

Tackling income inequality: the role of taxes and transfers

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Tax policy in Latvia: challenges and opportunities

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Context

- Market income-inequality was rising in many OECD countries before the crisis
- Crisis has made the issue of inequality and poverty all the more important
 - e.g.: In the US the top 1% captured 95% of the income gains from 2009 to 2012 (Saez, 2013)
- Link between inequality and growth is being reassessed:
 - some evidence that inequality above a certain level may hinder growth

Aims of the study

- What are the main determinants of inequality in OECD countries?
- Describe the role of taxes and transfers in reducing inequality
- Analyse policy trade-offs between growth and inequality

Roadmap of the presentation

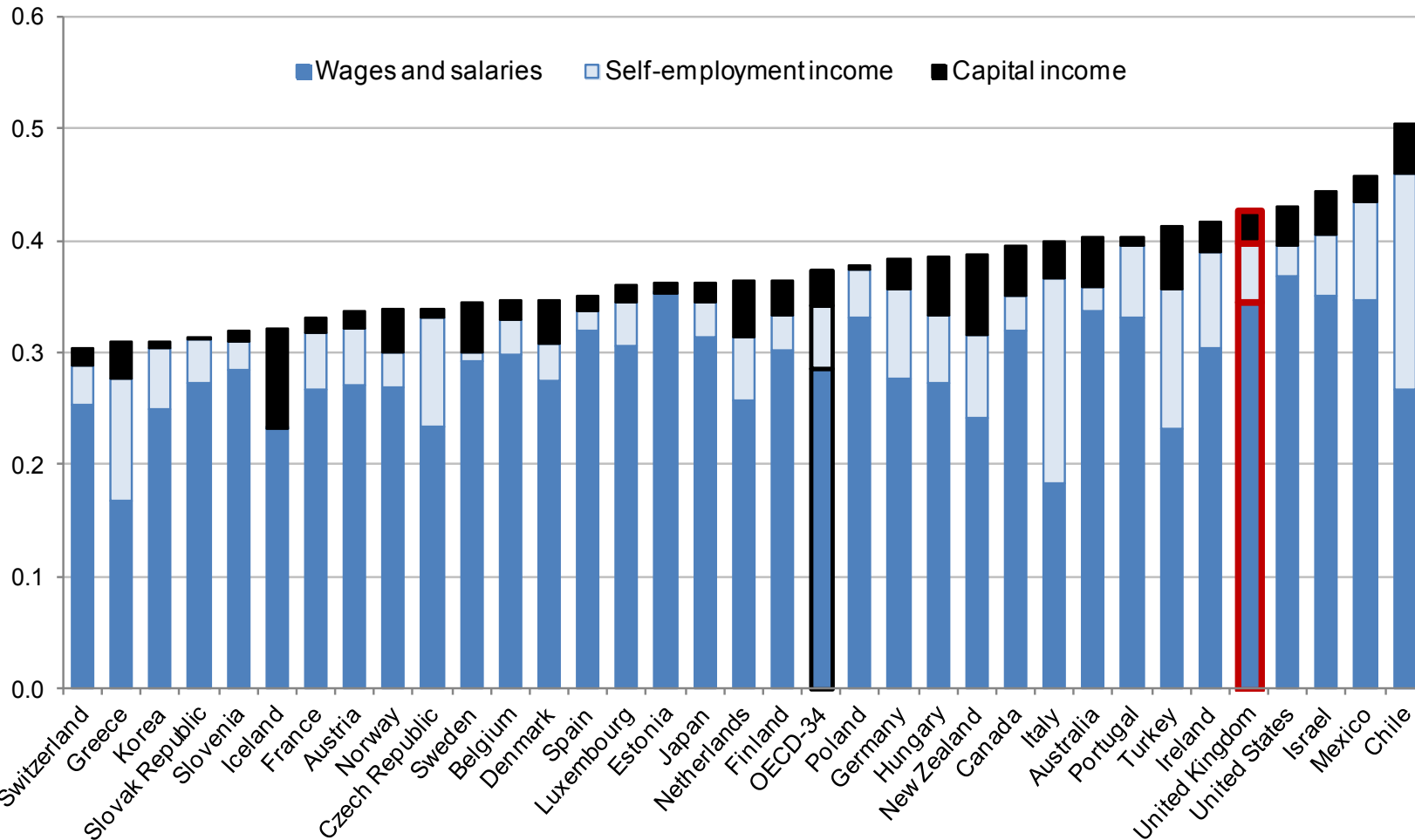
1. Factors affecting the distribution of labour income; overview of income-inequality trends during the crisis
2. The role of taxes and transfers in reducing inequality
3. Policy trade offs and complementarities between inequality and growth

Income-inequality trends – a brief overview

Market income inequality is driven by labour income (much) more than by capital income

Contributions to the concentration coefficient of market income, working age population, in the late 2000s

