



Fiscal Policy and Income Inequality

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**Taxation & Developing Countries (a PEAKS training course)
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- Trends in income inequality
- The impact of direct taxes and transfers
- Revenue and spending comparisons: Levels and composition
- Policy implications
- What are the key policy challenges in low-income countries?



Trends

- Income inequality is increasing in many countries.

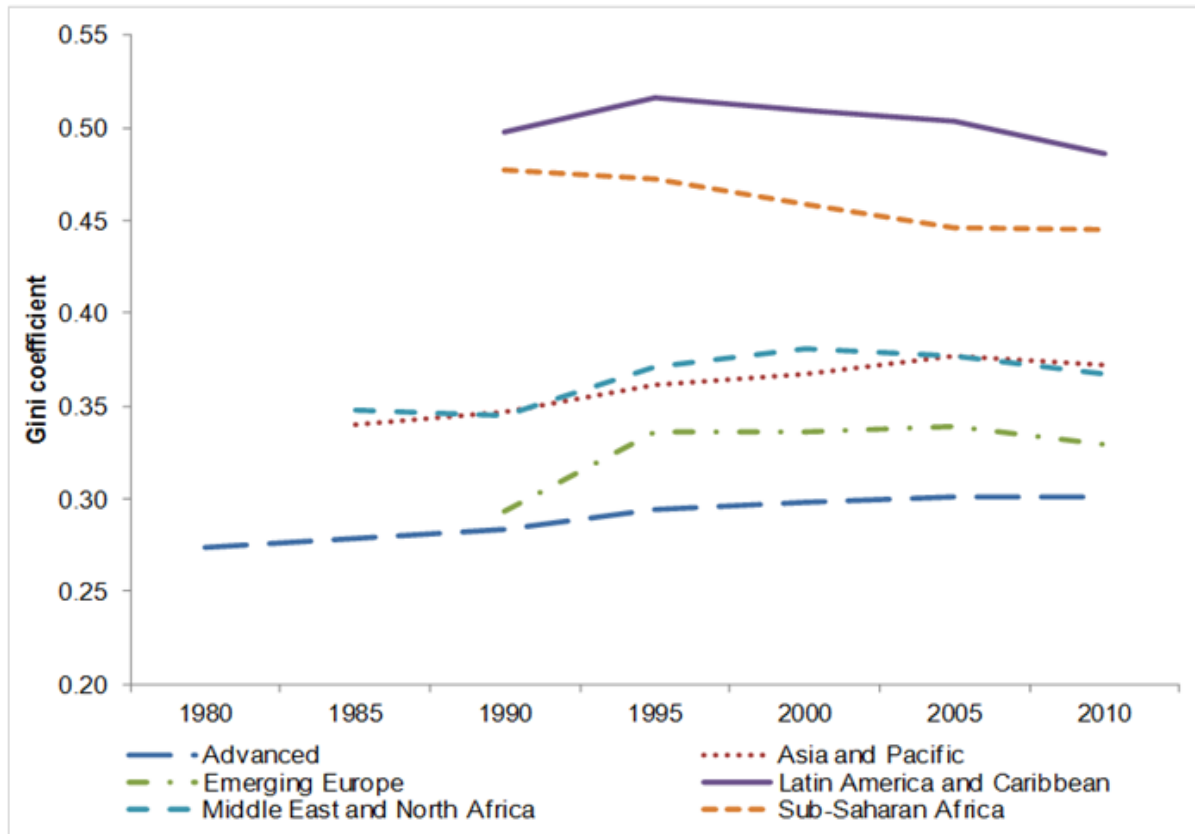
Does this matter?

- *Intrinsic value*

If existing income inequality is perceived as the outcome of unfair processes and unequal access to opportunities.

- *Instrumental value*

Can help to reduce inequality in other dimensions that matter (social, political, economic), promote progress in poverty reduction and growth.



