easterly, 2001; Mauro, 1995; Rodrik, Subramanian and Trebbi, 2002).

Gender policies

Gender inequality is an important source of income inequality. Gender inequality in health and education translates to less personal agency, decision-making power and economic opportunities for women, which in turn negatively affect women's income and lead to higher income inequality between men and women. According to the International Labour Organization (ILO) (2019), wage earners represented only about one in three workers in Africa in 2017 (this proportion is slowly increasing). In the same year, men accounted for two thirds of waged employees, a gender imbalance that had changed little over the previous 10 years.

Because of this imbalance, gender policies that improve the socioeconomic status of women and address gender inequality will help to reduce income inequality. Redistributing and balancing care responsibilities, creating a pipeline of talent to close the gender gap in employment and entrepreneurship, and tackling discriminatory laws and restrictive social norms that hold back girls and women are examples of gender policies that can improve women's lifetime earning opportunities. Some gender policies have already been implemented and have proven their efficiency in reducing income inequality. For instance, the Women Entrepreneurship Development Project provides finance and business support for growth-oriented women entrepreneurs in Ethiopia. The project is currently disbursing roughly USD 3 million in loans and training roughly 600 entrepreneurs every month. This programme has effectively helped to reduce inequality by increasing the income of women-owned firms by 40.77 per cent. These gender policies that close gaps in lifetime labour earnings between women and men could help to achieve a 'gender dividend' of USD 172 trillion (ILO, 2020).

DETERMINANTS ASSOCIATED WITH INCREASING INCOME INEQUALITY

Financial globalisation

Financial globalisation has increased income inequality and caused downward pressure on the labour share in developed and developing countries since 1995 (Lee and Jayadev, 2005). An increase in financial openness of 1 percentage point reduces the labour income share by 0.3 percentage points (ILO, 2008).

Financial globalisation has negatively affected income inequality by facilitating the movement of capital across borders. Low-skilled, outward foreign direct investment from advanced economies may in effect be relatively high-skilled, inward foreign direct investment in developing economies (Figini and Görg, 2011), thus increasing demand for high-skilled workers in recipient countries. Financial globalisation is also a driver of inequality, as it increases the likelihood of financial crises. In doing so, greater financial openness may disproportionately hurt the poor (De Haan and Sturm, 2016; Ghosh, Ostry and Qureshi, 2016). Another channel through which financial globalisation has affected inequality is the impact it has had on the bargaining power of labour. By reducing this power, financial globalisation has decreased the labour share of income and thus increased income inequality (Furceri, Loungani and Zdzienicka, 2018; Harrison, 2002). Indeed, financial globalisation gives great importance to maximising shareholder value and to private equity funds in corporate management. This demand for higher dividend payouts from active shareholders has made managers more resistant to claims for wage increases than in the past, while the threat of outsourcing and downsizing has weakened unions and the bargaining position of workers.

Technological change

Technological change has also played a central role in driving up the skill premium (the ratio of the wages of skilled to the wages of unskilled workers), resulting in increased labour income inequality in both developed and developing countries (IMF, 2015). This is because technological change can disproportionately raise the demand for skilled labour over low-skilled and unskilled labour by eliminating many jobs through automation or raising the skill level required to attain or keep those jobs (Dabla-Norris et al., 2015; Jaumotte, Lall and Papageorgiou, 2013). Technology can also increase capital intensity in production, which will in turn increase the returns to capital and the relative income of capital owners, leading to higher income inequality (Dao et al., 2017).

Type of economic development

In theory, in the process of the economic development of a country, inequality would first increase and then decrease. In developing countries, the shift from agriculture to industry should ultimately improve income distribution by increasing the income of relatively poor households (Kuznets, 1955).

However, Africa's transition out of predominantly primary sector activities into tertiary sector activities has not resulted in preferred economic development outcomes. This is because these activities are largely informal and not especially productive. The growth of these largely informal activities is concentrated in low-productivity areas of economic activity, which increases income inequality (McMillan, Rodrik and Verduzco-Gallo, 2014).

Economic development can have different impacts on distribution of income depending on the nature of the labour market. It can reduce income inequality if it involves a large number of labour-intensive, productive and formal firms, which in turn boost wage employment and decrease income inequality. In contrast, capital-intensive sectors and informal activities have the potential to increase income inequality.

