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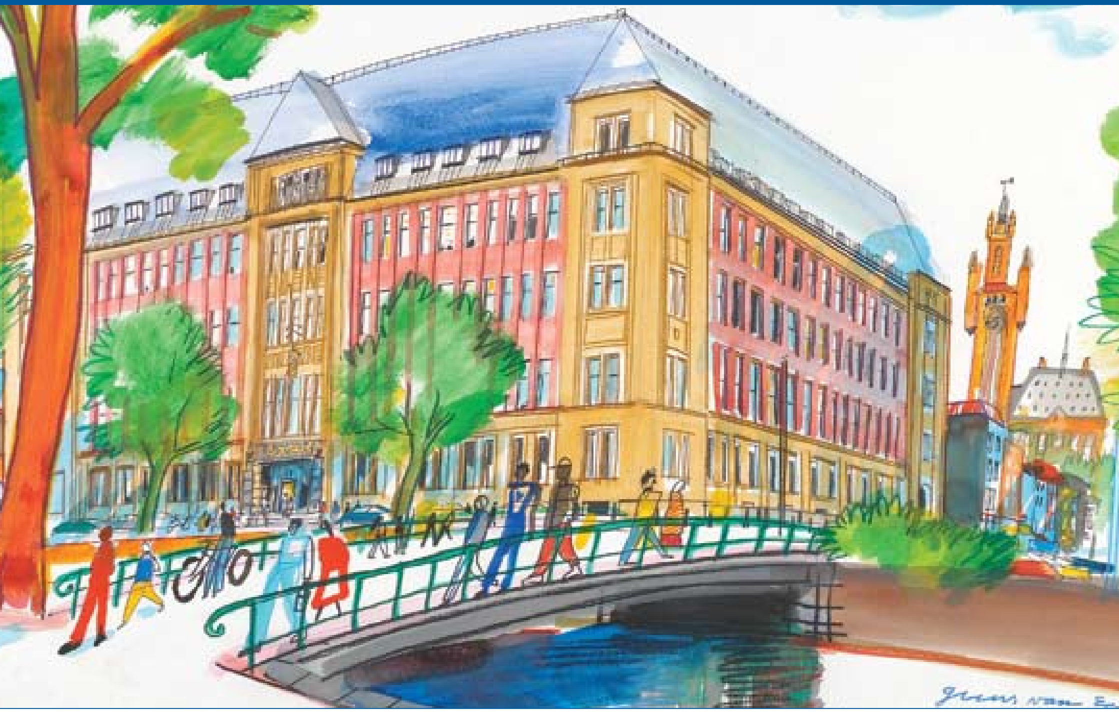

Income Inequality Revisited: Can one bring sense back into economic policy?

Inaugural Address

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Income inequality has become mainstream. Chairman of the American Federal Reserve Board, Ben Bernanke (Bernanke, 2007), lectures on the danger of growing inequality; there are debates in the Financial Times; the two 2007 issues of the World Economic Outlook of the IMF deal with growing inequality; and many governments, at least in their public statements at the UN, seem to be concerned with growing income inequality. Earlier, major UN organizations devoted their flagship reports to income inequality (eg. UN 2006). These were preceded by several research projects on inequality, notably those at the United Nations World Institute for Development Economic Research, at the beginning of this decade.

Yet despite these growing public statements I fail to notice a groundswell of indignation or a coherent set of policies that take income inequality to heart.

I would like to share with you today my growing concern with this and by reviewing various themes on income inequality see how we can strengthen academic analysis and debate to stem the growing tide of income inequality. I feel a bit humble in this respect, as various people in the audience share my concern and have also taken up, in various ways, the challenge posed by growing income inequality.

Trying to be a good academic I will first deal with the question of *what* we are talking about: *what* do we mean by income inequality? Then I will discuss *why*, despite various critiques, it is remains important to focus on *income* inequality and *which* measures of income inequality are relevant. Then I will briefly review *how* we have arrived at this growing income inequality and discuss *what* we could possibly do about it. The current situation is very much dominated by greater integration of various markets and splashes of technological development often called globalization. I will argue that globalization has influenced the functioning and outcome of various aspects of the labour market and that greater attention to labour market institutions and greater coherence between economic and labour market policies is a necessary condition to stem growing inequality.[1]

What do we mean with income inequality?

