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FISCAL POLICY AND INCOME REDISTRIBUTION

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The main objective of this paper is to put into perspective the possibilities for poor countries to use their fiscal systems for redistributive purposes. Most of the discussion will be centered on the taxation side of the fiscal equation. The conclusions emerging from it will probably be disheartening to those who believe that a major assault on the problem of inequality can be effectuated by fiscal means. But this does not mean that tax policy can be of no help at all in promoting greater equity. Indeed, though its limitations are severe when judged against the goal of a major improvement in the overall distribution of income, the possibilities for significant achievements look far brighter when viewed in terms of the more limited objective of bringing about a more equitable distribution of the fiscal burden itself. In fact, if there is any single message to emerge from this paper, it is that when we look at a tax system with the distribution issue in mind, we are far better advised to think in terms of bringing about a fairer distribution of the tax burden than in terms of having a major impact on the overall distribution of income in the society in question.

I. The Main Constraints on Tax Policy

Frequently, when the income distribution problem in LDC'S is discussed, statements like the following emerge: "The top quintile of the income distribution now gets half of the existing total after-tax income, while the bottom quintile gets only 5 percent. Thus if only an additional tenth of the

top group's share were taken away and given to the bottom group, the latter's share could be doubled." This kind of arithmetic makes good fodder for seminars, but does not do much for policy, as it papers over all of the problems involved in effectuating the sort of change it contemplates.

Basically, these problems fall into five classes:

a) The affected factors of production may leave the country.

b) The affected factors of production may shift to other activities (in which lower taxes are paid) within the country.

c) The taxes in question may be evaded.

d) The taxes in question may not be levied in the first place.

e) The taxes may be levied but not have the desired effect.

There follow some brief comments on each of these items.

a) <u>On factors of production leaving the country</u>. This may at first glance appear to be a point of little practical importance, given the constraints that exist in today's world with respect to international migration. Nonetheless, I think such a judgment is unwarranted, especially in the context of redistributive fiscal policy measures. The facts, I believe, are that the strongest barriers to international migration bear against the poorest strata of the income distribution in LDC'S, while the possibilities for migration by the upper strata are quite real (viz. the large fractions of the output of doctors by Filipino and Colombian medical schools that have ended up practicing in the U. S., and the large numbers of Indian social scientists teaching in U. S., Canadian, and U. K. universities.)

Much more important than labor migration, however, is that of capital. There can be little doubt that most wealthy people, in any less-developed country in the world, can and do find ways of having bank accounts and securities portfolios abroad. In many cases, the capital-market movements involved are perfectly legal; in others the black market is used as a vehicle for transferring funds. But in any event, the funds do get abroad, where

they earn incomes which rarely pay any tax to the treasury of the country of origin. I believe that we can and should take as a datum that wealthy people in most LDC's earn yields on their foreign holdings equal to the nominal yields on those investments minus whatever taxes may be withheld at the source by the host country. These are the yields which they compare with what they can earn at home.[1/] If the economic return to capital becomes more unfavorable for home-country investment, this will carry as a consequence a greater flow of funds overseas, where it will be beyond the effective reach of the LDC tax net. Any discussion of redistribution by fiscal means which does not recognize the existence and importance of this avenue of escape from local taxation must be characterized as hopelessly unrealistic.

b) Tax "shelters" within the country. Realism also dictates that one recognize the existence (and probable inevitability) of areas within most LDC economies where factor incomes are taxed at effectively lower rates than in other areas. As far as capital is concerned, there is usually a relatively high rate of taxation of corporate profits, a lower rate of tax

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1/ It should be noted that the use of the black market as a vehicle for the transfer of funds does not in itself lower the yield perceived by the LDC investor. If the official exchange rate is Rs. 7.5 to the dollar, and the black market rate Rs. 11.25, it is true that it takes 50 percent more rupees to buy a black market dollar than an official one, but if the black market dollar is invested abroad at a yield of 8 percent, and if the proceeds of the investment are then transferred back to the country of origin at the black market rate, the yield in rupees is also 8 percent. Black market transactions run risks of detection (though in fact the likelihood is small) and of changes in the relevant exchange rate between the time of initial investment and the time that funds are repatriated, but the investment yield itself is unaffected by the use of the black market to transfer funds.

applying to many non-corporate activities (e.g. farming, retailing), and probably no tax at all on the imputed income from owner-occupied housing. In addition there are often special tax incentive schemes aimed at attracting funds to backward regions (e.g. Northeast Brazil) or to specified activities (e.g. low-income rental housing).

