



Low-Income Countries Seminar

# Income Inequality and Fiscal Policy in Low-Income Countries

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## **Presentation is based on:**

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

**Available at:**

**<http://www.imf.org/external/pubs/cat/longres.aspx?sk=40024>**



## Background

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- ❑ **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**

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- 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

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### □ Fiscal policy can affect income distribution

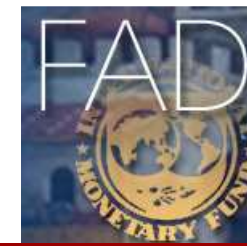
- ❖ **Directly.** By reducing inequality of disposable incomes compared to inequality of market incomes
- ❖ **Indirectly.** Through impact on future earnings of individuals and inequality of market incomes

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

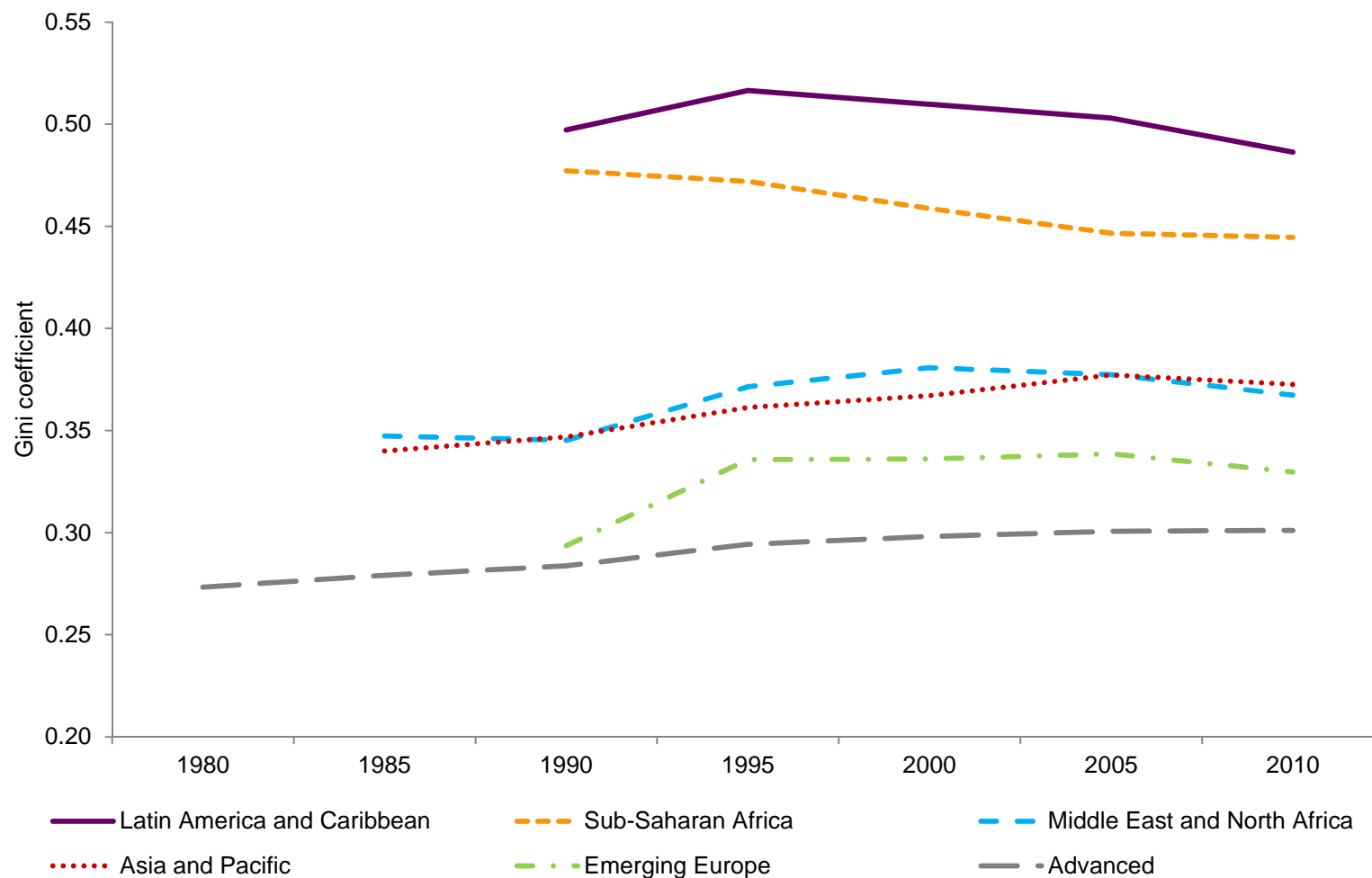
### □ But taxes and transfers may distort allocation of resources (equity-efficiency trade-off)

