
LIBERALIZATION, INTEGRATION AND DISTRIBUTION

A. Introduction

In a large number of developing countries, especially in Africa and Latin America, the debt crisis of the early 1980s and the macroeconomic adjustment and policy reforms introduced in response thereto have shaped recent trends in income distribution. As noted in chapter III above, during the 1980s income distribution in general worsened in countries where growth collapsed as a result of the debt crisis. However, in a number of countries, particularly in Latin America, the situation did not improve with recovery. With very few exceptions, inequality is now greater than before the outbreak of the debt crisis.

The debt crisis itself brought about an immediate increase in income inequality, since the short-term costs of adjustment were not shared equally by all income groups. The external trade and financial shocks created large macroeconomic imbalances, the elimination of which had a widely diverse impact on different income groups. Worsening terms of trade due to the collapse of commodity prices in the early 1980s caused foreign exchange losses for the economy as a whole, but hit commodity producers in particular, reducing their incomes. Nor did the burden of budgetary transfers, necessitated by a sharp swing in net external financial transfers brought about by cut-backs in bank lending and the hike in international interest rates, fall equally on all groups. Property incomes, on the other hand, could be more easily protected because of the exit option provided

by capital flight. The adjustment required to adapt to shrinking external resources necessitated a sharp decline in the pace of economic activity, producing significant unemployment and underemployment. As discussed in some detail in *TDR 1989*, in most countries the burden of shifts in relative prices designed to alter competitiveness, such as currency devaluations, fell disproportionately on labour incomes, as evidenced by the sharp declines in real earnings throughout the 1980s. External shocks and the adjustment process gave rise to serious distributional conflicts and rapid inflation in many debtor countries.

Many, if not all, of the immediate causes and effects of the debt crisis, as well as the dislocations caused by stabilization and macroeconomic adjustment, are now a matter of history in a number of countries. Success in stabilization has been almost unprecedented. Contrary to earlier expectations, many countries have made significant progress in normalizing their relations with international capital markets, and capital inflows in such countries have been restored at an unexpected volume and speed. Commodity prices have seen some recovery following the collapse of the early 1980s. Economic activity has picked up, albeit moderately, in most countries. However, they have not been able to reverse the deterioration in income distribution, in large part because the drastic changes that have taken place in public policy in response to the crisis have resulted in funda-

mental and permanent shifts in income distribution. Nowhere else has this shift been more drastic than in Latin America. As has been noted,

... the new modality under which the economies are functioning and the new rules of public policy involve greater income inequalities and more precarious employment situations than in the past. ... Consequently, one should not expect significant equity improvements in these countries as a consequence of stabilization and recovery. Indeed, full deployment of policy reforms and associated adjustment measures ... may still bring a medium-term increase in income inequality.¹

The new modality and new rules are designed to give greater freedom to market forces. While

they encompass a vast area of public policy, including taxation, public spending, public enterprises, labour markets, agriculture, trade, industry and finance, they seek to assign a greater role to markets primarily through a closer integration with the global economy. Accordingly, this chapter will discuss the impact of policies in two principal areas of integration, namely trade and finance, on income distribution. Attention will be focused on the evolution of wage differentials between skilled and unskilled workers, the distribution of manufacturing value added between labour and capital, the impact of agricultural price reforms on domestic terms of trade, and the sources of increases in the share of interest and other financial incomes.

B. Trade liberalization and wage inequality

The view that globalization will promote greater income equality in developing countries is based primarily on the assumption that greater integration of developing countries into the world trading system through the elimination of tariff and non-tariff barriers would benefit the poor. This view is based on the premiss that under free trade a country's production structure is shaped by comparative advantage, determined by its relative factor endowments. Thus, a country should produce and export those goods which use its most abundant domestic resources most intensively, and import those goods which require its least abundant factors. Since capital was considered to be the relatively scarce factor in developing countries, these countries would import capital-intensive goods and export goods which use land and labour more intensively. As a result, the demand for labour should rise and the demand for capital decline, causing labour incomes to improve relative to capital incomes.

According to a growing body of opinion, the increasing international mobility of capital has reduced the importance of differences in the level of capital stock in determining a country's comparative advantage, whilst the growth of trade in goods

with high knowledge and skill content has increased the importance of relative endowments of skilled and unskilled labour in shaping the pattern and effects of trade. It follows that since skilled labour will be in relatively scarce supply in developing countries, their production under free trade should concentrate on agricultural and manufactured products that require unskilled labour. This would consequently increase in the relative demand for unskilled labour, which should lead to a reduction in wage inequality. Consequently, globalization is expected not only to improve labour incomes relative to capital incomes, but also to increase the incomes earned by unskilled labour relative to those earned on the human capital embodied in skilled labour.

Since the mid-1980s, a large number of developing countries have undertaken unilateral trade liberalization measures, including elimination of non-tariff barriers and sharp reductions of tariffs. Trade liberalization has gone much further in Latin America than elsewhere. Most Latin American countries which had once erected much greater barriers to imports than East Asian countries have recently gone further than the latter in dismantling such barriers. In the early 1990s, compared to East

Asia, the average and maximum tariff rates in six of the largest countries of Latin America were smaller by almost one half and two thirds, respectively, and their dispersion was considerably lower. Non-tariff barriers were quite moderate and on the whole lower than those in advanced industrial countries as well as the East Asian NIEs.²

Despite the theoretical prediction of reduced income inequality, the evidence from this experience of trade liberalization in Latin America on earnings differentials points in a different direction: in almost all countries that resorted to a rapid trade liberalization following the so-called import-substitution strategy of industrialization, the gap between the wages of skilled and unskilled workers has increased. A number of studies examining the behaviour of relative wages in various episodes of trade liberalization in Argentina, Chile, Colombia, Costa Rica, Mexico, and Uruguay find almost unanimous evidence of rising rather than falling wage differentials.³ In most countries the wage gap widened while the real wages of unskilled workers actually fell and unemployment increased. Again, the increased skill premium has been associated in some cases with increases in the supply of skilled labour relative to unskilled labour. There were certainly other factors operating on wages and employment during such episodes of trade liberalization, including those linked to macroeconomic adjustment and labour market reforms. However, the evidence shows that while these factors may have also contributed to increased wage inequality in some countries, it is explained primarily by trade liberalization.

