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Chapter V

THE ROLE OF FISCAL POLICY IN INCOME DISTRIBUTION

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A. Introduction

Achieving a pattern of income distribution that policymakers deem desirable and that is acceptable to society as a whole has been an objective of fiscal policy in its own right. This is because it favours social cohesion and political stability and enables the entire society to participate in the overall growth process of the economy, even if the contribution of different groups of the population varies. But achieving a pattern of income distribution that boosts growth and employment creation should also be considered an intermediate objective. For both reasons, it is essential for developing countries to carefully consider the way in which fiscal policies influence income distribution as part of their development strategies.

There are two perspectives on what sort of income distribution fiscal policy should aim to achieve and why. One perspective, from the supply side, believes a more unequal income distribution that favours profit-making and higher income groups, which have a greater propensity to save, will enhance growth. This is because it is expected to lead to greater investment as a result of increasing net profits and aggregate savings. Another perspective, from the demand side, expects that a more equal distribution in favour of middle- and lower income groups, which have a lower propensity to save, will strengthen domestic consumption and lead to greater investment and employment by firms on the expectation of higher demand. In both cases, investment in real productive capacity is understood to be the driving force for economic progress.

In the first three decades of the post-war era, this latter approach dominated the thinking about the link between income distribution, investment, growth and economic policies, especially in most developed countries. These policies reduced inequality and led to relatively fast growth and relatively low unemployment. However, the policy orientation from the late 1970s onwards shifted towards the former approach, resulting in greater inequality, higher unemployment and slower growth.

In addition to labour market policies, which are discussed in chapter VI of this *Report*, fiscal policy provides the main instruments for influencing income distribution. These instruments include taxation, social transfers and the provision of public services. All of these have played a central role in governments' attempts not only to influence income distribution, but also to support the growth process in both developed and developing countries. Therefore, an assessment of the causes of the rise of inequality in most countries since the early 1980 must include an enquiry into the role that fiscal policy has played in this context.

To be sure, influencing income distribution is only one of several objectives of fiscal policy. But even when decisions regarding the ways in which public revenue should be raised and public expenditure allocated are not taken with the specific intention of influencing income distribution, they inevitably influence this distribution in one direction or the other. Therefore, the conduct of fiscal policies over the past three decades has to be seen in the context of a broader reorientation of macroeconomic policies and structural reforms that have rarely helped to reduce inequality; indeed, they have often increased it.

It is essential for developing countries to consider the way in which fiscal policies influence income distribution as part of their development strategies.

From the mid-1970s onwards, fiscal policies in developed countries gradually changed their focus to the elimination of "market distortions" resulting from taxation. At the same time, policy decisions tended to place a greater emphasis on achieving fiscal balance, and much less than in the past on other macroeconomic or development needs. The general tendency to reduce the role of the State in the economy meant that whenever budgetary adjustment was considered necessary, it was sought through spending cuts rather than by raising additional revenue.

In many countries, market-friendly tax reforms reduced the tax-to-GDP ratio, lowered marginal tax rates and served to strengthen those elements of the public revenue system that had regressive effects on income distribution (i.e. elements which tended to increase income inequality). This new orientation also shaped fiscal policies in developing countries, where policy reforms in the 1980s and 1990s were strongly influenced by the conditionalities and recommendations of the international financial institutions. These institutions also emphasized the need to strengthen the financial position of the public sector and reduce government interference in the allocation of resources (*TDR 2006*, chap. II).

This chapter discusses how fiscal policy on both the revenue and expenditure sides has affected income distribution across different social and income groups, and how it can be modified to narrow the income gap. It argues that more progressive taxation can help to reduce inequality in the distribution of income and wealth without curtailing incentives to undertake investment in fixed capital, innovation and skills acquisition. On the public expenditure side, social transfers and the provision of social services can alleviate the effects of socially undesirable distributive outcomes arising from market forces and from unequal initial endowments. The precise mix of the instruments that have been used or that can be recommended varies according to the specific conditions prevailing in each country, in particular its stage of development, administrative capacities and social preferences.

This chapter is organized as follows. Section B reviews some major changes in the design of revenue systems and the pattern of public expenditure that appear to have contributed to greater inequality over the past 30 years. It also describes more recent fiscal policy measures taken in developing and transition economies with a view to reducing inequality. Section C draws on these experiences and on further theoretical considerations to offer some recommendations for fiscal measures that would reduce inequality while at the same time strengthening the dynamics of growth and development.

B. Fiscal policies and inequality

1. Public finances and income distribution

From the mid-1970s onwards, there was an increasing convergence of views among influential economists and policymakers that tax systems generally needed to be modified to achieve greater "neutrality" of taxation (Tanzi, 1987). This was part of a broader shift in the economic paradigm, based on the perception that the stagflation (i.e. high unemployment combined with high inflation) experienced by developed and some developing countries in the 1970s was partly due to the distorting effects of State intervention (for a more detailed discussion, see *TDR 2010*, chap. V, sect. B). As a result, monetary policy began to give priority to fighting inflation at the expense of efforts to check rising unemployment. It was believed that the unemployment problem could be solved by introducing greater flexibility in "hiring and firing" conditions and in wage determination, and by shifting the distribution of income in favour of profit-making. The perception of what makes a "good tax system" shifted from one that explicitly introduces distortions into the functioning of capitalist market economies to one that minimizes such distortions (Steinmo, 2003). It was based on a revival of the belief in the efficiency of markets. According to this view, the tax burden and government expenditure should be kept to a minimum, and the distribution of the tax burden and allocation of public expenditure should be determined primarily by efficiency criteria (McLure, 1984; Musgrave, 1990). Distributional considerations should only come into play to avoid extreme income inequality, which should be reduced mainly through expenditures (e.g. Engel, Galetovic and Raddatz, 1999). High taxation of corporate profits and high marginal income tax rates for those at the top of the income scale were seen as slowing down economic activity, but also as being ineffective in redistributing income and wealth (Bird and Zolt, 2005).

In the context of slow growth and rising unemployment, the change in economic thinking also influenced broad public opinion about what is "socially acceptable". Although it was clear that the reduction of progressive taxation would increase inequality, there was little popular opposition to it in the developed countries, because the tax reforms, similar to labour market reforms, were widely believed to be the only way to restore growth and keep companies from relocating production abroad. Similarly, in developing countries, policies that provided extensive tax privileges to owners of capital, in particular to TNCs, were considered "socially acceptable" or "desirable" because they promoted foreign capital inflows.

2. Tax reforms in developed countries

In developed countries, tax reforms typically included: scaling back the progressive tax rates on personal income, particularly marginal rates at the top end of the income scale; reducing the number of income tax brackets; cutting back corporate tax rates; broadening the income tax base by eliminating loopholes and exemptions; and increasing rates of indirect taxes – in particular the value-added tax (VAT) – and social security contributions (Sandford, 1993: 10–20).

Table 5.1

FISCAL REVENUE INDICATORS, DEVELOPED COUNTRIES, 1981–2010

(Per cent of current GDP)

	1981–1985	*1986–1990*	*1991–1995*	*1996–2000*	*2001–2005*	*2006–2010*
Total revenue and grants	41.6	42.5	42.8	42.2	41.5	41.8
of which:						
Tax revenue	26.6	27.8	26.9	26.3	25.9	26.0
of which:						
VAT	5.5	6.1	6.3	6.7	7.0	7.1
Border tax	0.9	0.8	1.1	1.1	0.8	0.6
Income tax	13.3	13.9	12.8	12.3	12.0	12.1
of which:						
Corporate income tax	2.5	2.7	2.7	3.1	3.2	3.5
Other tax revenue	6.9	7.0	6.7	6.2	6.1	6.1
Social contributions	9.5	9.7	10.9	10.3	10.1	10.0
Other revenues[a]	7.3	3.3	5.1	6.1	5.4	5.3
Memo item:						
Ratio of income tax to VAT	2.42	2.28	2.03	1.84	1.71	1.70

Source: UNCTAD secretariat calculations, based on Eurostat, *Statistics Database*; *OECD.StatExtracts* database.
Note: Data refer to the five-year average of the mean observation of general government revenue.
a Includes capital revenues.

The changes in the tax structure, allegedly aimed at making the tax system more "neutral", favoured some interests over others. The elimination of loopholes and exemptions in most cases reduced certain privileges of taxpayers in the higher income groups. At the same time, cuts in income and capital taxation, together with increases in consumption taxes, led to a redistribution of the tax burden which fell more heavily on lower income groups. The overall effect of these changes in the tax structure made taxation more regressive. Indeed, a review of tax reforms in OECD countries did not find a single country where the tax system became more progressive (Steinmo, 2003: 223).

The redistributive effects of the tax system depend to a large extent on the share of income tax in total revenues and the progressivity of the personal income tax schedule. In developed countries, but also in a number of developing countries in Asia, income tax is the largest source of public revenues (tables 5.1 and 5.2). During the period 2006–2010, income tax in developed countries, including corporate income tax, accounted for 46.5 per cent, on average, of total tax revenues, compared with a regressive VAT of 27.3 per cent, on average. Since the early 1980s, the share of income tax has fallen and that of VAT has risen continuously. The ratio of income tax to VAT, which may be taken as an approximate measure for the progressivity of the tax system, fell from 2.42 in the first half of the 1980s to 2.03 per cent in the first half of the 1990s and to 1.70 per cent in the 2006–2010 period. In addition, it is also important to consider the scale of income tax. In particular, marginal tax rates at the top of the income scale are an important element in overall progressivity, even though the top earners constitute a small segment of the population, because they often account for a large share of aggregate income and the total income tax yield. Yet marginal personal income tax rates at the top of the income scale in OECD countries fell from an average of 71 per cent in the late 1970s to around 57 per cent in the late 2000s (chart 5.1).

