The TDR 2012 in 12 points

1. The world economy is slowing down from 4.1 per cent in 2010 to 2.7 per cent in 2011 and to between 2 and 2.5 per cent in 2012. Developed economies are expected to grow at around 1 per cent in 2012, as the result of a moderate recovery to close to 2 per cent in the United States and Japan and a new recession in the European Union. Growth will be stronger in developing and transition economies, sustained by resilient domestic demand, although it is also set to decelerate to around 5 and 4 per cent respectively. However, no country would be spared in case of a new financial shock in developed countries which would result in capital flows reversal, shrinking global trade volume and falling commodity prices.

2. The main reason for slow growth in developed countries is the lack of demand. High unemployment puts pressure on wages and income expectations of private households and the balance-sheet adjustment in the private sector is not yet finished. In this context, fiscal tightening and "labour market flexibility", which includes wage cuts and increased uncertainty for workers is self-defeating, as domestic demand and, consequently, growth, public revenues and employment are further weakened. Lowering labour costs in many countries with strong trade ties at the same time will not significantly improve competitiveness and is counterproductive as it diminishes domestic demand everywhere. Instead, policymakers should use fiscal, credit and incomes polices for recovering (in developed economies) or sustaining (in developing and transition economies) domestic demand, especially in surplus countries. Income redistribution in favour of low- and middle-income groups would contribute to this aim, as it would improve the purchasing power of agents with a high propensity to consume.

3. There is an on-going debate about the relationship between income inequality and growth. Some economists argue that income concentration is needed to generate savings and investment, and that policies aimed at reducing inequality tend to undermine economic efficiency and growth. Other economists contend that high inequality dampens aggregate demand, deprives many people of access to education and credit, and represents an enormous waste of development potential. In this respect, recent theoretical and empirical works find a negative correlation between inequality and growth. This Report argues that rising inequality is neither a necessary condition for sound economic growth, nor its natural result. By contrast, full participation of all citizens in the proceeds of the economy as a whole is indispensible for successful and sustained development.

4. Income inequality has increased significantly in most regions since the 1980s. The share of wages in total income has fallen in most developed and many developing countries. Concurrently, personal income distribution became more unequal in all regions since around 1980, although this took place within very different contexts (i.e. with rapid GDP growth in Asia, and with economic depressions in Latin America, Africa and the transition economies). In recent years, several developing countries have managed to simultaneously accelerate GDP growth and reduce inequality levels, heading to a more inclusive development strategy. The evidence indicates that the relationship between growth and inequality is complex and can be altered by proactive economic and social policies.

5. Inequality also rose between countries. In 1980, the per capita income of the 15 richest countries was 44 times that of the 15 poorest; this ratio rose to 62 times in 2000. With the better growth performance in developing countries in the last few years, that gap diminished to 56 times in 2009. At the global level – this is, taking all the world population together – income inequality receded in the last decade for the first time in 150 years, owing to the rapid increase in the per capita income in very populated developing countries, and also to growth recovery in most transition and developing countries.

6. Rising income inequality in the last three decades occurred in parallel with deepening trade, financial globalization and rapid technological change. This coincidence led to the widespread view that increasing inequality is an inevitable by-product of those structural changes. However, the effects of globalization or technological changes on equality depend on initial conditions, economic policies and institutional settings. Indeed, more appropriate macroeconomic and labour market policies could have mitigated, if not prevented, the recent rise of income inequality despite a globalizing economy and rapid technological change.

7. In developed countries, rising inequalities resulted in part from behavioural changes in the corporate sector aimed at maximizing shareholder value. Rather than reacting to greater international competition through productivity-enhancing investment, the institutional arrangements were modified in ways that allowed companies to create inequality by the threat of off-shoring production to low-wage countries and the use of much of their profits for dividend payments and share buybacks. As a result, domestic wage restraint has been accompanied by a widening gap between the top income groups (including rentiers and "working rich" in top management positions) and those at the bottom of the income ladder, with the richest 1-per cent concentrating between 10 and 20 per cent of national income.

8. In developing and transition economies, the distributional outcomes of globalization and technological change depended on attendant changes in production structures. Labour moving from agriculture towards more productive activities, such as manufacturing, may initially have adverse distributional effects, as in China: all workers are better off, but by different degrees. On the other hand, when finance-led globalisation leads to premature de-industrialisation and/or financial instability and crises (as in Latin America and transition economies), labour moving from manufacturing to less productive activities such as informal services normally tends to reduce wage levels and worsen income gaps. Financial crises and extended privatisations have also altered the ownership structure of enterprises, leading to increased wealth and income concentration.

9. The policy orientation that has prevailed since the 1980s was based on the belief that there was a trade of between equality and efficiency, and governments had to choose the latter. This led to the reorientation of fiscal policy seeking to minimize State intervention and eliminate "the distortion" of progressive taxation. In labour markets, this reorientation aimed at more "flexibility" in wage formation and less job protection, which in this view discourages hiring. These reforms have contributed to rising income inequality without providing better social services, higher investment, stronger employment creation and growth.

10. By relying on wage compression as the main tool for expanding employment, such labour market reforms dismissed the important contribution of income distribution to demand growth and employment creation: if overall productivity grows without a commensurate increase in wages, demand will eventually fall short of the production potential, thereby reducing capacity utilisation, profits and investment. In addition, by promoting wage differentiation at the firm level, these reforms would undermine the incentives for investment, innovation and productive gains. Indeed, if less efficient firms can compensate for their lower profits by cutting wages, they are not forced to increase their productivity to survive.

11. Collective bargaining, complemented by government recommendations or general guidelines, should prevent the wage share from falling (with wages increasing in line with overall productivity growth and the inflation target) and the emergence of large differences in wages for similar occupations. Other instruments may be used to correct the market outcome in favour of those with weak negotiation power or excluded from the formal sector, including legal minimum wages, enhanced public employment and measures to increase the income of informally employed and self employed.

12. Progressive taxation and public spending designed to improve the provision of essential goods and services to low-income groups (including social transfers) can also contribute to the process of inclusive growth: it would reduce income inequality and provide at the same time the prospect of expanding demand that is needed in investment decisions. It is possible to improve tax collection and make it more progressive without negatively affecting economic incentives. For example, profits from productive entrepreneurial activity may be taxed at a lower rate than profits from purely financial activity and capital gains that provide no benefits for the overall economy. Similarly, taxation could be increased on top incomes resulting from rent-seeking activities as compared to productive work. In resource-rich developing countries, governments should appropriate a fair share of commodity rents and ensure that they benefit the entire population and not just a few domestic and foreign actors. By enlarging fiscal space, governments can apply counter-cyclical policies, redistribute income and finance investment for a more sustainable and inclusive growth.