I will concentrate on reviewing growing income inequality at a national level: that is income inequality between people and households within countries. In the current climate of cosmopolitan thinking one could argue that one rather needs to be concerned with inequality on a world scale and do away with the notion of national identity. And indeed many studies have shown that inequality between nations has increased, for example the ratio between the average income of the 20 richest nations and the 20 poorest countries has risen from 53 in 1960 to 121 in 2000 (WCDSG, 2004). But this process has been accompanied by a growing inequality within most countries (Cornia 2004) and policy making is mainly national: the World Commission on the Social Dimension of Globalization (WCSDG) states that 'globalization starts at home' and argues that national policies can make a great difference. Paying attention to inequality at the national level therefore remains important.[2] This does not mean that no attention should be given to international inequality, as I have argued elsewhere.

The classical economists paid attention mainly to the distribution of income *between labour and capital* (factor income distribution). This distinction drove the great classical debates for

1 Some of the ideas developed here originate from various articles and book on income inequality I wrote earlier and which are listed in the references.

2 During the 1980's and 1990's income inequality before taxes and subsidies was more or less the same in Finland and the UK, rising in both countries; but while income inequality after taxes and subsidies rose in the UK, it declined in Finland! Atkinson 2004.

many years. Less attention was given to this in the post war period as neoclassical production functions often assumed a constant capital share. However, for good reasons, attention to factor income distribution is coming back. I will say more on that later on.

After the Second World War attention shifted to personal income or household income distribution. One can interpret personal income in three ways. The first is income earned from whatever activities are undertaken (by some analysts termed primary income). Primary income is determined by markets and market institutions. The second interpretation of personal income is income after deduction of taxes and inclusion of transfer payments (sometimes called secondary income). Thirdly one can add to the secondary income the imputed benefits from public expenditure (sometimes labelled tertiary income). I am listing this not to complicate things but to be clear at to what we are talking about and also, as I will later argue, to discuss the need to review policy interventions. Most discussions focus on secondary income inequality and implicitly assume that redistributive policies are equivalent to tax policies (and then argue that globalization is restricting national tax policies so that politicians nowadays have a reduced set of tools).

Why does it remain important to focus on income inequality?

Some argue that attention to income inequality is exaggerated as other aspects of life are equally or even more important: issues such as health, democratic participation, freedom etc. Often statistics are used to show that inequality of life expectancy has declined or that increases in political rights have increased.

Very recently, the Commission on Sustainable Health, which looked into the challenges of the global health system, published its report. The report had three overarching messages, the second of which was: *'Tackle the inequitable distribution of power, money and resources – the structural drivers of those conditions of daily life - globally, nationally and locally.'* (WHO, 2008). So those who belittle the fact of growing income inequality will find little comfort in continuing to argue that we should look more at health inequalities, as the commission's report argues that a major determinant of health inequality is income inequality! Mkandawire (2004) has also argued that not all democracies necessarily pursue egalitarian polices.

Others argue that attention to income inequality is not necessary as long as the economy is growing and poverty declining.[3] (This was actually one of the main tenants of the Millennium Development Goals (MDGs), which concentrated on poverty reduction. Jolly (2007) and Vandemoortele are among those who have criticized the MDGs for focussing insufficiently on inequality.)

However there are moral and economic reasons to be concerned with inequality per se. Cullity (2004) mentions four moral reasons:

1. Inequality as domination: imposing hardships on other groups;

2. Inequality of political and legal status as a consequence of income inequality;

3 This observation is actually based on an economic concept which was made famous by the Italian economist Pareto, who argued that any outcome of a policy is optimal if at least one member of society sees his position improved by that policy. This so-called Pareto optimality has guided neoclassical policy making for a long time.

3. Inequality as callousness: when others cannot meet their basic needs;

4. Brute inequality: inability of a society to include all groups in welfare enhancement.

An economic reason to be concerned with income inequality is that research over the last one and half decades has shown that there need not to be a trade-off between equality and growth, or between inequality and efficiency.

From the 1950s and into the 1970s analytical emphasis was on probable trade-offs between growth and income distribution. This derived in part from Kuznetz's famous 'inverted-U hypothesis' which postulated that inequality would rise in the initial phases of development, then decline after some crucial level was reached: hence policy action on reducing inequality would be unwarranted. Growth theories could be cited in support of the hypothesis, such as the Lewis model of 'economic development with unlimited supplies of labour'. Also Kaldor's growth model, in which capitalists have higher marginal propensity to save than workers, implies that redistribution of profits raises the growth rate. This, however, is of less relevance to developing countries (Aghion, Caroli and Garcia-Penalosa, 1999).

