

# Policies for Inclusive Growth

Strengthening the link between economic  
growth and equity

Background Policy Note prepared for G20 Framework Working  
Group | July 2024



**THE WORLD BANK**

# Introduction

This background policy note was prepared under the requires of the G20 Framework Working Group. It summarizes the latest evidence on trends in poverty reduction, shared prosperity and inequality and provides policy recommendations to strengthen the link between growth and equity<sup>1</sup>. This note aims to complement other background work prepared by other International Organizations. It also complements the World Bank background inputs related to the current global macroeconomic and financial conditions.

The first part of the note presents the latest trends on poverty and inclusive growth using two new indicators the World Bank has adopted to measure inclusive growth: the Global Prosperity Gap and the number of countries with high inequality. The second part summarizes key findings from recent work on strategies for poverty reduction and policies to reduce inequality within countries. Reducing poverty in low and middle-income countries will require more investments in the productive capacities of the poor and their ability to generate income and contribute to economic growth. Reducing inequality within countries and promoting an inclusive growth process requires a comprehensive strategy encompassing pre-market, in-market, and post-market interventions.

## 1. Renewed Focus on Inclusive Growth

The recent slowdown in the pace of global extreme poverty reduction, combined with the uneven economic impacts of the COVID-19 pandemic, and the challenges brought on by conflict, climate change, and inflation underscore the urgent need for a renewed focus on inclusive growth. In 2020, due to the COVID-19 pandemic, the number of people living below the international extreme poverty line of \$2.15 a day rose by over 70 million, marking the largest one-year increase since monitoring began in 1990. In 2020, the world also experienced the largest increase in global income inequality in recorded history (World Bank 2022a).

While the share of people globally living in extreme poverty is very close to pre-pandemic levels, poor economies have yet to recover and close the gap, further exacerbating global inequality. Within-country inequality also remains unacceptably high in many countries, hindering efforts to reduce poverty (Haddad et al., 2024). Today, the world is at a juncture where economic growth is projected to remain low and uneven, and the impact of climate change to increase. Therefore, ensuring that growth reaches the poorest segments of the population and that inequality levels are kept in check is essential.

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<sup>1</sup> All data used in this report is based on the latest publicly available World Bank data published in April 2024 on the Poverty and Inequality Platform, unless otherwise stated. This data provides the first post-pandemic assessment of poverty and inequality trends using household survey data.

## Box 1: A New Measure to Track Shared Prosperity

Since 2013, the World Bank has been tracking shared prosperity, recognizing that average growth alone is not a good marker of development, but that it matters how this growth is distributed particularly among the least well-off. In a renewed push to focus on inclusive growth, the World Bank has adopted a new measure to its corporate scorecard this year: the Global Prosperity Gap.

### The Global Prosperity Gap

Shared prosperity encapsulates two ideas: economic progress and equity. From a global perspective, progress in shared prosperity depends on three distinct aspects: (a) Size of average growth for the world; (b) Distribution of that average growth across countries, ideally tilted in favor of lower-income countries; (c) Distribution of a country's growth within its population, ideally pro-poor. All three aspects are captured by the Global Prosperity Gap, bringing together the notions of *progress* (measured by average growth) and *equity* (measured by the level of inequality in society) into one indicator of inclusive growth.

The Global Prosperity Gap gives a greater weight to the incomes of the poor. Poorer households – and thus also poorer countries – contribute significantly more to the index than their better-off counterparts at any point in time, and income growth among the poorest households in the world matters significantly more to reduce the Global Prosperity Gap than growth among the better-off. Furthermore, the Global Prosperity Gap can be decomposed among geographic regions, countries, or other population groups to understand the drivers of the global prosperity shortfall.

The Global Prosperity Gap (PG) is derived by:

$$PG(y, z) = \frac{1}{N} \sum_{i=1}^N \frac{z}{y_i}$$

Where  $i = 1, \dots, N$  indexes individuals;  $y_i$  denotes individual  $i$ 's income or wealth;  $y = (y_1, \dots, y_n)$  denotes the distribution of incomes ordered from smallest to largest; and  $z > 0$  is a parameter whose value can be interpreted as the prosperity standard, currently set at 25\$ per day.

The PG is a simple average of individual contributions, where the contribution of a person at the threshold  $z$  is 1, the contribution of a person with half the threshold  $z$  is 3, and so on. The PG index is the average factor by which individual incomes must be multiplied to reach the prosperity standard  $z$ . A detailed overview including the statistical properties of the Global Prosperity Gap can be found in Kraay et al. (2023).

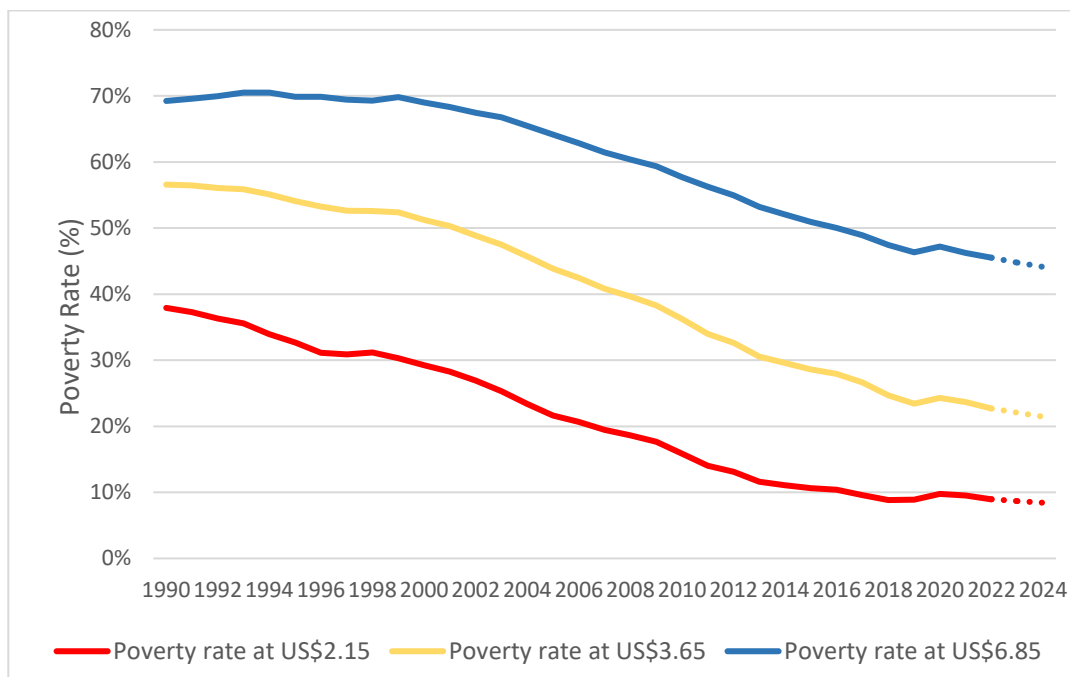
## Trends in Poverty Reduction and Shared Prosperity

