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Addressing Inequalities and Challenges to Social Inclusion through Fiscal Policy

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Paper prepared for the Expert Group Meeting on *Addressing Inequalities and Challenges to Social Inclusion through Fiscal, wage and Social Protection Policies*, organized by the Division for Social Policy and Development (DSPD) of the United Nations Department of Economic and Social Affairs (UNDESA).
United Nations Headquarters, New York, Conference Room S-1522, 25-27 June 2018.
Grateful to Dr. Zulfan Tadjoeddin and Dr. Taneem Muzaffar of Western Sydney University for assistance with data analysis and editing.

"Fiscal policy accounts for a large share of differences in inequality across countries".[1]

I. Introduction

Fiscal policy affects inequality both directly and indirectly. The fiscal policy instruments – taxes, subsidies, transfers and expenditure – have direct redistributive roles. As highlighted by the International Monetary Fund (IMF), "Fiscal policy can help enhance redistribution by reducing both disposable (post-tax-and-transfer) and market (pre-tax-and-transfer) income inequalities. Taxes and income-related transfers affect disposable income inequality, whereas in-kind transfers such as health and education spending influence the inequality of market incomes. Fiscal policy can be a powerful redistributive instrument."[2]

The overall fiscal stance as a macroeconomic policy tool also affects inequality. For example, a pro-cyclical fiscal stance exacerbates impacts of a shock on unemployment. Recessions tend to impact negatively on the most disadvantaged cohorts in the society because they disproportionately bear the burden of unemployment and the associated income losses. When wealth losses that accompany joblessness are considered, the income inequality generalizes to rising wealth inequality.

On the other hand, consistent counter-cyclical fiscal policy with strong automatic stabilizers (e.g., social protection measures) ameliorates the social impacts of shocks by hastening recovery and protecting socio-economically disadvantaged groups. That is, government expenditure should rise during down-turns to fill the gaps in private sector spending, and there must be built-in mechanisms to protect the vulnerable.

However, fiscal policy as a redistributive tool has fallen out of favour since the early 1980s. High and rising public debt levels together with faltering growth, following the two oil price shocks of the 1970s, provided the background where taxes and transfers have been increasingly seen as distortions affecting incentives for both capital and labour, thus growth inhabiting. Rapid globalization since the mid-1980s has also induced tax competition as countries tried to allure mobile foreign direct investment (FDI). Thus, there have been steep declines in top marginal tax rates for both personal and corporate income across developed and developing countries over the past three decades.

The focus of fiscal policy also shifted from stabilization to fiscal consolidation since the early 1980s. This has made fiscal policy more pro-cyclical, and subservient to monetary policy which gave priority to inflation over unemployment. Thus, fiscal

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[1] IMF blog by Vitor Gaspar and Mercedes Garcia-Escribano, 'Inequality: Fiscal Policy Can Make the Difference', 11 October 2017, https://blogs.imf.org/2017/10/11/inequality-fiscal-policy-can-make-the-difference/

[2] IMF (2017), *Fiscal Monitor* (October), p. 1

policy has not been able to cushion the impact of inflation-focused monetary policy on unemployment. Furthermore, the adverse distributional impacts of pro-cyclical macroeconomic policies have been made worse when fiscal consolidation targeted mainly public expenditure, which fell disproportionately on social spending, such as health, education and social protection, as governments simultaneously committed to lowering tax burden.

Governments also resorted to selling public assets and state-owned enterprises to address public debt. Thus, the privatization programme since the 1980s has resulted in a massive shift of public wealth to the private sector. In many instances, Public-Private Partnerships (PPPs) increased governments' fiscal woes due to inadequate risk-sharing, resulting in contingent fiscal liabilities. These developments have diminished governments' ability not only to directly transfer income, but also to invest in social sectors to build human capital.

The above developments have coincided with rising inequality and declining inclusiveness around the world during the past three decades. This paper is aimed at highlighting the channels through which lowering tax rates and fiscal consolidation through expenditure cuts and privatization contributed to rising inequality. It will argue that tackling inequality requires reversing the trends and restoring the redistributive role of fiscal policy. It will also provide an analytical framework for redistributive fiscal policy for outcomes (i.e., income) and opportunities (i.e., income-generating assets, including human capital).

The paper begins with presenting some key stylized facts through scatter plots relating fiscal indicators (e.g., tax/GDP, social expenditure/GDP ratios) to inequality indicators (e.g., Gini coefficient and percentile income shares). The rest of the note is organized as follows: Section III provides a summary of developments fiscal areas since the 1980s; Section IV highlights the channels through which fiscal policy developments affected inequality; Section V argues for recreating distributive fiscal policies for opportunities (stock of income-generating assets) and outcomes (income flows); Section VI contains concluding remarks.

II. Stylized facts – fiscal policy and inequality

There is a widespread belief that trends and changes in income inequality can be at least partly caused by changes in the level and composition of government revenue and spending. This follows from the well-studied Kuznets' hypothesis that inequality first rises with the level of income and then declines. Therefore, to the extent government's taxation and spending policies affect the level of GDP, they will also have implications for inequality.

Figures 1 and 2 broadly confirm this stylized fact in a cross-section of over 100 countries – developed and developing. Figure 1 uses alternative measures of inequality – Gini coefficient and income share of top 10% of the population. Both show that there is a negative association between tax/GDP ratio and inequality. That

is, higher the tax-GDP ratio, the lower is the level of inequality. This negative association between tax-GDP ratio and inequality is more robust in developed countries where generally tax-GDP ratio is high and inequality is low compared to developing countries.[3]

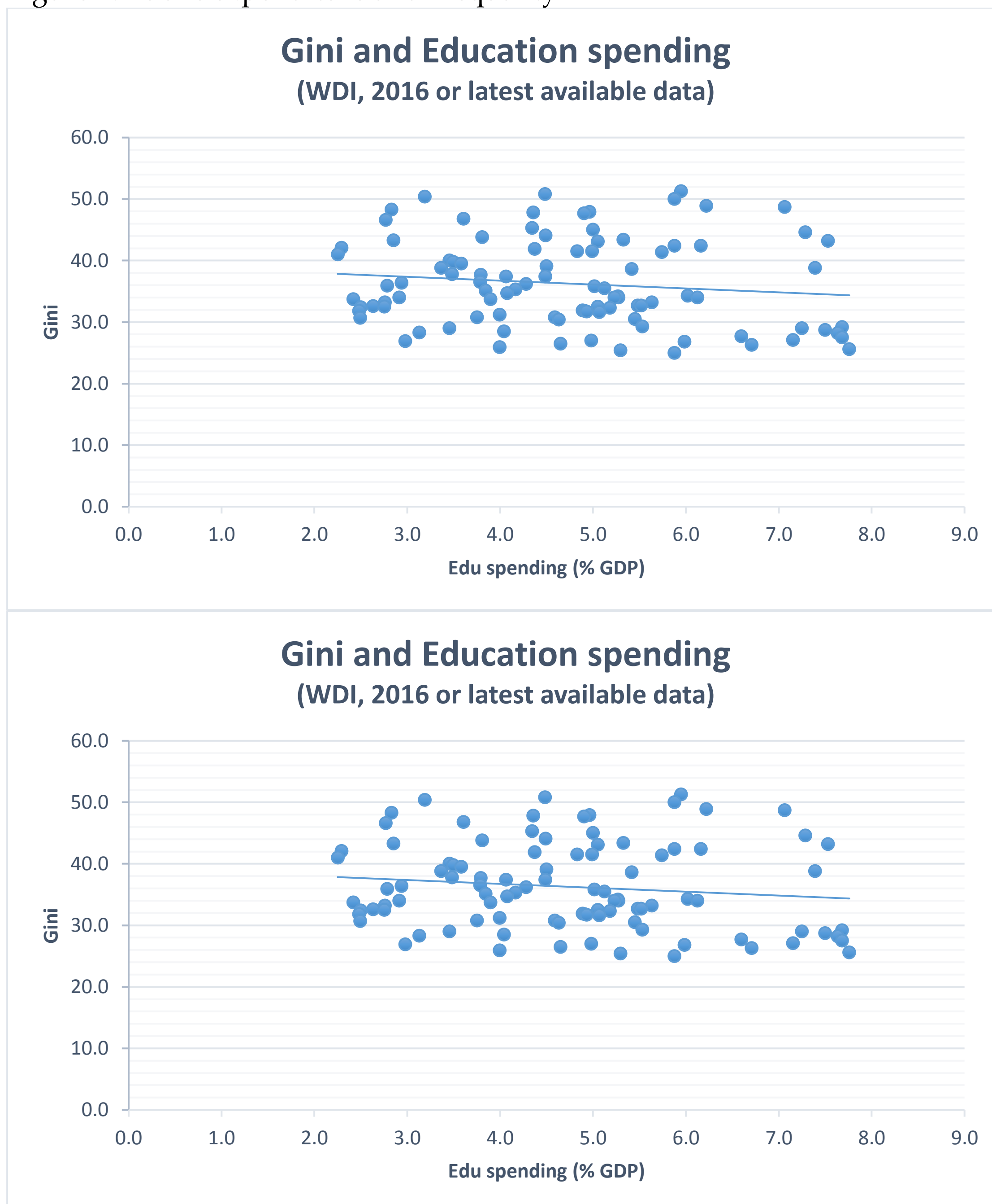
Figure 1: Government revenue and inequality

Source: World Development Indicators (various issues)

[3] For example, Islam, Madsen and Doucouliagos (2018) find a strong negative association between tax-GDP ratio and alternative measures of inequality in 21 OECD countries over a long time period spanning 1870 to 2011. Islam, Md. Rabiul, Jakob Madsen, and Hristos Doucouliagos (2018), ' Does inequality constrain the power to tax? Evidence from the OECD', *European Journal of Political Economy*, vol. 52, pp. 1–17

Higher tax/GDP ratio means greater ability of the government to spend on sectors that help reduce inequality. For example, higher public expenditure on health and education supports accumulation of human capital and hence contributes to enhancing equality of opportunities. This stylized fact is confirmed by Figure 2 which plots public education expenditures (as % of GDP) and alternative measures of inequality.