Source: Bastagli, Coady and Gupta (2012)



Inequality Trends

- **High-income countries**: in most countries inequality started increasing in the 1980s and through the mid-1990s.
 - **Eastern Europe**: between the late 1980s and mid-1990s inequality increased in most transition countries and has followed mixed trends since then.
 - **Latin America and the Caribbean**: region with the highest income inequality; most countries experienced an increase in income inequality during the 1980s and until the 2000s; from then inequality has declined in most countries. Levels in 2006 close to those of the early 1990s; more recently continued decline.
 - **Sub-Saharan Africa**: mixed trends in expenditure inequality; decreased in 4 out of 6 countries for which data are available in 1980s-1990s; little change in countries for which data are available in the late 1990s.
 - **Asia and the Pacific**: from the mid-1990s to 2007, inequality increased in 14 countries and decreased in 8 countries.
 - **Middle East and North Africa**: inequality increased in 9 of 12 countries in the region between 1990 and 2005.
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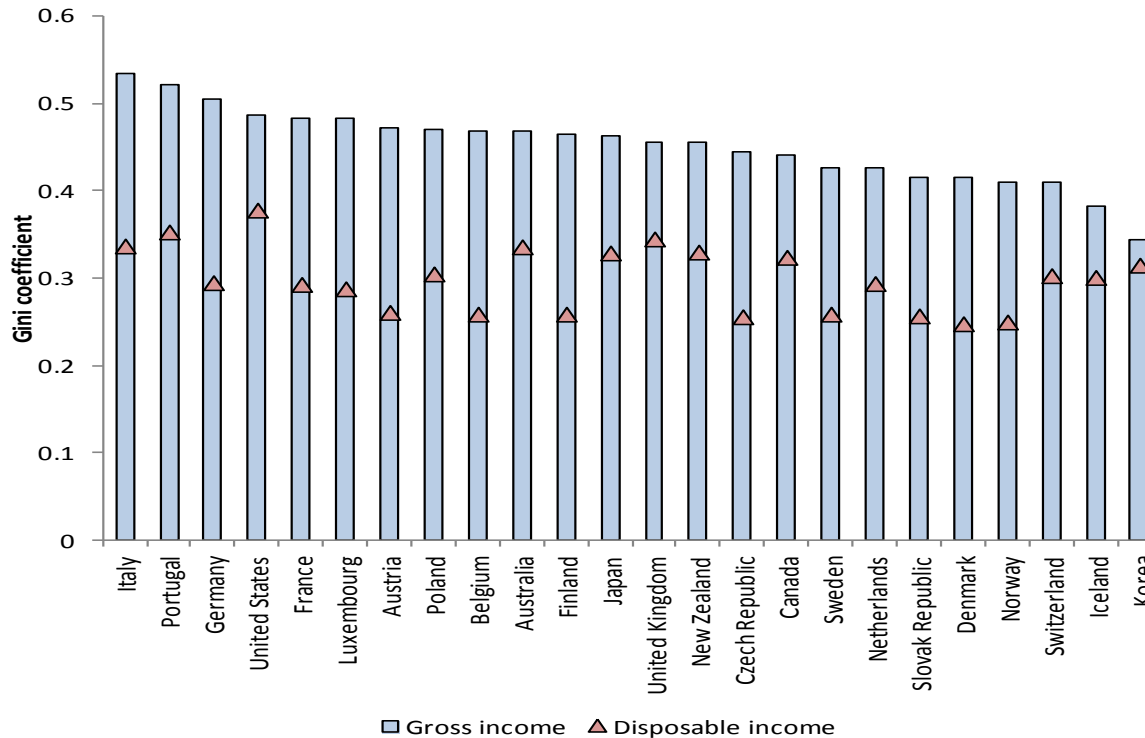
Inequality Trends

- Also striking, the difference in inequality between higher-income and developing countries:
 - Average inequality in the two most unequal regions (Latin America and Sub-Saharan Africa) exceeded a Gini of 0.45 every year. In the two most equal regions (Eastern Europe and High-income OECD countries) was less than 0.34. A difference of 11 percentage points.
 - Income inequality in Norway: 0.25 and Sweden: 0.26, in Brazil: 0.54 and South Africa: 0.65 (late 2000s).



