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## **“Addressing inequality through EU Development Cooperation – Response to the 2030 Agenda” (ADM- MULTI/2016/375-093)**

**Product A: Conceptual & Measurement  
Framework for Addressing Inequality**

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**Box 1: Addressing Inequality through EU Development Cooperation: measures proposed**

**The Agenda 2030 for Sustainable Development, makes the reduction of inequality one of the key goals to be achieved by the international community by 2030.** In response, the EU has produced a new Consensus on Development (2017), which focuses on reducing inequalities and calls for an assessment of *“the determinants and trends of economic and social inequalities”* in order to *“strengthen our tools and approaches to make them more effective in addressing inequality”*.

**This Report proposes specific measures to strengthen the EU’s tools and approaches to address inequality:**

- **A 3-level conceptual framework** is proposed by which to analyse the causes of inequality and identify the appropriate policies to reduce inequality. The 3 levels correspond to the different levels at which household income distribution can be considered and measured:
  - **Primary** income distribution is the distribution of household incomes earned from economic activities *before* taxes and subsidies.
  - **Secondary** income distribution is the distribution of household incomes *after* deduction of taxes and inclusion of transfer payments.
  - **Tertiary** income distribution is the distribution of household incomes when imputed benefits from public expenditure are added.
- **In order to monitor DEVCO’s contribution to the reduction of inequality, three types of indicators will be needed:**
  - **Standard monitoring indicators**, to permit cross-country comparisons of the level of inequality in partner countries.
  - **Contextual indicators**, by which to characterise the determinants and drivers of inequality at the country level.
  - **Portfolio Indicators**, by which to identify and measure the share of EU funded development cooperation initiatives addressing inequality.
- **EU DEVCO should aim to collect and report regularly on three standard indicators of income inequality**, namely the Gini coefficient, the income share of the bottom 40 % of the population, and the Palma ratio (the ratio of the income share of the bottom 40% to that of the top 10%). These indicators should be supported by data on the access to different levels of education, health care and other services of the bottom 40%.
- **To apply the Conceptual Framework, a comprehensive analysis of the inequality context is needed within the country strategy and related programming documents.** This should be based on a set of “framing indicators”, as a way of understanding the inequality context.
- **Two “Portfolio indicators” are required to identify and measure the share of EU development initiatives addressing inequality reduction objectives:**
  - The **“Equality Marker”**, which would record the “intentionality” of policies funded by the EU based upon their stated objectives;
  - **The anticipated share of project/ programme benefits targeted to the bottom 40%.**

## I. Our objective: developing a policy framework to address Inequality

1. **The Agenda 2030 for Sustainable Development, "Transforming Our World", makes the reduction of inequality one of the key goals to be achieved by the international community by 2030.** SDG 10 is to "Reduce Inequality between and among countries" and is based on ten targets that detail the different dimensions that this goal encompasses. In response to this new set of objectives, the EU has produced a new Consensus on Development (2017), which focuses on reducing inequalities and calls for an assessment of *"the determinants and trends of economic and social inequalities"* in order to *"strengthen our tools and approaches to make them more effective in addressing inequality"* (paragraph 37).
2. In many OECD countries, income inequality has increased since the 1980s and is now as high as at the beginning of the 20th century, a fact which has been widely debated thanks in particular to Thomas Piketty's book on capital in the 21st century. Oxfam's work also indicates that wealth is highly concentrated globally, with 1% of the population owning more than 50% of the world's wealth, i.e. as much as the 99% of the rest of the population.
3. **Within developing countries, recent analysis indicates that the level of income inequality is high and, on average, higher than 30 years ago** (Alvaredo and Gasparini, 2015). This average hides a wide variety of trajectories, as income inequality appears to have decreased in some countries of Latin America (Brazil, Peru, Mexico), while it has increased in some Asian countries (China and Vietnam); yet the upward rise in the overall average is undisputed and a major source of concern internationally.
4. **This report<sup>1</sup> presents the approaches commonly used for the analysis of inequalities, explains the different points of view on why inequalities matter, and proposes a conceptual and measurement framework for the EU.** The conceptual framework aims:
  - (i) to provide a basis for understanding the different levels at which inequalities are formed; and
  - (ii) to provide a framework by which to evaluate policies and programmes to address inequalities, by identifying the underlying drivers of inequality at these different levels as well as the public policies that might counteract those drivers and thus help to reduce inequality.
5. In connection with this conceptual framework, the measurement framework proposes a set of indicators, by which to assess the level of inequalities in ODA beneficiary countries, and to monitor the impact of development interventions on inequalities.

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<sup>1</sup> This report has been prepared by Fiscus and IRD-DIAL, France as part of the Study "Addressing inequality through EU Development Cooperation – response to the 2030 Agenda". It lays out the conceptual and measurement framework for assessing inequalities and evaluating policies and programmes to address inequalities ("Product A"). Product B (Analysis of existing measures to address Inequality in EU development cooperation) is a companion volume.

## 2. Concepts and definitions of Inequality

6. **Inequality refers to differences between individuals or groups: it is inherently a relational concept.** In other words, inequality is about gaps between people. Unlike poverty - which is a characteristic that can be defined at the individual level - inequality is based upon inter-individual differences. Different concepts have been developed to analyse these differences, some focusing on differences between groups, and others on differences between individuals. In defining and conceptualizing inequality, four key distinctions are commonly made:
  - Economic vs social inequality;
  - Inequality of opportunities vs inequality of outcomes;
  - “Between” vs “within” inequality;
  - Vertical vs horizontal inequality.
7. **Economic inequality refers primarily, and most commonly, to differences in economic outcomes such as income, consumption or asset ownership (wealth).** By extension, it may also refer to differences in non-economic outcomes that are *driven* by people’s economic positions. Inequalities arise in many dimensions which are not themselves economic but which are driven by differences in economic status. In particular, in the absence of compensating actions by the state or society, income inequality is likely to cause people to be unequal in terms of political power or rights, as well as in education outcomes (access, levels, quality), health outcomes (access, morbidity, mortality), access to basic utilities (water, sanitation and energy), and access to social and legal protection.
8. **Social inequality may refer either to differences in social outcomes, such as education or employment, or to differences in social status or position,** which are reflected in the circumstances in which people live and work and interact with the state. Social inequalities – such as differences in life expectancy or access to democratic freedoms - may persist even when economic inequalities are reduced, or alternatively social inequalities may be reduced through state-financed services, while economic inequalities persist.
9. **Social and economic inequalities are strongly inter-related.** This can easily be observed from data showing that there are both economic and social drivers in many outcomes (e.g. Marmot, 2005, for health outcomes). However, it is difficult to disentangle causal relationships and derive a simple answer as to whether policies should prioritize the reduction of social or economic inequality. In fact, **evidence indicates that social and economic inequalities are most effectively addressed simultaneously.**
10. **A second important distinction is made between “inequality of outcomes” and “inequality of opportunity”.** The first concept simply relates to differences in outcomes such as those mentioned above – differences in income or in educational attainment, for example. The second, inequality of opportunity, refers to differences in “life chances” – in the probability of attaining certain social or economic outcomes, given one’s starting circumstances. Thus, it captures

the part of inequality of outcomes that can be attributed to differences in *circumstances and in the limitations those circumstances place upon the options available to different individuals or groups*. Inequalities in outcomes are partly driven by inequalities in opportunities, but also by differences in *effort and aptitude*, amongst other factors.

11. This distinction has been conceptualized by Roemer (1998) who considered circumstances such as age, sex, disability, race, ethnicity, origin, or religion. Not surprisingly, inequality of opportunity is positively correlated with inequality of outcome – that is, countries with a higher degree of income inequality are also characterised by greater inequality of opportunity. Inequality of opportunity is also negatively correlated with measures of inter-generational mobility, both in incomes and in years of schooling. In other words, societies with greater equality of opportunity have higher levels of inter-generational mobility.
12. **The terms “within” and “between” are used to distinguish inequality within groups from inequality between groups.** For a given population partitioned into groups, total inequality can be decomposed into inequality between groups and inequality within groups. This distinction is helpful to highlight the contribution of “between group” inequality to total inequality. For instance, in the case of China, the urban-rural income gap has been shown to “explain” 31.6% of income inequality in 2002 (Sicular et al., 2007). Likewise, global inequality results from both inequality between countries and inequality within countries and SDG10 makes explicit reference to both dimensions<sup>2</sup>.
13. **A related and often used distinction is made between “horizontal” and “vertical” inequality.** Social or economic inequality may be measured *among individuals (or households) within a particular country, or region or in the world as a whole*. This is referred to as **vertical** inequality (Stewart, 2008). Alternatively, inequality may be measured *across different groups of people within a society*—for example, between men and women or between different ethnic or religious groups, or people grouped by region or age. This type of inequality is referred to as **horizontal** inequality.

Table 1: Two broad perspectives on Inequality

| <b>“Inequality in starting conditions”</b> | <b>“Inequality at the end point”</b> |
|--|--------------------------------------|
| Social                                     | Economic                             |
| Opportunities                              | Outcomes                             |
| Between                                    | Within                               |
| Horizontal                                 | Vertical                             |

14. **These different terms reveal two broad perspectives on inequality, relating on the one hand to starting conditions and on the other to inequality at the end point.** Both perspectives are important in understanding and tackling inequality. The terms “social”,

<sup>2</sup> The measurement of global inequality requires three pieces of information: (1) the average income per capita for each country (2) the population size of each country, (3) the distribution of income in each country (for instance average income per capita by decile). Inequality between countries is usually computed using information on average incomes per capita only (1). However, a population-weighted global inequality measure requires taking into account the size of the population (2), as well as the distribution of income across deciles within each country (3).

“opportunities”, “between” and “horizontal” all make reference to differences between groups which are defined by circumstances, where it is the starting conditions which are the primary concern – the potential for equality/ inequality. The terms “economic”, “outcomes”, “within” and “vertical” refer to a more continuous concept of distribution, where the concern is more with the end point, influenced of course by initial circumstances but also other factors. (See Table I.)

- 15. Available evidence indicates that the variation between countries explains more than two thirds of the total global variance in the Gini coefficient** (Alvaredo and Gasparini, 2015). The international development agenda and related global initiatives on tax transparency and compliance, trade, technology transfer and the environment aim, amongst other things, to reduce inequalities between countries. However, the primary focus of most development policies and programmes is at the country level.
- 16. Inequality at the national level remains an important obstacle to fast growth and poverty reduction.** Data from PovcalNet on inequality within countries analysed by Alvaredo and Gasparini (2015) suggest that income inequality measured by the Gini coefficient spans a wide range in developing countries with values from 0.25 to 0.63. Data aggregated by region indicates that income inequality is highest in Sub-Saharan countries, followed by Latin American and Caribbean countries.

## Box 2: The focus of this report and of the proposed Conceptual Framework

- Acknowledging the importance of within country inequality, **this report focuses on inequality within countries.**
- **The conceptual framework highlights income inequality**, (see chapter 4) although economic and social inequalities are discussed throughout the report.
- Inequality in a given country can be decomposed into inequality between various groups (horizontal) and inequality within those groups (vertical): **the conceptual framework facilitates analysis both of vertical and horizontal inequality.**
- **The conceptual framework addresses both inequality of opportunity and inequality of outcomes.**

### 3. Why should development policy target inequality?

17. **The EU is committed to achieving the 2030 Agenda for Sustainable Development.** The goal of reducing inequality within and among countries (SDG10) has received considerable attention as the issue of inequalities has gained ground in the public debate. Also, in contrast with other parts of the World, the EU social model is grounded on equity considerations. As a result, European governments redistribute income on a larger scale than, for example, the U.S. government: European social programs are more generous and reach a larger share of citizens, European tax systems are more progressive, and European regulations designed to protect the poor are more extensive (Alesina, Glaeser and Sacerdote, 2001).
18. There are several reasons to fight against inequality, each with different policy implications. It can be seen as an end in itself – inequality is wrong and should be reduced – or a means to an end – e.g. inequality needs to be reduced to achieve faster poverty reduction. This chapter outlines five different perspectives commonly considered in discussing inequality and why it matters.
19. **The moral case considers that reducing inequality is an end in itself.** This view is rooted in political and philosophical traditions that emphasize egalitarian principles. These principles are enshrined in Article 1 of the Universal Declaration of Human Rights as well as in the Constitutions of many democracies around the world. As already mentioned, the moral case against inequality is strongly upheld in many European countries and has generated a more egalitarian social model than that of other OECD countries.
20. **In contrast, the “Kuznets hypothesis”, considers inequality as an unavoidable “by-product” of development.** In this view, embraced by many early development thinkers (see Box 3), inequality is expected first to increase and then to decrease as the economy grows. Despite its critics – coming from both empirical and theoretical angles – the Kuznets hypothesis remained for many years one of the main tools used in thinking about the relationship between development and inequality. While the Kuznets hypothesis was found to account for some stylized facts when it was first spelled out, it is not supported by more recent and robust empirical evidence. In particular, its prediction of low inequality in high income societies does not account for the sustained increase in income inequality that started in the early 1980s in practically all developed nations.
21. More recently, Milanovic (2016) introduced the idea of “Kuznets waves”, in which the relationship between inequality and growth may fluctuate repeatedly. These fluctuations are driven both by technological revolutions, e.g. the ‘transfer of labour from more homogenous manufacturing into skill-heterogeneous services (thus producing a decline in the ability of workers to organise),’ and by globalisation, ‘which has both led to the famous hollowing out of the middle classes in the West and to the pressure to reduce high tax rates on mobile capital and high-skilled labour.’ This theoretical proposal has yet to be supported by robust empirical evidence.



