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**Article — Published Version**

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Intereconomics

*Suggested Citation:* Groemling, Michael (2002) : Why does redistribution not shrink when equality is high?, Intereconomics, ISSN 0020-5346, Springer, Heidelberg, Vol. 37, Iss. 4, pp. 204-211

This Version is available at:

<https://hdl.handle.net/10419/41172>

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Michael Groemling\*

## Why Does Redistribution Not Shrink When Equality Is High?

*Studies on growth and distribution often claim that there is a positive relationship between the extent of inequality and the amount of redistribution. The following article presents empirical evidence for 15 high-income countries to show that even in economies with relatively high equality redistribution does not shrink, and offers a number of politico-economic explanations for this fact*

The question whether redistribution negatively affects growth runs like a thread through economic research and has been pondered by numerous authors, particularly since the evolution of the modern welfare state. However, in the early nineties the focus changed to the relationship between redistribution and growth in economies with widely different levels of development.<sup>1</sup> Some of these comparative studies conclude that inequality harms growth because it leads to more redistribution. According to this reasoning it is not the direct impact of inequality but its indirect effect via redistribution which impairs growth. This article purports that low inequality is not necessarily correlated with low redistribution. It will present empirical evidence for 15 high-income countries and politico-economic explanations to show that even in economies with relatively high equality redistribution does not shrink.

### Theoretical Background

Theory and empirical evidence on the relationship between redistribution and growth are based on the assumption that individuals have different incomes because they are differently equipped with capital and differently endowed with human capital. The decision to invest in capital and human capital depends on the conditions under which investors can reap the benefits of their investment. According to Persson and Tabellini<sup>2</sup> this decision is distorted in societies with an unequal income distribution. In unequal

societies the political process often results in high taxes on investment returns and as a consequence low investment in capital and human capital. The capital stock and the growth potential of these economies will therefore be low. These explanations combine new growth models with theories of endogenous politics. In democracies the majority of the voters decides on the extent of redistribution. The poorer this majority the more resources will be redistributed from the rich to the poor or from individuals who invest to those who do not invest.

A study by Alesina and Rodrik<sup>3</sup> confirms these findings by Persson and Tabellini but concludes that redistribution and the taxation involved also have positive effects on growth and that these may even dominate over the negative effects in countries with low tax rates. Public expenditure and the taxes involved will be accepted even by the capital-rich. This argument is supported by the following idea: tax financed public expenditure not only serves redistributive purposes but also raises labour and capital productivity so that taxes have a non-linear effect on growth.<sup>4</sup> On the one hand, this positive effect on

<sup>1</sup> For a survey of the multiple relations between inequality, redistribution and growth see Michael Groemling: *Ist Ungleichheit der Preis für Wohlfahrt? Zum Verhältnis von Wachstum und Verteilung*, Cologne 2001.

<sup>2</sup> Torsten Persson, Guido Tabellini: *Is Inequality Harmful for Growth?*, in: *American Economic Review*, Vol. 84, 1994, pp. 600-621.

<sup>3</sup> Alberto Alesina, Dani Rodrik: *Distributive Politics and Economic Growth*, in: *Quarterly Journal of Economics*, Vol. 109, 1994, pp. 465-490.

<sup>4</sup> Robert J. Barro: *Government Spending in a Simple Model of Endogenous Growth*, in: *Journal of Political Economy*, Vol. 98, 1990, pp. 103-125.

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productivity dominates the negative incentive effect if taxes on capital returns are low. On the other hand, high taxes diminish the return on capital and thus reduce investment and economic growth. Alesina and Rodrik therefore conclude that high inequality hampers growth because it causes high taxation.

Perotti<sup>5</sup> extends this argument. According to him the effects of redistribution on growth also depend on the stage of development. The fiscal costs of redistribution impair the growth process particularly in poor countries because only high-income groups are able to invest in human capital and to increase the human capital stock of the economy. Even in the case of maximal redistribution the poor will not have enough resources to increase the macroeconomic human capital stock to any sizeable degree by their investment. In the case of minimal redistribution the rich will be able to invest in their human capital and will thereby increase the national stock of human capital. This in turn will boost growth and development and create resources for growth-enhancing redistribution in the future. Thus the majority of the population faces an intertemporal trade-off – more equality now or more growth and more equality later. In order to enable the rich to invest now, and to improve the prospects of the poor, the majority should therefore opt for a moderate degree of redistribution today.

