Fiscal policies to reduce inequality

Policy brief

giz Deutsche Gesellschaft
für Internationale
Zusammenarbeit (GIZ) GmbH

As a federally owned enterprise, GIZ supports the German Government
in achieving its objectives in the field of international cooperation for
sustainable development.

Published by:
Deutsche Gesellschaft für
Internationale Zusammenarbeit (GIZ) GmbH

Registered offices
Bonn and Eschborn, Germany

Friedrich-Ebert-Allee 32 + 36
53113 Bonn
T +49 228 4460-0
F +49 228 4460-17 66

Dag-Hammarskjöld-Weg 1-5
65760 Eschborn
T +49 61 96 79-0
F +49 61 96 79-11 15

E info@giz.de
I www.giz.de/en

Author:
Oxford Policy Management (OPM), Berlin

Editor:
GIZ sector programme "Good Financial Governance"
GIZ sector programme "Reducing Poverty and Inequality as part of the 2030
Agenda"

Design/layout:
DIAMOND media GmbH, Neunkirchen-Seelscheid

Photo credits:
Shutterstock.de

Bonn 2021

Acknowledgements

This publication was commissioned at the end of 2020 by the Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ) GmbH and coordinated and updated by Sandra Stelzner and Julia Bastian of the GIZ sector programme "Good Financial Governance" as well as by Miriam Reiboldt and Julia Debski of the GIZ sector programme "Reducing Poverty and Inequality as part of the 2030 Agenda". GIZ would like to thank Oxford Policy Management (OPM) for the analysis. It has benefitted from invaluable discussions with and comments from Judith Zimmermann (OPM), Owen Willcox (OPM), Virginia Barberis (OPM), Sebastian Silva Leander (OPM), Gereon Kaus (GIZ) and Holger Apel (GIZ). If you have any questions, please do not hesitate to contact us at poverty-inequality@giz.de or public-finance@giz.de.

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

Table of contents

List of tables, boxes and figures

Designing fiscal policies to reduce inequality in developing countries

Background – inequality and fiscal policies

Inequality is on the rise in many countries worldwide. It is becoming an obstacle for economic growth, endangers social cohesion and hinders the functioning of democracies worldwide.

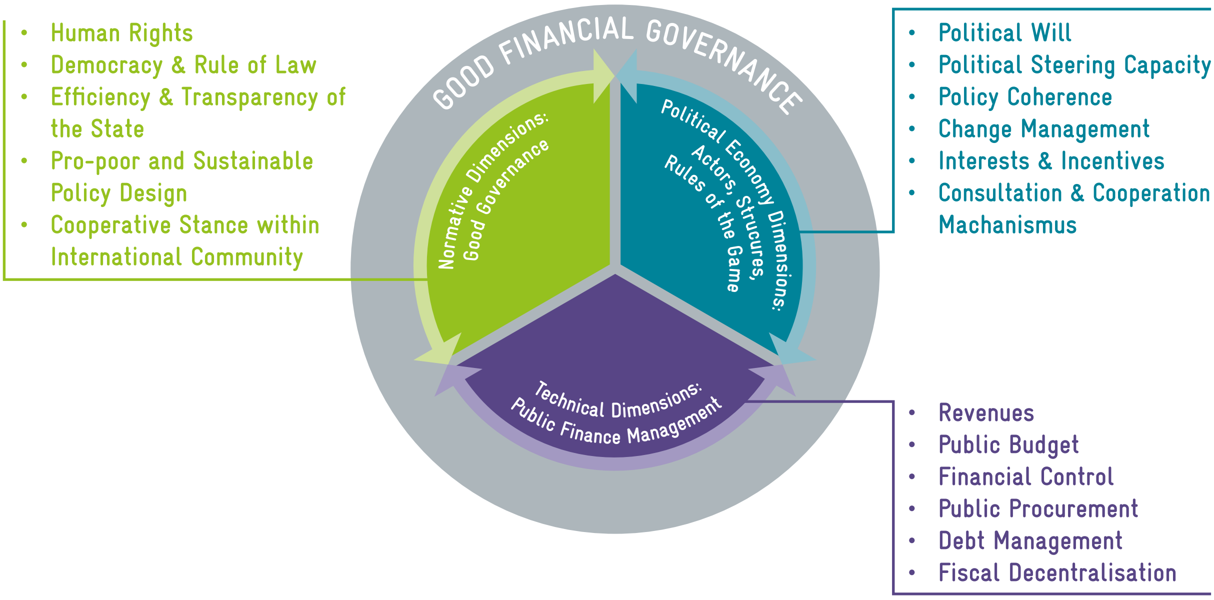
The COVID-19 pandemic exacerbated inequality and threatens the progress made so far. The decline of the global economy, the loss of jobs and the lack of social protection for minorities as well as unequal access to health services and an uneven vaccination rollout act as accelerators of inequality. This 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.