### 2.1. Trends in Poverty Reduction

In 2024, about 8.5 percent of the global population is living in extreme poverty (Figure 1). This means that about 700 million people in the world still live on less than US\$2.15 per day. After decades of progress, the pace of global poverty reduction began to slow by 2015, in tandem with subdued global economic growth. In addition, the COVID-19 pandemic hit at an unprecedented scale, representing the biggest setback in the fight against global poverty in decades (World Bank 2022a). Global extreme poverty jumped by nearly 1 percentage point in 2020 and 70 million people fell into poverty that year. In 2022, the poverty rate was still higher than in 2018, suggesting that four years were lost in the fight against extreme poverty.

Poverty also remains a relevant challenge for many middle-income countries. The total population living on less than \$6.85 per day<sup>2</sup> (the typical line of upper-middle-income countries) has grown since 2020, due to population growth. About 45 percent of the global population live under \$6.85 a day. Using the \$3.65 a day poverty line, which is typical of the national poverty lines used in lower-middle-income countries, one in five people remain poor in 2024 (21 percent of the global population).

Figure 1: Poverty between 1990 and 2030, US\$2.15, US\$3.65 and US\$6.85



Sources: World Bank Poverty and Inequality Platform

Note: Estimates are based on the latest official World Bank data and provide the first post-pandemic assessment of global poverty using household surveys. The data covers the period from 1990-2020 while the estimates for 2023-2024 are based on extrapolations.

<sup>2</sup> The World Bank is now tracking this poverty rate, in addition to the extreme poverty rate, as part of its corporate mission.

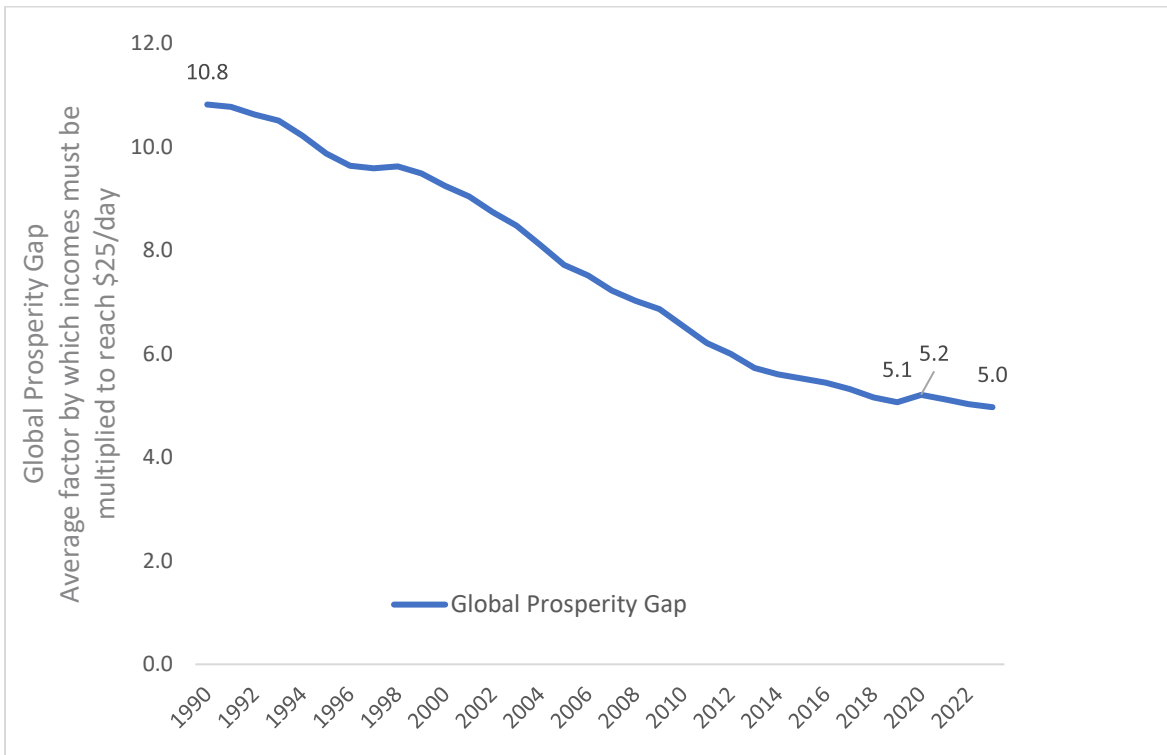
Progress in poverty reduction is projected to remain slow and the goal of eradicating poverty is far out of reach. Even prior to the COVID-19 pandemic, the pace of poverty reduction was not fast enough to reach 3 percent by the end of the decade (World Bank 2018b). The pandemic put the goal even further out of reach, leading to a loss of poverty reduction by about four years (Mahler, Yonzan and Lakner 2022). Poverty rates are projected to continue to decline only gradually until 2030. At this rate, 7 percent of the global population will remain in extreme poverty in 2030, which falls well short of the target of reaching a poverty rate of 3 percent. Forward-looking projections estimate that extreme poverty will be increasingly concentrated in Sub-Saharan Africa (SSA) and in Fragile and Conflict affected States (FCS). By 2030, half of the global extreme poor will be in SSA, and another quarter is projected to be in FCS.