A similar explanation is given by Galor and Tsiddon.<sup>6</sup> Technical progress and growth depend on the macroeconomic stock of human capital. And according to Lucas<sup>7</sup> the human capital stock of an economy also has positive externalities on labour and capital productivity and therefore on growth. But the effectiveness of these externalities depends on the level of human capital. In other words, there is a threshold. The externality does not work and the growth process will not unfold unless the human capital stock is above that threshold. No redistribution or moderate redistribution enables rich groups to build up human capital and lift the macroeconomic human capital stock above that threshold so that more and more people will be able to invest.

The adverse effects of redistribution on growth

need not occur in relatively rich economies with an already high stock of human capital. Redistribution may foster human capital formation of poor population groups and strengthen the growth potential of rich countries.<sup>8</sup> But research and empirical evidence on the negative impacts of redistribution on the incentives to invest, innovate and work in modern welfare states have been mushrooming for decades.<sup>9</sup>

According to the studies and explanations referred to, redistribution will be harmful for growth. Many historical examples of countries at different stages of development have been cited to confirm this result. However, the underlying assumptions, in particular that a high level of inequality goes along with a high degree of redistribution, have to be carefully scrutinised. In the following we shall therefore look at 15 developed countries with low degrees of inequality and ask why the volume of redistribution is not necessarily low when inequality is already low.

#### Inequality and the Extent of Redistribution

The studies mentioned above deduce that the volume of redistribution increases with inequality. They therefore conclude that the political demands for redistribution would decrease with more equality so that the adverse effects of redistribution on growth would also be smaller. There are, however, considerable doubts about these conclusions. Particularly in the welfare states of developed economies with their comparatively low degrees of inequality there is enduring complaint about the high level of redistribution. The counter-arguments are, then, that the volume of redistribution does not diminish with a higher degree of equality and that there is no positive relationship between inequality and redistribution. These arguments are reinforced by empirical evidence and theoretical explanations.

In comparison to many developing regions the high-income countries analysed in this study have a low level of inequality.<sup>10</sup> When compared to each other they differ widely, however. Table 1 shows the extent of inequality in the distribution of disposable household income – measured by Gini-coefficients – in 15 developed economies. The Anglo-American

<sup>5</sup> Roberto Perotti: Political Equilibrium, Income Distribution, and Growth, in: *Review of Economic Studies*, Vol. 60, 1993, pp. 755-776.

<sup>6</sup> Oded Galor, Daniel Tsiddon: Human Capital Distribution, Technological Progress, and Economic Growth, CEPR Discussion Paper, No. 971, London 1994.

<sup>7</sup> Robert Lucas: On The Mechanics of Economic Development, in: *Journal of Monetary Economics*, Vol. 22, 1988, pp. 3-42.

<sup>8</sup> Roberto Perotti, op. cit.; Gilles Saint-Paul, Thierry Verdier: Education, Democracy and Growth, in: *Journal of Development Economics*, Vol. 42, 1993, pp. 399-407.

<sup>9</sup> For a survey of that line of argumentation see Michael Groemling, op. cit., pp. 173-182.

<sup>10</sup> For more details see Michael Groemling, op. cit., pp. 35-38.

## INCOME DISTRIBUTION

**Table 1**  
**Income Distribution in International Comparison**

Gini-coefficients of disposable income

	mid-1980s	mid-1990s
Italy	0.31	0.35
United States	0.34	0.34
Ireland	0.33	0.32
United Kingdom	0.29	0.31
France	0.28	0.28
Germany	0.27	0.28
Belgium	0.26	0.27
Japan	0.25	0.27
Norway	0.23	0.26
Netherlands	0.24	0.25
Austria	0.24	0.24
Finland	0.21	0.23
Sweden	0.20	0.23
Denmark	0.23	0.22

Data for Spain is not available

Sources: R. Arjona, M. Ladaique, M. Pearson: Growth, Inequality and Social Protection, OECD Labour Market and Social Policy Occasional Papers, No. 51, Paris 2001; Michael F. Förster: Trends and Driving Factors in Income Distribution and Poverty in the OECD Area, OECD Labour Market and Social Policy Occasional Papers, No. 42, Paris 2000.

economies (United States, Ireland, United Kingdom) and Italy rank at the top, and the Scandinavian economies of Finland, Sweden and Denmark rank at the bottom. With a few exceptions (Italy, Norway, Sweden, and Finland) there was, however, no pronounced increase in inequality in the nineties. In one third of the 15 countries the degree of inequality remained constant or even declined.

Another piece of evidence is that in a long-term perspective government expenditure has grown markedly faster than macroeconomic activities. As a result public expenditure in per cent of gross domestic product has increased over the last century.<sup>11</sup> The average expenditure-to-GDP ratio of all economies rose from 11.4 per cent in 1913 to 45 per cent in 2000. During the eighties and nineties it was even higher. Only after the Maastricht treaty required a consolidation of the national budgets did governmental outlays start to decelerate.