The ratchet effect

In developing countries, the decline in labour share after economic shocks in the 1990s was the consequence of the ratchet effect – after an economic shock or a financial crisis, the labour share in gross national income decreases, and then increases at a slower pace than GDP in the recovery phase (van der Hoeven and Saget, 2004).

In the context of the COVID-19 pandemic, the ratchet effect could be one factor explaining an increase in income inequality. The pandemic could be assimilated to an economic crisis, characterised by sharp falls in aggregate output and consumption (Barro and Ursúa, 2008), which will negatively affect the labour share and increase income inequality. The ILO (2020) has estimated that, because of quarantine measures and social distancing, there has been a decline in working hours of around 10.7 per cent – equivalent to 305 million full-time jobs; global income losses of between USD 860 billion and USD 3 440 billion; an increase in global unemployment of more than 25 million people; and an additional 8.8 million people in working poverty around the world. This especially affects low-paid, informal and unprotected workers, as they mostly hold jobs that cannot be done from home and do not have paid leave or sick leave, leading to an increase in socioeconomic inequality.

Labour market reforms

Labour market reforms aimed at increasing job market flexibility – such as laxer employment protection legislation, lower minimum wages, less prevalent collective bargaining, and reforms aimed at reducing union density – reduce the labour share of income by reducing the bargaining power of workers, and thus increase income inequality (Checchi and Garcia-Penalosa, 2008; Ciminelli, Duval and Furceri, 2018; Jaumotte and Osorio Buitron, 2015). The International Monetary Fund (IMF) has found that an increase in the labour market flexibility index of 8.5 per cent is associated with a rise in market inequality of 1.1 per cent in both developed and developing countries (Dabla-Norris et al., 2015).

In developing countries, the combination of rigid hiring and firing and employment protection regulations and weak income protection systems has encouraged informality, fuelling wage inequality.

Natural resource dependence

Even in middle-income countries such as South Africa, dependence on natural resources has negatively affected income inequality through various channels. These countries' high capital intensity limits lower-skilled employment creation, reinforcing the wage gap. An economy based on natural resources also favours illicit financial flows, illegal tax evasion and trade mispricing, which reduce the funds available for productive and inequality-reducing investment. The rest of the gains from natural resources may also be captured by the elite, resulting in high levels of inequality. The COVID-19 crisis has highlighted the importance of secure rights to access and management of natural resources in order to strengthen people's resilience and help those who are heavily reliant on these resources to reduce the inequality gap.

POLITICS AND INEQUALITY

In addition to economic determinants, some political choices can also help explain the rise in inequality.

A neoliberal approach

It is one of the tenets of neoliberalism that only markets with relatively little government intervention can create sustained economic growth. Yet a lack of government intervention (particularly taxation and regulation) risks the concentration of wealth in the hands of a small minority, leading to an increase in inequality (Piketty, 2014).

> 'One of the flaws of market fundamentalism is that it paid no attention to distribution of incomes or the notion of a good or fair society' (Stiglitz, 2008).

A neoliberal approach defined by deregulation, rapid reductions in public spending, privatisation, financial and trade liberalisation, generous tax cuts for corporations and the wealthy, and a 'race to the bottom' to weaken labour rights can explain the rise in inequality taking place in Africa and Asia in the 1980s and 1990s, in Latin America in 2000 and in Russia, where income inequality has almost doubled in the 20 years since 1991 (Oxfam, 2014).

Corruption: the capture of power by elites

A high degree of corruption is often associated with redistribution towards the rich, reinforcing inequality (Sonin, 2003). Elites can use their political influence to obtain government favours such as tax exemptions, sweetheart contracts, land concessions and subsidies. These exemptions undermine the capacity of governments to invest in sectors such as education, healthcare, the environment and climate change, and agriculture – sectors that play a vital role in reducing inequality.

Corruption also increases income inequality through lower economic growth, poorly designed social programmes, and the use of wealth by the well-to-do to lobby governments for favourable policies. Policies that favour the well-to-do often perpetuate inequality in asset ownership, lower social spending and support unequal access to education. In addition, by facilitating tax evasion, corruption affects a government's ability to collect taxes and then implement redistributive policies (Gupta, Davoodi and Alonso-Terme, 2002).

