INEQUALITY AND POLICY: THEORY AND EVIDENCE

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ABSTRACT

Income inequality remains a major social and economic challenge for both economic and political reasons. This paper shall aim to dissect and study a few of the aspects of the nature of inequality and policy. The first section of the paper serves as the introduction whereas the second section delves into the question of whether inequality is harmful or not. The third and the fourth sections elaborate on fiscal and social policies that deal with inequality. The fifth section presents case studies of countries' experiences in dealing with inequality through policy and the last section concludes.

KEYWORDS: *Inequality, Social Policy, Fiscal Policy*

INTRODUCTION

Since the 1990s, evidence on the amount of inequality in developing nations has become more widely available, thanks to the widespread availability of high-quality, nationally representative household surveys. This is a matter of concern as high levels of inequality have the potential to stymie progress on critical development outcomes and contradict basic conceptions of equity and fairness (Birdsall, 2010) **[1].** Today, over 60 developing countries have Gini coefficients of income disparity of more than 40, of which around three quarters are in Latin America and Sub-Saharan Africa (Huang, Morgan & Yoshino, 2019; Kanbur, Rhee & Zhuang, 2014) **[2,3].** As a result, it's no surprise that income disparities and other aspects of welfare are a major policy concern in many low- and middle-income countries around the world.

Despite this, there is no clear consensus on whether and how governments can do much to lessen inequality. One rationale is that, despite substantial fluctuations in government policy, levels of inequality within countries tend to remain relatively consistent over time (Li et al, 1998; Scheidel, 2018) **[4,5].** This viewpoint can be contested, however. Recent decades have demonstrated that government action may reduce inequality significantly in very short periods of time. Latin America, for example, had a decline in income disparity in almost all of the region's countries during the first decade of the 2000s, due to public policies that aimed at tackling the phenomenon (Alvaredo & Gasparini, 2015; Lustig, Lopez-Calva & Ortiz-Juarez, 2013a). [**6,7]**

In this chapter, we outline the ways economic theory deals with the issue of inequality and investigate whether theory has been backed by empirical evidence. There are mainly two tools available to governments to deal with inequality directly: fiscal policy and increasing availability of opportunities through mechanisms that promote social mobility. This paper shall seek to touch upon the review of literature that studies the issue in question and further study analysis drawn from empirical evidence related to them. It is important to remember, however, that this chapter is mostly concerned with income disparities within countries. Of course, income is only one aspect of wellbeing, and it does not necessarily correlate favourably with other key factors like health and well-being, but it is significant enough to warrant more investigation in its own right.

Is inequality really a problem?

According to economic theory, inequality might reduce growth in three scenarios: i) if greater inequality gives birth to mistrust and people no longer trust business and pro-business policies. This may ultimately reduce the incentives to invest (Bertola 1993; Perotti 1996) **[8,9].** ii) If poor individuals are not able to afford worthwhile investments such as education and this translates into lower aggregate output (Galor and Zeira, 1993) **[10]** iii) If the adoption of advanced technologies is contingent on a minimum critical amount of domestic demand (Krueger, 2012) **[11].** Alternatively, inequality may help fuel growth if i) higher inequality incentivizes one to work harder and undertake risks to take advantage of higher rates of return (Mirrlees, 1971) [**12]** or ii) higher inequality fosters aggregate savings and capital accumulation because of the lower propensity to consume of the rich (Bourguignon, 1990) **[13].**

Empirically, studying inequality has been hard due to poor quality of the data available, limited possibilities of studying changes in income distribution and lack of an estimation approach that captures time series variation (Cingano, 2014) **[14].** Nonetheless, some have tried to investigate the impact of inequality on economies empirically. Dabla-Norris et al. (2015) **[15]** conclude that inequality matters for growth and its sustainability. They find that if the income share of the top 20 percent of the income group increased, then GDP declines over a medium term, suggesting an absence of the trickle-down effect. Alternatively, an increase in the income of the bottom 20 percentile is associated with an increase in GDP. On the other hand, a considerable amount of empirical work has found the relationship between inequality and growth to be either positive or insignificant (Li and Zou, 1998; Forbes, 2000).[4,16]

One may conclude that a substantial amount of literature consisting of theoretical and empirical studies has sought to identify whether inequality is good or harmful for growth during the last few decades. Theoretical work has provided mechanisms that support both options, and the substantial empirical literature that has attempted to distinguish between these mechanisms has mostly proved inconclusive. Nevertheless, inequality remains a concern on philosophical and moral grounds and thus, inequality reduction remains a key issue for governments the world over.

Fiscal Policy: How far can it take us?

The most obvious way for governments to combat inequality is through fiscal policy - decisions about the volume and structure of expenditure and taxation. On the one hand, progressive taxation and spending can help to reduce inequality in disposable income. On the other hand, public spending on education, for example, can assist to reduce inequality in market income by improving the human capital of lower-income households, resulting in greater salaries and earnings. This section deals with the former whereas the latter shall be a part of the second section of this paper.

According to traditional economic theory, taxation is good for the purposes of equality as it takes money from those who are earning well and helps finance redistribution programs for those at the bottom of the economic pyramid. Though this may be bad for the economy as a whole due to loss in incentives for those earning well, it has been assumed that taxation and redistribution should help combat inequality. However, empirical evidence on how beneficial has tax policy actually been is limited, and sometimes it does not corroborate with the theory.

