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**Promoting Group Justice:  
Fiscal Policies in Post-Conflict Countries**

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CENTER ON  
INTERNATIONAL  
COOPERATION

POLITICAL ECONOMY  
RESEARCH INSTITUTE

**PROMOTING GROUP JUSTICE:  
FISCAL POLICIES IN  
POST-CONFLICT COUNTRIES**

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Public Finance in Post-Conflict Environments  
A Policy Paper Series  
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# PREFACE

## PUBLIC FINANCE IN POST-CONFLICT ENVIRONMENTS: A POLICY PAPER SERIES

In the wake of violent conflict, a key element of building a durable peace is building a state with the ability to collect and manage public resources. To implement peace accords and to provide public services, the government must be able to collect revenue, allocate resources, and manage expenditure in a manner that is regarded by its citizens as effective and equitable.

The tasks of revenue mobilization, budget allocation, and expenditure management are bound together by political imperatives as well as economic logic. To collect revenues, the state must be seen as legitimate in the eyes of its citizens. And to secure legitimacy, the state must allocate resources and manage expenditure effectively and equitably.

The need to build legitimate and capable states in war-torn societies is now widely recognized. *The Principles for Good International Engagement in Fragile States*, adopted by the development ministers of major donor countries in March 2005, declares that statebuilding is ‘the central objective.’ This represents a striking break from the prevailing wisdom in the closing decades of the 20th century, when the state was widely regarded as the problem. The state has been rediscovered: it is now invoked as the solution. The policy rhetoric has changed from downsizing states to building state capacity.

Yet little systematic work has been done on what the international community can and should do to strengthen the capacities of post-war states to mobilize, allocate, and spend public resources.

This policy paper series, jointly published by the Center on International Cooperation (CIC) at New York University and the Political Economy Research Institute (PERI) at the University of Massachusetts, Amherst, seeks to redress this gap by presenting innovative policy proposals targeting critical issues in postwar public finance.

Building state capacities in public finance is crucial to the success of peacebuilding efforts for three reasons:

- » First, governments must be able to ensure *sustainable funding* for new democratic institutions, for social programs that ease tensions and redress grievances, and for public investments to promote economic growth and development. In the early post-war years, countries often receive a

large influx of external assistance that temporarily can meet some of these needs. But aid typically diminishes over time, so domestic resources are necessary to sustain these institutions and programs. A key challenge is to ensure that aid does not ‘crowd out’ domestic fiscal capacities, but instead stimulates their growth.

- » Second, fiscal capacities are needed to build a *legitimate state*. Democratic elections do not, in and of themselves, ensure state legitimacy. Neither do ‘quick impact projects’ in which international aid agencies seek to fill urgent needs. Legitimacy comes in large part from government delivery of services that people need and want. Elections provide an avenue for the citizenry to voice demands; responding to those demands requires the capacity to mobilize, allocate, and spend public resources effectively.
- » Third, in some cases there is a need to curtail extra-legal taxation by ‘warlords’ and armed groups so as to *enhance security*. In Afghanistan, for example, control of border customs outposts is not only a fiscal issue but also a security issue. Similarly, control over revenues from natural-resource extraction, such as logging in Cambodia or diamonds in West Africa, is often crucial for establishing the state’s monopoly not only in legitimate taxation but also in legitimate force. At the same time, domestic fiscal capacity is the only sustainable source of financing for public security after external peacekeepers have withdrawn.

The papers in this series offer policy proposals designed to strengthen the fiscal dimension of statebuilding. The authors draw on extensive personal experience in public finance matters in war-torn societies, and on lessons from comparative studies, including *Peace and the Public Purse: Economic Policies for Postwar Statebuilding* (Boulder: Lynne Rienner, 2007), the outcome of the first stage of the CIC’s statebuilding project. After a concise recapitulation of the problems to be addressed, the authors concentrate on proposing solutions that can be practically implemented.

We hope these policy papers will find a wide audience amongst those who are grappling with the difficult challenges of post-war reconstruction, and that the proposals they put forward will assist in the twin tasks of building legitimate and effective states and building a durable peace.

JAMES K. BOYCE  
*Lead economist, Peacebuilding as Statebuilding Program*

# PROMOTING GROUP JUSTICE: FISCAL POLICIES IN POST-CONFLICT COUNTRIES

## EXECUTIVE SUMMARY

Evidence suggests that economic inequalities – particularly “horizontal inequalities” among groups defined by ethnic, racial, linguistic, regional, and religious lines – can generate social tensions and fuel violent conflict. Well-designed fiscal policies can help build a sustainable peace by working to reduce these inequalities. This paper reviews some challenges raised by analyzing the impacts of tax and expenditure policies on inequality in post-conflict settings, and makes recommendations for incorporating distributional effects into fiscal policy making.