With respect to labor income, such special provisions are far less common, but substantial differences in the effective burden of taxation arise through differential evasion. Heavy taxation, at the source, of salary incomes thus gives rise to professional services being carried on under special contracts outside the formal salary structure of the firm. Similarly, heavy taxes on wage incomes lead to the subcontracting of simple manufacturing processes to small supplier firms which are in a better position than large companies to avoid or evade such taxes. Even where direct subcontracting is not undertaken, it appears that the relatively heavy taxation of wage and salary incomes in "organized" industry (e.g. modern textile firms, supermarkets, department stores, etc.) is a key factor in the survival of competitive activities (e.g. handicraft textiles, small retail shops) in the "unorganized" sector.

c) Tax evasion clearly plays a role in the processes discussed under a) and b) above. It merits a separate heading mainly to underline its ubiquity and inevitability. This is not to say that efforts to attack tax evasion are in vain--quite to the contrary, such efforts are utterly essential for any reasonable degree of equity in taxation. But I do feel that a frank recognition of the phenomenon of evasion is required for the design of an equitable tax system. To pretend that farmers, shopkeepers, and independent professionals pay income taxes with anything like the same fidelity as wage and salary workers subject to withholding only leads to an exaggerated reliance being placed on personal income taxation as a revenue source, and to a consequently greater degree of horizontal inequity between those who

cannot evade the legally [illegible] tax and the other groups [illegible] easier access to evasion routes. The course of wisdom for most [illegible] is to combine a diversified tax portfolio (so that those groups which can evade a particular tax are at least picked up on other taxes in the package) with moderate rate structures (to limit the incentive to evade) and energetic enforcement (to limit the degree of response to whatever incentive exists). There can be no doubt, however, that this strategy has the effect of blunting the apparent possibilities for strongly redistributive taxation--a conclusion which, in my view, should be taken as a fact of life.

d) Political constraints is probably the best term under which to summarize the reasons why strongly redistributive taxes may not be levied in the first place. The U. S. is able to have marginal income tax rates of 50 percent on personal incomes of, say, 8 times the per capita GNP. Such rates are evaded to some extent and by some groups, but they are paid in full by salaried workers subject to withholding and by others. But what can be taxed in the U. S. out of incomes of $50,000 per year and more, cannot be done in India on incomes of $800 per year and up, or in Central America on incomes in excess of $4,000 or $5,000. Part of the reason why it cannot be done lies in real factors like those mentioned under a) and b) above. But a very important part lies directly in political factors. Put very simply, heavy taxation of incomes above the indicated figures would directly hit the very civil servants who design and administer the tax structure, and also the legislators who put it into law. In spite of the fact that their incomes put them in the top percentile or two of the income distribution, these groups, by and large, do not consider themselves as rich, but rather as part of a struggling middle class. Their tastes and consumption habits are not extravagant by international standards, or even in terms of the traditions of the elite in their own countries. The fact that these people are demonstrably a part of the very upper stratum of society in their own

impoverished nations does not make them any more eager or willing to impose new, heavy, tax burdens on themselves. As long as this attitude prevails, and as long as the groups in question have the political clout to make it stick, even U. S.-style progressivity in income taxation will remain out of the range of possibility for the LDC'S in question.

e) The incidence question is in a sense simply the reflection of the forces referred to above. In very broad terms it can be summarized with the comment that tax structures are likely in fact to be a lot less progressive than they look. If, for example, the owners of capital in an LDC have access to outlets for their funds in the world capital market at yields of 8 percent, efforts to tax the use of those funds at home will have the effect of a further capital outflow. In all likelihood, the final result will be that capital invested at home will still have an after-tax yield of 8 percent (or whatever is judged by the investors to be reasonably comparable with the yields obtainable on the international market). If the taxation of income from capital at home is light, lots of funds will stay at home, and will produce a before-tax yield of, say, 10 percent. If the relevant taxation is heavy, more capital will flow abroad, and that which stays at home may end up with a before-tax yield of, say, 16 percent. In both of these cases the LDC owners of capital are really in the same income position--earning 8 percent after taxes on their investments. But in the first case they appear to be bearing low taxes, and in the second to be bearing high taxes. In fact, as the example was framed, the burden of taxation on income from capital is in both cases passed on in the form of higher real product prices or lower real wages or both. Its ultimate incidence will depend on the distribution among income groups of the consumption of the affected products, and on the degree of substitutability of labor for capital in the affected activities. But reasonable values for the relevant parameters covering these aspects of incidence would surely lead to the tax

being effectively more like a consumption tax and/or a general wage tax than a tax which truly reduces the real income of capital owners by the amounts collected.

