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Inequality and fiscal policy

Properly designed, fiscal policies can be effective tools for redressing social and economic inequality. **Frances Stewart** and **Rajesh Venugopal** examine how.

Fiscal policy—the level and composition of a government's taxation and expenditure—can be used to address different kinds of inequality within a country: inequality between individuals or households (vertical inequality) and inequality between groups (horizontal inequality). Taxation is particularly relevant for addressing economic inequalities, and expenditure for social inequalities.

The first step in devising appropriate fiscal policies is to gain an in-depth understanding of the status and dynamics of group identity and horizontal inequalities along various dimensions through a scoping study. The study should examine whether these groups are ranked hierarchically, how they are regionally distributed, and whether they are specialised in particular activities.

Tax policy

Tax policy in developing countries typically suffers from problems of level and composition: there is often weak revenue mobilisation and the system frequently fails to address inequality.

The tax system can contribute to reducing inequalities directly by increasing its progressiveness, and indirectly by raising additional revenue to finance expenditure devoted to reducing inequalities.

Increasing the progressiveness of the tax structure

This method works best where groups are hierarchical in terms of income such that horizontal inequalities (HIs) and vertical inequalities (VIs) overlap.

Direct taxes on income, profits and capital gains are usually the most progressive part of any developed country tax system. In addition, property taxes are also typically progressive because poorer people (groups) have less property than richer ones. A simple approach to improving progressivity is to exempt all property below a certain value. The start-up costs of meeting data requirements in the form of a cadastre may be onerous but have long-lasting benefits, including by improving the security of property rights. For developing countries, on average, land taxes account for 0.5% of GDP and around 18% of local government revenue, but Indonesia has a much more extensive tax with higher rates which generate two-thirds of local governments' own revenue (Bird and Slack 2006; Kelly 2004).

Indirect taxes A value-added tax which has exemptions for basic necessities (including food) can be progressive. This is the situation, for example, in Kenya: according to estimates for 1997, VAT was progressive, allowing for exemptions and zero rating (Wanjala 2007). Almost half developing countries that adopt VAT exempt food (ibid). VAT could also incorporate higher rates ▶

Three principles of tax design

- Identity should not be used as the basis for tax liability as this goes against basic principles of tax equity. Rather, horizontal inequality should be addressed in an indirect way, e.g. by using geographical, income level or occupational criteria as a basis for taxation.
- Redistribution is not the only goal of tax policy: other objectives should not be neglected. Where possible, taxes should be designed so as to fulfil each of the objectives; where not, any tradeoff needs to be considered carefully.
- There is no single, overarching policy framework: countries vary greatly and each case has to be examined individually.

on luxuries, although multiple rates cause administrative complexity. An alternative is to levy particular excise taxes on luxuries. Other indirect taxes that are likely to improve VI and probably HI would be heavy motor vehicle duties and taxes on airlines and flights. Fuel taxes can be differentiated so as to tax the sorts of fuels that richer people use and not poor people's fuels. Similarly, food subsidies can improve distribution when specifically directed at staple foods.

Tailoring taxes to group behaviour

Privileged versus deprived groups can often be identified through their location, their productive activities and their consumption behaviour and taxes can then be designed so as to reduce group inequality:

Location Decentralised administrations can devise revenue-sharing formulae to improve the position of poorer districts and ipso facto of poorer groups. This was attempted in Indonesia's post-2001 'Big Bang' decentralisation. Governments can also use property taxes to differentiate between wealthier and poorer locations.

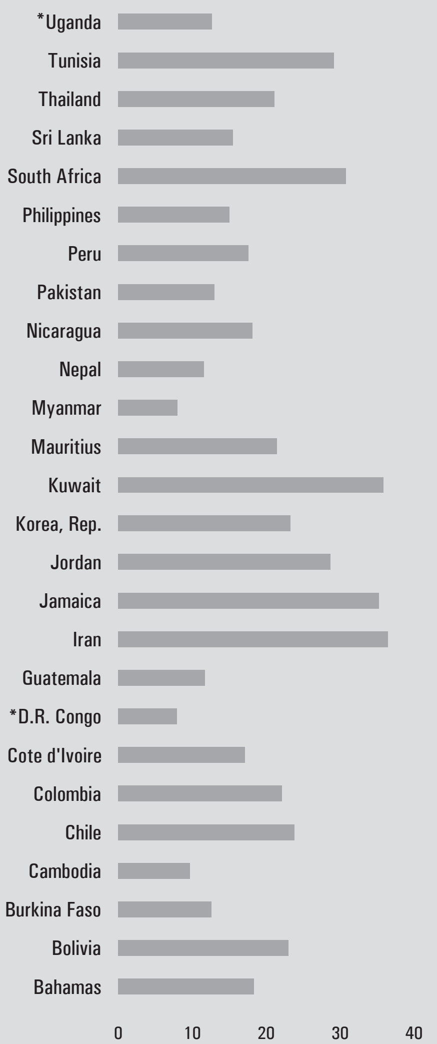
Occupation Many HIs arise from differential group concentrations in specialised economic activities, such as export versus food crop producers; merchants versus farmers; or formal versus informal sector activities. This makes it possible to address HIs by differential taxation of exports, wholesale trade, or the formal sector.

