

Low-Income Countries Seminar

Income Inequality and Fiscal Policy in Low-Income Countries

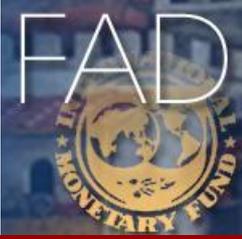
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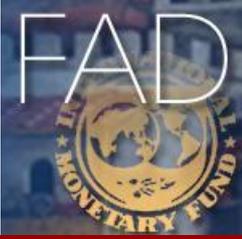


Presentation is based on:

F. Bastagli, D. Coady, and S. Gupta, 2012, “Income Inequality and Fiscal Policy”, IMF Staff Discussion Note, SDN/12/08(Revised).

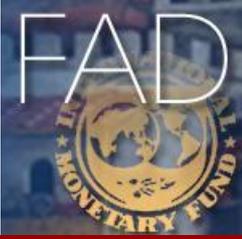
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Background

- Income inequality has increased in most advanced and many developing economies over recent decades**
- Emphasis on inclusive growth has led to a growing concern about income inequality in developing countries (e.g., China and India)**
- So how can fiscal policy contribute to lowering income inequality?**



Plan of Presentation

- I. Role of fiscal policy**
- II. Trends in income inequality**
- III. How has fiscal policy affected income inequality in advanced economies?**
- IV. How effective has fiscal policy been at reducing inequality in developing countries?**
- V. Lessons for the design of fiscal policy in developing countries**

I. Role of Fiscal Policy

I. Role of Fiscal Policy

□ Fiscal policy can affect income distribution

- ❖ **Directly.** By reducing inequality of disposable incomes compared to inequality of market incomes
- ❖ **Indirectly.** Through impact on future earnings of individuals and inequality of market incomes

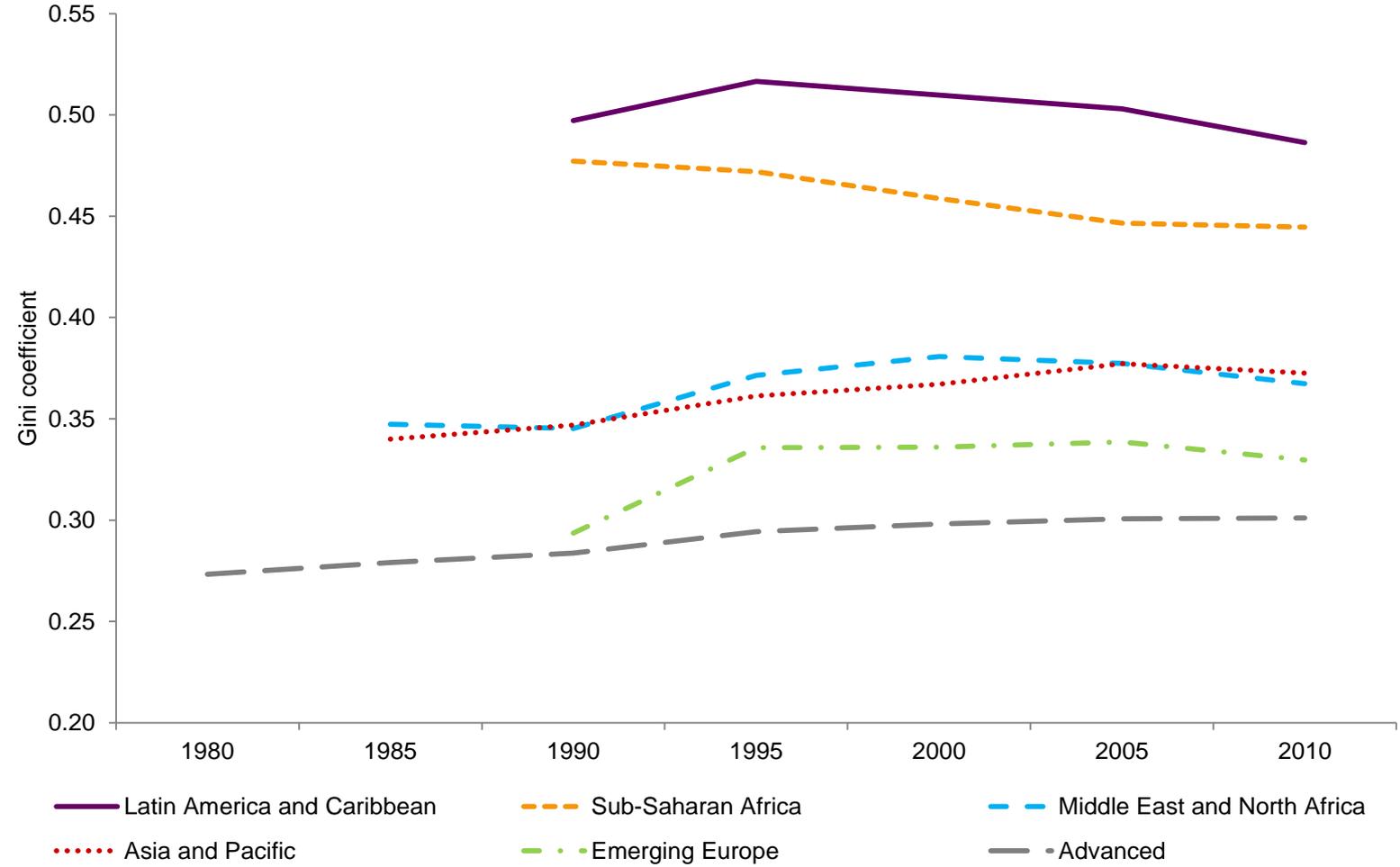
□ Role likely to vary across countries reflecting range of policy instruments available but also social preferences towards equity and efficiency

□ But taxes and transfers may distort allocation of resources (equity-efficiency trade-off)