## 2.2. Trends in Shared Prosperity

In 2023, the Global Prosperity Gap is estimated to be 5 meaning that incomes globally would have to increase on average 5-fold for everyone in the world to reach a minimum prosperity standard of \$25 a day. The pandemic slightly increased the prosperity gap, but since 2022 it came back to pre-pandemic levels. The Global Prosperity Gap increased from 5.07 in 2019 to 5.21 in 2020, and then declined to 5.03 in 2022. In other words, in the five years since the start of the pandemic, prosperity has only improved globally by 4 percent (Figure 2).

Despite the recent stagnation in the prosperity gap, since the 1990s there has been substantial progress in shared prosperity (Figure 2). In 1990, the average shortfall from the global prosperity standard was 10.8, meaning that incomes on average needed to be increased close to 11-fold to bring everyone around the world to \$25 per day. By 2022, the latest year with official data, this shortfall was less than half. Over this 30-year period the Global Prosperity Gap only increased (worsened) twice: during the Asian financial crisis (an increase of 0.7 percent from 1997 to 1998) and during the Covid-19 pandemic (an increase of 3.3 percent from 2019 to 2020).

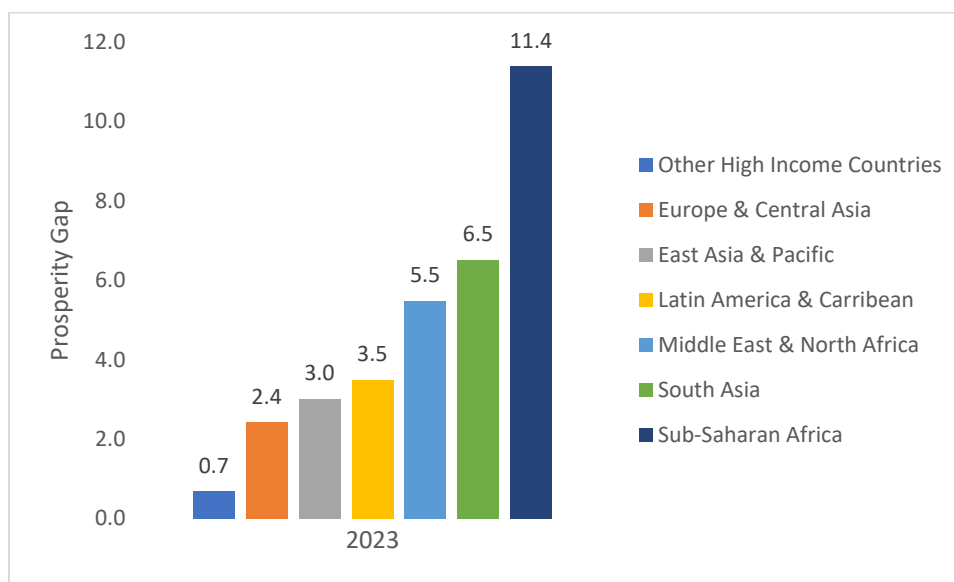
Figure 2: Trends in the Global Prosperity Gap, 1990-2023



Sources: World Bank Prosperity Gap Dashboard and Poverty and Inequality Platform (PIP version 20230919\_2017)  
 Note: The Prosperity Gap is expressed in 2017 PPPs. The estimates are calculated using 1000-point binned distribution derived from country-level household survey unit record data or grouped data. Note that these estimates are preliminary, as they are estimated on a grouped version of the income distributions instead of the micro data directly. The data covers the period from 1990-2019, while estimates for 2020-2023 are based on projections.

In 2023, the prosperity gap ranged from 0.7 in High-income counties to 11.4 in SSA. This signals the large disparities in income levels across regions. In SSA average incomes would need to rise by more than 11-fold to reach the global prosperity standard of \$25 (Figure 3). The region with the second highest regional prosperity gap is South Asia (SAR), with a gap of 6.5 in 2023, followed closely by the Middle East and North Africa (MENA) whose trends have been extrapolated from 2018 due to lack of survey data.