The worsening of the position of unskilled labour in Latin America has recently been noted, among others, by ECLAC:

The distance separating the incomes of professional and technical personnel from those of workers in low-productivity sectors increased by between 40 per cent and 60 per cent in 1990-1994. This was due to the rapid improvement of the labour incomes of skilled manpower and the reduction or lack of growth in pay levels for workers not taking part in the modernization of production, who account for a large percentage of total employment.⁴

Chart 9 shows changes in earnings of three different skill groups of labour in Latin America in recent years for countries and periods for which such data are available. Of the 10 countries in-

cluded in the chart, all except one experienced widening gaps between skilled workers (professional and technical workers) and unskilled workers (i.e. those in low-productivity sectors). With the exception of Chile, Costa Rica and Uruguay, real earnings of unskilled workers fell during the periods covered, with declines reaching 30 per cent in Bolivia and Brazil, and 20 per cent in Colombia and Mexico. In Bolivia and Brazil real earnings of unskilled workers fell much more than those of skilled ones. In Colombia and Mexico, declines in the earnings of unskilled workers were associated with increases in those of the skilled. In Chile the increase in the real earnings of unskilled workers during 1990-1994 (a cumulative 5 per cent) remained well below the rise in real per capita income in the same period (over 20 per cent). The earnings gap of public employees and workers in bigger firms with skilled workers also widened in most countries, though by a lower margin.⁵

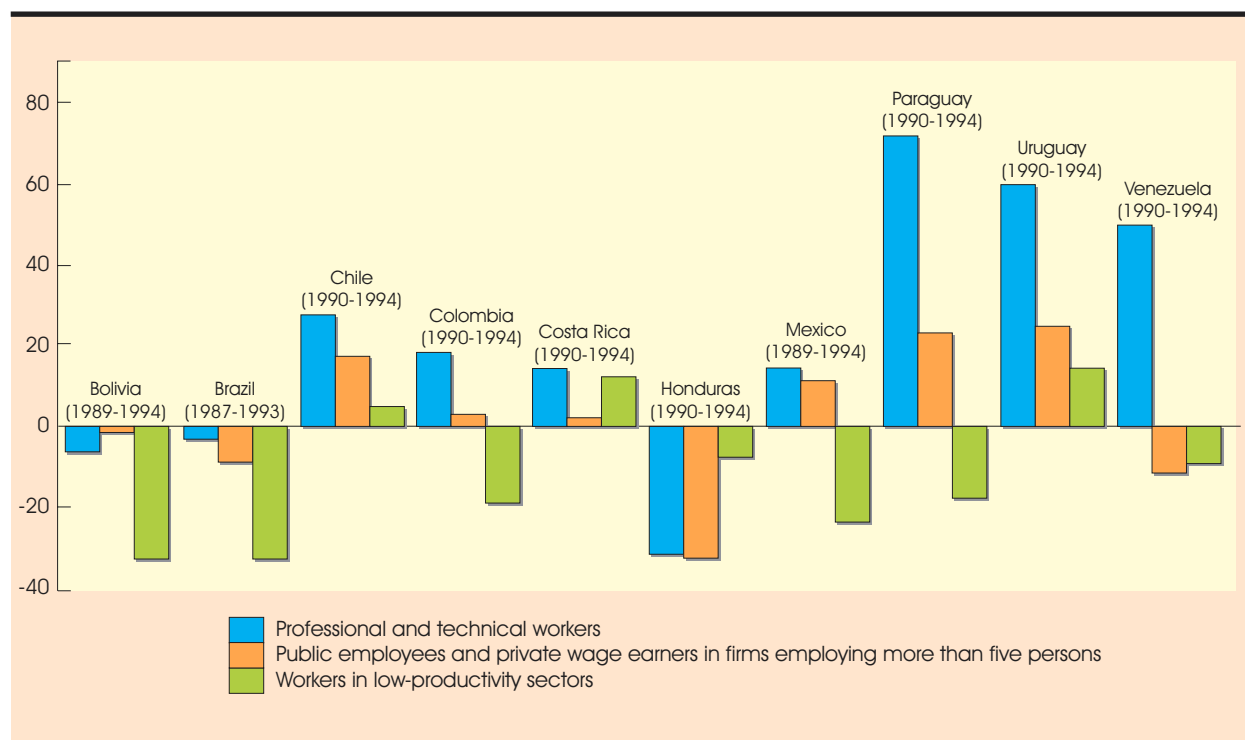
Increased wage dispersion in manufacturing during the recent period of globalization is also reported by the ILO, for a sample of 30 countries in Africa, Asia and Latin America which compares average real wages over 1975-1979 with those in 1987-1991. The largest increases in wage dispersion were in Chile, Thailand, Brazil, and the United Republic of Tanzania. It was found that in about two thirds of all the countries real average wages had fallen, and that the fall was correlated with a rise in wage dispersion.⁶ The economies in which wage dispersion diminished include the first-tier East Asian NIEs, where it was accompanied by significant increases in labour productivity. The only exception to diminishing wage dispersion in East Asia is Hong Kong.

A number of explanations have been offered to reconcile the increased wage inequality with the theoretical implications of the impact of comparative advantage on trade. If trade liberalization and increased capital mobility accelerate the introduction of best-practice technology in developing countries, and if the use of such technology requires specially trained labour, the increase in demand for skilled labour may lead to a widening of the wage gap. However, a fairly sizable shift in technology would be required, which should be reflected in a sharp increase in imports of capital goods as well as in an expansion of exports of skill-intensive products. Yet, the greater openness observed in Latin America has not generally been associated with a significant increase in investment and technology transfer. As analysed in greater

Chart 9

CHANGES IN EARNINGS OF VARIOUS CATEGORIES OF URBAN LABOUR IN LATIN AMERICAN COUNTRIES IN THE 1990s

(Per cent)



Source: ECLAC, *The Equity Gap. Latin America, the Caribbean and the Social Summit* (LC/G.1954 (CONF. 86/3)), Santiago, Chile, March 1997, table II.5.

Note: Workers in low-productive sectors include wage earners in firms employing up to five persons, own-account workers not employed in professional or technical occupations, and domestic employees.

detail in *TDR 1995*, investment in the region was sluggish even in the presence of massive inflows of capital. Moreover, much of the increase in investment was in residential construction; in 1992, for the seven major Latin American countries taken together, investment in machinery and equipment was lower than in the early 1980s.

More importantly, the observed shift in wage differentials towards skilled labour has not been associated with any relative increase in the exports of more skill-intensive products. In Chile there has been a sharp recovery in investment, but it has been accompanied by rapid growth of labour-intensive and natural resource-based exports. Productivity has strengthened as a result of the investment boom, but the export surge appears to be strongly influenced by the fact that real wages in these sectors lagged behind productivity growth. For Argentina, Chile and Colombia taken together,

the share of primary commodities plus resource-based and labour-intensive goods in total exports fell only slightly, from 89 per cent to 82 per cent, from 1985 to 1994. The decline was from 64 per cent to 58 per cent in Brazil. The only country which showed a sizable decline in the share of such exports was Mexico (from 45 per cent to 23 per cent), but what appears to be a jump from the lower skill range to the upper range in fact reflects an increase in labour-intensive, assembly-type *maquiladora* activities associated with FDI.⁷

In some instances demand for skilled labour (as measured by educational attainment) has increased relative to that for unskilled labour without a significant increase in investment to upgrade the industry and move exports towards technology-intensive products. Industries producing low-technology products have replaced less-educated with more-educated labour (including managers). This

skill-upgrading may have been triggered by trade liberalization when the industries concerned were no longer able to compete with imports, and competitiveness could not be restored simply by lowering the wages of unskilled labour, but it necessitated taking on more skilled labour. There is some evidence that such a skill-biased demand shift occurred in Mexico during 1987-1993 in the traded-goods sectors.⁸

It was noted in the previous chapter that in the course of surplus labour absorption, employment of unskilled labour could be raised without an increase in real wages. Since unskilled labour-intensive activities also employ some skilled labour, absorption of unskilled labour would be associated with an increased demand for skilled labour. When the skilled labour is in short supply, this could lead to a rise in the wages of skilled labour and widening of wage inequality. That may indeed be one reason for rising wage inequality in countries such as Chile which, as already noted, have successfully been absorbing surplus labour. However, it does not explain the general experience. First, as noted above, wage differentials rose even where the supply of skilled labour increased. Secondly, and more importantly, wage differentials rose mostly in the context of falling real wages and falling employment of unskilled labour in manufacturing.