## **II. Trends in income inequality**

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



Trends in Disposable Income Inequality, 1980–2010

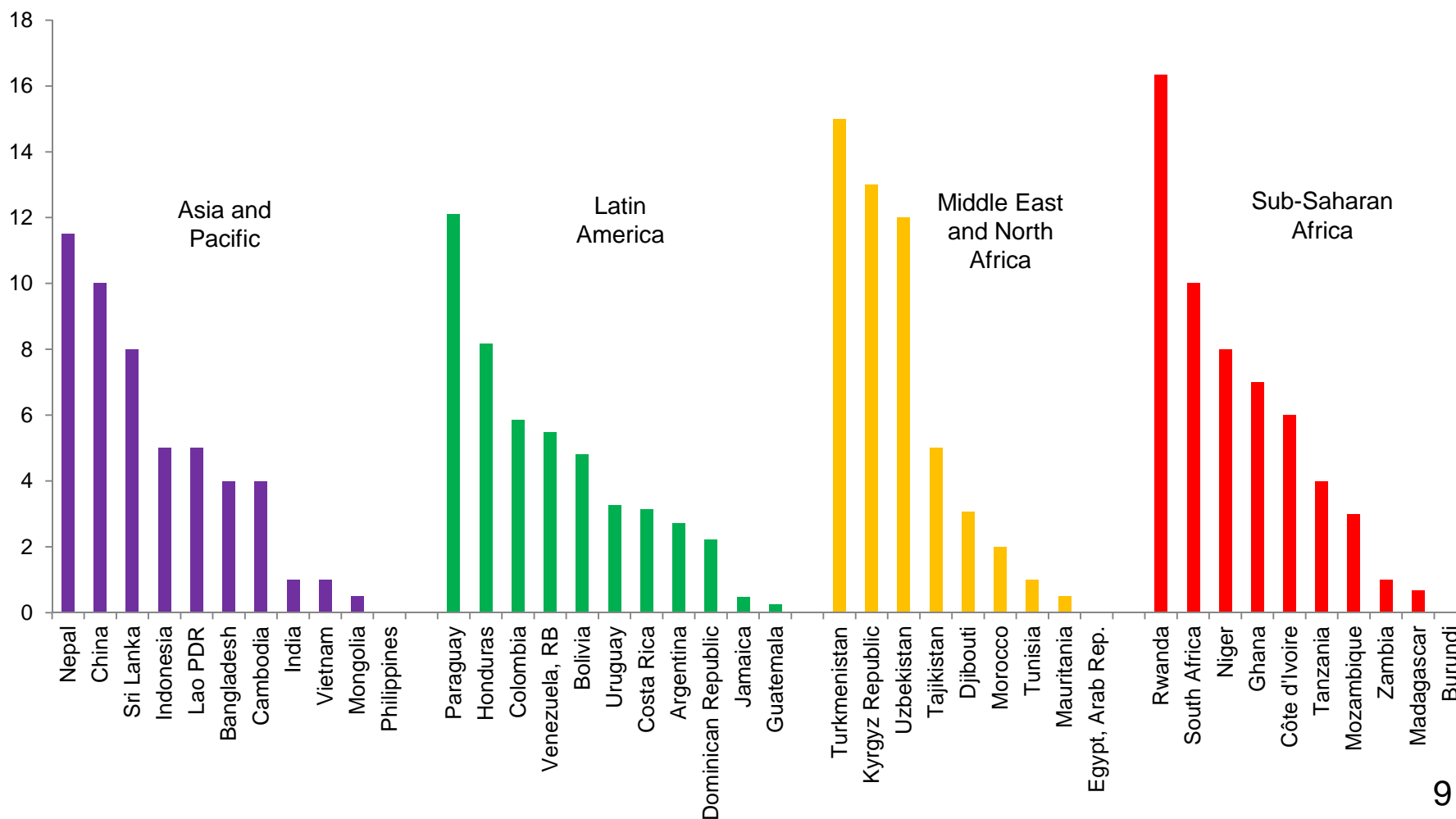




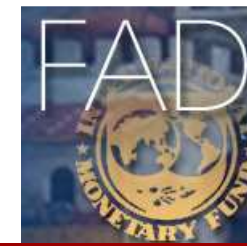
.....and has been increasing in many of these

## Changes in Disposable Income Inequality Across Regions, 1990–2005

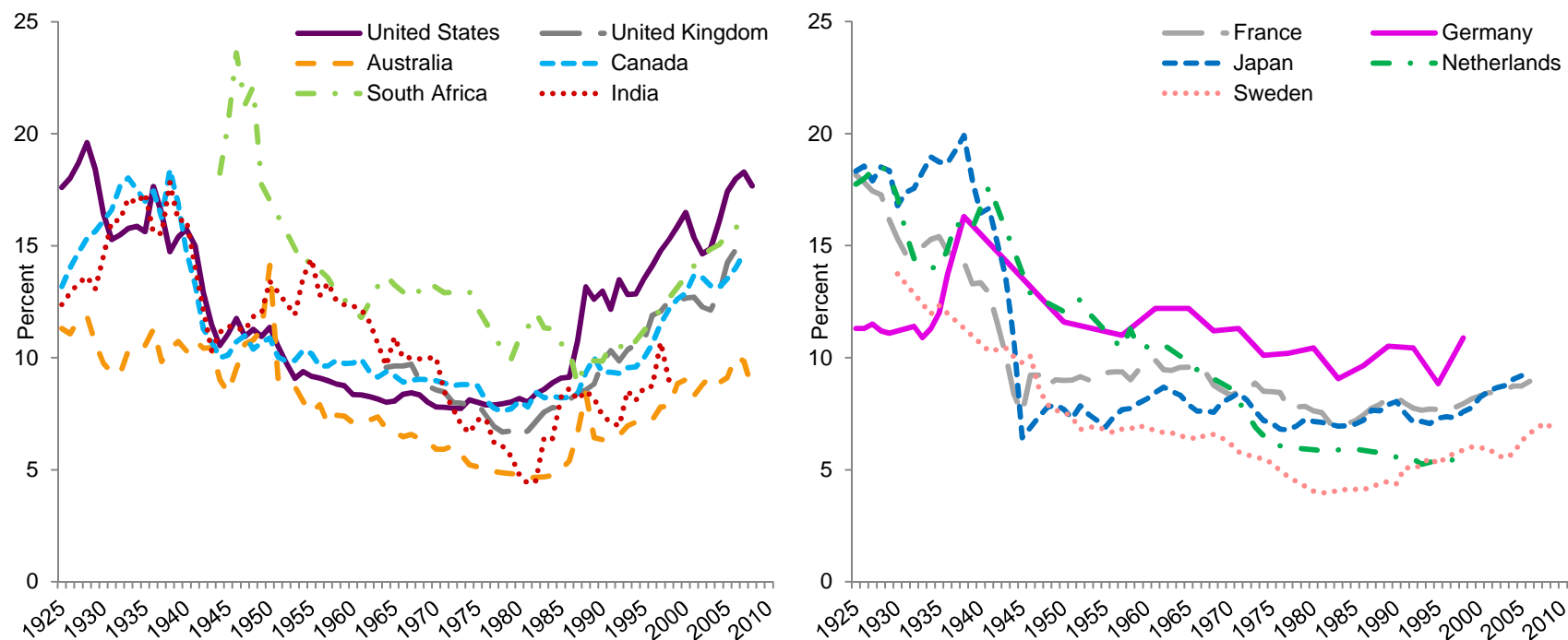
(Percentage-point change in Gini coefficient)