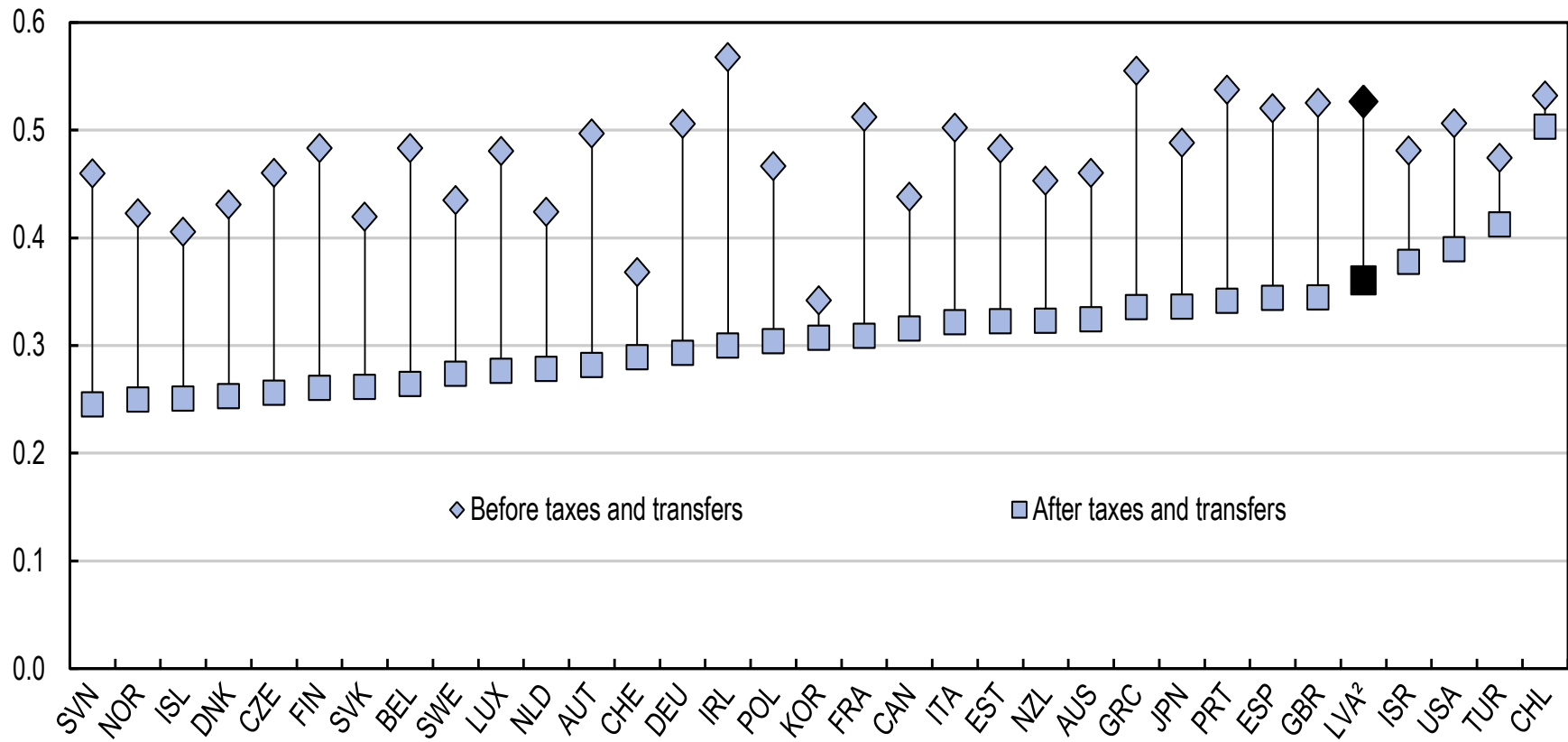
Concentration coefficient



Income inequality – determinants

Taxes and transfers reduce market income inequality

Market and disposable income inequality
Gini coefficient, scale from 0 "perfect equality" to 1 "perfect inequality", 2011¹



¹ 2009 for Japan, 2010 for Belgium, 2012 for Australia, Finland, Korea, Netherlands and the United States.

² OECD Secretariat calculations from EU-SILC – preliminary results.

