

# Markets, Labor, and Inequality

**E**CONOMIC GROWTH GENERALLY BENEFITS the majority of a country's population as the economy becomes more efficient, creates more jobs, and raises incomes. Yet while most households gain, inequality between individuals and groups often persists: between men and women, between ethnic groups, or indeed between households. And growth fails to reach some groups at all. The disabled, the economically disadvantaged, and those living in poor, lagging regions are among those most at risk of getting left behind. Lacking equal access to assets—and especially to education and skill training—and often faced with other obstacles such as ethnic or sex discrimination, these groups may be unable to take advantage of the new opportunities generated by economic change.

Growth does not necessarily mean greater inequality. Long-term growth has often reduced inequality, for example in Colombia, Indonesia, and Malaysia. And growth almost always reduces poverty, sometimes despite rising inequality, as in Brazil between 1960 and 1980. But societies need to worry about the distribution of income if for no other reason than that a more equal distribution of income ensures that the benefits of growth get spread more evenly and reach the poor.

This chapter examines the distribution of the income that people derive from their labor—whether from wage-paying employment or from self-employment on a farm or as a trader. It examines the dimensions of and reasons for persisting inequality across individuals, regions, and gender and ethnic groups. And it asks what governments can do to spread opportunities and to help those who get left behind.

## What determines inequality of labor incomes?

In all countries the wages paid to workers in different sectors and occupations vary widely. Even in formerly socialist Poland, average wages in 1993 in the highest-paid occupations—engineers and extractive occupations—were nearly 80 percent higher than those in the lowest-paid—personal services. Skilled white-collar workers in the financial services industry could earn three times the wage of an unskilled worker in retail trade. Differences in wages across individuals reflect, to a large extent, different talents and skill endowments, as well as differences in working conditions or job requirements. Difficult jobs, and jobs per-

formed in risky or dirty environments, are likely to pay higher wages than jobs of equivalent skill that are easier, safer, and cleaner.

Even when all these factors are taken into account, however, some differences in wages remain. These may reflect unobservable individual ability, discrimination, or other forms of market failure. Even in the highly integrated labor market of the United States, detailed studies of wage differentials find that individual characteristics and industry-, occupation-, and firm-related factors explain only between 50 and 70 percent of the observed variance. Comparisons of wage dispersion across countries indicate that although inequality tends to decline as economies grow richer, it can vary greatly between countries at similar income levels.

A market-based distribution of labor income can be more or less equal or can leave many workers living in poverty. Two factors are especially important in determining the degree of inequality. The more powerful influence is the initial distribution of assets, especially of education (Table 6.1). The poorest members of society are usually those with less access to land, credit, and social services and fewer of the skills that allow poor workers to move into high-productivity, higher paying sectors. The second determinant of inequality is in the way that similar assets are rewarded differently across sectors and occupations. These differences exist not only between jobs in the formal modern sector, but also between returns to labor in the wage sector and in self-employment, and between outcomes within self-employment.

### *Inequalities in the distribution of assets*

Income inequality across workers is strongly associated with inequality of education and skills. Educational attainment is the single most important predictor of individual labor incomes. Combined with other human capital variables such as experience and occupation, skills account for one-third to one-half of the variation in earnings observed across individuals within countries. Not surprisingly, policies that increase the education of the poor can have a dramatic impact on wage inequality. Educational inequality in Brazil continues to far exceed that in the Republic of Korea and explains more than one-fourth of the much greater earnings inequality there. In Colombia the expansion of

*The poor are usually those with less access to education.*

**Table 6.1** Average years of schooling by per capita income quintile in selected developing countries

Country	Lowest	Second	Third	Fourth	Highest	All
Brazil	2.1	3.1	4.3	5.7	8.7	5.2
Costa Rica	4.8	5.6	6.2	7.1	9.4	6.8
Guatemala	1.0	1.5	2.3	3.5	7.0	3.2
Viet Nam <sup>a</sup>	5.1	5.7	6.1	6.5	8.0	6.4

**Note:** Data are for all persons fifteen years and over.

a. Data are by expenditure quintile.

