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Promotion of Equitable Monetary and Fiscal Policies[1]

Benedict Clements[2] Sanjeev Gupta[3] João Tovar Jalles[4]

Abstract

This paper delineates equitable fiscal and monetary policies, along with their corresponding institutional frameworks, which can be tailored to help countries fulfill the fundamental tenets of the UN's 2030 Agenda. Monetary policy should aim to keep inflation at low or moderate levels, thus avoiding the deleterious effects of high inflation on inequality. Sound governance of central bank practices includes the establishment of independence and accountability for the central bank; solid policy and operational strategies; and transparent communications. Fiscal policy is the government's primary instrument for achieving redistribution. Emerging Market and Developing Economies (EMDEs) will need to increase revenues by reforming tax expenditures; more extensive excise taxes on goods with negative externalities; and improving the design of the income tax. On the spending side, priorities include curtailing fuel subsidies; increasing health spending to provide a basic package of universal health benefits; reallocating health outlays toward primary and preventive care; and reallocating education spending toward primary and secondary schools. Sound fiscal governance includes the implementation of fiscal responsibility laws and medium-term fiscal frameworks (MTEFs); aligning these MTEFs with Integrated National Financing Frameworks; creating Independent Fiscal Institutions, such as Fiscal Councils; implementing transparent budgetary processes; and strengthening research capacity.

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1. Introduction: Understanding the Strategy

In recent years, research has underscored the detrimental impact of inequality on both the economy and society.[5] Various studies have shown that increasing income inequality: (1) leads to negative consequences for economic growth and its long-term sustainability;[6] (2) hampers the pace at which growth reduces poverty;[7] (3) affects social cohesion, making it difficult to gain broad political support for growth-enhancing reforms;[8] (4) can result in political instability, violence and conflict as marginalized population groups are deprived of access to assets and education opportunities;[9] and (4) can lead to excessive leverage and credit, increasing the probability of a financial crisis.[10]

Policymakers possess two primary economy-wide tools to address rising inequality. Firstly, they have fiscal policy which involves influencing the economy by adjusting the scale and composition of taxes and public expenditures. This responsibility typically falls under the purview of the ministry of finance or the treasury, aligning with the government's economic agendas or priorities. Secondly, they have monetary policy which involves modifying interest rates or the money supply to regulate aggregate demand, with the aim of controlling inflation and/or stabilizing output. Carried out by a nation's central bank, this function employs various strategies, including changes to policy or interbank interest rates, adjustments to banks´ reserve requirements, and transactions involving government securities and foreign exchange.

The UN's Agenda 2030,[11] adopted in 2015, emphasizes the need to combat inequalities within and across countries. The agenda also calls attention to the promotion of gender equality and the creation of conditions for environmentally sustainable, inclusive, and continued growth. These three goals are significant among the 17 adopted by the UN to end poverty. The rising inequality, which manifests both vertically (e.g., income, wealth, and opportunity disparities among individuals) and horizontally (e.g., differences among population groups, genders, and

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[5] Ferreira, I. Gisselquist, R., Tarp, F. (2022), "On the Impact of Inequality on Growth, Human Development, and Governance, *International Studies Review*, Vol. 24(1), viab058.

[6] Ostry, J., Berg, A., and C. Tsangarides (2018). "Redistribution, Inequality, and Growth: New Evidence". *Journal of Economic Growth, 23, 259-305.*

Berg, A., and J. Ostry (2017). "Inequality and Unsustainable Growth: Two Sides of the Same Coin?" *IMF Economic Review,* Vol. 65(4), pp. 792-815.

[7] Ravallion, M. (2004). "Pro-Poor Growth: A Primer". Policy Research Working Paper Series 3242, World Bank, Washington, D.C.

Dabla-Norris, E., K. Kochhar, N. Suphaphiphat, F. Ricka and E. Tsounta (2015). "Causes and Consequences of Income Inequality: A Global Perspective," IMF Staff Discussion Notes, 15(13).

[8] Claessens, S., and E. Perotti (2007). "Finance and Inequality: Channels and Evidence." *Journal of Comparative Economics,* Vol. 35(4), pp. 748-773.

[9] Ayodele Odusola, Giovanni Andrea Cornia, Haroon Bhorat, and Pedro Conceição*, Income Inequality Trends in Sub-Saharan Africa: Divergence, Determinants, and Consequences,* UNDP, 2017

[10] Rajan, R. 2011. *Fault lines: How Hidden Fractures Still Threaten the World Economy.* Princeton: Princeton University Press.

[11] United Nations (2015), *Transforming Our World: the 2030 Agenda for Sustainable Development*. https://sdgs.un.org/2030agenda

regions) is threatening the achievement of the core principle of the 2030 Agenda, which is "leaving no one behind." [12]

Distributive concerns take on heightened importance in the current juncture, given the low projected growth in many economies in the near term and the deepening economic imbalances that have surfaced in numerous developing countries in the aftermath of the COVID-19 pandemic.[13] These imbalances are now limiting fiscal space in many of these countries, with 60 percent of low-income countries facing a high risk of either failing to meet their financial obligations or having already done so.[14] Over the past three years alone, the number of sovereign debt defaults in these countries has surged to 18, surpassing the total for the previous two decades.

The aim of this guidance note is to delineate equitable fiscal and monetary policies, along with their corresponding institutional frameworks, which can be tailored to help countries fulfill the fundamental tenets of the UN's 2030 Agenda. Recognizing the diverse starting points and varying institutional capacities of countries, these policies will necessarily need to be country specific. The note underscores that fiscal policy stands as the primary instrument for advancing the UN agenda, with monetary policy playing a complementary supportive role.[15] The policy frameworks should aim to foster conditions where the incomes of the poor increase at a faster rate than the national average, as well as safeguarding them against unexpected economic shocks.

The remainder of this note is structured as follows: Section 2 explores trends in income distribution, both globally and within countries, shedding light on the often-greater inequality in wealth compared to income. It discusses the impact of the COVID-19 pandemic on income inequality and examines how prevailing economic conditions limit the scope of monetary and fiscal policies. Section 3 analyzes the mechanisms through which monetary and fiscal policies influence income inequality, followed by a discussion on policy reforms needed in these two areas to support the UN's 2030 agenda. Section 4 outlines the institutional frameworks necessary to ensure equitable monetary and fiscal policies. In Section 5, we briefly address how, despite having appropriate frameworks in place, the implementation of fiscal and monetary policies may face obstacles due to political economy considerations. Sections 6, 7, and 8 present three country studies, a compilation of peer-to-peer learning and research opportunities, and avenues for international cooperation in monetary and fiscal policies, respectively.

[12] Oxfam (2018). *Reward Work, Not Wealth*, https://oi-files-d8-prod.s3.eu-west-2.amazonaws.com/s3fs-public/file_attachments/bp-reward-work-not-wealth-220118-en.pdf; and World Inequality Lab (2018). *World Inequality Report 2018*, https://wir2018.wid.world/files/download/wir2018-full-report-english.pdf

[13] World Bank, *Global Economic Prospects*, January 2024.

[14] World Bank, *International Debt Report 2023*, World Bank, 13 December 2023.

[15] Throughout the text, we focus on policies that can improve the distribution of income and support higher living standards for low-income groups, which in effect, ensures that low-income groups are not left behind.

2. Public Sector Situation and Trends

2.1 Trends in income inequality and wealth[16]

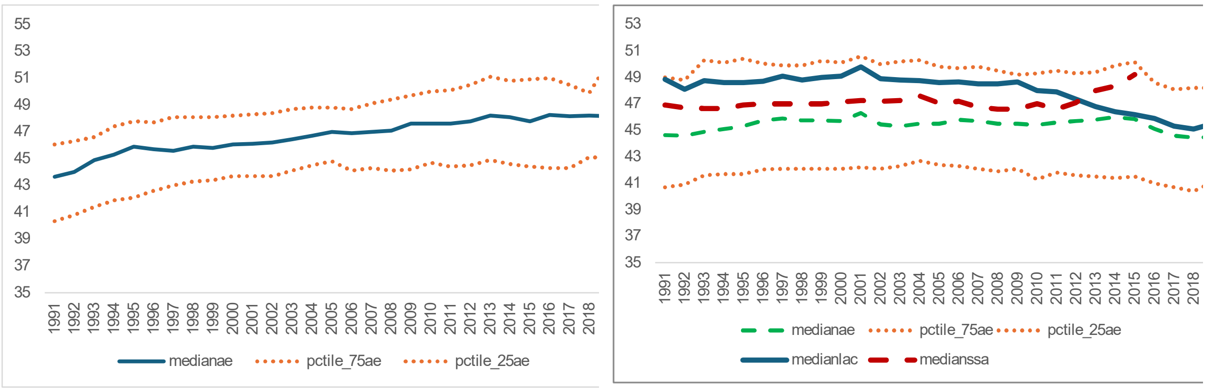
On a global scale, inequality has experienced a decline, propelled by the rapid economic growth of emerging market and developing economies (EMDEs), notably China and India, and the resultant income convergence between EMDEs and advanced economies (AEs). Similar global trends are observable in the relative income gaps between the top and bottom 10 percent of the world population.[17]

The reduction in income inequality on a global level stand in contrast to developments within individual countries, where median market income inequality has been increasing in advanced economies (AEs), on average. Figure 1 illustrates the median gross or market Gini index—reflecting household income from wages and non-wage sources before taxes and transfers—between 1991 and 2019 in EMDEs and AEs. A Gini index of zero means a perfectly even distribution of income among the population. Market income inequality has remained relatively constant in EMDEs, though it has decreased slightly in recent years. This trend, however, masks regional heterogeneity: while Latin America has been improving its income distribution, sub-Saharan Africa has experienced the opposite. Additionally, there is visible worsening inequality in fast- growing Asian countries such as China and India (not shown).

[16] This section draws on Clements, B., S. Gupta, J. Jalles (2024). Fiscal Policy and Income Distribution in the Turbulent Era in *Fiscal Policy in a Turbulent Era* edited by Enrique Alberola, Elgar.
[17] Clements, B., R de Mooij, S. Gupta, M. Keen ed (2015). *Inequality and Fiscal Policy*. IMF, Washington DC.

Figure 1. Income Inequality: Market Gini in Advanced Economies (AEs) and Emerging Market and Developing Economies (EMDEs)

Advanced Economies **Developing Economies**



Note: the market Gini index is before government tax and transfers. Interquartile range of Gini coefficients; median is the solid blue line, top and bottom quartiles are the orange dotted lines of respective distributions; for the right-hand-side chart, the dashed red and green lines denote the median for the Sub-Saharan and Latin American regions, respectively. 32 advanced economies and 66 emerging market and developing economies.

