WASHINGTON--The world’s top economic institution is sounding the alarm about a growing chasm between rich and poor, warning that rising income inequality is weighing on global economic growth and fueling political instability.

The International Monetary Fund’s latest salvo came Thursday in a top official’s speech and a 67-page paper...
The IMF warned that rising income inequality is becoming one of the biggest impediments to global growth. Cornell professor Eswar Prasad, author of "The Dollar Trap" and a former IMF official, discusses how seriously U.S. investors should take developments in China.

detailing how the IMF's 188 member countries can use tax policy and targeted public spending to stem a rising disparity between haves and have-nots.

IMF Managing Director Christine Lagarde has made the issue a high priority for the fund, warning—along with some of the fund's most powerful shareholders—that inequality is threatening longer-run economic prospects. Last month, Ms. Lagarde said the income gap risked creating "an economy of exclusion, and a wasteland of discarded potential" and rendering "the precious fabric that holds our society together."

The IMF is wading deep into a problem that no less than President Barack Obama and Pope Francis have called a defining issue of our time, and the fund's potential prescriptions are likely to be a lightning rod for debate. They include raising taxes and redistributing wealth.

"Redistribution can help support growth because it reduces inequality," David Lipton, the fund's No. 2 official and a former senior White House aide, said in a speech Thursday at the Peterson Institute for International Economics. "But if misconceived, this trade-off can be very costly."

The IMF has a long history of studying economic disparities from an academic perspective. But the political turmoil spreading across Ukraine, Egypt and Venezuela in recent years underscores their real-world importance. In each of those countries, income inequality and poor economic management helped propel widespread unrest.

The financial crisis exacerbated the problem in rich nations. Surging joblessness after the 2008 financial meltdown gave traction to groups such as Occupy Wall Street and the Robin Hood Tax Campaign, a prominent nonprofit coalition seeking higher tax revenue to back programs benefiting poorer Americans.

"There's a sense that the burdens of the crisis have been unevenly distributed, that the middle classes and the poor have footed more of the bill of the crisis than the economic elite," said Moisés Naím, a senior economist at the Carnegie Endowment for International Peace and Venezuela's former trade minister.

Inequality in several advanced economies, including the U.S., has returned to levels not seen since before the Great Depression, the fund said. In Greece, the epicenter of Europe's debt woes for several years, the poorest 10% of the population was hit hardest by a cut in the tax-free threshold for income taxes, according to IMF data. Economic hardship there has been cited as a significant factor in the rising popularity of the fascist movement Golden Dawn and related violence against immigrants.

Along with advanced economies, income inequality has grown in the Middle East, in North Africa and in Asian countries. While the disparity has declined in Latin America and sub-Saharan Africa, it is still far higher in those regions than in the rest of the world.

Those trends are prompting the fund's top brass to champion the cause, as they hope to shape—or in some cases jump-start—public debates over policies for protecting the poor and redistributing wealth. For the fund, protests in Athens, Lisbon, Caracas and Tripoli in the past year are manifestations of the broader underlying reality of income inequality that public officials must address through careful calibration of tax and budget policies.
That is particularly important—and difficult—for governments to do as they also try to slash public debt. In the U.S., for example, health care, social security and other entitlement commitments in coming decades are expected to far outweigh the ability of the government to pay for them. A 2011 IMF paper estimated that just to contain future budget costs, the federal government would have to raise taxes by 35% and cut entitlement spending by an equal percentage.

The IMF’s latest paper doesn’t prescribe country-specific measures, but it does offer several proposals that are likely to be controversial. Most notably, the IMF says many advanced and developing economies can narrow inequality by more aggressively applying property taxes and "progressive" personal income taxes that rise as incomes increase.

The median top personal income-tax rate across the globe has halved since the 1980s to around 30%. But the IMF says "revenue-maximizing [personal income tax] rates are probably somewhere between 50% and 60% and optimal rates probably somewhat lower than that."

Developing countries in particular could benefit from expanding their tax bases and raising revenues through personal income taxes, the IMF said. The fund estimates that less than 15% of income in developing economies is covered by personal income taxes, and the amount of revenues garnered from such taxes represents only a fraction of that generated in advanced economies.

There is also "considerable scope to exploit" property taxes more fully, the fund said.

Governments' antipoverty programs are largely constrained by limited tax revenues, said Nancy Birdsall, president of the Center for Global Development, a Washington think tank.

If developing economies broaden the tax base and scale up the burden on higher earners, governments could spend more on education and health services, the fund said. Those programs, among others, can break poverty that spans generations, and also boost income, which in turn fuels stronger longer-term growth.

While raising taxes on the well-to-do may pique some conservatives, the fund also offers support for some of their arguments. Although inequality may be rising, on average, poverty rates have seen substantial declines in developing economies as strong overall growth lifted the prospects of entire populations.

Growth remains the biggest factor in lifting the impoverished out of economic hardship, Mr. Lipton said.

The IMF’s paper also said the effect of raising minimum wages on inequality is ambiguous. "Given the uncertainty around the possible effects of wage and employment regulations, fiscal instruments such as well-designed in-work social benefits are in most cases a superior approach," the fund said.

Even where there is income for social spending, it is often badly structured, the fund says. One of the biggest economic burdens facing many emerging markets is food and fuel subsidies.

The governments in Venezuela, Ukraine and Egypt have relied heavily on state subsidies and neared default in recent years. State coffers couldn't afford the rising costs, despite political pressure to keep them.

The IMF also said developing economies should unify and expand their social-assistance programs, better target benefits to the poorest and tie state cash transfers to the most vulnerable to education and health services.