**Source:** Viet Nam poverty assessment; Psacharopoulos and others 1993.

education reduced wage differentials between top and bottom by 20 percent, despite rising demand for skilled workers. In both Malaysia and Costa Rica increased educational opportunities were associated with sharp reductions in wage inequality. As Figure 6.1 illustrates, the expansion of education generally works to reduce wage dispersion. But there are exceptions: in countries such as Chile and Mexico the positive effects of increased education have been swamped by strong shifts in demand against unskilled workers.

Inequality between rural and urban incomes is particularly pervasive. Much of this inequality has its origins in decades of policies that favored cities over the countryside. Although in many countries these have been partly or wholly abandoned, in others—especially in Africa—they remain in place. Antirural policy biases have included discrimination against agriculture arising from overvalued currencies and industrial protection, and from the taxation of export commodities. These were aggravated by biases in favor of cities in the allocation of physical and social infrastructure, and by land policies that made it difficult for the poor to acquire land, sharply reducing self-employment opportunities in rural areas. Compensation for these adverse policies, where it was given, largely benefited richer, larger farmers and left poor rural workers and small-scale farmers to bear the brunt of discrimination. As discussed in Chapter 4, these policy biases led to a premature movement of workers into the cities, before the cities were able to gainfully employ them, and to the depression of wages in the urban informal sector.

Inequality can show remarkable persistence across generations, as the benefits of physical and educational assets and positions of power are transmitted from parents to children, and cultural norms that perpetuate inequality become embedded in economic systems. Altering the distribution of assets is crucial to breaking these circles of poverty and reducing income inequality. But this is not easily accom-

plished. Large redistributions of land (or of capital) have seldom occurred except in times of great political upheaval. In parts of East Asia where reforms put land securely in the hands of small farmers, they have led to accelerated rural growth, employment, and political stability. Where the land was collectivized, or where small farmers did not receive secure rights to the land, as in Mexico, reforms were associated with stagnation and social distress. Nevertheless, where much land remains inefficiently used in large holdings, further land reform will be needed.

An easier way to reduce poverty and increase equality of incomes is to change the distribution of human capital. Unlike with physical capital or land, this can be done by adding to the existing stock rather than through redistribution. Investing in the *human* capital of the poor, through primary health care and education, has been an important part of successful strategies of poverty alleviation in countries such as Indonesia and Colombia.

