6 Tax systems and their equalising potential

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Low- and middle-income countries need to increase their tax revenue collection dramatically to finance progress towards the Sustainable Development Goals. This chapter discusses why equitable and sustainable tax systems, progressive tax design, implementation and monitoring should be given more attention in the broader fiscal and economic context – as essential tools for tackling poverty and inequality. It examines and shares examples of complementary fiscal measures, such as enforcement and targeted redistribution to the poorest to make fiscal systems fairer and to generate greater revenue. It notes that using tax systems to pursue environmental goals such as through domestic carbon taxes, often cited as a promising new revenue source, have limited revenue generation potential. It concludes with forward-looking suggestions to tap the full levelling potential of tax systems.

Key messages

- Achieving the Sustainable Development Goals (SDGs) by 2030 requires a dramatic doubling of tax collection in low- and lower middle-income countries. This increase will take time. Aid remains an essential source of financing in the medium term – including aid to support tax efforts.
- The intense pressure on low- and middle-income countries to increase revenue to meet often unrealistic targets, while justified by large financing gaps, risks incentivising ineffective, inequitable and unsustainable tax practices.
- Tax administration and implementation, alongside the design of tax policy, play an underappreciated role in ensuring progressivity. Weaknesses in implementation have unintended consequences on poverty and inequality, even under progressive tax policy.
- Uneven tax enforcement disproportionately affects lower income earners and smaller firms, with tax complexity and compliance costs compounding inequity. More effective enforcement on higher income taxpayers would improve both equity and revenue generation.
- The tax system could be used to pursue environmental goals, including the sustainable management of natural resources and reduced health costs of pollution in urban areas. However, environmental taxes are unlikely to become a major source of revenue for low- and middle-income countries.

Introduction

Increased tax collection to reduce poverty and inequality – and make progress towards the SDGs – must be achieved in a way that is equitable, sustainable and efficient. Achieving the SDGs, including those related to poverty and inequality, requires dramatic increases in tax revenue in low- and middle-income countries.[1] In 2019, it was calculated that absent a significant increase in official development assistance, the average low- or middle-income country would have to double its tax collection by 2030 to make substantial progress towards five key SDGs, up from the current average of less than 15% of its gross domestic product (GDP).[2] This is a massive challenge: over the past 30 years, low- and middle-income countries rarely achieved tax increases beyond 5 percentage points of GDP. History shows that sustaining tax increases of 0.5 percentage points of GDP per year is already a very ambitious target (Gallien, Lees and Mascagni, 2024[1]). Achieving equitable and sustainable revenue increases, therefore, takes time (Gallien, Lees and Mascagni, 2024[1]).

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Tax systems primarily contribute to tackling poverty and inequality by generating sufficient revenue to fund public expenditure, such as social protection, healthcare and education. New and innovative tax instruments, for instance environmental taxes (Box 6.1), may hold significant potential for greater revenue generation, although environmental challenges will increase financing needs more than they could ever raise revenue across low- and middle-income countries. Reforms to strengthen revenue administrations' capacity and taxpayers' compliance will be needed to lay the essential foundation for increased revenue mobilisation. In addition to raising revenue, tax systems also directly affect poverty and inequality through their design and implementation. For this reason, how tax is raised is as important as how much of it is collected. Tax administration and implementation are key to ensuring equitable and sustainable revenue increases.

Box 6.1. While environmental taxes play a key role in addressing inequality, their revenue-generating potential is limited

Low- and middle-income countries face huge climate financing needs, reinforcing their acute need for revenue generation. Domestic carbon taxes, while ubiquitous in international debates, have limited revenue potential. In South Africa, the only African country to have introduced such a tax, the carbon tax raised a paltry USD 40 million out of a total of USD 77.1 billion in taxes collected in 2020-21 (Baker, 2022[2]). Such taxes, then, can hardly be expected to make a substantial dent in low- and middle-income countries' financing needs. Nonetheless, a wider deployment of environmental taxes in low- and middle-income countries can help tackle environmental concerns such as poor waste management and air pollution, which disproportionally affect low- and middle-income households, and can do so in a progressive way.

Environmental taxes that help sustainable resource use or address urban pollution can play an important role in low- and middle-income countries (Keen, 2023[3]). Recent research shows that policy makers across sub-Saharan Africa see these taxes as holding the greatest potential to both generate revenue and redress existing inequalities (Occhiali, 2023[4]). For example, tariffs that disincentivise the import of second-hand cars and incentivise greener alternatives are likely progressive in contexts where private vehicle ownership remains a luxury and vehicle ownership taxes can finance public transport (Granger et al., 2021[5]). Waste taxes, the main source of financing for waste disposal in high-income countries, are rare in low- and middle-income countries; however, where they are in use, they tend to be applied with regressive flat rates. Linking them instead to property taxes could make waste taxes a progressive source of revenue for improved waste management (Matheson, 2022[6]). Likewise, efforts to rationalise tropical forestry taxation are often unsuccessful, but there are positive examples of fees structures disincentivising logging in peri-urban areas while keeping fuelwood affordable in rural areas where alternative fuels are scarce (Hamissou, 2001[7]).

