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**Research Report**

## Can the EU confront inequality in developing countries?

Briefing Paper, No. 14/2012

**Provided in Cooperation with:**

German Institute of Development and Sustainability (IDOS), Bonn

*Suggested Citation:* Furness, Mark; Negre, Mario (2012) : Can the EU confront inequality in developing countries?, Briefing Paper, No. 14/2012, Deutsches Institut für Entwicklungspolitik (DIE), Bonn

This Version is available at:

<https://hdl.handle.net/10419/199695>

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## Can the EU Confront Inequality in Developing Countries?

### Summary

The distribution of global income is extremely unequal. In 2011, the richest 20 per cent of the world's population controlled more than 80 per cent of the world's income, compared to less than 2 per cent for the poorest 20 per cent. In many parts of the developing world, inequality remains stubbornly high even as absolute numbers of people living in poverty fall. Studies by the World Bank, the IMF, UNDP and UNICEF have all shown that high inequality is detrimental to sustainable economic growth and long-term poverty reduction.

While recent EU policy statements have recognised that inequality is a major development challenge, few concrete measures are in place for tackling it. The European Commission's October 2011 "Agenda for Change" proposed that the EU would focus on "inclusive and sustainable growth", thereby enabling more people to benefit from wealth and job creation. But the Agenda does not grapple with the politically sensitive question of what "inclusive" actually means. In August 2012 the Commission started to answer this question with a "Communication on social protection in EU development cooperation". This document makes some welcome suggestions, including placing social protection at the heart of dialogue with developing countries.

There is no controversy about the need to equip workers with the education and skills needed to participate in a growing economy. Only a mean-spirited few would argue with the benefits of universal healthcare and

social protection for improving equality of opportunity. Reducing income inequality is, however, also crucial.

This raises difficult questions for EU development policy. First, should the EU devote more political and financial resources to support efforts to confront inequality in developing countries? If so, should these be primarily focussed on middle-income countries, or least-developed countries as well? Second, what is the role of the state vis-à-vis the private sector? Would facilitating more private sector activity help reduce inequality? Third, what are the lessons from the EU's own experiences in promoting inclusiveness that could be translated into its international development policies? How can these lessons be offered to partners without creating an impression that the EU is lecturing them?

Measures aimed at reducing income disparities should be central to any development strategy, both for middle-income countries where income is growing and for poorer countries where mechanisms for capturing and redistributing wealth are absent. In the current political climate, such progressive thinking is out of favour in most European countries. The EU is shying away from models that worked for Europe itself and have started to work in parts of Latin America. Rather, it is replicating the "growth-plus-safety nets" model, with added emphasis on the private sector. While this is an improvement on discredited "Washington Consensus" approaches, it is still predicated on the "trickle down" philosophy and does not target inequality specifically.

Can the EU confront inequality in developing countries?

### An agenda for inclusive growth?

The European Commission's October 2011 "Agenda for Change" policy statement proposed that the EU would focus on "inclusive and sustainable growth", thereby enabling more people to participate in, and benefit from, wealth and job creation. EU member states signed off on the Agenda at the May 2012 Foreign Affairs Council, and the Commission is ready to use it as the basis for implementing its aid programmes over the next budget period from 2014 to 2020.

But what does "inclusive" actually mean for EU development policy? The Agenda mentions investment in human capital, health and education, and emphasises trade, governance and integration in global markets. The Agenda only mentions the word "inequality" once, in reference to inequality of opportunity, not income. On 20 August 2012 the Commission added more substance with the release of a Communication on social protection in EU development cooperation. This document makes some strong suggestions, including placing social protection at the heart of dialogue with developing-country governments, supporting domestic initiatives to make tax systems more redistributive, and supporting measures to address gender inequalities. Its publication indicates that at least some EU development policymakers are interested in mainstreaming the inequality issue.

There is no controversy about the need to equip workers with the education and skills needed to participate in a growing economy. Only a mean-spirited few would argue with the benefits of universal healthcare and social protection for improving equality of opportunity. A balanced income distribution is, however, also crucial, and this raises difficult questions for EU development policy.

