Fiscal Policy, Income Redistribution and Poverty Reduction in Latin America

Nora Lustig
Samuel Z. Stone Professor and Director of CEQ Institute
Tulane University
Nonresident Senior Fellow Brookings Institution, CGD and IAD

Paper co-authored with Valentina Martinez Pabon (Yale University) and Carola Pessino (IADB)

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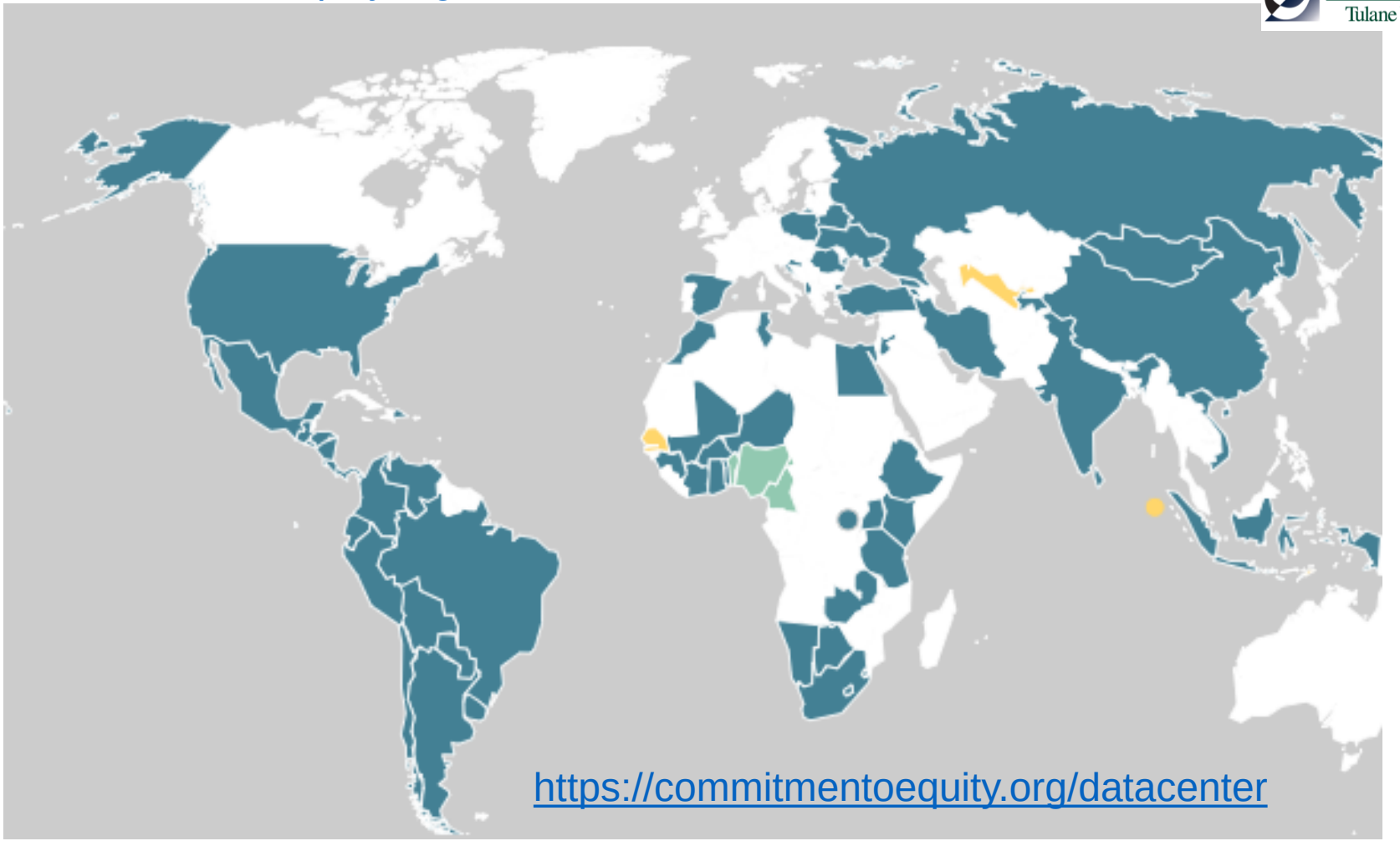