II. Trends in income inequality

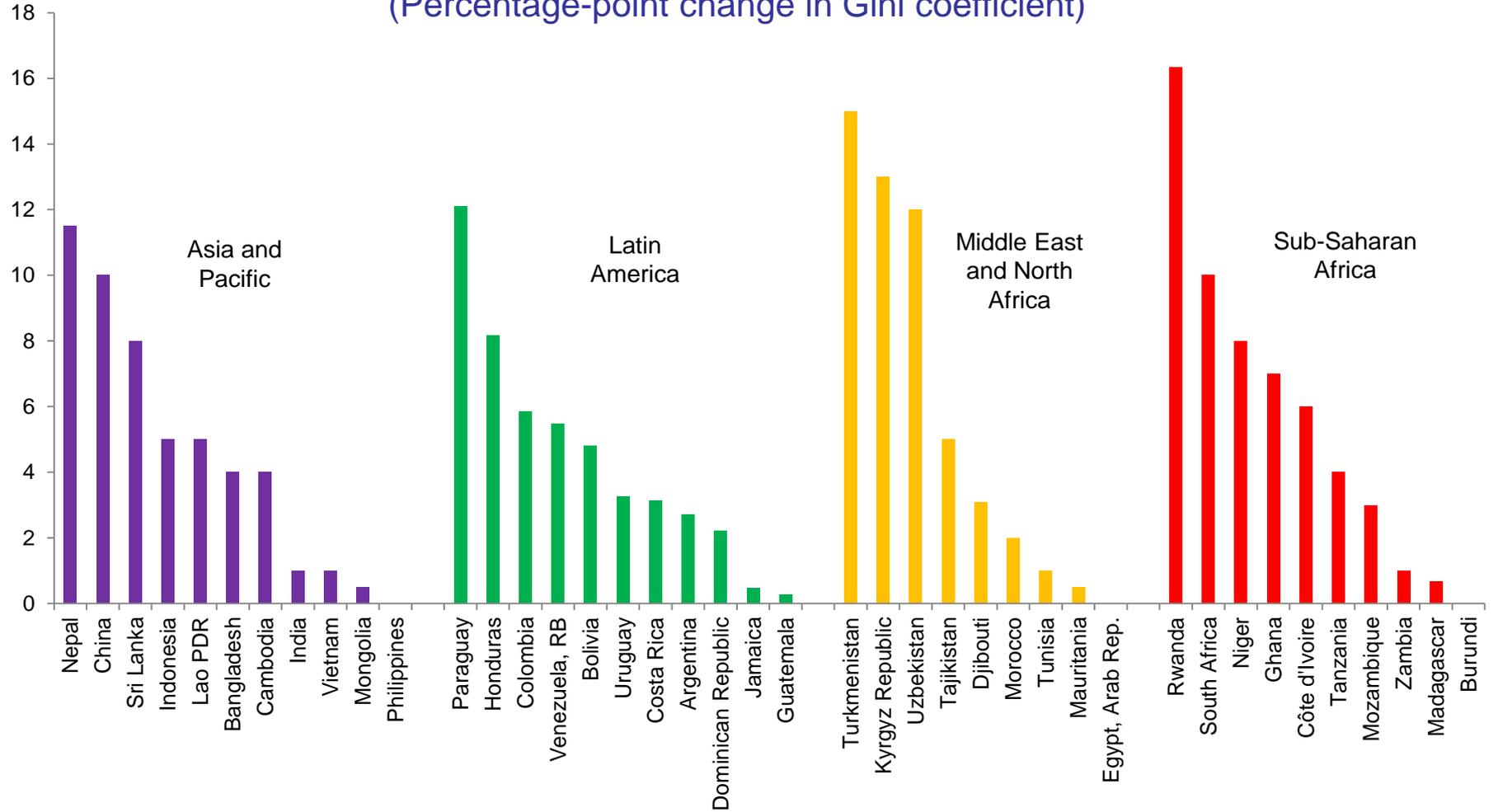
Income inequality is substantially higher in low-income economies.....

Trends in Disposable Income Inequality, 1980–2010



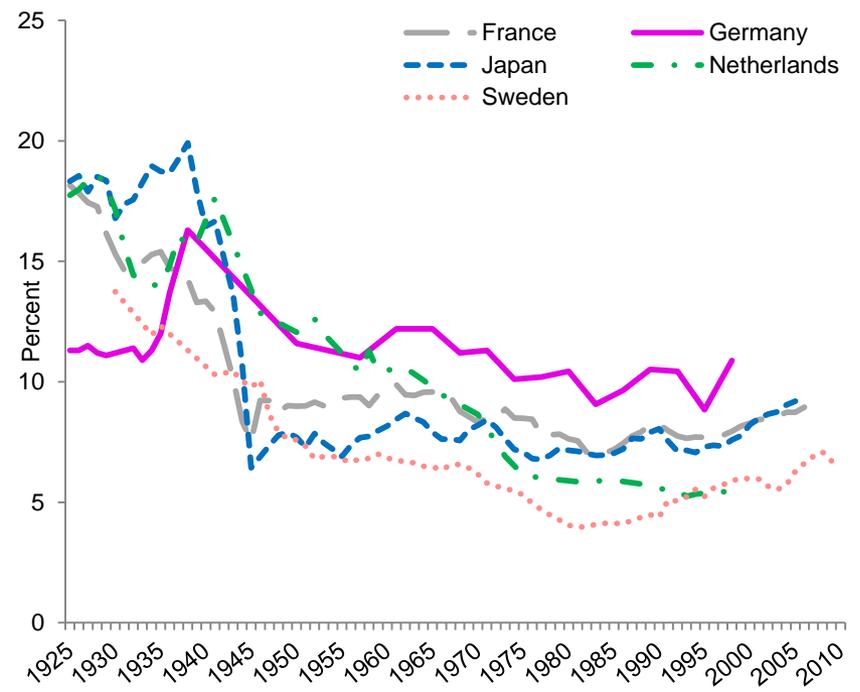
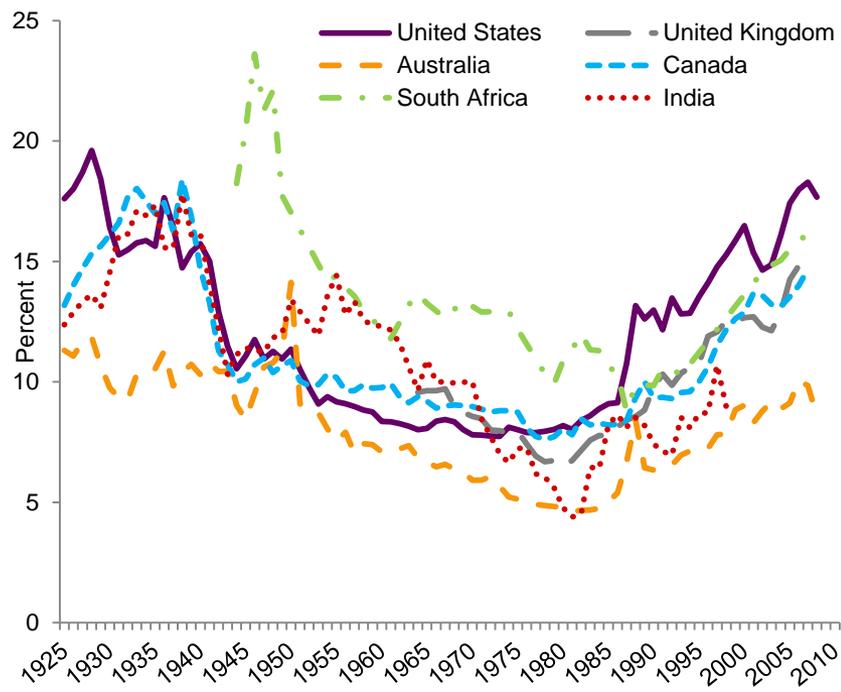
.....and has been increasing in many of these

Changes in Disposable Income Inequality Across Regions, 1990–2005
 (Percentage-point change in Gini coefficient)



More recently, the focus has been on the rising income share of the top income groups