Impact of Direct Taxes and Transfers

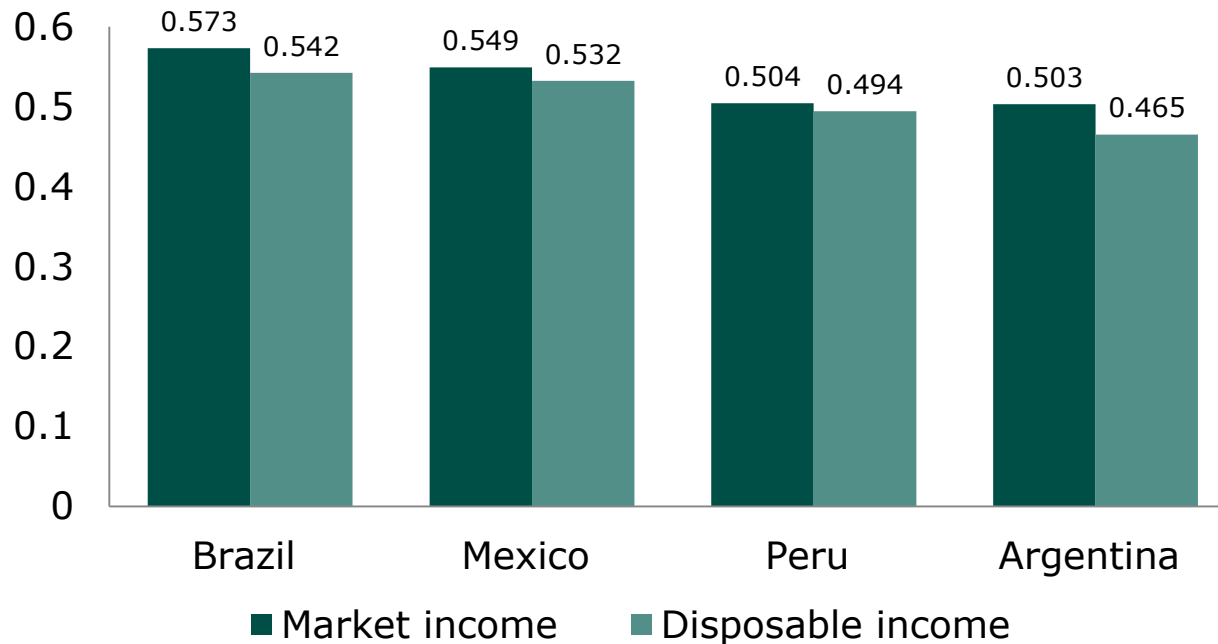
- Income inequality was reduced by one-third in OECD countries (Source: OECD, 2011)





Impact of Direct Taxes and Transfers

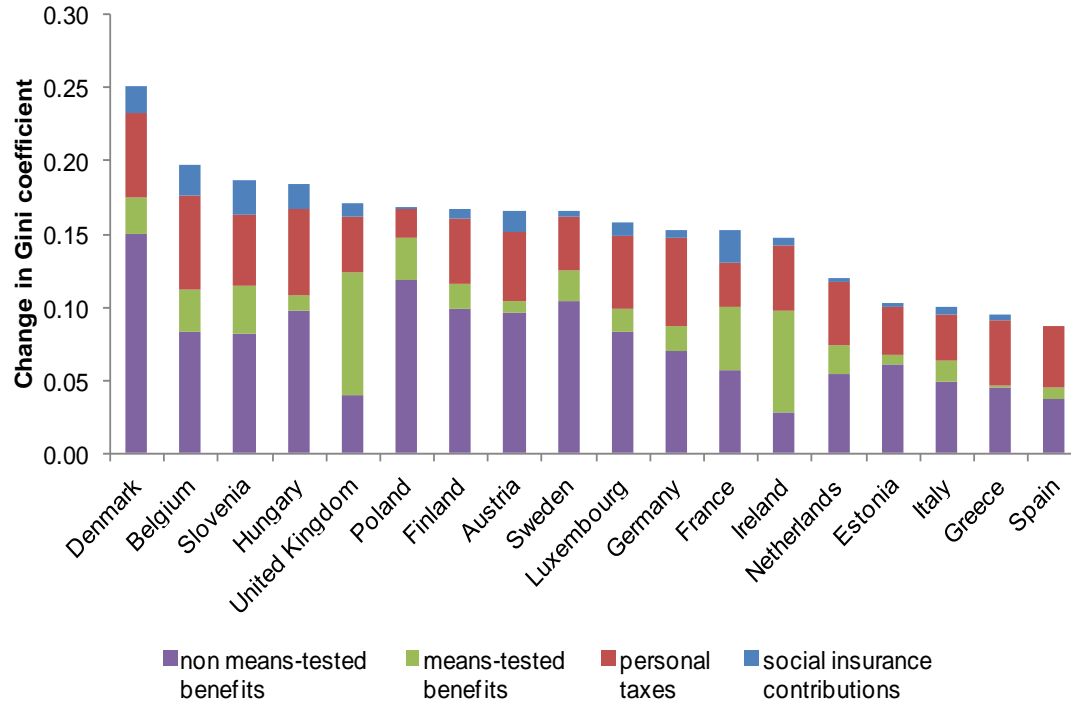
- Income inequality was reduced by 2 percentage points on average in LAC countries (Source: Elaboration from Lustig et al, 2012)