### THE CHALLENGE OF MEASUREMENT

The first step in understanding the status and dynamics of horizontal inequalities (HIs) is to map the group boundaries that form the basis for discrimination or favoritism. A careful scoping exercise is needed to answer four key questions:

- (1) Are the salient groups ranked hierarchically?
- (2) Are they geographically concentrated, or dispersed?
- (3) Are they specialized in certain economic sectors or activities?
- (4) Does the government have the political inclination to tackle inequalities?

After the relevant groups are defined, both income and non-income dimensions of HI should be measured. The latter include ownership of land and other assets, employment, education, and infant and child mortality. Simple comparisons of averages – such as per capita income – can conceal distributional differences within groups, so comparisons at various points across the distribution are also needed.

This paper proposes three approaches to tackle these measurement challenges:

- » Where data needed to measure horizontal inequalities are not available (or highly inadequate), small-scale household surveys should be conducted to assess inter-group disparities in (a) asset ownership; (b) employment; (c) incomes; (d) education; and (e) health and nutrition.
- » Where conflict-relevant group boundaries are not evident, perceptions surveys should be conducted on attitudes toward identities and inequalities.
- » In addition to regional and linguistic categorizations, statistical offices should be encouraged to include ethnic, religious, or racial categorization (if relevant and politically feasible) in subsequent data collection.

### TAXATION POLICIES

Tax policies in post-conflict settings can and should aim not only to mobilize revenue but also to address inequality. These aims are interrelated as perceptions of tax-policy inequity can undermine the legitimacy of the taxation system and deter compliance, impeding revenue collection. Addressing distributional issues by making tax liability directly dependent on religious, ethnic, or racial identity, risks strengthening group divisions. Policies can be devised, however, to increase progressivity and tax more heavily those groups that are relatively privileged. To this end, the paper recommends that policy makers:

- » Increase the general progressivity of the tax system by (a) increasing the role and progressivity of direct taxes and property taxes, and (b) increasing the progressivity of indirect taxes by raising rates on luxuries and exempting basic goods consumed by the poor.
- » Design indirect taxes to bear more heavily on privileged groups, by introducing taxes or increasing rates on geographic areas and production and consumption activities in which such groups are concentrated.

## EXPENDITURE POLICIES

Expenditure policies also can be designed to redress HIs. People benefit from public expenditure in the allocation of contracts and employment, as well as in their access to public services.

Four relevant types of expenditure can be distinguished:

- (1) Expenditures with differentiated effects on both inter-regional and intra-regional lines, such as expenditure on infrastructure.
- (2) Expenditures with differentiated benefits across groups but not necessarily across regions, such as airline subsidies.
- (3) Expenditures with differentiated benefits across regions but not necessarily within regions, such as expenditure on environmental quality.
- (4) Transfer payments to specific communities, households, or individuals.

To improve the distributional impacts of public expenditures, the paper offers the following recommendations:

- » In the construction of facilities and delivery of services, allocation of contracts and employment should explicitly consider fairness among groups. Potential policies to promote this include competitive and transparent bidding procedures for contracts; “fair” employment legislation and rules; and technical assistance and possibly quotas to ensure equitable distribution.
- » The distributional impacts of public services should be monitored, and allocations made to ensure greater horizontal and vertical equity by targeting pro-poor sectors, activities within sectors, and locations. In federal or decentralized systems, revenue-sharing formulae should be designed to improve

regional equity. Aid allocation should follow similar principles.

- » Aid donors should assist governments to identify types of expenditure that will reduce inequalities, drawing on available data, light surveys, and evidence from other countries. Where capacity is a constraint, they should provide technical assistance to integrate distributional impacts into public expenditure reviews and planning. Where willingness to tackle inequalities is a constraint, they should undertake policy dialogue and conditionality, and direct their own resources to improving horizontal and vertical equity.

## CONCLUSION

The need to tackle horizontal inequality in post-conflict policies is increasingly recognized. Innovative policies can address this need. Collecting data on inequalities will enable policy makers to analyze the distributive impacts of the fiscal system, and to devise tax and expenditure policies to redress these biases. Aid donors have an important role to play in ensuring a government’s success in these efforts.

# PROMOTING GROUP JUSTICE: FISCAL POLICIES IN POST-CONFLICT COUNTRIES

BY FRANCES STEWART, GRAHAM BROWN, AND ALEX COBHAM<sup>1</sup>

This paper reviews the impact of fiscal policies on inequality in post-conflict settings, and offers proposals to integrate distributional concerns better into policy making. We first review the relationship of inequality to conflict, focusing on the importance of “horizontal inequalities” across groups that are culturally defined on the basis of ethnicity, religion, race, or other attributes. After considering how groups should be selected for assessing horizontal inequalities, we examine measurement and data issues. We then discuss how tax and expenditure policies can contribute to the goal of building a durable peace by helping to reduce distributional inequalities.

“Evidence supports the view that horizontal inequalities (HIs) are often a source of violent conflict.”