Figure 3: Prosperity Gap in 2023 across regions



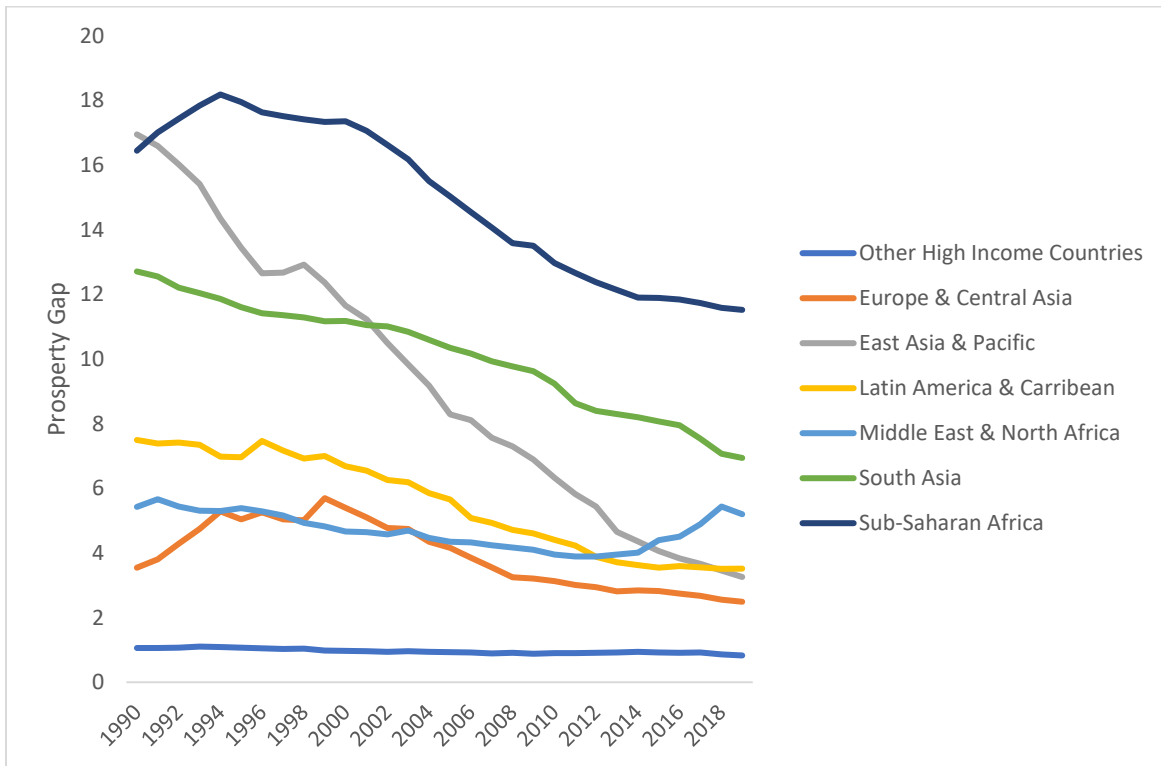
Sources: World Bank Prosperity Gap Dashboard and Poverty and Inequality Platform (PIP version 20230919\_2017)

Note: The Prosperity Gap is expressed in 2017 PPPs. Estimates for 2023 are based on extrapolation of trends from the period between 1990-2019. Note that these estimates are preliminary, as they are estimated on a grouped version of the income distributions instead of the micro data directly.

Historical trends also show the uneven progress in shared prosperity across regions and the large role of East Asia and the Pacific region (EAP) in driving past progress (Figure 4). Strong progress in EAP has meant that the region's prosperity gap has decreased the most, from 17.0 in 1990 to 3.3 in 2019. South Asia started with a lower prosperity gap in 1990 (12.7) and, while some progress was made over the next three decades, the prosperity gap still stands at 7.0 in 2019. Progress in reducing the prosperity gap in the SSA has stalled in the last decade, falling only from 11.9 in 2014 to 12.5 in 2019. MENA is the only region where the regional prosperity gap has increased over the last decade.

Between 1990 and 2019 the Global Prosperity Gap improved at an annual rate of 2.6 percent, with global mean income increasing at an annual rate of 1.5 percent and global inequality declining by 1 percent. These gains in global prosperity over the past three decades were driven primarily by catch-up growth in populous and relatively poorer regions of the world, in particular China and other countries in EAP. The growth convergence of these populous and relatively poorer regions led to a substantial reduction in global interpersonal inequality.

Figure 4: Trends in Regional Prosperity Gap 1990 - 2019



Sources: World Bank Prosperity Gap Dashboard and Poverty and Inequality Platform (PIP version 20230919\_2017)

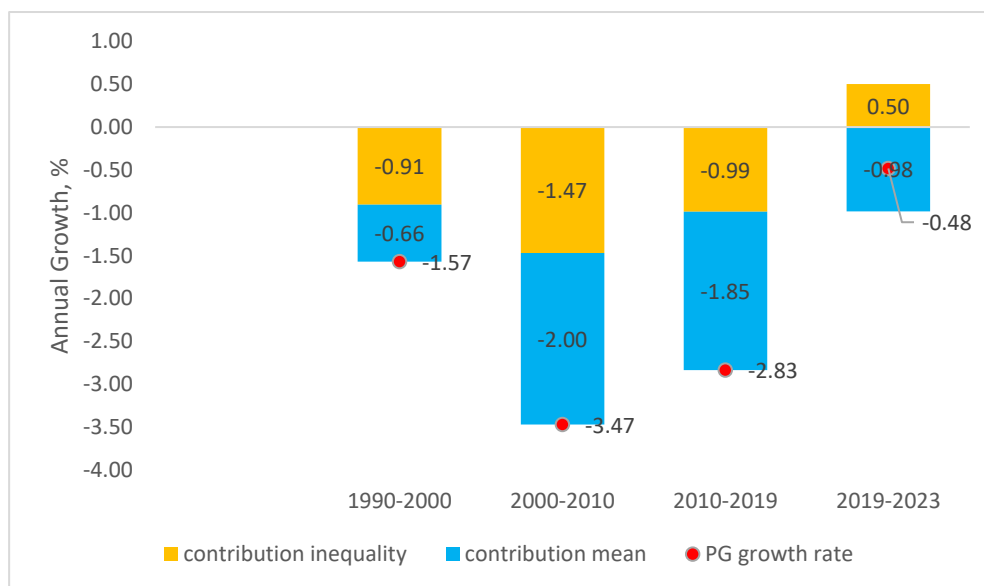
Note: The Prosperity Gap is expressed in 2017 PPPs. The data covers the period from 1990-2019. Note that these estimates are preliminary, as they are estimated on a grouped version of the income distributions instead of the micro data directly.

Over time, the role of inequality in reducing the Global Prosperity Gap has declined substantially (Figure 5). Between 1990 and 2000, the Global Prosperity Gap improved at an annual rate of 1.57 percent, with slightly less than half of the gains coming from the narrowing of global inequality. The reductions in the Global Prosperity Gap were larger in the subsequent two decades (annualized reduction of 3.5 percent between 2000 and 2010, and by 2.8 percent between 2010 and 2019). These reductions were driven by strong economic growth and the narrowing of global inequality, but the contribution of inequality reduction declined significantly after 2010. In the most recent period inequality has *increased*, in effect dampening the extent to which growth has reduced the prosperity gap. In 2020, the world experienced the largest single-year increase in global income inequality in decades (Mahler, Yonzan and Lakner 2022).

