Summary Brief

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What Might an Agenda for Equitable Taxation Look Like?

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The past decade has witnessed an unprecedented surge in international attention to the challenge of expanding tax collection in developing countries; this accelerated in 2017. This has, however, come with a risk that too little attention will be given to how that revenue is raised, with potential perverse impacts on the poor. It is correspondingly very important to put an equal emphasis on tax equity, and there has been significant recent movement in that direction.

But the notion of tax equity raises difficult questions. There is no single right definition of the term. It is very hard to measure precisely the distributional effects of taxation and fiscal activities, especially in low-income countries where compliance is highly imperfect, relevant statistics are few and sometimes inaccurate, and where poorer people in particular may be obliged to pay significant informal, unrecorded taxes. And what is best in abstract may be limited by both technical and political constraints.

Notwithstanding these challenges, important progress has been made on simulating the impact of taxes and related spending on inequality and poverty, led most notably by the Commitment to Equity (CEQ) Institute and UNU-WIDER. While these micro-simulations are inevitably limited by imperfect data and resultant assumptions, they offer critical insights into questions of taxation, inequality and poverty. The key question now facing researchers and advocates alike is what comes next in translating these new insights into concrete action.

The key step is likely to lie in developing and advancing general rules of thumb about how to increase equity through taxation – or at least minimise the chances of increasing inequity. One such rule of thumb has been proposed by CEQ: that the net effect of new taxes should never reduce the cash incomes of poor people. The objective is laudable, and a useful guide for long-term policymaking. It has already helped to inspire a greater focus on equity among governments and donors. However, over the short and medium term it may also pose significant risks if applied too rigidly, particularly in low-income countries. Practically, it risks being bogged down in complex technical debates around how to most accurately measure and define the poverty impact of specific tax policies with imperfect data. Conceptually, it is a comparatively restrictive standard, which appears relatively

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well-suited to middle-income countries – but may prove more challenging in low-income countries facing limited revenue-raising options, greater challenges in direct redistribution and sometimes pervasive informal taxation.

Without abandoning this long-term goal, we thus suggest a primary focus on refining and developing the quasi-consensus that already exists around specific policy options. This can be informed by estimates produced by CEQ and others. This brief seeks to clarify definitions, evidence and points of potential disagreement, and to suggest key elements of a potential future agenda: (1) stronger and broader personal income taxes, (2) more effective and simplified property taxes, (3) transparency around tax exemptions, (4) improved taxation of multinational corporations (MNCs), (5) reducing opportunities and incentives for informal taxation, (6) pairing consumption taxes with simple exemptions for essential goods, (7) efforts to expand civic engagement around tax issues and strengthen fiscal contracts, and (8) reasonable efforts to balance potentially poverty-increasing taxes with new transfers.

What is Equitable Taxation?

Tax debates have long focused on the achievement of two broad dimensions of equity. **Horizontal equity** – ensuring that those in similar economic circumstances face similar tax burdens – reflects a belief that everyone should be treated equally under the law. **Vertical equity**, in turn, captures the widely-held view that those who are comparatively well-off should pay more taxes as a share of income, in order to contribute to a well-functioning state, public services and redistribution. Taxes that impose a higher relative burden on those with higher incomes are correspondingly termed **progressive**, while taxes that impose a heavier relative burden on those with low income are **regressive**.

The simplest version of an equitable tax agenda is to argue that all taxation should be progressive. This, however, is widely understood to be too simplistic. **The equity of a tax system is best understood in the context of the entire fiscal system; that is, how revenue is collected and how it is spent**. A highly progressive tax may be very bad for the poor if the revenue that is raised is not spent on subsidies or services that benefit them. More commonly, a regressive tax may be very good for the poor if the revenue is spent overwhelmingly to benefit poorer groups, as even regressive taxes collect the bulk of revenue from wealthier individuals.