**Box 3- Does Economic Growth bring more or less Income Inequality?**

Whether economic growth brings more or less equality in the distribution of income has been thoroughly discussed in the economic literature (Bourguignon, 1990). The question is both a theoretical and an empirical one. Among classical economists, the discussion on inequality focused on the functional distribution of income, which reflects the way national income is shared between production factors (Sandmo, 2015). In a society of classes, such as that of the 18<sup>th</sup> and 19<sup>th</sup> centuries, the division between “labourers” and “capitalists”, made the link between the factor income distribution and the personal income distribution obvious.

In line with that view, the distinction between functional and personal distribution in Lewis’ growth model is irrelevant since the model is based on a two-class society comprising “capitalists” and “workers”. Lewis’ model provides a still widely used view of economic development that focuses on labour transition between two sectors. The model considers a dualistic economy comprising a modern manufacturing sector – where labour productivity is high – and a traditional agricultural sector, where labour is abundant and its productivity is much lower. In that model, an underdeveloped economy is characterised by all individuals being employed in the traditional sector. Growth in that economy occurs through the expansion of the manufacturing sector which draws labour from the agricultural sector. As a result, the output per head of labourers who move from the subsistence sector to the modern sector increases, increasing inequality in the short term and reducing it in the long term.

This simple dualistic model can account for Kuznets theoretical proposition of an “inverted-U” relationship between the level of income inequality and the level of economic development. On the basis of data for the United States, England and Germany, Kuznets found that income inequality – as measured by income per capita – had decreased after the end of the First World War. He suggested that this period had been preceded by one of increasing inequality.

Kuznets’ explanation was based on the shifts from the agricultural (or traditional) sector of the economy to the non-agricultural (or modern) sector. Indeed, when the share of the modern sector – where individuals earn more than traditional workers – in total employment goes from zero to unity with growth, inequality first increases from zero to a maximum when the population is divided equally among both sectors and then decreases again, tending towards zero when the economy is close to being fully “modernized” (Bourguignon, 1990). Factors behind the decrease of inequality are diminishing inter-sectoral productivity differences (which may be accelerated by expanded education) and diminishing returns to capital. Political pressure for greater social transfers may accelerate the reduction in inequality both directly and by enhancing the poverty-reducing effects of growth.

22. **The third view considers reducing inequality as a means to accelerate the reduction of poverty.** Analysing the “Growth-Inequality-Poverty triangle”, Bourguignon (2000) shows that there is a precise relationship between economic growth, poverty reduction and the changing distribution of income in a given country. Specifically, the elasticity of poverty with respect to average income depends both on 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 one percent change in mean per capita income.
23. Using data on a sample of developing countries, Ravallion (2001) estimates that, the average growth elasticity of poverty is around 2.5 – i.e., a one percent increase in mean income reduces the proportion of people below the poverty line by 2.5 percent. There is however much cross-country heterogeneity behind this average figure. More recent research indicates that the overall elasticity for developing countries has declined over 2005-2008 (Ram, 2013). In the case of Sub Saharan countries, empirical evidence suggests that the impact of GDP growth on poverty reduction is significantly lower than for other developing countries (Fosu, 2008).

24. **The fourth view emphasizes the effects that inequality – as well as policies aimed at reducing it – may have on growth.** It is based on economic theories regarding the role played by incentives in fostering economic growth. It is structured around the so called “**equality-efficiency trade-off**” laid out by Arthur Okun in his 1975 book entitled “Equality and Efficiency: the Big Trade off”, which examines the potential negative effects on economic efficiency, which may be introduced by measures to reduce inequality. According to IMF researchers (Ostry et al., 2014), this perspective is “deeply embedded in policymakers’ consciousness” (p. 5), ... although not in empirical research. In the most recent Fiscal Monitor (October 2017), the IMF, based on current empirical research, downplays the importance of the equality-efficiency trade-off and emphasises the substantial scope for inequality-enhancing fiscal policies, which do not entail fiscal trade-offs.<sup>3</sup>
25. Challenging the importance of the equality-efficiency trade-off, a more recent growth-inequality literature has emphasized theoretical reasons why growth may be faster in a more egalitarian environment, because in an unequal economy certain types of markets may be efficient for the rich but not accessible by the poor (e.g. Aghion et al., 1999). This literature highlights the existence of insurance and capital market imperfections that prevent the poor from investing in human and physical capital, and thus lead to a sub-optimal level of investment for society as a whole. This view has led to the promotion of micro finance projects and to a focus on the accumulation of human capital through increasing access to health and education for all. Another questioning of the equality-efficiency trade-off comes from evidence that inequality can fuel social discontent and threaten social and political stability with adverse effects on growth (e.g. Fajnzylber et al., 2002; Alesina and Perotti, 1996).
26. **The efficiency view has led to the distinction between “good” and “bad” inequality,** where, following Roemer’s conceptualization, “good” inequality stems from differences in efforts while “bad” inequality results from differences in circumstances, in other words “inequality of opportunity”. According to this view, policies to reduce inequality should focus on “bad” inequality, aiming to give equal opportunities to all, without necessarily giving attention to inequality of outcomes. This view has been laid out in the World Bank’s World Development Report of 2006. It remains an important component in the World Bank position on inequality, as will be more thoroughly discussed in Chapter 6. However, such a view is, to a degree, at odds with the European social model, which considers that high levels of inequality of outcomes are morally wrong in themselves.
27. **The fifth view considers the interaction between inequality, politics and economic growth.** Arguing that the rich have more political power than the poor, one view emphasizes the risk of political capture by the economic elite (Stiglitz, 2012) that will lead to low levels of taxation and redistribution, which, in turn, will aggravate the concentration of income and threaten democracies. This perspective has been given new momentum by recent work on the increase of

<sup>3</sup> “This *Fiscal Monitor* focuses on how fiscal policy can help governments address high inequality while minimizing potential trade-offs between efficiency and equity” (IMF, 2017, p.1).

income and wealth concentration at the top of the distribution in OECD countries by Piketty and his co-authors from the World Wealth and Income Database project (<http://wid.world/>).

28. An alternative view has developed around the ‘Meltzer–Richard hypothesis’ that a more unequal income distribution will create a democratic majority for more redistribution which in turn will have a negative impact on growth (through its impact on efficiency, in line with the equality-efficiency trade-off). However, as we note below, and as the IMF have stressed (Ostry et al, 2014; IMF Fiscal Monitor, October 2017), empirical evidence indicates that the equality-efficiency trade-off is only present where there are very high levels of income redistribution, levels which would not be feasible in most Developing Countries, where levels of tax collection represent significantly lower proportions of GDP.
29. **In summary, there are very powerful reasons for the European Union to place a high priority on the reduction of inequalities** both as an important moral objective in itself – fully consistent with the European social model – and as a means to achieve faster reductions in poverty, and more peaceful, more harmonious societies. While there may be trade-offs between equity and efficiency within OECD countries, where high levels of income distribution are in principle possible, empirical evidence suggests that such trade-offs are not normally present in Developing Countries, where high levels of income redistribution through fiscal policy are not feasible. (See Box 4.)
30. In Chapter 4, in the presentation of the conceptual framework, we will show that policies to combat inequality need not be limited to fiscal policies or cash transfers that aim to alter the secondary distribution of incomes. There are also feasible policies that can be pursued in Developing Countries to address the primary determinants of inequality – for example, by tackling inequalities in the distribution of land, by improving access to capital or by addressing inequalities in the labour market.

**Box 4: Why address inequality – five perspectives and the related empirical analysis**

**Why address inequality: five perspectives:**

- **Inequality is morally wrong, and thus reducing inequality should be an end in itself.** For this reason, egalitarian principles are enshrined in Article I of the Universal Declaration of Human Rights.
- **Inequality may be an unavoidable by-product of economic growth – the “Kuznets hypothesis”.** Early 20<sup>th</sup> century empirical data supported this hypothesis but not empirical data post 1980.
- **Reducing inequality is a means to accelerate the reduction of poverty.** The “Growth-Inequality-Poverty triangle” shows that there is a precise relationship between economic growth, poverty reduction and the changing distribution of income in a given country. (Bourguignon, 2000).
- **Inequality may undermine market efficiency and thus inhibit growth.** If there is an “equality-efficiency trade-off”, measures to reduce inequality may also inhibit growth but this is likely only when there are very high levels of income redistribution, and therefore not in Developing Countries.
- **Inequality, politics and economic growth may interact, threatening social stability and democracy or inhibiting economic growth.** Political capture by the economic elite may lead to low levels of taxation and redistribution, aggravating the concentration of income and threatening democracies.

**What does the empirical research tell us?**

- Concerning the inequality-growth debate, there is now plenty of empirical evidence that high or rising inequality has a negative effect on the rate of growth or the length of growth spells (e.g., Berg and Ostry, 2011; Easterly, 2002).
- Ostry et al. (2014) examine the complex relationships on which the “efficiency” and “political economy” perspectives are based, using a cross-country dataset that captures measures of redistribution by comparing secondary inequality (after taxes and transfers) with primary inequality for a large number of OECD and non-OECD countries. Their findings indicate that:
  - (i) More unequal societies tend to redistribute more (in line with the ‘Metzer-Richard hypothesis’).
  - (ii) Lower net inequality seems to drive faster and more durable growth for a given level of redistribution (in contrast to the equality-efficiency trade off).
  - (iii) The direct impact of redistribution on growth appears to be benign, except in countries where redistribution is very high (suggesting that the equality-efficiency trade off applies only in quite extreme circumstances).
  - (iv) Finally, the combined direct and indirect effects of redistribution – including the growth effect of the resulting lower inequality – are on average pro-growth.