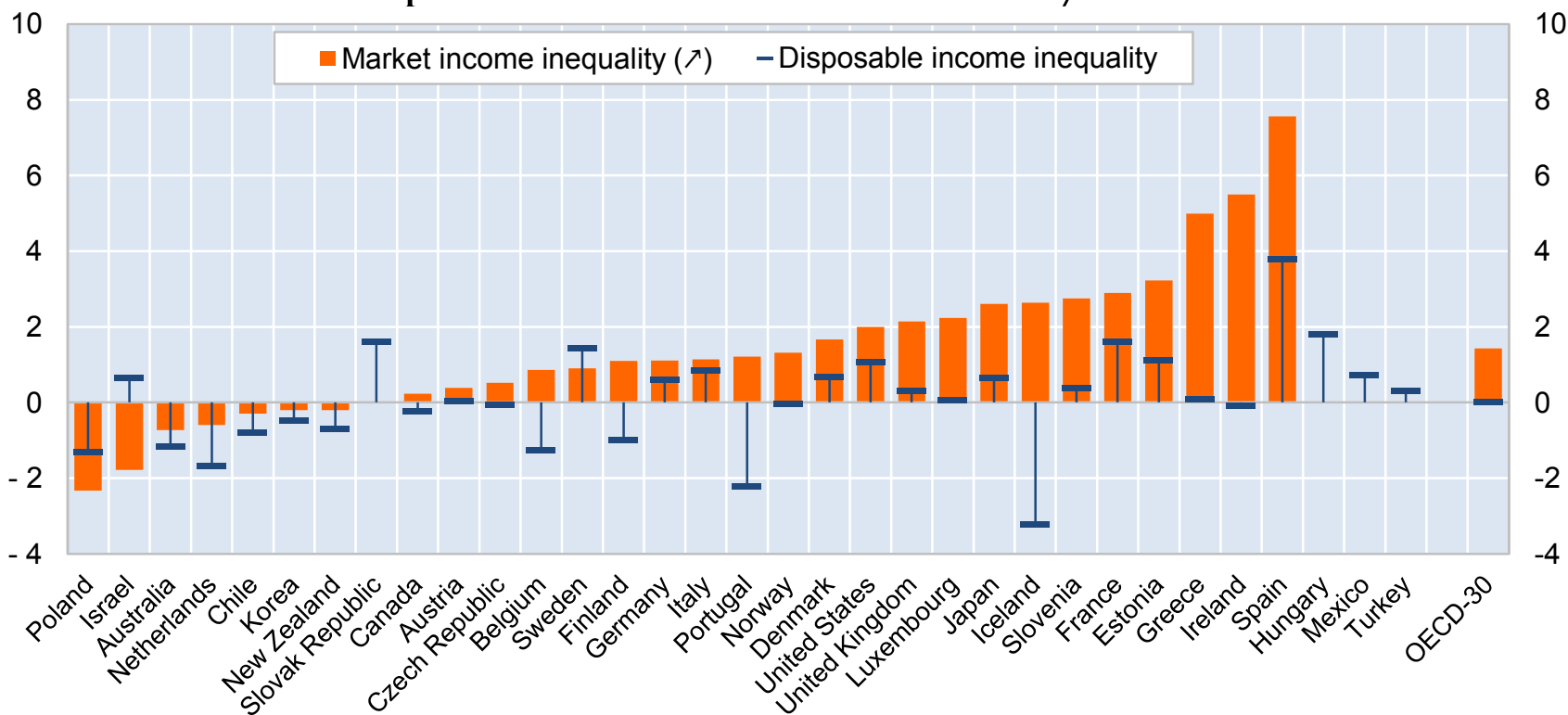
Source: OECD Income Distribution database and OECD Secretariat calculations.

The crisis has increased market income inequality

inequality but taxes and transfers cushioned the impact on disposable income

Market income inequality rose considerably

Percentage point changes in the Gini coefficient of household market and disposable incomes between 2007 and 2011



The tax and transfer system

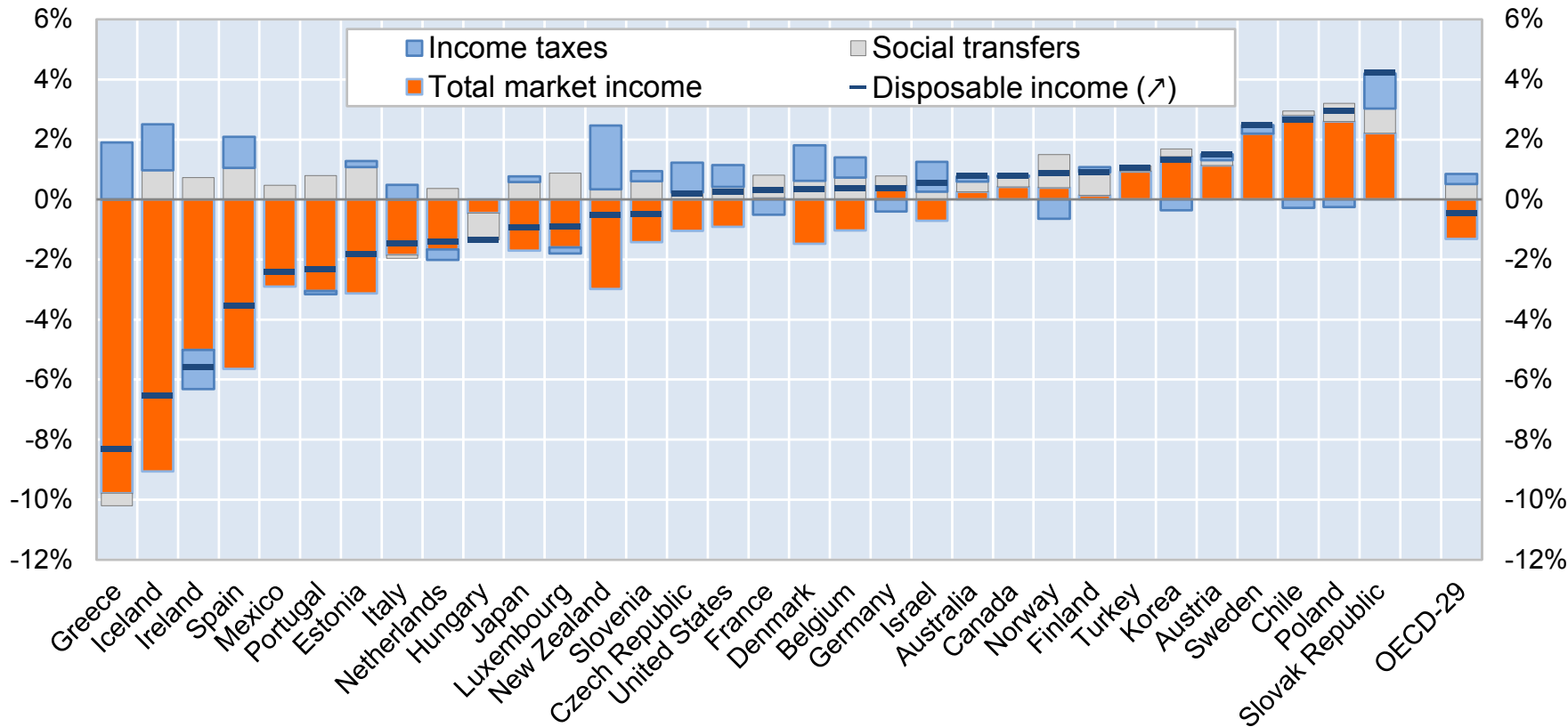
States. Data for 2011 refer to 2009 for Japan; 2010 for Austria and Belgium; and 2012 for Australia, Finland, Hungary, Korea, Mexico, the Netherlands and the United States. For Hungary, Mexico and Turkey data on market income inequality are not available. There is a break in the series in 2011 for the United Kingdom, and results are not strictly comparable. 2011 data for Ireland and the United Kingdom are provisional. OECD-30 average excludes Hungary, Mexico, Switzerland and Turkey.

