

Redistribution through taxes and social transfers*

Main findings

- This chapter examines the extent to which taxes and social transfers have managed to redistribute the gains and losses from economic growth over the past 15 years or so. As shown in Chapter 3, the tax/transfer system can be a powerful redistribution mechanism and this is confirmed by more detailed analysis set out in this chapter. A key finding is that, despite increasing income inequality, the redistributive impact of taxes and social transfers has generally not been able to reverse this raising trend.
- One reason for this is that taxation has become less progressive and therefore less likely to address the growing income inequality found in the majority of ILO member states (see Chapter 1). Generally speaking, indirect taxes – which are typically regressive – have become a more important source of government revenue. By contrast, tax rates both on corporate income and on top personal incomes have, on average, declined over the past 15 years or so. Between 1993 and 2007, the average corporate tax rate (for all countries for which data exist) was cut from 37.5 per cent to 27.1 per cent. In the case of top personal income taxes, the average rate was cut from 37 per cent to 34 per cent over the same period.
- Another factor is that the weaker progressivity of tax systems has in general not been offset by increased recourse to social transfers for redistribution. Over the past 15 years, social transfers as a percentage of GDP have declined in developed countries and in Africa and slightly increased in the rest of the developing world. Although targeted social assistance is much more progressive than other social transfers, especially in developing countries, the budget allocated to assistance is too small to make any significant difference to inequality. On the other hand, spending on social insurance programmes has grown relatively quickly in many developing countries, but often with little effect on reducing income inequality. Indeed, such programmes tend to be only slightly progressive (as is the case in many developed countries and those countries with universal non-contributory social protection) or actually regressive, as in many developing countries they exclude workers from the informal sector.

* Excellent research assistance was provided by Megan Gerecke, including data gathering and editorial suggestions.

- Any policy using taxes and benefits as instruments to address income inequality needs to ensure that it is effective. Taxes and benefits, if badly designed, can affect growth and job prospects, and in some cases even increase inequality. The analysis in this chapter shows, however, that it is possible both to meet growth and employment objectives and reduce inequality. Brazil, Mauritius and Malaysia are interesting cases in point.

Introduction

The widening income inequalities seen around the world have triggered a debate over the extent to which taxes and/or social transfers should be used more actively for redistribution. Income redistribution can be justified not only on ethical, but also on economic or political grounds. For instance, by reinforcing perceptions that economic growth is advantageous for all groups, redistribution policies may enhance political support for pro-growth policies (Boadway and Keen 2000; Commission on Growth and Development 2008). Chapter 3 of this report showed that the welfare state, in its broadest sense, is a powerful mechanism for redistribution. This chapter focuses on the issue in further detail.

Government-led redistribution uses three principal mechanisms: progressive taxation; social transfers that favour the poor; and public provision of social services, such as education and health care. While all three will be considered, this chapter will focus most closely on taxation and social transfers.

Progressive taxation, by definition, contributes to income redistribution, as wealthier individuals pay proportionately more taxes than those on lower incomes. Personal income taxes and property taxes are generally believed to be progressive, whereas corporate taxes tend to be “U-shaped”, being regressive at low levels of corporate income and progressive beyond a certain threshold. Indirect taxes such as consumption taxes are generally regressive and tend to fall disproportionately on people with low incomes.¹

However, great care needs to be taken in using the tax instrument for redistribution purposes. It is crucial that taxes should not distort incentives to work, invest and create wealth. Any recourse to tax reform to reduce income inequalities should therefore take into account the possible impact on economic growth and employment.

Redistribution can also take place through social transfers, including social assistance benefits and social insurance programmes. The former typically target the needy and can therefore be expected to have a strong redistributive effect. In developing countries, however, social insurance programmes (such as pensions and unemployment insurance) may be regressive rather than progressive; and this tendency is exacerbated by the fact that such programmes tend to exclude workers in the informal economy, who disproportionately comprise the poor.

Lastly, investment in education, health and other social services can also exert a redistributive effect (box 5.1). While taxes and social transfers have an immediate effect on income distribution, public provision of social services tends to have a more long-term impact. Government programmes in primary education or health care and infrastructure investment in areas such as water and sanitation may help alleviate the deep-rooted aspects of inequality by creating opportunities (or what Amartya Sen calls capabilities).

Inequality can thus be addressed through a combination of social service provision, social transfers and taxation; and ideally, the redistributive effects of taxes and social

1. In developing countries, as will be seen below, the tax system as a whole is generally regressive (Gemmell and Morrissey 2005).

expenditure should be analysed in tandem (Burgess and Stern 1993).² Such an analysis should take into account the effects of redistribution policies on economic incentives. As emphasized by the Commission on Growth and Development (2008), excessive or badly designed redistribution efforts will damage growth prospects and hinder development.

The aim of this chapter is to examine how far recent changes in national tax systems and government expenditure on social transfers have affected inequality over the past few years. First, the chapter discusses trends in the composition and levels of social transfers and taxes and explores how these trends relate to income inequality. Second, it addresses in detail the extent to which taxes and social transfers are effective in redistributing income. This is done by comparing income inequality before and after the payment of taxes and benefits.³ In the final section, country examples will be presented to show how different government policy frameworks have made it possible to maintain income inequality at reasonable limits, while at the same time supporting economic growth and job creation.

A. Social transfers, taxation and income inequality: what are the trends?

In the following section, simple associations between various redistribution instruments and income inequality are presented. Obviously, these associations do not necessarily imply causality and the next section will examine in greater depth the causal links at work.

Social transfers and inequality

There is a relatively strong negative association between spending on social transfers and inequality (fig. 5.1).⁴ The correlation between social benefit spending by central government and income inequality is -0.75 for the 64 countries for which data are available. In other words, countries that spend more on social transfers tend to have lower income inequality. For example, among developed countries, income inequality is relatively high in the United States, where spending on social transfers is limited. By contrast, the countries that spend the most on social transfers (mostly European countries, such as Austria, Belgium, Denmark⁵, France, Germany and Sweden) have relatively low income inequality.

The negative relationship between income inequality and social transfers can be interpreted as evidence that high-inequality countries lack the economic or political means to

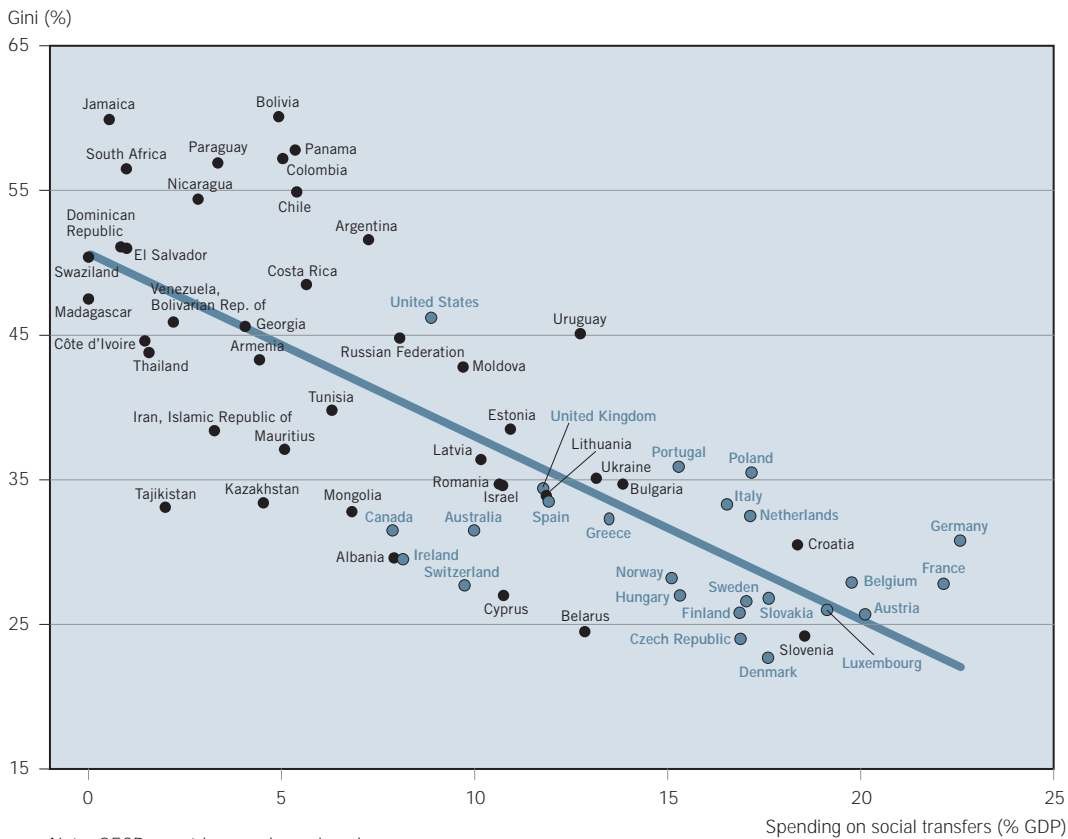
2. Historically, there were only two kinds of redistributive tax-based social spending: poor relief and public schools (Lindert 2004). Lindert argues that social transfer increased in all developed countries in the twentieth century and that by the 1980s most of them devoted 10 per cent of their revenue to social transfers. In other words, “the history of taxing and transferring is not just a miscellany of separate and unique national histories, but a common pattern” (p. 11).