Figure 2: Public expenditure and inequality



Source: World Development Indicators (various issues)

As in the case of tax-GDP ratio, the negative association between public expenditure and inequality is stronger in developed countries, which generally have greater tax

power and hence spend higher proportions of GDP than developing countries. That is, tax power matters.

However, there is more than the above broad stylized facts. For example, types of taxations (e.g., direct and indirect taxes, income and wealth taxes etc.) as well as progressivity of tax structure can have significantly different impacts on both tax power (tax-GDP) ratio and inequality. Over the past three decades countries have become more dependent on indirect taxations which are generally more regressive. At the same time, they have also cut top marginal tax rates. Thus, the tax structure has become less progressive reducing its effectiveness as a redistributive tool.

Additionally, it is argued that the effects of taxation on income distribution needs to be seen in the context of the trade-offs between growth and equity, and this means looking at the overall effects of any reform on the fiscal regime as a whole, and not just at whether individual taxes are progressive or regressive. The proponents of tax cuts used the theory of optimal taxation to argue that a tax rate beyond a threshold level negatively affects entrepreneurial spirit and hence growth.[4] But Figure 3 casts serious doubts about this claim. It shows a very week statistically insignificant negative relationship (correlation coefficient -0.084) between tax-GDP ratios and

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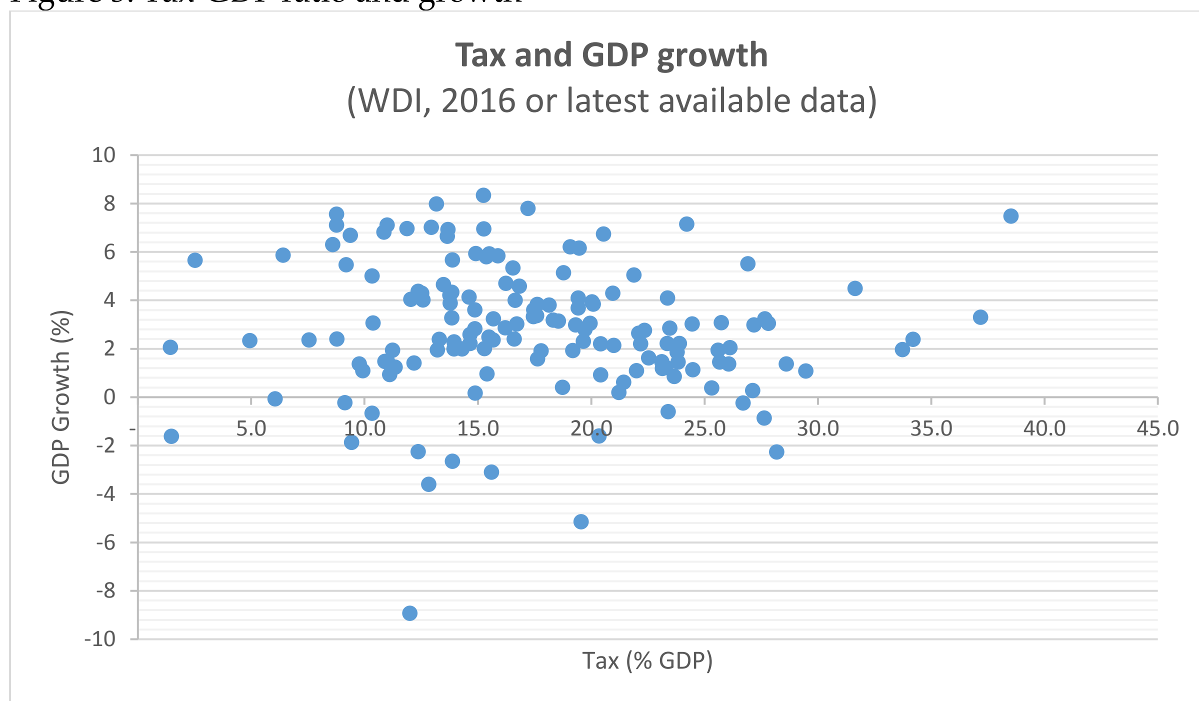
[4] The theory of optimal taxation had a profound impact on tax theory and dominated academic discourse concerning the design on a tax system. At the centre of the optimal taxation theory is the assumption that tax payers respond to a tax system, either treating it as a burden or encouragement. Thus, efficient taxation minimizes the efficiency losses incurred through the excess burden of taxation when collecting a specified amount of tax revenue. Frank Ramsey (1927) showed that authorities intending to raise a given amount of tax revenues should impose a tax in inverse proportion to the elasticity of demand for the good, so that commodities which experience inelastic demand are taxed more heavily. This would imply a regressive tax structure – higher tax rates for essential goods and services, and lower rates for luxuries. See Ramsey, Frank (1927), "A Contribution to the Theory of Taxation", *Economic Journal*, 37 (March), pp. 47-61.
A second line of influential optimal taxation theory is that of James Mirrlees (1971), which formalized the classic trade-off between equality and efficiency. It posited that governments' attempt to tax high ability individuals to give transfers to those of low ability would discourage high ability individuals from exerting as much effort, thus adversely affecting growth. Therefore, the tax system has to be incentive compatible to make sure that high ability taxpayers keep producing at the high levels corresponding to their ability. See Mirrlees, James (1971), "An Exploration in the Theory of Optimal Income Taxation", *Review of Economic Studies*, 38, pp. 175-208.
The work of both Ramsey and Mirrlees has been influential in diminishing the role of progressive taxation over the past three decades. They have been used to justify tax cuts at the top on the ground that a wealthier person has more flexibility when making labour supply decisions. The same argument has been applied to corporate tax cuts as capital is more mobile than labour. This argument has got an added impetus during the 1990s at the height of globalization and countries engaged in competitive corporate tax cuts.
However, practitioners find the theory of optimal taxation problematic despite enormous intellectual resources that have gone into it. For example, Vito Tanzi, former Director of IMF's Fiscal Affairs Department noted, "optimal taxation, a branch of public finance that had conquered the academic world…[But] in terms of concrete results, optimal taxation theory must be considered a highly unproductive activity. Its recommendations often conflict with what governments want to do or what taxpayers expect them to do." Quoted in Boadway, Robin W. (2012) *From Optimal Tax Theory to Tax Policy: Retrospective and Prospective Views*, Cambridge, Mass: MIT Press.

growth rates in about 150 countries involving both developed and developing economies.

Figure 3: Tax-GDP ratio and growth



Source: World Development Indicators (various issues)

Finally, although the tax-GDP ratio has generally increased, in most cases, it has not been commensurate with the increase in demand for public expenditure. Thus, most countries have experienced rising debt levels which forced them to either cut or restraint public spending. This means, public spending, including transfers, have not been sufficient enough to offset the adverse impact of falling tax progressivity on inequality during the past decades. In sum, income distribution worsened due to falling progressivity of taxation and inadequate public social spending, including transfers since the early 1980s.