What, however, would constitute an equitable net fiscal system in the context of the sustainable development goals and broader poverty reduction efforts? The most common focus is on ensuring that tax and spending systems are **inequality-reducing**, while there is increasing attention on ensuring that systems are also **poverty-reducing** – that is, ensuring that the value of direct government-provided benefits exceeds the burden of tax payments for poorer households. Because only a proportion of government revenue is used to deliver direct benefits to poorer taxpayers, it is very possible for a tax system to be inequality-reducing, but also poverty-increasing.

The most potentially contentious debate is over what should be counted as a direct benefit to taxpayers in assessing the effects of taxation on inequality and poverty. Should analysis focus only on **cash incomes**, and thus consider only direct subsidies and cash transfers as benefits, or should it concentrate on what might be called **effective incomes**, by also incorporating the implied value of directly consumed public services (e.g. education and health care)?

What Do We Know About Existing Inequity?

The most ambitious efforts to measure the poverty and equity impacts of tax systems in developing countries have come from the Commitment to Equity Institute. Their micro-simulations have sought to estimate from household surveys and official data the combined impact of the largest taxes and related spending on the income of households at different points on the income distribution. UNU-WIDER has progressively expanded a similar programme for providing tools to governments to model the distributive and poverty impacts of tax and spending policies. While the models do not seek to capture the dynamic effects of shifts in tax structure on growth, it is not clear that this is, in practice, a significant concern.[1]

Owing to the limits of household survey data, and access to only limited information from government accounts, these micro-simulations rely on substantial assumptions in order to estimate the incidence of tax and spending on poor households. For example:

- They make **educated guesses about the actual share of consumption taxes in the prices of goods consumed by the poor**, often sold in the informal sector. This is due to imperfect enforcement and unclear pass through of taxes to consumers.
- Estimates of the value of public services provided by government are based on government accounts – a process that **quite likely overestimates the true value of the services consumed by poor people**, which are often subject to underfunding and significant corruption.
- They are **unlikely to include informal taxes and some user fees**, which are not generally well captured by household surveys and do not appear in government budgets.

The estimates are inevitably imperfect. But they are still very useful, and offer the best guide available to key policy questions.

Several key messages recently summarised from CEQ research offer a general guide, with the poor defined as those below the international standard of US$1.90 per day:

1. Tax systems in the 29 countries that they have studied **universally reduce inequality and increase average effective incomes among the poor** (i.e. incomes inclusive of the imputed value of directly provided services), owing to at least mildly progressive public expenditure. However, as noted above, there are reasons to believe that these estimates may overstate the true value of public benefits to the poor.
2. However, tax systems in developing countries are, in general, **far less progressive and redistributive** than tax systems in OECD countries, and thus offer extensive scope for becoming more equitable.
3. **In general, direct taxes (e.g. income taxes, corporate taxes) are more progressive, while consumption taxes (e.g. VAT) are relatively neutral**, depending which essential goods are excluded and their reach among poorer groups.
4. Despite being inequality-reducing and increasing effective incomes, **tax systems in six countries studied by CEQ are estimated to reduce cash incomes among the poor, driven by consumption taxes that are not offset by direct subsidies or cash transfers**. Cash income poverty is frequently also increased among those with incomes between $2 and $10 per day.
5. The impact of consumption taxes on poorer groups is **shaped very substantially by whether basic commodities, particularly food, are exempted from taxation**.

A key reason why developing country tax systems are less progressive than those of OECD countries is **the weakness of more progressive direct taxes**. Despite similar tax rates, personal income taxes make up a much smaller share of total tax revenue in developing countries. This reflects extensive evasion and poor enforcement,

[1] While there is a frequent presumption that shifts towards direct taxes may modestly slow growth, empirical evidence remains contested and imperfect, particularly for developing countries. Among other problems, disaggregated data remains quite incomplete, limiting the quality of possible research. The few estimates that do exist are based on revenue-neutral shifts in tax structure. In practice shifts in tax structure are likely to also be revenue-increasing (i.e. the policy question is often about which aspects of tax collection to focus on). These revenue increases can be argued to contribute to growth where revenue mobilisation is very low.

particularly related to the non-wage incomes that are dominant among the wealthiest. Property taxes are similarly poorly exploited, despite booming property markets in many capital cities.