As fiscal policies are one of the most powerful instruments available to governments to reduce poverty and inequality, tackling inequality through fiscal policy design, needs to be high on the political agenda.

The good financial governance (GFG) approach and the reduction of inequality

The German development cooperation (GDC) takes a holistic view of fiscal policy incorporating the normative and political-economy dimensions of policy formulation in addition to the technical dimension (see Figure 1). As such, GFG is focusing on the reduction of poverty and inequality through fair, accountable and transparent public financial management systems. Within this strategic approach six main technical areas are identified, 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.

Figure 1: Dimensions and areas of action of the good financial governance approach



Fiscal policies are defined as governments' use of revenue or expenditure and can be particularly useful in reducing inequality of income and wealth. 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.

This policy brief presents the results of a thorough analysis of the impact of selected fiscal policies on inequality. It depicts the status quo of inequality reducing fiscal policies in the reform partner countries of German development cooperation (GDC) in order to provide guidance for further cooperation in this regard.

Designing and implementing inequality-reducing fiscal polices

OVERVIEW

Fiscal policies on the revenue and on the expenditure side impact inequality differently. Therefore, both sides need to be considered jointly to have the biggest impact on the reduction of inequality. Progressive taxation and other well targeted tax policies can ensure that taxpayers are taxed effectively and according to their ability to pay, meaning overall the richest persons or entities pay more taxes than the less wealthy. In contrast, the expenditure side can grant access to important basic services that increases the chances of generating higher income or wealth by less wealthy people in the future. Additionally, when designing fiscal policies, existing trade-offs between competing objectives need to be considered and balanced against each other, e.g. revenue mobilisation, inequality reduction or other policy goals such as investment promotion or climate protection.

On the revenue side, the tax mix and the design of each tax is crucial when it comes to the effectiveness of combating inequality. Not every tax is equally suited for reducing inequality because some taxes, e.g. the value-added tax (VAT), do not consider the ability of taxpayers to pay and thus tend to be regressive. Yet, they can generate large amounts of revenue because of their relatively easy implementation and enforcement amongst others. As can be seen below, taking the ability to pay of taxpayers in the design of taxes into account can make their implementation more complex, as there is no single standardised approach.

On the expenditure side, evidence suggests that the redistributive impact of education, health and social protection spending is large and progressive but needs to attain a certain spending level to have impact. Several studies find that the redistributive impact of fiscal policy interventions is greater on the spending side of the budget. In recent years, cash transfer programmes have gained importance and became an essential tool of redistribution. They have also played an important role in COVID-19 response measures. They need to be carefully designed and their scope depends on available financing, either through domestic resources or donor-funding. As donor funding can cease, long-term sustainability of cash transfer programmes depends on securing continuous domestic funding.

> Fiscal policies on the revenue and on the expenditure side impact inequality differently. Therefore, both sides need to be considered jointly to have the biggest impact on the reduction of inequality.

POLICY CONSIDERATIONS

Fiscal policy considerations to reduce inequality are numerous; this brief focusses on the design of personal income taxes (PIT), corporate income taxes (CIT), wealth taxes, consumption taxes, digital services taxes and carbon pricing as well as conditional and unconditional cash transfer programmes. For a more detailed overview of fiscal policy considerations refer to Table 1 in the Annex.

