SUMMARY OF THE BOOK:

INEQUALITY, GROWTH AND ERADICATION OF POVERTY

Challenges and Solutions

By

Bjarne Larsen Kron,
2015

Setting the stage – the degree of absolute poverty in the world

By 2011, about *1 billion people* lived below the *absolute poverty line of 1.25 USD/day*. Of these two-thirds lived in middle-income countries (MIC), one-third in low-income countries (LIC). Almost half of the population in Africa South of Sahara (SSA) and close to one fourth of the people in South Asia lived in absolute poverty. There has been a *structural shift* in location of absolute poverty since 1990, when 1.8 billion people lived in poverty, as a number of populous countries have moved up the economic ladder. In 1990, the large countries India, Indonesia, Nigeria, Pakistan and the Philippines were all LICs, and China belonged the lower middle-income group (LMI). The first group of countries are now LMIs and China is an upper middle-income (UMI) country. This structural shift has a number of important consequences for policy measures to be implemented to eradicate absolute poverty.

Use of an economic measure to assess the wellbeing of people is a rather single minded approach. This has led to development and use of the multidimensional poverty index (MPI), which measures poverty according to ten indicators organised around the three dimensions of health (child mortality and nutrition), education (years of schooling and child school attendance) and living standards (electricity, improved sanitation, improved drinking water, flooring, cooking fuel and assets ownership). Close to *1.6 billion people are MPI poor*. Of the MPI poor, around half live in severe poverty. Including people vulnerable to poverty (0.6 billion), close to 2.2 billion people is either living in poverty or at risk for falling into this group.

The key challenge is to eradicate all absolute poverty, whether measured in economic or non-economic terms.

A world with too much inequality

Inequality in income and wealth is perceived as necessary for economies to grow. Incentive structures need to be in place which reward risk taking, talent and entrepreneurship. This is required for innovation and investments, prerequisites for a growth in production that can take people out of poverty. The pie needs to be larger, if all people should have the possibilities to live a decent life without going hungry to bed. At the same time there is a growing recognition that the *size of inequality matters for economic growth*. And inequality has gone too far when the richest 80 people in the world own the same as the poorest 50% - 3.5 billion - of the world population. This degree of inequality is far from necessary to maintain an incentive structure for increasing economic growth, and the global income distribution does not reflect effort but only very unequal opportunities.

Whether measured by the Gini coefficient or Palma ratio, MICs are the most unequal group of countries. In particular countries in Latin America, followed by SSA, experience high degrees of economic inequality.

There are a number of risks associated with this high, and growing inequality. Apart from being morally unacceptable, the level of inequality in many countries is one of the reasons for unrest and rebellion. The growth rates needed to take all out of poverty are high and unattainable in many countries, if inequality remains at the present levels. At the same time, with increasing inequality, the acceptance of the governance and economic systems (and thereby the coherence of societies) can disappear. The level of excessive concentrations of income risk leading to damaging outcomes in societies, as has also been emphasised by the World Economic Forum in their annual risk ratings.

Sustainable economic growth for eradication of poverty

Growth in income for the 1 billion people living below the absolute poverty line is particularly difficult. Having such a low income that all income is consumed leaves no possibilities for saving and investment, with disastrous results in terms of falling income - *a poverty trap*. But with an income level above subsistence minimum, saving and investment is possible, and the economy has a possibility to gradually sustaining itself. However, the economy must grow by more than the population growth rate and the annual depreciation of the capital stock in order to raise the per capita income. This calls for a different set of policies to secure economic growth in populations living below and above the poverty line.

The response to reduction in poverty from economic growth depends on a number of factors, including the level of income and degree of inequality in a society. The lower the income, the higher must the economic growth be to take people out of poverty. And a higher degree of inequality makes it more difficult for economic growth to remove poverty. As the president of the World Bank has stated, the poverty elasticity of growth has to change, i.e. growth must have a larger effect on the poor than it has had over the last 20 years, should we be able to remove extreme poverty.