Focussing on the effects of inequality and growth, Cornia (2004) finds that there is a distinct non-linear relationship between initial income inequality and economic growth and argues that too low a level of inequality is bad for growth (free-riding, high supervision costs), but also that too high levels of inequality can have serious negative consequences. Income inequality in most developing countries is currently in the high range. More recently, economists at the World Bank have taken up this point and make a distinction between deserved and undeserved income inequality or between good and bad income inequality (Ferreirra, 2007). This distinction brings in too much unnecessary value judgement and the analytical approach of the non-linear approach is much preferred.

Birdsall (2005) argues that income inequality in developing countries matters for at least three instrumental reasons:

- Where markets are underdeveloped, inequality inhibits growth through economic mechanisms;
- Where institutions of government are weak, inequality exacerbates the problem of creating and maintaining accountable government, increasing the probability of economic and social policies that inhibit growth and poverty reduction;
- Where social institutions are fragile, inequality further discourages the civic and social life that underpins effective collective decision making that is necessary to the functioning of healthy societies.

There is thus a growing consensus that countries with an 'initial condition' of a relatively egalitarian distribution of assets and income tend to grow faster than countries with high initial inequality. *This is an extremely important conclusion, because it means that reducing inequality strikes a double blow against poverty.* On the one hand, a growth path characterised by greater equality at the margin directly benefits the poor in the short run. On the other hand, the resulting decrease in inequality creates in each period an 'initial condition' for the future that is growth enhancing. Thus, any growth path that reduces inequality reduces poverty through redistribution and *via* 'trickle down'.

Thus both on moral grounds as well as on analytical grounds the concern for income inequality and especially concern for growing income inequality is a proper concern.

Having established that concern for income inequality is justified, we have to face the question of how to measure income inequality. This discussion alone can keep economists busy at long congresses and I will not dwell on this, with the exception of one point which has become relevant and can have a direct consequence on policy making: a common measure used by many analysts is the so-called Gini ratio which on a scale of 0 to 1 indicates the level of inequality. The index is constructed in such a way that it gives importance to how income is redistributed around the middle incomes. But recently we have witnessed the phenomenon of growing inequality caused by top incomes (Atkinson 2007), which some argue may not be always covered sufficiently by the changes in the Gini ratio. Leigh (2007) however, making use of detailed data for 13 developed countries, has found a strong and significant relationship between top income share and broader inequality measures such as the Gini ratio. Although it is not always correct to transpose research findings from developed countries to developing countries, there is some indication that more than average increases in top incomes can be indicative of an overall widening inequality and that general indices, as the Gini index, capture such rises in top incomes.

However, one phenomenon that is not picked up by general inequality statistics is gender inequality. Elson (2007) and Heintz (2006) find that many factors are put forward to explain the gender gap in earnings – differences in education, shorter tenure in the labour market and interruptions in women's employment histories associated with raising children. Nevertheless, as Heintz reviews: a large quantity of research has shown that, even after controlling for education, age and job tenure, gender gaps in remuneration remain. In part, this is due to the persistence of earnings gaps within occupational categories (Horton, 1999), suggesting that wage discrimination remains influential. Research also suggests that earnings differentials between men and women are also apparent across the various forms of informal work (Chen *et al.*, 2005). However, Heintz argues that labour force segmentation is as important, if not more important, in determining the gap between women's and men's earnings. Women are disproportionately represented in lower paying forms of employment, often with fewer social protections and less stable incomes. Much less is known about the gender earnings gap in low-income countries, where informal forms of employment, including widespread non-wage employment, dominate. Also, the structure of production and responses to global integration can impact on changes in the gender income gap. For example, Seguino (2000) finds that capital mobility is one contributing factor to higher wage inequality in Taiwan. Since women are more concentrated in industries in which capital mobility is high, their bargaining power, and hence their wages, would fall relative to men as global integration progresses.

How did income inequality develop over the last two decades?

Regarding *income and earnings inequality in industrialized countries*, Gottschalk and Smeeding (1997) observe that at any given time there are wide differences across modern countries in the level of earnings, and that nations with centralized bargaining (for example, Sweden and Germany) have greater equality than nations with less centralized bargaining (for example, the US and Canada). They also observe in almost all industrialized countries some increase in wage inequality among prime-aged males during the 1980s. Wage inequality increased the most in the US and the UK and the least in the Nordic countries. The increased demand for skilled workers, coupled with differences among countries in the growth in the supply of skilled workers, explains a large part of the differences. Furthermore (and important for policy making) they observe that institutional constraints on wage determination also seem to matter. The rise in relative unemployment rates among the least skilled in some, but not all, countries with centralized wage-setting institutions suggests that such institutional constraints were at least partially responsible for limiting the rise in inequality. For the US they explain the rapid rise in earnings inequality by reference to a variety of structural changes in the economy such as changes in industrial structure; more foreign trade; more immigration; skill-based technical change; and the weakening of labour market institutions such as minimum wage setting and unionization that limit the effects of the free market. They cite studies which confirm that the weakening of these two labour market institutions explain a large part, possibly even 50 per cent, of the increase in the dispersion in wage earnings in the US. Looking for common features and differences between the US and European countries, Gottschalk and Smeeding argue that differences in wage-setting institutions may well account for some of the differences in the growth in inequality: 'There is certainly a *prima facie* case that countries with high union coverage on centralized wage setting were able to limit the growth in inequality', they write (1997: 653).