Ethnic fractionalisation

Ethnic fractionalisation has been an important driver of income, especially in Africa, because it affects the way the state implements policies and provides public goods and services (Alesina, Baqir and Easterly, 1999; Alesina and La Ferrara, 2005; Casey and Owen, 2014). For instance, the dominant ethnic group can have greater access to education and the job market, increasing income inequality. Alwy and Schech (2004) confirm this finding for Kenya, where they show that access to education is greater and the quality of education better in the home provinces of the ruling elite.

Why tackle economic inequality

It is commonly agreed that addressing inequality of opportunities is fundamental to ensuring that a person's background will not outweigh their actions and achievements in terms of outcomes. **The growing consensus on the importance of avoiding excessive outcome inequality, and in particular income inequality, is based on both intrinsic and instrumental reasons.**

Irrespective of moral considerations, there are strong arguments for reducing inequality levels within countries. First, evidence shows that **inequality acts as an obstacle to sustainable economic growth**. The relationship between inequality and growth is complex and has received considerable attention from economists. High levels of inequality are, on average, negatively correlated with economic growth, human well-being and environmental protection; countries with more equal income distributions tend to grow faster. Recent econometric work also shows that longer periods of growth are associated with lower inequality. Although some degree of inequality is to be expected in a market economy, there is no consensus as to the level of inequality at which the negative impact on growth would be minimal.

Second, **inequality is an obstacle to reducing poverty**, as economic growth is less efficient in lowering poverty in countries with high levels of inequality. Further, tackling excessive income inequality is poverty reduction in itself: **for a given income growth rate, decreases in poverty are larger when accompanied by inequality reduction** (Ravallion, 2001). This is a purely mechanical relationship driven by the actual distribution of income, with any improvement in incomes resulting in lower poverty if the distribution improves. The partial reverse is also true: an increase in incomes may have no effect on poverty if inequality increases, because the bottom of the distribution may not benefit from such economic growth.

There is, therefore, a double dividend associated with reduced inequality: first, it accelerates growth, and, second, it accelerates the pace at which growth contributes to poverty reduction. (See '**The poverty-growth-inequality triangle**', below.)

Third, inequality is a threat to democracy, social cohesion, and peaceful and resilient societies. High inequality may be bad for the income growth of the poor yet good for that of the rich. The higher the income inequality, the stronger and more influential the role of economic power in determining democratic elections and decisions (Atkinson, 2015). The concentration of wealth in ever-smaller sections of society places a strain on democracy, undermining its legitimacy and distorting democratic outcomes. Inequality and weakened democracy can facilitate corruption and enable abuses of power and influence peddling, further eroding good governance. More, evidence shows that horizontal inequality (between groups), whether political or socioeconomic in nature, is linked to conflict: inequality between groups, including gender inequality, increases the risk of violent conflict, while violence and conflict in turn can further worsen inequality. Perceptions of inequality and injustice also act as triggers for mobilisation and conflict.

Inequality is holding back women, girls and other groups that are discriminated against. Cultural and social norms lock girls and women into unequal power relations. This leaves them with little control over decisions that affect their lives and limit their social, economic and political participation. Gender inequality is often greater when women and girls experience other forms of exclusion caused by factors such as disability, age, ethnicity, sexual orientation, geographical remoteness and religion.

Empirical evidence illustrates that **income inequality has a negative impact on other sustainable development outcomes**, such as the sustainable management of natural resources (e.g. land, forests and water) and biodiversity protection – and vice versa. For instance, disadvantaged groups suffer disproportionately from the effects of climate change and environmental degradation, which results in even greater inequality. Economic inequality also has negative impacts on health outcomes, such as life expectancy and nutritional status.