Impact of Direct Taxes and Transfers

- Non-MT transfers, MT benefits, personal taxes and social insurance contributions (Source: Paulus et al, 2009)



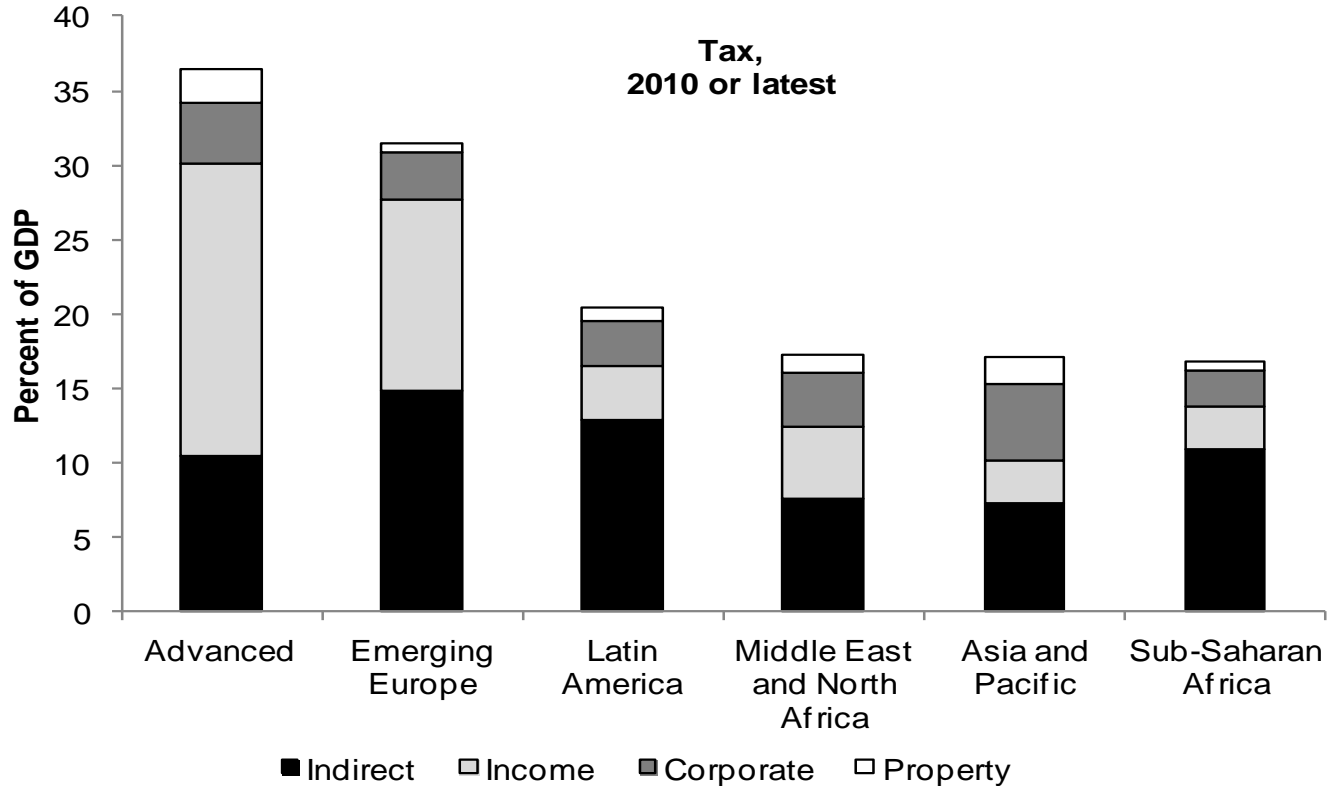


Limited Scope For Generalisations, However...

