TACKLING INEQUALITY ON ALL FRONTS

A comprehensive mix of fiscal policies can curb inequalities at every stage where they emerge

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The COVID-19 pandemic appears likely to worsen inequalities in an enduring way, further widening the gap between haves and have-nots in advanced economies and reversing progress in developing economies. Many low-skilled workers, young people, and women have lost income and job opportunities. The pandemic has also accelerated long-term trends, such as automation and digitalization, that could soon make many jobs obsolete. Massive disruptions in learning threaten to leave long-lasting scars on opportunities for today's youth. Unequal access to vaccines and lagging recoveries put low-income countries further behind.

Various aspects of inequality—in income, wealth, educational attainment, gender, health, opportunities—are closely related and mutually reinforcing. For instance, education and gender inequalities combine to weaken women's ties to the labor market, which can lead to a lifetime of precarious employment or lower earnings. Similarly, inequalities in income can be perpetuated through lower intergenerational mobility. Given its complexities, a single policy tool cannot address inequality. A comprehensive policy approach is needed.

More than redistribution

To tackle inequality, policies need to focus both on market income—income before taxes and transfer payments, or *predistribution*—and disposable income after *redistribution* through taxes and transfers. Predistributive public policies aimed at narrowing differences in market incomes at their source, such as through public education, help ensure an equal playing field. While necessary, such policies are not sufficient to limit inequalities. Public intervention through social transfers and taxes is needed to help people cope with various life events related to unemployment, aging, family, disability, or sickness.

Effectively tackling inequality requires a mix of policy instruments aimed at leveling the playing field before people enter the labor market, ensuring that labor market conditions remain fair and socially acceptable, and bringing the necessary corrections to inequalities through redistribution (see Chart 1). Countries that spend more on social sectors (including education, health, and social protection) and have more redistributive tax systems tend to be more successful on average in reducing inequality (see Chart 2). In this respect, fiscal policy is the most agile and effective tool to curb inequalities at each stage of their emergence.

Opportunities and incentives

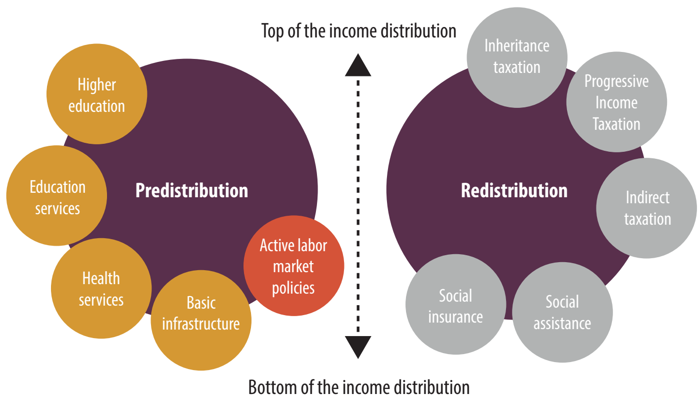
Fiscal policies can create opportunities for those who would otherwise be disadvantaged. In many economies, advanced and emerging alike, large disparities exist between higher- and lower-income households in terms of access to quality education, health care, and digital technologies. These disparities put children in unequal starting positions.

Public spending can, in part, compensate for the gap between rich and poor in private spending on children and help reduce the importance of parental background and other circumstances that are beyond an individual's control. This is achieved through efforts to ensure access to basic public infrastructure, such as clean water and sanitation; basic health services; and social investments—for instance, in education. These policies can increase intergenerational mobility and also, by facilitating

Chart 1

Upstream and downstream

Fiscal policy tools can affect inequality before and after it develops. Some have a greater impact on people on the higher rungs of the income distribution, while others benefit those on the lower rungs more.

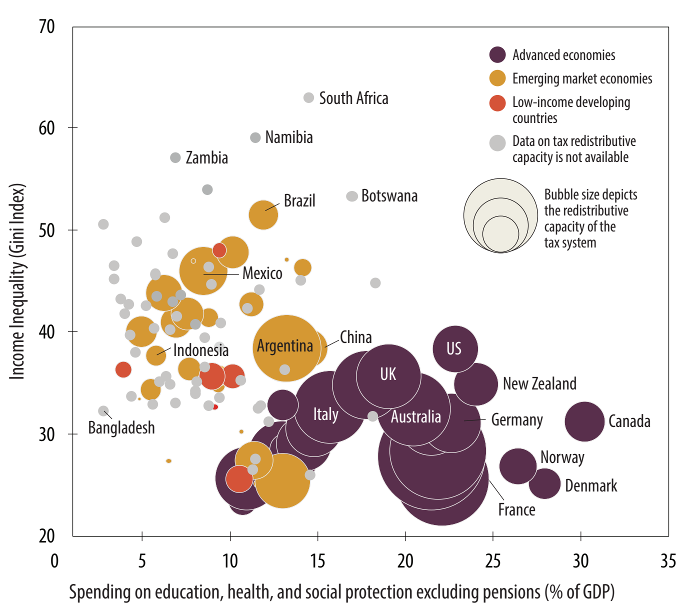


Source: IMF staff.
Note: The spheres represent different fiscal policy tools for reducing inequality. Those on the left help correct inequality primarily at the predistribution stage, those on the right at the redistribution stage. The vertical position of the tools shows where they have the most impact on the income distribution scale. Yellow = basic public services; gray = transfers or taxes; red = labor market policies.