In 2000 Germany's expenditure-to-GDP ratio (47.2 per cent) ranked between Sweden (56 per cent) at the top and the United States (29.5 per cent) at the bottom (Table 2). However, compared to other countries Germany was not successful in slowing down the increase in public spending. A shining example is Ireland: its expenditure-to-GDP ratio declined from over 50 per cent in the early eighties to around 35 per cent recently.

There is evidence that the inflation of public spending has mainly been caused by expanding social budgets. Tanzi and Schuknecht conclude, "The growth in public spending in the post-1913 period was a consequence of the progressive and growing government involvement in education, health, pensions, unemployment, welfare assistance, and other such activities."<sup>12</sup> A study by Atkinson and van den Noord<sup>13</sup> shows that for the OECD-countries:

**Table 2**  
**Long-term Government Expenditure in International Comparison**

Public expenditure as a percentage of GDP

	1913	1920	1937	1960	1970	1980	1990	2000	Maximum	Year of Maximum
Sweden	10.4	10.9	16.5	31.0	42.1	60.1	56.4	56.0	67.7	1993
Denmark	n.a.	n.a.	n.a.	n.a.	47.0	56.0	56.0	54.2	60.6	1993/1994
France	17.0	27.6	29.0	34.6	37.5	46.1	49.3	51.1	53.9	1993
Austria	n.a.	14.7	20.6	35.7	38.5	48.1	48.6	50.3	53.1	1993
Belgium	13.8	22.1	21.8	30.3	36.5	58.6	53.3	50.0	59.0	1983
Italy	11.1	22.5	24.5	30.1	31.7	41.9	53.1	47.8	56.4	1993
Finland	n.a.	n.a.	n.a.	n.a.	29.9	38.1	44.5	47.7	60.4	1993
Germany	14.8	25.0	34.1	32.4	38.1	47.9	42.8	47.2	47.3	1996
Netherlands	9.0	13.5	19.0	33.7	43.9	55.2	49.4	45.0	54.7	1983
Norway	9.3	16.0	11.8	29.9	36.7	43.3	49.7	41.9	52.0	1992
Spain	11.0	8.3	13.2	18.8	21.4	32.2	39.7	40.7	47.8	1993
United Kingdom	12.7	26.2	30.0	32.2	37.8	43.0	41.8	39.1	45.4	1993
Japan	8.3	14.8	25.4	17.5	18.8	32.0	31.3	38.4	38.1	1999
Ireland	n.a.	18.8	25.5	28.0	37.0	48.9	37.8	35.4	52.2	1982
United States	7.5	12.1	19.7	27.0	30.3	31.8	33.6	29.5	34.8	1992
<b>Average</b>	<b>11.4</b>	<b>17.9</b>	<b>22.4</b>	<b>29.3</b>	<b>35.1</b>	<b>45.6</b>	<b>45.9</b>	<b>45.0</b>		

n.a. = not available

Sources: Vito Tanzi, Ludger Schuknecht: Reconsidering the Fiscal Role of Government: The International Perspective, in: American Economic Review, Papers and Proceedings, Vol. 87, 1997, pp. 164-168; Nicholas Crafts: Globalization and Growth in the Twentieth Century, IMF Working Paper, No. 44, Washington DC 2000; Institut der Deutschen Wirtschaft Köln: Deutschland in Zahlen, Cologne 2001; H. Warltizer: Staatsausgaben und Wirtschaftswachstum. Ein internationaler Vergleich, in: Beiträge zur Wirtschafts- und Sozialpolitik, No. 254, Cologne 1999.

**Table 3**  
Income Transfers in International Comparison  
as a percentage of GDP

	1970	1980	1990	2000
Germany	13.0	16.6	15.2	18.6
Austria	14.1	16.2	17.7	18.3
Sweden	10.1	17.1	19.3	18.3
France	12.0	15.5	16.9	18.1
Italy	11.8	14.2	18.1	17.3
Denmark	10.5	16.2	17.8	17.2
Japan	4.6	10.1	11.4	15.7
Belgium	11.0	16.1	15.1	14.4
Norway	9.0	11.3	16.0	13.7
United Kingdom	8.0	11.6	11.9	13.1
Finland	5.9	9.5	12.6	12.6
Spain	5.9	10.9	12.7	12.4
Netherlands	10.0	16.4	15.5	11.8
United States	7.1	9.8	10.0	10.5
Ireland	10.0	10.7	11.9	9.7

Source: Paul Atkinson, Paul van den Noord: Managing Public Expenditure: Some Emerging Policy Issues and a Framework for Analysis, OECD Economics Department Working Papers, No. 285, Paris 2001.