3. Pre-tax income is usually defined as all sources of “market income” or “private sector income”, including wages and salaries (before social security contributions), bonuses and exercised stock-options, employer and private pensions, self-employment income, business income, dividends, interest, rents and realized capital gains. Disposable income is calculated as pre-tax income + social benefits – taxes.

4. Social benefit spending (consolidated central government) is defined by the IMF’s Government Financial Statistics Manual (2001) as transfers to protect the entire population against certain social risks such as medical services, unemployment compensation, social security pensions, and social assistance benefits. Social security benefits include sickness and invalidity benefits, maternity allowances, children’s or family allowances, unemployment benefits, retirement and survivors’ pensions, and death benefits. Subsidies, grants and other social benefits include all unrequited, non-repayable transfers on current account to private and public enterprises; grants to foreign governments, international organizations and other government units; and social security, social assistance benefits and employer social benefits in cash and in kind.

5. General government spending on social transfers.

Figure 5.1. Social transfers and income inequality

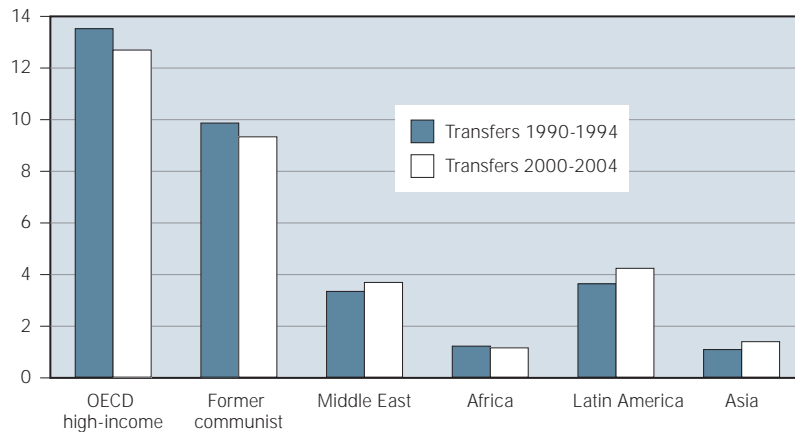


fund social programmes. Some authors have referred to the so-called “Robin Hood paradox”, whereby redistribution is least when it is most needed (Lindert 2004). In fact, however, the reverse causality may be true: the low spending on social transfers in a high-income country like the United States may help explain its above-average income inequality.

Spending on social transfers has tended to decline as a percentage of GDP, except in Latin America and some Asian and Middle Eastern countries

There are wide regional variations in social transfer spending (fig. 5.2). OECD high-income countries spend the most, on average, though their spending decreased slightly over the period 1990-2004, from 13.5 per cent to 12.7 per cent of GDP. Spending on social transfers was also relatively high in the former communist countries, at around 9 per cent of GDP, although there, too, there was a marked decline in spending over the period 1990-2004. Among the developing countries, spending on social transfers is highest in Latin America, where it increased over the period 1990-2004 from 3.6 per cent to 4.2 per cent. Latin America is closely followed by the Middle East and North Africa. Developing countries in Asia and sub-Saharan Africa spend the least, at around 1 per cent of GDP, although within the sub-Saharan Africa region, two countries defy the regional trend: Mauritius and Seychelles. Mauritius devoted 3.6 per cent of its GDP to social transfers in 1990-94 and 5.2 per cent in 2000-04, while in Seychelles the figure stayed stable at around 7.55 per cent. If we exclude these two small island countries, however, the average for sub-Saharan Africa is reduced to 0.83 per cent of GDP for the first period and 0.73 per cent for the second.

Figure 5.2. Trends in spending on social transfers (% GDP)



Source: ILS estimates based on International Monetary Fund 2007 and Global Development Network Growth Database (<http://www.nyu.edu/fas/institute/dri/global%20development%20network%20growth%20database.htm> [18 July 2008]). GDP from World Bank, World Development Indicators 2008.

These data show that social transfers as a percentage of GDP declined in developed countries but increased in most developing countries over the 15-year period, with the exception of Africa, where average spending on social transfers slightly decreased.

The role of taxes

Taxes are generally used to raise revenues for government, provide incentives for certain activities and correct market failures. Of particular relevance to this report is their role in redistributing income for the benefit of people on low incomes.⁶

The approach to taxation has changed over time. During the 1950s and 1960s, the distributive and developmental role of taxes was widely acknowledged. From the 1970s on, however, there has been growing attention to the perverse effects of excessively high taxes on economic activity and incomes. In addition, the international dimension of taxes has become increasingly visible. In particular, taxes may affect the location decisions of firms and high-income groups. As a result, it is argued that there may be a risk of tax competition among countries that try to attract foreign capital and wealthy individuals.

The tax system relies increasingly on indirect taxes and less on income taxes

The data reveal that the contribution of the various taxes to total government revenue has changed since the early 1990s.

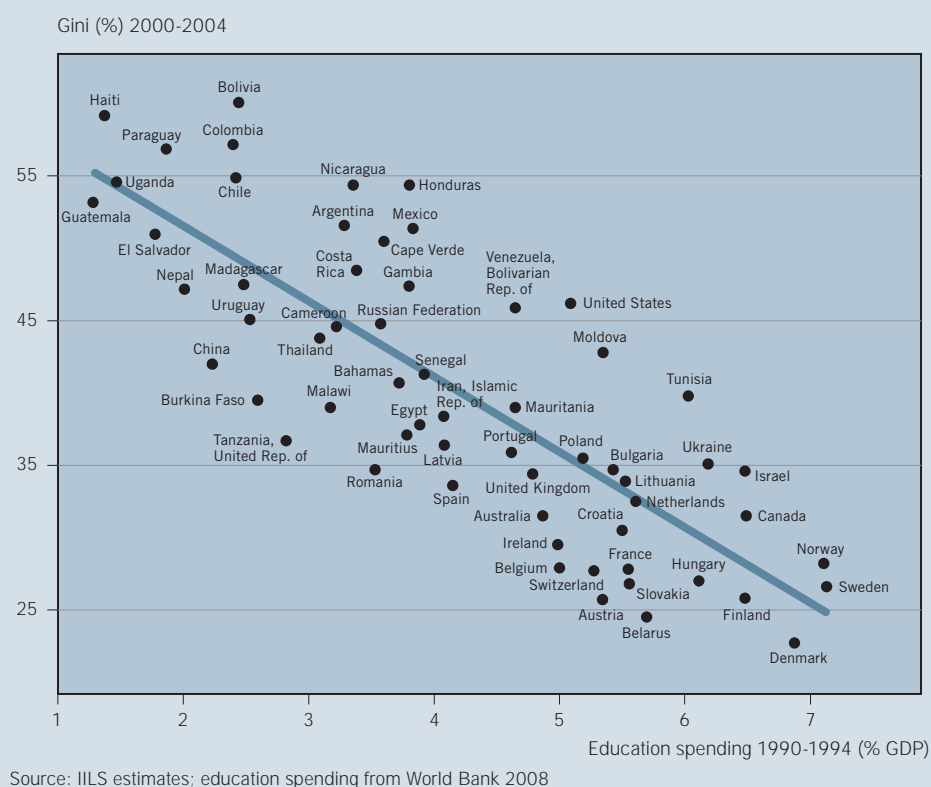
First, the revenue contribution of taxes on goods and services – including value added tax (VAT) – has increased in a majority of countries, whatever their level of economic development. In high-income countries, the share of taxes on goods and services in total government revenues grew by 8.5 percentage points between the periods 1990-94 and 2000-04. In middle-income and low-income countries, the increase was 11.5 percentage points and 4 percentage points, respectively.

6. Musgrave (1959) described taxation as playing various roles: stabilization, allocation and distribution. Stabilization refers to counter-cyclic roles that governments engage in to smooth economic activity and consumption. Allocation refers to the provision of public goods and distribution refers to transferring income from the rich to the poor for a more equitable society.

Box 5.1. The role of education and health in reducing inequality

Although this chapter is primarily concerned with social transfers, other government programmes may also have a significant effect on income inequality. This is particularly the case with education and health programmes, which directly support low-income groups, since they tend to benefit all individuals more or less equally and replace private spending on health care and schooling. In addition, education and health programmes may help redistributive opportunities over the long run, enhancing human capital in all groups and thus changing income capabilities. Moreover, spending on education and health is unlikely to create significant economic distortions: on the contrary, it is likely to be associated with higher economic potential, while also addressing existing inequalities. The fact is that countries that spent more on education in the early 1990s tend to have lower income inequality in the 2000s (see fig. 5.3).

