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Determinants of governmental redistribution: Income distribution, development levels, and the role of perceptions

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ABSTRACT

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We empirically investigate the relationship between income inequality and redistribution, accounting for the shape of the income distribution, different development levels, and subjective perceptions. Cross-national inequality datasets that have become available only recently allow for the assessment of the link for various sample compositions and several model specifications. Our results confirm the Meltzer-Richard hypothesis, but suggest that the relation between market inequality and redistribution is even stronger when using perceived inequality measures. The findings emphasize a decisive role of the middle class, though also approving a negative impact of top incomes. The Meltzer-Richard effect is less pronounced in developing economies with less sophisticated political rights, illustrating that it is the political channel through which higher inequality translates into more redistribution. *Journal of Comparative Economics* **45** (2017) 930–962. Department of Economics, University of Würzburg, Sanderring 2, D-97070 Würzburg, Germany.

1. Introduction

What determines the extent of redistribution? The well-known Meltzer and Richard (1981) model applies the median voter theorem, originally developed by Downs (1957) and Hotelling (1929), to the field of inequality and redistribution. In a majority-voting framework, the Meltzer-Richard hypothesis predicts that a higher level of inequality leads to greater demand for redistribution that translates to an expansion of the welfare system. Although the theoretical basis of the Meltzer-Richard model is profound and broadly accepted, the empirical findings are far from consistent. A significant and positive relationship between inequality and redistribution is found by Milanovic (2000) and Scervini (2012), while other studies observe a negative link (Georgiadis and Manning, 2007), no significant relationship (Kenworthy and McCall, 2008 and Gouveia and Masia, 1998), or multiple steady states (Bénabou, 2000).

So far, two main problems have impeded research on the inequality-redistribution nexus. First, earlier studies often rely on rough measures of redistribution. However, the extent to which specific fiscal policy instruments are actually redistributive often remains unclear. Second, truly comparable cross-national data on income inequality has long been rather scarce.

Although comparability and quality of the LIS Cross-National Data Center are unparalleled among cross-national inequality data, the calculations which use a uniform set of assumptions and definitions on the basis of harmonized micro data

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result in a limited data coverage of only 232 country-years for which net inequality is available. While this limitation hampers research on inequality based on a broad panel of countries, the incorporation of a larger set of observations typically comes at the cost of sacrificing the benefits of comparability. Fortunately, some major progress has been made in cross-national inequality datasets in recent years, particularly with regard to the World Income Inequality Database (WIID) and the Standardized World Income Inequality Database (SWIID). The latest update of the SWIID to version 5.0 now includes 174 countries from 1960 to present, enabling acquisition of roughly 4600 country-year observations that are comparable to those obtained by the LIS. Unlike previous data collections, the clear distinction between inequality before and after taxes and transfers allows for computation of a direct measure of redistribution via the “pre-post” approach. The large data coverage also permits inclusion of developing countries in the empirical analysis. However, as data quality in the SWIID varies across different country groups and periods, such analyses require careful treatment of the data. To account for the uncertainty in the SWIID data, we compare our baseline results with regressions based on multiple imputations and estimates that rely on the WIID data. For additional robustness checks, we employ further proxies for redistribution, including parameters of structural tax progressivity and transfer payments.

We make use of the recent advancement in data availability by examining the Meltzer-Richard hypothesis on a broad basis. In doing so, the contribution of the paper is threefold. First, we empirically investigate the redistribution-inequality nexus for a cross-nationally comparable dataset built entirely on national micro data. This analysis also includes the effect of different shapes of income distributions. The intuition of this strategy is that inequality may be driven by top or bottom income earners, yielding varying effects on redistribution due to different political influence of these groups. Second, we enlarge the sample and analyze the Meltzer-Richard effect in a broad panel of countries, thereby accounting for different development levels and varying sophistication of political rights. Finally, we elucidate the role of perceptions, illustrating that it is not the actual, but rather the subjective level of inequality that determines demand for redistribution.

In a majority voting model, groups other than the median voter should exert only negligible influence on redistribution. In practice, however, top incomes may be reluctant to support redistribution while the bottom decile of the income distribution typically benefits from a more expansive welfare system. To lower the financial burden through redistribution, top incomes might engage in rent-seeking behavior. Some studies (Scervini, 2012 and Bassett et al., 1999) state that de facto political power may be above the median, as higher income levels devote additional resources towards campaign contributions. Additionally, Rosenstone and Hansen (1993) show that political participation increases with income and education. This may also explain why rationally-acting politicians have an incentive to refrain from focusing on bottom-income voters (Blais, 2000 and Norris, 2002). In contrast, redistribution via the unemployment system may benefit the lowest incomes disproportionately if labor market conditions affect redistributional activities of policymakers (Scervini, 2012).

In democracies, the relationship between market income inequality and redistribution is stronger than in authoritarian regimes (Perotti, 1996). As gaining votes does not play a significant role in policy making in non-democratic regimes, governments can ignore preferences of poorer voters (Milanovic, 2000). Empirical evidence regarding the impact of democracy on redistribution is, however, somewhat inconclusive. While Persson and Tabellini (1994) emphasize the importance of democratic institutions, Scervini (2012) confirms the findings of Alesina and Rodrik (1994) and Perotti (1996) indicating that democracy does not have a significant influence on redistribution. Acemoglu et al. (2015) refer to the fact that different institutional regimes have varying effects on redistribution depending, inter alia, on the stage of development.

Recent investigations further emphasize that individuals often hold erroneous beliefs about income inequality. Previous research focused on biased perceptions of inequality within a country or in the cross-section. Cruces et al. (2013) explore the perceptions of individuals in a micro study from Argentina and observe systematic biases in individuals' perceptions of their own relative position in the income distribution. Likewise, Norton and Ariely (2011) and Chambers et al. (2014) show that perceptions on the level of income and wealth inequality in the United States are heavily distorted. Fernández-Albertos and Kuo (2016) employ data from a web-based survey in Spain and find that only 14 percent of the participants correctly assigned themselves to the decile in the income distribution to which they actually belong. Further studies (Niehues, 2014, Engelhardt and Wagener, 2014, and Gimpelson and Treisman, 2015) use data from the International Social Survey Programme (ISSP) on self-assessment by individuals concerning their position on the income scale to compare actual and perceived inequality across countries. They provide some evidence that the Meltzer-Richard effect may be less pronounced when examining actual inequality, but may increase if perceived inequality measures are analyzed, implying that it may be the perception of the electorate rather than objective data that drives the demand for redistribution. In this paper, we follow earlier approaches, compiling subjective inequality measures based on the ISSP and the World Value Survey (WVS). Owing to recent advancements in data availability, our study provides a first attempt to explore the effect of perceptions on redistribution in a panel context.

Our findings point to a positive and significant link between market inequality and redistribution in the OECD countries. The results are robust to several model specifications and various sample compositions as well as different measures of income inequality and different social security and pension systems. Whereas the baseline estimations study the effect of officially reported market inequality, perceived inequality measures highlight an even larger impact. If citizen-voters consider the income distribution to be highly unequal, there may be strong demand for redistribution, even if “real” market inequality is moderate or low. Conversely, if voters are not aware of the “true” extent of inequality, demand for redistribution may be lower than that induced by the actual distribution of incomes. Moreover, our paper provides robust evidence that the shape of the income distribution is highly relevant for redistributional issues of the government. While the middle class exerts a significant influence on the amount of redistribution, we do not find any such impact for individuals at the bottom of the