Regarding developing countries, Cornia (2004) argues that the last two decades have witnessed a *widespread and symmetric rise in within-country inequality in developing countries.* There are three possible explanations for this. First, limited migration to advanced nations did not help in equalising the distribution of income in the countries of origin. Second, international financial flows have become less stable and more un-equalizing. And third, inequality was also influenced in a non-negligible way by domestic policy and institutional reforms – such as those of the labour market, financial sector, tax reform – which may have been introduced to facilitate the international integration of poor countries but which had unfavourable effects on labour income compared to profit income and wage differentials. Finally, Cornia argues, there are the inequality impacts of globalisation. These contradict the predictions of standard theory, which is unable to capture the effect of other factors such as domestic institutional weaknesses, the complexity of trade and finance in a multi-country multi-goods environment, persistent and rising protectionism in the North and the equity impact of other domestic reforms that are often introduced to facilitate the drive towards globalisation.

I mentioned earlier the conventional wisdom that sees the labour share in GDP as relatively constant. Research by Diwan (2001) and Harrison (2002), however, shows that the proportion of GDP that goes into wages and other labour income is variable over time. Harrison shows that, in the group of poorer countries, labour's share in national income fell on average by 0.1 percentage points per year from 1960 to 1993. The decline in the labour share accelerated after 1993, to an average decline of 0.3 percentage points per year. In the richer subgroup, the labour share grew by 0.2 percentage points before 1993, but then fell rapidly by 0.4 percentage points per year.

She tested for factors that could explain changes in labour shares. Changes in factor shares are primarily linked to changes in capital/labour ratios. However, measures of globalization (such as capital controls or direct investment flows) also play a role. Exchange rate crises lead to declining labour shares, suggesting that labour pays a disproportionately high price when there are large swings in exchange rates (ie., wages are more severely affected than GDP). Capital controls are associated with an increase in the labour share, an effect that Harrison attributes to the weaker bargaining position of capital vis-à-vis labour if the cost of relocating production increases with capital controls. The weak bargaining position of labour under open capital accounts is also a causal mechanism explored by Lee and Jayadev (2005). They found that financial openness exerted a downward pressure on the labour share both in developed and developing countries for the period from 1973-1995.

Harrison also finds that increasing trade is associated with a fall in the labour share. This result is robust across various specifications of the regression analysis. These results point to a systematic negative relationship between various measures of globalization and the labour share. Similarly, Vos (2007) argues that it is also clear that trade liberalization is no panacea for poverty reduction. Average welfare gains are mostly small and in many instances have been inequality enhancing. The overall decline in the labour share is partly explained by what some call the ratchet effect: after an economic shock or a financial crisis the labour share in gross national income decreases but then in the phase of recovery increases less quickly as GDP increases (van der Hoeven and Saget 2004). Some authors argue that the decline in labour share after economic shocks was, in effect, the consequence of a too high labour share before the crisis, thus partly blaming labour for the build-up of the crisis. However, only in a minority of cases have financial crises been caused by bidding up wages and labour shares. In most cases the crisis was caused by external events or rent-seeking behaviour of capital owners. In a study of the manufacturing sector in a large sample of developing countries, Amsden and van der Hoeven (1996) argue that a decline in real wages and a fall in the wage share of value added in most non-Asian developing countries in the 1980s and the 1990's reflect a redistribution of income from labour to capital, as low wages were made to bear the burden of uncompetitive manufacturers.

As the former chief economist of the IMF, Kenneth Rogoff, observed when he returned to academia: *The simple truth is that corporations represent capital, and capital – in the form of factories, equipment, machines, money, and even houses – has been the single biggest winner in the modern era of globalization. Corporate profits are bursting at the seams of investors' expectations in virtually every corner of the world. .... Many policymakers seem to be under the impression that surging profits are a purely cyclical phenomenon, ...Wait a bit, they predict, and wages will fully catch up later in the cycle. Not likely. Capital's piece of the pie has been getting bigger for more than 20 years, and the trend looks set to continue*. ......Rogoff , 2005.