## INEQUALITY AND CONFLICT

While it seems plausible that high levels of inequality generate resentment and fuel conflict, the evidence on whether higher “vertical inequality” between rich and poor in the society as a whole increases the risk of violent intra-state conflict is inconclusive.<sup>2</sup> More evidence supports the view that horizontal inequalities (HIs) are often a source of violent conflict (Stewart 2000; Mancini 2005; Østby 2006). Intergroup inequalities generate powerful grievances that leaders can

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2 For discussion, see Collier and Hoeffler 2004; Auvinen & Nafziger 1999; and Lichbach 1989. Even so, it remains important to tackle severe vertical inequality since it leads to high levels of poverty and is often associated with a higher incidence of violent crime (Bourginon 1999).

use to mobilize followers. Such mobilization is especially likely where there is political as well as economic inequality – where group leaders are excluded from formal political power and significant numbers of group members are economically deprived. What matters most are not objective inequalities but subjective perceptions of inequality and unfairness.

Examples of countries and regions where HIs appear to have been a factor in provoking violent conflict include Côte d’Ivoire, Rwanda, Northern Ireland, Nepal, Chiapas, and Sudan. The particular type of inequality that provokes conflict varies from one society to another – for example, land was a major issue in the conflict between whites and blacks in Zimbabwe, while in Northern Ireland the conflict between Protestants and Catholics centered more on housing and employment. Note that it’s not only deprived groups who initiate conflict – richer groups may do so too to preserve their privileges, as in the Biafran conflict in Nigeria in 1967–70.

Fiscal policies can help. Taxation is particularly relevant in addressing economic inequalities and social inequalities that have some impact on economic disparities. While most policies aimed at political inequalities lie outside the fiscal system (in constitutional arrangements, for example), decentralization of the fiscal system can empower local groups and thereby reduce political HIs.

## THE SCOPING EXERCISE: DEFINING GROUPS

The first step in understanding the status and dynamics of horizontal inequalities in a country is to classify the relevant identity groups: the group boundaries that people perceive as important and on the basis of which discrimination or favoritism occurs.

“The first step in understanding the status and dynamics of horizontal inequalities in a country is to classify the relevant identity groups.”

An initial *in-depth investigation* of the history and political economy of the country in question will suggest such delineations. If *surveys of people's own perceptions* of identity distinctions are available, or if such a survey can be carried out, this can provide valuable insights. Such surveys ask people which groups they feel are privileged or deprived, and which are favored or disfavored by the government. They can also ask about the importance of different aspects of identity to the people themselves. Often, a “multiple approach,” which examines a *variety of group classifications* (e.g., ethnic, regional, and religious), is useful because it highlights the main inequalities.

Apart from defining the conflict-relevant groups, the scoping exercise also should address four questions:

- » Are the salient groups ranked hierarchically – that is, most members of one group are better off than the other group(s) – or are they unranked, so that each group contains comparable fractions of rich and poor (Horowitz 1985)?
- » Are groups geographically concentrated, or are they dispersed?
- » Do groups specialize in particular economic activities (e.g., trading, subsistence farming, or cash-crop farming)?
- » Is the government politically inclined to tackle inequalities, or does it wish to preserve them? For the purposes of this discussion, we can describe these types as “willing” and “unwilling,” though in fact the situation may not be so clear-cut. For example, the government’s willingness may depend on how supportive aid donors are of efforts to redress inequalities. And there may be divisions within the government on this issue.

Each of these questions is relevant for policy design.

## MEASUREMENT ISSUES

While there is a voluminous literature on the measurement of vertical inequality, which has

given rise to well-known measures such as the Gini coefficient, methods for measuring horizontal inequality have only begun to receive much attention. Here we review measurement issues for both income and non-income dimensions of HI.

### *Horizontal inequality in incomes*

Providing summary information on horizontal inequality is more complex than summarizing vertical inequality, precisely because we are now concerned with groups. HI is most frequently represented by the comparison of average per capita incomes of different groups, but this measure conceals distributional differences within those groups.

“HI is most frequently represented by the comparison of average per capita incomes of different groups...how groups compare at different points within an income distribution may be important, too.”

Yet from both a political and a policy perspective, how groups compare at different points within an income distribution may be important, too. For example, consider the following scenarios, all of which are consistent with a situation in which Group A has a higher average income than Group B:

- Case 1: Group A outperforms Group B at every income level.
- Case 2: The elite (say, the top 5%) of group A has a higher income than the elite of group B, but incomes are the same across the remainder of their respective populations.
- Case 3: The elite and the middle class (say, top 60%) of both groups have similar incomes, but the bottom 40% of group A has a significantly higher income than its group B counterpart.
- Case 4: The elite of group A have a higher income than their counterparts in group B, but the bottom 40% of group A have significantly lower incomes than the bottom 40% of group B.



