An empirical investigation on the drivers of income redistribution across OECD countries

By Orsetta Causa, OECD Economics department

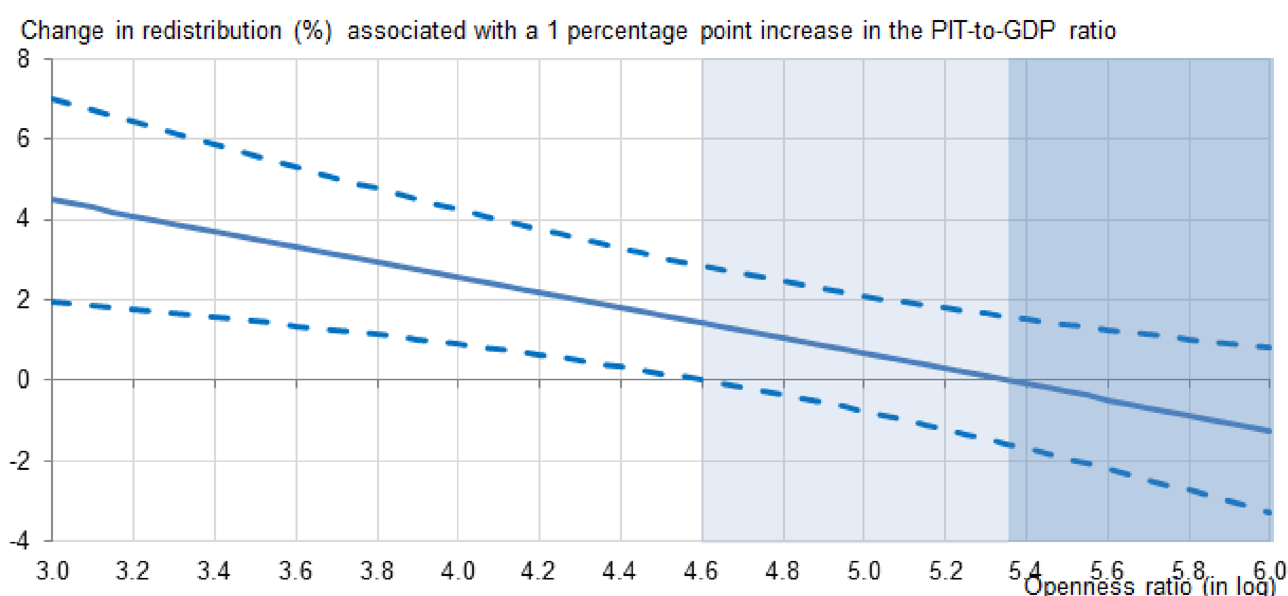
Income inequality has increased in most OECD countries over the past two decades. This has come about both because incomes before taxes and transfers have become more unequally distributed, and because the extent of redistribution through taxes and transfers has fallen ("Income redistribution through taxes and transfers across OECD countries"). A new OECD paper by Orsetta Causa, Anna Vindicis and Oguzhan Akgun provides an empirical investigation on the drivers of the widespread decline in income redistribution across OECD countries over the last two decades.

The results suggest that the size of the redistribution system plays a major role for income redistribution, in particular on the spending side, confirming previous OECD findings. Hence, the relatively widespread decline on cash transfers to the working-age population is found to have contributed to the decline in income redistribution to the working-age population.

On the revenue side, the empirical analysis uncovers an interaction between increased economic integration and the capacity of personal income taxes to reduce income inequality. Indeed, the results suggest that stronger trade ties across countries have made a given level of tax receipt through personal income taxes less effective at reducing income inequality. The estimated marginal effect of the personal income tax to GDP (PIT-to-GDP) ratio on redistribution thus

depends on the degree of countries' openness (Figure 1): for around half of OECD countries, the effect of the PIT-to-GDP ratio on redistribution is significantly positive but this effect declines with openness levels. For a country at the OECD average level of trade openness, a one percentage point increase in the PIT-to-GDP ratio is associated with a 2% increase in redistribution. For the countries for which such effect is statistically significant, it ranges from 3.7% (USA) to around 1.5% (Korea).