Recent research by Daudey and Garcia Penalosa (2007) finds that factor distribution of incomes is an essential and statistically significant determinant of the personal distribution of income and that a larger labour share is associated with a lower Gini coefficient of personal incomes.

How **to react to the problem of growing income inequality?**

We can distinguish 4 sets of reactions to growing income inequality:

- The question is wrong, because we are misreading the statistics, (as discussed earlier income is not important or we don't pick up lower prices of electronics which lower income groups consume etc.).
- Income inequality is indeed increasing, but it is not a problem. It is either a temporary phenomenon in the course of

development or an indication of the rewards of the current economic system.

- Growing income inequality is indeed a problem, but especially with current globalization there is little one can do (TINA: There is no alternative). This argument is usually based on the assumption that national governments cannot increase taxes and transfers as this would effect international competitiveness or that governments in developing countries are incapable of dealing with income inequality.
- Growing income inequality is a problem, but with political will something can be done about it. Redistribution is necessary.

Weeks, Dagdeviren and myself have argued that implementing an agenda of redistribution involves major problems, but that these problems should not be exaggerated. In many developing countries such problems might prove no more intractable than the problems associated with implementation of other economic policies, such as structural adjustment policies. An effective orthodox monetary policy is difficult to implement if a country is too small or underdeveloped to have a bond market. Similarly, replacing tariffs by a value added tax would be a daunting task in a country whose commerce was primarily through small traders. The international financial institutions have recognised these constraints to adjustment programmes, and they typically made the decision that constrained implementation of such adjustment programs was preferable to non-implementation. But the same argument can be made for a redistributive strategy: *to achieve poverty reduction, it might be preferable to redistribute growth imperfectly than to implement the status quo imperfectly.*

Income inequality and labour markets

A recent study on explanations for growing inequality over the last decade (Angeles-Castro, 2006) concludes that high employment levels reduce inequality and, especially, high employment levels in the industrial sector reduce inequality. *Targeting for employment and for reduction of income inequality can thus be combined objectives in policy making.*[4]

What is the role of labour market institutions in this? New insights have been recently provided by Freeman (2007), who concludes on the basis of an analysis of labour market institutions in developing and developed countries, that these institutions reduce inequality but have modest, uncertain or time varying impacts on aggregate outcomes such as employment and other variables likely to be affected by wages.

One reason, Freeman argues, why effects other than on inequality may be modest, is that the political economy of institutional interventions rules out collective bargaining settlements and regulations that are truly expensive to an economy. For example no country would impose a minimum wage that disemployed a large fraction of the work force; and no union or employer would sign a collective bargaining agreement that forced the firm to close. Taking this line of thinking to its logical conclusion, Freeman argues that economies that rely on well-functioning labour market institutions may have reduced the transaction costs of bargaining and developed long-term

4 Their results correspond well with the observations made above that part of growing inequality can be explained by the policies undertaken during the process of liberalization and adjustment, including policies to make the labour market more efficient in order for a country to grow faster. Van der Hoeven and Taylor, 2000, have argued that the notion of efficient labour markets in most adjustment programs was mainly based on considering the allocative efficiency of these markets, but that dynamic and redistributive efficiency were neglected during the adjustment programs, leading to greater inequality.

relations among parties such that they more often than not produce efficient outcomes per the Coase Theorem. He concludes that to help assess these interpretations and increase our knowledge of institutions, reducing inequality requires inputs from areas of research that have played little role in the debate over the link between labor institutions on aggregate outcomes and argues that one such area is experimental economics. Evidence from laboratory experiments suggesting that people care about fair processes and outcomes and cooperate more than rational optimizing models of human behaviour suggest, opens the door for studies on the conditions needed for institutions to improve the market. [5]

Freeman's finding is very important because, if labour market institutions have as major objectives or outcomes a reduction of inequality, and have varied effects on growth and employment, and if higher employment is contributing to lower inequality as argued above, then policies aimed at strengthening well-functioning labour market institutions and having an explicit goal of increasing employment will contribute to lower inequality.

