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Addressing inequalities and challenges to social inclusion through fiscal, wage and social protection policies

Report of the Secretary-General

Summary

The present report is submitted pursuant to Economic and Social Council resolution E/2018/3. It summarizes the latest trends in global, cross-country and within-country inequality and highlights how countries have used fiscal, wage and social protection policies to reduce inequality and address challenges to social inclusion. It also contains recommendations on how countries can make further progress on these issues.

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I. Introduction

1. High income inequality is harmful for the pace and sustainability of growth over time, as it undermines the productivity and dynamism of the economy because of suboptimal investments in education and health.[1] Greater income inequality is associated with diminished intergenerational mobility and reduces the impact of growth on poverty reduction. It also undermines social cohesion and trust in socio-political systems. Deep social disenchantment and political instability have also been fomented in countries where the process of globalization, liberalization and economic growth have left some population groups behind. Issues of equity, lack of equal opportunity and voice, persistent unemployment and inclusion were brought to the forefront of public attention by uprisings and mass protest movements that followed the failure of markets, particularly the 2008 global recession.[2] The rise in income and wealth inequality has led to a growing global consensus on the imperative to combat rising inequality and address social exclusion.

II. Inequalities posing challenges to social inclusion and sustainable development for all

A. Trends in income and wealth inequality

2. Global inequality levels remain very high despite sharp falls in the recent past.[3] Similarly, income inequality between countries has also been falling since 1990. However, average within-country inequality has been rising in many regions of the world.[4] Income inequality has increased in almost all regions since 1980 and high and rising inequality within countries has resulted in the global top 1 per cent of earners capturing twice as much of the growth in global income as the 50 per cent poorest individuals.[5] Although the bottom 50 per cent of the world's population has seen its income grow, it only captured 12 per cent of total growth between 1980 and 2016, while the top 1 per cent captured 27 percent. The income share of the global bottom 50 per cent also stagnated at around 9 per cent during this period. The 2008 global recession exacerbated the rise in income inequality, notably in countries where output and employment losses were more pronounced.[6]

3. In terms of wealth inequality, the wealth share of the world's top 1 per cent increased to 33 per cent in 2016, from 28 per cent in 1980. If the world is to follow the combined experience of China, Europe and the United States of America, the richest 1 per cent are on track to own 39 per cent of the world's wealth by 2050, from 33 per cent in 2016.[7] Eighty-two per cent of the wealth generated in 2017 went to the

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[1] J. Ostry, A. Berg and C. Tsangarides, "Redistribution, inequality, and growth", IMF Staff Discussion Note 14/02 (February 2014).

[2] *Report on the World Social Situation 2013: Inequality Matters* (United Nations publication, Sales No. 13.IV.2).

[3] The term "global inequality" refers to the relative inequality of incomes among all peoples of the world no matter where they live.

[4] Christoph Lakner and Branko Milanovic, "Global income distribution: from the fall of the Berlin Wall to the great recession", *World Bank Economic Review*, vol. 30, No. 2, pp. 203–232.

[5] Facundo Alvaredo and others, *World Inequality Report 2018* (World Inequality Lab, 2017). Available from https://wir2018.wid.world/download.html.

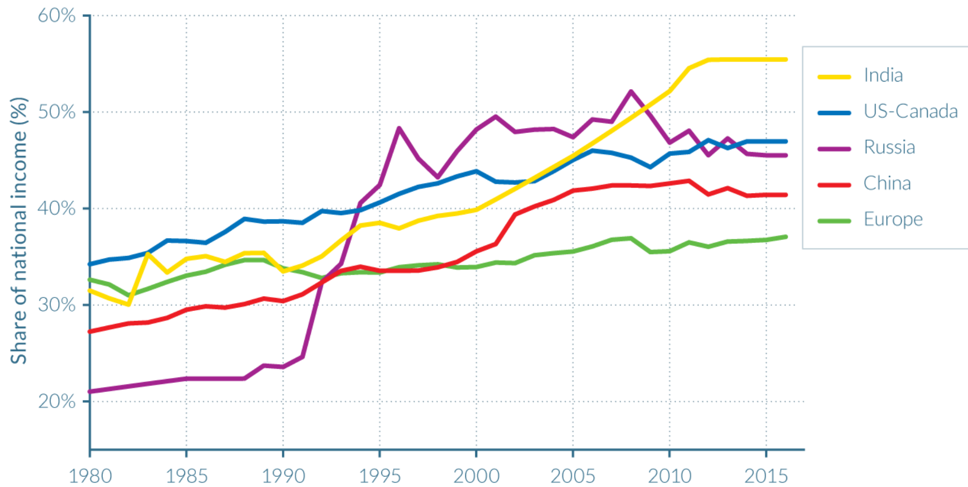
[6] International Monetary Fund (IMF), *World Economic Outlook: Challenges to Steady Growth* (October 2018).

[7] Facundo Alvaredo and others, note 5 above.

top 1 per cent, while the 3.7 billion people who make up the poorest half of the world saw no increase in their wealth.[8]

4. The global rise in income inequality has occurred at vastly different rates across regions. Since 1980, Europe has experienced a moderate increase. In contrast, income inequality rose sharply in North America and Asia, while Latin America, the Middle East and sub-Saharan Africa retain some of the world's highest income inequality levels,[9] in spite of a decline in inequality in 17 sub-Saharan Africa countries between 1991 and 2011.[10] The Middle East has replaced Latin America and the Caribbean as the most unequal region in the world. The figure below shows how inequality has been rising everywhere, though at different speeds.

Top 10 per cent income shares across the world, 1980–2016



Source: Facundo Alvaredo and others, *World Inequality Report 2018* (World Inequality Lab, 2017).

5. Since 1980, cross-country inequality has increased, but began to trend downwards after 2000. Overall, income inequality among countries has been shifting towards convergence between developed and developing countries.[11] This convergence is mainly due to rapid growth in Asia, notably China and India, coupled with slow growth in Western Europe. Rapid growth in China and India has resulted in strong income growth of the poorest half of the global population. Furthermore, average national incomes in sub-Saharan Africa and Latin America have fallen behind the world average since 1980.

6. While global inequality may have declined, within-country income inequality rose in many countries, although the overall picture varies depends on the time period and indicator used. Rising income inequality has occurred at different speeds, with North America, China, India and the Russian Federation posting some of the most rapid increases since 1980.[12] In some countries, spatial inequality across regions has

[8] Oxfam International, *Reward Work, Not Wealth* (Oxford, January 2018).