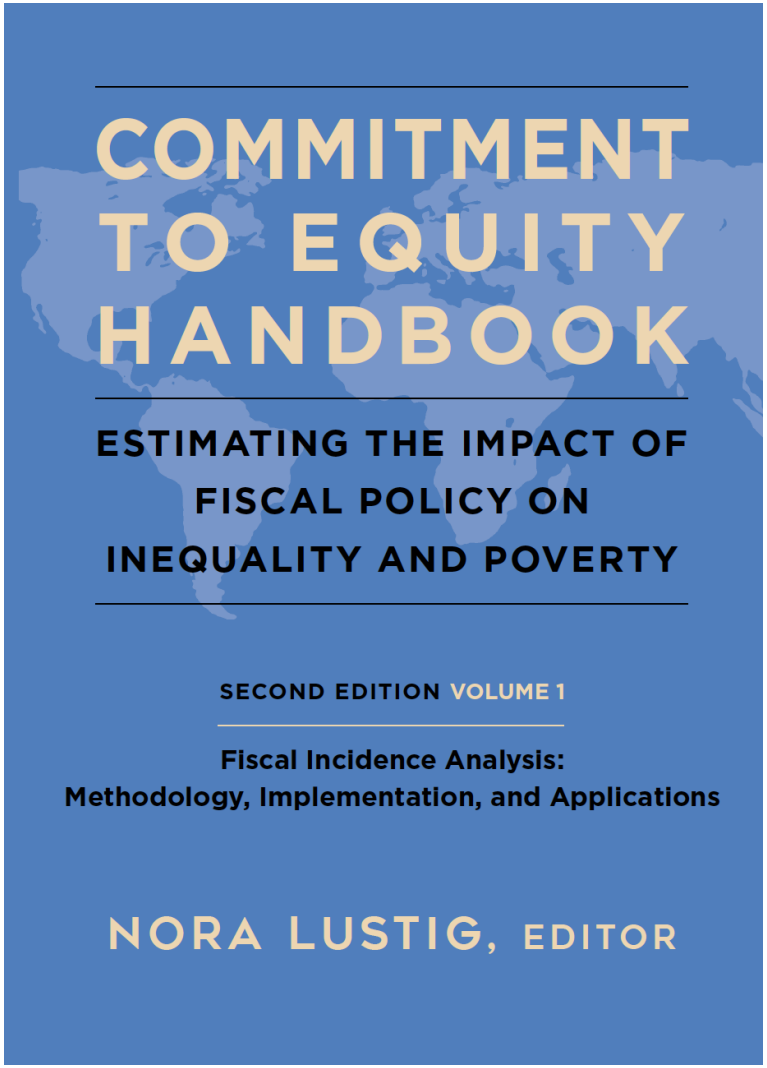

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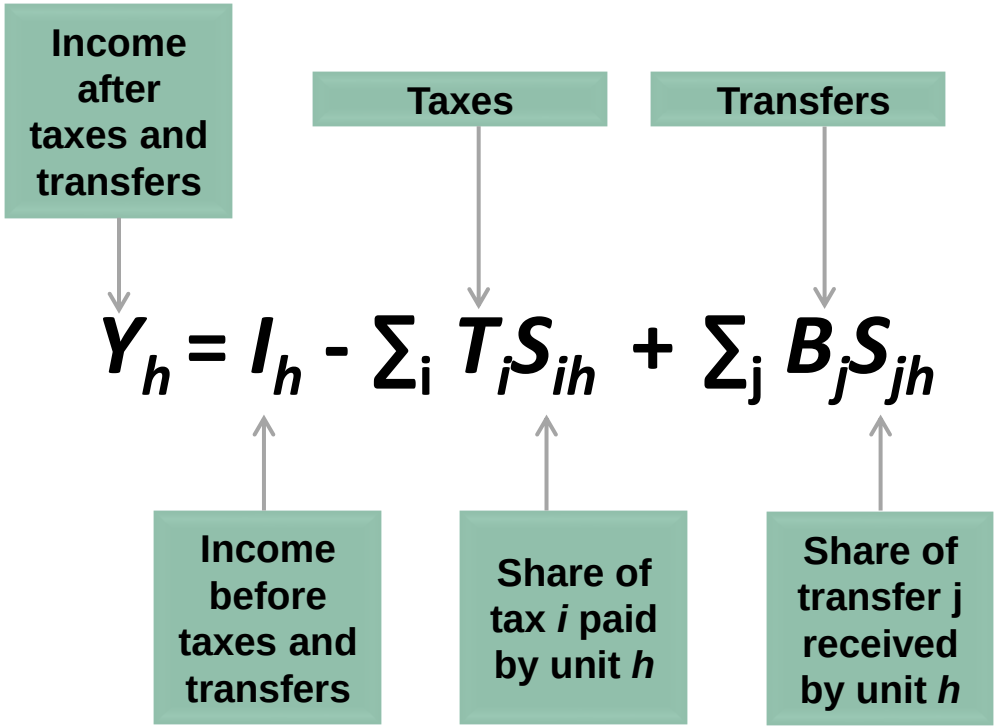
Lustig, Nora, editor. 2018 and **2022**. *Commitment to Equity Handbook. Estimating the Impact of Fiscal Policy on Inequality and Poverty.* Brookings Institution Press and CEQ Institute, Tulane University.