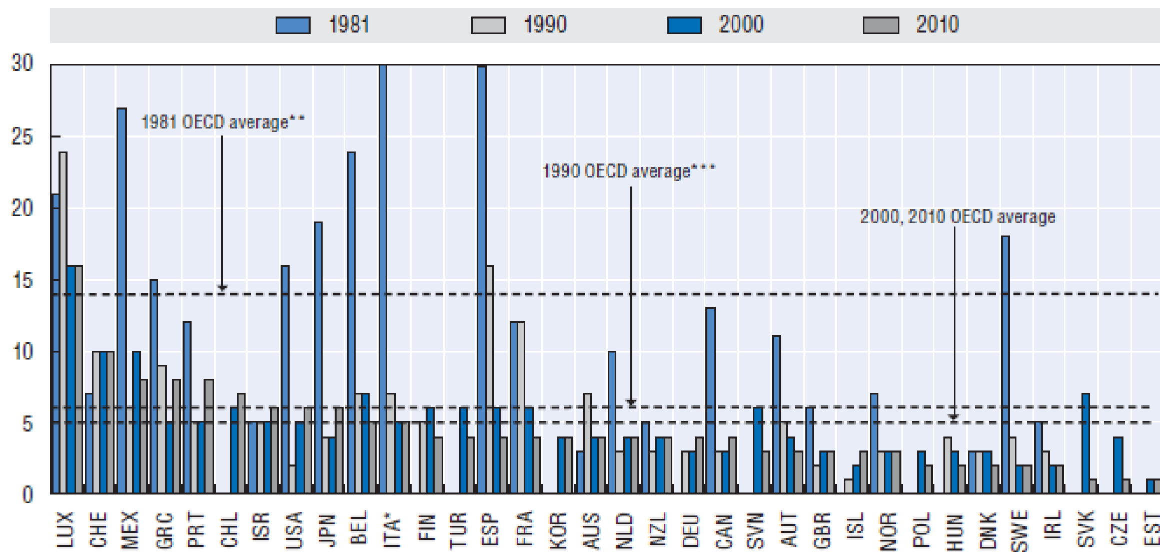
III. Trends in fiscal instruments

This section traces the decline of fiscal policies redistributive capacity. In particular it will focus on (a) declines of tax progressivity, (b) expenditure-based fiscal consolidations, and (c) fiscal risks due to privatization and public-private partnerships.

III.1 Tax cuts and VAT reduced tax progressivity

Globally there have been declines in tax rates since the early 1980s. The OECD countries have reduced their top statutory personal income tax (PIT) rates, along with the number of tax brackets over the last three decades. On average, there were 14 PIT brackets in 1981 across OECD countries, which dropped to 6 by 1990 (see Figure 4).

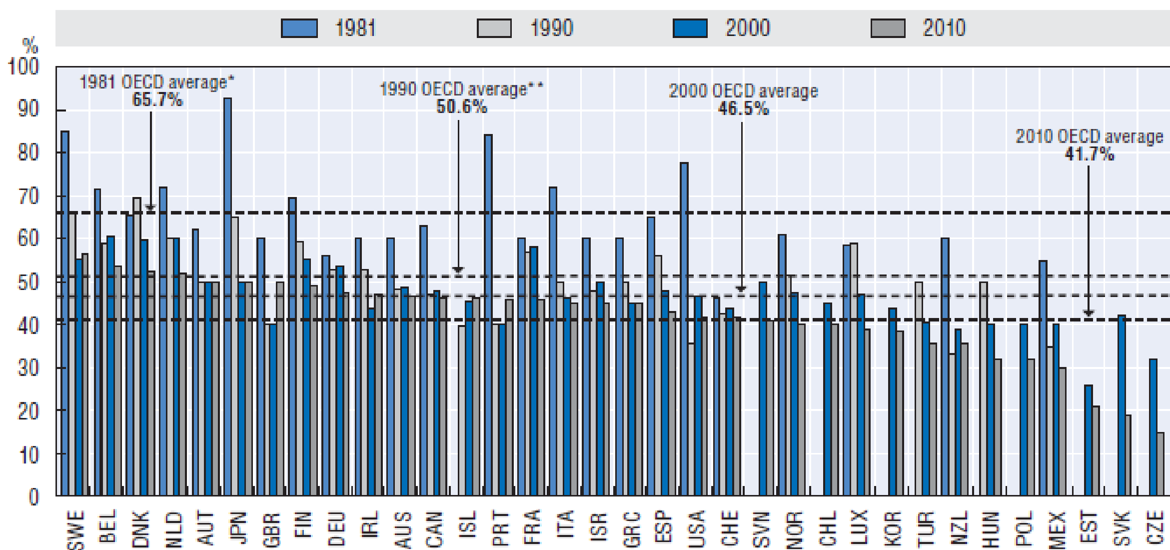
Figure 4: Number of central personal income tax brackets



Source: OECD (2012) "Special Feature: Trends in personal income tax and employee social security contribution schedules"

The average combined central and sub-central top statutory rate (including surcharges and taking into account the deductibility of sub-central or other income taxes from the central tax base) declined by more than 15 percentage points, from 65.7% in 1981 to 50.6% in 1990 across OECD countries. The top combined PIT rate declined by about 4 percentage points in the 1990's (to 46.5% in 2000), and then by almost 5 percentage points in the 2000's (to 41.7% in 2010; see Figure 5). It declined further to 35% in 2015.

Figure 5: Top combined statutory personal income tax rate



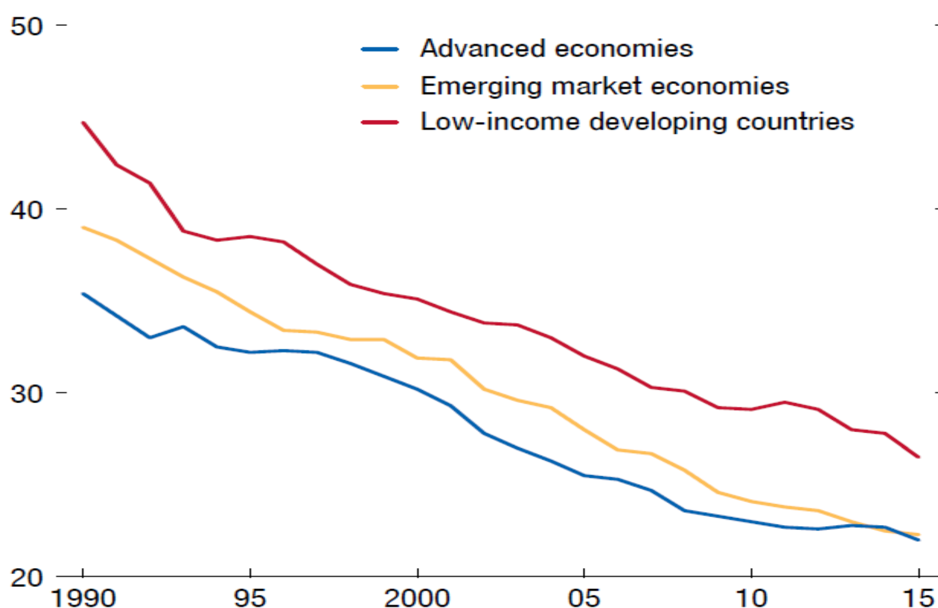
Source: OECD (2012) "Special Feature: Trends in personal income tax and employee social security contribution schedules"

As noted in the IMF's 2017 (October) Fiscal Monitor, tax systems may be even less progressive in reality than suggested by statutory rates, because wealthy individuals often have more access to tax relief and more opportunities to avoid taxes. They also

have more resources to dedicate to tax planning, as well as greater incentives to engage in such activities.

There has also been a race to the bottom with regard to the CIT in emerging and developing economies in bid to attract mobile foreign direct investment (FDI). Figures 6a & 6b reveal a declining trend in statutory corporate tax rates, the average CIT rate dropping from about 31% in the mid-1990s to 26% in 2007. The pattern holds for each region, as well as when using medians. The most pronounced rate reductions occurred in Europe, with several transition economies sharply reducing their tax rates.

Figure 6a: Trends in corporate income taxes, 1990-2015



Source: IMF (2017) *Fiscal Monitor*, October

As expected, the decline in the statutory tax rate coincided with a fall in effective average tax rates in every region. Africa witnessed a major reduction of marginal rates, as a result of the combination of narrower tax bases and lower rates. A race to the bottom is evident among special regimes, most notably in the case of Africa, creating effectively a parallel tax system where rates have fallen to almost zero.[5] Overall, the trend is declining gradually in emerging and developing economies, similar to advanced economies, where comparable effective average marginal tax rates declined by about 10 percentage points over 1982-2001 and by 5 percentage points during 1990-2001.[6]