[9] Facundo Alvaredo and others, note 5 above.

[10] United Nations Development Programme (UNDP), *Income Inequality Trends in sub-Saharan Africa* (New York, 2017). Available from www.africa.undp.org/content/ dam/rba/docs/Reports/undp-rba_Income%20Inequality%20in%20SSA_Chapter%201.pdf.

[11] François Bourguignon, *The Globalization of Inequality* (Princeton, Princeton University Press, 2015).

[12] Facundo Alvaredo and others, note 5 above, and World Bank, *Poverty and Shared Prosperity 2018: Piecing Together the Poverty Puzzle* (Washington, D.C., 2018), available from https://openknowledge.worldbank.org/bitstream/handle/10986/30418/9781464813306.pdf.

become more pronounced, along with the emergence of economically distressed regions and concentrated inequality in cities and towns.

B. Trends in non-income inequality

7. Income inequality is but one of several dimensions of inequality, including inequalities of access and opportunity in relation to education and health services, productive assets, financial services and political representation. These inequalities are interrelated and mutually reinforcing, resulting in significant differences in various outcomes such as overall well-being and lifetime earnings across different groups. For instance, people in poor health spend fewer years being gainfully employed, earn less, and their lifetime earnings are lower compared to those of healthy workers. Poor health reduces the lifetime earnings of less-educated men by 33 per cent, compared to a reduction of 17 per cent for highly-educated men.[13]

8. These inequalities persist even though the world has seen remarkable improvements in health outcomes. The overall global trends show convergence in outcomes such as life expectancy at birth, child mortality and average years of education. On average, people are living longer, with life expectancy at birth increasing to 70.8 years in 2010–2015, from 58.1 in 1970–1975. The gap in life expectancy at birth between the more developed regions and the less developed regions narrowed to 9.3 years in 2010–2015, from 16.4 years in 1970–1975. Despite these health gains, significant disparities persist. Children born in sub-Saharan Africa face higher odds of dying before age 5 than children born in other major world regions. Within countries, disparities in health also exist among individuals and groups. In many countries, where one lives also makes an enormous difference in terms of how long one lives, especially when the individual is poor.

9. The world is more educated than ever before. There has been a steady increase in the average level of educational attainment across countries, with a dramatic rise in schooling in developing countries. Among the global population aged over 15, the average number of years of schooling increased to 7.89 in 2010, from 4.39 years in 1970. Differences between developed and developing countries have also declined, but the gap in the average number of years remains high (4.1 years in 2010), having narrowed by less than 1 year since 1950. In developing countries, the average number of years of schooling increased to 7.2 in 2010, from 3.35 in 1970. In advanced countries, average years of schooling jumped to 11.30 in 2010, from 7.64 in 1970.[14] Further, group-based inequalities remain an important aspect of within-country inequalities. In India, a 20- to 24-year-old woman from a poor, rural household is 21.8 times less likely than one from a rich urban household to have attended school and 5.1 times more likely to have married before turning 18 years of age.[15] There are also large generational and gender gaps. In South Asia, the ratio of years of schooling among females to males was 68.6 per cent in 2010, compared to 80.0 per cent in sub-Saharan Africa and 98.3 per cent in Europe and Central Asia.

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[13] OECD, *Preventing Ageing Unequally* (Paris, 2017). Available from www.oecd-ilibrary.org/employment/preventing-ageing-unequally_9789264279087-en.

[14] www.barrolee.com/data/yrsch.htm.

[15] United Nations Entity for Gender Equality and the Empowerment of Women (UN-Women), *Turning Promises into Action: Gender Equality in the 2030 Agenda for Sustainable Development* (United States, 2018).

10. To expand and deepen financial inclusion for historically unserved or underserved population segments and regions, many countries are promoting the uptake of mobile money and expanding the coverage of banks.[16]

III. Inequality, social inclusion and fiscal policies

A. Effects of tax and spending policies on inequality and social inclusion

11. Fiscal policy is mainly understood as governments' management of tax revenues and their expenditures and benefits systems, including transfers and subsidies. When these policies are inclusive, they can be powerful tools for reducing income inequality and promoting inclusive growth. Fiscal policy can also address challenges to social inclusion by equalizing the opportunities or terms on which individuals and groups take part in society. This includes improving people's capabilities, promoting equality of opportunities for education, health and employment and improving access to quality basic infrastructure. It also entails removing barriers to access to financial services. To be effective, policymakers should examine the effects of tax and spending measures together, instead of in isolation. They should ensure that the size and composition of total government spending devoted to social expenditures is pro-poor, equalizing and targeted at effective programmes. Equally important is the progressivity of all taxes.

12. In a 2018 study of 29 low- and middle-income countries from around 2010, it was found that fiscal systems reduced income inequality in all cases but increased poverty in some cases. Inequality did not increase in any country because of taxes, subsidies and social spending. However, the extreme poverty headcount ratio was higher after taxes and transfers than before in Ethiopia, the United Republic of Tanzania, Ghana, Nicaragua, Uganda and Guatemala. This is due to the fact that people living in poverty were net payers into the fiscal system and were therefore impoverished by consumption taxes.[17] The overriding principle in the design of fiscal systems should be to ensure that poor people do not end up as net payers. High consumption taxes on basic goods can lead to this regressive result. Hence, to reduce the regressivity of taxes on goods and services, it may be necessary to exempt or set lower tax rates for basic goods that low-income households depend on, while setting higher rates for luxury goods that are principally consumed by wealthier households.

13. In developed countries, fiscal policies have reduced inequality and improved education and health outcomes through transfers. In countries of the Organization for Economic Cooperation and Development (OECD), evidence from the period preceding the 2008 great recession shows that nearly three-quarters of the reduction in income inequality was due to cash transfers, with direct taxation accounting for the rest.[18] Similarly, in the European Union, government redistribution through the tax and benefit system reduced inequality by close to one third. Significant reductions in income inequality were largely due to spending on education and health as well as

[16] World Bank Group, *Toward Universal Financial Inclusion in China: Models, Challenges, and Global Lessons* (2018). Available from https://openknowledge.worldbank.org/bitstream/handle/10986/29336/FinancialInclusionChinaP158554.pdf?sequence=9.

[17] Nora Lustig, "Fiscal policy, income redistribution, and poverty reduction in low and middle income countries", Center for Global Development Working Paper 448 (January 2017, updated July 2018). Available from www.cgdev.org/sites/default/files/fiscal-policy-income-redistribution-and-poverty-reduction-july-2018-revision.pdf.