Gross Income Share of Top One-Percent in Selected Advanced and Developing Economies, 1925–2010



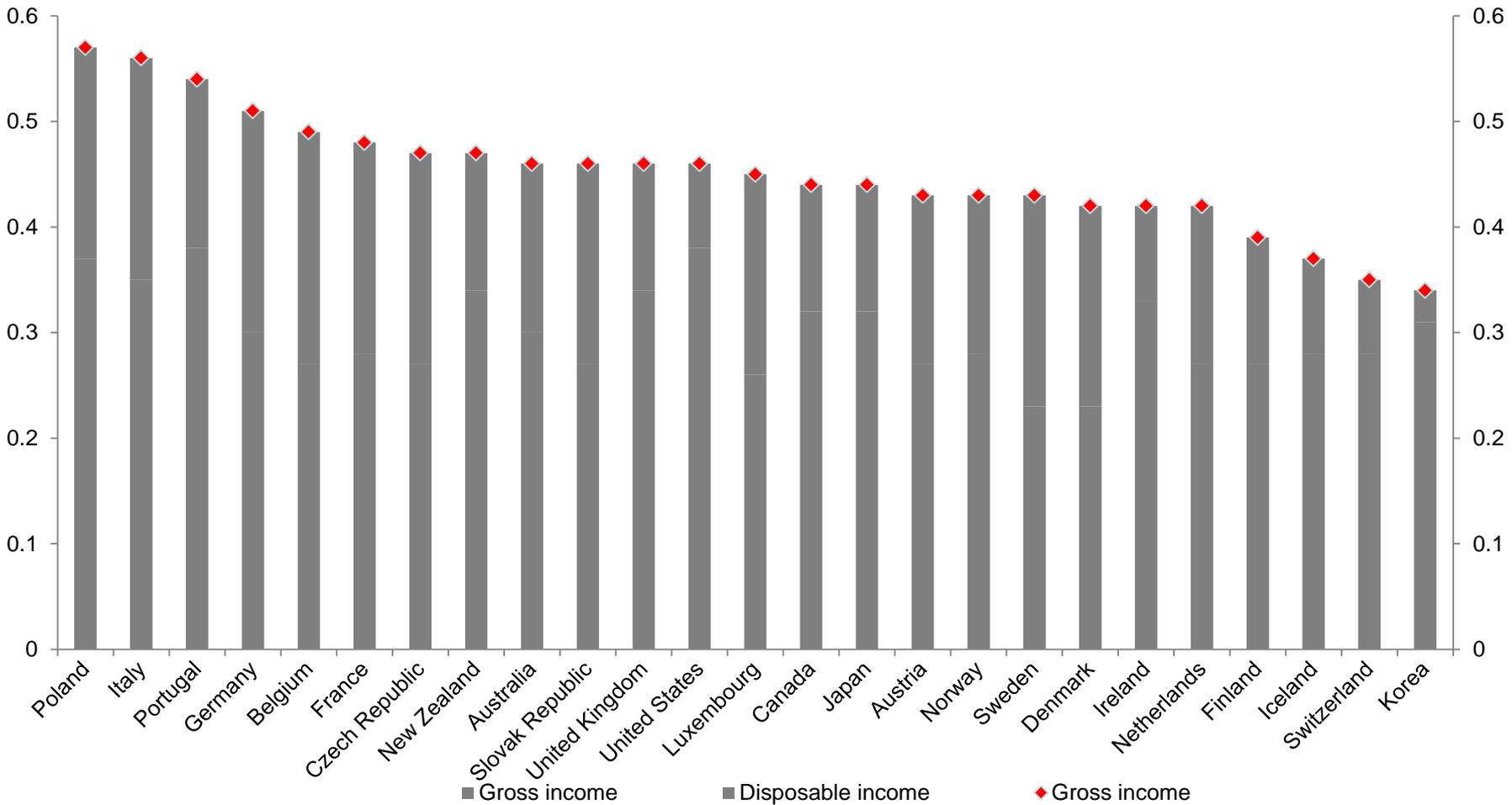
Source: World Top Incomes Database

**III. How has fiscal policy
affected income inequality in
advanced economies?**

In advanced economies, fiscal policy has reduced income inequality by one-third

Redistributive impact in OECD countries, 2008

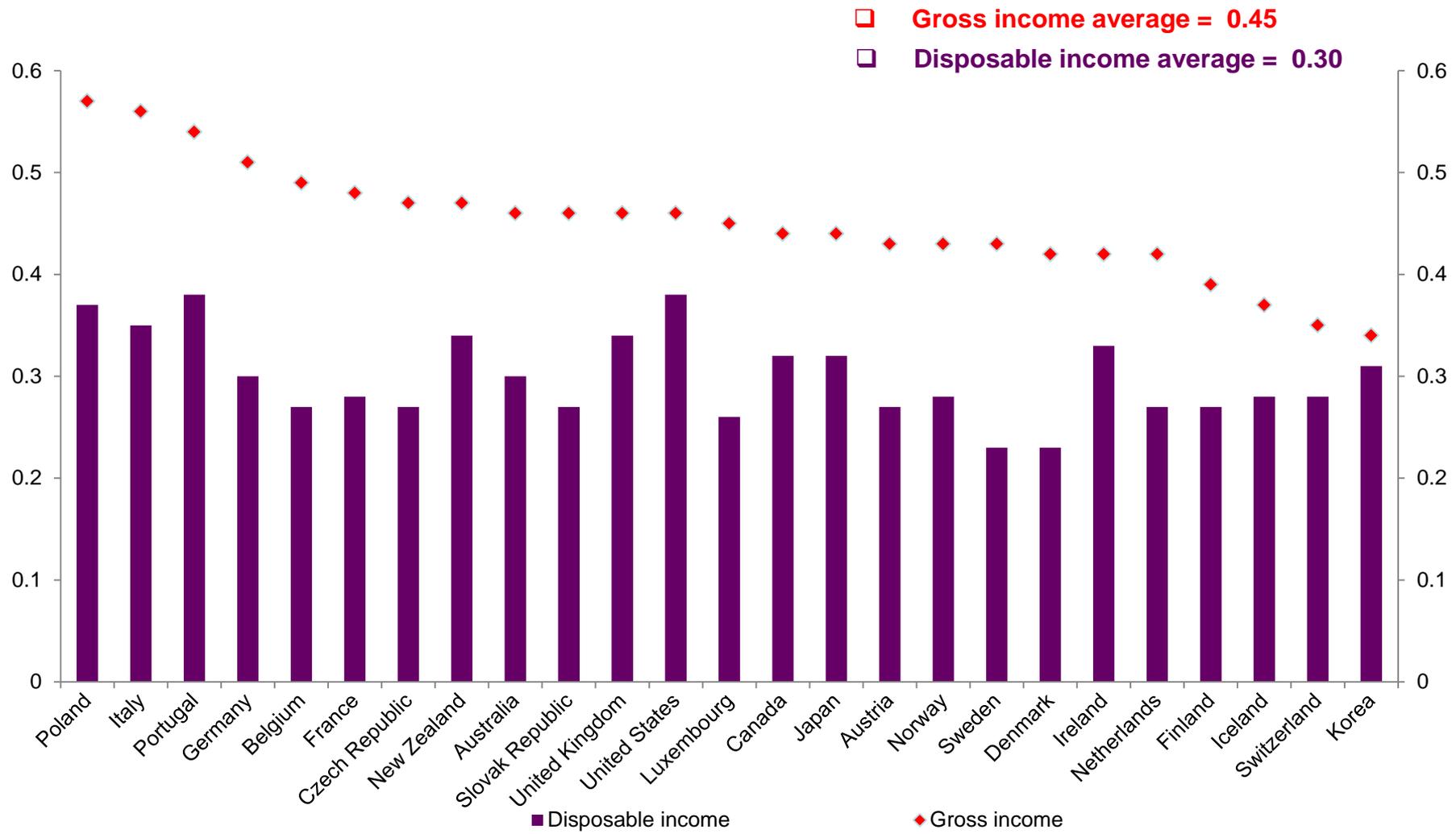
□ Gross income average = 0.45



Source: OECD, 2008.

In advanced economies, fiscal policy has reduced income inequality by one-third

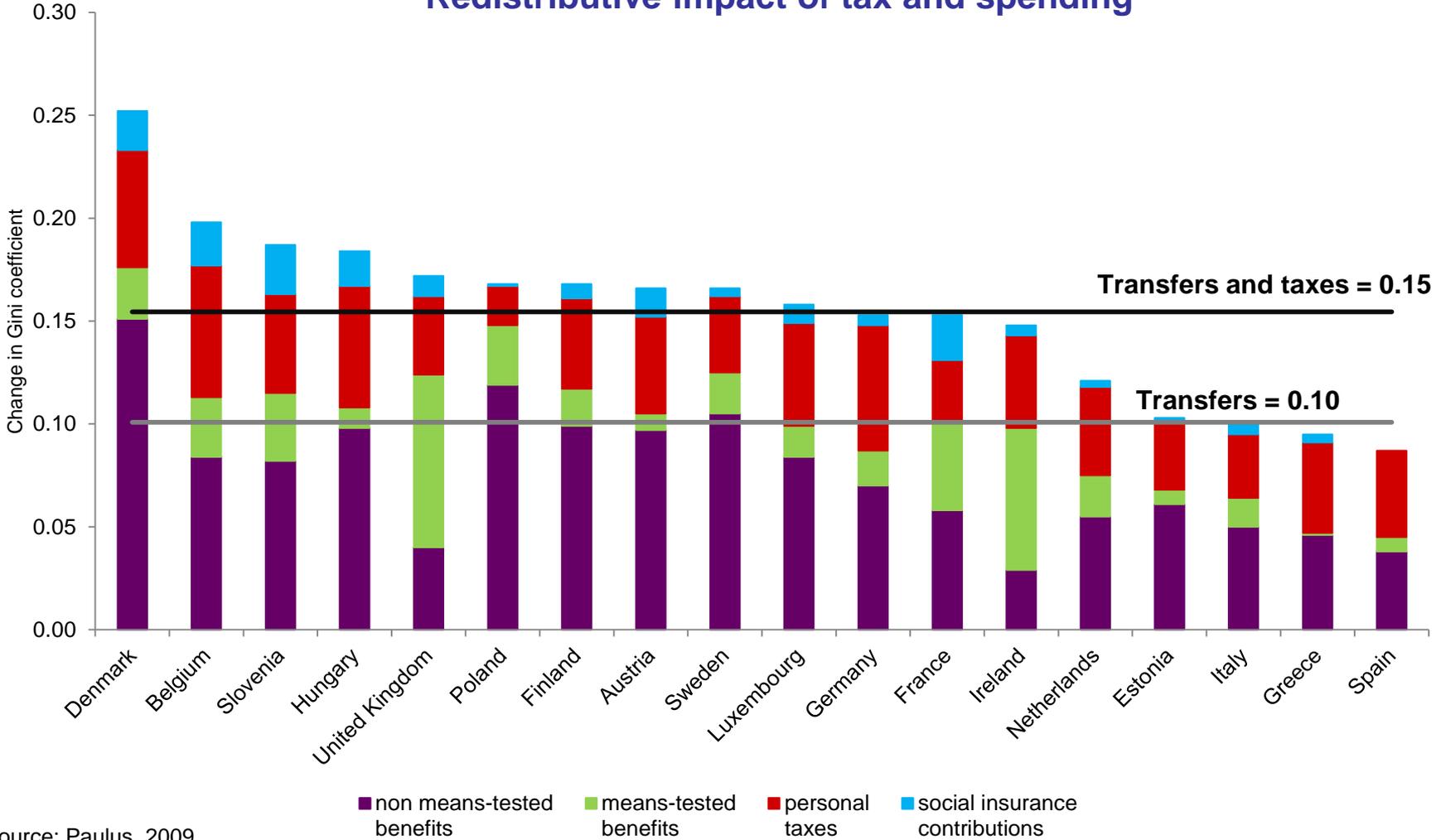
Redistributive impact in OECD countries, 2008



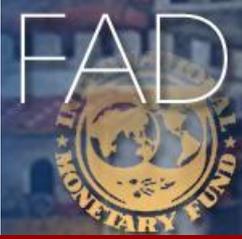
Source: OECD, 2008.

.....with about two-thirds of this impact is achieved on the expenditure side

Redistributive impact of tax and spending

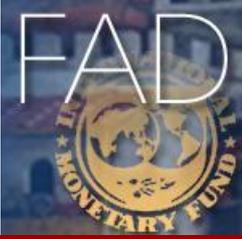


Source: Paulus, 2009.



Indirect taxes and in-kind transfers also influence the redistributive impact of fiscal policy

- ❑ **Indirect taxes.** Studies find that the value-added tax (VAT) and excise duties are regressive in European countries (O'Donoghue et al., 2004; Warren, 2008)
- ❑ **In-kind transfers.** Spending on education, health care and housing benefits decreased the Gini coefficient by 5.8 percentage points on average in 5 European economies (Paulus et al., 2009)