At the national level, countries can boost shared prosperity by accelerating economic growth or reducing inequality. The Global Prosperity Gap gives a greater weight to the incomes of the poor and therefore income growth among the poorest households in the country matters significantly more to reduce the gap than growth among the better-off. In other words, high within-country inequality provides a penalty in the global ranking (see example Box 2). Poor countries need higher growth to reach the prosperity standard of \$25 per day, but poor countries with high levels of inequality need a whole lot more growth.



Figure 5: Decomposition Prosperity Gap between Mean Growth and Inequality  
1990-2023



Sources: World Bank Prosperity Gap Dashboard and Poverty and Inequality Platform (PIP version 20230919\_2017)

Note: Growth is calculated as the log difference, which is an approximation. Change in Prosperity Gap is the sum of the (negative) growth in the mean income and the decline in inequality. Inequality is measured using the inequality measure related to the Prosperity Gap. Note that these estimates are preliminary, as they are estimated on a grouped version of the income distributions instead of the micro data directly. The data covers the period from 1990-2019, while estimates for 2020-2023 are based on projections.

### 2.3. Trends in Within-Country Inequality

Today inequality is high in 52 countries (see Figure 6). As part of a new commitment to monitor within-country inequality the World Bank recently introduced a new key indicator<sup>3</sup>: the number of countries with high inequality defined as a Gini index above 40 (Haddad et al. 2024). While complete equality is neither feasible nor necessarily desirable—for instance, a part of inequality of wages reflects differences in efforts—there is a broad consensus that when inequality in a country is too high it is detrimental.

High inequality countries are concentrated in Sub-Saharan Africa and Latin America. Over time, the number of high-inequality countries has declined. Before the COVID pandemic, in the period between 2014 and 2019, within-country inequality was as likely to fall as to increase but reductions in inequality were likely to be larger than increases, particularly in the Latin America and Caribbean, East Asia and

<sup>3</sup> The World Bank Poverty and Inequality Platform contains Gini estimates for 169 countries comprising about 98% of the world's population. Some countries have annual estimates while others have less frequent estimates. For the analysis used in this report, half of countries have a Gini index from 2020 or later, while the latest Gini index of 10 countries predates 2011. For more details see Haddad et al. 2024.

Pacific, and Europe and Central Asia regions (Figure 7). Countries in the Middle East and North Africa were more likely to experience an increase in inequality, whereas it was either stable or declining in South Asia. Altogether, in a sample of 78 countries, 34 had falling inequality, compared with 13 with rising inequality. In 31 countries, the Gini index was essentially unchanged; it varied by less than 1 Gini point over time (World Bank, 2022a).

Figure 6: High-inequality countries

Country <i>Consumption</i>	Year	Gini	Country <i>Income</i>	Year	Gini
South Africa	2014	63.0	Columbia	2022	54.8
Namibia	2015	59.1	Belize	1999	53.3
Eswatini	2016	54.6	Brazil	2022	52.0
Botswana	2015	53.3	Panama	2023	48.9
Zambia	2022	51.5	Guatemala	2014	48.3
Angola	2018	51.3	Honduras	2019	48.2
Mozambique	2019	50.5	Costa Rica	2022	47.2
Zimbabwe	2019	50.3	Nicaragua	2014	46.2
Congo, Rep.	2011	48.9	Ecuador	2022	45.5
Comoros	2014	45.3	Guyana	1998	45.1
Lesotho	2020	44.9	Paraguay	2022	45.1
Congo, Dem. Rep.	2020	44.7	Venezuela, RB	2006	44.8
South Sudan	2016	44.1	Türkiye	2021	44.4
Grenada	2018	43.8	Mexico	2022	43.5
Rwanda	2016	43.7	Chile	2022	43.0
St. Lucia	2015	43.7	Bolivia	2021	40.9
Ghana	2016	43.5	Philippines	2021	40.7
Central African Republic	2021	43.0	Argentina	2022	40.7
Uganda	2019	43.0	Malaysia	2021	40.7
Madagascar	2012	42.6	Uruguay	2022	40.6
Cabo Verde	2015	42.4	Peru	2022	40.3
Cameroon	2021	42.2	Trinidad and Tobago	1992	40.3
Papua New Guinea	2009	41.9			
Djibouti	2017	41.6			
Haiti	2012	41.1			
Turkmenistan	1998	40.8			
São Tomé and Príncipe	2017	40.7			
Tanzania	2018	40.5			
Jamaica	2021	40.2			
Mirconesia, Fed. Sts.	2013	40.1			

Sources: World Bank Poverty and Inequality Platform

Note: Only countries with a Gini coefficient above 40 are listed.

There is no clear pattern across countries in changes in within-country inequality during the Pandemic. Richer countries were more likely to experience a decline in inequality as a result of the fiscal response introduced to counteract the anticipated pandemic-related income losses (Clark et al. 2020). In low- and middle-income countries changes in inequality were highly context-dependent on where in the income distribution the people most affected were located and the capacity of a country to implement fiscal mitigation measures, such as emergency cash transfers (World Bank, 2022a).

Figure 7: Within-Country Inequality 2014 – 2019

Region	Number of countries			Total number of countries	Mean Gini Index	
	Gini index up	Gini index down	Gini index unchanged		2014	2019
East Asia and Pacific	1	6	2	9	38.4	36.9
Europe and Central Asia	2	12	7	21	32.7	31.5
Latin America and the Caribbean	3	8	15	26	32.2	31.6
Middle East and North Africa	1	3	2	6	47.0	45.9
South Asia	2	0	1	3	33.8	35.4
Sub-Saharan Africa	0	1	3	4	35.4	35.4
Rest of the world	4	4	1	9	41.7	39.8

Source: World Bank Poverty and Inequality Platform

Note: The table shows data points for 78 economies, excluding those with data in 2020. Increases and decreases in the Gini index refer to changes greater than 1 Gini point. The mean Gini index is calculated as the unweighted average of country-level Gini coefficients.

