



# Reducing inequality: The role of good financial governance

## The international debate on inequality

The problem of inequality has received increasing attention over the last few years. While progress to reduce poverty has been made in recent decades, the fruits of economic and social progress are not equally shared: 'Taken together, the bottom half of the global population own less than 1% of total wealth. In sharp contrast, the richest decile hold 87% of the world's wealth, and the top percentile alone account for 48.2% of global assets' (Credit Swiss global wealth report 2014).

### Defining inequality:

Inequality is a multi-dimensional phenomenon. Following Amartya Sen's capability approach, inequality thus embraces a number of different dimensions of deprivation and the distribution of human opportunities for personal development:

- economic dimension (e.g. income, decent work, assets);
- human dimension (e.g. education, health);
- political dimension (e.g. empowerment, rights);
- sociocultural dimension (e.g. status, dignity);
- protective dimension (e.g. insecurity, risk, vulnerability).

Approaches to reduce inequality in development cooperation can aim either to reduce income inequality or to tackle inequality of opportunity between households/individuals (vertical inequality) and between groups (horizontal inequality).

Skewed distribution of income and wealth (vertical inequality; inequality of outcome), as well as uneven access to social services and the marginalisation of people belonging to certain groups (horizontal inequality; inequality of opportunity) negatively affect societies. Both these forms of inequality are intertwined, being two sides of the same coin.

A paradigm shift with respect to inequality is visible. Previously, it was commonly argued that inequality was necessary to foster competition as a basis for well-functioning markets and economic growth. In recent years, however, these traditional views have been challenged from several angles, both

on purely economic grounds as well as through socio-political arguments that look at the detrimental effects of inequality on political stability and wellbeing in society. For these reasons, the World Economic Forum's 2014 Global Risk Report ranks 'severe income disparity' as the fourth global risk of highest concern (out of a total of 10 listed). Moreover, the increase in violent conflict and inequality between countries has contributed to motivating (economic) refugees to risk their lives attempting to reach Western countries. It is therefore not surprising that the proposed Sustainable Development Goals (SDGs) include a specific goal on reducing inequality.

## Good financial governance and inequality

The German development cooperation's Good Financial Governance (GFG) approach distinguishes itself from standard public financial management (PFM) reforms in that it takes into account the normative and political-economy dimensions of public finance reforms.

### The normative underpinnings for reducing inequality through GFG

The German understanding of financial governance is based on a set of national and international norms and values. These include, among others, the reduction of poverty and inequality by means of fair, accountable and transparent public finance systems. Moreover, the current coalition agreement that guides German development cooperation policy stipulates that more inclusive growth must be achieved and that the evolution of sound fiscal institutions must be promoted.

### The political-economy dimension of inequality and GFG

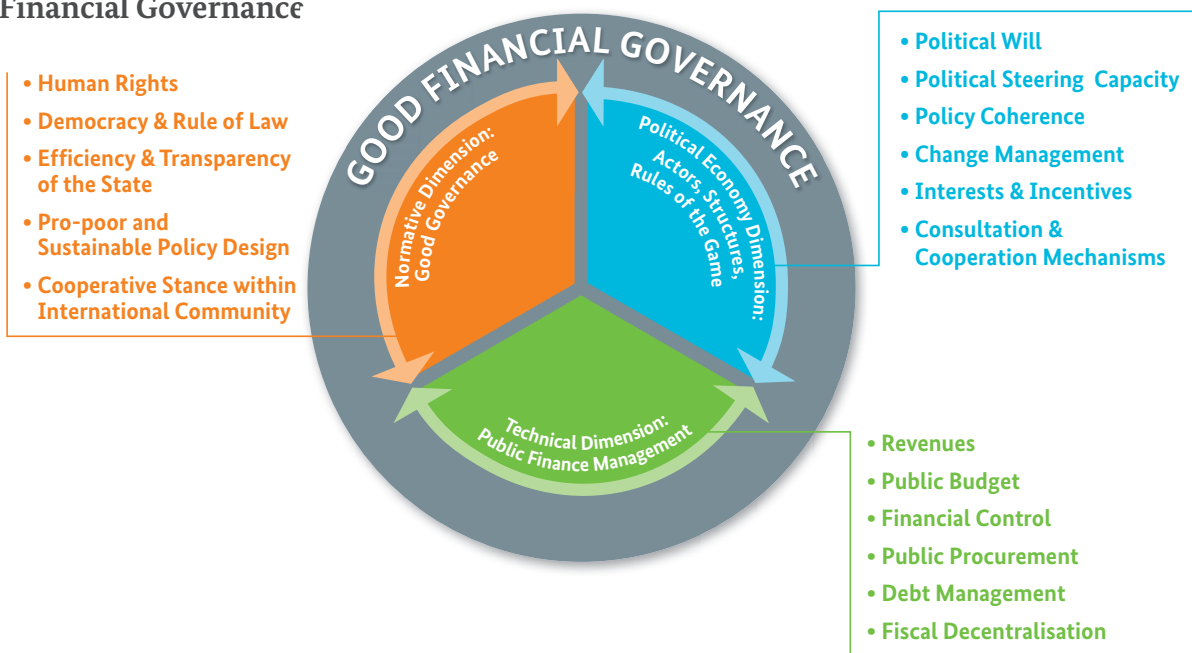
Reducing inequality is a highly contentious topic. At first sight, there seems to be an overall consensus on the negative impact of and need for reducing inequality. Yet, the measures for achieving such a reduction (e.g. progressive income taxation, subsidy reduction, cutting ineffective expenditure programs) are often highly political, are contentious in nature and touch upon the distribution of power within and among countries. Redistributing wealth and providing more equal access to public goods and services can produce winners and

