

This article was prepared by staff of the IMF's Fiscal Affairs Department.

Should Equity Be a Goal of Economic Policy?

During periods of economic expansion, people see their incomes rise and living standards improve. Even in good times, however, an unfortunate few may be left behind. When and how should governments intervene to ensure not only that the size of the pie increases, but that everybody gets a fair share?

SINCE the beginning of the 1990s, global output has risen by more than 3 percent annually, and inflation has slowed in most regions. Some groups and individuals have done better than others, however, and income disparities have grown in many countries, developed as well as developing. If economic growth and equity do not always go hand in hand, how should policymakers respond? This is one of the most pressing issues facing policymakers today.

The importance of equity

Different societies have different perceptions of what is equitable, and these social and cultural norms shape the policies they will adopt to promote equity. Although there is a consensus that extreme inequality of income, wealth, or opportunity is unfair and that efforts should be made to raise the incomes of the poorest members of society, there is little agreement on the desirability of greater income equality for its own sake or on what constitutes a fair distribution of income. Equity issues are especially complex because they are inextricably intertwined with social values, but economic policymakers need to devote greater attention to them, for a number of reasons:

- Some societies may view equity as a worthy goal in and of itself because of its moral implications and its intimate link with fairness and social justice.
- Policies that promote equity can help, directly and indirectly, to reduce poverty. When incomes are more evenly distributed, the number of individuals below the poverty line decreases. Equity-enhancing policies,

particularly investment in human capital, can, in the long run, boost economic growth, which, in turn, has been shown to alleviate poverty.

- Increased awareness of the discrimination suffered by certain groups because of their gender, race, or ethnic origin has focused attention on the need to ensure that these groups have adequate access to government services and receive fair treatment in the labor market.

- Many of today's policies will have an impact on the welfare of future generations, which raises the issue of intergenerational equity. For instance, the provision of very generous pension benefits to current retirees could be at the expense of tomorrow's retirees—an important issue in many transition and industrial countries.

- Policies that promote equity can increase social cohesion and reduce political conflicts. To be effective, most policies require broad political support, which is more likely to be forthcoming when the distribution of income is seen as fair. However, macroeconomic adjustment that entails growth-enhancing structural reforms may increase unemployment and worsen inequality in the short run. In such circumstances, it is critically important to have well-targeted social safety nets to shelter the consumption levels of the poor.

Growing inequality

The degree of income inequality varies greatly from region to region. It is greatest in Latin America and sub-Saharan Africa, and lowest in Eastern Europe; other regions fall

between these two extremes. In Latin America, the average Gini coefficient—the most commonly used measure of inequality, with 0 representing perfect equality and 1 representing total inequality—is almost 0.5. The average Gini coefficient in sub-Saharan Africa is slightly lower, but there is considerable variation among countries. Income inequality has a regional dimension in both Africa and Latin America—average incomes are significantly higher in urban areas than in rural areas.

In recent years, income inequality has been increasing in a large number of countries. This increase has been most striking in the transition economies, where the average Gini coefficient had been around 0.25 until the late 1980s; by the mid-1990s, it had risen to more than 0.30. While this may not appear to be a large increase, it is quite significant for the short period being assessed. Gini coefficients tend to be relatively stable in countries over long periods. Income inequality has also increased in several major industrial countries and is beginning to increase in some East Asian countries.

Much of the debate about income distribution has centered on wage earnings. But wages tell only part of the story. The distribution of wealth (and, by implication, capital income) is more concentrated than labor income. In Africa and Latin America, unequal ownership of land has been identified as an important factor in the overall distribution of income. Furthermore, in recent years, there has been a shift from labor to capital income (including income from self-employment) in many countries. In transition countries, this shift has been due primarily to the privatization of state-owned assets. The analysis of trends in nonlabor income in countries with well-developed capital markets and pension funds is more complicated. Pension funds and other financial institutions receive a sizable portion of capital income, and the share of capital income in total household income typically changes over the life cycle of the individuals in each household.

Is globalization the cause?

Globalization has linked the labor, product, and capital markets of economies around the world. Increased trade, capital and labor movements, and technological progress have led to greater specialization in production and the dispersion of specialized production processes to geographically distant locations. Developing countries, with their abundant supply of unskilled labor, have a comparative advantage relative to developed countries in the production of unskilled-labor-intensive goods and services. As a result, production of these products in developed countries has come under increased competitive pressure. Economic theory tells us this should apply downward pressure on the relative compensation of unskilled workers in developed countries and upward pressure on the compensation of their counterparts in developing countries.

