
# Fiscal policies to reduce inequality

Handbook

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*This Handbook is a subcomponent of a tripartite publication that also consists of an **Analysis of German reform partner countries** and a **Policy Brief**.*

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# List of abbreviations

| | |
|---|---|
| **AEOI** | Automatic exchange of information |
| **ATAF** | African Tax Administrative Forum |
| **BEPS** | Base erosion and profit shifting |
| **CCTs** | Conditional cash transfers |
| **CFC** | Controlled foreign corporation |
| **CIT** | Corporate income tax |
| **$CO_2$** | Carbon dioxide |
| **DST** | Digital services taxes |
| **EC** | European Commission |
| **EU** | European Union |
| **EITC** | Earned income tax credit |
| **EOIR** | Exchange of information on request |
| **ETS** | Emissions trading scheme |
| **EUR** | Euro |
| **GDP** | Gross domestic product |
| **GFG** | Good Financial Governance |
| **GNI** | Gross national income |
| **IMF** | International Monetary Fund |
| **MIS** | Management information system |
| **OECD** | Organisation for Economic Co-operation and Development |
| **PAYE** | Pay-as-you-earn |
| **PIN** | Personal identification number |
| **PIT** | Personal income tax |
| **SDGs** | Sustainable Development Goals |
| **UCTs** | Unconditional cash transfers |
| **UK** | United Kingdom |
| **USA** | United States of America |
| **USD** | United States Dollar |
| **WHO** | World Health Organization |
| **VAT** | Value-added tax |

# Glossary

**Base erosion and profit shifting (BEPS)** – refers to legal tax planning strategies used by multinational enterprises that exploit gaps and mismatches in tax rules in an artificial way to avoid paying tax.

**Capital gains tax** – a tax levied on the profit from the sale of an asset, for example, financial securities or property.

**Carbon pricing** – a cost applied to carbon emissions to encourage polluter to reduce the amount of carbon emitted. The most common forms of carbon pricing are a carbon tax or an emissions trading scheme.

**Cash transfer** – form of social assistance provided by the government to subgroups of the population deemed eligible by society on the basis of their vulnerability or poverty.

**Contributory programme** – transfers provided to people that depend on a history of contributions by the beneficiary or his/her employer, e.g. a pension.

**Consumption tax** – a tax levied on consumption spending on goods or services. Consumption taxes can include excise levies, sales taxes or a value-added tax.

**Direct tax** – a tax paid directly to the government/imposing entity by the person on whom it is imposed.

**Distortion** – when the imposition of a tax results in changes to economic variables that could result in lower economic growth over time. For example, personal income taxes can lead to less saving by the wealthy, which leads to less investment. The long-term impact could be less economic growth.

**Elasticity** – the extent to which the demand for a good or service changes with the change of its price. Goods that are necessities, such as staple foods and fuels, will see little change in how much of a good is sold, even if the price goes up. This good is said to be price inelastic. If consumers have alternatives, or if goods are a luxury, the amount of the good sold will change by much more than that of a necessity when prices increase. In terms of tax incidence, if a good's demand is inelastic relative to the supply, producers will be able to shift more of the tax onto consumers and thus consumers bear the incidence.

**Equality** – the right of individuals or groups to have the same treatment and the same social position.

**Excise levy** – a tax levied on the consumption of a specific good, often with the goal of raising revenue and decreasing consumption of a socially undesirable good like tobacco or alcohol.

**Exemption** – an exemption is a deduction to reduce the amount of income (entirely or partially) that would otherwise be taxed.

**Externality** – when costs or benefits are imposed on other parties without their consent. Often the solution to the problem of an externality is to internalise the cost, i.e. make the originators pay for the damage, through the use of a tax, such as a carbon tax.

**Global Forum on Transparency and Exchange of Information for Tax Purposes (Global Forum)** – the Global Forum is a group of over 160 jurisdictions that includes all G20 countries, financial centres, and the majority of its members are developing countries. Together they work on an equal footing to put an end to offshore tax evasion by fostering the effective implementation of transparency and exchange of information standards worldwide and more specifically, the exchange of information on request (EOIR) and automatic exchange of information (AEOI).

**Income** – money received on a regular basis, usually from a salary, in exchange for the provision of work, for the production/provision of a good or a service or the proceeds from investments.

**Income tax** – a tax levied on the income that a business or individual earns.

**Indirect tax** – a tax collected by an intermediary from the person who bears the ultimate economic burden of the tax. Usually refers to taxes such as consumption taxes.

**Inequality** – a fundamental disparity that permits one individual certain (material) choices, while denying another individual those very same choices. In terms of taxes this handbook focusses on two forms of inequality that are important:

- Horizontal inequality – do taxpayers with similar levels of income pay similar levels of tax?
- Vertical inequality – is the tax paid proportionate to the ability to pay? In other words, is the tax burden distributed fairly so that those who are able to pay more, pay more?

**Nexus** – a connection between the taxing authority and an entity that must collect or pay the tax. Without a sufficient nexus the taxing authority is not allowed to impose taxes on the income of the entity.

**Non-contributory programme** – transfers provided to people that are independent of a history of contributions by the beneficiary or his/her employer, e.g. cash transfer for disabled persons.

**OECD Inclusive Framework on BEPS** – an initiative where over 135 countries and jurisdictions are collaborating on the implementation of measures to tackle tax avoidance, improve the coherence of international tax rules and ensure a more transparent tax environment. This work includes the challenges of taxation in a digitalised economy.

**Personal income tax (PIT)** – a tax levied on an individual's income. This can include wages and salaries, which are usually paid to tax authorities by the employer, on behalf of the employee. The personal income tax often includes income from capital gains and income from interest. The treatment of dividends varies by country, ranging from fully exempt from personal income tax to fully subject to the tax. The selfemployed have to file their own return and make their own payment.

**Proxy means test (PMT)** – gives a score to each household based on a set of observable household characteristics that are suggestive of whether a household is poor. Such characteristics may include the size of the household; the gender of the head of the household; the demographic composition of the household, household's assets, etc.

**Recycled revenue** – refers to the spending of revenue that is generated from the imposition of carbon pricing. On what objectives or how this revenue is spent determines how progressive the carbon pricing scheme/carbon taxes will be.

**Share equity** – the shareholder's claim on assets after a company's debts have been paid.

**Tax base** – the total amount of assets or income that can be taxed by a taxing authority, usually by the government. It is used to calculate tax liabilities. This can be in different forms, including income or the value of property. The base can be narrowed by increasing exemptions, i.e. excluding certain parts of the base from taxation.

**Tax incidence** – who ultimately bears the burden of a tax, as opposed to on whom it is initially imposed (only pays it to the taxing authority). For example, a tax on petrol is paid by refineries, but the tax is part of the final price of the product (however, (often) separately stated). Thus, the economic burden of the tax is on the consumer and not the refineries.

- A tax is regressive if the incidence falls on people in poverty.
- A tax is proportional if the tax rate is the same for all who pay, regardless of income.
- A tax is progressive if the rich pay more, i.e. the incidence falls on the wealthy.

**Tax rate** – the ratio, usually a percentage, at which a person or company pays tax.

- The **statutory** tax rate is the rate specified in the law.
- The **effective** tax rate is the rate that is actually paid, after all deductions.
- The **average** tax rate is the rate paid over all income.
- The **marginal** tax rate is the rate paid on the last Euro.

**Value-added tax (VAT)** – is a consumption tax placed on a product (or service) whenever value is added at each stage of the supply chain, from production to the point of sale. The amount of VAT that the user pays is on the cost of the product, less any of the costs of materials used in the product that have already been taxed.

**Wealth** – the assets a person, family or corporate owns, including property and financial assets.

**Wealth tax** – a tax on the assets that an individual or entity owns, rather than on their income. Wealth taxes come in many forms:

- Property taxes levy taxes on the value of property that is owned.
- Inheritance taxes tax the value of the transferred wealth at the time of death.

Net wealth taxes levy a tax, usually a small percentage, on the size of the assets owned.

1

# INTRODUCTION

**Inequality within and between states has reached a level that hinders economically, socially and environmentally sustainable development. High and rising inequality manifests itself in different ways. It can negatively impact economic growth, threaten the realization of human rights, impede social cohesion and undermine the functioning of democracies worldwide. More than two-thirds of the world's population live in countries, where inequality is rising.**

**The COVID-19 pandemic has exacerbated inequality.** The decline of the global economy, the loss of jobs and the lack of social protection as well as unequal access to health services and an uneven vaccination rollout act as accelerators of inequality. This not only translates into a widening gap in terms of income and wealth but can also lead to unequal access to basic social services, to unequal opportunities as well as to an increase in poverty.

**Therefore, tackling inequality needs to be high on the political agenda and actively dealt with, for example through fiscal policies, which are defined as governments' use of revenue or expenditure.** One of the most powerful instruments available for governments to reduce poverty and inequality are taxes and transfers. Hence, fiscal policies can be particularly useful in reducing inequality of income and wealth.

**Yet, inequality is a multi-dimensional phenomenon manifesting other forms of inequalities which are equally important – such as the access to and outcome of education and health or regional disparities.** Inequalities also exist among social groups and can be determined by gender, ethnicity, or race. Moreover, fiscal policies are also important to address other multidimensional inequalities beyond wealth and income by influencing important framework conditions such as the access to and outcome of education, health and other basic social security systems. Nevertheless, economic inequality is strongly correlated with inequalities in these different domains. In addition, a more equal distribution of income and wealth is associated with faster economic growth, the reduction of poverty as well as more social cohesion. Therefore, this Handbook will focus on fiscal policies and how they can be used to reduce inequality of income and inequality of wealth.

**While principles of fairness would suggest that inequality should not be tolerated at all, economic arguments concerning the tolerable level of inequality have been ambiguous.** In 1955, Simon Kuznets observed that as workers moved from agriculture to industry and from rural to urban areas, income inequality might increase, the so-called Kuznets curve. Thus, income inequality might be an inherent feature of development. Kuznet's paper had the unfortunate consequence of normalising inequality and even suggesting that it may serve a positive purpose. This conclusion was not uncontested and in recent years, various economists have shown that inequality should not be tolerated. The key contributions of Thomas Piketty, Anthony Atkinson, Amartya Sen and others, indicate that inequality is harmful to economic growth and social inclusion, and positive action is needed to reverse it.

**Lower inequality is associated with faster and more durable growth.** Ostry, Berg and Tsangarides (2014) examine the question of whether there is a cost to redistributive policies econometrically and find that there is no growth penalty to redistributive policies. In addition, periods of faster economic growth last longer in countries with more equal income distributions. Thus, policies that reduce inequality will be growth-enhancing in the long run as they will support faster and longer periods of growth.

**When more equal economies grow, poverty is reduced more than in unequal economies.** Fosu (2011) examined the impact of economic growth on poverty reduction in developing countries since the 1980s. He finds economic growth to be the main factor leading to poverty reduction. Yet, the prevailing level of inequality plays a mediating role. In countries with higher levels of inequality, poverty was reduced less. In effect, the benefit of economic growth was directed to middle- and upper-income bands, rather than to people in poverty. Thus, its potential for faster poverty reduction is a further reason to reduce inequality. Moreover, people in poverty and other left behind groups also have unequal access to, for example, education or the labour market. This is called inequality of opportunity. To reduce those inequalities, all people should have the same prospect of achieving what they desire. Inequality of outcome, as another concept, focuses on existing levels of inequality revealed in levels of income or wealth. Hence, inequality of opportunity is focused on ensuring that everyone has the same starting line while inequality of outcome is focussed on the finishing line.

**Inequality is now commonly seen as a social ill, and not an undesirable side-effect of the development process.** Rather, the deleterious consequences of inequality on health and education outcomes, economic growth, national well-being as well as social cohesion are being increasingly recognised. In 2015, the Sustainable Development Goals (SDGs) were agreed in the United Nations General Assembly, including SDG 10 to reduce inequality between and within countries, a notable change from the Millennium Development Goals. COVID-19 is likely to worsen inequality as it affects people in poverty and those in informal employment, with insufficient health care, the most.

**Reducing inequality needs a multi-facetted approach, taking different aspects into consideration.** Adequate fiscal policies are a powerful tool to combat inequality, thereby aiming at reducing inequality of income and wealth. Latin America and the Caribbean are the regions with the highest income-inequality, while developed economies have the lowest income inequality. Three-quarters of the difference in inequality between these two regions is due to more effective use of fiscal redistribution in developed economies (IMF, 2017).

**This Handbook identifies and outlines how to implement the most effective policies to reduce such inequality with a specific focus on developing countries, using a technical as well as a political economy analysis.** This is necessary as political, social, and administrative aspects might hinder the implementation of policies that theoretically seem effective. Besides, there are often trade-offs related to the introduction of policies. For example, increasing government expenditure on cash transfers may reduce inequality, but it will reduce the funding available for other types of expenditure such as on education, health, or infrastructure. Thus, political, technical, social, and administrative considerations as well as trade-offs with other government objectives need to be carefully evaluated when the introduction of a certain policy is considered.

Adequate fiscal policies are a powerful tool to combat inequality, thereby aiming at reducing inequality of income and wealth.

**After presenting the methodological approach in the following section, each chapter of the Handbook is structured in five sub-sections:** First, there is an overview of each policy, followed by details on how to implement the policy. The role of each policy instrument is assessed based on a political economy analysis:

- **Effectiveness** at achieving its goals (either raising revenue or providing support to those living in poverty).
- **Efficiency** in terms of having least distortionary impact on economic growth.
- **Impact** on the reduction of inequality.
- **Enforceability,** the degree to which people or institutions can be made to comply with a policy.

Each section concludes by presenting a case study on how the policy is implemented and concludes with general recommendations.

2

# METHODOLOGICAL APPROACH

**Most of the literature concerning the reduction of inequality comes to similar conclusions about the broad types of policy needed to decrease inequality with the help of fiscal policies. The International Monetary Fund (IMF) recommends improved targeting of social assistance programmes, increased use of conditional cash transfer programmes, expansion of non-contributory pensions, increased access to education and health, and increased coverage of a progressive personal income tax (PIT).**

**The German development cooperation itself takes a more holistic view to fiscal policy incorporating the normative and political-economy dimensions of policy formulation.** As such, the Good Financial Governance (GFG) framework is based on the reduction of poverty and inequality through fair, accountable and transparent public financial management systems. This strategic approach identifies six main technical areas, namely creating fair, transparent and efficient tax systems, redistributive and fair public expenditure management, using procurement systems, fiscal decentralisation, debt management and accountability for the use of public funds used to reduce inequality.

> The Good Financial Governance (GFG) framework is based on the reduction of poverty and inequality through fair, accountable and transparent public financial management systems.

## 2.1 Selected fiscal policies on the revenue and expenditure side

Taking into consideration the holistic GFG approach, this Handbook will not only take into account technical aspects, but also the political economic perspective of selected fiscal policies. In particular, the Handbook will consider the following:

### Revenue side

**The revenue side has an important role to play when it comes to inequality reduction:** firstly, it generates revenue which can be used for inequality-reducing measures and secondly, if appropriately designed, the fiscal policies on the revenue side can ensure that the richer pay more than the less-wealthy.

**This Handbook will focus on and examine taxes like personal income tax and capital gains, corporate income tax and consumption taxes** that provide most governments with the majority of their income. Because these taxes are widely used and so important to mobilise revenue, their impact on inequality can be large. This Handbook will focus on how these taxes can be implemented in such a way that their inequality-reducing impact is as large as possible.

Additionally, the Handbook will look at the following:

- **Wealth taxes** are also important tools for reducing inequality. Yet, the implementation is difficult, and some countries have abandoned their use. This Handbook will identify strategies to ensure these taxes achieve their objectives. **Property taxes** are an important tax on wealth because they are relatively easy to implement and, unlike other taxes on wealth, the underlying asset is immobile, which makes the evasion of property taxes difficult.

- The rich have better access to the legal and accounting skills necessary to achieve **tax evasion and tax avoidance**, which can make levying taxes on the wealthy difficult. Nonetheless, if inequality of income and wealth should be reduced, it is indispensable to tackle this challenge. It is necessary to set up policies against tax avoidance and tax evasion and make sure that the wealthy also contribute to the tax revenues of a country.

- Tax policy needs to respond to new challenges arising through technology and changing policy goals. As such, this Handbook will examine **digital services taxes** and **carbon pricing**, and their impact on inequality.

**The analysis of taxes will focus on how they can be implemented in such a way as to increase their impact on reducing inequality**, or in the case of consumption taxes, how to reduce their regressive nature. This will necessarily involve the discussion of tax rates, targeting and the use of exemptions and deductions.

## Expenditure side

**On the expenditure side, the Handbook provides an overview of spending policies:**

- **Education** and **health** that are often some of the largest categories of government expenditure and can have a significant impact on the lives of those living in poverty.

- **Social protection**, in particular **cash transfer programmes**, which can have dramatic impacts on inequality and poverty, especially in poorer economies. The use and success of these policies in countries such as Brazil and recently in African economies deserves a close examination.

## Combining tax and expenditure

**The extent of fiscal redistribution will be determined by both the size of fiscal measures and their progressivity.** Thus, a tax that raises only a small amount of revenue is likely to have less impact on reducing inequality than a more effective tax. Similarly, a PIT, which can be levied at higher rates for those who earn more income, can have a greater impact on income inequality.

**Individual elements of a specific policy might be regressive, while the whole package could be progressive.** Cash transfers can reduce inequality, but programmes need to be large to have a meaningful impact. In some cases, funding cash transfers with a regressive consumption tax is necessary to achieve sufficient scale. In Sweden, for example, regressive cash transfers are allied to progressive taxation to achieve substantial fiscal redistribution. The regressive transfers are necessary to provide political legitimacy for progressive taxes.

## 2.2 Measuring inequality

**In order to evaluate the effectiveness of inequality-reducing policies specific measures are needed to determine the degree and trends of inequality in a country.**

**Results of measuring inequality can vary depending on the underlying source of data.** Income inequality is best measured using databases of tax administration data. As such records are not always available in countries in the global south, inequality is alternatively measured using surveys of consumption. Whether consumption inequality depict the same trends as income inequality is an empirical question that has not been fully resolved. But, as income can vary from year to year, consumption data is an additional factor when considering inequality. Consumption inequality, for example, may also be a better measure of well-being under certain circumstances. For example, an individual's level of well-being could be higher once they have paid off debt, which allows them to increase consumption, even though their income has not changed. Moreover, other specific sources of income such as wages, capital gains, taxes, and benefits can be used to better understand economic inequality. Nevertheless, a thorough knowledge and reliable data of income and wealth inequality is scarce. This can partly be explained by the fact that relevant data is not collected thoroughly by statistical administrations and household surveys often underestimate the income and wealth of people at the top of the income distribution. In addition, official statistics often disregard the comparatively large informal sector.

> Nevertheless, a thorough knowledge and reliable data of income and wealth inequality is scarce.

**There is no one definitive measure of inequality.** Rather, each measure has strengths and weaknesses. To judge which measures are useful, four criteria are applied:

- **Anonymity** – which individuals are where in the distribution should have no impact on the measurement of inequality.
- **Population principle** – population size should not impact the outcome of the inequality measurement.
- **Relative income principle** – inequality is about measuring relative incomes (or consumption or wealth). An increase in income levels should not change the result of inequality measurement on its own.
- **Transfer principle** – inequality is reduced when lump sums are transferred from a richer individual to a poor individual.

**The most common measure is the Gini coefficient, which ranges between 0 and 1**, with higher values representing more unequal distributions. The Gini coefficient contains information about the whole distribution, is independent of the size of the population and adheres to the transfer principle. However, one constraint of using the Gini coefficient as a measure for inequality is that economies with similar Gini coefficients may have different income distributions.

**While the Gini coefficient might be the best-known measure for inequality, other measures are also available, such as the coefficient of variation and the variance of log income.** The coefficient of variation is the ratio of the standard deviation of income to the mean of income. This is scale invariant, as is the variance of log income. The coefficient of variation and the variance of log income will rank distributions in the same order as the Gini coefficient if the Lorenz curves do not cross. In practise, the Gini coefficient puts a higher weight on the middle of the distribution, the coefficient of variation is more sensitive to changes in the income of the rich and the variance of log income puts higher weight on change in the lower tail of the distribution.

**Other useful summary statistics to illustrate inequality are the Palma Ratio and the use of percentile ratios.** These focus on specific points of the distribution, rather than encompassing the whole distribution. For example, many studies utilise the interdecile ratio, which is the ratio of income of the 10th percentile of the distribution to the income of the 90th percentile of the distribution. The Palma Ratio divides the ratio of the richest 10% of the population's share of gross national income (GNI) by the poorest 40%'s share. Moreover, the Theil Index, which has the advantage of being decomposable, is increasingly used. It allows for inter-group comparisons of measurement subjects (World Bank, n.d.).

**When measuring inequality, it is also important to take taxes and transfers into account.** The adoption of the Sustainable Goal 10 ("reduce inequality within and among countries") of the 2030 Agenda created an international mechanism that hols countries accountable for their effort to reduce inequality. However, there was no indicator to monitor the impact of fiscal policies as such on the income distribution.

**The adoption of the new SDG indicator 10.4.2 ("redistributive impact of fiscal policy") fills this gap and recognizes the relevance of fiscal policies in reducing inequality.** The indicator measures the difference between pre-fiscal and post-fiscal Gini indices on income (Lustig, Mariotti and Sánchez-Páramo, 2020). All countries are mandated to produce this subcomponent of the SDG 10 ("reduce inequality within and among countries"), which holds countries accountable for their efforts to reduce inequality in all its dimensions, for example, by encouraging governments to "adopt policies, especially fiscal, wage and social protection policies, and progressively achieve greater equality" (Target 10.4).