The growth model of a country impacts directly on its environment and contribution to climate change. With climate change being one of the largest threats facing mankind in the 21st century, climate change mitigation and adaptation measures must form part of all efforts to eradicate poverty and securing economic growth. Using the term growth therefore implies that it is environmentally *sustainable* and contributes to reduce the negative impacts of climate change.

Redistribution as a key policy instrument

An important policy measure to lift people permanently out of absolute poverty and secure that they can save and invest for their own sustainance, is that they receive an income transfer sufficiently high to cover the *poverty gap*.

Will the poor countries have enough income to redistribute? Will all people in the country not just become poor if the countries start redistributing their low income? The answers to these questions are surprising.

The principle of a redistribution policy could be to increase the marginal income tax of the 10 per cent of the population that earns the highest incomes. It should be increased enough to be able to redistribute this tax income to all those living below the poverty line, so that the poorest would get an annual income equivalent to the poverty line (1.25 USD per day, 450 USD per year). If this was the case, the poverty gap would disappear and no one would live below the poverty line any more.

If this calculation is done on the basis of information from the World Bank poverty database, the surprising result is that in 86 of the 116 countries covered by the analysis, it would only require that the marginal income tax rate of the 10% with the highest incomes should be increased by less than 20% to cover the redistribution requirement for eradicating all absolute poverty. And of the 30 LICs, 8 countries could do with less than an increase in the marginal income tax rate of 20 %. Of the 86 MICs, it is only in 8 countries that the marginal income tax percentage should be increased by more than 20%.

Redistribution tax required for eradicating absolute income poverty

% tax increase	Number of countries			Total
	LIC	LMI	UMI	
0 - 10	4	31	39	74
10-20	4	8	0	12
20-30	6	3	0	9
30-40	3	1	1	5
40-50	5	1	0	6
50-100	4	2	0	6
Above 100	4	0	0	4

Calculated from World Bank, PovcalNet, 2015 figures.

This seems to be a manageable task in the absolute majority of countries. This has at least three *consequences for policy design*. First, as almost all MICs can eradicate absolute poverty by redistributing a small part of their income, there is no reason for countries in the rich part of the world to use scarce development aid resources, aimed at poverty eradication, in MICs. Second, redistribution must also be on the agenda when governments in LICs design strategies to eradicate poverty. Third, development aid should only be provided to LICs where these countries have or are willing to introduce effective redistribution schemes to remove all or part of absolute poverty.

Using education to reduce inequality and increase economic growth

Education plays two major roles in terms of removing absolute poverty. Education is an end in itself and part of the poverty concept, and primary education for all will improve the standing of a country in terms of basically eliminating this dimension of multidimensional poverty. The other effect is in terms of its impact on increasing economic growth, which takes people out of poverty. Universal primary education in combination with a substantial proportion of people completing secondary education is a must for maximising the effect of education investments on long-term income growth. For this to happen, the present huge inequalities in education attainment among different income groups have to be removed. And not least, the quality of education must improve. As it is now, the appalling fact is that after 4 years of primary schooling, 250 million children worldwide cannot read and write.

Improved health for economic growth and reduction in poverty and inequality

Like education, health is an end in itself and part of the poverty concept, and improved health for all will improve the standing of a country in terms of reducing this dimension of multidimensional poverty. The interventions especially by the Global Fund to combat just the three diseases of HIV/AIDS, malaria and tuberculosis have meant a world of difference for millions of people. And brought hope that with sufficient willingness and funding it is possible to save millions of lives especially among the poorest income groups in LICs and MICs. For society this will also have positive ramifications, in terms of people continuing being productive and in less strain on health facilities. An added benefit of improved health is the impact on population growth.

But this should not remove (as is often unfortunately the case) the attention from the other parts of the health system, which also have an obligation to prevent and cure all the other diseases. There are clear tendencies for *de facto* creation of dual systems, one well resourced from the Global Fund, and one less well resourced by the respective governments. This puts an additional pressure on governments to prioritise their own funding by adding further resources to the health sector.