The incidence effects of taxes work similarly when labor migration is involved. If some members of the affected group move out of the country as a consequence of the tax structure, the before-tax rewards of those who remain are increased, so that patients (for example) end up paying part of the tax burden nominally falling on doctors.

Where the reallocations induced by the tax system take place within the economy (i.e. by a reshuffling of factors from heavier-to lighter-taxed activities) rather than by a net out-migration of labor or capital, the situation is somewhat different. Here the most directly traceable effect of heavier taxation of a factor in some activities is to lower the real rewards earned by the same factor in lighter-taxed activities. Thus, for example, the heavier taxation of corporate earnings operates (in the absence of out-migration of capital from the country) to drive down the rewards earned by capital in non-corporate uses. Similarly, the heavier taxation of the earnings of salaried professionals works in the direction of lowering those of professionals in independent practice. Under certain circumstances (the so-called Cobb-Douglas case is the best example), this process simply works as a tax-spreading device--the tax on the income of corporate capital falls in the final analysis on the income of all (i.e. corporate plus non-corporate) capital, and the tax on the earnings of salaried accountants is spread ultimately among all (i.e. salaried plus self-employed) accountants.

This "tax-spreading" effect, which means that when a particular factor is subject to higher taxation in some activities than in others, the effect of this higher taxation is felt by similar factors in all activities (even those subject to little or no taxation) is the clearest implication of incidence theory when out-migration is not a significant element in the

picture. But there may be other effects as well--causing impacts on consumers as a group or on the real earnings of other productive factors. I shall not go into those effects here, however, since one cannot generalize even about their direction without knowledge of the particulars of the case at hand.

II. Some Redistributional Fiscal Policy Exercises

The discussion of the preceding section can best be viewed as a springboard for the analysis about to be presented. It is a springboard in the sense that, to pass from the previous section to the exercises we are about to engage in, a certain leap is involved--the exercises are not the logical consequence of what went before, but are, I hope, motivated and made plausible by it.

The particular meat that I would like to extract from the previous section for use in what is to follow is the judgment that there are strong grounds for caution and deliberation in the design of tax structures. In particular, crude arithmetical exercises purporting to show the redistributive potential of the tax system should be viewed with skepticism. I hope that enough skepticism has been implanted in the minds of my readers that they will be willing to accept the following self-imposed rules for judging what can plausibly be done by progressive taxation in an LDC context.

A. We will consider progressive taxation to begin at a level equal to the average per-family (or per-earner) income of the country.

B. We will consider applying only moderate rates of tax (say 10 to 25 percent) to incomes immediately in excess of the average described in A. Thus, earnings in excess of the average, but less than 1 1/2 times it would be taxed at rates no greater than, say, 10 percent; and earnings between 1 1/2 and 2 1/2 times the average would be taxed at rates no greater than, say, 20 percent.

C. For incomes substantially in excess of the average, higher rates can be applied, but they should only gradually approach a limit of, say, 40 percent, and this limit should come into play at incomes in excess of, say, five or six times the average as defined in A.

These rules are in fact quite "optimistic" ones, when it comes to assessing the redistributive potential of taxes in an LDC environment. Pechman and Okner, in a recent monograph have analysed the entire U. S. tax system (federal, state, and local) under eight different sets (variants) of incidence assumptions. Under none of these sets does the average rate of tax of the 95th percentile of the income distribution exceed 25 percent, or that of the 99th percentile exceed 30 percent, or that of the top percentile exceed 40 percent.[2/] Our "simulations" for LDC's, we shall see, come quite close to these figures, when combined with a "base" of proportional taxation (such as might be provided by sales or value-added taxation) striking all income groups at a rate of around 10 percent.

