Inequality – the biggest threat to the market outlook

We believe that inequality in income levels in an absolute sense, uneven distribution of the growing pie and inequality and inequity at the social level constitute one of the biggest risks to the market outlook in the medium to long run. Maybe even in the short run.

The debate is now in the limelight during the high-octane electoral process that is on right now. There were references to redistribution of wealth and to inheritance tax.

Why is this debate relevant now?

Why is this important for the market?

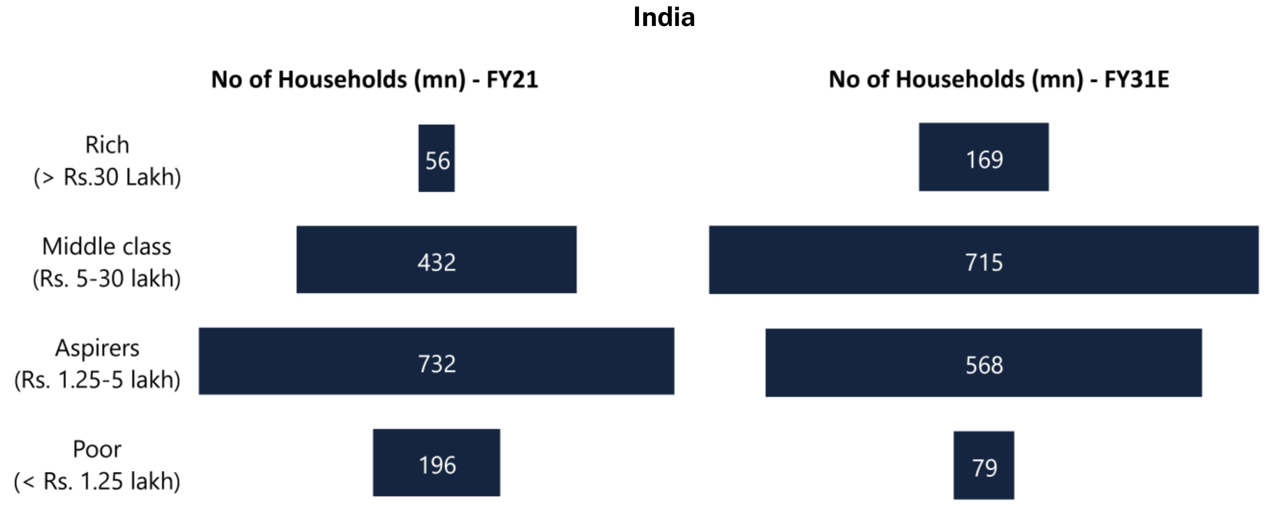
Before making our case on this, may we highlight that we had in our June 2023 newsletter focussed on the issue of K-shaped recovery. We said the following in summary:

1. Globally, inequality is a big issue.
2. K-shaped recovery is something that is for real. K-shaped recovery cannot however be mistaken for low growth or growth that should be shunned at all times.
3. Inequality is a big problem for the political economy.
4. The challenge is not to deny the K or kill the upwardly mobile stroke. The political and economic challenge is to address the problematic stroke in the K.

All these points have come into sharper focus in recent months and have been in many ways occupying the centre-stage of various debates. While no society can aspire to achieve perfectly equal distribution of wealth or income, the massive imbalances we are witnessing will be a touchy issue in the political economy for the times to come.

Quality of growth may influence the quantity

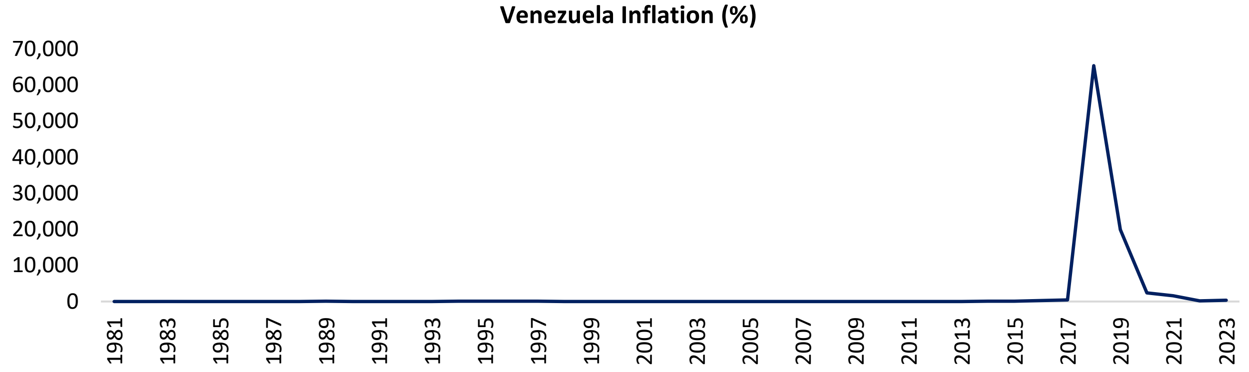
Successful economies have seen a growth in their middle class during the journey to the status of being developed economies. A robust and meaningfully large middle class goes hand in hand with a less uneven distribution of income.