Free online version available at: http://commitmentoequity.org/publications-ceq-handbook/

Fiscal incidence analysis (FIA)



Taxes and transfers included in FIA

- Taxes
  - Direct taxes
  - Indirect taxes Contributions to social security
- Transfers
  - Direct cash transfers (including noncontributory pensions)
  - Not-in-cash direct transfers such as school uniforms and school feeding programs
  - Contributory pensions
  - Indirect subsidies
  - In-kind transfers such as spending on education and health

Tax shifting assumptions

- Economic burden of direct personal income taxes is borne by the recipient of income
- Burden of payroll and social security taxes is assumed to fall entirely on workers
- Consumption taxes are assumed to be shifted forward to consumers
- These assumptions are strong implying that labor supply is perfectly inelastic and that consumers have perfectly inelastic demand
- In practice, they provide a reasonable approximation (with important exceptions such as when examining effect of VAT reforms), and they are commonly used

Tax evasion assumptions: case specific

- Income taxes and contributions to Social Security
  - Individuals who do not participate in the contributory social security system are assumed not to pay them

- Consumption taxes
  - Place of purchase: informal markets are assumed not to charge them
  - Some country teams assumed small towns in rural areas do not pay them

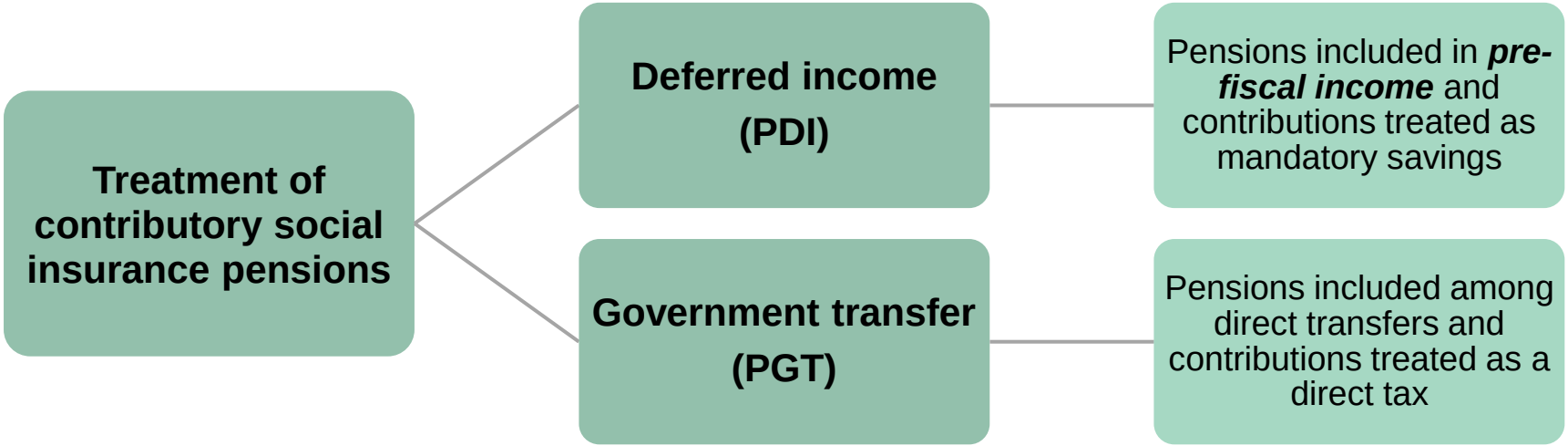
Monetizing in-kind transfers

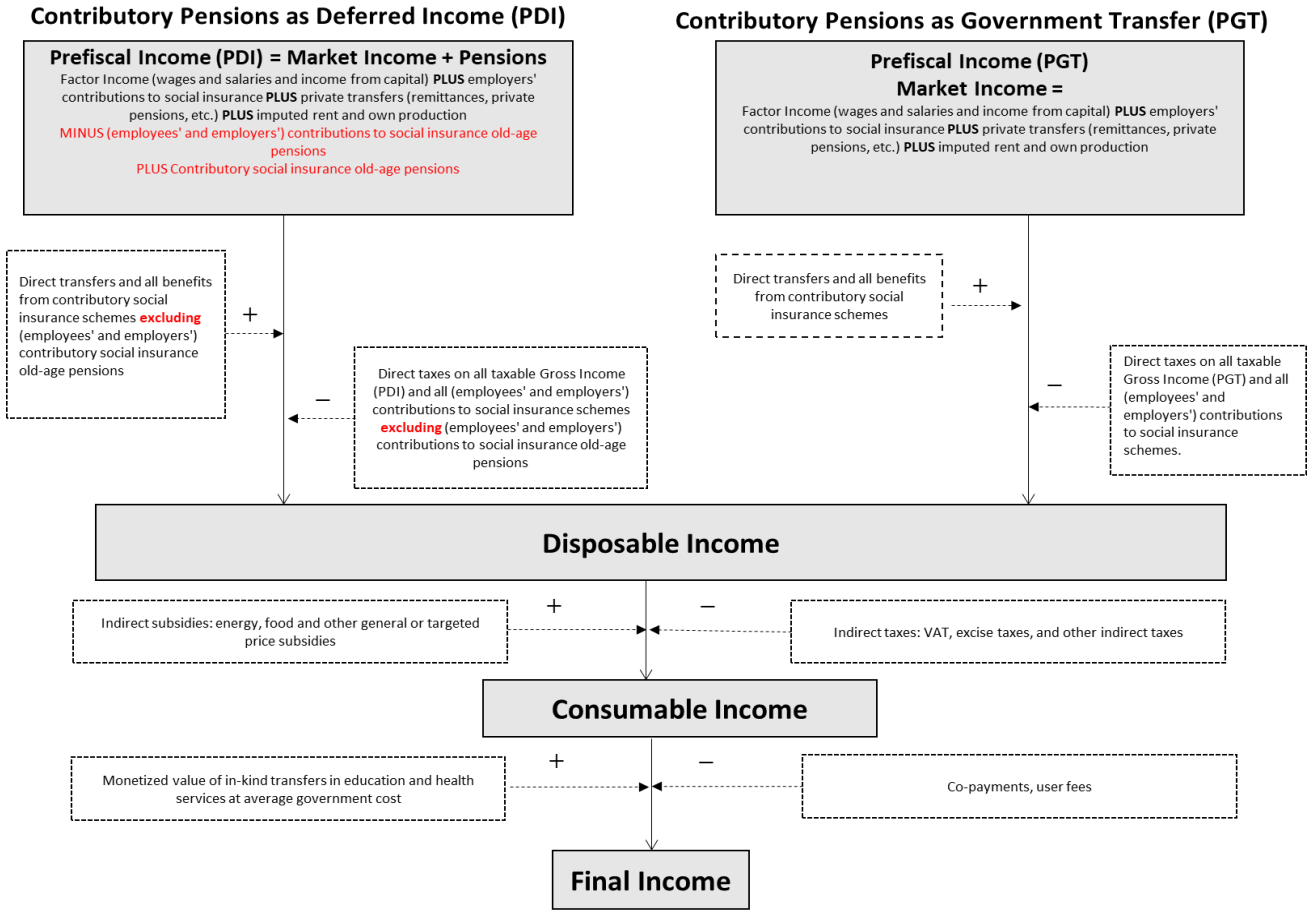
- Incidence of public spending on education and health followed so-called “benefit or expenditure incidence” or the “government cost” approach
- In essence, we use per beneficiary input costs obtained from administrative data as the measure of average benefits
- This approach amounts to asking the following question:

  How much would the income of a household have to be increased if it had to pay for the free or subsidized public service at the full cost to the government?

- New methods in forthcoming 2nd edition of Handbook

Treatment of contributory pensions





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FOUR CORE INCOME CONCEPTS

Fiscal incidence analysis: caveats

- Accounting approach
  - No behavioral responses
  - No general equilibrium effects
  - No intertemporal effects
    - ❖ However, economic rather than statutory incidence
- Point-in-time
- Mainly average incidence; a few cases with marginal incidence

Does the net fiscal system decrease inequality? Lambert's fundamental equation

For the net fiscal system to be equalizing:

$$RE_N = \frac{(1-g)RE_t + (1+b)RE_B}{1-g+b} > 0$$

RE: redistributive effect (e.g., pre-fisc Gini MINUS post-fisc Gini)
g: taxes as a ratio of pre-fisc income
b: transfers as a ratio of pre-fisc income
t: taxes
B: transfers

Condition 1:

$$\rightarrow RE_t > -\frac{(1+b)}{(1-g)} RE_B$$

Source: Lambert (2001)

Sign and size of the contribution of a tax or transfer to the change in inequality

- Marginal contribution equals the inequality measure without minus the inequality with the tax or transfer of interest.
- If difference is positive (negative), the tax or transfer is equalizing (unequalizing)
- Gives correct answer to the “without vs. with comparison” but does not fulfill the principle of aggregation: the sum of the marginal contributions will not equal the total change in inequality

Main messages

1. Analyzing the tax side without the spending side, or vice versa, is not very useful
   - Taxes can be unequalizing but spending sufficiently equalizing so that the unequalizing effect of taxes is more than compensated [we knew this]
   - Taxes can be regressive but when combined with transfers make the system more equalizing than without the regressive taxes [surprised?]