We start with a hypothetical LDC income distribution which is, in relative terms, a bit more equal than that reported by Pechman and Okner (Table 4-2, p. 46) for the U. S. Columns (1) and (2) of Table Ia present this distribution. In Column (3) the average income of each fractile, relative to the overall national average, is calculated. Where this relation exceeds unity, the excess over one represents what rule A would permit to be tapped for progressive taxation. This excess is shown in Column (4). Column (5) gives the marginal tax rates which were applied to each group's income, in accordance with rules B and C.

The derivation of the average tax per unit in the fractile group, presented in Column (6), was done as follows: for the fourth quintile, the

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2/ See Joseph A. Pechman and Benjamin A. Okner Who Bears The Tax Burden? (Washington; The Brookings Institution, 1974) Table 4-4, p. 51.

rate of 10 percent was applied to the tax base of 0.25 "average incomes," shown in Column (4). For the ninth decile, with a taxable income of 0.50 [from Column (4)], the first 0.25 was taken to be taxed at the rate of 10 percent, and the second 0.25 was assumed to be taxed at a rate of 16 percent, the total resulting tax being .065 [= (.25) x (.1) + (.25) x (.16)] "average incomes." The rest of Column (6) is built up in the same way. For the 91st - 95th decile, "taxable income" is 1.00 "average incomes." The first 0.50 of this would carry a tax of .065 (as calculated above), to which would be added a tax of 20% on the second 0.50, yielding a total tax of .165 "average incomes."

In Column (7) the average tax rate for each group is found by dividing the calculated tax [Column (6)] by the average income of the group [Column (2)]. Finally, in Column (7), the total tax of each group is calculated, as a percent of total income, by multiplying the average rates of tax from Column (6) by the percentage shares [from Column (2)] of each group in total income.

The global total of tax collections under the hypothetical setup depicted in Table Ia is 6.3 percent of the total income of all groups taken together. This is a sizeable sum, viewed in fiscal policy terms. And it is to be emphasized that the tax system in question (viewed as the progressive component to be added to some proportional base) is significantly more progressive than the U. S. tax system under any of the incidence variants explored by Pechman and Okner. It is thus probably quite unrealistic to expect this strong a tax performance from a typical LDC. But we shall explore its consequences nonetheless, with the aim of setting outside limits on what can reasonably be expected.

Needless to say, the tax side of the fiscal equation does not by itself effectuate a full redistribution. For this the expenditure side must also be taken into account. This is done in Table Ib, where the assumption is made

that the benefits associated with the expenditure side are distributed among groups in proportion to their incomes. The net gains and losses accruing to the different income groups under these assumptions are shown in Column (5) of Table Ib. The most notable feature of this Table is the relatively small degree of benefit received by the lower income groups, in spite of the quite progressive tax structure.

This draws attention to the obvious point that the expenditure side has a very important influence on the ultimate redistributive properties of the fiscal system.

Unfortunately, our capacity for quantifying incidence by income group is even more limited on the expenditure than on the tax side, so I shall only make a few general statements here. A great many government outlays go for general purposes (administration, police, the courts, national defense) whose assignment as benefits to particular income groups is necessarily quite arbitrary. The notion that these benefits are roughly proportional to income and/or wealth, however, seems at least to be a plausible approximation. Allocation in accordance with income also seems to be a sensible basis for government expenditures on such items as highways and other infrastructure investments, insofar as their costs are not covered by direct user charges (which for present purposes should not be counted as taxes). When one asks what are the expenditures that can reasonably be allocated on a per-capita or per-family-unit basis, they turn out to be relatively few: primary education, publicly dispensed medical services, and family allowances (in some countries) seem to be the best candidates here. (Actually, many family-allowance setups apply only to certain categories of workers, which exclude the very poor; and public secondary and higher education has benefits which at least in LDC'S are concentrated disproportionately among the well-to-do.) Expenditures that are truly concentrated toward the bottom end of the income distribution are

TABLE Ia

Hypothetical Pattern of Income Distribution With Progressive Taxes (U. S.-Type Distribution)