A well-designed progressive PIT takes the ability to pay of a taxpayer into account and can act as a counterweight to more regressive taxes, such as VAT. However, due to a large informal sector including wealthy individuals evading taxes, developing countries face specific challenges with the implementation of PIT. Therefore, administrability should be one of the guiding principles when designing a PIT in order to reflect limited capacities of tax administrations. Moreover, it should be avoided that wealthy individuals profit more from allowable deductions and exemptions than people in poverty. Two major features are specifically helpful in this regard:

- Having a **large basic allowance** that excludes people under a certain income threshold from taxation.

- Introducing an **administrable number of tax bands** with adequate rates including a top band directed at the very rich with a top tax rate.

With regard to the latter, it should be especially avoided that the majority of taxpayers falls within this top band. Additionally, to reduce inequality, a PIT should be designed in a way that company owners do not have any or only little incentive to shift salary income into capital income, such as dividend income, which is often taxed considerably lower than salary income.

Corporate taxation is an effective revenue generator, also in developing countries, and can support the reduction of inequality as company ownership is extremely unequally distributed. Thus, taxing companies through CIT can help to make sure that they contribute their fair share to public revenue. In this context, it is important that exemptions are carefully designed, for example, being of temporary nature and monitored over time, to make sure that the forgone revenue creates a benefit for the country, e.g. increased investment and employment. Having less burdensome compliance obligations and eventually even lower tax rates for micro and small businesses might be another option to promote these businesses. This eventually leads to higher economic growth and job creation and in the end also to additional revenue as they grow over time. Additionally, loopholes should be closed since they allow multinational enterprises to take advantage of differences in tax systems in different countries through aggressive tax planning. To ensure that multinational enterprises pay a minimum corporate tax rate and to address the current challenges arising from the digitalisation of the economy, 132 jurisdictions have committed to the OECD Inclusive Framework's two-pillar plan to reform the international tax system on the 1st of July 2021. The OECD announced that the details and the process of implementation are to be finalised in October 2021 at the earliest.

Wealth taxes including property taxes target the wealthy and can thus contribute to decreasing inequality within a country. Wealth taxes can take different forms, such as net wealth taxes, gift and inheritance taxes and property taxes, amongst others. In comparison to income taxes, they do not tax the income of a taxpayer, but their possessions. Comparable to the PIT, an administrable approach should be chosen as the identification and valuation of wealth can become quite complex, thus limiting effective implementation. To not burden people in poverty, an appropriately large basic allowance should be used. Additional exemptions should be kept to a minimum to avoid that the tax burden can be effectively reduced to a minimum or even zero, as those taxes usually do not mobilise a lot of revenue. Property taxes raised at a local level could finance enhanced local service delivery which could improve citizens' acceptance of the tax. To implement up-to-date property taxes, land and/or property registries are needed to certify and verify actual ownership. However, the introduction of wealth taxes or consumption taxes directed at the wealthiest might be particularly hard to introduce as they are usually an influential lobby and therefore often influence (political) decisions in their favour.

In addition to different design options of income and wealth taxes, it is generally important to close loopholes in existing laws and make sure that especially the wealthy contribute their fair share to public revenue through respective policies. High net-worth individuals as well as large multinationals have better access to aggressive tax planning expertise. This can result in revenue losses for governments through tax avoidance and tax evasion. Interagency as well as international cooperation can help to address these challenges, for example through:

- (automatic) exchange of information,
- joint audits,
- other mutual assistance in tax matters, and
- participation in initiatives such as the Global Forum or the OECD Inclusive Framework on Base Erosion and Profit Shifting (BEPS) which support international cooperation.

Additionally, these policies need to be supplemented by increased implementation and enforcement efforts. Focussing these efforts on the wealthy takes limited capacities in developing countries into account and helps to improve tax administration performance. The reason for this is that the cost-benefit ratio is better when focusing on wealthier taxpayers instead of small taxpayers. The latter generally contribute

only a small amount to the total tax revenue due to their small income. This can also increase the general acceptance of taxation and trust in government to ensure acceptance of the tax system by a larger part of the population. Furthermore, less complex tax designs and the use of digital solutions can facilitate the work of tax administrations and increase their performance. Digital solutions, such as enterprise resource planning systems or digital platforms can even contribute to make taxation less prone to corruption, because all activities can be monitored and due to automatization, less involvement of a person is required.