# 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

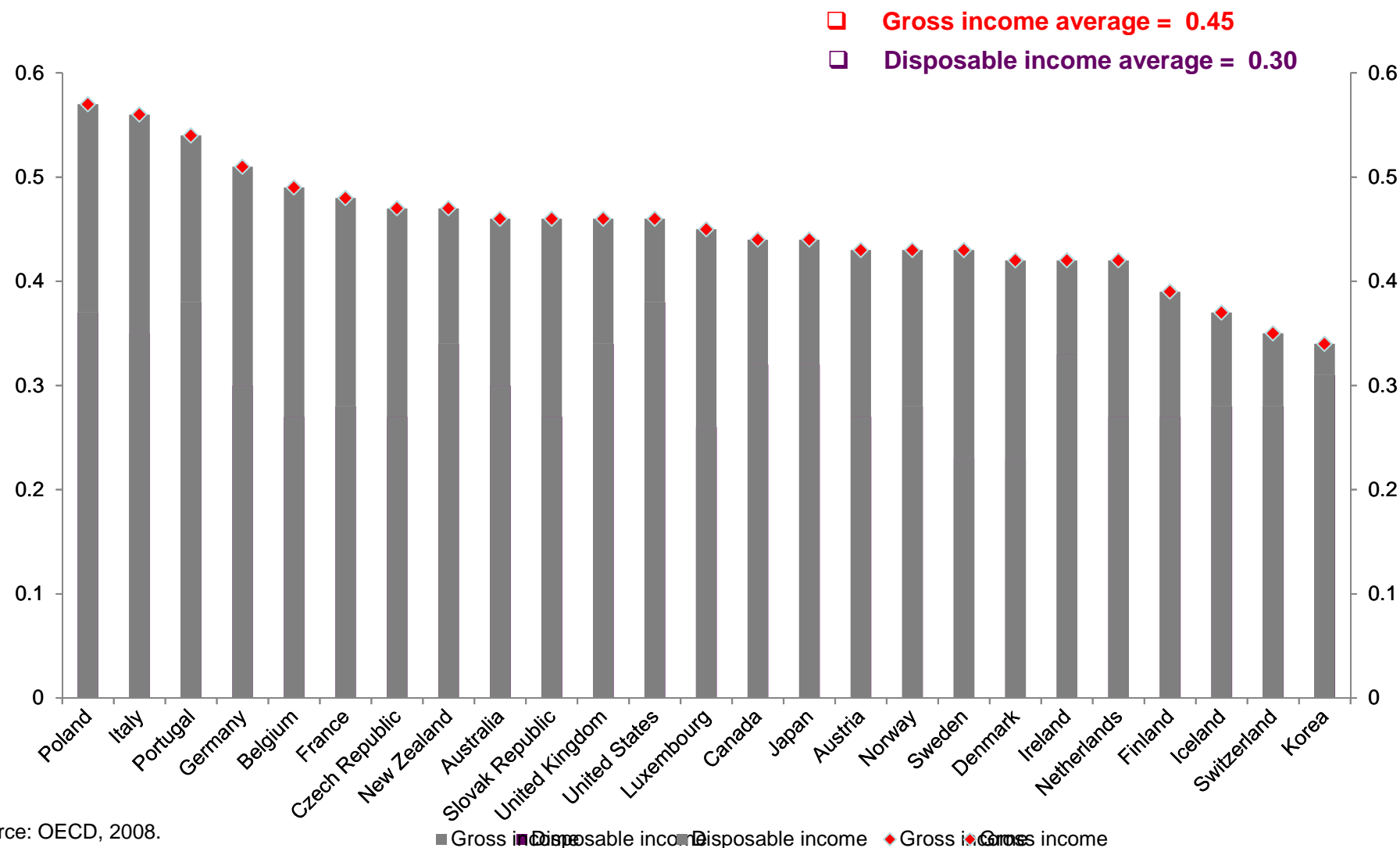


Source: World Top Incomes Database

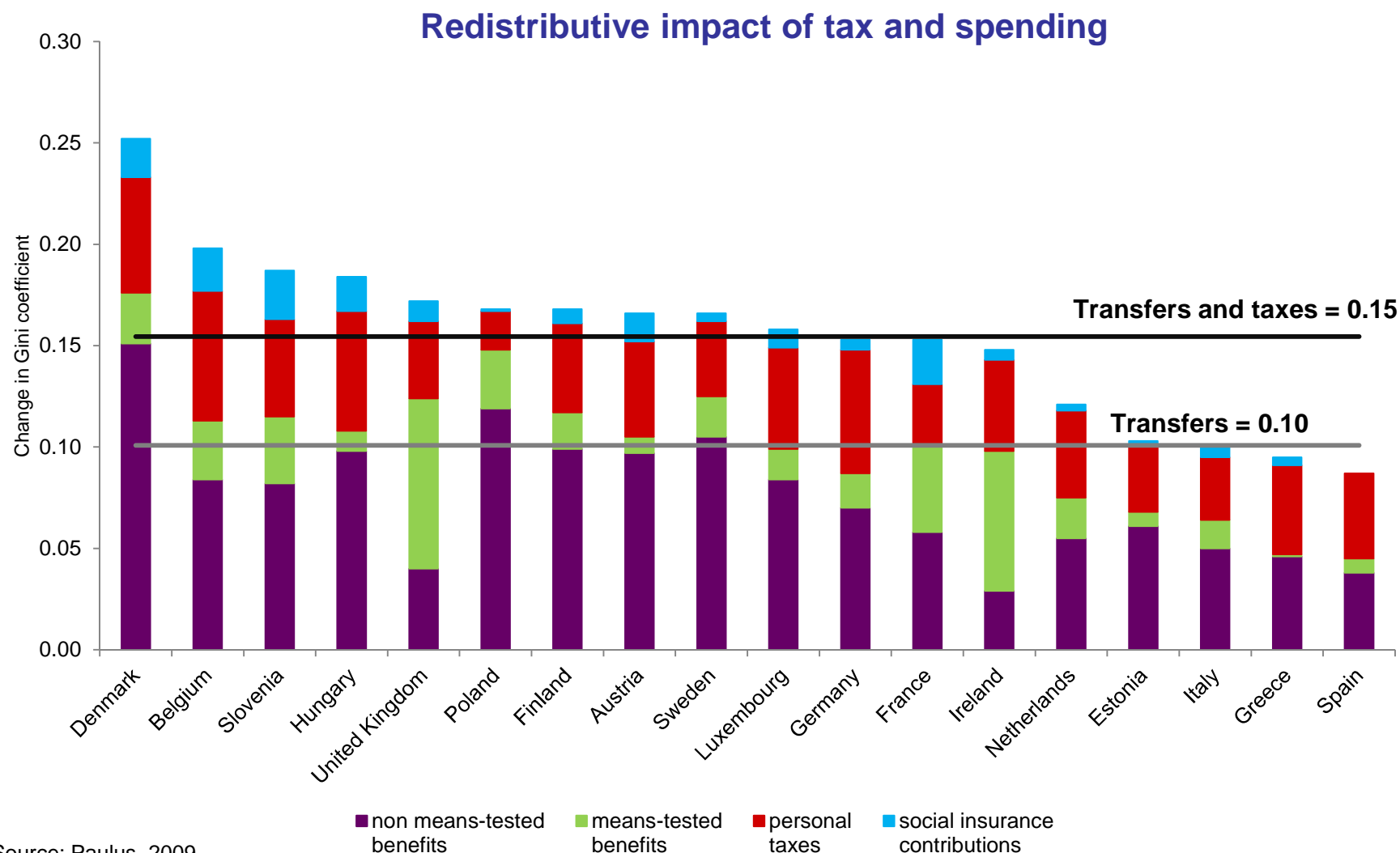
### **III. How has fiscal policy affected income inequality in advanced economies?**

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

## Redistributive impact in OECD countries, 2008



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