Although these rates fell in a majority of OECD countries, the change in the degree of progressivity of the tax system as a whole differed among these countries. One reason for this was divergent patterns in the taxation of wealth (Piketty, 2010). The evolution of estate and wealth taxes in France, for

Table 5.2

FISCAL REVENUE INDICATORS, SELECTED REGIONS, 1991–2010

(Per cent of current GDP)

	1991–1995	*1996–2000*	*2001–2005*	*2006–2010*
Africa				
Total revenue and grants	22.1	21.0	23.8	28.2
of which:				
Tax revenue	14.4	14.0	15.0	16.4
of which:				
VAT	4.4	4.4	4.9	5.4
Border tax	5.3	5.0	4.2	4.2
Income tax	4.0	4.2	5.1	6.2
of which:				
Corporate income tax	2.5	2.4	2.3	3.4
Other tax revenue	0.7	0.4	0.8	0.6
Social contributions	2.0	1.8	2.3	2.7
Other revenues[a]	5.6	5.3	6.5	9.1
Memo item:				
Ratio of income tax to VAT	0.91	0.95	1.04	1.15
Latin America				
Total revenue and grants	21.3	22.7	23.9	27.3
of which:				
Tax revenue	12.5	13.8	14.8	16.7
of which:				
VAT	4.7	5.4	6.4	7.3
Border tax	1.8	1.6	1.3	1.2
Income tax	2.8	3.3	3.6	4.7
of which:				
Corporate income tax	2.0	2.2	2.2	3.0
Other tax revenue	3.2	3.5	3.5	3.4
Social contributions	2.9	2.8	2.8	3.1
Other revenues[a]	5.9	6.1	6.3	7.5
Memo item:				
Ratio of income tax to VAT	0.60	0.61	0.56	0.64
East, South and South-East Asia				
Total revenue and grants	20.9	19.6	19.2	20.7
of which:				
Tax revenue	14.4	13.8	13.7	14.9
of which:				
VAT	4.5	4.5	5.2	5.6
Border tax	2.4	1.7	1.5	1.4
Income tax	4.8	5.4	5.4	6.2
of which:				
Corporate income tax	3.0	3.1	3.5	4.3
Other tax revenue	2.7	2.2	1.6	1.7
Social contributions	0.7	1.2	2.2	3.0
Other revenues[a]	5.8	4.6	3.3	2.8
Memo item:				
Ratio of income tax to VAT	1.07	1.20	1.04	1.11
West Asia				
Total revenue and grants	28.5	30.3	34.6	35.8
of which:				
Tax revenues	5.5	5.9	6.5	6.9
Social contributions	1.0	2.1	1.8	3.8
Other revenues[a]	22.0	22.2	26.3	25.1
Transition economies				
Total revenue and grants	..	28.0	29.9	34.2
of which:				
Tax revenue	..	18.7	18.3	20.6
of which:				
VAT	..	8.8	10.1	12.2
Border tax	..	2.1	1.9	1.9
Income tax	..	4.9	5.1	5.9
of which:				
Corporate income tax	..	2.7	3.3	3.3
Other tax revenue	..	2.9	1.2	0.6
Social contributions	..	8.5	8.6	9.2
Other revenues[a]	..	0.8	3.0	4.4
Memo item:				
Ratio of income tax to VAT	..	0.56	0.50	0.48

Source: UNCTAD secretariat calculations, based on ECLAC, *CEPALSTAT*; IMF, *World Economic Outlook* and *Government Finance Statistics* databases; and national sources.

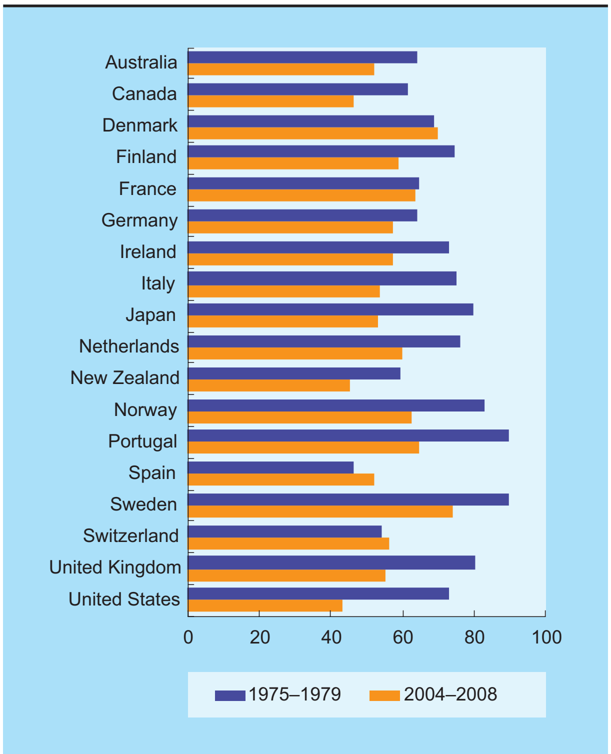
Note: Data refer to the five-year average of the mean observation of general government revenue, except for Argentina, Bolivia, the Bolivarian Republic of Venezuela, Colombia, Costa Rica, Ecuador, El Salvador, Mexico, Nicaragua, Panama, Paraguay and Uruguay, for which data refer to the non-financial public sector. For the composition of developing country groups, see table 5.3.

a Includes capital revenues.

Chart 5.1

TOP MARGINAL INCOME TAX RATES IN SELECTED OECD COUNTRIES, 1975–1979 AND 2004–2008

(Per cent)



Source: Piketty, Saez and Stantcheva, 2011.
Note: Data are averages for each period. They refer to personal income tax at both central and local government levels. Whenever data for those periods are not available, the first five-year period after 1975 and the most recent five years were used (for details, see Piketty, Saez and Stantcheva, 2011, appendix C).

instance, contrasted sharply with that in the United Kingdom and the United States during the period 1970–2005 (Piketty and Saez, 2007). The progressivity of the overall tax system clearly declined in the United Kingdom and the United States. In these countries since the early 1980s, there has been a drop in average individual income tax rates, payroll taxes, estate, gift and wealth taxes, and corporate tax (only in the United States) for those at the very top of the income distribution, who also hold a large share of the capital. By contrast, progressivity in the overall French tax system has remained almost unchanged, as the introduction of a wealth tax and an increase in the inheritance tax in the early 1980s more than offset the reduction of the personal income tax rate. At the same time, inequality in the distribution of disposable incomes increased much less in France than in the United Kingdom and the United States.

The proponents of neoliberal tax reforms justified the reduction of progressive taxation on the grounds that this would reduce distortions in factor allocation and thereby improve the efficiency of the economy, with positive effects on gross incomes for all. The OECD endorsed this approach: "The pursuit of greater neutrality has been based on the growing acceptance of the fact that a proportional tax system is more likely to be optimal from an efficiency point of view than one which is graduated and selective" (OECD, 1989: 184–185). However, the idea that tax "neutrality" increases economic efficiency derives from an economic model that does not take account of the numerous cases of market failures and unequal initial endowments that occur in the real world, and which discriminatory taxation seeks to correct (see, for example, Aiyagari, 1995; Koskela and Vilmunen, 1996; Pissarides, 1998). It also neglects the role of income distribution in determining the level of domestic demand.

Lower taxation of high-income groups and profits was expected to lead to greater investment in two ways. First, it was believed that higher net profits would increase the incentives and financial resources for reinvestment by companies. Second, higher net incomes at the upper end of the income scale were expected to boost aggregate savings, since these income groups have a higher-than-average propensity to save. This, in turn, would also – quasi automatically − lead to higher investment. As globalization advanced in the 1990s, it was also argued that reducing the tax burden, especially on profits, was necessary because high corporate taxes had an adverse impact on the international competitiveness of companies. Moreover, lower corporate taxes would prevent a relocation of production to low-tax countries (which, mostly, were also low-wage countries).

However, it is unlikely that investment will grow in an economy when the propensity to consume falls and expectations of a growth of demand worsen, especially in a situation when both labour and existing productive capacities are not fully employed. Indeed, policies that aim at increasing aggregate savings and result in lowering mass consumption are more likely to lead to reduced investment and further weaken output growth.

It is therefore not surprising that tax reforms which lowered the progressivity of the tax structure did not result in higher overall efficiency and faster growth in OECD countries (Piketty, Saez and Stantcheva, 2011; see also chart 5.2A). However, the magnitude of the decline of top tax rates was a good predictor of the increases in pre-tax income concentration in these countries (chart 5.2B).[1] Reduced top marginal tax rates also encourage a greater distribution of corporate profits among shareholders – who are mainly to be found in the top income groups – rather than reinvestment of such profits. Such income, in turn, is more likely to be saved in the form of acquisitions of existing assets, rather than being spent for consumption (Bakija, Cole and Heim, 2012).

In sum, tax reforms in many developed economies at the end of the last century mainly benefited the highest income households, except when the decline of top marginal rates was counterbalanced by increases in other taxes with a progressive incidence. But despite the reduction in progressivity of the tax systems and lower corporate taxes, growth remained slow and unemployment relatively high.