- public expenditure increased everywhere until the eighties and only in the nineties did its growth begin to slow down;
- there are pronounced differences in the level of public expenditure among the economies considered;
- the introduction and expansion of welfare programmes have been driving forces behind the inflation of public outlays.

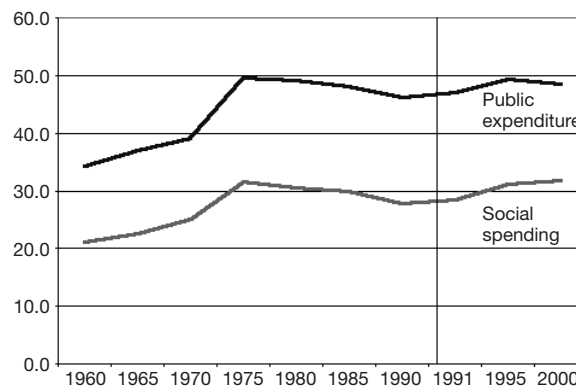
Based on OECD data Table 3 shows the development of income transfers, i.e. pensions, unemployment, sickness, disability, family, and housing assistance, over the period 1970–2000. According to this definition of income transfers, in 2000 Germany topped the ranking of the transfer-to-GDP ratios, followed closely by Austria, Sweden and France. But comparing the increase of those ratios from 1970 to 2000 Germany holds a centre position. The largest expansion occurred in Japan and the Scandinavian countries except Norway. The United States and the Netherlands registered the smallest increases of their transfer ratios compared to 1970, and in Ireland the transfer ratio even decreased.

A more detailed look at the German expenditure-to-GDP ratio reveals a trend similar to the social budget-to-GDP ratio.<sup>14</sup> This supports the thesis that the

<sup>11</sup> Vito Tanzi, Ludger Schuknecht: Reconsidering the Fiscal Role of Government: The International Perspective, in: American Economic Review, Papers and Proceedings, Vol. 87, 1997, pp. 164–168; Nicholas Crafts: Globalization and Growth in the Twentieth Century, IMF Working Paper, No. 44, Washington DC 2000.

**Figure 1**  
Public Expenditure and Social Spending in Germany 1960–2000

1960–1990 West Germany, 1991–2000 Germany; as a percentage of GDP



Sources: Statistisches Bundesamt, Volkswirtschaftliche Gesamtrechnungen, Wiesbaden, various volumes; Institut der Deutschen Wirtschaft Köln: Deutschland in Zahlen, Cologne 2001.

expansion of government outlays was essentially a result of the increases in social spending and the corresponding redistribution. At least for Germany it can be stated that an almost constant, and in international comparison relatively equal, income distribution has gone along with increasing government expenditure and redistribution.

It is noteworthy that the expansion of social expenditure in Germany over the last decade was not merely a result of reunification and the situation in East Germany:

- expenditure on social protection surged in East Germany from 1991–2000 by more than 100 per cent up to € 117 billion. Expenditure per capita more than doubled – from € 3,560 to € 7,710 in the same period;
- but social expenditure also increased in West Germany during the nineties by more than 40 per cent up to € 528 billion. In 2000 expenditure per capita was € 7,880, up € 2,100 compared with 1991.

<sup>12</sup> Vito Tanzi, Ludger Schuknecht, op. cit.

<sup>13</sup> Paul Atkinson, Paul van den Noord: Managing Public Expenditure: Some Emerging Policy Issues and a Framework for Analysis, OECD Economics Department Working Papers, No. 285, Paris 2001.

<sup>14</sup> The expenditure-to-GDP ratio and the social-budget-to-GDP ratio differ from the ratios in Tables 2 and 3 because of different definitions. But this does not adversely affect the meaningfulness of the statements.



**Politico-economic Explanations**

There are several politico-economic explanations for the fact that redistribution does not necessarily decrease when inequality remains unchanged or even decreases.<sup>15</sup>

1. *The political process favours distributional goals.* Politicians tend to focus on outcome-oriented goals.<sup>16</sup> Redistributive measures in particular often trigger demonstrable and quantifiable results in a short time and will be preferred whenever they can be attributed to a single political act. Growth, on the contrary, is a complex process that depends on a multitude of determinants. Politics that foster growth often show results only in the long run and the results are in many cases not quantifiable or attributable to single measures. Therefore even in less unequal societies politicians usually opt for distributional goals.