2. Analyzing the impact on inequality only can be misleading
   - Fiscal systems can be equalizing but poverty increasing [surprised?]

Source: Lustig (2018)

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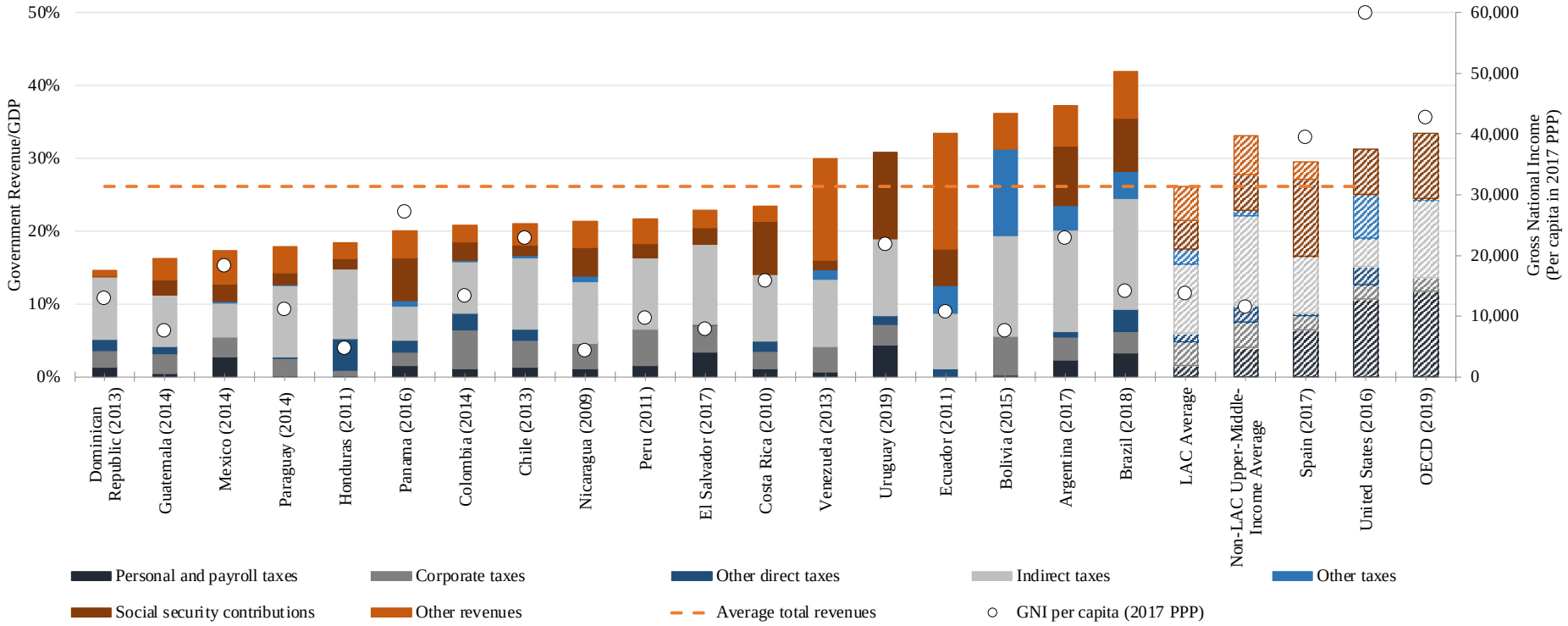
Size and Composition of Government Revenues and Spending