An alternative explanation of increasing wage dispersion suggests that factor supplies should be compared on a global basis. On this view, the increased competition in labour-intensive products from countries such as China, India and Indonesia, where unskilled labour is much more abundant and much less expensive, has caused the share of middle-income countries to decline in the global market for labour-intensive products, offsetting the predicted rise in relative demand for unskilled labour in such countries. Just as increased unemployment of unskilled labour and increased wage inequality in industrial countries are explained by the expansion in North-South trade in manufactures, so greater openness is said to lead to similar labour market problems in middle-income developing countries, which find it increasingly difficult to compete at home or abroad with cheaper producers. This is another way of saying that in such countries the poor suffered from trade liberalization because they were not poor enough, or because they were not sufficiently numerous. At the same time, these countries are unable to expand their skill-intensive exports be-

cause they cannot compete with industrial countries. While the effect of these two influences on wage inequality depends on their relative strengths, it is assumed that the loss of competitiveness has been greater in the less skill-intensive products, partly as a result of the presumed skill-enhancing effects of increased openness.

The emergence of low-cost producers of labour-intensive manufactures in Asia has no doubt changed the parameters in international trade for other exporters of such products, and its effect should also have been important for the first-tier East Asian NIEs, where about half of their exports consisted of such goods in the mid-1980s. However, these countries have been able to respond to the new competition by restructuring and upgrading their labour-intensive exports, and by shifting towards skill-intensive products.⁹ As noted in *TDR 1996*, there was a wave of capital goods imports into the Republic of Korea and Taiwan Province of China during the 1980s as the economies were restructured toward more skill-intensive industrial activities. This upgrading took place before imports were liberalized in the second half of the 1980s. The share of labour-intensive products in the combined exports of the two economies fell from over 40 per cent in 1985 to 25 per cent in 1994, while the share of skill- and technology-intensive exports doubled, reaching over 56 per cent in 1994. In the Republic of Korea wage differentials narrowed throughout the 1980s, while in Taiwan Province of China the trend towards widening wage inequality was reversed in the latter half of the decade. In both cases, restructuring and upgrading were facilitated by increased supplies of skilled labour brought about by appropriate manpower policies. In Hong Kong, where wage inequality increased throughout the 1980s, there was little upgrading; the share of labour-intensive and primary exports fell from 60 per cent in 1985 to only 53 per cent in 1994.

It thus appears that the effect of trade liberalization on wages and income distribution differs considerably among countries, depending on the domestic and international conditions under which it is implemented. While resource endowments are certainly important in determining comparative advantage, there are also other factors that influence the degree of competitiveness of various industries. In this respect, it is important to recall the textbook argument invoked to counter the idea that low-wage countries have an unfair competitive advantage in international trade relative to high-

wage countries. It is not relative wage costs, but output per head, that determines international competitiveness. Two countries with similar relative endowments of skilled and unskilled labour can have different productivity levels in any given industry, depending on their success in learning and upgrading. That the burden of low productivity often falls on labour is also recognized by the World Bank:

Increased competition also means that unless countries are able to match the productivity gains of their competitors, the wages of their workers will be eroded. In the coming decade the most vulnerable groups are likely to be:

- unskilled workers in middle-income and rich countries, ..., as they face competition from low-cost producers; and
- some entire countries (especially in sub-Saharan Africa) that lack the dynamism needed to compensate for rising competition and match the efficiency gains achieved by their competitors, or the flexibility to move into other products.¹⁰

This is also illustrated by the data on international wage differentials in table 31. The table includes some major exporters of labour-intensive goods such as textiles and clothing. There are sig-

nificant wage differences among these countries in the same industries. The Republic of Korea and Hong Kong have wages 10-15 times those in some other major exporters such as India and Indonesia, but they have been successfully competing in export markets thanks to their high productivity levels and further upgrading of these products, even though Hong Kong has been feeling the strains of greater competition from cheaper producers because of its failure to adapt as fast as the Republic of Korea. These productivity differences are not simply a reflection of relative supplies of educated labour. They are determined by the success of past industrial and trade policies, and cannot readily be altered by changes in the pattern of incentives.

Herein lies the main difference between trade liberalization in the first-tier East Asian NIEs and most other middle-income developing countries. In the former, liberalization followed the successful implementation of industrial and trade policies; protection and support were removed in large part because they were no longer needed. In the latter, on the contrary, liberalization has largely been triggered by the failure to establish efficient, competitive industries in labour-and/or skill-intensive sectors. Accordingly, the impact of increased competition brought about by trade liberalization on income distribution has been crucially different.

C. Integration and distribution between labour and capital

The recent period of globalization has not only witnessed increased earning differentials among workers in developing countries. It has also seen a shift in income distribution from wages to profits in industry.

Chart 10 shows the evolution of the share of wages in manufacturing value added for 26 developing countries since the mid-1970s. In more than half of the countries the share increased between the latter half of the 1970s and the first half of the 1980s or else remained constant. Among countries where it increased were a number of African, Latin American and Asian countries that suffered

from the debt crisis. By contrast, there was a widespread fall in the average share of wages between 1980-1985 and 1985-1992, affecting all Latin American countries in the chart except Panama and also all African and Mediterranean countries. Altogether, the wage share rose in only six countries during this period, four of which are in East Asia.

These figures indicate that movements of real wages lagged behind those of labour productivity in countries outside East Asia. However, there are considerable differences among countries in the relative rates of change of the two variables. In

Chart 10

SHARE OF WAGES IN MANUFACTURING VALUE ADDED IN 26 DEVELOPING COUNTRIES

(Index numbers, 1975-1980=100)



Source: ILO, World Employment Report, 1996/97 (Geneva: ILO, 1996), table 2.

general, real wages declined in conditions of stagnant or only slow productivity growth. In particular, in all the major Latin American countries shown in the chart (other than Chile) manufacturing output and employment also fell or stagnated. In Chile both productivity and real wages rose, in the context of expanding output and employment. In most East Asian countries, including those where the wage share fell (Malaysia and Singapore), productivity and real wages both rose rapidly alongside manufacturing employment and output. In South Asia manufacturing employment generally stagnated, but output, productivity and real wages rose. Employment was relatively stable in Kenya, South Africa and Zimbabwe, while it rose rapidly in Mauritius. However, in all these countries the wage share fell as real wages stagnated or declined.¹¹

There can be little doubt that the behaviour of real wages, employment, output and productivity is influenced by external trade and finance, and increasingly so in recent years. A full account of these influences would require detailed information and analysis at the country level, which is beyond the scope of this *Report*. However, certain general patterns can be distinguished.

