

**OXFAM AMERICA**  
RESEARCH BACKGROUNDER

# **The Drivers of Economic Inequality**

A primer

V. Nicholas Galasso



**OXFAM**  
America



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## Author information and acknowledgments

V. Nicholas Galasso, Ph.D., Research and Policy Advisor, Oxfam America

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# ACRONYMS AND ABBREVIATIONS

BRICSAMIT	Brazil, Russia, China, South Africa, Mexico, Indonesia, Turkey
FDI	Foreign Direct Investment
GATT	General Agreement on Tariffs and Trade
GDP	Gross Domestic Product
HI	Horizontal Inequalities
IFIs	International Financial Institutions
IMF	International Monetary Fund
LICs	Low Income Countries
MDGs	Millennium Development Goals
MICs	Middle Income Countries
OECD	Organisation for Economic Co-operation and Development
PPP	Purchasing Power Parity
VI	Vertical Inequalities
WTO	World Trade Organization

# INTRODUCTION

This paper is intended to offer a background of the state and drivers of global economic inequality. The paper is divided into two major parts. The first is descriptive and the second explanatory. The first part provides a snapshot of global economic inequality, along with a discussion of how economic growth and poverty reduction in China (and to a lesser extent India) altered the global distribution of income and wealth. The second major part provides a short analysis of the major drivers of inequality. The overview of the drivers is not exhaustive, however, as there are other contributing factors outside of the reach of a paper such as this.

It can be a herculean task to wrap one's head around economic inequality. It involves taking into account population growth, economic dynamics, geographies, political institutions, and social discrimination - simultaneously. This paper intends to offer a concise account of trends (both globally and within countries) over recent decades to inform Oxfam staff on these issues.

# INEQUALITY FROM A GLOBAL AND COUNTRY PERSPECTIVE

## 1.1 SNAPSHOTS OF GLOBAL INEQUALITY

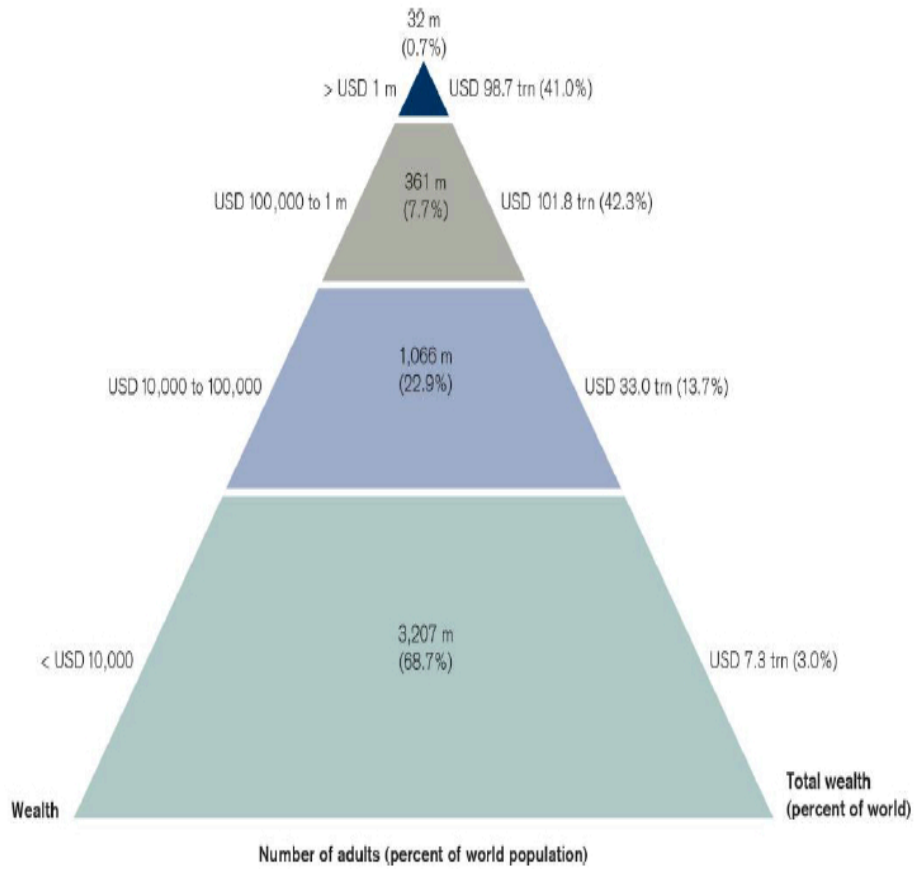
It is difficult to conceptualize economic inequality. In part, this is because inequality is such a relative experience. Throughout this section, inequality is treated in two ways: First, through a global lens and then through a country lens. **Global inequality refers to inequality among individuals of the world, without reference to the countries where people live.** Basically, imagine lining up everyone on the planet by their income and wealth status. Inequality can also be measured at a country level. Entire countries can be compared to one another, or we can look inside specific countries and focus on national distributions. Figure 1 offers three different ways to think about global inequality.<sup>1</sup>

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<sup>1</sup> Anthony Shorrocks, Jim Davies, and Rodrigo Lluberasis, "Global Wealth Report," (Zurich, Switzerland: Credit Suisse Research Institute, 2013); Branko Milanović, *The Haves and the Have-Nots : A Brief and Idiosyncratic History of Global Inequality* (New York: Basic Books, 2011); Dalton Conley, *You May Ask Yourself : An Introduction to Thinking Like a Sociologist* (New York: W.W. Norton & Co., 2011).

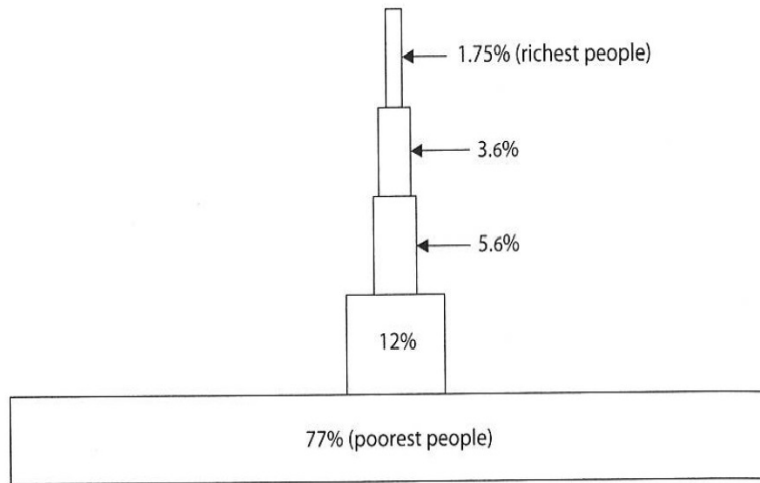


**Figure 1a. Snapshots of global inequality**



Source: Credit Suisse Wealth Report (2013)

**Figure 1b. Snapshots of global inequality**

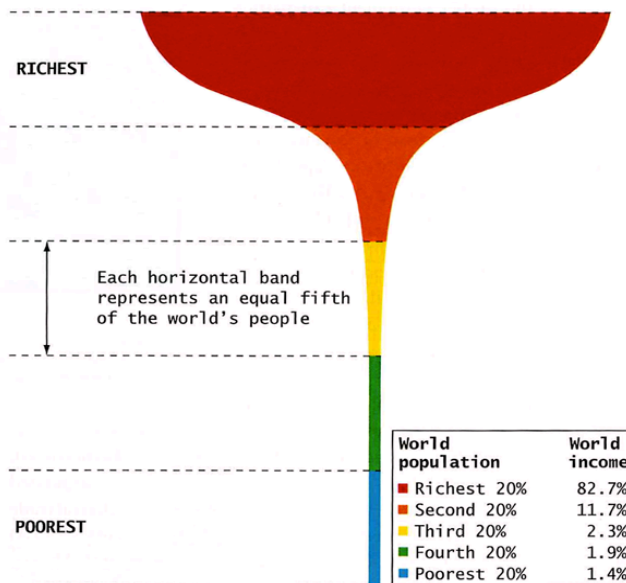


The global pyramid: What percentage of people in the world do you need to generate successive 20 percents of global income?

*Note:* The width of each block is proportional to the percentage of people. The height of each block is the same (since each block contributes 20 percent of the global income).

Source: Milanovic (2012)

**Figure 1c. Snapshots of global inequality**



Source: Conley (2011)

## 1.2 INEQUALITY OVER TIME—FROM CLASS TO LOCATION

Global inequality is higher than any one country's inequality level.<sup>2</sup> Further, the trend of high global inequality appears to have hardly moved in decades. One estimate suggests that between 1998 and 2008 the global Gini shifted from 76.3 to 75.9 percent. Alas, despite the absolute decrease of extreme poverty over this period, global inequality is largely unchanged.<sup>3</sup>

How did the world become so unequal?

Inequality between people and countries grew substantially from the early 1800s to the middle of the 20<sup>th</sup> century. Before this divergence began, individuals throughout the world had more similar living standards.<sup>4</sup> Two hundred years ago, Western countries were roughly 90 percent richer than the rest. This may sound like a lot; however, by 2000 this gap skyrocketed 750 percent.<sup>5</sup> The Industrial Revolution caused the widening to occur by sparking rapid median income growth in Western Europe and its offshoots, compared to mean incomes elsewhere.<sup>6</sup>

We should think of inequality before the 1820s as mostly an outcome of class structures within countries, since differences in wealth and earnings between people living in different countries were closer. By contrast, inequality today is mostly a consequence of where someone is born or lives.<sup>7</sup>

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<sup>2</sup> This understanding is derived from the Gini Coefficient. The Gini is a standard measure of inequality. It ranges on a scale between 0 and 100 (sometimes it is written as ranging between 0 and 1). Zero indicates total equality and one hundred (or '1') indicates total inequality (meaning all the income, wealth, or whatever is being measured is consolidated by a single actor). According to PovcalNet, the range of country Gini levels is from 19.4 to 74.3 percent, with an average of 42.2 percent. Only two countries have Gini levels higher than 70 percent (Jamaica and Namibia).

<sup>3</sup> Christoph Lakner and Branko Milanović, "Global Income Distribution from the Fall of the Berlin Wall to the Great Recession," (Washington, D.C.: The World Bank, 2013).

<sup>4</sup> Lant Pritchett, "Divergence, Big Time," *Journal of Economic Perspectives* 11, no. 3 (1997).

<sup>5</sup> Western countries reflected in this figure include Austria, Belgium, Denmark, Finland, France, Germany, Italy, Netherlands, Norway, Sweden, Switzerland, the UK, Japan, Australia, New Zealand, Canada and the US. See Angus Maddison, "Contours of the World Economy and the Art of Macro-Measurement 1500-2001," in Ruggles Lecture, IARIW 28th General Conference (Cork, Ireland 2004).

<sup>6</sup> The US, Canada, Australia, and New Zealand.

<sup>7</sup> For an overview of historical changes in global inequality, see Branko Milanović, "Global Inequality and the Global Inequality Extraction Ratio: The Story of the Past Two Centuries," The World Bank; Francois Bourguignon and Christian Morrisson, "Inequality among World Citizens: 1820-1992," *American Economic Review* 92, no. 4 (2002); Angus Maddison, "Measuring and Interpreting World Economic Performance 1500-2001," *Review of Income and Wealth* 51, no. 1 (2005).

## 1.3 HOW HAS GLOBAL INEQUALITY CHANGED IN RECENT DECADES?

The great global divergence between the early industrializing nations and the rest of the world grew throughout the 19<sup>th</sup> and early 20<sup>th</sup> centuries, plateauing around 1950. Between 1960 and 1980, global inequality remained stable. Poor countries were not catching up to rich countries, nor were rich and poor countries converging.<sup>8</sup> However, this trend began changing by the early 1980s. Growth took off in rich countries, raising median incomes faster than in poor countries. This would suggest global inequality was set to become worse in coming decades. Instead, global inequality held constant between rich and poor countries. The reason for this is China's economic reforms, which led to significant growth. The result was that this growth pulled hundreds of millions out of extreme poverty, thereby offsetting the inequality inducing rise of median incomes in rich countries.

Previously, it was thought that the offsetting effect of China's growth (with contributions from other developing countries) was causing global inequality to decline. However, these calculations do not account for the growth of top incomes during the past 20 years. Factoring in top incomes is difficult because measures of economic inequality are determined through national level surveys. The results tend to underestimate inequality because the rich are less represented in such surveys.<sup>9</sup> For instance, Lakner and Milanović estimate the global Gini moved from 76.3 to 75.9 percent between 1988 and 2008 (as shown above). However, if their estimate of top incomes is removed from the sample, the figures become 72.5 percent for 1988 and 69.6 percent for 2008.<sup>10</sup>

Therefore, accounting for top incomes is a crucial factor in assessing global inequality trends. Without such estimates, it appears as though global inequality has fallen. However, including top income estimates suggests global inequality has hardly moved.