[18] Isabelle Joumard, Mauru Pisu and Debbie Bloch, "Tackling income inequality: The role of taxes and transfers", *OECD Journal: Economic Studies*, No. 1 (2012), pp. 37-70. Available from www.oecd.org/eco/public-finance/TacklingincomeinequalityTheroleoftaxesandtransfers.pdf.

sickness, disability, family and child benefits during the period 1980 to 2014. However, because of behavioural responses and macroeconomic effects, the total effect of fiscal policy on inequality reduction was smaller than its direct effect.

14. The experience of developed countries also suggests that fiscal policy has had a stabilizing effect on income and consumption over the economic cycle, preventing poverty during economic downturns. Some of the consumption is absorbed by savings behaviour. Hence, transfers can ensure that people recover quickly from economic hardship. The more progressive the tax and benefits system, the higher its stabilization effect. In the United States, fiscal transfers such as the earned income tax credit are an important anti-poverty programme. Besides providing income support to the working poor, the programme also facilitates social inclusion by encouraging the participation of low-income adults in the labour market. Further, the programme reduces inequality because of its long-lasting effects on maternal and children's health and children's development such as improved school performance, lifetime health, and earnings in adulthood.[19]

15. The choice and size of fiscal policy instruments that countries deploy to affect income distribution are influenced by several factors that include administrative capacity, preferences within societies for redistribution, the role envisaged for the State and country-specific political economy considerations. However, a balance should be struck to ensure that both tax and expenditure policies do not discourage incentives for work or household and firm decisions to invest in education and in entrepreneurial activities. When workers' earnings rise but their after-tax income rises less, their incentive to work typically declines. This is often a result of increases in income and payroll taxes or declines in benefits.

16. Policymakers need to examine the impact of higher taxes on labour income and of social security contributions on incentives to work. Further, means-tested social transfers can provide disincentives for unemployed low-skilled workers, older workers and second earners to look for jobs. Targeted tax reforms such as introducing work-contingent tax credits and providing age-based concessions for young and older workers have the potential to stimulate labour force participation rates among these groups, contributing to reducing the number of potential welfare beneficiaries. Further, introducing financial incentives for employees, such as temporarily reducing employee social security contributions, can reduce the cost of hiring unemployed workers.[20]

B. Effects of public spending on inequality and social inclusion

17. Highly redistributive social transfers aimed at reducing inequalities of opportunity, such as education and health spending and social protection benefits, have significant long-term effects. Investments in basic infrastructure have similar effect. These transfers and investments also reduce poverty and foster social inclusion. Social spending on expanding access to education and health care over the last 15 years has reduced income inequality in emerging and developing countries by reducing the inequality of education and health and by expanding the ranks of the middle class. In Latin America, higher education spending has been the most

[19] Hilary Hoynes, "The earned income tax credit: a key policy to support families facing wage stagnation" (Berkeley, California, Institute for Research on Labor and Employment, January 2017). Available from http://irle.berkeley.edu/files/2017/IRLE-The-Earned-Income-Tax-Credit.pdf.

[20] OECD, *Taxation and Employment*. OECD Tax Policy Studies No. 21 (2011).

important driver behind the declining trend in income inequality.[21] In Asia, social spending on education and health has contributed to significant reductions in income inequality.[22]

18. On the other hand, changes in social policy measures, particularly reductions in government spending on social protection programmes, reduced benefit levels and more strict eligibility criteria, have contributed to a general deterioration of income distribution in both developed and developing countries.[23] Cuts in the amplitude of transfers such as unemployment and disability benefits and enforcement of stricter eligibility criteria were accompanied by sharp increases in income inequality in the United Kingdom of Great Britain and Northern Ireland and the Netherlands in the 1980s and mid-1990s. Although those cuts successfully contained government expenditure growth, the real disposable income of many beneficiaries fell sharply.[24]

19. Education is recognized as an equalizer and a means for inclusion. Spending on pre-school, primary and secondary education has been found to be pro-poor in developing countries.[25] Social spending on education also promotes gender equality and empowers women, contributing to improvements in labour force outcomes and maternal and child health. To achieve these goals, fiscal policies influence individual or household decision-making by subsidizing education at various levels and investment in skills. Hence, education is generally heavily subsidized in both developing and developed countries. In OECD countries, public expenditures on education average about six per cent of gross domestic product.[26] In developing countries, wealth inequality declines as secondary or higher education increases. In Africa, private returns to higher education are also higher than returns to primary education.[27] Further, the premium of lifetime earnings associated with higher education has increased around the world, reflecting higher demand for college-educated workers. In the United States, the median annual earnings of full-time workers with a four-year bachelor's degree are 79 per cent higher than the earnings of workers with only a high school diploma.[28] However, as access to higher education has become more stratified, with access to top universities depending increasingly on socioeconomic status, expansion of higher education could potentially worsen inequality. A related concern is that while education subsidies encourage more investment in education and skills, such policies can be regressive since they may disproportionately benefit students of better-to-do and better-informed families.

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[21] E. Tsounta and A.I. Osueke, *What is Behind Latin America's Declining Income Inequality?*, IMF Working Paper WP/14/124 (2014).

[22] Seok-Kyun Hur, *Government Spending and Inclusive Growth in Developing Asia*, Asian Development Bank Economics Working Paper Series No. 415 (November 2014). Available from https://ssrn.com/abstract=2558893.

[23] ILO, *World Social Protection Report 2017–2019: Universal Social Protection to Achieve the Sustainable Development Goals* (Geneva, International Labour Office, 2017).

[24] Koen Caminada and. Kees Goudswaard, "International trends in income inequality and social policy", *International Tax and Public Finance*, vol. 8, No. 4, pp. 395–415.

[25] Nora Lustig, "The redistributive impact of government spending on education and health: evidence from thirteen developing countries in the Commitment to Equity Project", Commitment to Equity Project Working Paper No. 30 (March 2015). Available from www.commitmentoequity.org/publications_files/Comparative/CEQWPNo30%20RedisImpactGovntSpendEducHealth%20March%202015.pdf.

[26] Robert A. J. Dur and Coen N. Teulings, "Are education subsidies an efficient redistributive device?", in Jonas Agell, Michael Keen and Alfons J. Weichenrieder (eds.), *Labour Market Institutions and Public Regulation* (Cambridge, Massachusetts, MIT Press, 2004), pp. 123–161.

[27] Abebe Shimeles, "Can higher education reduce inequality in developing countries?", *IZA World of Labor*, July 2016. Available from http://dx.doi.org/10.15185/izawol.273.