Source: authors´ computations based on Solt´s (2009) updated Standardized World Income Inequality Database (SWIID).[18]

Household wealth exhibits a much greater level of inequality compared to income. This is primarily attributed to higher saving rates among high-income individuals, leading to faster wealth accumulation compared to poorer households. Greater risk tolerance by affluent individuals, as well as variations in prevailing tax systems and the role of private pensions, contribute to differences in wealth accumulation across countries. Concerningly, wealth inequality has been on the rise since 2000 in most AEs and EMDEs, reversing a declining trend observed from the end of the Second World War until the 1970s.[19] Figure 2 below illustrates trends in wealth Gini between 2000 and 2020 in selected countries from both income groups.

Initial findings suggest a worsening of inequality since the beginning of the COVID-19 pandemic, linked to significant decreases in output and increased levels of poverty, especially in developing countries.[20] Social assistance programs in these nations, crafted to protect low-income groups, often overlooked middle-income groups. In other developing areas, like sub-

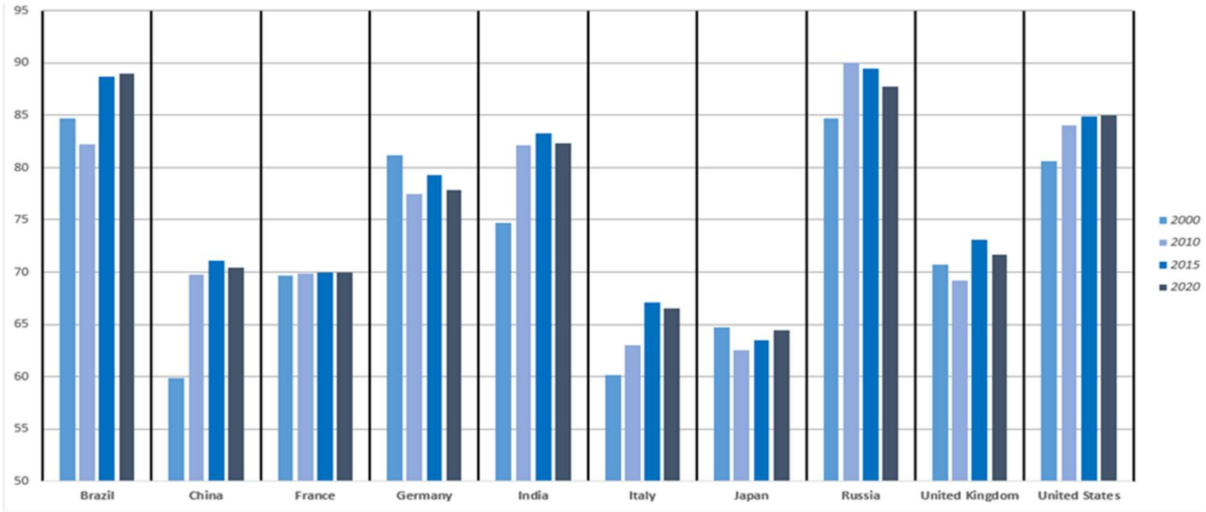
[18] Solt, F. (2009). "Standardizing the World Income Inequality Database," *Social Science Quarterly*, Southwestern Social Science Association, 90(2), 231-242.

[19] T. Piketty (2014), *Capital in the Twenty-First Century*, Harvard University Press.

[20] Blofield, M., Lustig, N., and Trasberg, M. (2021). “Social Protection during the pandemic: Argentina, Brazil, Colombia and Mexico”, Center for Global Development Note, February 2021 chrome-extension://efaidnbmnnnibpcajpcglclefindmkaj/https://www.cgdev.org/sites/default/files/Note-Blofield_Lustig_Trasberg-Revised_0.pdf

Saharan Africa, the pandemic impacted all income classes equally. Furthermore, the pandemic has had notable detrimental effects on school attendance among low-income students,[21] foreshadowing future rises in both income and opportunity inequality.

Figure 2. Wealth Gini in Selected Countries, 2000-2020



Source: Credit Suisse Global Wealth Databook, 2021

Throughout the pandemic, in reflection of greater fiscal space, fiscal policy in advanced economies shifted towards greater redistribution, albeit often through temporary measures enacted during this period.[22] Simulations for the European Union reveal that tax and benefit systems, incorporating new measures, successfully mitigated 75 percent of income losses stemming from the pandemic, a notable increase from the 40 percent observed in the pre-pandemic era.[23] Notably, in the United States, the temporary expansion of income support was both substantial and progressive.[24]

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[21] International Monetary Fund (2021). *Fiscal Monitor: A Fair Shot*, April.
[22] International Monetary Fund (2022). *Fiscal Monitor: Helping People Bounce Back, October.*
[23] ibid.
[24] Ganong, P., F. Greig, P. Noel, D. Sullivan, and J. Vavara (2022). "Unemployment Insurance." In *Recession Remedies: Lessons Learned from the U.S. Economic Policy Response to COVID-19*, edited by Wendy Edelberg, Louise Sheiner, and David Wessel, 49–90. Washington, DC: Brookings Institution.

2.2 Prevailing Economic Conditions and their Impact on Monetary and Fiscal Policy Design

The state of the economy and the economic outlook influence and constrain the design of sound monetary and fiscal policies (Box 1). [25]

In times of economic downturn, such as recessions or periods of low growth, central banks face constraints in implementing monetary policy due to their diminished capacity for interest rate adjustments. When interest rates are already at or near historic lows, central banks encounter limitations in stimulating borrowing and investment through conventional monetary policy channels. This constraint is particularly pronounced in economies grappling with the zero lower bound, where nominal interest rates cannot be pushed further down. In such scenarios, central banks might resort to unconventional measures like quantitative easing or forward guidance to influence market expectations and bolster economic activity. However, the effectiveness of these tools may be tempered by diminishing returns over time and concerns about potential side effects on financial stability and income inequality.

Similarly, prevailing economic conditions influence inflation dynamics. Inflationary pressures, whether driven by supply-side disruptions or demand-pull factors, can curtail the maneuverability of central banks. Inflation exceeding the central bank's target threshold may necessitate a tightening of monetary policy to prevent overheating and preserve price stability, which may result in unemployment with consequences for income distribution. Conversely, the efficacy of monetary stimulus may be constrained if inflation expectations remain anchored below target levels, limiting the impact of interest rate cuts on consumer and business behavior.

The efficacy of implementing fiscal policies is shaped by a country's prevailing fiscal space, which is defined as its ability to engage in discretionary increases in expenditures or reductions in taxes while concurrently (a) maintaining access to financial markets and (b) meeting all current and prospective payment obligations without default or resorting to extraordinary financial assistance, such as backing from international organizations or the governments of wealthy countries and their agencies. [26]

Robust economic growth plays a crucial role in expanding fiscal space by generating higher revenues. This, in turn, empowers a country to invest more in its social sectors, infrastructure and climate transitions. Given that developing countries generally possess a smaller capital base, they

[25] Buchanan, J. (1975) "The public finances: An introductory textbook", R.D. Irwin Publisher ISBN: 9780256016338; Buchanan, J. and Wagner, R. (1977). "Democracy in Deficit: The Political Legacy of Lord Keynes". Liberty Fund.

[26] International Monetary Fund (IMF). (2017). "Fiscal Transparency Handbook." Washington, DC: International Monetary Fund; and IMF (2018), "Assessing Fiscal Space: An Update and Stocktaking," IMF Policy Paper, June.

stand to gain a greater growth dividend from productive capital investments. This dynamic presents an opportunity for fiscal policy to expand fiscal space steadily over time.

Figure 3 provides an overview of trends in fiscal indicators linked to fiscal space and shows that during the early 2000s, EMDEs experienced a contraction in fiscal space.[27] This situation briefly improved leading up to the global financial crisis but took a downturn again in the 2010s. Throughout the decade from 2010 to 2019, there was a marked worsening in government debt indicators across three-quarters of these nations. Moreover, both external and private debt levels rose, alongside a deterioration in market confidence. The reduction in fiscal space during the last decade was more uniformly experienced than the improvement observed in the earlier years, despite historically low interest rates and substantial reserve holdings. The onset of the COVID-19 pandemic in 2020 exacerbated these challenges, significantly impacting fiscal space.

Efficient use of public expenditures is essential for maximizing the impact of fiscal policies.[28] Unproductive spending funded solely through borrowing limits a country's fiscal space by adding the burden of repaying loans and associated interest. Rising debt-to-GDP ratios pose a significant constraint on fiscal policy choices by limiting the government's ability to finance additional spending.[29] Limited fiscal space has necessitated a focus on revenue mobilization efforts to support increased spending as discussed in section 4.2.[30]

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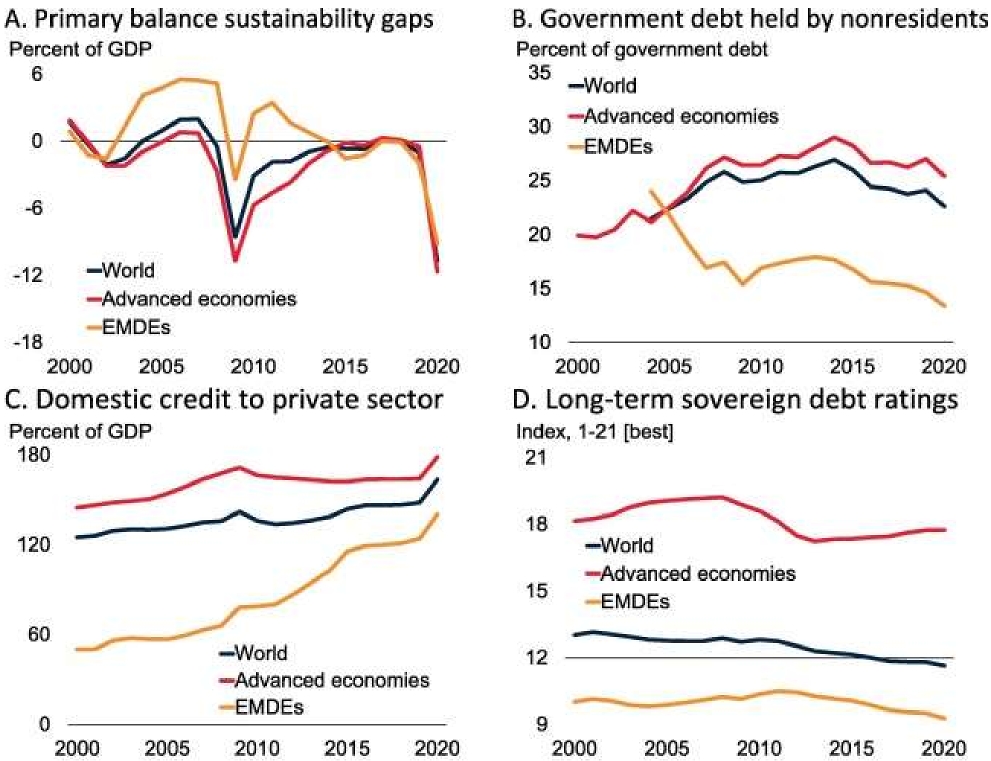
[27] Kose, M. A., Kurlat, S., Ohnsorge, F., Sugawara, N. (2022), "A cross-country database of fiscal space", *Journal of International Money and Finance*, Vol. 22, 102682.