### 1990 to the present

Although global inequality remained largely unchanged, we have seen important shifts in the arrangement of the global distribution. Today, millions of people who were living in low-income countries (LICs) in the 1980s now occupy the middle of the global income ladder (again, this is mostly because of China). Figure 2 demonstrates income growth for percentiles of the global distribution between

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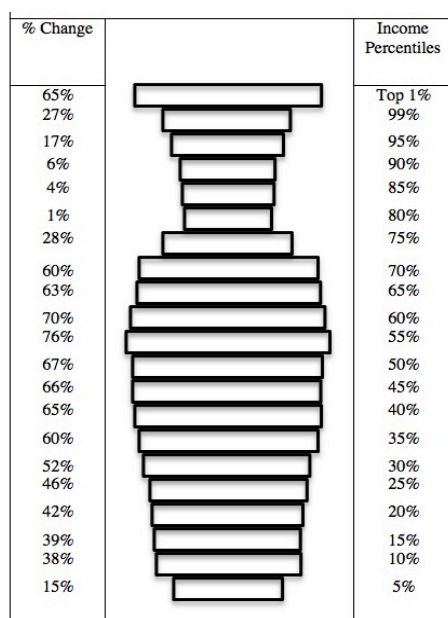
<sup>8</sup> Milanović, *The Haves and the Have-Nots: A Brief and Idiosyncratic History of Global Inequality*.

<sup>9</sup> James E. Foster, Suman Seth, Michael Lokshin, and Zurab Sajaia, "A Unified Approach to Measuring Poverty and Inequality Theory and Practice," World Bank, <http://elibrary.worldbank.org/doi/book/10.1596/978-0-8213-8461-9>.

<sup>10</sup> Milanović, "Global Income Distribution from the Fall of the Berlin Wall to the Great Recession."

1988 and 2008. Each percentile represents the total mean growth rate between the two data points. As we can see, the largest growth occurred between the 50<sup>th</sup> and 60<sup>th</sup> percentiles. Growth was lower than the average around the 75<sup>th</sup> percentile, and then reverts back to higher than the average at the top 1 percent. As Milanović says, those in the 50<sup>th</sup> to 60<sup>th</sup>, and top 1 percent, are winners of globalization, whereas those in the 75<sup>th</sup> (made up of low income earners in advanced economies) are the losers.<sup>11</sup>

**Figure 2. Percentage change of real incomes, 1988-2008**



Source: Milanović, 2012

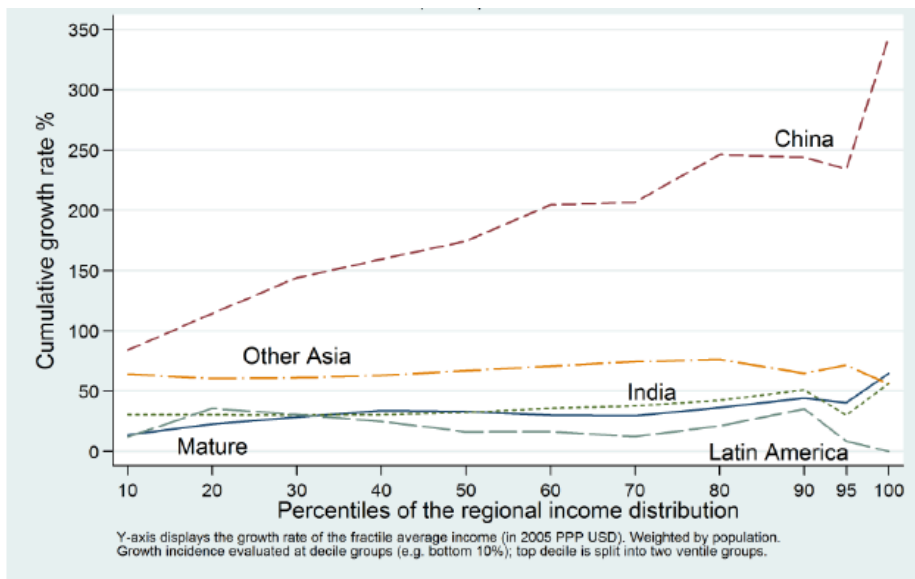
What nationalities are represented by the changes in the global distribution in Figure 2? From which countries, for instance, do those occupying the bulging 50<sup>th</sup> to 60<sup>th</sup> percentiles hail? What about the top 1 percent? As Figure 3 (below) shows, the Chinese experienced the largest growth, as average incomes tripled over this period. With contributions from India and some other developing countries, the middle of the global distribution is now mostly occupied by the Chinese. However, as Figure 3 demonstrates, Chinese income growth was strongly pro-rich (in fact, the growth of China's upper deciles had the biggest impact on changes to the global distribution). Therefore, while millions left extreme poverty in China over these two decades, economic inequality rose significantly. The growth of China's rich also changed the country composition of the global distribution. Whereas the richest Chinese only made it to between the

<sup>11</sup> Milanović, *The Haves and the Have-Nots : A Brief and Idiosyncratic History of Global Inequality*.

65<sup>th</sup> and 70<sup>th</sup> percentiles in 1988, today China's top decile reaches as far as the 80<sup>th</sup> to 85<sup>th</sup> percentiles.<sup>12</sup>

Turning to other regions, income growth in Latin America has been marginally lower than the global average, whereas sub-Saharan Africa saw virtually no growth (not shown). In sum, China and Other Asia saw the largest growth. India and advanced economies (Mature) also experienced above average growth.

**Figure 3. Global growth incidence curve by region, 1988-2008**

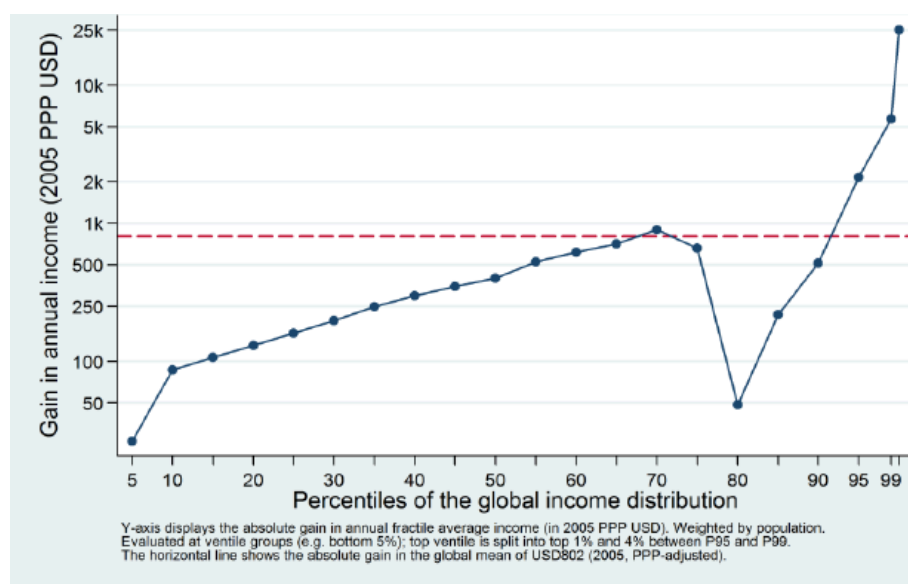


Source: Lakner and Milanović, 2013

The other bulge in the global income distribution is at the top 1 percent, which indicates that those already at the top also did quite well. It is important to recognize that growth in Figure 2 is measured in relative terms between the two dates for every percentile (1988 and 2008). Therefore, the *absolute* gains made by the top 1 percent are magnitudes larger than those below. For instance, the per capita income of the top 1 percent in 1988 was \$PPP 39,000, whereas the median income was \$PPP 600. As Figure 4 shows, the average per capita income of the top 1 percent increased by \$PPP 25,000 while the absolute gain at the global median was only \$PPP 400. Overall, 44 percent of the growth between 1988 and 2008 went to the top 5 percent of the world population.

<sup>12</sup> Milanović, "Global Income Distribution from the Fall of the Berlin Wall to the Great Recession."

**Figure 4. Absolute income gains, 2008-2013**



Source: Lakner and Milanović, 2013

## 1.4 ECONOMIC GROWTH AND INEQUALITY IN CHINA AND INDIA

After significant market reforms in the late 1970s, China's economy began to grow rapidly, producing real increases in average incomes in the world's most populous country. The effect was to offset income growth in rich countries, thereby curbing any increases to global inequality during the 1980s. The impact of rising average incomes in China during this period cannot be overstated. If not for China's rising incomes, global inequality would likely have become much worse. India, the world's second most populous country, would eventually contribute to China's curbing role with its own economic expansion and rising average wages.

In 1980, China and India accounted for approximately 2 percent of global Gross Domestic Product (GDP), with other developing countries making up about 16 percent. By 2005, China and India nearly quadrupled their share to 7 percent, while other developing countries declined to 15 percent.<sup>13</sup> The past three decades have seen China's trade volume increase eightfold, edging out

<sup>13</sup> Maurizio Bussolo, Rafael E. De Hoyos, Denis Medvedev, and Dominique Van der Mensbrugge "Global Growth and Distribution : Are China and India Reshaping the World?," World Bank, Development Economics Prospects Group, [http://www-wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2007/11/12/000158349\\_2007112111936/Rendered/PDF/wps4392.pdf](http://www-wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2007/11/12/000158349_2007112111936/Rendered/PDF/wps4392.pdf).

Germany in 2009 to become the world's largest exporter.<sup>14</sup> Wages in China's manufacturing sector have also increased dramatically over the past decade. Between 2002 and 2009, average manufacturing wages rose rapidly, from \$0.60 to \$1.74 an hour.<sup>15</sup> Calculated monthly, between 2005 and 2010, average wages increased from \$150 to \$350 per month, to \$4200 per year.<sup>16</sup> So long as growth remains steady, the wage gap between China and upper-middle-income economies should continue to close. China's 12th Five Year Plan predicts that if its economy grows at 7 percent per year, wages will expand equally fast and may double in the next decade, to \$700 per month. If China's currency continues to appreciate, its real wages could approach \$1000 per month, putting it on par with high-middle-income countries such as Turkey and Brazil. The same estimates predict that steady growth could even see real wages as high as \$2000 a month, leveling Chinese workers with counterparts in Taiwan and South Korea.<sup>17</sup>

Although less impressive than China, India's growth is also remarkable, averaging around 4 percent per year since 1980. Much of this growth is from its dynamic service sector, which grew annually at 1.4 percent between 1978 and 1993, and then to 3.9 percent between 1993 and 2004.<sup>18</sup> Between 1978 and 2000, the service sector increased its share of GDP from 38 to 49 percent.<sup>19</sup> Estimates suggest that incomes in India will catch up from one tenth of average incomes in rich countries to one sixth by 2030.<sup>20</sup>

Although poverty is still widespread, the years of strong growth have significantly affected extreme poverty levels in both countries. China saw the number of people living below \$1.25 per day decrease from 835 million to 157 million between 1981 and 2009.<sup>21</sup> India's gains in poverty reduction have been more recent. Between 2005 and 2012, the percentage of the rural population living on

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<sup>14</sup> Ardo Hansson, Louis Kuijs, Alvaro Vincelette Manoel, and Andronova Gallina "China : Global Crisis Avoided, Robust Economic Growth Sustained," The World Bank, <http://elibrary.worldbank.org/content/workingpaper/10.1596/1813-9450-5435>.

<sup>15</sup> U.S. Bureau of Labor Statistics, International Labor Comparisons. <http://www.bls.gov/fls/china.htm#manufacturing>

<sup>16</sup> Oxford Analytica, March 28, 2011. In 2010-2011, China's minimum wage grew by 25% in 30 municipalities.

<sup>17</sup> V. Chandra, J. Y. Lin, and Y. Wang "Leading Dragon Phenomenon: New Opportunities for Catch-up in Low-Income Countries," *Asian Development Review* 30, no. 1 (2013).

<sup>18</sup> Pranab K. Bardhan, "Poverty and Inequality in China and India: Elusive Link with Globalisation," *Economic and Political Weekly* 42, no. 38 (2007).

<sup>19</sup> Mohammad Amin and Aaditya Mattoo, "Human Capital and the Changing Structure of the Indian Economy," World Bank, Development Research Group, Trade Team, <http://dx.doi.org/10.1596/1813-9450-4576>.

<sup>20</sup> Bussolo, "Global Growth and Distribution : Are China and India Reshaping the World?"