Consumption taxes such as VAT are excellent revenue generators, but they are not per se inequality reducing. Zero-rating products for consumption taxes are not actually progressive, unless the product or service is consumed almost entirely by people in poverty. However, in developing countries VAT could be progressive due to the high informality and VAT mostly being collected in cities and supermarkets where the wealthy live and consume. This shows how difficult it is to determine whether a tax is regressive or progressive. Nonetheless, ideally the revenue generated by consumption taxes is used for pro-poor spending. Regarding the design, using fewer exemptions and rates increases efficiency. However, some well-targeted zero-rating or lower rating of certain basic goods should be kept. To increase the fairness of the tax system, excise taxes on luxury goods and socially undesirable goods (e.g. alcohol and tobacco) could be part of the overall tax mix of a country.

Similar to consumption taxes, carbon taxes have their biggest impact on inequality by providing the government with revenue for pro-poor spending and deterring undesired behaviour. Climate and environment damages are usually felt first and hardest by people in poverty. Therefore, deterring damaging behaviour and using the generated funds for pro-poor spending can help to reduce inequality, protect the most vulnerable and our planet as a whole at the same time. Social grants are the most progressive method to recycle revenue from carbon taxes, while lowering distortionary taxes is more efficient. Governments need to make a political decision which aim is more important.

Digital services taxes are recently emerging taxes; hence, it is difficult to fully assess their revenue generation potential. However, their introduction could make the tax system fairer and reduce existing inequality, as online service provision can be done remotely without having a physical presence in a country. Consequently, there is the potential that those companies are usually only subject to tax in their jurisdiction of residence, but not where value is created through user participation.

In addition, the expenditure side is particularly important for the reduction of inequality. Health and education spending, for example, promotes growth and productivities and reduces inequalities as well as disparities in human capital. Spending on social protection reduces poverty and ensures income security across the life cycle of a beneficiary, specifically in emergencies, such as the global health crisis or climate change. Public spending is also crucial to reduce gender inequality.

Cash transfer programmes can support the reduction of inequality by providing regular cash assistance to people in poverty and other 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 (CCTs) or unconditional (UCTs), depending on whether the beneficiary needs to comply with specific behavioural requirements to be eligible for the transfer.

The effect of cash transfers will depend to a large extent on the size and the funding source or mix of the transfer. Middle-income countries can raise more revenue than low-income countries and are thus able to achieve larger reductions in income inequality and poverty through cash transfers. If financed through reallocating funding from the abolition of – usually regressive – subsidies, this could lead to a large reduction of inequality. Financing cash transfer programmes through 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 enough revenue.

Governments should make cash transfers as large as politically feasible considering the political buy-in of the population. Size refers not only to the amount of cash received by each beneficiary, but also ensuring coverage of all the population that is considered as beneficiary. Evidence of the positive impact of the programme can then be used to scale up the programme over time. Some populations are more tolerant of unconditional cash transfers than others. Applying conditions might increase political feasibility, although making transfers conditional involves large administrative costs and there is little evidence that the conditions achieve the desired poverty-reducing impacts.

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. Poverty targeted cash transfers and child grants typically identify women as recipients. It has been shown that these targeted transfers increase women's decision-making

power and control of resources. However, some argue that targeting women automatically places responsibility on them to fulfil programme's requirements. Hence, the use of conditionalities needs to carefully consider gender relations in specific context to avoid unintentionally reinforcing traditional gender roles.

When designing cash transfers, governments should tailor proposals to their administrative capacity. Effective cash transfer programmes need appropriate institutional arrangements and staffing, data information management e.g. on eligibility criteria or complaints tracking, communication measures that reach beneficiaries as well as reliable finance and accounting to make sure transfers are disbursed timely and accurately.