From a political perspective, in Case 1, both the elite and the masses of the lower-income group have grievances, a situation that may make rebellion more likely. Malaysia in the 1960s and apartheid South Africa are examples. In Case 2, the elite have a grievance but not the rest of the population, so perhaps a rebellion is less likely.<sup>3</sup> In Case 3, the income parity among the upper- and middle-income groups may reduce the likelihood of violent conflict, unless the elite feel politically disenfranchised or threatened, in which case they may find it easy to mobilize support among the lower-income groups. The Rwandan genocide in 1994 is an example. In Case 4, anti-elite resentments in group B can translate into violence against the poorest stratum of group A – a dynamic that has been seen in Sri Lanka.

The differences are relevant from a policy perspective, too. In the first case, policies are needed both to increase entrepreneurial and civil-service opportunities at the top and to provide basic services and economic opportunities to the masses. In the second case, efforts to reduce tensions should be focused on elites. In the third and fourth cases, it is a matter of improving the position of poorer members of the group.

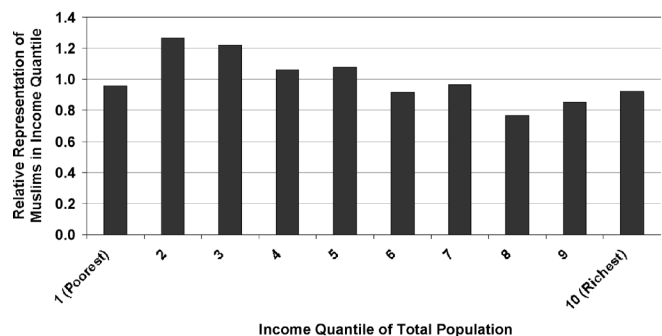
In addition to average per capita income, therefore, group distributional data are necessary. Such data can be presented in two useful ways:

- » Compare the proportions of each group in each income quantile relative to its proportion in the overall population. This method reveals by how much particular groups are over- or under-represented at different points in the income distribution.
- » Estimate the ratios of average incomes between two groups for each decile or quintile.

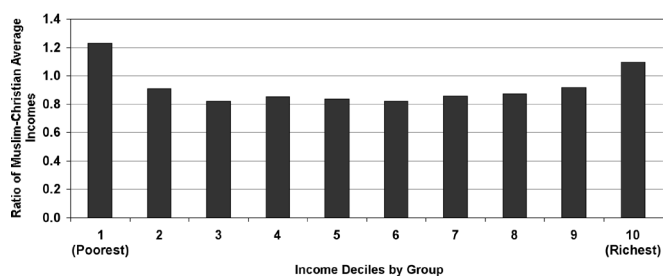
<sup>3</sup> The Calabar region in Nigeria is one area where the elites of the Quas and Efuts felt disadvantaged compared with the Efiks in political appointments and business opportunities, but the mass population felt they were equally treated with respect to employment and amenities. No conflict occurred in Calabar, while neighboring Warri, where both elites and the general population perceived HIs, has experienced recurrent violent conflicts. For discussion, see Ukiwo 2006.

These two measures are illustrated below with reference to Christian-Muslim disparities in the Indonesian province of Maluku in 1995, shortly before religious conflict broke out there. The ratio of average Muslim household income to average Christian household income in the province was 0.91. Figure 1a shows the relative representation of Muslims in each income decile, indicating that Muslims were under-represented (relative to their share in the province's total population) in the top five deciles and over-represented in the poorer deciles, except the very poorest decile, where they were slightly under-represented. Figure 1b shows the ratio of average incomes of the two groups by decile. The middle eight deciles of Muslims were poorer than their Christian counterparts. But the top 10% of Muslims had somewhat higher average incomes than the top 10% of Christians, a relationship that was disguised by the fact that Muslims were under-represented in the top decile of the population as a whole.

**FIGURE 1A:**  
POPULATION SHARES IN MALUKU, INDONESIA, 1995



**FIGURE 1B:**  
INCOME RATIOS IN MALUKU, INDONESIA, 1995



Source for Figures 1a and 1b: Authors' calculations from 1995 Indonesian Inter-Censal Survey.

Investigations of the socio-economic roots of the conflict in Maluku have identified the erosion of the dominance of the Christian population – which had been privileged by the colonial regime – as a source of grievance. The tension issued from two particular areas: friction between indigenous Christian farmers and their largely Muslim transmigrant counterparts; and resentment among Christian elites about the increasing preference given to Muslims by Jakarta (e.g., Brown et al. 2005). The data support that analysis: while Christian incomes remained around 10% higher than those of Muslims overall, they had fallen below Muslim incomes at the bottom and top ends of the distribution curve. In the end, the conflict engulfed many more people, but the initial tensions emerged precisely at those points in the income distribution curve.

“Where the data permit, it is desirable to compare performance in non-income dimensions of HIs across the distribution.”