2. *Redistribution incites distributional conflicts.*<sup>17</sup> In societies with relatively low inequality individuals strive for distributional advantages when they realise that they can boost their income more by rent-seeking than by working. An already high volume of redistribution strengthens the incentives to get control of a larger part of the distributional budget not only by legal means, but also by illegal acts, such as bribery of officials. Corruption adversely affects growth and development as well as the income distribution and distributional fairness.<sup>18</sup>

In this context it is important to mention the interplay of institutions and distributional politics. Rules of distribution are on the one hand a part of the institutional setting of a society and influence economic incentives and growth. On the other hand, redistribution shapes the underlying institutions.<sup>19</sup> According to a thesis on the emergence and evolution of institutions by Knight distributional rules also result from distributional conflicts.<sup>20</sup> Distributional institu-

tions emerge and change due to the efforts of individuals and groups to gain distributional advantages. In addition, conflicts over remaining inequalities increase as the distribution becomes more equal. Envy and the pressure on politicians to boost redistribution are therefore more pronounced in societies with less inequality. Kristov, Lindert and McClelland<sup>21</sup> show that the demand for redistribution rises with increasing social affinity.

3. *The demands to safeguard entitlements multiply with growing prosperity.* Public expenditure and redistribution increase because employees' and employers' behaviour changes with growing wealth.<sup>22</sup> In this case the emphasis of economic policy often changes towards the preservation of existing firms and jobs – in particular when adjustment burdens arise as a consequence of technological progress, structural change and globalisation. Employees put pressure on politicians to expand social security, e.g. employment protection, duration and level of unemployment benefits and early retirement arrangements. Firms demand subsidies for restructuring. Social spending will increase further if the productive structures of the economy become rigid and market powers grow weary.

4. *The number and the power of pressure groups which lobby the state for their distributional goals increase in mature economies.* Therefore the volume of redistribution rises.<sup>23</sup> Stable political and institutional conditions – as found in mature welfare states with a low degree of inequality – provide an optimal sphere of influence for pressure groups. Governments permanently have to increase their distributional expenditure to appease pressure groups and avoid distributional conflicts. Acemoglu and Robinson<sup>24</sup> show that pressure groups expand particularly as a result of inefficient redistribution. Inefficient redistribution makes the present beneficiaries stay inside the

<sup>15</sup> In the nineteenth century Adolf Wagner already defined the law of growing public expenditure (Wagner's Law). But this explanation focused more on governmental interference into the allocation process, i.e. government investment and public production, and not on social transfers.

<sup>16</sup> Horst Zimmermann: *Wohlfahrtsstaat zwischen Wachstum und Verteilung: Zu einem grundlegenden Konflikt in Hoheinkommensländern*, Munich 1996.

<sup>17</sup> Assar Lindbeck: *Redistribution Policy and the Expansion of the Public Sector*, in: *Journal of Public Economics*, Vol. 28, 1985, pp. 309-328; Assar Lindbeck: *How can Economic Policy Strike a Balance Between Economic Efficiency and Income Equality*, in: *Federal Reserve Bank of Kansas City (ed.): Income Equality: Issues & Policy Options*, Kansas City 1998, pp. 295-336.

<sup>18</sup> Jean Cartier-Bresson: *Economics of Corruption*, in: *OECD Observer*, No. 220, 2000, pp. 25-27.

<sup>19</sup> According to contract theory, institutions are intended results of the political process. Whereas according to the evolutionary point of view they are an unintended and spontaneous result of individual acts.

<sup>20</sup> Frank Knight: *Institutions and Social Conflict*, Cambridge 1992.

<sup>21</sup> Lorenzo Kristov, Peter Lindert, Robert McClelland: *Pressure groups and redistribution*, in: *Journal of Public Economics*, Vol. 48, 1992, pp. 135-163.

<sup>22</sup> Gilles Saint-Paul: *Understanding Labour Market Institutions*, in: *World Economics*, Vol. 1, 2000, No. 2, pp. 73-87.

<sup>23</sup> Mancur Olson: *The Rise and Decline of Nations: Economic Growth, Stagflation, and Social Rigidities*, New Haven 1982; Denis Mueller: *The Political Economy of Growth and Redistribution*, in: Denis Mueller (ed.): *The Political Economy of Growth*, New Haven, 1983, pp. 261-276.

<sup>24</sup> Daron Acemoglu, James Robinson: *Inefficient Redistribution*, CEPR Discussion Paper, No. 2122, London 1999.

favoured groups and raises the incentives for non-members to join in.

5. *Redistribution also rises because most of it happens within the middle class.* In modern welfare states the scope of redistribution goes beyond redistribution from the rich to the poor. Most of the transfers benefit the middle class and are financed by the middle class. The middle class thus redistributes from its left to its right pocket. It is even conceivable that middle class agents take over resources that were originally earmarked to be redistributed from the rich to the poor. All of this may permanently increase the volume of redistribution.