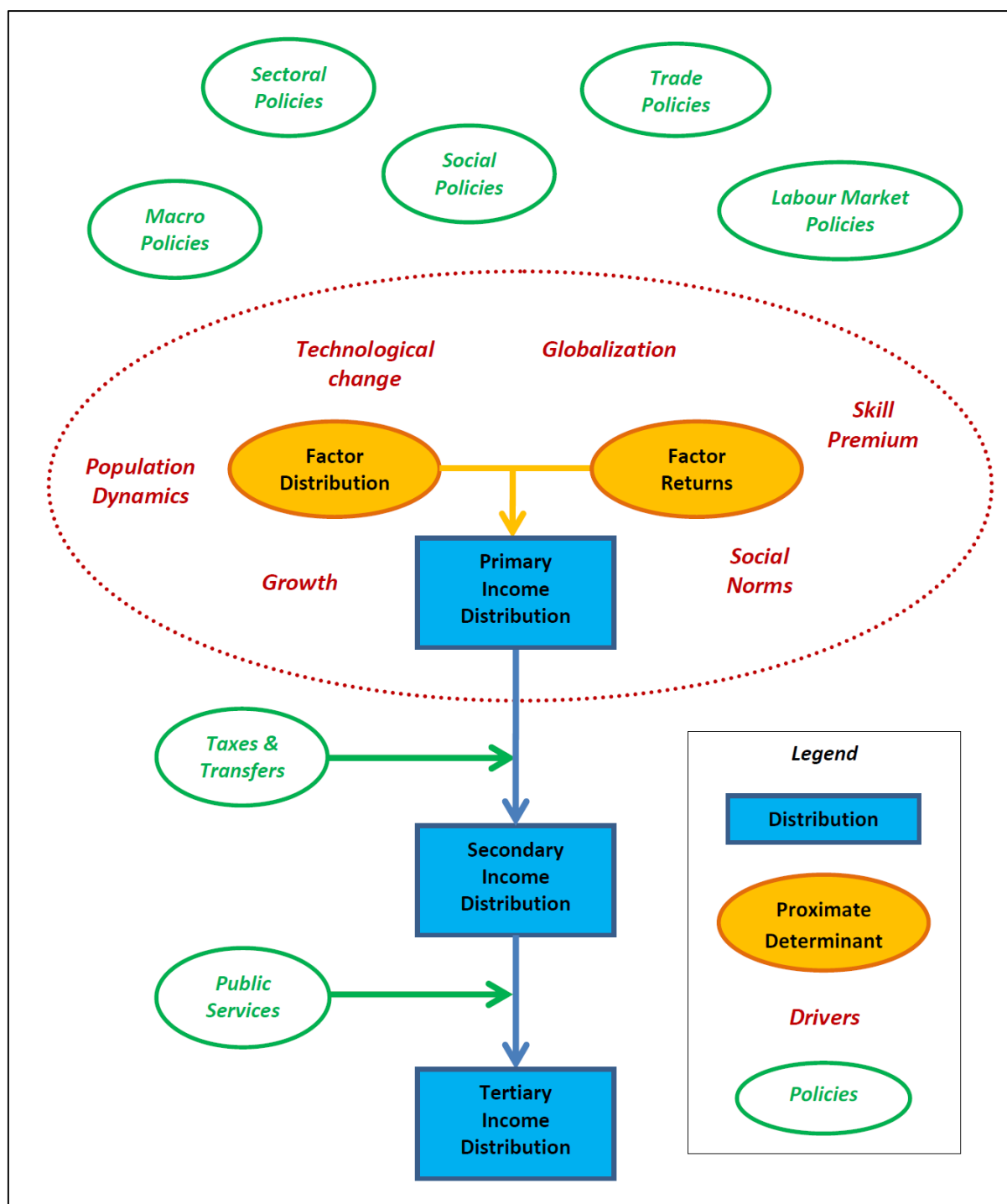
## 4. The conceptual framework for addressing inequality

31. In this chapter, we present a simple conceptual framework to be used to guide the design of development policy interventions to address inequality. The framework is focused on economic inequality, specifically on income inequality, which as we have noted is very frequently associated with social inequality.
32. The conceptual framework is a three level framework, corresponding to the three different levels<sup>4</sup> at which Personal (or household) Income Distribution can be considered and measured:
- **Primary** income distribution is the distribution of household incomes earned from economic activities *before* taxes and subsidies (also referred to as “Market Income”).
  - **Secondary** income distribution is the distribution of household incomes *after* deduction of taxes and inclusion of transfer payments (also referred to as “Disposable Income”).
  - **Tertiary** income distribution is the distribution of household incomes when imputed benefits from public expenditure are added to household income after taxes and subsidies.
33. Different criteria can be used to consider the drivers of primary income inequality. The proposed conceptual framework distinguishes between “proximate determinants”, “drivers” and “policies”.
- **Proximate determinants** are the immediate determinants of the primary income distribution<sup>5</sup>.
  - **Drivers** are the socio-economic and demographic processes that affect primary income distribution.
  - **Policies** are all interventions (including programmes and projects) designed by the State.
34. Figure 1 presents the architecture of the conceptual framework. In the following sub sections, we examine proximate determinants and drivers of inequality, as well as policies to reduce inequality.
35. Tables 2 – 6 at the end of the chapter provide some examples of public policies, which, in the appropriate circumstances, are likely to reduce the degree of inequality at each of the three levels of the income distribution. They are presented with a brief explanation of their rationale, a statement of the specific objectives which they are designed to address and some examples of indicators that might be used to assess their impact on the reduction of inequality. These are thus the types of policies which the EU should promote, depending upon the level of the income distribution at which it is intended to combat poverty and, of course, subject to the feasibility and political acceptability of these policies in the given country context.

<sup>4</sup> Lustig and Higgins 2013) use an analytical framework based on 5 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 3-level conceptual framework here presented.

<sup>5</sup> The concept of “Proximate determinants” comes from the analytical framework developed by Mosley and Chen (1984) for the study of child mortality. This framework relies on the distinction between proximate and socio-economic determinants of child mortality. Proximate determinants directly affect child mortality, such as maternal factors (age, parity, and birth interval), environmental contamination (hygienic factors, water, and sanitation), nutrition, injuries, and personal illness control. In contrast, all socio-economic variables have to operate through these proximate determinants and thus indirectly affect child mortality.

Figure 1: The proposed Conceptual Framework for design of policies to address inequality



#### 4.1 Proximate determinants of primary income inequality

36. **Primary (or market) incomes** are those incomes resulting from employment and/or productive activities, prior to any tax deductions or any supplementation through pensions or social transfers. Inequality in the primary income distribution therefore has two origins: unequal distribution of production factors (land, labour, human and physical capital) and/or unequal returns to these factors (rents, wages, and profits).

- 37. The distribution of physical factors such as capital and land is the result of social and political history.** This distribution may be hard to change in the short run given that factors of production are privately owned in most countries, and that large owners can resist redistribution through lobbying and/or elite capture of policies. In the U.S. and Europe, only financial crises and World War II have led to a significant and lasting falls of the share in national wealth (and resulting income) of the top decile (Piketty, 2014). These shifts have been driven by the collapse of stock market prices during financial crises, destructions brought about by war, and the implementation of high levels of taxation to finance the war effort.
- 38. In developing countries, land is a critical factor of production.** Thus, the balance between large and small farms has a strong impact on inequality at the national level. Indeed, the countries with the highest levels of inequality in the world also have a highly skewed distribution of land (e.g. Brazil, South Africa) while countries with fairly equal land distribution are among those with the lowest levels of inequality (e.g. former communist countries).
- 39.** Unequal distribution of land is mainly observed in contexts where discriminatory policies have prevailed, either related to a “historical” organisation of production based on slavery (e.g. Brazil) or to conflicts over resources between indigenous population and settlers (e.g. South Africa, Zimbabwe). This unequal distribution can be aggravated by market imperfections. Indeed, in countries where the distribution of land is unequal, the subsidization of capital to promote modernization has mostly benefited large owners. In addition, the high transaction costs of providing formal credit in rural markets tend to bias banks’ policies against lending to small farmers (Deininger, 2003).
- 40. The relative prices (or returns) on factors of production will also drive primary income inequality.** Scarce and/or more productive factors are usually paid a higher price and their owners earn a higher share of national income. Until World War II, primary income inequality in developed countries was primarily driven by unequally distributed land and physical capital (Piketty, 2014). Since the 1980s, the rise in primary income inequality has been driven by a concentration of capital, the decline of the share of labour in national income, and an increase in labour income inequality related to the rise of top wages. Indeed, evidence shows that in the last decades, earnings dispersion has increased dramatically because of the increase of top wages. Autor, Katz and Kearney (2008) document a strong increase in wage inequality for males in the U.S.: between 1963 and 2005, weekly wages for the least skilled workers (the tenth percentile of the wage distribution) grew by about 30 percent, whereas wages for the most skilled workers (as measured by the ninetieth percentile of the wage distribution) rose by about 80 percent. The increase in other dimensions of inequality related to work have been documented in many developed countries such as the increase in the precariousness of labour contracts, in the share of short contracts as well declining unionisation (Bourguignon, 2012; Standing, 2016).
- 41. The ratio of the wages of skilled to unskilled workers is referred to as the skill premium.** This ratio is likely to be affected by supply and demand, as well as institutional factors.

In the U.S., strong growth in the relative demand for more educated workers – driven by **skill biased technological change** – combined with fluctuations in the supply of human capital explains in large part the long-run evolution in educational wage differentials (Goldin and Katz, 2007). In Latin American countries, the decline in income inequality observed between 2000 and 2010 has been in part attributed to a fall in the premium to skilled labour (Lustig et al., 2013). In developing countries, the pattern of returns to education in urban West Africa has been shown to be convex in all sectors<sup>6</sup>, including in informal activities (Kuepie et al., 2009), suggesting that the **skill premium** is likely to be an important driver of primary income inequality through its impact on earnings dispersion. The importance of the skill premium as a driver of income inequality points to the key role educational policies can play in reducing inequality.

42. **Employment inequality – differing degrees of employment/ unemployment - is also a driver of primary income inequality.** In particular, the least skilled in the labour market are in most countries more likely to be unemployed or partially employed. This effect can be exacerbated by centralized wage-setting institutions which prevent relative wages from adjusting to changes in the demand for skills. Indeed, a rise in relative unemployment rates among the least skilled has been observed in some countries with centralized wage-setting Institutions (van der Hoeven, 2010). In France, while wage inequality has remained relatively stable, the inequality between individuals in the working age population has increased dramatically as unemployment rates for the least skilled have soared (Bourguignon and Martinez, 1996 cited by Piketty, 2004).

## 4.2 Drivers of primary income inequality

43. Socio-economic and demographic processes will affect primary income distribution through their impact on factor distribution and factor returns. These may be divided into three broad categories:
- (i) **Economic drivers**, including growth processes, technological change, trade and globalisation;
  - (ii) **Cultural and social norms**, especially those which are discriminatory; and
  - (iii) **Population dynamics**.

### **Economic drivers**

44. **The growth process is likely to affect income distribution depending on how growth differs between sectors and how it influences returns to factors.** Growth may stem either from the increase in the availability of factors or from the increase in the productivity of factors brought about by **technological change**. Available evidence indicates that growth is distribution-neutral on average (World Bank, 2006). However, the data also shows that the incidence of economic growth (its distributional pattern) can vary dramatically across countries.

<sup>6</sup> In other words, for workers in any sector of the economy the returns to secondary education are higher than those to primary education and tertiary education brings still higher returns, up to a point where the returns to increased years in tertiary education start to decline. Hence, in urban West Africa the skill premium gives disproportionate returns to secondary schooling and to the early stages of tertiary education.



- 45. Evidence indicates that the sectoral composition of growth matters:** in particular, growth in unskilled labour-intensive sectors (agriculture, construction and manufacturing) usually have a stronger effect on poverty reduction (Loayza and Raddatz, 2010) than growth in skilled labour-intensive sectors. As a consequence, two countries with similar rates of growth in mean incomes can have very different growth profiles across the population. The World Development Report of 2006 (World Bank, 2006) illustrates this variation by a comparison of the growth incidence in Tunisia (1980–2000) and Senegal (1994–2001). In both countries, the average annual growth rate in the mean incomes from the household survey was close to 2.5 percent. However, the distribution of this growth was much more beneficial to the poor in Tunisia, resulting in a much higher decrease in the headcount index of poverty (67 vs 15 percent for Senegal).
- 46.** Globalization is a powerful economic driver that has reached unprecedented levels in the last decades and is likely to affect inequality both between and within countries. The evidence on the distributional effects of globalization indicates that while it had a positive impact on equality between countries (through its positive impact on the economic growth of emerging countries), globalization is likely to have had a negative impact on equality within countries. In China, the progress of globalization over the 80s and 90s has been accompanied by a large fall in poverty rates, but also an increase in income inequality, with the overall Gini coefficient rising from 0.28 in 1981 to 0.42 in 2004. Different channels are at work since globalization affects trade competition, technological change as well as financial development (IMF, 2007).
- 47. In developing countries, many studies find that globalization increases the wage skill premium at the national level** (Goldberg and Pavcnik, 2007). Recent work also indicates that regional inequality resulting from greater trade openness (favouring some regions but hurting others) is long lasting as spatial and sectoral mobility of workers appears to be limited in many settings (Goldberg and Pavcnik, 2007; Dix-Carneiro and Kovak, 2015). This result points to a potentially powerful driver of inequality in these countries.

### ***Cultural and social norms***

- 48. Discrimination is another powerful driver of inequality affecting both factor distribution and the returns to factors.** Discrimination is defined as the differential treatment of individuals based on their race, ethnicity, origin, religion, sexual orientation or gender. It can manifest itself in various ways, contributing to unequal access to social services such as education and health (Klasen, 2005), unequal access to employment (Morrisson and Jutting, 2005) or unequal wages (Nordman et al., 2011).
- 49. Discrimination may be deliberate and overt but in many cases is the result of commonly accepted social norms.** This is especially the case for gender inequality. Indeed, together with overt discrimination, internalized social norms may prevent women from participating in the labour market. Using country level data on gender inequality and institutions such as laws, norms, traditions, and codes of conduct, Morrisson and Jutting (2005) find that social

institutions are the most important single factor determining women's participation in economic activities outside the household.