Figure 5.3. Education spending and inequality



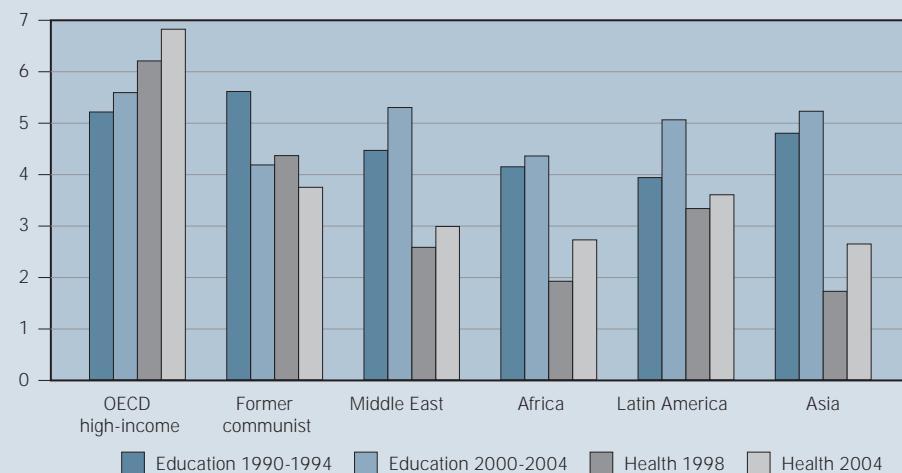
Second, the share of taxes on income, profits and capital gains in total government revenues has decreased in all the country groups. For high-income countries, this figure decreased by 1 percentage point between the periods 1990-94 and 2000-04. In middle-income and low-income countries, the decrease was 3.5 percentage points and 1.7 percentage points, respectively.

Third, the contribution of taxes from international trade also decreased considerably in all the groups. It used to be an important source of revenue for most of the developing countries, but, as a result of trade liberalization, revenues from trade taxes as a percentage of total government revenues fell by 6.5 percentage points between the periods 1990-94 and 2000-04, and by as much as 8.5 points in developed countries and 10.7 points in middle-income countries.

The above trends seem to reflect deliberate policy choices. For example, the average corporate tax rate for the world as a whole decreased from 38 per cent in 1993 to less than

Many countries have tried to provide universal health and education services in order to reduce inequality. Access to basic education and primary health care has even become a “right” enshrined in the Constitution of several countries. Education and health spending has increased in all regions, except in the former communist countries (Eastern Europe and Central Asia) where both education and health spending declined over the 1990s and 2000s from 5.6 per cent to 4.2 per cent of GDP (see fig. 5.4). Over the same period, education spending increased from 3.8 per cent to 5.1 per cent in Latin America, from 4.6 to 5.4 per cent in the Middle East and from 4.1 per cent to 5.1 per cent in Asia. Africa saw the smallest increase (from 4.2 per cent to 4.4 per cent of GDP). As for health spending, the OECD high-income countries spend around 7 per cent of GDP on health, while the figure in the developing world is around 3 per cent. Among the developing countries, Latin America spends the most, at 3.6 per cent of GDP. The figure is the same for the former communist countries.

Figure 5.4. Trends in education and health spending (% GDP)



Source: Education spending from World Bank, World Development Indicators 2008 (average for each period); health spending from World Health Organization (WHO) national health accounts (<http://www.who.int/nha/en/>).

Where redistribution is concerned, the design of education and health programmes is important. For instance, research has shown that public spending on primary and secondary education is generally progressive, especially in developing countries, as is spending on primary health care. Such spending, which mainly benefits poor households, can therefore reduce inequality. By contrast public spending on tertiary education and hospital services is generally of disproportionate benefit to the rich.

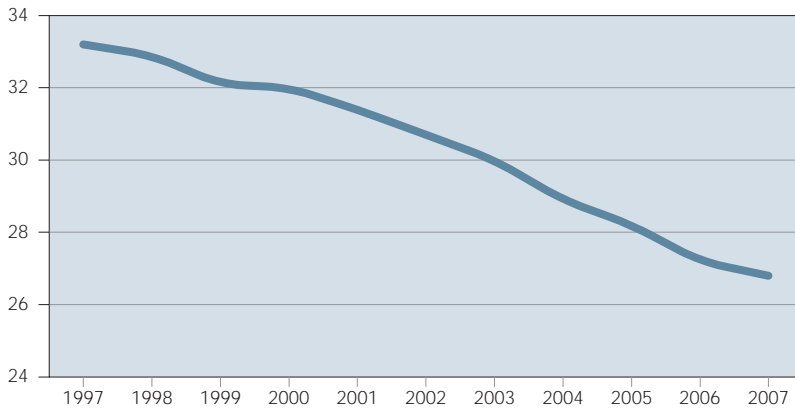
26.8 per cent in 2007 (KPMG 2008) (fig. 5.5).⁷ Remarkably, the rate declined in 78 of the 97 countries for which data are available.⁸ The reduction was more homogeneous and pronounced in OECD countries than in the developing countries of Asia and Latin America, where it also declined but not uniformly. For the Africa region, there are data only for South Africa, Mauritius, Zambia, Mozambique and Botswana. In South Africa, corporate tax rates decreased from 37.8 per cent in 2001 to 36.9 per cent in 2007; in Mauritius, they decreased from 25 per cent in 2005 to 22.5 per cent in 2007, and Zambia, Mozambique and Botswana, they remained stable at 35 per cent, 32 per cent and 25 per cent, respectively.⁹

7. As earlier noted, however, data are mainly available from 1993 for OECD countries and from 1997 for other countries. Globally, corporate tax decreased from 32.2 per cent in 1997 to 26.8 per cent in 2007.

8. It increased in only seven countries and remained the same in 12 countries.

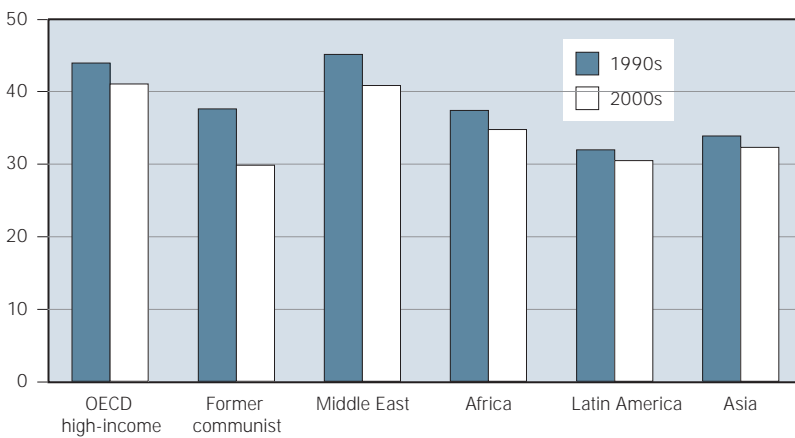
9. Corporate tax rates have been declining since the mid-1980s, a trend which started in the United Kingdom (KPMG 2008). It is argued that countries reduce corporate taxes in order to compete for business, tax receipts and job creation.

Figure 5.5. Global corporate tax rates, 1997-2007 (%)



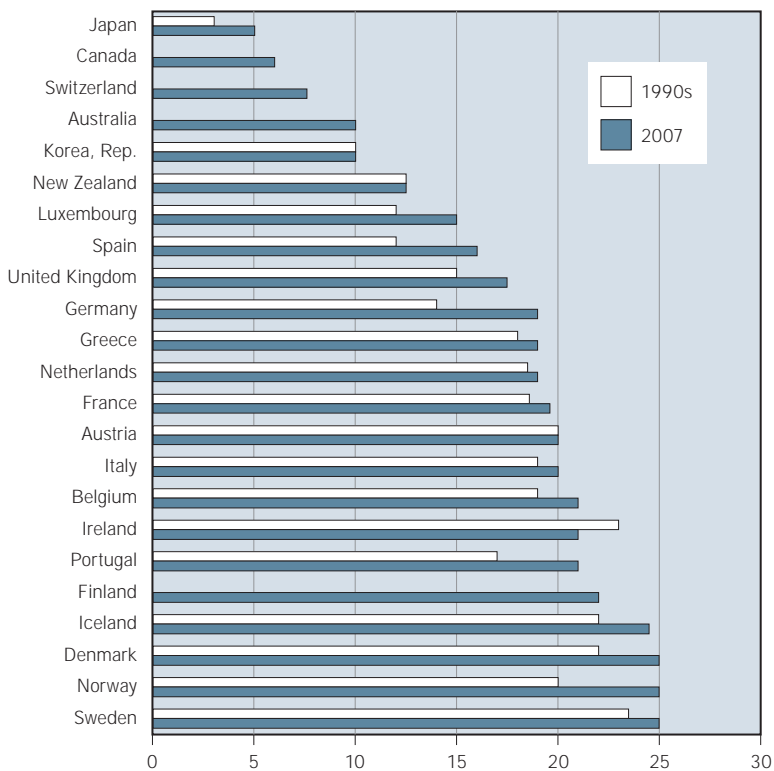
Source: KPMG 2008

Figure 5.6. Top marginal individual income taxes, worldwide (%)



Source: World Bank, World Development Indicators 2008 (average for each period).

Figure 5.7. VAT Trends in OECD countries, 1990-2007 (%)



Source: KPMG 2008 and OECD database (<http://www.oecd.org/dataoecd/12/13/34674429.xls>)

The lowest corporate tax rates in 2007 were found in Cyprus, Bulgaria and Paraguay at 10 per cent followed by Ireland at 12.5 per cent. The highest rates – 55 per cent – are found in the oil-producing countries, Kuwait and United Arab Emirates, followed by the OECD countries Japan (41 per cent), USA (40 per cent) and Germany (38 per cent). The high-spending welfare states (Denmark, Finland, Norway and Sweden) have taxes at around 28 per cent. This confirms Lindert's (2004) argument, that welfare states generally have a more pro-growth tax system and business-friendly environment than low-spending countries like the United States and Japan. Corporate tax rates are generally higher in low-income than in high-income countries. In the seven low-income countries for which data are available,¹⁰ corporate tax rates have remained stable at about 33 per cent since 1997. No country has increased corporate tax rates since 2000, although some OECD countries did so slightly in the mid-1990s (these being Australia, Canada, Finland, France, Greece, Italy and Luxembourg). Only seven countries have increased their corporate tax rate since 1997: Argentina, Brazil, Chile, Dominican Republic, Hong Kong, China, Pakistan, and Papua New Guinea. The general decline in corporate taxes worldwide is based on the assumption that higher corporate taxes discourage private sector investment and are therefore harmful for economic growth (Johansson et al. 2008).