<sup>21</sup> The World Bank, POVCAL.



less than \$1.25 per day decreased by 9.55 percent. Within cities, the number is down 7.23 percent.<sup>22</sup>

Inequality within China and India is a different story. Despite impressive gains in average incomes and poverty reduction, inequality has risen along with growth. In both countries, the benefits of growth have been unevenly distributed by geography, economic sector, and even within households.<sup>23</sup>

## 1.5 TRENDING INCOME INEQUALITY WITHIN CHINA AND INDIA

Before the reforms of the late 1970s, more than 80 percent of the Chinese population lived in absolute poverty. Since reform, its Gini index has risen from 29.1 percent in 1981 to 42.1 percent in 2009. Much of China's inequality is explained by differences in regional development and the contrast between urban and rural areas. Geographic inequalities also layer upon ethnic inequalities, as China's minority populations live primarily in the rural northeast, south-central, and southwest regions of the country (whereas China's urban centers lie along its eastern coastline). The majority Han population is considerably more urban than China's ethnic minorities. Urban household income per capita is 2.5 times that of rural counterparts. Unfortunately, ethnic minorities are more likely to be poor and have less access to education, health, and economic opportunities.<sup>24</sup>

India has historically been a highly unequal society. Its caste system inhibits social mobility, and landlessness is a primary determinant of poverty.<sup>25</sup> As in China, geography correlates significantly with inequality. A major issue confronting policymakers is how better to incorporate excluded Indian states into the development process.<sup>26</sup> Uneven economic growth has only made India's social stratification worse. Unlike China and Vietnam, India's export expansion has been in capital and skill-intensive industries. Therefore, the benefits of

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<sup>22</sup> The World Bank, "New Estimates Reveal Drop in Extreme Poverty 2005-2010," <http://go.worldbank.org/4K0EJIDFA0>.

<sup>23</sup> Sachin Chaudhuri and Martin Ravallion, "Partially Awakened Giants: Uneven Growth in China and India," *Dancing with giants : China, India, and the global economy* (2007).

<sup>24</sup> Emily Hannum, "Ethnic Disparities in China: Geography, Rurality, and Socioeconomic Welfare," in *Indigenous Peoples, Poverty, and Development*, ed. Gillette Hall and Harry Anthony Patrinos (New York: Cambridge University Press, 2012).

<sup>25</sup> K. Deininger, S. Jin, and H. K. Nagarajan "Land Reforms, Poverty Reduction, and Economic Growth: Evidence from India.(Report)," *Journal of Development Studies* 45, no. 4 (2009).

<sup>26</sup> Amitabh Kundu and K. Varghese, "Regional Inequality and 'Inclusive Growth' in India under Globalization: Identification of Lagging States for Strategic Intervention " in working papers series (Oxfam India, 2010 ).

growth have yet to reach the country's large number of unskilled workers.<sup>27</sup> Between 1994 and 2005, India's Gini increased from 31 to 33 percent.<sup>28</sup>

## 1.6 INEQUALITY WITHIN COUNTRIES

Although global inequality barely moved in recent decades, inequality within countries continued to rise. In middle-income countries (MICs), millions escaped extreme poverty but now hover just above the poverty threshold. In the advanced economies, income inequality came down over the second half of the 20<sup>th</sup> century. Yet, the trend is reversing - even among northern Europe's social democracies. The trend is not totalizing, however, and inequality has declined or is showing signs of decline in certain countries in recent years. Vietnam, South Korea, Mexico, and Brazil are among a small number of countries that have reduced, or are moving in the direction of lowering income inequality within their borders.

The figures below depict growing income inequality among some of the most populous middle-income countries in the world (Russia, a high-income country, is included, too).<sup>29</sup> The data present the changing distributions of national income accruing to the top 10 percent and the bottom 40 percent of earners. These are national snapshots and hide more nuanced facts concerning income inequality. For instance, a more fine-grained analysis would include trending income inequalities between rural and urban earners, or across social identifiers such as gender and ethnicity.

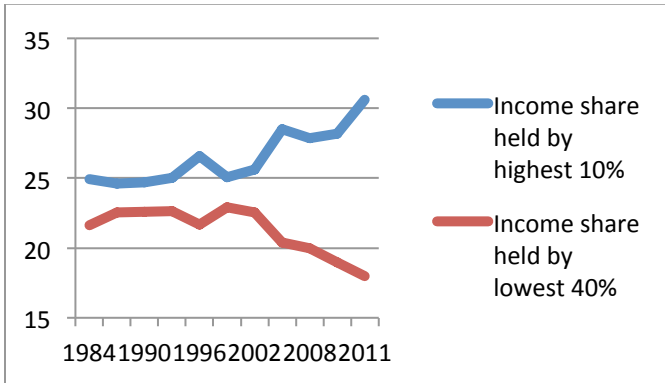
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<sup>27</sup> P. Bardhan, "Poverty and Inequality in China and India: Elusive Link with Globalisation," *ECONOMIC AND POLITICAL WEEKLY* 42, no. 38 (2007).

<sup>28</sup> World Bank Poverty and Inequality Database.

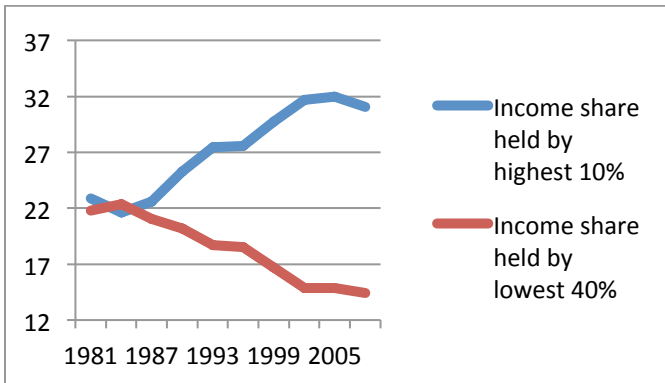
<sup>29</sup> Country classifications are based on the World Bank's Country and Lending Group categories. See <http://data.worldbank.org/about/country-classifications/country-and-lending-groups>. With the exception of the Russian Federation, all countries in the charts are classified as middle-income countries. The Russian Federation is classified as a high-income economy.

**Figure 5. Indonesia (lower-middle income country)**



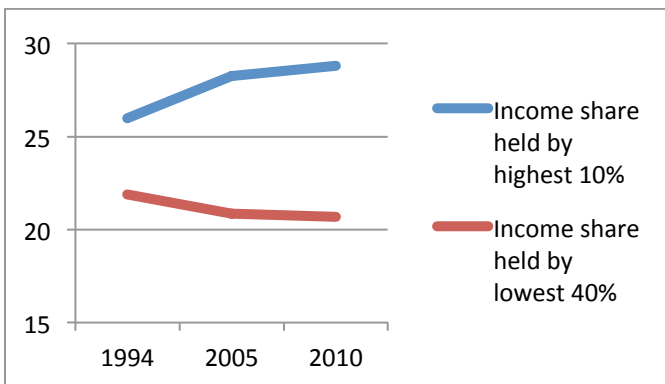
Source: Author's calculations using World Bank data (2013)

**Figure 6. China (Upper-middle income country)**



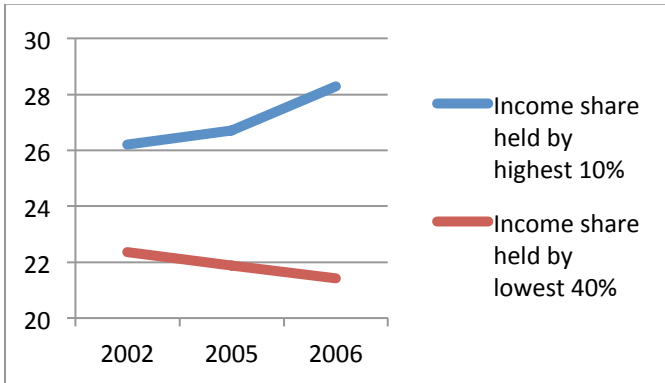
Source: author's calculations using World Bank data (2013)

**Figure 7. India (Lower-middle income country)**



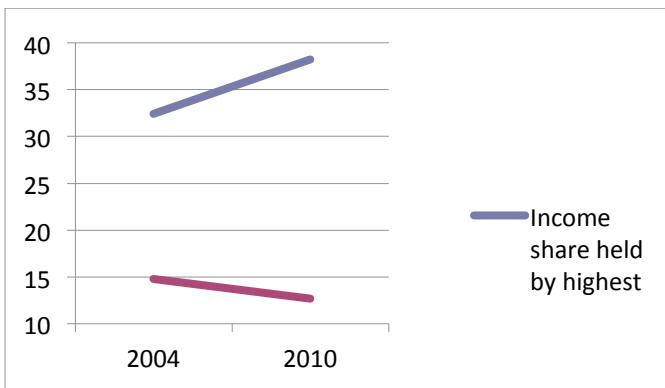
Source: author's calculations using World Bank data (2013)

**Figure 8. Pakistan (lower-middle-income country)**



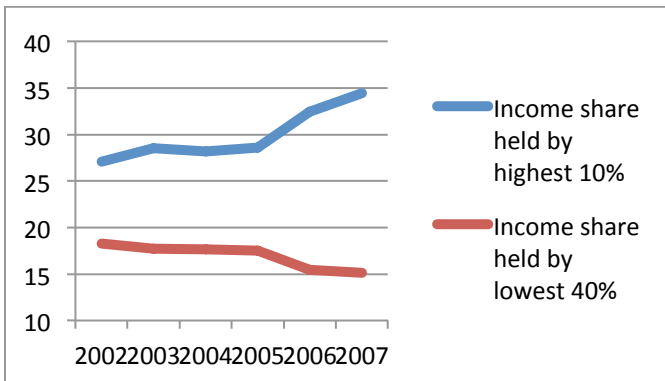
Source: author's calculations using World Bank data (2013)

**Figure 9. Nigeria (lower-middle income country)**



Source: author's calculations using World Bank data (2013)

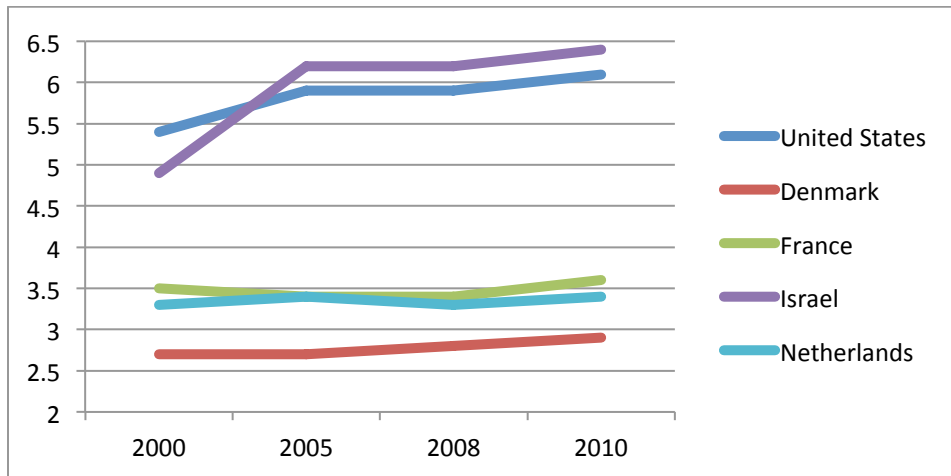
**Figure 10. Russian Federation (high-income country)**



Source: author's calculations using World Bank (2013)

Inequality is rising in many advanced economies, even where equality was strong during the 20th century. Figure 11 represents changing ratios of disposable income between the top 10 percent of earners and the bottom 10 percent in select Organisation for Economic Co-operation and Development (OECD) economies.

**Figure 11. P90/P10 Disposable income decile ratio, OECD**

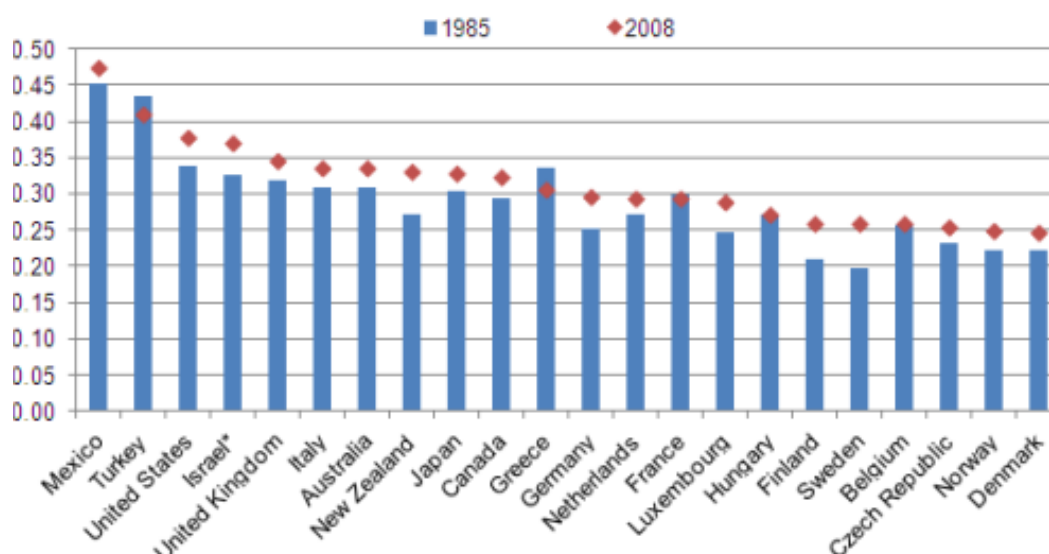


Source: author's calculations using OECD P90/P10 Disposable Income Decile Ratio Statistics

Gini coefficients also point to growing income inequality across the wider OECD. According to the OECD data, inequality increased in 19 out of 24 countries from the mid 1980s to late 2000s. for instance, inequality is higher today in Canada, Denmark, France, Germany, Norway, and Sweden. Across advanced economies, the average income of the richest 10 percent is nine times that of the poorest. In Italy, Japan, and Korea the gap between the richest and poorest 10 percent has grown to 10 to 1. In Israel, Turkey, and the U.S. it is 14 to 1. The gap is 25 to 1 in Mexico and Chile.<sup>30</sup> Figure 12 compares the Gini of select OECD countries between 1985 and 2008.