This explanation is consistent with the aforementioned pressure group thesis because most influential lobby groups often pursue middle class interests even when taking up the cause of the poor.<sup>25</sup> The reasons are, firstly, that small groups with a specific cause are often more efficiently organised and can stand their ground better than large groups with more or less diffuse interests. Many of these small and well organised pressure groups do not pursue the interests of poor groups but that of the influential middle class. Secondly, the political process favours specific and easily recognisable benefits financed by general taxes with intransparent incidence.

6. *Distributional transfers accumulate over time.* So called ratchet effects can explain why this happens: while it is easy to introduce and expand transfers, it is often nearly impossible to withdraw them. There are some convincing explanations why reforms – particularly those aimed at reducing government and social expenditure – are blocked:<sup>26</sup>

- status-quo preferences: the present state is preferred because of uncertainty about the benefits of alternatives;
- endowment effects: possessed goods and privileges are valued more than those not possessed;
- loss aversion: a deterioration, e.g. a reduction of social benefits, is experienced more intensely and hurts more than a similar improvement, e.g. a tax reduction.

<sup>25</sup> Norbert Berthold: Ansätze einer ökonomischen Theorie der Sozialpolitik – Normative und positive Aspekte, in: Jahrbuch für Wirtschaftswissenschaften, Vol. 42, 1991, pp. 145-178.

<sup>26</sup> Friedrich Heinemann: Die Psychologie irrationaler Wirtschaftspolitik am Beispiel des Reformstaus, ZEW Discussion Paper No. 00-12, Mannheim 2000; Allan Drazen: Political economy in macroeconomics, Princeton NJ 2000; Raquel Fernandez, Dani Rodrik: Resistance to Reform: Status Quo Bias in the Presence of Individual-specific Uncertainty, in: American Economic Review, Vol. 81, 1991, pp. 1146-1155.

Selfish behaviour by bureaucrats can additionally boost redistribution.<sup>27</sup> One example is the so-called staircase effect: last year's budget is taken for granted and builds the base for the new budget.

7. *Some redistributive programmes have a built-in mechanism for increasing expenditure.* Distributive measures unfold momentum, particularly whenever the group eligible for transfers grows because of demographic developments. Moreover, the distributive amount goes up when the costs of redistributive benefits and services increase. Little or insufficient competition among service suppliers hampers cost cutting or reforms to improve efficiency, e.g. in the public health system.

8. *Historically redistribution has also been pushed by the displacement of relatively simple tax and social systems by complex decision-making processes.* The efficiency of a system usually decreases with increasing complexity. In order to manage more complex systems additional and more powerful interventions are needed. This in turn causes a growing amount of distributive resources. A familiar metaphor for this argument is the oil spot theorem by Ludwig von Mises: according to this theorem interventions that disturb the workability of a system trigger a spiral of interventions. Metaphorically speaking they spread like an oil slick.

### Redistribution, Taxes and Debt

Hence, governmental expenditure, especially that for redistributive purposes, does not shrink with less inequality. The same holds true for the financing of the expenditure. There are principally two ways to finance public outlays:<sup>28</sup> higher taxes and social contributions or higher national debt.

The economies analysed differ remarkably in the level of tax and social security contributions. Table 4 shows that the extremes of the ranking are occupied by Sweden at the top and Japan and the United States at the bottom. The ratio of taxes and social security contributions to GDP amounts to more than 50 per cent and less than 30 per cent respectively. In addition this ratio has risen in all countries over the long run.

Not only the tax and social security contribution burden has increased but also the degree of

<sup>27</sup> Assar Lindbeck: Redistribution Policy ... , op. cit.

<sup>28</sup> The financing of public expenditure via inflation will not be considered; see Milton Friedman: Government Revenue from Inflation, in: Journal of Political Economy, Vol. 79, 1971, pp. 846.

government indebtedness. The debt ratio (national debt as a percentage of GDP) more than doubled in West Germany from 1960 (18.6 per cent) to 1990 (43.5 per cent). In 2000, government debt amounted to 60 per cent in Germany. In countries like Japan, Italy and Belgium the national debt even exceeds the annual economic output. Politicians prefer debt financing of public expenditure because they can relatively conveniently justify a higher budget and avoid distributional conflicts that would possibly emerge with expenditure cuts or higher taxes.<sup>29</sup> However it must be kept in

mind that repayments will limit the freedom of action of governments and taxpayers in the future, even if politicians proceed from a so-called debt illusion which assumes that in contradiction to the Ricardian equivalence theorem the electorate does not take into account that debt repayments and interest charges have to be repaid by themselves or their children.