3. *Public revenues in developing countries and transition economies*

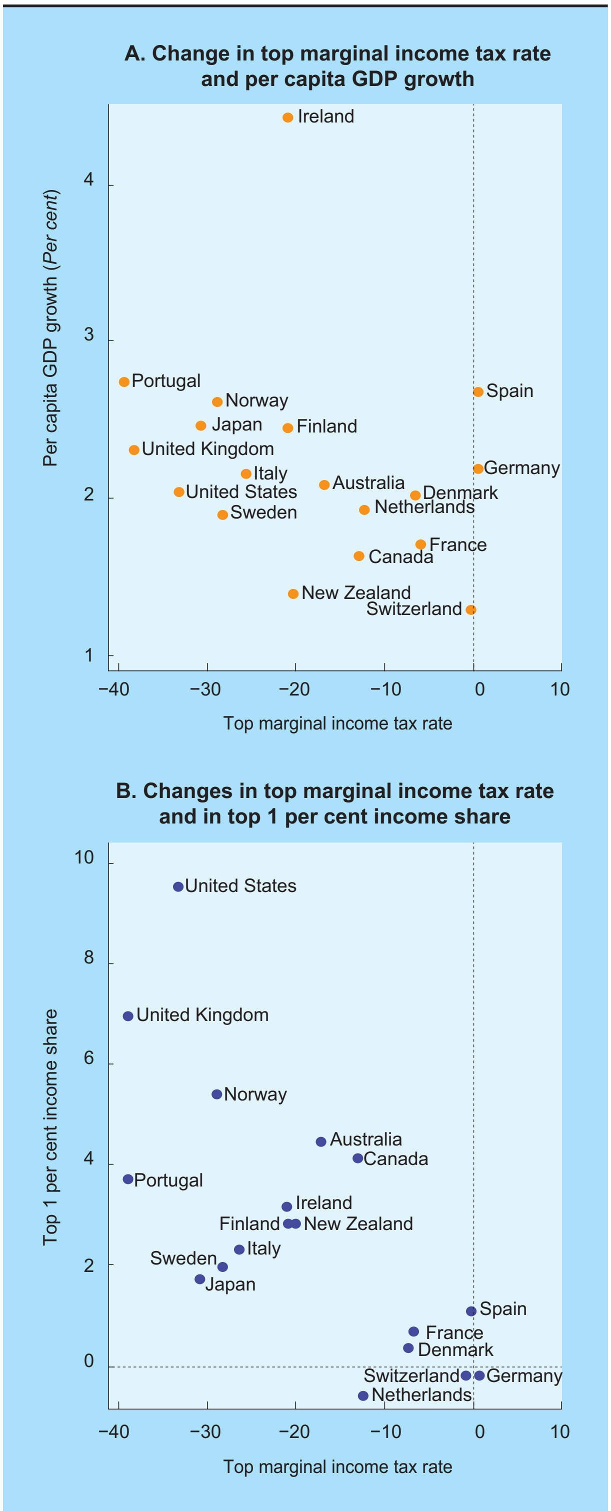
(a) *Structure of public revenues*

The structures and levels of government revenue collection differ considerably between developing and developed countries (tables 5.1 and 5.2). In developing countries, especially in Latin America, as well as in the transition economies, the share of income taxes in total public revenues is much lower than in developed countries. On the other hand, the shares of regressive VAT as well as other revenues, such as royalties and State property taxes, are considerably higher in developing countries.

The lower share of the income tax yield and the higher share of VAT in total tax revenues indicate that the tax system overall is more regressive in developing and transition economies than in developed countries. In the 2006–2010 period, the share of income tax (including corporate income tax) in total tax revenue was the lowest in Latin America (28 per

Chart 5.2

CHANGE IN TOP MARGINAL INCOME TAX RATE, PER CAPITA GDP GROWTH AND CHANGE IN TOP 1 PER CENT INCOME SHARE IN SELECTED OECD COUNTRIES FROM 1975–1979 TO 2004–2008



Source: Piketty, Saez and Stantcheva, 2011.
Note: Data refer to changes in the average for each period. They are in percentage points unless otherwise specified.

cent) and the highest in East, South and South-East Asia (42 per cent). The share of VAT was the lowest in Africa (33 per cent) and the highest in the transition economies (59 per cent).

To some extent, the impact on income distribution that results from the lower progressivity of the tax system in developing countries is mitigated by a high share in public revenue from royalties and State property, especially from the extractive industries. This higher share results mainly from exports of oil and minerals, and thus does not represent a charge on domestic taxpayers. However, its share in total public revenues varies by region. In 2006–2010, these revenues accounted for 9.1 per cent of GDP in Africa and 7.5 per cent in Latin America; it was especially high in West Asia (25.1 per cent) but very low in East, South and South-East Asia (2.8 per cent). Nevertheless, the redistributive effects of the tax systems in developing countries are relatively limited, not only because of their overall structure but also because of the generally smaller share of public revenue in GDP.

Revenue collection structures are more regressive in developing and transition economies than in developed countries.

Particularly at early stages of economic development, owing to a large informal sector and limited government capacities, direct and progressive taxes are difficult to collect.[2] Moreover, in most of those developing countries where income distribution is highly unequal, taxation is also regressive, and tax evasion by earners of non-wage incomes is widespread. This contributes to even greater inequality because richer people have greater opportunities and skills for evading taxes. According to estimates from Tax Justice Network (2011), tax evasion or avoidance reduces tax revenues by $3.1 trillion worldwide every year. Similarly, transfer pricing – which refers to the setting of prices in international transactions between associated enterprises within a TNC – enables the shifting of TNCs' profits to low- or no-tax jurisdictions, and thus unfairly deprives a country of tax revenues (Jomo, 2012).

There have been significant changes in the structure of tax revenues in developing countries and the transition economies over the past three decades, owing partly to recommendations of the international financial institutions and the conditionalities attached to their lending, especially in the 1980s and 1990s. About 50 per cent of all adjustment loans provided by the IMF and the World Bank between 1979 and 1989 included conditions relating to fiscal reforms, and more than 50 per cent included conditions relating to both trade reforms and the rationalization of government finances which had tax reform elements (Webb and Shariff, 1992: 71).

The emphasis of the reforms of the 1980s and 1990s was primarily on two of the three classic functions of fiscal policy (Musgrave, 1959): ensuring macroeconomic stability and efficient resource allocation. The third function, that of influencing income distribution, was considered to be of minor importance. Especially at the beginning, advice by the international financial institutions focused on generating greater revenue to enable countries to keep up with their debt repayments and to reduce fiscal deficits. From the early 1990s onwards, they paid greater attention than before to encouraging what was considered to be a more efficient allocation of revenues to private production and investment, but also to equity and tax administration (World Bank, 1991: 9–10). Like other market-friendly reforms undertaken in many developing countries, changes in the structure of public finances generally presupposed a trade-off between efficiency (to be optimized by relying on market forces as much as possible) and equity (requiring government intervention).

The fall of public revenue as a result of reduced trade taxes and tariffs owing to greater trade liberalization was replaced in part by higher revenue from income tax, and partly by more broad-based consumption taxes, particularly VAT. In the 1990s (and probably also in the 1980s, though no comprehensive data are available for that period), such tax reforms appear to have led to a more regressive tax system if the ratio of income tax revenue to VAT revenue is taken as a rough indicator. In the 1980s, this ratio fell in 10 out of 14 countries in Latin America and the Caribbean for which data are available (Sáinz and Calcagno, 1992). Subsequently, this ratio fell again, from an already very low average level of 0.60 in the first half of the 1990s to 0.56 in the period 2001–2005, before increasing to reach 0.64 in 2006–2010. In East, South and South-East Asia, it first rose from 1.07 in the first half of the 1990s to 1.20

in the late 1990s, and then fell to 1.11 in 2006–2010. Distinct from these two regions, in Africa the ratio of income tax revenue to VAT revenue has been rising continuously over the past 20 years, from 0.91 in the first half of the 1990s to 1.15 in 2006–2010. By contrast, the transition economies have seen, on average, a decline in this ratio, from an already low level of 0.56 in the second half of the 1990s to 0.48 in 2006–2010. While this rough indicator does not take into account possible shifts in the income tax scale or possible variations in the rates of the VAT for different types of goods and services that are consumed in different quantities by the various income groups, it suggests that the evolution of the tax system has become more regressive.

(b) Level of public revenues

The fact that in many developing countries tax systems are more regressive also explains to a large extent why the share of total public revenue in GDP is, on average, much lower in developing than in developed countries. Regressive structures of revenue collection make the system dependent on the purchasing power of the lower and middle-income groups, but since this tax base is relatively small, the yield from this source is also limited.

During the period 2006–2010, the share of total public revenue and grants in GDP in developed countries ranged from 30 per cent to almost 60 per cent, with a mean of 41.8 per cent (table 5.1). This was much higher than in developing countries, where that share was, on average, only 28.2 per cent in Africa, 20.7 per cent in East, South and South-East Asia, 27.3 per cent in Latin America, 34.2 per cent in the transition economies, and 35.8 per cent in West Asia (table 5.2). As a result, developing countries, on average, have had less scope to influence income distribution through fiscal measures.

The effects of changes in the tax structure on total public revenue have differed across countries. Several studies have found that many low-income and least developed countries experienced a decline in their public revenue in the 1980s and 1990s, mostly as result of falling income and trade taxes (Heady, 2001; Khattry and Mohan Rao, 2002; Gemmell and Morrissey, 2003). Moreover, the expected efficiency gains from trade liberalization did not materialize partly due to the absence of fiscal schemes that could have compensated for the loss of revenue from trade taxes (Rodrik, 2006).

Available data for countries in sub-Saharan Africa and Latin America suggest that there were seldom any increases in government revenues in the 1980s and early 1990s. In the 1980s the fiscal-revenue-to-GDP ratio declined in 7 out of 14 countries in Latin America and the Caribbean (Sáinz and Calcagno, 1992). On average, Latin American countries saw a slight increase in this ratio after 1995 and especially after 2005, on account of a rise in both tax and non-tax revenues.

In Africa, the share of total public revenue in GDP fell until the second half of the 1990s, but then recovered, particularly after 2005, when rising earnings from commodity exports boosted non-tax revenues. In East, South and South-East Asia, the share of public revenue in GDP fell between 1995 and 2005, but subsequently recovered to reach almost the same level as in the first half of the 1990s. The budgets of countries in West Asia and those of the transition economies benefited from a continuous increase, on average, in public revenue as a share of GDP.