SPOTLIGHT ON THE GERMAN REFORM PARTNER COUNTRIES

The ability of the German reform partner countries, namely Côte d'Ivoire, Ethiopia, Ghana, Morocco, Senegal, Tunisia and Togo, to reduce inequality is limited by their relatively low level of tax revenue as well as common concerns such as high levels of informality and expensive subsidies. More revenue for the government provides the opportunity for a greater reach of targeted expenditure such as cash transfer schemes, which can have a substantial impact on poverty and inequality. Moreover, high levels of informality make the collection of taxes difficult and subsidies on fuels and electricity can be regressive, i.e. creating a larger benefit for population with a higher income.

Hence, strengthening tax administration capabilities and increasing the amount of collected tax is an ongoing concern. Tunisia is the most advanced in this respect, yet there is room for improvement. Most countries could benefit by focusing their initial tax efforts on the few taxpayers who should be paying most of the tax, e.g. by establishing / further strengthening a tax unit for the largest corporate and individual taxpayers as advised by the International Monetary Fund. Interagency and international cooperation, such as exchange of information and mutual assistance, are effective means to combat tax avoidance and evasion, which is usually prevalent among the wealthier. In addition, the demonstration effect of targeting wealthy taxpayers can increase public perceptions of the fairness of taxation, compliance by the non-wealthy and trust in the government.

Most of the reform partner countries grant subsidies, either to petroleum products or to electricity, or to both. These subsidies are regressive and should be reviewed. Reform of these subsidies is difficult because they are popular with the electorate. However, appealing to a more efficient use of public resources to alleviate poverty but also promote longer-term human capital development might make the abolishment of subsidies more acceptable.

Property tax remains underutilised in the reform partner countries; its increased use is recommended. The property tax is inequality-reducing and there are mechanisms to implement it, even in an environment of weak land administration. Encouragingly, Ethiopia discussed the introduction of property taxes in the fiscal year 2020/21. Senegal and Cote d'Ivoire are also planning to improve collection of property taxes in the near future.

Annex

Table 1: Policy matrix of fiscal policies to reduce inequality

	Strengths	Weaknesses	Recommendations
Personal income taxes (PIT)	• Able to be levied according to ability to pay, strong component to reduce inequality	• Informality can mean PIT is hard to collect in developing countries • Fairly complex to implement	• Increase the rate applying to the top income band • Use a large basic exemption, which ensures that people in poverty are not covered in the PIT net • Other exemptions should be kept to a minimum. If this is not possible, an alternative minimum tax can be used • If tax administration capacity is very weak, a flat tax may be temporarily appropriate
Corporate income taxes (CIT)	• Generates large amount of revenue in developing countries • Strong component to reduce inequality because company ownership is distributed extremely unequal so any tax that impacts on corporate profitability is likely to have an equalising impact	• A complex tax to administer • Lower rates are used to attract investment or to promote one particular industry, although cuts in CIT tax rates are associated with reversing this equalizing impact (although tax rate cuts can be balanced with base broadening)	• Consider if and to what extent a reduction in tax rates creates an incentive for companies to invest/to stay competitive • Review of exemptions with regard to their effectiveness • In cases where enforcement capability is low and use of exemptions is high, consider the use of an alternative minimum tax[1]
Consumption taxes	• Raise substantial amounts of revenue • Relatively simple to administer • Does not advantage one sector of the economy over another	• Usually regressive at high levels of income because the wealthy consume relatively less of their available income and thus save more than people in poverty • Consumption taxes do not base tax rates on ability to pay, so their impact on inequality is limited	• Certain products that are used mainly by people in poverty should have a zero or lower rate • Consumption taxes can also be levied on luxury goods, to increase the inequality-reducing impact

1 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, but it would seem suited to developing economies too.

