

EXECUTIVE SUMMARY

Rising inequality and slow economic growth in many countries have focused attention on policies to support inclusive growth. While some inequality is inevitable in a market-based economic system, excessive inequality can erode social cohesion, lead to political polarization, and ultimately lower economic growth. This *Fiscal Monitor* discusses how fiscal policies can help achieve redistributive objectives. It focuses on three salient policy debates: tax rates at the top of the income distribution, the introduction of a universal basic income, and the role of public spending on education and health.

Inequality, Growth, and Fiscal Redistribution

Global inequality—measured across all citizens of the world by abstracting from national borders—has been declining in recent decades, reflecting strong income growth in some large emerging market economies such as China and India. However, the picture of inequality within countries is mixed: while income inequality has increased in most advanced economies, trends in other economic groups have been more varied. In fact, inequality has declined in almost half the countries for which data are available. The forces underlying rising inequality also vary across time and regions. A key source has been technological change favoring higher skills.

Economic growth is fundamental. In many countries, growth has ensured that increases in inequality are compatible with improving living standards for households across all deciles of the income distribution, although there are significant differences across countries regarding the extent to which growth has been inclusive. This diversity of experiences and empirical analysis suggest that there is no systematic adverse trade-off between increasing growth and decreasing inequality.

A substantial share of the differences in inequality across economic groups and over time can be attributed to differences in redistributive fiscal policies. In advanced economies, direct taxes and transfers reduce income inequality on average by about one-third, with three-quarters of this reduction achieved through transfers. In developing economies, fiscal redistribution is

much more limited, reflecting lower and less progressive taxation and spending and greater reliance on regressive indirect taxes.

Progressivity of Income Taxes and Transfers

Progressive taxation and transfers are key components of efficient fiscal redistribution. At the top of the income distribution, marginal income tax rates that increase with income levels can achieve greater progressivity. While various instruments can enhance progressivity at the bottom of the income distribution, this *Fiscal Monitor* focuses on the universal basic income (UBI)—an identical transfer to the entire population—a proposal that has been widely debated recently and is being tested in several countries. Overall, the appropriate combination of progressive tax and transfer instruments should reflect country-specific circumstances, including administrative capacity, the performance of the existing safety net, underlying fiscal pressures, and social preferences.

Progressivity at the Top . . .

How steeply should marginal (and average) tax rates increase with income? Optimal tax theory suggests significantly higher marginal tax rates on top income earners than current rates, which have been on a declining trend. Could declining progressivity be a response to concerns about potential negative effects of progressivity on growth? Empirical results do not support this argument, at least for levels of progressivity that are not excessive. Advanced economies with relatively low levels of progressivity in their personal income tax (PIT) may therefore have scope for raising the top marginal tax rates without hampering economic growth. Different types of wealth taxes can also be considered. Emerging markets and low-income developing countries should focus on gradually expanding the coverage of the PIT and raising indirect taxes—including excise taxes on luxury goods and consumption items that generate negative externalities, such as fossil-fuel-based energy, alcohol, and tobacco—to generate funding for progressive spending.

How should capital income (including profits, interest, and capital gains) be taxed? Capital income is distributed more unequally than labor income, its share in total income has risen over recent decades, and it is often taxed at a lower (and declining) rate than labor income. Adequate taxation of capital income is needed to protect the overall progressivity of the income tax system by reducing incentives to reclassify labor income as capital income and through a more uniform treatment of different types of capital income. Many countries should emphasize reducing opportunities for tax evasion and avoidance. Taxes on real estate or land are both equitable and efficient and remain underused, but may require a sizable investment in administrative infrastructure, particularly in low-income developing countries.