- The redistributive effect is on average larger for non-means-tested benefits, followed by personal taxes and M-T benefits.
- In-kind transfers (e.g., education and health) also reduce inequality (nearly 5pp on average).
- Equalising impact of personal income taxes, which fall more heavily on higher income groups.
- Indirect taxes tend to be regressive; e.g. consumption taxes have a significant regressive impact in OECD countries.



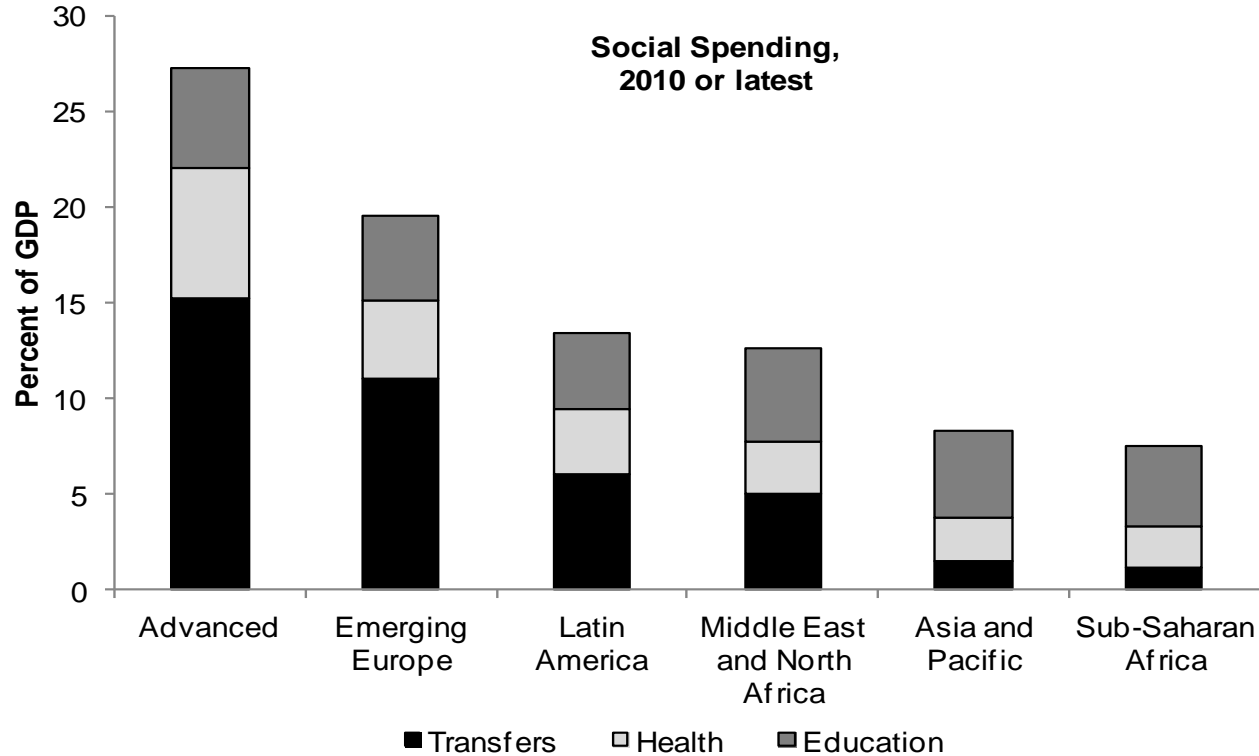
Impact of Policy in Developing Countries is Limited... by Low Revenue



Source: Bastagli, Coady and Gupta (2012)



Impact of Policy in Developing Countries is Limited... by Low Spending



Source: Bastagli, Coady and Gupta (2012)