Taxes on the highest personal incomes have also decreased (see fig. 5.6). Since the early 1990s, they have fallen by 3 percentage points, on average. Decreases have been recorded in 66 of the 110 countries for which data are available. There were slight increases in 28 countries and rates were stable in the remaining 16. The former communist countries tend to have the lowest top individual taxes, followed by Latin America and Asia, while the OECD high-income countries and the Middle Eastern countries have the highest rates, averaging over 40 per cent.

Cuts in corporate tax and top personal income tax have been accompanied by increased indirect taxation, in particular by higher VAT rates.

In 2007, the global average VAT rate was 17 per cent. The European countries have the highest rates, at around 20 per cent, followed by the OECD countries at 18 per cent (see fig. 5.7). The average rate is 11 per cent in the Asia and Pacific region and 14 per cent in Latin America. Among individual countries, Denmark, Norway and Sweden have the highest rate, at 25 per cent, followed by Iceland at 24.5 per cent, Uruguay at 23 per cent, Finland, Croatia and Poland at 22 per cent, and Argentina, Belgium and Portugal at 21 per cent. The lowest rates – 5 per cent – are found in Japan, Canada, Panama and Taiwan (China). Some countries, including the United States, still do not have VAT.

VAT rates generally increased in the 1990s, except in Ireland, but stabilized in the 2000s. In Germany, it has increased continually, rising from 13 per cent in 1980 to 19 per cent in 2007; the same is true in Norway, where it increased from 20 per cent to 25 per cent. In the Latin American region, the rate rose steadily, from 10 per cent in 1980 to 15 per cent in 2007. In other developing countries, it stayed stable over the period 1990-2007.

In many countries, social spending is funded not only through taxation, but also through social contributions, including social security contributions by employees, employers and self-employed individuals. This is significant, in that social contributions are regressive in some countries and thus tax low-paid employment disproportionately. Looking at the trend since the 1990s, we find that social contributions as a percentage of revenue have increased from an average of 18 per cent to 20 per cent in 2004. The proportion is much higher in developed countries, rising from 25 per cent in the 1990s to over 27 per cent in 2004. In the developing countries, it increased from 13 per cent to 16 per cent.

10. These are Bangladesh, India, Mozambique, Pakistan, Papua New Guinea, Viet Nam and Zambia.

B. To what extent do taxes and social transfers shape income distribution?

The previous section presented general trends in social transfers and taxes, and their relationship with income inequality. This section examines in detail the extent to which social transfers and taxes shape income distribution in different regions and countries. It focuses on countries for which data exist on individuals' market income (that is, income before taxes and social transfers) and final income (income after taxes and social transfers).

Redistribution in developed countries

The extent of fiscal redistribution has remained broadly constant

Taken as a whole, taxes and social transfers have failed to stop the trend of rising market income inequality in developed countries. Data for 14 developed countries based on the Luxembourg Income Study (LIS) show that, since the 1980s, the Gini coefficient on final income has risen almost as much as that on market income.¹¹

Except in Switzerland where it remained stable, income inequality before tax increased in the countries surveyed between the early 1980s and late 1990s. The average Gini coefficient before tax for all 14 countries rose from 0.41 in the 1980s to 0.45 in the late 1990s, increasing by 3.4 per cent points (see fig. 5.8).

Inequality in terms of disposable income also increased for most of the countries (except for Denmark, the Netherlands and Switzerland, where it decreased, and France where it remained stable). The Gini index for disposable income inequality averaged 0.26 in the 1980s and increased by 0.9 percentage points to reach 0.28 in the late 1990s.

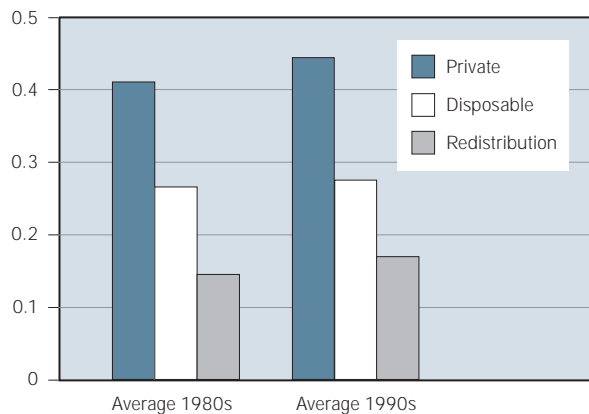
As a result, the extent of fiscal redistribution also increased, on average, only slightly over the same period from 0.15 to 0.17 (increasing by 2.5 percentage points¹² and actually decreased in two countries, Sweden and the Netherlands, where both private income inequality and disposable income inequality have decreased. These two countries, together with Belgium, Denmark and Finland, redistribute the most, compared to the OECD average. Meanwhile, the lowest level of distribution takes place in Australia, Canada, Switzerland and the United States. The slight average increase in fiscal redistribution has not generally kept pace with the rapidly increasing levels of inequality. In other words and to be precise, the private income Gini increased by 3.4 per cent, while redistribution only increased by 2.5 per cent, resulting in a net increase of inequality by 0.9 percentage points.

These findings on redistribution are supported by the literature, such as Estes (2004), which identified the Nordic countries (Denmark, Finland, Norway and Sweden) as "social leaders" within the developed countries, and Esping-Andersen (1990), which posited three models of the welfare state: the socio-democrats (the Nordic countries and the Netherlands), the liberal (Australia, Canada, Japan, Switzerland and the United States) and the

11. LIS is an impressive and very valuable data set on fiscal redistribution (see Mahler and Jesuit 2006). The data set, which contains 68 data points for 14 OECD countries, covering the period from the late 1970s to 2004, includes: a measure of fiscal redistribution (pre-tax minus after-tax Gini index); the share of redistribution explained by progressive taxation; the share of redistribution explained by social transfers (disaggregated by pensions, unemployment and other benefits); a measure of the overall size of social transfers (average transfers / pre-tax household income); a measure of how well social transfers are targeted towards low-income groups (Kakwani's "index of concentration"); and the extent to which taxes and social transfers reduce poverty. There are, however, some shortcomings in the data set. For example, it includes only direct taxes (income taxes and payroll taxes). Indirect taxes, such as VAT, which are likely to be more regressive, are omitted.

12. Fiscal redistribution is represented by the difference between the Gini index for final income and the Gini index for market income.

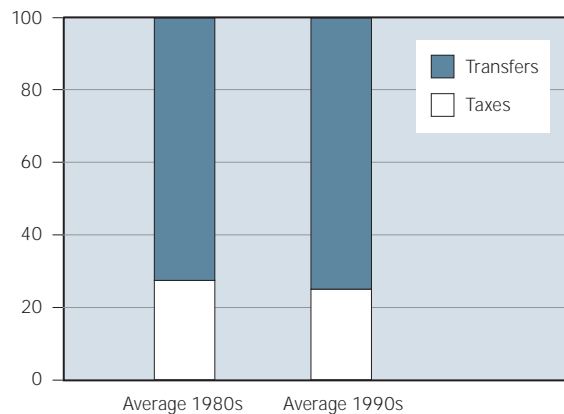
Figure 5.8 Inequality and redistribution in OECD countries, 1980s and 1990s



A definition of private sector income is given in footnote 3. Disposable income means private income plus social transfers (retirement benefits, child and family allowances, unemployment compensation, sickness, maternity, disability, accident or other social insurance and benefits in cash or in kind), once direct taxes – income taxes and mandatory social insurance contributions – have been deducted. Fiscal distribution is the difference between the Gini coefficient in private and in disposable income.

Source: Mahler and Jesuit 2006

Figure 5.9. Share of taxes and transfers in redistribution in OECD countries (%)



Source: Mahler and Jesuit 2006

conservative (Austria, Belgium, France, Germany and Italy). Esping-Andersen's work is one of the most important and most frequently cited contributions to recent debates on social policy and welfare. Other researchers using the LIS data set drew similar conclusions (Kenworthy and Pontusson 2005; Pontusson 2005; Mahler and Jesuit 2006).

The fact that the Nordic countries perform well on redistribution conforms with their reputation as generous welfare states (Esping-Andersen 1990; Kangas and Palme 2005). France too, as the literature shows, stands out as a generous welfare state in terms of its net public social spending, at 30 per cent of GDP (OECD 2006, p. 79).