Source: OECD Income Distribution and Poverty Database.

Taxes and social transfers mitigated falls in market income in most OECD countries

Annual percentage changes in household disposable income between 2007 and 2011, by income component

The tax and transfer system



Notes: Market incomes are reported net of taxes in Hungary, Mexico and Turkey. A positive sign of income taxes indicates a lower tax burden in total income. OECD-29 average excludes Hungary, Mexico, Turkey (for which data on taxes are not available), the United Kingdom (for which no comparable data for 2011 are available) and Switzerland (for which 2007 data are not available). 2011 data for Ireland are provisional.

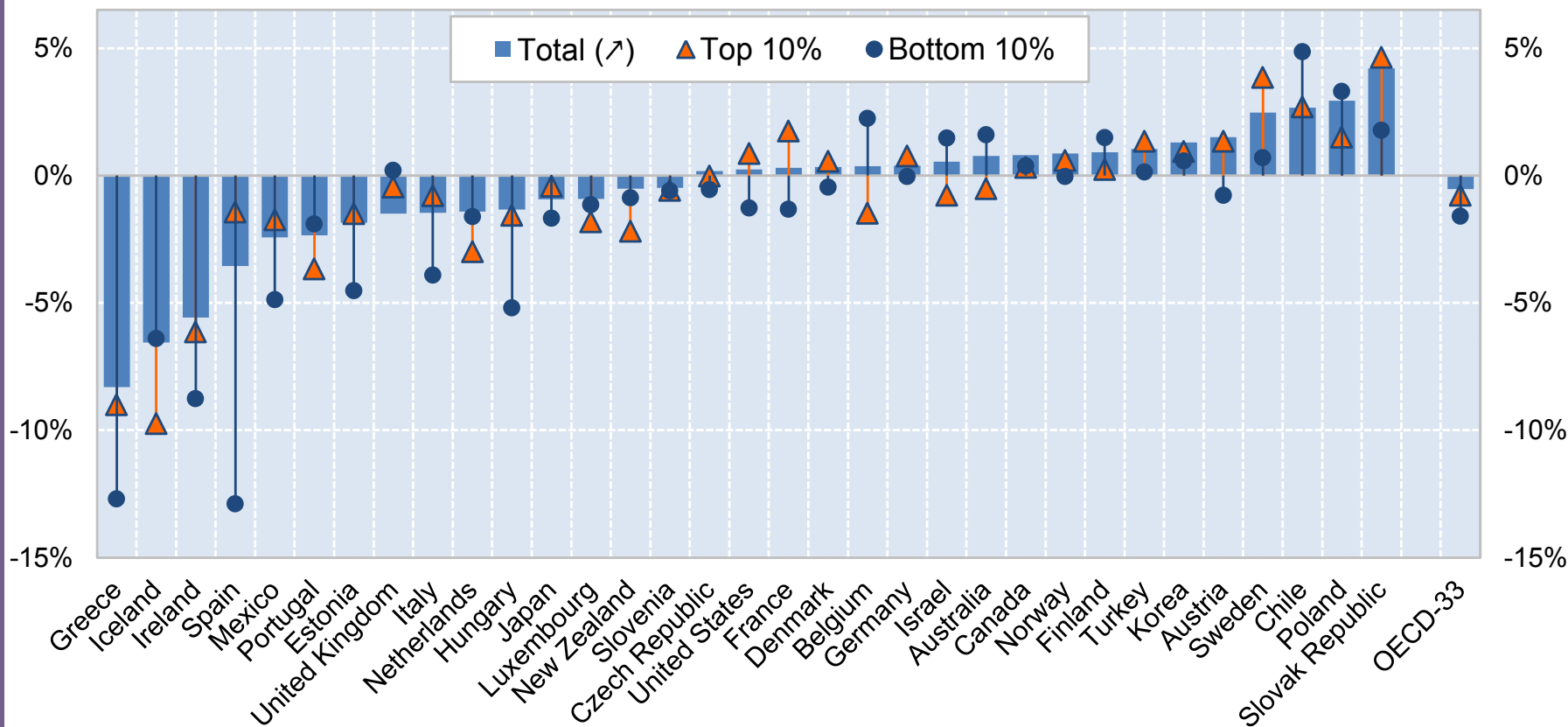
Source: OECD Income Distribution and Poverty Database.

