What are the most important economic effects - good and bad - of forced redistribution? How should this inform government policy?

Question Three – Economics

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1 Introduction

Forced redistribution of income happens in almost every country in the world. It occurs for every dollar of tax revenue that the government spends because those who have paid the taxes do not usually receive the same amount of redistribution from the government in return.

Redistribution can be defined as the transfer of goods (including money) between subjects from a baseline distribution through a social mechanism, including a change in tax laws, monetary policies, or tort law (Barry, 2018). In this essay, I will discuss the effect of redistributive policies on inequality, growth, and democracy within a country. Examples of redistributive policies analyzed include tax and spending on education. Lastly, policy suggestions will be made based on the conclusions from the discussion.

Since the government forcibly redistributes income through public spending, government spending as a percentage of GDP can thus be a good measure of the level of redistribution within countries. Many countries have a high level of redistribution. In 2018, out of the 192 available data, 40 countries (20.8% of total) had a government spending more than 40 percent of their gross domestic product in that year (International Monetary Fund, 2019). These include countries like Sweden, Norway, Denmark, and Finland, which are typical welfare states.

2 Redistribution and Inequality

One of the major arguments justifying forced redistribution is that redistribution helps to reduce income and wealth inequality. Inequality in income is prevalent among many countries. A measure of inequality, the Gini coefficient, reflects the extent to which the distribution of income among individuals or households within an economy deviates from a perfectly equal distribution, with 0 being perfect equality and 100 being perfect inequality (The OECD Statistics Directorate, 2002). In 2018, Brazil had a Gini coefficient of 53.9, and Columbia had a Gini coefficient of 50.4. Both figures show staggering levels of inequality, compared to a value of 28.8 in Sweden, a typical example of a welfare state (The World Bank Development Research Group, n.d.). In those countries with high levels of inequality, a small portion of the population within the economy gets a more substantial share of the economy's output than their share of the population.

The United Nations argues that inequality harms poverty reduction and destroys people's sense of fulfillment as well as self-worth, thus breeding crime, disease, and environmental degradation. Most importantly, it is said in the same publication that inequality harms sustainable growth and development (The United Nations, 2017, p. 1). Reducing inequality thus became a mission for governments due to its social as well as economic significance.

The conventional theory believes that forced redistribution can be used to bridge income inequality. The effect may take two paths. Firstly, the government can use tax and social benefits to influence individual income. A progressive direct tax system would take a more significant portion of the income of rich people than that of poor ones. Therefore, the government can use the additional tax revenue from the rich to produce social welfare programs for the poor, such as unemployment pay. Giving out means-tested benefits for those in need rather than universal benefits can ensure that the poor get the transfer payments originated from the rich. The second form of redistribution involves investment in educational and healthcare opportunities. Though individuals can also use their own redistributed income to invest in themselves, governments can lead the effort in bringing opportunities to the poor that can help the poor to increase their productivity and increase their income in the long run. The funds required should also come from taxes paid by the rich (Bourguignon, 2018).

Empirical studies, such as DeFina & Thanawala (2004), Kenworthy (1999), as well as Allegrezza et al. (2004), have found positive relationships between redistributive efforts and reduced inequality and poverty in dozens of countries around the world.

However, some researches disagree with this common argument. Higgins & Lustig (2015) found that in 10 out of 17 developing countries in the study, at least a quarter of the poor in the countries pay more in taxes than they receive in transfers and subsidies (p. 71). They believed that the imperfect designs of the tax and welfare systems in these countries have only made inequality smaller among a portion of the population while leaving some poor people poorer by giving them fewer benefits than the amount they pay in taxes. Some previously non-poor people are also dragged into poverty in this way.

Another line of argument can be found in Nozick (1974). Nozick argued that, no matter what social structure an economy had at the start, inequality in income and wealth will become the ultimate outcome. Even if the economy started with a perfectly equal society, the freedom to trade in markets would result in unequal distributions of income and wealth in the end. In other words, "liberty upsets patterns." Nozick used the example of Wilt Chamberlain being paid a quarter for each fan that came to watch him play. Both the player and the fans made this transfer voluntarily and ended up with a Pareto Superior transaction. However, the result is a massive redistribution of income from basketball fans to Wilt Chamberlain, and inequality took hold. Nozick argued that only acts of constant coercion, such as regular efforts of forced redistribution, can maintain the "pattern" where equality is achieved.

3 Redistribution and Growth

The primary relationship between redistribution and growth has been partly explored in the previous section. By redistributing income from the rich to the poor or by investing in education and healthcare opportunities for the poor, the government can increase the productivity of low-income individuals. Total labor supply and total output can increase, and growth will be achieved.