Income inequality also has an intergenerational impact, as children's opportunities are correlated with their parents' income. Children born in families at the bottom of the income distribution scale, in comparison with more fortunate peers, suffer from gaps in the development of cognitive and non-cognitive skills and physical abilities, which in turn are important determinants of future socioeconomic success (Heckman, 2008). This disadvantage increases over time, affecting learning paths and putting young people at greater risk from phenomena such as early school leaving, child labour and youth unemployment, reducing future earning potential and preventing socioeconomic mobility (Heckman, 2008; Narayan et al., 2018). Parent–child transmission of excessive income inequality can also raise barriers to talent and initiative, denying societies potential opportunities for economic growth (Atkinson, 2015).

The poverty-growth-inequality triangle

Reducing inequality is a means of accelerating the reduction of poverty. The 'poverty-growth-inequality triangle' shows that there is a precise relationship between economic growth, poverty reduction and the changing distribution of income in a given country (Bourguignon, 2003).

Specifically, the elasticity of poverty with respect to average income depends on both the initial level of development and the initial degree of income inequality. This elasticity is defined as the percentage reduction in poverty rates associated with a 1 per cent change in mean per capita income.

The practical meaning of this is that reducing poverty requires **a combination of policies favouring growth and those redistributing wealth, thus reducing inequality**. This in turn translates a redistribution of income into more poverty reduction for a given amount of growth. Therefore, **policies focusing only on growth, without considering wealth distribution, risk having little impact on poverty reduction**.

For the intrinsic and instrumental reasons outlined here, and also because there is a growing body of empirical evidence on the subject, **excessive inequality is beginning to be acknowledged as the social and economic malady that it is**. This in turn has led to the recognition – for example, in the SDGs – that tackling this problem is a fundamental goal for development.

Responses to tackling inequality by the European Union and other international organisations

The European Union

The EU, being the largest contributor to development cooperation, has a crucial role to play in the global commitment to reducing inequality. Equality is one of the foundations of the EU's social model, which is by far the most equitable model in the world and one with a strong record of implementing progressive policies, from income redistribution to welfare state assistance. The goal of reducing inequality is at the heart of many EU policies, and approval for this goal continues to gain ground in public debate.

The EU's commitment to reducing inequality has been outlined in numerous policies, texts and documents, as well as agreements it has adopted, including the following.

- The Charter of Fundamental Rights of the European Union, in Chapter III, 'Equality', covers equality before the law; prohibition of all discrimination including on the basis of disability, age or sexual orientation; cultural, religious and linguistic diversity; and the rights of children and the elderly.
- Article 3 of the Treaty of Lisbon states that the EU 'shall combat social exclusion and discrimination, and shall promote social justice and protection, equality between women and men, solidarity between generations and protection of the rights of the child'.
- The new European consensus on development recognises the importance of addressing inequality, calling on the EU and its Member States to 'act to reduce inequality of outcomes and promote equal opportunities for all [to] directly assist the poorest and most vulnerable sections of society and … to promote more inclusive, sustainable growth that does not compromise the ability of future generations to meet their needs' (paragraph 36). The consensus also calls on the EU and its Member States to 'assess the determinants of and trends in economic and social inequality and [to] strengthen their tools and approaches to make them more effective in addressing inequality' (paragraph 37).
- SDG 10 under the 2030 Agenda for Sustainable Development aims to reduce inequality within and among countries. In particular, aside from the targets related to the inclusion of the most vulnerable, a target is set to 'progressively achieve and sustain income growth of the bottom 40 per cent of the population at a rate higher than the national average'. The SDGs also highlight the interlinkages between inequality and other dimensions throughout other goals and targets, namely those relating to poverty and growth (Goals 1, 8 and 9); gender equality and inclusion (Goal 5); environmental sustainability (Goals 6, 7, 11–15 and 17); health, nutrition and education (Goals 2, 3 and 4); and conflict and access to justice (Goal 16).

More recently, the political guidelines of the current European Commission have called for 'equality for all and in all of it senses'. Moreover, the importance of addressing inequality cuts across the political priorities put forward by President von der Leyen, notably the European Green Deal, 'An economy that works for people', and 'A Europe fit for the digital age'. For the first time, the College of Commissioners now includes a Commissioner for Equality.

The EU has translated these commitments into specific dimensions, and then into important policy documents that reflect the EU's approach to tackling inequality. These dimensions include the following.