Where public revenues fell in the 1980s and 1990s, this reduced the scope for governments to enhance the development process and improve income distribution, especially as slow growth prevented an expansion of the income and consumption tax base in African and Latin American countries. These countries also experienced difficulties in borrowing on international capital markets during these years, while a large proportion of their public revenue was absorbed by high interest rates on their foreign debt and debt repayments. Thus, even where public revenue rose, it was insufficient to finance the large amounts required for investment in infrastructure to enhance growth (given the complementarity of public and private investment) and to increase social spending aimed at reducing income inequality.

Alternative sources of revenue could have been the surpluses of State-owned enterprises (SOEs), particularly in countries with rich natural resource endowments. However, from the mid-1980s onwards, in most countries many SOEs, including in the extractive industries, were privatized and the proceeds were used in large part to repay external debt.

In order to obtain the necessary foreign exchange, the privatization operations were often promoted by offering tax incentives to foreign investors, and the distribution of the rents from the exploitation of natural resources (i.e. the difference between the sales value and the cost of exploitation of natural resources) was often strongly biased in favour of the TNCs. This also led to considerably reduced gains of government revenues (*TDR 2005*, chap. III). It is only in recent years that a number of governments started to renegotiate their contracts with TNCs in the extractive sector (see *TDR 2010,* chap. V, sect. 5), as reflected partly in the figures for "other revenues" in table 5.2.

Market-friendly tax reforms of the 1980s and 1990s presuppose a trade-off between efficiency and equity ...

In order to adjust public budgets to this shortage of revenues, many countries reduced the provision of public services, or could not expand them in line with the needs of their growing populations. Following recommendations by the international financial institutions, many of them introduced user fees for public services such as education, health care and highways, which previously had been provided without charge. While the positive effects of these measures on fiscal balances appear to have been limited, they adversely affected disposable incomes in various ways, depending on the income profiles of the different users. The imposition of user fees for highways, for instance, tends to affect mainly the richer households in developing countries who are the main consumers of such services. By contrast, school fees, especially for primary education, and medical fees are more regressive, and have often led to the exclusion of the poor and vulnerable segments of society from the use of such services.[3] This, in turn, has adverse consequences for economic growth and the future distribution of primary income, as it perpetuates low skill levels among the members of the poorest households.

... However, recent experiences in Latin America and elsewhere suggest that progressive taxation can improve the fiscal balance, income distribution and economic growth.

In lower income countries an increase in official development assistance (ODA), especially in the form of budgetary support for countries undertaking fiscal reforms, could have compensated for the decline in public revenues from domestic sources. However, during the 1980s ODA flows per capita stagnated, and in the first half of the 1990s they even fell dramatically, not only in per capita terms but also in absolute terms (*TDR 2008*, chap. V).

From the mid-1990s onwards, ODA disbursements recovered from a historically low level. However, much of this increase was directed at a few countries emerging from several years of conflict, or was provided in the form of debt relief, so that it had a limited effect on current budgets. Despite the increase in ODA, a large gap – in the order of $50–$60 billion per year – remained between actual ODA flows and the aid estimated to be necessary for implementing measures to achieve the Millennium Development Goals (MDGs), in particular the goal to reduce poverty by half between 2000 and 2015. On the other hand, an increasing proportion of ODA targeted health, education and other social activities, with positive effects on income distribution in the recipient countries. But since the increasing share of ODA for these purposes meant a decline in the share of ODA allocated to growth-enhancing investment in economic infrastructure and productive capacities, its effects on structural change and the creation of new employment and wage opportunities were limited (*TDR 2008*, chap. V).

Various factors contributed to the general increase in public revenues as a percentage of GDP in developing and transition economies after 2000. In some countries, especially in Africa, the increase in ODA flows was a major factor, but in general it was the result of higher tax revenues, and in countries where the primary sector accounts for a large share of GDP, it was due to higher commodity prices.

In all regions, the rise in public revenues in the 2006–2010 period was on account of higher indirect taxes and income taxes. But equally important was the rise in non-tax income in commodity-exporting countries. The rise in commodity prices helped these countries to increase their fiscal revenues significantly, in some cases by 8 to 12 percentage points of GDP between the late 1990s and 2010 (*TDR 2011*, table 2.1).[4]

For Latin America there is evidence that a growing share of commodity rents has been captured by the State in recent years (Cornia, Gómez-Sabaini and Martorano, 2011). But tax reforms introducing a more progressive tax system also drove the rise in public revenues in some Latin American countries. For example, in Uruguay a new progressive labour income tax and a flat capital income tax were introduced, while some indirect taxes were reduced, with the objective of improving the fiscal balance, income distribution and economic growth. It is estimated that this reform helped to reduce the Gini coefficient, and thus inequality in personal income distribution, by 2 percentage points, without having any discernible disincentive effect (Martorano, 2012).

4. Fiscal space and public expenditure

The design of a national revenue system and the pattern of public expenditure can influence income distribution, but the effects vary. A progressive tax system affects all income groups and their relative incomes, including the income gap between the middle-class and top income earners. On the expenditure side, social transfers and the free or subsidized provision of public services are often directed at specific groups, such as the poorest, families with many children, the elderly and the unemployed. From this perspective, social expenditure is better suited to preventing or reducing poverty and to protecting social groups that are particularly disadvantaged or vulnerable. However, to what extent public expenditure aimed at reducing inequality should be targeted to specific social groups, and how, has been subject to debate (UN/DESA, 2008).

Targeting specific groups most in need, as opposed to providing more generalized coverage, has often been suggested by the multilateral financial institution and bilateral donors as a way to achieve social objectives, especially poverty reduction, without a rise in total social spending (Besley and Kanbur, 1990; Gelbach and Pritchett, 1995). This may mean greater support to certain groups at the expense of others who may also be in need of social support for other reasons, or it may be at the expense of public spending for purposes that are important for enhancing the development process more generally. It has also been argued that targeting requires administrative capacities and involves transaction costs, and that the selection of the groups to be targeted may often be influenced by political interests (Mkandawire, 2007). Targeting can also lead to social segmentation and differentiation that can have negative effects on social cohesion (UN/DESA, 2008).

In practice, the rationale for social spending in most countries is mixed: while certain types of spending aim to benefit society as a whole, others are targeted to specific groups that are in need of economic support and social protection. Both types of social spending in different combinations may be justified, depending on each country's specific situation. In general, the public provision of health care and education is of particular importance for overall economic development, while transfers in cash and in kind to specific segments of the population may be necessary for the eradication of extreme poverty. The main challenge, therefore, appears to be not so much to decide whether social spending should be targeted or provided universally when budgetary resources are limited, but to raise additional public revenues and, when necessary, to seek additional financial resources from international donors.

It appears that the scope for increasing public revenues through fiscal measures such as progressive taxation of high incomes may well be underestimated in many developing countries, including the poorer ones. As seen in chapter III, comparisons between the distribution of market income (gross income) and disposable income show that redistributive fiscal measures, although weakening (OECD, 2011), have been more effective in reducing inequality of disposable income in developed countries than in developing countries (Chu, Davoodi, and Gupta, 2000).[5] This is largely explained by the fact that in developing countries tax collection represents a smaller share of GDP and is less progressive (or even regressive). However governments in developed countries also tend to be more successful than those in most developing countries in influencing income distribution through greater social transfers and better public provision of social services. Most developing countries have fewer public financial resources for these purposes.

Policy reforms under structural adjustment programmes of the 1980s and 1990s failed to provide adequate protection and services to a majority of the population. The provision of health services, to be financed through cost recovery or pre-payment schemes, became "less accessible and less affordable and worse" in many African countries (Narayan et al., 2000: 87; UNCTAD, 2002). In Latin America, the quality of education provision varies, with the lower income groups having access to lower quality educational services (ECLAC, 2010). With respect to Latin America's pension systems, coverage declined across the board after the reforms that privatized the public pay-as-you-go systems (Mesa-Lago, 2004). Owing to falling or insufficiently growing government revenues – in particular in a period of growing debt service – the level of social transfers and provision of public goods necessary to tackle growing inequality were inadequate. In addition, overall GDP growth remained subdued despite greater income inequality.

Structural adjustment programmes of the 1980s and 1990s failed to provide adequate protection and services to a majority of the population.

Since the late 1990s, and especially after 2002, a rise in public revenues has enabled governments in some developing and transition economies to enlarge their fiscal space, including for taking measures aimed at reducing inequality. In addition to an increase in government revenues as a share of GDP, a reduction of the interest burden on the public debt since the late 1990s has also contributed to the enlargement of fiscal space in many countries. The lower interest burden was partly the result of lower international interest rates in countries that are primarily indebted to private creditors, and partly due to debt relief in countries primarily indebted to official creditors. Indeed, the unprecedented amount of official debt relief that has been granted to developing countries since the mid-1990s reduced the share of public finances that had to be allocated to debt repayment in a number of low- and middle-income countries. However, the impact of international debt relief on developing countries has varied considerably, especially between those that benefited from the Heavily Indebted Poor Countries initiative (and later the Multilateral Debt Relief Initiative) and others that did not. Moreover, there is no clear evidence that debt relief has been additional to other forms of aid (*TDR 2008*, chap. VI; UNCTAD, 2008). In many instances the debt relief provided has been insufficient to allow the redirecting of significant funds for enhancing infrastructure development and for reducing inequality. In some countries this has meant that governments have had to incur new debt, including domestically.

To the extent that a greater amount of public revenues have become available over the past decade, governments in several countries have been able to increase their current and capital expenditures, especially in Latin America, and to a lesser degree in Africa and East, South-East and South Asia more recently (table 5.3). At the same time many of them have been able to reduce their fiscal deficits, in some cases even generating a fiscal surplus. In Latin America, the mean total public expenditure rose by 5.3 percentage points of GDP and the mean total current expenditure by 4.9 percentage points between the early 1990s and late 2000s. In Africa, they increased by 3.8 percentage points and 1.5 percentage points, respectively, between the late 1990s and late 2000s.[6]

One important effect that higher fiscal revenues can have on income distribution is that it increases the potential for redistributive effects by lowering the tax burden for low-income groups. In the short run, enlarged fiscal space also allows an increase in public expenditures for infrastructure investment, improving the provision of public goods and expanding cash transfer programmes.