## 2.3 Tax and expenditure indicators

**Detailed analysis of tax returns could determine if inequality-reducing policies are having the desired impact.** Ultimate success would be measured as a decline in inequality, for example in inequality of income, wealth, or consumption. Income surveys are expensive and infrequent, so it would be useful to have intermediate measures which would show whether policies are having the desired impact. The intermediate measures will objectively show whether taxes are having the inequality-reducing impact desired and whether policy changes to make taxes more progressive are operating as expected. For example, it is recommended that if governments want to retain a tax on net wealth, they should be careful to eliminate as many exemptions as possible, in order to boost the tax yield. The tax authorities can collect data from tax returns to verify to what extent deductions are being used. With this information it could be identified who is using the deductions and if there might be a need for adjustment. However, using data from tax returns would only be worthwhile if there are sufficient taxpayers actually filing a return.

**The tax administration should collect the following data to determine if taxes are reducing inequality:**

- **The share of taxes** raised by each tax. Raising more tax by progressive income taxes will be inequality-reducing, while relying more on consumption taxes will be regressive.

- **The use of deductions.** Heavy use of certain deductions would result in less revenue and less impact on inequality if these deductions are being used by the wealthy to reduce tax liability. On the other hand, certain deductions can increase the inequality-reducing impact. This is a delicate balance because use of deductions is often driven by other objectives that government is pursuing, such as encouraging saving for pensions, but the case for a deduction needs to be weighed against the revenue loss and the impact on inequality.

- **The number of taxpayers in each band of PIT.** Tax authorities should monitor the share of taxpayers that are being impacted by each tax band. If the bands are not sufficiently progressive, many taxpayers will be paying the top tax rate. In order to reduce vertical inequality, only the highest income earners should be paying the top tax rate.

- **The amount of revenue being raised by wealth taxes.** Wealth taxes are not very effective revenue raisers. However, if very little revenue is being raised, it could indicate that evasion is taking place, which would also negate the inequality-reducing impact. It would also be useful to monitor increases in wealth to confirm whether these are translating into revenue. Again, the failure to collect revenue means the inequality-reducing function is also not effective.

- **Expenditure on zero-rated or lower rated goods.** Exemptions on consumption taxes can be expensive and regressive. Expenditure surveys should be analysed to ensure that zero rates only apply to goods that are favoured by people in poverty. If the middle-class or wealthy also consume the good, then the zero-rating/lower rating can become regressive.

**On the expenditure side, two dimensions can be considered to assess whether public spending is reducing inequality: incidence of benefits and incidence of beneficiaries** (OECD, 2018b). Public spending would reduce inequality if people in poverty receive more benefits, as measured by use of public services and transfers received, than the wealthy in relation to their level of income or consumption.

- **Incidence of benefits** measures how much of the total amount of benefits created by public spending is received by each group of the population, ordered by their income or consumption level. Relevant indicators include the share of total benefits by income or consumption decile, amongst others.

- **Incidence of beneficiaries** shows the share of each income or consumption group benefiting from public spending, and it can be further disaggregated into categories, such as urban or rural populations. The analysis at beneficiary level can also look at the proportion of total beneficiaries belonging to each consumption or income group. Relevant indicators include the percentage of individuals benefiting from government spending in each income or consumption decile as well as the share of total beneficiaries of government spending by income or consumption decile.

- **Household survey data**, capturing information on public services and transfers to households (i.e. health and education and social protection programmes), as well as government spending data are necessary to analyse distributional impact of public spending.

# 3

# TAXES

**The ultimate goal of taxation is to raise revenue for the government. At the same time, taxes can have a redistributive impact or be used to pursue other goals, such as discouraging undesired behaviour. Because of their many impacts, governments can use taxes to pursue many different goals. This Handbook focusses on examining the effect taxes can have on reducing inequality. Therefore, the Handbook will need to focus on how to evaluate inequality when it comes to taxes, the so-called incidence of a tax or a tax burden as well as the design of a tax including the likelihood to avoid or evade such taxes.**

In **evaluating inequality**, there is a need to consider two different types:

- **Horizontal inequality** – do taxpayers with similar levels of income pay similar levels of tax?
- **Vertical inequality** – is the tax paid proportionate to the ability to pay? In other words, is the tax burden distributed fairly so that those who are able to pay more, actually pay more?

**Another important concept is the incidence of a tax, which is defined as the party which ultimately is affected by a tax**. This is often distinct from the party that pays the tax to the tax authority. For example, in case of a carbon tax, it is often paid by companies that own oil refineries. However, these companies will then increase the price of their product so that the cost of the tax is shared between the company and the consumer. How much of this increase companies can pass on to consumers will be determined by the extent to which the demand for a good changes with a change in its price, the elasticity of demand. Goods that are necessities, such as staple foods and fuels, will see little change in how much of a good is sold, even if the price goes up. This good is said to be price inelastic. If consumers have alternatives, or if the good is considered a luxury, the amount of the good sold will change much more than of a necessity when its price increases. In terms of tax incidence, if a good's demand is inelastic relative to the supply, producers will be able to shift more of the tax onto consumers and thus consumers will bear the incidence.

**Incidence will vary according to economic circumstances.** Because the middle class in developed economies holds most of their wealth in property, the incidence of a property tax will be on the middle class. In developing countries, it is mostly the wealthy who own property and thus bear the incidence of the tax. The incidence of taxation on net wealth, given an appropriate design, is purely on the rich, so this is a tax with a large inequality-reducing effect.

**In analysing taxes, there is a need to distinguish between tax rates and effective tax rates.** The tax rate, or statutory tax rate, is the rate stipulated in law, usually a percentage of the value of the tax base. For example, a CIT rate may be 20% of the value of a company's annual (pre-tax) profits. The effective tax rate is the percentage of their income that an individual or a corporation pays in taxes. Because of deductions, exemptions, preferential rates, credits, and loopholes, the effective tax rate of an individual or a company is usually lower than the statutory tax rate.

**It is also important to differentiate between tax avoidance and tax evasion.** Tax avoidance is the use of legal means to reduce the final tax liability (e.g. using differences in tax systems). Tax evasion is reducing tax liability through illegal means such as hiding wealth or not declaring income.

**Most governments use a tax policy mix for their tax system, where the reduction of inequality plays a subordinate role.** No single tax fulfils all functions a government requires, namely, to raise revenue at little cost and administrative effort, have little impact on efficiency and reduce inequality. For example, consumption taxes generate large amounts of revenue, are efficient and relatively easy to administer. However, consumption taxes can be regressive. Income taxes are used because they generate revenue and can be used for inequality reduction, particularly using progressive income tax bands. Income taxes, however, are inefficient because they have an impact on market prices which could result in less economic growth, and they are administratively more difficult to implement. Thus, governments use different tax instruments in a tax policy mix, which can achieve multiple objectives, such as maximising revenue and reducing inequality.

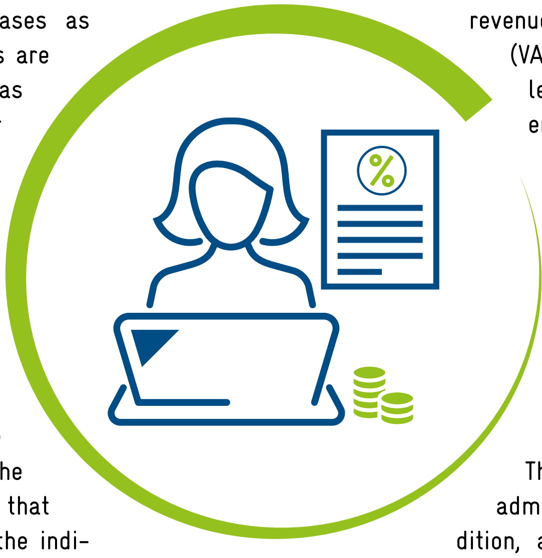
**The tax policy mix used can differ between developing and developed economies.** In developing countries, direct taxation of income tends to be difficult due to the large proportion of individuals who work in the informal sector and lower capability of tax administrations. Even in the formal sector, the use of bank accounts is often limited, making it difficult to enforce income tax collection. Consequently, these countries have tended to rely to a large extent on indirect taxes, such as value added taxes, import tariffs and other distortionary taxes. These taxes reduce economic efficiency, due to the distortions they impose on market prices, thus reducing economic growth in the long run. Furthermore, they tend to be far more regressive than income tax because they do not take into account the income, i.e. the ability-to-pay of the taxpayer. In many cases taxation in developing countries exacerbates inequality (Prasad, 2008).

**Data on tax collection shows how the pattern of revenue collection is different between countries that are members of the Organisation for Economic Co-operation and Development (OECD) and developing countries.** The OECD Global Revenue Statistics Database contains data on the collection of taxes in 63 developing countries and 37 OECD economies. This data shows that in 2018 consumption taxes raised 38.9% of total tax revenue in developing countries, compared to an OECD average of 28.4%. Developing countries also raised 21.2% of revenue on excise duties and tariffs, OECD economies only raised 9.6% of revenue through these taxes. OECD countries tended to raise more revenue from PIT (23.9% vs 14.8%) while developing countries raise more revenue from CIT (17.7% vs 9.3%) (OECD, 2020).

> The OECD Global Revenue Statistics Database contains data on the collection of taxes in 63 developing countries and 37 OECD economies.

# 3.1 Personal income taxes

**Personal income taxes (PIT) are paid on income, e.g. on the salary of the taxpayer.** There are different forms of collection: either they are directly paid (usually by the self-employed) or withheld by the employer, such as pay-as-you-earn (PAYE) or payroll taxes. In most countries, PAYE is a progressive tax, the rate you pay increases as your salary does. Payroll taxes are similar but are usually levied as a lump sum, e.g. EUR 100 per person, or as a flat rate as a percentage of income, i.e. 20% of income, regardless of the level of income. Both PAYE and payroll taxes are usually paid by employers on behalf of their employee. In some countries there is a possibility for employees to file an additional tax return for the respective year to make sure that all applicable deductions for the individual are applied and all taxable income, not only salary income, is considered. PIT is also required to be paid by the self-employed, however as there is no employer who can withhold the tax for the employee, the self-employed will have to file and pay their income tax directly to the respective tax authority. The wealthy often receive further income from investments, which is usually taxed by a capital gains tax, as part of PIT. PIT will also tax income from interest and dividends, however, a specific rate often applies for such capital income. Other income may also be subjected to PIT, e.g. income from renting activities.



## Background and objective

**The objective of PIT is both - to collect adequate tax revenues and reduce vertical inequality at the same time, i.e. collecting proportionally more tax from high-income earners.** PIT is levied on the income of individuals. For most taxpayers this will be on wages, but wealthier taxpayers often earn substantial portions of their income through returns from company ownership or financial assets. Many countries tax capital gains under the PIT.

**PIT is one of the most important methods to raise revenue.** In OECD economies, PIT raised more revenue than CIT or value-added tax (VAT). Developing countries are less successful at raising revenue through PIT. High levels of informality will reduce PIT because it is to a large extent paid by companies on behalf of their employees. If companies are not registered for tax, they do not provide employees with payslips and do not pay salaries into bank accounts. Therefore, it is difficult for tax administration to levy PIT. In addition, a relatively high level of tax evasion by wealthy individuals (often called high-net worth individuals), who are often self-employed and have substantial additional capital income, reduces the collected PIT. In practise, PIT in developing countries is mostly a tax on civil servants and those working in large companies (Keen, 2012).

**The PIT is not only important for revenue, but also to reduce inequality.** The IMF (2017) argues that although reducing inequality for those at lower incomes is best served through social grant programmes, the inequality-reducing policies that will have a greater impact on the rich will rely on taxation, often a PIT.

**PIT is usually levied in a progressive way with higher income earners facing higher tax rates, as ability to pay increases.** Thus, PIT can have an important role in reducing inequality. In Latin America, for example, 80% of PIT is paid by the richest 10% of the population (Barreix et al., 2017).

**However, since 1980, PIT rates have declined, and PIT has become less progressive as rates on the highest incomes were reduced** (Peter, Buttrick and Duncan, 2009). Since 2009 top marginal rates have trended slightly higher in advanced economies (Gerber, et al., 2018).

**PIT can be difficult to administer because it requires tax administrators to determine the taxable income of a taxpayer versus their overall gross income.** This can be complicated if there is more than one source of income, especially capital income, and many deductions or exemptions apply.

**The urge to simplify PIT has resulted in some governments instituting a flat tax – a PIT with only one band.** The main advantage of this approach is that a flat tax is slightly easier to implement. However, its inequality-reducing effect decreases or ceases to exist. There has also been a tendency to move away from a uniform approach to income and instead build 'dual income tax systems', differentiating treatment on labour and capital income (Keen, 2012). This means income mostly from labour and capital is taxed differently. Such trends are observed both in developed and developing countries.

**PIT can be levied on either global income or according to income type.** Global income attempts to levy a tax on all income a taxpayer earns from various sources at one rate, while the schedular approach acknowledges distinctions between sources that could lead to different rates applied to different sources of income. For example, capital income is often taxed at a lower, uniform rate while wage income is taxed according to progressive tax bands.

**The essential distinction is the treatment of capital income earned through holdings of financial assets.** These financial assets are predominantly held by the rich. As it has become easier for the wealthy to move funds across borders and markets, the concern has been that taxing capital income at a too high level will result in this capital being transferred to another jurisdiction (Zee, 2002). Taxing immovable wealth or wealth a person would like to have around and would thus not be willing to move to another country could be a solution to this problem. Additionally, lower taxation of capital income can encourage savings in middle income households. In order to not disadvantage poorer households from saving, a policy option is to offer the possibility to tax their savings at their individual PIT rate in case the PIT rate is lower than the tax on capital savings, and/or to offer a deduction on income from interest, so that only the savings of the rich are taxed.

## Implementation

**The basic idea of progressive PIT is that people should pay proportionally more taxes as their income increases, i.e. according to their ability to pay.** However, in practice the design of a PIT can be relatively complex, and progressivity may be undermined or enhanced by how it is implemented. The most common factors to take into account include:

- **Income bands:** these are the different levels of income for which tax is calculated at different *tax rates*, which increase for higher income bands.

- **Allowances:**

    - A **basic allowance** rebates taxes if income falls below a minimum threshold. The basic allowance makes the tax more progressive by ensuring that people in poverty are not paying PIT. It is also enhancing administration as revenue agencies can focus their efforts on taxpayers who will be paying more tax. The IMF (2017) recommends that countries with weak tax administration or high levels of informality use a high basic allowance and then decrease the allowance over time as capacity improves.

    - **Targeted allowances** for spending income on certain activities for example, health expenses, charitable giving, work-related expenses, larger families and political concessions.

- **Pension contributions:** usually pension contributions are deductible, but treatment can vary on income received from pension funds and the receipt of pension itself.

- **Different treatment of capital income:** capital income (interest, dividends and capital gains) can be subject to a different treatment (in terms of tax rates and specific tax bands) or partly exempted from tax (for instance for government bonds). For example, Brazil has a PIT with 5 bands, with a top tax rate of 27.5%. Capital income is subject to a flat rate of 15%. This increases horizontal inequality, as taxpayers earning the same income but from different sources would have a different tax liability.

**The relationship between PIT rates and revenue raised is dependent on institutional quality:** in countries with low administrative capacity, higher rates can be associated with lower collection. PIT collection in developing countries declines as the size of the informal sector increases and might lead to authorities responding by raising tax rates on the few taxpayers paying PIT (Peter, Buttrick and Duncan, 2009).

**PIT is a difficult tax to administer because it can be challenging to determine a taxpayer's taxable income.** This is especially so in developing countries where wealthy taxpayers can hide assets and there is little (third-party) information to corroborate taxpayer information. This can weaken the inequality-reducing impact of PIT as top income earners are more likely to successfully evade the tax. This can increase vertical inequality, as top income taxpayers pay less than their ability to pay.

## Strengths and weaknesses

### Effectiveness

**PIT raised revenue to the value of 8.3% of GDP in OECD countries in 2018.** Some countries were able to raise substantial revenue purely from PIT. Denmark raises the most, more than 24% of GDP. By contrast, the 63 non-OECD countries in the OECD Global Revenue Statistics database, were only about to raise an average of 2.3% of GDP in 2018. Developing countries face many barriers to raising revenue from PIT, not least because of small formal labour markets, meaning that very few people pay PIT. This also impacts the inequality-reducing impact of PIT.

### Efficiency

**PIT can have substantial disadvantages over consumption taxes because it results in greater distortions to market prices and incentives.** PIT reduces the after-tax wage, so taxpayers may decide to work less because the benefit of working has fallen. They may also feel that they need to work more because they are poorer. These effects result in distortions to labour supply that can reduce economic growth.

**However, Piketty et al. (2011) concluded that the impact on labour supply is relatively small so concerns about inefficiency are exaggerated.** Even though high-income percentiles paid lower taxes and have increased their income share this has failed to generate economic growth. Instead, the decline in top PIT rates is strongly correlated with increases in income inequality. Piketty et al. (2011) conclude that the optimal top tax rate, which maximises revenue with the least distortions is 83% for the United States of America (USA). The rate is currently 37%, though it was 93% in 1963. Piketty (2011) argues that the decline in the top rate is due to political power of the wealthy.

**PIT has relatively high administrative costs related to the correct determination of the taxable income and the filing of the return both for the tax administration and compliance costs for the taxpayer.** Administrative costs and the large size of the informal economy in developing countries combined with tax evasion by the wealthy reduce the significance of PIT in many developing countries, where it is confined to be a labour tax for the formally employed (Bird and Zolt, 2008), which ultimately limits the impact of PIT on inequality (Duncan and Peter, 2012). Taxpayers, who are financially, but also sometimes literally, illiterate would struggle to file for taxes and comply with legislation. Increasing use of tax education can be helpful in decreasing this problem. Additionally, technology is making many administrative burdens considerably smaller. Nonetheless, consequent use of modern technology, not only as a link to the taxpayer, e.g. online filing opportunities, but for internal risk and audit processes, could further improve tax administration performance with regard to PIT as well as to other taxes.

**If PIT taxes capital gains, the return on capital can be reduced**, which can reduce investment and growth in the long run. This needs to be balanced against inequality concerns because people in poverty have very little, if any, capital income.

## Enforceability

**As PIT is collected through withholding by employers (a so-called payroll tax or pay as you earn) it can generally be enforced easily.** Consequently, in some countries, employees do not even have to file a PIT declaration on their own. When employers claim wages as a deductible cost for their CIT, there is an incentive for employers to report on PIT correctly. This enhances enforceability and increases corporate tax compliance.

**However, in developing countries many people are self-employed and/or part of the informal economy, which weakens enforcement.** Thus, generally, only the government and large, often state-owned or internationally active companies contribute to the collection of PIT for their employees. Similarly, companies that operate informally do not pay CIT, which weakens enforcement of CIT.

**When PIT is levied on taxpayers who are self-employed, the tax can be complex to enforce.** For these particular taxpayers, PIT is costly to administer. In addition, the wealthy can hide assets and use tax planning to avoid or even evade PIT.

**In order to maximise the PIT take, the marginal tax rate of PIT cannot be too different from that for CIT (Zee, 2005).** Business owners are able to choose to pay themselves either through a salary, or through dividends. If the PIT rates are too high above the corporate rate, business owners will choose to receive their income through dividends, rather than salaries, which will lower the amount of tax they pay.

## Impact on inequality

**The PIT should be progressive, meaning that it should reduce inequality by taxing taxpayers according to their ability to pay.** But tax evasion and design characteristics have the potential to make the tax less progressive, or even regressive. For example, a PIT system which is too complex for the taxpayers but especially the tax administrations to implement may collect little revenue, not even among the wealthy. Hence, there should be a balance between an administrable approach which is usually less progressive and a progressive, but usually more complex approach.

**The IMF (2017) argues that progressivity in developing countries can be enhanced by:**

- Increasing the rate applying to the **top income band**.
- Using a **large basic allowance**, which ensures that people in poverty are not caught in the PIT net. As economies develop and a middle-class emerges, PIT will apply to more taxpayers and the basic allowance can be decreased.
- **Limiting allowable deductions.** Deductions for mortgage interest and medical insurance can be highly regressive. These deductions should be eradicated or capped. In addition, the number of deductions should be limited. Adding further deductions is increasing administrative complexity and increases the scope for tax avoidance by the wealthy.
- Ensure that **fringe benefits**, such as stock options and bursaries which are usually only obtained by the wealthy in developing countries, are assessed and taxed correctly, as they could be an avenue for evasion.
- Reduce the scope for turning "normal" income into **capital income** by increasing the rate of tax on capital gains or by taxing capital gains with the same rate as the rest of the income, e.g. salary, as these accrue to the wealthy. The capital gains tax may not raise much revenue itself, but it does force wealthy taxpayers that usually generate a large part of their income from financial investments, sometimes from unearned inherited wealth, to declare more income subject to PIT.

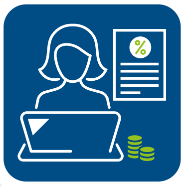
**In countries with very low tax administration capacity, it might be worthwhile to consider a (temporary) flat tax, meaning one tax rate for all taxpayers.** The trade-off could be between having a less progressive PIT and raising no PIT tax revenue at all. Besides, as many poorer households are part of the informal economy and thus not paying taxes at all, there is no adverse effect on those from the flat tax. With the enhancement of the tax administration's capacities this system should be changed in the long run into a more progressive one.

**In order to avoid that exemptions are reducing the amount of tax too much or even to zero, authorities can use an alternative minimum tax.** The minimum tax sets a floor on the amount of tax a taxpayer should pay, regardless of exemptions. In practice that would mean that the law would need to require a taxpayer to pay the higher amount between the minimum tax amount and the amount calculated based on the ordinary PIT scheme. This is well suited to use in developing countries.

## Spotlight 1: Earned Income Tax Credit

The United States of America enhances the inequality-reducing impact of PIT through the Earned Income Tax Credit (EITC), which is effectively a negative income tax for low-wage earners. It provides a large tax credit to people in poverty, so that anyone who works, receives a subsidy from government. For someone with three children, the subsidy could be as much as USD 6,600 a year. EITC only accrues to those who pay income taxes, so it does not distort the decision to work.