[28] Sandy Baum, *Higher Education Earnings Premium: Value, Variation, and Trends* (Washington, D.C., Urban Institute, February 2017).

20. In many countries, policymakers have sought to reduce income and non-income inequalities and challenges to social inclusion, such as high youth unemployment, by increasing the share of government spending on education. Global public education expenditure was 4.7 per cent of world GDP and 14.1 per cent of total public expenditure in 2015.[29] Public expenditures on education include the provision of free or subsidized schooling, teachers, classrooms and teaching materials. The reduction in education inequality across the world is primarily due to increased government spending on education as a share of national income in many developing countries. Hence, combating inequality and addressing social exclusion through education requires scaling up public spending to boost school enrolment and completion rates, particularly of young girls, children with disabilities, ethnic and religious minorities, children living in poverty and those in poor remote rural areas and urban slum settlements. Expenditure targeting such children does not amount to much. In 2013, it was estimated that government expenditure and donor funding levels would have to be increased by $26 billion per year to meet the goal of providing basic education to all children in 46 low and middle-income countries by 2015.[30] From 2015 to 2030, an estimated $340 billion would have to be spent per year (compared to the 2012 level of $149 million) to ensure that every child and adolescent in low- and lower middle-income countries has access to good quality education from the pre-primary to upper secondary level.[31]

21. Policymakers also seek to tackle the credit constraints that prevent low-income students from pursuing higher education by conditioning student loans, grants and tuition fees on parental income. Such policies have contributed to higher levels of educational attainment by students from low-income backgrounds. However, student loans that are intended to provide everyone with equal access to education are imposing a huge debt burden on middle- and low-income students in some countries, entrenching income and wealth inequality.

22. Reversing this trend requires more public support for and access to affordable higher education. Women also tend to be disproportionately affected by student debt since they take longer to pay it off, partly as a consequence of the gender pay gap. Some evidence also shows that, in advanced economies, the expansion of education is associated with a net increase in income inequality.[32] In this group of countries, the income inequality-increasing impact of rising levels of education offsets the relatively smaller impact of decreasing education inequality at the lower levels of education inequality. And in developing countries where child labour is prevalent, school attendance has an opportunity cost for households that depend on child labour for domestic chores, farming or other income-generating activities.[33] In the absence of compulsory schooling or laws banning child labour, increasing public expenditure on education can worsen inequality between children who take advantage of improved schooling opportunities and those who do not.

[29] United Nations Educational, Scientific and Cultural Organization (UNESCO), *Global Education Monitoring Report 2017/18: Accountability in Education — Meeting Our Commitments* (Paris, 2017). Available from http://unesdoc.unesco.org/images/0025/002593/259338e.pdf.

[30] UNESCO, "Education for all is affordable — by 2015 and beyond", Education for All Global Monitoring Report, Policy Paper 06, February 2013. Available from http://unesdoc.unesco.org/images/0021/002199/219998E.pdf.

[31] http://uis.unesco.org/sites/default/files/documents/education-2030-incheon-framework-for-action-implementation-of-sdg4-2016-en_2.pdf.

[32] David Coady and Allan Dizioli, *Income Inequality and Education Revisited: Persistence, Endogeneity, and Heterogeneity*, IMF Working Paper WP/17/126 (2017).

[33] Martin Ravallion and Quentin Wodon, "Does child labour displace schooling? Evidence on behavioural responses to an enrollment subsidy", *The Economic Journal*, vol. 110, No. 462 (March 2000), pp. C158–C175.

23. A government's commitment to combating inequality and equalizing opportunities is also demonstrated by the share of total government spending devoted to expanding affordable and quality health care and services. Around 2010, government spending on health varied from 0.9 per cent of GDP in Indonesia, to 1.3 per cent in Ethiopia and 5.2 per cent in Brazil.[34] Income-related health inequalities are lower in countries characterized by a universal public health system or with high levels of public social spending.[35] In Europe, social spending has a positive impact on equalizing health status across countries.[36] In Kenya, deworming treatments in childhood have been shown to reduce school absences while also raising average wages in adulthood by as much as 21 to 29 per cent.[37] Increasing the share of government spending on health-care systems can directly improve child, adolescent and maternal health outcomes and enhance intergenerational economic mobility. Further, emerging and low-income countries can raise life expectancy at birth by 1.3 years on average if they eliminate inequalities in basic health coverage, while keeping spending levels unchanged.[38]

24. However, it is important to note that countries cannot address inequities in health status and in health systems or improve health by simply increasing government expenditure on health. For instance, health-care spending at the individual level can worsen income inequality and poverty, as people living in poverty spend a much greater proportion of their income on health care compared to richer people. At the macro level, health care spending can crowd out resources from other investment such as spending on education or environmental protection.

25. Besides public spending on education, health and social protection, fiscal measures that improve access to quality basic infrastructure services such as roads, electricity, safe water and sanitation, particularly in rural and remote areas, also reduce income inequality and foster social inclusion.[39] Such spending improves growth of incomes in these areas and therefore reduces spatial inequalities. Access to infrastructure removes physical obstacles to access to education and health-care services and even employment, helping to reduce inequality and social exclusion. Energy subsidies aimed at helping people living in poverty and low-income households are also used by many countries as fiscal tools to reduce inequality and exclusion. However, the experience of developing countries is that the top 20 per cent of households capture, on average, seven times as many of the benefits of energy subsidies as do the bottom 20 per cent, worsening inequality.[40]

26. In the Middle East and North Africa, many countries rely on consumption subsidies that include fuel, food and housing for reducing inequality. In 2011, countries in the region devoted 8.6 per cent of the region's total GDP, or 22 per cent

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[34] Nora Lustig, note 25 above.

[35] Javier Alvarez-Galvez and others, "The impact of socio-economic status on self-rated health: Study of 29 countries using European social surveys (2002–2008)", *International Journal of Environmental Research and Public Health*, vol. 10 (March 2013), pp. 747–761.

[36] Javier Álvarez-Gálvez and Antonio M. Jaime-Castillo, "The impact of social expenditure on health inequalities in Europe", *Social Science and Medicine*, vol. 200 (March 2018), pp. 9–18.

[37] Sarah Baird and others, "Worms at work: long-run impacts of child health gains" (2011). Available from www.cgdev.org/sites/default/files/archive/doc/events/KLPS-Labor_2011-05-16-Circulate.pdf.

[38] IMF, "Tackling inequality", *Fiscal Monitor* (October 2017). Available from www.imf.org/en/Publications/FM/Issues/2017/10/05/fiscal-monitor-october-2017.