Thus, environmental taxes can contribute to addressing current inequities. However, more research is needed to understand how tax instruments can address low- and middle-income countries' environmental issues in a just way. While fiscal instruments have potential, they should be deployed to tackle environmental problems as a priority rather than to mobilise revenue. Financing climate adaptation and mitigation in low- and middle-income countries will require high-income countries to continue to fulfil their pledge to direct USD 100 billion each year to climate finance, which took 13 years to be met for the first time.

Sources: Baker (2022[2]); Keen (2023[3]); Occhiali (2023[4]); Granger et al. (2021[5]); Matheson (2022[6]); Hamissou (2001[7]).

Progressive tax design is essential to tackle poverty and inequality and deserves more attention in the broader fiscal and economic context

Tax systems in low- and middle-income countries typically include the policy elements most commonly required for progressivity: progressive income tax rates with exemptions for low- and middle-income earners, value-added tax (VAT) exemptions for basic goods and taxes on types of incomes – such as dividend, rent or capital gains – that accrue particularly to higher income earners. Progressive tax systems may still, however, have unintended consequences for poverty and inequality in practice. A clear example is the impact of inflation on tax exemption thresholds meant to protect those with low incomes, as was seen in Ethiopia. During a high inflation period in the 2010s, Ethiopia's tax exemption threshold fell well below the level policy makers intended it to be. To retain its real value it should have increased fivefold, but reform was delayed, and the threshold's value kept decreasing to half the national poverty line. The delays in adjusting the income tax schedule – and the outdated tax threshold in particular – resulted in the inclusion of workers below the poverty line in the tax net, with a likely negative effect on poverty (Hirvonen, Mascagni and Roelen, 2018[8]). Recent evidence also shows that lower income earners across several low- and middle-income countries pay a variety of tax-like contributions, especially at the local and community level, that are often regressive (Gallien and van den Boogaard, 2021[9]). These informal levies must be considered when designing formal tax systems, as they reinforce the need for exemption thresholds and progressive income tax schedules.

A second example of an unintended consequence concerns VAT exemptions for basic consumption goods. While these help improve progressivity in the short term, they might be less effective than other fiscal options to promote fiscal redistribution in the longer term. VAT is often considered to be regressive because it is levied at the same rate regardless of the consumers' income level. Most governments, however, exempt basic goods such as food or school uniforms, which represent a large proportion of poor households' consumption. These exemptions address concerns over the regressivity of VAT, but their effectiveness is limited by the tendency of poor households to purchase from informal markets (Bachas, Gadenne and Jensen, 2023[10]). As a result, the benefits of VAT exemptions, in absolute terms, accrue to higher income households more than the low- and middle-income ones that they are meant to target. In the long term, governments with stronger administrative capacity can improve fiscal redistribution by eliminating most VAT exemptions and using the resulting revenue gains to fund broad-based transfers to low- and middle-income households. Warwick et al. (2022[11]) showed that recycling the amount gained by eliminating VAT exemptions towards a universal, untargeted transfer would improve both poverty and inequality measures. This logic also applies to exemptions for menstrual hygiene products (MHPs), often advocated on grounds of gender equality. They are unlikely to improve poorer women's access to MHPs and mostly benefit higher income women (Byrne, 2023[12]). If such exemptions are eliminated, the foregone revenue could be used to fund targeted direct provision of MHPs (Grown and Mascagni, 2024[13]).

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Stronger enforcement on higher income individuals and firms would help make tax systems fairer and generate greater revenue

Tax administration itself can have direct implications on equity, with uneven enforcement effort representing the clearest example. While tax administrations go to great lengths to squeeze (often non-existent) revenue out of micro and small informal firms, higher income earners remain largely off the (tax) hook. The conventional wisdom that formalising the informal sector can yield large revenue increases led many revenue authorities to implement mass registration campaigns that brought thousands of new taxpayers into the tax net. However, no substantial revenue gain was achieved because a significant proportion of new taxpayers are below or at the taxable threshold. Once registered, they either do not file or nil-file (Lediga, Riedel and Strohmaier, 2020[14]; Mascagni et al., 2022[15]; Gallien et al., 2023[16]). Worse, these campaigns can have unintended consequences on tax fairness: the substantial resources dedicated to registering unproductive taxpayers could be better spent to identify higher income individuals who often escape the tax net. These individuals' tax liabilities disproportionately originate from rental income, capital gains and investment income, tax types that are often poorly enforced. A stronger focus on higher income earners would hence increase both equity and revenue generation. For example, the Uganda Revenue Authority's unit dealing with high-net-worth individuals collected over USD 5.5 million in the first year after its establishment – an amount that likely only represents the tip of the iceberg (Kangave et al., 2018[17]; Santoro and Waiswa, 2024[18]).

