Tackling income inequality

Wednesday, Mar 28, 2012

By *Dr. Sadiq Ahmed*

The substantial reduction in poverty in Bangladesh since independence is a cause for celebration.

Members of the working class often suffer the adverse effects of the country's growing income inequality.Photo: STAR

A major reason for this decline in poverty is the rising per capita income, growing from less than 2 percent a year in the 1970s to around 5 percent a year in the 2000s.

Yet, it is worrisome that an estimated 47 million people are still below the national poverty line. Continued rapid growth in per capita income will help reduce poverty further, but the ability of higher growth to lower poverty is hampered by growing income inequality. Available evidence from the Household Income and Expenditure Surveys (HIES) suggests that income inequality as measured by the 'gini coefficient' has been rising, growing from 0.39 in 1983/84 to 0.47 in 2005/06, although falling slightly to 0.46 in 2010.

Another dimension of the inequality problem is provided by the respective income shares of the bottom and top 5 percentile of the population. The income share of the bottom 5 percent of the population fell from 1.2 percent in 1983/84 to 0.8 percent in 2010. In comparison, the income share of the top 5 percent has grown from 18.3 percent to 24.6 percent over the same period. In addition to the adverse implications for poverty reduction effort, the growing concentration of income presents a social challenge of relative deprivation. History is replete with examples of social and political unrest in environments where huge differences in the standards of living of citizens prevail.

The government, the academics and civil society leaders have often expressed concern over this development. Yet a coherent strategy and the implementation of underlying policies remain to emerge. Despite the populist stance of many policy decisions of the various governments, the end result in terms of income distribution is very different.

Bangladesh is not alone in showing growing income inequality. Notable other countries that have experienced growing income inequality along with rapid economic growth include China and India. In economic literature, there is a debate popularised by Nobel Laureate Simon Kuznets about whether low income countries will have to experience some increases in income inequality before they reach a threshold level of income after which income inequality will fall.

The validity of this inverted U-curve relationship between growth of per capita income and income inequality, popularly called the Kuznets-hypothesis, has been researched extensively but inconclusively. A priori, there is no obvious reason that income inequality must increase in order to achieve high rates of economic growth. The observed phenomenon in many countries is a reflection of initial unequal distribution of wealth and assets and the fact that the underlying growth strategies and policies have not specifically addressed the inequality challenge.

The income inequality problem has sometimes been sought to be addressed through policies that seek to change the initial unequal distribution of wealth and assets. In one extreme, the economic philosophies of communism and socialism are based on the premise of redistributing income directly through public rather than individual ownership of wealth and assets. In market economies of the type prevailing in Bangladesh, a radical programme of redistribution of existing wealth and assets to address the problem of income inequality is not a realistic option.

Even the more limited effort of trying to redistribute land is not a pragmatic policy option. International experience of land redistribution in market economies is fraught with disappointing performance. The successes of the oft-quoted experiences of Japan and Korea are really special cases. Furthermore, in Bangladesh, the average size of land-holdings is very small. Individual ownership of large land holdings is limited. The government is the biggest land-holder and some redistribution has been attempted from time to time with limited success owing to severe governance problems including the political clout of professional land grabbers.

The dynamic redistribution of wealth, assets and income through policies, regulations and institutions that seek to increase human capital and earnings capabilities of the poor citizens hold much better promise and prospects. Access to better education and healthcare is a fundamental right of the Bangladeshi citizen and requires utmost attention of the government.

Despite all the progress being made on the education front, including better gender balance, the 2010 labor force survey shows that a whopping 40 percent of the workforce has no education; some 23 percent has only up to primary education; and less than 4 percent has tertiary education. Similarly, while there has been progress with health indicators, there is still a long way to go to ensure much better health indicators and services for the citizens. Public spending on education is a mere 2.4 percent of GDP while it is only 1 percent of GDP on health. In comparison, Korea spends 4.8 percent of GDP on education and 3.5 percent of GDP on health.

Clearly, a major way that the government can help improve income distribution is by making faster progress in building the human capital of the poor. This will equip the poor to get better and higher paying employment. An educated and healthy labor force can also help increase the rate of growth of GDP while improving income distribution. This will require raising the share of public spending on education and health to at least 4 and 2 percent of GDP respectively. This will also require major improvements in the delivery of public education and health services through education policies, governance and institutional reforms.

A second area where public spending has to increase concerns rural infrastructure — rural roads, rural electricity, irrigation and flood control. Past government spending in this area has helped increase farm productivity and food production. The near food self-sufficiency of Bangladesh despite rapid population growth is testimony to the success of this policy. Yet, much of the labor force remains engaged in low productivity and low earnings agriculture. There is a need both to diversify agriculture into higher value-added activities and to help transfer surplus labor from agriculture to non-farm activities in rural and urban areas. This transformation will support both growth and income distribution by helping increase average labor productivity in the economy. An additional spending of 1 percent of GDP on rural infrastructure will be helpful.

In addition to public spending on rural infrastructure, availability of rural credit is an important determinant of this transformation. The scaling up of formal credit to the rural economy remains a huge challenge.

A third area where public spending has to grow is on social protection. Presently, the government spends 2.4 percent of GDP on social protection. There are important concerns about the quality and targeting of this spending that needs urgent review and reform. Additionally, the government may need to increase spending on social protection to at least 3 percent of GDP.

Higher public spending on education, health, rural infrastructure and social protection by an estimated additional 4 percent of GDP is a seemingly tall order in the present environment of public resource constraint. A closer look will suggest that a strategy to mobilise this additional funding is certainly within the reach of public policy.

In the first place, the government spends some 4 percent of GDP on subsidies, of which 3 percent of GDP is on energy. This can be cut by half through price increases and diverted to the above mentioned more socially responsive spending.

Secondly, a major reason for the resource constraint is low tax collection, especially from personal income taxes. Bangladesh collects a mere 1 percent of GDP from personal income taxes while the top 5 percent of the population owns 25 percent of the total national income. This yields an effective income tax rate of 4 percent, which is ridiculously low.

Increasing the effective income tax to even 10 percent would yield income tax from this group alone in an amount of 2.5 percent of GDP. Applying the tax rate to the top 10 percentile that owns 35 percent of the national income will yield 3.5 percent of GDP. This will require closing of loopholes that lets capital gains escape the tax net, introducing a modern property tax system, and improving tax administration and compliance.

Together, this combination of expenditure reallocation (2 percent of GDP) and additional tax effort focused on personal income (2.5 percent of GDP) can finance the additional 4 percent of GDP required to fund critical social programmes. This fiscal policy package can be a powerful instrument for improving income distribution as the incidence of this tax and expenditure package is likely to be highly progressive.

In addition to a more effective fiscal policy, the government can also help improve income distribution through better governance. This requires rule of law, proper regulations and letting institutions grow and work. Rent seeking behaviour through discretionary access to public bank loans, non-repayment of these loans, insider trading and other manipulations in stock markets, tax evasion, corruption in public procurement and public spending, and illegal land grabbing including public land are all examples of how massive income transfer has happened to the top 5 percent of the population based on political patronage in different periods. Improved governance that makes key public institutions like the central bank, public commercial banks, public enterprises, the Tax Department, Rajuk, and the municipalities work on the basis of defined rules of business and accountability rather than through political directives is likely to help Bangladesh achieve better income distribution.

The writer is vice chairman of Policy Research Institute of Bangladesh. He can be reached at sahmed1952@live.com