losers. For instance, powerful interest groups, who potentially stand to lose out because of redistributive policies, are often capable of disproportionately influencing the manner in which tax structures evolve or in which proposed tax reforms are implemented. Moreover, policymakers may decide that inequality-reducing measures are unfeasible because they themselves stand to lose out or because they are so intertwined and dependent on the support of economic elites that they have few incentives to change the status quo. Also, a country's population may, for cultural or historical reasons, be wary of too much government involvement. As such, particularly when looking at inequality through a GFG lens, it is vital to understand the various interests and power dimensions that define the space for policy intervention.

### Reducing inequality through sound public financial management

In many European countries, fiscal policy has played a significant role in reducing income inequality – particularly on the expenditure side, but also through progressive tax systems. In developing economies, the redistributive impact of fiscal policy is severely restricted by lower overall levels of both taxes revenues and transfers compared to advanced economies. Additionally, the way taxes are raised is often characterised by governance deficits, which have a major negative impact on equality. As a result, spending is also much lower in developing economies, particularly in the Asia-Pacific region and in sub-Saharan Africa, mainly due to low transfer spending. This substantially reduces the redistributive potential of fiscal policy in developing economies. Public expenditure is particularly important in the social sector (especially for education, health and social protection) and also to guarantee access to basic infrastructure (water and sanitation, electricity, roads), in particular in deprived areas.

## Good Financial Governance



## Measures to reduce inequality from a GFG perspective

Measures aimed at reducing income inequality should be central to any development strategy. Sound taxation and the effective use of public funds can play a pivotal role in addressing inequality. If GFG is to tackle inequality, policymakers must have an understanding of the fiscal policy instruments that can narrow existing gaps in income and opportunities. However, they should also take into account the framework conditions for actually implementing fiscal policies (e.g. high share of informal activities, limited administrative capacities, problems of fiscal restraint). The following aspects only highlight possible entry points for supporting measures aimed at reducing income inequality from a GFG perspective.

### 1. Creating fair, transparent and efficient tax systems

#### Reform regressive taxes

Heavy reliance on fiscally attractive consumption taxes, such as VAT, is ultimately regressive: the burden for low-income taxpayers is proportionately higher because they consume a larger share of their earnings than wealthier taxpayers. Applying differential VAT rates for basic necessities and luxury goods can help to address this problem, but these kinds of measures remain exceptional and are often costly to administer. Indeed, taxes on goods consumed primarily by the poor are most consistently found to be regressive, whereas taxes on luxury items like cars, beverages and alcohol are most likely to be progressive.

### Reduce harmful tax exemptions

Tax exemptions are commonly deployed as a fiscal instrument to promote economic growth and stimulate investment. However, tax exemptions often become arbitrary and can end up mainly benefiting taxpayers with a high level of political and economic influence – the very people who should be taxed more intensively from an equality point of view.

