

## It's harder for governments to tax their way out of rising inequality

Written by The Conversation

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Higher inequality makes it harder to raise taxes and therefore redistribute income to fight its spread, our analysis shows. This is because in the past, on average, inequality has reduced the amount of income tax governments can collect as a share of GDP.

We also found a similar, though smaller, effect with less visible indirect taxes. Our findings help explain the difficulty governments, including Australia's, are experiencing in raising taxes, declining top income tax rates and growing budgetary pressure and debt burden.

In a study with [Rabiul Islam and Jakob Madsen](#), we reassessed the impact of inequality on taxation and redistribution for 21 high income OECD economies over the period spanning 1870 to 2011. We looked at the relationships between inequality, taxes and government spending.

We focused on inequality generated by each of these economies before government redistribution of tax revenues, measured by the [Gini coefficient](#) - a statistical measure of the income or wealth distribution of a nation's residents - and the income share of the top 10%.

After contracting for over 100 years, income inequality has risen since the 1980s. This is largely due to factors such as declining unionisation, technological advances, and globalisation.

Inequality has risen significantly throughout the [OECD](#) economies in recent three decades. For example, the income share of the top 1% in [Australia](#) doubled from 4.5% in 1981 to 9% in 2013.

Most economists see inequality as important for providing incentives that reward risk and effort. Nevertheless, rising inequality can create major economic and social challenges, potentially adversely affecting [economic performance](#) and people's [political engagement](#).

Democratic governments usually respond to inequality with a myriad of policies and public spending designed to redistribute incomes. These are funded principally through taxation and

debt.

According to economists' thinking, democratic governments adopt policies that reflect the [median voter](#)'s preferences. So, as inequality rises, the expectation is that there will be greater demand for redistribution and therefore more taxation. Emerging evidence suggests this widely held view among political scientists and most economists is incorrect.

### Limiting the power of government to fight inequality

Fiscal policy is an inherently political process. Virtually all government action involves some redistribution, from social security to subsidised schools and transport.

One explanation for our findings is that rising inequality reflects more than diverging incomes. As inequality increases, people become more segregated socially and [their trust](#) in each other deteriorates.

With widening income differences and growing social divisions, citizens are less willing to support each other and taxpayers less willing to pay taxes. As the gap widens between taxes paid and government services received, voters lose satisfaction with the tax system. So, when people have less motivation to pay tax, tax resistance and tax evasion rise.

At the same time, political pressure accumulates to curtail taxes and lobbying intensifies against redistribution of incomes. The middle class has a lot of political power and its willingness to pay taxes and support income redistribution policies is particularly important.

This varies between nations, with calls for more redistribution in some and [less in others](#). [Ethnic and racial differences](#) also play a critical role in some nations.

Political pressure and lobbying against redistribution and tax resistance take time to bite into government's fiscal policy and their effects persist. Our analysis detects the effects of inequality

as rather long lived, lasting up to 20 years.

The taxes collected today and redistribution and public spending from governments today are constrained by rising inequality over the past three decades. This may be why many OECD governments are finding that at exactly the time when they are wanting to redistribute more, they face greater constraints on their power to tax and their ability to redistribute.

### **The challenge for governments**

The major challenge for democratic governments is the need to provide good governance, engage with voters and protect incentives to generate economic prosperity, while at the same time increasing redistribution in the face of rising inequality. All this at a time when inequality creates greater demand for redistribution from some and political pressure against taxation and redistribution from others.

Moreover, nations compete internationally and hence domestic taxes are influenced and constrained by taxes and policies adopted in other nations. Needless to say, resolving these conflicts is difficult.

In our study we find that inequality constrains both taxes and spending, but the effect on taxes is much stronger. This suggests that budgets will continue to come under heavy pressure and the debt burden is likely to mount. Unfortunately, transferring this fiscal burden to the next generation may be the most expedient option.

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