[39] Asian Development Bank, *Infrastructure for Supporting Inclusive Growth and Poverty Reduction in Asia* (2017). Available from www.adb.org/sites/default/files/publication/29823/infrastructure-supporting-inclusive-growth.pdf.

[40] David Coady, Valentina Flamini and Louis Sears, "The unequal benefits of fuel subsidies revisited: evidence for developing countries", in Benedict Clements and others (eds.), *Inequality and Fiscal Policy* (Washington, D.C., International Monetary Fund, 2015).

of government spending, to such subsidies.[41] In Malaysia, energy subsidies account for about 5 per cent of GDP. Although such subsidies are part of the social compact in many countries, they cause inefficiencies in the economy and are inefficient in supporting people living in poverty. However, removing them raises the price of goods and household expenditures on energy and transport, leading to increases in overall inequality, particularly in urban areas.

27. More importantly, in those countries with high public debt and large medium-term financing needs, the pressure on public budgets may require reductions in the provision of public services or welfare benefits, or a reversal of recent tax cuts. Such reductions have been shown to increase income inequality and poverty. Fiscal consolidations in 17 OECD countries over the period 1978–2009 led to an increase in income inequality and long-term unemployment and a decrease in wage income shares.[42]

IV. Inequality, social inclusion and wage policies

28. Evidence from advanced, emerging and low-income countries reveal that wages can account for as much as 70 per cent of total household income. Hence, the distribution of wages and employment opportunities in the labour market are key determinants of overall income inequality trends in many countries. Changes in income inequality between 2006 and 2010 were significantly affected by changes in wage inequality, controlling for the effect of other income sources in the household and for employment effects. Wage effects were more significant for middle-income workers.[43] The wage discrimination against women, youth, older workers, persons with disabilities, indigenous groups and migrant workers costs these groups lost wages, reduced pensions and social security benefits. Eliminating discrimination should be part of an overall strategy of reducing inequality, particularly addressing group-based inequality and the social exclusion of disadvantaged and vulnerable groups. Wage growth also offers a path out of poverty and dependence on public transfers.

29. Stagnation in wage growth is another cause for concern. Although the global economy has seen falling unemployment rates since the Great Recession, wage growth has been subdued. According to estimates by the International Labour Organization (ILO), the global unemployment rate has been stabilizing after three years of rising unemployment rates. The unemployment rate is expected to reach 5.5 per cent in 2018, from 5.6 per cent in 2017. However, the total number of unemployed is expected to remain stable in 2018, above 192 million persons. Further, 1.4 billion workers were in vulnerable employment in 2017.[44] In developed countries, the unemployment rate in 2018 is projected to fall below pre-crisis levels, to reach 5.5 per cent. Employment growth has also improved in emerging and developing countries compared to 2016. However, employment growth is expected to fall short of labour force growth. In terms of inclusion in the labour market, women, youth, persons with disabilities and older persons are more likely to be unemployed or to be in vulnerable forms of employment.

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[41] Carlo Sdralevich and others, *Subsidy Reform in the Middle East and North Africa: Recent Progress and Challenges Ahead* (Washington, D.C., IMF, 2014).

[42] Laurence Ball and others, *The Distributional Effects of Fiscal Consolidation*, IMF Working Paper WP/13/151 (June 2013).

[43] ILO, *Global Wage Report 2014/15: Wages and Income Inequality* (Geneva, International Labour Office, 2015).

[44] ILO, *World Employment and Social Outlook: Trends 2018* (Geneva, International Labour Office, 2018).

30. Wage growth is the missing piece in the economic recovery that is under way in many countries. Workers' wages have not kept pace with productivity for decades and rising costs of living are also a drag on the purchasing power of workers. Wage growth around the world slowed in 2015 to 1.7 per cent, compared to 2.5 per cent in 2012, and has yet to catch up to the pre-crisis rates of about 3.0 per cent. If China is not included, growth in global wages dropped from 1.6 per cent in 2012 to 0.9 per cent in 2015. Wage growth among developed countries of the Group of Twenty (G20) rose to 1.7 per cent in 2015, from 0.2 per cent in 2012. This was the highest rate in a decade. In contrast, real wage growth declined to 2.5 per cent in 2015, from 6.6 per cent in 2012 among emerging and developing G20 countries.

31. In Europe, real wage growth recovered from a negative trend in the post-crisis years but has remained rather subdued since 2015. Excluding Eastern Europe, real wage growth declined from 1.6 per cent in 2015 to 1.3 per cent in 2016 and further declined to about zero in 2017. In the United States, real wage growth declined from 2.2 per cent in 2015 to 0.7 per cent in both 2016 and 2017.[45] For the period from October 2017 to October 2018, real average weekly earnings increased by 0.9 per cent.[46] Wage growth remained at 4.0 per cent in Asia and the Pacific. However, more recent data indicate that Asian workers are expected to lead global wage growth in 2018, with China, India and Viet Nam posting solid gains. Wage growth declined to 3.4 per cent in Central and Western Asia and stood at 2.1 per cent in the Arab States and at 2.0 per cent in Africa. Real wages fell in Latin America and the Caribbean and in Eastern Europe by 1.3 per cent and 5.2 per cent, respectively.[47] However, higher average wage growth may not automatically benefit all employees equally, dampening the effect of wage growth on inequality.

32. Indeed, wage distribution is biased toward top income earners in most countries. In Europe in 2010, the top 10 per cent of the highest paid workers took on average 25.5 per cent of the total wages paid to all employees, while the lowest-paid 50 per cent got 29.1 per cent of total wages paid. In Brazil the share of the top 10 per cent stood at 35.0 per cent in 2015 while that in India and South Africa stood at 42.7 per cent and 49.2 per cent, respectively. In most countries, wage inequality is even steeper for women. In Europe, the gender pay gap in the top one per cent of wage earners was about 45 per cent in 2015. In contrast, the overall hourly gender pay gap was about 20 per cent.[48]

33. To reduce wage inequalities, policymakers can choose from various policy options, including minimum wages, strengthening the institutions of collective bargaining, addressing gender pay gaps, for example by promoting equal pay for work of equal value, and addressing unequal wages between groups of workers. Minimum wages have a more positive effect on wages of workers at the bottom than the top tail of the wage distribution, implying an equality-enhancing role. Extremely low wages must be supplemented with transfers to reduce inequality and poverty.[49]

34. Combating inequality through wage policies requires labour market policies that focus on the quantity and quality of jobs and the inclusiveness of the labour market. Labour markets need to be made more inclusive by removing barriers that prevent the full participation of groups with lower employment rates, notably women, young people, older workers, persons with disabilities, migrants and indigenous groups.