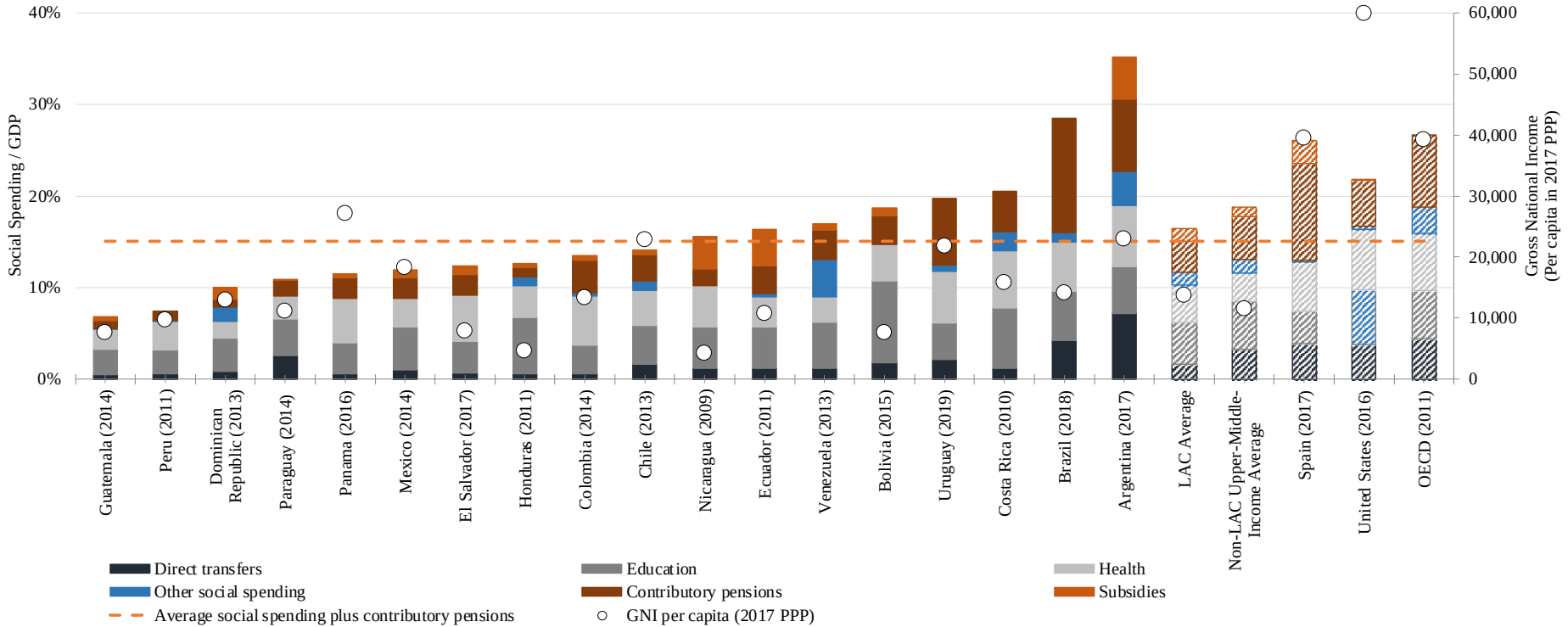
Size and Composition of Government Revenues (as a % of GDP)



Notes:
- Countries ranked by total government revenue (collected in the year in parenthesis) as a percentage of GDP

Source: see bibliographical reference by country at the end of this presentation.

Size and Composition of Social Spending and Subsidies (as a % of GDP)



Notes:

- Countries ranked by social spending plus contributory pensions plus subsidies (executed in the year in parenthesis) as a percentage of GDP. Due to the lack of data on social spending (sub-components), the graph bars may appear to be out of order.

Source: see bibliographical reference by country at the end of this presentation.