Public investment increased in Africa, Latin America and West Asia, and at the same time public debt and interest payments declined as a percentage of GDP. The increase in public investment is a key factor for enabling structural change and employment generation, not only because of its direct demand effects, but also because it is often necessary for inducing private fixed investment to follow or to take place in parallel.

Table 5.3

FISCAL EXPENDITURE, SELECTED REGIONS AND COUNTRY GROUPS, 1991–2010

(Per cent of current GDP)

	1991–1995	1996–2000	2001–2005	2006–2010
Developed countries				
Total expenditure	47.4	44.1	43.1	44.5
of which:				
Capital expenditure	5.0	4.6	4.3	4.7
Current expenditure	42.5	39.6	38.8	39.7
of which:				
Interest payments	5.2	3.9	2.7	2.3
Africa				
Total expenditure	26.6	23.8	26.2	27.6
of which:				
Capital expenditure	5.5	5.5	6.6	7.8
Current expenditure	21.1	18.3	19.6	19.8
of which:				
Interest payments	2.7	2.4	2.5	1.7
Latin America				
Total expenditure	24.5	26.6	27.7	29.8
of which:				
Capital expenditure	5.2	5.3	4.6	5.7
Current expenditure	19.3	21.3	23.1	24.2
of which:				
Interest payments	2.8	2.8	3.3	2.3
East, South and South-East Asia				
Total expenditure	22.0	20.7	21.5	22.1
of which:				
Capital expenditure	5.7	5.1	4.8	4.8
Current expenditure	16.3	15.5	16.7	17.3
of which:				
Interest payments	4.4	2.5	2.5	2.1
West Asia				
Total expenditure	37.7	33.6	32.0	30.0
of which:				
Capital expenditure	4.9	5.0	5.7	6.5
Current expenditure	32.8	28.5	26.3	23.6
of which:				
Interest payments	2.7	4.7	4.1	2.2
Transition economies				
Total expenditure	..	36.1	30.7	33.1
of which:				
Capital expenditure	..	5.9	4.6	5.1
Current expenditure	..	30.2	26.1	28.1
of which:				
Interest payments	..	1.9	1.1	0.6

Source: UNCTAD secretariat calculations, based on Eurostat, *Statistics Database*; *OECD.StatExtracts* database; ECLAC, *CEPALSTAT*; IMF, *World Economic Outlook* and *Government Finance Statistics* databases; and national sources.

Note: Data refer to the five-year average of the mean observation. East, South and South-East Asia comprises: China, China, Hong Kong SAR, Taiwan Province of China, India, Indonesia, the Islamic Republic of Iran, the Republic of Korea, Malaysia, Nepal, the Philippines, Singapore, Sri Lanka, Thailand and Viet Nam. (Data for China refer to budget revenue and expenditure; they do not include extra-budgetary funds or social security funds.) Latin America comprises: Argentina, Bolivia, the Bolivarian Republic of Venezuela, Brazil, Chile, Colombia, Costa Rica, Cuba (only for revenue indicators), Dominican Republic, Ecuador, El Salvador, Guatemala, Haiti, Honduras, Mexico, Nicaragua, Panama, Paraguay, Peru and Uruguay. Africa excludes: Botswana, Burkina Faso, Equatorial Guinea, Lesotho, Liberia, Madagascar, Mauritania, Mayotte, Saint Helena, Seychelles, Somalia, Western Sahara and Zimbabwe. West Asia excludes: Iraq, Jordan, Occupied Palestinian Territory and Yemen. Transition economies excludes Montenegro.

5. Influencing income distribution through public spending

Improved fiscal accounts have also enabled governments to influence income distribution through the better provision of public goods, including education. In Latin America, for example, public expenditure on education increased from 4.1 per cent to 5.2 per cent of GDP between 2000 and 2010.[7] It was accompanied by an increase in secondary school enrolment rates, from 72 per cent to 86 per cent, and an increase in the number of years of education of the workforce from 7.4 years to 8.2 years.[8]

An enlarged fiscal space can have a more immediate effect on income distribution to the extent that it is used for increasing social transfers. Indeed, parallel with enlarging their fiscal space, many developing and transition economies have undertaken reforms in the area of social protection. In particular, there has been a fairly sizeable expansion of social protection in Latin America and in some South-East Asian countries over the past decade.

A review of recent experiences suggests that social transfers and the public provision of social services can be powerful tools for reducing inequality of disposable incomes. Detailed international data on social expenditure spanning the past two decades are rather scarce, but data on current public expenditure suggest that public spending aimed at reducing inequality may have risen. In Latin America, in 7 countries out of 10 for which ECLAC provides data, public spending on subsidies and other current transfers increased significantly, though in some cases from relatively low levels. The increases ranged between 50 per cent and more than 200 per cent. In Argentina, for instance, these expenditures increased from a 3-year average of 8.2 per cent of GDP in 1990–1992 to 14.8 per cent in 2007–2009, and in the Bolivarian Republic of Venezuela they rose from 7 per cent to 13.9 per cent of GDP during the same period.

Since 2002, the widespread introduction of targeted social assistance in the form of conditional and non-conditional cash transfers appears to have had a sizeable impact on income inequality in Latin America (Cornia, 2012). In the transition economies, both total and current government expenditure as percentage of GDP rose by more than 2 percentage points or more between 2001–2005 and 2006–2010. In East, South and South-East Asia, although the share of government social expenditures in GDP rose less, in absolute terms it increased significantly. By contrast in West Asia, the share of such expenditure in GDP fell, though it remained higher than in Africa and other parts of Asia.

Some examples of social expenditure programmes that have recently been introduced in developing and transition economies following an enlargement of their fiscal space are presented below.

In Latin America, the failure of the earlier market-friendly policy reforms prompted a fundamental rethinking of the approach to social policy (Huber, 2009). The new approach aims at providing broad social protection against significant risks, improving access to social transfers for those in need, and greater provision of public services and goods with the same quality standards for all groups of society. Entitlements are based on citizenship and are conferred as rights, with a minimum of discretionary authority on the part of the agencies concerned, but the entitlements are also linked to corresponding obligations (Filgueira et al., 2006). This principle has shaped a number of new initiatives, such as a universal child allowance in Argentina, a universal old-age pension in Bolivia, and an old-age pension, and disability, sickness and maternity benefits in Brazil (ILO, 2010 and 2012).

In parallel, key instruments of social policy for poverty alleviation and redistribution, including conditional cash transfers (CCTs), have been introduced in a number of countries.[9] Non-contributory expenditures on social assistance in general, and CCTs in particular, appear to have been quite effective in protecting the poorest segments of society (Lindert, Skoufias and Shapiro, 2006; Cornia 2012), making the overall effects of the public finance system more progressive. There is also evidence that democratization and the abandonment of clientelism have improved the incidence of social expenditure (Lopez-Calva and Lustig, 2010). Such tax-financed programmes can have a stronger inequality reducing effect than social insurance schemes, even if unit transfers are relatively small (Skoufias, Lindert and Shapiro, 2010; Goñi, López and Servén, 2011). Significant fiscal redistribution in Latin America has also been achieved through in-kind transfers, such as the provision of health and education services provided cost-free or at a low cost.

In sub-Saharan Africa, only a few countries, mainly in Eastern and Southern Africa have expanded their social protection programmes so far. Social protection in this region differs from other developing regions in terms of coverage, quality and level of assistance. Until the late 1990s, formal social protection schemes covered, on average, less than 5 per cent of the workforce (Palacios and Pallarés-Millares, 2000). More recently, two types of social assistance schemes have been introduced. One, applied in some countries of Southern Africa, aims at old-age protection; the other targets extreme poverty, and is applied mostly in low-income countries in Central, East and West Africa (Niño-Zarazúa et al., 2012: 163–164).

In many Southern African countries, non-contributory social pension schemes that formerly targeted only certain groups of elderly poor have been extended to provide almost universal coverage, without discrimination by ethnic origin, and they are largely tax-funded. In many Southern African countries, the provision of non-contributory social pension schemes that targeted the elderly poor of certain ethnic groups have been extended as domestic initiatives no longer based on racial discrimination. This scheme is largely tax-funded, and the transfer payments to the elderly are almost universal. In Lesotho, Namibia, South Africa and Swaziland, the pension schemes reach between 80 and 100 per cent of the elderly at an estimated cost of 1–3 per cent of GDP (Barrientos, Niño-Zarazúa, and Maitrot, 2010; Devereux, 2007; Niño-Zarazúa et al., 2012). In Southern Africa, family structures have enhanced the effectiveness of income transfers since old-age grants are, in practice, income transfers to poor households with older people. This is because they tend to be deployed by recipient families for children's schooling, for improved health care and for reallocating productive resources within households (Barrientos, 2008; Møller and Sotshangaye, 1996).

Recent experiences suggest that social transfers and the public provision of social services can be powerful tools for reducing inequality of disposable incomes.

Several of the new transfer programmes in Central, East and West Africa are financed largely by ODA. And in many cases their design reflects the influence of international organizations and changing donor priorities as they attempt to shift their support from emergency and humanitarian aid to social protection.[10] These programmes have also benefited the recipient countries in terms of improving their fiscal space. The latter is a result of both debt relief and increased public revenues from faster growth and from natural resource exploitation in several countries. These recent experiences suggest that even in poor countries it is politically, fiscally and administratively feasible to implement social protection programmes (Giovannetti and Sanfilippo, 2011). However, they also show that in countries with a small fiscal base, increases in ODA remain crucial for institution-building.