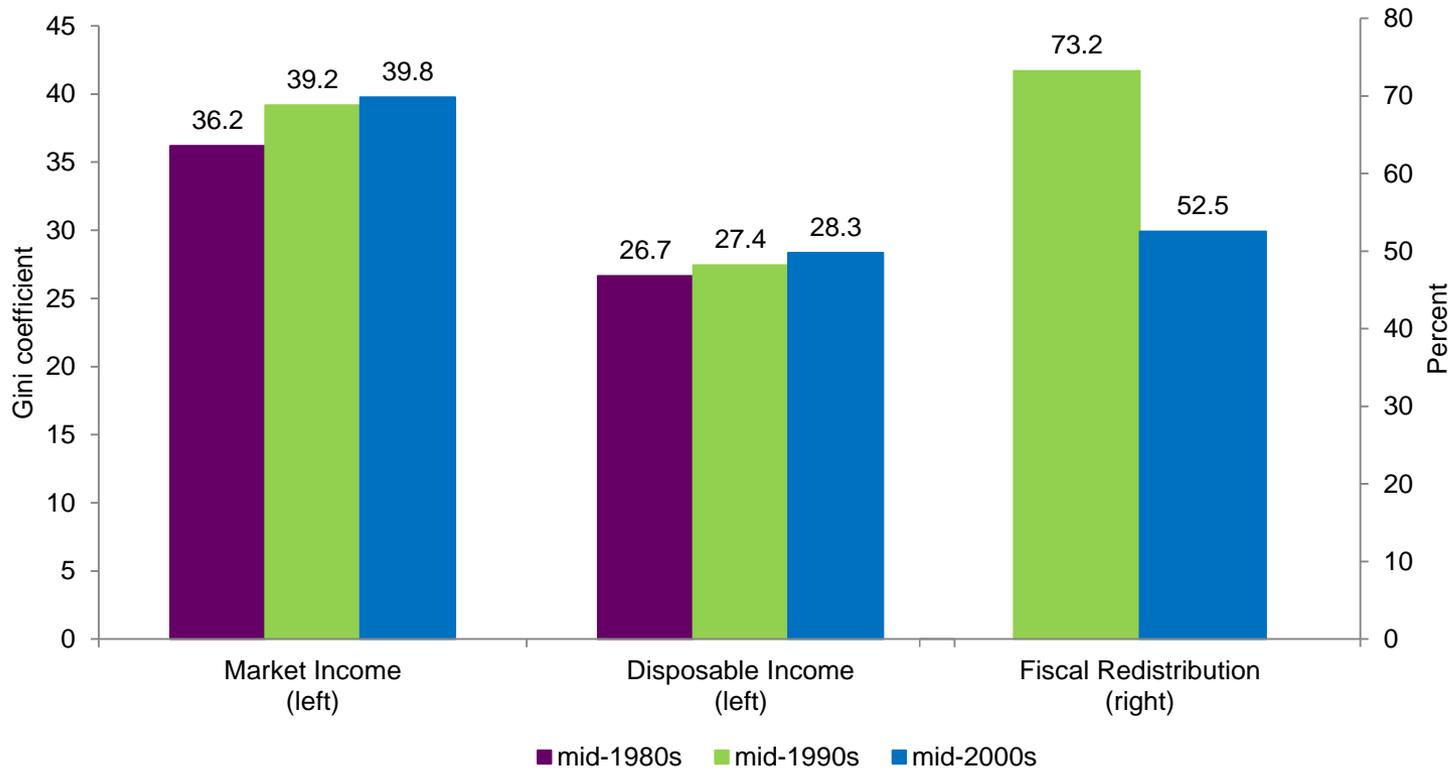


Corporate income taxes may not be as progressive as often assumed

- ❑ The incidence of corporate taxes will tend to fall on wages as capital is more mobile
- ❑ However, taxation of “rents” (above normal profits) is likely to fall on owners of capital

However, the redistributive impact of fiscal policy has decreased since the mid-1990s

Diminishing Redistributive Impact of Fiscal Policy Since Mid-1990s

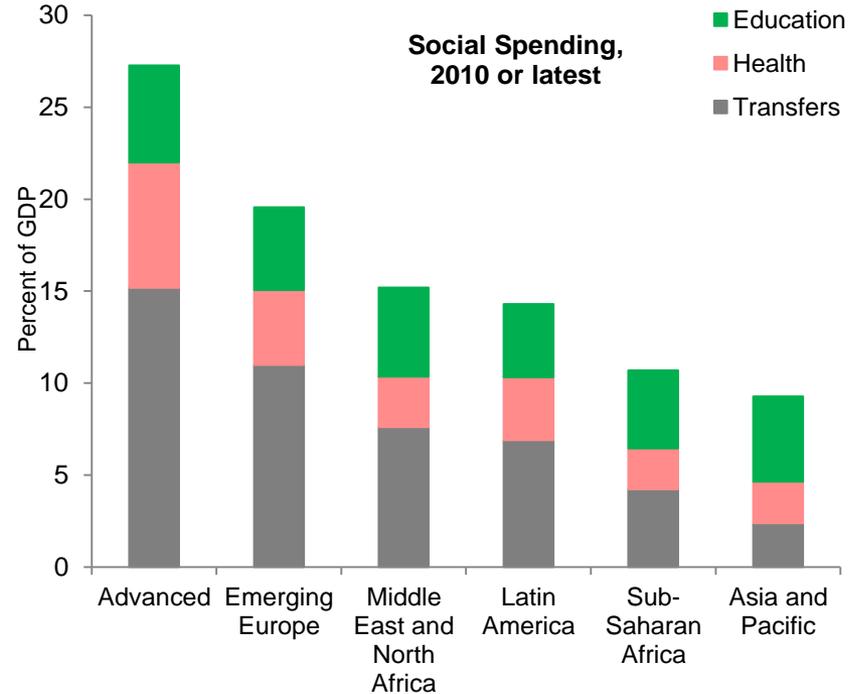
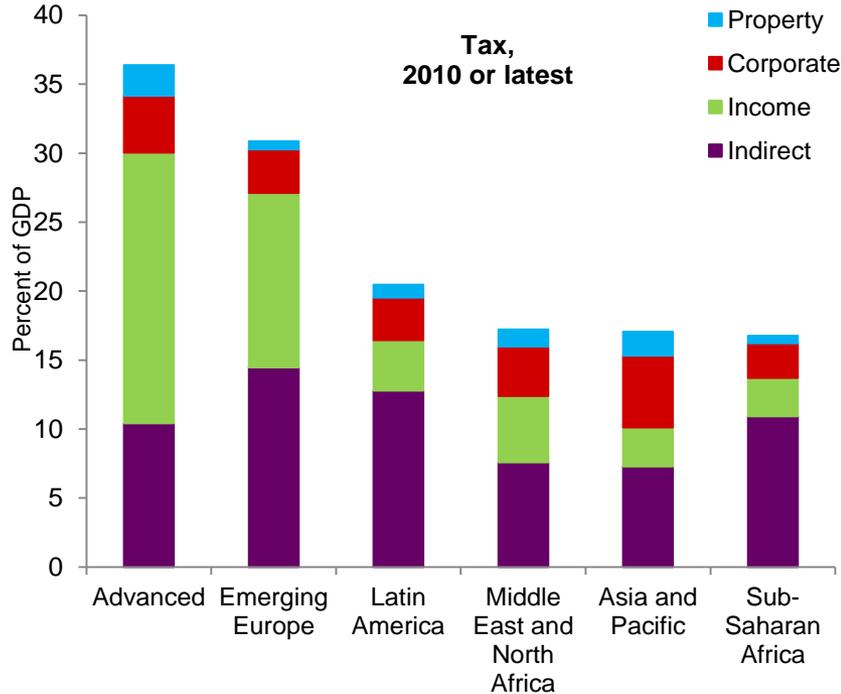


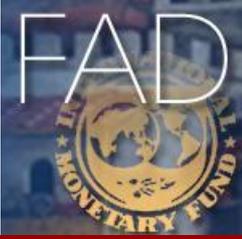
Source: Immervoll and Richardson, 2011; OECD, 2011.