[45] ILO, *Global Wage Report 2018/19: What Lies Behind the Gender Pay Gap* (Geneva, International Labour Office, 2018).

[46] United States Bureau of Labor Statistics, "Real earnings — October 2018", news release, 14 November 2018. Available from www.bls.gov/news.release/pdf/realer.pdf.

[47] ILO, *Global Wage Report 2016/17: Wage Inequality in the Workplace* (Geneva, International Labour Office, 2017).

[48] Ibid.

[49] www.statista.com/chart/12407/wage-growth-around-the-world-in-2018/.

Second, the quality of jobs needs to be reinforced by promoting decent work, making jobs more secure and sufficiently remunerated, avoiding inequality of treatment between temporary and permanent employment and tackling informality (informal employment). Further, investments in education, particularly higher education and skills training, are critical in improving labour market outcomes and in narrowing the wage gap, although in high-income countries the gender pay gap is largest at the top of the skills and earnings distribution. In Brazil, the Gini coefficient of labour earnings fell from 0.50 to 0.41 between 1995 and 2012, primarily owing to a falling education premium. Reductions in the gender, race, informality and urban-rural wage gaps also contributed to the decline.[50]

35. Many countries have sought to counter wage inequalities in the labour market, more specifically in the lower half of the wage distribution, by setting a statutory minimum wage level. Evidence from across developed countries suggests that the erosion of minimum wages relative to the median wage is strongly associated with increases in overall inequality.[51] Evidence also shows that minimum wages, if set at an adequate level, can also have an impact on inclusion, notably participation in the labour market.

36. Despite the fact that empirical evidence shows that minimum wages, when correctly set, do not have an adverse effect on overall employment, there are debates over the effects of minimum wages on employment demand. Much of the debate centres on whether, and to what extent, raising the minimum wage increases the labour and production cost to employers, causing job losses and informality. A related issue is whether increasing the minimum wage raises the cost of low-wage workers relative to other inputs, such as automation and more productive higher-skilled workers, which may cause employers to replace low-wage workers with those alternative inputs.

37. The burgeoning literature on the impact of minimum wages on employment demand in emerging economies shows that, overall, minimum wages have only a minimal or no impact on employment. These findings are consistent with the evidence in more advanced countries, which also shows very small or no effects of rising minimum wages on employment. In 14 major emerging economies that include Brazil, China, India, Mexico, the Russian Federation and South Africa, minimum wages were found to have minimal or no impact on employment. However, the impact on youth, low-wage earners and low-skilled workers tends to be negative but small. Further, there is little evidence that higher minimum wages lead to more informal employment.[52] In Asia, the employment effects of minimum wages are also mixed. In Thailand, large positive effects on the wages of prime-age males were observed, but only small effects on unemployment rates for female, older persons and less educated workers.[53] In sub-Saharan Africa, the proportion of workers covered by minimum wages is relatively small compared to other regions, reflecting the large share of workers in subsistence agriculture and in urban informal employment.[54] Nonetheless,

[50] Francisco H. G. Ferreira, Sergio P. Firpo and Julián Messina, "Ageing poorly?: Accounting for the decline in earnings inequality in Brazil, 1995-2012", World Bank Policy Research Working Paper 8018, March 2017.

[51] Florence Jaumotte and Carolina Osorio, "Inequality and labor market institutions", IMF Staff Discussion Note SDN/1514, July 2015.

[52] Stijn Broecke, Alessia Forti and Marieke Vandeweyer, "The effect of minimum wages on employment in emerging economies: a survey and meta-analysis", *Oxford Development Studies*, vol. 45, No. 3 (2016), pp. 366–391.

[53] Ximena Del Carpio, Julián Messina and Anna Sanz-de-Galdeano, "Minimum wage: does it improve welfare in Thailand?", Discussion Paper No. 7911 (Bonn, Germany, Institute for the Study of Labor, 2014).

[54] Haroon Bhorat, Ravi Kanbur and Benjamin Stanwix, "Minimum wages in sub-Saharan Africa: a primer", *World Bank Research Observer*, vol. 32, No. 1 (February 2017), pp. 21–74.

the employment effects of introducing or increasing minimum wages are consistent with global results. Although some evidence points to small negative employment effects, overall, most findings show that an increase in the minimum wage does not necessarily result in a decrease in employment.

38. Similarly, the effects of minimum wage rates on low-skilled, female low-skilled and youth employment were found to be minimal in 19 OECD countries from 1997 to 2013.[55] In the United States, recent evidence also suggests modest or no minimum wage effects on the employability of restaurant workers and young workers.[56] More importantly, a higher minimum wage is associated with increases in family income for many low-wage workers. However, some past studies found that an increase of the minimum wage had negative employment effects on minimum wage earners, notably for young people.[57]

39. Country experiences show that for minimum wages to be effective, it is important that the policies be tailored to the specific needs of each country. Given the specific circumstances and policy objectives of each country, it is advised to keep minimum wages "as complex as necessary but as simple as possible" and to avoid wage differentiation between different groups of workers which is not based on objective valid reasons, such as educational objectives, work experience or skills. Some countries have a single minimum wage rate, possibly with regional variations, while others have more complex systems, which may vary by sector and occupation. Both approaches have their merits, with systems that are more complex than necessary possibly losing some of their effectiveness. Exclusions from the law should be kept to a minimum, paying attention not to exclude particularly vulnerable workers such as domestic and agricultural workers. There should be a balanced and evidence-based approach to setting the minimum wage level, in full consultation with social partners and with the participation of experts when required. Moreover, minimum wage systems should leave space for the determination of wages through collective bargaining. The wage level (or levels, in case several apply) should be adjusted from time to time taking into account the cost of living, the needs of workers and their families and the needs of the economy, including, but not limited to, labour productivity and employment trends. It is important to monitor the effects of minimum wages on the wages and incomes of workers and their families; on employment, the sustainability of enterprises and informality; and on government finances (the public sector wage bill). Measures to ensure their effective application should also be put in place. These include labour inspections, adequate sanctions, information campaigns and capacity-building activities for employers and workers. If the "aspirational" minimum wage exceeds the economy's immediate capacity, a medium-term strategy can be adopted.[58]

40. Ending gender inequality and eliminating the gender pay gap is essential to reducing inequality. To address gender inequality and close the gender pay gap, countries should invest in girls and women and promote policies that ensure more and better jobs for women and equal pay at work. Increasing access to and control over productive assets, financial services and basic infrastructure is also critical. Countries should also develop comprehensive policy frameworks across legal, economic, social and labour sectors that eliminate gender-based discrimination and ensure wage equality, transparent pay scales and gender-neutral job evaluation systems. Other

[55] Simon Sturn, "Do minimum wages lead to job losses? Evidence from OECD countries on low-skilled and youth employment", *ILR Review*, vol. 71, No. 3 (May 2018), pp. 647–675.