#### *Non-income dimensions of inequality*

Evidence on the dimensions of HIs unconnected to income is also necessary. To plan public expenditures, policy makers need to know where the main problem lies. Is it, for instance, a matter of inadequate access to education, or poor economic opportunities, or both? Does access to land or employment levels show the sharper inequalities, and which is more important to people? Data are often scarce in postwar settings, but certain areas that are fundamental to well-being should have priority for data collection. Apart from income, these include land and other assets; employment; educational access at various levels; and health statistics such as infant and child mortality.

Where the data permit, it is again desirable to compare performance in these non-income dimensions across the distribution, rather than rely simply on comparisons of average performance.

#### *Data issues*

Socio-economic data broken down by the relevant ethno-cultural categories are often sparse. Sometimes – as, for example, in Nigeria – ethno-

cultural variables are not included in surveys because of their political sensitivity (Okolo 1999). For quick assessment, it may be necessary to use some other characteristic as a proxy for ethno-cultural difference. Two such options are region and language.

Regional data are often more readily available. The degree to which they are useful for HI assessment depends on the extent to which identity groups are geographically segregated. As a rule of thumb, region is a useful proxy if more than half the members of the relatively deprived group are concentrated in the targeted region while less than half of the privileged group are in the targeted region. In many African countries, ethnic and religious groups are regionally concentrated, so regional inequality may be a suitable proxy. And in some cases, region itself defines group identities.

An alternative proxy is language, on which information sometimes is available where ethnic variables are not – as in Indonesian surveys in the New Order period. Comparison of Indonesian language statistics at the district level with ethnic data that became available at a later date shows close correlations, suggesting that language is an effective proxy for ethnicity in this context (Mancini 2005). Similarly, language is often used as a marker for indigenous identity in Latin America (see, for example, Beckett and Pebley 2002). It is important to note, however, that in some contexts, language may not be an appropriate proxy, particularly where divisions are religious rather than ethnic – as in Northern Ireland, for instance.

The first need in any country is to conduct an inventory of available data. Potential data sources include:

- » Census data and other official surveys, such as household expenditure surveys, which often include ethnicity or language, and sometimes religion.
- » Demographic and health surveys (DHS), many of which include ethnic identification along

with information on access to social services and ownership of domestic assets.

- » Regional data from the census, household surveys, and public expenditure accounts.
- » Specific sectoral data (e.g., from schools and hospitals), which often contain ethnic and regional information.

Urgent data gaps can be filled by conducting “light” surveys and using focus groups.<sup>4</sup>

**Proposal 1a:** Where data needed to measure horizontal inequalities are not available (or highly inadequate), small-scale household surveys should be conducted to assess inter-group disparities in (a) asset ownership, (b) employment, (c) incomes, (d) education, and (e) health and nutrition.

**Proposal 1b:** Where conflict-relevant group boundaries are not evident, perceptions surveys should be conducted on attitudes toward identities and inequalities.

**Proposal 1c:** In addition to regional and linguistic categorizations, statistical offices should be encouraged to include ethnic, religious, or racial categorization (if relevant and politically feasible) in subsequent data collection.

## TAX POLICIES

Key tasks for tax policies in post-conflict settings are to mobilize revenue and to address inequality. The two are related, since perceptions of inequity in tax policies undermine their legitimacy, deter voluntary compliance, and thereby impede revenue mobilization. Here our focus is on policies to redress inequality.<sup>5</sup>

Although horizontal inequalities are often defined in terms of religious, ethnic, or racial categories, it is undesirable to make tax liability dependent

on a person’s religious, ethnic, or racial identity. To do so would risk strengthening group divisions as well as violating basic principles of tax equity. Nevertheless, tax policies can be designed to promote horizontal equality. This can be done by increasing the (vertical) progressivity of the tax structure and by identifying taxes that will bear more heavily on privileged groups than on deprived ones.

“Tax policies can be designed to promote horizontal equality...by increasing the (vertical) progressivity of the tax structure and by identifying taxes that will bear more heavily on privileged groups.”

### *Increasing the progressivity of the tax structure*

Progressive taxation – that is, policies that tax a higher percentage of the incomes of the rich than of the poor – will usually improve HIs as well as reduce vertical inequality. Indeed, they will always do so where the groups are ranked hierarchically, such that for each decile the income level of the deprived group(s) is below that of the privileged group(s). This situation is fairly common – for example, it generally holds for indigenous groups in Latin America.

Direct taxes on income, profits, and capital gains are typically the most progressive component of any tax system. In the immediate post-conflict environment, the administrative requirements of direct taxes often make it difficult to rely heavily on them. To the extent that they can be introduced, however, they will help to ensure progressivity in subsequent years.