IV. How effective has fiscal policy been at reducing inequality in developing countries?

Impact of fiscal policy in developing economies is limited by low tax-spending levels...

Levels and Composition of Tax Revenues and Social Spending

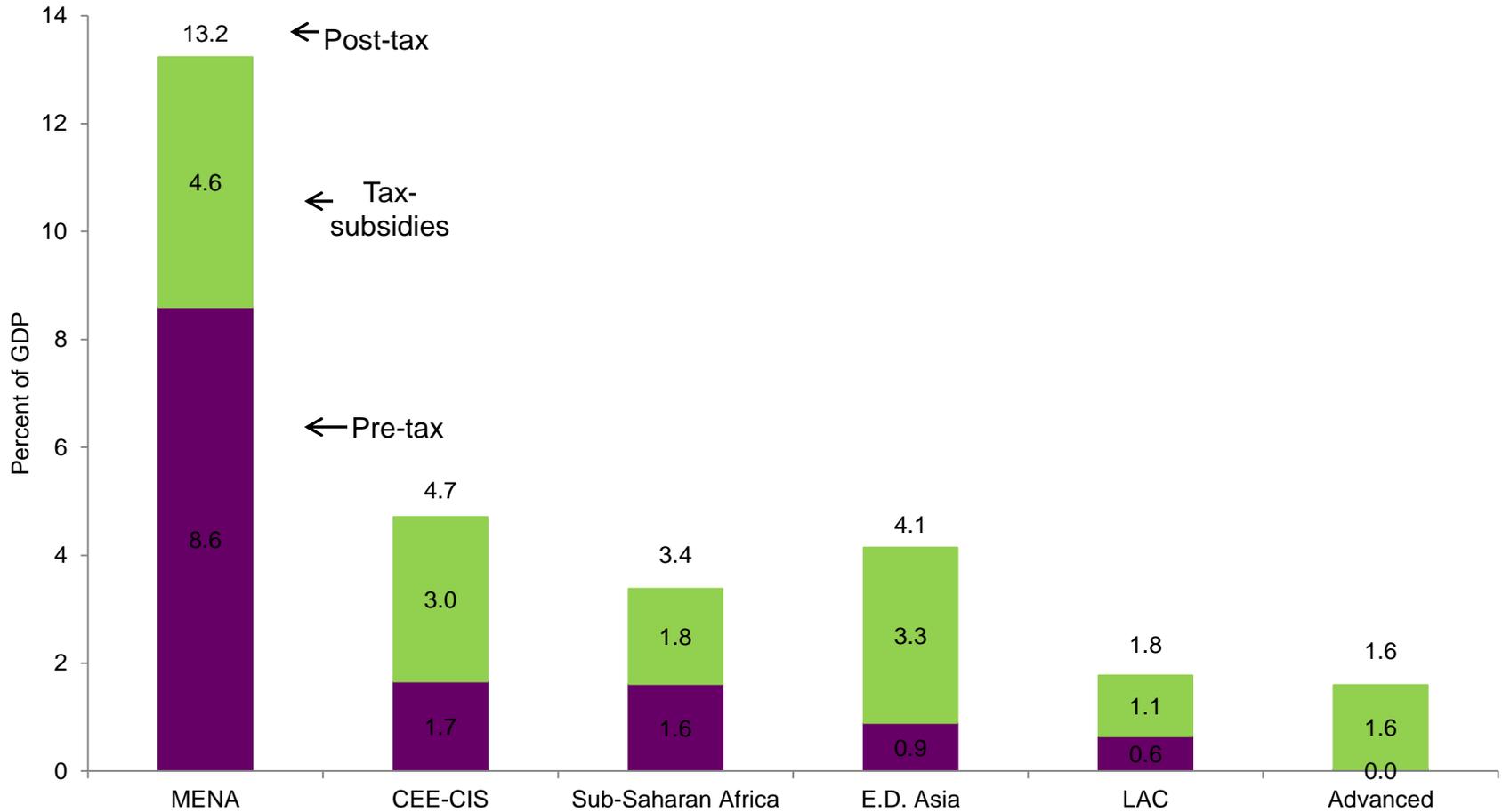




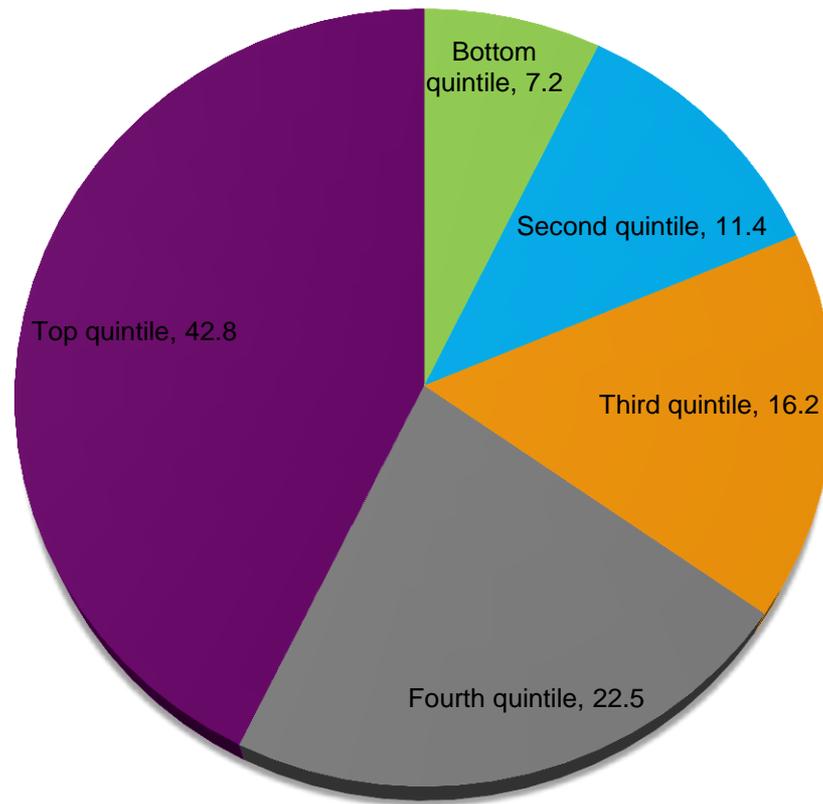
.....as well as less progressive taxes and transfer programs

- ❑ Greater reliance on indirect taxes and narrower tax bases**
- ❑ Progressivity of direct taxation is weakened by tax noncompliance and narrow tax bases**
- ❑ On the spending side, poor targeting limits the redistributive capacity of transfer programs**

Energy price subsidies as a percentage of GDP

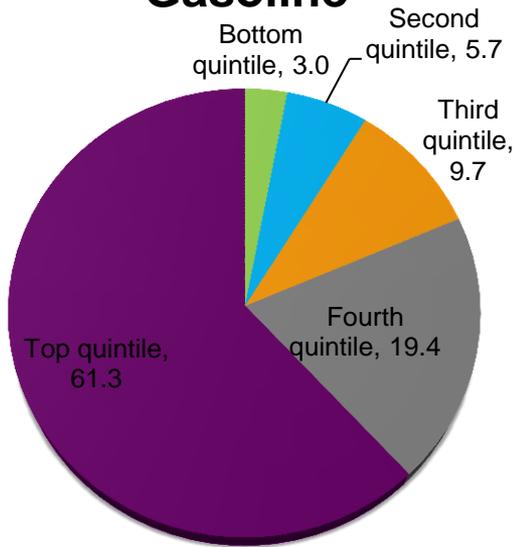


Fuel subsidies benefit upper income groups the most...