Consumption It is possible to target taxes towards forms of consumption that benefit wealthier groups. For example, taxes on alcohol would not affect Muslims, who form the relatively deprived groups in many societies. User fees that target services little used by poorer groups, such as higher education or heavy use of water (with appropriate exemptions), may yield beneficial results.

Altering the regional balance of taxation Regionally based HIs can be due to economic geography, as well as political and historical factors, often including colonial policy. For unitary states, the main redistributionary contribution of taxes is to address VI, while raising revenues to finance HI reduction through allocating expenditures disproportionately to poorer regions. A more federal or decentralised state can be directly responsive to regional HIs, by adjusting the regional distribution of revenue and expenditure to benefit poorer regions. In Nigeria, for example, the 1989 formula for the allocation of central revenues to the states was 30% equally distributed among the states, 40% according to population, 15% (inversely) for social development, and 5% for local tax effort.

Government revenue (excluding grants) as a percentage of GDP

Selected developing countries 2005



Source: WDI, World Bank *2002

Raising revenue

In addition to increasing the progressivity of the tax system to reduce inequality, a major contribution of the tax system is in raising revenues to undertake HI-reducing expenditures. Where total revenues are low, raising tax revenues is an important part of policy towards HI. Most low-income countries have a low tax base (average 10.4% of GDP), and need to focus on increasing revenues. Key areas to be addressed are low tax rates, weak administration and low compliance.

Low tax rates By comparing rates and revenue raised from different types of taxation in relation to GDP in the country with the average in a comparable set of countries, particularly low tax rates can be identified where rises in rates would be warranted.

Administration and compliance Weaknesses in administration can be overcome by reforms and technical assistance. Low compliance is partly a matter of the nature of the tax administration: effective tax administration requires well-trained officials and low levels of corruption. Compliance is also affected by the prevalent culture: if it is believed that few comply then low levels of compliance are likely. Donors and central governments can introduce incentives for greater compliance by making matching contributions. Durand and Thorp's (1998) study of the successful case of Peru, in which reforms of the administration greatly increased revenue, identifies three necessary conditions for success: political support from on top; ongoing bureaucratic regeneration; and general improvements in the relationship of state and society.

Expenditure policy

The impact of government expenditure on HIs can be analysed in relation to three distinct types of expenditure: (a) infrastructure investment (the government accounts for over three-quarters of investment in poor countries); (b) contracts and employment (the public sector typically accounts for half of formal sector employment); and (c) service provision (the provision of health and education, important in themselves, and they contribute to improved incomes).

Evidence suggests that there is often inequality in the distribution in each of the types across racial, religious, ethnic or geographical groups. It is essential to ensure appropriate group participation in each of the three types of government expenditure. Most attention is generally paid to the distributional implications of the third type (service provision), whereas the first two are often more important in their impact on HIs and, in particular, the visible and felt impact. At a minimum this implies anti-discrimination legislation and monitoring, but in some contexts it may also be appropriate to introduce positive discrimination. Such policies towards the allocation of both government contracts and government employment have been adopted in quite a large number of countries, including Canada, Malaysia, South Africa, Northern Ireland and the US. They include:

■ Anti-discrimination employment legislation.

■ Guidelines for all public decision makers.

■ Setting targets and quotas.

■ Careful monitoring of progress.

■ Competitive and transparent bidding procedures for contracts.

■ Incentives and penalties, including allocating contracts only to firms where fair employment practices are being followed.

■ Providing set asides for contracts for businesses controlled by particular groups, or preferences for such groups.

The third category of expenditure, government-provided goods and services, can be categorised in the following way: (a) goods with non-allocable benefits (e.g. defence expenditure or debt servicing); (b) goods with allocable benefits across groups but not by region (e.g. expenditure on national television which benefits only those with TV sets; or patronage of a particular religion); (c) goods with allocable benefits across regions but not intra-regionally (e.g. expenditure to limit environmental damage); (d) goods with allocable inter-regional and intra-regional benefits—this includes much government expenditure, e.g. expenditure on social services and economic infrastructure; and (e) transfer payments, which include direct payments to communities or households or individuals administered according to particular criteria. These can be allocated among individuals and groups according to their design.