Property taxes are also usually progressive. The extent of the progressivity depends, of course, on the design of the tax and the rates charged. Even flat rate property taxes are progressive, however, because poor people (groups) have very little property: asset inequality usually exceeds income inequality. A simple approach to improving progressivity further is to exempt all property below a certain value. Property taxes

<sup>4</sup> Fuji (2006) discusses a variety of approaches to rapid poverty mapping. A Core Welfare Indicator Survey (CWIQ) can be designed quickly and inexpensively to identify access to public services from the perspective of the user (McKay 2004; Reinikka and Svensson 2004).

<sup>5</sup> Issues of revenue mobilization in post-conflict countries are discussed in a companion policy brief by Michael Carnahan (2006).

are particularly appropriate in post-conflict reconstruction because government expenditure to maintain and build a durable peace is likely to generate significant returns for those holding property.

Indirect taxes can also be progressive if properly designed. Import duties and value-added taxes can include exemptions for basic necessities and higher rates for luxury goods. Specific excise duties can target luxuries as well. Other progressive indirect taxes include motor-vehicle duties and taxes on airline flights. Fuel taxes can be differentiated so as to tax more heavily the sort of fuels that richer people use (petrol) than those poor people do (kerosene).

“Property taxes are particularly appropriate in post-conflict reconstruction because government expenditure to maintain and build a durable peace is likely to generate significant returns for those holding property.”

**Proposal 2: Increase the progressivity of the tax system by (a) increasing the role and progressivity of direct taxes and property taxes and (b) increasing the progressivity of indirect taxes by raising rates on luxuries and exempting basic goods consumed by the poor.**

*Identifying taxes that will bear more heavily on privileged groups than on deprived ones*

Where people live, what they produce, and what they consume are markers of their group identity. These differences make it possible to use tax policies to reduce HIs by differentiating on the basis of location, productive activities, and consumption behavior:

- » *Location:* Efforts to change the regional balance of net revenue can improve HIs where groups are regionally concentrated. In federal states, where tax rates can be varied by region, the formula that determines

central government tax rates can be designed to improve the situation of poorer regions. Region-specific tax exemptions, which some European countries use to promote regional development, can do the job as well.

- » *Production activities:* Specialized production gives rise to possibilities for designing taxes to differentiate among groups. In Ghana, for example, groups that are more privileged than subsistence producers and northern farmers produce cocoa, so taxing cocoa production would help group distribution. In settings where most people in the informal sector are of a different ethnic group from those in the government and formal sector – as, for example, in Niger (Barlow and Snyder, 1993: 1187-8) – taxes on the formal sector will reduce HI.
- » *Consumption behavior:* Consumption patterns provide another avenue for tax differentiation. For example, user fees designed to fall on services that poorer groups use little (such as higher education or large-farm irrigation) can yield beneficial results.

“Transparency and fairness require public debate on tax policies, publicly disseminated rules, simplicity in the system, and a minimum of discretionary exemptions.”

**Proposal 3: Design indirect taxes to bear more heavily on privileged groups, by introducing taxes or increasing rates on geographic areas and production and consumption activities in which such groups are concentrated.**

Although we have identified a range of tax policies that could assist in reducing HIs, the main contribution of the tax system in this effort is in raising the revenues with which to undertake HI-reducing expenditures. Attention to the distributional incidence of taxation is also important, however, in order to avoid a sense of unfair treatment by groups. Transparency and fairness require public debate on tax policies, publicly disseminated rules, simplicity

in the system, and a minimum of discretionary exemptions.

## EXPENDITURE POLICIES

People benefit from public expenditure by three routes:

Route 1: Contracts and employment in constructing public facilities.

Route 2: Contracts and employment in delivering services.

Route 3: Access to services.

The distributional incidence of each is important. The first route is quantitatively significant, since public investment frequently accounts for three-quarters or more of total investment in poor countries. The second route is also important, as government employment often accounts for over half of total formal-sector employment. And the third route determines who benefits from government services, such as health and education, that are important both in themselves and because they contribute to improved incomes.

Many analyses of the distributional impact of public expenditure focus only on Route 3. This is insufficient, not only because of the quantitative importance of the first two routes, but because of their high visibility and political sensitivity.<sup>6</sup> Routes 1 and 2 may have particularly strong effects on the distribution of opportunities and incomes among the upper-income strata of the population.

### *Contracts and employment*

In the allocation of contracts and employment, choices are limited by enterprise and skill level, affording little scope for changing vertical inequality (VI) significantly. The choice of technique can influence VI – for example, labor-intensive construction techniques offer more jobs to low-skilled and low-income people –

<sup>6</sup> For example, in both Ghana and Nigeria a much higher proportion of people believe that their ethnicity affects their chances of getting government jobs and contracts than access to public services (Langer and Ukiwo 2006).

but efficiency considerations tend to override distributional ones in the awarding of contracts and hiring, which may help explain why these are often ignored in the analysis of the distributional incidence of public expenditure.