<sup>30</sup> OECD, "Divided We Stand: Why Inequality Keeps Rising," (2011).

**Figure 12. Income inequality changes across OECD, mid 1980s and late 2000s**



Source: OECD Statistics, *Divided We Stand*

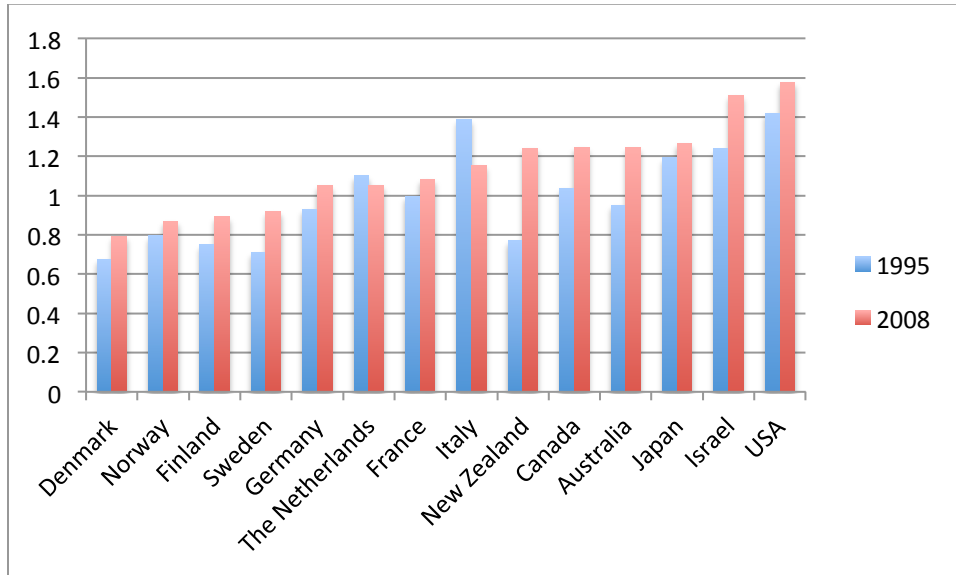
<http://www.oecd.org/newsroom/societygovernmentsmusttacklerecordgapbetweenrichandpoorsaysoecd.htm>

Figure 13 divides the mean disposable income of the top earning decile against the bottom 4 deciles to produce what is called a *Palma ratio* for select OECD countries. Comparing 1995 and 2008 data points, income inequality between the top 10 percent and bottom 40 percent has worsened in all 14 countries measured, with the exception of Italy and the Netherlands. However, post-2008 data suggest that despite shifting downward, inequality is rising again in both countries.<sup>31</sup> A Palma ratio of 1 indicates that the top 10 percent captures the same amount of national income as the bottom 40 percent. This ratio has been argued as an ideal equity threshold.<sup>32</sup> As figure 13 shows, Denmark, Norway, Sweden, and Finland remain under this threshold, whereas Germany and France are only slightly above. Although these countries remain either under or just above, inequality is trending higher across all of these historically equal countries.

<sup>31</sup> See Loris Vergolini, "Income Inequalities in Italy: Trend Over Time." Presentation, Inequality and Crisis in Europe Paris 8, Saint-Denis, April 6, 2012, [http://inequalitywatch.eu/IMG/pdf/Inequalities\\_Italy.pdf](http://inequalitywatch.eu/IMG/pdf/Inequalities_Italy.pdf) and <http://www.oecd.org/els/soc/49499779.pdf>

<sup>32</sup> Michael W. Doyle and Joseph E. Stiglitz, "Eliminating Extreme Inequality: A Sustainable Development Goal, 2015–2030," <http://www.ethicsandinternationalaffairs.org/2014/eliminating-extreme-inequality-a-sustainable-development-goal-2015-2030/>.

**Figure 13. Palma—Mean disposable income, working age population**



Source: author's calculations using OECD Statistics

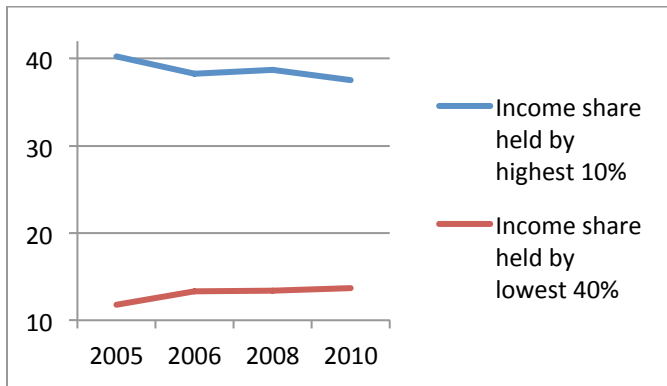
Some countries have seen inequality decline. The rate and depth of decline, however, vary significantly, and for some it is too soon to suggest a real trend. For instance, Brazil, one of the most unequal countries in the world, has seen income inequality contract since the early 2000s. However, it is unclear whether inequality will continue to shrink as its economy slows. The following figures track the contraction of income between the top 10 percent and the bottom 40 percent in Brazil, Mexico, the Philippines, and Vietnam.

**Figure 14. Brazil (upper-middle income country)**



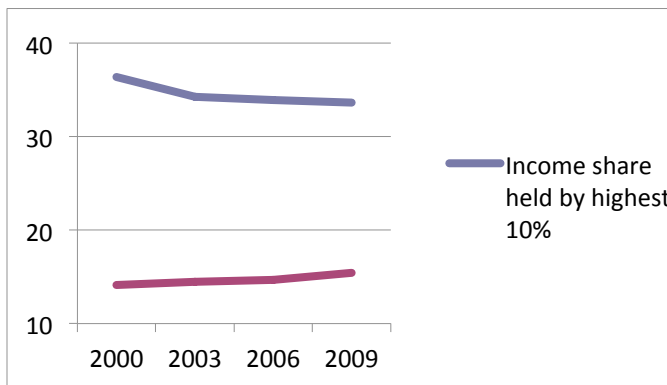
Source: author's calculations using World Bank data

**Figure 15. Mexico (upper-middle income country)**



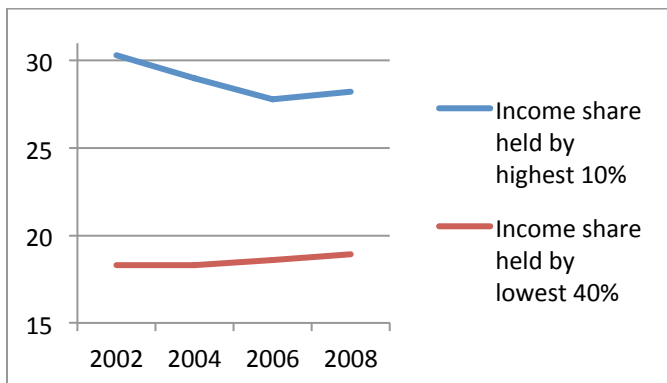
Source: author's calculations using World Bank data

**Figure 16. Philippines (lower-middle income country)**



Source: author's calculations using World Bank data

**Figure 17. Vietnam (lower-middle income country)**



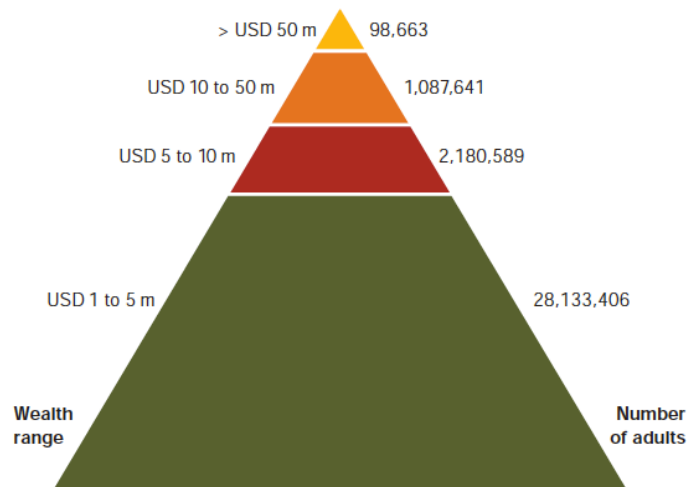
Source: author's calculations using World Bank data



## 1.7 TOP INCOMES

Globally, income is highly concentrated at the very top. In contrast to Figure 1, which offers snapshots of the entire global income distribution, Figure 18 magnifies the very apex.

**Figure 18. The apex of the global wealth pyramid**



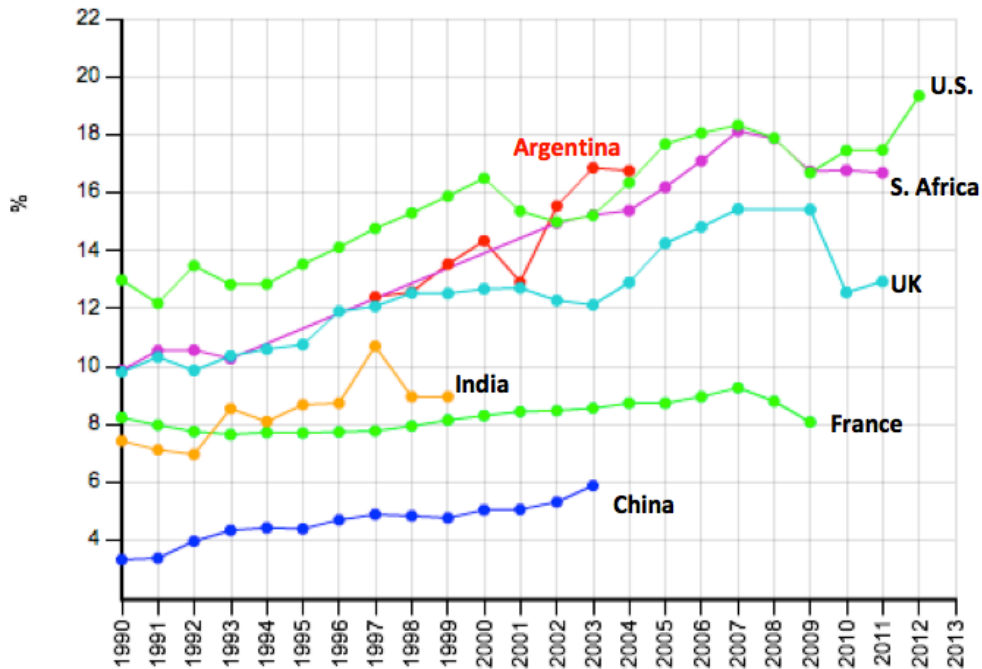
Source: *Forbes* Global Wealth Report (2013)

### Growth of top incomes by country

In advanced economies, we now know a lot about the shares of national income held by the top 1 percent and fewer. In contrast, we know very little about top incomes in developing countries. As discussed earlier, it is difficult to assess the shares of income and wealth among the rich through surveys. To get around this, the economists associated with the World Top Incomes database began to examine the government tax records of the richest percentiles in advanced economies.<sup>33</sup> Similar exercises are underway in developing countries, but this is a more difficult task. Figure 19 demonstrates the trend of concentrating incomes among the top one percent in seven countries. As shown, good data exists for the US, the UK, and France. The data are less complete, however, for Argentina, South Africa, India, and China.

<sup>33</sup> Facundo Alvaredo, Anthony B. Atkinson, Thomas Piketty, and Emmanuel Saez, *The World Top Incomes Database*, <http://topincomes.g-mond.parisschoolofeconomics.eu/>, August 21, 2014.