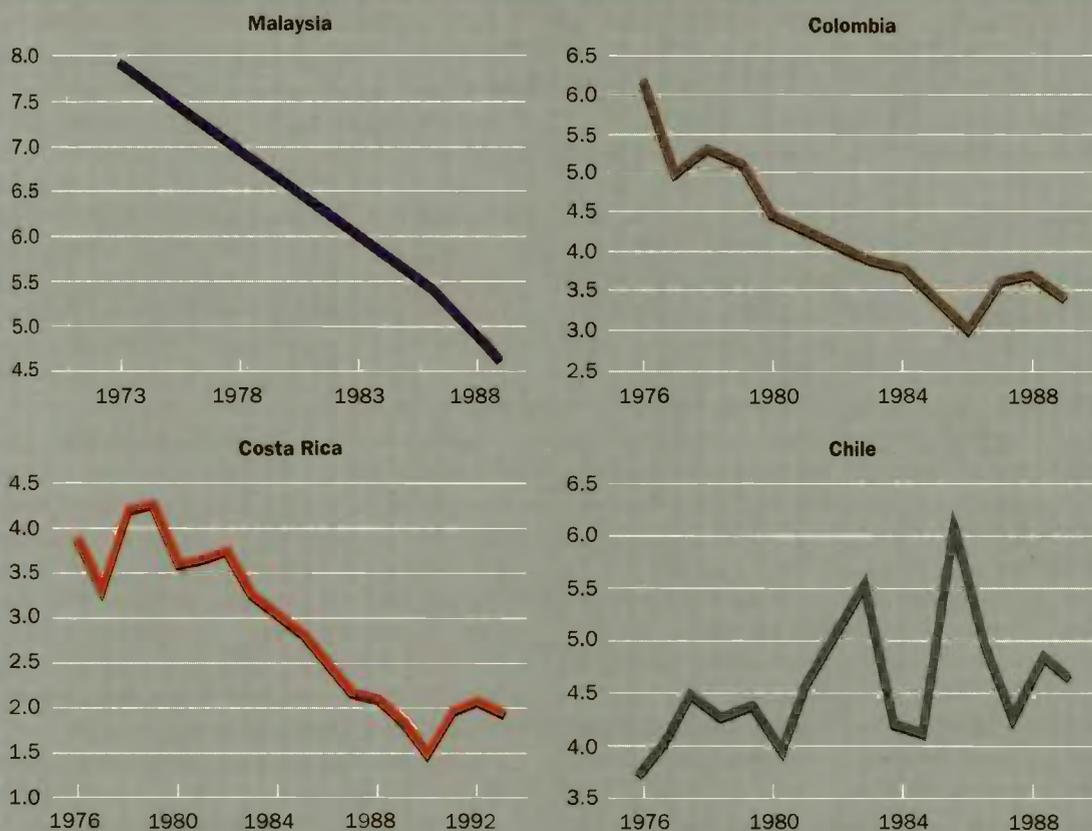
#### *Inequalities in the returns to assets*

Increasing the returns to the few assets that poor workers hold also has an important influence on the distribution of income. Since the main asset of the poor is their labor, this means, above all, removing biases that tend to depress returns to labor.

Shifting to a less distorted and more formalized labor market can function as an equalizing mechanism. In the absence of market failures such as discrimination, the wage labor market ensures that similarly productive workers employed in comparable jobs receive similar pay. As a result, outcomes in the wage labor market are less tied to workers' initial endowments of assets than are the outcomes from self-employment.

Formal labor markets, however, are often distorted and biased against the poor. In many countries urban development has encouraged the growth of groups of protected

*The wage gap between workers at differing levels of education has narrowed, except where labor demand has shifted strongly against the unskilled, as in Chile.*



**Figure 6.1 Wage differentials between university and primary school graduates.** Data are ratios of the average wage of a university graduate to that of a worker with only primary education. Source: Fields 1994; Gindling and Robbins 1994; Robbins 1994; Robbins, background papers.

formal sector workers. Outsiders, including most of the poor in the rural sector and the urban informal sector, lack access to the high-wage jobs with greater job security and better working conditions that privileged workers enjoy.

### Dimensions of inequality

Even in the absence of distortions, labor market outcomes can be inequitable because of discrimination—for example, against women or ethnic groups. Labor outcomes may also be conditioned by regional differences, making households victims of the accidents of geography. Three types of in-

equality have proved particularly difficult to resolve through market forces alone: inequalities between men and women, inequalities between ethnic and social groups, and inequalities across regions.

#### *Inequalities between men and women*

In almost all societies women have less power than men, receive less for their work, and have less control over household resources, and in many countries they receive less education. Women have less access to better paying jobs in the formal sector and are disproportionately represented among unpaid family workers and in the informal sector.

When women are allowed to enter the same markets as men, they often face discrimination.

Although women work fewer hours on average in market activities than men, this difference is more than offset by their greater hours of effort in household activities. In almost every country, women are responsible for a disproportionate share of work within the household. In Bangladesh men and women were found to work approximately the same number of hours per week. But whereas men devoted 90 percent of their work hours to income-generating activities, women allocated 80 percent of their work time to household chores. This division of labor continues to hold even when women work outside the home. Argentine women work on average seventy-three hours a week in the home if they are not employed, and fifty-six hours if they are—far more than men. These differences between men and women in the allocation of effort affect the distribution of power within the household. Where women earn little in the cash economy, they have less say in the allocation of family income and in strategic household decisions, such as those about schooling. The evidence shows that this distribution of power has detrimental effects on children, especially daughters.