The pain of the crisis was not equally shared

Poorer households tended to lose more or gain less

Annual percentage changes in household disposable income between 2007 and 2011, by income group

The tax and transfer system



Notes: There is a break in the series in 2011 for the United Kingdom, and results are not strictly comparable. 2011 data for Ireland and the United Kingdom are provisional. Source: OECD Income Distribution and Poverty Database.

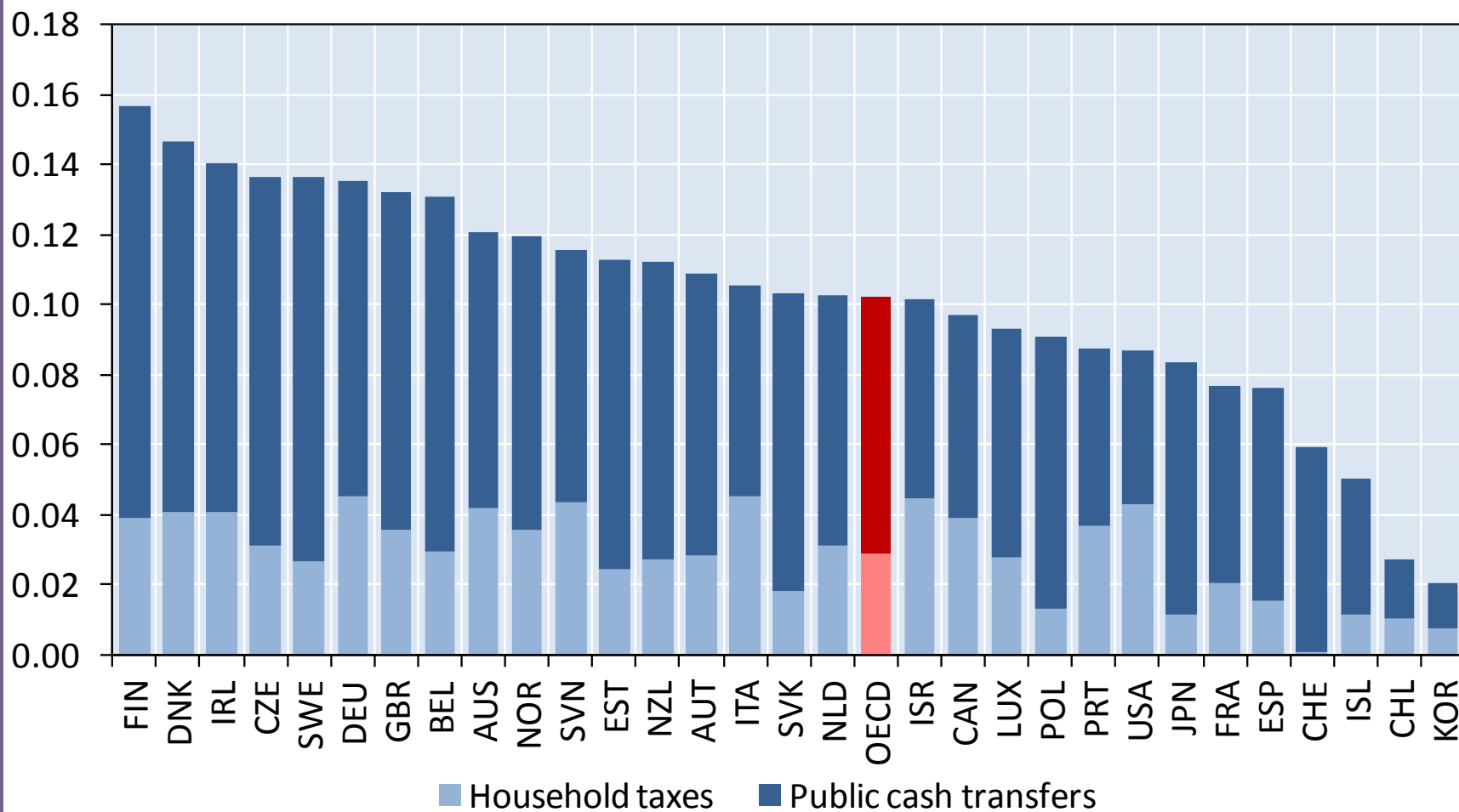
How taxes and transfers reduce inequality