First of all, the erosion of real wages and declines in manufacturing employment and output appear in general to have been associated with rapid import liberalization after prolonged application of import-substitution policies. It is in countries which pursued such policies that wage inequality has increased, thus confirming the close correlation between rising wage dispersion and falling real wages noted above. By contrast, countries which continued to maintain high import barriers did not experience either a similar contraction in the manufacturing sector or a sharp drop in real wages. However, while the situation varied among these countries, employment generally fell or stagnated, while manufacturing output registered some growth. In East Asia, on the other hand, manufacturing output, employment, productivity and real wages expanded rapidly, while these countries intensified their integration into the global trading system.

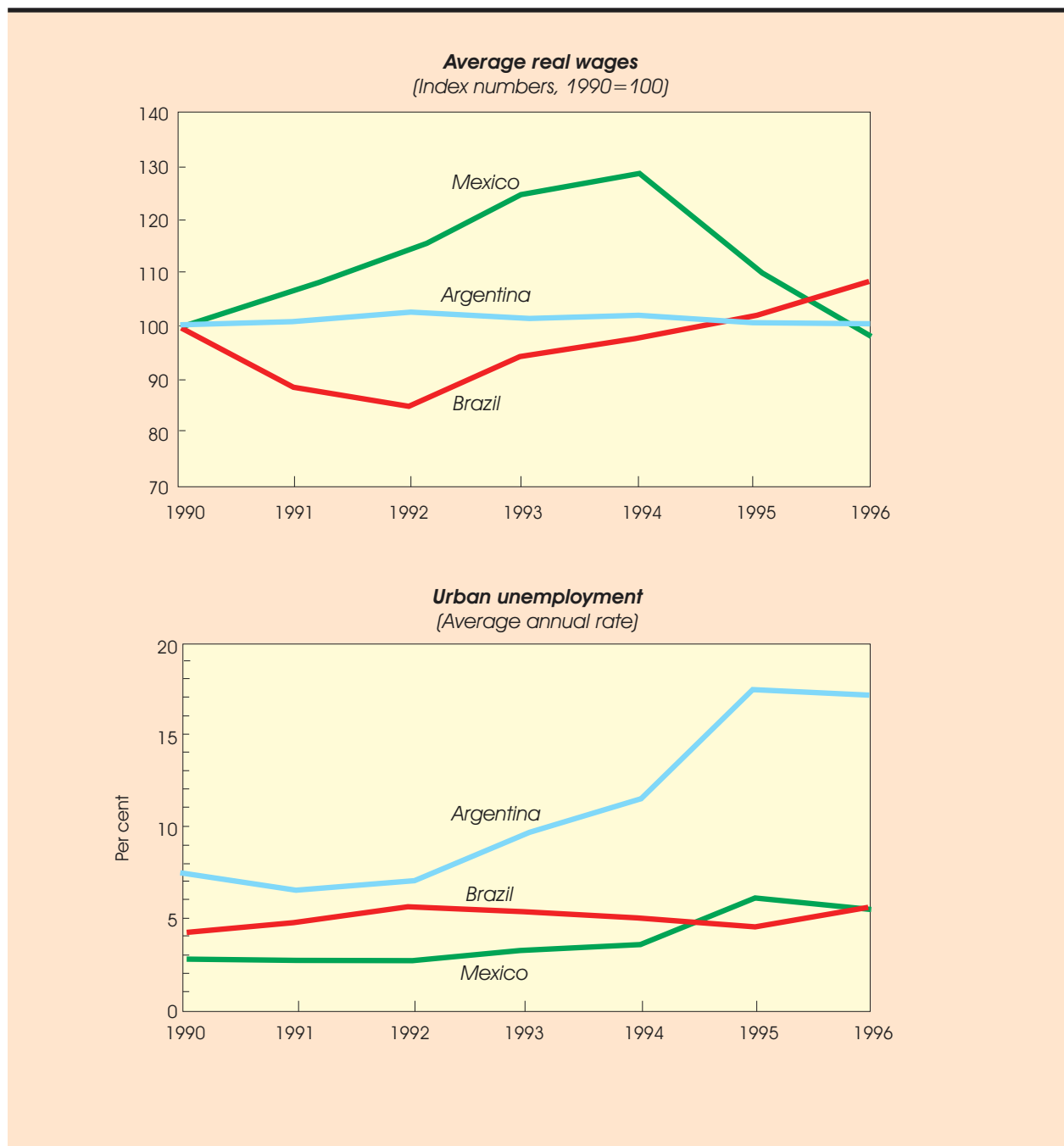
Beginning in the early 1990s, the behaviour of productivity, wages and employment has been increasingly influenced by external private capital flows because of their impact on exchange rates, import costs and competitiveness. This is particularly the case in Latin America, although a number

of countries in Asia and Africa have also been recipients of increased capital flows. Differences among countries in their policy approach to capital flows and their macroeconomic effects have been examined in greater detail in past *TDRs* as well as in a number of country studies published by UNCTAD.¹² These studies suggest that the volatility of capital flows is often closely reflected in the behaviour of real wages, often causing them to deviate from their sustainable levels.

A surge in capital inflows associated with exchange-based stabilization programmes and accompanied by trade liberalization can artificially boost real wages by allowing exchange rates and trade balances to deviate significantly from their sustainable levels. Because of the erosion of competitiveness due to currency appreciation, employment tends to decline in manufacturing, although it may increase in services. While tariff cuts and appreciation lower import costs for industry, and efforts to rationalize production lead to labour shedding, profits in industry may nevertheless be squeezed as increased competition reduces firms' total sales. When the bubble bursts and capital flows are reversed, the exchange rate comes under pressure, and a deflationary adjustment follows, involving cuts in domestic absorption and depreciation of the currency. Labour then tends to lose the gains achieved during the boom phase, not only through declines in real wages but also through shrinking employment; while there is a rise in employment in export sectors, it is often more than offset by a decline in the non-traded goods sectors. The wage-employment configuration can indeed turn out to be much worse than before the beginning of the boom.

The experience of Mexico in the 1990s illustrates this situation (chart 11). Real wages in manufacturing started rising after 1990 as the currency appreciated. Urban unemployment remained relatively stable in the first half of the 1980s even though manufacturing employment fell.¹³ Following the financial crisis at the end of 1994, real wages collapsed and urban unemployment rose sharply. In 1996, real wages returned to the level of 1990 while unemployment was significantly higher. Argentina went through a similar process, but in that country, the burden of adjustment fell entirely on domestic costs, as the nominal exchange rate remained tied to the dollar. Consequently, unemployment rose to unprecedented levels (chart 11). A similar process of wage-overshooting appears to be under way in Brazil, where manufacturing

ARGENTINA, BRAZIL AND MEXICO: REAL WAGES AND URBAN UNEMPLOYMENT, 1990-1996



Source: ECLAC, *Preliminary Overview of the Economy of Latin America and the Caribbean, 1996* (Santiago, Chile: United Nations publication, Sales No. E.96.II.G.13), tables A.4 and A.5.

real wages have been rising constantly alongside the appreciation of the currency and the widening trade deficits since the *Plano Real* was introduced in 1994. Although total urban unemployment has remained stable, manufacturing employment has been falling, and many of the jobs created in the

urban non-manufacturing sector appear to be low-quality ones; it has also been suggested that Brazilian firms have responded to loss of competitiveness by “informalizing their labour force”.¹⁴ The crucial question is again the sustainability of this process.