Some division of labor between men and women flows from the dominant role of women in childrearing. Especially when lives are relatively short and fertility is high, women tend to be tied to home-based activities for a significant fraction of their working lives. Sometimes a premium on physical strength, as in most unskilled work, can reinforce the economics of the traditional gender-based division of labor. But such a division becomes more and more inefficient as development and technological change result in longer working lives for women, fewer children, and a higher premium on skills.

The differences in the returns to work for men and women stem from two factors. First, most women are less proficient in marketable skills because of biases against women in education and skill training. Educational biases are severe in Asia and the Middle East and significant in Africa, but insignificant in Latin America and the countries of the former Soviet bloc. Second, women often face a narrower range of job opportunities, and so attain worse labor market outcomes than men with the same endowments. In many countries large female-male wage differentials remain even after controlling for differences in education and experience (Box 6.1). In India women's real wages are 51 percent of men's, and only 34 percentage points of the gap can be explained by differences in worker characteristics. In Kenya women's wages are 18 percent lower than men's after adjusting for skill and experience. In Latin America average female wages are 71 percent of average male wages, and only 20 percentage points of the differential can be explained by differences in human capital. Even in the former Soviet Union, women earned on average 30 percent less

than men. Less than one-tenth of this differential was due to differences in endowments.

Economic growth has proved a slow instrument of change in the status of women. Among the industrial countries inequality between men and women remained remarkably stable for nearly two centuries before declining sharply over the last thirty years. Shifts from agriculture into industry and services have not always had much impact on occupational biases against women—occupational segregation in Russia, for example, remains severe, explaining much of the observed wage differentials between men and women there. But there is hope that in the developing countries change will come faster. Recent evidence for six developing countries in East Asia, Latin America, and Sub-Saharan Africa indicates that growth has increased female wages and reduced wage differentials in all but one country. Employment segregation, on the other hand, has remained largely unchanged.

These lags flow from a number of factors. Men's greater power in most societies affects whether women participate in the labor force—when men prefer that their wives not work outside the household, for example. Discrimination in the workplace, stemming in part from cultural norms, is widespread. And there are many associated institutional and legal factors that tend to reduce demand for women workers, especially in formal jobs—for example, paternalistic discrimination may prevent women from working in “dangerous” occupations or at night.

Weaker labor market opportunities produce weaker incentives to educate girls; this creates a vicious cycle, since less educated women are much less likely to educate their daughters. Breaking this cycle can be difficult. Increasing pressures and incentives to educate girls is essential, and support for childcare and legal reforms can also play a role. Measures to reduce discrimination in the workplace and to avoid raising the cost to employers of hiring women through paternalistic attempts to protect them also are important (see Chapter 11).

#### *Inequalities between ethnic and social groups*

Indigenous people of Latin America, African Americans and Native Americans in the United States, gypsies in Central and Eastern Europe, scheduled castes in India, and blacks in South Africa have in common a relatively low status in the labor market associated with their ethnicity or the group in society into which they were born. These inequalities are between households, not within them, but here too the story is one of individuals whose futures are determined by the accident of their birth.