## Box 1: Case Study – Personal Income Tax in China



**PIT tax revenues increased substantially between 1986 and 2010.** Progressive income tax was introduced in 1980 after China started to open and embarked in a series of reforms which gradually introduced elements of a market economy. PIT was introduced with an extremely high exemption threshold (basic allowance), so that very few people were affected by the tax. However, the combination of a high-income growth and an adjustment of thresholds that did not keep up with inflation and salary growth resulted in a gradual increase in the number of people that had to pay PIT. In fact, from 1980 until 2011 tax bands and respective tax rates remained the same (with nine tax bands with progressive rates from 5% to 45%). It is estimated that while in 1986 only 0.1% of the Chinese population paid the tax, in 2008 this percentage rose to 20%, and its significance passed from 0.1% of GDP in 1986 to 2.5% of GDP in 2008. Piketty and Qian (2009) contrast the rise of significance of progressive income tax in China with a stagnant performance of a similar tax in India where exemption and income brackets have been regularly adjusted with the pace of the economic growth, so that just 2-3% of Indians pay such taxes contributing 0.5% of GDP.

**The evolution of PIT in China is similar to that of many OECD economies.** Current levels of taxation in many OECD countries have been achieved slowly, starting with low tax rates and a small number of taxpayers, and expanded gradually in specific historical periods, often to fund a war. The formidable and sustained economic growth experienced by China has been associated with an increase in the role of PIT as a source of tax revenues and a gradual increase in the number of taxpayers and this was achieved almost by 'inertia' simply by not adjusting tax bands or increasing tax bands at a rate lower than inflation. The lesson of ad hoc adjustments of thresholds as applied in China is important and partly goes against traditional advice of 'automatic adjustments' such as annual tax rate adjustments to account for inflation. This could be implemented in other fast-growing economies to further increase the amount of PIT raised over time.

## Take-aways

- **Progressive PIT should play an important role in any tax system as PIT are the primary means of ensuring fiscal redistribution from those at the top of the income profile.** It is important that the tax profile is progressive, but also that top rates should only apply to wealthy taxpayers.

- **Authorities in developing countries should begin implementation with a large basic exemption to ensure progressivity and administrative efficiency.** As tax administrative capacity increases, the basic allowance should be reduced. At very low levels of capacity, a flat tax may be a pragmatic choice for a limited amount of time until higher capacities are reached. However, given the possible negative impact on inequality, this option needs to be carefully evaluated.

- **Tax authorities should use withholding mechanism, whenever feasible and possible.** Tax administration is made easier and compliance increased if the tax is withheld by employers.

- **Progressivity can be enhanced by increasing the rate paid on the top tax band.** It should be ensured that only top earners fall under the top tax band.

- **Taxing capital gains at a lower level than salaries** should be considered, even though it could be a regressive measure, if authorities are unable to tax capital effectively due to capacity constraints. On the other hand, this could create an incentive for the high-income manager-owners to shift their income from salary income into capital income.

- **The system should be designed as simple as possible with deductions kept to a minimum and limited in size.** If this is not possible, an alternative minimum tax can be used, which will ensure that a certain minimum amount of tax is paid for income surpassing the basic allowance.

# 3.2 Corporate income taxes

**Companies pay CIT on profits made during the tax year.** These taxes are paid before any distribution of profits to shareholders through dividends. CIT is an important revenue source, especially in developing countries, but it can also decrease the return to investment, which could lead to lower economic growth in the long run.

## Background and objective

**CIT is levied on the profits of corporations.** Company ownership is distributed extremely unequal so any tax that impacts on corporate profitability is likely to have an impact on inequality. Additionally, there is a long-term trend to offer lower CIT rates with the intention to gain site advantages. Especially developing countries are often granting large tax exemptions or tax holidays to certain industries with the intention to attract foreign direct investment. In addition to low tax rates and preferential treatment, tax avoidance resulting from the high mobility of capital, which can be used by multinational corporations

> Company ownership is distributed extremely unequal so any tax that impacts on corporate profitability is likely to have an impact on inequality.

(and others) to shift profits to low-tax jurisdictions, is further reducing government revenues from corporate taxes. As developing countries collect less taxes from PIT in comparison to developed countries, but depend to a higher degree on CIT, a decrease in CIT can result in less service delivery by governments or pushes the burden of revenue onto other, less mobile tax bases. CIT is administratively difficult but despite this, it is an important source of tax revenue for developing countries, especially in resource rich countries. For example, Malaysia and Nigeria both collected more than 40% of their total tax revenue through CIT in 2018.

## Implementation

**CIT is a complicated tax to administer.** Usually, it is designed as a tax on net profits which is more difficult to determine than sales. In order to levy the tax, authorities need an understanding of the company's balance sheet and its income statement. The fundamental problem in arriving at a level of net profit, is determining which deductions can be made. The key issues are:

- **Depreciation** – the assets a company owns are depreciated over their useful life, with depreciation being a cost that reduces profit. The IMF (1995) recommended that developing countries should keep the number of asset categories to an appropriate minimum with one depreciation rate each. This makes administration easier and reduces the scope for avoidance.
- **Business expenses** – valuation of inventories[1] and intangible assets, and the cost of sales can be hard to verify, making CIT administratively complex.
- **Valuation of transactions within multinational enterprises can be difficult.** In some cases, multinationals have been found to price transactions between members of a corporate group so that tax liability is shifted towards jurisdictions with lower CIT rates, resulting in a lower total tax bill. Tax administrations try to enforce an "arm's length" rule, meaning that the price of transactions should be what would occur in the market if these were two separate entities. Setting prices accordingly and verification by the tax administration is not an easy task for companies and tax administrations given the uniqueness of many intercompany transactions and the scarceness of available independent (third party) data.

**Zee (2005) recommends that the CIT rate should be similar to the top marginal rate for PIT.** This reduces the incentive for company owners to shift their income between the two taxes, avoiding tax. For example, if PIT rates are much higher than CIT rates, business owners can pay themselves lower salaries but take larger dividends. Adequate taxation on dividends is a mechanism to address this issue.

**Many countries have a simplified alternate tax regime for small businesses.** This reduces the compliance burden on small businesses and allows tax administrations to focus resources on larger companies which should be paying more tax because their ability to pay is generally higher (better cost benefit ratio). It also allows authorities to levy less tax on small businesses to foster them, if needed. This reduces vertical inequality.

**Global cooperation in tax administration is making implementation of CIT easier.** Mutual assistance on tax matters, including support with the enforcement of tax liability, country-by-country-reporting and exchange of information improves countries' access

1 Inventories valuation can become problematic when a large quantity of inputs is bought and stored, without exact dates of use. Straightforward valuation methods, such as using the average price and first in, first out (FIFO) or last in, last out (LIFO) simplify administration.

to tax information. Some tax administrations have conducted joint audits of the same company across two countries. This helps both – taxpayers and tax administrations – as unilateral adaptions on the taxable income by one tax authority without a corresponding adjustment in the other jurisdiction can be prevented – leading to less disputes from double taxation. Although such audits require a high level of coordination, it could be further assessed if such an approach could serve as a means for urgently needed knowledge transfer from higher capacity to lower capacity countries.

## Strengths and weaknesses

### Effectiveness

**The 63 developing countries in the OECD Global Revenue Statistics Database were able to raise 3.2% of GDP in CIT in 2017, comprising 17.7% of total revenue.** Only consumption taxes are used more in developing countries. This average includes some tax havens, such as the Seychelles which raises 6.7% of GDP through CIT and Trinidad and Tobago, which raised 5.8% of GDP in 2017. OECD countries were able to raise an average of 3.0% of GDP in CIT in 2017, 8.7% of total tax revenue.

### Efficiency

**CIT raises the cost of capital and is thus a disincentive to invest.** In the long-run, this can result in less investment and thus lower long-run economic growth. This needs to be balanced against the need to raise revenue and the inequality-reducing impact of the CIT (Gale and Samwick, 2014). However, a global minimum tax, as discussed currently by the Inclusive Framework on Base Erosion and Profit Shifting (BEPS), could partially prevent a race to the bottom.

**Developing countries often use CIT rates as an incentive to attract investment**, or to promote one particular industry, for example manufacturing or extractives industries. This can act as a barrier to the efficient allocation of capital, as funds will flow to sectors of the economy that are less productive. In general, efficiency can be increased by using a single CIT rate, reducing exemptions to a minimum and broadening the base that the tax applies to. OECD countries have

been able to maintain their tax take from CIT through base-broadening even as CIT rates have fallen (Devereaux et al., 2002).

**Additionally, tax competition as well as tax avoidance have a considerable effect on the amount of revenue that governments can collect**. CIT rates have fallen in recent decades as tax competition has made higher rates unsustainable. The average of CIT rates in six developing countries fell from 33% in the 1980s to 22% in 2017. In OECD economies, CIT rates fell from 44% during the 1970s to an average of 26% in 2017 (Amaglobeli et al., 2018). OECD statistics show that in 72 developing countries, the average CIT rate fell from 26.2% in 2000, to 19.3% in 2020. OECD economies' CIT rates fell from an average of 29.3% to 17.2%. Of the 109 countries for which there is data, only six increased CIT rates in this period (OECD, 2020). Ireland has reduced statutory CIT rates to 12.5% but some companies are able to use exemptions and allowances to reduce their effective CIT tax rate to 0-2.5%. Mauritius and some other countries apply a similar approach.

## Enforceability

**Despite its relative complexity, CIT can be enforced quite easily, especially with regard to big, multinational and specifically regulated companies, such as cell phone service providers and banking.** They all usually act in the formal sector, have the necessary internal (tax) accounting structures and knowledge within the company and they are concerned about their reputation. Sometimes, governments even use other contacts with companies to enforce compliance. For example, many governments will not award tenders to companies without a valid tax clearance certificate indicating that they have paid tax. Another possibility is the withdrawal of certain permits, such as import permits. Thus, companies depending on such permits or contracts have an incentive to be tax compliant.

**Developing countries need to compete on CIT rates for accounting profits but also need to compete against each other for investment by multinational corporations through the use of tax incentives for investments.** For example, many developing countries offer tax holidays for investors thereby competing against each other. Often this results in a race to the bottom because these holidays and similar incentives reduce the CIT take. The IMF finds that there has been a "partial race to the bottom" where tax incentives in Africa have sometimes reduced the effective CIT rate to zero (Abbas et al., 2012). Governments offering overgenerous incentives, which are neither analysed before their introduction nor constantly monitored for their effectiveness, can harm a country's welfare, some of them can even be harmful. Regarding the latter, the introduction and maintenance of so-called harmful regimes is monitored by the Forum on Harmful Tax Practices. Countries need to be aware that jurisdictions that introduce harmful tax incentives face the risk of being "blacklisted". However, regimes which are not harmful, but only wasteful still harm the county as the tax administration renounces badly needed revenue without gaining from this concession.

**Some tax havens have even reduced their statutory CIT rates to zero. The IMF estimates that developing countries lose USD 200 billion of revenue every year through the use of tax havens.** In 2012, US multinationals reported profits of USD 80 billion in Bermuda, greater than their combined profits in Japan, China, Germany, and France. Bermuda imposes no taxes on profits, incomes, dividends or capital gains. Other zero-rate locations include Jersey, the Cayman Islands, Vanuatu and Guernsey. Some tax havens can be in even found in Europe, such as Malta and the Netherlands.

**In response to the problem of tax competition, Piketty (2014) proposed a global tax on capital, allied with complete transparency of bank transactions.** The amount of international cooperation required to implement this tax, means that it remains a pipe dream, as Piketty acknowledged.

**A slightly more modest proposal is being worked out in the OECD/G20 Inclusive Framework on BEPS.** One part of the BEPS 2.0 proposal envisages to ensure that multinational corporations face a minimum effective tax rate on profits, probably set around an effective tax rate of 15%. If the multinational corporation is not paying the minimum effective rate in one location, it can be levied at another. This will reduce the impact of tax havens. The currently discussed concept is going into the direction of an enlarged controlled foreign corporation (CFC) rule which many countries have already introduced in some way. However, the administrative burden is high making enforcement quite complex. At the moment of publication of this paper, it looks more than likely that

such a global minimum tax will be introduced. Nonetheless, if a global solution cannot be found, another solution could be to harmonise tax incentives or even tax rates on a regional level with similar economies, where possible.

## Impact on inequality

**Company ownership is very unequally distributed, leading to CIT having a large impact on the income of the wealthiest households.** In the USA, for example, the richest 1% of households own 56% of the value of shares. This means that any reduction in CIT will have large impacts on inequality as the wealthy will likely receive larger dividends. Households in the second income quintile effectively pay 2.3% of their income on CIT. For the richest 0.01% of households, this rises to 4.6%. Piketty and Saez (2007) conclude that the US tax system has become markedly less progressive since the 1960s and much of this is driven by lower CIT rates. As extreme as the inequality of share ownership in the USA is, it is likely to be more unequal in developing countries because there are fewer mechanisms and resources available for poorer households to access stock ownership. In middle-income and OECD economies, the general public can acquire access to shares through stock exchanges.

**Cuts in CIT tax rates can lead to an increase in inequality.** Nallareddy et al. (2018) show that when USA states cut CIT, it led to higher wages across the board, but that company owners take more of their income in dividends and less in salary, thus taking advantage of the lower CIT rate.

**In cases where enforcement capability is low and the use of deductions is high (and a decrease of deductions not possible), tax authorities should consider the use of an alternative minimum tax.** This is another tax calculation that sets a floor on the amount of tax that all profitable companies must pay. This approach has been used in developed economies like the USA, but it would seem suited to developing countries too. Usually the minimum tax is applied to a simplified base, such as profits or income to make administration easier.

**The impact on inequality can be enhanced by using a progressive CIT.** Most countries levy a flat CIT with

## Box 2: Case study – Corporate income tax in Argentina

**In 1990, Argentina was only able to raise 0.5% of GDP through CIT.** By 2018, this had risen to 2.8% of GDP, slightly below the average of developing countries which reached 3.2% of GDP. In contrast to the weak performance on CIT, Argentina collects 14.5% of GDP in consumption taxes, much more than the developing country average of 10.1% of GDP. Because of substantial collection of a regressive tax, there was a clear need to increase collection of income taxes to improve the impact on inequality. Inequality was severe: the top earning 0.01% of all taxpayers earned 17% of all capital income.

**Governments in the 1990s were able to exploit two features of the Argentinian political system**: there was no major right-wing party representing the interests of the business elites, and organisation amongst the business elites was weak, resulting in strong organisations for each industry which were not able to work together to form a unified voice for businesses. Thus, the government was able to weaken opposition to increase CIT by buying off individual constituencies. Labour intensive industries were promised a tax reduction on social security contributions to offset the full impact of the increase in CIT and construction firms acquiesced once government threatened to halt highway construction.

**The government was able to both increase the rate of CIT and broaden the base, resulting in a large increase in CIT revenue.** The CIT rate was increased from 20% to 35% in 1998. In the early-2000s, this reform was extended as government tightened rules on transfer pricing to regulate transactions with subsidiaries located in tax havens. In addition, taxes were levied on corporate interest income and corporate assets. Business lobbying was unable to overturn the introduction of these new regulations but was able to increase the basic exemption amount. In conclusion, it is possible to increase levels of CIT, but the government has to be able to exploit opportunities for reform.

only one rate. Progressive CITs are used amongst others at state level in the USA and by Swiss cantons. Higher rates for more profitable companies would reduce vertical inequality and could be a tool for competition policy, as companies engaging in anti-competitive behaviour are often very profitable. This would be slightly more difficult to administer. Determining net profit is the most difficult part of administering a CIT, applying that net profit to a rate schedule is simple.

## Take-aways

- **CIT is an important component of a progressive tax system**. The more revenue CIT raises, the more resources are available for fiscal redistribution.
- **Tax authorities should resist the urge to reduce tax rates in order to compete with other countries.**
- **Progressive CIT rates, i.e. lower tax rates for small business, can be used, which will reduce vertical inequality**. These may be especially useful in developing countries where a few large corporations dominate the economy.
- **Tax incentives need to be analysed before being introduced and carefully monitored, otherwise they could become overgenerous and result in the effective CIT rate going to a low level or even zero.**

- **Countries need to be aware that jurisdictions that introduce harmful tax incentives face the risk of being blacklisted.** Additionally, the current status of the OECD Inclusive Framework negotiations suggests that tax havens will lose revenue in the future as other countries will be allowed to tax profits not taxed by the tax haven. Tax havens could be negatively impacted in the near future, so it is best to not reduce CIT rates below a certain level.

- **Higher tax rates will have a larger inequality-reducing impact, but higher rates can be difficult to achieve politically.** In this case, base broadening by reducing exemptions can be a good alternative.

- **Alternative minimum taxes can reduce administration costs and tax avoidance.** In this regard, the work of the Inclusive Framework on BEPS on the introduction of a global minimum tax (so-called pillar 2) should be closely monitored. Global solutions should be preferred to individual country solutions as it prevents the fragmentation of the international tax law landscape.

- **Tax avoidance schemes reduce revenue in developing countries, meaning that inequality-reducing expenditure cannot take place.** However, international cooperation on taxation is making tax administrations more effective as more information is shared. Developing countries should participate as much as possible in initiatives such as mutual assistance on tax matters and exchange of information. Joint audits, auditing a company together with another country to avoid disputes over double taxation in advance, may be even a learning opportunity for developing countries.

- **Simplified regimes for small businesses are a better mechanism both for the tax authority and the taxpayer, and their use is encouraged.**

## 3.3 Digital services taxes

**In the last few years, concern has grown that the existing international tax system does not properly consider the digitalisation of the economy and as a consequence, especially market countries, miss out on revenues.** Traditionally, companies are taxed wherever they produce or otherwise create added value[2] – typically this means having some form of permanent and physical connection to the respective country. The location of consumers or users was not relevant for corporate taxation. However, nowadays as many services are provided online, i.e. without any form of physical presence in a country, e.g. the provision of a platform, such as Facebook, taxation of such activities in the country of the user has not been possible so far.

**Digital service taxes (DST) take this development into account.** They can be both implemented as an indirect tax or as a direct tax. They are one way to ensure that the country where users are located, and which

2 In a traditional sense creating added value was only related to the activities of the group / company itself.

> Digital service taxes (DST) can be both implemented as an indirect tax or as a direct tax.

are now considered to contribute to value creation, can tax profits from such activities. Usually, they are designed in such a way that a certain tax rate is applied on the profits deriving from a digital activity.

## Background and objective

**New information technologies, including the internet, have allowed new modes of supply which has implications for taxation.** One new mode of supply is where users contribute to value creation. For example, a user who writes a Facebook post has created content that other users will consume. At the same time, Facebook is selling advertising based on the number of users who are using the site, even though it has not created all the content, but rather functioned as a platform for users. Economies where consumers are based argue that value is being created in their jurisdiction, but they are unable to levy a tax on the transaction as companies do not need a physical presence (nexus) in this country to generate profits from such activities, which traditionally is the prerequisite for levying a tax.

**In the past, the European Commission (EC) floated proposals for a digital services tax.** At the same time, discussion have been initiated with the USA to avoid conflicts or a "trade war" as many of the companies affected by such a digital services tax are US companies. By now, this process has been brought to a stop (at least temporarily) because the OECD initiated discussions about the allocation of taxing rights in a digitalised economy as well as the introduction of a global minimum tax at the OECD/G20 Inclusive Framework on BEPS to find a global solution.

**On the 1st of July 2021, 132 Jurisdictions have committed to the OECD Inclusive Framework's two-pillar plan to reform the international tax system.** This compromise is envisaged to contain a commitment to abolish all unilateral digital services taxes upon introduction of the global solution. Previously, the EC had announced to take up the issue of a DST again in case no global consensus can be found in time and a number of countries had started to implement DSTs unilaterally due to the delay in the process, which had been further slowed down by the COVID-19 pandemic. These were for example Austria, the Czech Republic, France, India, Indonesia, Spain, Thailand, Italy, Turkey and the United Kingdom (UK). France had agreed to withdraw its national digital tax the day as a new global taxation rule is in force. The UK had promised that their tax is a temporary measure, which will be eliminated once a multilateral agreement has been reached. At the time of writing, e.g. Brazil is considering a DST.

**Many of these countries announced that the DST is supposed to be a temporary solution until a final global solution is found within the Inclusive Framework on BEPS.** It is expected that the OECD Inclusive Framework's two-pillar plan will come into force in 2023. The OECD announced that the details and the process of implementation are to be finalised in October 2021 at the earliest. However, the concern is that once a tax is introduced, it is harder and less likely that it will be taken back, as this will inevitably result in a loss of tax revenue for governments. If many countries enact their own DSTs, this will increase costs of compliance and the risk of double taxation.

## Implementation

**Taxation under a DST would not depend on a certain form of physical presence, but on the location of the user or where covered digital services are provided/consumed.** This means that market countries, i.e. countries where the user is located, can also tax (parts of) the profits of such digital companies located outside of their country.

**A DST would commonly target three types of service providers.** These are:

- Any interface where advertising is sold based on who is using the interface. This would affect companies like YouTube, Facebook and Google.
- Any intermediation service, where the function of the platform is to link buyers to sellers. This would include companies like Airbnb and Uber.
- The sale of data gathered by platforms, generated through user activities.

**However, the exact scope differs from country to country.** Likewise, the applied tax rate is different in each country: e.g. the original EC proposal suggested to apply a 3% tax on gross turnover. The UK has implemented a DST at 2% and Austria at 5%. Many of the introduced DST do only apply to transactions with a certain minimum threshold in order to ensure that only big companies will have to pay the tax. As DST might be also applicable to companies which have a presence in a country and are thus subject to taxation there anyway, a mechanism to avoid double taxation, e.g. through a credit, should be introduced.