How can employment or redistributive targets make a difference? A few examples

The first illustration is in the realm of macroeconomic policy. The World Bank has over the last five years become more

5 A recent experiment is the so-called ultimatum game between two players, where the first player proposes to divide a cake or a sum of money in two, while the second player, the receiver, can only take or leave the proposition by the first player. Economic theory would posit that the receiver accepts all offers of various divisions made by the first player since each offer is greater than zero. But experiments show that most people reject an offer that is below 20 percent of the initial cake and are thus arbiters of fairness. However, experiments with chimpanzees showed that chimpanzees acted more as a homo economicus than the homo sapiens (The Economist , October 6 , 2007).

concerned with growing inequality and has devoted various research publications to this. One example is *Analyzing the Distributional Impacts of reform, A practitioners Guide* Chapter 2 on Monetary and Exchange rate reforms (Conway 2005). It opens with a reference to the so-called 'policy trilemma' of international economic policies (see Mundell 1963; Cohen 1993; Obstfeld, Shambaugh and Taylor 2004). This states that national economic policy space is circumscribed by the impossibility of pursuing the following three policies simultaneously: open capital account, fixed exchange rates, and independent monetary policy. The trilemma posits that only two out of these three policies can be combined. For example, under a system of an open capital account and fixed exchange rates, countries cannot pursue an independent monetary policy, for example to stimulate employment growth, since interest rates are determined by world interest levels. Conversely, if countries need to undertake an independent monetary policy, they have either to revert to flexible exchange rates or opt for a closed capital account. The restriction of these options can hamper policies for full employment. The entire policy guide in the World Bank's publication is based on this observation, ie. an acceptance of mainstream economic theory. Had there been an explicit objective to put employment creation and inequality reduction as a primary objective, however, this work could have probed much more into exploring new policy avenues: more recent research argues that the policy trilemma, which has guided policy makers for several decades, can be relaxed by avoiding the ultimate solutions referred to above and by looking beyond the traditional alternatives of fixed versus flexible exchange rates, or open versus closed capital accounts, to adopt intermediate options in these three policy domains – like a capital account management through the selective application of capital controls, or a managed real exchange rate (see Bradford 2004).[6]

Although capital controls have, much like any other policy instrument, not always been fully effective in reaching their stated objectives (see Ariyoshi and others 2000), they have contributed to regaining greater policy autonomy in several cases. In Chile, for example, controls imposed on inflows have helped to reduce their level and to change the composition of inflows towards longer maturities, hence increasing the autonomy of monetary policy (Gallego, Hernández and Schmidt-Hebbel 1999; see also de Gregorio, Edwards and Valdés 2000). The more controversial issue is controls on outflows, but Edison and Reinhart (2001) argue that such controls enabled Malaysia to stabilize exchange rates and interest rates during the East Asian crisis and to gain more policy autonomy. Kaplan and Rodrik (2001) conclude that the Malaysian approach has led to a faster economic recovery and to a smaller decline in real wages and employment than IMF policies would have done.

How could a system of a managed real exchange rate, the second element mentioned earlier, stimulate employment? Rodrik (2003) and Frenkel (2004) provide three channels. Active management of the real exchange rate would allow for higher capacity utilization in times of unemployment, if applied in combination with the appropriate mix of macroeconomic and fiscal policies. It would also stimulate output growth and hence employment, if combined with appropriate industrial policies, as the experience in various Asian countries has shown. It could shift the sectoral composition of exports

6 For example, in the case of China, research from the IMF argues that making the quasi-fixed exchange rate more flexible would allow the country to pursue a more independent monetary policy. The same paper also argues for a cautious approach to capital account liberalization, given the institutional weaknesses of China’s financial system (see Prasad, Rumbaugh and Wang 2005). The argument could be extended to many other developing countries. Rather than abandoning capital controls altogether, they should remain a policy tool that can be used selectively.

towards more labour intensive goods, and hence increase the employment elasticity of the economy as a whole.

Employing a policy mix with intermediate options such as a managed capital account and a managed real exchange rate requires more fine-tuning and coherence in policies rather than relying on rule-of-thumb policy interventions. This necessitates national institutions with explicit mandates for employment and capabilities to achieve this.

Another possible, supplementary, element to relax the policy trilemma would be to include one or two additional policy instruments to complement the fiscal and monetary tools (see also Tinbergen 1970 [1952]). Bradford (2004) suggests, for example, social pacts or coordinated wage bargaining to hold down inflation and so to "free up" other policies aimed at growth and employment creation. Also, a greater concern for inequity and a reduction of national inequalities could contribute to reducing inflationary pressure and could be added either as part of a social pact or as a stand-alone policy instrument (see van der Hoeven and Saget 2004). It is thus very important to have employment creation and equitable distribution as explicit policy objectives for macro economic policies.

