IMF Conference on "Economic Policy and Equity"

Issues Paper

Fiscal Affairs Department

Prepared by the
Expenditure Policy Division for the
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CONTENTS

I. BACKGROUND

Since the beginning of this decade, global output has grown by over 3 percent annually and inflation has slowed down in virtually all regions of the world. Although many countries have experienced rising incomes and living standards, this economic expansion has been shared unevenly by the regions of the world. Moreover, income inequality has risen in some of these same countries, leading to renewed concern that economic growth and equity do not necessarily go hand in hand.

The purpose of this conference is to explore the nexus between economic policy and equity. Perceptions of equity derive from social and cultural norms, and each society will emphasize its own values in forming policies to promote equity. Although there are no universally accepted criteria to judge equity, there is a consensus that equity is improved as the incomes of the least fortunate are raised, and especially as families are raised out of poverty. Views are more varied about the extent to which greater income equality is desired for its own sake. In short, there is general agreement that extreme inequality of income, wealth, or other determinants of individual opportunity is socially unacceptable, but little agreement on precisely what constitutes a fair distribution. These are difficult issues that strike at the core of societal values, but answers are necessary for informed policymaking and to assess whether policies are successful.

There are many reasons why equity is of interest to policymakers:

- First, a society may view equity as an objective in and of itself because of equity's intrinsic moral importance and its intimate link with society's perception of fairness and social justice.

- Second, policies that promote equity can contribute—both directly and indirectly—to a reduction in poverty. A more even income distribution tends to reduce the number of individuals below the poverty line. Furthermore, equity-oriented policies that lead to greater investment in human capital encourage economic growth, which has been shown to alleviate poverty over the long term.

- Third, increased awareness of the need for gender, racial, and ethnic equity has sharpened the focus of policymakers on issues concerning the access of specific population subgroups to government-provided services, and the need to ensure fair treatment in the labor market.

- Fourth, many current policies will have an impact on the welfare of the coming generations. For instance, a provision of very generous pension benefits for this generation could come at a cost to the next generation—an important issue in many transition and industrialized countries.

- Fifth, policies that promote equity can have a salutary effect on social cohesion and reduce political conflicts. Effective policies typically require broad political support, which is more likely to be forthcoming when the distribution of income is seen as fair. Macroeconomic adjustment with major 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.

- Finally, although achieving greater equity does not necessarily come at the expense of economic growth, any attempt by policymakers to *dramatically* influence income distribution through large-scale tax and transfer programs can have a substantial negative impact on growth.

The rest of this paper will describe the four key issues to be addressed during the conference sessions, as well as the potential implications for Fund policies and operations. The key questions to be raised in each session will be delineated at the end of each section.

II. Issues for the Conference

Economic policy and equity: an overview

Income inequality varies greatly among regions. It is currently the highest in Latin America and Sub-Saharan Africa and the lowest in Eastern Europe, with the other regions arrayed in between. In Latin America, the average Gini coefficient—a commonly used measure of inequality—is almost 0.5, with most countries having a coefficient exceeding 0.4 (a coefficient of 1 represents complete inequality, whereas a coefficient of zero represents perfect equality). In Africa, this coefficient is, on average, slightly below that in Latin America, although there is considerable variation among countries. Furthermore, in both Africa and Latin America, income inequality has a regional dimension: average incomes in urban areas are significantly higher than in rural areas.

Income inequality has risen in recent years in a substantial number of countries. This trend has been most pervasive in the former centrally planned economies, where the transition to a market economy was accompanied by rising inequality. Until the late 1980s, transition economies had the most equal income distribution: the average Gini was in the mid-.20s. However, this had changed by the mid-1990s, by which time the average Gini coefficient rose to the low-.30s. Shrinking budgetary expenditures and public enterprise sectors have affected the relative income of public-sector workers. Rising informal sector activity, together with sectoral shifts, have also had an impact on the relative income shares of workers. The rising trend in income inequality has not been limited to transition economies, however. Inequality has also increased in several G-7 countries and is beginning to rise in some of the East Asian countries. These trends heighten the urgency for addressing equity issues.

Much of the income distribution debate has centered on the distribution of wage earnings. But the distribution of labor income explains only part of the distribution of income. The limited data on wealth distribution indicate that 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 explaining the overall distribution of income. Furthermore, in many countries, particularly in transition countries, there has been a shift from labor to capital income (including from self-employment) in recent years. The fundamental change in asset distribution in transition countries occurred with the privatization of state-owned assets. The analysis of trends in nonlabor income in other countries with well-developed capital markets and pension funds, however, is 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.