## Strengths and weaknesses

### Effectiveness

**As DSTs are quite new, there is little data available on the revenues they are raising.** One of the oldest DST is India's Equalisation Levy, which imposes a 6% levy on all purchases of products on the internet by Indian residents. The tax is only payable by non-resident companies. At present, the levy is not raising substantial amounts of revenue: in the 2017-18 fiscal year, the levy raised USD 73.4 million. The tax was expanded in April 2020 to include a 2% levy on e-commerce operators.

### Efficiency

**From an international perspective, the most inefficient outcome would be if internet platforms faced different tax rates with different tax laws in every jurisdiction, they do business in.** Richter (2019) argues that if this approach is followed, the costs of providing these services will rise and internet platforms will degrade their services through under-investing in quality. Additionally, the risk of double taxation will rise. Therefore, a multilateral negotiated global settlement would be a better solution than the unilaterally introduction of DST. Such an attempt is currently under way in the OECD Inclusive Framework on BEPS and the prospects of finding a global solution are good. Another option for creating a win-win solution would be for the consumer-host country and the platform-host country to agree on a definition of the tax base and an approach to split the tax revenue and the taxing authority between themselves. This is slightly less ambitious than a global solution but would also require an extensive amount of (political) negotiations among countries, even if they negotiate and agree bilaterally. Even though a multitude of DSTs would be inefficient from an international perspective, it could be efficient for local jurisdictions as the tax would be levied on an untaxed activity.

### Enforceability

**DSTs are relatively easy to calculate; however, it would need to be carefully designed in order to ensure company compliance, especially those without a physical presence.** One of the main challenges for tax authorities would probably be how to implement the legislation for companies without a physical presence in a country and to be able to know about the relevant activities and the extent of these activities. Therefore, it would be important to include relevant registration, reporting and/or disclosure obligations as well as penalties. Next to the companies themselves, intermediaries located in the country could be obliged to report relevant data and/or withhold the applicable tax. Additionally, making such information part of an exchange of information would be helpful. Penalties can also be an incentive for companies to be compliant. Next to standard penalties, Indonesia has included in their law for a VAT on digital services the termination of access to the internet in the country. However, it remains to be seen if this can be effectively enforced.

### Impact on inequality

**It is debatable in how far a DST can be considered an equalisation tax as foreseen by the EC because the tax should be applicable to both domestic and foreign firms.** When presenting its proposal, the EC mentioned the policy objectives i) restore the coherence of value creation and ii) level the tax playing field, which led to the DST gaining the moniker, the equalisation tax. Further, the EC contends that US-based providers of these services are not taxed sufficiently, because under US law, the foreign income of US companies was not taxable. This gives US companies an advantage over European firms because European firms are taxed on their global income. However, Becker & Englisch (2018) note that ideally the DST needs to comply with international tax law, so it cannot discriminate between domestic EC and foreign-owned, probably US, companies. Thus, the DST will also be levied on domestic companies, negating the purpose of undoing an unfair tax advantage.

**Additionally, from current discussions, it looks more than likely that the goal to tax big tech companies more is difficult to achieve, as they will most likely directly pass on the additional tax to business partners or customers.** Google has already indicated that it intends to pass on the full amount of the tax to advertisers, while Amazon has passed it on to its customers in the UK (FT, 2020). It appears that large internet platforms are using their market power to avoid bearing the cost of the tax themselves, which might mean DSTs are not achieving their goal of taxing foreign corporates making profits in their jurisdiction. In the worst case, the passing on of the tax to the user might affect the less-wealthy adversely and reduce the access of poorer households, as they might not be able to afford an increase in prices.

**Apart from the tax itself not being inequality reducing, DSTs are unlikely to have any significant impact on inequality while they raise little income.** E.g. the aforementioned DST in India is currently only raising USD 73.4 million. A country with a large population like India is expected to raise more revenue than a country with a smaller population. Hence, countries with lower populations will be expected to raise even less money.

## Take-aways

- **DSTs are less of a priority than other taxes in terms of inequality reduction** such as taxes on income, consumption taxes and even carbon taxes. However, it is still an additional source of revenue, which can be implemented fairly easily. Nonetheless, in order to avoid a fragmentation of the international tax landscape, a global consensus would be preferable.

- **When designing a DST, it is important to make sure that the necessary information on users will be accessible to the tax authorities.** Therefore, reporting and disclosure obligations would need to be reviewed and updated, as necessary.

# 3.4 Wealth taxes

**Wealth taxes are levied on the amount of wealth that a person owns.** Wealth includes assets such as property, company shares and financial instruments. Wealth is a stock of assets whereas income is a flow of money. Wealth taxation can happen on an annual basis or at the time of death or when giving a gift. Wealth taxes are appealing in theory as there should be a strong inequality-reducing impact, but they have been difficult to implement.

## Background and objective

**There are two main types of wealth tax:**

- **Taxes on net wealth** are levied on the wealth of a taxpayer on a recurrent basis. For example, France used to levy a recurrent wealth tax on family households which have global assets greater than EUR 1.3 million.
- **Taxes on the transfer of wealth** include the inheritance and donation or gift tax. This tax is especially concerned with preventing the intergenerational transfer of large fortunes.

**Wealth taxes do not raise a lot of revenue.** The rationale for taxing wealth is not purely economic. Taxing wealth enhances progressivity of the tax schedule and reduces concentration of wealth, particularly inherited wealth, which threatens social cohesion. Because wealth taxes are aimed specifically at taxing the rich, they can increase social acceptance of other forms of taxation and government expenditure, because they promote a sense of fairness.

## Implementation

### Recurring tax on net wealth

In order to levy a tax on net wealth, the actual value of wealth needs to be established. As the name implies, this should be the value of assets less the value of debt.

Some considerations in implementing a net wealth tax:

- **Base** – Most jurisdictions tax the global wealth of residents and the assets of non-residents that are based in the country. Depending on who is included in the tax base, it can be relatively easy to hide certain assets from the authorities. This creates an incentive for taxpayers to invest in valuable items such as arts and jewellery, as it is more difficult to receive information about these assets than about cash deposits in a bank. Also, tax havens and bank secrecy are an obstacle in identifying the correct amount of wealth of an individual. However, the development in recent years is showing good progress with regard to transparency, the abolishment of bank secrecy and tax havens.
- **Rate** – Most countries have low rates with some progression. Germany used to charge 1% of taxable net wealth of individuals per year and 0.6% of corporations of before it was suspended in 1997. Higher rates for larger fortunes will reduce inequality.
- **Basic Exemption** – When introducing the tax, it is best to have a large basic exemption in order to avoid poor households paying the tax. As the average income in a country rises, this can be reduced if needed.

> There are two main types of wealth tax: Taxes on net wealth and Taxes on the transfer of wealth

- **Exemptions** – Typical examples include donations to charitable foundations, religious organisation and not-for-profit organisations.
- **Valuation** – Determining values can be quite challenging and complex, especially the valuation of interests in businesses. The IMF (1995) recommends that businesses be subject to the tax themselves, meaning not only individuals but also legal persons, e.g. businesses, will have to pay such a tax on their wealth, which resolves the issue of taxing them in the hands of individuals.

### Taxes on the transfer of wealth

A tax on inheritance needs to be combined with a well-designed donations tax of a similar rate, as taxpayers will try to avoid estate tax by donating wealth to their beneficiaries. Sometimes these taxes can be combined. For example, the UK Capital Transfer Tax used to treat gifts during the life and through inheritance as one taxable event.

## Strengths and weaknesses

### Effectiveness

**Taxes on net wealth generally do not raise substantial revenue because the wealthy lobby to include exemptions, which are then used to reduce tax payments.** In the last three decades, 13 European countries have eliminated their taxes on net wealth. Only three remain. In Switzerland, the tax on net wealth raises 3.7% of tax revenue and in Norway it raises just 1.1% of tax revenue. Germany raised only 0.8% of tax revenue through a net wealth tax but then cancelled the tax because of an adverse finding from the Constitutional Court, combined with the low revenue yield (Drometer et al., 2018). The OECD Global Revenue Statistics Database shows that taxes on net wealth raise an average of 0.2% of GDP in OECD countries. Inheritance taxes raise even less, at only 0.1% of GDP. In developing countries, inheritance taxes have raised only 0.1% of total tax revenue.

**Inheritance or gift taxes also do not raise substantial revenue. While inheritance taxes might not be effective revenue raisers, that might not be the purpose of the tax. Instead it is mainly used due to its redistributive nature.** Britain had the most unequal distribution of income in the world in the 19th century and the first decade of the 20th century. Politicians argued that this was a source of instability, noting that economies with high levels of income inequality had been vulnerable to fascism and populism. The top rates on the inheritance tax went as high as 98% in the 1940s and were above 80% for the whole period between 1940 and 1980. The top centile owned 70% of wealth in 1910, and this fell to 22% by 1970. Interestingly, the estate tax had different rates for wealth accumulated through income and wealth accumulated through financial assets, with the latter taxed much more heavily (Piketty, 2014).

### Efficiency

**Wealth taxes can be more efficient than taxes on income** because the tax is not levied on a productive activity, only on accumulated capital. Taxpayers cannot change the amount of tax they pay through increasing or decreasing the amount they work, as in the case of a PIT. Thus, wealth taxes do not distort the choice between work or leisure, meaning that labour supply is unaffected, leading to little impact on economic growth. This results in an efficient tax.

**Wealth taxes could also enhance the efficiency of the tax system** as PIT or CIT do not tax all wealth generating assets. Additionally, the richer the taxpayer the more likely it is that he or she has access to tax planning experts and can avoid or even evade PIT or CIT. A weak tax administration might even increase this risk. Thus, wealth taxes could fill in the gaps in CIT and PIT, especially when it comes to immovable, not easy to hide assets, such as property. On the other hand, wealth taxation could be considered a form of double taxation as the income which is used to acquire the assets which underly the wealth should have already been taxed through CIT and PIT.

**Wealth taxes have a very small negative impact on economic growth.** Hansson (2002) found that a 1% increase in wealth tax resulted in economic growth declining by 0.05%, a result that essentially means there is no impact.

## Enforceability

**Net wealth taxes are expensive to administer.** Assigning ownership to assets is difficult especially when ownership is concealed behind trusts or hidden in tax havens. Independently from that, valuing these assets is often not straightforward. Some economists have argued that even though the principle behind wealth taxes is good, it is impractical for developing countries to actually collect wealth tax revenues (Rudnick & Gordon, 1996).

**Taxes on transfer of wealth are slightly easier to administer.** Valuing assets is as difficult as in the case of net wealth taxes but assigning ownership to assets is easier. The new owner has an incentive to ensure that the correct legal process to transfer ownership of assets is followed, which allows tax authorities to have sight of wealth. Taxes on transfers of wealth are only collected at death or transfer of the asset, not every year as in the case of taxes on net wealth, which are collected every year. Thus, the administrative costs of transferring wealth taxes could be lower This would require developing countries to have systems to enable tax authorities to be aware of the deaths of taxpayers or other transfer of assets subject to such a tax.

**Tax havens make wealth taxes difficult to administer.** Wealth to the value of 10% of global GDP is held in tax havens, and three-quarters of this wealth is not reported (Alstadsæter et al., 2018). 22% of Latin American wealth is held overseas, as is 30% of African wealth. The most effective solution to this problem is international coordination through e.g. the participation in the Global Forum on Transparency and Exchange of Information for Tax Purposes.

**Only the wealthiest use tax shelters.** In Colombia, for example, it was found that the wealthiest 0.01% were 24 times more likely to use an offshore tax shelter than the wealthiest 5%. In 2015, Colombia used a voluntary disclosure scheme which imposed a 10-13% penalty on the value of the disclosed wealth but forgave taxpayers for outstanding taxes. Ultimately the scheme uncovered 1.73% of GDP of hidden wealth. The publishing of the Panama Papers and signing of a tax treaty with Panama resulted in an 800% increase in disclosure. Tax paid by those who disclosed assets doubled in the years after reporting hidden assets (Londoño-Vélez and Ávila-Mahecha, 2018).

## Impact on inequality

**Wealth is distributed even more unequally than income** and the inequality of wealth is deepening. In addition, wealth accumulates as the wealthy are able to save more and invest in assets that offer returns, meaning that the rich get richer. Wealth taxation can play a role in reducing this inequality.

**The OECD has argued that taxes on wealth can still be effective if exemptions are limited and countries share tax information automatically (OECD, 2018a).** Piketty (2014) also argued for automatic sharing of tax information to enable his proposal of a global tax on

capital. This tax would be progressive and be based on all forms of wealth to prevent the failures seen in the wealth taxes in Europe. Piketty (2014) argues that the main function of this tax would be to reduce inequality and safeguard democratic government; raising revenue would be a secondary consideration.

## Take-aways

- **Wealth taxes are an essential part of a well-functioning tax system.** They should be used for their inequality-reducing impact, more than for revenue generation.
- **The urge to amend the wealth tax through adding exemptions needs to be resisted very strongly.**
- **The difficulty administering a wealth tax means that it may not be appropriate for all developing countries.** If tax administration capacity is weak, it may be better from an inequality perspective to focus on PIT and CIT first.
- **Administering an estate duty is easier than a net wealth tax as the new owners of the assets will want their interest registered.** Developing countries should focus on inheritance taxes, before net wealth taxes.

### Box 3: Case Study – Wealth taxation in Sweden

**Sweden enacted a tax on net wealth in 1911.** The effective rate on wealth peaked in the period between 1948 and 1975, when the wealthy could pay a rate of 2.5% annually. Effective rates fell below 1% in 1970 and by 1990, effective rates had gone down to zero. Essentially, the increases in effective tax rates were driven by rate increases but reductions in the effective rate came about because of exemptions. In 1974, tax authorities allowed firms to undervalue their inventory, which led to a decline in assessed wealth. In 1991, the wealth tax was abolished for unlisted corporate shareholdings, which pushed effective rates for those who owned private companies to zero.

**Exemptions proved to be a major weakness of the tax.** Land and forest holdings were exempted in 1991. Thus, taxpayers could reduce their net wealth by taking loans and then using the loans to buy agricultural land. Other assets that were exempted included art, antiques, gold, silver and jewellery.

**In 1989, foreign exchange controls were lifted in Sweden which resulted in an outflow of capital to tax havens.** Tax planning reached such a level that the extremely rich felt that paying the tax on net wealth was voluntary, while the moderately rich still could not avoid the full tax.

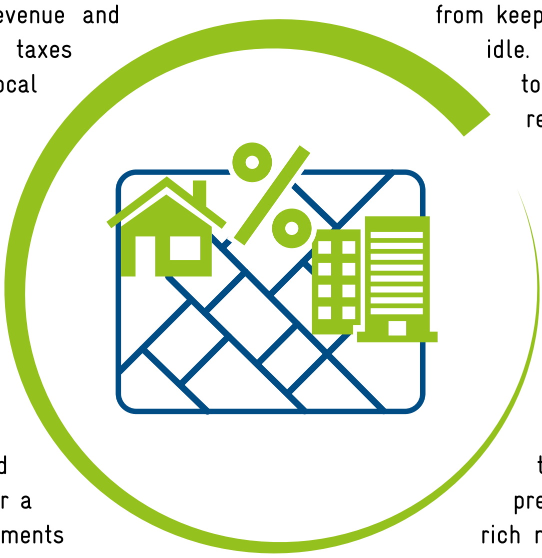
**Tax collection was so weak that between 2001 and 2006 when household wealth increased by 60%, revenue collected from tax on net wealth declined by 42%.** The Government was faced with a choice to reform the tax fundamentally, by reducing exemptions and broadening the base, or to abolish the tax. In 2011, the tax on net wealth was abolished. This pattern was repeated throughout Europe as taxes on net wealth generated low revenues at high cost.

# 3.5 Property taxes

**Property taxes are levied on the value of a fixed property, such as land, a house or an office building.** Property taxes are usually used to fund local governments.

## Background and Objective

**Property ownership is unequally distributed, meaning that a property tax is effectively a tax on wealth.** The IMF advises many countries, particularly developing countries, to increase their use of the property tax (IMF, 2017) both to raise revenue and to reduce inequality. Property taxes are used primarily to fund local governments.



## Implementation

**The efficiency and impact on the reduction of inequality of a property tax will be determined by how it is implemented.** Implementation strategies requiring more sophisticated administration will also deliver a more progressive tax. Governments use three methods to value the tax base for property taxes, namely per-unit, area-based or value-based. Valuation-based systems are used in countries with more effective administration and where it is easier to establish the value of a property.

**Value-based approaches can use three methods to assess taxable value:**

1) **Rental value:** This defines the tax base as the rent that can reasonably be expected in a fair market transaction. While appealing on both inequality and efficiency grounds, since it ties the tax value to the potential yield of the property, this type of valuation may be difficult in practice. This will particularly be the case in developing countries where rental markets may be shallow and highly informal. Rent control policies can also be a complicating factor. Rental valuation is used in countries such as Singapore, Hong Kong and Australia.

2) **Capital value:** This defines the base as the market value of the property in an open market. This tends to be easier to assess than rental value, as fewer adjustments need to be made for vacant land, etc. However, it will face many of the same practical problems as rental valuation due to the scarcity of data and lack of capacity to effectively monitor property values. South Africa levies tax on the market value of the property.

3) **Land (or site) value:** This disregards the value of structures or improvements made on the land. This method will discourage landowners from keeping their land unproductive or idle. It is also likely to be easier to administer and monitor, as it requires significantly less information for the valuation – although it will be equally difficult to assess in cases where market data is missing. However, this type of valuation may be regressive because it does not consider the value of the structures that have been built on the land – structures that will presumably be more expensive in rich neighbourhoods. Jamaica taxes the unimproved value of land. Land and buildings are valued and taxed separately in Namibia, Eswatini (former Swaziland) and the Philippines (Franzsen and McCluskey, 2017).

**Per-unit and area-based approaches are easier to administer than value-based approaches but less progressive.** These methods are used where property records have less coverage. A per-unit tax applies a uniform tax to all buildings or pieces of land. Because it does not take value into account, it is regressive. An area-based tax assigns the tax based on the area that the property is located in. This is easy to administer and also allows for some progressivity as wealthier areas can be assigned higher tax values. The Democratic Republic of Congo uses an area-based system. Some cities in Tanzania use a combination of an area-based system and value-based: the value-based system is preferred but if the property has not been valued, then area-based taxation is used.

**The establishment of a more accurate cadastre and efficient land administration system allows for the use of value-based systems, which are more efficient and more equitable.** These reforms can be reinforcing. In Lesotho and Kenya, the tax is only applied on properties that appear in the property register, meaning that owners can evade the tax by refusing to register. Failure to register, however, leaves owners more vulnerable to challenges to title and thus there is an incentive for them to register their property.

**In Sierra Leone, a simplified points system is used to establish property value for the tax.** Properties were assigned points based on their size, location, and the number of buildings on the property. The small amount of rental data available was then used to link points to values. This is a useful hybrid of the per-unit and rental-based approaches. Strong political support, the tying of revenue to provision of public goods and the simplified valuation system resulted in a successful reform (Greico et al., 2019).

## Strengths and weaknesses of property taxes

### Effectiveness

**Property taxes are widely used, but they appear to be more effective in developed economies.** In 2017, OECD countries on average raised revenue to the value of 1.1% of GDP through property taxes in 2017. The average for African economies in 2017 was 0.1% of GDP, while Latin American countries raised 0.4% of GDP. Canada and the United Kingdom raised 3.1% of GDP through recurrent property taxes. In terms of the share of total tax revenue raised, OECD countries raised 3.2% of tax revenue through property taxes in 2017 whereas developing countries could only raise 1.1% (OECD, 2020). The Bahamas raised 5.6% of tax revenue through property tax, while Barbados raised 4.3%. This disparity led the IMF to argue tax collected from immovable property could be almost three times higher than it currently is in lower middle-income countries[3].

### Efficiency

**An OECD study (2010) ranked property tax as the least distortive tax instrument in terms of reducing long-run GDP per capita**, followed by consumption taxes (and other property taxes), PIT, and finally CIT. Property tax is less harmful to growth than other types of taxation. Property cannot be moved in response to changes in taxation. Consequently, taxes on property tend to result in little change in market prices, and so no decline in investment and growth. Property tax can be considered as a tax on accumulated wealth, it should not alter future behaviour.

**Not all taxes on immovable property are equally efficient.** (Capital transfer) Taxes on sales of property may reduce turnover of property and hence distort the allocation of this important component of capital. Some countries, such as Senegal and the Central African Republic, have transaction taxes on the transfer of property in excess of 15%. Such high transaction costs may also have negative spill-over effects on other economic variables, for instance by discouraging labour mobility as individuals will be less likely to move to areas with higher employment or crowding out other types of consumption.

### Enforceability

**A key constraint on the collection of property tax is land administration records and their maintenance.** In developing countries, land registration databases, which record who owns parcels of land, are often incomplete and contain errors. Consequently, the tax administration is not aware that property exists, which should be subjected to tax and who the owner is, i.e. the tax debtor. This prevents tax administrations from using more effective valuation-based methods of valuing properties. In the case of Cameroon, less than 1% of land is registered. This allows widespread evasion of property tax.

**Payment of property tax is increased best through both coercion and positive incentives.** One strategy is to explicitly tie the property tax to fiscal devolution. As government functions are passed to lower levels of government and accountability increases, the property tax can be proposed so that it is tied to service

3 The estimate was computed by comparing the current rate of taxation on immovable property in selected countries with the rates prevailing in the 5 best performing countries in the same income group.

## Spotlight 2: Modalities to register properties

Some countries have started to use drones in order bring their registries up-to-date and to identify property as well as the condition of the property.

delivery in the minds of voters (Kelly, 2013). Improved local services and infrastructure delivery will also build the case for property taxation. Indeed, one of the first papers examining property taxes, Oates (1969), found that public service delivery increased property prices more than property taxes reduced prices. Greece, El Salvador and South Africa collect property taxes on the same bill as payments for water and electricity, reducing the cost of compliance to the taxpayer. In the case of South Africa, non-payment is punished by cutting off electricity supply and, in the case of commercial buildings, water supply as well. Other countries use tax clearance certificates, which encumber the property with the value of outstanding taxes, in the event that it is sold. Tax clearance certificates could also be made mandatory for private sector services (such as a home loan) or provision of other government services.