**Figure 19. Top 1 percent share of national income**



Source: Facundo, Atkinson, Piketty, and Saez, World Top Incomes Database

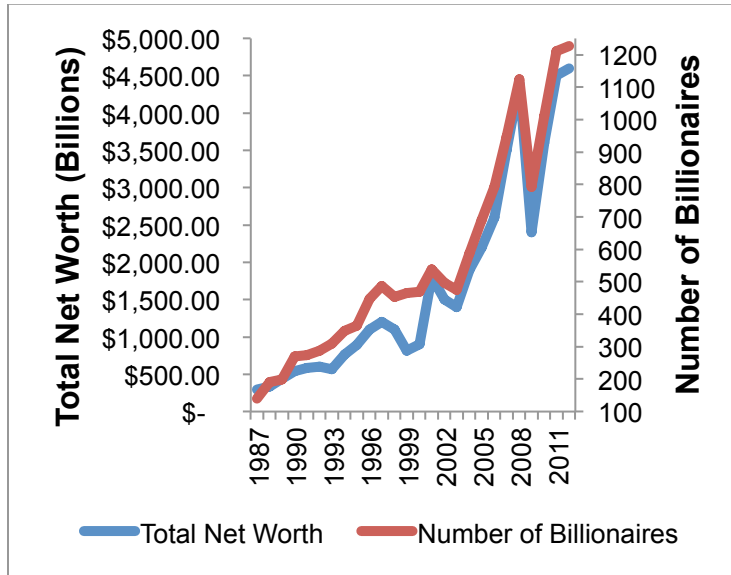
### Growth of billionaires

Since *Forbes* began tracking in 1987, the number of billionaires has dramatically increased from 140 to more than 1,600. As Oxfam calculated in January 2014, the richest 85 people possess the same amount of wealth as the bottom half of humanity.<sup>34</sup> *Forbes* later recalculated our figure to account for changes in billionaire wealth. Their revised estimate is that only 66 people hold the same amount of wealth as the poorest half.<sup>35</sup> Figure 20 charts both changes to the number of individual billionaires and the amount of wealth held among this cohort. Clearly, an enormous amount of wealth continues to accrue to a very few number of people. To think about it differently, trillions are accruing annually to a list of individuals that grows by a few dozen—if that—each year.

<sup>34</sup> Ricardo and V. Nicholas Galasso Fuentes-Nieva, "Working for the Few: Political Capture and Economic Inequality," in Oxfam Briefing Paper 178 (Oxfam International, 2014).

<sup>35</sup> Kasia Moreno. "The 67 People As Wealthy As The World's Poorest 3.5 Billion," *Forbes*, 25 March 2014, <http://www.forbes.com/sites/forbesinsights/2014/03/25/the-67-people-as-wealthy-as-the-worlds-poorest-3-5-billion/>

**Figure 20. Growth of billionaires and billionaire wealth**



Source: *Forbes*

## 1.8 SUMMARY

This section presented a short history and current picture of income inequality among countries and individuals. From this data, we can ascertain that inequality between the economies of Western Europe and other regions grew rapidly and significantly from the early 1800s until the middle of the 20th century. Inter-country inequality remained roughly stable until the emergence of globalization in the early 1980s. At this point, growth took off in advanced economies and average incomes began rising in the West. Inequality between countries did not increase, however. The start of market liberalization in China meant the average income of the world's most populous country rose, too. The effect curbed any worsening of inter-country inequality. Conversely, inequality within countries shifted in the opposite direction. In countries at all levels of development, certain population segments gained greatly while others gained less, or not at all.

Unfortunately, it continues to be difficult to measure income inequality. For this reason, the data reported by large international financial institutions (IFIs) and country governments should be taken as best approximations of income distributions. Many countries, especially in the developing world, have administered income surveys for less than 30 years. This makes it difficult to track changes accurately in the distribution over sufficient periods of time. Further, for many countries it makes more sense to measure consumption than income, as poor people often live outside money economies. In addition, a lack of standardization among differing country surveys complicates international

comparisons. The rich are also harder to reach and less inclined to reveal the extent of their income and wealth. This leads many to assume that current inequality estimates are conservative and that inequality is worse than the data suggest.

For the US, the most significant change has been within the top decile. The income differential between the apex of the distribution and the 90<sup>th</sup> percentile is greater than the difference between the 90<sup>th</sup> percentile and everyone below. Saez calculates that in 2010, the average income for families in the .01 percent was \$23,846,950. The average family income for those between .1 and .01 percent drops significantly, to \$2,802,020.00, whereas the average for the 1 percent was \$1,019,089.<sup>36</sup> The average family income of those at the 90<sup>th</sup> percentile was \$246,934 whereas the bottom 90% averaged \$29,840.<sup>37</sup> From 1976 until 2011, the total share of income accruing to the top 1 percent more than doubled, from 9 percent to more than 20 percent.<sup>38</sup> Other upper percentiles in the US also made gains, though none as significant as the top 1 percent. For instance, the 95-99 percent only saw a 3 percent gain during the same period. Between the boom years of 2002 and 2006, three-quarters of all economic gains accrued to the top 1 percent of the population. In the post-crisis recovery, the top 1 percent captured 93 percent of the gains.<sup>39</sup>

Now that we have a sense of how global inequality has changed, and what it looks like today, the next section explores the drivers of economic inequality.

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<sup>36</sup> Emmanuel Saez, "Striking It Richer: The Evolution of Top Incomes in the United States (Updated with 2012 Preliminary Estimates)," (2013).

<sup>37</sup> See Chrystia Freeland, *Plutocrats : The Rise of the New Global Super-Rich and the Fall of Everyone Else* (New York: Penguin Press, 2012).

<sup>38</sup> Thomas Piketty and Emmanuel Saez, "Income Inequality in the United States, 1913-1998," *The Quarterly Journal of Economics* 118, no. 1 (2003).

<sup>39</sup> Saez, "Striking It Richer: The Evolution of Top Incomes in the United States (Updated with 2012 Preliminary Estimates)."

# THE DRIVERS OF ECONOMIC INEQUALITY

## 2.1 INTRODUCTION

This section offers an account of the drivers of economic inequality. To help with clarity, the drivers are disaggregated into different buckets. Admittedly, there are drawbacks to this approach. Primarily, although considering these issues separately helps categorize them, it also obscures important nuances. For instance, sources of inequality do not operate in isolation from one another. Instead, they should be considered as highly interdependent, overlapping, and reinforcing. Economic inequality is not the result of simple cause and effect, rather it is the product of a complex web of phenomena involving the interplay of social, geographic, economic, historical, and political forces.

## 2.2. HORIZONTAL INEQUALITIES

In many contexts, economic inequality is a product, and reflection, of horizontal inequalities. The term “horizontal inequalities” (HI) refer to inequality among salient groups, which may be culturally defined or constructed based on an array of social identity features. This is distinct from conceptualizing inequality as a rank among individuals or households, known as vertical inequalities (VI). For instance, the language of the Millennium Development Goals (MDGs) focuses on the sheer number of individuals living in poverty. Some critique this approach because it does not address the group dimension of poverty. It is often identifiable groups rather than discrete individuals who are disproportionately excluded from societies’ resources.<sup>40</sup>

How are such groups defined? People can be grouped in many ways. In fact, most people hold a multiplicity of identities and thus are members of many groups simultaneously. Classification can be based on self-identification or can result from legal categorization by a political authority (such as citizenship).<sup>41</sup> Often, when referring to HI, we are describing groups that share a cultural identity. Of course, the ties that bind groups together may also rest on ethnicity

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<sup>40</sup> Frances Stewart, "Horizontal Inequalities: A Neglected Dimension of Development," in QEH Working Paper Series–QEHWPS81 (Queen Elizabeth House, University of Oxford, 2002).

<sup>41</sup> Frances Stewart, Graham Brown, and Luca Mancini "Why Horizontal Inequalities Matter: Some Implications for Measurement " in CRISE Working Paper No. 19 (Queen Elizabeth House, University of Oxford, 2005).

(such as a common history or language), religion, gender, geography, age, and even class.

Rigid boundaries are paramount for classifying groups. Since HI tend to persist over not only many years, but also generations, we must ensure we are focused on groups whereby identity is easily knowable and difficult to transcend.

Therefore, the groups we are interested in are those where membership is recognizable to both those inside and outside the group. This is not to suggest that moving from one group to another is impossible, only that it is difficult. For instance, it is challenging to transcend gender and citizenship.

HI describe how groups are structurally differentiated from each other based on status and access to the range of a society's resources. Figure 21 provides a taxonomy of the economic, social, political, and cultural dimensions of HI groups' experience.<sup>42</sup>

### Figure 21. Typology of horizontal inequalities

- **Economic HIs** include inequalities in access to and ownership of assets—financial, human, natural-resource-based, and social, and also inequalities in income levels and employment opportunities, which depend on such assets and the general conditions of the economy.
- **Social HIs** include inequalities in access to a range of services, such as education, healthcare, and housing, as well as to the benefits of educational and healthcare outcomes.
- **Political HIs** include inequalities in the distribution of political opportunities and power among groups, including control over the army, the cabinet, local and regional governments, parliamentary assemblies, the police, and the presidency. They also encompass inequalities in people's capacity to participate politically and express their needs.
- **Cultural status HIs** include disparities in the recognition and standing of different groups' language, religion, customs, norms, and practices.

Source: Stewart (2010)

HI perpetuate through explicit or structural differential treatment among groups. For instance, black Americans and women were long excluded from access to economic opportunities and political decision-making (among other arenas). These exclusions, exacerbated by socio-biological preconceptions concerning

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<sup>42</sup> Taken from Frances Stewart, "World Development Report 2011 Background Paper," (Washington, D.C.: World Bank, 2010).

race and gender, still perpetuate HI between blacks, women, and white men, despite the political emancipation of the former two.

A paramount concern of HI is their propensity to evolve into civil unrest and violent conflict. To be clear, most multi-ethnic and multi-religious societies are peaceful.<sup>43</sup> However, societies plagued by economic and political inequalities along group lines may instigate deep resentments leading to violence. This is a serious ramification facing societies with deep HI.

## 2.3 GEOGRAPHY

Geography is arguably the most important determinate of inequality. In terms of the global distribution among individuals, the country to which you are born, or migrate, has more influence over your income and wealth status than any amount of hard work, skills, or effort. Indeed, in many ways the lottery of life boils down to where, and to whom, you are born.

Geography plays an important role in driving inequality within countries, too. For instance, country regions may be characterized by differences in productivity levels, allocation of government resources, and sheer distances to markets. Government favoritism of certain regions over others can deepen inequalities across groups, especially through unequal access to social services, educational opportunities, and government revenues. Furthermore, differences in natural resource endowments between regions can worsen inequalities.

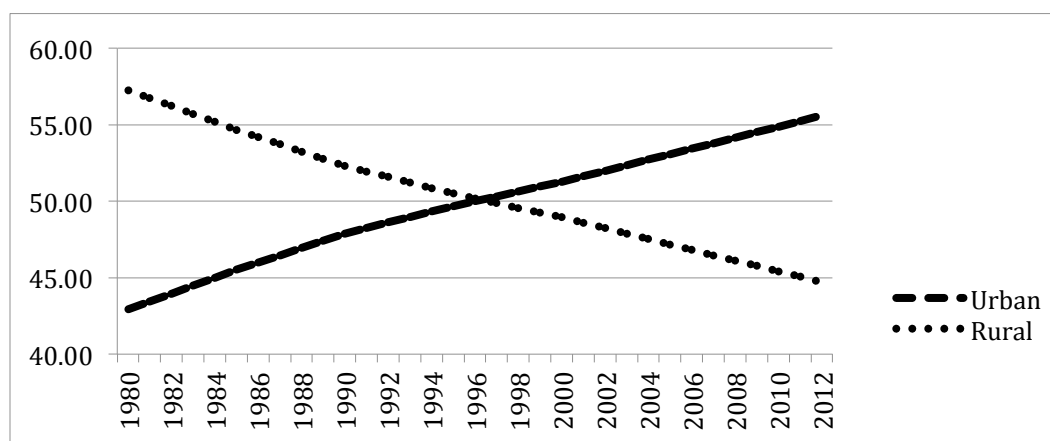
The impact of geography on within country inequality is most evident between urban and rural regions. A recent study of 65 countries (including lower middle income, middle income, and some of the poorest countries in the world) suggests urban-rural inequality accounts for 40 percent of mean country inequality, and much of the variation in inequality across countries. Therefore, developing countries with large levels of inequality most likely have significant urban-rural disparities.<sup>44</sup> Figure 22 demonstrates the fundamental shift in population between rural and urban places in 100 Middle Income Countries (MICs).

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<sup>43</sup> James D. Fearon and David D. Laitin, "Ethnicity, Insurgency, and Civil War," *American Political Science Review* 97, no. 1 (2003).

<sup>44</sup> Alwyn Young, "Inequality, the Urban-Rural Gap, and Migration.(Report)," *Quarterly Journal of Economics* 128, no. 4 (2013).