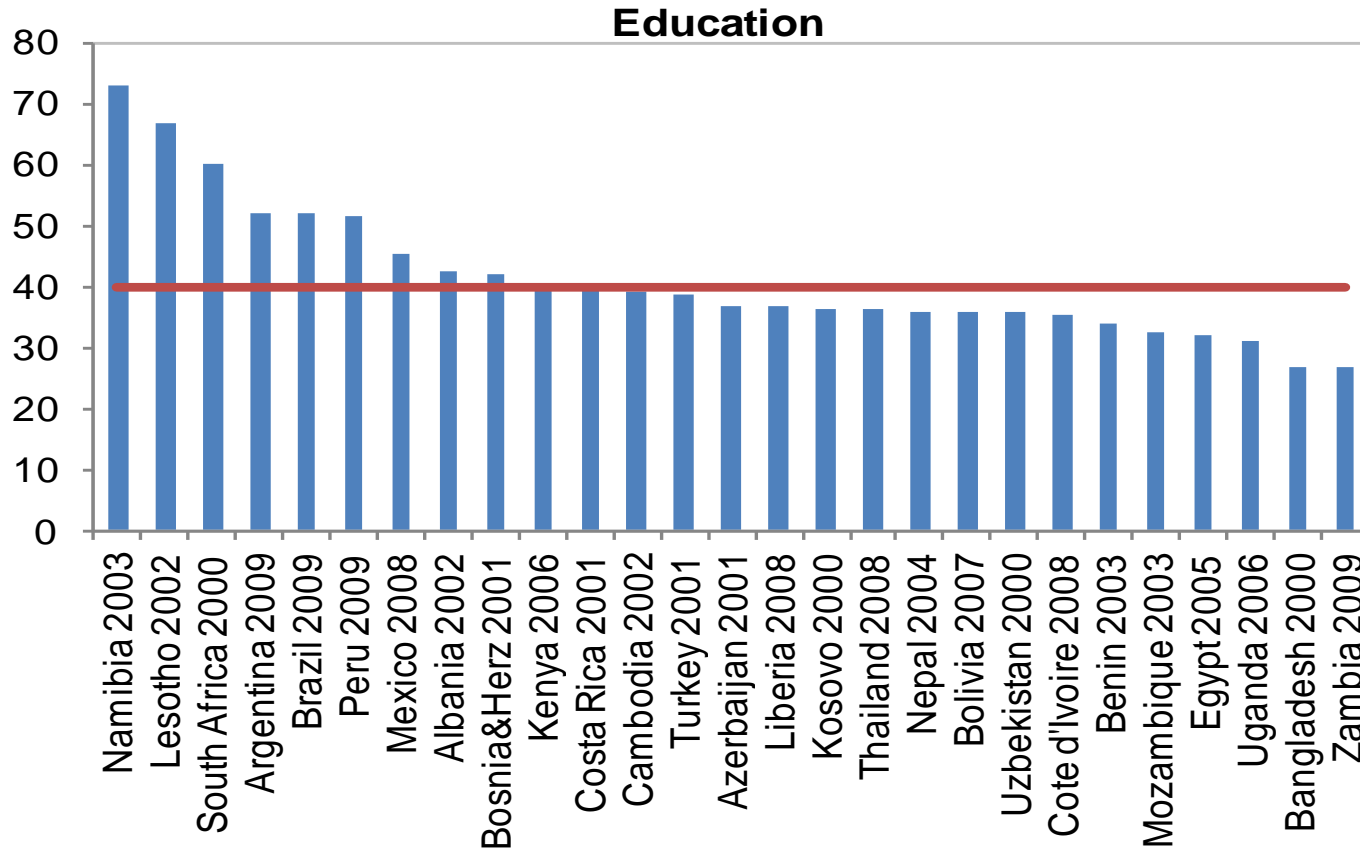


Also Limited By the Composition of Policy

- Heavy reliance on indirect taxes (in many cases regressive since exempt items are not those disproportionately purchased by the poor).
- Narrow income tax base (high “informality”, non-compliance, preferential treatment of capital and other incomes).
- Social insurance benefits restricted to formal sector (tend to be regressive).
- Social assistance spending often low and/or poorly targeted (e.g. universal price subsidies).