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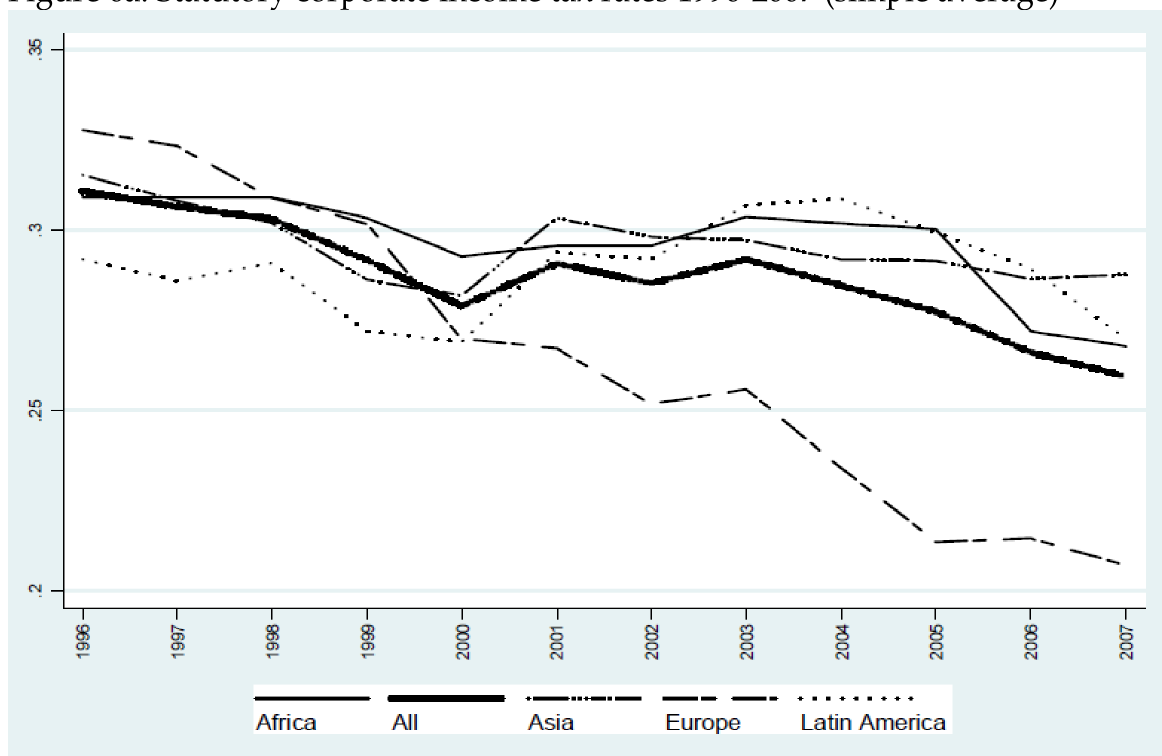
[5] Abbas, S. M. Ali and Alexander Klemm, with Sukhmani Bedi and Junhyung Park (2012), " A Partial Race to the Bottom: Corporate Tax Developments in Emerging and Developing Economies", *IMF Working Paper*, WP/12/28

[6] Devereux, M. P. and Griffith, R. (2003), 'Evaluating tax policy for location decisions', International Tax and *Public Finance*, vol. 10, pp. 107–26.

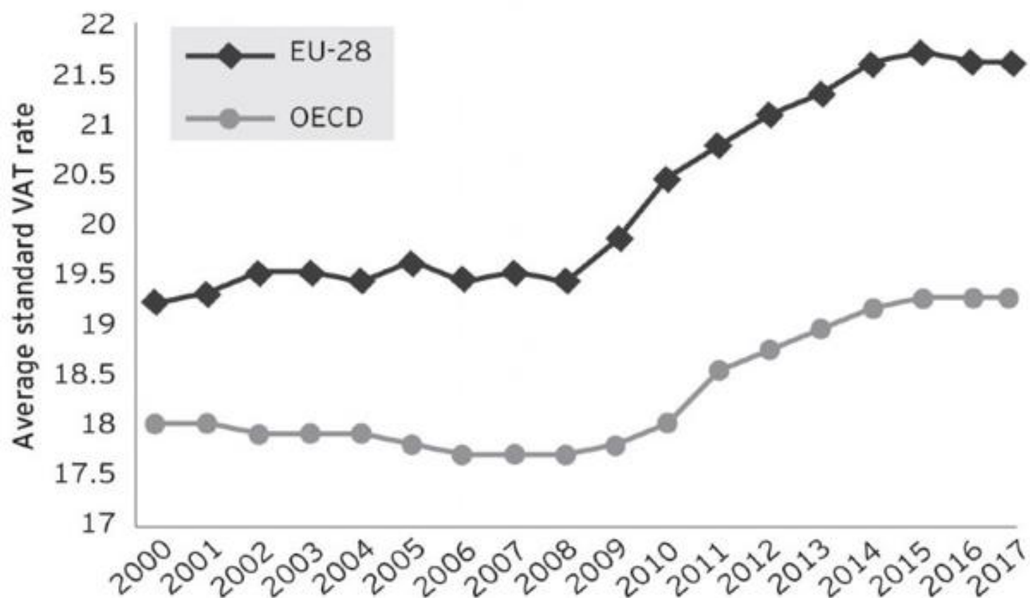
Figure 6a: Statutory corporate income tax rates 1996-2007 (simple average)



Source: Abbas, S. M. Ali and Alexander Klemm, with Sukhmani Bedi and Junhyung Park (2012), "A Partial Race to the Bottom: Corporate Tax Developments in Emerging and Developing Economies", *IMF Working Paper*, WP/12/28

Despite the cuts in tax rates (both PIT and CIT), tax revenues generally rose in almost all regions – developed and developing – as measured by median tax-GDP ratio. This is because, the emphasis shifted from direct to indirect taxes, such as value added tax (VAT) or goods & services tax (GST). For example, VAT as a percentage of GDP in OECD countries increased from 3.2% in 1965 (when it was first introduced) to 7% in 2014. VAT now accounts for over 21% and consumption taxes (including VAT/GST, sales taxes, and other general taxes on goods and services) constitute roughly a third of the total tax revenue in OECD countries. As indirect taxes became an important source of governmental revenues, VAT/GST rates have reached unprecedented heights in recent years in developed countries (see Figure 7). A flat-rate GST or VAT is regressive as the poor and low-income households end up paying proportionately more than the rich.

Figure 7: Trends in VAT rates, EU-28 & OECD (200-2017)



Source: Earnest and Young (2016), *Indirect Tax in 2016: A review of global indirect tax developments and issues*
https://www.eycom.ch/en/Publications/20160317-Indirect-tax-developments-in-2016/download

In sum, cuts in marginal tax rates for PIT and CIT together with rising VAT/GST rates have made the tax system less progressive, thus diminishing its redistributive power. According to the IMF's 2017 (October) Fiscal Monitor, fiscal redistribution was able to offset about 60% of the increase in market income inequality in advanced between 1985 and 1995. But, average fiscal redistribution hardly changed between 1995 and 2010 when market income inequality continued to increase. The redistributive capacity of fiscal policy in emerging and low-income economies has historically been limited because of lower levels of taxes and transfers, compounded by weak taxation systems and a narrow tax base. Yet, they, too, witnessed a decline in the redistributive capacity of fiscal policy.

III.2 Fiscal consolidations achieved through spending cuts

If income redistribution cannot be pursued effectively on the tax side, then it would be natural to argue that equity objectives be addressed on the expenditure side. However, since the 1970s, which saw high and rising debt levels, attention shifted to government's budget constraint and optimal debt level.

But there is no consensus as regards the optimal public debt level.[7] Various limits are suggested or followed, such as 60% debt-GDP ratio in the case of European Union; but it was determined based on the median debt-GDP ratio in countries at the time of Maastricht Treaty. The suggested OECD guidelines for debt threshold ranges

[7] See Chowdhury, Anis and Iyanatul Islam (2010), "Is there an optimal debt-to-GDP ratio?", *Voxeu commentary*, 9 November, https://voxeu.org/debates/commentaries/there-optimal-debt-gdp-ratio

from 30 to 50% of GDP.[8] The IMF has suggested a threshold of 40% external debt ratio for developing and emerging economies; but did not explain its basis, other than saying that it is a useful benchmark based on historical experiences of debt sustainability.[9]

Nevertheless, there is a tendency to treat these benchmarks for debt-to-GDP ratios as "optimal" in the specific sense that crossing these thresholds poses threats to debt sustainability. This is consistent with the IMF's global macroeconomic model which assigns a dual role to fiscal policy: (1) smoothing out business cycles in the short run; (2) meeting targets for debt sustainability in the long run.[10]

Thus, there have been various episodes of fiscal consolidations. One IMF study identified 173 episodes of fiscal consolidations in 17 OECD countries during 1978-2009.[11] The magnitude of fiscal consolidation episodes ranges between 0.1 and about 5% of GDP, with an average of about 1% of GDP. But with lowering of tax rates already institutionalized, the burden of fiscal adjustment fell on expenditure, targeting health, education and social protection.

It is generally believed that that spending restraint (notably with respect to government consumption and transfers) is more likely to generate lasting fiscal consolidation and better economic performance than raising taxes. Unfortunately, there has been little or no recognition of the fact the rising debt levels could be a result of falling revenues due to tax cuts and tax competition.

III.3 Privatization and Public-Private Partnerships worsened fiscal position

The emphasis on fiscal consolidation has also seen sales of public assets. The argument of an improved budget position relies on the view that the proceeds from the sale of public assets exceed the net present value of proceeds that would have produced through annual dividends to the government.