- Recently, the human rights-based approach to inclusive growth based on equality and social justice has been reviewed to integrate gender mainstreaming. The new integrated tool builds on the lessons learned from, and the achievements of, the application of the previous rights-based approach toolbox and consolidates the context of, rationale for and priorities of a renewed approach. It aligns with the SDGs under the 2030 Agenda for Sustainable Development and integrates the gender mainstreaming approach into a single coherent approach to EU development cooperation. It reaffirms and translates the EU's policies and political commitments to the rights-based approach and gender mainstreaming into an approach that can more effectively deliver concrete results for all people. In so doing, it reduces levels of inequality of both income and opportunities for specific groups, without discrimination of any kind (such as on the basis of race, colour, sex, language, religion, political or other opinion, national or social origin, property, birth or other status). This area of work includes the Council Conclusions on EU Human Rights Guidelines on Safe Drinking Water and Sanitation (Council of the European Union, 2019b), which reaffirm the EU's commitment to increasing its focus on economic, social and cultural rights in its external policy through securing access to water and sanitation and through water diplomacy.

- Reducing inequality of outcomes and opportunities is also a focus of the Commission Communication 'A Decent Life for All' and the Council's conclusions on a transformative post-2015 agenda of 16 December 2014, which pledge to integrate the SDGs into an agenda that will focus on ending poverty and fighting inequality.
- Through the Commission Communication 'Social Protection in European Union Development Cooperation', the EU emphasises the importance of universal access to social protection and asserts that social protection reduces inequality, contributes to inclusive and sustainable growth, can help to strengthen the compact between citizens and the state, and promotes social inclusion, cohesion and greater accountability.
- The EU is committed to promoting social cohesion, including through the Commission Communication 'The roots of democracy and sustainable development: Europe's engagement with civil society in external relations', which states that 'while states carry the primary responsibility for development and democratic governance, synergies between states and [civil society organisations] can help overcome challenges of poverty, widening inequality, social exclusion and unsustainable development'.
- The Commission Communication on establishing a new partnership framework with third countries under the European agenda on migration, of 7 June 2016, proposes that 'the removal of bottlenecks to investment in SMEs [small and medium-sized enterprises] and sustainable infrastructure should address some of the root causes of migration directly, given the high impact of such investments in terms of employment and inequality reduction'.
- The European Green Deal is the 'new growth strategy that aims to transform the EU into a fair and prosperous society, with a modern, resource-efficient and competitive economy where there are no net emissions of greenhouse gases in 2050 and where economic growth is decoupled from resource use'. The Green Deal sets out the EU's ambitions as a global leader to mobilise an EU and global response to tackle the global challenges of climate change and environmental degradation. This includes a steadfast EU commitment to the Paris Agreement as the indispensable multilateral framework for tackling climate change. The Green Deal therefore aims, by addressing the environmental and climate crisis, to help reduce the burden on and the inequality gap among those most dependent on environmental resources.

More recently, the EU has taken a significant political step towards integrating reducing inequalities into its approach to development cooperation, leading to the development of this reference document. This happened because of the documents described below.

- The Commission Staff Working Document 'Implementation of the new European Consensus on Development – Addressing inequality in partner countries' summarises the ways in which the EU supports the reduction of inequality in partner countries and presents a series of recommendations to further address inequality as a cross-cutting element necessary to achieve the objectives – and improve the impact – of EU development cooperation.
- The Council's conclusions on the above Staff Working Document affirm that tackling inequality is an internal and external priority for the EU and that equality and solidarity are among the values and principles guiding the EU and its external action.

International organisations

In 2015, through the adoption of the 2030 Agenda for Sustainable Development, world leaders committed to reducing inequality within and among countries. Internationally, this was a first in terms of adopting the reduction of inequalities as a key developmental challenge and common goal for the whole international community. High levels of inequalities have been identified as one of the main challenges facing the contemporary world. Accordingly, a specific SDG (**SDG 10: Reduce inequality in and among countries**) is expressly devoted to addressing this challenge. SDG 10 is meant to reduce inequalities by 2030, in terms of both outcomes and opportunities, between individuals and groups as well as between and within countries. The 10 targets of SDG 10 focus on income inequalities, but they also consider social dimensions (see Box 2.1 for four key targets). Through this goal, countries commit, between 2015 and 2030, to progressively achieve and sustain income growth of the bottom 40 per cent of the population at a rate higher than the national average. That income growth is to take place while countries are empowering and promoting the social, economic and political inclusion of all individuals irrespective of age, sex, disability, race, ethnicity, origin, religion, or economic or other status.