- 50. Gender discrimination is often based on patriarchal norms prevailing in many societies.** For example, gender inequality in land ownership is due to male preference in inheritance, male privilege in marriage, male bias in state programmes of land distribution, and gender inequality in the land market, where women are less likely to be buyers than men (Deere and De Leal, 2014). Gender inequality is also prevalent in labour markets both in developed and developing countries. On top of being an issue *per se*, gender inequality has been shown to be strongly associated with income inequality over time and across countries. In Sub-Saharan countries, recent research indicates that gender inequality is not only associated with high income inequality but also with low growth (Hakura et al., 2016),

### ***Population dynamics***

- 51. Population dynamics, which refer to both population growth and population mobility, are powerful, but often ignored, drivers of inequality:**

- Concerning population growth, since the relevant metric for income inequality analysis is defined at the per capita level, the incidence of population growth – i.e. its relative pace across the deciles of the income distribution – is likely to matter. Indeed, available evidence indicates that there exists an important fertility differential between rich and poor households which results in higher inequality of income per capita.
- The declining rate of fertility along the distribution of income is also likely to drive income inequality in the long run. First, in a given area, population growth will determine the quantity of factors of production available per capita at least for fixed factors such as land. Second, the fertility differential is likely to affect the accumulation of human capital (De La Croix and Doepke, 2003).

- 52. Population mobility such as internal migration is also likely to affect income inequality.**

Indeed, allowing individuals to move from low to high productivity areas is likely to contribute to lowering inequality between areas, at least in the long run, although, as mentioned above, spatial and sectoral mobility of workers has been shown to be limited in many settings. (Goldberg and Pavcnik, 2007; Dix-Carneiro and Kovak, 2015). The restriction of population movements – through the regulation of residency changes – is likely to exacerbate both urban-rural inequality and inequality within the rural area by diminishing the bargaining power of workers vis-à-vis land owners. As discussed in Box 2 above, labour mobility between sectors is key in the process of structural transformation from traditional to modern economies.

## **4.3 Policies to address primary, secondary & tertiary income inequality**

- 53.** Public policies affect income distribution either directly through their impact on proximate determinants (factor endowments and factor returns) or indirectly through their influence on

socio-economic drivers of inequality. Public policies can impact on any of the three levels of income distribution – primary, secondary or tertiary. We discuss each of these in turn and present at the end of this section a series of tables illustrating some of the key policy options.

### ***Policies addressing Inequality in Primary Income Distribution***

54. **Some policies affect primary income inequality through their impact on factor distribution.** One example is land reform. Where extreme inequality in land distribution and underutilization of large tracts of productive land co-exist with deep rural poverty, a case for redistributive measures to increase access to land by the poor can be made, both politically and from an economic perspective (see Deininger, 2003). Indeed, countries that have successfully implemented land reform have much lower income inequality and, in some cases, this seems to have fostered economic growth (Benabou, 1996).
55. The distributive impact of **trade and macro policies** is likely to be both policy and context dependent since it is brought about through changes in relative prices that cause shifts in output, wages, and employment. As indicated by Pavcnik (2017), economists have long known that international trade generates winners and losers within developing and developed countries. One rationale for trade liberalisation promoted by structural adjustment policies and the Washington Consensus was to eliminate the bias against agriculture stemming from trade barriers designed to protect infant industries (Thiele, 2002). This bias was believed to hurt agricultural households and hence its removal was expected to lower inequality. However, empirical evidence on the distributive impact of trade liberalization using country level data show that while trade openness is positively associated with growth, there are no strong correlations with income distribution on average (World Bank, 2006).
56. More generally, the impact of trade-induced price changes on income distribution depends upon exactly which prices change and how producers and consumers are affected. For example, the effects for agriculture of removing protection (for manufacturing) will depend on whether agricultural prices subsequently rise or fall and whether the poor are net producers or consumers of previously protected products (Ravallion, 2004).
57. Evidence accumulated over the past two decades confirms that the answer to the question “does trade increase inequality” is nuanced and context specific as it depends on (i) the nature of changes in trade policy or trade patterns and the mechanisms involved, (ii) the mobility of workers and capital across forms, industries, and locations, (iii) the position of affected individuals in the income distribution of a country (Pavcnik, 2017). Evidence from Vietnam (McCaig 2011, McCaig and Pavcnik 2014 cited by Pavcnik, 2017) and India (Topalova 2007, 2010 cited by Pavcnik, 2017) illustrates how trade can decrease poverty [Vietnam] or increase poverty [India] within a country.
58. **Other policies affect primary income inequality through their impact on factor prices.** Given the importance of individual wages and earnings to household incomes, **labour market institutions and policies** are likely to influence income inequality through their impact on employment and earnings dispersion. Strong and opposing views are held on the costs and benefits

of labour market institutions, such as minimum wage legislation. Given that there is likely to be some degree of substitutability of labour and capital in the production process, the ultimate answer is highly context dependent and evidence has to come from empirical studies.

59. Reviewing empirical results for the US and EU, Salverda and Checchi (2015) show that minimum wage legislation and active labour market policies are positively correlated with earnings equality. In middle-income Latin American countries, a group of studies show that minimum wage policies had a moderating influence on wage inequalities and, for some countries, contributed to the overall reduction in income inequality (Lustig et al., 2013). Where the formal sector employs a significant share of the active population, minimum wage legislation may be a powerful instrument to mitigate wage inequality. In low-income countries, minimum wage legislation may also affect the distribution of earnings through a “light-house” or “demonstration” effect that the formal sector has on the informal sector since higher wages in the formal sector may induce workers in the informal sector to ask for higher wages.
60. Covering a wider scope, Betcherman (2012) reviews the findings of over 150 studies on the impact of four types of labour market institutions: minimum wages, employment protection regulations, unions and collective bargaining, and legally mandated benefits. The review places particular emphasis on results from developing countries and explores impacts on living standards (employment and earnings effects), as well as productivity, and social cohesion. On balance, Betcherman finds that the impact of labour market institutions is smaller in most cases than the “heat of the debates” would suggest. He also finds that distributional impacts are clearer, with two effects predominating: an equalizing effect among covered workers but with potentially large groups such as youth, women, and the less skilled disproportionately outside the coverage and its benefits.
61. **These results highlight the importance of analysing the drivers that affect the collective bargaining power of workers.** Obviously, trade unions and the legal system that protect workers and define acceptable wages and working conditions are likely to enhance the bargaining power of workers. Conversely, that power is likely to be negatively affected by any driver – such as globalization – or policy – such as capital market liberalization – that increases the mobility of capital. Indeed, the possibility of capital to relocate (more easily than workers can migrate) as well as the decrease of trade barriers and trade costs is likely to negatively affect wages.

### ***Policies addressing Inequality in Secondary Income Distribution***

62. **For a given primary income inequality, secondary income inequality is determined by net fiscal and social transfers.** Their impact on income inequality depends, firstly, on the size of transfers relative to national income and, secondly, on the incidence of these transfers.
63. In OECD countries, fiscal and social transfers are significant: total taxes represent about 40% of national income while monetary transfers (public pensions, unemployment and family benefits, and means-tested transfers) represent about 15% of national income. Concerning incidence, the tax and transfer system reduces the disparity of income in almost every country but the extent of redistribution appears to vary substantially across countries (Morelli et al., 2015). Comparing the

distributions of pre-tax and pre-transfer income with disposable household income (post tax and transfers) for 31 OECD countries, Morelli et al. show that fiscal redistribution achieves reductions in Gini coefficients ranging from 3.1 points in South Korea to 26.0 points in Ireland.

- 64. In developing countries, the redistributive capacity of fiscal policies is typically much lower, given that taxes generally represent 10% to 15% of national income.** This ratio has stagnated in recent decades as declining trade tax revenues related to trade liberalization were, in many countries, not replaced by more modern income or value added taxes. This can be explained in part by the importance of the informal sector that largely escapes both indirect and direct taxation.
- 65. Nevertheless, available empirical analysis for developing countries indicates that fiscal systems are always equalizing.** Using comparable fiscal incidence analysis, Lustig (2017) examines the impact of fiscal policy on inequality and poverty in twenty-eight low and middle income countries for around 2010, concluding that in all cases the impact of taxes and transfers was equalising. Increasing domestic resource mobilization thus appears as a valuable objective to enhance the redistributive power of fiscal policies (Lay and Robilliard, 2017).
- 66. In Middle-Income countries, fiscal redistribution has increasingly made use of means-tested government transfers.** These transfers appear to have played an important role in the decline of income inequality in many countries in Latin America. In the cases of Argentina, Brazil and Mexico, Lustig et al. (2013) find that the most important factor in accounting for the decline in non-labour income inequality was a significant rise in importance of the equalizing contribution of government transfers. In these countries, although they represent a small share of total government social spending, Conditional Cash Transfer programs have had remarkable redistributive power.

### ***Policies addressing Inequality in Tertiary Income Distribution***

- 67. Tertiary income inequality results from the incidence and scale of public expenditures,** given the secondary income distribution. Again, the redistributive power of these policies depends heavily on the relative size of public expenditures with respect to national income.
- 68. In OECD countries, government spending (excluding social transfers) represents on average about 25% of national income.** In developing countries, these expenditures represent a much smaller share – rarely higher than 15% of national income and often significantly less. Although social sectors as well as infrastructures have benefited from large ODA flows in the last decades, public spending is necessarily limited by the prevailing low levels of domestic resource mobilization.
- 69. Social sector spending has a positive impact on equality provided it aims at providing access to the poorer segments of the population.** As spending on primary education benefits poor households, it will usually be more progressive than subsidies for higher education. More generally, ensuring universal access to public services such as education and health, and ensuring that quality does not vary across regions or neighbourhoods, will reduce inequality since the imputed value of services represents a higher income share for households at the lower tail of the distribution.

## 70. Evidence from benefit incidence analysis in 28 low and middle income countries confirms the equalising effect of investments in pre-primary and primary education.

(Lustig, 2017). It shows that spending on pre-school and primary school is progressive in almost all countries in absolute terms, that absolute progressivity in secondary school spending is less prevalent, and that tertiary education spending tends to be more regressive than progressive. Moreover, there are other positive distributional effects of pre-primary and primary school spending which are not captured by cross-country benefit incidence analysis<sup>7</sup>.

### Box 5: The proposed Conceptual Framework to address Inequality

#### Key elements of the Conceptual Framework:

- **A 3-level conceptual framework** is proposed by which to analyse the causes of inequality and identify the appropriate policies to reduce inequality.
- **The 3 levels correspond to the different levels at which household income distribution can be considered and measured:**
  - **Primary** income distribution is the distribution of household incomes earned from economic activities *before* taxes and subsidies.
  - **Secondary** income distribution is the distribution of household incomes *after* deduction of taxes and inclusion of transfer payments.
  - **Tertiary** income distribution is the distribution of household incomes when imputed benefits from public expenditure are added to household income after taxes and subsidies.
- The framework distinguishes:
  - **Proximate determinants** which are the immediate determinants of the primary income distribution.
  - **Drivers** which are the socio-economic and demographic processes that affect primary income distribution.
  - **Policies** which are all interventions (including programmes and projects) designed by the State to combat inequality.
- The proximate determinants of inequality in the primary income distribution are of two types: unequal distribution of production factors (land, labour, human and physical capital) and unequal returns to these factors (rents, wages, and profits).
- Socio-economic and demographic “drivers” will affect primary income distribution through their impact on factor distribution and factor returns. They include: (i) **Economic drivers** - growth processes, technological change, trade and globalisation; (ii) **Cultural and social norms**, especially those which are discriminatory; and (iii) **Population dynamics**.
- **Tables 2 – 6 provide examples of public policies, which, in the appropriate circumstances, are likely to reduce the degree of inequality at each of the three levels.**

<sup>7</sup> Benefit incidence analysis provides a useful diagnostic of the direct redistributive impact of public spending but it does not account for its non-monetary and indirect effects. It also fails to take account of more complex effects, such as the cross-elasticity of demand between primary and secondary schooling, whereby expanding opportunities for secondary schooling may increase the demand for primary schooling, with positive distributional effects for future generations.