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

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- ❑ **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)

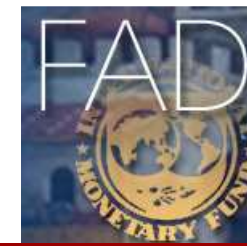
## **Corporate income taxes may not be as progressive as often assumed**

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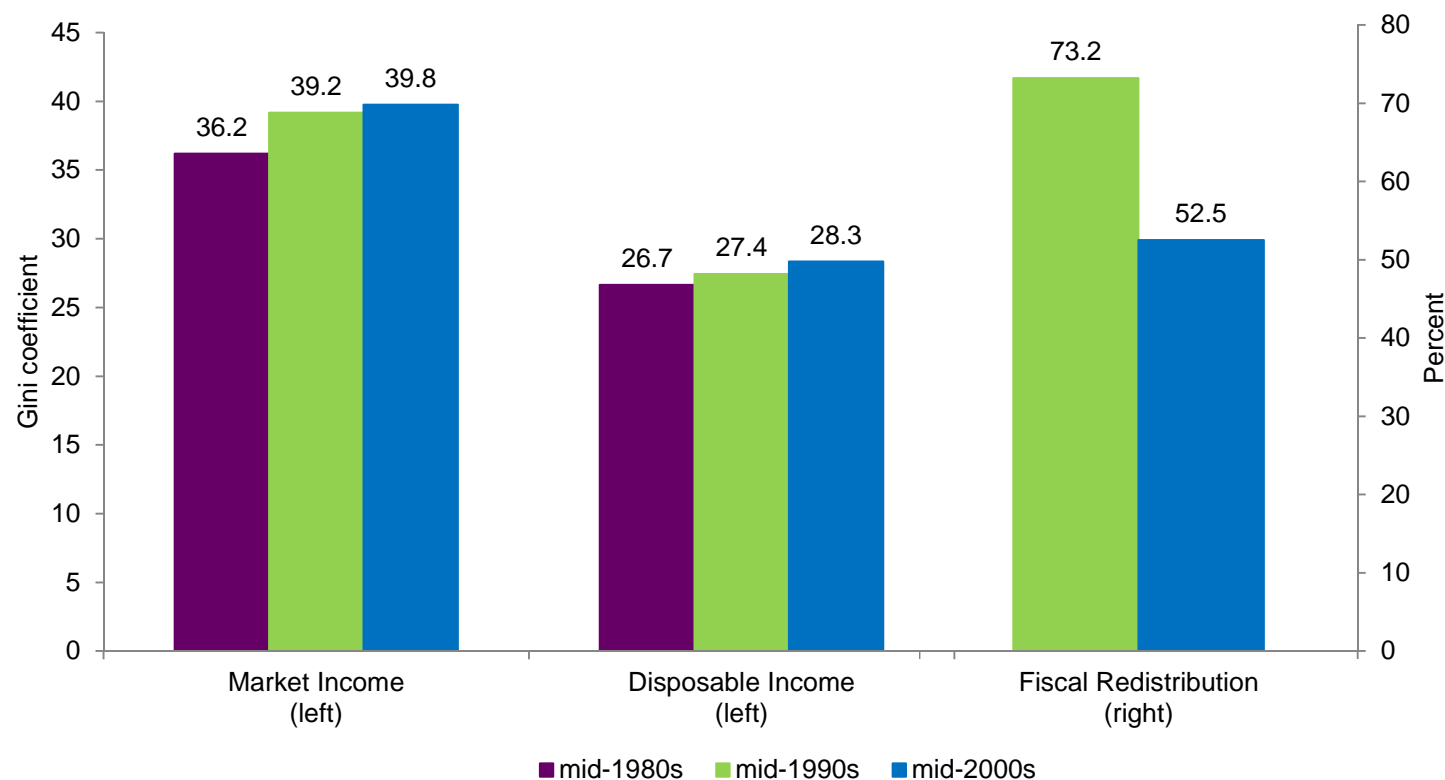