Groups such as Andean Indians and South African blacks typically earn less than other workers in the same economies. Indigenous male workers in Bolivia earn on average 60 percent of what a nonindigenous worker earns. The wages of Guarani speakers in Paraguay are 64 percent

### Box 6.1 Do lower wages for women indicate discrimination?

Not all of the observed gender wage gap necessarily represents discrimination in the labor market. A lower wage for women in a given economy may reflect their lower productivity in wage employment. Women in developing countries often have less schooling and on-the-job experience than men, and estimates of wage discrimination need to account for such factors. One method is to estimate returns to certain attributes and characteristics, such as schooling, experience, and occupation, separately for males and females, and then decompose the observed wage differential into two parts. The first shows the component of the wage differential due to women actually having “worse” attributes and characteristics than men, whereas the second addresses what women would be earning if they had the *same* attributes as the men in the economy. This second measure points to discrimination, if women’s earnings are still less than those of men.

The most striking examples of the use of this methodology come from countries such as Ecuador, Jamaica, and the Philippines. Women in those countries actually have more education and experience, on average, than men but get paid between 20 and 30 percent less. In these countries, women would actually have higher wages than men were their contributions valued equally by the labor market.

The decomposition analysis has some problems: for example, using “years since school” as a measure of experience may misstate the nature of women’s experience, or the use of broad occupational categories may obscure a tendency for women to hold lower status jobs than men within the same occupation. Nevertheless, results from a wide range of developing countries make it clear that labor markets do discriminate against women workers.

of those of Spanish speakers. And in Brazil, blacks earn only 50 percent as much as whites. But, as with that between men and women, not all of the wage gap reflects discrimination. About 70 percent of the difference in earnings between indigenous and nonindigenous workers in Bolivia, for instance, can be attributed to differences in schooling attainment and experience. The remaining 30 percent is unexplained, reflecting unaccounted-for factors such as differences in ability or quality of education, and labor market discrimination.

Every seventh person in India—about 2 percent of the world’s population—is a member of a scheduled caste. These lowest-caste individuals are born into families whose traditional occupations—scavenging, tanning leather, working in agriculture—yield little return to education or skill acquisition. Tradition also used to dictate that these families could not change their occupations—a street cleaner’s son also became a street cleaner. This extreme labor market inflexibility provided few incentives for members of the lower castes to educate themselves. The custom of inherited occupations has been relaxed in recent years, but in 1988–89 a third of workers in the informal sector in the Indian state of Bihar belonged to scheduled castes.

In South Africa, white colonialism and then apartheid rule actively created differences in assets and power between whites and blacks. Democracy finally brought political power to the black majority, but the government now faces the tough problem of reversing the results of many decades of discrimination, most of all in education and skills. For the group that attended school in the 1970s and 1980s the situation is particularly severe. Schools for blacks were of poor quality in any case, but in addition many schoolchil-

dren resisted apartheid through school boycotts. Most enter the new era with a strong political consciousness but a weak ability to gain from expanding economic opportunities.

Members of groups with little economic, social, and political power are vulnerable to self-reinforcing cycles of low education and low returns in the labor market feeding back into lower incentives to acquire human capital. These cycles make it increasingly difficult to overcome relative—and sometimes absolute—poverty and alienation from the increasing prosperity in which others in the economy participate. Intergenerational issues again matter, particularly where groups get stuck in complex cycles of dependency and inferiority.

One group that has expressly used government policy to pull itself into the economic mainstream is the *bumiputeras*, or ethnic Malays, in Malaysia. Literally “sons of the soil,” most *bumiputeras* were confined for most of this century to traditional small-scale agriculture and rice cultivation. At independence, even though they were the ethnic majority and controlled the public sector, their economic role was limited, with industry and finance mostly in the hands of the ethnic Chinese middle class. To increase their role in the economy the Malaysian government undertook a number of concerted policies, including targeted and subsidized education and preferential treatment in an expanding public sector. These policies succeeded in raising the educational attainment and the average incomes of the *bumiputeras*. As a result, inequality of incomes between the *bumiputeras* and the rest of the population, mainly Chinese and Indians, declined significantly: between 1970 and 1984 the average incomes of the *bumiputeras* rose 40 percent more than the incomes of other groups. However,

these policies have not contributed as much to reducing overall inequality, because inequality of incomes *within* each ethnic group has increased.