Although most analyses of inequality focus on income, the case can be made that a more appropriate focus would be on the inequality of consumption. Because of both redistributive policies and the smoothing of consumption over the life cycle, the distribution of annual consumption is likely to exhibit substantially less inequality than the distribution of annual income. At least for some concepts of equity, the distinction between consumption and income can be important.

Crucial to any discussion of economic policy and equity is the degree to which policies that promote equity might curtail growth. If these two social goals are in conflict, a fairer society may be achieved only at the cost of a less well-off society. The evidence on this issue is mixed. Large scale tax and transfer programs may, in fact, slow growth, but poverty alleviation and universal access to basic health care and education can simultaneously improve equity and enhance the human capital on which growth depends.

Finally, an important issue is whether policymakers should focus on outcomes, such as the number of poor, or on creating conditions for equal opportunity for all participants in the economy. For some manifestations of income inequality, such as poverty, outcomes are clearly critical. For others, 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.

Questions for discussion

- Are income and consumption inequalities increasing in developing, newly industrialized and transition economies?
- How important is wealth inequality in influencing income distribution?
- How important is the distribution of human capital for promoting equity?

- How does equity manifest itself as a policy issue? Because of its implications for the extent of poverty? For economic efficiency and growth?
- When is it appropriate for countries to focus on equality of opportunity? And on equality of outcomes?
- How far should governments go in pursuing equity?

Addressing equity issues in policymaking

Countries have adopted different strategies to promote equity. For example, some have actively promoted the use of public resources to raise the bottom tier of the income distribution. Others have focused on the top percentiles with highly progressive taxes. On the other hand, some countries have relied more on growth to help low-income families. Underlying the latter strategy has been the concern that implementing policies that overtly target the poor may retard growth through their adverse impact on efficiency. Other countries have found that even when equity-oriented policies are designed and formulated, other factors constrain the implementation of these policies.

The extent to which countries have focused on equity has varied. In Latin America during the 1980s, the primary interest of policymakers was to achieve sustainable growth, and a viable balance of payments and structural reforms were the policies seen as critical for achieving this objective. The promotion of growth was also seen as essential in transition economies, but this was accompanied by the adoption of policies aimed at helping those population groups adversely affected by the transition. Such policies included the distribution of shares of privatized enterprises; the adaptation of some existing social policy instruments to protect vulnerable groups; and the establishment of social safety nets in the form of targeted subsidies, cash compensation in lieu of subsidies, severance pay and retraining for retrenched public sector employees, and public works programs. In many countries, however, the lack of budgetary resources prevented an effective shielding of vulnerable groups (such as pensioners living alone), despite efforts to better target this spending.

One of the constraints to the pursuit of equity-oriented policies has been their likely impact on efficiency and therefore on economic growth. Regulations that safeguard employment, for example, can impede the flexibility of labor markets, discourage new investment, and reduce job creation and growth. This need not be the case for all equity-oriented policies, however. Policymakers are recognizing the complementarity of high growth and at least some policies to improve equity, particularly with respect to fiscal policy.

Although fiscal policy has been viewed as the principal vehicle for assisting low-income groups and those affected by reform programs, many countries have sought to institute specific labor market policies to influence the income distribution. The rationale underlying these policies is that relative wages exert a strong influence on overall income inequality. This has led many European countries to opt for high minimum wages, generous unemployment benefits, and a wide array of job protection interventions. Although these policies can result in rigidities, advocates of these policies maintain that they help achieve a socially desirable redistribution of income. On the other hand, the alternative "American model" of labor market flexibility has achieved high employment levels, but at the cost of potentially larger inequalities. To mitigate the potential effect of market flexibility on low-wage workers, the United States has instituted wage subsidies to simultaneously redistribute income and promote employment. Given that labor market policies can have a large bearing on earnings, these competing visions of the labor market are central to the debate over income inequality in many developing and newly industrialized countries.

There are a number of other constraints on the implementation of equity-oriented policies. First and foremost is the financing requirement: high levels of spending on targeted programs may not be consistent with a sustainable macroeconomic framework. Second, the large share of the economy engaged in rural and informal sector activities—which is a characteristic of many developing countries—may limit the ability of governments to reach the most vulnerable. The rural and informal sectors may have limited interaction with formal sector institutions, including the government, and this makes the delivery of government assistance (*e.g.*, cash transfers) problematic. In a similar vein, a lack of administrative capacity may also hamper redistributive efforts; for example, high rates of tax evasion, due to weak tax administration, make it difficult to utilize the tax system as a vehicle for income redistribution. Political constraints can also limit policy makers' ability to reallocate spending to low-income groups, given their lack of political power relative to other interest groups; they may also limit the potential for redistributing assets, such as land.