As noted above, short-term capital flows may not exert a significant influence on underlying trends in investment, employment, productivity and income distribution as long as they are not allowed to generate serious instability in exchange rates and balances of payments. However, if a "hands-off" approach is pursued, the resulting increase in the variability of key prices, including exchange rates,

interest rates and real wages, could adversely affect competitiveness. This in turn could be prejudicial to investment and productivity growth in industry, since the greater volatility would increase risks and raise the risk-adjusted barrier rates of return required on new investment. Since there are other alternatives for investible funds, the major burden of the increased instability is likely to be on labour incomes.

D. Agricultural price reforms

As discussed in the previous chapter, in countries where much of the labour force is concentrated in rural areas, the distribution of income is greatly influenced by agricultural policies. An area of government intervention that has attracted particular attention in this respect in recent years is price policy. Excessive taxation of agriculture in Africa, particularly of major export crops through Marketing Boards (MBs), is considered to be at the root of the region's economic ills, not only because it has created distortions and disincentives, but also because it has shifted income distribution against agriculture, where most of the surplus labour and poverty is located. Agricultural pricing policy, together with currency overvaluations, has often been regarded as the key factor in creating an urban bias in African countries. Accordingly, a major area of reform has been the deregulation of agricultural prices and dismantling of MBs.¹⁵

Reforms of this nature have been undertaken in most of sub-Saharan Africa (SSA) since the early 1980s. Of the 39 MBs which had monopolies for 11 export crops in 23 countries, 10 have been abolished and six no longer hold a marketing monopoly. While previously prices were set for export crops in 25 countries out of 28 for which information is available, this number has now fallen to 11. Moreover, where MBs continue in existence, their prices are now more closely linked to world prices. In North Africa, with the exception of Egypt, liberalization has generally proceeded more slowly, particularly in crops considered to be of key importance. For food crops in particular, the number of sub-Saharan countries with price controls has fallen from 15 to 2 and, except for limited inter-

vention by government agencies in three countries, food crop markets have everywhere been liberalized. For fertilizers, there were formerly subsidized pricing and marketing controls in 20 countries out of 25 for which information is available, against only two by 1992, while five other countries have continued with subsidies, but under deregulated markets. Elsewhere, fertilizer markets have been either totally liberalized or else subsidies have been abolished. In parallel to these reforms, most consumer price controls and food subsidies have also been removed.¹⁶

The effects of these reforms on income distribution in Africa are difficult to assess. Nevertheless, since the latter depends very much on relative prices of agricultural products, a comparison of these prices before and after the reforms could shed an important light on the extent to which price distortions, taxation of agriculture and urban bias have been removed. For this purpose two sets of "price scissors" will be used. The first consists of (i) prices received by farmers for specific crops and (ii) unit export (or border) prices (converted into national currencies) received by the exporting agent. This set of price scissors makes it possible to assess the evolution of the surplus extracted by the exporting agents (i.e. MBs or private traders). It also helps to assess how the "gains" from devaluations and "losses" due to overvaluations are distributed between exporters and producers.

The second set consists of aggregate index numbers of agricultural prices, on the one hand, and of manufacturing prices, on the other, whereby

Table 40

**TERMS OF TRADE OF AGRICULTURE FOR SUB-SAHARAN AFRICA AND THE WORLD,
1973-1995**

<i>Agricultural terms of trade of:</i>		1979 (1973=100)	1985 (1979=100)	1995 ^a (1985=100)
(1)	Sub-Saharan Africa ^b	114.0	102.8	130.6
	World			
(2)	Food and beverages ^c	86.1	57.8	81.7
(3)	Agricultural raw materials ^c	77.0	85.6	93.0
	Ratio of sub-Saharan to world terms of trade of agriculture			
(1)/(2)	Food and beverages	1.32	1.78	1.60
(1)/(3)	Agricultural raw materials	1.48	1.20	1.40

Source: UNCTAD secretariat calculations, based on World Bank, *World Development Indicators, 1997* (CD Rom).

a Preliminary estimates.

b Unweighted mean of the ratios of the implicit GDP deflators for agriculture to those for manufactures in 13 countries (Benin, Burkina Faso, Cameroon, Côte d'Ivoire, Ghana, Kenya, Senegal, Zambia; Botswana, Burundi, Gambia, Nigeria and Sierra Leone). The deflator for total GDP was used for the five latter countries, where the share of manufactures in GDP was less than 10 per cent in 1973.

c Ratio of the index of free market prices for each of the two groups of commodities to that of the export unit value of manufactures.

the terms of trade for the whole agricultural sector, including products sold in domestic markets, can be measured. These two series are derived as the sectoral deflators from GDP data in current and constant prices. Agricultural prices thus obtained represent prices received by producers. Movements in the agricultural terms of trade also reflect changes in the degree of the "squeeze" of farmers through backward market linkages. A comparison of the domestic terms of trade with the relative prices of agricultural and industrial products in world markets over time could help identify the origin of these movements and provide some indication as to the extent to which distortions are removed.¹⁷

Table 40 compares for 13 SSA countries changes in their terms of trade for agriculture with changes in the world terms of trade for agriculture, distinguishing food and raw materials, for three consecutive periods (1973-1979, 1979-1985 and 1985-1995). In all three periods world terms of trade fell for both groups of agricultural prod-

ucts, while the domestic terms of trade in SSA countries improved. As a comparison of the last two rows of the table indicates, there are no striking differences between the pre-reform and post-reform periods regarding the improvement in the domestic terms of trade in comparison with movements in world prices. From 1973 to 1979 the domestic terms of trade fell in only four countries; from 1979 to 1985 it fell in five; and from 1985 to 1995 in four. Among the 13 countries in the sample, markets for export crops are now deregulated in four (Côte d'Ivoire, Gambia, Nigeria, Sierra Leone). For this subgroup, the agricultural terms of trade fell by 3.7 per cent from 1985 to 1995. By contrast, they rose by 54.8 per cent in five countries which still had centralized price setting, under regulated or partially liberalized markets.

Table 41 compares prices received by farmers with border prices of specific commodities in major exporting countries of Africa. There can be little doubt that in such products MBs have ex-

Table 41

**RATIO OF PRODUCER PRICES TO EXPORT UNIT VALUES FOR MAJOR COMMODITIES IN
NINE MAJOR EXPORTING AFRICAN COUNTRIES, 1973-1994**

Country	Commodity	Average ratio in:		
		1974-1979 (1973=100)	1980-1985 (1979=100)	1986-1994 (1985=100)
Cameroon	Cocoa	66.9	168.7	142.9
Côte d'Ivoire	Cocoa	88.1	136.4	163.6
	Coffee	82.5	115.5	307.1
Egypt	Cotton	93.4	149.0	88.6
Ghana	Cocoa	84.9	277.1	89.4
Kenya	Coffee	101.9	93.9	82.5
	Tea	110.0	105.6	83.7
Malawi	Tea	89.7	84.1	155.9
	Tobacco	91.0	103.8	68.3
Sudan	Cotton	109.8	93.8	169.6
United Republic of Tanzania	Cotton	106.3	148.1	16.2
	Tea	90.2	107.8	46.6
Zimbabwe	Tobacco	93.7	104.3	97.5
<i>Average of nine countries</i>		93.0	129.9	116.2

Source: UNCTAD, *Handbook of International Trade and Development Statistics*, various issues; FAO data base.