In most, but not all countries, the redistributive impact of cash transfers is higher than that of taxes

Point reduction in concentration coefficients

late 2000s

The tax and transfer system



Size and progressivity of taxes and transfers determine the redistributive impact

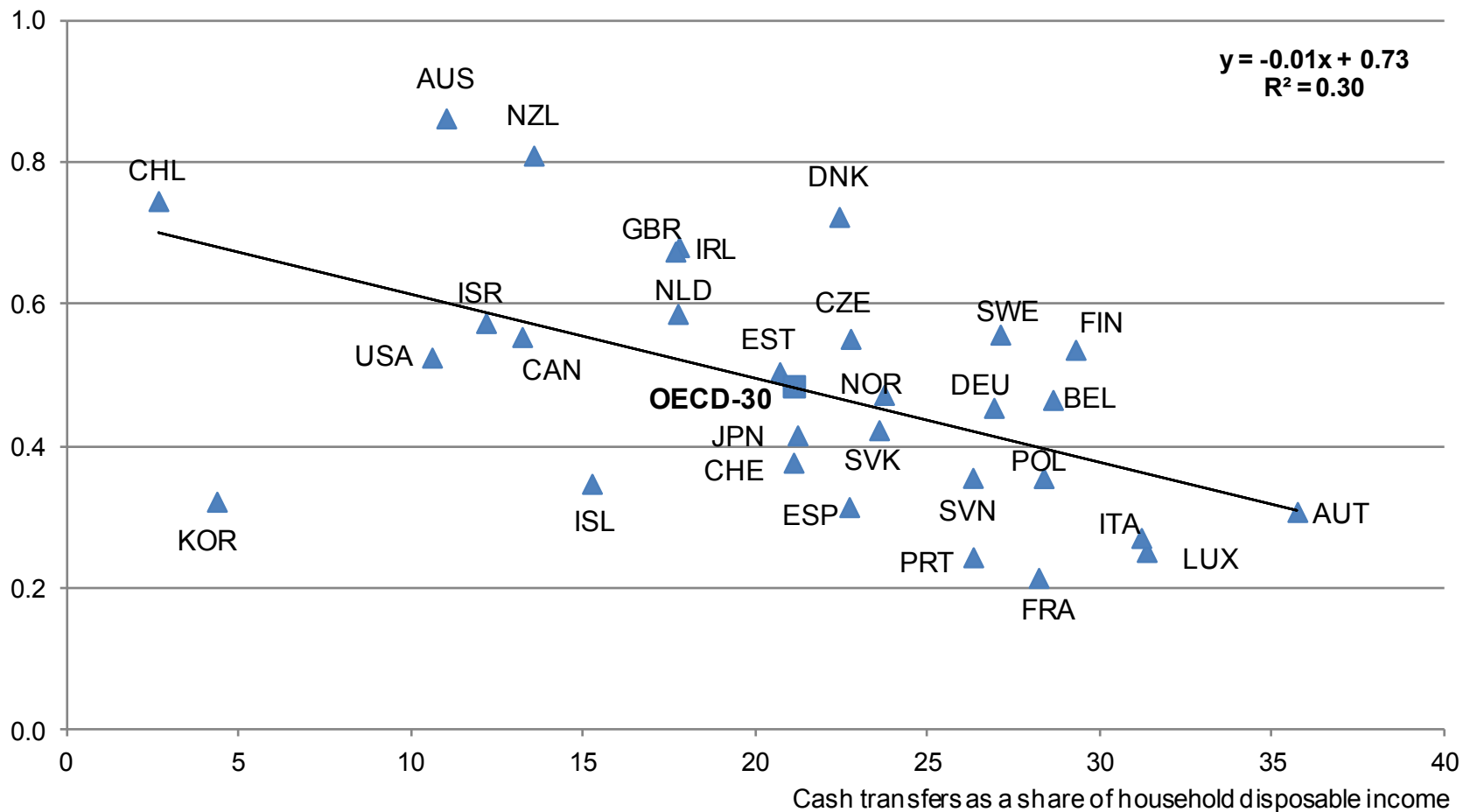
- The % reduction in inequality between market income and market income *plus* transfers
 - ≈ size of cash transfers + Progressivity of cash transfers (Kakwani index)
 - market income *plus* transfers and disposable income
 - ≈ size of tax systems + Progressivity of taxes (Kakwani index)

(Assuming transfers are paid before taxes)