### Develop mechanisms to enforce compliance among large firms and high-wealth individuals

In many countries, the high revenue potential of large firms and high-wealth individuals (HWI) remains underexploited because of their access to complex legal and illegal strategies that reduce their respective tax burdens. This, in turn, undermines the redistributive function of the tax system that should be taxing the rich more heavily than the poor. Increasing tax revenues from these taxpayer groups can be achieved by creating specialised HWI units and large-taxpayer units within tax administrations.

### Investigate the potential for taxing wealth (property, inheritance), capital income and energy

These forms of taxation significantly target the wealthy, yet they are the least deployed tax instruments in developing countries. A key issue is that these countries collect hardly any data on capital income and wealth. As such, their tax administrations need to develop the capacities required to gather this data and to better explore these kinds of taxation.

### Increasing voluntary tax compliance

A fair tax system across all taxpayer segments and sound public financial management (e.g. efficient and effective public investments) are driving forces for voluntary tax compliance. Reducing inequalities by on the one hand tackling tax evasion, corruption and inefficiencies in public spending and on the other hand fostering progressive taxation creates positive incentives for taxpayers to pay their contributions (i.e. enhanced tax morale).

### Strengthen tax authorities

In many developing countries there is a gap between legal taxation liabilities and actual collection. This is partly due to underlying weaknesses in institutions and governance. More and better capacity building in tax administrations is therefore needed to broaden the tax base through increasing personal income tax (PIT) coverage, which is particularly weak in most developing countries.

### Develop the potential of under-taxed natural resource wealth

Many natural-resource-endowed countries lose out on important revenue opportunities through, for example, tax breaks and reductions for mining companies but also corrupt practices and rent-seeking behaviour.

## 2. Redistributive and fair public expenditure management

### Strengthen GFG in key sectors that are vital for reducing inequality of opportunity

Expenditure management in sectors like health and education should be strengthened in order to enhance policy coherence and the effective and efficient use of public funds.

### Cut unproductive, inefficient expenditure

Budget officials should make greater efforts to assess whether programmes intended to reduce inequality actually meet their targets. Programme budget reforms, as well as better quality and timely monitoring and evaluation might be helpful in this respect.

### Analyse the redistributive nature of public budgets

While national development policies often express the intent to reduce poverty and inequality, budget allocations might not always reflect these political goals. Budgets can also disproportionately favour sectors that do not directly enhance social





wellbeing (e.g. defence). Tools for assessing the (potential) redistributive effect of reforms and budgetary allocations (policy impact assessments, gender budgeting, etc.) are already available.

### Improve the capacity to implement better-targeted transfers

An example of poor targeting is, for instance, that the middle class captures most of the gain from primary education and primary health care, particularly in sub-Saharan Africa and transition economies. A number of factors influence poor targeting, ranging from insufficient administrative capacity or failures in accurately identifying intended beneficiaries, to corruption and patronage, where politicians end up targeting public expenditure at regions or groups to which they have allegiance. In many cases, poor targeting can be explained by barriers to access, such as user-fees or physical distance, which prevent poor individuals from benefiting from the public services the state provides.

### Reduce universal price subsidies

Even though economically disadvantaged groups may benefit from certain subsidies, expenditure reforms should focus on the at-times detrimental effects of universal price subsidies and regularly scrutinise the utility and efficiency of these subsidies in terms of how they benefit the target group.

## 3. Procurement systems as an instrument for reducing income inequality

### Strengthen the involvement of small and medium-sized enterprises in public contracting

Depending on the country, public procurement accounts for around 50% of government expenditure and can therefore be

employed as a strategic instrument for redistributing wealth. Approaches that involve redesigning parts of the public procurement legal framework can contribute to strengthening small and medium-sized enterprises and, therefore, to reducing income inequality. The approaches include, for example, splitting public tenders into lots or granting smaller enterprises preferential pricing options that mean their bids have a better chance of competing against those of bigger outfits. Yet, the success of such measures depends largely on strengthening the capacities of procurement units and enhancing integrity and internal control mechanisms.

## 4. Accountability regarding the use of public funds in order to reduce inequality

### Audit social expenditure programmes

All audits bear the possibility of improving fiscal policies, rule-of-law and – indirectly – reduce inequality. In particular, supreme audit institutions (SAIs) should be provided with the capacity to play a key role in evaluating the effectiveness, quality and policy coherence of social expenditure programmes that aim explicitly or implicitly to reduce inequality (performance audit). SAIs are often the institutions most people trust when it comes to sourcing credible information about the performance of public institutions and to monitoring whether publicly funded programmes achieve their desired social impacts.

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