Note: The average ratio is obtained by dividing annual index numbers for producer prices by the annual index numbers for export unit values (multiplied by 100). A value above 100 indicates that between the base year and the period in question the rise in producer prices exceeded, on average, the rise in border prices, signifying a lower rate of "surplus extraction" from the producers by the exporting agent (discussed in the text).

tracted large surpluses, particularly during price booms and after devaluations. But again, the evidence shows that extended periods of currency appreciation and depressed world prices have often been associated with declining rates of surplus extraction.¹⁸ Of the countries included in the table, Côte d'Ivoire, Egypt, Malawi and the United Republic of Tanzania are among those that have carried out reforms. Cameroon, Ghana and Kenya, on the other hand, have continued with centralized price setting and/or MBs. In the first group all except Côte d'Ivoire show a widening of price scissors since the mid-1980s, which suggests that there

have been large and even growing profit margins for private traders at the expense of farmers. The results are mixed in countries with regulated markets; they point to a pro-farmer price movement in Cameroon but increased "taxation" by MBs in Ghana and Kenya.

These results strongly suggest that, contrary to original expectations, market-based reforms have not so far had a great impact on farm income in much of Africa. A number of other studies also support this conclusion. For example, a study on Egypt before and after the deregulation of agricul-

tural prices, based on a direct comparison of producer prices with input prices for individual crops, shows that after the price reforms, the price-cost margins declined for cotton, and widened for maize, rice and sugar cane.¹⁹ Comparing producer prices with overall price movements, the World Bank has estimated the average domestic terms of trade for export crops for 27 SSA countries in two different periods, 1981-1983 and 1989-1991. It found that there had been an improvement in 10 countries. For countries where centralized price setting has continued, the terms of trade for export crops rose by 4.8 per cent between these two periods, whereas for countries implementing reforms there was a decline of 18.8 per cent.²⁰

As discussed in the previous chapter, the early development experience of Taiwan Province of China, which is generally regarded as a key example of rapid growth with equality, shows that “taxing” agriculture through price policies can actually be compatible with high rates of agricultural growth as well as greater income equality. The recent experience of Africa shows that policies designed to remove such price distortions are insufficient to promote greater incentives and equality. The reasons are likely to vary from country to country. However, a common element underlying this failure appears to be the neglect of

serious market imperfections and shortcomings in undertaking reforms. It seems that many of the markets for export crops are dominated by a few traders. Producer prices have continued to be depressed, particularly in regions with poor infrastructure and low population density and where hungry-season food purchases of farmers lead to the interlocking of credit and product markets. Farmers in remote locations were particularly affected following the abandonment of pan-territorial pricing in a number of countries.

This is yet another example of a “big bang” liberalization without preparing the institutions and infrastructure needed for markets to perform effectively. It is true that state monopolies in agricultural markets have for many years been the single most important factor preventing the development of essential ingredients of private markets. However, most of the reforms appear to have been undertaken as if the ingredients for such markets already existed. Certainly, over time competitive forces may prevail and some of these earlier trends may be reversed. However, the present outcome could have been avoided if a gradual approach had been adopted to reforming agricultural pricing by first establishing the necessary institutional and physical basis rather than unleashing market forces in one fell swoop.

E. Debt, finance and distribution

In many developing countries, particularly the middle-income countries, there has been a rapid expansion in recent years in outstanding domestic debt relative to GDP, accompanied by an associated increase in the share of interest in the national income. Since the early 1980s interest payments on total private and government debt have been rising rapidly, reaching levels as high as 15 per cent of GDP in recent years in a number of countries. This unprecedented expansion of public and private debt and associated interest payments took place concomitantly with financial liberalization, advocated on grounds of both efficiency and equity. Liberalization was justified on the grounds that financial repression, notably the policy of

maintaining nominal interest rates below the rate of inflation, not only led to inefficiency in the allocation of resources and discouraged savings, but also redistributed wealth at the expense of savers. Since large savers are often in a position to hedge against inflation, small savers were thought to be particularly vulnerable.

Deregulation of interest rates was also accompanied by a major shift in the financing of budget deficits from central banks to the private sector. It was also argued that the privileged access of governments to central bank financing increased inequality because of its effects on inflation, and that the introduction of the discipline of private

financial markets in the public sector would increase fiscal responsibility and encourage budget balance. Setting monetary growth targets was considered to be the best way to eliminate price instability. In the face of continued government deficits, meeting these targets meant that increasing amounts of debt had to be held on private sector balance sheets.

For a number of reasons, financial liberalization in many middle-income countries gave rise to a massive expansion of public and private debt. First, interest rates were deregulated under conditions of rapid inflation and depressed economic activity resulting from the debt crisis. Consequently, while nominal interest rates rose sharply and real interest rates reached double-digit figures, the financing gaps in the public and private sectors widened due to the effect of recession on revenues, and often a "Ponzi" financing pattern emerged whereby interest payments were financed by incurring new debt at very high interest rates. Second, a number of governments in highly-indebted countries, particularly in Latin America, faced net financial transfers abroad as net new borrowing fell short of interest payments. Consequently, they had to borrow at very high rates at home in order to service their external debt.

The increased public and private debt has witnessed the emergence of a new class of rentiers whose incomes depend as much on capital gains on financial assets as on interest payments. In socio-economic terms, the origin of this class appears to vary from country to country. Since most countries undergoing the development process lack the kind of viable institutional investors which dominate developed country financial markets, the main sources of finance are wealthy individuals whose activities are intermediated through the banking system. Further, large segments of the industrial and commercial classes have been attracted to borrowing and lending, and to buying and selling existing assets, as a source of income, rather than to investing in commercial or industrial ventures or construction as they normally would under conditions of "repressed finance". The attractive terms which have been offered on public debt in order to shift government financing from the central bank to the private sector has meant that low-risk, often tax-free, government bonds constitute an increasing proportion of the total investments of such rentiers. This tendency has gone so far that in some middle-income countries the corporate sector has become a surplus sector, lending directly and indirectly to the public sector.

Although the public domestic debt has risen rapidly since the early 1980s in a number of developing countries, the stock of such debt as a proportion of GDP is still small compared to the proportion in industrialized countries. For instance, in mid-1996 it was around 30 per cent in Brazil and Turkey - two countries which saw a rapid accumulation of domestic debt in the past decade - compared to 60 per cent or more in most industrial countries. However, in developing countries this debt has been accumulated over a very short period. Moreover, real interest rates in these countries are considerably higher than in the industrialized countries, often reaching double digits. Thus, real interest payments on debt tend to be much higher than in industrial countries; in Brazil and Turkey they have reached 5-6 per cent of GDP, compared to 2-3 per cent in most industrial countries.