Social transfers, not taxes, are the main source of redistribution

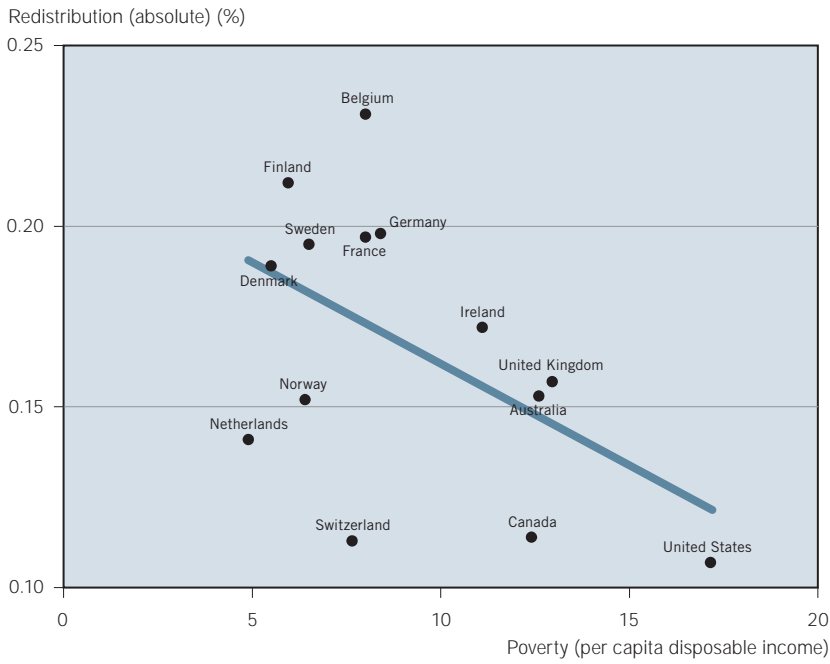
According to a study (Mahler and Jesuit 2006), social transfers generally have a greater impact on redistribution than taxes. On average, transfers contribute to 75 per cent of fiscal distribution in OECD countries, compared to only 25 per cent for taxes (see fig. 5.9). Moreover, the share of fiscal distribution through taxes decreased from 27 per cent in 1980s to 24 per cent in the late 1990s, while the contribution of transfers increased in the same proportion.

Low-inequality countries (the Nordic countries, Germany, Belgium and the Netherlands) rely heavily on social transfers as a redistribution device. By contrast, countries with higher inequality (Australia, Canada and the United States) rely more heavily on taxes.

The strong redistributive effects of social transfers can also be illustrated by considering the links between transfers and poverty (see fig. 5.10). Countries that have higher levels of poverty – individuals with lower disposable income – tend to redistribute less. For example, the United States, which has the highest level of poverty in the developed world redistributes the least, while Denmark, Finland and Sweden, which have low levels of poverty, redistribute the most.¹³

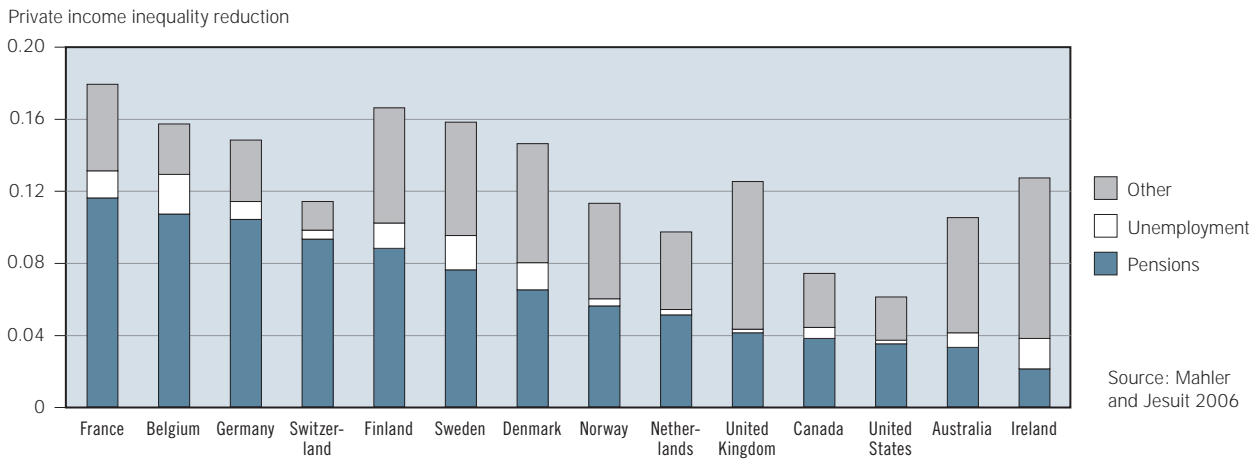
13. See Prasad (2008) for more details.

Figure 5.10. Redistribution and poverty in OECD countries



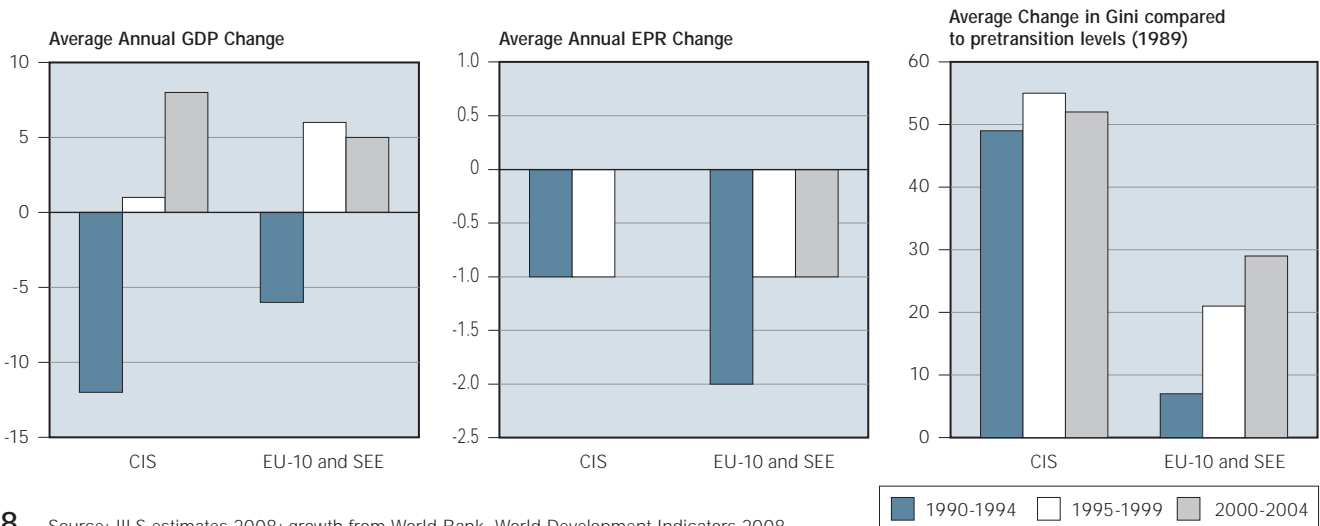
Source: Mahler and Jesuit 2006 on the basis of LIS for latest years.

Figure 5.11. Sectoral contribution to reduced income inequality, latest available data in OECD countries



Source: Mahler and Jesuit 2006

Figure 5.12. Change in inequality, EPR and growth in countries with economies in transition, 1990-2004 (%)



138 Source: ILS estimates 2008; growth from World Bank, World Development Indicators 2008.

Pensions have a strong redistributive effect in developed countries

More than half the redistributive impact of social transfers comes from pension benefits (and as much as 80 per cent or more in Switzerland and 70 per cent in Germany) (see fig. 5.11). As for unemployment transfers, their contribution to redistribution is around 7 per cent. Other benefits such as social assistance and sickness benefits are responsible for around a third of redistribution.

Redistribution in countries with economies in transition

In countries with economies in transition, inequality has typically increased since the 1990s (though Slovenia is a notable exception to this trend). In Central and Eastern Europe, inequality has grown at a gradual and steady rate on average, whereas in the Commonwealth of Independent States (CIS) inequality initially increased sharply, peaked in the late 1990s and, since this time, stabilized or even moderately declined (see fig. 5.12).

After the initial economic crisis brought on by transition, many Central and Eastern European states were able to stimulate growth and some, employment; despite these successes, slow or non-existent employment growth and high unemployment continue to be problems in the region. By contrast, while the CIS economies were harder hit by transition, since the late 1990s they have been able to increase growth and create employment.

The factors that contributed to increased income inequality are beyond the scope of this chapter, which primarily focuses on redistributive policies. Different regions chose different paths with social protection spending. The EU-accession countries and South Eastern Europe (SEE) focused on social security and approached social assistance as a residual benefit for those not covered by the broadly-based pensions, unemployment and child allowance benefits. Countries like Poland and Hungary retained their safety nets in an attempt to make the economic reforms more palatable. Their broad coverage has meant that the programs have strong political support, but lack funds.¹⁴ Middle-income CIS countries have also retained social insurance schemes, in addition to a wide range of subsidies for various goods and an array of benefits targeted at particular groups, like war veterans. By contrast, low-income CIS countries faced drastic reductions in government revenue and, thus, had to reduce their safety nets and focus spending more intensely on targeted social assistance.

Utilizing a variety of different inequality indicators, Giammatteo (2006) finds that social transfers and taxes reduced income inequality in Poland, Hungary, and to a lesser extent Russia (see table 5.1). Similar results have been found for other central European countries (Cerami 2003).

Table 5.1 Inequality and redistribution in countries with economies in transition

	Poland			Russia			Hungary		
	1992	1995	1999	1992	1995	2000	1991	1994	1999
Market income Gini	0.341	0.391	0.372	0.418	0.499	0.493	0.386	0.422	0.478
Disposal income Gini	0.27	0.301	0.284	0.393	0.445	0.435	0.28	0.32	0.291

Source: Giammatteo 2006

14. Indeed, most countries in this region had to reform their social insurance schemes in the late 1990s to address fiscal constraints.