**Figure 22. Urban and rural population (percent of total population); Average of 100 lower and upper-middle-income countries**



Source: author's calculation from World Bank data

Natural resource endowments between regions are an important way in which geography can worsen within country inequalities. For instance, mining activity in Peru increased nearly twentyfold over the past two decades. Between 1993 and 2000, the value of mining exports more than doubled to \$3.2 billion; and then rose sevenfold between 2000 and 2010 to \$21.7 billion. Mining now makes up 14 percent of Peru's GDP. This dramatic expansion increased inequality between producing and non-producing districts (the lowest administrative level in Peru). Producing districts now enjoy better standards of living and larger household consumption than otherwise similar districts.<sup>45</sup> Conversely, extractive revenues may bypass the producing regions and become invested in non-producing ones, thereby worsening inequality in the opposite way. This tends to occur in countries with centralized political systems, as central governments distribute revenues on the basis of national government priorities or biases, not on where the revenues originate. For instance, the capital region in Niger appropriates resource revenues, yet invests little in the producing regions.<sup>46</sup>

The combination of regions differentiated by natural resource and ethnicity can be a recipe for political unrest and violence.<sup>47</sup> Ethnically divided societies with

<sup>45</sup> Norman Loayza, Jamele Rigolini, and Alfredo Mier y Teran, *Poverty, Inequality, and the Local Natural Resource Curse* (Washington, D.C.: The World Bank, 2013).

<sup>46</sup> Michael Ross, Paivi Lujala, and Siri Aas Rustad, "Horizontal Inequality, Decentralizing the Distribution of Natural Resource Revenues, and Peace" in *High-Value Natural Resources and Post-Conflict Peacebuilding*, ed. Paivi Lujala and Siri Aas Rustad (New York, NY: Earthscan, 2012).

<sup>47</sup> Thorvaldur Gylfason and Gylfi Zoega, *Inequality and Economic Growth: Do Natural Resources Matter?* (Munich: CESifo, 2002). see also Tullio Bucciellato and Michele Alessandrini, "Natural Resources: A Blessing or a Curse? The Role of Inequality," (Centre for Financial & Management Studies, 2009).



extractive industries experience higher levels of inequality and conflict than homogenous societies.<sup>48</sup> Distinct groups may fight one another or actively engage in rent seeking to win control over revenues, in turn exacerbating HI.<sup>49</sup> The presence of natural resource wealth can also push regions to seek independence from the rest of the country. For instance, Ross, Lujala, and Rustad cite 10 instances of secessionist movements between 1960 and 2005 by regions with significant oil, gas, and mineral resources.<sup>50</sup>

## 2.4 TECHNOLOGY

Rising inequality can be a consequence of technological change, as technological shifts favoring skilled over unskilled workers sometimes create wage inequalities between the two groups. Research on the link between technological changes and inequality can be traced at least to the economist Simon Kuznets, famous for the Kuznets curve. However, this stream of literature expanded in the 1990s due to new wage and inequality data from the 1970s and 1980s in advanced economies. Its core argument is that technological change, especially the introduction of the computer, caused wage inequality to rise. New technologies increased the productivity and demand for skilled workers, thereby increasing their wages relative to unskilled workers’.

The technology hypothesis is useful for understanding wage inequality in developing countries too, as technology transfers have created wage differentials between skilled and unskilled workers. This effect is closely intertwined with financial globalization, which is discussed in the next section, especially since foreign direct investment (FDI) spurs technological diffusion and adaptation.<sup>51</sup> Independently, technology engenders its own skills bias that returns higher wages to skilled workers. FDI magnifies this disequalizing process by targeting investment in higher skills and higher technologically dependent sectors. One recent study calculates an average annual increase of the Gini coefficient at .42 percent between 1981 and 2003 for 51 countries. Of this, technology made a

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<sup>48</sup> See Benedikt Goderis and Samuel W. Malone, "Natural Resource Booms and Inequality: Theory and Evidence," *Scandinavian Journal of Economics* 113, no. 2 (2011); Ruikang Marcus Fum and Roland Hodler, "Natural Resources and Income Inequality: The Role of Ethnic Divisions," *Economics Letters* 107, no. 3 (2010).

<sup>49</sup> Alberto Alesina and Edward L. Glaeser, *Fighting Poverty in the Us and Europe : A World of Difference* (Oxford: Oxford University Press, 2004).

<sup>50</sup> Ross, "Horizontal Inequality, Decentralizing the Distribution of Natural Resource Revenues, and Peace ". Countries include Angola, Burma, Democratic Republic of the Congo, Indonesia (two instances), Morocco, Nigeria, Papua New Guinea, Sudan, and Yemen.

<sup>51</sup> Daron Acemoglu, "Patterns of Skill Premia," *ROES Review of Economic Studies* 70, no. 2 (2003). On technology diffusion, see *Global Economic Prospects 2008: Technology Diffusion in the Developing World*. World Bank, 2008.

significant contribution of .74 percent annually.<sup>52</sup> Clearly, technological change is a significant driver of inequality.

Technology's inequality-increasing effects may compound HI and the inequality impact of geography. For instance, industries requiring higher skills tend to emerge in urban rather than rural areas. Similarly, the rising wage gap between skilled and unskilled workers often translates into a tension between manufacturing and agricultural jobs, which tend to follow the geographic divide. Becoming a higher-skilled worker may also require access to skills training or education. These opportunities are often restricted by factors involving geography and group identity (especially gender).

In advanced economies, technological change and globalization are often presented as the most fundamental drivers of inequality in recent decades. However, this simplified story faces empirical skepticism. First, if technological change drives inequality, then the data should reflect a smooth increase as technology slowly changed labor demand for higher skilled workers. Instead, inequality ballooned in the 1980s. Second, even though there was widespread adoption of new technologies across high-income countries, wage inequality worsened much more in the U.S., and to a lesser extent in the UK, than in other advanced economies.

A revised hypothesis emerged to meet these critiques. This hypothesis is based on a categorization of jobs as being either routine, non-routine manual, or non-routine cognitive. According to this approach, computers are good at routine jobs. Therefore, high-wage, routine manufacturing jobs were eventually replaced by new technologies. This hollowed out the well-paid, routine work occupied by many in the middle classes of advanced economies. Computers are not good, however, at non-routine manual and non-routine cognitive jobs. Therefore, in the wake of new technologies in the workforce, what are left are high-wage, high-skill non-routine and low-wage, low-skill non-routine jobs. According to the argument, computers were used in the 1980s to enhance routine jobs, not replace them. In the 1990s, new technologies increasingly replaced routine work, pushing forward rising wage polarization since that time. Still, despite these seemingly persuasive explanations, this approach fails to capture the experience of advanced economies other than the US, and to some extent the UK.

Without a doubt, technology is an important component of inequality. However, in a vacuum it offers little explanatory power. It excludes salient underlining and interacting causes, such as HI, local histories, other forms of social exclusion, and government intervention to address displacements by new technologies.

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<sup>52</sup> F. Jaumotte, S. Lall, and C. Papageorgiou, "Rising Income Inequality: Technology, or Trade and Financial Globalization?," *IMF Economic Review* 61, no. 2 (2013).

## 2.5 FINANCIAL AND TRADE GLOBALIZATION

The literature on the effects of economic globalization on poverty and inequality is immense and contested. In fact, the literature was so dense *ten years ago* two economists quipped that instead of reviewing the literature, it was more appropriate to conduct a review of the literature reviews.<sup>53</sup>

This section will consider financial liberalization and trade liberalization separately.<sup>54</sup> Both parts of this section will focus on new evidence from a large study conducted by the International Monetary Fund (IMF). The study examines 51 countries (21 advanced and 30 developing) between 1981 and 2003 and finds that financial and trade globalization affected income distributions in opposite directions.<sup>55</sup> Financial globalization, especially Foreign Direct Investment (FDI), mainly benefited the richest quintile, thus driving inequality up. In contrast, trade globalization is associated with rising incomes in the bottom four quintiles compared to the richest, thus reducing inequality.<sup>56</sup> Because of the immensity and inconclusiveness of the literature, the IMF's findings support some claims while challenging others. For instance, though there seems to be greater consensus that financial globalization contributes to inequality, researchers highlight important caveats to this claim.<sup>57</sup> The first section will review results concerning financial globalization and the second will review trade globalization.

The IMF study conducted by Jaumotte et al. presents strong evidence that financial globalization contributed to within inequality. According to their estimation model, a one standard deviation increase of inward FDI from its sample mean raises inequality by 2.9 percent.<sup>58</sup> Likewise, in a separate, larger study of 149 countries researchers found that between 1970 and 2010 capital

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<sup>53</sup> Pinelopi Goldberg and Nina Pavcnik, "Trade, Inequality, and Poverty: What Do We Know?," *Brookings Trade Forum* 2004, no. 1 (2004).

<sup>54</sup> In this section, the terms 'globalization' and 'liberalization' are used interchangeably to signify the processes of economic integration in the capital flows and trade areas.

<sup>55</sup> Jaumotte, "Rising Income Inequality: Technology, or Trade and Financial Globalization?." Twenty of the countries are advanced, and 31 are developing countries. High income are Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Ireland, Israel, Italy, Japan, Korea, Netherlands, Norway, Singapore, Spain, Sweden, the United Kingdom, and the United States. Developing economies: Upper middle include Argentina, Brazil, Chile, Costa Rica, Malaysia, Mexico, Turkey, Uruguay, Venezuela, and Panama; lower middle include Bolivia, Ecuador, Egypt, El Salvador, Guatemala, Honduras, Indonesia, Iran, Paraguay, Peru, Philippines, Sri Lanka, and Thailand. Low income include Ghana, India, Kenya, Pakistan, Uganda, Bangladesh, and Zambia. The World Bank classification uses the following income thresholds: low income is \$875 or less; lower-middle income, \$876–\$3,465; upper-middle income, \$3,466–\$10,725; and high income, \$10,726 or more. Indicates countries for which the Gini coefficient is constructed using consumption survey data.

<sup>56</sup> See also D. Asteriou, S. Dimelis, and A. Moudatsou "Globalization and Income Inequality: A Panel Data Econometric Approach for the Eu27 Countries," *Economic modelling*. 36 (2014)..

<sup>57</sup> Silke Bumann and Robert Lensink, "Financial Liberalization and Income Inequality: Channels and Cross-Country Evidence," (DFID/ESRC 2013).

<sup>58</sup> Jaumotte, "Rising Income Inequality: Technology, or Trade and Financial Globalization?."

account liberalization typically increased the Gini coefficient by .8 percent in the short term (one year after liberalization) and by approximately .7 to 2.5 percent five years after such reforms.<sup>59</sup> Therefore, financial globalization, especially FDI, seems to have an unequalizing impact. The inequality producing effect of FDI occurs because investment tends to be directed toward sectors requiring higher skills, thus inducing a skills-bias wage differential.<sup>60</sup> This unequalizing impact occurs in both developed and developing countries. In both groups, FDI tends to favor workers who already possess higher skills and education, thereby raising the demand for, and wages of, such workers.

In addition to increasing inequality in recipient developing countries, outward FDI from developed countries seems to increase inequality at home, too. This is because it reduces employment in what may be considered low-skilled sectors in an advanced economy and transfers them to what may be considered high-skilled sectors in developing economies.<sup>61</sup> Financial globalization has also been shown to increase inequality by widening the profit-wage ratio, increasing returns to capital, and reducing the labor share of income. Both Jayadev and Epstein and Furceri et al. find capital liberalization to have a statistical and long-lasting impact on the labor share of income. The latter estimate that liberalization reforms decreased the labor share of income by .7 percent in both the one-year and five-year terms.

Financial liberalization especially increased the flow of FDI to MICs. These flows enhanced investment in secondary and tertiary sectors of the economy, boosting wages of those either already possessing skills or able to acquire them.<sup>62</sup> As we have mentioned, the growth of wages in these sectors also drove rural-to-urban migration, shifting workers from low-paying agricultural jobs to higher-paying jobs in the manufacturing and service sectors. As figure 23 below shows, FDI to MICs increased substantially, especially after 1990. Although the economic crisis decreased the amount of global FDI in recent years, flows to MICs remain resilient. In fact, if we widen the analysis from MICs to all developing countries,

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<sup>59</sup> Laurence M. Ball, Davide Furceri, Daniel Leigh, and Prakash Loungani "The Distributional Effects of Fiscal Austerity," United Nations, Dep. of Economic and Social Affairs.

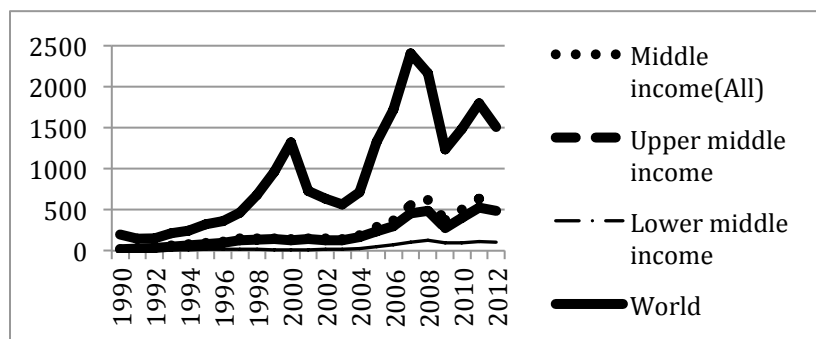
<sup>60</sup> Eli Berman, John Bound, and Zvi Griliches "Changes in the Demand for Skilled Labor within U.S. Manufacturing: Evidence from the Annual Survey of Manufacturers," *The Quarterly Journal of Economics* 109, no. 2 (1994).

