FISCAL POLICY AND INCOME INEQUALITY SUMMARY NOTE

Income inequality has increased in both advanced and developing economies in recent decades. Evidence from public surveys indicates that widening income inequality has been accompanied by growing public demand for income redistribution.

Through their fiscal policies, governments can play a significant role in reducing inequality of income and wealth, as well as inequality of opportunity.

Both tax and spending policies need to be carefully designed to balance distributional and efficiency objectives. Some policies, such as those that expand the access of the poor to education and health services, can improve both efficiency and equity, Others, however, may involve tradeoffs between redistributive and efficiency goals. Just how much redistribution a country should seek to achieve depends on a number of factors:

(1) To what extent does the public favor redistribution?
(2) What kind of role does the public want the government to play?
(3) How important are redistributive objectives, compared with other spending priorities such as new infrastructure?
(4) How much can the government afford to spend on redistributive policies without incurring large budget deficits and public debt?

How can governments affect income distribution?

Both tax and spending policies can alter the distribution of income both over the short- and medium-term. For example, progressive income taxes and cash transfers can reduce the inequality of disposable incomes today. Spending on education has an impact on future earnings, and therefore could eventually increase the number of individuals earning a higher income.

Given the need for more deficit reduction in some countries, what can those governments do to make sure that this fiscal adjustment does not increase inequality?

- More targeted social spending helps ensure that budget cuts safeguard benefits for the poor.
- Reduce the overlap and duplication in programs to save on spending without cutting back on benefits.
- Rely more on progressive revenue measures (such as income and property taxes) to avoid the need for large cuts in social transfers, though room may be limited if taxes are already high.

(5) How much revenue can the government raise to finance its spending without negatively affecting economic incentives that hurt economic growth?
(6) How much capacity does the government have to administer redistributive programs?

Designing tax and spending policies

Each government will have a different goal as to how much redistribution they want to achieve. But all governments will want to look for ways to achieve redistribution in a manner that either improves economic efficiency or minimizes any adverse effects on incentives to work, save, and invest. These effects on incentives are important because they can affect the level and rate of economic growth, and thus the capacity of the government to generate resources for redistributive spending in the future.

There is no single set of policies that constitutes "best practice" for achieving efficient redistribution. Nevertheless, cross-country experience suggests a number of promising options that countries could consider:

In advanced economies:

1. *Target social benefits to low-income groups.* Limiting benefits to low-income groups is efficient because it allows the government to boost the incomes of the poor at a low fiscal cost. To make sure that there are adequate incentives for benefit recipients to work, benefits should be phased out gradually as incomes rise.
2. *Raise retirement ages in pension systems.* This will help improve the financial stability of pension plans without cutting benefits. Enhanced social protection programs and disability payments can help meet the needs of low-income workers who may have shorter life expectancies and difficulty working until a full retirement age.
3. *Improve the access of lower-income groups to education and maintain access to health services.* As countries reform their healthcare systems, they need to ensure coverage is maintained for low-income earners. On education, low-income families need better access to education beyond secondary education, which can help break the generational transmission of poverty.
4. *Implement progressive personal income tax rate structures.* For example, countries with flat tax schedules (i.e., where everyone pays the same rate) could consider higher rates for top income earners than for those in the middle of the income distribution.
5. *Utilize better opportunities to raise property taxes.* These taxes are equitable and efficient, and there is scope to raise them in many countries.

6. *Reduce regressive tax exemptions*. Some exemptions tend to benefit the well-off, like the mortgage-interest deduction in the United States, where homeowners with more expensive homes and higher mortgages get a bigger tax break.

In developing economies:

1. *Consolidate social assistance programs and improve targeting.* In many cases, countries have a large number of small, fragmented programs that suffer from substantial overhead and administrative costs. In addition, better targeting of benefits would allow programs to expand their coverage of the poor.
2. *Expand conditional cash transfer programs as administrative capacity improves*. These programs make assistance to families conditional on sending children to school and/or visiting health clinics for preventive healthcare. They have proven effective in both reducing poverty and strengthening education and health outcomes. This helps reduce inequality today while also strengthening equality of opportunity.
3. *Expand noncontributory "social" pensions for the poor.* These are pensions that are funded from the general budget, with the aim of providing all of the elderly poor—even those with no contributions to the formal pension system—with a pension that lifts them out of poverty.
4. *Improve the access of low-income families to education and health services.* Broadening access to universal health care will improve the health and productivity of the poor and have positive social and economic effects. To be fiscally affordable, the health care package should be focused on essential health services. Increasing access to high-quality secondary education is essential for providing upward mobility and greater equality of opportunity for lower- and middle-income groups—scholarships, based on need, can help improve access.
5. *Expand coverage of the personal income tax.* Often, a large a share of the population is excluded from the personal income tax because the income threshold for filing taxes is too high. Lowering the threshold would increase revenues from the personal income tax and shift a larger share of the tax burden to those with the ability to pay.
6. *Look for opportunities to raise property taxes.* There is considerable scope to exploit this tax more fully, both as a revenue source and as a redistributive instrument. Developing economies will also need a sizable investment in administrative infrastructure to improve their ability to raise revenues from these taxes.