- ☐ **The incidence of corporate taxes will tend to fall on wages as capital is more mobile**
- ☐ **However, taxation of “rents” (above normal profits) is likely to fall on owners of capital**

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



## Diminishing Redistributive Impact of Fiscal Policy Since Mid-1990s

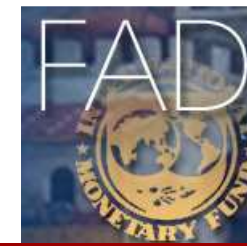


Source: Immervoll and Richardson, 2011; OECD, 2011.

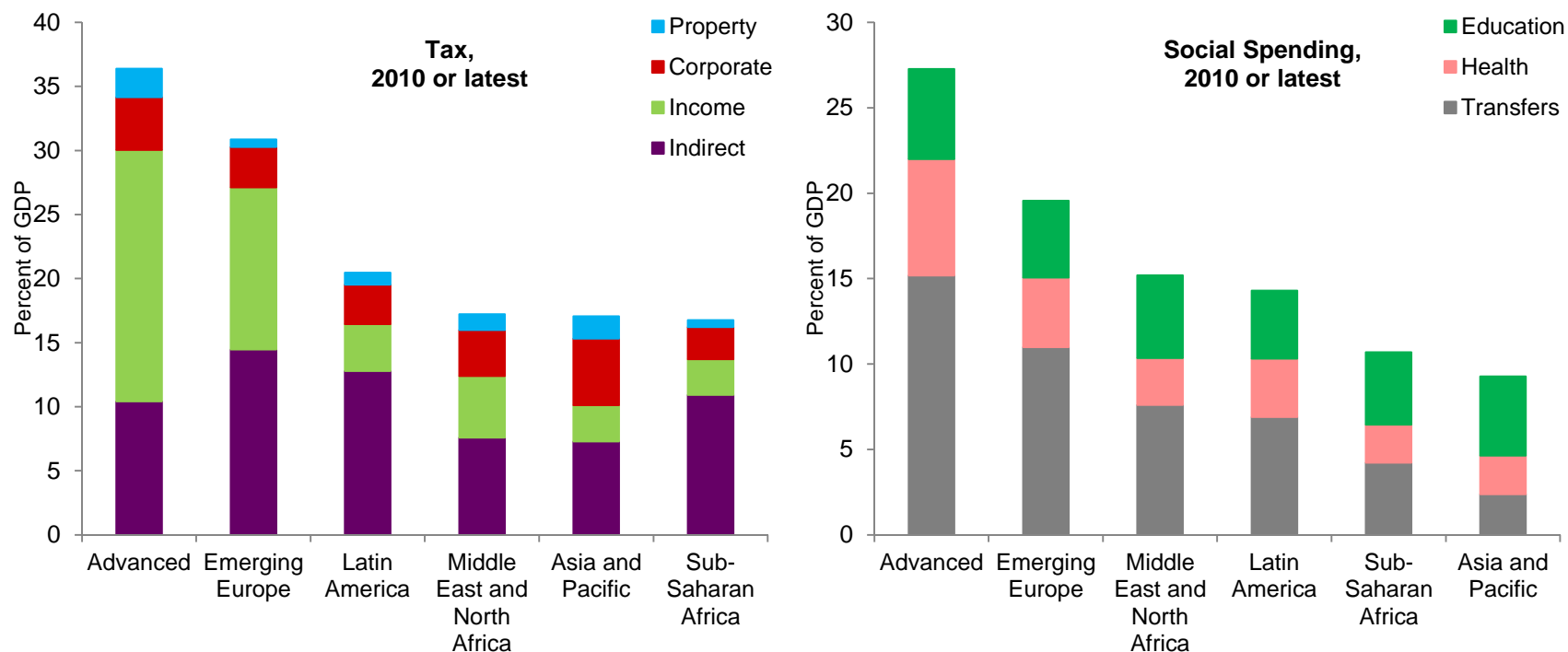