[56] Sylvia Allegretto and others, "Credible research designs for minimum wage studies: A response to Neumark, Salas and Wascher", *ILR Review*, vol. 70, No. 3 (May 2017), pp. 559–592.

[57] David Neumark, J.M. Ian Salas and William Wascher, "More on recent evidence on the effects of minimum wages in the United States", *IZA Journal of Labor Policy*, vol. 3 (2014).

[58] ILO Minimum Wage Policy Guide (see www.ilo.org/global/topics/wages/minimum-wages/lang--en/index.htm).

important measures include establishing a floor to the wage structure and expanding the current rights for equal pay for work of equal value. In addition, there is a need to strengthen social policy and support, including leave provisions, childcare support, flexible working arrangements that support work-life balance, unpaid care work and social support for children.

V. Inequality, social inclusion and social protection policies

A. Social protection for social inclusion and reduction of inequality[59]

41. Social protection has emerged as one of the key policy instruments to reduce inequality and poverty simultaneously, while also promoting inclusive growth. Social protection contributes to reducing inequalities through three main channels. First, social protection reduces poverty and income inequality through the provision of cash or in-kind transfers and facilitating access to health care and other services. Second, it addresses the exclusion of vulnerable groups and offers a path out of poverty by reducing unequal opportunities and guaranteeing access to basic services such as education, health and nutrition and providing employment opportunities through government-sponsored employment guarantee schemes to low-skilled poor rural workers. Third, it provides protection against risks and in case of shocks, helps to smooth household incomes and consumption and counteracts irreversible asset depletion associated with external shocks.

42. Although countries are increasingly recognizing the importance of social protection in promoting inclusive development, significant coverage gaps remain. Only 45.2 per cent of the global population is covered by at least one social protection benefit. This means that 54.8 per cent, or four billion people, have no social protection at all. The proportion of the population covered by at least one benefit varies from 17.8 per cent in Africa to 38.9 per cent in Asia and the Pacific, 67.6 per cent in the Americas and 84.1 per cent in Europe and Central Asia. Further, only 29 per cent of the global population is covered by comprehensive social security systems that include the full range of benefits. Almost 1.3 billion children globally are not covered by social protection and only 21.8 per cent of unemployed workers receive unemployment benefits.[60]

43. To enhance the role of social protection in reducing inequalities, efforts should be made to close coverage gaps, enhance the adequacy of benefits, extend social protection to all workers in need, including disadvantaged or vulnerable groups, and streamline existing fragmented social protection programmes into nationally appropriate social protection systems, including floors. These include contributory social protection, social services and social assistance.

44. Social protection strategies should provide effective protection for all and extend protection to those who are currently not covered, including the "missing middle", referring to those who are neither covered by social transfers targeted at the poorest, nor social insurance. Many workers in the informal economy, the working poor and workers engaged in vulnerable employment lack access to adequate social protection, although they are exposed to greater risks of job losses, illness, injury or disability. Globally, about 2 billion people work in the informal economy, representing 61 per cent of global employment and 50 per cent when excluding

[59] A comprehensive examination of the role of social protection in reducing inequality and promoting inclusion can be found in *Promoting Inclusion through Social Protection: Report on the World Social Situation 2018* (United Nations publication, Sales No. E.17.IV.2).

[60] ILO, *World Social Protection Report 2017–2019*, note 23 above.

agriculture.[61] In sub-Saharan Africa and Southern Asia, 9 in 10 workers are in informal employment, while in South-Eastern Asia and the Pacific it is more than 7 in 10 workers. Hence, countries should extend social protection to the workers in the informal economy. In Africa, the African Union adopted the "Social protection for informal and rural economy workers" strategy to promote the provision of a minimum social protection package to informal and rural workers and their families.

45. Cash transfers for children have expanded in low- and middle-income countries over the past decades, although coverage and benefit levels remain insufficient in many countries. The United Nations Children's Fund (UNICEF) and ILO are examining whether universal child grants could be an important practical policy instrument to ensure that all children realize their potential, as well as to reduce inequality and poverty. Such investments in children have multiple long-term benefits. In addition, the universality of such grants contributes to reducing administrative costs and technical complexities associated with identifying target populations, while avoiding exclusion errors as well as stigmatization associated with being poor.

B. Social protection systems, including social protection floors

46. The 2030 Agenda for Sustainable Development (General Assembly resolution 70/1) calls for universal social protection that includes guaranteeing a social protection floor for all as part of social protection systems. Currently, 187 countries have committed themselves to establishing such floors to provide a nationally defined set of basic social security guarantees, and build progressively comprehensive social protection systems, by adopting the ILO Social Protection Floors Recommendation (No. 202) in 2012.[62] The floors are to ensure at a minimum that, over the life cycle, all in need have access to essential health care, including maternity care, without risk of hardship and an increased risk of poverty, and basic income security throughout the life course, including in case of maternity, sickness, disability, employment injury and old age. The floors are affordable in most low-income countries and many developing countries have achieved universal coverage for at least one branch. The cost of a set of cash benefits for 57 low-income and lower middle-income countries range from 0.3 of gross domestic product (GDP) for Mongolia to 9.8 per cent of GDP for Sierra Leone — with an average cost of 4.2 per cent of GDP. These costs include universal benefits for 364 million children, 81 million pregnant women, 103 million persons with severe disabilities and 153 million older persons.[63] Lack of coverage and adequacy are linked to insufficient public investments in social protection. Only 1.1 per cent of global GDP is allocated to social protection for children, compared to an allocation of 6.9 per cent for older persons. Further, public investments are shrinking as a negative impact of austerity or fiscal consolidation cuts.

47. One of the key challenges to expanding social protection, particularly in low- and middle-income countries, is adequate financing. To meet the basic minimum of a social protection floor, low-income and middle-income countries without such a floor must increase public spending to an average of 5 per cent and 2 per cent of their GDP,

[61] ILO, *Women and Men in the Informal Economy: A Statistical Picture*, 3rd edition (Geneva, International Labour Office, 2018). Available from http://www.ilo.org/global/publications/books/WCMS_626831/lang--en/index.htm.