### **Policy tables:**

**Table 2: Addressing Social & Primary Income Inequality: Improving access and quality of social services, and basic legal protection**

| <b>Policy Areas</b>                  | <b>Rationale</b>  | <b>Inequality reducing policy objectives</b>  | <b>Monitoring indicators</b>  |
|--------------------------------------|---|---|---|
| <b>Education and Health</b>          | <b>Access to quality education and health</b> is a central dimension of social equality. Investments can thus directly decrease inequality at the tertiary level and may also enhance returns to labour, thus reducing primary income inequality.   | <ul style="list-style-type: none"> <li>• Ensure access to primary and secondary for bottom 40%.</li> <li>• Enhance quality of primary &amp; secondary schools accessed by bottom 40%</li> <li>• Promote access to higher education for bottom 40%.</li> </ul> | <ul style="list-style-type: none"> <li>✓ Schooling achievements at each level for bottom 40%.</li> <li>✓ Schooling rates at each level for bottom 40% children.</li> <li>✓ Access rates to health facilities for bottom 40%.</li> <li>✓ Access rates to reproductive health services for bottom 40% women.</li> </ul> |
| <b>Water, Sanitation, and Energy</b> | <b>Access to water, sanitation, and energy</b> is a key determinant of wellbeing with important impacts on health, education and employment, and thus positive effects on primary income distribution.  | <ul style="list-style-type: none"> <li>• Ensure access to water, sanitation, and cheap energy for bottom 40%.</li> </ul>  | <ul style="list-style-type: none"> <li>✓ Access rates to water, sanitation, and energy for bottom 40%.</li> </ul>   |
| <b>Governance</b>                    | <b>Access to legal protection and corruption-free services</b> is a central dimension of social inequality and can help to ensure protection of rights to property, or to communal assets such as water and grazing rights, which may thus serve to protect factor endowments within the primary income distribution. | <ul style="list-style-type: none"> <li>• Ensure access to legal protection and corruption-free services for bottom 40%.</li> </ul>  | <ul style="list-style-type: none"> <li>✓ Access rate to legal protection for bottom 40%.</li> <li>✓ Corruption perception index</li> </ul>  |

Table 3: Reducing Primary Income Inequality 1- Improving returns to assets

| Policy Areas  | Rationale   | Inequality reducing policy objectives  | Monitoring indicators   |
|---|---|--|---|
| <b>Infrastructure</b>   | <b>Remoteness</b> and transport costs are key determinants of urban-rural inequality and regional disparities.  | <ul style="list-style-type: none"> <li>Improve spatial integration and access to markets by promoting the construction of rural roads.</li> </ul>  | <ul style="list-style-type: none"> <li>✓ Access to market for bottom 40%.</li> </ul>  |
| <b>Agricultural policies</b>                                  | <p><b>Productivity</b> in the agricultural sector is a key driver of rural livelihoods. Both food and cash crops matter for small farmers.</p> <p><b>Land distribution</b> is a key determinant of income inequality both in rural areas and at the national level.</p> | <ul style="list-style-type: none"> <li>Support agricultural research adapted to small farm technology.</li> <li>Enhance access to seed and modern inputs for bottom 40% farmers.</li> <li>Enhance access to markets (see above)</li> <li>Secure land rights for bottom 40%.</li> <li>Promote efficient and fair land market regulations.</li> </ul>  | <ul style="list-style-type: none"> <li>✓ Agricultural productivity for bottom 40% agricultural households.</li> <li>✓ Land owned by bottom 40% agricultural households.</li> </ul>  |
| <b>Employment and Labour market policies and Institutions</b> | Labour is the main, and sometimes only, factor owned by the poorest. <b>Un and underemployment, wage gaps /low wages and non-decent working conditions</b> are thus a key determinant of primary income inequality.   | <ul style="list-style-type: none"> <li>Promote employment and labour market policies that increase access to decent work and provide regulation and protection for workers, including rights to unionize and collective bargaining, minimum wage regulation, child/forced labour bans, access to social security.</li> <li>Improve working conditions including working hours and occupational health and safety; progressively extending these also to the informal economy.</li> </ul> | <ul style="list-style-type: none"> <li>✓ Percentage decent jobs for bottom 40%.</li> <li>✓ Access rates to employment related social protection for bottom 40%.</li> <li>✓ Formalisation of the informal sector?</li> </ul> |
| <b>Education and training</b>                                 | <b>Quality education and training</b> is a key determinant of access to better jobs and higher earnings.  | <ul style="list-style-type: none"> <li>Ensure access to primary, secondary, higher education and training for bottom 40%.</li> </ul>   | <ul style="list-style-type: none"> <li>✓ Schooling achievements at each level for bottom 40%.</li> <li>✓ Access to training for bottom 40%.</li> </ul>  |



Table 4: Reducing Primary Income Distribution 2- Economic and trade policies

| Policy Areas                             | Rationale  | Inequality reducing policy objectives  | Monitoring indicators  |
|--|--|--|--|
| <b>Macroeconomic and monetary policy</b> | <b>Low inflation and macroeconomic stability</b> are key to preventing financial crises likely to adversely impact the incomes of the bottom 40%.  | <ul style="list-style-type: none"> <li>Maintain low inflation and macroeconomic stability</li> </ul>   | <ul style="list-style-type: none"> <li>✓ Inflation rate</li> <li>✓ Macroeconomic indicators</li> </ul> |
| <b>Trade policy</b>                      | <p><b>Trade liberalization</b> is important for economic growth but can be inequality enhancing.</p> <p><b>Trade barriers</b> are likely to be driven by rent-seeking behaviour or induce elite-capture.</p> | <ul style="list-style-type: none"> <li>Reduce inequality impact of trade policies</li> <li>Support the sustainable development chapter of trade policies and agreements</li> </ul> | <ul style="list-style-type: none"> <li>✓ Pro-poor trade policy</li> </ul>                              |

**Table 5: Reducing Secondary Income Inequality: Increasing fiscal redistribution by the state (incl. social transfers)**

| Policy Areas         | Rationale  | Inequality reducing policy objectives   | Monitoring indicators  |
|----------------------|--|---|--|
| <b>Fiscal policy</b> | Tax policies are determinants of secondary income inequality. The fiscal pressure also determines the capacity of the State to redistribute through transfers and public spending. | <ul style="list-style-type: none"> <li>• Increase tax per GDP ratio through reducing exemptions, closing tax loopholes and tax evasion.</li> <li>• Promote redistribution through progressive taxation, based on analysis of the equalising effects of taxes and subsidies</li> </ul> | <ul style="list-style-type: none"> <li>✓ Fiscal pressure (ratio of tax per GDP)</li> <li>✓ Share of taxes paid by bottom 40%</li> <li>✓ Share of tax receipts from direct taxation.</li> </ul> |
| <b>Social policy</b> | Social transfers are determinants of secondary income distribution   | <ul style="list-style-type: none"> <li>• Ensure social transfers are targeted to bottom 40%.</li> </ul>   | <ul style="list-style-type: none"> <li>✓ Social transfers as a share of GDP</li> <li>✓ Share of social transfers accruing to bottom 40%</li> </ul>   |

**Table 6: Reducing Tertiary Income Inequality: Enhancing the redistributive incidence of public spending**

| Policy Areas                    | Rationale   | Inequality reducing policy objectives  | Monitoring indicators  |
|---------------------------------|---|--|--|
| <b>Public spending</b>          | Public service provision in health and education determines tertiary income distribution. | <ul style="list-style-type: none"> <li>• Ensure access to public services for bottom 40%.</li> </ul> | <ul style="list-style-type: none"> <li>✓ Public spending as a share of GDP</li> <li>✓ Share of public spending accruing to bottom 40%</li> </ul> |
| <b>Public sector management</b> | Poorly functioning public sector lowers ability to apply redistributive policies          | <ul style="list-style-type: none"> <li>• Improve public sector management</li> </ul>                 | <ul style="list-style-type: none"> <li>✓ CPIA (Country Policy and Institutional Assessment)<sup>8</sup>:</li> </ul>                              |

<sup>8</sup> The CPIA is a rating of countries produced by the World Bank using a set of 16 criteria grouped in four clusters: economic management, structural policies, policies for social inclusion and equity, and public sector management and institutions.

## 5. The proposed measurement framework for Inequality

71. In order to monitor and enhance DEVCO's contribution to the reduction of inequality, three different types of indicators will be needed:

- (i) **Standard monitoring indicators**, which permit cross-country comparisons of the level of inequality in partner countries and could therefore assist in assessing DEVCO's impact on the reduction of inequality, through monitoring and evaluation work and policy reviews.
- (ii) **Contextual indicators**, by which to characterise the determinants and drivers of inequality at the country level, to be used as baseline for the programming and design of development projects and programmes to address inequality.
- (iii) **Portfolio Indicators**, by which to identify and measure the share of EU funded development cooperation initiatives addressing inequality reduction objectives.

### 5.1 Standard monitoring indicators of inequality

72. Where data on household income or consumption are available, a variety of indicators can be developed. In order to be useful for policy, i.e. for reporting on inequality levels and monitoring the inequality impact of development interventions, indicators should fulfil three broad criteria:

- They should be statistically robust, in the sense of having the properties necessary to be consistent and accurate, as presented in Box 6.
- They should be feasible to calculate on a reasonably regular basis.
- They should be readily understandable to a layperson, not familiar with statistical techniques.

#### Box 6 - Desirable statistical properties of inequality indicators

The measurement of income inequality is made possible by the growing availability of household surveys around the world. The analysis of this data, pioneered by Ravallion, has been used to assess the incidence of poverty in the world and its evolution.

In order to be consistent and accurate, indicators must have a set of desirable properties. The most essential theoretical property of an inequality measure is called the **Pigou-Dalton principle of transfers** which requires that any transfer from a richer to a poorer individual should decrease (or at least not increase) inequality as long as the transfer does not change the relative position of the two individuals.

Apart from the principle of transfers, it is generally agreed that proper inequality metrics should satisfy two minimal invariance requirements:

**Scale invariance:** rescaling all incomes leaves inequality unchanged; similarly duplicating the population leaves inequality unchanged.

**Symmetry or anonymity:** swapping the incomes of any two individuals leaves inequality unchanged.

Another desirable property of inequality measures is **sub group decomposability** which makes it possible to decompose the inequality within a large entity into inequality within and between its sub entities, using information about mean income and population shares for each sub entity. The property of decomposability also makes aggregation possible.

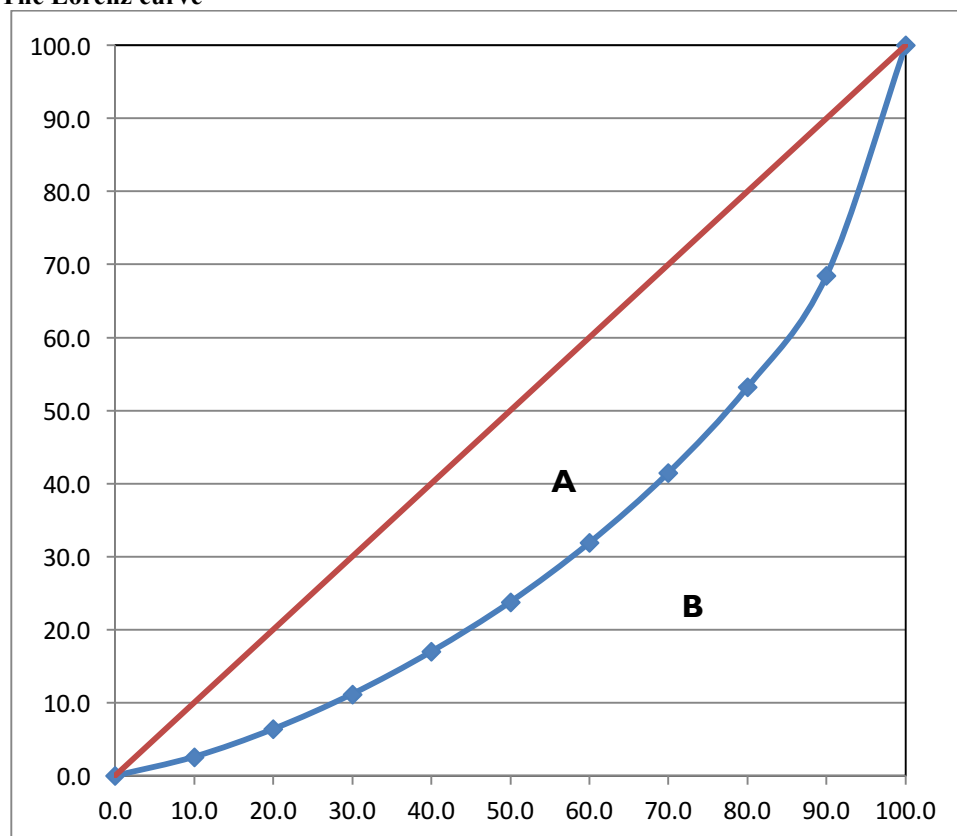
- 73. Given that in practise, no single readily available indicator fulfils each of these criteria, it is proposed that EU DEVCO should aim to collect and report regularly on three commonly available indicators of income inequality**, namely the Gini coefficient, the income share of the bottom 40 % of the population, and the Palma ratio (the ratio of the income share of the bottom 40% to that of the top 10%). Furthermore, these indicators of income inequality should be supported by additional data on social inequalities, by reporting on indicators of access to different levels of education, health care and other services of the bottom 40%. In this section, we explain these indicators and the rationale for their adoption as standard measures of inequality.
- 74. Measuring the shares of total income earned by different fractions of the population is a common and very practical approach to measuring income inequality.** It is illustrated in Table 7 which presents the distribution of household consumption per capita by decile share for developing countries. The figures indicate that the poorest decile in the population of developing countries earns 2.6% of total income on average while the richest decile earns 31.5%. Between these two extremes, the share of income increases gradually. These income shares provide information on inequality at different points of the distribution. As can be seen from the last two columns, the shares vary significantly across countries. Taking the first and last decile shares as examples, available data suggest that the income share of the bottom decile in developing countries varies between 1 and 4.4 %, while that of the top decile ranges from 19.5 to a staggering 51.7%.