Figure 1. The effect of the size of PIT on redistribution decreases with trade openness



Redistribution is defined as 1 minus the ratio of the Gini coefficient of household disposable incomes and the Gini coefficient of household market incomes.
The dashed lines indicate the 95% confidence interval. Light shading indicates a positive not significant effect and darker shading indicates a negative not significant effect. PIT-to-GDP ratio measures total taxes on income plus employees' Social security contributions as a ratio of GDP.
Source: Calculations are based on Table 3, column 9 in Causa et al (2018).

For a given overall size of the tax and transfer system, the estimation results suggest that changes in specific tax and transfer instruments have contributed to the decline in redistribution. Most important among these are:

- Reductions in the progressivity of personal income taxes, driven by a flattening of the tax schedule in the upper-part of the wage distribution as well as by a decline in top personal income tax rates and in the

taxation of dividend income at the personal level.

- Reductions in the generosity and duration of unemployment-related transfers, including cuts to social assistance for the long-term unemployed, which have often taken place in combination with increases in spending on active labour market policies. This finding is thus likely to reflect the effect of policy reforms to boost work incentives among target groups and to shift from passive to active support for the unemployed.

At the same time, not all policy changes went in the direction of reducing redistribution: the decline in redistribution has been partly mitigated by progressive family-friendly policies, such as widespread increases in spending on early education and childcare, as well as by tax cuts to low wage earners.

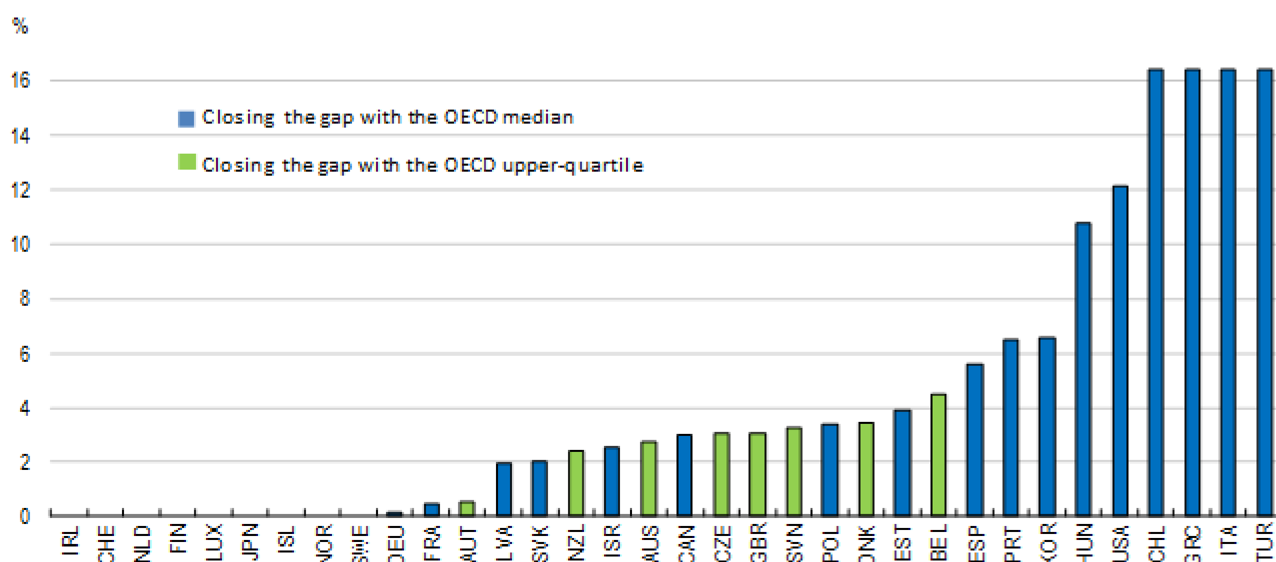
These estimates are used to simulate the income redistribution effect of selected tax and transfer reform scenarios, taking into account the countries' relative starting point in each policy area. Transfer reform scenarios deliver larger effects than tax reform scenarios. The scenarios consistently point to major redistribution gains in countries where social spending on working-age population is relatively low and/ or weakly targeted to low-income households (Figure 2). Increases in long-term unemployed- related transfers to married couples deliver major redistribution gains where these transfers are low or non-existent (e.g. Chile, Greece, Italy, Turkey and the United States) The magnitude of these effects reflects the large implied size of the simulated reforms for these countries and should therefore be interpreted in light of alternative policy objectives, in particular efficiency objectives in terms of job search incentives, alongside budgetary constraints. Still, those same countries that exhibit comparatively low passive support for the long-term unemployed tend to also exhibit comparatively low active support. As a result, policy packages that would combine more generous cash transfers with more effective activation and