A detailed model of how such growth occurred is given in Benabou (2002). Benabou used his model to confirm two ways of increasing growth. Firstly, the government can provide welfare benefits to people and give them tax breaks so that they can spend more on education themselves. Another route is by directly subsidizing the education industry with a fiscal package, making learning more attractive for all.

Both policies are effective in achieving growth but differ in important ways. First, each effective dollar spent on educational service would be more beneficial to growth compared to tax reduction. However, to reach the same level of certainty equivalent, more educational finance is required than tax transfers. In other words, "educational finance always dominates taxes and transfers from the point of view of growth, but is inferior from that of insurance (Benabou, 2002, p. 31)." A combination of both policies would be optimal in promoting growth.

Additionally, empirical support for the claim that growth can be an indirect effect of redistributive policies can be found in Ostry et al. (2014).

4 Redistribution and Democracy

This section will discuss the relationship between redistribution and democracy (where everyone can vote). Boix (2003) proposed that increasing levels of economic equality would reduce redistributive demands because "redistributive pressures from the poorest social sectors on the well-off voters diminish (p. 10)." Muller (1988) had also found empirical evidence proving that the democratic experience (the total length of time that a country has been as a democracy) has an inverse relationship with the level of inequality within the democracy. Combining the two conclusions, we can infer that as a country stays longer in democracy, inequality is going to reduce through redistribution, and less redistribution will be demanded within the democracy because inequality is lower. Interestingly, the level of democracy does not show a negative relationship with inequality (Muller, 1988).

It has been commonly debated whether it is just to forcibly redistribute people's income, especially in a democracy. Nozick (1974) argued that "Taxation of earnings from labor is on a par with forced labor (p. 169)." The reasoning is simple. For someone who chooses to work extra hours to earn additional income, he or she must prefer the additional income more than the leisure hours forgone. On the other hand, those who work less must have a higher utility for leisure time than the income he or she would otherwise have earned in the same period. The total utility will reduce after redistribution of the additional income generated by those hard-working individuals to those who need money because they choose to rest rather than work. In summary, this redistribution hurts both the welfare of the hard-working individuals within the democracy and also the total welfare of the whole society.

5 Policy Proposal

Arguments discussed above proved that the issue of redistribution is somewhat controversial when governments try to design their public policies. Fortunately, the above discussions can still yield some robust conclusions related to redistribution policies. Three different proposals are made based on the relationships between redistribution and inequality, growth, as well as democracy.

Primarily, some governments would have to redesign their tax and welfare system so that the smallest possible number of individuals below the median income are left worse-off after redistribution. A practical solution is to give negative income taxes for poor individuals below a certain income threshold to maximize the effect of progressive taxation. To avoid the redistributive impact of regressive taxes from the poor to the rich, those poor people in need of certain essential products should enjoy exclusive tax breaks from the government. These policy adjustments would ensure that the poor will not pay more in taxes than they receive in welfare payments in the short run.

Secondly, the welfare system should be designed so that the government can provide the poor people with educational opportunities to increase their productivity and income in the long run. Temporary redistribution is not sustainable in maintaining equality and growth. However, this conclusion does not mean that taxation policies are not useful. The government should use both a combination of tax breaks and direct fiscal spending on education to boost the maximum growth in the long run, as argued in Benabou (2002).

Thirdly, regarding the justice of redistribution and democracy, the government should follow the view of the majority through national votes. Though it is said that the level of democracy is unrelated to the level of inequality, it is still essential for governments to ensure that votes are fair and transparent, thus allowing the results to reflect the redistributive demands of the majority fully. By redistributing (or not redistributing) with respect to the opinions of the majority, the highest number of agents within an economy is made better-off under such policies. Besides, the government should be prepared to redistribute for long periods while maintaining its democratic structure. The result will be lower inequality and less demand for redistribution.

6 Conclusion

This essay has discussed three aspects of redistribution: redistribution and inequality, redistribution and growth, as well as redistribution and democracy. Though theoretical views differ, it can be found that i) redistribution does not necessarily reduce inequality, ii) reducing inequality through redistribution accelerates growth, and that iii) as a country stays longer in democracy and uses redistributive policies, inequality will reduce, and less redistribution will be demanded within the democracy. These conclusions are derived from both theoretical models as well as empirical research studying international data.

It is impossible to simply conclude that redistribution is favorable or unfavorable for a nation. However, discussions of the three aspects of redistribution had yielded three policy insights: i) ensure that the tax and welfare system are favorable for the highest possible number of people both in the short and long term, ii) use a combination of tax breaks and fiscal packages to spend on education and healthcare, iii) and ensure that the democratic structure brings fair voting to reflect the majority's preference for redistribution.

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