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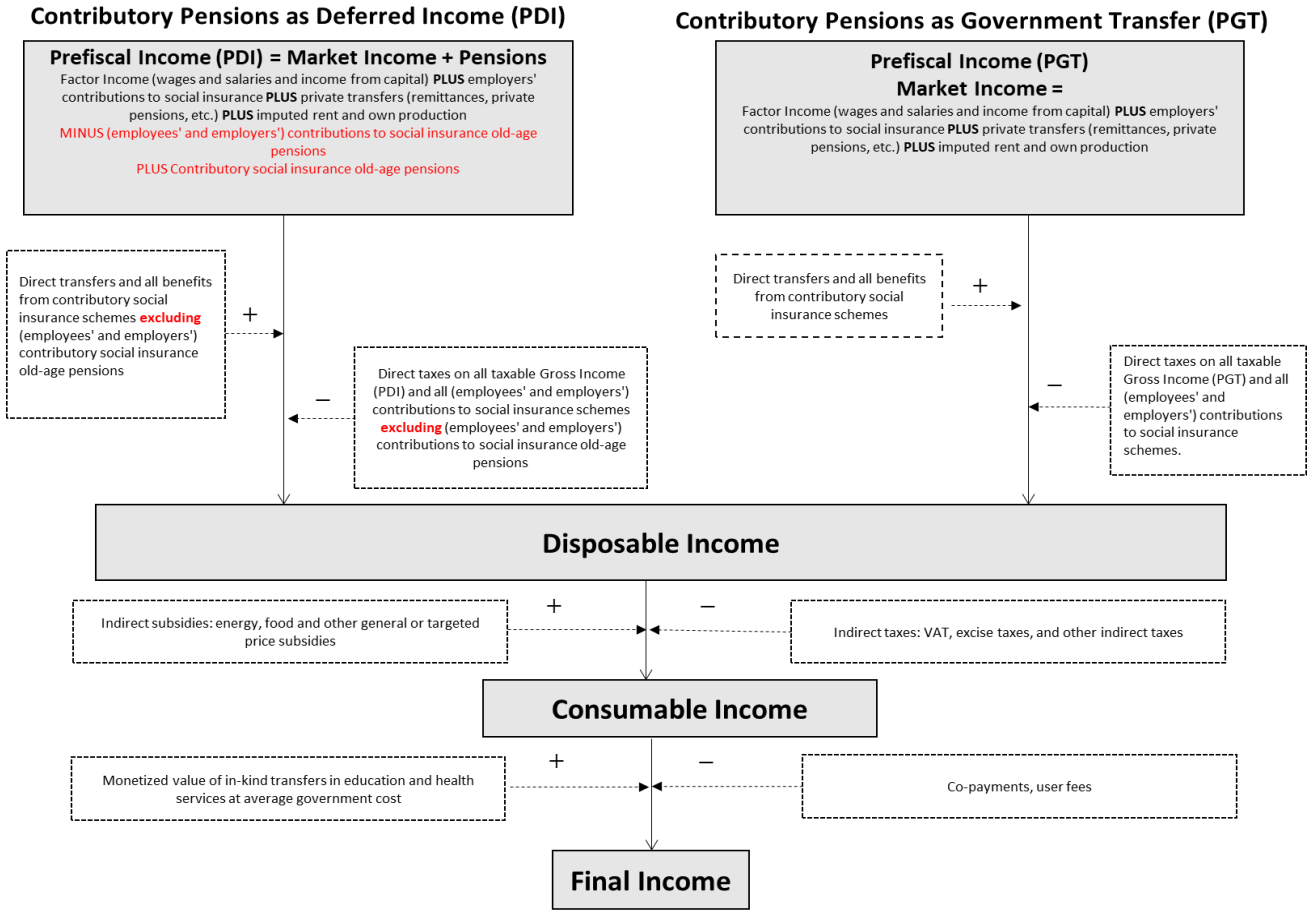
Fiscal Policy and Income Inequality



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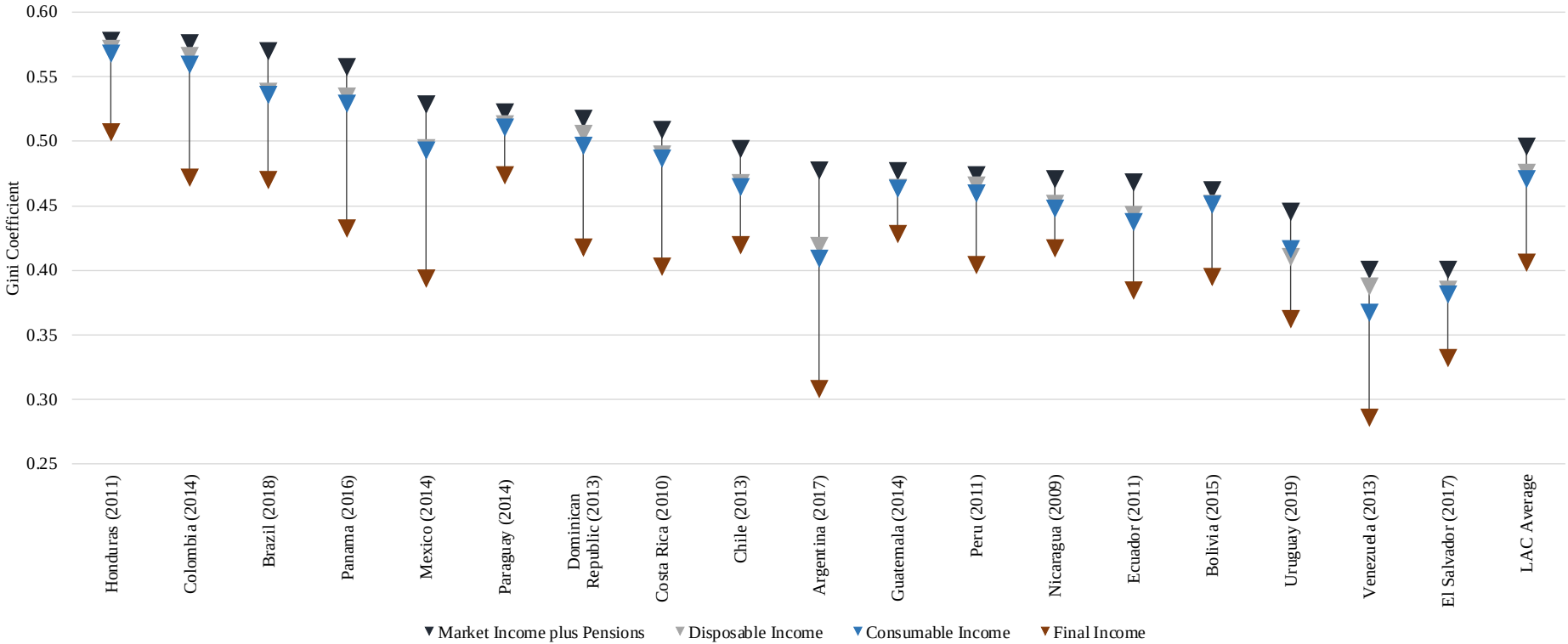
FOUR CORE INCOME CONCEPTS