**IV. How effective has fiscal policy been at reducing inequality in developing countries?**

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



## Levels and Composition of Tax Revenues and Social Spending



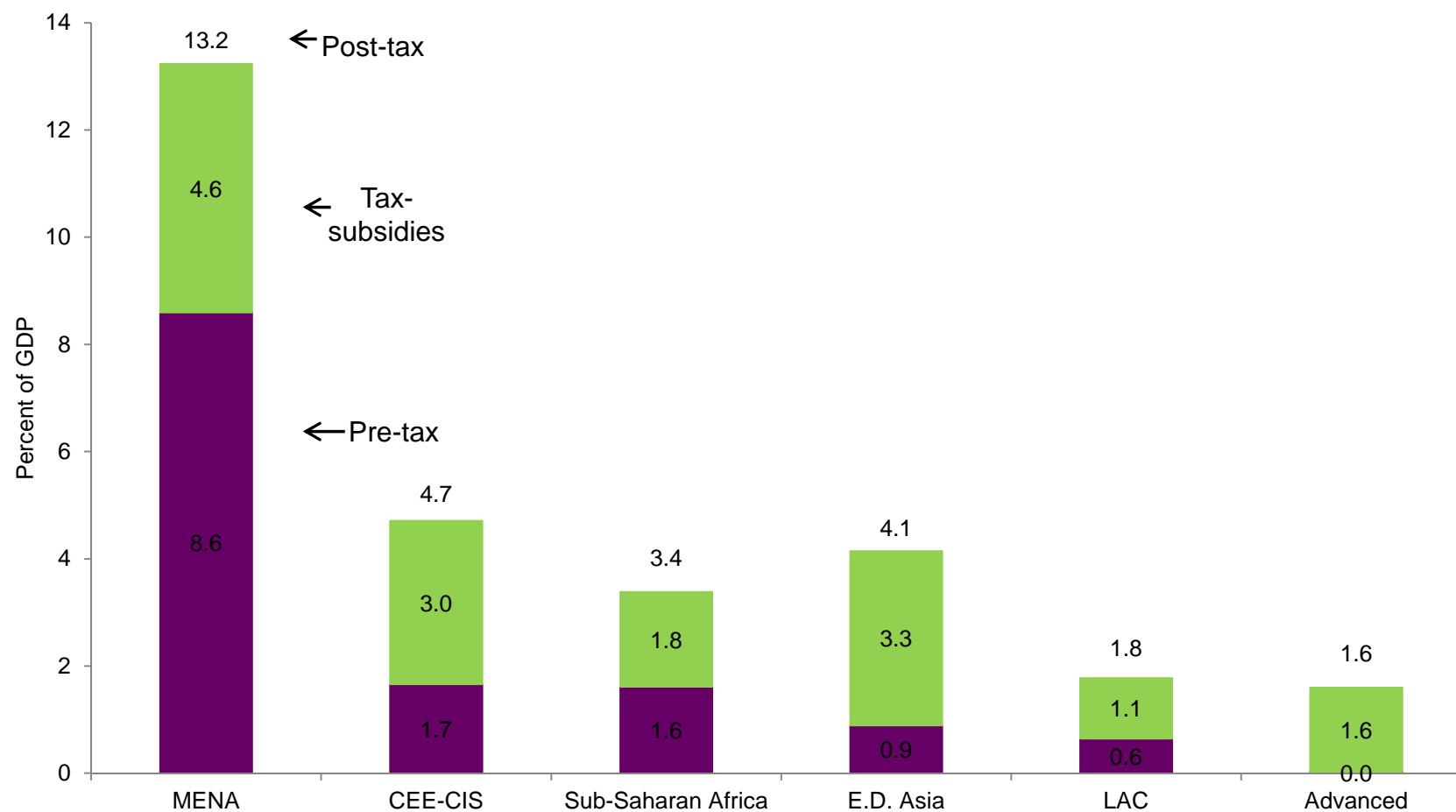
**.....as well as less progressive taxes and transfer programs**

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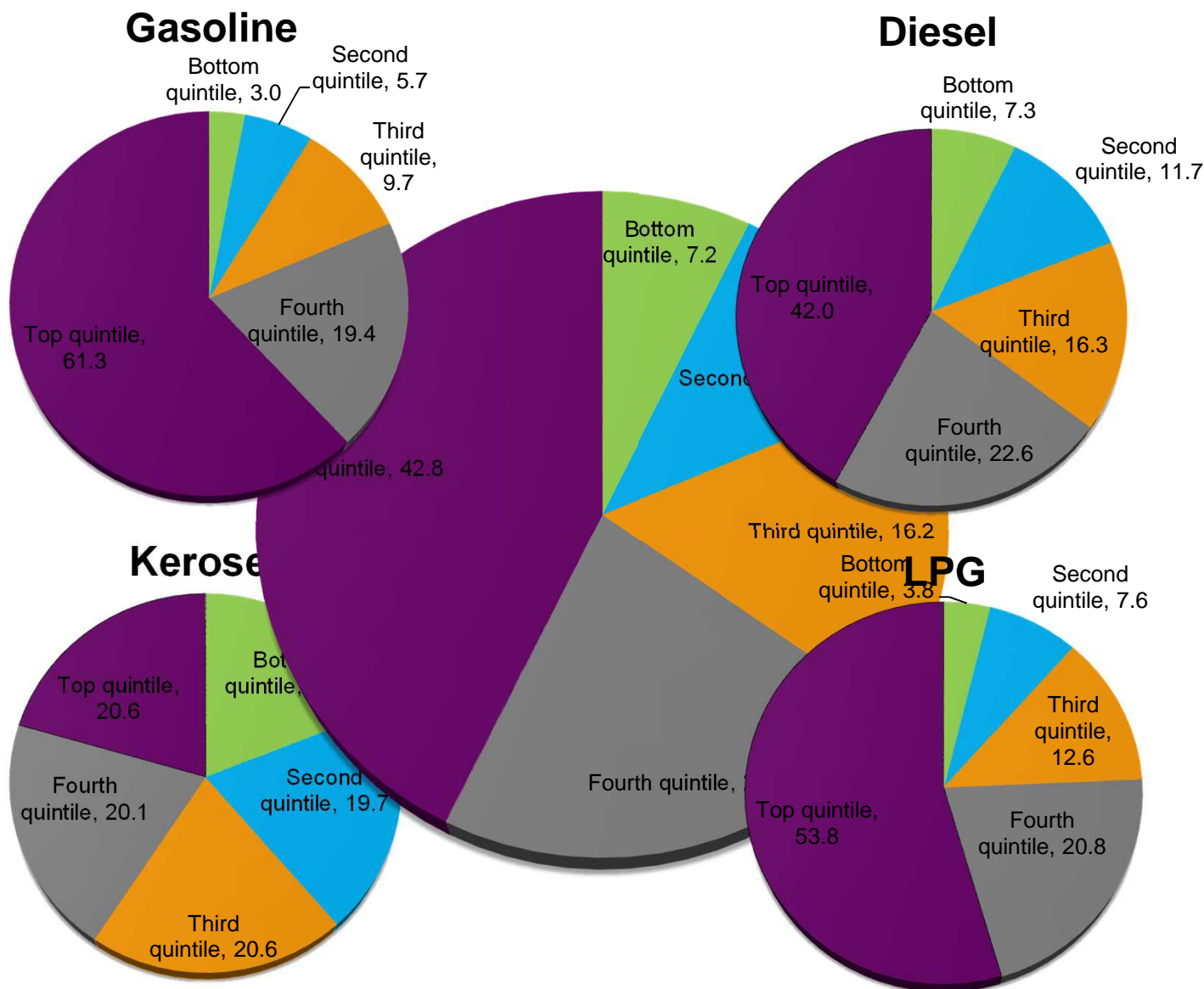