BOX 2.1 Key targets under SDG 10

Target 10.1. By 2030, progressively achieve and sustain income growth of the bottom 40 per cent of the population at a rate higher than the national average.

Target 10.2. By 2030, empower and promote the social, economic and political inclusion of all, irrespective of age, sex, disability, race, ethnicity, origin, religion or economic or other status.

Target 10.3. Ensure equal opportunity and reduce inequalities of outcome, including by eliminating discriminatory laws, policies and practices and promoting appropriate legislation, policies and action in this regard.

Target 10.4. Adopt policies, especially fiscal, wage and social protection policies, and progressively achieve greater equality.

Policies to meet the above targets include anti-discrimination laws, progressive taxation and wages, social protection, regulation of financial markets, enhanced representation for developing countries, planned and well-managed migration schemes, and strengthened official development assistance.

Inequality is also indirectly addressed in **SDG 1**, which aims to end poverty. These two goals are strongly connected, because reducing inequalities in income contributes to tackling poverty. Indeed, reducing inequality is an essential condition for meeting the 2030 global poverty eradication target (SDG Target 1.1) (Lakner, Negre and Prydz, 2014). Furthermore, SDG Target 1.2 is a commitment to halving poverty by national standards, which implies concrete and substantial reductions in inequality to very low levels for countries with purely relative poverty lines, which include many EU Member States[(4)]. Inequality is reflected in other goals of the 2030 Agenda for Sustainable Development, in particular those aimed at increasing access to services and resources and those referring to sustainable and equitable access to and use of natural resources such as water, land, forests and biodiversity, along with the development of sustainable lifestyle opportunities for all.

Inequality is a central element of the 2030 Agenda for Sustainable Development, meaning that development partners' agendas on this priority must be aligned. Accordingly, a number of international organisations have committed to reducing inequality.

The World Bank has endorsed the goal of promoting 'Shared Prosperity'. Shared prosperity is defined as fostering growth in the income or the consumption expenditure of the poorest 40 per cent of the population during the period to 2030. **The shared prosperity goal is intrinsically related to the goal of reducing poverty**, measured as the population

[(4)] Poverty lines that are purely relative (60 per cent of the median, for instance) cannot halve poverty by increasing incomes faster, as the poverty rate would remain constant if growth were distributionally neutral. If poverty is defined using a purely relative threshold, it inequality must decrease for poverty to fall. In the case of Germany, Negre and Prydz (in a presentation at PEGNet in Zurich in 2017 entitled 'SDG 1.2, relative poverty and inequality') have estimated that Gini index would need to fall from 32 per cent to 22 per cent for SDG 1.2 strictly to be met.

living on less than USD 1.9 per day, to no more than 3 per cent by 2030. The two are defined as 'twin goals' because sharing prosperity with the bottom 40 per cent of the income distribution significantly contributes to decreasing the incidence of poverty. The World Bank also monitors the shared prosperity premium (Lakner, Negre and Prydz, 2014; World Bank, 2015a, 2015b, 2016 and 2018b), which accounts for distributional changes and is conceptualised as the income growth of the bottom 40 per cent compared with the average income growth in each country. The shared prosperity premium is an indicator of progress towards Target 10.1 of SDG 10. The shared prosperity premium has also been officially adopted by the G20 as one of the indicators used as part of its enhanced structural reform agenda (OECD, 2017). This indicator is not, strictly speaking, an inequality measure, but it provides a clear indication of the direction and intensity of inequality changes over time[5].