[28] International Monetary Fund (IMF). (2019). "Fiscal Monitor: How to Mitigate Climate Change." Washington, DC: International Monetary Fund.

[29] Reinhart, C. M., and Rogoff, K. (2010). "Growth in a Time of Debt." *American Economic Review*, Vol. 100(2), pp. 573-578.

[30] OECD. (2020). "Tax and Fiscal Policy in Response to the Coronavirus Crisis: Strengthening Confidence and Resilience." Paris: OECD Publishing.

Figure 3. Exploring four dimensions of fiscal space over time across income groups



Note: Aggregates are computed with nominal GDP in U.S. dollars as a weight (A and C) or government debt in U.S. dollars as a weight (B), or as simple averages (D). Sustainability gaps are based on current conditions. The sovereign debt ratings are converted to a numerical scale ranging from 1 to 21 (higher, better rating). The horizontal line at an index value of 12 is the border between investment grade and non-investment grade.

Source: Kose et al. (2022) (cf. footnote 41).[31]

3. Methods of implementation: Sound monetary and fiscal policies to support the distributive agenda

3.1 Monetary policy

In contrast to fiscal policymakers, monetary policymakers have traditionally viewed inequality as a secondary issue since monetary policy instruments cannot be targeted at specific population segments. That said, monetary policy can play a crucial role in supporting equitable growth by containing inflation at low or moderate levels. In fact, the relationship between

[31] Kose, A., Kurlat, S., Ohnsorge, F. and Sugawara, N., (2022), A cross-country database of fiscal space, *Journal of International Money and Finance*, 128, issue C, number S0261560622000857

inequality and monetary policy has received renewed attention in the aftermath of the Global Financial Crisis (Carstens, 2021; BIS, 2021) - see Figure 4.[32]

High rates of inflation are a tax on the poor because they hold more of their assets in cash, rather than in short-term interest-bearing assets where depositors can demand higher interest rates to compensate for higher inflation. That said, empirical studies suggest that inflation above 5-6 percent per year can have a deleterious effect on income distribution.[33] As discussed later in the note, stronger monetary and fiscal institutions can help ameliorate the impact of inflation on inequality. Furthermore, greater transparency in monetary policy can reduce the adverse effects of inflation on inequality,[34] as can a more developed financial sector.[35]

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[32] Carstens, A (2021): "Central banks and inequality," remarks at the Markus' Academy, Princeton University's Bendheim Center for Finance, Basel, 6 May. BIS (2021): Annual Economic Report, June, p 45.

[33] On the thresholds where inflation affects inequality, see Bulir, A. (2001), "Income inequality: does inflation matter?", *IMF Staff Papers,* Vol. 48(1), pp. 139–159; and Glawe, L. and H. Wagner (2024), "Inflation and inequality: new evidence from a dynamic panel threshold analysis," *International Economics and Economic Policy*. For other papers assessing the impact of inflation and inequality more broadly, see Bulir, A. and A.-M. Gulde (1995), "Inflation and Income Distribution: Further Evidence of Empirical Links," IMF Working Paper WP/95/86; Guitián (1998) op cit.; Easterly, W., and S. Fischer (2001), "Inflation and the Poor," *Journal of Money, Credit and Banking*, Vol. 33(2), pp. 160–178; Kim, D-H and S-C Lin (2023), "Income Inequality, Inflation, and Financial Development," *Journal of Empirical Finance*, Vol. 72, pp. 468-487; and Colciago, A., A. Samarina, and J. de Haan (2019), "Central Bank Policies and Income and Wealth Inequality: A Survey," *Journal of Economic Surveys,* Vol. 33(4), pp. 1199–1231.

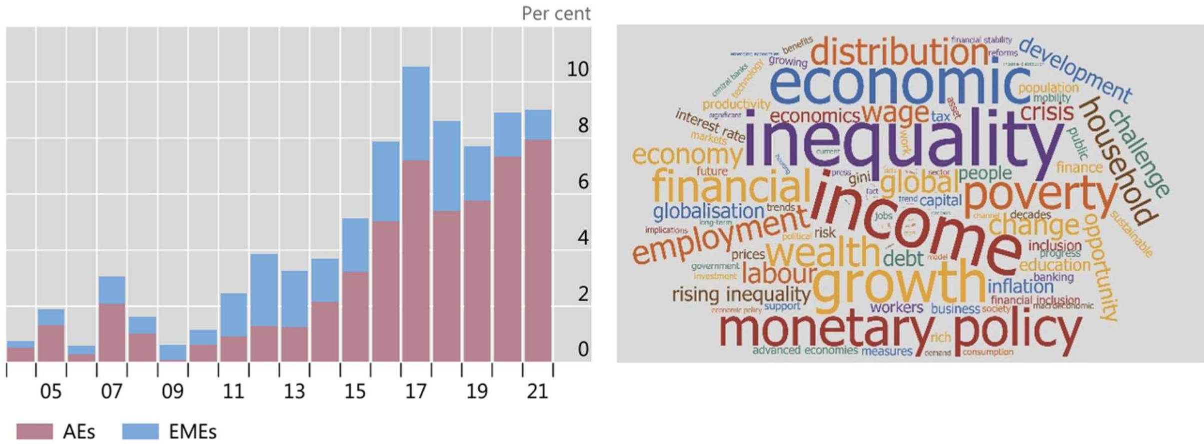
[34] De Mendonca, H. F. and Esteves, D.M. (2018), "Monetary authority's transparency and income inequality,"" *Review of Development Economics,* Vol. 22(4), pp. e202-e227.

[35] Kim, D-H and S-C Lin (2023), "Income Inequality, Inflation, and Financial Development," *Journal of Empirical Finance* Vol. 72, pp. 468-487.

Figure 4. Inequality and Central Bank Communications since the Global Financial Crisis

Share of speeches mentioning inequality[1]

Frequency of occurrence of words in short excerpts of speeches around mentions of inequality[2]



Note: LHS: All speeches of central bankers mentioning the keywords “inequality” and “distributional consequences/impact of monetary policy” expressed as a share of all central bankers’ speeches in the BIS database. Only selected speeches in English and, for the United States, only speeches by members of the Board of Governors of the Federal Reserve System and the Federal Reserve Bank of New York are included in the database. Data until end-May 2021. RHS: The cloud contains selected words and phrases that appear in short excerpts around mentions of “inequality” and “distributional consequences/impact of monetary policy” in central bankers’ speeches. The size of each phrase reflects its relative frequency.

Source: Pereira da Silva, L., Kharroubi, E., Kohlscheen, E., Lombardi, M., Mojon, B. (2022), Inequality Hysteresis and the effectiveness of macroeconomic stabilization policies, BIS. ISBN 978-92-9259-563-0

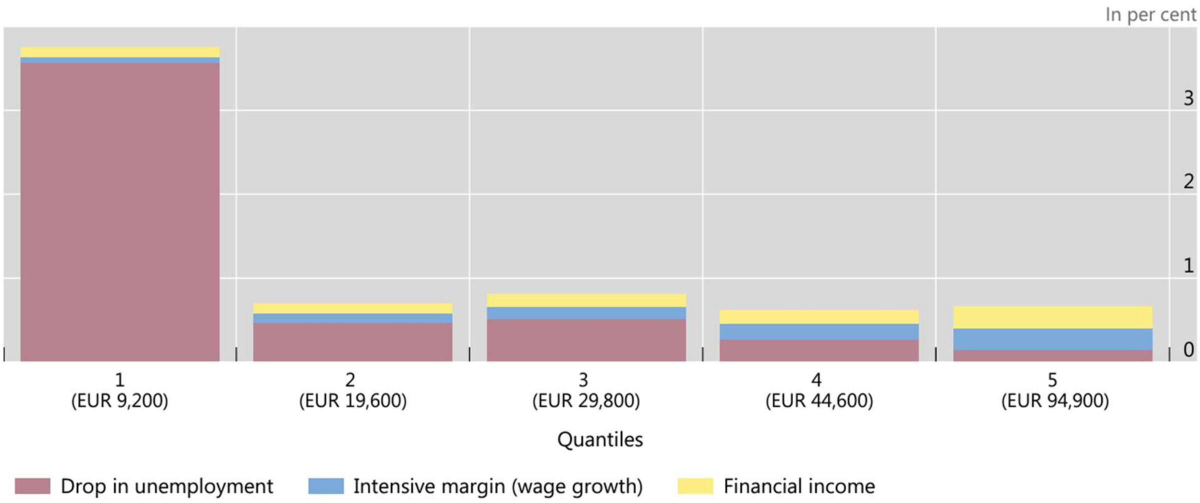
However, in the *short-run*, monetary tightening—by reducing economic activity and increasing unemployment—may increase income inequality, underscoring the need for adequate safety nets to protect the poor.[36] In the same vein, monetary policy shocks associated with the unexpected movements in monetary policy increase inequality, with a stronger effect in countries lacking strong redistributive policies.[37] The impact of tightening on inequality depends on the sources of income of different households (financial assets, wages for skilled and unskilled labor, and transfers). Interestingly, recent monetary easing seems to have helped the distribution of income. For instance, ECB’s unconventional monetary policy measures benefited mainly households at the bottom quintile of the income distribution (Figure 5). This effect primarily

[36] Contrary to common concerns, a tight monetary does not result in lower economic growth over *the medium-term*. Recent empirical evidence suggests that countries that successfully reduce inflation do not experience lower output, employment, or real wages over a 5-year period. See Ari, A., C. Mulas-Granados, V. Mylonas, L. Ratnovski, and W. Zhao (2023), “One Hundred Inflation Shocks: Seven Stylized Facts,” IMF Working Paper WP/23/190, September.