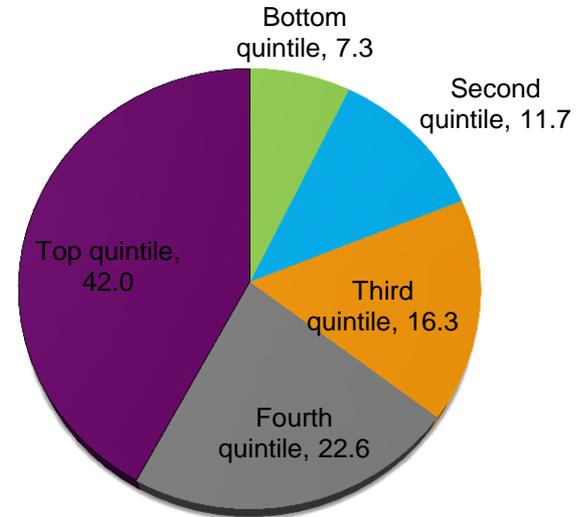


...across all products

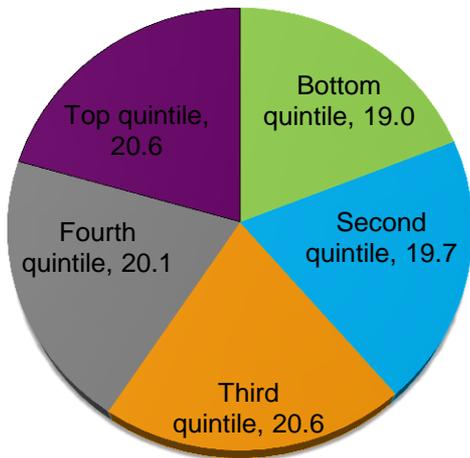
Gasoline



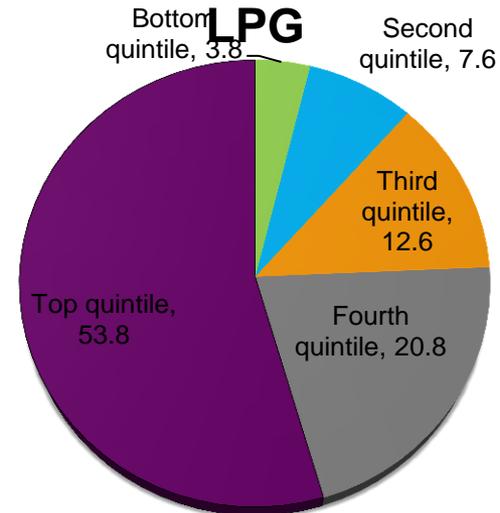
Diesel



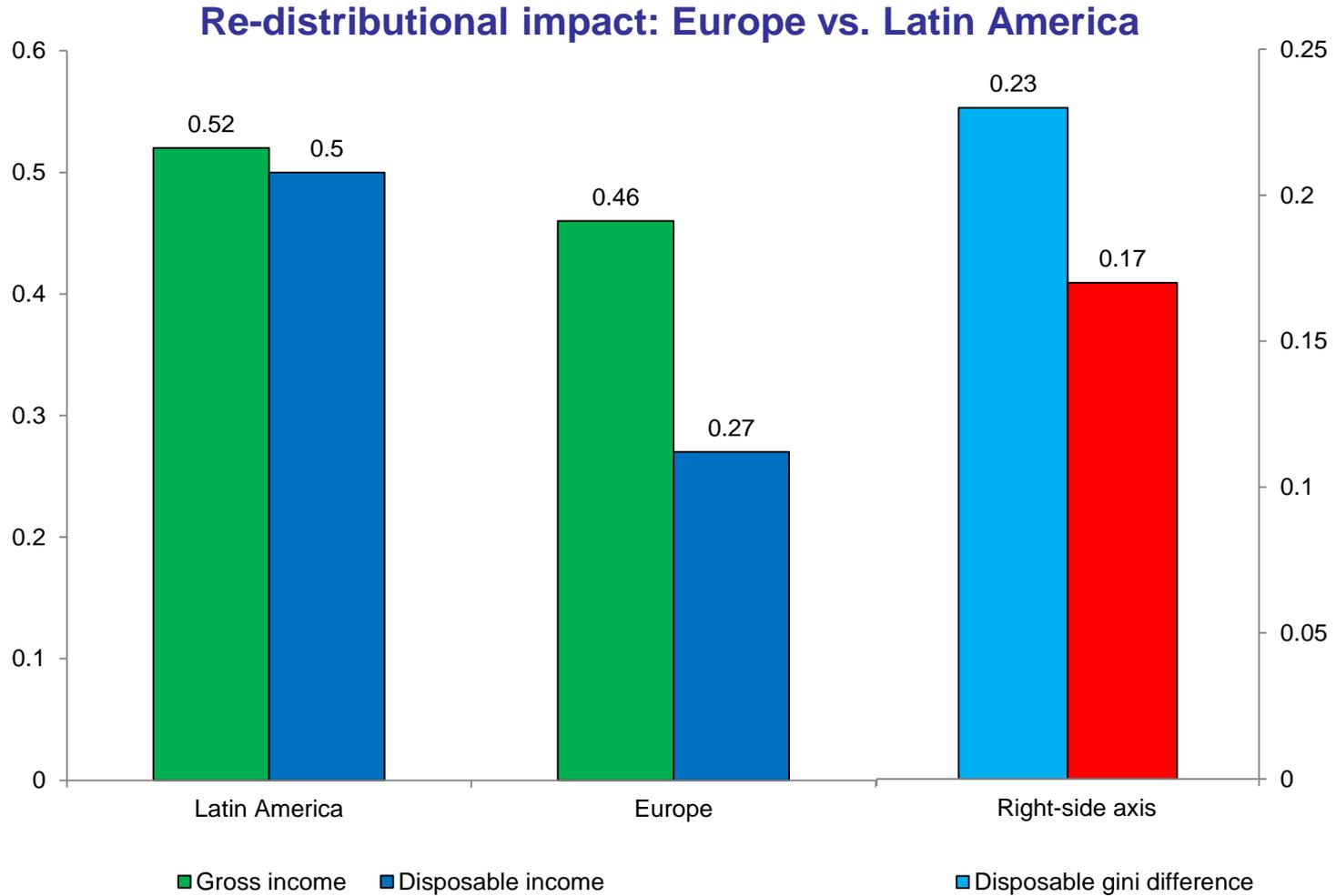
Kerosene



LPG



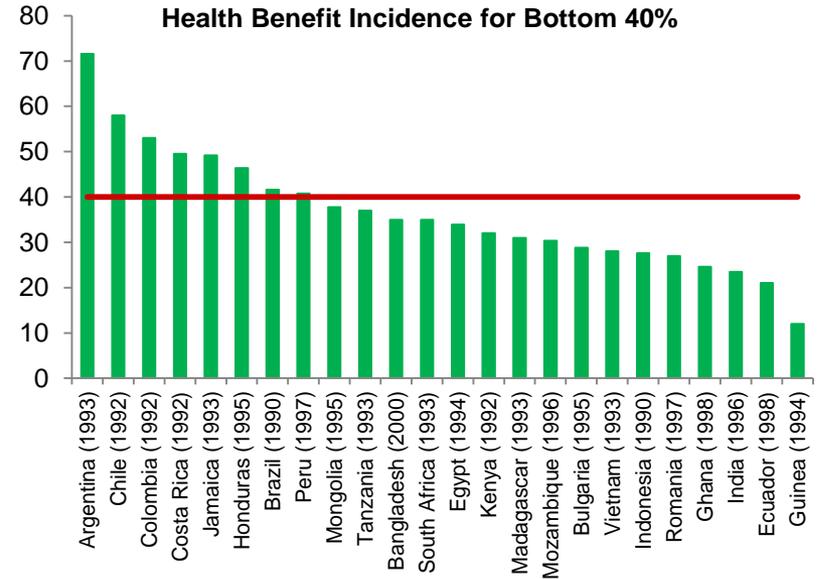
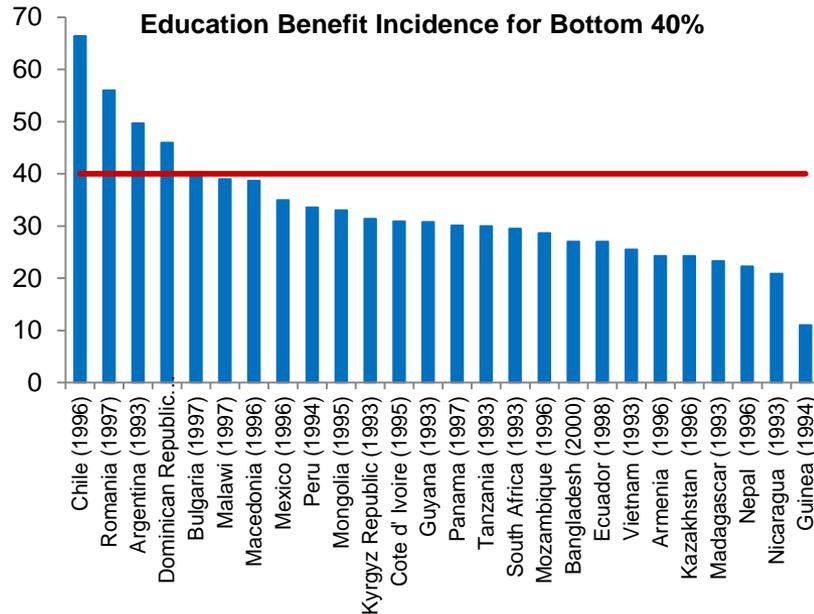
Fiscal policy accounts for nearly 3/4 of Europe vs. Latin America Gini difference



Source: Goñi, López and Servén, 2008

In-kind public spending has been found to be regressive in many developing economies

Benefit Incidence of Education and Health Public Spending (share of bottom 40 percent)



Conditional cash transfers

- The recent expansion of “conditional cash transfer” programs provides a promising approach for enhancing the distributive power of public spending in developing economies
 - ❖ The largest programs, in Brazil and Mexico, have reduced the Gini by 2.7 percentage points (Soares et al., 2007)

- However, these programs need to be targeted to the poorest households

V. Lessons for the design of fiscal policy in developing countries

Lessons for the design of fiscal policy

- In developing economies, the capability of fiscal policy to address income inequality needs to be enhanced

- This requires improvements on two fronts:
 - ❖ The level of tax and spending needs to be increased
 - ❖ The redistributive impact of tax and spending needs to be improved

Enhancing role of tax policy

□ Strengthening resource mobilization capacity

- ❖ Improvement in administrative capacity
- ❖ Expansion of corporate and personal income tax bases (addressing exemptions, loopholes, and tax compliance)