A second example is that of considering central banks as agents of development as suggested by Epstein, 2007. He argues that an employment-targeting approach to central bank policy may seem quite alien to those schooled in the orthodox tradition of inflation targeting and financial liberalization, but that in fact this has been quite common historically in both currently developed and developing countries. Over the years, central banks have been seen as agents of economic development, not just agents of economic stabilization. And while sometimes central banks have failed quite spectacularly in this mission, there have been other important success stories, including important periods in the US, UK, France, Germany, Japan, South Korea and India, to name just a few examples.

As for developing countries, Amsden (2001 and 2007) describes the key role that investment banks played in the industrialization success stories countries such as South Korea, Taiwan, Malaysia, Brazil, Argentina and others, in mobilizing and directing savings to key industrial sectors, and in particular to those specializing in exports. Epstein (2007) recalls that in many of these cases, central banks were a key part of the government apparatus that played a supporting role by maintaining low interest rates, maintaining capital controls to help stabilize exchange rates at competitive levels, and sometimes engaging in direct lending for preferred purposes. Engaging in these developmental roles, using a wide variety of instruments, was widely seen as a key part of the central bank's mission. After the Second World War, there was a major trans-formation of central banking in the developing world. In many respects, these changes paralleled those in the developed world. Epstein deplores the resilience of inflation targeting and argues that inflation targeting is far from benign as it creates in central banks a *culture* of inflation focus, or even inflation obsession.[7] An explicit employment target besides an inflation target could change the mindset of traditional economists.

A third example is that of setting minimum wages. Several ILO studies (Saget 2001, 2008) have observed that, as a consequence of structural adjustment and liberalization policies and a

7 '*Millions of dollars are spent studying every aspect of inflation, but few aspects of unemployment; thousands of hours of the time of highly scarce, skilled economists are spent pouring over complex models designed to show how to get inflation down from 8 to 4 per cent, but not on how to create more and better jobs; and if other government officials or those in civil society ask the central bank to do something about employment creation, the central banks can respond, "that's not our job". More than anything else, the cost of inflation-focused monetary regimes is to divert the attention of the some of the most highly trained and skilled economists and policy makers in developing countries away from the tasks that previous generations of central bankers took for granted as being their main job: to help their countries develop, to create jobs, and to foster socially productive economic growth*'. Epstein 2007.

breaking down of trade unions and labour market institutions, the minimum wage in a sizeable number of countries is so low that it is does not contribute to reducing inequalities or poverty reduction and has become meaningless. In a second set of countries, the minimum wages appears to fulfill its objective of reducing poverty without hampering employment creation.[8] But there is also a set of countries where the minimum wage is very high: too high in fact to be considered as a genuine minimum wage. This is the so-called "maxi minimum wage" (Saget 2008). Here often minimum wage legislation amounts to average wage fixation. Poorly developed collective bargaining is often a driving factor behind the emergence of such "maxi minimum wages": minimum wage consultations are the only forum where trade unions can make their demands known, with the danger that the resulting minimum wage is not a genuine threshold, but rather the actual wage earned by most formal workers. In such a process, countries are actually trying to pursue multiple goals with a single policy instrument: the minimum wage is used as a reference to fix wages and incomes policies, to get a grip on inflation and to promote social dialogue. As is known from macroeconomic policy, one needs to have as many policy instruments as policy goals: the minimum wage-setting machinery is expected to respond to too many policy goals (Saget 2008) .

The interesting and policy-relevant conclusion is that both too low and too high minimum wages are an indication of malfunctioning labour markets. Well-functioning labour market institutions would contribute to more relevant income inequality and poverty reducing minimum wages, without

8 It has been argued that the existence of minimum wages results in greater informal employment. ILO 1977 shows however that minimum wages up to 2/3 of the level of wages of unskilled workers will not produce substantial increases in informality.

jeopardizing employment and economic growth. If employment and fair distribution of income was set as an overarching policy goal, the credibility of such labour market institutions would have been strengthened.

Conclusion

I asked the question whether *one could make sense again of economic policy in the light of growing inequalities.* Based on what I have discussed, the answer to that question is no; or not yet. Economic policy needs to embedded, or more deeply embedded, in a larger social construct which accepts equitable income distribution and employment creation as ultimate policy goals. Unless that has been fully accepted, one cannot yet make full sense of current economic policy.