According to Gaspar and Garcia-Escribano (2017) **[17],** fiscal policy helps offset nearly a third of income inequality. Similar results are found by Bhatti et al. (2015) **[18].** Lustig (2018) **[19]** also finds that fiscal policy unambiguously reduces inequality. However, Goni et al (2011) **[20]** study six Latin American countries and find that taxes and transfers helped reduce Gini coefficients of disposable income inequality by only one percentage points, in sharp contrast to countries of Western Europe that saw a reduction in Gini coefficients of up to ten percent. Although there is considerable variation across countries, it has been seen that the redistributive effect of fiscal policies is much lower in developing countries when compared to their OECD counterparts. This could be explained by reasons such as lower tax revenue collections and weaker institutions.

Social Policy: Myths and Realities

Scholars and politicians that advocate for social investment (SI) programmes expect that SI policies will reduce income inequality and poverty, among other objectives, however empirical evidence on whether SI policies achieve these objectives is conflicting. On the one hand, studies have shown that specific SI policies have positive consequences. Some studies, on the other hand, imply that SI policies are less pro-poor and, in certain cases, may even worsen inequality and/or poverty. This could be due to the fact that sometimes the benefits of social policies flow to the upper income classes due to intentional capture or faulty designs of programs.

Education spending, according to Huber and Stephens (2014) **[21],** reduces market income inequality. According to Huber et al. (2020) **[22],** public education funding minimises wage disparity. Similarly, Busemeyer (2015) **[23]** finds that spending on public education reduces income inequality among households. By contrast, Van Vliet and Wang (2015) **[24]** argue that social investment programmes have become less redistributive. According to their study, when Nordic countries are excluded, government spending on social policies shows a positive relation with income inequality amount eleven European countries, i.e., social policies increase inequality). When they included Nordic countries in the sample, they found no significant association between social investment spending and income inequality. Sakamoto (2021) **[25**] finds mixed evidence of the effectiveness of social policies in reducing income inequality.

Inequality and Policy in action

This section aims to elaborate on how three major developing countries - Brazil, Mexico and China- have tried to redress inequality and how successful they have been in their goal. Though studying inequality and attributing it to any particular policy remains a challenging task, this section of the paper shall use reliable literature that seeks to uncover answers to some of the most important questions in this area of study.

A) Brazil

Brazil had one of the highest levels of income inequality in the entire world in the past. However, the Gini coefficient experienced a reduction by over five percentage points between 1998 an 2009. This has been attributed to two main policy programs of the government – the Benefício de Prestação Continuada, a transfer for the elderly and disabled, and Bolsa Familia, a Conditional Cash Transfer (CCT). These programs saw huge increases in coverage and also the size of the cash transfers. It has been estimate that these cash transfer programs accounted for nearly 10 percent decline in inequality over the period in question. (Lustig et al, 2013) **[7].** Another reason that is also considered to be a cause behind the reduction in inequality is the significant expansion of public education, leading to a fall in the relative wages of more skilled workers and consequently, a decline in labor income inequality. According to Alvaredo and Gasparini (2015) **[6],** an increase in the national minimum wage also contributed towards the fall in income inequality.

B) Mexico

Mexico also enjoyed a trajectory very similar to Brazil and experienced a reduction of nearly seven percentage points in income inequality between 1996 and 2010 (Lustig et al, 2013) **[7].** This was mainly attributed to the implementation and expansion of two major government transfer programs - Progresa/Opportuniades, a CCT programme which reach nearly 19 percent of households in Mexico, and Procampo, a cash transfer for agricultural producers. It has been estimated that these two programmes together accounted for an 18 percent decline in income inequality. Some also argue that a rise in public spending on education contribute to the decline in wage inequalities.

C) China

China's economic structures, institutions, and social policies have all changed dramatically since the end of the 1970s. China's economic growth has been among the world's quickest during the last three decades. Over the same time period, China had one of the world's fastest growth in income and wealth disparity. While annual GDP growth was close to 10% on average between 1985 and 2014, the Gini coefficient of income distribution rose from 0.38 to 0.471 during the same time period. Despite this shift, official figures show that China's income disparity has been decreasing for the past five to six years. The Gini coefficient of national income inequality had reached its highest level in 2008, and has been falling ever since. China has revised its social policy in recent years with the goal of minimising wealth gaps. The government's economic policy has shifted as well, from an emphasis on economic growth and efficiency to equal sharing of the benefits of growth; from supporting investment and export growth to encouraging consumption.

Since 2003, the Chinese government has implemented new measures to boost rural and low-income households' incomes. These programmes have made a significant contribution to closing the income divide between urban and rural households (Li and Sicular, 2014) **[26**]. They have included an exemption for rural households from agricultural taxes and levies since 2006. This exemption from agricultural taxes and levies has helped to reduce income disparities in rural areas and between urban and rural areas, and since the reforms, taxes have been more progressive. Agricultural subsidies for farming households have been a part of Chinese policy since 2002. These subsidies also led to a narrowing of the income gap between urban and rural households. In addition, the Dibao Program, a cash transfer programme that guarantees a minimum income for poor and low-income households, which started in the mid-1990s, expanded very rapidly from 1999 onwards to cover rural as well as urban areas. By the end of 2013, nearly 54 million rural people were receiving funds under the programme. Finally, China has gradually expanded its rural social protection framework over the last ten years, both in terms of the areas covered as well as the number of people under its ambit, with two schemes having a particularly noticeable effect - the New Rural Cooperative Medical Scheme and the New Rural Pension Scheme (Shi, 2016) **[26].**

Concluding Remarks

According to some, governments should primarily be concerned with the question of growth and poverty rather than inequality. This belief supports the view that once the economic pie is maximized, benefits will accrue to the bottom class through economic mechanisms. However, past experience has shown that this may not be the case and special attention is required to address the issue of inequality as it has its own implications for growth and social cohesion. This paper aimed to highlight what methods governments can rely on to achieve this goal. Later, the paper delved into studying the experiences of a few countries in dealing with inequality.

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