The situation is very different for horizontal inequality. Contracts and employment are often biased in their racial distribution (e.g., in South Africa under apartheid), religious distribution (e.g., in Northern Ireland), or ethnic distribution (e.g., in Kenya and Sri Lanka). Regional location may also be biased. Hence fairness in the distribution of contracts and employment in the public sector is crucial in formulating public policy to address HI.

Policies to achieve greater fairness include competitive and transparent bidding procedures for contracts; “fair” employment legislation and rules; and careful monitoring of allocation coupled with policies to counter disproportionate allocations, such as technical assistance to disadvantaged groups and, when necessary, quotas for contracts and government employment.

“Hence fairness in the distribution of contracts and employment in the public sector is crucial in formulating public policy to address HI.”

**Proposal 4: In the construction of facilities and delivery of services, allocation of contracts and employment should explicitly consider fairness among groups. Policies to promote this may include competitive and transparent bidding procedures for contracts; “fair” employment legislation and rules; and technical assistance and possibly quotas to ensure equitable distribution.**

### *Access to public services*

Turning to the distributional impact of access to services, it is helpful to differentiate among five types of public expenditure:

- *Expenditure with allocable inter-regional and intra-regional benefits:* Most public expenditure benefits particular people in particular regions

(for example, expenditure on social services or economic infrastructure). Redirection of this expenditure toward deprived regions and groups can do much to redress both horizontal and vertical inequalities.<sup>7</sup>

- *Expenditure with non-allocable benefits:* In principle, expenditure on “pure public goods,” whose impacts affect the whole population equally, benefits poorer groups disproportionately in relation to their incomes. In practical terms, such goods are few and far between, so they generally cannot be relied upon to bring about significant redistribution.
- *Expenditure with allocable benefits across groups but not across regions:* Goods and services that have national benefits for people with particular characteristics – for example, subsidies for national airlines that benefit only those who fly, or radio broadcasts in a specific language benefiting only speakers of that language – potentially have important distributional impacts. Ensuring that such expenditures are fairly distributed can be a significant way of improving horizontal equity.
- *Expenditure with allocable benefits across regions but not intra-regionally:* Expenditures that benefit everyone in a particular geographic area (for example, expenditure to improve environmental quality) can contribute to changing HIs where groups are regionally concentrated.
- *Transfer payments:* Transfer payments – that is, direct payments to communities, households, or individuals based on particular criteria such as income or age – typically are designed to reduce vertical inequality. They can also be designed to affect HI: either directly, by making group membership a criterion (which might be regarded as undesirable in some cases), or indirectly, by using allocation criteria that favor deprived groups, such as income, size of family, employment status, or education status.

7 Regrettably, the overall record of policies toward regional development has not been good in terms of reducing disparities, although they may have prevented gaps from widening farther (Shankar and Shah 2003).

In federal and decentralized systems, resource transfers from the central government to states or districts can reduce inequality. Nigeria, for example, has an equalizing element in its revenue-sharing formula: in one version, 30% of state allocations were distributed equally among the states, 40% according to population, 15% (inversely) with social development, and 5% according to local tax effort (Ahmad and Singh 2003). Similarly, following the 2001 “Big Bang” decentralization in Indonesia, one-third of consolidated government expenditure was devolved to the districts, according to a formula based on expenditure needs and fiscal capacities; this, in theory at least, involved major redistribution to poorer districts.<sup>8</sup>

In post-conflict contexts, aid frequently finances a very large proportion of expenditure on public services. Thus it is vital that aid donors, as well as governments, take these considerations into account – both in their policy dialogue with the government and in projects they undertake directly (Stewart and Brown 2006). The relevant expenditure arenas include disarmament, demobilization, and reintegration (DDR) and security sector reform (SSR), both of which are large in most post-conflict situations.

Malaysia provides an instructive example of the successful use of fiscal policy to address HIs in a post-conflict setting. A serious outbreak of violence in 1969 led to the introduction of a set of policies to improve HIs in the 1970s. These addressed all three aspects of public expenditure, and included not only the redirection of expenditure but also quotas in government employment and contracts to improve the position of the relatively deprived Malays among both the elite and the masses. These policies successfully reduced HIs, contributing to a period of sustained peace.

In Mozambique, in contrast, the need to correct HIs was not recognized during post-conflict reconstruction. Although reconstruction has been successful in other respects, HIs have been accentuated, for government services and aid

8 Expenditure needs were determined by population, area, poverty (later replaced by the inverse of the Human Development Index and regional per capita income), and costs (Hofman et al. 2006).

distribution are strongly skewed toward the South. So far, however, this situation has not led to renewed outbreaks of violence, in part because it occurred in a context of overall growth in incomes and services (Stewart 2006).