### 3. Policies for Inclusive Growth

Growth and equity are key outcomes to sustain a robust process of shared prosperity. When all members of society have the opportunity and skills to generate income, society becomes more equitable. This inclusivity not only benefits individuals but also stimulates economic growth, as more people contribute to the economy, resulting in overall improvements for both the poor and non-poor.

Gains in global shared prosperity have come to a standstill in recent years. The world has witnessed a slowdown in the pace of poverty reduction, combined with an increase in global inequality resulting from the COVID-19 pandemic and challenges brought on by conflict, climate change, and inflation. At the same time, the outlook points to slow economic global growth in the coming years (World Bank 2024a). Against this global economic backdrop, there is an urgent need to act on both fronts to boost shared prosperity: accelerating economic growth and improving the inclusiveness of growth.

In low and middle-income countries policies and development strategies need to ensure growth benefits the poor better. Reducing poverty will require more investments in the productive capacities of the poor and their ability to generate income and contribute to economic growth. Addressing inequality in highly unequal countries requires a comprehensive strategy encompassing pre-market, in-market, and post-market interventions.

#### 3.1 Policies to promote pro-poor growth

Over the past two decades, sustained economic growth has lifted more than one billion people out of extreme poverty and improved average living standards considerably (Dollar and Kraay 2016). However, economic growth has not benefited all groups equally and has also left many behind. In many places, primarily in Sub-Saharan Africa, the poor have not benefitted sufficiently from economic growth. For example, per capita GDP growth of 1 percent is associated with poverty reduction of only 1 percent in Sub-Saharan Africa, compared to 2.5 percent in the rest of the world (World Bank 2024b).

The limited impact of growth on poverty reduction results from factors that constrain the productive capacity of the poor and their ability to generate income and contribute to economic growth (López-Calva and Rodríguez-Castelán 2016). Examples of such factors include: (i) limited access to education which hinders the accumulation of human capital and productive capacity; (ii) lack of basic infrastructure (electricity, sanitation and drinking water); (iii) the economic structure and dependence on natural resources; and (iv) the prevalence of conflict and instability.

Reducing poverty in low and middle-income countries will require substantial investments and policy reforms that make growth more pro-poor. The most effective way to ensure that the poor benefit more from economic growth is through:

- (1) promoting growth that uses labor:** Economic growth leads to poverty reduction, but the sectoral composition of growth matters for the speed of poverty reduction. Development strategies that promote growth of labor-intensive sectors such as agriculture and manufacturing have been shown to lead to larger reductions in poverty as it provide opportunities for the poor to use their most abundant asset, labor (Loayza and Raddatz 2010).
- (2) investments in basic services such as education, healthcare, and infrastructure:** Access to basic services remains highly unequal despite significant improvements in coverages globally. Ensuring widespread access to basic services, particularly primary education, and health care are key to enabling the poor to accumulate human capital and strengthen their productive capacity to earn income in the economy. Substantial investment is needed in basic infrastructure to improve access to clean water, electricity, and roads such that the poor face lower barriers to produce goods and trade in the world economy.

These investments and policy reformed aimed at making the growth process more pro-poor are not only important to reduce poverty but also to reduce the risk of people falling back into poverty and enhance their resilience to future climate change and other shocks (Hallegatte and Rozenberg 2017; Doan et al. 2023).

### 3.2 Policies to address high inequality

High levels of inequality result from several factors and the appropriate actions to address inequality will differ across countries (World Bank, 2016; 2024b)<sup>4</sup>. However, to the extent that inequality is structural, and not simply the result of differences in individual talents or efforts, it reflects low levels of equality of opportunity. Inequality of opportunity is the extent to which differences in outcomes across individuals are driven by circumstances into which people are born and are beyond their control, such as gender, ethnicity, or parental background, as opposed to differences in individuals' talent or effort.

Reducing inequality of opportunity is not only important because it is unfair, but also because it is inefficient and results in lower economic growth. Low equality of opportunity reduces incentives to invest in human capital and productive capacity of people, as one's outcomes in the labor market are more dependent on factors outside one's control, such as the education and socio-economic background of one's parents. Low equality of opportunity is also linked to misallocation of talent (Hsieh et al. 2019) which is detrimental for economic growth (Ferreira et al. 2018).

Initial disparities in opportunities lead to inequality of outcomes across three interrelated stages: First, in the pre-market stage, during which individuals accumulate human capital before joining the labor market, existing inequalities such as differences in educational opportunities and unequal access to basic health services lead to disparities in human capital and the productive capacity of people. Second, during the in-

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<sup>4</sup> The World Bank (2016) report provides a comprehensive overview of the global evidence on policies aimed at reducing inequality. The World Bank (2024b) report highlights factors and important policies to reduce inequality in Sub-Saharan Africa.

market stage when people engage in productive activities, poorly functioning labor or capital markets can systematically limit certain groups' access to productive income-generating opportunities, for example due to wage discrimination or unequal access to basic infrastructure such as electricity or water. Finally, in the post-market stage, inequalities can be further exacerbated or redressed through taxes, social transfers, and subsidies. Importantly, these stages are interconnected, with spillovers occurring from one state to the other. For example, inequality in access to quality education will be compounded by labor market distortions or lack of competition, which could then be exacerbated by regressive taxes.