Based on this theory, some authors have claimed that globalization is to blame for growing income inequality in developed countries. Others argue that the widening gap

between the wages of skilled workers and unskilled workers in the developed countries is due to the development and dispersion of skill-intensive technologies rather than to increased trade. Several empirical studies have tried to gauge the relative importance of both trade and technological progress in the decline of relative wages of unskilled workers in developed countries. Estimates of the contribution of increased trade to the total increase of the wage differential between unskilled and skilled workers range from negligible to 50 percent. This large variation is a function of the structure of production in developed countries and the share of their labor market that is in direct competition with low-skilled workers in developing countries.

The debate regarding the effect of globalization on income distribution in developing countries mirrors the debate on developed countries. Although, all other things being equal, increased openness would be expected to increase the relative wages of unskilled workers in developing countries, experience has been mixed. Evidence suggests that the relative wages of unskilled workers increased in East Asian countries in the 1960s and 1970s but decreased in Latin America in the 1980s and early 1990s. There are two possible explanations for why wages fell in Latin America: first, the opening up of developing Asian countries—Bangladesh, China, India, Indonesia, and Pakistan—where unskilled labor is even more abundant; second, the availability of new production technologies that are biased toward skilled labor.

The effect globalization has on income distribution seems to be determined to some extent by a country's level of development and the technologies available to it. Similarly, exposure to international competition may change institutions (for example, trade unions) and thereby affect income distribution. Some observers contend that, because of the mobility of capital, globalization limits the ability of union workers to achieve a "union wage premium," thus decreasing the bargaining power of workers vis-à-vis capital. In addition, globalization may lead to sharp short-run changes in the distribution of income, as barriers to trade are reduced and the distribution of production is reallocated among sectors.

It is often argued that globalization makes it more difficult for governments to implement equitable policies. Increasingly mobile capital and labor have limited the ability of governments to levy taxes and transfer income to those affected by globalization. To the extent that capital is more mobile than labor, the incidence of taxes to finance safety nets for those affected by globalization is shifted to labor.

Policy responses

The extent to which countries have focused on promoting equity and the strategies they have adopted vary widely. Some countries have actively promoted the use of public resources to raise the incomes of those on the bottom tier of the income distribution. Others have focused on the top percentiles by levying highly progressive taxes. Yet others, concerned that policies targeting the poor may result in

economic inefficiencies and distortions that retard growth, have taken an indirect approach, seeking to help low-income families by stimulating overall economic growth.

In Latin America during the 1980s, the primary goal of policymakers was achieving sustainable growth, and a viable balance of payments and structural reforms were seen as critical to achieving this goal. Growth has also been one of the primary goals of the transition economies, but their strategies have included policies aimed at helping groups likely to be hurt by the transition. Such policies have included the distribution of shares of privatized enterprises, the adaptation of social policy instruments to protect vulnerable groups, and the establishment of social safety nets (for example, targeted subsidies, cash compensation in lieu of subsidies, severance pay and retraining for retrenched public sector employees, and public works programs). However, the lack of budgetary resources has made implementation of these policies difficult.

Fiscal policy—taxation and spending—is a government's most direct tool for redistributing income, in both the short and the long run. However, the effect of redistributive tax policies, especially in the face of globalization, has been small. Policymakers should focus on developing a broadly based, efficient, and easily administered tax system with moderate marginal rates. Although the primary goal of the tax system should be to promote efficiency, policymakers also need to consider how to distribute the burden of taxation so the system is seen as fair and just.

The expenditure side of the budget offers better opportunities than the tax side for redistributing income. The link between income distribution and social spending—especially spending on health and education, through which governments can influence the formation and distribution of human capital—is particularly strong, and public investment in the human capital of the poor can be an efficient way to reduce income inequality over the long run.

The amount of resources governments can and should devote to social expenditures depends on various factors, including the tax-to-GDP ratio and the resources devoted to other spending. Public expenditures should displace private expenditures only when they yield higher social benefits. Priority should be given to the most productive public expenditures, and unproductive public expenditures—for example, excessive military spending, wages for an over-staffed civil service, and budgetary transfers to inefficient public enterprises—should be curtailed. Civil service reform and the privatization of services that can be better provided by the private sector—especially if accompanied by a reallocation of expenditures to the social sectors—are likely to be both growth- and equity-enhancing, particularly in developing countries, where public sector employees come primarily from the middle- and upper-middle-income classes.

Outlays on health and education can improve the existing pattern of income distribution, depending to a large extent on their allocation within sectors and who receives the benefits. Studies show that spending on basic health care and

primary education is far more effective in reaching the poor than spending on higher education or hospital-based curative care; the former reduces disparities in human capital across income groups and can decrease income inequality in the long run (see “Public Spending on Human Development,” by Sanjeev Gupta, Benedict Clements, and Erwin Tiongson in this issue). Studies also show that, in countries without some form of health risk pooling, serious illnesses are the single most important factor driving families into poverty.