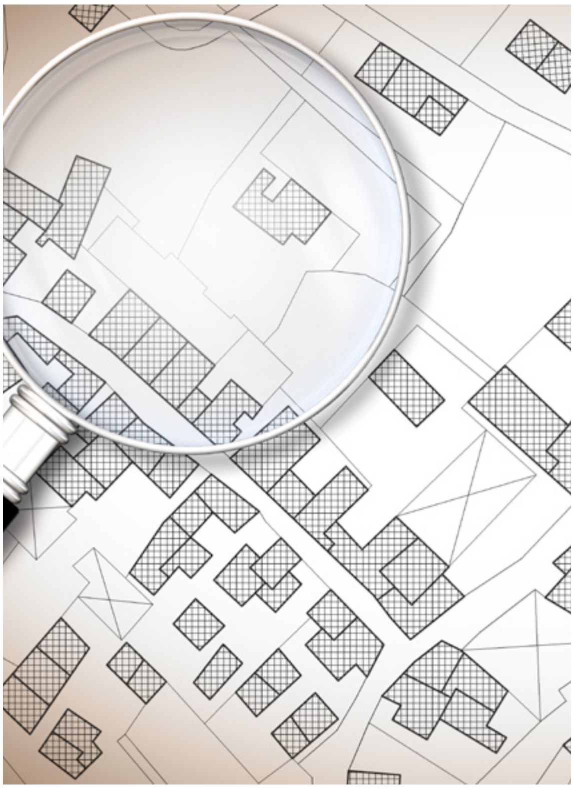
### Impact on inequality

**Property taxes can be an effective tax on wealth.** Property as a tax base is immobile. The wealthy often respond to taxation by changing tax residence or using exemptions to reduce their tax liability. Which cannot be done with a property tax as it cannot be moved. The tax can be quite simple with few or no exemptions and the rough value of the tax base is easily discernible, thus difficult to evade. Sennoga, Sjoquist, and Wallace (2007) used a computable general equilibrium model calibrated to economic conditions encountered in developing countries to simulate the distributional impact of property taxes. The study finds that property tax will be progressive in countries where the burden is borne predominantly by middle- and high-income earners.

**The design of the tax plays a significant role in determining its progressivity.** Borge and Nyhus (2012) examine the incidence of property tax in nine municipalities in Norway and find that property tax is regressive in five municipalities, proportional in three and only progressive in one. They argue that property taxes are best made progressive by using increasing rates, rather than a large deduction, which is often used to prevent people in poverty from becoming property taxpayers. Singh (2018) shows that property taxes in the USA are often regressive because assessed values of the highest valued properties are regularly underestimated.

**The largest burden of a property tax can fall on the middle-class,** as they hold most of their wealth in property – while the wealthy own property as well as other financial assets (Piketty, 2014). Usually property taxation includes a minimum value. Below this point the tax does not apply, which increases the impact on the reduction of inequality.

**The inequality-reducing impact of a property tax could be enhanced by increasing the tax rate for second homes.** In developing countries, only the very wealthy own a second home. Hence the tax would most likely fall almost exclusively on the very rich.



## Box 4: Case study – Property tax collection in Bogotá, Colombia

**Bogotá in Colombia developed an innovative self-assessment scheme to help reduce resistance towards property tax and improve collection rates.** As in many other developing countries, property taxes were only levied on a small proportion of property owners in Bogotá. Cadastral valuations were outdated with assessed values between 20% to 30% of the actual market values.

**To address this issue, the city of Bogotá introduced a self-assessment scheme in 1993, forcing taxpayers to declare properties they owned along with their values.** The new statute established that declared land values could not be less than the highest of the following three benchmarks: (1) 50% of the commercial value; (2) the cadastral valuation; and (3) the previous year's self-assessment, indexed to inflation. The 50% provision was repealed in 1994 because it was impossible to assign a market value to every property in the city unless a transaction had occurred. Even though the first of these benchmarks was abandoned subsequently, due to a lack of data on market transactions, the scheme helped to improve the municipality's information on real estate values in the city, especially for informal properties that had previously been excluded from the cadastral registry. The existence of an autonomous cadastral organisation in the city was considered instrumental in implementing the greater autonomy granted over the property tax base.

**As a result of these measures, in 1994 tax filings doubled and tax revenues grew by 77% in real terms** (Norregaard, 2012). A few years later, however, the system faced a crisis as the country entered recession, which led to a sharp drop in property prices. This resulted in many properties having a market value lower than the minimum allowable legal value reported under the scheme. In response to this problem, the national government decided to replace the self-assessment scheme with an independently calculated price index for urban and rural properties whose values were not adjusted by the Cadastre Office.

**A second round of reform commenced in 2009 as the local government sought an increase in revenue to fund a subway.** The cadastral values of all 2.1 million properties in Bogotá were updated, resulting in a 47% real increase in the cadastral value of properties. In order to reduce "sticker shock"- the resistance to a tax based on its higher than expected level – the municipality capped annual increases (Ruiz & Vallejo, 2010).

## Take-aways

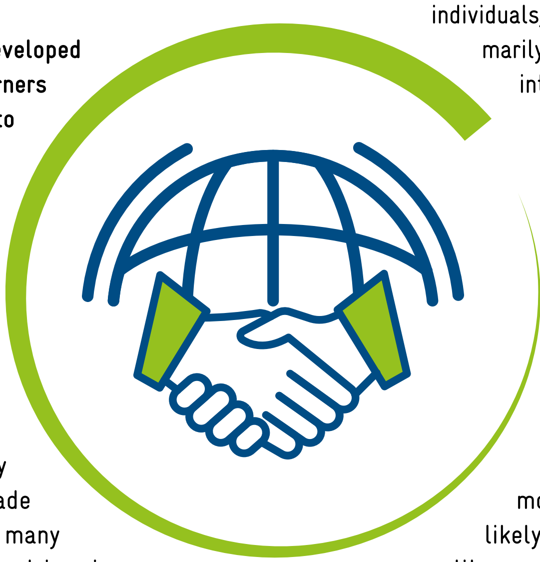
- **Taxes on property are generally underused** which holds a potential to increase its use for most countries.
- **There is a long history of implementing property taxes in developing countries.** Tax authorities are encouraged to review this history to determine which approach works best in their particular context. More effective land administration, including up to date property registries will improve implementation and equality-impact of the tax.
- **It is not necessary to implement a property tax with the most sophisticated valuation methods from the start.** Authorities can begin implementation with simpler methods, thus building administrative capacity, and only implement more sophisticated approaches once it is feasible.
- **The inequality-reducing impact of a property tax can be enhanced by using a progressive rate structure and applying a higher rate to second homes.**
- **Adding property tax to invoices for municipal electricity and water supply** makes compliance easier for taxpayers and offers municipalities the option of cutting off services if the tax is not paid.

# 3.6 Further measures to effectively tax wealthy individuals and companies

This section focusses on effectively taxing wealthy individuals and companies and addresses increasing tax collection from top income earners e.g. through higher rates and strengthened enforcement, tax evasion by wealthy individuals, which are often called high-net worth individuals, as well as tax avoidance which is mostly relevant for big multinational enterprises.

## Background and objective

**In many countries, including developed countries, the top income earners pay less tax proportionally to their income than average income earners.** This is partly a result of the fact that top income earners often derive most of their income from capital, which is mobile, and can therefore easily be moved around or abroad and they have better access to tax planning experts so they can easier avoid or even evade paying taxes. Furthermore, in many countries, including some countries in the Global North, top income earners have been successful in lobbying policy makers to provide them targeted tax breaks to reduce their own tax burden, or lower tax rates on capital. In most developed and many developing countries, inequality has increased sharply in recent years, partly as a result of reductions in the top marginal tax rates (Piketty and Saez, 2007).



**However, several Latin American countries, which belong to the most unequal in the world, have been successful in increasing tax revenue from the very rich**, which in turn has contributed to decreases in economic inequality. One of these countries is Chile, which saw its Gini-coefficient decrease from 0.55 in 2000 to 0.52 in 2006. Chile was able to successfully close loopholes used to avoid tax and oppose tax evasion.

## Implementation

**Raising public revenue is particularly challenging in developing countries characterised by extreme inequality.** This is because wealth is concentrated in the hand of a few, often very powerful and politically influential individuals, who receive their income primarily from capital and are therefore internationally mobile.

**Consequently, in a country characterised by extreme inequality, policy makers often face a delicate trade-off between targeting and political feasibility.** The more targeted the tax policy is aimed at the very rich, the more likely it is to be acceptable to the masses, but at the same time, more targeted taxation is more likely to antagonise the very wealthy elites and trigger capital flight or political backlash.

**Potential measures, next to the introduction of some form of wealth tax and adjusting the top tax bracket of the PIT in a way that the wealthiest pay the most, are strengthening the tax administration's capacities, closing loopholes in the tax system and including measures against tax avoidance and tax evasion.** Due to their better access to tax planning experts and higher, often mobile, income, they have an incentive to avoid or evade taxes more than the less wealthy. In this regard, existing loopholes should be closed, transparency, e.g. through increasing reporting and disclosure obligations, increased and value creation aligned with economic activities.

## Spotlight 3: Strengthening Tax Compliance in Uganda

Most countries could benefit by focusing their initial tax efforts on the few taxpayers who should be paying most of the tax. Uganda followed the IMF advice and established a unit within tax services to focus on taxing the wealthiest individuals and companies in 2015. The initial work of the unit was to identify the wealthy. This was achieved through tracking real estate transactions, large financial transactions, purchases of luxury cars, rental income, and income from imports and exports. In addition, the unit prioritised CEOs and business owners and targeted sectors such as manufacturing, real estate, financial services and professional services, including doctors and lawyers. Once the list of potential wealthy taxpayers was finalised, the Uganda Revenue Authority met with the taxpayers and educated them about their obligations and notified them that their tax affairs were under scrutiny.

Tax compliance amongst the wealthy increased from 13% to 78% and an additional EUR 4.5 million was collected in the first year of operation of the unit. This work is administratively difficult and also requires strong political commitment from the leadership of the revenue authority because the wealthy are almost inevitably politically powerful. The inequality-reducing impact of this is substantial, as PIT is the primary method to extract revenue from the wealthy. In addition, the demonstration effect of targeting wealthy taxpayers can increase public perceptions of fairness of taxation and increase compliance by the non-wealthy (World Bank, 2020).

**As tax avoidance and tax evasion are often cross-border phenomena, international cooperation is an effective mean to tackle the problem that a country's sovereignty ends at its borders.** Information, joint audits and support with regard to enforcement of tax liabilities from other countries make it easier for a tax administration to tackle tax avoidance and evasion. Measures, such as proposed by the OECD BEPS Action plan as well as other identified BEPS measures can be, as suitable to the specific context of the country, effective means of combatting tax avoidance by large multinationals. The members of the OECD Inclusive Framework on BEPS have committed to implement the BEPS package as coherently as possible and fight tax avoidance. As less developed countries will receive additional support from the OECD when it comes to the implementation of the respective measures, a membership could be considered. On the side of tax evasion, the participation in the Global Forum and the Automatic Exchange of Information can be a mighty instrument to fight tax evasion. Automatic exchange of information involves the systematic and periodic transmission of "bulk" taxpayer information by the source country to the residence country concerning various categories of income (e.g. dividends, interest, etc.). It can provide timely information on non-compliance where tax has been evaded either on an investment return or the underlying capital sum, even where tax administrations have had no previous indications of non-compliance.

**Additionally, interagency cooperation within the country is another key to combat tax avoidance and tax evasion.** Often, different government agencies or even departments possess information that can be highly relevant for effective taxation however through lack of coordination and information sharing, the relevant officers do not possess this information and tax avoidance, or tax evasion goes unnecessarily undetected.

## Strengths and weaknesses

### Effectiveness

**Actions aimed at increasing tax collection from top income earners range from increases in top marginal tax rates on income, capital and inheritance, to closure of loopholes in the tax system, and finally measures aimed at combating tax evasion and tax avoidance,** e.g. the introduction of Automatic Exchange of Information and mutual assistance in tax matters in general. Some actions, such as closing loopholes or increasing cooperation and information exchange, may generate less political resistance than new taxes and may therefore be preferable from a political point of view – rather than initiating new reform processes. Increasing a tax administration's capacity also creates less resistance in the population and can contribute to tax the better-off more effectively. In this regard, enhanced efforts should be directed at those who should be paying most of the tax, i.e. large taxpayers consisting of wealthy individuals and large companies.

### Impact on inequality

**Measures targeted at top earners often have a dual objective of reducing vertical and horizontal inequality.** Reducing vertical inequality can also play an instrumental role in improving tax-acceptance among the middle classes that often have to bear the brunt of taxation and may feel unfairly taxed in comparison to richer individuals (political economy dimension of GFG). In cases where certain top earners benefit from legal loopholes in the tax system, and targeted tax breaks, efforts to improve tax collection among top income earners may contribute to reducing horizontal inequality, by ensuring that individuals earning the same income pay the same taxes (normative dimension).

## Box 5: Case study – The political economy of Chile's fiscal policy reforms

**Historically, Chile had been one of the oldest and most mature democracies in Latin America and had been able to develop ambitious social protection systems by Latin American standards.** However, in 1973, the social and economic reform process was interrupted by a military coup, which saw the reversal of many social and political advances that had been achieved over the previous decades. During this period, inequality skyrocketed, and political and economic power was consolidated in the hands of a small number of businesspeople with close connections to the military regime.

**Although democracy was formally re-established in 1990, it was on terms that had been defined by the outgoing military regime.** For instance, the military continued to be financed directly from copper exports, independently of the national budget and it maintained a constitutionally protected right to appoint a sufficient number of senators to block any major reform initiative.

**The concentration of wealth in the hands of a small number of individuals meant that the country's economy was vulnerable to capital flight and divestment by the elite**, which further reduced the government's room for manoeuvre. This explains why, for the first 10 years after the return of democracy, the country's Gini-coefficient remained almost unchanged, even though left-wing governments had been voted at every election since the fall of the dictatorship. In 2000, Ricardo Lagos' centre-left coalition was elected on a platform of social reform and modernisation. Faced with the above-described constraints, the government set out on an agenda to gradually reform the tax system, which Fairfield (2013) describes as being articulated around the following 6 strategic axes:

- Attenuating the impact of reform to render them more acceptable to the elites.
- Obscuring the incidence of the reform to temper elite antagonism against them.
- Legitimising the reforms by reducing vertical and horizontal inequality.
- Making social spending contingent on specific taxes to increase their acceptability.
- Compensating the elites by offering benefits in return for support of tax reforms.
- Emphasising the positive effects of the reforms on political and economic stability.

The first three of these strategies work on the revenue-side of the reform, while the latter three work on the expenditure side. Over several years, the Lagos government deployed these different strategies in different degrees and combinations in order to attempt to strike the right balance between mobilising public support for the reform, while tempering elite antagonism, which could result in important capital flight or even violent backlashes.

### Attenuating the impact and obscuring incidence

**In Chile, the business community was extremely well organised and cohesive.** During the dictatorship, they had been able to develop influential pressure groups and applied coordinated lobbying tactics to influence policy issues that mattered to them. Furthermore, the well-organised business community was able to affect economic outcomes by disinvesting and withdrawing capital in a coordinated manner, as had been done in the 1970s. Due to these constraints, the successive governments that had been in power after the dictatorship had been unable to enact significant reforms to the tax system, in particular as concerns direct income taxes.

**In order to circumvent these constraints, the Lagos government focused on the following points:**

- **The reforms proposed were modest in size and were introduced gradually.** The 2001 tax-evasion reform succeeded in raising tax revenue by 1% of GDP, which was sufficiently modest to prevent a major backlash from the business elite, but was significant in the Chilean context, where no major tax reform had been successful after the dictatorship.

- **Instead of focusing on raising direct income taxes, as they had initially planned, they started by closing loopholes in the existing tax system through targeted legislation and focused on combatting tax evasion by increasing controls and enforcement of existing laws.** This allowed them to raise additional revenue without having to legislate politically controversial tax reforms. In fact, the government repeatedly went out of their way to refute claims that they were undertaking a tax reform and argued instead that they were simply trying to enforce existing tax laws, most of which had been enacted during the military dictatorship.

- Once the **anti-tax-evasion measures** had been accepted, the government gradually expanded its message **from tax evasion to tax avoidance**, deliberately blurring the line between the two concepts so as to force the right-wing opposition into a broader debate on the right level of taxation.

**Despite its relative success, this strategy presents the obvious drawback of being inherently limited in its capacity to significantly raise additional revenue.** Additional revenue would probably need the imposition of new taxes. Another problem with this strategy, if it is used repeatedly, is that actors can learn to anticipate the government's actions and take preventative measures to block even modest reforms in the future.

## Reducing horizontal inequality

**In the first wave of reforms, the government appealed essentially to broadly accepted and uncontroversial notions of horizontal inequality.** In particular, they emphasised the unfair competition that tax-evading businesses meant for law-abiding firms. This message appealed both to the population in general and to large parts of the business elite that were playing by the rules. In so doing, they managed to fragment the opposition that had until that point been very solidly coordinated in its opposition to any kind of reform.

**By framing the debate as a moral issue around compliance with the law**, rather than an issue of taxation, the government managed to disarm a lot of the traditional opposition to tax reform. As a consequence, several right-wing senators that had invariably opposed previous attempts at reform chose to abstain in the senate vote, rather than voting against, out of fear of being branded as supporters of tax evaders and criminals.

## Reducing vertical inequality

**The government had tried to reduce vertical inequality between rich and poor to justify its reforms.** These were popular with voters, given the country's high levels of inequality. However, because of the constitutional biases introduced at the end of the dictatorship, the opposition was notoriously unresponsive to these types of messages that appealed to the median voter. Instead, they considered their core constituencies to be the military, which was allowed to appoint several senators independently of electoral outcomes, and the business elite, on which the party relied for funding and to which many of the politicians belonged. While the party also needed to reach out to voters in order to gain sufficient representation in the senate, they often did so by appealing to very poor and uneducated voters, whom they co-opted through clientelism and patronage rather than by appealing to particular policy options.

**However, things have changed in 2005 when vertical inequality became a debated policy issue before the presidential elections.** The government got unexpected support from the leader of the right-wing opposition, who attempted to exploit the popular concern with inequality by claiming that the problem was due to the government's anti-business policies, which, he argued, prevented a large part of the population from benefiting from the country's impressive economic growth.

**The president seized this opportunity to attack one of the most blatant symbols of vertical inequality, which had persisted from the dictatorship.** It was a law, known as 57 bis, which constituted a perpetual government subsidy for owners of new-issue stocks. Studies had shown that 72% of the recipients of this benefit belonged to the 0.5% richest households in the country. Legislation was quickly proposed to repeal this law, and received nearly unanimous support in the senate, even though all previous attempts of reforming the law had been systematically blocked by many of the same senators. By forcing the opposition to engage in the ethical debate on vertical inequality, the president had forced the opposition to defend positions that were incompatible with some of their previous policy positions.

### Compromising and emphasising the benefits of the reform

**As part of the government's strategy to increase tax revenue, the government made a point by emphasising the need to preserve the macro-economic stability that had characterised the Chilean economy since the 1980s, in contrast with many of its Latin American neighbours.** This was a point of consensus in Chilean politics, and one that was at the heart of the right-wing opposition's policy stance. But macro-economic stability required preserving the fiscal surplus. This meant that increases in public expenditures were contingent on increasing public revenue.

**The Lagos government made use of this point to weaken the opposition's resistance against tax reform.** In public debates, the president often emphasised the need to maintain the macro-economic stability cherished by the right and made specific reforms contingent on the prior availability of finance. Earmarking of new taxes for specific purposes was used to emphasise the link between public revenue and social expenditures.

**The reforms were made possible by the important concessions offered by the government to the opposition on other policy issues that were close to their heart such as privatisation** (Fairfield, 2013). In this respect, Chile's institutionalised party system and stable rules of the game created incentives for cooperation and consensus-building in congress (Flores-Macías, 2010). This stands in contrast to other Latin American countries, which have been characterised by political instability and polarised politics.

## Take-aways

- **Appeals to fairness can be a potent political tool to compel the rich to pay more taxation.**
- **Getting the rich to pay more tax is a political process.** Government must be ready to pay off constituencies, make compromises and use coercion to achieve its goals.
- **Closing loopholes and increasing inter-agency as well as international cooperation**, such as exchange of information and mutual assistance in tax matters, are effective means to make sure the wealthy, individuals as well as companies, do not benefit from better access to tax planning expertise and avoid or even evade taxes.

# 3.7 Consumption taxes

Consumption taxes are paid by consumers when buying a good or service. They are usually paid by the seller on behalf of the consumer and added to the price of the good / service.

## Background and objective

**There are three main types of consumption taxes:**

- **VAT** is levied on the value-added at each stage of production. Each VAT vendor will pay the tax administration the tax paid by their client (to the company as a part of the final price of the product), less the amount of VAT they themselves paid when buying the production inputs. In the end, only the final consumer is burdened with the tax.

- **Sales taxes** are usually a percentage of the price of the final good, paid at the point of sale. Legislation will dictate whether they are included in the sales price or not. In Australia the sales tax is levied at each stage of production, while in the USA, some local and state governments use a sales tax only on final consumption.

- **Excise taxes** are applied to specific products, with the tax rate varying by the type of product. Alcohol and tobacco are often subject to excise taxes. The analysis below refers mostly to sales taxes and VATs, except where excise taxes are mentioned specifically.