The negative effects of uneven enforcement are compounded by tax complexity and taxpayer confusion, which affect particularly smaller taxpayers. Research shows that tax complexity has equity implications, as compliance costs are regressive and result in higher tax burdens for smaller firms (Slemrod and Venkatesh, 2002[19]; Coolidge, 2012[20]). For example, a recent study shows that, on average, 40% of the smallest firms across a diverse set of 11 countries do not make use of their VAT credit from production inputs they purchase, effectively increasing their VAT bills above what they would technically owe (Brockmeyer et al., 2024[21]). The reason is that smaller firms tend to have less access to high-quality tax advisory services, weaker capacity to obtain tax exemptions and other benefits, and greater difficulty navigating an increasingly complex and digitised tax system (Mascagni et al., 2022[22]). Similar challenges exist for corporate and employment income taxes (Mascagni and Mengistu, 2019[23]; Benzarti, 2013[24]).

Ways forward to use the levelling potential of tax systems

Tax administration and implementation, alongside the design of tax policy, play an underappreciated role in ensuring progressivity. Administrative and institutional capacity is essential to monitor how tax systems work in practice, adjust them to maintain equity and ensure that enforcement pressure is evenly applied across groups in society. The intense pressure on low- and middle-income countries to increase revenue to meet unrealistic targets, while justified by large financing gaps, risks incentivising ineffective, inequitable and unsustainable tax practices. A broader focus on tax administration – and its reality in the context of low- and middle-income countries – can help mitigate this risk. The international community, including the Addis Tax Initiative and the Tax Administration Diagnostic Assessment Tool, is increasingly shifting away from a narrow focus on how much a country's revenue increases to broader considerations on how its revenue increases, including greater attention to tax administration (Addis Tax Initiative, 2023[25]). This focus on tax administration is particularly important to ensure that revenue mobilisation efforts promote rather than hamper equity and poverty reduction. The examples discussed above illustrate the impacts and unintended consequences of tax administration and implementation: thresholds, exemptions and administrative effort can all affect poverty and inequality in negative ways unless they are carefully monitored.

In practice, a reform agenda for equitable taxation certainly includes, among other features, greater efforts to tax the wealthy and to increasingly relieve administrative pressure and tax burdens on low- and middle-income earners and small firms, including by stopping mass registration campaigns and introducing simplified processes. In parallel, low- and middle-income countries, with the support of development partners, must continue ongoing efforts to increase administrative capacity and encourage taxpayer compliance, including by leveraging digitisation and data analytics for better tax administration. These efforts can result in both greater revenue mobilisation and improved equity, while also laying the foundations for sustainable revenue generation in the longer term.

Last but not least, the role of taxation to tackle poverty and inequality must be firmly embedded in a broader fiscal perspective. The levelling potential of tax mobilisation can only be fully tapped when the resulting revenue is spent to improve economic, human and social outcomes, especially for low- and middle-income households. Tax is only one of many fiscal policy tools available to governments (e.g. universal basic income, cash transfers, direct provision of goods such as MHPs) and it should be carefully evaluated against other policy options when pursuing specific goals such as gender equality, environmental sustainability and poverty reduction. Improving outcomes and services for citizens would, in turn, have positive implications for trust and tax morale, which might lead to improved tax compliance and higher revenue generation.

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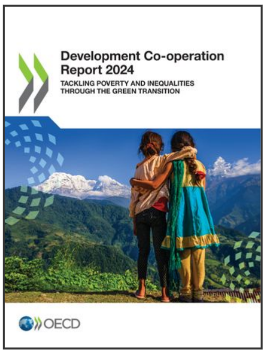
Notes

[1] In this chapter, low- and middle-income countries include both low-income and lower middle-income countries, according to the standard World Bank classification.

[2] The estimates refer to substantial progress towards achieving five of the SDGs, not achieving all of them. See: https://www.imf.org/en/Publications/Staff-Discussion-Notes/Issues/2019/01/18/Fiscal-Policy-and-Development-Human-Social-and-Physical-Investments-for-the-SDGs-46444.



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