Countries with large cash transfers tend to have less progressive systems

Late 2000s

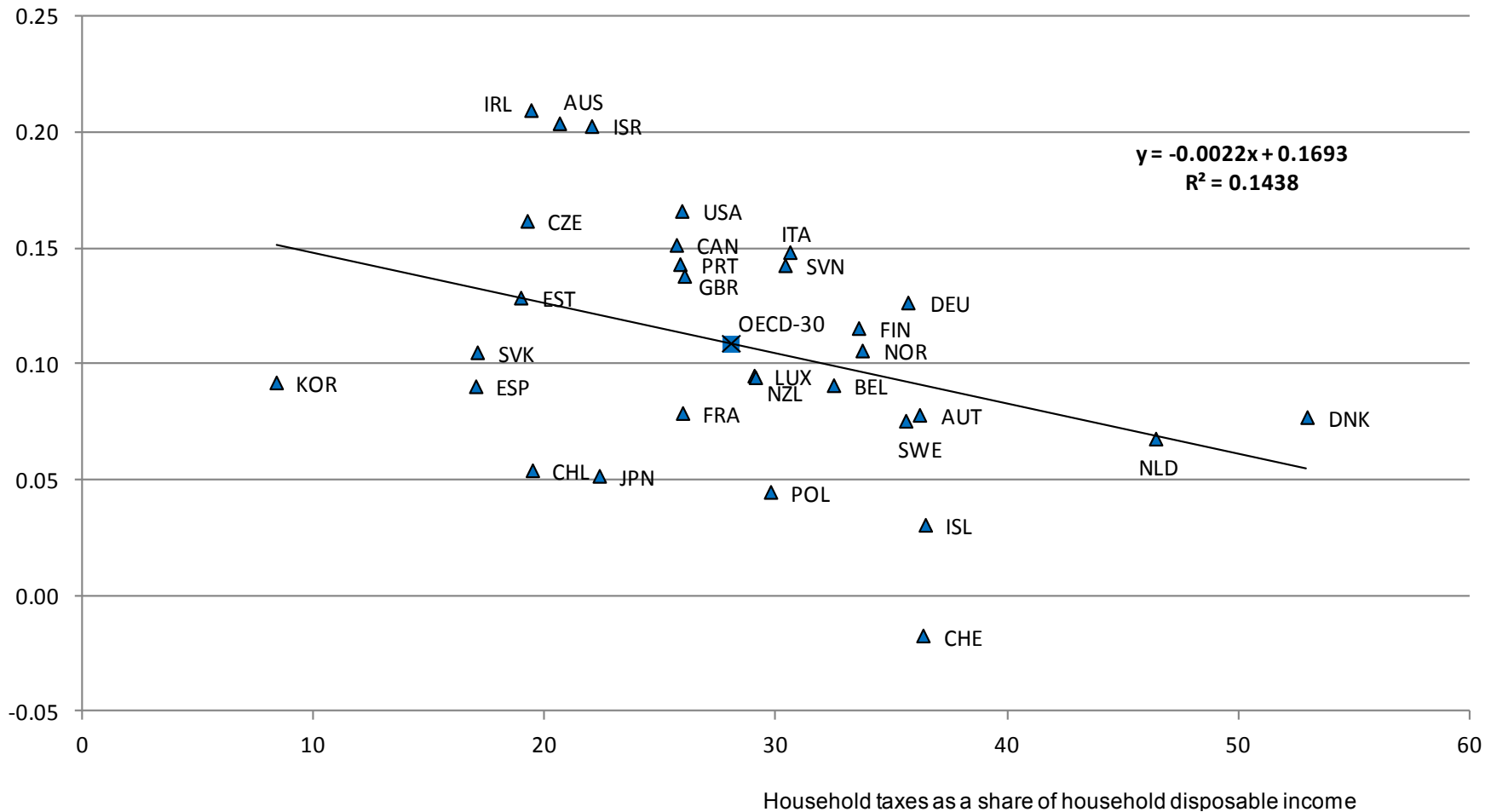
Progressivity index of cash transfers



Countries with large household income taxes tend to have less progressive taxes

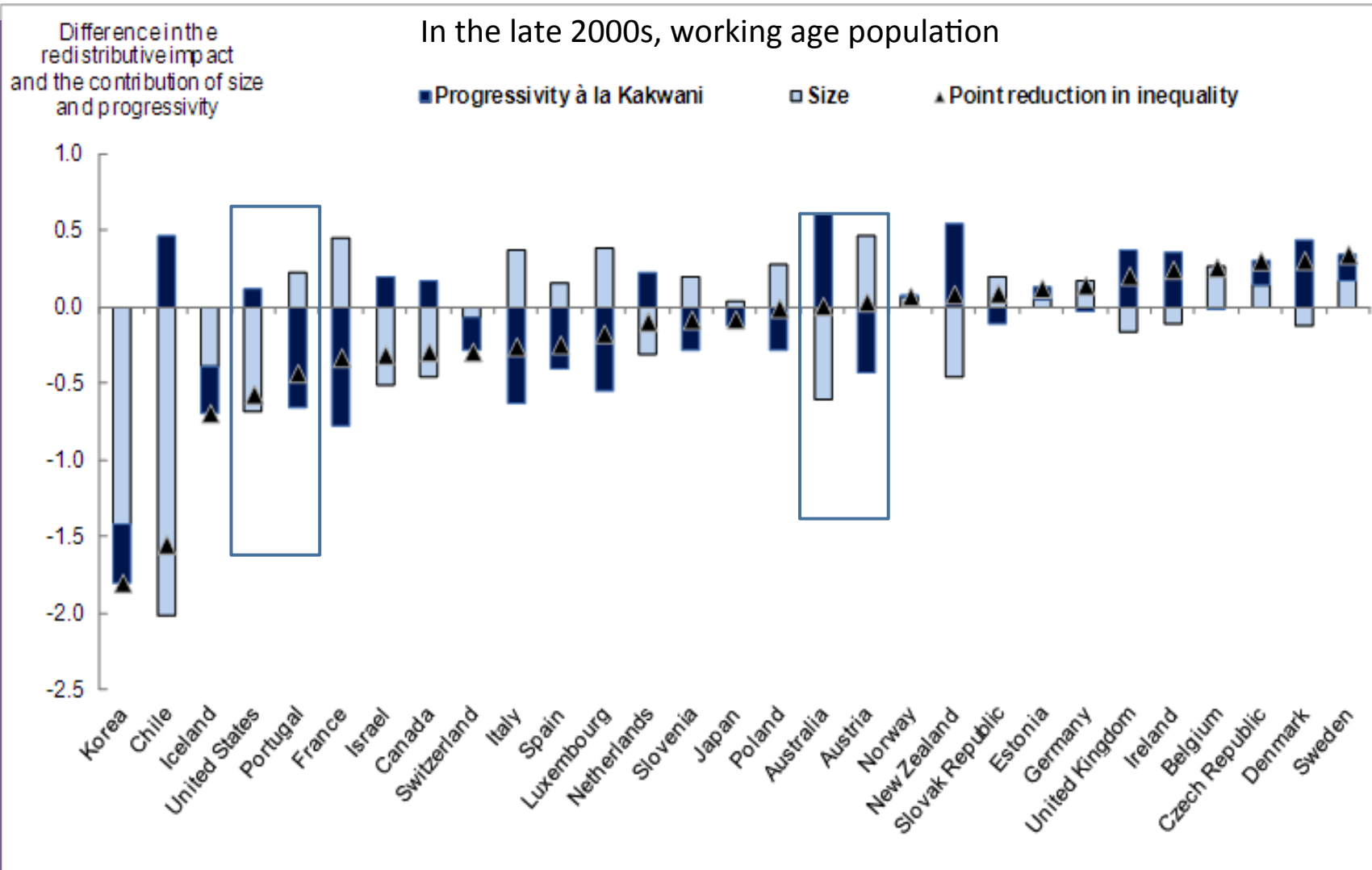
Late 2000s

Progressivity index of household taxes



The tax and transfer system

Cash transfers: size and progressivity explain their impact on inequality



Policy trade offs and complementarities between income inequality and growth

Measures to improve human capital are clear win-win strategies.

Impact of policies

A rise in:	Employment rate	Earnings equality	Labour income equality	GDP per capita
Equity in education	?	+	+	+
Upper-secondary and tertiary graduation rates	?	+	+	+
Initiatives to foster the integration of immigrants	+	+	+	+
Initiatives to raise female labour force participation	+	+	+	+
Initiatives to combat discrimination	+	+	+	+

In the area of labour and product markets, the equality effects depend on the precise measure.

A rise in:	Employment rate	Earnings equality	Labour income equality	GDP per capita
Minimum wage (relative to median wage)	0/-	+	?	0/-
Unionization	?	+	+	?
Legal extensions of collective wage agreements	-	?	-	-
The gap between protection on regular vs. temporary work	-	-	-	-
Product market regulation	-	0/+	?	-

Many tax policies imply trade-offs with respect to the growth and distribution objectives.