[62] ILO, *World Social Protection Report 2017–2019*, note 23 above, and "Promoting social protection floors for all: time for action" (brochure, available from http://ilo.org/wcmsp5/groups/public/---africa/documents/publication/wcms_348663.pdf).

[63] Isabel Ortiz and others, *Universal Social Protection Floors: Costing Estimates and Affordability in 57 Lower Income Countries*, Extension of Social Security Working Paper No. 58 (Geneva, International Labour Office, 2017).

respectively.[64] To fund social protection systems, governments need to broaden the tax base and introduce or strengthen progressive taxation. This entails strengthening national tax systems, reducing the informal economy and tackling tax avoidance. To ensure fiscal sustainability, countries can reallocate public expenditures from less appropriate uses such as fuel subsidies to social protection. They can also expand coverage of contributory schemes, better manage debt and adopt a more accommodative macroeconomic framework.[65] Governments may consider increasing fiscal resources from natural resources or exploring innovative sources of development finance.

C. Impacts of greater investment in social protection

48. Social protection benefits play an important role in reducing poverty and inequality. The combined effects of taxes and transfers can reduce income inequality significantly. In some OECD countries, the combined effects of taxes and transfers reduce income inequality by more than 40 per cent. [66,67] The effects of cash transfers to vulnerable households on the reduction of poverty and inequality have also been well documented. In many Latin America countries, evidence indicates that cash transfers targeted to households living in poverty have had a noticeable redistributive effect, contributing to a decline in inequality. Cash transfer programmes in Mexico and Brazil reduced income inequality by 21 per cent between the mid-1990s and mid-2000s and were, after labour income, the second most powerful driving force in the reduction of inequality.[68] Cash transfers also lead to significant increases in school enrolment and expenditures on and use of agricultural inputs and investment in assets and livestock accumulation, and an overall positive effect on employment.

49. However, cash transfers alone are insufficient to help people permanently escape poverty, as the positive effects of social protection on poverty can easily be undone by regressive tax systems. To have a meaningful effect, the transfers need to be regular, predictable and preferably substantial, covering at least 25 to 30 per cent of average consumption needs, and they should be coupled with measures that foster access to the labour market and productivity. Social cash transfer programmes need to be designed as part of a national social protection system and within a wider socioeconomic policy framework that includes poverty reduction strategies.

VI. Recommendations

50. Rising inequality is neither desirable nor inevitable. With the right set of policies and institutions, inequality in all its forms can be curbed. Hence, to reduce inequality and address challenges to social inclusion, the Commission may wish to consider the following recommendations:

(a) **Countries should enhance the role of fiscal policies in addressing inequalities of opportunities and outcomes and promote social inclusion by expanding and sustaining fiscal space. This entails raising revenues rather than cutting productive social expenditures, improving tax fairness, reducing the**

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[64] www.adb.org/news/events/strategies-for-financing-social-protection-to-achieve-the-sdgs.

[65] Isabel Ortiz, Matthew Cummins and Kalaivani Karunanethy, *Fiscal Space for Social Protection and the SDGs: Options to Expand Social Investments in 187 Countries*, Extension of Social Security Working Paper No. 48 (Geneva, International Labour Office, 2017).

[66] OECD, *Society at a Glance 2016: OECD Social Indicators* (Paris, 2016).

[67] OECD, *In It Together: Why Less Inequality Benefits All* (Paris, 2015). Available from www.oecd.org/els/soc/OECD2015-In-It-Together-Chapter1-Overview-Inequality.pdf.

[68] Sergei Soares and others, “Conditional cash transfers in Brazil, Chile and Mexico: impacts upon inequality”, *Estudios Económicos* (special issue, 2009), pp. 207–224. Available from https://pdfs.semanticscholar.org/4367/a7279d6f7e82281f9705e0ad9cb54517ea58.pdf.

informal economy, increasing tax progressivity, rationalizing exemptions and implementing administrative reforms to stem tax evasion and illicit financial flows. Countries should also diversify revenue sources by reducing volatility and enhancing sustained growth;

(b) **To simultaneously address inequality and poverty, governments should carefully choose options for expanding fiscal space and, in particular, carefully assess the possible adverse impacts of austerity-based fiscal consolidations on inequality, poverty and social inclusion. Fiscal policy needs to be carefully designed to balance equity, stabilization and efficiency concerns, considering potentially harmful indirect effects. In this context, governments should design tax and transfers systems to ensure that people living in poverty, the working poor and the near poor do not end up as net payers. The incomes of these groups after taxes and transfers should not be lower than their market incomes before fiscal interventions;**

(c) **Labour market policies that strengthen institutions that provide adequate labour protection to all workers, especially the most disadvantaged, and minimum wages, should be part of policies to boost income growth for the vast majority of workers. To address informality, developing countries should also implement business entry reforms, reduce compliance costs and set incentives to support small businesses and ensure their transition to the formal economy;**

(d) **To ensure that women's employment and earnings contribute to curbing inequality, countries should implement policies that support female labour participation, promote equal pay for work of equal value and embed gender equality in all policymaking;**

(e) **Policymakers must address the disadvantages that women, youth, older workers, persons with disabilities, migrant workers and temporary and part-time workers face in employment. Possible initiatives include setting minimum wages; broadening minimum wage coverage so as to benefit all groups; improving access to quality secondary and tertiary education to build human capital and upgrade skills over the longer term; helping young people to enter the labour force and the unemployed to re-enter the labour market by providing employment services, and removing barriers to hiring and retaining older workers. Temporary and part-time workers should not be subject to wage penalties based on occupational status and should also receive prorated, paid annual family and sick leave to secure parity with full-time workers;**

(f) **Public spending that ensures universal health coverage and access to quality health care and inclusive and equitable access to quality education at all levels, including early childhood education, is crucial for achieving equity of opportunities for all and addressing disparities in human capital. Countries should increase investment to expand public provision of such basic services and increase public expenditure on infrastructure, particularly in rural areas;**

(g) **Countries should build national social protection systems, including floors that cover all people throughout the life cycle, guarantee access to essential goods and services and reduce unequal opportunities for people living in poverty and socially excluded groups. The design of social protection systems should also ensure that benefits do not create work disincentives and that they promote gender equality. Countries should include the universal child grant as one component of social protection floors, since investments in children have multiple long-term benefits;**

(h) **Countries should better coordinate social protection policies and measures with poverty reduction programmes and universal social policies to avoid excluding people in informal or precarious jobs.**