However, as in the industrialized countries, the accumulation of debt by the public sector in developing countries has been associated with a sharp slowdown in public investment. Much of the new debt has been contracted in order to finance current spending and transfers, including interest payments, rather than investment. Indeed, public investment has often been cut in order to service debt. The combination of increased public debt and reduced public investment suggests that the debt does not correspond to an equivalent build-up of productive capacity, capable of producing additional revenues for its servicing. The burden has had to fall on ordinary tax revenues, implying a redistribution from taxpayers to holders of government debt.

The redistributive effect of government debt depends on who pays the taxes and who holds the debt and, hence, receives interest payments. In industrial countries where the taxation is progressive and government debtholding is widespread, particularly in the portfolios of pension and provident funds, the servicing of government debt through taxation may not distort income distribution. Evidence from the United States suggests that the redistributive impact of government debt may even be positive due to the progressiveness of the tax system and the dispersion of debt ownership.²¹ However, this does not seem to be generally the case; for instance, there is evidence to show that the redistributive impact may have been negative in the 19th century in Great Britain.²² Although it is difficult to estimate the precise redistributive effects of government debt in developing countries because of lack of information regarding the dis-

Chart 12

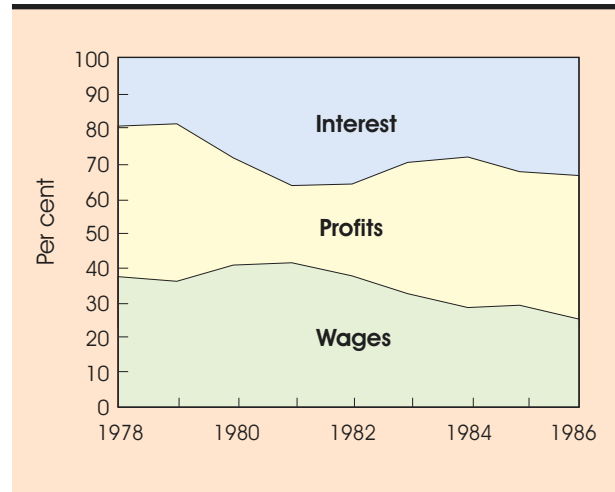
tribution of debt ownership by different income groups and institutions, there are strong reasons to believe that an increased government debt held primarily by the private sector aggravates inequalities in income distribution. First, in most developing countries the taxation system is highly regressive, both because of widespread evasion of taxation on non-wage incomes, and also because of heavy reliance on indirect taxes. Second, the ownership of government debt appears to be highly concentrated. For instance, in Turkey, where government debt is held primarily by banks, bank deposits are heavily concentrated in large accounts: according to one estimate, the Gini coefficient of bank deposits in Turkey in the 1980s was close to 0.7, and 60 per cent of deposits were held by 11 per cent of deposit holders.²³

As noted above, in some countries new debt is incurred in order to meet interest payments on outstanding debt. While postponing taxation required for debt servicing, recourse to such financing tends to aggravate the problem by increasing the wealth concentration relative to GDP. Since typically real interest rates on public debt are well in excess of real growth rates, the debt/GDP ratio will rise continuously even if a Government incurs no new debt to finance its non-interest expenditures. However, this process cannot continue indefinitely, and eventually the debt will have to be serviced from tax revenues, and the tax burden will rise significantly because the stock of debt will have grown in relation to GDP.

It is generally agreed that inflation is regressive in its effects on income and wealth distribution because the rise in nominal incomes of the poor does not keep up with the rise in prices, particularly as regards the urban poor and the lower middle class. Moreover, inflation constitutes a tax on currency holdings, and such holdings amount to a greater proportion of the incomes of the poor than the rich as financial liberalization proceeds. While a shift from money printing to bond printing may benefit the poor in the former sense, it will not necessarily do so when the redistributive effects of government debt are compared and contrasted with the inflation tax on currency holdings. Such holdings do not generally amount to more than a few percentage points of GDP, and tend to decrease rapidly as inflation accelerates. Consequently, when the tax system is highly regressive and government debt ownership is concentrated, income redistributed from poor taxpayers to rich bondholders may well exceed the inflation tax that the poor

DISTRIBUTION OF VALUE ADDED^a IN INDUSTRIAL FIRMS IN TURKEY, 1978-1986

(Percentage of total value added)



Source: Y. Akyüz, "Financial Liberalization in Developing Countries: Keynes, Kalecki and the Rentier", in G. Helleiner, S. Abrahamian, E. Bacha, R. Lawrence and P. Malan (eds.), *Poverty, Prosperity and the World Economy: Essays in Memory of Sidney Dell* (London: Macmillan Press, 1995).

a Gross value added before taxes.

would have paid under conditions of inflationary financing.

The rise in interest rates has also been a key factor in the increase in interest payments as a proportion of value added in the corporate sector. The immediate effect of financial liberalization in the 1980s was to squeeze profits by pushing up the cost of capital and transferring a greater part of corporate income to rentiers. Thus, the rise in interest rates and the share of interest in national income were initially reflected in a redistribution of property income from profits to rentiers.

However, mark-ups in trade and industry typically respond to sustained increases in interest rates in the same way as they respond to changes in other costs. Since, under financial liberalization, interest rates adjust rapidly to changes in the price level, mark-up pricing implies that the greater interest burden tends to be shifted onto labour. There is indeed evidence from some countries that the re-

distribution of income in favour of rentiers has been at the expense of labour. For example, in Turkey, the hike in interest rates brought about by financial liberalization in the early 1980s initially resulted in a tight profit squeeze, but the share of profits in value added recovered subsequently at the expense of wages while interest payments con-

tinued to absorb about one third of value added, against less than 20 per cent in the late 1970s (chart 12). Since interest rates on corporate debt have generally increased in the past decade, it is likely that some of the income redistributed from wages to profits in manufacturing (see chart 10) accrued to rentiers rather than industrial entrepreneurs.

F. Conclusions

This chapter has outlined recent trends in wage inequality, the distribution of manufacturing value added between labour and capital, agricultural prices and terms of trade, and interest incomes. Growing earnings inequality between unskilled and skilled workers, coupled with a declining wage share in manufacturing value added, can be expected to worsen personal income distribution in semi-industrialized countries, a tendency which could be reinforced by increases in the share of interest incomes. In more agrarian economies, these tendencies could be reinforced if the benefits of agricultural price liberalization accrue to oligopsonistic traders, and if policies to align producer prices in agriculture more closely to world prices are confounded by declines in the latter.

Trade liberalization and financial liberalization have thus strengthened some of the forces making for increasing inequality in income distribution in the short run. But the crucial issue is what will happen in the longer term. According to one view, the recent dislocations caused by trade liberalization in developing countries, including widening earning inequalities, are temporary, being the inevitable consequences of a shift from a "distorted trade regime" to free trade which will eventually be reversed as markets prevail and bring about productivity gains and upgrading. On this view, all that Governments need to do is simply to maintain free trade and facilitate this process by policies designed to increase the supply of skilled labour. Proponents of this view accordingly believe that it is possible to envisage a new kind of Kuznets curve associated with greater integration: at first inequalities increase, but subsequently they decrease.