All this is perhaps utopian, but I slipped the word *again* into my initial question. Why? Because half a century ago Dutch economic policy was based on five objectives, all of them agreed in a social compact between workers, employers and governments of various political natures. These goals were: full employment; equitable income distribution; shared economic growth; price stability; and a sustainable Balance of Payments. Not only in the Netherlands but also in various other West European countries, the period of the fifties and the sixties were characterised by rising employment, fairly equitable inequality and growth. Some analysts have labelled that period as the Golden Age: the willingness to set economic and social goals and to adhere to these goals contributed much to this. What is also remarkable is that a goal of achieving an equitable distribution of income was accepted, at a time when research on inequality and growth had not yet advanced as far as it has today and major research conclusions still pointed towards a trade-off between economic growth and reducing inequality. Yet, despite this assumed trade-off, maintaining an equitable distribution of income was accepted as one of the five basic economic goals.

A second example of a period in which countries grew fast and maintained a fairly equal distribution of incomes is the period 1965 till 1980 when the so-called Asian tigers laid the basis for their extremely fast development trajectory. This was achieved through a combination of redistributive policies (land redistribution and high investments in education) and of rapid but managed industrial development (Adelman 1979,Amsden 2001).

Although these two examples of combining growth with equitable income distribution may at first instance look very different, they have, as Singh (forthcoming) has observed, at least one element in common: both are examples of restrained capitalism. In Europe the restraints came from social pacts and the functioning of the labour markets, while in the Asian tigers government bureaucrats and political elites provided the restraint.

This juxtaposition of two experiences of growth with concern for equitable income inequality and the possible lessons to be drawn from this, provide a challenge that goes much beyond proper economic policy and requires a combination of various academic disciplines to deal with it.

This is one of the reasons that I have gladly accepted to be engaged at the ISS, where there is an emphasis on academic rigour, dealing with development issues from different angles, and with a goal to be policy relevant at village, national and international level .[9]

9 This is a long tradition at ISS as van Niewenhuiize argued during the 25th anniversary conference in 1977: *As an academic institution that is in some way exceptional , the institute has to steer a middle course between the serenity and the intellectual integrity and independence of academia and the vulnerability of being an extensive arm of development*

Another reason is that the question of income inequality has always played an important role in the ISS. For example, the 25th anniversary volume (ISS,1979) contains various analyses on inequality and redistribution, including Adelman's theme of redistribution before growth, while the 50th year anniversary volume has one third of its contributions devoted to Globalisation, Inequality and Poverty (Spoor 2004) .

I would therefore like to thank friends and colleagues or former colleagues at the ISS like Rob Vos, Karel Jansen, Valpi Fitzgerald, Ruud Teekens, Louis Emmerij, Graham Pyatt, Bas de Gaay Fortmann, Nico Schrijver, Ashwani Saith, Marc Wuyts, and Jan Pronk with whom I collaborated or tried to collaborate on issues of inequality, basic needs and employment and Dutch development politics and who stimulated my thinking over a long time. More recently, especially for this current endeavor, I received tremendous support from Freek Schiphorst, Irene van Staveren, Mansoob Murshed and Louk de la Rive Box who were not only of great help in developing my ideas, but also helped me settling in at ISS. Without their advice and support I would probably not have been standing here today. I also learned a lot from Henk Thomas, in a certain way my predecessor in staff group 3, and from David Dunham who ably filled in my gaps of the history of the ISS. I look forward to collaborating with you all as well as with many other colleagues, with whom I am starting to make acquaintance.

I am also glad that some of the international scholars I have been collaborating with have gladly accepted to participate in the seminar this morning and to be present at this inaugural address. They may not always have realized it, but collaborating with them was often a breath of fresh air for me, resisting

policies. To exist and survive in the resulting field of tension is one of its salient characteristics. It is also a matter that demands great care at all times (van Niewenhuijze 1977).

the temptation - always looming when one works in a bureaucracy like I did for so many years - to rely on slogans, quick fixes and best practices. Thank you so much.

I would also like to thank the two generations of students for broadening my understanding of a world more complex than when I was a student. I hope that I will be able to share with them the sense of critical analysis and the attitude of not taking anything for granted; approaches that I always received from my professors Cramer, Duisenberg, de Wolff and Zimmermann in Amsterdam and especially from my promoters Linnemann and Bos.

But ...I could not be here were it not because of the support and understanding of Marianne, Kees and Jorick. I was frequently literally in the air, traveling, and probably even more often with my head in the air, thinking out ideas. They have always supported that and, even more so, have always given me their useful opinions on world matters. A true treasure, to be cherished. Thank you and *Nos Iungit Felix Familia.*

Rector of the Institute, in your invitation you wrote that this inaugural address is my formal acceptance of appointment. So here you have it ...I will sincerely do my best to do justice to the expectations you, staff group 3 and staff group 1 have put in me.

Thank you

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