(1) Fractile of Income Distribution	(2) Percentage Share of Total Income Received	(3) Average Income in Fractile, As % of National Average Income [= (2) ÷ (1)]	(4) Excess of Fractile Average Income Over National Average	(5) Marginal Tax Rate Applied	(6) Calculated Tax Per Unit in Fractile	(7) Average Rate of Tax in Fractile [=(6) ÷ (3)]	(8) Total Tax in Fractile, as % of Total Income [=(7)x(2)]
Lowest quintile (20)	5	.25	--				
Second quintile (20)	10	.50	--				
Third quintile (20)	15	.75	--				
Fourth quintile (20)	25	1.25	0.25	.10	.025	.02	.500
Ninth decile (10)	15	1.50	0.50	.16	.065	.043	.645
91st-95th percentile (5)	10	2.00	1.00	.20	.165	.083	.830
96th-99th percentile (4)	12	3.00	2.00	.30	.465	.155	1.860
Top percentile (1)	8	8.00	7.00	.40	2.465	.308	2.465
TOTAL	100						6.300

TABLE Ib

Group Gains and Costs of Progressive Taxes Cum Proportional Expenditures

(1) Fractile of Income Distribution	(2) Percentage Share of Total Income Received	(3) Costs of Progressive Taxes (From Table Ia, Col. 8)	(4) Gains From Proportional Expenditures	(5) Net Gains (+) or Costs (-)
Lowest Quintile (20)	5	--	+.315	+.315
Second quintile (20)	10	--	+.630	+.630
Third quintile (20)	15	--	+.945	+.945
Fourth quintile (20)	25	- .500	+1.575	+1.075
Ninth decile (10)	15	- .645	+ .945	+ .300
91st-95th percentile (5)	10	- .830	+ .630	- .200
96th-99th percentile (4)	12	-1.860	+ .759	-1.101
Top percentile (1)	8	-2.465	+ .501	-1.964

even harder to find. This category could include welfare payments in developed countries, but few LDC'S have direct welfare programs. Within the LDC'S only a few cases can be found (such as India's famine relief and rural works programs) in which the benefits of government outlays accrue predominantly to the poor.

Thus I believe that the type of redistribution implied by Table Ib can probably be taken as an optimistic assessment of what fiscal policy is likely to be able to do for income distribution in most LDC'S. The effect is certainly small, if one starts with grandiose hopes of a major impact. The Gini coefficient for the distribution of income represented by Columns (1) and (2) of Table Ia is .402. That result when Column (2) is adjusted for the transfers shown in Column (5) of Table Ib is .372--only a modest change.

If the above gives a realistic picture of the possibilities of fiscal policy, based on the assumption that expenditure incidence is proportional, one may perhaps inquire as to what would happen if the moneys raised from taxation were spent much more equally. An attempt in this direction is reflected in Table Ic, where the assumption is made that the same amount of revenue as is involved in the tax explored in Table Ia is instead raised by proportional taxation but spent in such a way that each unit (individual or family, as the case may be) benefits equally. This last is an absurdly optimistic assumption, from the point of view of redistribution, but we explore its consequences nonetheless. Its implied effect on income distribution is given in Column (5) of Table Ic. Here it is seen, as should be expected, that the lowest income strata are more strongly benefited than is the case with the implicit transfer explored in Table Ib. But nonetheless the overall change in income distribution is again modest, with the Gini coefficient being reduced from .402 to .377

TABLE Ic

Group Gains and Costs of Proportional Taxes Cum Equal Expenditures Per Unit

(1) Fractile of Income Distribution	(2) Percentage Share of Total Income Received	(3) Costs of Proportional Taxes	(4) Gains from Equal Outlay Per Unit	(5) Net Gains (+) or Costs (-)
Lowest quintile (20)	5	- .315	+1.260	+ .945
Second quintile (20)	10	- .630	+1.260	+ .630
Third quintile (20)	15	- .945	+1.260	+ .315
Fourth quintile (20)	25	-1.575	+1.260	- .315
Ninth decile (10)	15	- .945	+ .630	- .315
91st-95th percentile (5)	10	- .630	+ .315	- .315
96th-99th percentile (4)	12	- .759	+ .263	- .496
Top percentile (1)	8	- .501	+ .052	- .449

Tables IIa, IIb, and IIc are patterned after the corresponding Tables I, the only difference being that the assumed income distribution is more unequal, more closely approximating present-day reality in most LDC'S. Together with the stretching of the upper tail of the income distribution, there is a corresponding stretching of the range over which the assumed tax rates apply, but the general pattern of rise of marginal rates from 10 percent to 40 percent is similar to that in Table Ia. The shift in assumptions between the Tables of set I and those of set II has very little effect on the overall conclusions to be drawn from the exercise. With the more unequal distribution of Tables II, a somewhat larger fraction (8.5 versus 6.3 percent) of total income is raised by the assumed progressive tax pattern. The net redistribution revealed in Table IIb, where the progressive tax is joined to a proportional expenditure pattern, is also somewhat larger than that emerging from Table Ib, but the basic picture of a very modest impact on the lowest quintiles of the distribution remains. The Gini coefficient falls from .498 to .462 as the distribution of Column (2) of Table IIa is modified by the transfers shown in Column (5) of Table IIb.