There may also be legal impediments to the more vigorous pursuit of equity: constitutional rules on revenue sharing, for example, may limit the amount of resources a central government allocates to redistributive policies.

Questions for discussion

- *How has equity been addressed in policy-making? What instruments have been used to implement these policies?*
- *Operationally, has the trade-off between equity and efficiency been considered large? Has economic growth contributed to reducing inequality in some countries?*
- *What are the legal, administrative, and financial constraints policymakers have faced in promoting equity?*

Equity issues in a globalizing world

Globalization has linked the labor, product and capital markets of economies around the world. Increased trade, capital and labor movements, and technological progress have enabled greater specialization in production and the dispersion of specialized production processes to geographically distant locations. Less-developed 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, in developed countries the production of these products 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 less-developed countries.

Because of this effect on the wages of unskilled workers, some authors have claimed that globalization has increased income inequality in developed countries. The evidence on the impact of increased trade on wage inequality in developed countries is mixed, however. A recurrent theme in the globalization debate is whether increased trade, as opposed to technological developments—both technological advances and the more rapid dispersion of existing technologies—explain the growing disparity in the wages of skilled workers and unskilled workers in developed countries. Several empirical studies have tried to gauge the relative importance of trade versus technological progress for the observed decline in relative unskilled wages in developed countries. The estimates for the share of increased trade in the total increase of the wage differential between unskilled and skilled workers range from close to zero to 50 percent.

The debate regarding the effect of globalization on income distributions in less-developed countries mirrors the debate on developed countries. Although it would be expected that, ceteris paribus, increased openness would increase the relative wage of unskilled workers in less-developed countries, actual experience has been mixed. For example, evidence suggests the relative wage of unskilled workers increased in East Asian countries in the 1960s and 1970s, but decreased in Latin America in the 1980s and early 1990s.

Two factors might explain the experience in Latin America. First, the recent developments in middle-income countries in Latin America may have been shaped by the opening up of less-developed Asian countries (Bangladesh, China, India, Indonesia, and Pakistan), where unskilled labor is even more abundant than in these middle-income countries. In other words, the same competition from unskilled-labor-rich countries affects the income distribution in developed countries and middle-income countries. Second, globalization can affect the income distribution in less-developed countries not only through trade but also through new production technologies that become available with the opening up of an economy. If these new technologies are biased toward higher-skilled labor, the effect of technological globalization could more than offset the effect of more open trade.

The diverse experiences of less-developed countries suggest that the level of development and the nature of technological progress affect the relationship between globalization and equity. Similarly, exposure to international competition and influences may change institutions (e.g., trade unions), and thereby affect the income distribution. Because of the mobility of capital, some observers contend that globalization limits the ability of union workers to achieve a "union wage premium," thus changing 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 among sectors is reallocated.

It is often argued that globalization constrains governments in the formulation of equitable policies. Increasingly mobile capital and labor have limited the ability of governments to levy taxes and transfer them to those affected by globalization. To the extent that capital is more mobile than labor, it also shifts more of the burden of safety nets to labor.

Questions for discussion

- *How has globalization affected equity in developing, newly industrialized, and transition economies? Has globalization affected specific population groups—for example the elderly and women—more than others?*

- *How has globalization changed the appropriate mix and effectiveness of redistribution policies?*

Policy responses: design and implementation

The extent to which a country perceives a need for more equity not only depends on its level of development but also its values and objectives as represented in its "social welfare function," which is influenced by cultural, regional, ideological, and historical factors.

As noted earlier, reform measures designed to achieve macroeconomic stability and to remove impediments to long-term sustainable growth may have an adverse effect on the poor and other vulnerable groups in the short run, and therefore social safety net expenditures become critical to mitigate these adverse short-term effects. Social safety nets are not only desirable from an equity standpoint, but are often vital to ensure political support for the reform process.

Government intervention in a number of other policy arenas also has significant, although indirect, equity implications. Monetary policy and the overall macroeconomic stance of the government have a bearing on both the level and distribution of income, as high inflation tends to curtail economic growth. Trade liberalization often results in both enhanced economic growth and improved equity, especially in developing countries where restrictive trade regimes often involve the taxation of agricultural exports and protective tariffs for import-competing industrial activities. Devaluations also have equity implications. This is particularly true in low-income countries, where the poor are often concentrated in the agriculture-intensive export sector, whereas urban middle- and upper-income classes are most closely linked to import-sensitive activities and hence suffer from devaluation.