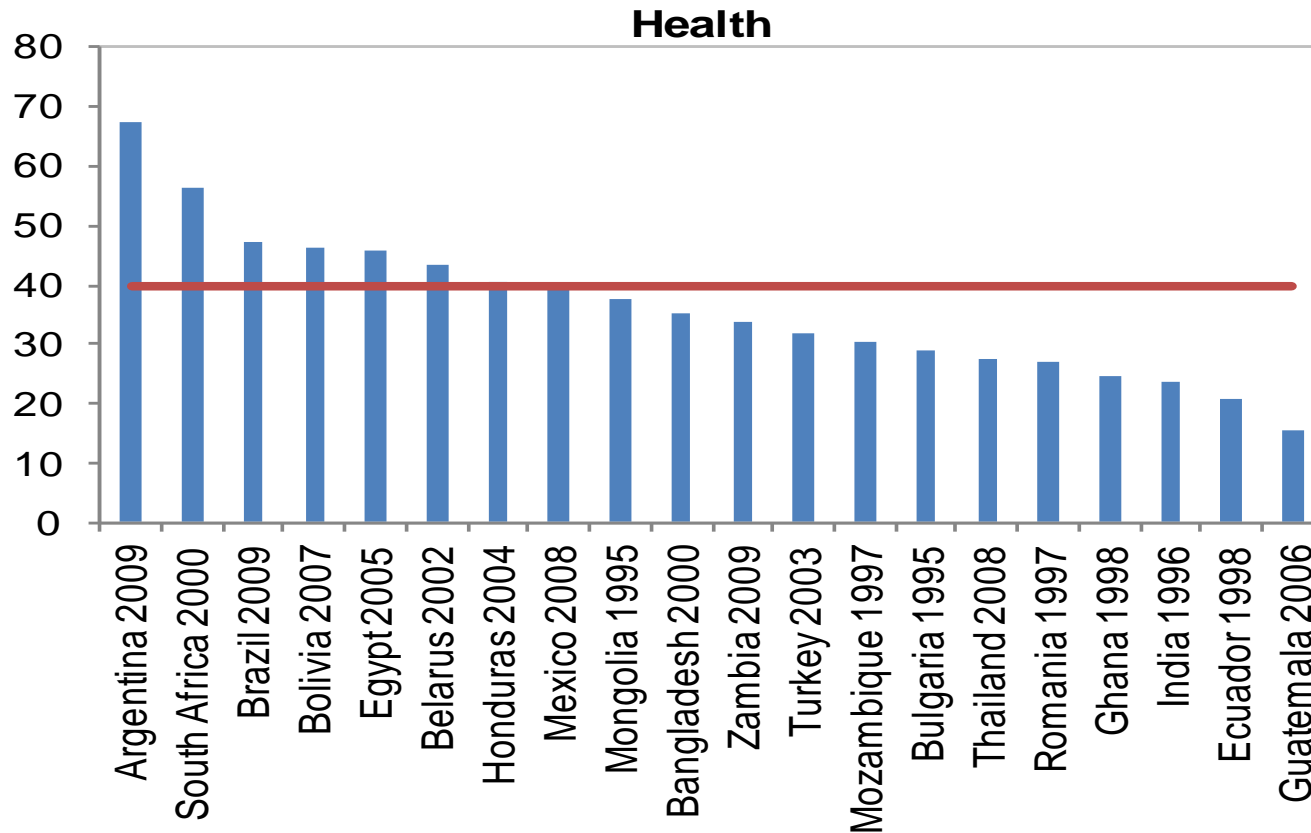
In Kind Transfers are Also Often Regressive



Source: Bastagli, Coady and Gupta (2012)



In Kind Transfers are Also Often Regressive



Source: Bastagli, Coady and Gupta (2012)



Policy Implications: Enhancing the Redistributive Role of Policy

- **Strengthening resource mobilization capacity**
 - Expansion of progressive tax policy instruments
 - Expansion of corporate and personal income tax bases through reducing exemptions, closing loopholes, and improving tax compliance
 - Employment formalization and social insurance expansion
 - Improvement in administrative capacity
- **Higher spending with elements of targeting**
 - Expansion and improved targeting of social assistance (eliminate universal price subsidies)
 - Expansion of health and education



Policy Implications and Follow-up Issues

- Inequality is increasing in most countries and taxes and transfers are an important set of instruments governments can use to address it.
- Taxes and transfers should be considered jointly.
- General conclusions with respect to particular taxes are quite hard to find – progressivity/regressivity conclusions are country-specific and design details matter.



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