Source: News articles, Spark Fund Research

The proportion of Middle- & Higher-income households to the total is expected to move up from 1 in 3 to over 1 in 2 by 2030. In particular, the middle-income households reaching a critical mass and growing from there will drive consumption across categories as these are the households that will have the disposable income to enable consumption. This in turn is required to drive investment spending. Infrastructure creation can sustain only if there is a viable user base for the infrastructure being created. This necessitates affordability. A virtuous cycle is therefore a sine qua non for sustained economic growth.

New consumers will not be born if income and wealth end up getting concentrated in fewer and fewer pockets. At the same time, it will be impossible to prevent inequality from going up when there is rapid economic progress. Coercive action to smoothen the inequality through excessive taxation or attempts at forced redistribution can end up in disastrous consequences.



Source: International Monetary Fund, Spark Fund Research

Though a small country, radical policy intervention in Venezuela ended up destroying living standards across the board. The per capita income collapsed from USD 11,000 to about USD 3,000 in under 10 years to 2023. This should come as a clear warning to policymakers wanting to force income re-distribution or wealth re-balancing by weaponizing taxation and executive fiat.

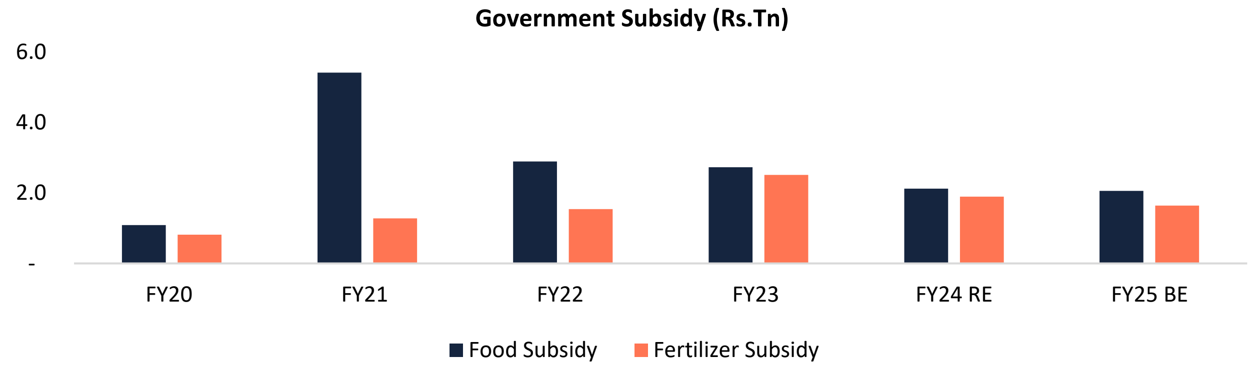
On the contrary, look at the correlation between peak tax rates and per capita income levels in India.

Decade	Peak Personal Tax Rate at the end of each decade (%)	Per Capita Income at end of each decade ($)	Poor as at end of each decade (%)
1970s	97.8	272	63.4
1980s	72.0	375	50.8
1990s	54.0	450	48.0
2000s	33.7	1377	33.5
2010s	35.5	1913	13.2
Now	39.0	2601	15.0

Note: Tax rate is FY basis, Per capita Income is CY basis.
Source: International Monetary Fund, Finance Act (Ministry of Finance), World Bank, NITI-Aayog, Spark Fund Research

Moderate levels of taxation and reasonable stability in the same have resulted in rising incomes and reduction in abject poverty.

In the meanwhile, social security safety nets have mitigated the hit on the poor.



Source: Union Budget (February 2024)- Ministry of Finance, Spark Fund Research

In India, a combination of moderate and stable taxation regime coupled with directed subsidies targeting the lower strata have helped. The evidence so far is that the quality and quantity of growth have been in as good a balance as is possible when a poor country tries to transition itself. We believe that Indian policymaking has enough maturity to learn from its own experience so far. All the same, we have to be prepared for taxes to remain elevated in India as the bill for social security needs to be paid. The hope is that arbitrary and draconian taxes will be shunned.

Why should the market be concerned about inequality?

Two reasons

One, a sustained and less volatile economic growth is something that can help consistent earnings growth. This is the fuel that keeps the market going at the end of the day.

Secondly, the optics around all of this has a profound impact on market multiples. If there is a Damocles sword of an arbitrary and unpredictable tax regime which is hanging over the head of the market, the market multiples will be hit. The market returns have benefitted as much from expansion in multiples as from earnings growth. While some part of this is due to a secular fall in interest rates, confidence in the future is a factor that cannot be downplayed.

Which is why we believe that inequality and inequity constitute a clear and persistent threat to the market outlook. There are visible risks to the market from global uncertainties, geopolitics and the outlook for our own growth/earnings. Alongside, there will be a long shadow that the debate over inequality may cast on the outlook. We need to watch how well the incoming government will address this issue. The debate over inequality is not going away any time soon.

Warm regards,

P Krishnan (CIO) and Team Spark Fund