[37] Furceri, D, P. Loungani, and A. Zdzienicka (2018), “The Effects of Monetary Policy Shocks on Inequality,” *Journal of International Money and Finance*, Vol. 85, July, pp. 168-186. Most studies on monetary policy and income inequality have been conducted for advanced economies. Most (but not all) of these studies indicate that monetary tightening (loosening) increases (reduces) inequality. See Colciago, Samarina, and de Haan (2019, op. cit.) for a survey of empirical studies.

occurred through the extensive margin of labor, meaning it helped lift households out of unemployment, rather than increasing the salaries of those who were already employed.[38]

Figure 5. ECB's unconventional monetary policies and income distribution



Note: The numbers in brackets show the initial levels of mean gross household income. Aggregate of Germany, Spain, France, and Italy. Additional effect on financial income percentage increase in mean income and its components across quintiles of gross household income.

Source: Michele Lenza and Jirka Slacalek, (2018), "How Does Monetary Policy Affect Income and Wealth Inequality? Evidence from Quantitative Easing in the Euro Area," The Centre for Economic Policy Research Discussion Paper DP16079.

The empirical evidence on monetary policy and its effects on the distribution of wealth are mixed.[39] On the one hand, low interest rates increase the value of financial assets which are primarily owned by higher-income groups. On the other hand, should lower interest rates result in an unforeseen inflationary surge, there might be a shift in wealth from creditors to debtors. This could potentially benefit middle-income households who own homes and carry mortgages, thereby contributing to a reduction in wealth inequality. These studies were undertaken before the COVID pandemic and the sharp rise in asset valuations since 2020. Consequently, further research is warranted to explore the effects of accommodative monetary policies on wealth inequality.

Over the longer-term, countries that have adopted inflation targeting as their monetary policy framework have not experienced lower economic growth, while enjoying lower volatility

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[38] Michele Lenza and Jirka Slacalek, (2018), "How Does Monetary Policy Affect Income and Wealth Inequality? Evidence from Quantitative Easing in the Euro Area," The Centre for Economic Policy Research Discussion Paper DP16079.
[39] The discussion in this paragraph draws on Colciago, Samarina, and de Haan (2019), op. cit.

in output and inflation.[40] Furthermore, adopting an inflation targeting regime enables countries to effectively navigate economic shocks; for instance, such countries had greater flexibility to lower interest rates following the Global Financial Crisis, resulting in improved macroeconomic outcomes.[41]

In practice, developing countries that have implemented inflation targeting (or some variant of it) have used monetary policy to reach other objectives, especially over the short term, such as stimulating economic activity or limiting volatility in the exchange rate.[42] However, to ensure the credibility of a regime focused on inflation, it is essential to limit the pursuit of additional objectives.[43]

Furthermore, effective coordination between monetary and fiscal policy is necessary for macroeconomic stability. High fiscal deficits financed by credit from the central bank may impede monetary policy's effectiveness in achieving inflation targets.[44] Good monetary policy frameworks—such as inflation targeting—can foster fiscal discipline, since the latter is needed to meet inflation targets.[45]

3.2 Fiscal Policy[46]

Public debt sustainability is a key ingredient for macroeconomic stability and the maintenance of fiscal space, which provides countries the room to raise spending or cut taxes to support activity in an economic downturn.[47]

Beyond its role in supporting macroeconomic stability, fiscal policy is the government's primary instrument for achieving redistribution. As noted earlier, fiscal policy affects inequality primarily through taxes and expenditures that redistribute income. If these taxes or expenditures affect some income groups more than others (for example, if income taxes are paid disproportionately by upper-income groups), they affect income inequality. In a similar vein, government transfers payments can affect inequality if they disproportionately benefit lower-income groups. Thus, the size of these taxes and transfers (as a share of GDP) determines their aggregate effect on inequality. Government provision of in-kind benefits (for example, spending

[40] See, for example, De Carvalho Filho, I. (2011), "28 Months Later: How Inflation Targeters Outperformed Their Peers in the Great Recession," *The B.E. Journal of Macroeconomics*, Vol. 11(1), pp. 1-46, and M. Arsic Z. Mladnovic, and A. Nojkovic (2022), "Macroeconomic Performance of Inflation Targeting in European and Asian Emerging Economies," *Journal of Policy Modeling,* Vol. 42, pp. 675-700.
[41] De Carvalho Filho (2011), op. cit.
[42] See IMF (2015), "Evolving Monetary Policy Regimes in Low-Income and Other Developing Countries," IMF Policy Paper.

[44] For a brief overview of related studies on fiscal dominance and the fiscal theory of the price level, see Minea, A. and R. Tapsoba (2014), "Does Inflation Targeting Improve Fiscal Discipline?" *Journal of International Money and Finance* Vol. 40, pp. 185-203.
[45] Minea and Tapsoba (2014), op. cit.
[46] This section draws on Clements, B., S. Gupta, and J. Jalles (2024), "Fiscal Policy and Income Distribution in the Turbulent Era" in *Fiscal Policy in a Turbulent Era* edited by Enrique Alberola, Elgar.

on health and education) further affects inequality. This spending can positively affect the formation of human capital and an individual's capacity to earn income over their lifetime. In this way, efficient social spending covering a large proportion of low-income households can bolster growth, reduce inequality, and facilitate social mobility.

The redistributive effect of fiscal policy can be measured by the difference between households' initial income (including wages and non-wage income, as defined above as "market" income) and the income remaining after accounting for income and wealth taxes, as well as government transfer payments ("disposable" income). AEs exhibit a substantial degree of fiscal redistribution relative to EMDEs (Table 1). This redistribution results in a decline in inequality in AEs by about a third, as opposed to about a tenth in EMDEs. About three-fourths of the reduction in inequality in AEs is achieved through transfers, particularly non-means-tested social benefits such as public pensions and family benefits.[48] Personal income taxes also contribute significantly to reducing inequality, sometimes surpassing the impact of means-tested transfers.

There is some debate regarding trends in the redistributive effects of fiscal policy in AEs. Based on estimates using the Standardized World Income Inequality Database (Table 1), fiscal policy in AEs became more redistributive between 1990 and 2019.[49] Others have argued that the redistributive impact of fiscal policy in AEs weakened in the pre-pandemic era, reflecting less redistributive transfers and the decreasing progressivity of personal income taxes.[50] [51] As discussed earlier, fiscal policy became more redistributive in AEs during the pandemic, although in many cases this was the result of temporary fiscal measures.

[48] Gupta, S. (2018), "Fiscal Policy and Inequality: An Agenda for Reform," Working Paper commissioned by the Group of 24 and Friedrich-Ebert-Stiftung New York. https://www.g24.org/wp-content/uploads/2018/08/Income_Inequality_and_Fiscal_Policy_FINAL.pdf

[49] Solt, F. (2009), "The Standardized World Income Inequality Database," *Social Science Quarterly,* 90(2), 231-242 (updated).

[50] Causa, O. and M. Hermansen (2020), "Income redistribution through taxes and transfers across OECD countries," *Research on Economic Inequality* 2017: 29–74.

[51] For the United States, a recent paper using tax data has challenged the conventional wisdom that income inequality has worsened, and that taxation has become less progressive. See Auten, G., and D. Splinter (2024), "Income Inequality in the United States: Using Tax Data to Measure Long-Term Trends," *Journal of Political Economy*, forthcoming https://doi.org/10.1086/728741.

Table 1. Redistributive effects of fiscal policy in advanced and emerging market and developing economies

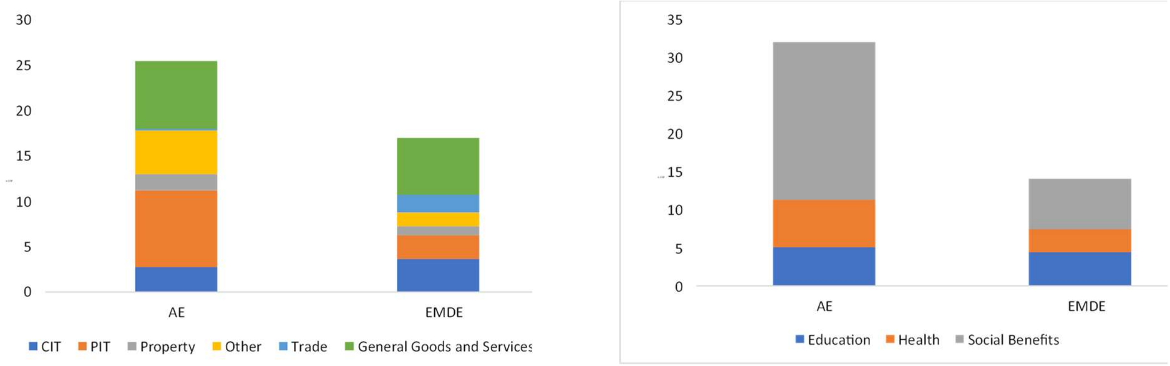
	Gini Disposable		Gini Market		Absolute Redistribution (market – disposable)	
	1990	*2019*	*1990*	*2019*	*1990*	*2019*
Advanced Economies	28.8	29.8	43.1	48.1	14.3	18.3
Emerging Markets and Developing Economies	41.1	39.9	44.4	43.9	3.3	4.0

Note: Figures refer to mean Gini coefficients. The data covers 32 advanced economies and 66 emerging market and developing economies.
Source: authors' computations based on Solt´s (2009) updated SWIID database.[52]

Fiscal policy is less redistributive in EMDEs than AEs for several reasons. First, in EMDEs, a smaller share of tax revenues comes from direct taxes (income and wealth taxes), which are more progressive than indirect taxes (including those on consumption such as the value added tax).[53] Second, tax systems in EMDEs generate a lower level of revenues (as a share of GDP) (Figure 6). This limits the amount that government can spend while maintaining macroeconomic stability, including for social benefits that can help achieve redistribution. Third, pension systems in EMDEs typically only cover workers in the formal sector and thus miss the large share of the workforce employed in the informal sector. This results in both low contribution revenues for pension systems and ultimately a low number of pension beneficiaries; it also makes it difficult to extend coverage to those in the informal sector without large transfers from the central government. Fourth, reflecting administrative challenges and the scarcity of fiscal resources, social assistance programs do not reach all low-income households. In Latin America, for example, about two-thirds of those in the bottom fifth of the income distribution are covered, while in developing Asia, less than half are covered.[54] Finally, a sizeable share of social benefits goes to middle-income households, rather than to those that are relatively poor; in effect, this limits how much redistribution is achieved with these programs.[55]

[52] Solt, F. (2009), "The Standardized World Income Inequality Database," *Social Science Quarterly,* Vol. 90(2), pp. 231-242.
[53] Abdel-Kader, K. and R. De Mooij (2022), "Tax policy", in V. Cerra, B. Eichengreen, A. El-Ganainy, and M. Schindler (eds), *How to Achieve Inclusive Growth*. Oxford: Oxford University Press.
[54] Clements, B., S. Gupta, and J. T. Jalles (2022), "Fiscal policy for inclusive growth in Asia", CGD Working Paper 611. Washington, DC: Center for Global Development.
[55] In Latin America, the poorest 20 percent captures about 6 percent of the benefits; in developing Asia, about 10 percent. See Clements et al. (2022), op cit.