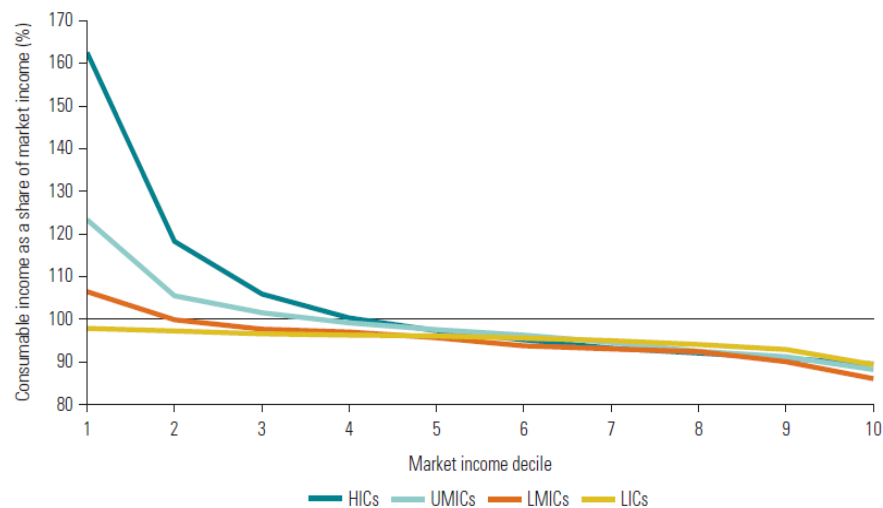
Government policies can address inequality at each of these three interrelated stages:

- (1) Pre-market policy interventions** focus on foundational elements that expand equal opportunities by providing public goods such as education, healthcare, and family support. Ensuring access to quality early childhood education, equitable K-12 education funding, and affordable higher education are critical steps. Additionally, universal healthcare coverage and preventive care are essential to improve productivity and quality of life. Supporting families through paid parental leave, affordable childcare, and direct financial assistance helps level the playing field from the start. Successful pre-market interventions can reduce inequality of opportunity by leveling the playing field for groups that are constrained by the circumstances they are born in, such as gender, ethnicity or parental background.
- (2) In-market policy interventions** aim to create a fair and inclusive labor market. This includes improving access to labor markets and ways to earn income, improving the access to and use of productive assets such as land, and strengthening labor rights and safe working conditions. Anti-discrimination measures are crucial, as they promote equal employment opportunities and support diversity and inclusion within organizations. Moreover, providing access to affordable credit and business development services for small businesses and entrepreneurs, particularly in underserved communities, fosters economic growth and job creation.
- (3) Post-market policy interventions** include all taxes, transfers and subsidies that make part of government's fiscal policies. Governments can significantly reduce inequality by making tax systems more progressive and redistribute income through pro-poor transfers. Investing in adequate social protection programs, such as unemployment benefits, pensions, and health care, helps mitigate income inequality by providing support to the disadvantaged and against shocks. Fiscal policy reforms can have important long-term impacts on making a country's growth path more inclusive (see next section).

### 3.3 Fiscal Policy Reforms for More Inclusive Growth

Fiscal policy has a key role in reducing within-country inequalities and support a more inclusive growth process. A comprehensive analysis of the impacts of taxes, transfers, and subsidies on household income of 94 countries shows that fiscal policy reduces inequality in all countries. High-Income countries (HICs) are effective at ensuring that taxes, transfers, and subsidies do not reduce the disposable income of poor households. Low-income countries (LICs) and middle-income countries (MICs) tend to be less successful than high-income countries (HICs) in ensuring that fiscal policy benefits the poor. In two-thirds of LICs and MICs the income of the poor falls after taxes have been paid and transfers and subsidies have been received (Figure 8).

Figure 8. In two-thirds of LICs and MICs incomes of poor households is lower after fiscal policy

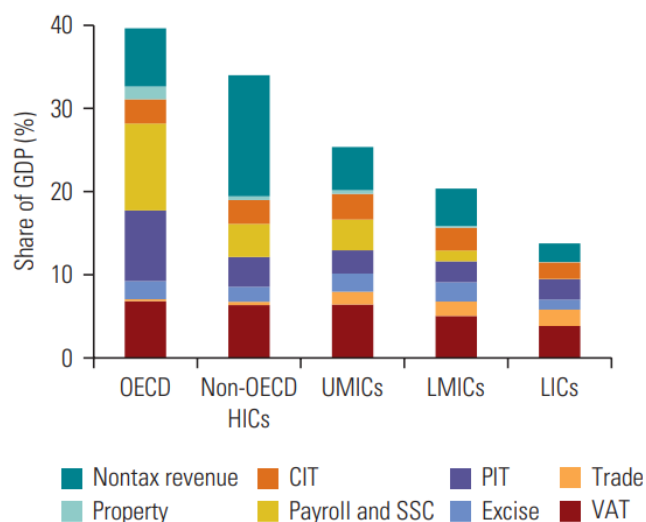


Sources: World Bank (2022a). Original estimates based on data from CEQ Institute, CEQ Data Center on Fiscal Redistribution, <https://commitmenttoequity.org/datacenter/>; Organization for Economic Co-operation and Development data; World Bank data.

Note: The figure shows consumable income (income after direct and indirect taxes have been paid and cash transfers and subsidies have been received) as percentage of market income decile, aggregated by income group using medians.

In LICs and MICs the informal sector accounts for a large share of the economy. In informal economies where income is not easily observed, recorded, and taxed, there is a greater reliance on indirect taxes (value added, excise and trade taxes). Because of this reliance, a significant share of revenue is collected from the poor. Direct taxes (personal income tax, social security contributions) are typically more progressive because they can be designed to increase with income, unlike taxes on goods that everyone must purchase regardless of income level. Over 60 percent of taxes in LICs and MICs are collected indirectly, compared to just 28 percent for OECD member countries (Figure 9).

