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Do Poorer Countries Have Less Capacity for Redistribution?

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The government of a rich country will be disinclined to give its aid to a country that has internal capacity to tackle poverty through redistribution from people at a similar standard of living to taxpayers in that rich country. Yet we do not have tools for measuring the capacity for redistribution that reflect this property. Indeed, past measures imply heavy tax burdens on people who would be considered poor in rich countries.

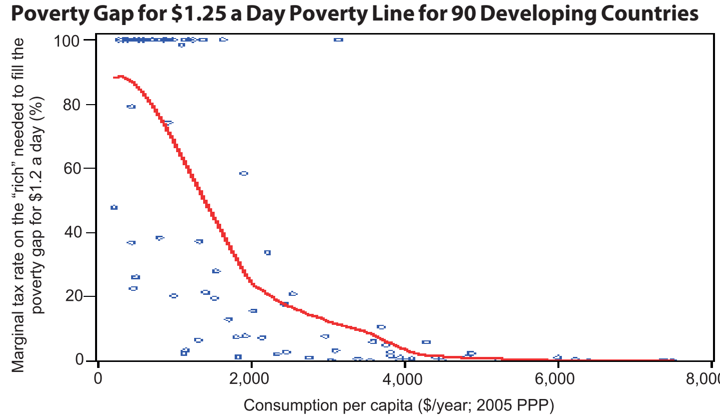
The issue of country capacity for redistribution also arises in discussions of development policy within developing countries. It is often argued that "sustained poverty reduction is impossible without sustained growth." To accept this claim one must essentially reject its corollary: "sustained poverty reduction is impossible through income redistribution." Is that right?

New and better measures of the capacity for redistribution can be devised and implemented with currently available data (Ravallion, 2009). These measures make a more appealing assumption about how the required tax burden is to be allocated amongst those living above the poverty line: the burden is set to zero until one reaches a standard of living that would not constitute poverty in a representative rich country, and then rises as a share of income in excess of the rich-country line.

On implementing these measures using data for 90 developing countries, I find that developing countries fall into two distinct groups. The first appears to have little or no scope for making a serious impact on the problem of extreme absolute poverty through internal redistribution from those who are not poor by US standards. The second group appears to have far more scope for such redistribution. Most of the poorest countries in terms of mean consumption fall into the first group. The marginal tax rates (MTRs) needed to fill the poverty gap for the international poverty line of $1.25 a day are clearly prohibitive (marginal tax rates of over 50 per cent and many of 100 per cent or higher) for the majority of countries with consumption per capita under $2,000 per year at 2005 purchasing power parity. Even covering half the poverty gap would require prohibitive MTRs in the majority of poor countries. Yet amongst better-off developing countries—over $4,000 per year (say)—the marginal tax rates needed for significant pro-poor redistribution are actually very small—less than 1 per cent on average, and under 6 per cent in all cases (see Figure.)

Basic-income schemes (guaranteeing the poverty-line income to everyone, whether poor or not) financed by progressive income taxes would also require prohibitive marginal tax rates in the poorest half of developing countries. If the tax burden is confined to those who are not poor by developed-country standards, providing a basic income of $1.25 a day would call for marginal tax rates of 100 per cent or more for three-quarters of countries. Even for middle-income developing countries, this type of redistribution only starts to look feasible in terms of the implied marginal tax rates if one allows for a basic income appreciably less than $1.25 a day and/or significant tax burdens on the middle class.

MTR on those Living above the US Poverty Line Needed to Cover the Poverty Gap for $1.25 a Day Poverty Line for 90 Developing Countries



The emphasis often given to the role of economic growth for poverty reduction in poor countries can claim support from this new evidence on the capacity for redistribution in poor countries. The poorest countries appear to have weak capacity for attacking poverty through income redistribution, given the sheer weight of poverty and thinness of the rich strata in their starting distribution. But with sufficient economic growth the tax rates on the rich required for covering the poverty gap start to fall rapidly. Thus it makes sense that the poorest countries focus on growth, and rely more on aid, but that redistribution starts to emerge as a viable strategy for fighting poverty at higher income levels.

These new measures and data suggest an affirmative answer to the question posed in the title of this One Pager. However, that support comes with qualifications. The capacity for redistribution varies amongst countries at any given level of mean income. And the variance is highest amongst the poorest countries; there are even a few poor countries where a substantial dent on poverty could be made with seemingly light taxation of the rich. These differences bear little relationship to a standard measure of inequality, but reflect the deeper parameters of the distribution of income in each country that have generated lower poverty to start with.

Reference:

Ravallion, Martin (2009) "Do Poorer Countries have less Capacity for Redistribution?" *Policy Research Working Paper* 5046, World Bank (Washington, DC). <http://econ.worldbank.org/docsearch>.

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