Progress towards the achievement of the 'twin goals' of shared prosperity and reduction of poverty is monitored by the World Bank in a series of Poverty and Shared Prosperity reports. The first was launched in 2016, with the subtitle 'Taking on inequality'. The second report, subtitled 'Piecing together the poverty puzzle', was published in 2018, and in 2020 the World Bank published the third report, with the subtitle 'Reversals of fortune'. Before the World Bank endorsed the goal of shared prosperity, its approach to inequality reduction tended to be centred on horizontal inequalities, as laid out in *World Development Report –Equity and development*, published in 2006. The report's focus was on equity defined as equality of opportunity and avoidance of deprivation in outcomes. To follow up on the 2006 *World Development Report*, the World Bank developed an index specifically to monitor equality of opportunity: the Human Opportunity Index, which measures how equitably basic services are distributed among different segments of the population. Another recent contribution from the World Bank on the analysis and discussion of inequality trends and dynamics is the report *Fair Progress? Economic mobility across generations around the world* (Narayan et al., 2018). The report specifically explores the intergenerational transmission of inequalities. Overall, the World Bank has incorporated a remarkable distributional lens into its interaction with client countries by means of a new analytical tool enabling in-depth analysis of poverty and the distribution of income, the systematic country diagnostic.

Other important contributions have been made to the global commitment to reducing inequality. Research and publications by international organisations such as the United Nations Development Programme (UNDP), the Organisation for Economic Co-operation and Development (OECD) and the IMF, have added greatly to our understanding of inequality.

The long-standing commitment of UNDP to addressing inequality is exemplified by the reformulation of its Human Development Index (HDI) to account for inequality. The HDI was one of the first attempts to measure human advancement; it relies on a composite index of indicators for life expectancy, education and per capita income. In 2010, the UNDP introduced the inequality-adjusted HDI (IHDI), which gives the HDI values for each component – education, health and income – adjusted for inequality. The IHDI accounts for the distribution of each component among a country's population. Thus, the IHDI can be understood as providing information on a distribution-sensitive average level of human development. Since 2010, the IHDI has been calculated every year and reported on in the Human Development Report series. The UNDP's position on inequality and commitment to reducing it were reiterated in a 2014 report, *Humanity Divided – Confronting inequality in developing countries*, followed by a 2016 document titled 'UNDP support to the implementation of Sustainable Development Goal 10', in which eight policy areas in both the domestic and the international policy arenas were specified as priority areas for intervention by UNDP to reduce inequality. In 2017, UNDP published a study titled Income Inequality Trends in sub-Saharan Africa – Divergence, determinants, and consequences, with policy guidance on reducing income inequality in sub-Saharan Africa. More recently, the *Human Development Report 2019* explored inequality in human development, looking beyond income, beyond averages and beyond today. It analyses what forms of inequality matter and what drives them, recognising that pernicious inequality is

[5] For an in-depth discussion, see Ferreira, Galasso and Negre (2018).

generally better thought of as a symptom of broader problems in a society and economy. Strikingly, it proposes that a new generation of inequality is opening up, around education, and around technology, climate change and the environment – two seismic shifts that, unchecked, could trigger a new great divergence between rich and poor of the kind not seen since the Industrial Revolution. The report also considers what policies can tackle the drivers of inequality – policies that can simultaneously help nations to grow their economies, improve human development and reduce inequality.

The OECD's extensive work on inequality touches on both income and social inequality, in particular in relation to education, health and well-being. In 2015, the organisation launched the OECD Centre for Opportunity and Equality, a new platform for promoting and discussing policy-oriented research on inequality. In addition, the OECD has published a number of key studies in the past decade, monitoring inequality trends and also inequality drivers and dynamics. In 2015, it published **In It Together – Why less inequality benefits all**, a key study on the negative effects of increased income inequalities on political and social cohesion, as well as on GDP growth. The 2018 report **A Broken Social Elevator? How to promote social mobility** analyses evidence on the relation between social mobility and inequalities of income and opportunities.

The IMF's work on income inequality has centred on how fiscal policies can contribute to reducing income inequalities and strengthening economic growth. A number of staff working documents and discussion papers have been published in this respect, for example **Redistribution, Inequality, and Growth** of 2014 and the 2017 **IMF Fiscal Monitor: Tackling inequality**. All the above represent valuable sources of information that can complement the EU's approach and understanding of inequality around the world. These partners and their publications should be consulted regularly, as research and knowledge on inequality is increasingly in demand and fundamental to inform our approach to reducing inequality and to maximise the effect of our efforts to do so.

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