In most former communist countries, pensions dominate public transfer spending. For example, in 2005 they made up 70% of social protection spending in the EU-8 countries and 50% in the poorest CIS countries (World Bank 2005). While pensions are generally not distributed equally, their distribution is more equitable than market incomes, thus they help reduce inequity (Mitra and Yemtsov 2006). Family and child assistance benefits tend to be progressive in the region, especially in CIS countries (Fox 2003).¹⁵ Generous pre-transition expenditure on health and education and other services left a legacy of high human development.

Limited evidence suggests that post-transition tax reforms have been in the favour of more equality (Mitra and Yemtsov 2006). Looking at Poland, Hungary and Russia, Giammetto (2006) finds that direct taxes reduce income inequality, though their impact is less than that of transfers (see table 5.1). In Central Asia and Russia, economic transition brought an implosion of tax revenues, with a shrinking tax base and poor tax collection.¹⁶ In response, many countries reduced social spending and some reformed their tax system. For instance, in Russia in 2000, a flat income tax of 13% was introduced, along with higher flat taxes for corporations. The implications of such reforms for income inequality have not been thoroughly explored.

New challenges lie ahead for the transition economies. Unemployment must be addressed across the region. With the energy sector boom in Russia and Central Asia, regional inequality has increased, with some provinces benefiting from the new wealth disproportionately.¹⁷ On a more positive note, there appears to be a way forward for the region: tellingly in these countries, increased employment has typically coincided with increased equality (World Bank 2005), suggesting the answer may be found in a more holistic approach – one that uses economic and social policy together to pursue growth and equity.

Redistribution in developing countries

In the developing countries, not only is the tax base narrow, but the bulk of employment is in the informal sector, while social transfers are very limited (except in Latin America, where social transfers are higher than in other developing countries). The redistributive role of tax in developing countries is negligible, because tax revenue is dominated by indirect taxes (such as consumption taxes), which are regressive. While social transfers have the potential of reducing inequality, progressive programmes (such as universal pension schemes, social assistance) are underfunded and regressive transfer schemes are dominant.

There is no data set comparable to LIS for developing countries and very few studies have been conducted to analyse welfare regimes and social policy.¹⁸ The combined results of a number of different studies will therefore be used to show the impact of taxation and social transfers on inequality.

15. However their small size in the EU-accession countries limits their impact.

16. Some exceptions to this trend exist in the CIS countries. For instance, Belarus has been able to maintain its level of tax revenue (Gerry and Mickiewicz 2008).

17. Notably, in many CIS countries, low labour mobility may not be able to counteract such regional inequity.

18. Exceptions include Gough and Wood (2004), Haggard and Kaufman (2008) and United Nations Research Institute for Social Development (UNRISD) research on “Social policy in development contexts” which produced several regional and thematic books including one for Africa, one for Latin America and one for East Asia.

Latin America

Latin America is one of the most unequal regions of the world in terms of income, access to assets, social services and even political participation. There are extensive social insurance programmes with wide employment protection and public provision of education and health care, but minimal social assistance programmes (Barrientos 2004). As pointed out in the first section, Latin America's social transfers are higher than other developing countries. Looking through a historical lens, Lindert (2004) showed that Latin America was indeed unusual in the developing world: it "spen[t] more on social transfers than did the Europeans before 1930, when their income levels and age distributions were comparable" (p. 219). Latin American tax systems are "slightly progressive at best", but, within the region, some systems are regressive overall, if indirect taxes are included (Lindert, Skoufias and Shapiro 2006).

What is the impact of social transfers on income inequality in Latin America? Goni et al. (2008) address this question and find that in six countries (Argentina, Brazil, Chile, Colombia, Mexico and Peru) the impact is minimal, reducing the Gini coefficient by around 1.4 points, on average (see fig. 5.13). (This stands in stark contrast to the average 12-point reduction in the Gini coefficient in OECD countries resulting from public transfers as shown above.) Colombia is the most successful of the six countries in this regard, having managed to reduce its inequality by 3.4 points by virtue of such public transfers as cash transfers, pensions, unemployment insurance and social assistance. Brazil is next, with a Gini reduction of 1.9 points (see box 5.2), and then comes Chile with 1.5 points, closely followed by Argentina. In Peru, inequality actually increased by 0.2 points after social transfers.

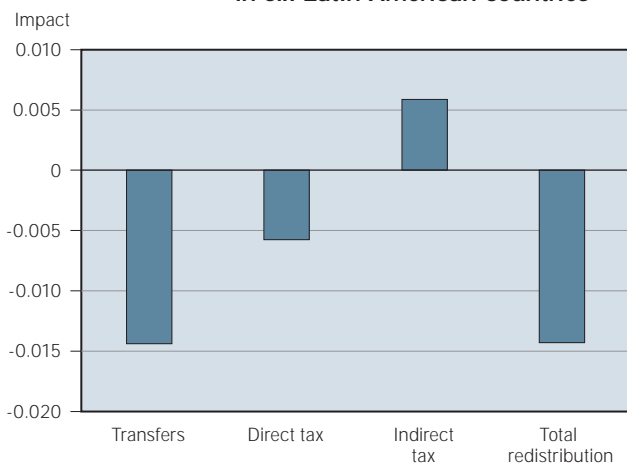
Redistribution through direct taxes has even less of an impact on inequality, with an average 0.6 per cent decline in the Gini coefficient for the six countries (see fig. 5.13). The highest amount of redistribution through taxes takes place in Colombia, followed by Mexico, Peru, Argentina and Chile. As in most countries, income taxes in the six countries are progressive but their contribution to government revenue is smaller than that of indirect taxes.

Redistribution through the fiscal system is also hampered by the effect of indirect taxes and the tax burden on the poor. For example, if indirect taxes such as VAT, excise tax, and import tariffs are included in the analysis, income inequality increased in all the countries, by 0.5 points on average by around 1.4 points in Peru, 0.5 in Brazil, 0.8 in Chile and 0.7 in Colombia.

Looking at individual cases, we see that the tax system slightly increased income inequality in Chile, where the Gini coefficient increased from 0.488 in 1993 to 0.496 in 1996 (Engel, Galetovic and Raddatz 1999). One reason for this is the effect of indirect taxes such as VAT, excise tax and import tariffs. The poorest devote around 11 per cent of their income to VAT, the rich only 6 per cent. It should be noted, however, that, as stated earlier, indirect taxes in some developed countries like the United Kingdom are even more regressive, increasing inequality by around 4 per cent. If direct and indirect taxes are taken together for the Latin American countries, the post-tax effect on inequality becomes neutral, on average. Only Mexico, Argentina and Colombia have a tax system that is progressive overall and slightly reduces inequality, with a reduction of the Gini coefficient of less than 1 point (Goni et al. 2008).

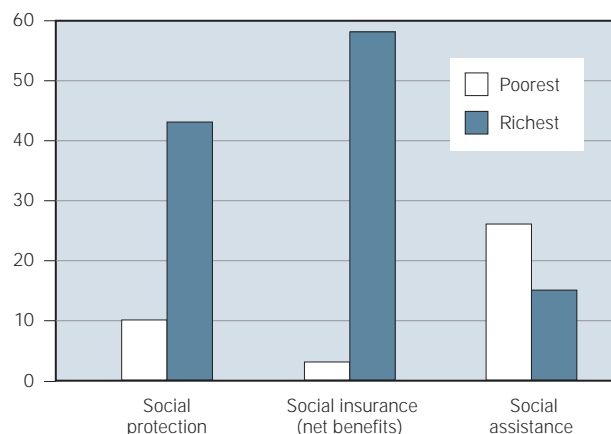
The tax burden on the poor also reduces the impact of redistribution. For example, Goni and his co-authors (ibid.) find that the bottom quintiles have a comparatively higher tax burden than the top quintiles. In Argentina, the bottom quintile devotes over 20 per cent of its household revenue to taxes (income, VAT and others), compared to 19 per cent for the top quintile. In other countries a similar trend is observed: in Chile, the poor pay 15 per cent and the rich 12 per cent, while in Peru the poor pay over 20 per cent, the rich pay 13 per cent and the middle-income groups pay around 8 per cent. Colombia and

Figure 5.13. Redistributive impact (average) of transfers and taxes on inequality in six Latin American countries



Source: Goni et al. 2008

Figure 5.14. Absolute incidence of social security provision in eight countries in Latin America (%)



Source: Lindert, Skoufias and Shapiro 2006

Mexico have a more or less equal tax burden (13 per cent for both rich and poor, while the middle-income groups pay around 8 per cent.)

Thus, if taxes (both direct and indirect) and public transfers are taken into account, we find that overall redistribution in Latin America is minimal. On average, the six Latin American countries considered are able to reduce income inequality through taxes and transfers by only 1.4 point (see fig. 5.13) as against to around 16 points in OECD countries (if only public transfers and direct taxes are included). The reduction in inequality ranges from over 4 per cent in Colombia to 2 per cent in Argentina and 1.5 per cent in Mexico, and even less in Brazil and Chile. In Peru, inequality actually increases by 0.8 per cent after taxes and public transfers are taken into account.