#### *Inequalities across regions*

Inequality often has a regional dimension. Almost all countries manifest regional disparities in resource endowments, incomes, and growth rates, and these are known to persist over time. Some regions' relative disadvantages are so extreme as to constrain the opportunities of individuals born there. A child born in the Mexican state of Chiapas, for example, has much bleaker prospects than a child born in Mexico City: the child from Chiapas is twice as likely to die before age five, less than half as likely to complete primary school, and ten times as likely to live in a house without access to running water. Assuming that he or she does not migrate, such an individual will earn 20 to 35 percent less than a comparable worker living in Mexico City and 40 to 45 percent less than one living in northern Mexico.

Initial conditions are a crucial determinant of regional performance. Scarce resources, a history of neglect, lack of investment, and a concentration of low-skilled people who may be ethnically distinct from the rest of the population combine to explain the lagging performance of certain areas. Gansu, with an income per capita 40 percent below the national average, is one of the poorest regions in China. Unfavorable geography, poor soil that is highly susceptible to erosion, low and erratic rainfall, and limited off-farm employment opportunities underlie its high poverty levels. Chaco Province in Argentina has a GDP per capita that is only 38 percent of the national average. Low educational attainment and lack of infrastructure, especially roads, explain much of this deviation.

Relative and absolute regional poverty can persist for long periods even when growth in other parts of the economy is strong. The crash of the sugar economy in the seventeenth century, for instance, pushed northeastern Brazil into a decline from which it has never fully recovered. In the United States the fortunes of coal-mining West Virginia waned with the collapse of the coal industry and the increased importance of oil and gas in energy production. It remains one of the poorest areas in the United States to this day. In Thailand rapid development failed to reach the northern hill people. Fewer than 30 percent of their villages have schools, and only 15 percent of the hill people can read and write Thai. Their average annual income is less than a quarter of GNP per capita.

#### **What can be done to help those left behind?**

Market-based growth that makes efficient use of labor and encourages a large wage employment sector can be good for achieving equality. But market-based development alone is a weak instrument for reducing inequalities between the

sexes, between ethnic groups, or between otherwise similar people. Improving the distribution of initial endowments, especially by promoting access to education for the poor, is crucial for realizing improvements in the distribution of incomes. Public action can play a role in accelerating change by pushing to improve the human endowments of those worse off and by acting to reduce discrimination. But tackling the problems of those left out is a formidable challenge for policy, in industrial as well as in developing countries. Investment in these individuals often has a low return, either because they are old and have relatively few years of work left, or because they lack the basic skills necessary to function in a work environment, or because they are stuck in backward regions.

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*A fifty-three-year-old widow of the Kapu caste from the Chintapalli village of Raole Mandal in India lives alone in a mud hut. She was married to an older, propertyless cousin, whose death has left her without independent resources. She survives on lacemaking. Working for ten hours a day on 5,000 meters of thread, she earns the equivalent of \$0.30 per day. Old age, ill health, and strong caste identification preclude her from participating in other remunerated activities.*

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*An underemployed agricultural laborer living near Tamale in Ghana's savanna region works on average less than four days a week. When employed, he gets paid around \$0.80 a day. During the cotton harvest there is enough work, but in winter jobs are scarce. He, his wife, and their five children live in a mud hut. His wife and ten-year-old daughter help care for their small vegetable garden, which supplies food for the family dinner table even when the father is not working. The parents worry about their children's future. They would like to move to an area with more job opportunities but cannot afford to lose the family's only asset, their small plot of land.*

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What can governments do about cases such as these? Policies to help those left out must combine special measures to reintegrate able-bodied individuals into the world of work, transfers to sustain their living standards above a certain minimum, and interventions to reach their children and give the next generation the opportunity to escape poverty.