The large challenges due to the high population growth

The total population of our world continue to increase. By October 2011 it had reached 7 billion. With each woman in countries like Niger, the Democratic Republic of Congo (DRC) and Somalia getting on average between 6.5 and 7.5 children during her child bearing age the challenge in terms of securing sufficient food, education and health services is close to insurmountable. More than 80% of the total population lives in LICs and MICs, with only 12% staying in LICs. South and East Asia accounts for half of the world population. The poorest region, SSA, has an average population growth rate of about 3%.

The estimated time it will take for the population growth rate to approximate zero depends on the assumptions used for calculations. According to the United Nations (UN), the population will still be increasing into the next century, having reached 10.9 billion by year 2100. Although the assumptions used by the UN are much criticized, the projections illustrate well the seriousness of the issue: Almost 4 billion more people by the turn of the next century – or an increase by more than half of the present world population. But unless the time in between the next 1 billion person arrives on the planet (now around 12 years) is not increased drastically we will reach 10 billion people much before year 2100.

There is significant inequality in total fertility and under-5 mortality among income groups, with both fertility and mortality rates decreasing with increasing income. This underlines that contrary to what most population analysis is concerned about, measures to reduce the level of inequality must be an integrated ingredient when designing policy interventions to curb population growth. Even though there have been much criticism and discussion of *family planning* programmes, these are intrinsic to anti-poverty efforts by facilitating increases in living standards. Had countries like China and India not implemented (much discussed and controversial and in many cases using unacceptable methods) family planning programmes, there would today on our planet have been many hundred millions of additional people who would have to be fed.

An international trade regime benefitting the strongest

Trade is about politics, both at the international and domestic levels, vested interests and distribution of its gains. Had it been the case that free trade is so beneficial for all partners as usually argued, there would not have been that many protective measures (monetary as well as non-monetary trade barriers) in place. And it would not have taken more than a decade for the WTO to make its first agreement (which only came at the Bali meeting in December 2013).

The international trade regime does not operate effectively seen from the point of view of LICs. Expansion in *South-South trade* provides the best prospects for benefitting from international trade. Although the *duty free quota free access* for Least Developed Countries (LDC) to both the EU and other high-income country markets is an advantage, the best offer the high-income countries can provide is to let this regime cover 100% of goods (except arms). The present 97% coverage in effect excludes essential products, where LDCs have a comparative advantage. Improved trade facilitation (like reforms of border management procedures), also in LICs, will assist in reducing costs of international trade to the benefit of exporters and importers in these countries.

Global value chains play an increasing role in international trade, with a large proportion of global trade being linked to the international production networks of multinational companies. Therefore the *distribution of gains from trade facilitation* depends on the structure of markets in which the *global value chains* operate. Most often, trade facilitation benefits will not be reflected in lower consumer prices or in higher payment to upstream firms (small suppliers) or payment of higher wages to workers employed by upstream firms. Often only a smaller share of the value added in traded goods stems from the primary producers, be it labourers or small farmers in LICs or MICs. This provides opportunities for multinational (lead) firms in global value chains to capture a proportionally large portion of benefits from trade facilitation.

Structural transformation through investments

Structural transformation of LICs is a must for taking them permanently out of poverty. It requires that people be moved from low productivity sectors to growing sectors experiencing positive productivity growth, if positive dynamic structural transformation should be obtained. These sectors differ from country to country and detailed country analysis is required to identify high productivity growth sectors and measures to promote these. This type of assessments is part of supportive *investment policies* to be implemented for underpinning structural change. Other essential elements of investment policies are in particular creation of *forward and backward linkages and spillover effects* from foreign direct investment (FDI), but also removal of bottlenecks to new economic activities, strengthening the intellectual property regime, competition policy and promotion of entrepreneurship. South-South integration, both in terms of FDI and trade, must be one of the elements in policies for accelerating the process of structural transformation, in particular in SSA, where the needs are largest.

The power of agricultural led growth to reduce poverty and inequality

Agriculture is by far the most powerful sector to remove absolute poverty. Similarly, under agricultural led growth, inequality is reduced more than under non-agricultural sector led growth. With an objective of eradicating absolute poverty and to reduce inequality, agriculture therefore place itself in a unique and very strong position. Within the non-agricultural sectors, agro-processing is the one performing best on these two criteria – reduction of poverty and inequality, and is as such an important supplement to, and ingredient of agricultural sector led growth.