	Strengths	Weaknesses	Recommendations
Property taxes 	• Most efficient type of tax as it creates few distortions in markets • 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 • Equalising impact because properties are mainly owned by the better off	• Can be difficult to administer without an up to date database of property ownership • Determination of property value can be quite complex	• Impact could be increased by raising rates on second homes • Adding property tax to invoices for municipal electricity and water supply makes compliance easier for taxpayers and offers munici-palities the option of cutting off services if the tax is not paid • Not necessary to implement the property tax with the most sophisticated valua-tion methods from the start. Governments can begin im-plementation, thus building administrative capacity, and only implement more so-phisticated approaches once it is feasible • Link the use of revenues from tax property to better service delivery can improve political feasibility
Wealth taxes: inheritance ta-xes and taxes on net wealth 	• Aimed directly at reducing inequality, thus strong impact as the tax is borne by the wealthy • Can enhance efficiency of the tax system by taxing income that may not have been taxed	• Lobbying by the wealthy leads to the adoption of exempti-ons, which can reduce the effective rate to low levels, even zero • An expensive tax to collect as the wealthy have access to tax planning resources • Total revenue is usu-ally modest	• If tax administration capaci-ty is weak, it may be better to focus on PIT and CIT first to reduce inequality. Further, many countries abolished the net wealth tax • Inheritance taxes are easier to administer than net wealth taxes and achieve similar goals, so they should be implemented before a net wealth tax. Appeals to fairness can be a potent political tool to compel the rich to pay wealth taxes and use of exemptions needs to be resisted very strongly

	Strengths	Weaknesses	Recommendations
Digital service taxes (DSTs)	• Enables jurisdictions to make up for revenue lost through consumption moving online and loss of physical nexus	• Could be difficult to administer in developing countries as tax authorities have little information about activities • DSTs have been recently introduced and have raised little revenue so far, so they are unlikely to be having much of an impact on inequality, for now • In the worst case, the passing on of the tax to the user might exclude poorer households from using services at all as they might not be able to afford the increase in prices	• DSTs are less of a priority than other taxes as their impact on inequality is small and they are potentially difficult to implement for developing countries • It may be worthwhile to delay implementation to see the results from multilateral negotiations about digital taxation, including solutions emerging from the OECD Inclusive Framework on Base Erosion and Profit Shifting (BEPS)[2]
Carbon taxes	• Effective in decreasing carbon emissions • Create revenues that can be linked to other policies to reduce inequality • Consequences from climate change will be borne by the poorest first, thus carbon taxes can help reducing negative impact of climate change on people in poverty	• Regressive because people in poverty spend a greater proportion of their income on carbon-intensive goods than the wealthy do • Public support for carbon taxes in developing countries could be undermined by the perception that economic growth is more important	• The regressivity of the tax can be offset by tying the use of revenues to other policies that promote equality. Policies need to be targeted to people in poverty as much as is 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, including cash transfers • Some carbon intensive goods which are primarily used in poor households could be exempted / have a lower rate if no adequate substitution exists

2 BEPS refers to legal tax planning strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations where there is little or no economic activity. This undermines the fairness and integrity of tax systems because businesses that operate across borders can use BEPS to gain a competitive advantage over enterprises that operate at a domestic level. Moreover, when taxpayers perceive that multinational corporations are legally avoiding income tax, it undermines voluntary compliance by all taxpayers.

	Strengths	Weaknesses	Recommendations
Conditional Cash transfers (CCTs) and Unconditional Cash Transfers (UCTs)  CCTs attach conditions to the monetary transfer, such as health check-ups UCTs do not impose any requirements on the beneficiaries in terms of actions that they must undertake in order to receive the transfer	• Large impacts in the lives of people in poverty, leading to decreases in inequality and poverty	• Small size of the transfer limits impact on inequality • UCTs can be seen as too generous, resulting in programmes being vulnerable to being closed or reduced • Transfers targeted at the poor can be expensive to administer and result in non-poor beneficiaries receiving grants • Making transfers conditional involves large administrative costs, and there is little evidence that the conditions achieve the poverty-reducing impacts that are desired	• 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 • Targeting beneficiaries based on demographic characteristics should be preferred where administrative capacity is low • Funding cash transfers through consumption taxes may result in a regressive programme. Funding should come from income taxes • 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

Deutsche Gesellschaft für
Internationale Zusammenarbeit (GIZ) GmbH

Registered offices
Bonn and Eschborn

Friedrich-Ebert-Allee 32 + 36
53113 Bonn, Germany
T +49 228 44 60-0
F +49 228 44 60-17 66

Dag-Hammarskjöld-Weg 1 - 5
65760 Eschborn, Germany
T +49 61 96 79-0
F +49 61 96 79-11 15

E info@giz.de
I www.giz.de