Each of these categories of spending affects HIs to a different degree, and can hence be used to remedy them in distinct ways. Broadly speaking, the last two categories—goods and services the benefits of which are directly allocable, and transfer payments—are the most useful for addressing VIs and can also be designed to address HIs.

To summarise, with respect to government expenditure, improvements in HI can be achieved via reallocation in the production, running and consumption of publicly funded services:

■ By a policy towards participation in government contracts for the construction of public facilities, and in employment in the public sector.

■ By a focus on pro-poor public goods and those that favour particular groups, e.g. subsidising radio not television, bus transport not air travel; and supporting the language and religion of poor groups.

■ By locating a higher proportion of public goods in regions where poor groups are concentrated; and within regions in specific locations where poorer groups are concentrated. For example, in Lima, the white elite live in one area and indigenous migrants in another. Schools, transport, sanitation, and housing located in the slum areas of Lima would benefit indigenous people, not the white population. Any such improvements in HI would, of course, also improve VI.

■ By appropriately designed transfer payments which can improve both VI and HI significantly. ▶

Why is raising government revenue important for redistribution?

■ Government expenditure is often progressive, benefiting the poor more than the rich, at least in proportion to their original incomes. It follows that in so far as taxes raised are neutral vis-à-vis income distribution, even if not progressive, higher revenue and expenditure will improve income distribution.

■ It is politically much easier to achieve redirection of expenditure towards particular groups if this is through extra expenditure, rather than if it involves taking some benefits away from existing groups.

■ Raising taxes also plays a political role which is especially important in post-conflict countries: those who pay taxes have a perception of having a stake in the government, particularly representative government. As Ross (2004) has argued, turning around a one-time rallying cry, there is 'no representation without taxation'. His evidence demonstrates that the greater the proportion of government expenditure financed by taxation the more representative the forms of government, suggesting that raising revenue would contribute to reduced political HIs.

Data

A first requirement in designing fiscal policies to reduce HIs is to identify the nature of the HIs in the country. Data on HIs can be difficult to find as household surveys often do not include questions on ethnicity or religion, sometimes because of their political sensitivity. The first need in a country is to conduct an inventory of available data, and of urgent data needs. Working with recipient countries to develop appropriate data collection tools is then important.

In the short term, it is often possible to get sufficient data using shortcut methods. One possibility is to take some other characteristic as a proxy for ethno-cultural difference, for example data by region or by the language spoken, which are often more readily available than socio-cultural data. The degree to which regional data are useful, however, depends on how far identity groups are geographically segregated. As a rule of thumb, region is a useful proxy for measurement and policy if more than half the members of the deprived group, and less than half of the privileged group, are concentrated in the targeted region. In many African countries, ethnic and religious groups are regionally concentrated so regional inequality may be a suitable proxy for ethnic or religious inequality and in some cases region itself defines group identities. Another proxy for ethnicity is the use of a language variable, which is sometimes available where ethnic variables are not—as in Indonesian surveys in the New Order period.

Imaginative use of existing data generally contributes considerably. Possible data sources include:

Census data, where ethnic or language data are often included, and sometimes religion.

The Demographic and Health Surveys (DHS), many of which include ethnic identification, as well as information on access to social services and ownership of domestic assets.

Living Standards Measurement Surveys (LSMS) which sometimes include ethnic variables.

Regional data from household surveys, the census and sometimes public expenditure accounts.

Specific sectoral data (e.g. from schools and hospitals) which often contain ethnic and regional information.

Where there remain major gaps, small household surveys can be rapidly conducted to supplement existing data, including a limited number of basic variables (e.g. asset ownership; nature of employment; incomes; educational attainments; and anthropometric data).

The role of aid-givers

A first requirement is to promote awareness of the need for such policies and their nature. Opportunities for this arise where aid donors are involved in general policy discussions, for example in association with public expenditure reviews, or the Poverty Reduction Strategy Papers, or economic policy reform and adjustment more generally. In each case, donors should include discussions about the need to review HIs and to use fiscal policy to correct them where they are high.

Donors can provide technical assistance in data analysis and support for supplementary surveys as judged necessary.

Donors can assist governments in policies to raise revenues, including supporting improvements in tax administration, and in compliance, and in identifying which tax rates are relatively low and might be increased.

Donors can also assist in identifying types of expenditure that would reduce inequalities, drawing on available data. Where governments are unwilling to correct sharp HIs, donors may themselves contribute to reducing HIs through the distribution of aid; they may work with NGOs to promote expenditures reducing HIs; and they may try to change government policy via policy dialogue and conditionality. ■

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This policy briefing is based on CRISE Working Paper 65: **The Implications of Horizontal and Vertical Inequalities for Tax and Expenditure Policies** by Frances Stewart, Graham Brown and Alex Cobham. Available to download at www.crise.ox.ac.uk/pubs/workingpaper65.pdf

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