### Redistribution by Regulation

Redistribution is determined not only by public expenditure and revenues (taxes, social security contributions and debt) but also by regulations.<sup>30</sup> Property rights can be curbed in product, capital and labour markets by regulations on quantities and prices (e.g. price ceilings for certain goods, minimum wages, working time regulations, job classifications). Examples of how government regulations intervene in the income formation of individuals are:

- The German law on opening hours in the retail sector is based on the social goals of certain pressure groups (unions, churches). Burda shows that such a regulation of a product market has adverse effects on output, employment and the level of income in an economy.<sup>31</sup>
- Insufficient wage differentiation because of government intervention in the labour market destroys employment, particularly in branches and regions which are under pressure from structural change, technological progress and globalisation.<sup>32</sup> The ensuing unemployment places a burden on growth prospects not only because higher taxes and social security contributions are needed to finance the rising transfer volume but also because the potential human capital stock is not used efficiently. A lower degree of wage differentiation as a result of explicitly or implicitly set minimum wages

**Table 4**  
**Taxes and Social Security Contributions in International Comparison**  
as a percentage of GDP

	1970	1980	1990	2000
Sweden	39.8	48.8	55.6	53.3
Denmark	40.4	45.4	47.1	48.4
Finland	32.5	36.9	44.9	46.5
Belgium	35.7	43.7	43.9	46.0
France	35.1	41.7	43.0	45.5
Austria	34.9	40.3	41.0	43.3
Italy	26.1	30.4	38.9	42.3
Netherlands	37.1	45.2	44.6	41.8
Norway	34.9	42.7	41.8	40.2
Germany	32.9	38.2	36.7	37.8
Great Britain	37.0	35.1	36.3	37.7
Spain	16.9	23.9	34.4	35.3
Ireland	29.9	32.6	33.6	31.5
USA <sup>1</sup>	28.1	27.6	27.6	28.9
Japan	19.7	25.4	30.9	27.1

<sup>1</sup> 1999

Sources: H. Warlitzer: Staatsausgaben und Wirtschaftswachstum. Ein Internationaler Vergleich, in: Beiträge zur Wirtschafts- und Sozialpolitik, No. 254, Cologne 1999; Institut der deutschen Wirtschaft Köln: Deutschland in Zahlen, Cologne 2001; OECD: Economic Outlook, No. 69, Paris 2001.

**Table 5**  
**Government Debt in International Comparison**  
General government gross financial liabilities as a percentage of GDP

	1970	1980	1990	2000
Japan	n.a.	52.0	64.6	122.9
Italy	37.9	58.0	97.3	110.5
Belgium	65.2	78.5	128.6	110.3
Austria	18.8	36.1	57.3	63.1
Spain	15.1	17.0	43.7	60.7
Germany	18.6	31.7	43.5	60.3
United States	n.a.	37.7	66.6	58.8
France	n.a.	20.4	36.3	57.6
Netherlands	n.a.	46.0	77.1	56.1
Sweden	27.0	39.6	42.1	55.7
Denmark	12.0	36.4	57.7	46.1
Finland	11.8	11.6	14.5	44.0
United Kingdom	81.3	55.0	35.2	42.8
Ireland	51.5	72.3	97.5	38.6
Norway	n.a.	n.a.	29.5	28.0

n.a. = not available

Sources: OECD: Economic Outlook, No. 69, Paris 2001; European Commission: European Economy, No. 71, Luxembourg 2000.

<sup>29</sup> For politico-economic explanations of budget deficits see Gian Maria Milesi-Ferretti: Fiscal Rules and the Budget Process, in: CEPR Discussion Paper, No. 1664, London 1997; Douglas Elmendorf, Gregory Mankiw: Government Debt, NBER Working Paper, No. 6470, Cambridge MA 1998.

<sup>30</sup> Gerhard Fels, Jürgen Matthes, Claus Schnabel: Germany: Between Corporatist Stability and Corporate Flexibility, in: Group of Thirty (eds.): The Evolving Corporation: Global Imperatives and National Responses, Washington DC 1999, pp. 83-125; Gilles Saint-Paul, op. cit.

<sup>31</sup> Michael C. Burda: Product Market Regulation and Labor Market Outcomes: How Can Deregulation Create Jobs?, in: ifo Studien, Vol. 46, 2000, No. 1, pp. 55-72.

<sup>32</sup> Karl-Heinz Paqué: Structural Unemployment and Real Wage Rigidity in Germany, Kieler Studien, No. 301, Tübingen 1999; Hans Gersbach: Product Market Competition, Unemployment and Income Disparities, in: Weltwirtschaftliches Archiv, Vol. 135, 1999, No. 2, pp. 221-240.