**Table 7: Decile shares, distribution of household consumption per capita, Developing countries, 2010.**

| Deciles | Mean | Std. Dev. | Coef.Var. | Min. | Max. |
|---------|------|-----------|-----------|------|------|
| 1       | 2.6  | 0.81      | 0.31      | 1.0  | 4.4  |
| 2       | 3.8  | 0.86      | 0.23      | 1.5  | 5.8  |
| 3       | 4.8  | 0.90      | 0.19      | 2.0  | 6.8  |
| 4       | 5.8  | 0.92      | 0.16      | 2.6  | 7.8  |
| 5       | 6.8  | 0.92      | 0.13      | 3.5  | 8.8  |
| 6       | 8.1  | 0.87      | 0.11      | 4.7  | 9.9  |
| 7       | 9.6  | 0.80      | 0.08      | 6.6  | 11.0 |
| 8       | 11.7 | 0.65      | 0.06      | 9.0  | 12.7 |
| 9       | 15.3 | 0.84      | 0.05      | 12.7 | 17.6 |
| 10      | 31.5 | 6.12      | 0.19      | 19.5 | 51.7 |

Source: Alvaredo and Gasparini, 2015.

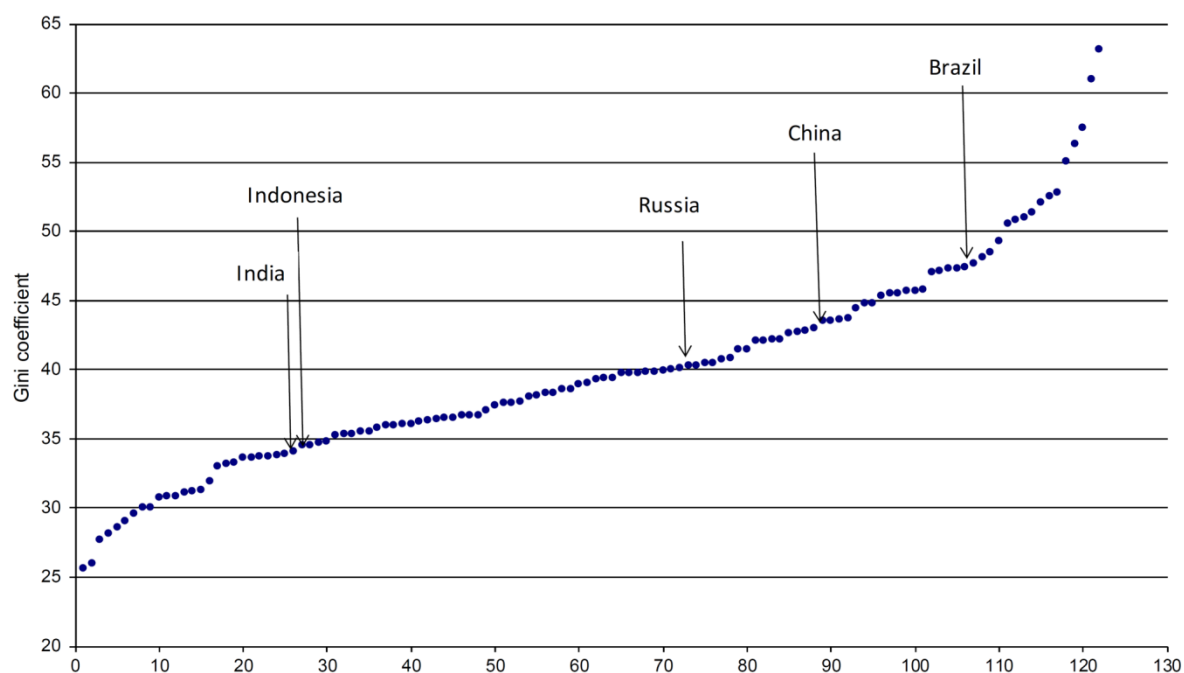
- 75. The Lorenz curve is widely used in distribution analysis, as a graphical display of income shares by deciles or percentiles.** The Lorenz curve is obtained by plotting the proportion of total income on the y axis that is cumulatively earned by percentile of the population on the x axis. Figure 2 plots a Lorenz curve using the data from Table 7.

**Figure 2: The Lorenz curve**

**Note:** The Lorenz curve in blue reports the y% share of overall income earned by the bottom x% of the population. The 45 degree line in red is the line of equality. This Lorenz curve is built from the data in Table 7.

- 76. The Gini coefficient is the best known and most commonly reported indicator of inequality: it is a synthetic indicator which summarises in a single number the characteristics of a given income distribution.** The Gini coefficient is based on the Lorenz curve: it is the ratio of the area (“A” in Figure 2) between the line of perfect equality (the 45 degree line) and the observed Lorenz curve, to the area of the triangle below the line of perfect equality (areas “A”+ “B” in Figure 2). In theory, the Gini may range between 0 and 1, where 0 indicates perfect equality and 1 indicates maximum inequality. In the case of developing countries, Alvaredo and Gasparini (2015) show that the Gini coefficients for the distribution of household consumption per capita range from 0.25 to 0.63 (Figure 3<sup>9</sup>).
- 77. Despite its popularity, the Gini coefficient has drawbacks, and as such it should always be used in combination with other inequality indicators.** From a statistical point of view, it has two main drawbacks: the first is that it is “tail-insensitive” in that it does not capture where in the distribution the inequality occurs. As a result, two very different distributions of income can have the same Gini coefficient. The second drawback is that it is not decomposable. In addition, the Gini coefficient has the disadvantage that it is not easy to interpret for the average lay person, who would not normally be aware of what might be considered a “high” or a “low” Gini coefficient.

<sup>9</sup> Data are computed using PovCal data for over 120 countries for 2010 (or the nearest year with available data).

**Figure 3: Gini coefficients for the distribution of household consumption per capita in developing countries, 2010**

Source: Alvaredo and Gasparini, 2015. *Note:* countries sorted by their Gini coefficients.

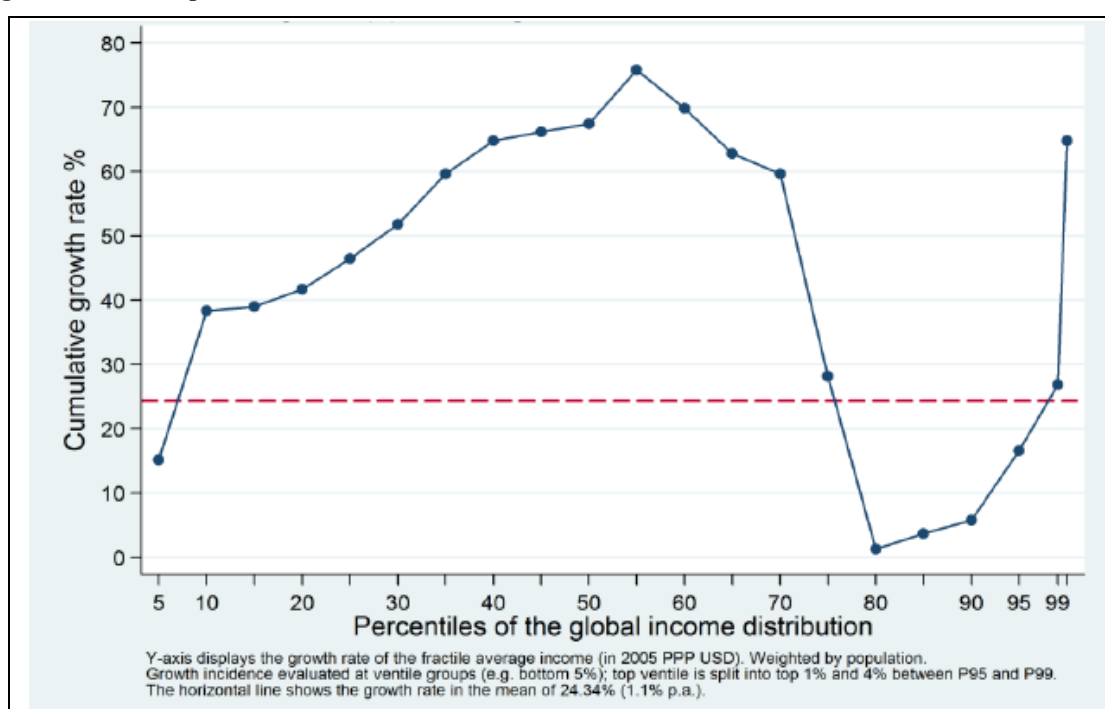
- 78. A straightforward and commonly used alternative indicator to the Gini coefficient is the share of income held by the bottom 40%.** As a complement or an alternative to the Gini, income shares are often used because, in contrast with the Gini, they are easier to grasp and interpret by the average lay person. While in certain circumstances the income share of the bottom 10% or 20% may be a more useful indicator, target 1 of SDG 10 is explicitly focused on the income growth of the bottom 40% relative to national average income. For this reason, most development agencies have adopted the income share of the bottom 40% as a common indicator of inequality, and there are strong reasons why the EU should monitor this indicator in each of its countries of operation.
- 79. However, despite their ease of interpretation, income shares – such as the share of the bottom 40% - can only describe a specific part of the income distribution.** This suggests that, ideally, different shares should be used in conjunction. To address this limitation, ratios of income shares are often used as way of summarizing information about different parts of the income distribution.
- 80. A good example is the Palma ratio which is defined as the ratio of the top 10% of the population's share of gross national income divided by the share of the bottom 40%.** Its use is based upon research that found that incomes of the “middle class” (deciles 5 to 9) almost always represent about half of gross national income while the other half is split between the richest 10% and poorest 40%, and that the share of those two groups varies considerably across countries (Palma, 2011). The Palma ratio addresses the Gini coefficient's insensitivity to changes at

the top and bottom. Given the emphasis on the growth of top incomes in the current debate on inequality, the Palma ratio would be a relevant candidate for the EU to adopt for monitoring purposes.

#### Box 7 - The Growth Incidence Curve (GIC)

The **Growth Incidence Curve** (GIC is a curve of growth rate of per capita income for every percentile of income distribution between two points. It is a widely used tool to describe the evolution of income distribution across time in a given country or region but can also be used to analyse the incidence of different policy scenarios. The most famous GIC is that produced by Lakner and Milanovic in their study of the evolution of global inequality between 1998 and 2008 (Lakner and Milanovic, 2015). It was created by ranking the world's population, from the poorest 10% to the richest 1%, in 1988 and again in 2008. At each rank, the chart showed the growth in income for each percentile between these two years. Because of its shape, it has been labelled “the elephant curve” and was widely circulated in the media to illustrate “a decile of discontent”.

**Figure 4: The “Elephant Curve”: Global Growth Incidence Curve, 1988-2008**



Source: Lakner and Milanovic, 2015

The interpretation of the “elephant curve”, and of GIC curves in general, is not straightforward. What it shows is how the income share of households in a given decile in 1988 compares with the income share of those households who were in that decile in 2008. However, these households may not be the same since households who were in a given decile in 1988 might be in a different decile in 2008. Without longitudinal panel data, it is impossible to draw GIC curves that would answer the question “how did the income share of those households who were in a given decile in 1988 fare over 20 years?”.