Figure 9. LICs and MICs collect taxes in the least progressive way



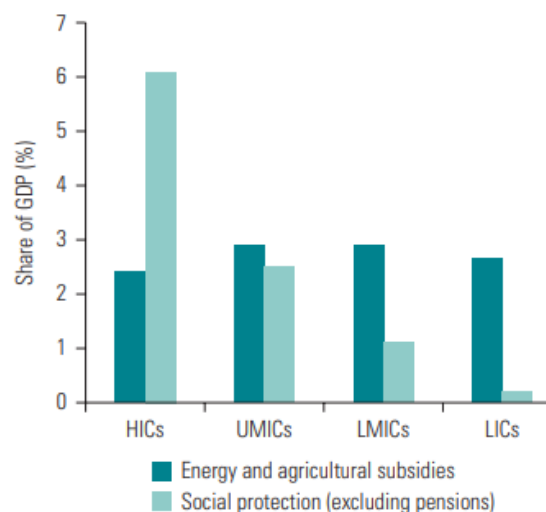
Source: World Bank (2022a). Original estimates based on data from: International Centre for Tax and Development <https://www.ictd.ac/>; CEQ Institute, CEQ Data Center on Fiscal Redistribution <https://commitmenttoequity.org/datacenter/>, OECD data, World Bank data

Note: Government revenue as percentage of total market income by market income decile, aggregated by income group. CIT is corporate income tax. PIT is personal income tax.

At the same time, LICs and MICs spend less on transfers than on subsidies, which benefit the poor less (Figure 10). In HICs, spending on social protection far exceeds spending on subsidies. In upper-middle income countries (UMICs), spending on energy and agricultural subsidies is equal to spending on social protection, whereas in lower-middle income countries (LMICs) and LICs social protection spending is less than one-half and one-tenth of spending on energy and agricultural subsidies, respectively. Only 20 percent of spending on subsidies reaches the bottom 40 percent in each country, and this, combined with low spending on transfers, means there is little compensation for the reduction in income and consumption brought about by indirect taxes. Subsidies are widespread, in part, because they are popular, providing support to many interest groups on whom governments depend for support in contrast to targeted transfers. However, the high share of benefits that goes to the rich points to the need to develop systems that can deliver transfers more broadly. Increasingly, LMICs and LICs are developing stronger transfer systems that can reach more households, and important advances were made during the response to COVID-19.



Figure 10. MICs and LICs spend less on transfers than on subsidies which benefit the poor less



Source: World Bank (2022a). Original estimates of agricultural subsidies based on the International Organisations Consortium for Measuring the Policy Environment for Agriculture database (<https://www.agincentives.org/>). Original estimates of energy subsidies based on International Institute for Sustainable Development (<https://www.iisd.org/>). Original estimates of social protection based on World Bank BOOST Open Budget Portal (<https://www.worldbank.org/en/programs/boost-portal>) and IMF Government and Finance Statistics database ([https:// data.imf.org/gf](https://data.imf.org/gf))

Note: Figure compares spending on energy and agricultural subsidies with spending on social protection (excluding pensions) as a share of gross domestic product (GDP), aggregated by income group.

Given these structural challenges, this report highlights three priority areas for fiscal policy reform:

- (1) Reorient spending away from subsidies towards support targeted to the poor and vulnerable.** Subsidies are often poorly targeted. For example, one-half of all spending on energy subsidies in LICs and MICs goes to the richest 20 percent of the population, who consume more energy. Programs that target cash transfers are more effective in reaching the poor. More than 60 percent of spending on cash transfers reaches the bottom 40 percent.
- (2) Mobilize revenue without hurting the poor.** Personal and corporate income taxes can be made more progressive in many LICs and MICs. Additionally, new forms of taxation can be introduced such as for example health and carbon taxes. If indirect taxes need to be raised, cash transfers can be simultaneously used to offset their effects on the most vulnerable households.
- (3) Reorient spending to invest in long-run growth.** High-value public spending, such as investment in education, infrastructure or research and development can have beneficial impacts on growth, inequality, and poverty decades later. Increasing public investment in social services, such as healthcare and education, can promote inclusive growth. Studies indicate that such investments

improve human capital and long-term economic prospects. Ensuring all children, regardless of socio-economic background, have access to quality education can reduce inequality and promote inclusive growth. Evidence from a large set of countries shows that investment in early childhood education yields high returns in terms of future earnings and economic productivity (Holla et al. 2021). Moreover, providing vocational training and opportunities for lifelong learning can help workers adapt to changing job markets. Studies indicate that such programs improve employment outcomes and earnings, particularly for disadvantaged groups.

- (4)** Finally, **investing today to prepare for future crises** can also yield long-run benefits. The COVID-19 pandemic has shown that years of progress in poverty and inequality reduction can disappear quickly when countries cannot mount a fiscal response to a major shock. Crisis financial planning can equip countries with a strategic plan for unleashing financial tools that can deliver the amount and timing of financing required in a crisis. Governments can invest in expanding the reach of automatic stabilizers, such as employment guarantee schemes, and set up adaptive cash transfer programs as part of financial crisis planning.

In the long run, better debt management will be essential to increase countries fiscal space for responding to ongoing and future crisis. In many LICs and MICs fiscal space is highly constrained due to high levels of indebtedness. Governments can take action to proactively reduce exposure to risks that threaten to worsen public debt such as pursuing regulatory reform in financial markets, improving debt transparency, and implementing a common framework for debt restructuring or relief (World Bank, 2021). Governments at high risk of debt distress can pursue proactive debt management with creditors, such as debt reprofiling, which replaces existing debt by new debt with a different currency or maturity profile. Governments can also coordinate with creditors on debt restructuring, which requires prompt and comprehensive debt recognition, coordination with and among creditors, and a medium-term plan for the reforms needed to achieve debt sustainability. Governments and their creditors can benefit from improvements in sovereign debt transparency, which requires full disclosure of claims against the government and the terms of the contracts governing the debt. Contractual innovations can help overcome coordination problems and speed up the resolution of unsustainable debt, but they are not a universal solution. Pro-active debt management can improve long-term debt sustainability and improve governments' fiscal room to promote redistributive policies (World Bank 2022b).

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