Figure 6. Average taxes and spending in relation to GDP in advanced and emerging markets and developing economies, 2019 (or latest available year)



Source: Authors' calculations using United Nations WIDER Government Revenue Dataset (accessed in November 2022) and IMF WEO Data for nominal GDP. Expenditure categories are from the World Bank WDI. Sample includes a maximum of 35 advanced economies (AEs) and 68 emerging markets and developing countries (EMDEs).

EMDEs expanded transfers and the coverage of social assistance to poor households during the pandemic, but much more modestly than advanced economies, due to limited fiscal space and less developed social safety nets.[56]

EMDEs can also design their indirect taxes on consumption (such as the value added tax (VAT), import duties, and excise taxes) and subsidies (such as those for energy) in ways that can affect inequality. Across AEs and EMDEs, however, the net effect of indirect taxes and subsidies on inequality is about zero. The slightly negative effect of indirect taxes on inequality is offset by subsidies, which favor upper-income groups.[57] Given that lower and middle-income groups have a higher propensity to consume their incomes than upper-income groups, indirect taxes have a less progressive incidence than direct taxes. The incidence of different indirect taxes, however, varies both between AEs and EMDEs and by tax. In EMDEs, the composition of imports and differences in the consumption basket between low- and high-income groups have a bearing on the distributive incidence of import duties. For example, reductions in trade taxes for luxury products can raise inequality. In OECD countries (most of whom belong to the advanced economy group), excise taxes on alcohol, tobacco, and energy tend to increase inequality, as they are more proportionately consumed by lower- and middle-income groups.[58] In the developing economies, research indicates a more mixed picture, with results differing across countries.[59]

[56] International Monetary Fund (2022), *Fiscal Monitor*, October.
[57] Granger, Hazel; Abramovsky, Laura; Pudussery, Jessica (2022) "Fiscal policy and income inequality: The role of taxes and social spending," Overseas Development Institute), London
[58] OECD (2014), "The distributional effects of consumption taxes," OECD Publishing.
[59] Granger et al. (2022), op. cit.

The appropriate design of the VAT in EMDEs—and its impact on inequality—have generated considerable attention, given the relatively high share of tax revenues that come from this tax. In AEs, the VAT is regressive as it applies to a broad base of products, including those consumed by lower- and middle-income households.[60] For EMDEs, however, the evidence is less clear-cut. In practice, it has been difficult for EMDEs to administer the tax to small traders and producers; because of this, many are intentionally excluded from VAT. Because the poor often make their purchases from small traders, the products they consume are often not affected by the VAT.[61] As a result, low-income groups may not necessarily pay more VAT (as a share of their total consumption) than other income groups. Furthermore, in assessing the distributive impact of VAT (or any other tax), it is important to consider how the revenues raised from that tax will be spent. For example, raising the VAT, even if slightly regressive, could have a dampening effect on inequality if the resulting revenues are used to finance expenditures that are well targeted to the poor.

Given the importance of raising revenues to help finance higher levels of expenditure, as well as reduce inequality, tax reform has almost always been on the reform agenda in EMDEs. The track record on these reforms, however, has been mixed, and their impact on income distribution has not always been favorable.[62] The best outcomes have been observed for improvements in revenue administration and the personal income tax. Not all regions, however, have had positive outcomes from personal income tax reforms; in sub-Saharan Africa (and fragile countries in particular), inequality was exacerbated because of shortcomings in reform design.

The rise in food and fuel prices in both AEs and EMDEs, in response to the war in Ukraine that began in early 2022, led many countries to cut taxes or implement subsidies for these products. Most of these were across-the-board cuts in taxes or subsidies that made prices cheaper for both poor and rich households alike. As such, they were not well targeted to the poor and were fiscally costly (averaging more than ½ percent of GDP).[63] Because they were not well targeted to low-income groups, it is unlikely that these subsidies and tax cuts reduced inequality. In EMDEs, where energy is primarily consumed by middle- and upper-income groups, the subsidies aggravated inequality. [64]

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[60] See Clements, B., R de Mooij, S. Gupta, M. Keen ed (2015). *Inequality and Fiscal Policy*. IMF, Washington DC.

[61] Jenkins, G., H. Jenkins, and C.-Y. Kuo (2006). "Is the Value Added Tax Naturally Progressive?" Working Paper 1059, Queen's University, Kingston; Bachas, P., L. Gadenne, and A. Jensen (2021). "Informality, Consumption Taxes, and Redistribution." HKS Working Paper No. RWP21-006.

[62] Gupta, S. and Jalles, J. (2022), "Do tax reforms affect income distribution? Evidence from developing countries", *Economic Modelling,* 110, 105804.

[63] Amaglobeli, D., E. Hanedar, G. Hong, and C. Thévenot (2022). "Fiscal Policy for Mitigating the Social Impact of High Energy and Food Prices." IMF Note 2022/001, June; and IMF (2022), op. cit.

[64] See Clements, B., D. Coady, S. Fabrizio, S. Gupta, T. Alleyne, and C. Sdralevich (2013), eds., *Energy Subsidy Reform: Lessons and Implications*, International Monetary Fund.

Untargeted tax cuts and subsidies are fiscally costly and often inequitable, and there are many other fiscal instruments (such as cash transfers targeted to the poor) that can help protect the real incomes of the vulnerable at a lower fiscal cost. Nevertheless, phasing out temporary tax cuts and subsidies should be done with care, as the rise in food and energy prices that accompanies these reforms will reduce the real incomes of the poor. As such, they should be accompanied by compensatory measures for low-income households.[65] If such measures cannot be implemented in the near term, a more gradual pace to reforms may need to be adopted. In the longer term, there need not be any tradeoff between the policy goal of protecting (or raising) the real incomes of the poor and reducing inequality, if governments utilize the fiscal savings from reforms to help finance programs that benefit low-income groups and bolster economic growth.[66]

In AEs, government spending on health and education is significant and together, these outlays average over 10 percent of GDP (Figure 4). These services are used more intensively by low- and middle-income groups than those in the upper-income tiers. [67] Therefore, they reduce inequality, with a corresponding reduction in the disposable Gini coefficient of 0.05.[68] In EMDEs, these outlays also have a salutary effect on inequality, but the associated reduction in the disposable Gini is only 0.03.[69] This reflects the incomplete access of the low-income population to these services, especially in health, and the lower levels of government spending on these services. The limited redistribution also owes to the composition of spending in EMDEs, which can include outlays that primarily benefit upper-income groups, such as tertiary education and curative health care.

4. Agenda for reforming policies, frameworks, and institutions for meeting the 2030 Agenda

4.1 Reforming monetary policies

In AEs, countries with credible monetary policy frameworks can focus on achieving inflation targets *over the medium term*. A more gradual approach to monetary tightening can mitigate large increases in unemployment and inequality. The ability of central banks to take a more gradual approach depends on inflation expectations, which are influenced by the public's perception of the central bank's commitment to price stability. When inflation expectations are

[65] Banerji, A., V. Crispolti, E. Dabla-Norris, R. Duval, C. Ebeke, D. Furceri, T. Komatsuzaki and T. Poghosyan (2017), "Labor and product market reforms in advanced economies: Fiscal costs, gains, and support", *IMF* Staff Discussion Note2017/003; Clements, B., and D. Coady, S. Fabrizio, S. Gupta, T. Alleyne, and C. Sdralevich (2013), op. cit..

[66] Clements, B., R. de Mooij, M. S. Gupta and M. M. Keen (2015), *Inequality and Fiscal Policy*. Washington, DC: IMF.

[67] Granger et al. (2022), op. cit.

[68] Granger et al. (2022), op. cit.

[69] Granger et al. (2022), op.cit.

well anchored, monetary policy can support economic activity and employment through low policy interest rates and quantitative easing, as seen during the COVID-19 pandemic. To offset the adverse effects of monetary policy on unemployment and inequality, fiscal instruments such as unemployment benefits and other targeted transfers to low-income groups are appropriate.

In cases where very low interest rates are necessary to stimulate economic activity, it is essential to recognize and address the adverse effects on wealth inequality through fiscal policy instruments. This may involve measures such as increased taxation of assets or higher taxes on high-income earners as discussed in the following section.

Given the adverse effects of inflation on inequality, it is appropriate for EMDEs to adopt monetary policy frameworks aimed at keeping inflation at moderate levels of no more than 5-10 percent per year. In instances where inflation exceeds its target, countries with well-anchored inflation expectations can gradually tighten monetary policy to attenuate the effects on output. Countries without such credibility do not possess this flexibility. Over the medium term, countries that successfully reduce inflation do not experience lower output, employment, or real wages;[70] thus, a commitment to low inflation is compatible with a macroeconomic strategy focusing on equitable growth. Nevertheless, EMDEs should expand their fiscal toolkit to protect the incomes of the unemployed, offsetting the short-term effects of monetary tightening on poverty and inequality.

Countries that target control of inflation often have flexible exchange rates. This allows the exchange rate to adjust to external shocks and frees up monetary policy to focus on meeting inflation targets. However, given various structural weaknesses prevalent in EMDEs such as shallow foreign exchange markets, there may be instances where exchange rate intervention is beneficial in limiting exchange rate depreciation and its ensuing effects on inflation. The vulnerabilities to external shocks and the pros and cons of these interventions should be weighed carefully on a case-by-case basis.[71]

4.2 Reforming tax and spending policies[72]

There is limited room for higher levels of spending to achieve redistribution goals in AEs, unless paired with cuts in other outlays. In EMDEs, increases in tax revenues and improvements in resource utilization are necessary. Nevertheless, there is potential to align government

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70 See Arsic et al. (2022), op. cit.

71 See Basu, S, E. Boz, G. Gopinath, F. Roch, and F. Unsal (2020), "A Conceptual Model for the Integrated Policy Framework," IMF Working Paper WP 20/121; and Adrian, T., G. Gelos, and D. Hofman (2022), "Tools such as foreign exchange intervention can ease the effects of shocks but need to be carefully weighed against potential longer-term costs," IMF blog https://www.imf.org/en/Blogs/Articles/2022/04/04/blog04042022-how-africa-can-navigate-growing-monetary-policy-challenges.