Fiscal policy is a government's most direct tool for redistributing income, both in the short and the long run. The budget principally offers two channels for influencing income distribution: taxation and government expenditures. Empirical evidence supports the view that the expenditure side of the budget offers better opportunities than the tax side for redistributing income; the role of redistributive tax policy has proven to be very limited, especially in the face of globalization. Thus, tax policy should focus primarily on developing an efficient system of easily administered taxes with broad bases and moderate marginal rates. Although efficiency considerations should dominate the design of the tax system, governments can nevertheless endeavor to design tax systems that are seen as consistent with society's perception of a just burden of taxation. In this regard, horizontal and vertical equity are important.

On the expenditure side, there is more room to affect income distribution. The link between government spending and income distribution is particularly strong in the case of social spending, including expenditures on health and education. Through expenditures on health and education, governments influence the formation and distribution of human capital. Thus, public investment in equitable human capital formation can be an efficient route to reducing income inequality over the long run.

The amount and efficacy of the resources governments can and should devote to social expenditures depends on various factors, such as the tax-to-GDP ratio and the resources devoted to other spending. Tax policy can indirectly contribute to equity by raising enough resources to allow a level of expenditures on public services that is sufficient to promote social goals without creating a drag on economic growth. Policies that improve the level and composition of public expenditures can be an efficient method for achieving greater equity. Resources should be put to their most efficient use. Public expenditures should displace private expenditures only when they yield higher social benefits; similarly, priorities for public expenditures must be aligned with the productivity of these expenditures. Curtailing unproductive public expenditure can free resources for more productive ends, including the mitigation of poverty.

Examples of unproductive government expenditure include excessive military spending, wages for an overstaffed civil service, and transfers to inefficient public enterprises. Civil service reform and the privatization of commercially viable government services—especially if accompanied by a reallocation of expenditure to the social sectors—are likely to be both growth- and equity-enhancing, particularly in developing countries where the public sector employs primarily the middle- and upper-middle-income classes.

Although most outlays on health and education tend to improve the existing pattern of income distribution, some do so more efficiently than others. Benefit incidence studies show that expenditure on basic health care and primary education are far more effective in reaching the poor than expenditure on higher education or hospital-based curative care. Studies also show that in nations without social risk-pooling, household expenditures for uncertain serious illnesses often become the primary poverty generator. In addition to having a greater immediate impact on the poor, expenditure on basic health care and primary education will also reduce the variation in human capital across income groups, and decrease income inequality in the long run. In many developing countries, however, the provision of costly hospitals and universities in urban centers is often given priority over basic health and education services in rural areas.

Finally, enhanced governance can improve both equality of opportunity and equality of outcomes. The perception that there is equality of opportunity and that the "rules of the game" for economic mobility are fair have a large bearing on whether the population views the distribution of income as fair and just. Therefore, governments should promote equality of opportunity by running a deregulated economy, with few opportunities for corrupt practices, coupled with strong, accountable institutions and a well-functioning judicial system. Moreover, curtailing corruption can directly reduce income inequality, since the gains from corrupt practices tend to be captured by the well-to-do.

Questions for discussion

- *What roles do economic, cultural, and ethical factors play in determining the attitude of governments toward income distribution? How important are regional and historical differences?*

- *What policy instruments have successfully promoted equity? How extensive should social safety nets be?*

- *What more can be done by governments?*

Implications for Fund policies and operations

Fund advice on macroeconomic and structural issues has distributional implications. Therefore, the Fund must inevitably address equity issues in its discussions with member countries. However, the Fund's involvement in equity issues must be seen in the context of its mandate. This mandate, as laid out in the IMF Articles of Agreement, is to promote international monetary cooperation, balanced growth of international trade, and a stable system of exchange rates. Fulfilling this essentially macroeconomic mandate is the Fund's primary contribution to sustainable economic and human development. In recent years, with the Fund's increased attention to the problems of the developing and transition countries, social aspects of economic policy have become more prominent, including those linked with questions of equity.

The key ingredients of equitable economic policy that the Fund has incorporated in its advice, both in programs supported by the Fund and its other core activities—surveillance and technical assistance—are the following:

- Macroeconomic policies that secure low inflation and a viable balance of payments position. These policies provide a framework within which growth can flourish, thereby reducing poverty and avoiding the adverse distributional effects of inflation;

- Structural policies that enhance the 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 basic health care and primary education; and

- Well-targeted social safety nets.

Following the recent external review of the Extended Structural Adjustment Facility (ESAF), the Fund is strengthening its programs by more systematically incorporating social safety nets and more rigorously monitoring the composition of expenditure.

Questions for discussion

- *How can the Fund—within its essentially macroeconomic mandate—more effectively address distributional issues in its activities?*

- *How should Fund programs respond to countries' different perceptions of equity? Can an international consensus be forged on a minimum set of equity conditions that should be met?*

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