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We do not have to live with the scourge of inequality

By Jonathan Ostry

A more redistributive tax system appears to lead to higher growth, says Jonathan Ostry

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Rising inequality is widely seen as a plague. But policy makers have been reluctant to take steps to reverse it, fearing that this would distort incentives and stunt prosperity and economic growth.

It is often said that political power is more equally distributed than economic power, especially in democracies, and that this creates pressure to tackle inequality. Some say it is the policy of redistribution, rather than inequality itself, that is antithetical to economic growth. For most policy makers, redistribution has a bad name: a false cure that may be worse than the disease of inequality itself.

Yet economists are divided on the issue. Some emphasise the disincentives to work and invest that result from high taxes and transfers. But others have argued that redistribution need not be detrimental to growth. If progressive taxation is used to finance public infrastructure, or health and education benefits for the less well-off, it may actually contribute to economic growth. Sharing wealth more equally may actually help produce more wealth overall.

That, anyway, is the theory. But does it work in practice? That is a question that my colleagues Andrew Berg, Haris Tsangarides and I have set out to answer in recent research.

We looked at recently assembled data on pre and post-tax inequality in a large cross-section of developing and developed countries. By comparing the two, we could work out how much redistribution takes place through the fiscal system in each country. We have two striking results.

First, inequality matters, not only for its own sake but also because it makes an important difference to the level of economic growth. More unequal societies have slower and more fragile economic growth. It would thus be a mistake to imagine that we can focus on economic growth and let inequality take care of itself. Importantly, we established that growth is faster in more equal societies than in less equal ones, regardless of whether they have highly redistributive tax systems. The lower growth observed in highly unequal societies does not seem to be a side-effect of redistribution, as some people have claimed.

Second, we found little to suggest that a modestly redistributive tax system has an adverse effect on growth. True, there are some signs that highly redistributive tax systems – the top 25 per cent of our sample – may crimp economic performance. But the levels of redistribution seen on average in the broad cross-section of countries we looked at seem to have had negligible direct effects on growth.

Put these two observations together and you come to an important conclusion for policy. Making the tax system modestly more redistributive seems to have little direct effect on growth. Over time, however, it will result in a more equal distribution of income – and that, in turn, seems to lead to higher growth. Taking into account the direct effect of redistribution, and the indirect effect that operates through reduced inequality, we find that average levels of redistribution are associated with higher and more durable growth. Even large redistributions – undertaken presumably with the goal of improving equality – do not seem to carry a clear growth cost.

We are not passing judgment on broad macroeconomic policies. Nor are we saying that countries wishing to enhance the redistributive role of policy should forget the need to ensure that the tax system does not give rise to perverse incentives. This is particularly important when governance and administrative capacity are weak. And caution is always warranted in drawing policy implications from cross-country empirical analysis of the kind that we have conducted. Corroboration must be sought elsewhere.

But we do see an important lesson. If there were a big trade-off between redistribution and growth, as has long been assumed, one would expect to see evidence of it in a study like ours. Our conclusion is rather that the measures that governments have typically taken to reduce inequality do not seem to have stunted growth.

In some quarters, rising inequality has been met with a defeatist attitude. Yet inaction in the face of inequality seems unlikely to be warranted as a standard policy prescription.

The writer is deputy director of the research department of the IMF. The views expressed here are his own and not those of the IMF

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Spread wealth but not by high taxes