### Inequality slows economic growth and undermines poverty reduction

In 2011, the richest 20 per cent of the world's population controlled more than 80 per cent of the world's income, compared to less than 2 per cent for the poorest 20 per cent. In many parts of the developing world, inequality remains stubbornly high even as absolute numbers of people living in poverty fall. Middle-income countries like China, India, Indonesia and Nigeria are home to more than 60 per cent of the world's poor. In Africa, impressive economic growth has left many people behind. A recent study coordinated by Kofi Annan found that although 70 per cent of Africans live in countries where GDP growth averaged 4 per cent or more in the last decade, around half of the continent's population still live on less than US\$ 1.25 / day.

Evidence suggests that growth is unlikely to be either sustainable or inclusive, unless the tendency towards

rising inequality can be arrested and reversed. Recent studies by the IMF and UNICEF found that longer growth spells are robustly associated with more equality in income distribution.

Annual median change in poverty	Decreasing income	Increasing income
Increasing inequality	+14.3 %	-1.3 %
Decreasing inequality	+1.7 %	-9.6 %

Source: Ravallion (2001)

Ravallion (2001) showed that persistently high inequality is associated with low poverty-reduction rates. Figure 1 shows that the elasticity of poverty to growth differs greatly depending on the accompanying changes in inequality. Among countries whose income decreased, poverty in those with rising inequality increased eight times more than in those with falling inequality. Conversely, in countries whose income increased, poverty reduction was seven times stronger in those with falling inequality in comparison to those where it rose.

Development policy has come to embrace approaches that are called "pro-poor" or "inclusive". At the policy level, this has meant adopting programmes that aim to foster broad-based growth, especially through the private sector. In Latin America, programmes like *Bolsa Familia* in Brazil have contributed to important reductions in income inequality. The Asian Development Bank has started to develop indicators for measuring inclusive growth that include several dimensions of socio-economic inequality, including gender equity. The International Labour Organization recently adopted a recommendation on social protection floors including healthcare and basic income security.

### The EU's approach to inequality in developing countries

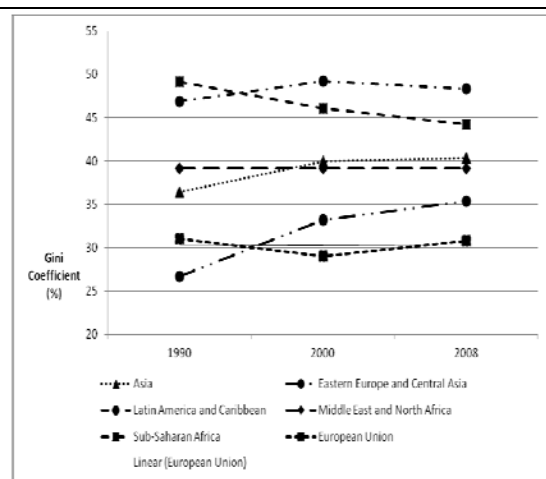
In the praxis of EU development cooperation, the difficulty of implementing policies aimed at reducing inequality becomes apparent. Although the Commission earmarks around 20 per cent of its development aid for social programmes, most is actually spent on activities to promote economic growth and tackle governance issues like police and judicial reform. This aid is undoubtedly helpful, but has had limited impact on social cohesion and does not address inequality directly, either in terms of opportunities or outcomes. One specific social cohesion programme, EUROsocial in Latin America, is very promising, but it is small and marginal.

Recent debates about the future focus of European aid indicate that EU member states will insist that the Commission bases future aid allocations on income differences between partner countries rather than income distributions within them. The Commission's recent proposal to end bilateral development cooperation with several "upper middle income" countries is based on gross domestic product per capita calculations and the partner country's share of the global economy, and does not take inequality into account. In the rush to encourage developing countries to "graduate" from aid, it is important not to miss the opportunity to promote growth that is more inclusive.

### The EU's successful social model is not for export

The inclusive growth model adopted in Europe, where states have assumed important redistributive roles, has contributed to consistently high and cohesive levels of human development since the Second World War. As Europe wrestles with self-doubt about its future and its place in the world, this is a good time to reflect on what the European project has been about: providing for the long-term peace, prosperity and well-being of the citizens of its member states. It should not be forgotten that although the EU's social model varies from country to country, it contains core features – such as low inequality – that make it one of Europe's great successes.

**Figure 2: Changes in regional Gini coefficients 1990–2008**



Sources: Ortiz / Cummins (2011); EuroStat data.