The IMF paper, *Fiscal Policy and Income Inequality* is available at www.imf.org/inequality

The income share of top income groups

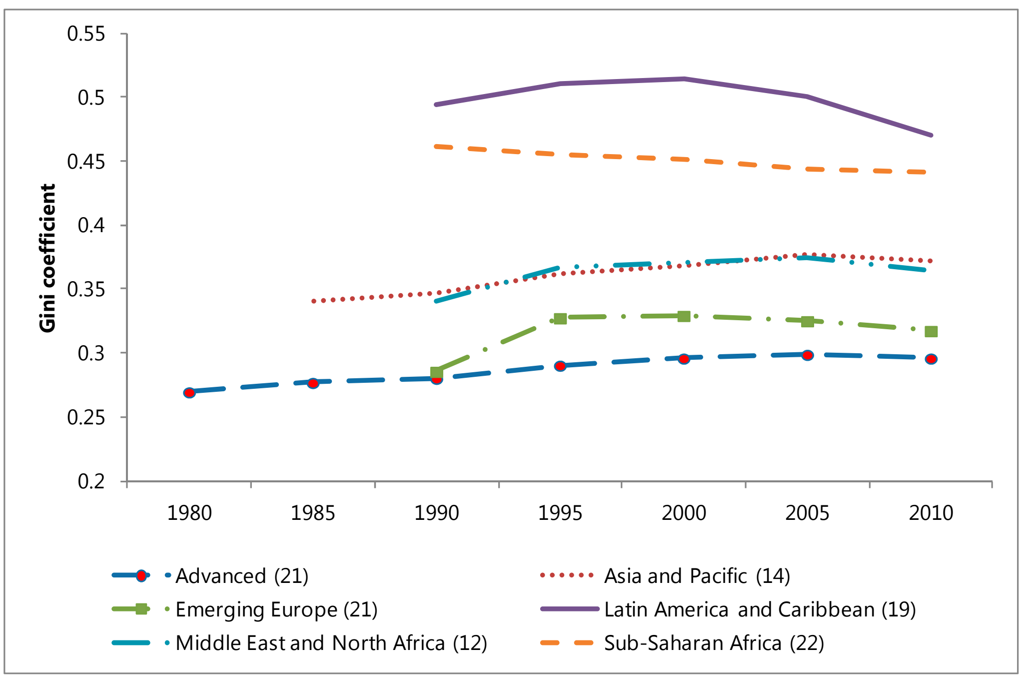
Over the last three decades, the market income shares of the richest one-percent of the population have increased substantially in many advanced economies, as well as in India and China.

For example, in the United States, the share of market income captured by the richest 10 percent surged from around 30 percent in 1980 to 48 percent by 2012, while the share of the richest one-percent increased from 8 percent to 19 percent. Even more striking is that the fourfold increase in the income share of the richest 0.1 percent, from 2.6 percent to 10.4 percent.

Variation exists across countries in how much the share of the highest income groups has risen. The increase in the share of the top one-percent has been much less pronounced in Southern European and Nordic economies, and hardly any increases have been observed in continental Europe and Japan. These different experiences across countries reflect domestic policy choices as well as global factors.

Inequality across regions

Income inequality is significantly higher in developing economies than in advanced economies. In advanced economies, inequality is, on average, increasing. In developing economies, the picture is mixed. Average inequality has risen in Middle East and North Africa economies and Asia and Pacific economies, but is on a downward trajectory in Latin America and sub-Saharan Africa.



Source: OECD; Luxembourg Income Study Database, Socio-Economic Database for Latin America and the Caribbean (SEDLAC); World Bank; Eurostat.

Note: Disposable income is income available to finance consumption once income taxes and public transfers have been netted out The Gini coefficient ranges between 0 (complete equality) and 1 (complete inequality).