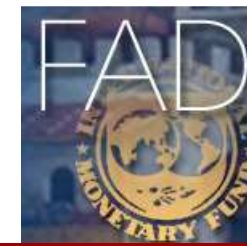
- ☐ **Greater reliance on indirect taxes and narrower tax bases**
- ☐ **Progressivity of direct taxation is weakened by tax noncompliance and narrow tax bases**
- ☐ **On the spending side, poor targeting limits the redistributive capacity of transfer programs**

# Energy price subsidies as a percentage of GDP

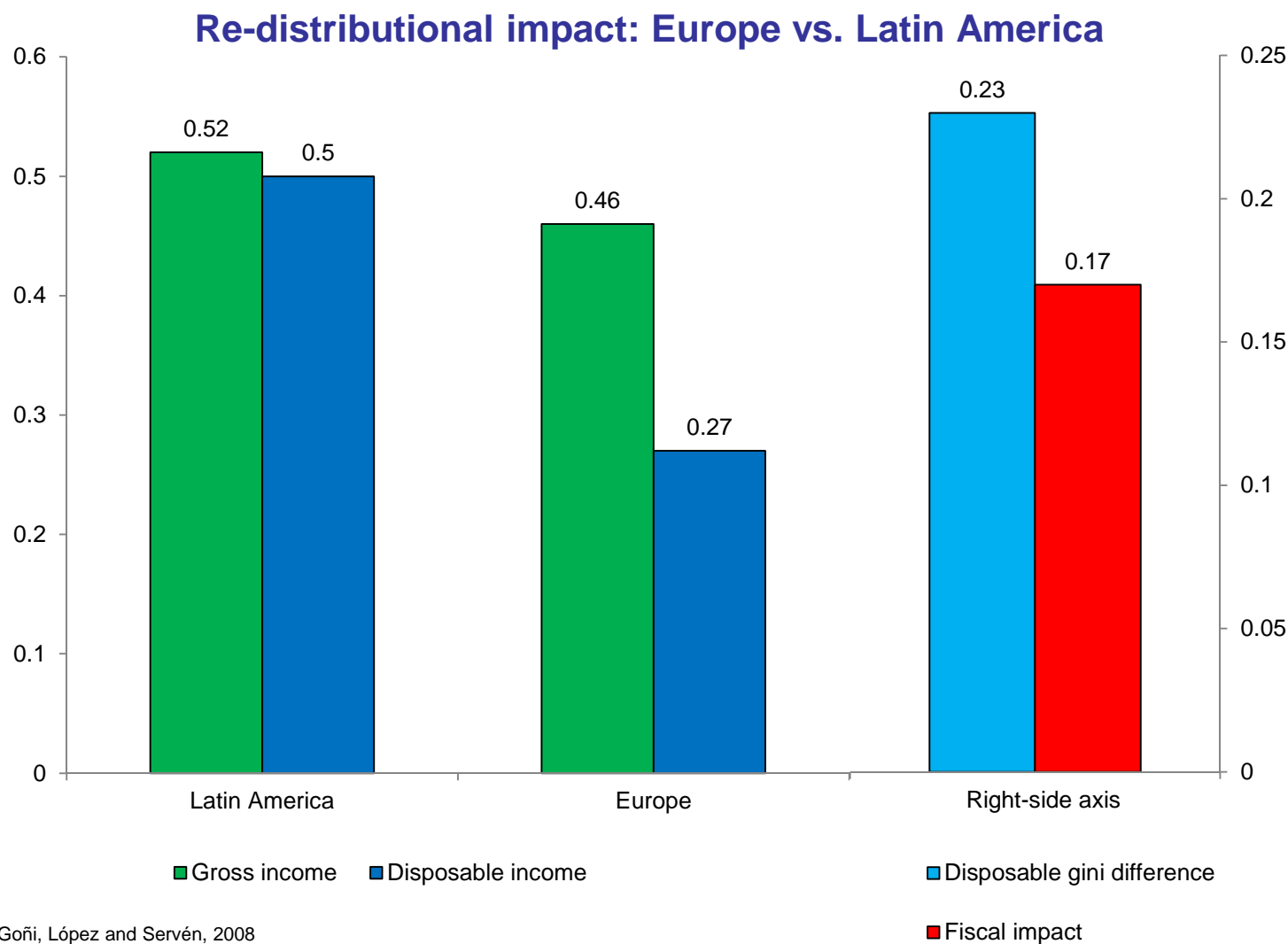


# Fuel subsidies benefit upper income groups the most... ...across all products





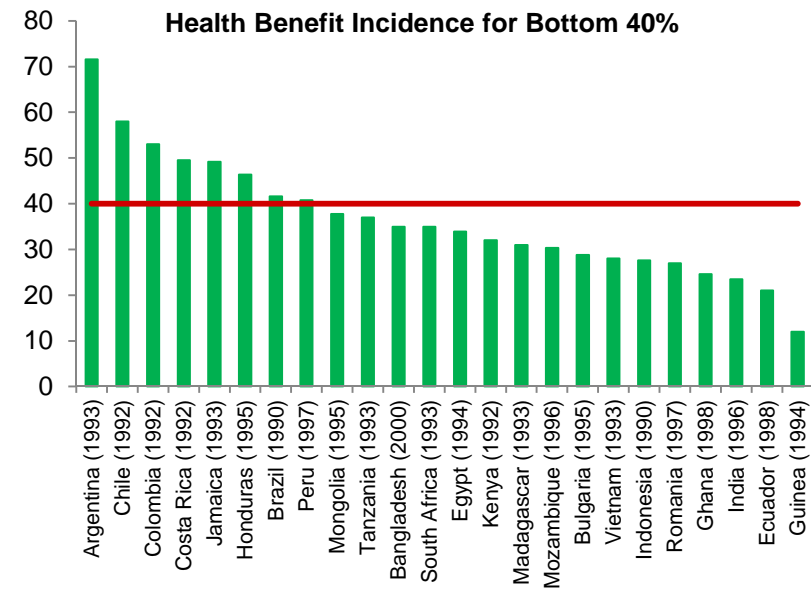
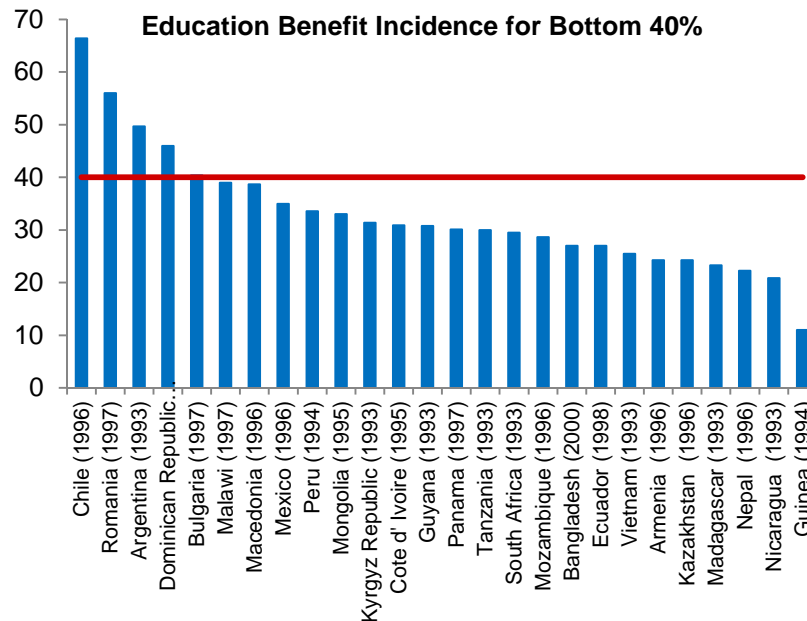
# Fiscal policy accounts for nearly 3/4 of Europe vs. Latin America Gini difference



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

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- ❑ 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**

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- ❑ **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**

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### **☐ 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**

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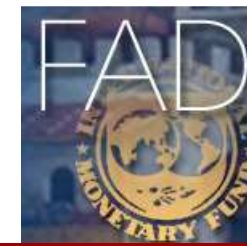