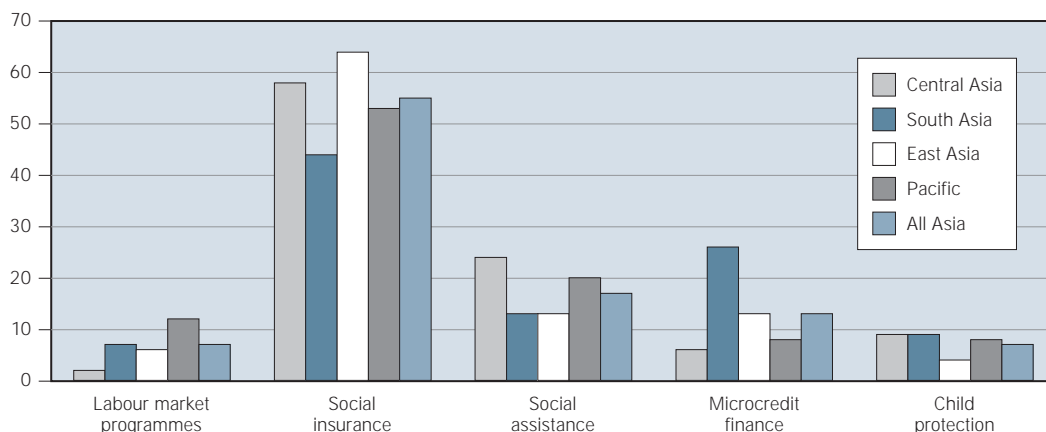
Which kind of social transfers?

The data reveal that public social protection transfers mostly benefit richer people (Lindert, Skoufias and Shapiro 2006; United Nations 2006). In Latin America, most of the poor are in informal sector employment and not included in any social protection scheme. For example, in eight Latin American countries¹⁹, only 10 per cent of social protection transfers go to the poorest quintile, compared to 43 per cent that go to the richest (see fig. 5.14). Social insurance is even more regressive, as the poorest quintile receives only 2 per cent of transfers, whereas the richest receives 58 per cent. This is not unexpected, since it is formal sector workers who contribute to social security, through social insurance programmes. There is no universal pension coverage system in the developing countries of Latin America, although in Brazil there are attempts to incorporate poor households into the pension system (see box 5.2) (Uruguay and Bolivia have near-universal pension systems).

This does not mean that all social transfers are regressive. Social assistance spending is progressive and pensions may be provided for low-income households, as in Brazil. About 26 per cent of social assistance transfers go to the lowest quintiles. However, of the 7.3 per cent of GDP that is spent on social transfers programmes in the countries under consideration, 6.3 per cent goes to social insurance (pensions and unemployment insurance)

142 19. Argentina, Brazil, Chile, Colombia, Dominican Republic, Guyana, Mexico and Peru.

Figure 5.15. Social protection expenditure, by category, in Asia and the Pacific (%)



Source: Baulch et al. 2008

and only 1 per cent to social assistance programmes (Goni et al. 2008). Such a low level of public spending suggests that the impact on inequality and poverty is minimal.

Conditional cash transfers to poor families have been regarded as an effective means of reducing poverty in Latin America. These programmes started in Mexico and Brazil in the mid-1990s, focusing on school attendance and health care. Similar initiatives were adopted subsequently in other countries in the region – in Argentina, Chile, Colombia, Dominican Republic, Ecuador, Honduras, and Jamaica – and other parts of the world, such as Bangladesh, Burkina Faso, Cambodia, Ethiopia, Lesotho, Pakistan and Turkey. Conditional cash transfers are very progressive, in that about 75 per cent of the spending goes to the two bottom quintiles (ibid.).

Asia and the Pacific

Income inequality is relatively high in the Asia and Pacific region. There are some countries which have managed to reduce inequality through economic growth and employment generation: this is the East Asian productivist model, where social policy is an instrument for economic growth and nation building, social security is largely provided by the extended family network (Gough 2004; Lindert 2004) and social spending is relatively low, compared with other developing countries (see box 5.3 on Malaysia.) The South Asia region, on the other hand, represents a different redistributive model, based on “informal security”, where reliance on networks, linkages, informal rules and personal favours is widespread (Gough and Wood 2004). This model is also characterized by a highly organized community-based welfare system and involvement of development organizations in the provision of welfare, together with high levels of remittance flows.

According an Asian Development Bank report (Baulch et al 2008), only 17 per cent of social protection expenditure in the Asia and Pacific region goes on social assistance programmes (ibid.).²⁰ Fiji has the highest proportion, at around 49 per cent, whereas

20. The Asian Development Bank (ADB) recently ventured into creating a social protection index for 31 countries from the Asia and Pacific region. The ADB defines social protection as “the set of policies designed to reduce poverty and vulnerability by promoting efficient labour markets, diminishing people’s exposure to risks, and enhancing their capacity to protect themselves against hazards and the interruptions/loss of income” (Ortiz 2001). Consequently, it used data from five broad areas: labour market policies and programmes, social insurance, social assistance, micro- or area-based schemes, and child protection. In its final calculation, the ADB used the following indicators to construct the social protection index:

Box 5.2. Brazil: Inequality, employment and growth

Brazil has received praise for its economic and social development performance between 1990 and the 2000s. It managed to reduce income inequality by around 2 per cent, and at the same time increase employment by around 2 per cent per year and generate economic growth (see fig. 5.16). Its employment to population ratio has been constant at around 62 per cent. How has it managed to do this?

Figure 5.16. Brazil: Change in inequality, employment and growth, 1990-2006 (%)



Source: ILS estimates 2008; growth from World Bank 2008

Brazil has a relatively high level of social spending, at around 25 per cent of GDP (pensions alone account for 11 per cent). Social policy has been a key component of the developmental welfare system, which is organized under three pillars: universal provision of education and health; some social assistance for the poor; and contributory social security schemes and provision by the private sector (Draibe 2007). Health and education expenditure represents around 40 per cent of total public spending on social programmes, while social insurance programme expenditure represents around 50 per cent.

Social benefits largely take the form of contributory social insurances programmes, while social assistance programmes are very limited. It is estimated that pensions alone account for 85 per cent of total cash transfers to households, with other contributory benefits making

Bhutan has no social expenditure budget. Although, overall, 55 per cent of social expenditure goes on social insurance programmes – generally pension schemes in many countries make up the bulk of their social expenditure. In Malaysia, for example, pensions accounts for 90 per cent of total social protection expenditure (see box 5.3) and in many other countries over 70 per cent. Labour market and child protection are allocated roughly 7 per cent of the social protection budget and microcredit financing on average 13 per cent. Only 35 per cent of the population as a whole is covered by any form of social protection; and as for the poor, the average for Asia and the Pacific is only 57 per cent, with individual shares ranging from 1 per cent in Papua New Guinea to 100 per cent in the Cook Islands, India, Japan and the Republic of Korea.

- Total expenditure on all social protection programmes (percentage of GDP)
- Beneficiaries of social protection programmes targeted at key groups (unemployed, elderly, sick, poor/social assistance, poor/micro-credit, disabled, children with special needs)
- Number of social protection beneficiaries who are poor
- Average social protection expenditure for each poor individual.

up 11 per cent of the total and non-contributory benefits 4 per cent. Non-contributory benefits include the very well-targeted Bolsa Escola (school attendance benefit) for low-income families and old-age and disability benefits for low-income individuals.

Since pensions account for the bulk of transfers, it is worthwhile looking closer at the Brazilian pension system. The social security system was originally designed to cater for those in formal sector employment and so excluded informal sector workers. It has, however, been reformed to include low-income households. Around 64 per cent of employed workers are currently covered by social security (Ansillero and Paiva 2008). There are two mandatory public pensions, one for private sector workers and the other for civil servants. The private sector pension covers both urban and rural workers. Unlike urban workers, rural workers are not required to contribute in order to be eligible, but only have to provide evidence of 15 years of rural activity (in a way, this becomes a type of social assistance, since it is basically non-contributory). The rural workers have been gradually incorporated into the scheme since the 1970s. Their inclusion on a non-contributory basis is perhaps one of the most redistributive aspects of the scheme. The civil service pension is much more generous than the private sector one, providing around seven times the benefits, on average. Successive governments have tried to reform the system to make it universal.

What is the impact of social transfers and taxation on income inequality?

Private income accounts for 70 per cent to 80 per cent of a household's disposable income, while the rest comes from social benefits (mainly pensions) (Soares et al. 2006). Pensions increase the revenue of those who earn less than the minimum wage by 5 per cent in 2004, as compared with 2.3 per cent in 1995. As most pensioners live in households with virtually no market income, pensions thus contribute to the reduction of inequality. Indeed, poverty levels are lower among the elderly than the national average.

Brazil has a complex tax system that hurts the poor the most. Although the income tax is progressive, indirect taxes (consumption taxes and VAT) neutralize this effect. For example, in 2004 households with an income of up to twice the national minimum monthly wage spent 46 per cent of their income on indirect taxes, compared with 16 per cent for those who earned more than 30 times the minimum wage (Zockun 2007). Moreover, this tax burden increased by 21 per cent for the poorest between 1996 and 2004.

The case of Brazil shows that universal non-contributory pension schemes are possible for developing countries (Willmore 2007; Arza 2008). It also shows that such schemes, and targeted social transfers generally, especially social assistance, can help reduce income inequality. The Brazilian case demonstrates that the current tax system is a poor redistributive tool and therefore it needs to be reformed. More emphasis should however be placed on redistribution policies, such as social transfers, universal pension coverage and the provision of social services.