**VAT is the most popular type of consumption tax,** with 168 countries using a VAT (Gale, 2020). The USA is the only major nation which does not use a VAT. Nearly 80% of countries in Africa have adopted a VAT and they raise 25% of total tax take in Africa. Often VAT is one of the major revenue sources of a country.

**The tax base for consumption taxes is the total amount of sales of goods and services.** Consumption taxes are proportional to consumption, implying that they are regressive at high levels of income because the wealthy save more than people in poverty. As consumption taxes do not base tax rates on the ability to pay, they might even increase vertical inequality. Many countries improve the progressivity of the tax by exempting certain basic goods from consumptions taxes.

## Implementation

**Consumption taxes are easy to implement because the value of a transaction is easy to determine (the sales price) and companies serve as tax collectors for the government.** In case of a retail sales tax, the amount of the tax is only applied to the final sales price of the product. A VAT is applied to each stages of production. For example, when a wholesaler sells a product to a retailer, the wholesaler adds the VAT amount. When the wholesaler pays VAT to the tax administration, they offset the VAT they have received with the VAT they have paid. This gives them an incentive to report correct invoices. A VAT thus generates its own audit trail, making it easy to administer and hard to avoid.

**Most countries apply a VAT reporting threshold,** which allows small businesses to escape from the burden of filing a VAT return. This also ensures that the tax administration effort is directed towards the largest potential taxpayers.

**Developing countries often collect most of their VAT on imports.** For example, in 2015 a sample of 15 African countries collected more than half of their VAT from imports, with the Democratic Republic of the Congo, Mozambique and Madagascar collecting more than 60% from imports. Collecting VAT from imports is simple because imports can be taxed at a port, so there are few locations to administer the tax. As administrative capacity increases, VAT is extended to local producers.

## Strengths and weaknesses

### Effectiveness

**VATs and excise taxes are effective at raising revenue** (Keen and Lockwood, 2006). OECD countries with a VAT are able to raise 3% of GDP more in revenue, which is a roughly 10% increase in revenue. Developing countries raised 38.9% of revenue from consumption taxes in 2017, with VATs raising 27% of revenue, sales taxes raising 1.5% and excise taxes raising 10% of total tax revenue. This is a greater share than PIT and CIT combined. In 50 of 70 developing countries in the OECD Global Revenue Statistics Database, consumption taxes are the largest revenue raising tax.

### Efficiency

**All three types of consumption tax are generally viewed as efficient because they distort incentives and relative prices less than other types of taxes.** The main implication is that the price of consumption is raised, which results in less consumption and more savings. In the long run, higher levels of savings should lead to higher economic growth. The most famous paper on the topic found that the marginal efficiency cost, the cost per USD 1 extra of revenue raised, of the CIT was USD 0.84, capital taxes was USD 0.92 and sales tax was only USD 0.26 (Jorgensen and Kun-Young, 1991). In practise, most governments use both a consumption tax, because it raises large amounts of revenue, and a PIT to offset the regressive impact of the consumption tax.

**VATs have the advantage of neutrality** as it will not advantage one sector over another. For example, the ease with which VAT can be identified ensures that VAT can be rebated for exports, ensuring that production for export is not disadvantaged by the VAT. International trade will not be affected by a VAT because it can be levied on imports. Finally, as VAT is levied at each stage of production, it does not advantage one stage of production over another. This is not the case for excise levies or sales taxes.

All three types of consumption tax are generally viewed as efficient because they distort incentives and relative prices less than other types of taxes.

### Enforceability

**Enforceability is a key weakness of sales taxes because the retailer can evade the tax through simply not recording the sale and collecting the tax themselves.** The incentive to evade will increase as the rate of the sales tax increases. Even advanced countries such as Iceland, Norway and Sweden have been unable to contain evasion at high levels of the retail sales tax. These considerations would be even more important in economies with high levels of informalisation. In contrast, a VAT generates an audit trail which can be monitored.

**Collection of consumption taxes will be limited by the extent of informality in an economy, though not to the same extent as income taxes.** For example, even in an economy with high levels of informality, consumption taxes can be applied to imports and transactions in formalised, usually bigger companies, e.g. supermarket chains.

**Excise taxes are relatively easy to enforce because they can be levied at the source.** For example, excise taxes on alcohol can be levied at breweries, while excise taxes on luxury vehicles can be levied at the port.

### Impact on Inequality

**Most countries try to make consumption taxes less regressive by applying exemptions or lower rates to certain goods and by using excise taxes on goods consumed by the rich.** Exemptions to consumption tax need to fulfil two criteria to be truly progressive:

## Spotlight 4: Zero rating in South Africa

South Africa has used zero-rating to obtain social objectives. There is anecdotal evidence that girls are sometimes forced to miss schools because they cannot afford sanitary pads. In 2019, the government exempted sanitary products and also provided an allocation for the provision of pads in schools.

- **The good or service needs to be consumed almost solely by people in poverty.** Usually, the rich will consume the same goods as people in poverty, though the goods will make up less of the rich person's expenditure. However, it could still be that the rich spend more on a good or service than people in poverty, in which case the exemption or lower rate would become regressive.
- **The exemption or lower rate must result in a decline in the final price of the product.** Whether and to what extent this will occur is a function of how much demand for- or supply of a good changes, when prices change, the elasticity. In most cases, some of the tax benefit will be captured by the retailer and producer of the good.

**Excise taxes on luxury goods (e.g. luxury vehicles, yachts) are an effective means of targeting a consumption tax at those with highest ability to pay.** In poor economies with limited ability to levy an income tax, this a useful method of taxing the wealthy. Excise taxes are efficient because they can be targeted at goods with high price elasticities of demand, which results in fewer distortions. Excise taxes on socially undesirable goods with negative externalities such as tobacco, alcohol and petroleum can reduce inequality and lead to more social cohesion (IMF, 2017).

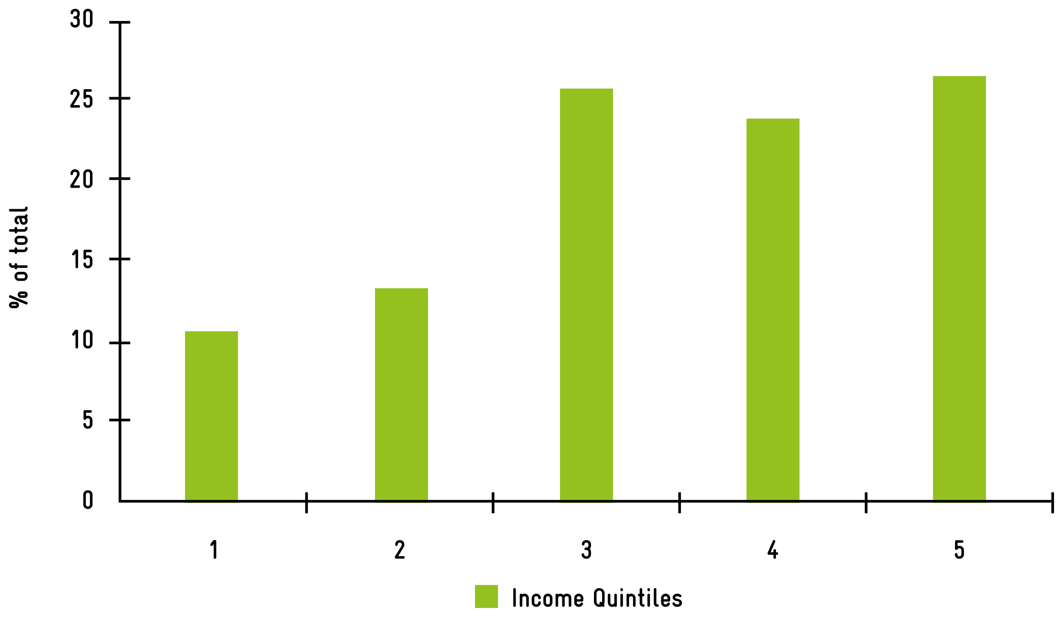
**Additionally, theorists have tried to find ways to make consumption taxes more progressive, one proposal is a personal expenditure tax.** However, progressive consumption taxes, as distinct from a VAT or retail sales tax, are difficult to administer. In order to collect a progressive consumption tax, governments would need to know how much each household consumed, and then levy a tax with increasing rates. The data requirements for this would be substantial, especially compared with the VAT or the sales tax. India (twice) and Sri Lanka[4] briefly trialled such a personal expenditure tax but found that the cost of administration was too high relative to the revenue collected (Viard, 2013) making such a progressive tax unrealistic for now.

**Country-specific incidence analyses have shown that taxes assumed to be regressive such as consumption taxes can be progressive, for example in Togo (World Bank, 2021a).** This is due to the circumstance that the statutory incidence (who should pay) of consumption taxes differs from the economic incidence (who actually pays). In developing countries, VAT is often confined to urban areas, which tend to be better off. The informal sector will also escape consumption taxes. Thus, *de facto*, a VAT in some circumstances could be more progressive than expected.

4 India from 1957 to 1962 and 1964 to 1966 and Sri Lanka from 1959 to 1963 (Viard, 2013).

## Box 6: Case Study – Zero-rated goods in South Africa's VAT

**Figure 1: Gains from zero-rated goods and exemptions**




**South Africa provides a useful example of the use of zero-rated goods to improve progressivity.** South Africa implemented a VAT in October 1991. VAT was initially levied at 14% and increased to 15% on 1 April 2019. Certain categories of goods, termed merit goods, are zero-rated. These include basic foodstuffs, paraffin (mostly used by people in poverty for cooking and heating), public transport, basic and pre-primary education and tertiary education.

**However, National Treasury (2007) notes that the benefit of merit good exemptions accrues mainly to the wealthy.** The study examined how the benefits of zero-rating accrue to income quintiles. In only two quintiles did the benefits accrue to the poorest quintile, mielie meal and brown bread. In total, the savings from zero-rating basic foodstuffs are captured by the middle-class and the wealthy. The third-, fourth- and fifth-income quintile acquire 26.9%, 24.2% and 23.7% of the gains. The poorest quintile only gains 11.2% of total benefits. The gains from exempting services are even more skewed, with the top income quintile capturing 73.8% of total benefits. This is mainly because the services that are exempted are consumed by wealthier people in South Africa. For example, public transport could be broken down into formal and informal public transport. No VAT is collected on informal public transport, mostly minibus taxis, so the value of the exemption accrues to the wealthy. The exemption for primary education is an example of two well-intentioned policies interacting in an unintended way. The exemption on VAT was introduced in 1991. Subsequently, primary schooling has become free for the 3 poorest income quintiles. Thus, the exemption is only effective for the higher income quintiles.

**This together with the high leakages from many zero-rated products emphasises the need to design the tax and the applicable exemptions carefully.** If all the exemptions had been eliminated, then cash transfers could have been increased by 11%. This might have been a more effective way to improve progressivity. Thus, governments need to be careful about the use of exemptions and make sure that they are consumed as much as possible by the poorest, otherwise exemptions could lead to regressive outcomes.

## Take-aways

- **Consumption taxes are easy to implement, raise large amounts of revenue and are efficient.** Even though they should be part of every tax system, it is important not to overuse the tax. This for example has occurred in some Latin American countries, resulting in regressive tax systems.

- **Of the consumption taxes available, the VAT is relatively easy to administer and has the virtue of generating corroborating information.**

- **The VAT is regressive so it needs to be complemented with targeted excise taxes,** which can be levied on luxury goods, thus reducing inequality. PIT also complements a VAT well as it is more progressive.

- **Certain products that are mainly used by people in poverty should have a lower or even a zero rate.** Despite these goods being purchased by the wealthy as well, poorer households spend a higher share of their income on these goods. Lower taxes on certain products make urgently needed goods more affordable for poorer households. Therefore, these taxes can be progressive and have an impact on the reduction of inequality.

# 3.8 Carbon pricing

**Carbon pricing is a method of assigning a specific price to carbon to incentivise producers to emit less carbon dioxide ($CO_2$).** $CO_2$ is responsible for global warming and climate change, which exacerbates different types of inequalities by affecting livelihoods, health, and productivity worldwide. Climate change also increases the frequency and intensity of natural disasters, making it harder for those affected to cope with the impacts. The consequences of climate change are unevenly distributed and affect people in poverty particularly hard, although they are not always the biggest polluters. Before pricing, polluters were only constrained by regulation. As the price of carbon increases, polluters should emit less or at least pay a higher price for it. Thus, carbon pricing can help shift the burden to those who are responsible for it and therefore have an impact on inequality.


## Background and objective

**The Paris Agreement on Climate Change aims at keeping the increase in global mean temperature below 2°C above pre-industrial levels – through cutting global carbon emissions.** Carbon taxes and emissions trading schemes, collectively referred to as carbon pricing, are a way of assigning a price to carbon so that use of carbon-intensive products declines, thus reducing emissions. In order to achieve the goals of the Paris


Agreement, the price of carbon should be USD 40-80/t$CO_2$, rising to USD 50-100/t$CO_2$ by 2030. Currently only 5% of carbon prices are above USD 40/t$CO_2$.

**There are currently 30 carbon taxes and 31 emissions trading schemes (ETS) in place covering 22% of global greenhouse gas emissions.** Carbon pricing is most prevalent in Europe, but Canada, China, and some countries in Latin America also have schemes. The tax is levied on producers but because demand for goods like fuel or coal does not change much as prices change, producers can push most of the tax onto the consumers.

**To meet the goals of the Paris Agreement, many new carbon taxes and ETS will need to be implemented.** However, people in poverty spend more of their income on carbon-intensive goods, such as electricity, heating and food, than the wealthy do, so a tax that raises the price of carbon will be regressive. Carbon taxes thus need to become more progressive, or they should be tied to other policies that reduce inequality, to ensure that carbon taxes have the necessary political support to create a durable decline in the use of fossil fuels.

**A carbon tax is regressive, but the use of the generated revenue can offset inequality.** The main goal of pricing carbon is to increase the price on carbon and thereby, disincentivising the production and use of carbon-intensive goods and services. The revenue that is generated is not necessary to achieve this goal, so activists have focussed on how to use the revenue generated by carbon pricing to offset the regressive impact of the tax. This is referred to as the recycling of revenue. In theory, the revenue from the tax would be earmarked for specific uses. In general, governments do not like to earmark revenues as expenditure is then determined by tax collection, rather than policy.

## Implementation

**Two mechanisms – carbon tax and ETS – are available to reduce carbon emissions.** A carbon tax is a tax on the amount of carbon dioxide released when burning fossil fuels, while an ETS sets aggregate limits on the amount of carbon that can be emitted, allocates permits to individual firms and allows firms to trade these permits, thus putting a price on carbon emissions. Both mechanisms will be regressive.

**A key issue to implementation is how to make carbon pricing politically popular.** A society's willingness to pay a carbon tax depends on political, economic and cultural factors. Citizens in Germany and China with higher educational attainment were more willing to pay a carbon tax. Willingness to pay in the United States is mostly a partisan issue. Other barriers included the fact that large emitters like the United States and India are not pricing carbon. Developing countries are more concerned with growth and see carbon pricing as a potential barrier to their development. Further, ETS can be politically unpopular because of the perception that they allow companies to profit from pollution.

**In societies with low trust, explicit earmarking of the use of recycled revenues led to greater acceptance of a carbon tax.** For example, in high-trust Sweden, the carbon tax is directed into general government revenue, while other governments use revenues to invest in green technologies or tax reductions.

**Carbon taxes are more popular when they are not called taxes.** Labelling carbon taxes as fees or climate contributions and explicit linking the tax and use of the revenue, for example, consistently referring to the "fee and dividend" makes the carbon tax more popular and durable (Kleinert, et al., 2018).

## Strengths and weaknesses

### Effectiveness

**Carbon pricing has been effective in reducing the amount of carbon emitted.** Andersson (2017) finds that carbon taxes in Sweden reduced carbon emissions by 11% a year. Interestingly, Andersson finds that this effect is three times larger than it should be the case given the price elasticity of demand for petrol. A similar effect was found in British Colombia, which recorded a four-times larger than expected effect. This suggests that carbon taxes may be more effective than predicted.

**Carbon pricing can also be effective in the long run.** Aghion, et al (2012) show that when the price of petrol is high, the automobile industry directs research and development towards cleaner technologies that reduce consumption and emissions.

### Efficiency

**The ultimate aim of carbon pricing is to correct an inefficiency called an externality.** An externality is an action which affects other parties without being reflected in market prices. In the case of pollution, companies only bear the private cost of pollution but the impact on pollution is felt by the whole of society, specifically by people in poverty and other vulnerable groups, so pollution is more costly than a strictly market outcome would be. This is extremely inefficient. Carbon pricing internalises the externality by applying a more correct, higher price on carbon, thus cutting down on pollution.

**Carbon taxes can also increase the efficiency of a tax system, depending on how recycled revenues are used.** Thus, a carbon tax can increase efficiency if the revenue is used to reduce taxes on capital and CIT, followed by labour taxes and a lump sum payment as the least efficient use of revenue. This rank order is exactly the opposite of the impact on inequality, thus there is a trade-off between progressivity and efficiency.

### Enforceability

**A carbon tax is levied at the point of production to make collection easier.** Thus, the tax on petroleum is collected at refineries, coal at the mine gate and natural gas at the wellhead. Producers would report on their production for CIT and the return data would then be used in the calculation of the carbon tax liability. This tax is difficult to evade because the assets cannot be moved. The level of the tax is calculated according to the carbon content of the fuel, with fuels that contain more carbon, such as petroleum, carrying a higher tax. The tax is levied on producers who would then increase the price of their final good. This would result in consumers purchasing less of carbon-intensive goods and also incentivise producers to use inputs with less carbon. The carbon tax should also be levied on imports at ports to prevent countries with no or lower carbon taxes gaining an advantage over local producers. Enforcing the carbon tax at borders complies with the international trade law of the World Trade Organisation.

In practise, many countries already collect a tax on petroleum or a royalty tax on mining, so the carbon tax would often be an extension of an existing tax. In developing countries, where broader taxes such as CIT and PIT will be limited due to informality, a carbon tax could be a useful revenue raiser (Parry, 2019, p.17).

### Impact on inequality

**Carbon taxes could increase inequality in developing countries, although it can lead to less carbon emissions, mitigating the effects of climate change.** These are often felt most severe by people in poverty. Therefore, carbon taxes could, in the long run, have an impact on the reduction of inequality. Nevertheless, modelling the potential effect of the introduction of a carbon tax in South Africa showed that unemployment was likely to increase and that lower paid workers would face more job losses than the wealthy. If the revenue from the tax was recycled through social grants, then the carbon tax package would be progressive even though the initial tax itself was regressive (Alton et al., 2012). The general result of many analyses of carbon pricing is that while the tax itself is regressive, governments can spend the proceeds of the tax in a progressive way such as in cashless grants to people in poverty then the regressive nature of the tax can be offset. For example, Fremstad and Paul (2019) show that if the USA imposes a USD 50 carbon tax, this would be highly regressive. To counter this impact, the study argues that the tax revenues be diverted to a carbon fund, not general revenue, which then pays equal dividends to all citizens. This approach results in a progressive carbon tax as the incomes of those in the poorest decile would increase by 5.1%, while those of the richest would decline by 0.9%.

**Other uses of the recycled revenue are less progressive.** Various other uses of the revenue have been proposed, such as reducing PIT or CIT, but in general these produce worse results for the reduction of inequality than a per-capita dividend. Whether or not this is correct in practise will depend on the other taxes levied in an economy. In case that, for

## Box 7: Case study – Carbon tax in British Columbia, Canada

**British Columbia implemented a carbon tax in 2008.** The tax is levied on petroleum, natural gas, diesel, propane, coal and home heating fuel. Initially, the tax was applied to all industries but an exemption for agriculture was made in 2012. To prevent sticker-shock, the tax was set at USD 10/t$CO_2$ in 2008, with an increase of USD 5/t$CO_2$ till 2012.

**The carbon tax raised USD 1.1 billion in 2012 but the tax was explicitly designed to be revenue neutral, so the revenue was recycled.** When the tax was introduced, the rate of PIT was reduced by 5% for the two lowest income bands. This should enhance progressivity. CIT was reduced by 1%. Lump sums were provided to households with income below USD 35,000 per annum. The lump sum was USD 100 per adult and USD 30 per child. The tax was planned to have no impact on the fiscal deficit of government because expenditure would increase by the same amount as revenue. In effect, the tax has not raised as much revenue as anticipated, but the expenditure went ahead regardless, so the whole package would have resulted in a slightly larger deficit.

**Yet, the tax has been effective.** Per-capita use of fossil fuels declined by 17% after the tax was introduced, even as usage rose by 2% in the rest of Canada.

**Yamazaki (2017) examined the employment impact of the carbon tax. It was found that employment decreased in carbon-intensive industries with airlines hardest hit, losing 2,000 jobs.** However, under the assumption that carbon-intensive industries are capital-intensive with elastic demand, the drop-in employment from the carbon tax was less than the job increases in clean service industries. It was found that in aggregate, employment increased by 63,000 jobs over 6 years, an increase of 4.5%, overall. The tax did have a statistically significant negative impact on wages, which might also explain part of the increase in employment.

example, a PIT is poorly designed, regressive and distortionary, it may be optimal from an efficiency perspective to use the revenue to reduce the rates of this PIT (Klenert et al., 2018). In practise, political considerations mean that recycled revenue will be distributed across a number of areas, rather than solely being directed to CIT or to dividends.

**Carbon pricing can result in lower employment in carbon-intensive industries.** Recycled revenue on the other hand will create jobs in other industries to offset these jobs but it is difficult to predict which effect will be larger. If jobs are lost this would result in increasing inequality.

## Take-aways

- **Getting carbon pricing right is fundamental to the future habitability of our planet.** Thus, even though carbon pricing can be regressive, it is recommended that countries implement carbon taxes.

- **The regressivity of the tax can be offset by progressive recycling of revenue**, which needs to be targeted at people in poverty as much as politically possible.