<sup>61</sup> Michael Ian Cragg and Mario Epelbaum, "Why Has Wage Dispersion Grown in Mexico? Is It the Incidence of Reforms or the Growing Demand for Skills?," *Journal of Development Economics* 51, no. 1 (1996).

<sup>62</sup> Whereas the primary sector concerns the extraction or harvesting of products from the earth, the secondary sector concerns the manufacturing and processing of finished goods. These occupations include metalwork, automobile and textile production, construction, engineering, and building. The tertiary sector includes the service industries, including retail and wholesale, transportation and distribution, entertainment, banking, restaurants, insurance, tourism, and healthcare.

FDI flows reached more than \$700 billion in 2012, capturing a record share of 52 percent of all FDI inflows.<sup>63</sup>

**Figure 23. FDI inflows, global and by middle-income countries (in billions of dollars)**



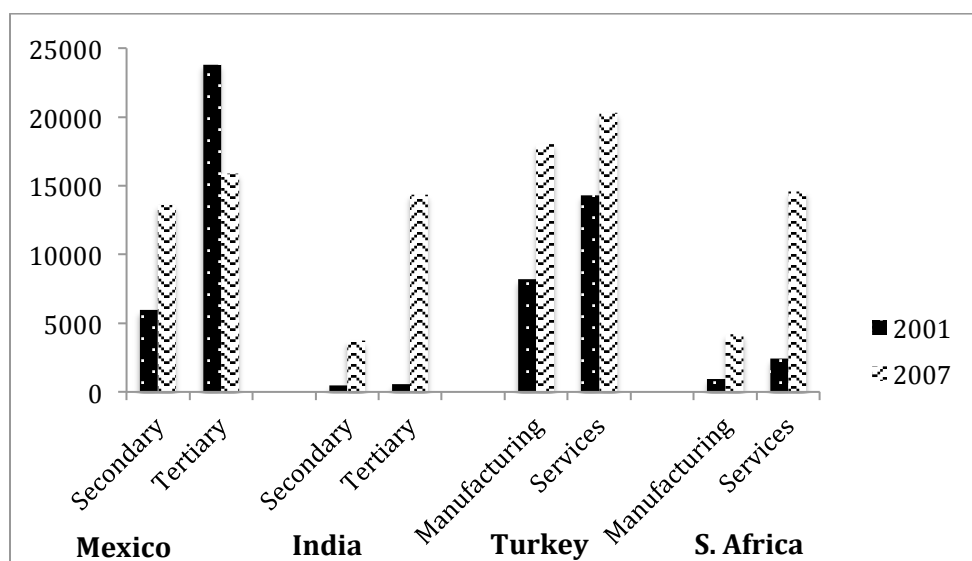
Source: author's calculation from World Bank data

Within MICs, the flow of FDI to secondary and tertiary sectors, where wages are higher than primary sector jobs in extraction and agriculture, rose substantially. Figure 24 below illustrates this growth in four of the eight BRICSAMIT countries.<sup>64</sup> The only decrease among the group was the tertiary sector in Mexico.

<sup>63</sup> "Global Outlook: News - Unctad Paints Bleak Fdi Picture in 2013 World Investment Report," Foreign Direct Investment (2013).

<sup>64</sup> Brazil, Russia, India, China, South Africa, Mexico, Indonesia, and Turkey. The US dollar figures for South Africa were converted from South African rand on February 19, 2014. Source: author's calculation based on UNCTAD Investment Country Profiles.

**Figure 24. FDI flows to secondary and tertiary sectors (in millions of dollars)**



Source: author's calculations from World Bank data

In terms of the effect of trade liberalization on inequality, the literature remains highly contested. That wages should rise from liberalization among low skill workers in labor abundant countries, and fall among low skill workers in high skill countries is a function of the Heckscher-Ohlin model. However, years of empirical evidence suggest to many that wage inequality became worse in *both* developing and developed countries after liberalization.<sup>65</sup>

In contrast, the new IMF data suggests trade liberalization seems to reduce inequality in both developed and developing countries.<sup>66</sup> The IMF study suggests that in developing countries trade reducing inequality because of its impact on agricultural markets. Liberalization of agricultural trade raises the incomes of farm-related workers, of whom make up a significant portion of the labor force. In

<sup>65</sup> Donald J. Robbins, "Hos Facts: Facts Win; Evidence on Trade and Wages in the Developing World," in *Development Discussion Paper No. 557*, ed. H.I.I.D. (1996); Adrian Wood, "North-South Trade and Female Labour in Manufacturing: An Asymmetry," *Journal of Development Studies* 27, no. 2 (1991); Jere R. Behrman, Nancy Birdsall, and Miguel Szekely "Economic Policy Changes and Wage Differentials in Latin America," *Economic Development & Cultural Change* 56, no. 1 (2007); Epelbaum, "Why Has Wage Dispersion Grown in Mexico? Is It the Incidence of Reforms or the Growing Demand for Skills?"; Ana Revenga, "Employment and Wage Effects of Trade Liberalization: The Case of Mexican Manufacturing," *Journal of labor economics*. 15, no. 3 (1997); G. H. Hanson and A. Harrison, "Trade Liberalization and Wage Inequality in Mexico," *Industrial and Labor Relations Review* 52, no. 2 (1999); Janet Currie and Ann Harrison, "Sharing the Costs: The Impact of Trade Reform on Capital and Labor in Morocco," *jlaborconomics Journal of Labor Economics* 15, no. S3 (1997); Pinelopi Goldberg and Nina Pavcnik, "Short-Term Consequences of Trade Reform for Industry Employment and Wages: Survey of Evidence from Colombia," *TWEC World Economy* 28, no. 7 (2005).

<sup>66</sup> Although the literature on trade's impact on inequality is significantly contested.

addition, the shift of underemployed agricultural workers to manufacturing or service sectors, where marginal returns to income are higher, also raises aggregate productivity and the wages of those remaining in agriculture.<sup>67</sup>

Likewise, an OECD study finds the impact on wage-inequality from greater trade integration to be neutral in developed economies, even when only looking at the effects of import penetration from developing countries (an observation running counter to Heckscher-Ohlin model, which expects that such trade flows should reduce manufacturing and service wages in higher income countries).<sup>68</sup> The only instances in which imports from lower-income countries drove wage dispersion was in countries with weak employment protection laws.

The IMF study finds evidence for this equalizing effect in its estimation model. The study suggests that a one-standard-deviation increase in the exports-to-GDP ratio decreases inequality by 3.4 percent. Likewise, a one-standard-deviation decrease in tariffs reduces inequality 2.6 percent.

The literature remains too contested concerning the impact of trade liberalization on inequality. There is, however, stronger evidence that the *rules* of the global trade regime<sup>69</sup> place asymmetrical burdens on the livelihoods of citizens in developing countries.<sup>70</sup> In fact, Oxfam developed and executed a global campaign against these rules in the late 1990s through the mid 2000s. The focus of the campaign centered on eliminating the practice of dumping highly subsidized developed country goods onto developing country markets, removing developed country tariffs that discriminated against developing country agricultural exports, and the reducing the legal sanctity of patents that keep the price of medicines (among other vital goods) from becoming lowered in developing countries.

## 2.6 WEAK WAGE-SETTING INSTITUTIONS

Weakened wage-setting institutions are attributed to rising economic inequality. This explanation is largely relevant to advanced economies, the US in particular. However, pressures on such wage-supporting institutions certainly have currency outside of advanced economies, too. This explanation focuses on the declining minimum wage, weakened bargaining power and falling unionization rates, and

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<sup>67</sup> Jaumotte, "Rising Income Inequality: Technology, or Trade and Financial Globalization?."

<sup>68</sup> OECD, "Divided We Stand: Why Inequality Keeps Rising."

<sup>69</sup> Embodied first in the General Agreement on Tariffs and Trade (GATT) and later in the World Trade Organization (WTO)

<sup>70</sup> Kevin Watkins and Penny Fowler, "Rigged Rules and Double Standards: Trade, Globalisation, and the Fight against Poverty ", ed. Oxfam (Oxford: Oxfam International 2002).

new norms eschewing government's role in realizing a more equal distribution of income.

As it is highly US focused, the core argument claims that today's inequality is the result of the breakdown of the post-World War II tacit arrangement among business, government, and unions. Known as the Treaty of Detroit, the institutions hypothesis claims that these three groups ensured that the gains from productivity growth were shared with workers across the income distribution. This arrangement, it is argued, contributed to declining inequality from the late 1940s until its breakdown in the 1970s. Three observations over the past 30 years support this hypothesis: First, the real value of the minimum wage has decreased significantly; second, union rates have fallen, and laws emerged hindering the ability of unions to organize; third, norms and attitudes regarding the role of government to shape the wage and income distribution have become more conservative.

## 2.7 POLITICAL INEQUALITY AND CAPTURE

Inequalities can be exacerbated by political representation skewed in favor of certain groups and individuals over others. This is the case when the distribution of society's resources are prejudiced because of influence or other biases favoring privileged groups. In countries with relatively strong democracies, this may occur because the licit rules of politics make it possible for powerful interests to gain and keep control over government decision-making. In authoritarian or hybrid regimes, the distribution of state resources may be linked to being a member of the ruling party's "in-group." In both contexts, various forms of corruption and cooptation can be at play. Political inequalities often overlap and reinforce the other drivers listed above, especially in terms of group identities, geography, and economic globalization.

Political inequality may signal that governing institutions are captured by certain interests or actors. This dynamic means that the channels through which society's resources are distributed are effectively controlled and distributed to favor certain segments. One result of this is that resources and privileges become hoarded by those with the power to capture, and others are excluded.<sup>71</sup> The ramification of such hoarding can further socio-economic gaps between high-income families and those with fewer economic resources across generations. This dynamic effectively hinders intergenerational mobility. Oxfam advanced this argument in its briefing paper *Working For the Few*.<sup>72</sup> Our finding is supported by analysis suggesting that high levels of inequality are strongly

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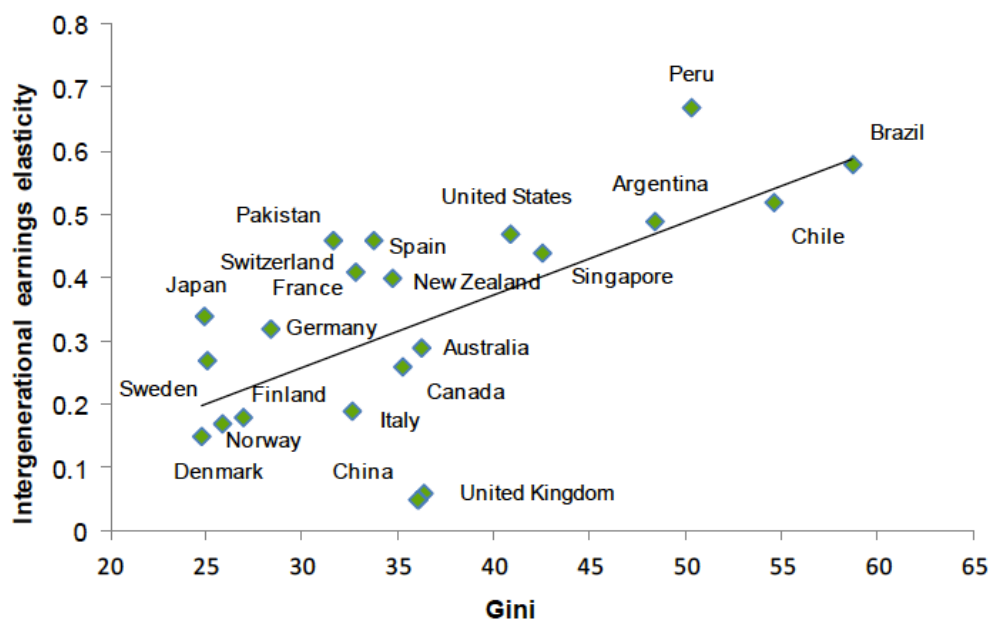
<sup>71</sup> See "Working for the Few: Political Capture and Economic Inequality."

<sup>72</sup> Ibid.



associated with lower intergenerational mobility between fathers and sons.<sup>73</sup> Figure 25 illustrates this link between inequality and mobility.