72 This section is partly drawn from Clements, B., S. Gupta, J. Jalles (2024). Fiscal Policy and Income Distribution in the Turbulent Era in *Fiscal Policy in a Turbulent Era* edited by Enrique Alberola, Elgar.

spending more effectively with redistribution goals by adjusting its composition in both country groups. Furthermore, many countries could change the composition of taxation to enhance progressivity.

In AEs, there is little room to expand the overall tax effort due to its already elevated level. However, there are various reform avenues to improve tax composition. In this regard:

- Raising top marginal rates for personal income tax, particularly in countries with low rates, could be pursued. The revenue-maximizing rate, considering its impact on labor supply, is estimated at around 50-60 percent.[73]
- Reducing tax exemptions for income taxes, which often benefit upper-income groups and undermine tax efficiency, is another option.
- Widely adopting the globally agreed minimum corporate tax rate can help safeguard revenues and mitigate tax competition between countries.
- Introducing or increasing taxes on net wealth, especially considering recent increases among high-income groups since the COVID-19 pandemic, offers substantial revenue potential.[74]
- Raising property taxes, known for their progressivity and efficiency compared to other forms of capital taxation, could be explored.
- Instituting an appropriate carbon tax to incentivize the transition to cleaner energy sources presents an opportunity for significant revenue generation.[75] These revenues could finance reductions in labor taxes or support progressive expenditures, particularly those benefiting low-income groups affected by higher energy costs.

Regarding expenditures, the reform agenda in AEs should focus on improving the quality of public services with a focus on ensuring greater equality of opportunity. This involves:

- Enhancing the quality of public education spending available to low-income households, especially considering the pandemic's adverse impact on learning among the poor students who have limited access to virtual learning tools.[76]
- Improving the quality and accessibility of public health services for low-income households.
- Adjusting social assistance payments to levels sufficient for poverty elimination, while incorporating work requirements to mitigate adverse effects on labor supply. Benefits can be phased out gradually as labor income rises.

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[73] IMF (2013). *Fiscal Monitor: Taxing Times.*

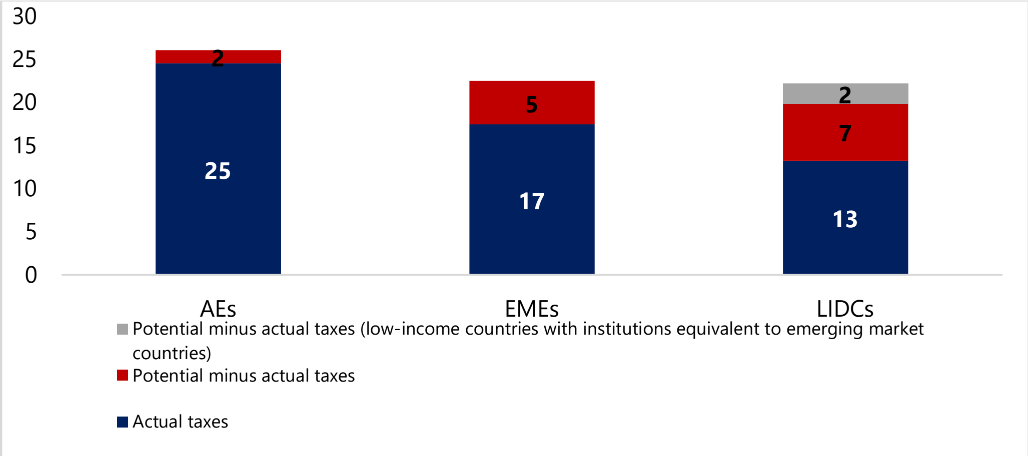
[74] Chancel, L., and T. Piketty, E. Saez, and G. Zucman (2021). *World Inequality Report 2022*, World Inequality Lab (wir2022.wid.world).

[75] Black, S., I. Parry, J. Roaf, and K. Zhunussova (2021). "Not Yet on Track to Net Zero: The Urgent Need for Greater Ambition and Policy Action, IMF Staff Climate Note 2021/005, International Monetary Fund.

[76] Agostinelli, A., M. Doepke, G. Sorrenti, and F. Zilibotti (2022). When the great equalizer shuts down: Schools, peers, and parents in pandemic times. *Journal of Public Economics,* Vol. 206, 104574

EMDEs, unlike AEs, will need to increase revenues as a share of GDP and prioritize spending to create space for financing higher levels of redistributive spending while advancing fiscal consolidation (see Box 2). It has been estimated that low-income developing countries (LIDCs), many of which are in Africa, could raise the tax-to-GDP ratio by an additional 9 percentage points through tax system and institutional reforms, while EMEs could achieve a 5-percentage point increase (Figure 7).[77] These two groups collectively constitute EMDEs.

Figure 7. Tax Potential and Tax Effort, 2020 (Percent of GDP)

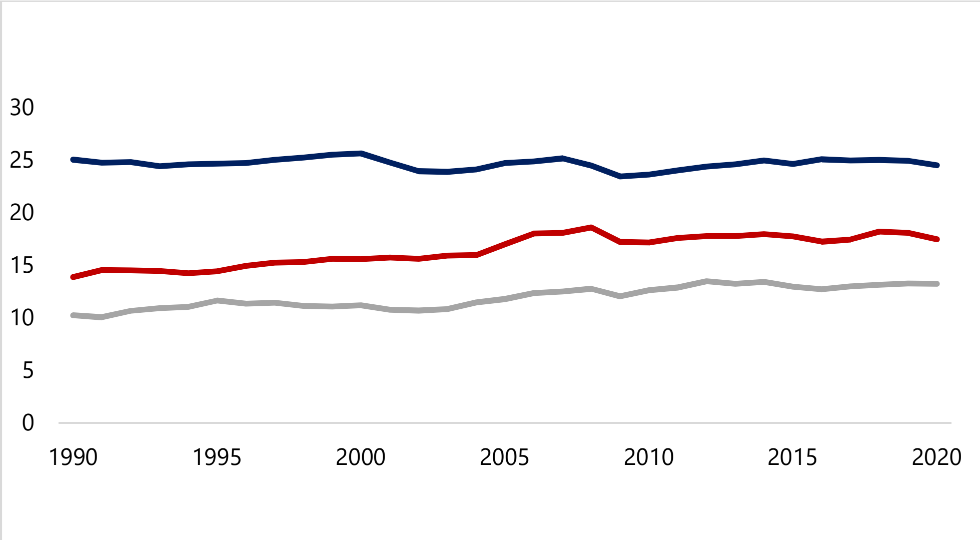


Source: Authors' elaboration based on data from Benitez et al. (2023), "Building Tax Capacity in Developing Countries."[78]

In EMDEs, revenues experienced an average increase of 2-4 percentage points of GDP between 1990 and 2011. However, a concerning trend emerged between 2012 and 2020, with revenues stagnating, with the tax-to-GDP ratio hovering around 13 percent in LICs and 17 percent in EMEs (Figure 8). This stagnation, underscored by several LICs collecting less than 10 percent of revenues relative to GDP, has impeded crucial funding needed for social sectors and overall development.

[77] Benitez, J.C., Mansour, M., Pecho, M., and Vellutini, C (2023). *Building Tax Capacity in Developing Countries*, International Monetary Fund (IMF), Washington, D.C., 19 September.
[78] Benitez et. al (2023) op. cit.

Figure 8. Tax Revenue, 1990-2020 (Percent of GDP)



Note: blue, red and grey lines denote Advanced Economies, Emerging Markets and Low-income Countries, respectively.

Source: Authors' elaboration based on data from Benitez et al, "Building Tax Capacity in Developing Countries."[79]

The revenue measures EMDE governments should prioritize include:

- Enhancing the effectiveness of the Value Added Tax (VAT), which has encountered challenges due to exemptions and reduced rates. Simultaneously, extending VAT to cover the import of digital services and online-purchased parcels would broaden the taxable base. To enhance the progressivity of the VAT, one approach is to establish high enough minimum thresholds for filing. This adjustment would exempt numerous small-scale sellers, from whom individuals with lower incomes often make purchases, and would help simplify VAT administration. In addition, complementary reforms in other areas (such as labor market laws) that reduce the disincentives for firms to join the formal sector and register for taxes should be considered.
- Significant revenues are lost due to tax expenditures.[80] In certain cases, VAT exemptions are granted for products heavily consumed by the poor, such as food. However, in many countries, these exemptions have not effectively reduced inequality, given the substantial consumption of these products by middle and upper-income groups.[81] Even if applying

[79] Benitez et. al (2023) op. cit.
[80] Gupta, S. and Jalles, J. (2023), "Priorities for Strengthening Key Revenue Sources in Asia", *Asian Development Review*, Vol. 40(2), pp. 271–303.
[81] Granger, H.,et. Al (2022) op. cit..

VAT to some exempted products makes the tax more regressive, this impact can be mitigated by increasing pro-poor spending.

- Additional revenue generation opportunities exist through excise duties on petroleum products, alcoholic beverages, tobacco, unhealthy foods (e.g., sugary drinks), and plastic waste.
- There is potential not only to improve the design of personal income taxes to boost revenues but also to introduce higher rates for capital income (such as interest, dividends, and capital gains). Adjusting the threshold for personal income tax can be instrumental. In certain countries, a relatively small percentage of workers are subject to income tax due to the high threshold,[82] and a relatively low top rate.[83]
- Moreover, given the prevalence of informality in many developing countries, implementing simplified regimes for the self-employed and micro-enterprises can enhance tax compliance and reduce the size of shadow economy. In many countries, actual revenue collection falls below tax potential due to poor tax compliance.
- However, achieving these objectives requires a comprehensive approach that navigates carefully through vested interests and may progress slowly, as evidenced by the two-decade timeline for a modest 2 percentage point increase in the tax-to-GDP ratio from 1990 to 2012 in LICs.

EMDEs currently allocate approximately 7-9 percent of GDP to education and health, with an additional expenditure of up to 8 percent of GDP on public investment.[84] This spending is expected to rise as countries aim to meet the Sustainable Development Goals (SDGs) and allocate resources for climate transitions. However, evidence suggests that many governments in EMDEs are not achieving these objectives at the lowest feasible cost, indicating room for enhanced efficiency and improved targeting to expand fiscal space.

In this context, some nations, notably in Africa, spend 20-35 percent more resources in both education and health sectors to achieve comparable goals compared to more efficient countries.[85] For instance, in India, six states have the potential to reduce education and health spending by 50 percent or more without compromising service provision.[86] Furthermore, several

[82] Abdel-Kader, K., and R. De Mooij (2022). "Tax Policy," in V. Cerra, B. Eichengreen, A. El-Ganainy, and M. Schindler, eds., *How to Achieve Inclusive Growth* Oxford: Oxford University Press.