But it was not the case in most instances as the privatization programme resulted in shifting of profitable state-owned enterprises and public assets because the private sector is generally not interested in loss-making entities. Thus, the sales of public assets had only temporary or short-run impact on public debt; but impaired

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[8] OECD (2015) "Achieving prudent debt targets using fiscal rules", *Economics Department Policy Note* No.28, July, www.oecd.org/eco/Achieving-prudent-debt-targets-using-fiscal-rules-OECD-policy-note-28.pdf

[9] IMF (2002). "Assessing sustainability", 28 May 28, https://www.imf.org/external/np/pdr/sus/2002/eng/052802.pdf

[10] See Kumhof, Michael, Douglas Laxton, Dirk Muir, and Susanna Mursula (2010). "The Global Integrated Monetary and Fiscal Model (GIMF) – Theoretical Structure", February, *IMF Working Paper* (10/34), p.45. The authors of GIMF arrive at "calibrated debt-to-GDP ratios" that range from 50 to 60%% (Table 7), noting that they are "roughly in line with the data" (p.52).

[11] See Devries, Pete, Guajardo, Jaime, Daniel Leigh, and Andrea Pescatori (2011), "An Action-based Analysis of Fiscal Consolidation in OECD Countries," *IMF Working Paper* No. 11/128. They applied the narrative approach and used historical accounts from OECD and EU's annual reports describing what happened to the budget deficit in a particular country/period; but they did not go into the details of policy makers' intentions, discussions and congressional records.

governments' long-term revenue capacity as they lost their profitable assets. Governments have forgone future revenue to get money now, but in the long run they became worse off, especially when they were left with the unprofitable ones, or when the new private owners used various loopholes to avoid and evade taxes.[12]

Studies found that in many cases, the revenues from privatization were too little and too late to provide a solution to many fiscal crises.[13] An analysis of 29 transition countries over 20 years found a robust negative relationship between privatization and the budget balance. A heavy loss of revenue appears to be associated with the privatization process.[14]

Public-Private Partnerships (PPPs) have also gained prominence as a means to resolve governments' fiscal burden, especially for infrastructure. PPPs are also used to in some social sector, such as health. But studies have found that PPPs are not necessarily a panacea.[15] The historical experience of several countries in the developed and developing world shows that PPPs can pose a huge financial risk to the public sector due to inadequate risk-sharing with private partners.

Contrary to the claims, PPPs are often riskier for governments than for the private companies involved; typically, the government is expected, if not contractually required to step in to assume costs if things go wrong. That is, PPPs usually socialize costs and risks while guaranteeing profits for the private partner. Some longer term fiscal implications of PPP-related 'contingent liabilities' have been acknowledged by the IMF, another advocate of PPPs.[16]

IV. Impacts on inequality

This section highlights the impacts of fiscal developments on inequality.

IV.1 Declines in tax progressivity

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[12] For example, Australia's the busiest international airport, Sydney Airport, paid no tax in the 10 years since it was privatized. The last time Sydney Airport paid tax was before its sale to Macquarie Bank in 2002. Not only has the company that controls the airport continued to structure its affairs so that it has no tax liability, it has also won a tax benefit of almost $400 million! https://www.smh.com.au/business/airports-pot-of-gold-20130822-2segw.html

[13] See, for example, Pinheiro, A.C., Schneider B., (1994). "The Fiscal Impact of Privatization in Latin America". *The Quarterly Review of Economics and Finance* 34 (1), pp 9-42. The paper develops a model, incorporating time preferences and longer term fiscal impacts, which shows that major fiscal benefits can be expected only under rare circumstances.

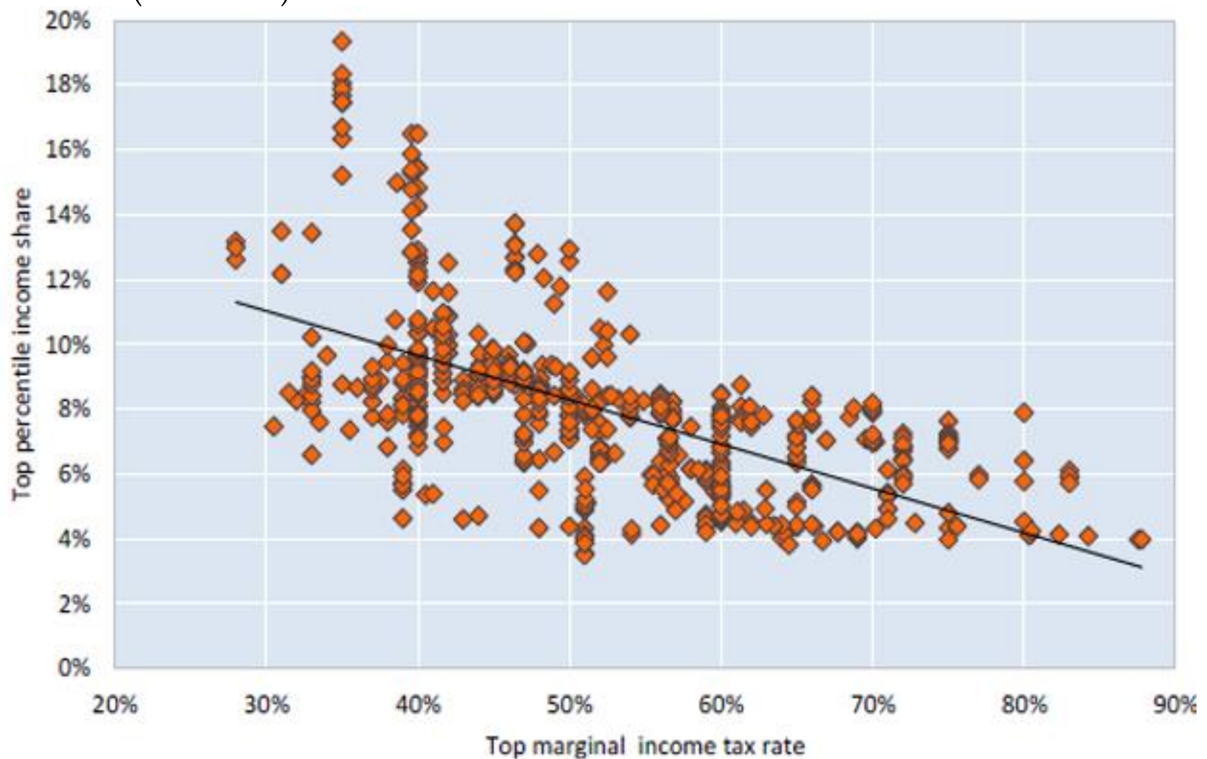
[14] Crivelli, Ernesto (2013) "Fiscal impact of privatization revisited: The role of tax revenues in transition economies", *Economic Systems*, 37(2), June, pp 217-232

[15] See Jomo KS, Anis Chowdhury, Krishnan Sharma, Daniel Platz (2016) 'Public-Private Partnerships and the 2030 Agenda for Sustainable Development: Fit for purpose?' *DESA Working Paper* No. 148, http://www.un.org/esa/desa/papers/2016/wp148_2016.pdf

[16] Queyranne, Maximilien (2014), "Managing Fiscal Risks from Public-Private Partnerships (PPPs)", https://www.imf.org/external/np/seminars/eng/2014/CMR/pdf/Queyranne_ENG.pdf. Also see IMF's "Informal Session to Brief: Analyzing and Managing Fiscal Risks—Best Practices", https://www.imf.org/external/np/pp/eng/2016/050416.pdf

It is obvious that the steep decline in the progressivity of the tax system over the past three and half decades has significantly diminished fiscal policy's ability to address inequality of post-tax-transfer disposable income. But at the same time, the decline in progressivity seemed to have also contributed to the rise in pre-tax (market) income inequality. In fact, here is a strong correlation between top tax rates and top pre-tax income shares (see Figure 8).

Figure 8: Pooled top marginal tax rates and top percentile income share in 17 OECD countries (1975-2012)



Source: OECD (2014), "Focus on Top Incomes and Taxation in OECD Countries: Was the crisis a game changer?", May

Historical evidence suggests that higher marginal tax rates create restraints on executive salary packages. Research has shown that changes in tax structure, especially reductions in marginal tax rates are largely responsible for the perverse rise in executive salaries since the 1980s.[17] For example, in the early 1960s, when a typical chief executive at a large American company made only 20 times as much as the average worker, the top marginal tax rate was 91%. If a CEO had accepted the bonuses, he/she could keep only a tiny fraction of them. Thus, there was not much incentive for bonuses and share options that push the CEO salary package to the

[17] Gorry, Aspen, Kevin A. Hassett, R. Glenn Hubbard, Aparna Mathur (2015), "The Response of Deferred Executive Compensation to Changes in Tax Rates", NBER Working Paper No. 21516, http://www.nber.org/papers/w21516

Also see Piketty, T., Saez, E., & Stantcheva, S. (2014). 'Optimal taxation of top labor incomes: A tale of three elasticities', *American Economic Journal*: *Economic Policy* 6(1), pp. 230–271. Using data from 18 OECD countries, they find a strong correlation between cuts in top marginal tax rates and increases in the share of total income going to the richest 1% since 1975.

stratosphere. But now there is no restraint when the US top marginal tax rate dropped to 39.6%.