Africa

Much of Africa's welfare and redistributive system is classified as a generalized "insecurity regime" based on families, clans and patrimonial relations, together with increased intervention by international organizations (Gough and Wood 2004).

As shown above, fiscal policy, including taxation and social transfers, is becoming more and more important in reducing poverty and inequality in many developing countries, including those in Africa. However, data on redistribution in Africa is very difficult to obtain. There have been some studies done on social spending and taxation in a few selected countries, including South Africa and Cameroon. For example, taxation and social spending reduced Gini inequality by 10 points in the 1990s in South Africa (McGrath, Janisch and Horner 1997; Nattrass and Seekings 2001). In Cameroon, Tabi, Akwi and Anzah (2006) showed that income tax, indirect taxes (VAT, commodity-specific excises and import duties) and other individual taxes (gasoline, petroleum products and excises) tend to be progressive. Mauritius is perhaps the only country in the Africa region which has sufficient data and in which numerous studies have been done to understand the high level of economic growth and its impact on social welfare (see box 5.4).

Box 5.3. Malaysia: Inequality, employment and growth

Since the mid-1970s, Malaysia has combined high economic growth and increased employment with reduced inequality. Between 1990 and 2007, the Gini coefficient has fluctuated, but on average it has remained fairly stable, dropping only slightly (0.005) over this period. Economic growth in the 1990s averaged over 7 per cent and in the 2000s around 5 per cent (see fig. 5.17). Similarly, employment has grown around 3 per cent per year since 1990, while the employment to population ratio has increased steadily reaching 62 per cent in 2006. Despite Kuznets' widely acknowledged theory that an increase in economic growth leads to increased income inequality, Malaysia has shown otherwise. How has it managed to achieve this?

Malaysia's economic development policy and economic management has been described as unconventional and unorthodox. The state-led development plans and the New Economic Policy were meant to reduce poverty and serve as tools for nation-building or "restructuring society". The government has been active in developing infrastructure and creating human capital through increased investment in education and health facilities, prerequisites for economic growth. In addition, it has given priority to the rural areas and traditionally disadvantaged ethnicities through targeted programmes and a focus on the agricultural sector.

Economic growth and structural transformation are considered to be the main contributors to the reduction of poverty and inequality. The state-led shift to labour-intensive export-orientated industrialization has created new, well-paid employment, while high growth rates have reduced absolute poverty. Rural-urban remittances and migration, together with training and education initiatives, have helped ensure that the benefits of this growth are equitable.

Malaysia has given priority to the education and health sectors as a way of increasing human capital. This has led to impressive results in literacy rates and general health outcomes. Its expenditure on health and education accounts for around 10 per cent of GDP, compared to a mere 1 per cent for social protection and welfare (since 90 per cent of the social protection budget is used for social insurance schemes). Within social protection, the compulsory saving schemes, especially the Employees Provident Fund, may also have contributed to the decrease in inequality.

Social security is generally taken care of by the family, and to some extent by the private sector. The high level of intra-family transfers, both across generations and between

Only two other countries in Africa have tried to set up a universal welfare system: Botswana and Namibia have both tried to implement a universal pension system.

By contrast with the developed countries, developing countries have never taken the taxation system seriously as an instrument for redistribution, regarding it merely as a way of raising revenue (Chu, Davoodi and Gupta 2000). Although income tax is generally progressive, the magnitude of indirect taxes reduces or neutralizes this progressivity. Even if tax revenue increases, it is unlikely that governments will spend it on

rural and urban areas, has been a key facilitator of Malaysia's equitable growth. Extended nuclear families have acted as a means of social protection and have invested heavily in social services, with private spending making up roughly 40 per cent of health and education expenditure.

New challenges exist for equitable growth in Malaysia. Improvements in sexual equality – commendable though they are – and decreasing fertility may undermine the ability of families to continue providing social security. Intra-ethnic inequality is increasing, as is inter-regional inequality (Ragayah forthcoming). The labour-intensive industrialization of the past may be unsustainable, given Malaysia's labour shortage; indeed, since 1990, Malaysia has begun to shift to capital- and technology-intensive industrialization, which may have an impact on equity and employment creation. Together these factors help explain the fluctuations seen in Malaysia's Gini coefficient over the past two decades; they serve as a warning and demand continued policy innovation if equitable growth is to be sustained.

Figure 5.17. Malaysia: Change in inequality, employment and growth, 1990-2007 (%)



Source: Gini coefficient and employment data from ILS estimates 2008; latest Gini data from Ragayah 2008; growth data from World Bank, World Development Indicators 2008.

reducing inequality or poverty, since the poor have little or no influence on any budget decisions. Nonetheless, it is important that governments have a judicious progressive expenditure policy, since social transfers, especially social assistance and universal pension coverage, will help reduce inequality more than taxes will. Countries in the developing world should thus give priority to a progressive expenditure policy in order to reduce inequality.

Box 5.4. Mauritius: Inequality and growth

The case of Mauritius throws an interesting light on how economic development can take place hand in hand with effective redistribution policies. Between 1980 and 2006, the Mauritius economy grew, on average, 4.1 per cent per year – much faster than the average for developing countries as a whole (see table 5.2). It also managed to increase both its employment rate – by 2 per cent per year between 1990 and 2007 – and the employment to population ratio, which reached over 55 per cent in 2006. At the same time, poverty rates were cut significantly, dropping from 20 per cent in 1997 to 8 per cent in 2006, while the share of national income for the poorest 20 per cent of households grew from 5.6 per cent in 1987 to 6.2 per cent in 2002 (see table 5.3).

Table 5.2. Average growth rates

	1980-1989	1990-1999	2000-2006
Growth (%)	4.9	4.2	3.1

Source: World Bank 2008

Table 5.3. Income inequality and poverty in Mauritius, by household

	1986/87	1991/92	1996/97	2001/02	2006/07
Income share (% GDP)					
Lowest 20 per cent	5.6	6.4	5.9	6.4	6.1
Highest 20%	44.2	43.5	46.2	44.0	45.7
Gini coefficient	0.396	0.379	0.387	0.371	0.389
% below poverty line	19.5	10.6	8.7	7.7	8.0

Source: Central Statistics Office of Mauritius, Household Budget Surveys (<http://www.gov.mu/portal/goc/cso/eice64/toc.htm>)

Social policy in Mauritius dates back to the 1940s, when the Central Development and Welfare Committee was established. In the 1950s, a social security scheme for plantation workers was instituted. Universal access to health and education is available, including free secondary and university education. There is also a non-contributory pension scheme covering all citizens over the age of 60. In addition, the price of essential commodities (notably rice and flour) is subsidized. Social assistance is provided, targeted at vulnerable groups.

Social programmes are funded by general taxation revenues. Personal income tax is markedly progressive: not only are tax rates and the distribution of taxable income progressive in themselves, but exemption limits are high so that low-income earners pay no tax at all.

Although government expenditure has stayed stable at around 25 to 26 per cent of GDP over the past decades, its focus has shifted from public administration and economic services to social services and social transfers. Social transfers increased from 6.1 per cent of GDP in the mid-1980s to 8.2 per cent in the late 1990s, 9.6 per cent in 2000-01 and 9.3 per cent in 2003-04. About 50 per cent of the transfers are used to finance various universal pension schemes and the rest go on education, parastatal bodies and local government. Social assistance subsidies are provided for essential commodities (rice and flour) and certain sections of the population (students, the elderly, disabled people and recipients of social assistance enjoy free transport).

Source: Nath forthcoming, Social policy in Mauritius, Background paper prepared for UNRISD project on "Social policies in small states".

C. Policy considerations

Taxes and social transfers can be important tools for redistribution. Yet, despite their potential, they have not been used to the extent needed to keep pace with increasing inequality. To the extent that policy makers consider rising income inequality problematic, several policy options can be considered. The purpose of these policy options is to address increasing income inequality without adversely affecting economic growth.

First, there may be a case for increasing the progressivity of the tax system. To this end, governments could ensure that tax rates on high incomes are not further reduced – an international trend highlighted in this chapter – and limit regressive tax exceptions. In certain countries there may be a case for refraining from further increase in VAT and other indirect taxes (often regressive), introduced to compensate for reductions in government revenue arising from lowered income taxes and trade tariff reductions.

Second, in order to avoid the risk of harmful international tax competition, multilateral action may be needed. Indeed there are many countries that cannot enhance the progressivity of their tax system, because doing so may encourage mobile, high-income groups to leave. Of course, any efforts to curb harmful tax competition must give consideration to cases where countries have legitimately reduced taxes to improve economic efficiency.

Third, tax and social policy need to support employment – a key redistribution mechanism. This means removing tax distortions that affect labour market participation.

Fourth, as this chapter has shown, social policy can be used more actively without sacrificing growth or employment objectives. This was shown to be the case in countries as diverse as Malaysia, Mauritius, Nordic countries and, to a certain extent, Brazil. In some of these countries, social protection was provided for the entire population (or in the case of Brazil, for low-income, rural households) and, at the same time, growth and employment were maintained. Access to basic social services, such as education, health and water, should be universal as these services increase human capital, support economic growth and limit the risk of excessive income inequality. In developing countries, the use of conditional cash benefits may prove to be an interesting innovation.

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