From the analysis of the preceding chapter, it would appear that though this is a possible outcome, it is an unlikely one. It is possible because, as the first-tier East Asian NIEs have shown, declining inequalities can be achieved if a rapid rate of growth is sustained long enough to absorb surplus labour. But it is not clear that this experience can be replicated under full-scale trade liberalization, particularly if carried out with financial liberalization. As already noted in chapter II, there are fundamental differences between export promotion policies and full-scale import liberalization in their effects on the exploitation of *static* comparative advantage based on existing resource endowments and know-how, as well as on the promotion of infant industries and realization of *dynamic* comparative advantages. Moreover, there can be little doubt that such a process depends crucially on investment, and the role of governments in accelerating capital accumulation was much greater in the East Asian successes than is typically assumed in the conventional approach. In these circumstances, there are serious dangers that growth will not be sufficiently rapid, particularly since, as already noted, population in surplus labour economies is growing relatively fast. It may be very difficult to promote investment and employment and raise productivity while competing with more efficient producers. Consequently, wage inequality may well become a more permanent feature of the middle-income countries, in very much the same way as it has become in a number of major industrial countries in the past two decades.

To avoid this trap it is important to focus policy more on the issue of capital accumulation and on management of the relationship between

capital accumulation and distribution. This issue is taken up in the subsequent chapters, examining first the possibility that an unequal distribution of

income or a particular pattern of factor shares can lead to slower growth, and then considering the policy implications for sustaining faster growth. ■

Notes

- 1 O. Altimir, "Income distribution and poverty through crisis and adjustment", *CEPAL Review*, No. 52, April 1994, pp. 8 and 26.
- 2 See *TDR 1993*, Part Two, chap. III.
- 3 For discussions of these findings, see E.J. Amadeo, "The knife-edge of exchange-rate-based stabilization: Impact on growth, employment and wages", *UNCTAD Review 1996* (United Nations publication, Sales No. E.97.II.D.2); D. J. Robbins, "HOS Hits Facts : Facts Win Evidence on Trade and Wages in the Developing World", *Development Discussion Paper* No. 557, Harvard Institute for International Development, Cambridge, MA, Oct. 1996; C. A. Pissarides, "Learning by Trading and the Returns to Human Capital in Developing Countries", *The World Bank Economic Review*, Vol. 11, No. 1, January 1997; and A. Wood, "Openness and Wage Inequality in Developing Countries: The Latin American Challenge to East Asian Conventional Wisdom", *ibid.*
- 4 ECLAC, *The Equity Gap. Latin America, the Caribbean and the Social Summit* (LC/G.1954 (CONF. 86/3)), Santiago, Chile, March 1997, p. 60.
- 5 Despite the mounting evidence on the impact of trade liberalization on increased earnings inequality in Latin America, a recent IADB study reports a positive effect of trade liberalization on personal income distribution. However, no attempt is made to reconcile these findings with all this other evidence to the contrary; see J. L. Londoño and M. Székely, "Sorpresas Distributivas Después de una Década de Reformas: América Latina en los Noventa" (mimeo), IDB, February 1997.
- 6 *World Employment Report 1996/97* (Geneva: ILO, 1996), table 5.9 and related text.
- 7 See *TDR 1996*, table 32.
- 8 M. I. Cragg and M. Epelbaum, "Why has wage dispersion grown in Mexico? Is it the incidence of reforms or the growing demand for skills?", *Journal of Development Economics*, Vol. 51, 1996.
- 9 Differences in the ability of different countries to respond to increased competition in labour-intensive products are also reflected by movements in the manufacturing terms of trade. During 1979-1994 the world price of manufactured exports of developing countries fell relative to that of the skill-intensive exports from industrial countries by about 2 per cent per annum. The decline was largest in LDCs, followed by ACP, Latin American and Mediterranean countries, while it was significantly smaller in East Asia; for the Republic of Korea, the manufacturing terms of trade indeed moved favourably during that period. See *TDR 1996*, Part Two, chap. III.
- 10 *World Development Report 1995. Workers in an Integrating World* (New York: Oxford University Press for The World Bank, 1995), p. 58.
- 11 On the behaviour of output, employment, real wages and productivity in these countries see ILO, *op. cit.*, figure 5.1.
- 12 See UNCTAD, *International Monetary and Financial Issues for the 1990s*, Vol. VIII (United Nations publication, Sales No. E.97.II.D.5), New York and Geneva, 1997.
- 13 On manufacturing unemployment see Amadeo, *op. cit.*
- 14 G. Gonzaga, "The effects of openness on industrial employment in Brazil", *Texto Para Discussão*, No. 362, PUC-RIO, Rio de Janeiro, November 1996.
- 15 These views have been elaborated in a series of studies at the World Bank, including the "Berg Report" *Accelerated Development in Sub-Saharan Africa: An Agenda for Action* (Washington D.C.: The World Bank, 1981); and M. Schiff and A. Valdés, *Plundering of Agriculture in Developing Countries* (Washington D.C., The World Bank, 1992).
- 16 *Adjustment in Africa: Reforms, Results and the Road Ahead* (New York: Oxford University Press for The World Bank, 1993), chap. 3 and table A.9; ECA, *Economic and Social Survey of Africa, 1994-1995* (United Nations publication, Sales No. E.95.II.K.8), Addis Ababa, 1995, pp. 50-52 and 87-88.
- 17 Ideally this should be complemented by an analysis of movements of sectoral productivity à la Prebisch,

- but this is extremely difficult for international comparisons.
- 18 See V. Jamal, "Surplus extraction and the African agrarian crisis in a historical perspective", in A. Singh and H. Tabatabai (eds.), *Economic Crisis and Third World Agriculture* (Cambridge University Press for the International Labour Organisation, 1993), p.77; IFAD, *The State of World Rural Poverty* (New York: New York University Press, 1992), p.83.
- 19 J. Baffes and M. Gautam, "Price Responsiveness, Efficiency, and the Impact of Structural Adjustment on Egyptian Crop Producers", *World Development*, Vol. 24, No. 4, 1997. These results are compatible with the movement of relative prices of Egyptian cotton shown in table 41.
- 20 *Adjustment in Africa* ..., tables A.9 and A.18.
- 21 See D. F. Vitalino and Y. E. Mazaro, "Public Debt and Size Distribution of Income" in P. Davidson and J. A. Kregel (eds.), *Macroeconomic Problems and Policies of Income Distribution* (Aldershot: Edward Elgar, 1989).
- 22 B. J. Moore, "The Effects of Monetary Policy on Income Distribution", in Davidson and Kregel, *op. cit.*, p. 28.
- 23 See Y. Akyüz, "Financial System and Policies in Turkey in the 1980s", in T. Aricanli and D. Rodrik (eds.), *The Political Economy of Turkey. Debt, Adjustment and Sustainability* (London: Macmillan, 1990).