Meanwhile, **public expenditure tends to be less progressive in developing countries**. This has begun to improve, particularly in Latin America, through the introduction of large-scale cash transfer and subsidy programmes that deliver increases in cash incomes. This is much less true in lower-income countries, where cash transfer programmes are less common and generally much smaller – largely explaining the net negative effect of the fiscal system on cash incomes in some low-income countries. In turn, an extensive literature has documented that, in areas of weak governance, budgeted public spending on the poor often fails to reach recipients effectively.

Finally, recent research suggests that, particularly in areas of weak governance, official revenue figures – reflected in the incidence models described above – **may substantially understate effective tax burdens on the poor**. These studies have found that so-called informal taxes – tax-like levies that are raised outside of the legal tax system, by both state and non-state actors – are sometimes significantly larger than formally reported government revenue, and are very regressive. This suggests that t**he net effect of formal and informal tax systems on equity is likely to be significantly less progressive than suggested by formal estimates**, adding urgency to efforts to increase equity.

Key Questions and Debates

There is increasing agreement about the need for greater equity in existing tax systems and about the broad empirical evidence, notwithstanding scope for further improvement. There are, however, lingering debates about how that evidence should be interpreted, and its implications.

Cash Incomes or Effective Incomes?

Policymakers have generally focused on the aggregate impact of taxes and spending on inequality and effective incomes, inclusive of the value of directly-provided public services. By this measure CEQ research suggests that fiscal systems in those countries that have been investigated are universally progressive and poverty-reducing – with even consumption taxes having a poverty-reducing impact, owing to the high value of key public services relative to the taxes paid by the poor.

However, CEQ has argued for an expanded focus on the poverty impact of taxes and spending on **cash incomes** – thus excluding the implied benefits to the poor of public services. Conceptually, they have argued that for the poorest households public services are no substitute for the cash income needed to access food, water and shelter. Empirically, focusing on cash incomes may be more accurate: estimates of the value of public services accruing to low-income populations based on government budgets involve larger assumptions and may be substantially overstated, as public spending may not in fact reach low-income populations very effectively.

A focus on cash incomes may thus be too pessimistic, insofar as it excludes important benefits of taxation, but a focus on existing estimates of effective incomes may be too optimistic, owing to the poor quality of public spending targeting the poor.

Are taxes that reduce the cash incomes of the poor ever acceptable?

CEQ has argued for a new principle for tax systems – or tax reforms: they should not reduce the cash incomes of the poor. That is, the total cost of tax payments by the poor should be smaller than total cash benefits through cash transfers and direct subsidies. This is a laudable goal, and should guide long-term policymaking as far as possible. But it has substantial implications: it can imply arguing against certain taxes even if they are inequality-reducing and increase the effective incomes of the poor, while putting broader limits on government revenue-raising.

This is most relevant to the case of consumption taxes in low-income countries. Because many low-income countries have few cash transfers or direct subsidies for the poor (for political reasons, but also due to lack of resources and capacity), consumption taxes are comparatively likely to reduce cash incomes. But these taxes are also inequality-reducing, and can increase effective incomes as long as public spending is moderately effective at reaching the poor, and may be preferable to often informal alternatives.

Over the long term the CEQ principle can create the necessary pressure to improve direct transfers to the poor, and ensure non-taxation of essential goods in the design of consumption taxes. Over the shorter term, however, it can imply opposition to revenue-raising instruments which, while imperfect, may be the best immediately available for low-income countries. Some flexibility is likely to be warranted and required in practice – though, by the same token, particularly perverse poverty impacts of taxation in some contexts, or a lack of even indirect benefits to the poor, should rightly raise questions about the appropriateness of planned reform.

What is the appropriate role of consumption taxes?