But the agro-business sector in SSA will not be able to effectively take people permanently out of absolute poverty, unless the agricultural sector is transformed through agricultural intensification with much higher yields, based on green revolution principles. The present agricultural productivity, and hence production, is simply too low to sustainable underpin structural transformation only on the basis of a growing agro-business sector.

Infrastructure and inclusive innovations foster eradication of poverty

One of the conditions for firms to be innovative and undertake technological development is that a proper infrastructure is in place, first and foremost electricity. But also the quality of transport infrastructure and availability of safe water and improved sanitation play a role, as this influences location of firms and skilled labour. This type of infrastructure is an obvious candidate for public investments. A new determining factor is availability of fibre optic networks for broadband provision and networks for mobile phone communication. Clustering of firms, enabling ease of transfer of information, knowledge and experience provides a better environment in which innovation can take place. And this type of clustering only takes place provided the full set of infrastructure needs is in place.

With improved access, Information Communication Technology (ICT)-based applications are increasingly important for *inclusive innovations* and offer prospects for extensively improving welfare and facilitating business opportunities for lower-income groups. There are many new ICT based innovations, ranging from use of mobile phones to transfer money; obtain price and market information on agricultural products; pregnant mothers getting regular text messages from health providers improving their attendance to antenatal and postnatal care and improving possibilities for health education. A state-of-the-art health helpline has been established in India providing 80 million people in Andra Pradesh with round-the-clock, qualified and standardised medical information, advice and counselling.

No doubt a variety of ICT based innovations developed to support agriculture, health, education and mobile banking have successfully improved the living conditions for the lower income groups they have reached. However, to have a wide impact the innovations must be able to reach larger *scales*.

Total poverty gap in LICs and MICs – the value of needs to remove all economic poverty

The total size of needs necessary to eradicate absolute poverty, measured as the value of the poverty gap in LICs and MICs, is less that 140 billion USD. Approximately the same size as the present value of global official development aid (ODA). In MICs the needs are about 80 billion USD, and in LICs a little less than 60 billion USD.

The size of international financial flows – in perspective of the global poverty gap

The total annual value of FDI, private flows, remittances and ODA, major financial flows into LICs and MICs, is more than 11 times larger than the global poverty gap. Total savings and tax payments in these countries amounts to more than 7 and 3 trillion USD respectively. And export, a powerful production and income generator, is larger that 5 trillion USD. Many times higher than the poverty gap.

International financial flows to LICs and MICs, 2013, in billion USD

	LIC	LMI	UMI	MIC	Total
FDI	24	110	601	711	735
Private debt and portfolio equity	2	114	286	400	402
Remittances	24	174	126	300	324
ODA	68	42	20	62	131
Total	118	440	1.033	1.473	1.592

Source: World Development Indicators, 2014 and OECD, ODA Tables and Charts, 2013.

The issue is that the poverty gap is largest in the countries where the tax income, export, FDI and remittances are smallest. So a distinction needs to be made between LICs and MICs. *MICs* are on all these parameters better off than LICs. And they are so much better off that *they can manage themselves in eradicating all absolute poverty*, even when two-thirds of the 1 billion people living below the absolute poverty line are found in MICs. The richest portions of people in MICs have such a high share of the income, that a redistribution scheme without much effort could eradicate all absolute poverty from one year to the next in most MICs. And with all the other resources these countries have available, there is every good reason to believe that they can manage this task themselves. They certainly do not need to be bailed out by taxpayers in high income countries through provision of ODA.

The situation is different for *LICs*. The have a little more than 40% of the global poverty gap. Of this more than half is found in just 4 countries: Bangladesh, DRC, Ethiopia and Madagascar. Four countries that collect very low percentages of GDP (10-14%) in taxes. But the total GDP of all LICs is only about 560 billion USD and their export 100 billion USD. They *can definitely not manage without additional external financial resources* – the poverty gap is about 10% of their total GDP. But the gap is not so large, that it is impossible to overcome the challenge of closing it.