- **In countries with high levels of trust, revenue can be used in general government revenue.** In countries where trust levels are lower, use of the revenue should be tied to specific expenditures. This could include cash transfers.

- **Governments should be cautious about increasing expenditure based on forecasts of revenue from carbon pricing.** It may be better to implement carbon pricing before the revenue recycling to avoid increasing deficits.

# 4

# GOVERNMENT EXPENDITURE

**Government expenditure can be used to reduce structural inequalities in the access to key assets and basic infrastructure (water and sanitation, electricity, roads) and to reduce income inequality by providing direct transfers to households and individuals. Public expenditure is particularly important in the social sector, i.e., education, health and social protection to reduce both disposable (post-tax-and-transfer) and market (pre-tax-and-transfer) income inequalities (IMF, 2017). Health and education spending promote growth and reduce inequality as well as disparities in human capital and productivity. Spending on social protection ensures income security across the life cycle of the beneficiary and in face of specific emergencies such as the recent food, fuel, financial and climate related crises as well as the global health pandemic (OPM, 2013; Durán-Valverde et al., 2020).**

**Available evidence suggests that the redistributive impact of spending on education, health and social protection, in particular cash transfer programmes, is large and progressive**. Several studies point out that the redistributive impact of fiscal policy interventions, especially for people in poverty, is greater on the spending side of the budget and that raising tax revenues and devoting the proceeds to social spending would improve the income of the poorest households (Causa and Hermansen, 2019; Hollar and Cubero, 2010; Anderson et al., 2016).

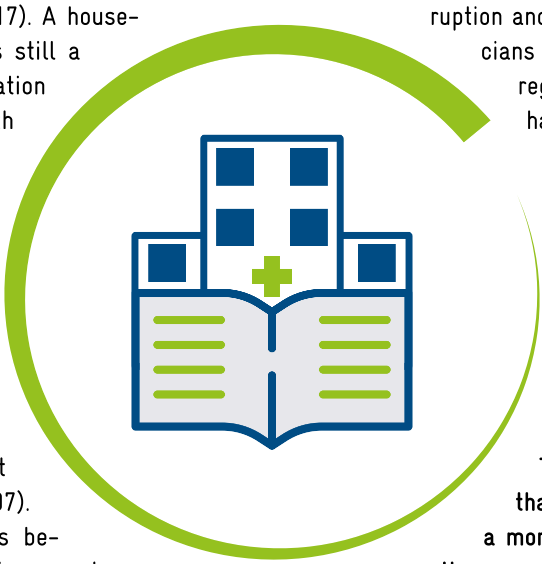
**The German development cooperation's GFG approach highlights the need to orient expenditure planning and execution towards the effective implementation of pro-poor development strategies (BMZ, 2014).** This aligns to the EU's strategy, which stresses increasing fiscal redistribution by the state, through pro-poor fiscal policies and social transfers, as one of the key actions for addressing inequality (Robilliard and Lawson, 2017).

The remainder of this chapter provides a brief overview of spending policies on education and health, while focusing more in detail on spending on social protection, in particular cash transfer programmes.

# 4.1 Education and health spending

**The IMF identifies education and health spending as one of the most important fiscal policy tools for addressing inequality** (IMF, 2017). Education and health policies can reduce both income inequality and inequality of opportunities, by promoting the accumulation of human capital and intergenerational earnings mobility.

**Despite progress in education enrolment and basic health coverage, gaps in education and health outcomes remain and are mainly explained by the lack of financial resources** (IMF, 2017). A household's socioeconomic status is still a determinant of access to education and strongly associated with children's learning outcomes, with students from disadvantaged background performing worse than students from better off families. Similarly, rich people have significant better access to health services and receive higher quality of care than people in poverty (Wagstaff et al., 2016; Houweling et al., 2007). Disparities in health outcomes between the rich and people in poverty have widened over time, as measured by the gap in life expectancy between the rich and people in poverty and the difference in infant mortality rate (Bosworth, Burtless, and Zhang, 2016; Case and Deaton, 2017; Wagstaff et al. 2014).



**Gender disparities also persist.** In low-income countries girls are less likely to be enrolled in school (IMF, 2017), and around the world many women and girls still have limited access to health care services, including both basic health care and essential health services directed at women, like family planning, pre- and neonatal care. This is largely due to lower social and financial independence of women, and the fact that women are more likely to work in the informal sector and are thus not covered by social health protection schemes where they exist. Gender inequality and discriminatory policies also continue to impede access to HIV/AIDS services especially for younger women, who have the highest infection rates in sub-Saharan Africa (while in all other regions adult men account for the highest new infection rates). However, men as well could be discriminated on the basis of gender, especially when it comes to spending for treatment of HIV and tuberculosis (WHO, 2019). The COVID-19 pandemic is reversing progress with regards to gender equality.

**Available evidence shows that public expenditure on education and health is often pro-rich in low and middle-income countries** (Davoodi, Tiongson, and Asawanuchit, 2010; Wagstaff et al., 2014). Poor targeting can be due to a number of different factors, ranging from insufficient administrative capacity to inaccurately identification of intended beneficiaries, to corruption and patronage, which leads politicians to direct public expenditures to regions or groups to which they have allegiance. In many cases, poor targeting can be explained by barriers to access, such as user fees, or distance, which prevent poor individuals from benefiting from public services that are provided by the state (Davoodi, Tiongson, and Asawanuchit, 2010).

**The empirical evidence shows that countries that tend to have a more pro-poor incidence of education spending also tend to have a more pro-poor incidence of health spending.** Davoodi, Tiongson, and Asawanuchit (2010) explore the relationship between benefit incidence on the one hand and indicators of access to education, health and social outcomes on the other, using simple measures of association. Their findings indicate that a more pro-poor benefit incidence structure of public spending on education and health is associated with better education and health outcomes, higher per capita income, better governance, wider availability of information, and closer location of health facilities to people in poverty.

**In conclusion, reallocating public expenditure towards disadvantaged students and schools, as well as health care services in poorer areas, would likely reduce**

**education, health and income inequalities.** Reallocating spending towards people in poverty will also improve efficiency if public resources reach those who need them most. Given that larger gender gaps are correlated to broader income inequality, focusing public spending on closing gender gaps in education and health would improve women's economic participation and ultimately contribute to reducing inequality (IMF, 2017). Countries must consider health inequality within and across groups and geographic areas and learn how gender norms, unequal power relations and discrimination based on sexual and gender orientation impede access to health services, as not only women are affected by gender inequality in health care (WHO, 2019).

# 4.2 Cash transfer programmes

## Background and objective

**Cash transfers are one of the programmes comprised in the social protection system of a country and are defined as a form of social assistance provided to people on the basis of demonstrated need rather than any contribution they have made to the government.** Conversely, contributory programmes (such as social security or pension schemes) are available to participants depending on the taxes or other mandatory contribution they had paid.

**In recent years, cash transfer programmes have gained importance and became an essential tool of redistribution that can reduce inequality also in less developed countries**[5] (Bastagli et al., 2016; Bourguignon, 2018; Slater, 2008). Cash transfer programmes provide regular cash assistance to people in poverty and certain vulnerable groups and do not require any monetary contribution from the beneficiary. Examples include poverty targeted cash transfers, child grants and social pensions for the elderly.

**Cash transfer programmes can be categorised as either conditional or unconditional, depending on whether the beneficiary needs to comply with specific behavioural requirements to be eligible for the transfer.**

- **Unconditional cash transfers (UCTs)** are defined as programmes that give cash to individuals or households and do not impose any requirements on the beneficiaries in terms of actions that they must undertake in order to receive the transfer. These types of programmes can sometimes lack political buy-in, as they give freedom to the beneficiary to use the cash as they please. For example, Latin American governments did not make use of unconditional programmes because they did not want to lose

5 See for instance the ILO social protection floor initiative which advocates for basic social security and income guarantees.

the support of the middle-class tax-payers, who were convinced of the demotivating effects of providing "handouts" to people in poverty (Scarlato and D'agostino, 2016).

- **Conditional cash transfers (CCTs)** have emerged as a politically viable alternative to unconditional cash transfers. CCTs attach conditions to the monetary transfer, such as health check-ups or regular school attendance by children, to ensure that cash transfers are allocated by recipients to intended purposes (Farrington and Slater, 2006).

**Poverty targeted cash transfers and child grants typically identify women as the cash recipient, to promote their autonomy and control over financial resources, ultimately contributing to women's empowerment.** Bastagli et al. (2016) review of the impacts of cash transfer programmes finds that transfers increase women's decision-making power and choices. However, some studies argue that targeting women automatically places responsibility on them to fulfil programme's requirements, especially for CCT (Ladhani and Sitter, 2020).

**A mixture of social and institutional conditions, as well as political factors drive the design and objectives of cash transfers, with a strong element of path dependency due to differences in the countries' welfare regime.** In Latin America, CCTs have emerged in response to the dramatic effects of financial crises in the 1980s. In these countries, CCTs aimed to encourage demand for social services and investments in human capital, in order to durably reduce intergenerational transmission of poverty and reduce inequality. In contrast, cash transfers have spread in sub-Saharan Africa primarily without conditions, to find alternatives to food and inputs transfers to support chronically food-insecure- and vulnerable households facing temporary income shocks. The main reasons for this approach in sub-Saharan Africa relate to the greater incidence of poverty, limited administrative capacity to implement conditionalities and monitor compliance, as well as capacity constraints in the provision of public services (Slater, 2008; Scarlato and D'agostino, 2016).

In recent years, cash transfer programmes have gained importance and became an essential tool of redistribution that can reduce inequality also in less developed countries.

## Implementation

**Implementation of cash transfer schemes requires administrative systems to implement four core mechanisms that cover registration, enrolment, payment delivery and grievance and redress** (Barrett and Kidd, 2015). Registration refers to the identification of potential beneficiaries[6]. Enrolment involves issuing a registered beneficiary with an identification code for the purpose of identifying themselves as part of the scheme and receiving cash. Payment delivery refers to the mechanism to deliver cash to beneficiaries (for example, through direct transfer to the beneficiary's bank account, manual payment at designated payment points, etc.). Grievance and redress mechanisms are necessary to receive complaints and appeals against exclusion. CCTs also require well-resourced operational monitoring to ensure adherence to the transfer conditionalities. The more complex the design of the transfer is, the greater efforts are needed in terms of capacity, coordination and logistics.

6 Registration involves collecting personal data from applicants, verifying accuracy of information submitted, assessing whether applicants comply with the programme's eligibility criteria, and storing applicants' data onto the Programme Management Information System.

**Barrett and Kidd (2015) identify seven crucial prerequisites for effective implementation of cash transfers:**

- Setting up **appropriate institutional arrangements** and staffing strategy for the management and delivery of the transfers.
- Developing operational manuals that clearly set out the **implementation processes**.
- Investing in capacity of the staff through appropriate **training**.
- Setting up a **management information system** (MIS) to store, track and manage beneficiaries' data. The MIS should support a minimum set of operational functions, such as eligibility assessment; entitlement calculation, and payroll production; payments reconciliation; complaints tracking; and production of analytical programme performance reports.
- Designing public **communication strategies** tailored to the target population, to **raise awareness** of the scheme existence, eligibility criteria and application process to make sure the most vulnerable can apply for these schemes.
- Ensuring finance and accounting functions associated to the **timely and accurate disbursement of payment** of beneficiaries.
- Setting up effective **monitoring**, performance management and learning systems, including functioning grievance and redress mechanisms.

**One of the key aspects to take into consideration is how to deliver money to the beneficiaries.** Delivering the transfers is one of the most logistically challenging operations of cash transfer programmes and governments might consider outsourcing this to a separate service provider with access to specialist technology and distribution networks. Over the last decade, in many low- and middle-income countries, there has been a move to use new approaches to deliver transfers to recipients, going beyond manual disbursement at designated payment points. For example, several cash transfer programmes support beneficiaries to open a bank account and combine cash provision with access to other financial services, such as savings, loans and insurance. In arid and semiarid regions in northern Kenya, for example, the government Hunger Safety Net Programme opens bank accounts for poor beneficiaries, who can access payments from local bank agents based in shops and other small businesses. In Uganda, where banking services are limited, payments are delivered through mobile phone service providers (Barrett and Kidd, 2015).

**Another fundamental challenge is to identify and enrol beneficiaries.** While the modality of identification depends on the targeting mechanism, participatory approaches involving community agents to assess eligibility are often employed for cash transfers specifically targeted at people in poverty. The enrolment process may involve the provision of a programme identification card, or a personal identification number (PIN) number associated to the beneficiary, linked to the government's social registry.[7]

**Cash transfers are an effective measure when they reach those in need and provide transfers of sizeable value.** In this respect, a progressive implementation of cash transfer programmes which incrementally

7 Social registries are information systems that support outreach, intake, registration, and determination of potential eligibility for one or more social programmes (Leite, et al., 2017).

scales up coverage and increases generosity of the transfer should be considered to increase the redistributive impact of cash transfers. Robust evidence on the efficiency and effectiveness of the programme can help to accelerate the programme expansion (Samson, 2020).

**The COVID-19 pandemic has highlighted the need for governments to be able to react swiftly to external shocks as well as the economic and social consequences of counter measures.** A major economic and social impact of the pandemic was an increase in poverty and the exacerbation of pre-existing inequality (Ferreira, 2021). Direct cash transfers to (vulnerable parts of) the population have played a major role in the governments' COVID-19 response highlighting the relevance of existing cash transfer programmes, including in developing countries (World Bank, 2021). As a shock-responsive social assistance, COVID-19 cash transfers aimed to mitigate the social and economic consequences of the pandemic. Despite being a short-term relief, such adaptive measures build on local existing social security and payment systems. Consequently, Lowe, McCord and Beazley (2021) emphasize the need of a resilient existing social protection system and infrastructure. At the same time the COVID-19 pandemic has also highlighted the need for further refinement of many systems, for example, by investing in additional digital and financial services infrastructure, institutional capacity, emergency-adjusted legislative frameworks as well as the expansion of a social registry.

## Strengths and weaknesses

### Effectiveness

**Evidence shows that cash transfers can bring positive results in the short and medium term but the impact on longer term human development outcomes, such as health status, education and nutrition, is less strong.** UCTs and CCTs contribute to beneficiaries' income and increase household expenditure, with no significant evidence for work disincentive effects. Cash transfers are also found to increase beneficiaries' savings and investment in livestock and agricultural inputs (Bastagli et al., 2016). Bastagli et al. (2016) argue that cash transfers do not always lead to improved learning outcomes or health and nutrition outcomes partly because these dimensions depend on several factors which might mediate the direct effect of the monetary transfers.

The review shows that cash transfers can be a policy tool to alleviate poverty, foster productive investments, and promote access to education and health services.

**The difference in effectiveness in terms of school enrolment and use of healthcare services between CCTs and UCTs is weak. In this respect, UCTs might be a more cost-effective policy option, compared to CCTs** (Baird et al., 2013; Bastagli et al., 2016). CCTs are found to be more effective if there are conditions that are strictly monitored and enforced (Baird et al., 2013). However, monitoring and evaluating conditions is costly and requires substantial administrative efforts, frequently not affordable in low- and middle-income countries. The analysis of CCTs in Honduras, Mexico and Nicaragua shows that monitoring beneficiaries' compliance increases administrative costs by more than 20% (Caldés, Coady, and Maluccio, 2006).[8] In addition, there is some evidence that the imposition of conditions may increase the risk of excluding the most vulnerable households that are least able to fulfil them, potentially aggravating inequalities (OPM, 2013). This is especially relevant, in areas where supply of public services, such as presence of functioning schools and health clinics, is severely constrained. In fact, conditions attached to cash transfers in low-income countries tend to be linked to the creation and rehabilitation of community assets (for example roads, water canals and market spaces) rather than the regular use of public services, or designed as "soft conditions", not accompanied by rigid penalties (Ladhani and Sitter, 2020).

**To conclude, the review shows that cash transfers can be a policy tool to alleviate poverty, foster productive**

8 Costs for identification of beneficiaries is similar although decreasing over time.

**investments, and promote access to education and health services.** Administering conditions is associated with high monitoring costs, and do not necessarily imply larger gains, especially in a scarcely resourced context where public services may be not available.

## Efficiency

**Cash transfers are typically found to be less expensive and more efficient than in-kind transfers or subsidies, with fewer distortionary effects on local markets** (OPM, 2013; Bourguignon, 2018). In particular, the analysis of the welfare effects of *Progresa* in Mexico, for example, shows that replacing distortionary food subsidies with cash transfers to poor households is associated with welfare gains, with the cost of raising USD 100 to finance the cash transfers being only USD 62 (Coady and Lee Harris, 2000). The same paper also estimates that financing cash transfers through VAT reforms which shift taxes towards price inelastic commodities show welfare gains. Nevertheless, these gains are much smaller than those associated with subsidy elimination (Coady and Lee Harris, 2000). Pilot experiments in three Indian states confirm some of these findings and show that cash transfers are less costly and better targeted to the truly needy than food subsidies (Muralidharan, Niehaus, and Sukhtankar, 2017).

**Cash transfers may generate efficiency gains from savings on logistics (compared to in-kind transfers) and may avoid disincentives to local good production.** Nevertheless, it is important to consider the capacity of the local market to absorb the increased demand as a result of the transfers (Slater, 2008). For example, in 2015 cash transfers in Ethiopia contributed to rising market food prices in the absence of actions to improve the supply of grains into markets where the Productive Safety Net Programme was distributing cash to poor households. This is particularly relevant because while positive effects of cash transfers are felt by both beneficiaries and non-beneficiaries, negative externalities are usually felt more acutely by non-beneficiaries.

**In low- and middle-income countries, where administrative capacity is low, data sources on poverty do not exist in the same amount and quality as they do in the higher income countries.** This reduces efficiency of poverty targeting cash transfer programmes and leads to transfers to households not targeted or omission of eligible households. Brown, Ravallion, and Van de Walle (2017) study the performance of the proxy means test (PMT) to identify poor households in a number of African countries. Their results indicate that on average, 80% of poor households are counted as non-poor by the test, and 40% of non-poor households are counted as poor. Ultimately, where administrative capacity is low, categorical targeting based on demographic characteristics can be a more efficient approach to reach the very poorest segment of the population (Samson, 2020; Kakwani, Soares, and Son, 2006; Brown, Ravallion, and Van de Walle, 2017).

**In conclusion, several cases in the literature convene that cash transfers are more efficient than in-kind transfers or subsidies**, and present fewer distortionary effects on local markets. However, poverty-targeted cash transfers require significant resources and often

struggle to identify poor households, basically excluding a large part of those in need and reducing the redistributive impact of such measure (Samson, 2020; Ladhani and Sitter, 2020; Kidd, Gelders, and Bailey-Athias, 2017). An emerging paradigm advocates for expanding coverage of cash transfer schemes and social protection in general, moving toward a more inclusive lifecycle approach by which policies are designed to address risks and vulnerabilities at each stage of a person's life rather than narrowly targeting people in poverty (Kidd, Gelders, and Bailey-Athias, 2017).

## Enforceability

**Enforceability of cash transfers is affected by three factors: (i) the government's fiscal space, (ii) political and institutional factors shaping social protection trajectories and relationships across interest groups in the society as well as (iii) the government's administrative capacity.** The interplay among these three factors affects the implementation of cash transfers in terms of targeting, coverage and conditionality.

**(i) Fiscal space:** Fiscal sustainability is a key challenge for cash transfer programmes. In many middle-income countries, such as Mexico, CCTs have been financed through the reallocation of resources from the abolition of subsidies (e.g. on fuel and food) and their sustainability depended on sustained economic growth. While strong emphasis is on narrowly targeting vulnerable and poor social groups in order to rationalise the use of scares resources, the main weakness of these policies is their limited size. To increase public spending governments would need to change the taxation system towards direct income and property taxes, and to take more actions to address tax evasion (Grugel and Riggirozzi, 2012). Low-income country governments are usually unable to finance cash transfers through payroll taxes, which were central to the emergence of the welfare state in developed countries (OPM, 2013). This is because of the high degree of informality of the economy and lack of infrastructure required for tax collection and administration. This also reflects a structural limitation of cash transfers, with the upper and middle classes having no political and economic incentive to pay for something that will only help the poorest share of the population. As a result, in poorer economies, cash transfer programmes tend to be small, partially or fully funded by development partners and often suffer from weak national political commitment. Expansion of cash transfers countrywide is mostly constrained by the lack of national resources and heavy dependence on donor funding (Scarlato and D'agostino, 2016).

**(ii) Political and institutional factors:** Institutional arrangements and internal politics will inevitably play a role in influencing cash transfer programming. Targeting and conditions of the transfers are political issues which are shaped by public attitudes regarding the perceived causes of poverty and inequality and are critical aspects for maintaining political support for cash transfers (Slater, 2008). When poverty is seen as an individual failure rather than the result of a structural lack of opportunity, UCT are believed to create dependency and generate work disincentives, although there is no empirical evidence for this (McIntosh and Zeitlin, 2020). Conditions attached to the use of the transfers can increase political acceptability and make cash transfers socially acceptable (Slater, 2008). Similarly, when the dominating view is that social assistance is not a basic right, categorical cash transfers or universal might face political resistance due to concerns over affordability, efficiency, and sustainability of such measures (Samson, 2020). Nonetheless, categorical targeting based on demographic categories (such as age or gender) rather than poverty targeted interventions, may avoid to a considerable degree social invidiousness of non-beneficiaries and receive larger support from the electorate, given that eligibility criteria would be easier to understand (Ellis, 2008).

**(iii) Government's administrative capacity:** As described in the implementation section, cash transfer schemes require a functioning administrative system to target and register beneficiaries, disburse the payments and allow for redress and grievances (Barrett and Kidd, 2015). The more complex the design of the transfer is, the greater efforts are needed in terms of capacity, coordination and logistics.