- 81. A popular (and striking) indicator of global inequality is the proportion of world income (or wealth) earned by the top percentile.** This is the indicator used by Oxfam in its recent press campaign on global inequality (Oxfam, 2016), namely the ratio of the income of the top one percent of the population to the remaining 99%. By definition, this indicator is sensitive to distribution between the top one percent and rest of the population. As a drawback, it is insensitive to changes in inequality that happen within those two groups, in particular between the poorest

40% and the “middle class” (deciles 5 to 9). A further drawback is that in many countries, data on the incomes of the top 1% is not readily available, partly because household surveys do not have adequate samples to accurately estimate the incomes of the top 1%, and partly because the survey methodology does not adequately capture the sources of income of the top 1%.

82. A related issue is whether relative or absolute inequality should be considered. **Relative Inequality** relates to proportional differences in incomes ( $YR/YP$ ). From that perspective the two distributions (10,20,30) and (20,40,60) are identical in terms of inequality. Instead, **absolute Inequality** refers to absolute differences in income  $YR - YP$ . From that perspective, the distribution (20,40,60) will be deemed more unequal than the distribution (10,20,30). The relative concept of inequality is appealing conceptually because it allows inequality and economic growth to be analysed separately. However, as shown by Ravallion (2004), perceptions about widening income gaps often carry absolute connotations and Atkinson and Brandolini (2010) argue that analyses of global inequality should consider both absolute and relative differences.
83. **Measuring and monitoring inequality in non-economic outcomes is also key.** It is often easier to grasp inequality in non-economic outcomes (education, employment, health... etc.) either along the economic distribution (quintiles or deciles of income or wealth) or across social groups (defined by some relevant characteristics). The approach recommended is that taken in the Policy Tables of Chapter 4, where the policy matrices make reference to **non-economic indicators for the bottom 40%**.

## 5.2 Operational challenges for monitoring inequality

84. **A first operational challenge for monitoring inequality is that, as for poverty, measuring inequality is demanding in terms of data.** Monitoring inequality requires referring to indicators that can only be built using household survey data. The most comprehensive and consistent source for this type of data is PovcalNet which has been developed by the World Bank for the purpose of public replication of the World Bank's poverty measures for its widely used international poverty lines, including \$1.90 a day and \$3.10 a day in 2011 Purchasing Power Parity (PPP) dollars. As of 2013, PovcalNet included more than 850 surveys from almost 130 countries, representing more than 90% of the population of the developing world, spanning the period 1979-2011. However, the World Bank warns that estimates of the densities near the bottom and top tails of the distribution are likely to be unreliable.
85. **Measuring top incomes using survey data is problematic.** For instance, looking at Argentina, Alvaredo (2010) finds that no observation with incomes above \$1 million was recorded in the 1997 household survey, although the Argentinian tax data contains close to 700 files in that range. Why the rich are missing in household surveys could be either for sampling reasons, low response rates or ex-post elimination of 'extreme' values (Alvaredo, 2010).
86. This inaccuracy of data on the top of the income distribution, as well as a renewed interest in studying the long-term evolution of income and wealth inequality, led a group of researchers to develop the World Wealth and Income Database (WID) project (wid.world). Compared to



databases built on household survey data, the main novelty of the WID database is to systematically combine tax data with national surveys and accounts which makes it possible to calculate series on the share of higher income that are longer and more reliable than the previous data on inequality. These series have had a significant impact on the global debate on inequality. In particular, by making it possible to compare the income shares captured by the top 1% over long periods and across countries, they have helped to reveal new facts and refocus the discussion on increasing inequality. They cover developing countries only very partially at present but coverage is expanding.

**87. Notwithstanding these operational challenges, the widespread use of regular household surveys now allows basic data on inequality to be updated annually or at least periodically (every 3 or 5 years).** As a result, for the vast majority of countries in which the EU has development programmes, it is possible to monitor on a regular basis the Gini Coefficient, the income share of the bottom 40%, the Palma ratio and a range of indicators on the access to social services of the bottom 40%.

### 5.3 Using framing indicators to characterise the inequality context

**88.** The conceptual framework presented in Chapter 4, in particular the discussion on policies, emphasises two things

- Inequality can stem from different sources. High levels of inequality might be driven by the distribution of land, the urban-rural gap, the skill premium, the gender gap, etc. Depending on which is the primary driver of inequality in a given country, different policies would be required to combat inequality.
- Relatedly, the impact of policy interventions on inequality is context dependent and identifying the appropriate indicators by which to assess impact requires a precise knowledge of the nature of inequality and the prevailing distributions.

**89. Hence, a comprehensive analysis of the inequality context is needed within the country strategy and the related programming documents.** A set of “framing indicators” is helpful, as a way of understanding the inequality context in each country and thus as an aid to guide the choice of policy interventions to reduce inequality.

**90. A list of “framing” indicators by which to qualify the “inequality context” might include:**

- Income level: LIC (GNI per capita of \$1,025 or less in 2015), L-MIC (GNI per capita between \$1,026 and \$4,035), U-MIC (GNI per capita between \$4,036 and \$12,475) (Source: WDI).
- Poverty level: in relation to national poverty lines and the international benchmark of USD 1.90 per day in 2011 Purchasing Power Parity (PPP) terms. (Source: National data; WDI, PovcalNet.)
- Level of Gini: low (less than 35), medium (35 to 45), high (above 45) (Source: WDI, PovcalNet).

- Governance and institutional factors: inequality mentioned in Constitution, redistributive policies, political stance on inequality and redistribution, CPIA, WGI, (Source: EU delegations, WGI and other international databases).
- Urban-Rural divide: ratio of rural to urban mean income (Source: WDI).
- Land distribution: percentage landless, skewness of distribution (Source: Gender and Land Rights Database (GLRD) at FAO, except for overall skewness of distribution).
- Earnings dispersion: P90:P10 percentile ratio of hourly wages, S10:S1 ratio of average wages (Source: ILO).
- Unemployment inequality: share of unemployment for lowest deciles (Source: ILO).
- Health inequality: primary/secondary/tertiary level health facilities access rates for bottom 40%, ratio of Q5 TFR / Q1 TFR (Source: DHS).
- Education inequality: primary/secondary/higher schooling rates for bottom 40%, skill premium (Source: ILO, WDI, except for skill premium).
- Gender differences: education gap, earning gap, labour force participation gap, CPIA gender equality rating (Source: ILO, WDI).
- Fertility differential: ratio of Q5 TFR / Q1 TFR (Source: DHS).
- Taxes and transfers: size of taxes and transfers (% of GDP), incidence/ progressivity (Source: WDI for size, CEQ for incidence/ progressivity).
- Public services: size of spending for public services (% of GDP), % public expenditure for health, education and social protection, share of private health and education services, public spending incidence (Source: WDI, except for incidence).

91. These data should be used at the country level to provide both a baseline and a roadmap for the design of policies better suited to reducing inequality. Much of the data listed above is readily available from widely used international statistical databases. However, notable exceptions are:

- *Data on the distribution of land.* As highlighted in the conceptual framework, land distribution is a key proximate determinant of primary income inequality in developing countries. While an international database on Gender and Land has been built and is maintained by the FAO, no similar database exists concerning the overall distribution of land.
- *Estimates of the skill premium.* The skill premium is a key driver of primary income inequality in developing countries. While data on educational attainment exists, allowing the computation of the skill premium (either on the basis of returns to education or the ratio of skilled to unskilled wages), such estimates are not available on a systematic basis.
- *Estimates of the incidence of taxes, transfers, and public spending.* Compiling such estimates requires data at the household level on consumption (for indirect tax incidence), on taxes paid, on public transfers received, and on the use of public services (health and education) at

different levels. This information on incidence can in principle be derived from household survey analysis (see Younger et al, 1999). However, such estimates are only available for very few countries.

## 5.4 Measuring the share of EU-funded programmes and projects addressing inequality reduction objectives

**92. In order to monitor and enhance DEVCO's contribution to the reduction of inequality, a third set of indicators is needed, which may be described as "Portfolio indicators".**

The purpose of these is to make it possible to identify and measure the share of EU funded development cooperation initiatives addressing inequality reduction objectives.

**93. In this respect, it is proposed that all EU development projects and programmes should include two indicators in their project/ programme documentation:**

- The **"Equality Marker"**, which would record the **"intentionality"** of policies funded by the EU based upon their stated objectives;
- **An estimate of the anticipated incidence of projects and programmes funded by the EU:** the anticipated share of project/ programme benefits targeted to the bottom 40%.

**94. The Equality Marker reflects whether an intervention targets inequality as one of its stated objectives.** The structure of this proposed indicator is directly inspired by the structure of the EU Results Framework Level 2 indicator on Gender Equality, which is intended to permit the annual reporting of the share of EU funded development cooperation initiatives promoting gender equality and women's empowerment<sup>10</sup>. Three levels of "E-marker" are proposed to be adopted for the Equality Marker:

- i) **E-0:** when inequality reduction is not targeted;
- ii) **E-1:** when inequality reduction is a significant objective;
- iii) **E-2:** when inequality reduction is the principal objective.

**95. The second proposed "portfolio indicator" is an estimate of the anticipated share of project/ programme benefits targeted to the bottom 40% of the income distribution.** It is proposed that such an indicator should be included systematically in all project/ programme financing agreements. Clearly, it would not be feasible to undertake detailed benefit incidence analysis for all projects and programmes but simple "back of the envelope" estimates, based on existing data from secondary sources should be feasible. In order to be useful and so as they might be replicated in subsequent monitoring or evaluation reports, it would be necessary to document the basis on which estimates are prepared, with a clear statement of assumptions. Guidance would need to be developed for this process but this should not prove unduly complicated. The inclusion

<sup>10</sup> Within this structure, there are three "G-markers": G-0: when gender equality is not targeted; G-1: when gender equality is a significant objective; G-2: when gender equality is the principal objective.

of such an indicator would be a most effective way to ensure a systematic consideration of the inequality impact of development projects and programmes<sup>11</sup>.

#### Box 8: The proposed Measurement Framework for Inequality

##### **Key elements of the proposed Measurement Framework:**

- **In order to monitor DEVCO's contribution to the reduction of inequality, three different types of indicators will be needed:**
  - **Standard monitoring indicators**, which might permit cross-country comparisons of the level of inequality in partner countries and could therefore assist in assessing DEVCO's impact on the reduction of inequality.
  - **Contextual indicators**, by which to characterise the determinants and drivers of inequality at the country level, to be used as baseline for the programming and design of projects and programmes to address inequality.
  - **Portfolio Indicators**, by which to identify and measure the share of EU funded development cooperation initiatives addressing inequality reduction objectives.
- **It is proposed that EU DEVCO should aim to collect and report regularly on three commonly available indicators of income inequality**, namely the Gini coefficient, the income share of the bottom 40 % of the population, and the Palma ratio (the ratio of the income share of the bottom 40% to that of the top 10%). These indicators of income inequality should be supported by data on social inequalities, by reporting on the access to different levels of education, health care and other services of the bottom 40%.
- **A comprehensive analysis of the inequality context is needed within the country strategy and the related programming documents.** This should be based on a set of “framing indicators”, as a way of understanding the inequality context in each country and thus as an aid to guide the choice of policy interventions to reduce inequality.
- **“Portfolio indicators” are required to make it possible to identify and measure the share of EU funded development cooperation initiatives addressing inequality reduction objectives.** It is proposed that all EU development projects and programmes should systematically include two indicators in their project/ programme documentation:
  - (i) **The “Equality Marker”, which would record the “intentionality” of policies funded by the EU based upon their stated objectives;**
  - (ii) **The anticipated share of project/ programme benefits targeted to the bottom 40%.**

<sup>11</sup> To illustrate how such an indicator might compel more careful reflection, the example of a project investing in power generation is an interesting case. Expansion of power generation capacity would only benefit the bottom 40% to the extent that a) they were already on the existing electricity grid, or b) improved power supplies served to reduce the cost of goods used by the bottom 40%; thus, in most developing countries the benefits accruing to the bottom 40% would be modest – perhaps 10 or 20% of total benefits. By contrast, a project for improved electricity distribution deliberately targeted to bring more power to the bottom 40% would bring much higher benefits for this group.