In addition to these financial flows, there exist a stock of resources, held by some citizens in LICs and MICs, which could be used to boost the economies in which these citizens live. Large amounts of capital - termed *illicit financial flows* - has during many years been siphoned off by corrupt presidents, ministers and government officials and stacked in hidden off shore bank accounts in various tax shelters. In addition, multinational companies have mis-invoiced import and exports to draw money out of the countries. In 2011, in just one year, the total amount was close to 1 trillion USD or almost 20% of total export from LICs and MICs.

Tax reforms to include increased collection of taxes and international combatting of tax avoidance

When it comes to financing, changes to both the international and domestic taxation regimes must be made. Countries must increase the level of revenue collection, tax avoidance must be halted, illicit financial flows combatted, new tax objects (like resource rents and financial transactions) introduced and the taxation system must be used to redistribute income from the very well off to people living below the absolute poverty line. Some of these tasks single countries cannot lift themselves. There is need for international support, a.o. for full transparency in tax payment by companies operating in more than one country, closure of all tax havens and much improved exchange of tax information.

Savings and well developed financial systems required for structural transformation

Well functioning financial systems play an important role in encouraging long run economic growth. Especially in encouraging expansion of liquidity to long-term investments, that can lead to structural transformation of economies. This underscores the necessity of developing *financial systems as a prerequisite for structural transformation* of LICs and MICs.

Increasing the value of remittances to eradicate poverty

The value of remittances at the recipient end is at present significantly lower than what it could be. Due to monopolies in the money transfer markets and a range of constraining regulations when it come to the large amounts of remittances transferred each and every year, the *cost of remitting funds* from one country to another is prohibitively high. At present 8% on average, but above 20% when it comes to e.g. some intra-SSA transfers. Reduction in transfer costs will greatly increase the value in recipient countries of remittances. Important players in changing the rules of the game for reducing these costs are governments of large remittance receiving countries and international organisations like the Universal Postal Union and the International Telecommunication Union. Fortunately, this issue has also been brought to the attention of the G-20, which latest discussed the issue in December 2014. But ODA providers can also play a role through their membership of these organisations.

Use of *diaspora* bonds to raise funding for e.g. infrastructure investments (like dams, roads, electricity generation, fibre network for internet but also hospitals and schools) is also a viable path forward. To overcome the potential resistance from investors, sufficient trust in government's ability and willingness to repay must be established. Often this would require provision of partial guarantees, which e.g. could be from the Multilateral Investment

Guarantee Agency, or from guarantee instruments established as part of innovative infrastructural financing mechanisms.

Increased, reprioritised and more effective ODA – with only one objective

Increased ODA, together with reprioritisation of provided ODA is also an element of the strategic framework for eradicating absolute poverty, reducing inequality and promoting sustainable economic growth. ODA must be reoriented so that its *only objective is eradication of absolute poverty*. Both on paper and in practise. Increased ODA flows are political decisions, and it continues to be a scarce resource. Hence only LICs should receive ODA, provided they are willing to enter into a deal with ODA providers. A deal, where they agree to undertake reforms of especially their tax systems to introduce redistribution schemes towards the absolute poor and increasing the share of funding to public education, provision of health services and family planning interventions.

Another essential reprioritisation of ODA is an *increase in its complementarity* with the other international financial flows. The reason being that ODA itself cannot solve the large challenges facing especially LICs. The amounts of ODA are too small, and recipient governments and ODA providers are not the main players in a number of sectors. To get most value from the scarce ODA money being available, innovative solutions to complement and increase the effects of other, and larger financial flows are needed.

The bottom line – we all have to contribute

The interesting feature is that the methodologies for eradicating absolute poverty, both its economic and non-economic aspects, reducing inequality and obtaining sustainable economic growth, are all well known. We know what should be done.

There is a role for ODA. But the largest work has to be done by governments in LICs and MICs themselves.

The political willingness is the most important feature, both in high, middle and low income countries. The world is now so globalised that common solutions are needed. We all have to contribute.