The distributional shift entailed in shifting from outlays proportional to income to equal outlays per unit, is (as should be expected) more marked when the underlying distribution of income is more unequal. The transfers shown in Column (5) of Table IIc reveal this, but the Gini coefficient is still reduced from .498 to .456. And the significance of even this modest fall must be tempered by the realization that the assumption of equal per-unit expenditure incidence (for a significant fraction of total public outlays) is distinctly extreme.

TABLE IIa

Hypothetical Pattern of Income Distribution With Progressive Taxes (LDC-type Distribution)

(1) Fractile of Income Distribution	(2) Percentage Share of Total Income Received	(3) Average Income in Fractile, As % of National Average Income [=(2)÷(1)]	(4) Excess of Fractile Average Income Over National Average	(5) Marginal Tax Rate Applied	(6) Calculated Tax per Unit in Fractile	(7) Average Rate of Tax in Fractile [=(6)÷(3)]	(8) Total Tax in Fractile, As % of Total Income [=(7)×(2)]
Lowest quintile (20)	4	.20	--				
Second quintile (20)	8	.40	--				
Third quintile (20)	12	.60	--				
Fourth quintile (20)	20	1.00	--				
Ninth decile (10)	16	1.60	0.60	.10	.06	.038	.608
91st-95th percentile (5)	12.5	2.50	1.50	.20	.24	.096	1.200
96th-99th percentile (4)	16	4.00	3.00	.23	.74	.185	2.960
Top percentile (1)	11.5	11.50	10.50	.40	3.74	.325	3.738
Total	100						8.506

TABLE IIb

Group Gains and Costs of Progressive Taxes Cum Proportional Expenditures
(LDC-Type Distribution)

(1) Fractile of Income Distribution	(2) Percentage Share of Total Income Received	(3) Costs of Redistributive Taxes	(4) Gains From Proportional Expenditure	(5) Net Gains (+) Or Costs (-)
Lowest quintile (20)	4	--	.340	+ .340
Second quintile (20)	8	--	.680	+ .680
Third quintile (20)	12	--	1.021	+1.021
Fourth quintile (20)	20	--	1.701	+1.701
Ninth decile (10)	16	- .608	1.361	+ .753
91st-95th percentile (5)	12.5	-1.200	1.063	- .137
96th-99th percentile (4)	16	-2.960	1.361	-1.599
Top percentile (1)	11.5	-3.738	.978	-2.760
			8.505	

TABLE IIc

Group Gains and Costs of Proportional Taxes Cum Equal Expenditures Per Unit
(LDC-type Distribution)

(1) Fractile of Income Distribution	(2) Percentage Share of Total Income Received	(3) Costs of Proportional Taxes	(4) Gains from Equal outlay Per Unit	(5) Net Gains (+) or Costs (-)
Lowest quintile (20)	4	- .340	+1.701	+1.361
Second quintile (20)	8	- .680	+1.701	+1.021
Third quintile (20)	12	-1.021	+1.701	+ .680
Fourth quintile (20)	20	-1.701	+1.701	--
Ninth decile (10)	16	-1.361	+ .851	- .510
91st-95th percentile (5)	12.5	-1.063	.426	- .637
96th-99th percentile (4)	16	-1.361	.340	-1.021
Top percentile (1)	11.5	- .978	.085	- .893

III. Observations on The Struggle for Greater Equality

The main lesson emerging from the preceding sections is that those who are striving to improve the distribution of income in LDC'S should be prepared for a long, arduous, demanding, and often frustrating struggle. The realities of unequal income distributions are stark, but the limitations and constraints that stand in the way of improvement are equally strong and real. There is no simple trick or touchstone, short of totally uprooting the existing economic, social, and political structure, that will with one or two or three strokes substantially alter the distributional picture that we now observe. The challenge is one of mustering the forces for an essentially permanent struggle, with many battles that are purely defensive, and others that gain ground bit by bit as a result of hard and continuous effort.