The growing pay gaps between executives and average workers are not only contributing to rising income inequality, but also are inimical to economic growth. A lopsided pay balance erodes the teamwork and trust on which businesses depend. On the other hand, a narrowing pay gap can promote industrial peace and higher productivity.

Top earners and their share in total incomes are not only affected by PIT. Other taxes, such as on dividend (or profit) and corporate income which play a role for top incomes, were also lowered in past decades across OECD countries. The average statutory corporate income tax (CIT) rate declined from 47% in 1981 to 25% in 2013 and taxes on dividend income for distributions of domestic source profits fell from 75% to 42% (Figure 9).

Figure 9: Dividend income and corporate income statutory tax rates, OECD average (1981-2013)

Source: OECD (2014), "Focus on Top Incomes and Taxation in OECD Countries: Was the crisis a game changer?", May

Thus, a large part of rising inequality in advanced countries may be explained by tax reforms since the 1980s involving cuts in the top marginal tax rates for personal income, including dividend, and corporate income.

Ironically, tax cuts are often justified on the ground that they would unleash entrepreneurial spirit and hence higher investment and growth. The stylized fact revealed in Figure 3 raises doubts about the robustness of this argument in favour of tax cuts. Recent research has found that past studies showing positive growth

impacts of tax cuts were either methodologically flawed or deliberately misleading.[18] Research at the US Congressional Research Service has found that "slower growth periods have generally been associated with lower, not higher, tax rates".[19]

In a recent article, *The Economist*, which generally has a pro-business stance, found that the relationship between tax rates and growth or investment is not very strong.[20] It concludes, "the decision to invest in a country depends on a lot more than tax". Research has shown that these may include good infrastructure, high quality education, and social cohesion.[21] Recent World Bank findings from its enterprise survey show that tax incentives are not high on the list of critical factors affecting inflows of foreign direct investment (FDI).[22]

Developing countries made tax bases narrower and provided substantial targeted tax incentives to attract mobile foreign direct investment (FDI). But studies have shown that such tax incentives generally failed to bring in enough FDI to compensate for loss tax revenues.[23] Additionally, the use of tax incentives may in practice cause more harm than good because targeting mobile activities is difficult, administratively risky, and prone to rent-seeking and corruption, particularly for countries with weak administrative capacity.[24]

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[18] Alinaghi, Nazila and W. Robert Reed (2016), 'Taxes and Economic Growth in OECD Countries: A Meta-Analysis', Department of Economics and Finance, School of Business and Economics University of Canterbury, Working Paper No, 37/2016, http://www.econ.canterbury.ac.nz/RePEc/cbt/econwp/1637.pdf
Huang Chye-Ching and Nathaniel Frentz (2014), 'What Really Is the Evidence on Taxes and Growth?: A Reply to the Tax Foundation' Center on Budget and Policy Priorities, 18 February, https://www.cbpp.org/research/what-really-is-the-evidence-on-taxes-and-growth

[19] Gravelle, Jane G. and Donald J. Marples (2014), 'Tax Rates and Economic Growth', Congressional Research Service, 2 January, https://fas.org/sgp/crs/misc/R42111.pdf

[20] The Economist (2017), 'Getting the most out of business taxes: Changing rates does not make a lot of difference', 15 June, https://www.economist.com/finance-and-economics/2017/06/15/getting-the-most-out-of-business-taxes

[21] OECD (2008) noted: 'while tax is recognized as being an important factor in decisions on where to invest, it is not the main determinant. FDI is attracted to countries offering: access to markets and profit opportunities; a predictable and non-discriminatory legal and regulatory framework; macroeconomic stability; skilled and responsive labour markets; and well-developed infrastructure. All of these factors will influence the long-term profitability of a project.' See OECD (2008), 'Tax effects on foreign direct investment'. Policy brief, http://www. oecd.org/investment/investment-policy/40152903.pdf

[22] World Bank (2017), *Global Investment Competitiveness Report 2017/2018*; https://openknowledge.worldbank.org/handle/10986/28493.

[23] A 2008 IMF research paper compared the cost of concessions in terms of revenue foregone with the benefits which were marginal at best in Caribbean countries. Foregone tax revenues ranged between 9.5% and 16% of GDP per year, whereas total foreign direct investment did not appear to depend on concessions. See Chai, Jingqing, and Rishi Goyal (2008), 'Tax concessions and foreign direct investment in the Eastern Caribbean Currency Union'. *IMF Working Paper*, WP/08/257. http://www.imf.org/external/pubs/ft/wp/2008/wp08257.pdf

[24] Abramovsky, Laura, Alexander Klemmi and David Phillips (2014), 'Corporate Tax in Developing Countries: Current Trends and Design Issues', *Fiscal Studies*, vol. 35, no. 4, pp. 559–588

IV.2 Expenditure-based fiscal consolidations

The IMF has undertaken a number of empirical studies to investigate distributional impacts of fiscal consolidations.[25] All of them found adverse consequences for income distribution.

Ball et al (2013) analysed episodes of fiscal consolidations in 17 OECD countries during 1978-2009 and found that fiscal consolidations typically had significant distributional effects by raising inequality, decreasing wage income shares and increasing long-term unemployment. Their study also revealed that spending-based adjustments have had, on average, larger distributional effects than tax-based adjustments.

The study by Woo et al (2013) of a panel of advanced and emerging market economies during 1980-2010 finds the following: (a) inequality can rise due to fiscal consolidations through various channels including their effects on unemployment; (b) spending-based consolidations tend to worsen inequality more significantly, relative to tax-based consolidations; (c) the composition of austerity measures matters: progressive taxation and targeted social benefits and subsidies introduced in the context of a broader decline in spending can help offset some of the adverse distributional impact of consolidation.

Furceri et al (2018) examined impacts on inequality of unanticipated fiscal shocks in 103 developing countries during 1990-2015. Their findings reveal that (a) unanticipated fiscal consolidations lead to a long-lasting increase in income inequality, while fiscal expansions lower inequality; (b) on average a cumulative decrease in government spending of 1% of GDP over 5 years is associated with a cumulative increase in the Gini coefficient over the same period of about 1 percentage point; (c) (unanticipated) fiscal consolidations lead to an increase in poverty.

In addition to the channels identified in the above studies, the manner in which fiscal consolidations are achieved also matters. For example, in many instances, cuts in basic social services and transfers such as pension, unemployment, education, health or disability benefits were implemented when top marginal rates for corporate and personal incomes were also cut, or large financial institutions were bailed out. Income gaps widens when 'Robin Hood' is reversed - cut public spending on the low-income and vulnerable individuals while handing tax cuts to corporations and rich individuals or bail out 'too-big-to-fail' financial institutions.[26]

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[25] Ball, Laurence, Davide Furceri, Daniel Leigh, and Prakash Loungani (2013), 'The Distributional Effects of Fiscal Consolidation', *IMF Working Paper* No. WP/13/151, June
Woo, Jaejoon, Elva Bova, Tidiane Kinda,and Y. Sophia Zhang (2013), 'Distributional Consequences of Fiscal Consolidation and the Role of Fiscal Policy: What Do the Data Say?', *IMF Working Paper* No. WP/13/195, September
Furceri, Davide, Jun Ge, Prakash Loungani, and Giovanni Melina (2018) 'The Distributional Effects of Government Spending Shocks in Developing Economies', *IMF Working Paper* No. WP/18/57

[26] See Goodman, Peter. S. (2018), "Britain's Big Squeeze: In Britain, Austerity Is Changing Everything", *The New York Times*, 28 May,

David Stuckler and Sanjay Basu investigated the human cost of austerity-based fiscal consolidations, especially when governments have axed spending on healthcare and social benefits.[27] They presented a mass of new data revealing how there were over 10,000 additional suicides and an estimated million extra cases of depression globally since governments started introducing austerity programmes in 2007. The work of Stuckler and Basu shows why governments' fiscal decisions matter.

IV.3 Privatization and PPPs

John Nellis and Nancy Birdsall have done a comprehensive review of research findings on the distributional impact of privatization.[28] They concluded that almost all privatization programmes did much more to enhance efficiency than equity. At least initially, privatization worsened wealth distribution and, to a lesser extent, income distribution. The increase in inequality varied across countries, from slight (in Latin America) to very large (e.g., in Russia and other transition economies). They further observed that adverse distribution impacts reduced the efficiency gains of the privatization process or long-term gains to the economy.