- ❖ Expansion of tax policy instruments (VAT plus excises)

Enhancing role of public spending

□ Higher and better targeted spending

- ❖ Expansion and improved targeting of social assistance (eliminate universal price subsidies)
- ❖ Expansion of health and education
- ❖ Expansion of conditional cash transfers

THANK YOU

Change in Gini Coefficient, 1990 to 2005

	<i>Change</i>	<i>Large Increase (Change ≥ 5)</i>	<i>Medium Increase (3 ≤ Change < 5)</i>	<i>Small Increase (0 < Change < 3)</i>	<i>Small Decrease (-3 < Change < 0)</i>	<i>Medium Decrease (-5 < Change ≤ -3)</i>	<i>Large Decrease (Change ≤ -5)</i>
<i>Latin America and Caribbean</i>	<i>1990-2005</i>	Colombia, Honduras, Paraguay, Venezuela	Bolivia, Costa Rica, Uruguay	Argentina, Dominican Republic, Guatemala, Jamaica	El Salvador, Panama	Brazil, Chile, Ecuador, Nicaragua, Peru	Belize, Mexico
<i>Sub-Saharan Africa</i>	<i>1990-2005</i>	Cote d'Ivoire, Ghana, Niger, Rwanda, South Africa	Mozambique, Tanzania	Burundi, Madagascar, Zambia	Cameroon, Nigeria, Uganda	Gambia	Burkina Faso, Central African Republic, Ethiopia, Guinea, Guinea-Bissau, Kenya, Lesotho, Malawi, Mali, Namibia, Senegal, Swaziland
<i>Asia and Pacific</i>	<i>1990-2005</i>	China, Indonesia, Rep. of Korea, Lao PDR, Nepal, Sri Lanka	Bangladesh, Cambodia, Taiwan	India, Mongolia, Philippines, Vietnam		Thailand	Malaysia
<i>Middle East and North Africa</i>	<i>1990-2005</i>	Kyrgyz Republic, Tajikistan, Turkmenistan, Uzbekistan	Djibouti	Egypt, Mauritania, Morocco, Tunisia	Pakistan		Iran, Jordan