... and at the Bottom

The UBI has received growing attention in academic, policy, and public discourse, and several countries are experimenting with different forms. While some countries already have some components of a UBI in place (such as universal child benefits and social pensions), no country has yet adopted a UBI that covers its entire population. Proponents argue that a UBI can address poverty and inequality more effectively than means-tested programs in the presence of information constraints, high administrative costs, and other obstacles (including social stigma) that limit the take-up of benefits. Others see a UBI as an instrument for addressing greater income decline and uncertainty generated by the impact of changing technology (particularly automation) on jobs. It is also advocated as a way to build support for structural reforms. Opponents highlight that universality implies an unnecessary leakage of benefits to higher-income groups. The associated high fiscal cost raises concerns about the program's affordability and the risk of crowding out other high-priority spending that promotes inclusive growth. UBI opponents also find problematic the delinking of income from labor force participation.

Is there a case for the adoption of a UBI? Under what circumstances could it be desirable, and how should it be financed? Or should governments focus on strengthening their capacity to use means-tested transfers? Whether a UBI is a good substitute for an existing social benefit system will depend on that system's

performance as well as on the government's administrative capacity and prospects for enhancing targeting.

In developing economies, where it is more likely for the current benefit system to be very sparse and coverage of lower-income groups might be very low, the adoption of a UBI may be an option for governments wishing to strengthen their safety nets in the short term. However, to be effective and preserve fiscal sustainability, such an expansion would need to be financed through efficient and equitable increases in taxes or cuts in spending, such as eliminating universal price subsidies or broadening the consumption tax base, including through taxes on consumption with negative externalities. Capacity constraints for mobilizing revenues may be an important factor that weighs on developing a universal safety net.

At the other end of the spectrum, for systems with generous benefits, broad coverage, and high progressivity, replacement of the existing system with a UBI would result in substantial decreases in benefits for many lower-income households—a likely scenario in advanced economies. It is therefore preferable to focus efforts on further strengthening existing systems through directly addressing any remaining coverage gaps in social safety nets due to eligibility rules or incomplete take-up and well-designed wage subsidies for low-income workers to provide incentives for work. The adoption of a UBI in such circumstances would therefore have to be motivated by other considerations, such as enhancing income insurance in the context of rising job insecurity due to rapid technological change and automation or building public and political support for structural reforms, such as eliminating food or energy subsidies and broadening the consumption tax base.

The fiscal cost of a UBI will depend on the level at which it is set. To illustrate, if it were set at 25 percent of median per capita income, the fiscal cost would be about 6–7 percent of GDP in advanced economies and 3–4 percent in emerging markets and developing economies. The impact on inequality, before financing, would be substantial in all countries, with one measure of inequality, the Gini coefficient, decreasing on average by five points. The reduction in poverty in emerging markets and developing economies would also be significant. The net redistributive impact of a UBI will, however, depend on how it is financed. This *Fiscal Monitor* analyzes a UBI with illustrative country cases, using microsimulation methods and a general equilibrium model to

account for behavioral responses, financing, and the trade-off between equity and efficiency.

Addressing Inequalities in Education and Health

Investments in education and health can help reduce income inequality over the medium term, address the persistence of poverty across generations, enhance social mobility, and ultimately promote sustained inclusive growth. Yet many countries still have sizable gaps in education and health services. Closing these gaps will also help address inequalities in other dimensions, such as gender and regional disparities.

Despite progress in education, sizable enrollment gaps between socioeconomic groups remain in almost the entire developing world. Globally, even when students from socioeconomically disadvantaged families are enrolled in education systems, they have substantially poorer actual learning outcomes than those from more affluent backgrounds, reflecting low-quality education.

Disparities in health outcomes are not narrowing in many countries. In advanced economies, the gap in life expectancy between males with tertiary education and those with secondary education or less ranges from about four to fourteen years and has even widened in some countries. The ratio of the infant mortality rate in the top socioeconomic quintile to that in the bottom quintile has increased in about half of emerging markets and developing countries, mostly reflecting slower improvements among the disadvantaged. While progress in health coverage has contributed to improvements in health outcomes, significant gaps remain in some emerging market economies and many low-income countries. Increasingly, health outcomes are determined by factors other than health care, including nutrition, education, and healthy behaviors, particularly in advanced economies.

Addressing remaining inequalities will require better targeting of public spending to disadvantaged groups to improve access to quality education and health care. This would also enhance overall efficiency.