Groups committed to redistribution have at times expressed significant hostility to consumption-based taxes because of their neutral or regressive incidence. Recent evidence makes it increasingly clear that, in general, such outright opposition is probably misguided: in most developing countries consumption taxes appear to be both inequality- and poverty-reducing, even when focusing only on cash incomes.

Of course, direct taxes are still more inequality-reducing. This points towards **the substantial value of advocacy in favour of more effective direct taxation**. But it argues for opposition to indirect taxes only if they are directly substituting for, and crowding out, direct taxes. Given extensive revenue needs in most developing countries, this does not appear to be the case on a large scale, with both direct and indirect tax collection having increased in recent years.

More complex is the case of lower-income countries, where consumption taxes are more likely to reduce cash incomes owing to the relative absence of direct transfers. Here ensuring non-taxation of the most important essential goods, led by basic foodstuffs, is particularly valuable. **But broader opposition to indirect taxes seems harder to justify.** Consumption taxes appear to be inequality-reducing, and will increase effective incomes as long as even a small share of public spending benefits the poor. Perhaps more importantly, **consumption taxes appear to be far more progressive than the user fees and informal taxes that appear otherwise likely to fill resource gaps, but which are largely overlooked by existing analyses.**

Given weak prospects for very large increases in direct taxes over the very short term, consumption taxes may thus generally be an important part of filling large resource needs, alongside continued emphasis on expanded progressive taxation and improved redistribution.

What about informal taxes?

Integrating the potential importance of informal taxes into these debates is complex: the magnitude of informal taxes can only be measured though detailed, complex and costly surveys, while complete estimates exist for only two countries, Sierra Leone and the Democratic Republic of the Congo. Yet available information makes clear that incorporating informal off-budget payments can paint a profoundly different picture of existing tax burdens in some countries. There is a clear need for more studies, but it is possible to map some likely implications for states where informal taxation is pervasive. Considering informal taxation is likely to:

1. Add urgency to calls to **pay greater attention to equity concerns** in designing tax reform, as it reveals that in at least some countries tax burdens on the poor are heavy, and very regressive, with large potential benefits from reform.
2. Suggest that the most immediate way to increase the progressivity of the real tax

burden on the poor (incorporating both formal and informal taxation) may lie not in shifts between direct and indirect taxes, but in **minimising regressive informal burdens**.

3. **Make consumption taxes with relatively neutral incidence appear comparatively desirable:** even if they increase cash poverty they are almost certainly less regressive than informal taxes, while informal taxes appear more likely to be pervasive where formal state revenue is inadequate to cover the real costs of public service delivery.

What Might an Agenda for Equitable Taxation Look Like?

Debates over the need for more equitable taxation are sometimes painted in conflictual terms. Yet recent experience suggests that most global actors, from civil society to the international financial institutions, increasingly share a broad interest in more equitable taxation, as well as significant common ground on how to achieve it. The greatest challenge may lie in moving ideas into action, given the potential for urgent revenue needs at the country level to override an in-principle desire to increase equity. What follows is a non-exhaustive list of likely elements of an equitable tax agenda:

1. **Strengthen personal income taxes – and not only on wages**. Personal income taxes can be highly progressive, and are vastly under-collected in developing countries. However, the quality of collection is uneven across types of income. For those in formal sector wage employment tax collection is often quite effective, placing a significant burden on a small section of the labour force. Three things are needed. First, effective enforcement among the relatively wealthy, where enforcement is often weak for both technical and political reasons. Second, better enforcement, in particular of taxes on various kinds of capital wealth – which is scarcely taxed in many countries and makes up the bulk of the income of the wealthiest. Third, more progressive income tax schedules, so that the very rich pay more than the simply well-off; at present top marginal income tax rates often kick in at moderate income levels.
2. **Improve property taxation, emphasising simplicity.** The most obvious opportunity for better taxing the wealthy lies in more effective property taxation. Property taxes are economically efficient, easily linked to service provision, and should be relatively easy to collect owing to the immovability of property. Yet almost everywhere property taxes are dramatically underexploited. This is in part a political problem. But it is also a technical problem, rooted in reliance on excessively complex valuation and administrative systems imported from the West. There is growing evidence of the superiority of simplified systems.
3. **Transparency around tax exemptions**. The IMF and others have long called for greater transparency around tax exemptions, which are frequently poorly targeted and amount to tax giveaways to large corporations and wealthy individuals. Greater transparency would, it is hoped, create pressure for reform. The absence of reform to date points towards the need for popular pressure to create change.
4. **Improved taxation of MNCs.** There remain important debates about the extent of likely revenue benefits to developing countries of new investments in taxation of multinationals, and the extent to which such investments should be prioritised. But there is little question that there exists substantial 'dangling fruit' in the form of revenue that could be secured through relatively straightforward reform and audits, and which would not only make tax systems more progressive, but also generate more equitable competition between local and international firms.
5. **Reduce opportunities and incentives for informal taxation**. Curbing regressive informal taxation will require reducing

both opportunities and incentives for more predatory and regressive payments. One of the primary drivers is the complexity of subnational tax systems. Multiple and poorly understood taxes and fees create opportunities for unscrupulous state officials to collect significant sums off the books. Yet such complexity rarely raises significant revenue for governments, who get the bulk of revenue from a handful of local sources. Dramatic simplification stands to reduce informality at little cost to government revenue. Meanwhile, inadequate formal government funding of frontline service delivery, often owing to inadequate central government transfers, appears to play a similarly critical role in driving regressive informal taxation. Where services are underfunded it forces reliance on informal user fees and levies to cover local costs and salaries. This de facto reliance on frontline financing invisibly shifts the fiscal burden from potentially redistributive taxes on income and consumption, and directly onto the (frequently poor) users of essential services.

6. **Consumption taxes are generally okay – but should exclude key essential goods**. Contrary to some advocacy, there is growing evidence that consumption taxes generally contribute to redistribution and poverty reduction – and are likely to be superior to other forms of subnational financing (formal and informal) of service delivery in low-income countries. But there is equally evidence that ensuring non-taxation of the most essential goods consumed by the poor – led by basic foodstuffs – can have important poverty reduction benefits without unduly increasing the complexity of tax administration. Changes to VAT thresholds and eligibility might similarly affect tax incidence, though more research is needed. The key lies in limiting exemptions to the most essential goods, or most poverty-reducing strategies, as more pervasive exemptions can quickly begin to erode the overall effectiveness of consumption taxes. That said, in areas of particularly weak governance, where almost any benefits to low-income groups appear unlikely, there will remain grounds to question the appropriateness of expanded consumption taxation without new assurances of public benefits.

7. **Encourage civic engagement and reciprocity**. The single best means to increase the equity of tax systems may not lie in the tax system at all, but in improving the progressivity of the public spending that it finances. The nature of this spending is not directly under the control of tax reformers. However, recent research has pointed towards ways in which tax reform may be designed so as to strengthen the ability of taxpayers to make reciprocal demands on government. This is likely to include expanded and more meaningful transparency, the creation of new spaces for popular engagement, and investment in strengthening the capacity of civil society to engage with tax issues – all with a focus on engaging lower-income groups. In some contexts pushing for limited earmarking of new revenue for poverty reduction, along with appropriate monitoring institutions, may also be appropriate.

8. **Encourage expanded direct transfers to the poor alongside potentially poverty-increasing tax reforms**. Evidence that consumption taxes are much more likely to be poverty-increasing in low-income countries appears driven by the relative absence of effective direct transfers. Over the short or medium term it may not be realistic for developing countries to expand such transfers sufficiently to fully offset new taxes, for both technical and political reasons. But there is every reason to pursue this broad goal as far as possible. Tax reform will sometimes increase the need for such transfers in order to ensure that poverty does not increase. In turn, debates about tax reform may offer a strategic political moment for strengthening demands for poverty reducing expenditures.

Further reading

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Credits

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