training for jobseekers would likely meet equity and efficiency objectives. The United States and Turkey would also boost redistribution by increasing spending on early education and childcare; and so would Mexico and Japan. This would not only increase redistribution but also help narrowing gender gaps and curbing child poverty. Reforms to enhance access to quality childcare for disadvantaged families are likely to maximise policy synergies between efficiency and equity.

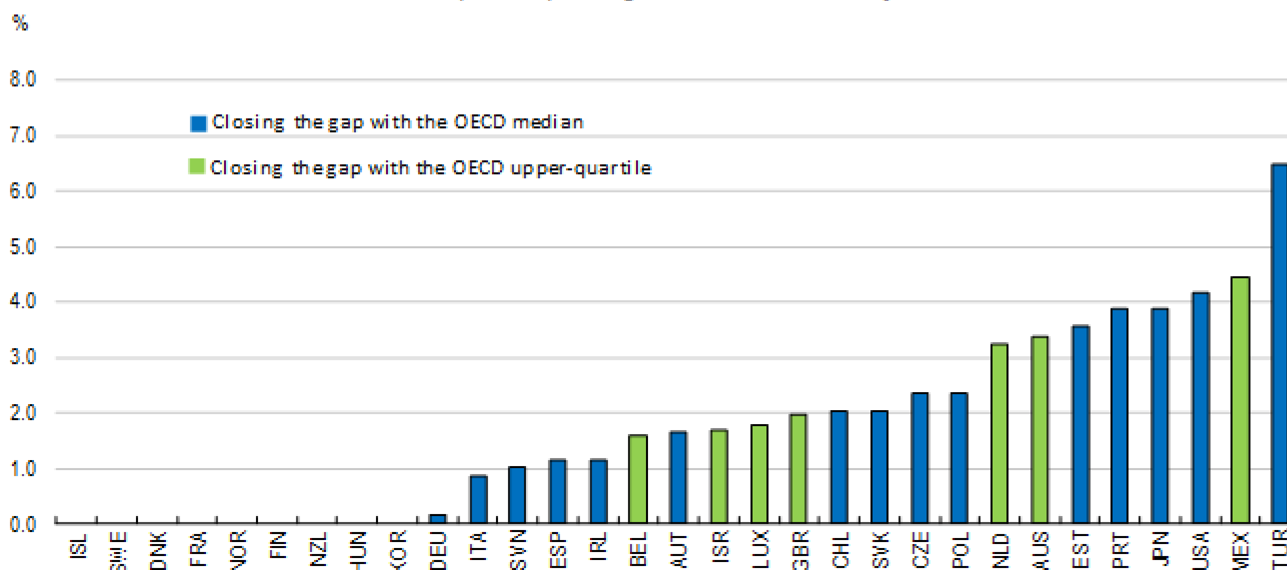
Figure 2. Illustrative income redistribution effects of selected transfer reforms

Reform-driven changes (%) in redistribution for the working-age population coming from:

A. Increases in long-term unemployment-related transfers for low-income married couples (including social assistance)



B. Increases in public spending on childcare and early education



Note: see Causa et al (2018) for details.

References:

Causa, O., A. Vindics and O. Akgun (2018), “An empirical investigation on the drivers of income redistribution across OECD countries“, *OECD Economics Department Working Papers*, No. 1488, OECD Publishing, Paris, https://doi.org/10.1787/5cb47f33-en.