#### *Targeted investments*

Society can attempt to integrate disadvantaged workers into the mainstream through retraining programs that give them basic skills or through programs that help them become self-employed. Targeted training programs for disadvantaged groups—whose focus is on reducing poverty rather than retooling the unemployed—are relatively rare in the developing countries but have a longer history in the industrial world. The United States, for example, has had pub-

lily sponsored programs to aid the disadvantaged since 1964. Many of these programs have been tied to transfer schemes such as the Aid to Families with Dependent Children program. These programs have been only moderately successful: training services have sometimes, but not always, raised participants' earnings. In general, training for the disadvantaged in the United States has been much more effective in helping adult women than in helping men or youths.

Deprivation and poverty usually go hand in hand with lack of access to both physical and social infrastructure. The allocation of government expenditures on social services is often biased against the poor, and especially against those in rural areas and lagging regions. The result is usually a lack of adequate sewerage, roads, and health and school facilities to serve poor communities. Redressing the balance through public infrastructure investment in these disadvantaged areas can be crucial to helping poor households pull themselves out of poverty. Since 1988, Mexico's Solidaridad program has provided poor municipalities with funds to finance small subprojects linked to school rehabilitation, improvement of rural water supply, and rural road rehabilitation and maintenance.

### *Transfers*

Sometimes there may be little scope for investment, either in skills or in infrastructure, to help those left behind. Poverty relief policies or transfers will then be necessary. These transfers can be integrated with more permanent income security mechanisms (see Chapter 13) or can be part of special transition measures (see Chapter 17). Whether permanent or temporary, the type of safety net chosen is usually a function of the country's income and traditions. In low- and middle-income countries public employment schemes can deliver these transfers cost-effectively. In recent years several countries have experimented with approaches that combine poverty relief with reintegration into the labor market for those displaced during adjustment episodes. For example, Bolivia, Honduras, Egypt, Guinea, and Senegal have all established social funds to encourage income-generating activities and the formation of micro-enterprises. These funds usually finance small-scale infrastructure projects, technical assistance, training, and micro credit schemes. However, not all those left out can be reintegrated into the labor market. For those unable to work—because of old age or disability, for example—complementary transfers of either cash or food may be necessary.

### *Reaching the next generation*

Policies aimed at reaching the children of those left behind are more likely to be effective. Breaking intergenerational cycles of poverty means giving children access to opportunities that have passed their parents by. Investing in the human capital of these children is key, but education alone is usually not enough: investing in their health and nutrition is also necessary. Chapter 5 noted, and previous editions of *World Development Report* have examined in some detail, the complementarities between these different types of interventions: better nutrition and health improve children's capacity to learn while in school and increase their productivity at work when they are older.

A number of countries are making efforts to improve the delivery of social services to the poor and their children. Colombia's community childcare and nutrition program, for example, provides preschool care that includes meals and health monitoring. Participating children benefit from exposure to preschool learning activities, improved nutrition, and health care. Families—especially mothers—benefit from the opportunity to seek paid employment outside the home. Mexico's Basic Health Care Program for the Uninsured Population (PASSPA) extends both basic health care services and targeted nutrition assistance to the uninsured poor. Bangladesh's general education program aims at increasing equitable access to primary and secondary schooling for poor children, especially girls. It focuses on expanding education services to poor, underserved communities, increasing the share of female teachers, and extending a successful pilot scholarship program for girls. El Salvador is experimenting with a targeted nutrition program that distributes food supplements to schoolchildren.

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Market-based development can reduce both inequality and poverty in developing countries. Ensuring that poor workers have access to education, and that labor markets are not so distorted that formal wage employment growth is stunted, is crucial to encouraging faster growth and reducing inequality. But inequalities persist even in growing economies, because of discrimination based on gender or ethnicity or because particular individuals or regions are excluded from the fruits of growth. Government policy should, wherever possible, fight discrimination and draw these excluded groups back into the mainstream. But above all, governments should ensure that the children of disadvantaged households do not remain trapped in poverty but instead have the chance to fulfill their potential.