### **□ Higher and better targeted spending**

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



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*THANK YOU*



# Change in Gini Coefficient, 1990 to 2005

	<i>Change</i>	<i>Large Increase (Change ≥ 5)</i>	<i>Medium Increase (3 ≤ Change &lt; 5)</i>	<i>Small Increase (0 &lt; Change &lt; 3)</i>	<i>Small Decrease (-3 &lt; Change &lt; 0)</i>	<i>Medium Decrease (-5 &lt; Change ≤ -3)</i>	<i>Large Decrease (Change ≤ -5)</i>
<b><i>Latin America and Caribbean</i></b>	<b><i>1990-2005</i></b>	Colombia, Honduras, Paraguay, Venezuela	Bolivia, Costa Rica, Uruguay	Argentina, Dominican Republic, Guatemala, Jamaica	El Salvador, Panama	Brazil, Chile, Ecuador, Nicaragua, Peru	Belize, Mexico
<b><i>Sub-Saharan Africa</i></b>	<b><i>1990-2005</i></b>	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
<b><i>Asia and Pacific</i></b>	<b><i>1990-2005</i></b>	China, Indonesia, Rep. of Korea, Lao PDR, Nepal, Sri Lanka	Bangladesh, Cambodia, Taiwan	India, Mongolia, Philippines, Vietnam		Thailand	Malaysia
<b><i>Middle East and North Africa</i></b>	<b><i>1990-2005</i></b>	Kyrgyz Republic, Tajikistan, Turkmenistan, Uzbekistan	Djibouti	Egypt, Mauritania, Morocco, Tunisia	Pakistan		Iran, Jordan