Figure 2 shows that despite recent increases in European Gini coefficients, inequality in the EU is well below that of the rest of the world. The know-how for advancing development in a cohesive manner, without excluding large groups of people, is an important value added of the EU in the development field. Indeed, the recognition of the need to tackle inequality and ensure cohe-

sion can be seen nowhere better than in "Europe 2020", the EU's growth strategy for the present decade, in which social cohesion is one of the five pillars.

EU Development Commissioner Andris Piebalgs has told the European Parliament that inclusive growth must address income distribution. His stance is consistent with the "universal values" of respect for human dignity, freedom and equality that are enshrined in the EU treaties and routinely referred to in development policy statements and agreements with non-EU countries. However, there appears to be little willingness to address inequality at the implementation level. The reason often mentioned is that inequality issues are politically sensitive in partner countries and should be avoided as a matter of respect for their own internal processes. This is in stark contrast to the way Europeans promote trade openness, including the Singapore Issues (public procurement, trade facilitation, investment and competition) rejected by most developing countries at the World Trade Organization.

### Inequality: too hot to handle

There are three main reasons why it is hard for EU development policy to confront inequality head on. First, it implies strengthening the redistributive role of the state, an objective that few current decision-makers are prepared to fight for. The limitations of light-touch approaches to development may be well known, but the intellectual sway and political clout of three decades of orthodoxy is considerable. Adherents to structural adjustment approaches still believe that economic growth will create broad prosperity, so long as the state limits its role in the economy to providing those public goods (law and order, protection of property rights) that facilitate "growth".

Second, the ongoing Euro crisis is impacting on the EU's potential to help fight inequality in developing countries. As aid budgets come under pressure, arguments for cutting aid to middle-income countries that should use their own resources to address their development challenges become louder. And yet, millions of poor people still live in middle-income countries. Many have yet to develop institutions to prevent people from slipping back into poverty, while disincentivising rent-seeking behaviour among elites. Amid austerity, devoting resources to addressing inequality in middle-income countries becomes harder.

A third factor is the difficulty of promoting policies to reduce inequality in developing countries while fiscal austerity within Europe is weakening the welfare-state model, and thus significantly increasing socio-economic inequality at home. This trend makes it increasingly hard to ask Europeans to care about inequality in mid-

dle-income countries especially. Nevertheless, developing-country elites are unlikely to take the EU's inclusiveness approach seriously while inequality is rising in Europe.

## Conclusions

Important lessons can be taken from Europe's experiences that can be applied to cooperation with developing countries. This means facing up to the intensely politically sensitive challenge of providing support to partner governments that are willing to address the inequality issue through the protection of civil rights and the provision of healthcare education and jobs, as well as by redistributing wealth. The extent to which state intervention is needed in order to foster inclusive growth is hotly debated, but it is worthwhile mentioning that if the public purse can be used to bail out too-big-to-fail banks and insurance companies, then it can also be tasked with fostering the inclusion of those too-small-to-benefit from economic growth.

Measures aimed at reducing income disparities should be central to EU development policy, both for middle-income countries where average income is growing and for lower-income countries where mechanisms for capturing and sharing wealth are absent. EU development policy could focus on ex-ante support for more inclusive value-chains and sectors such as insurances for the poor and agriculture, where market-based mechanisms may not be able to meet needs. It could also act ex-post, for instance by promoting progressive tax

systems and the pro-poor focus of social expenditure in countries with high inequality. The EU could offer twinning programmes to share expertise on fostering social cohesion in Europe, similar to programmes run by the Commission's DG Regio and DG Enlargement on regional cohesion and technical cooperation. Existing programmes, such as EUROsocial, could be boosted and adapted to the needs of other developing countries and regions. At the global level, the EU could take a strong position on inequality in international forums, especially the upcoming negotiations on a new set of indicators to succeed the Millennium Development Goals after 2015, and make this a key focus of its political dialogue with partner countries. There are also important measures Europeans could take in their own back yard, such as cracking down on tax havens.

It is difficult for the EU to promote policies to reduce inequality in developing countries while fiscal austerity is sapping inclusive growth, eroding the welfare-state model, and significantly increasing socio-economic inequality within Europe. However, the fact that social cohesion remains central to European domestic strategies but is largely ignored by development cooperation suggests that the EU is shying away from models that worked for Europe itself, and have started to work in parts of Latin America especially. Rather, it is replicating the World Bank's "growth-plus-safety nets" model, with added emphasis on the private sector. While this is an improvement on discredited Washington Consensus approaches, it is still predicated on the trickle down philosophy and does not target inequality specifically.

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