Although fiscal policy is usually viewed as the principal vehicle for assisting low-income groups and those affected by reform programs, a number of countries have introduced specific labor market policies in an effort to influence income distribution, the rationale being that relative wages exert a strong influence on overall income inequality. Many European countries have opted for high minimum wages, generous unemployment benefits, and a wide range of job-protection measures. Although these policies can result in rigidities, advocates maintain that they help achieve a socially desirable redistribution of income, while opponents argue that they discourage new investment and dampen job creation and growth. The United States, which has opted for more flexible labor markets, has achieved high employment levels, but the cost may be greater income inequality. To mitigate the potential effect of market flexibility on low-wage workers, the United States has introduced wage subsidies that simultaneously redistribute income and promote employment. Given the potentially large impact of labor market policies on earnings, these competing visions of the labor market are central to the debate over income inequality in many developing and newly industrialized countries.

Governments can also indirectly affect income levels and distribution through monetary policy and their overall macroeconomic stance. For example, high inflation tends to curtail economic growth and increase income inequality. Trade liberalization—especially when it occurs in developing countries that have had restrictive trade policies, such as taxation of agricultural exports and protective tariffs on imports—may boost economic growth and lead to more equitable conditions. Currency devaluations may also have implications for equity, particularly in low-income countries, where the poor are often concentrated in the agriculture-intensive export sector and middle- and upper-income urban dwellers tend to be more dependent on imports.

Another important issue is whether governments should focus on outcomes—such as decreasing the number of people living in poverty—or on ensuring that all members of society have equal opportunities. In extreme cases of income inequality, outcomes are clearly critical. In other cases, setting up a level playing field may be all that is necessary, and greater emphasis can be placed on policies that facilitate mobility between income classes and on ensuring that income and wealth are acquired justly and fairly. Measures governments can take to promote equality of opportunity include deregulating the economy; setting up strong, accountable institutions,

including a well-functioning judicial system; reducing opportunities for corrupt practices (curbing corruption can directly reduce income inequality, because the gains from corrupt practices tend to be captured by the well-to-do); and providing adequate access to health and education services.

Governments seeking to implement equity-oriented policies face a number of obstacles. First and foremost is the financing required: high levels of spending on targeted programs may not be consistent with a sustainable macroeconomic framework. Second, governments in many developing countries, where a large share of the population is engaged in rural and informal sector activities, may be unable to reach the most vulnerable groups. The rural and informal sectors may have limited interaction with formal sector institutions, including the government, making the delivery of government assistance (for example, cash transfers) problematic. In a similar vein, a lack of administrative capacity may hamper redistributive efforts; for example, tax evasion is a severe problem in countries with weak tax administration, making it difficult for governments to use the tax system as a vehicle to finance redistributive policies. Political constraints—low-income groups typically have less political power than other interest groups—may impede efforts to reallocate spending toward the poor or redistribute land or other assets to them. Legal impediments may also prevent governments from taking measures to promote equity—for example, constitutional rules on revenue sharing may limit the amount of resources a central government can allocate to redistributive policies.

Implications for the IMF

Because its advice on macroeconomic and structural issues has implications for income distribution, the IMF has no choice but to address equity issues in its discussions with member countries. However, its involvement in these issues must be seen in the context of its mandate, as laid out in the

IMF's Articles of Agreement—to promote international monetary cooperation, the balanced growth of international trade, and a stable system of exchange rates. It is in fulfilling this essentially macroeconomic mandate that the IMF can contribute to sustainable economic and human development. To help member countries achieve greater equity, the IMF has advocated the following in its advice:

- Macroeconomic policies that secure low inflation and a viable balance of payments position and thus provide a framework within which growth can flourish;
- Structural policies that enhance an economy's growth potential;
- The promotion of good governance and transparency in public sector operations;
- The promotion of sound fiscal policy, including the implementation of a fair and efficient system of taxation; the reduction of unproductive public expenditures; and the reallocation of spending to activities that are most beneficial to the poor, such as providing basic health care and primary education; and
- Well-targeted social safety nets to mitigate the adverse short-term effects of, and ensure political support for, reforms designed to achieve macroeconomic stability and remove impediments to long-term sustainable growth.

Following the recent internal and external reviews of its Enhanced Structural Adjustment Facility (ESAF), the IMF is strengthening its ESAF programs by systematically incorporating social safety nets into them and more rigorously monitoring the composition of expenditure. **F&D**

This article is based on a paper prepared by the Expenditure Policy Division of the IMF's Fiscal Affairs Department for a conference on economic policy and equity, which was sponsored by the IMF and held in Washington on June 8–9, 1998.

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