## 6. A review of other Development Partners' conceptual and measurement frameworks

### 6.1 The World Bank's position on inequality

96. In April 2013, the World Bank endorsed a new goal to promote “shared prosperity” as a second goal to that of “ending extreme poverty by 2030”. Shared prosperity is defined as the income growth of the poorest 40 percent of the population. This new goal and its consequences in terms of policy have been laid out in the 2016 Report on “Poverty and Shared Prosperity” entitled “Taking on Inequality”. A connection between Shared Prosperity and inequality is made by defining the Shared Prosperity Premium which compares the income growth of the bottom 40 percent to the average income growth. This corresponds to target 10.1 of SDG10 which is “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”.
97. Prior to the endorsement of the goal of “shared prosperity”, the approach of the World Bank with respect to inequality reduction was laid out in the World Development Report published in 2006 and entitled “Equity and Development”. The report’s focus is on equity defined as equality of opportunity and avoidance of deprivation in outcomes (WDR, 2006). The perspective adopted in the report appears to be instrumental and in particular very much shaped by efficiency concerns. In this view, the central reason why inequality must be reduced is because it threatens economic growth and poverty reduction.
98. The efficiency case entails a strong emphasis on the difference between inequality of outcomes and inequality of opportunities and a conviction that there is “good” and “bad” inequality with respect to its impact on growth. From that perspective, “bad” inequality results from circumstances (corresponding to Roemer’s definition of inequality of opportunities) while “good” inequality rewards differences in efforts. According to that perspective, reducing inequality of opportunities – “bad” inequality – is likely to foster growth. Two channels of impact are considered: the effects of unequal opportunities when markets are imperfect and the consequences of inequality for the quality of institutions as a society develops. Instead, reducing “good” inequality would entail a high efficiency cost since it would reduce incentives to work or invest.
99. Because it focuses on inequality between groups defined by “circumstances” such as sex, ethnicity, location of residence, or age, the “Inequality of Opportunity” approach embraces a “horizontal” perspective on inequality. Based on the work of Barros et al (2009), this view has led the World Bank to construct a “Human Opportunity Indicator” (HOI) to monitor inequality of opportunity and promote its reduction in order to “level the playing field”. The idea is to decompose total inequality into two components: a share that is likely due to circumstances and reflects inequality of circumstances and a residual share.
100. Conceptual issues arise however in implementing this idea. In particular, as argued by Wagstaff (2014) on the World Bank blog, “For outcomes relating to small children (...) we don’t

need to get into a complicated decomposition exercise to figure out the share of inequality of opportunity in total inequality – it's 100%. So it's odd the Bank's empirical work in this area does just such a decomposition exercise." Wagstaff goes on to discuss other issues related to what is left in the "residual" inequality – deemed to be "good", once inequality of opportunities has been taken out – and concludes "If we're honest, we actually have no idea how big the good bit of inequality is. (...) This is a huge limitation of the inequality-of-opportunity work."

**101. The second perspective laid out in the 2006 WDR is the poverty perspective** which argues that inequality must be reduced for countries to achieve the poverty reduction objective that defines the World Bank mission ("Our dream is a world free of poverty"). This view is based on the finding that when inequality is high, economic growth has less impact on poverty reduction (e.g. Ravallion, 2001).

**102. Unlike the "Inequality of Opportunity" approach, the "Shared Prosperity" approach concentrates on vertical inequality that entails comparing households along the distribution of income.** Regarding the operationalization of the Shared Prosperity approach into WB projects, the 2016 Shared Prosperity Report emphasises five policy areas. They include:

- Early childhood development and nutrition
- Health care and education
- Conditional cash transfers
- Rural infrastructure
- Taxation

**103.** Finally, in line with the World Bank's mandate, the policy areas emphasize within country inequality rather than the reduction of between country inequality.

## 6.2 The UNDP's position on inequality

**104.** The most recent major report that lays out UNDP's position with respect to inequality is entitled "Humanity Divided: Confronting Inequality in Developing Countries" and was published in 2014. Starting from a diagnostic that "wealth and income inequalities have reached new heights" the foreword by Helen Clark emphasizes that "Soaring inequalities distort budgets and political processes, leaving them ever more attuned to entrenched elites".

**105. The perspective taken by UNDP emphasizes human development and forcefully rejects the dichotomy between outcome and opportunity inequality.** "The two are but opposite sides of the same coin. Hence, development policy focusing on inequality reduction must address both." While the report also embraces an instrumental "poverty perspective" – inequality must decrease in order to ensure poverty reduction – the "efficiency perspective" is not central.

**106.** Although the foreword of "Humanity Divided" emphasizes the risk of elite capture, this concern does not appear to translate into precise policy prescriptions or indicators. The UNDP perspective emphasizes both within country inequality and between country inequality reduction.

107. In the area of inequality reduction, the goals of UNDP are obviously defined by SDG10 which includes 10 targets. The first one is “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”. While the indicator is clearly defined, the target is simply that the increase is higher for the bottom 40%. A more ambitious target could have been to define a minimum income share for the bottom 40%.

108. The policy framework laid out in the “Humanity Divided” Report is structured around three objectives

- Moderating income inequality
- Closing gaps in education, health and nutrition outcomes
- Addressing social exclusion by promoting agency, combating discrimination and transforming inequality-reproducing cultural norms.

109. The operationalization of UNDP’s vision to reduce inequality is laid out in a document released in 2016 and entitled “UNDP support to the implementation of SDG10”. The report emphasizes 8 policy areas that encompass both the domestic and international policy arenas.

- Social Protection
- Enabling legal and policy frameworks
- Governance for equitable health
- Local Economic Development
- Jobs and livelihoods
- Migration and human development
- Trade
- Financing for Development

**Table 8: Comparison of the approaches to combating inequality of the UNDP, the World Bank and the OECD**

|                    | <b>UNDP</b>  | <b>World Bank</b>   | <b>OECD</b>   |
|--------------------|--|---|---|
| <b>Vision</b>      | "Soaring inequalities distort budgets and political processes, leaving them ever more attuned to entrenched elites" Helen Clark, 2014  | "Levelling the playing field" Paul Wolfowitz, 2006<br><br>"Inequality is constraining national economies and destabilizing global collaboration in ways that put humanity's most critical achievements and aspirations at risk" Jim Yong Kim, 2016  | "We have reached a tipping point. Inequality can no longer be treated as an afterthought. We need to focus the debate on how the benefits of growth are distributed" OECD Secretary-General   |
| <b>Perspective</b> | Moral perspective<br>Emphasis on horizontal inequality (between groups) => human rights<br>Emphasis on elite capture<br>Both <i>within</i> and <i>between</i> countries<br>Reject the dichotomy between "inequality of outcome" and "inequality of opportunity". | Focus on equity defined as equality of opportunity + avoidance of deprivation in outcomes (WDR, 2006)<br><b>Efficiency perspective</b> on inequality => good and bad inequality w.r.t. its impact on growth<br>Good : due to effort<br>Bad : due to circumstances (= inequality of opportunity)<br><b>Poverty perspective:</b> inequality threatens the achievement of SDG1 by 2030<br>Focus on within country inequality | Inequality of <b>assets and opportunity</b> hinders the ability of poor people to participate in and contribute to growth.<br>High and rising levels of income inequality lower the poverty reduction impact of a given rate of growth and can reduce the political stability and social cohesion needed for sustainable growth.<br>The growth experience shows that rising inequality is not an inevitable consequence of the growth process, as long as there is a mix of policies that addresses both growth and distributional objectives, strengthens empowerment and deals with gender and other biases (e.g. race, caste, disability, religion). |
| <b>Goals</b>       | SDG10<br>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."  | Twin goals:<br>(1) to end extreme poverty by 2030, and;<br>(2) to promote "shared prosperity" by boosting the incomes of the poorest 40 percent of the population in every country.   |   |



|                      | UNDP  | World Bank   | OECD   |
|----------------------|---|--|--|
| <b>Indicators</b>    | Income growth of bottom 40% w.r.t Average income growth   | Human Opportunity Index (HOI)<br>Shared Prosperity = Income Growth of Bottom 40%<br>Shared Prosperity Premium = Income Growth of Bottom 40% - Mean Income Growth (= Target 10.1 of SDG10)  |  |
| <b>Policy areas</b>  | <ol style="list-style-type: none"> <li>1. Social Protection</li> <li>2. Enabling legal and policy frameworks</li> <li>3. Governance for equitable health</li> <li>4. Local Economic Development</li> <li>5. Jobs and livelihoods</li> <li>6. Migration and human development</li> <li>7. Trade</li> <li>8. Financing for Development</li> </ol> | <ol style="list-style-type: none"> <li>1. Early childhood development and nutrition</li> <li>2. Health care and education</li> <li>3. Conditional cash transfers</li> <li>4. Rural infrastructure</li> <li>5. Taxation</li> </ol> <p>Emphasis on reduction of <i>within</i> country inequality</p> |  |
| <b>Key Documents</b> | <p>“Humanity Divided: Confronting Inequality in Developing Countries” (2014)</p> <p>UNDP support to the implementation of SDG10 (2016)</p>  | <p>World Development Report “Equity and Development” (2006)</p> <p>Poverty and Shared Prosperity Report “Taking on Inequality” (2016)</p>  | <p>“In It Together - Why Less Inequality Benefits All” (2015)</p> <p>“Divided We Stand – Why Inequality Keeps Rising” (2011)</p> <p>“Growing Unequal? - Income Distribution and Poverty in OECD Countries” (2008)</p> <p>“Promoting Pro-Poor Growth: Policy Guidance for Donors” (2007).</p> |

## 7. Conclusions and Policy Implications for the EU

- I 10. Through the 2030 Agenda “Transforming Our World”, the development community is committed to reduce inequality between and within countries by 2030.** This objective encompasses many dimensions which are spelled out in the targets of SGD10 as well as other goals. Both economic and social inequalities should be reduced, inequality of outcomes as well as inequality of opportunity should be addressed, and both vertical and horizontal dimensions of inequality must be considered. Inequality is multidimensional, embracing not only economic, but social, and demographic differences, as well as inequalities in outcomes in terms of health and education, access to employment and to services. All these inequalities are strongly inter-related and must be treated as such.
- I 11. Although the relationship between inequality and growth is complex and still debated both in the theoretical and empirical literature, certain empirical trends are now overwhelmingly accepted.** The thinking on inequality has moved on from a belief that inequality is a consequence of development, at least in the early stages, to a recognition that inequality will in most cases hinder growth. Recent empirical evidence supports the case that high or rising inequality has a negative effect on the rate of growth. Moreover, the relationship between inequality and poverty is unequivocal: for a given level of growth, income poverty reduction is faster when the prevailing level of inequality is lower.
- I 12. The proposed Conceptual Framework considers three different levels at which income distribution can be analysed (primary, secondary, tertiary).** This framework shows how income distribution is affected by its inherent determinants, as well as by socio-economic drivers and by public policies. Drivers are socio-economic and demographic processes that affect primary income distribution. They include growth, technological change, social norms, population dynamics, and globalization. Policies – such as land reforms, trade and macro policies, labour market regulations, or social policies – are likely to affect primary income distribution either directly through their impact on factor endowments and factor returns or indirectly through their influence on socio-economic drivers of inequality. How fiscal policy will then affect secondary income distribution depends on its size and incidence. Finally, public spending will also affect tertiary income distribution and its impact will depend on its size and pattern.
- I 13. Unlike poverty, inequality is a relational concept.** The measurement of inequality rests on different tools. For income inequality, one helpful set of tools (income shares, Lorenz curve, Gini coefficient, Palma ratio) is based on information on the distribution of income. This information is computed using household data but it can be summarized in terms of fractions of the population such as deciles.
- I 14. Within this set of indicators, it is proposed that the EU DEVCO should aim to collect and report regularly on three commonly available indicators of income inequality, namely the Gini coefficient, the income share of the bottom 40 % of the population, and the Palma ratio (the ratio of the income share of the bottom 40% to that of the top 10%).** These

indicators of income inequality should be supported by data on social inequalities, by reporting on the access to different levels of education, health care and other services of the bottom 40%.

**I 15. In order to apply the proposed Conceptual Framework effectively, a comprehensive analysis of the inequality context is needed within the country strategy and the related programming documents.** This should be based on a set of “framing indicators”, as a way of understanding the inequality context in each country and thus as an aid to guide the choice of policy interventions to reduce inequality. Over the medium term, it would be desirable to undertake such an analysis in all countries which are significant recipients of EU Development Cooperation but, as a way of phasing in such a practice, it would make sense to apply it initially to countries with high levels of inequality - for example with a Gini coefficient greater than 45.

**I 16. “Portfolio indicators” are required to make it possible to identify and measure the share of EU funded development cooperation initiatives addressing inequality reduction objectives.** It is proposed that all EU development projects and programmes should systematically include two indicators in their project/ programme documentation:

- The **“Equality Marker”**, which would record the “intentionality” of policies funded by the EU based upon their stated objectives<sup>12</sup>;
- **The anticipated share of project/ programme benefits targeted to the bottom 40%.**

<sup>12</sup> Within this indicator, there would be three “E-markers”: E-0: when inequality is not targeted; E-1: when reducing inequality is a significant objective; E-2: when reducing inequality is the principal objective.

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