Spreading the Wealth

Fiscal instruments can reduce inequality, but some yield short-term results while others bear fruit over the long term

François Bourguignon

After years of quasi-neglect, economic inequality has taken center stage in the policy debate worldwide. In advanced economies, the apparent impact of globalization and technological change and the cost of counteracting these forces is raising concern. In developing economies, where inequality is higher, the issue is whether it poses a major obstacle to raising growth and reducing poverty. In both cases, the redistribution of income might achieve not only greater equality but also faster growth and, for developing economies, faster poverty reduction.

In countries where growth is satisfactory but benefits the poor much less than the non-poor, there obviously is a strong case for shifting resources from those at the top of the income scale to those at the bottom. Giving poor children access to better education and paying for it by taxing the affluent is one way to reduce inequality while also fostering future growth and poverty reduction. Redistributive policies could also help narrow the gap between rich and poor in countries with high inequality, where social and political tensions or the rise of populist regimes might prove bad for growth in the long run.

Knowing that a more equal distribution of resources may be good for development is one thing; having the right instruments to implement it is another. These instruments—from progressive taxation, cash transfers, and investment in human capital to regulation and inclusive growth strategies—do exist. But they are vastly underused in developing economies.

Straight income redistribution

Taxation and income transfers to the poorest segment of society are the most direct way to keep inequality in check and reduce poverty in the short term. These instruments are particularly appropriate when the benefits of growth fail to reach the poor. But most

ART: ISTOCK / TOPP_YIMGRIMM

Transfers to the poor should not consist merely of cash; they should also boost people's capacity to generate income.

of the time they are too small to really make a difference. On average, taxes on personal income and cash benefits to the poor are almost 10 times lower, as a proportion of GDP, than in advanced economies.

The success of conditional cash transfer programs has demonstrated that it is possible to transfer cash efficiently to poor people in developing economies. These cash transfer programs give money to households on the condition that they comply with certain pre-defined requirements, such as up-to-date vaccinations or regular school attendance by children. The spread of such initiatives as Mexico's *Prospera* (previously *Progresa*), or *Brazil's Bolsa Família* from Latin America to other developing regions—as well as the results of several pilots in poorer sub-Saharan African countries—shows the progress made in the last 15 years or so in the field of redistribution. New methods of means testing and cash distribution have made it possible (see "Reaching Poor People" in the December 2017 *F&D*).

Such programs should continue to improve in the future, thanks to advances in information technology, particularly the use of mobile money. But their current impact on poverty and inequality is limited. Their main weakness is their size, which amounts to 0.5 percent of GDP at most in middle-income countries. In poorer countries, they are still at the pilot stage.

Expanding those programs requires more resources. A higher and more effective income tax in the upper part of the income scale could help raise the necessary funds. In this respect, the generalized use of bank accounts, credit cards, and debit cards by higher-income people in most countries should make it easier to monitor personal incomes and reduce tax evasion. Political economy issues aside, this should lead developing economies' governments to place more emphasis on direct taxation than they presently do.

Developing economies tend to rely relatively more than advanced economies on the indirect taxation of domestic and imported goods and services. Indirect taxes are said to be regressive because they tax consumption rather than income, and wealthier people save a higher proportion of their income. But in addition, indirect taxation in developing economies may even increase poverty depending on the structure of tax rates and the consumption basket of households at various rungs of the income scale (Higgins and Lustig 2016). In any case, lowering taxes on goods such as food that weigh more in the budget of poor people achieves relatively little redistribution because wealthier people also consume these goods, perhaps as a lower proportion of their budget but possibly in larger quantity. The same argument applies to subsidies for purchases of basic goods like bread or fuel. Income transfers are preferable to subsidies because they cost less and are better targeted to the truly needy, as evidenced by the pilot experiments on the replacement of food subsidies by "direct benefit transfers" in some Indian states (Muralidharan, Niehaus, and Sukhtankar 2017).

There is therefore a strong case for the expansion of redistribution in developing economies when growth is satisfactory but poverty reduction is slow. There are political obstacles to doing so, however, as well as challenges related to the country's administrative capacity. Political opposition may well remain, but modern information technology is likely to improve administrative capacity.