To give a sense of the directions that such a struggle might take, I present below an illustrative listing of some possible measures to improve the distribution picture:

a) Eliminate the income-tax exemption of imputed rent on owner-occupied dwellings. There is probably no single fiscal area in which the cause of equality could be more directly and surely promoted than this one. Countries in which the very poor sleep in the streets are nonetheless implicitly subsidizing the housing of the wealthy to the tune of their marginal income-tax rates times the implicit rental in their dwellings (often two or three per family). This fact is clear, yet the political resistance to this particular reform is incredibly strong, and comes from homeowners of all income levels, and even from those who, though they do not now own houses, hope and plan some day to do so.

b) Shift part of the weight of progressive taxation from the income tax to a progressive consumption-expenditure tax. This, to my knowledge, is

the best way to induce the repatriation of capital held abroad by nationals of the country in question, to deter further capital outflows, and to capture within the local tax net the expenditures made by nationals traveling abroad (an important category of luxury spending in nearly all countries, but particularly so for the smaller ones).[3/]

c) Improve assessment procedures for property tax purposes, preferably by shifting to a self-assessment scheme. The property tax, as presently administered, is shot through with inequities. Assessed values differ from market values in grossly different degrees on different properties; inflation tends to be reflected in assessments only after incredibly long lags; and corruption is rife in the assessment process itself in many countries. A self-assessment scheme (particularly the market-enforced variety) would go far to rectify all these deficiencies.[4/]

d) Categorically eliminate subsidized housing for those above the median income. It is my general impression that most beneficiaries of public housing in LDC'S are in fact in the upper half of the income distribution.

e) Institute electricity rate structures that reflect the true economic cost of power generation. There can be little doubt that the cross-sectional demand for electric power is income elastic, yet this is one of the most ubiquitously subsidized public services.

f) Institute substantial tuition changes for public higher education, with special provision for the financing of the education of poorer students (preferably via loans.) This is of particular importance

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3. For elaboration on these points, see my "The Panamanian Income Tax System: A Heterodox View" (mimeo, June 1973).

4. For more on self-assessment, see "Issues of Tax Reform for Latin America," in my Taxation and Welfare (Boston: Little, Brown & Co., 1974).

in LDC'S where free or nearly-free university education is given predominantly to the children of the rich.

g) Where unemployment and underemployment are serious problems, institute programs in which the government serves as an "employer of last resort." The government, in such cases, can perform a truly positive function by being a "bad" employer, i.e. by standing ready to employ those who would otherwise be destitute, on terms and conditions such that no serious competition with "regular" employments is involved. Such programs have great potential for ensuring some opportunity to the very worst-off segments of society (at least those who are able-bodied), and they can also serve a useful informative function in giving direct information on the nature and extent of the poverty problem.

h) The government should avoid, in its own employment practices and in its legislation and regulations covering private-sector employment, the creation or perpetration of "labor elites." Labor elites are generated when wages and conditions in certain protected segments of the labor market are very substantially superior to those in the market at large. The syndrome of the government as a "model employer," paying not only greater-than-market wages but also throwing in a variety of ample fringe benefits (free or grossly-subsidized housing, generous retirement pensions, special dependency allowances, etc.) should be shunned. The money spent in providing amenities to the labor elite is better spent on activities that truly help the really poor.

i) Tax incentives to industry should be viewed with great suspicion. While no categorical case can be made against tax incentives which are properly designed to compensate for market imperfections or weaknesses, the fact remains that most tax incentive schemes actually

adopted in LDC'S have artificially encouraged the use of capital-intensive methods of production, and many have in addition resulted in the transfer of substantial sums from the public treasury into pure "producer surplus" in the hands of the owners of the affected enterprises.

The above listing could readily be extended, but I believe it is sufficient to support my main conclusions. They are:

i) The attack on the income distribution problem should be multi-faceted, operating on a lot of different fronts at once.

ii) There is no particularly close connection between the various facets of this attack. The battles can, by and large, be waged independently. All do not have to be fought or won simultaneously, and gains can be had by winning something along any given front.

iii) Serious political resistance is to be expected along any relevant front. Almost by its nature, redistribution (unlike pure trade) is a game in which there must be losers as well as winners. And the losers, being those who already gain from the status quo, are likely to have substantial entrenched power in the existing setup.

iv) Struggle is the key word where income redistribution is concerned. Mere lip-service to the cause will do no good.