**Table 6**  
**Regulation in International Comparison**

Level of market regulation: 0 = not regulated, 6 = highly regulated

	Labour Market <sup>1</sup>	Product Market <sup>2</sup>
Italy	3.3	3.3
Spain	3.2	2.2
France	3.1	2.7
Norway	2.9	2.2
Germany	2.8	1.9
Japan	2.6	1.8
Austria	2.4	1.8
Netherlands	2.4	1.8
Sweden	2.4	1.7
Belgium	2.1	2.7
Finland	2.1	2.3
Denmark	1.5	1.9
Ireland	1.0	1.1
United Kingdom	0.5	0.5
United States	0.2	1.1

<sup>1</sup> Employment protection legislation.

<sup>2</sup> Inward-oriented policies.

Source: Giuseppe Nicoletti, Stefano Scarpetta, Olivier Boylaud: Summary Indicators of Product Market Regulation with an Extension to Employment Protection Legislation, OECD Economics Department Working Papers, No. 226, Paris 1999.

causes not only efficiency losses but also problems of fairness:<sup>33</sup> government interventions exclude workers, particularly low-qualified and young workers, from the labour market and thus deny them equal opportunities.

- The insider-outsider theory of Lindbeck and Snower regards the wage bargaining process and labour market institutions as the main reason for long-term unemployment in many European countries.<sup>34</sup> The insider-outsider approach attempts to explain why wages do not react to unemployment. Unemployment, in particular long-term unemployment, is based on a conflict between the employed insider and the unemployed outsider. Insiders tend to shy employment-oriented wage policies because they fear a deterioration of their income position. Essential for this theory is that insiders have the power to avoid wage undercutting by the unemployed. This power results from labour market institutions, such as labour turnover costs (the costs of hiring and shedding employees). Because of these costs insiders can demand wages that are higher than the reservation wage of outsiders with similar productivity.<sup>35</sup>

<sup>33</sup> Assar Lindbeck: How can Economic Policy ... , op. cit.

<sup>34</sup> Assar Lindbeck, Dennis Snower: The Insider-Outsider Theory of Employment and Unemployment, Cambridge MA 1988.

<sup>35</sup> The reservation wages of outsiders are also influenced by the generosity of social transfers (e.g. duration and replacement rate of unemployment transfers).

- An international comparison reveals that labour force participation and thus the level of employment are lower the more the labour market is regulated.<sup>36</sup> The expansion of fixed-term contracts and part-time work in the mid-1990s in Germany stimulated job creation and relieved the labour market while the reversal of this deregulation runs counter to the aim of reducing structural unemployment in Germany.

A study by the OECD shows that there are pronounced differences in the level of product and labour market regulations in the countries considered.<sup>37</sup> Table 6 indicates that countries with highly regulated product markets – e.g. administrative burdens on start-ups, barriers to competition, regulatory and administrative opacity, subsidies for public enterprises and price controls – also have rigid labour markets. Regulated labour and goods markets together form an unfriendly business environment and dampen growth and employment.<sup>38</sup>

### Concluding Remarks

The danger that redistribution may paralyse the growth potential exists not only in economies with a relatively unequal income distribution. Empirical evidence and some economic explanations refute the thesis that there is a positive relationship between the extent of inequality and the amount of redistribution – even though this is occasionally a central argument in studies on growth and distribution. There are multiple political mechanisms that explain why redistribution also expands in economies with a comparatively high degree of equality.

Even within the group of developed countries analysed in this study there are some economies with a relatively high degree of inequality – e.g. Ireland and the United States – and with relatively low scores for indicators measuring the extent and effects of redistribution, such as the ratio of expenditure, transfers, tax and debt to GDP and the level of regulations. Other economies, like Sweden and Denmark, have a comparatively low degree of inequality but high scores for these indicators. Redistribution does not shrink with higher equality.

<sup>36</sup> Hans-Peter Klös, Holger Schäfer: Teilzeitarbeit und befristete Beschäftigung: Zur Arbeitsmarktrelevanz einer Reregulierung, in: *iw-trends*, Vol. 27, 2000, No. 4, pp. 74-88.

<sup>37</sup> Giuseppe Nicoletti, Stefano Scarpetta, Olivier Boylaud: Summary Indicators of Product Market Regulation with an Extension to Employment Protection Legislation, OECD Economics Department Working Papers, No. 226, Paris 1999.

<sup>38</sup> Giuseppe Nicoletti et al., op. cit.; Kees Koedijk, Jeroen Kremers: Market opening, regulation and growth in Europe, in: *Economic Policy*, Vol. 23, 1996, pp. 443-467.