**Proposal 5: The distributional impacts of public services should be monitored, and allocations targeted to ensure greater horizontal and vertical equity by targeting pro-poor sectors, activities within sectors, and locations. In federal or decentralized systems, revenue-sharing formulae should be designed to improve regional equity. Aid allocation should follow similar principles.**

#### *Process issues*

Few policy makers have detailed information about the distributional incidence of public expenditure.<sup>9</sup> But this is no reason to wait for improved information before acting. Rather, it suggests that use should be made of whatever information is available, including quick surveys and evidence from other countries. Abundant evidence from around the world indicates, for example, that the benefits from primary educational expenditure are more equally distributed than those from secondary or tertiary schooling. Similarly, construction of trunk roads in relatively rich areas is likely to be regressive while building feeder roads in relatively poor areas is likely to be progressive. Even with very limited knowledge of a particular country, enough is often known to improve the distributional incidence of public expenditure.

Governments may lack capacity to respond to inequality in a post-conflict environment. Their capacities to monitor inequality, analyze tax and public expenditure incidence, and institute targeted programs to benefit deprived groups is often weak. Technical assistance to build these capacities is needed.

Apart from capacity constraints, governments may be unwilling to address inequalities for a number

of reasons. In some cases, political leaders and government officials may be unaware of the true extent of horizontal disparities, or they may take the view that generic pro-poor policies constitute a sufficient response to address horizontal inequality. In other cases, governments may be deliberately exclusionary.

The case of an exclusionary government presents the most difficult case for external assistance actors. Three responses are appropriate: first, informal policy dialogue and formal policy conditionality to strengthen incentives for government efforts to reduce inequality; second, project and sectoral support directed to the deprived groups; and third, promotion of other objectives acceptable to the government that will assist the poorer groups, such as comprehensive education and health services. Because aid flows are often large relative to domestic revenue, donors can make a major contribution to overcoming inequalities in public expenditure.<sup>10</sup>

**“An exclusionary government presents the most difficult case for external assistance actors.”**

**Proposal 6: Aid donors should assist governments to identify types of expenditure that will reduce inequalities, drawing on available data, light surveys, and evidence from other countries. Where capacity is a constraint, they should provide technical assistance to integrate distributional impacts into public expenditure reviews and planning. Where willingness to tackle inequalities is a constraint, they should undertake policy dialogue and conditionality, and direct their own resources to improving horizontal and vertical equity.**

## CONCLUSIONS

This paper has argued that tackling inequality, particularly horizontal inequality, deserves an important place in post-conflict policies. The need to tackle inequalities has been recognized

<sup>9</sup> Studies of benefit incidence in a range of countries give some guidance on how different types of expenditure affect VI, but not HI (see the survey by Chu et al., 2004). For discussion of the limitations of benefit-incidence studies, see McKay (2004).

<sup>10</sup> See Stewart and Brown (2006) for further discussion of how aid can be used to reduce HIs.

explicitly in some recent peace agreements – for example, in Guatemala and Sudan – but implementation of measures to redress them has been problematic. At present, policies to redress horizontal inequalities do not form part of the standard development or reconstruction agendas of the international financial institutions and other external assistance providers. Since aid donors play such an important role in post-conflict situations, their own acceptance and implementation of the need to tackle inequalities can have a major impact.

“Since aid donors play such an important role in post-conflict situations, their own acceptance and implementation of the need to tackle inequalities can have a major impact.”

An important component of policies towards inequality is the collection of the data needed to measure the nature and extent of inequalities and to analyze the distributive impact of the fiscal system. Although the appropriate data are often not readily available, this does not present an insuperable problem, as enough is generally known, or can be rapidly collected, to identify appropriate policies.

The paper has outlined a variety of ways in which tax and expenditure policies can affect inequality. For example, improving the progressivity of taxation will reduce vertical inequality and also usually reduce horizontal inequality. Regional tax and expenditure policies can redress HI where deprived groups are regionally concentrated. Within regions, tax and expenditure can be designed to help deprived groups. The Malaysian case illustrates how such policies can be effective in reducing horizontal inequalities.

Politically, it is easier to redirect expenditure to deprived groups if this can be done out of increased total expenditure, rather than at the direct expense of better-off groups. At the same time, it is easier to mobilize increased resources if taxation is perceived to be equitable and if the

public believes it will receive services from the government in return. For both reasons, the goals of increasing revenue and reducing inequality are complementary.

An appropriately designed fiscal system should be able to contribute substantially to the reduction of inequality, if this is desired by the government. Where it is not, it is naturally more difficult to implement inequality-reducing policies effectively. In both cases, however, aid donors have an important role to play. Where the government has the requisite political will, donors can provide technical assistance to build capacity to analyze and redress inequalities. Where political will is lacking, donors may not be able to change firmly held positions of the government in power, but they can draw attention to the need to monitor and take action to reduce inequalities, as well as help collect relevant data, request that public expenditure reviews incorporate equity considerations, and ensure that their own assistance contributes to correcting inequalities.

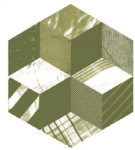


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