Increasing opportunities

Income redistribution will lower poverty by reducing inequality, if done properly. But it may not accelerate growth in any major way, except perhaps by reducing social tensions arising from inequality and allowing poor people to devote more resources to human and physical asset accumulation. Directly investing in opportunities for poor people is essential. Transfers to the poor should not consist merely of cash; they should also boost people's capacity to generate income, today and in the future. Education and training as well as access to health care, micro-credit, water, energy, and transportation are powerful instruments. Social assistance is critical to prevent people from falling into poverty traps when adverse shocks hit. Programs such as India's Mahatma Gandhi National Rural Employment Guarantee, in which the state acts as the employer of last resort, do precisely that.

Conditional cash transfers have been shown to motivate families to send their children to school, improve their nutrition, and monitor their health. But facilities to meet this additional demand must be made available and must be financed. The same is true of other programs focusing on improving opportunities for the poor. Financing these programs through progressive taxation while providing cash transfer incentives to poor households thus reduces inequality and poverty in the short term and helps these households generate more income over the medium and long term.

Is such a strategy of static and dynamic income equalization immune to the efficiency cost of redistribution? In other words, do these taxes and transfers take away the incentives for people to work, save, and become entrepreneurs? Given the limited scope of redistribution in developing economies, it is unlikely that it would have much effect on economic incentives. Substantial income tax progressivity may indeed be achieved with marginal tax rates much below those in advanced economies, where redistribution is not considered to be an obstacle to growth (Lindert 2004). Also, replacing distortionary indirect taxes or

The choice is difficult because some parties will necessarily lose in the short run.

subsidies with income transfers should improve efficiency. Moreover, conditional cash transfers appear to have no significant negative effect on labor supply; they may even encourage entrepreneurship (Bianchi and Boba 2013).

Strategies that promote greater equality and stronger growth rely on raising resources in a progressive way and spending them on programs that benefit the poorest segment of the population in this generation or the next one. Other policies that do not rely on redistribution may achieve the same goals. Before contemplating redistribution, however, governments ought to consider enhancing the pro-poor nature or inclusiveness of their growth strategies, in particular through fostering employment for unskilled workers.

Other policies besides straight redistribution are also available. Minimum wage laws—although controversial in advanced economies because of their potentially negative effects on employment when the minimum is set too high—generate more equality in the distribution of earnings. In developing economies, such policies may actually increase labor productivity by improving the physical condition of workers, as predicted by the efficiency wage theory. Part of the drop in inequality observed in Brazil at the turn of the century just as growth was accelerating has been partly attributed to the significant increase in the minimum wage (Komatsu and Filho 2016).

Anti-discrimination laws can also promote equality and foster growth by improving work and training incentives for minority groups. And anti-corruption strategies, by reducing rent seeking, are probably the best candidates for both enhancing growth and income equality, even if the inequality arising from corruption is often difficult to observe.

Governments can draw on an array of policies to foster growth by reducing inequality and ensuring that growth reduces poverty. The policies they adopt will depend on the relative importance of these two objectives and the time horizon over which they can be expected to deliver results. Pure income redistribution policies generate less future growth than those policies that expand the economic opportunities of poor people—but they reduce poverty immediately. They also alleviate social tensions and may thus free growth constraints in the case of excessive inequality. On the other hand, policies that enhance opportunities for the poor do less to reduce inequality today, essentially through taxation, but result in faster growth, less poverty, and greater equality tomorrow.

It is up to governments to choose their preferred policy combination. The choice is difficult because some parties will necessarily lose in the short run and might not make up for this loss anytime soon. Yet instruments are available today that would benefit all in the long run, through faster growth, more rapid poverty reduction, and less inequality. It would be a serious mistake not to make use of them. FD

FRANÇOIS BOURGUIGNON is a professor emeritus at the Paris School of Economics. He was the World Bank's chief economist from 2003 to 2007.

References:

Bianchi, M., and M. Boba, 2013, "Liquidity, Risk, and Occupational Choices." *Review of Economic Studies*, 80 (2): 491–511.

Higgins, Sean, and Nora Lustig. 2016. "Can a Poverty-Reducing and Progressive Tax and Transfer System Hurt the Poor?" *Journal of Development Economics* 122: 63-75.

Komatsu, B. Kawaoka, and N. Menezes Filho. 2016. "Does the Rise of the Minimum Wage Explain the Fall of Wage Inequality in Brazil?" Policy Paper 16, INSPER, São Paulo.

Lindert, P. 2004. *Growing Public*. Cambridge, United Kingdom: Cambridge University Press.

Muralidharan, K., Paul Niehaus, and Sandip Sukhtankar. 2017. "Direct Benefit Transfers in Food: Results from One Year of Process Monitoring in Union Territories." UC San Diego.