The adverse distributional impacts of privatization arose due to job loss, under-priced public asset sales and poor post-sale revenue streams, and reduced access due to price rises. Privatization may affect real income net of taxes if its fiscal effects differentially reduce the tax burden across households or differentially increase benefits of such government services as education and health, funded by new tax flows.

Studies of PPPs also conclude that they tend to exacerbate inequality by enriching politically well-connected businesses who profit from such projects, thus accumulating even more wealth at the expense of others. The more governments pay for such purposes, the less they have to spend on social services, including universal healthcare and social protection.

A research report for the UK Department for International Development found "a considerable and growing body of evidence which suggests that the greater portion of the public money spent on such partnerships produces, at best, no significant effect on the urban poor. At worst, much of the expenditure may actually lead to increased poverty by diverting public money and energies away from service delivery, subsidising corporate profits, and increasing social exclusion".[29]

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https://www.nytimes.com/2018/05/28/world/europe/uk-austerity-poverty.html?rref=collection%2Fissuecollection%2Ftodays-new-york-times&action=click&contentCollection=todayspaper®ion=rank&module=package&version=highlights&contentPlacement=1&pgtype=collection

[27] Stuckler, David and Sanjay Basu (2013) *The body economic: Why austerity kills*, London: Allen Lane

[28] Birdsall, Nancy and John Nellis (eds) (2005) *Reality check: the distributional impact of privatization in developing countrie*s, Washington DC: Centre for Global Development. Also see Birdsall, Nancy and John Nellis (2003), "Winners and Losers: Assessing the Distributional Impact of Privatization," *World Development*, Vol 31, No, 10, pp. 1617-1633.

[29] Cashdan, Ben (1998). "Public-Private Partnerships for Local Economic Development and their Impact on Poverty and Inequality".

In its most recent evaluation of the World Bank's involvement in PPPs, the Independent Evaluation Group highlights the need "to shed more light on important aspects of public service delivery - for instance, access, pro-poor aspects, and quality of service delivery."[30] It lamented that there is "not a single project with data available for all of the above-mentioned dimensions" and those on and pro-poor and fiscal effects are particularly sparse. Similarly, an IFC literature review on the gender impact of PPPs concludes that, despite policy level commitment, there is very little evidence of infrastructure projects taking conscious action on gender.[31]

Thus, although privatization and PPPs are seen as instruments to improve governments' fiscal space, in most cases, the outcome has not been very encouraging. But they have worsened income distribution and access equity.

V. Recreating distributive fiscal policy[32]

This section argues for recreating distributive fiscal policy to address the challenge of rising inequality. Following Lusting and Higgins (2012),[33] the discussion distinguishes between stock of income-generating assets (private and public) and receiving income flows (private and public) in order to identify distributive fiscal policy instruments.

Recent decades have witnessed tremendous concentration of wealth in the hands of few. There is no disagreement that asymmetric wealth distribution generates asymmetric labour and especially capital income flows, resulting in market or pre-tax income inequality. For example, Oxfam's *Reward Work, Not Wealth* report reveals

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https://assets.publishing.service.gov.uk/media/57a08da240f0b64974001982/R6911.pdf. In a major report, Oxfam (2014) warned that large-scale partnerships with the private sector could undermine Africans' land rights, exacerbate inequality and damage the environment.
https://www.oxfam.org/en/pressroom/pressreleases/2014-09-01/large-scale-partnerships-private-sector-could-undermine-africans.

[30] IEG (World Bank) 2014. World Bank Group Support to Public-Private Partnerships: Lessons from Experience in Client Countries, FY02–12, https://ieg.worldbankgroup.org/Data/reports/ppp_eval_updated2_0.pdf

[31] https://ppp.worldbank.org/public-private-partnership/sites/ppp.worldbank.org/files/documents/PIDG-IFC_Gender%20Impact%20of%20Private%20Public%20Partnerships%20in%20Infrastructure.pdf

[32] This section draws on Kohler, Pierre (2015), 'Redistributive Policies for Sustainable Development: Looking at the Role of Assets and Equity', *UNDESA Working Paper* No. 139, http://www.un.org/esa/desa/papers/2015/wp139_2015.pdf

[33] Lustig, Nora and Sean Higgins (2012) 'Commitment to Equity Assessment (CEQ): Estimating the Incidence of Social Spending, Subsidies and Taxes Handbook,' Tulane University Department of Economics Working Papers no. 1219.

that the world's wealthiest 1% got 82% of the wealth generated in 2017, while the bottom 50% saw no increase at all.[34]

Therefore, tackling rising wealth inequality and wealth concentration is key to preventing rising income inequality. Governments need to political will to implement policies of direct wealth transfers, through such measures as land reform and nationalization of financial institutions. These have to be supplemented with on-going wealth distributive tax measures, such as wealth or inheritance tax, property tax, etc. in order to prevent reoccurrence of wealth concentration.

An important policy message is that governments have to carefully assess their privatization and PPP programmes that have contributed to skewed wealth concentration and governments' fiscal risks.

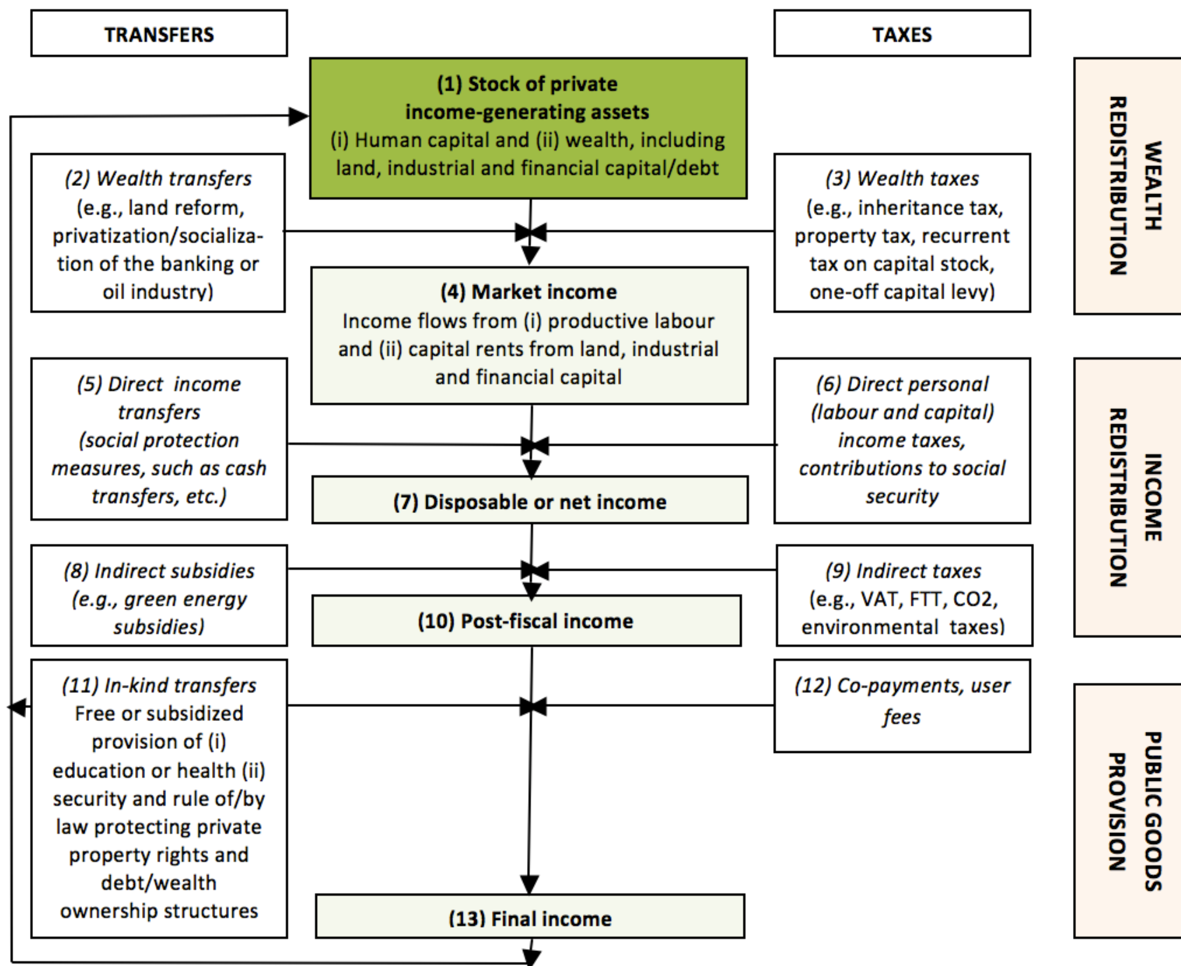
Figure 10 is a flow chart showing how various taxes and transfers can redistribute private income-generating assets and the flows of income from them. Private income-generating assets include properties (e.g. land or real estate) as well as industrial and financial capital. They also include human capital embodied in people, such as education and skills.