[83] Benedek, D., Benitez, J. C., and Vellutini, C. (2022), *Progress of the Personal Income Tax in Emerging and Developing Countries*, International Monetary Fund (IMF), Washington, D.C.

[84] Gupta, S. (2018). *Merely Collecting More Taxes Is Not Enough to Achieve the SDGs*, Center for Global Development, Washington, D.C.

[85] Gupta, S. and Verhoeven, M. (2001). The efficiency of government expenditure: experiences from Africa, *Journal of Policy Modelling,* Vol. 23(4), pp. 433-467; Herrera, S. and Pang, G. (2005). Efficiency of Public Spending in Developing Countries: An Efficiency Frontier Approac*h*, Policy Research Working Paper No. 3645, World Bank, Washington, D.C.

[86] Mohanty, R. K. and Bhanumurthy, N.R (2020). Assessing public expenditure efficiency at the subnational level in India: Does governance matter?*, Journal of Public Affairs,* Vol. 21(2), e2173.

EMDEs waste over one-third of their public investment due to inefficient spending practices, which is a significant setback given the extensive infrastructure gaps these nations face.[87] While estimates of spending inefficiency vary among programs and countries, they underscore the importance for policymakers to address persistent inefficiencies, especially when fiscal resources are limited.

Considering the above, priority reforms on the expenditure side should include:

- Shifting towards more efficient fuel pricing could generate substantial revenues, equivalent to 3.6 percent of global GDP. Subsidies on fossil fuels primarily benefit upper-income households and should be replaced with cash assistance for low-income groups to prevent increases in poverty. In 2023, the IMF estimated fossil fuel subsidies to be USD 7 trillion in 2022, or 7.1 percent of global GDP.[88] Despite the existence of 73 carbon pricing schemes in around 50 countries, implicit subsidies persist, contributing to environmental degradation and health issues. Implementing efficient fuel pricing policies could prevent 1.6 million premature deaths annually attributed to local air pollution.
- Many countries will need to increase spending on health to achieve universal health care, even with a modest package of benefits.[89] At the same time, resources should be reallocated away from hospital-centric structures and toward primary and preventive care to improve overall health outcomes.[90] System-wide reforms focusing on strengthening incentives for cost-effective care are necessary in many countries.
- While some countries may need to raise education spending, depending on their demographics, improving its composition and efficiency is crucial. Reallocation away from public universities toward primary and secondary schools can make education spending more progressive. Additionally, raising fees and tuition at the tertiary level could be offset by expanding financial assistance for low-income students. The mix of spending inputs (such as wages and medicines) could be improved to deliver better quality services. Efforts to improve the efficiency of education spending should focus on improving learning outcomes and the quality of teaching, especially in low-income regions.[91]
- In sectors other than social, governments should undertake spending reviews regularly to identify low-priority outlays that could be cut, thereby generating savings throughout the

[87] IMF (2015). *Making Public Investment More Efficient*, Washington, D.C., June; Barhoumi, K., Vu, H., Towfighian, N., and Maino R. (2018). *Public Investment Efficiency in Sub-Saharan African Countries*, International Monetary Fund, Washington, D.C.
[88] Black, S., Liu, Antung A., Parry, I.W.H., and Vernon, N.,(2023) IMF Fossil Fuel Subsidies Data: 2023 Update, International Monetary Fund, Washington, D.C.
[89] Gaspar, V., and D. Amagobeli, M. Garcia-Escribano, D. Prady, and M. Soto (2019). "Fiscal Policy and Development: Human, Social, and Physical Investments for the SDGs." IMF Staff Discussion Note 2019/003.
[90] Filmer, D., and R. Gatti, H. Rogers, N. Spatafora, and D. Emrullaha (2022). "Education and Health" in V. Cerra, B. Eichengreen, A. El-Ganainy, and M. Schindler, eds., *How to Achieve Inclusive Growth* Oxford: Oxford University Press.
[91] Ibid.

budget to boost redistributive spending. This can help create fiscal space for essential social investments.

5. Institutional arrangements to facilitate equitable fiscal and monetary policies

The effective design and execution of equitable monetary and fiscal policies within the framework of the SDGs hinge on several crucial factors: (i) aligning fiscal and monetary policy objectives with the SDGs; (ii) fostering efficient coordination between fiscal and monetary authorities at a high level; and (iii) establishing resilient institutional frameworks in both the monetary and fiscal spheres.

Given the importance of macroeconomic stability to achieving growth and generating the tax revenues that finance government spending for redistribution, both monetary and fiscal policies are relevant for a nation's sustainable development strategy. Thus, the evolution of macroeconomic performance, and developments in monetary and fiscal policies, should be reviewed on a regular basis at the cabinet level. Regular consultation and coordination mechanisms between the ministry of finance or the treasury and the central bank at the highest level (and working-level interactions among key senior officials) should also be implemented. It is important to emphasize that this process is likely to lead to different assessments of the appropriate mix of fiscal and monetary policies across countries, given their differing macroeconomic circumstances. For example, for countries with high inflation—which has adverse effects on income inequality and growth—a tightening of monetary policy and a temporary slowdown in the growth of government spending may be called for to help countries meet the SDGs, despite adverse effects in the short term.

Sound governance of central bank practices on monetary policy is based on the pillars of independence and accountability, solid policy and operational strategies, and transparent communications.[92]

1. **Establishing independence and accountability.** It is essential to establish, by law, the operational independence of the central bank.[93] A particularly important part of this operational independence is that the central bank is not compelled to finance government deficits and has sufficient financial strength to fulfill its mandate.[94] Strengthening central bank independence has a positive effect on countries' performance in containing

[92] This approach is drawn from Unsal, D. F., and C. Papageorgiou (2023), "Monetary Policy Frameworks: An Index and New Evidence," mimeographed; an earlier version is available from Unsal, F.D., C. Papageorgiou, and H. Garbers (2022), "Monetary policy frameworks: An index and new evidence," IMF Working Paper WP 2022/022.
[93] IMF (2015), op. cit; Unsual and Papgeorgiou (2023), op cit.
[94] IMF (2015), op. cit.

inflation.[95] Accountability implies that the central bank must provide clear objectives for monetary policy and report on its performance to the public vis-a-vis these objectives. It is also advisable to form an independent Central Bank Board comprised of different stakeholders, representing business, labor, and vulnerable communities to ensure adequate accountability to society.

2. **Solid policy and operational strategies. T**his entails clarity with respect to the objectives for monetary policy, including with respect to numerical targets and the data that define these targets; the time horizon to achieve these targets; setting targets for inflation over the medium term; and describing the conditions under which targets can be modified. In addition, the policy instruments (e.g., operations to affect interbank rates or a key central bank reference rate) should be well understood by the public and markets as a signal of the central bank's policy stance.

   Improving policy formulation and implementation will require further strengthening central banks' capacity in macroeconomic forecasting and analysis of the impact of monetary policies on output and inflation. In addition, there is significant scope for developing capacity to employ a monetary policy framework reliant on interest rate instruments rather than monetary aggregates.[96]

3. **Transparent communication practices.** This involves (i) following a clear cycle of communication to the public; (ii) announcing and explaining the policy stance following the conclusion of monetary policy meetings; (iii) publishing a regular monetary policy report; (iv) publication of data; and (v) inclusion of stakeholders, including by making information available in all major official languages and in a simplified matter to reach a broad audience.[97]

Sound *fiscal governance*, encompassing processes, institutions, and mechanisms surrounding fiscal policy, allows governments to transparently manage their finances while maintaining fiscal discipline and informing society of progress in fiscal policies to help meet the SDGs. These frameworks have evolved over time and comprise:

1. **Fiscal Responsibility Laws (FRLs):** A FRL establishes clear rules and targets for fiscal policy. In this context, fiscal rules serve as constraints on fiscal policy, typically in the form of numerical targets on budgetary aggregates such as government debt, deficits, and

[95] Jácome, L, and S. Pienknagura (2022), "Central Bank Independence and Inflation in Latin America—Through the Lens of History", IMF Working Paper WP/22/186.

[96] IMF (2015), op. cit.; Garbers. H. and D. F. Unsal (2021), "Monetary Policy in Low-Income Countries," in H. Ahir, M. Coppo, H. Garbers, G. Melina, F. Narita, D.F. Unsal, V. Malta, X. Tang, D. Gurara, L-F Zanna, L. Venable, K. Kpodar, and C. Papageorgiou, "Macroeconomic Research in Low-Income Countries: Advances Made in Five Key Areas Through a DFID-IMF Collaboration," IMF Departmental Paper 21/6.

[97] See also International Monetary Fund (2020), "The Central Bank Transparency Code," IMF Policy Paper.

expenditures.[98] [99] Fiscal rules vary significantly across countries in terms of their legal status, coverage, and enforcement mechanisms. For example, the Stability and Growth Pact in the European Union imposes a deficit limit of 3 percent of GDP and a debt ceiling of 60% of GDP on member states, with potential sanctions for non-compliance. Recent literature suggests that the effectiveness of fiscal rules continues to evolve with changing economic landscapes. The design of fiscal rules should adapt to the complexities of modern economies, be flexible and act counter-cyclically, where fiscal space permits, to accommodate economic shocks.[100]

2. **Medium-Term Fiscal Framework (MTEF**): Developing a medium-term fiscal framework enables governments to undertake strategic planning and budgeting beyond the annual cycle and typically cover three to five years—a consideration relevant for achieving the SDGs. MTFFs incorporate multi-year fiscal targets, expenditure priorities, and revenue projections to ensure fiscal sustainability and stability. They link policy, planning, and budgeting over the medium term to ensure that fiscal decisions are aligned with long-term objectives and resource availability.[101] Their success, however, is contingent upon the quality of the underlying macroeconomic projections, the integration of MTEFs into the budget process, and the capacity of institutions to implement them effectively. [102] The adoption and refinement of MTEFs have been widespread, reflecting their perceived benefits in aligning fiscal policy with long-term strategic goals, such as the SDGs.

3. **Align the MTEF with an Integrated National Financing Framework (INFF),** a tool to spell out how national sustainable development priorities can be financed. This will ensure that budgetary allocations and resource mobilization are consistent with the financing needs of SDG priorities.

4. **Independent Fiscal Institutions (IFIs**): Establishing independent bodies, such as fiscal councils or audit institutions, enhances fiscal governance by providing impartial analysis and assessments of government finances. IFIs contribute to greater transparency, accountability, and credibility in fiscal policymaking. Fiscal councils vary in their mandates, which can include assessing macroeconomic and fiscal forecasts, evaluating fiscal policy

[98] Kopits, G., and Symansky, S. (1998). Fiscal policy rules. IMF Occasional Paper No. 162.