In Asia, reforms of social protection systems vary considerably, reflecting a host of historical and other factors, including the level of economic development and the structure of the different economies. Several developing Asian countries, such as Bangladesh, Cambodia, Pakistan, and, more recently, Indonesia and the Philippines, have implemented CCT programmes over the past decade (ADB, 2012: 78). In the Republic of Korea, the expansion of the welfare system has strengthened the redistributive capacity of fiscal policies (Sung, 2009), with the largest contribution originating from direct taxation and cash transfers.[11] Redistributive policies in Thailand focus on poor rural areas,[12] while reform of the social protection system includes the provision of monetary transfers to the elderly poor, universal health coverage and 15 years of free education. In Malaysia, social objectives have traditionally been an integral part of the country's development strategy and constituted an important element of the National Development Policy (1991–2000) and the National Vision Policy (2001–2010) (Ragayah, 2011: 2).[13] In addition, the country's regional development strategy seeks to achieve balanced growth between the different regions of the country, regulate migration to urban areas and promote agricultural development. In all these efforts, State investments in infrastructure (transport, water and electricity, health and education) have been of paramount importance. However, in many developing Asian countries social protection usually has limited coverage. Moreover, the possibility to shield the poor against negative shocks remains constrained by the insufficient amount of resources allocated to social protection (ADB, 2008).

In China, the transition from a planned to a market economy has been accompanied by reform of the social security system. Work-related social insurance programmes, in particular for urban residents, were redesigned. In response to the emergence of urban poverty since the mid-1990s, the Government has shifted its emphasis to means-tested social assistance programmes as a major tool for combating poverty and maintaining social stability. As a result, the coverage of the Minimum Living Standard Guarantee System has been growing since the late 1990s, particularly in the coastal areas. In the western and central provinces, however, a significant proportion of the eligible population remains uncovered owing to insufficient funds at the disposal of local governments (Tang, Sha and Ren, 2003). Meanwhile, there is some support for housing, health care, education, employment and social services, but some argue that it needs to be further institutionalized (Leung, 2006). It has also been suggested that strengthening social policies and institutions that protect people against the many hazards associated with the rapid structural change China has been undergoing would help ensure that the benefits from fast growth are distributed to a larger proportion of the population (Xiulan and Yuebin, 2010).

In India, since the initiation of economic planning in 1951, there has been a long tradition of social transfers by both the central and state governments through a range of measures aimed at improving socio-economic security.[14] However, the large, centrally administered national programmes for poverty reduction had only limited success. Therefore in the 1980s more flexible schemes were implemented at a lower level of government with greater participatory and political oversight. A range of programmes aimed at reinforcing education and skills acquisition have also been initiated gradually since the 1990s by both the central and state governments,[15] but their effects have not yet fully materialized. Consequently, so far they have not prevented a significant rise of income inequality, especially in urban areas, since the beginning of the 1990s.

In several transition economies of Central Asia, recent social transfer schemes have not been particularly effective in addressing the needs of poor households owing to their limited coverage and funding (Gassmann, 2011). The social welfare policies of universal entitlement to State subsidies, inherited from the former Soviet Union, often means that meagre resources for social pensions are spread thinly over a large population. In addition, in many countries the design of transfer programmes appears to be inadequate. In Tajikistan, for instance, only 43 per cent of poor households receive transfers from the Government, while 33 per cent of non-poor households receive transfers (Son, 2012). Moreover, owing to decentralized budgets, poor localities that are the most in need tend to receive the least financial support. Hence, spending on social protection measures may need to be given greater priority as an item in the central government budget to ensure sustained and predictable funding (Gassmann, 2011). In the region's poorest countries, opportunities for rapid reforms seem to be more limited in the absence of increased domestic revenues. These countries therefore require additional external support for this purpose.

C. Policy recommendations

1. *Learning from experience*

Despite growing awareness of the social problems associated with increasing inequality, the design of fiscal policy in a large number of countries continues to be based on the belief that it is by minimizing State intervention not only in the economy in general, but also in favour of a more equal income distribution in particular, that maximum welfare for a society can be achieved. However, the market-friendly tax reforms that were undertaken over the past three decades based on this belief did not achieve their objective. When the redistributive elements in tax systems were weakened, thereby reinforcing the tendency towards greater inequality, the increase in the share of capital in GDP was not accompanied by the expected rise of fixed investment.

> The scope for using progressive taxation and government spending for reducing inequality and supporting economic growth is greater than is commonly assumed.

This shows that looking primarily, or exclusively, at the formal incidence of taxes and other public charges (i.e. the apparent income reduction for those who have to pay a higher tax) often leads to wrong assessment of the overall effects of a fiscal measure. Such a view fails to consider the benefits for the economy as a whole from a more equitable distribution of income and wealth resulting from fiscal measures – both on the revenue and expenditure side. First, there is a social return for taxpayers, even though it may not be proportional to each income group's tax burden. This return consists of direct benefits, in the form of overall government services and the provision of improved infrastructure, as well as indirect benefits for all in the form of greater social peace and cohesion when revenues are spent in a way that helps to reduce inequality and poverty and the likelihood of corruption and crime.

Second, and probably even more important, are the effects of the budgetary spending on aggregate demand and real income. Government expenditure, no matter how this is financed, has direct effects on income. Government revenues feed back into the economy as public spending which supplements private demand. It is often forgotten that the net demand effect of raising the average tax rate and, in parallel, overall government expenditure, is positive, since some of the additional tax payments are at the expense of the savings of taxpayers, while spending of the tax revenue will cause aggregate demand to rise by the full amount of the tax yield (Haavelmo, 1945).

The design of fiscal policy should also take into account the tax structure's indirect effects on demand, since it influences the pattern of net disposable incomes across different social groups. Aggregate consumption and the incentive for private firms to undertake fixed investments is greater when a given national income is distributed more equally, because lower income groups spend a larger share of their income on consumption than higher income groups. This is of particular importance in situations of high or rising unemployment.

Redistribution through fiscal measures may therefore be in the interest of society as a whole, especially where inequality is particularly pronounced as in many developing countries. This is supported by the experience in developed countries, as investment rates were not lower – but indeed often higher – in the first three decades of the post-war era, even though taxes on profits and top incomes were higher than after the widespread fiscal reforms implemented subsequently. There are strong reasons to believe that the willingness of entrepreneurs to invest in new productive capacity does not depend primarily on net profits at a given point in time, but on their expectations regarding future demand for the goods and services they can produce with additional capacity. This is of particular importance when considering the overall effect of an increase in corporate taxes. Provided that higher tax revenues are used for additional government expenditures, companies' expectations of a growth in demand will improve. This demand effect is independent of whether the additional government expenditures take the form of government consumption, public investment or social transfers. When the level of fixed investment is maintained as a result of favourable demand expectations, gross profits will rise − and generally so will net profits, notwithstanding the initial tax increase. In the process, additional income and employment will be created for the economy as a whole.

Based on these considerations, the role of fiscal measures as instruments for simultaneously stimulating economic activity and improving income distribution can be viewed in a different light. Indeed, the scope for using taxation and government spending for reducing inequality without compromising economic growth is likely to be much greater than is commonly assumed. Taxing high incomes at higher rates by using progressive scales does not remove the absolute advantage of richer individuals and does not take away the incentive for entrepreneurs to innovate and move up the income ladder. Taxing wealth and inherited fortunes may even be considered a means to providing incentives to the next generation to engage in economic activities in a manner that maximizes outcomes for society as a whole instead of relying on inherited fortunes.

2. Taxation, distribution and growth

As shown in chapter III, the share of income accruing to the highest percentiles has recently become larger in several developed countries. This means that in these countries there is greater potential for boosting government tax revenues, or for alleviating the tax burden of middle- and lower income groups, by increasing the top marginal rate. Clearly, there are upper and lower limits to the level of taxation. The lower limits are determined by the need to finance a minimum amount of public investment and services. The upper limits are difficult to determine due to the endogeneity of tax revenue (discussed in the next subsection), but also due to uncertainty about how the economic behaviour of taxpayers will respond to changes in tax rates. If tax rates are raised above a certain threshold, which is, however, impossible to determine precisely, the behavioural response of those who have to bear the greatest share of the tax burden may cause the tax base to shrink along with the economic activity that determines the tax base.

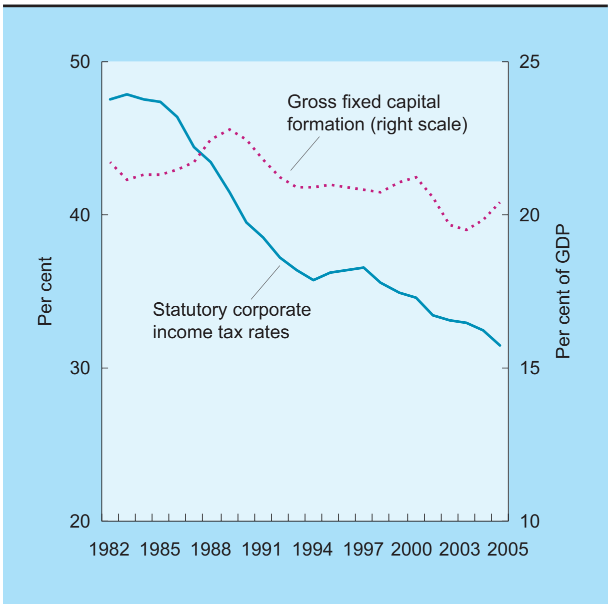
However, even on this count, the scope for higher marginal tax rates imposed on top incomes or on corporate profits is likely to be larger than is often assumed. One recent study has found that current top income tax rates in most OECD countries are well below those at which the total tax yield would be maximized (Piketty, Saez and Stantcheva, 2011). According to this study, revenue-maximizing top marginal income tax rates range between 57 per cent and 83 per cent. The lower bound rate refers to the taxation of top incomes from "productive" work, while the upper bound rate refers to the taxation of top incomes resulting from both rent-seeking activities (i.e. personal enrichment from capturing a larger slice of existing production rather than by increasing it) and productive work. In any case, these figures contrast sharply with the actual average of the top marginal income tax rate of 43 per cent in the 18 OECD countries during the 2004–2008 period. During this period, only three of these countries had average top marginal tax rates slightly above the lower bound of this range (57 per cent). To the extent that the income of the highest percentiles arises from rent-seeking activities, the impact of rising top income marginal tax rates on economic growth may even be beneficial because it will discourage rent-grabbing behaviour and increase others' revenues.