Revenue-neutral tax changes:	Disposable income equality	GDP per capita
Change tax mix from income to consumption tax	-	+
Change tax mix from income to real estate tax	-	+
Change tax mix from income to wealth and inheritance tax	?	+
Increasing top PIT rates and tax free allowances	+	?
Cutting tax expenditures and marginal rates	+	+

Contact information and underlying documents

Webpage

- <http://www.oecd.org/economy/public-finance/lessincomeinequalityandmoregrowth-aretheycompatible.htm>

Going for Growth 2012

- Chapter 5 « Reducing income inequality while boosting economic growth: can it be done? »

Monograph:

- OECD (2012), *Divided We Stand: Why Inequality Keeps Rising*, Directorate of Employment, Labour and Social Affairs, OECD

Others

- Income-Inequality-Update (<http://www.oecd.org/els/soc/OECD2014-Income-Inequality-Update.pdf>)

Working Paper Series on “Less income inequality and more growth – Are they compatible? ”

- WP 924: Part 1. Mapping income inequality across the OECD
- WP 925: Part 2. The distribution of labour income
- WP 926: Part 3. Income redistribution via taxes and transfers across OECD countries
- WP 927: Part 4. Top incomes
- WP 928: Part 5. Poverty in OECD countries
- WP 929: Part 6. The distribution of wealth
- WP 930: Part 7. The drivers of labour earnings inequality – An analysis based on conditional and unconditional quantile regressions
- WP 931: Part 8. The drivers of labour income inequality – A review of the recent literature