Progressive direct taxes and direct transfers are two main instruments to reduce market income inequality and stabilize disposable income to protect vulnerable individuals against shocks. The IMF's analysis did not find any robust justification for the decline in tax progressivity from the perspective of optimal taxation theory.[35] Nor did it find any strong evidence that lower tax progressivity significantly stimulates growth. On the other hand, as documented in the previous Section, the decline in tax progressivity has worsened income inequality considerably. Thus, the IMF concludes, "there would appear to be scope for increasing the progressivity of income taxation without significantly hurting growth for countries wishing to enhance income redistribution".[36]

However, given the increased dependence on regressive indirect taxation, countries need to strengthen their progressive transfer measures, such as social protection, cash transfer or universal basic income. Improving access to quality healthcare and education is crucial for achieving equity of opportunities or addressing inequality in human capital. This would require expanded public provisioning of such basic services and increased public social expenditure.

[34] OXFAM (2018), *Reward Work, Not Wealth*, https://www.oxfam.org/sites/www.oxfam.org/files/file_attachments/bp-reward-work-not-wealth-220118-en.pdf
[35] IMF (2017), *Fiscal Monitor*, October
[36] Ibid, p. 13

Figure 10: Redistributive fiscal policy instruments for private income-generating assets, and private income flows



Source: Kohler, Pierre (2015), 'Redistributive Policies for Sustainable Development: Looking at the Role of Assets and Equity', UNDESA Working Paper No. 139, http://www.un.org/esa/desa/papers/2015/wp139_2015.pdf

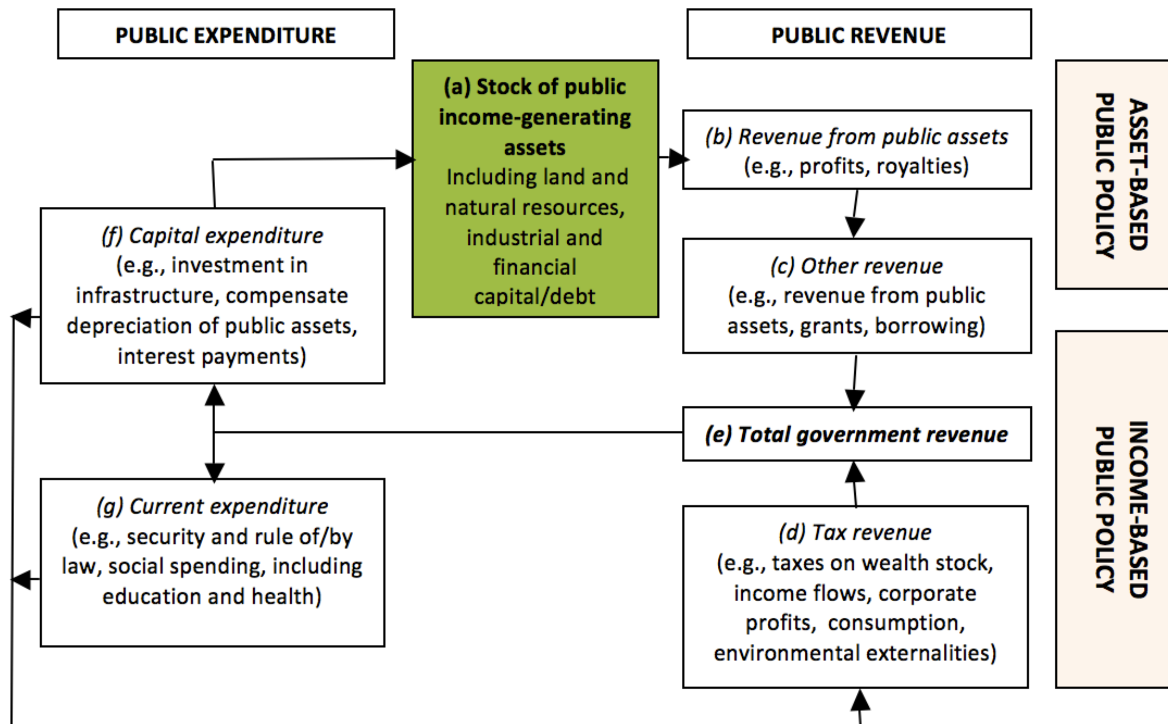
An important policy message is that governments have to carefully assess their austerity-based fiscal consolidations that had serious adverse impacts on human capital accumulation, and exacerbated poverty and inequality.

Obviously, redistributive policy instruments for income-generating private assets and income flows have implications for public assets and public income-expenditure flows. Hence, they should shape public policies as shown in Figure 11 which distinguishes between 'asset-based' and 'income-based' public policies.

For example, taxes (including corporate taxes) raise public revenues and transfers generate public expenditure. As highlighted earlier, governments' privatization programmes shifted massive amount of public income-generating assets to the private sector since the early 1980s. This weakened the capacity of governments to conduct asset-based public policies. As a result, governments are increasingly

relying on income-based public policies to fund their current and capital expenditures.

Figure 11: fiscal policy instruments for public income-generating assets and the public revenue-expenditure flows



Source: Kohler, Pierre (2015), 'Redistributive Policies for Sustainable Development: Looking at the Role of Assets and Equity', UNDESA Working Paper No. 139, http://www.un.org/esa/desa/papers/2015/wp139_2015.pdf

Therefore, strengthening their tax system and improving its progressivity become critically important. However, re-nationalization of some of the assets which are vital for equity should be considered. For example, the successful re-municipalization of Paris water supply in 2009 has become an inspiring model for many other cities both in France and abroad.[37] Several South American countries also adopted re-nationalization programmes in the early 2000s. However, re-nationalization programmes should be carefully designed and not driven by just populist back-lash.

VI. Concluding remarks

This paper reviewed the changing role of fiscal policy's redistributive role, both as a direct tax and transfer instruments as well as through stabilization. This trend coincided with a significant rise in income and wealth inequality across countries – developed and developing. Thus, the paper has argued for reversal of this trend,

[37] https://in.reuters.com/article/water-utilities-paris/pariss-return-to-public-water-supplies-makes-waves-beyond-france-idINL6N0PE57220140708

especially when the developments cannot be justified from both theoretical and empirical perspectives.

The decline of fiscal policy's role as a tool for economic stabilization and redistribution since the early 1980s has seen the rise of monetary policy as a dominant macroeconomic policy tool. This has significantly impacted both income and wealth inequality. Thus, the discussion of fiscal policy's role in addressing inequality will be incomplete without some discussion of monetary policy, as they are not only complementary, but also have independent redistributive impacts.

For example, inflation-targeting monetary policy since the early 1990s shifted the focus of macroeconomic policy from full employment to strict price stability. This has made not only monetary policy dominant over fiscal policy, but also both monetary and fiscal policies pro-cyclical. This has exacerbated the impact of a recession on unemployment and poverty. Secondly, blanket monetary tightening to keep inflation at a low single digit level regardless of causes of inflation had adverse impacts on financial inclusion, especially for SMEs.

Thirdly, it is now widely agreed that non-conventional monetary policy, known as quantitative easing (QE) during the recent financial and economic crisis (the 2008-2009 Great Recession) has contributed to uneven asset price inflation with financial asset prices growing much faster than non-financial asset prices. For example, the European Central Bank has acknowledged that quantitative easing (QE) has fuelled asset price inflation.[38] Kevin Warsh, a former US Federal Reserve Board member, has argued that QE has only worked through the 'asset price channel', enriching those who own financial assets, not the 96% who mainly rely on income from labour.[39] Thus, the QE has contributed to rising wealth and income inequality, while fiscal policy remained focused on austerity further exacerbating the situation.

The decline of fiscal policy reflects in part a significant change in the prevailing economic philosophy of governments, a return to a view that changes in liquidity are both more effective and more desirable than are variations in income as a means of regulating the economy. In part, it also stems from a belief that monetary policy is par excellence a non-discriminatory policy for regulating general economic activity.

However, even though monetary policy may be administered uniformly, it does not follow that it is therefore "neutral" as between the various claimants upon the resources of the economy. Uniform policies are neutral when applied under uniform circumstances; when the underlying conditions are not comparable, such policies may be highly discriminatory in their effect. A uniform monetary policy without allowance for special circumstances and needs is no more likely to be "neutral" as between different sectors of the economy than would be a uniform income tax imposed on all incomes without exemption.

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[38] https://www.ecb.europa.eu/pub/annual/html/ar2016.en.html#IDofChapter1_2_1_Box5
[39] https://www.forbes.com/sites/jonhartley/2015/06/25/how-federal-reserve-quantitative-easing-expanded-wealth-inequality/#74499ca421eb