It is also worth noting that fiscal policy pursues multiple objectives. From the point of view of development, fiscal measures that provide direct support to private fixed investment are essential. But the issue here is not to keep taxation of profits at a minimum; indeed, the gradual decline of the statutory corporate income tax rates did not lead to a rise in gross fixed capital formation (GFCF) in developed countries from the 1990s onwards (chart 5.3). Rather, what is needed is a differentiation in taxation of profits based on the origin of the profits and how they are used. For example, profits from productive entrepreneurial activity may be taxed at a lower rate than profits from purely financial activity, especially speculation and "unearned" capital gains that provide no benefits for the overall economy.

This is of particular concern in light of the immense expansion of the financial sector. Taxation of transactions in equity, bond, currency and derivatives markets, applied internationally or nationally, may help check a further expansion of destabilizing speculative activity that is conducted at the expense of financing real investment, while also having a progressive incidence (see also UN/DESA, 2012). Similarly, taxing bonuses in the financial sector at a higher rate than regular wage incomes may reduce the incentive for excessive risk taking.[16] In a financialized economy, taxation of capital gains – which so far has typically been lower than taxation of income from productive activities − and its differentiation between short-term and long-term changes in the value of financial and real assets, may also be worth considering in many countries. Again, it is justified on the grounds of reducing the incentives for short-term speculative investments and having the effect of increasing the progressive incidence of the tax system (Dodd, 2007; Toder and Banemann, 2012).

Chart 5.3

STATUTORY CORPORATE INCOME TAX RATES AND GROSS FIXED CAPITAL FORMATION IN SELECTED DEVELOPED COUNTRIES, 1982–2005



Source: UNCTAD secretariat calculations, based on an updated version of Devereux, Griffith and Klemm, 2002, at: http://www.ifs.org.uk/corptax/internationaltaxdata.zip.

Note: The data refer to the average of the following countries: Australia, Austria, Belgium, Canada, Finland, France, Germany, Greece, Ireland, Italy, Japan, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, the United Kingdom and the United States.

Additionally, in developed and developing countries alike, reinvested profits in the non-financial sector may be taxed at a lower rate than distributed profits. Moreover, a further differentiation could be made across specific areas of activity so as to provide incentives in support of a profit-investment nexus that helps to influence the direction and speed of structural change (*TDR 1997*, chaps. V and VI). In developing countries, taxing consumption of luxury goods at a higher rate than mass consumption, besides having a progressive incidence, may also help in this regard.

It should also be noted, however, that an increase in the progressivity of a tax system may not always imply proportionally stronger public finances as a whole. This is the case, for example, when the tax yield from imposing higher taxes on high-income groups is channelled back to more or less the same income groups in the form of interest payments on government bonds, which are typically held in large part by the wealthier segments of a population. By the same token, an individual regressive tax may not necessarily contribute to greater inequality if the tax yield is spent in such a manner that it has a progressive effect, for example through social transfers and improved public services. What matters, therefore, is the progressivity of the fiscal system as a whole in terms of the structure of both taxation and public expenditure.

3. Fiscal space in developing countries

The considerations in the preceding section are relevant for developed countries, emerging market economies and other developing countries alike, even though there are large differences in the structure of their public finances and in their administrative capacities to effectively raise certain types of public revenue. A major difference is also that fiscal space in most developing countries is more strongly influenced by international factors that are beyond their control, such as fluctuations of commodity prices and international interest rates, and the availability of external financing in the form of either private capital inflows or ODA. And fiscal space in low-income and least developed countries is smaller almost by definition (i.e. owing to their low level of national income).

Appropriating a greater share of commodity rents could benefit the entire population, and not just a few domestic and foreign actors.

Within these constraints, however, fiscal space is largely determined endogenously. A proactive fiscal policy influences the macroeconomic situation and the overall tax base through its impact on private sector incomes (see also *TDR 2011*, chap. II). Where private consumption and investment are weak, an appropriate expansionary fiscal policy can boost demand expectations and the willingness to invest, thereby enlarging the tax base. This will also enhance the scope of governments to raise additional revenue to finance expenditure that reduces inequality, or to restructure the pattern of taxation across different income groups. By contrast, general fiscal retrenchment, as currently pursued in many developed countries, but also under adjustment programmes in developing and transition economies, owing to its negative impact on aggregate demand and the tax base, will lead to lower fiscal revenues and thereby reduce the scope for such fiscal action.

Suitably designed reforms of direct taxation can simultaneously achieve the goals of lowering income inequality and boosting growth of output and employment creation in developed and developing countries alike. The low degree of progressivity in developing and transition economies' tax systems and the large differences between regions and countries in this regard suggest that in many of these countries there is considerable scope for tackling income inequality effectively through more progressive taxation. Of course, this requires not only a change in perspective regarding the role of public finances, but also a relatively high degree of formal employment and suitable administrative capacity. In this regard, developing countries' capacities to raise specific revenues vary greatly, depending on their level of development, the size of their informal sector and the composition of their GDP.

On the other hand, there are a number of potential sources of revenue that can contribute to improving equality while increasing government revenues, including in low-income countries. Taxation of wealth and inheritance is one such potential source that can be tapped in many developing countries for these purposes. This demands less administrative capacity, is harder to circumvent and has a progressive effect.

In resource-rich developing countries, income from the exploitation of natural resources and gains from rising international commodity prices are other potentially important sources of public revenue. By appropriating a greater share of commodity rents, governments can ensure that their countries' natural resource wealth benefits the entire population, and not just a few domestic and foreign actors. There appears to be considerable scope in many countries for collecting a larger amount of royalties and taxes, especially from companies active in the oil, gas and mining sectors. This is particularly important because the revenue potential from natural resources has grown significantly over the past decade owing to higher commodity prices and the discovery of new sources of energy, especially in Africa.

Strengthening international cooperation in tax matters could help avoid a downward spiral in competition for FDI and reduce tax evasion.

When terms-of-trade gains from commodity prices are expected to be temporary, they cannot serve as a solid basis for a sustained increase in government revenues and, in parallel, in public spending. However, even if temporary, the higher rents or windfall profits in the primary sector can still be used to help accelerate productivity growth and job creation elsewhere in the economy. This requires special taxation of the windfall profits and channelling them into productive investments elsewhere in the economy. The accumulation of unstable income of this kind in sovereign wealth funds or national development banks and spreading the use of these funds over time for specific social purposes may help to prevent a further increase in income inequality. High taxation of such windfall profits is especially justified since those profits are not the result of entrepreneurial success but of gyrations in international commodity prices that are beyond the influence of the individual commodity producer.

Another issue with regard to tax policies in developing countries is the treatment of TNCs and FDI, not only in the mining sector but also in the manufacturing and services sectors. While the activities of TNCs and FDI inflows have the potential to strengthen the productive capacity of host countries, this potential is not always fully exploited when the linkages with domestic producers remain weak. Nevertheless, developing countries often try to attract additional FDI by offering investors far-reaching – and sometimes excessive − fiscal concessions. Although these strategies have often been successful in attracting FDI, they may be worth reconsidering, because offering large tax concessions to attract FDI to the manufacturing sector generally involves competing with other potential host countries that are also offering concessions. This is problematic, since it creates a downward spiral in taxation that reduces the fiscal space of all the countries concerned. Moreover, any initial tax advantages will erode over time.

Strengthened international cooperation in tax matters could help avoid such tax competition, while preserving both the fiscal space of governments in countries that compete for production locations and the relative advantage that can be had from FDI on the basis of labour cost differentials (see also chapter VI below). Governments of the home countries of foreign investors could help prevent such tax competition by taxing profit remittances from FDI at a higher rate than domestic profits while deducting from the tax charge the typically much lower taxes already paid on the corporate profit in the host country. Taking into account the large differences in unit labour costs between the home and host countries, this could be done in such a way that the profits of the foreign investors from their production in the developing country would still be a multiple of those that would result from the production of the same goods at home.

Strengthened international cooperation on taxation is also necessary to reduce tax evasion. For this purpose, the current United Nations Committee of Experts on International Cooperation in Tax Matters could be made into a truly intergovernmental body. A new treaty based on the *United Nations Model Double Taxation Convention between Developed and Developing Countries: 2011 Update*[17] would support the interests of developing countries better than the one based on the current OECD model, since the former gives more taxing rights to developing countries.

Increasing public revenues with measures such as those discussed above would be important, though not sufficient, for enhancing the impact of fiscal policy on income distribution; much will also depend on how the increased revenues are spent, as discussed in the next section.

In several low-income and least developed countries it may be difficult or impossible to promptly implement any of these measures to increase fiscal space, because of their limited administrative and tax collecting capacities. In these cases, the multilateral financial institutions and bilateral donors would need to help by providing additional resources for social spending, as well as the appropriate technical and financial support for strengthening those capacities.

4. Public spending to reduce inequality

External financial support to low-income countries for social spending is all the more important for reducing inequality, since the lower the level of a country's income, the more limited is its scope for achieving some redistribution through progressive taxation. For many developing countries, increasing the progressive incidence of the public budget is probably best achieved through well-targeted redistributive spending, but also through growth-enhancing public investment.