Chart 2

Social expenditure, taxation, and inequality

Countries with higher social spending and more redistributive tax systems tend to have less inequality—though inequality is complex, and other factors are at play.
(income inequality, Gini Index)



Sources: IMF FAD Expenditure Assessment Tool; IMF FAD Income Inequality Dataset (Gini); IMF Government Finance Statistics; and IMF Working Paper 21/252, "Measuring the Redistributive Capacity of Tax Policies."
Note: The Gini index measures the extent to which the distribution of a variable, such as income or wealth, among individuals or households within an economy deviates from a perfectly equal distribution. A Gini coefficient of 0 represents perfect equality, while a coefficient of 1 implies perfect inequality.

human capital formation, can enhance long-term growth, particularly by increasing education levels among children from disadvantaged backgrounds. Public spending on basic services can be a priority where access gaps are large. However, the type of spending needs to be carefully assessed given country-specific circumstances. For instance, spending on higher education might benefit mostly richer households.

Fiscal policies can also influence inequality by providing incentives for labor market participation or children's education. For example, labor supply and employment can be affected by labor tax wedges, the difference between a worker's take-home pay and the corresponding total labor cost for the employer, and by participation tax rates, the difference between replacement income received by an unemployed person and his or her expected earnings. This is especially true for second earners. Refundable tax credits for low-income families, individualization of personal income tax filing, and more widely available and affordable childcare could reduce gender bias and encourage labor force participation. Conditional cash transfers, in addition to reducing poverty, can provide incentives for school attendance or regular health checkups.

Active labor market policies can support efficient functioning of labor markets, for instance through public employment services that assist the unemployed in finding suitable jobs or government-sponsored vocational training for those most excluded from the labor market. On the demand side, worker retention programs, which have been developed massively in advanced economies throughout the recent crisis, have helped governments invest in maintaining employment linkages. This has contributed to smoother recoveries and helped avoid massive job losses and business failures that would have fed inequality.

Redistribution

Redistributive policies can curb labor income inequalities. Direct taxes and transfers jointly reduce income inequality by more than one-third in advanced economies. However, in emerging market economies the extent of redistribution is much smaller. Overall redistribution accounts for 85 percent of the disposable income inequality between advanced and emerging market and developing economies. Social transfers help reduce inequality mostly at the bottom, and taxation at the top.

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Importantly, most of the redistribution is achieved through social transfers—social assistance, unemployment insurance, or pensions. The coverage of the most vulnerable groups and adequacy of the benefits rather than the aggregate level of spending determine the effectiveness of social transfers in terms of reducing poverty and inequality. As is often the case in policymaking, the design is crucial. Well-targeted transfers can help support vulnerable groups while keeping costs manageable. In this respect, the leap in digitalization is a new opportunity for governments. For example, it makes the identification of households and verification of eligibility easier and quicker. As a result, governments can improve coverage and targeting and reduce leakages through fraud, corruption, or errors. More progressive taxation, along with mobilizing revenues to finance social spending, has a large potential to reduce inequality, especially in countries where taxation is relatively low in terms of its overall burden and in its progressivity. Countries can achieve more redistributive tax systems through higher top marginal income tax rates, (in-work) tax credits for low-income households, and limiting loopholes in the taxation of capital income (dividends, interest, and capital gains).

Tax policy and administration reforms are also crucial for raising additional revenues, especially in countries with weak tax capacity, to provide financing for social spending. Indirect taxes, such as value-added tax and excises, are major revenue sources for most governments, and they are relatively easy to enforce and collect. While consumption taxes could be regressive, they can support equity objectives if they are used to finance basic public services, such as health care, education, and infrastructure. This is because poor households benefit more from these services than rich households, in proportion to their incomes.

Significantly raising revenues from direct taxes requires strong governance reforms and making use of opportunities from digitalization. Among these are real-time data on household expenditures, which can facilitate progressive taxation of consumption. International registers for asset ownership and greater transparency create additional revenue opportunities. Tax administration reforms can generate resources for higher spending on health, education, and social protection.

Navigating conflicting tensions

Fiscal policy often implies trade-offs. Governments have to prioritize under tight budget constraints. The current crisis has heightened these trade-offs. While fiscal policy has helped maintain livelihoods and contributed to the swift recovery, it came at a cost of unprecedentedly high debt levels in advanced economies. Many low-income developing countries face high risks of debt distress. Given the debt vulnerabilities, many countries will need to implement policies over the medium term to bring deficits sustainably down.

This fiscal adjustment will take place in a more challenging environment amid rising spending pressures from population aging, climate change, and acceleration of digitalization. Many countries will need to maintain higher health care spending and increase education spending.

Governments can navigate these heightened trade-offs—on the one hand, the need to reduce fiscal vulnerabilities and on the other hand, to support inclusive recovery—through appropriate policy design anchored in credible medium-term fiscal strategies. Experience with IMF-supported programs shows that it is possible to implement fiscal adjustment while mitigating the negative impact on vulnerable groups. These medium-term policies would need to take into account country-specific circumstances. Countries facing significant fiscal pressures from aging populations should adopt structural pension and health care reforms. Others could focus on eliminating wasteful subsidies and on improving efficiency of spending on public investments and goods and services. Many countries can boost revenues by broadening their tax bases and strengthening administrative capacities. FD

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