APPENDIX TO

FISCAL POLICY AND INCOME REDISTRIBUTION

by Arnold C. Harberger

Prepared for the Princeton/Brookings Income Distribution Project

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When this paper was initially presented at a preliminary conference of authors and discussants, the principal suggestion made was that the analysis underlying Tables Ib, Ic, IIb and IIc be extended to cover cases built on the assumption that moneys raised by progressive taxation would be spent in an egalitarian way (i.e. equal outlays per taxpaying unit). This is done in Tables Id and IId, and the effects of various combinations of policies on the Gini coefficient are summarized in Table III. (Readers of preliminary version should note that the Gini coefficients derived from Tables Ic and IIc were erroneously reported in that version, and have here been corrected).

As shown in Table III, one gets almost identical Gini coefficients for the Progressive Tax, Proportional Expenditure Package as for the Proportional Tax, Egalitarian Expenditure Package -- under either assumption concerning the basic distribution of income.

Not surprisingly, the combination of progressive taxes with egalitarian expenditure produces about twice the reduction in the Gini coefficient as either of the intermediate packages. However, I would like to emphasize the gross unrealism of this combination as a practical target for a major fiscal reform. It is certainly possible to find incremental

Table 4d

Group Gains and Costs of Progressive Taxes Cum Equal Expenditures Per Unit

(1) Fractile of Income Distribution	(2) Percentage Share of Total Income Received	(3) Costs of Progressive Taxes (From Table Ia, Col. 8)	(4) Gains from Equal Outlay per Unit	(5) Net Gains (+) or Costs (-)
Lowest Quintile (20)	5	--	+1.260	+1.260
Second Quintile (20)	10	--	+1.260	+1.260
Third Quintile (20)	15	--	+1.260	+1.260
Fourth Quintile (20	25	-.500	+1.260	+ .760
Ninth Decile (10)	15	-.645	+ .630	- .015
91st - 95th Percentile (5)	10	-.830	+ .315	- .515
96th - 99th Percentile (4)	12	-1.860	+ .263	-1.597
Top Percentile (1)	8	-2.465	+ .052	-2.413

Table IId

Group Gains and Costs of Progressive Taxes Cum Equal Expenditures Per Unit

(1) Fractile of Income Distribution	(2) Percentage Share of Total Income Received	(3) Cost of Progressive Taxes (from Table IIa, Col. 8)	(4) Gains from Equal Outlay per Unit	(5) Net Gains (+) or Costs (-)
Lowest Quintile (20)	4	--	+1.701	+1.701
Second Quintile (20)	8	--	+1.701	+1.701
Third Quintile (20)	12	--	+1.701	+1.701
Fourth Quintile (20)	20	--	+1.701	+1.701
Ninth Decile (10)	16	-.608	+ .851	+ .243
91st - 95th Percentile (5)	12.5	-1.200	+ .426	- .774
96th - 99th Percentile (4)	16	-2.960	+ .340	-2.620
Top Percentile (1)	11.5	-3.738	+ .085	-3.653

Table III

Gini Coefficients for Alternative Tax-Expenditure Packages

	BASIC DISTRIBUTION OF INCOME	
POLICY PACKAGE	U.S. TYPE	LDC TYPE
None	.402 (Ia)[1]	.498 (IIa)[1]
Progressive Taxes, Proportional Exp.	.372 (Ib)	.462 (IIb)
Proportional Taxes, Egalitarian Exp.	.377 (Ic)	.456 (IIc)
Progressive Taxes, Egalitarian Exp.	.347 (Id)	.419 (IId)

[1] Figures in parentheses give Table from which each Gini coefficient was derived. Gini coefficients calculated under the policy package labeled "None" are obtained from the unadjusted income distributions given in Column (2) of Tables Ia and Ib, respectively. Other Gini coefficients are based on these initial distributions, modified by the net gains and costs shown in the Tables indicated.

expenditures which indeed are distributed in an egalitarian way, and to finance them by incremental taxes that are raised in a progressive fashion. But that is a far cry from reorganizing the whole of a country's governmental expenditures so that they are egalitarian in their incidence, and reordering its entire tax system so as to be as progressive as our numerical expamples assume. Yet this type of major -- indeed revolutionary -- sort of change is what would be required to produce the Gini coefficients of the last row of Table III. Hence my classification of them as unrealistic.