**In conclusion, a mixture of context-specific considerations shapes the features of cash transfers.** There is not a single archetype but rather many models depending on socio-institutional conditions, political factors and available financial resources, as well as administrative arrangements and existing administrative capacity. Experience confirms that cash transfer programmes that apply conditions and are narrowly targeted to people in poverty tend to be fairly complex and require significant administrative capacity. At the same time, cash transfers seem to be more politically acceptable when the design features targeting or conditionality or a combination of the two.

## Impact on inequality

**Focusing on the impact of cash transfers on income inequality, the evidence shows the large redistributive potential of cash transfers.** However, the magnitude of impact varies across countries and is constrained by the amount of the transfer. The redistributive effect of cash transfers is larger in Eastern European countries, where large scale welfare programmes are a legacy of former socialist rule, than in other regions of the world (Anderson et al., 2016). In contrast, in Latin America, although the progressivity of the cash transfers is high, CCTs redistributive impact is limited in most countries, with the exception of Brazil, Mexico and Ecuador (Anderson et al., 2016; Amarante and Brun, 2016). This is mainly due to the size of these programmes, which amount to about 0.5% of GDP in most Latin American countries.

**In sub-Saharan Africa, several countries launched cash transfer programmes on a pilot basis, over the last decades, with the aim to move from emergency assistance towards more permanent social protection programmes. Comparative analysis on the redistributive impact of cash transfer programmes is nascent but promising.** Findings from a recent study assessing

## Box 8: Case study – Bolsa Família in Brazil

**The Bolsa Família programme was introduced as a nation-wide programme in Brazil in 2003 and rapidly increased its coverage to cover about 23% of the Brazilian population in 2018** (Ćirković, 2019). The coverage rate was set to match the poverty rate with the intention that all households with an income below the national poverty line would be eligible for the programme. The programme provides low income households with regular cash transfers, on the condition that they comply with specific behaviours, such as send their children to school or ensure they are properly vaccinated. In 2018, the monthly payment represented about 13% of the average income of beneficiary families (World Bank, 2020b).

**There is strong evidence that the Bolsa Família programme has successfully reduced poverty and inequality.** The World Bank estimates that by 2015 the percentage of the population living below the international poverty line had dropped from 13 percentage points to three in Brazil, with Bolsa Família accounting for between 33% and 50% of the observed decline (World Bank, 2020b). The programme has also contributed to reducing income inequality, as measured by the Gini Index, by around 2.7 points. This represents a significant impact on inequality, especially when one considers the fact that the Bolsa Família programme used to represent around 0.6% of GDP or 2.5% of the national budget.

**Regarding the implementation arrangements, a new ministry was specifically created at the central level to manage and monitor the implementation of the programme.** A unified single registry of all beneficiaries was set up to storage and manage beneficiaries' data. The enrolment of beneficiaries and case management was devolved to the municipal level wherever possible (Lindert, 2005).

**Despite the critical impact of Bolsa Família on poverty and inequality, the current government is reducing spending on this social assistance programme**, in the name of a different strategy to fight poverty, which relies on boosting economic growth and job creation, while cutting public expenditure. An article by The Economist (2020) reports that Bolsa Família will cost 0.4% of GDP by the end of 2020, with the average benefit falling in real terms because the transfer value is not automatically adjusted for inflation. The same article cites that the Bolsa Família shrinkage is the most important contributor to the observed recent increase in inequality in the country.

the feasibility of income floors in nine sub-Saharan Africa countries (Comoros, Ghana, Ivory Coast, Namibia, South Africa, Tanzania, Togo, Uganda, Zimbabwe) indicate that the existing joint impact of taxes and transfers reduce inequality in all countries (Lustig, Jellema, and Pabon, 2019). However, current combination of taxes and transfers increase post-fiscal poverty in all countries but upper middle-income Namibia and South Africa. This is because most countries in the study rely on indirect taxes as the main channel to collect revenues and use the largest proportion of resources to finance general price subsidies (especially on energy subsidies) rather than on cash transfers. In this scenario, the continuing expansion of non-contributory transfers could be an effective way to tackle inequality. Cash transfers can be an important part of a strategy to phase out fuel subsidies, which are regressive, while also increasing the progressivity of public spending.

**To conclude, cash transfer programmes could be a policy tool to reduce economic inequality (Braun and Ikeda, 2021).** However, the impact of cash transfer programmes on inequality reduction depends on the size of the transfers, which are often too small to make a long-lasting difference (Barba, van Regenmortel and Ehmke, 2020).

## Take-aways

- **Larger cash transfer programmes will have larger impacts on inequality and poverty.** But they may be more difficult to implement politically.

- **Starting a programme small may build political support amongst beneficiaries.**

- **Government expenditure is the most effective way to increase income for people in poverty.** Government expenditure on cash transfers, and public goods such as education and health should be encouraged and made as equitable as possible.

- **Funding cash transfers through consumption taxes can result in a regressive programme.** Income taxes are a more appropriate source of revenue.

- **The use of conditionalities needs to carefully consider the implications of targeting women for gender relations**, to avoid reinforcing traditional gender roles and unintentionally absolve men of responsibility in meeting conditions.

# 5

# RECOMMENDATIONS

**In the previous chapters, we have examined selected fiscal policies with regard to their inequality reducing impact and looked at design options supplemented by best practice examples. The main recommendations, which can be drawn from the analysis above, are the following:**

**Fiscal policy can have substantial impact on income inequality.** A more equal distribution of income is correlated with faster economic growth, poverty reduction, as well as more social cohesion. This Handbook examined the tools fiscal policy offers to reduce levels of inequality, focussing on developing countries. The analysed policies were selected as they are most used by governments (CIT, PIT, VAT) or could have a substantial impact on the reduction on inequality (e.g. wealth taxes including property taxes). The following recommendations are focussed on how to make these taxes as progressive as possible. However, it is also important to look at the bigger picture and consider all policies in place. Sometimes there may be also trade-offs with other policy goals which would need to be carefully balanced against each other. In some cases, individual elements of a package may be regressive. However, this could be necessary for either political or technical reasons. This should be tolerated if the entire reform package is progressive. Carbon pricing is a good example for this.

**In order to design policies effectively, governments should have a deep knowledge of their country's distribution of income, the causes and drivers of inequality as well as the behaviour of taxpayers in their specific context.** In fact, having a thorough knowledge and reliable data of income and wealth is scarce. This is partly due to the fact that relevant data is not collected by statistical administrations to track inequality. In addition, household surveys often underestimate the income and wealth of people at the top of the income distribution. These interconnected aspects must be known and considered before deciding which policies, be it taxes or transfers, to implement.

**Governments with more revenue can redistribute more.** This is because more tax revenue offers more opportunity for the successful implementation of inequality-reducing taxes. Larger governments also have more resources to provide cash transfers and expenditures on health and education that reduce inequality. Governments of developing countries should aim to increase their ability to tax in order to improve their ability to reduce inequality.

**To make tax systems as progressive as possible, governments should use income taxes more than consumption taxes.** However, it should be borne in mind that consumption taxes are effective revenue raisers, hence an adequate tax mix should be reached. Property taxes are a good substitute for countries that have not developed the capability to levy income taxes on a large scale.

**Wealth taxes can also reduce (wealth) inequality.** Yet there will be a constant lobbying effort to reduce the taxes' impact by allowing further exemptions. This pressure needs to be resisted, otherwise the tax will not achieve its goals. If a tax on net wealth is introduced, a relatively simple and easy to administer design is the key: the identification and valuation of taxable assets should be relatively easy and if property should be included and an additional property tax exists, it needs to be sure that no double taxation occurs (e.g. through the introduction of credit mechanism). If taxes on net wealth are too complex to administer, countries could opt for an inheritance tax, which would accomplish the same goals and is easier to collect. The use of wealth taxation can also increase public perceptions of fairness, which can lead to acceptance of further government redistributive spending and further taxation.

**Closing loopholes as well as cooperation and information sharing both on a national as well as an international level can be important tools to make sure the wealthy, individuals and companies, contribute their**

fair share of taxes. Next to interagency cooperation, exchange of information and other mutual assistance in tax matters will enable tax authorities to coordinate internationally and thus detect and deter tax evasion. These measures might be easier to introduce from a political point of view than introducing completely new taxes. The implementation of BEPS-measures helps to prevent tax avoidance through overly aggressive and artificial tax planning.

**Consumption taxes are effective revenue raisers and should therefore form part of any tax mix, although the tax itself tends to be regressive.** Targeted zero-rating or introducing lower rates for basic goods might still be helpful for the poorer. Nonetheless, zero-rating products for consumption taxes is not actually progressive unless the product or service is consumed almost entirely by people in poverty. Using fewer exemptions and rates increases efficiency. To improve the progressivity of consumption taxes, excise taxes on luxury goods and socially undesirable goods (e.g. alcohol and tobacco) could be introduced or taxed with a higher rate.

**Recycling revenue from carbon pricing can make the final outcome progressive.** Social grants are the most progressive method to recycle revenue, while lowering distortionary taxes is more efficient. Governments need to make a political decision on which aim is more important.

**Financing cash transfer programmes through the use of consumption taxes can result in the entire programme being regressive.** A more appropriate source of revenue is income taxes, but these may not always generate sufficient revenue.

**The effect of cash transfers will depend to a large extent on the size of the transfer.** Middle-income countries are able to raise more revenue than low-income countries and are thus able to achieve larger reductions in income inequality and poverty through cash

transfers. Eastern European countries have also been able to sustain large cash transfers introduced under socialism. Mexico was able to fund cash transfers through reallocating funding from the abolition of subsidies. This could result in a large decrease in inequality as subsidies are regressive.

**Governments should make cash transfers as large as politically feasible.** Evidence of the positive impact of the programme can then be used to scale up the programme over time. However, financial restrictions must be taken into account.

**No single design of a cash transfer will be effective automatically.** Governments should tailor proposals to the administrative capacity to implement policy and the political conditions they operate under. Some populations are more tolerant of unconditional cash transfers than others. The use of conditions might increase political feasibility, although making transfers conditional involves large administrative costs, and there is little evidence that the conditions achieve the poverty-reducing impacts that are desired.

**In developing countries, targeting transfers to people in poverty is difficult and results in higher administration costs.** Poor targeting can also reduce political popularity of programmes. Categorical targeting is more effective under these circumstances. The use of conditionalities can unintentionally lead to conflicts due to traditional gender roles. Nevertheless, targeting women and including them in conditionalities leads to a reduction of gender inequality.

**The COVID-19 pandemic has highlighted the potential role that efficient and effective cash transfer programmes could play in governments' response to external shocks that exacerbate existing poverty and inequality levels.** Well-designed programmes provide short-term relief to the targeted most vulnerable social strata, including those in the informal sector. For example, cash transfer programmes were implemented in 19 countries in Western and Central Africa as part of the COVID-19 response and proved the potential for adaptive protection measures (World Bank, 2021). However, they also revealed the need for a resilient underlying social protection system and infrastructure to tackle poverty in the long run.

**Overall, it can be seen that combating inequality through fiscal policies can only be effectively achieved if both the revenue and the expenditure side is considered.** On the one hand, taxes can play a large role in fiscal redistribution when it is focussed on extreme wealth. On the other hand, increasing the income of people in poverty is more effectively achieved through transfers and government expenditure. In the absence of government interventions, health and education outcomes are highly unequally distributed and closely linked to income. The rich have better health access and outcomes and achieve better education. Government's intervention should be aimed at providing similar outcomes for all citizens, regardless of their income. Countries that have a more inclusive education system are also able to make health services more inclusive. Thus, a holistic package of fiscal policies is important when tackling the reduction of inequality.

6

# POLICY MATRIX

## Table 1: Policy matrix

| Policy instrument | Strengths | Weaknesses | Impact on inequality | Impact increased by | Multilateral dimension | Take-aways |
|---|---|---|---|---|---|---|
| Progressive personal income taxes (PIT)  | Collects substantial revenue in developed economies.<br>Able to be levied according to the ability to pay, so strong inequality-reducing component. | Informality can make PIT collection difficult in developing countries, even if people earn considerable amounts of income.<br>Can be difficult to determine income.<br>Taxing capital at a different rate than general income may have advantages but can also create opportunities for avoidance and increase horizontal inequality.<br>Has impact on decision to work and labour supply, so is not efficient.<br>Taxing capital income differently can reduce horizontal inequality, as taxpayers with the same income but different sources of income could pay different tax rates. | Can have large impact on the incomes of the wealthiest.<br>Use of basic allowance can exempt people in poverty from the tax, increasing the inequality-reducing impact. | PIT and CIT improve collection of each other, as they enable more transparency about salary payments.<br>Taxation on net wealth can push wealthy taxpayers into paying more PIT as assets are declared. | The Global Forum on Transparency and Exchange of Information for Tax Purposes is an enabling mechanism to increase transparency to reduce evasion. | Progressive PIT are needed to ensure that the tax system is progressive.<br>Authorities in developing countries should begin the implementation with a large basic exemption to ensure progressivity and administrative efficiency. As tax administrative capacity increase, the basic allowance should be reduced.<br>Exemptions should be kept to a minimum. If this is not possible, an alternative minimum tax can be used.<br>It should be made sure that the top tax bracket with the highest tax rate targets the wealthiest. |
| Corporate income tax (CIT)  | Collects substantial revenue.<br>Generates large amount of revenue in developing countries. | A complex tax to administer because it requires calculation of net profit, and many deductions can apply.<br>Use of CIT rates as a policy tool for other objective, for example, attracting investment, can result in many rates, which is inefficient, and increases administrative complexity.<br>Tax incentives should be analysed for effectiveness before they are introduced and monitored over time to ensure they continue to be effective. | Can impact the incomes of the wealthiest.<br>Simplified tax regimes for small business can also be inequality-reducing.<br>The overuse of incentives reduces the revenue pool without necessarily achieving more investment. | PIT and CIT improve collection of each other, as they enable better taxation of capital income. | The OECD/G20 Inclusive Framework on BEPS is working on measures to increase tax avoidance through aggressive tax planning by multinationals.<br>International co-operation is a crucial element in preventing base erosion by multinationals. Initiatives, such as joint audits and exchange of information increases dispute prevention and the risk of double taxation. | CIT is an important component of a progressive tax system. Tax authorities should resist the urge to reduce tax rates in order to compete with other countries.<br>Tax incentives need to be carefully monitored, otherwise they could become overgenerous and result in the effective CIT rate going to zero.<br>Base broadening through reducing exemptions can increase the revenue take.<br>Alternative minimum taxes can reduce administration costs.<br>International cooperation on taxation is reducing tax avoidance. Developing countries should participate as much as possible. Measures include exchange of tax information, country by country reporting and mutual assistance in tax matters, e.g. joint audits.<br>Simplified regimes for small businesses are a good mechanism both for the tax authority and the taxpayer, and their use is encouraged. |

| Policy instrument | Strengths | Weaknesses | Impact on inequality | Impact increased by | Multilateral dimension | Take-aways |
|---|---|---|---|---|---|---|
| Consumption taxes | Raises substantial amounts of revenue.<br>An efficient tax as it does not distort markets.<br>A VAT generates its own audit trail, which makes it simple to administer.<br>Consumption taxes are neutral as they do not advantage once sector of the economy over another. | Does typically not consider ability-to-pay-high vertical inequality.<br>Difficult to make more progressive as retailers will capture some of the benefit of zero-rated products. | Consumption taxes tend to be regressive, especially at higher incomes as the wealthy can save more of their income.<br>Regressivity can be offset to a small extent by exempting basic goods from consumption tax.<br>Consumption taxes can also be levied on luxury goods to increase the inequality-reducing impact. | | | Consumption taxes are easy to implement, raise large amounts of revenue and are efficient. They should be part of every tax system, but care must be taken not to overuse the tax, as has occurred in Latin America.<br>Of the consumption taxes available, the VAT is the simplest to administer and has the virtue of generating corroborating information.<br>The VAT is regressive so it needs to be complemented with targeted excise taxes, which can be levied on luxury goods.<br>Certain products that are used mainly by the poor should have a zero or lower rate. |
| Property taxes | Most efficient type of tax as it creates few distortions in markets.<br>Because property tax is usually used to fund local government, it can be used to link taxation and service delivery in the minds of citizens. | Can be difficult to administer without an up to date database of property ownership.<br>Determination of property value can be quite complex. | In developing countries, the property tax will have a substantial impact on inequality because property ownership is unequally distributed.<br>In developed economies, the incidence of the tax is likely to fall on the middle-class, as they own much of their wealth in housing.<br>Impact increased by the fact that properties are not mobile.<br>Impact could be increased by raising rates on second homes. | | | Taxes on property are generally underused.<br>There is a long history of implementing property taxes in developing countries. Tax authorities are encouraged to review this history to determine which approach works best in their particular context.<br>It is not necessary to implement the property tax with the most sophisticated valuation methods from the start. Authorities can begin implementation, thus building administrative capacity, and only implement more sophisticated approaches once it is feasible. |

| Policy instrument | Strengths | Weaknesses | Impact on inequality | Impact increased by | Multilateral dimension | Take-aways |
|---|---|---|---|---|---|---|
| **Wealth taxes**  | Aimed directly at reducing inequality.<br>Can enhance efficiency of the tax system by taxing assets derived from income that may not have been taxed. | Lobbying by the wealthy leads to the adoption of exemptions, which can reduce the effective rate to low levels, even zero. This has occurred in several countries.<br>Identification of relevant assets and valuation can be complex.<br>An expensive tax to collect as the wealthy have access to tax planning resources.<br>Does not raise much revenue. | Strong impact as the tax is borne by the wealthy. | Because the tax is aimed specifically at the wealthy, it could increase public acceptance of other government taxation through increasing perception of fairness.<br>Wealth taxes increase the impact of CIT and PIT as assets are declared. | Participation in the Global Forum on Transparency and Exchange of Information for Tax Purposes is increasing transparency to reduce evasion. | Wealth taxes are an essential part of a well-functioning tax system. They should be used for their inequality-reducing impact, more than for revenue generation.<br>The urge to amend the wealth tax through adding exemptions needs to be resisted very strongly.<br>The difficulty administering a wealth tax means that it may not be appropriate for all developing countries. If tax administration capacity is weak, it may be better from an inequality perspective to focus on PIT and CIT first.<br>Inheritance taxes are easier to administer than net wealth taxes and achieve similar goals, so they should be implemented before a net wealth tax. |
| **Digital services tax (DST)**  | Enables jurisdictions to make up for revenue lost through consumption moving online and loss of physical nexus. | The introduction of unilateral digital services taxes leads to a further fragmentation of the international tax system, which can result in double taxation and an increased compliance burden. A global solution as currently sought by the Inclusive Framework on BEPS can prevent this. | DSTs have raised little revenue so far, so they are unlikely to be having much of an impact on inequality, for now. However, they are a relatively new kind of tax. Better administration of the tax may result in a larger impact. | | The OECD/G20 Inclusive Framework on BEPS is working on international guidelines on the taxation of the digital economy. These guidelines were due to be completed by the end of 2020 but have been delayed by the COVID-19 crisis.<br>The African Tax Administrative Forum (ATAF) is developing guidelines for implementing DSTs in Africa. | May be worthwhile to delay implementation to see what results from multilateral negotiations about the digital taxation in order to avoid a fragmented international tax law landscape.<br>In order to ensure tax authorities, have access to the relevant data existing reporting and disclosure obligations may need to be reviewed and enhanced.<br>DSTs are less of a priority in terms of inequality than other taxes such as taxes on income, consumption taxes and even carbon taxes. |

| Policy instrument | Strengths | Weaknesses | Impact on inequality | Impact increased by | Multilateral dimension | Take-aways |
|---|---|---|---|---|---|---|
| Carbon tax | Carbon pricing has been shown to be effective in decreasing carbon emissions. | Carbon taxes are regressive.<br>Carbon prices are currently too low to achieve the scale of carbon reduction needed.<br>Public support for carbon taxes in developing countries could be undermined by the perception that economic growth is more important. | Carbon taxes are regressive because people in poverty spend a greater proportion of their income on carbon-intensive goods than the wealthy do.<br>To reduce regressivity, the revenue generated by the tax should be spent progressively. In some cases, the carbon tax programme as a whole can be progressive. | Carbon taxes in individual economies will be enhanced by global adoption of carbon taxes. | | Getting carbon pricing right is fundamental to the future habitability of our planet. Thus, even though carbon taxes can be regressive, it is recommended that developing countries implement carbon taxes.<br>The regressivity of the tax can be offset by progressive recycling of revenue. This needs to be targeted to the poor as much is politically possible.<br>In countries with high levels of trust in politicians and government, revenue can be used in general government revenue. In countries where trust levels are lower, use of the revenue should be tied to specific expenditures. This could include social grants. |
| Cash transfers | Cash transfers can have large impacts in the lives of people in poverty, leading to decreases in inequality and poverty. | Unconditional cash transfers can be seen as too generous, resulting in programmes being vulnerable to being closed or reduced.<br>Transfers targeted at the poor can be expensive to administer and result in non-poor beneficiaries receiving grants. | If targeting is accurate, then cash transfers can have substantial impact on inequality.<br>The IMF argues that cash transfers are the most effective mechanism to reduce inequality at the bottom end of the income distribution. | Government spending on health and education can increase the impact of cash transfers.<br>Transfers can demonstrate the positive impact of government spending, thus leading to greater public acceptance of other types of social expenditure and the levying of taxation.<br>Larger programmes will have larger impacts. Thus, being able to raise more tax revenue is associated with a more effective cash transfer programme. | | Larger cash transfer programmes will have larger impacts on inequality and poverty. But they may be more difficult to implement politically.<br>Starting a programme small may build political support amongst beneficiaries.<br>Targeting beneficiaries based on demographic characteristics should be preferred where administrative capacity is low.<br>Funding cash transfers through consumption taxes may result in a regressive programme. Funding should come from income taxes.<br>The use of conditionalities needs to carefully consider the implications of targeting women for gender relations, to avoid reinforcing traditional gender roles and unintentionally absolve men of responsibility in meeting conditions. |

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