[100] Eyraud, L., Debrun, X., Hodge, A., Lledó, V. D., & Pattillo, C. (2018). Second-generation fiscal rules: Balancing simplicity, flexibility, and enforceability. IMF Staff Discussion Notes, SDN/18/04.
[101] World Bank. (2013). Beyond the Annual Budget: Global Experience with Medium-Term Expenditure Frameworks.
[102] Le Houerou, P., & Taliercio, R. (2002). Medium-Term Expenditure Frameworks: From Concept to Practice. Preliminary Lessons from Africa. World Bank, Working Paper No. 23651, Washington DC.

objectives, and promoting adherence to fiscal rules.[103] The credibility and effectiveness of fiscal councils depend on their independence, access to information, and the technical capacity to conduct rigorous analyses.[104] IFIs should establish channels for social dialogue to engage with stakeholders, and continuously assess and monitor the fiscal strategy vis-à-vis the fiscal authority's goals for fiscal sustainability. This includes deploying countercyclical measures where fiscal space allows and promoting inclusive growth.

5. **Transparent Budgetary Processes**: As discussed below, transparent budgeting ensures that budget formulation, execution, and reporting processes are open and accessible to the public.[105] This involves publishing comprehensive budget documents, conducting public consultations, and providing timely updates on budget execution.

6. **Strengthening Research Capacity:** Both monetary and fiscal authorities must prioritize the development and enhancement of their research capabilities to craft evidence-based, equitable monetary and fiscal policies. Collaborative efforts should be undertaken to conduct joint research on macroeconomic trends and the interplay among key indicators. Furthermore, establishing research partnerships with independent think tanks and academic institutions can enrich the depth and breadth of analysis.

A corollary of strong fiscal institutions is that they reduce the scope for corruption. Corruption not only diminishes the direct pool of resources available for redistribution but also erodes public trust in government institutions, rendering the implementation of social policies more challenging[106] and widening the gap between the rich and the poor.[107] Widespread corruption impairs the culture of compliance with tax laws and diminishes the state's capacity to provide public goods and services**.** Countries that are less corrupt collect between 2¾ percent of GDP and 4½ percent of GDP more revenue than those perceived to be more corrupt.[108] A reduction in corruption by one-third is associated with higher government revenues to the tune of 1.2 percent of GDP.

In this context, fiscal transparency and strong, accountable, and effective institutions enhance the effectiveness of fiscal policy by ensuring government financial operations are transparent and subject to public scrutiny. Initiatives and institutions that promote open budgets, public access to fiscal information, and independent audits can deter corrupt practices by

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[103] Debrun, X., & Kapoor, R. (2010). Fiscal policy and macroeconomic stability: Automatic stabilizers work, always and everywhere. IMF Working Paper No. 2010/111 Washington DC.

[104] Calmfors, L., & Wren-Lewis, S. (2011). What should fiscal councils do? *Economic Policy*, 26(68), 649-695

[105] International Monetary Fund (IMF). (2014). Fiscal Transparency Code. Washington, DC: IMF.

[106] Organisation for Economic Co-operation and Development (OECD) (2019). "Development Co-operation Report 2019: A Fairer, Greener, Safer Tomorrow." Paris.

[107] Organisation for Economic Co-operation and Development (OECD). (2020). "Tax and Fiscal Policy in Response to the Coronavirus Crisis: Strengthening Confidence and Resilience." Paris: OECD Publishing.

[108] International Monetary Fund (2019), op. cit.

increasing the likelihood of detection and holding corrupt officials accountable. By fostering informed public debate and enhancing government credibility and trust, fiscal transparency can lead to more prudent fiscal management. Providing accessible fiscal information empowers citizens and civil society organizations to hold public officials accountable, reducing opportunities for corruption and ensuring that redistributive policies are effectively targeted and implemented.[109]

By openly sharing information regarding fiscal policies, government expenditures, and overall public finances, governments build trust with their citizens (see box 3). This trust is essential for the effective implementation of fiscal policies. The IMF´s Fiscal Transparency Code and Handbook emphasize this aspect.[110]

6. Political Economy Challenges in Formulating Equitable Monetary and Fiscal Policies

Despite having appropriate frameworks in place, the implementation of fiscal and monetary policies often encounters obstacles due to political economy considerations. Legislative dynamics, the electoral cycle, and the ideological orientation of policymakers can individually or collectively define the scope and impact of policies aimed at reducing income inequalities.[111]

The strength of a government's majority in parliament can significantly influence its ability to enact substantial fiscal reforms. A robust majority may facilitate the passage of ambitious redistributive policies, whereas a slim majority might compel governments to propose more moderate policies to accommodate diverse parliamentary interests.[112]

Electoral motivations also play a critical role, as the timing of elections can profoundly influence fiscal policy decisions. Governments often adopt short-term populist measures to secure votes, such as increased spending or tax cuts, favoring immediate electoral gains. [113] Studies have shown that monetary policy can also be influenced by electoral motives, with governments sometimes engaging in expansionary policies to stimulate the economy ahead of elections to sway voter sentiment. [114]

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[109] International Monetary Fund (IMF). (2017). "Fiscal Transparency Handbook." Washington, DC: International Monetary Fund.
[110] www.imf.org/external/np/fad/trans/Code2019.pdf. www.elibrary.imf.org/display/book/9781484331859/9781484331859.xml
[111] Gaspar, V, Sanjeev Gupta, and Carlos Mulas-Granados. (2017) editors. *Fiscal Politics*, IMF.
[112] Ainsworth, S., & Sened, I. (1993). The Role of Legislators in the Determination of Interest Group Influence. *Legislative Studies Quarterly*, 18(4), 435-451.
[113] Drazen, A., & Eslava, M. (2010). Electoral Manipulation via Voter-Friendly Spending: Theory and Evidence. *Journal of Development Economics*, 92(1), 39-52
[114] Beck, N. (1984). Domestic Political Sources of American Monetary Policy: 1955-82. *Journal of Money, Credit and Banking*, 16(3), 273-284.

The ideological orientation of the ruling party crucially steers the direction of a country's policies. Left-leaning governments typically endorse higher public spending on social programs and progressive taxation aimed at wealth redistribution, while right-leaning governments might lean towards reducing taxes and minimizing government spending, advocating for market-driven solutions to foster economic growth.[115] In political environments where coalitions are necessary, fiscal policies often emerge from compromises between coalition partners, which can lead to inconsistent or suboptimal fiscal outcomes. Moreover, the power of interest groups like business lobbyists and labor unions can significantly shape fiscal policy, pushing for policies that favor their specific interests, which might divert policies from broader economic equality objectives.[116] That said, experience from energy subsidy reforms suggests that appropriate design, sequencing, and implementation of reforms can enhance the equity of resulting policies. A consultative reform process implemented transparently and gradually, and accompanied by targeted social safety net measures, has been found to result in more equitable outcomes.[117]

7. Conclusions

Distributive concerns are of great importance to policymakers, given the low projected growth in many economies and deep economic imbalances that have surfaced in the aftermath of the COVID-19 pandemic. These imbalances are now limiting fiscal space in many countries. Against this background, this paper delineates equitable fiscal and monetary policies, along with their corresponding institutional frameworks, which can be tailored to help countries fulfill the fundamental tenets of the UN's 2030 Agenda. Fiscal policy stands as the primary instrument for advancing the UN agenda, with monetary policy playing a complementary supportive role.

Monetary policy can play a crucial role in supporting equitable growth by containing inflation at low or moderate levels. High rates of inflation are a tax on the poor and have a deleterious effect on income distribution. The empirical evidence on monetary policy and its effects on the distribution of wealth are mixed, but the sharp rise in asset valuations in the post-COVID period, during an initial period of easy monetary policy, warrants further research. Effective coordination between monetary and fiscal policy is necessary for macroeconomic stability. Good monetary policy frameworks—such as inflation targeting—can foster fiscal discipline, since the latter is needed to meet inflation targets.

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[115] Ploeg, F. (1995). Political Economy of Monetary and Budgetary Policy, *International Economic Review*, 36(2), 427-439. Hicks, A., & Swank, D. (1992). Politics, Institutions, and Welfare Spending in Industrialized Democracies, 1960-82. *American Political Science Review*, 86(3), 658-674. Gilens, M. (2012). Affluence & Influence: Economic Inequality and Political Power in America. Princeton University Press.

[116] Olson, M. (1982). The Rise and Decline of Nations: Economic Growth, Stagflation, and Social Rigidities. Yale University Press.

[117] See Clements, B., D. Coady, S. Fabrizio, S. Gupta, T. Alleyne, and C. Sdralevich (2013), eds., *Energy Subsidy Reform: Lessons and Implications*, International Monetary Fund.

Given the adverse effects of inflation on inequality, it is appropriate for EMDEs to adopt monetary policy frameworks aimed at keeping inflation at moderate levels of no more than 5-10 percent per year. At the same time, EMDEs should expand their fiscal toolkit to protect the incomes of the unemployed, offsetting the short-term effects of monetary tightening on poverty and inequality. Sound governance of central bank practices can also facilitate achieving the 2030 Agenda. This should rest on establishing independence and accountability; solid policy and operational strategies; and transparent communications.

Beyond its role in supporting macroeconomic stability, fiscal policy is the government's primary instrument for achieving redistribution. On average, fiscal policy is not very redistributive in EMDEs, given the small share of tax revenues that comes from direct taxes (income and wealth taxes), the low level of revenues and social benefit spending, and the sizeable share of spending that goes to middle-income households.

EMDEs, unlike AEs, will need to increase revenues as a share of GDP and prioritize spending to create space for financing higher levels of redistributive spending while advancing fiscal consolidation. EMDE governments should place high emphasis on reforming tax expenditures, including exemptions for the VAT; implementing more extensive excise taxes on goods with negative externalities; improving the design of the income tax by lowering the filing threshold and raising tax rates on incomes from capital; and implementing simplified tax schemes to better incorporate the informal sector.

On the spending side, priorities include curtailing fuel subsidies; increasing health spending to provide a basic package of universal health benefits; reallocating health outlays toward primary and preventive care; reallocating education spending toward primary and secondary schools; and prioritizing improved learning outcomes and the quality of teaching. Outside the social sectors, spending reviews should be conducted on a regular basis to free up redistributive spending.

Sound fiscal governance can also facilitate reaching the 2030 Agenda. This includes the implementation of fiscal responsibility laws and medium-term fiscal frameworks (MTEFs); aligning these MTEFs with Integrated National Financing Frameworks; creating Independent Fiscal Institutions, such as Fiscal Councils; implementing transparent budgetary processes; and strengthening research capacity.