**Figure 25. The extent to which parents' earnings determine the income of their offspring**



Source: Corak (2013)

Political inequality and capture may manifest across the public policy spectrum. For instance, many countries experience capture of government agencies charged with regulating particular industries. This may occur when rules controlling the revolving door between the private sector and government are weak or ill defined. Instead of regulating industries to protect the public interest, regulators use their agencies to help industry increase profits, irrespective of the public interest.

This can have ramifications on income and wealth distribution, since it drives economic rewards to industries through deregulation of corporate activities in privileged sectors; assisting the formation of monopolies by influential firms; and by diverting state resources toward influential industries or firms and away from other social investments, such as greater access to education, new infrastructure, and healthcare.

<sup>73</sup> Miles Corak, "Income Inequality, Equality of Opportunity, and Intergenerational Mobility," *Journal of Economic Perspectives* 27, no. 3 (2013); John Ermisch, Markus Jäntti, and Timothy M. Smeeding *From Parents to Children: The Intergenerational Transmission of Advantage* (New York: Russell Sage Foundation, 2012); Timothy M. Smeeding, Markus Jäntti, and Robert Erikson *Persistence, Privilege, and Parenting: The Comparative Study of Intergenerational Mobility* (New York: Russell Sage Foundation, 2011).

India offers an example of how government corruption colludes with powerful economic interests to worsen both political and economic inequality. Despite having one of the largest populations of people living in extreme poverty, India has more than tripled its number of billionaires since the 1990s. Research into the sources of billionaire wealth in India indicates that most of it derives from rent-thick sectors of the economy. These are sectors in which economic activity is dependent upon government permissions, for instance, access to land, competitive permits, and control over the telecom spectrum. Although it is difficult to demonstrate causation between billionaire wealth and rent-thick sectors, that such wealth has emerged in sectors highly susceptible to bribes and corruption is very suggestive.<sup>74</sup>

In the 2000s, World Bank researchers began examining another facet of capture. This work examines how firms in transitioning market economies captured the state during periods of market liberalization.<sup>75</sup> In the nascent Russian Federation and in Eastern Europe, “early winners” used their wealth and influence to structure the state’s basic legal, legislative, and regulatory frameworks to their advantage. Corporations generated enormous amounts of wealth by laying claim to state assets at highly undervalued prices. In some transition economies, this occurred through privatization, whereby firms used influence over political structures to colonize productive sectors under their control.<sup>76</sup> In what Hellman, Jones, and Kaufmann call the “capture economy,” underprovided public goods were sold off “a la carte” by politicians and public officials to connected firms and individuals. In the capture economy, corporations shape and influence the creation of the rules of the game through private payments to public officials and politicians.<sup>77</sup> As firms and their beneficiaries became fabulously wealthy, the poor gained little if anything, and economic inequality expanded in countries with high levels of corruption and capture.<sup>78</sup>

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<sup>74</sup> Aditi Gandhi and Michael Walton, "Where Do India's Billionaires Get Their Wealth?," *Economic & Political Weekly* xlvii, no. 40 (2012).

<sup>75</sup> J. S. Hellman, G. Jones, and D. Kaufmann "Seize the State, Seize the Day State Capture, Corruption, and Influence in Transition," *Policy Research Working Papers - World Bank* no. 2444 (2000).

<sup>76</sup> Sanjay Pradhan, *Anticorruption in Transition : A Contribution to the Policy Debate* (Washington, D.C.: World Bank, 2000).

<sup>77</sup> Hellman, "Seize the State, Seize the Day State Capture, Corruption, and Influence in Transition."

<sup>78</sup> Pradhan, *Anticorruption in Transition : A Contribution to the Policy Debate*.

## 2.8 OTHER DRIVERS

This discussion of inequality drivers is not conclusive. Other phenomena are also important drivers of inequality and often interact with the complex of drivers already introduced. For instance, recent decades have witnessed increased patterns of assortative mating in advanced economies. Assortative mating means that people entering into relationships possess similar socio-economic characteristics, including levels of education and family wealth.<sup>79</sup> This trend toward mate similarity may be based in part on increasing levels of education among women, especially those from higher socio-economic backgrounds. Greater attainment of education has coincided with women entering into traditionally male dominated fields, particularly in professional jobs toward the top of the income distribution.

The multitudes remaining in informal labor markets is also an important component of inequality. In contrast to advanced economies, developing countries face large informality in their labor markets. Although informality does not directly entail higher income inequality, over time it can widen income gaps. Informal sectors are mainly made up of low-skilled workers and young adults. Their jobs are less stable than formal work is, and given that they are low skilled, they offer little chance of career advancement or human capital accumulation. Work in informal sectors can also hinder shifting into the formal sector, thereby trapping workers in low-skilled jobs. Informality also means workers remain outside social and labor protection regulations. The confluence of these factors contribute to inequality between formal and informal workers.<sup>80</sup>

Education also plays a large role in earnings disparity within developing economies.<sup>81</sup> Opportunities for children to receive high-quality education contribute greatly to better job prospects and higher wages. Yet, whereas developing countries have made progress in increasing primary enrollment rates, secondary and tertiary rates lag behind. Figure 25 demonstrates the extent of this lag across global regions and country income groups. The disparity between children who go on to secondary and tertiary schooling often overlaps with other inequalities.<sup>82</sup> For instance, enrollment is much lower in rural areas than in cities. Disadvantaged rural households are especially affected, as secondary school generally requires travel to urban areas. Gender norms between girls—who are typically expected to work within the home—and boys layer upon educational

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<sup>79</sup> Jeremy Greenwood, Nezih Guner, Georgi Kocharkov, and Cezar Santos, "Marry Your Like: Assortative Mating and Income Inequality," *Papers and Proceedings* 104, no. 5 (2014).

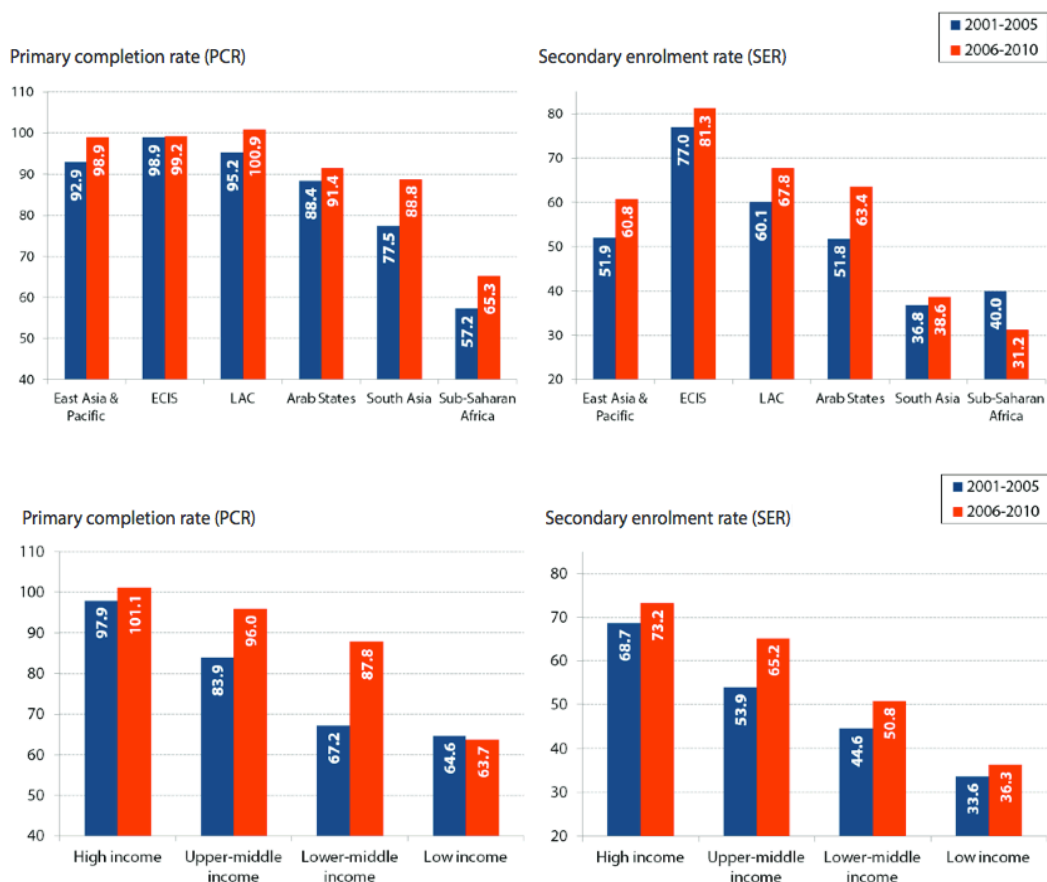
<sup>80</sup> *Divided We Stand*. OECD, "Divided We Stand: Why Inequality Keeps Rising."

<sup>81</sup> United Nations Development Programme, "Humanity Divided: Confronting Inequality in Developing Countries," (New York, NY 2013).

<sup>82</sup> OECD, "Divided We Stand: Why Inequality Keeps Rising."

inequalities, with the impact of heightening income earnings inequality later in life.<sup>83</sup>

**Figure 26. Primary and Secondary completion rates by region**



Source: UNDP, 2013

## 2.9 SUMMARY

Inequality is both a ubiquitous and complex human phenomenon. For all of human history, certain factors privileged some individuals and groups within societies over others.<sup>84</sup> This feature of humanity may always be with us. However, in the modern era we are facing *extreme* economic inequalities. Extreme inequality has emerged among citizens living in the same countries, and especially among individuals globally.

<sup>83</sup> *ibid.*

<sup>84</sup> Francis Fukuyama, *The Origins of Political Order: From Prehuman Times to the French Revolution* (New York: Farrar, Straus and Giroux, 2011).

Though not addressed in this report, the consequences of such severe inequality are worrisome. In fact, the World Economic Forum has identified growing income inequality as a top global risks facing the planet today.<sup>85</sup> Research from across the sciences suggests that extreme inequality poses a range of threats to humanity and to the planet. In many countries, we are witnessing how extreme inequality threatens social cohesion, undermines democracy, slows poverty reduction, and increases the likelihood of civil conflict and violence.<sup>86</sup> Furthermore, evidence suggests an association between living within highly unequal societies and experiencing greater anxiety and other forms of mental stress than in more equal societies. From a macroeconomic perspective, there is increasing evidence that extreme inequality can undermine market economies by weakening demand among consumers.<sup>87</sup> Relatedly, high inequality appears to hinder the full realization of economic growth, and to shorten the period in which countries experience growth spells.<sup>88</sup> As the recent financial crisis demonstrated, high inequality can lead to policies that infuse substantial economic volatility into markets. For instance, lawmakers in the U.S. responded to decades of flat wage growth by making credit easy to obtain and permitting banks to become overleveraged.

The purpose of this last section was to provide readers with a cursory introduction to some of the main determinants of inequality today. The review is certainly not conclusive, and readers are encouraged to learn more. Importantly, the goal of this section was to suggest that these drivers do not operate in isolation. Instead, they should be conceptualized as interdependent and self-reinforcing. For instance, geography and group identity should be understood as underlying factors determining where individuals stand in relation to others within country level and global income distributions. Yet, factors such as political capture and access to education layer upon these as well to create a web of circumstances affecting how individuals are differentiated by economic status.

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<sup>85</sup> World Economic Forum, "Global Risks 2014," (Geneva 2014).

<sup>86</sup> Richard G. Wilkinson and Kate Pickett, *The Spirit Level : Why Greater Equality Makes Societies Stronger* (New York: Bloomsbury Press, 2010); Joseph E. Stiglitz, *The Price of Inequality : [How Today's Divided Society Endangers Our Future]* (New York: W.W. Norton & Co., 2012). Comparing UNDP's Gini coefficient rankings and the OECD's list of fragile states: <https://data.undp.org/dataset/Income-Gini-coefficient/36ku-rvrj> and <http://www.oecd.org/dac/incaf/FSR-2014.pdf>; UN Office on Drugs and Crime (2011) UN Global Study on Homicide: [http://www.unodc.org/documents/data-and-analysis/statistics/Homicide/Globa\\_study\\_on\\_homicide\\_2011\\_web.pdf](http://www.unodc.org/documents/data-and-analysis/statistics/Homicide/Globa_study_on_homicide_2011_web.pdf); See also [http://www.who.int/violence\\_injury\\_prevention/violence/world\\_report/en/full\\_en.pdf](http://www.who.int/violence_injury_prevention/violence/world_report/en/full_en.pdf); Corporate Europe Observatory, "The Fire Power of the Financial Lobby: A Survey of the Size of the Financial Lobby at the Eu Level," (2014).

<sup>87</sup> Kermal Dervis, "The Inequality Trap," *Project Syndicate*, March 8 2012.

<sup>88</sup> Andrew Berg and Jonathan Ostry, "Inequality an Unsustainable Growth: Two Sides of the Same Coin?," *IMF Staff Discussion Notes* SDN/11/08 (2011).

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