Public investment in infrastructure, health and education, as well as environmental protection can create the conditions for higher productivity, diversification of production and decent formal employment in the rest of the economy. This also holds for the provision of fiscal incentives and improved public services within the framework of industrial policies aimed at diversification of economic activities. Generally, these measures may not reduce inequality directly, but they could contribute to strengthening a dynamic process of structural change through which fiscal instruments, and incomes policies (as discussed in chapter VI of this *Report*), would become more effective.

A progressive income tax, income transfers of various kinds to low-income groups and improved access to education and skills acquisition may contribute to correcting income inequality …

Taxing the rich to provide better public education may reduce inequality and promote faster growth. However, the provision of public services should also include the middle classes in order to raise overall skill levels, which will ultimately also contribute to a more equal income distribution and to an enlarged tax base in the future.

Increased government transfers may help reduce criminal activities as well, thereby alleviating social tensions and instability, and further stimulating investment and growth. There is evidence of a positive relationship between direct government transfers and growth. Public employment schemes, such as those launched in a number of developing countries in recent years (*TDR 2010*, chap. V), may have a positive effect on income distribution through several channels. First, they provide an income to workers who would otherwise be unemployed and who lack protection through any unemployment benefit scheme. Second, they help to establish an effective wage floor, similar to minimum wages imposed on employers in the formal private sector. Third, the additional demand for goods and services generated this way could help expand markets, and drive output growth and employment generation elsewhere in the economy, which in turn would contribute to enlarging the tax base. Fourth, they could be combined with projects to improve infrastructure and the provision of public services. Finally, such schemes could attract workers from the informal sector and provide them with professional skills, or enhance their existing skills, which would improve their employment prospects subsequently in the formal sector. There is evidence that public sector employment schemes can contribute to faster growth, and that they can be successfully implemented even in low-income countries with a low administrative capacity (Weeks, 2010).

The capacity of countries to introduce social security schemes, such as old-age pension funds or unemployment benefits, also depends to a large extent on their stage of development. On the other hand, the existence of such institutions and the size of the population covered can have positive effects on the process of structural change, development, and in the case of unemployment insurance schemes, on macroeconomic stability. Similar to other fiscal measures, they can also provide incentives for the self-employed and for workers in the informal sector to join the formal sector, even if the wages there are not higher. For the lowest income groups in developing countries, social transfers of this kind need to be financed from overall public revenues so as to achieve the desired distributional effects and ensure as broad a coverage as possible. For the middle- and high-income groups, social security may be based on specific individual contributions that determine individual entitlements. Even if a progressive element is built into such schemes, establishing a link between contributions and entitlements would increase the motivation of the population to contribute to the fiscal base (Huber, 2009). International financial institutions and bilateral donors can support the creation of such schemes by allocating ODA for such purposes.

… At the same time, these measures can support domestic demand and boost growth and employment creation in the economy as a whole.

Governments may also use the proceeds from higher tax revenues for different forms of concessional lending and technical support in favour of small producers in both the industrial and rural sectors. Apart from supporting productivity and income growth in these activities, the provision of such financing could also serve as a vehicle to attract small-scale entrepreneurs and workers into the formal sector. They would thus become part of a socio-economic dynamic that builds on various institutions, including social and labour market institutions. Similarly, when governments manage to obtain gains from rents and windfall profits resulting from commodity exports in international foreign currency, they may channel these proceeds to national public financial institutions that provide foreign exchange credits to investors in other sectors for the acquisition of capital goods and technologies from abroad.

In conclusion, a progressive income tax, income transfers of various kinds to low-income groups and improved access to education and skills acquisition may contribute to correcting inequality in the distribution of incomes. At the same time, these measures can support domestic demand and boost growth and employment creation in the economy as a whole. However, there are limits to achieving greater equality in personal income distribution in this way. A comprehensive policy approach to reversing the trend towards greater inequality will require a broader reorientation of economic policy that takes into account the dynamics linking productive investment, growth and income distribution, which are influenced by labour market and macroeconomic policies. These aspects are discussed in the next chapter.

Notes

1 Econometric estimates confirm this interpretation of the charts. For chart 5.2A, the regression of the real per capita GDP growth rate over the entire period on the change in the top marginal income tax rate using robust standard errors gives a non-significant coefficient at the 10 per cent threshold (p-value = 0.126) and a very low R-squared (R-squared = 0.07). For chart 5.2B, the regression of the change in the top 1 per cent income share on the change in the top marginal income tax rate using robust standard errors gives a highly significant coefficient (p-value = 0.001) and a much higher R-squared (R-squared = 0.50).

2 A review of the system of government revenue collection in the United States until the 1930s shows that the government at that time relied primarily on tariffs, selective excise tax, and, eventually, a corporate income tax for its revenues. In addition, a century ago, United States tax revenues, measured as a share of GDP, were much smaller than they are at present (Hinrichs, 1966).

3 For further discussions on this issue, see Reddy and Vandemoortele, 1996; Devarajan and Reinikka, 2004; and Dupas, 2011.

4 In Latin America, it has been calculated that the increase in fiscal space after 2002 was largely due to higher commodity prices. Revenues from taxes, profits and royalties from commodities accounted for as much as 50 per cent of some countries' total increase in fiscal revenues as a share of GDP. The other main contribution to revenue growth derived from a new emphasis on progressive taxation (Cornia, Gómez-Sabaini and Martorano, 2011).

5 However, substantial anecdotal evidence suggests that local residents in many communities in developing countries contribute substantially to the construction and maintenance of local public goods outside the formal tax system, and thus their contributions are not recorded (e.g. Ostrom, 1991). People contribute to social welfare projects in the form of both money and labour, in often complex arrangements that determine how much each household should pay and what penalties apply to free riders (Olken and Singhal, 2011). Given the nature of these arrangements, it is likely that the contributions are quite progressive. For more information about such informal arrangements in developing countries, see Schneider and Enste, 2000.

6 Because there is a great variation in the composition of countries in Africa between the periods 1991–1995 and 2006–2010, the calculations were made for the periods 1996–2000 and 2006–2010 to avoid spurious computations reflecting changes in the composition of the sample.

7 UNCTAD secretariat calculations, based on UNESCO, *Institute for Statistics* database and World Bank, *World Development Indicators* database.

8 Data referring to secondary school enrolment and the number of years of education come, respectively, from UNESCO, *Institute for Statistics* database and ECLAC, 2011.

9 CCTs, which consist of small cash transfers to poor families, are conditional on certain behaviours, such as regular school attendance and ensuring health check-ups of their children of a certain age. They are widely used to address the problem of keeping poor children in school and to encourage greater access to health care. Originating in Brazil and Mexico, CCTs have become an increasingly popular tool for combating poverty, with more than 30 countries now providing such programmes (Fiszbein, Schady and Ferreira, 2009; Fried 2012; ILO, 2012).

10 The new wave of social transfer programmes includes: the Social Cash Transfer Scheme launched in 2003 in Zambia; the Orphans and Vulnerable Children Programme launched in 2004 in Kenya; the Productive Safety Net Programme launched in 2005 in Ethiopia; the Livelihood Empowerment Against Poverty programme launched in 2008 in Ghana; as well as the recent scaling up of the Food Subsidy Programme in Mozambique and the Mchinji (social cash transfer) Programme targeting the ultra poor and labour-constrained households in Malawi. Several smaller pilot programmes in other countries in West, Central and East Africa also exist, but remain at a more experimental stage (ODI and UNICEF, 2009).

11 The Government responded to the Asian crisis by strengthening the protection system, which was built on "five social insurance programs (Industrial Accident Insurance, National Health Insurance, National Pension Program, Employment Insurance Program, and Long-Term Care Insurance), one social assistance program (the Minimum Living Standard Guarantee), and public pension programs for special categories" (Kwon, Dong and Moon, 2010: 8). In addition, a minimum living standard guarantee scheme offers benefits to poor people, provided they participate in training, public works projects or community service (Kwon, 2005).

12 Measures included a three-year suspension of the debt of small farmers, which benefited 1.9 million families between April 2001 and March 2004 (Trakarnvanich, 2010), and the introduction of micro-credit schemes through the Thailand Village and Urban Revolving Fund (Boonperm, Haughton and Khandker, 2009). A similar project was introduced in 2005 at village level with the aim of helping each village to cope with their communitarian problems. To reduce migration to the city and to favour local income generation, the Government also introduced the One Tambon-One Product programme in 2001, which provides people with advice and technical assistance for the sale of their home-made products. Finally, in 2005, the Government implemented the Special Purpose Vehicle programme which focuses on the creation of a State enterprise for supporting agricultural activities through the provision of inputs.

13 To achieve these objectives, the Government supported the creation of a Malay middle class by promoting the acquisition by ethnic Malays of assets and access to well-paid jobs, supporting financial and management training for firms run by them, setting enrolment quotas in tertiary education, and supporting activities of the poorest households.

14 See Prabhu (2001) for a detailed review of the concept of socio-economic security and its translation into practice in the Indian context.

15 These include the Dhanalakshmi, or the Conditional Cash Transfer Scheme for Girl Child, launched in 2008; the Janani Suraksha Yojana launched in 2005, which aims to reduce maternal and neo-natal mortality through institutional deliveries; the Balika Samridhi Yojana launched in 1997, which aims at creating an enabling environment for the girl child to be born and become an educated and healthy adult; the National Programme for Education of Girls at Elementary-Level under the Sarva Shiksha Abhiyan, launched in 2003; the Kasturba Gandhi Balika Vidyalay Scheme launched in 2004, which seeks to arrest the dropout rate of girls in secondary education and ensure their retention in school up to the age of 18 years. See Prabhu (2009) for details about the many schemes at the state level.

16 This may complement regulations relating to remuneration structures in the financial sector, but also in the non-financial corporate sector more generally.

17 See: http://www.un.org/esa/ffd/documents/UN_Model_2011_Update.pdf.

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