Fiscal Policy and Inequality

(Scenario PDI)

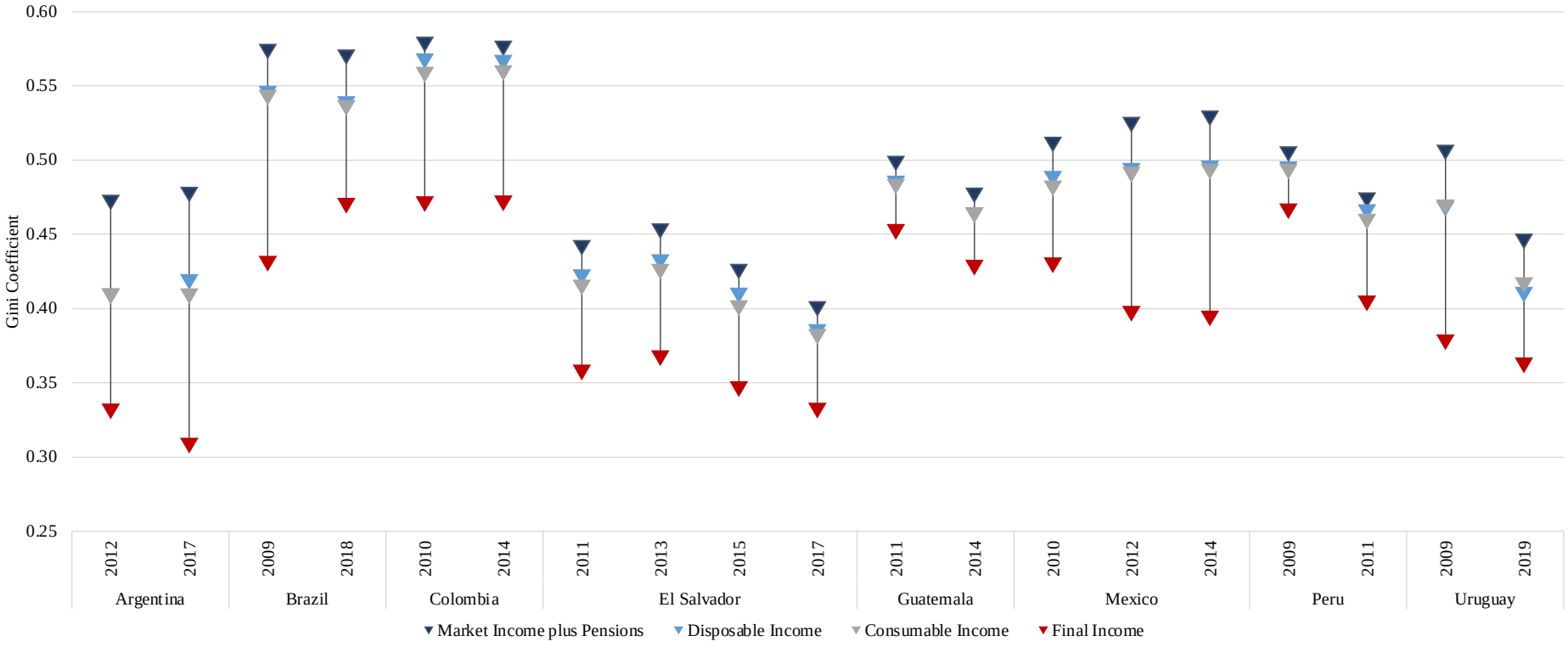


Notes:
- Information ranked by prefiscal Gini coefficient

Source: see bibliographical reference by country at the end of this presentation.

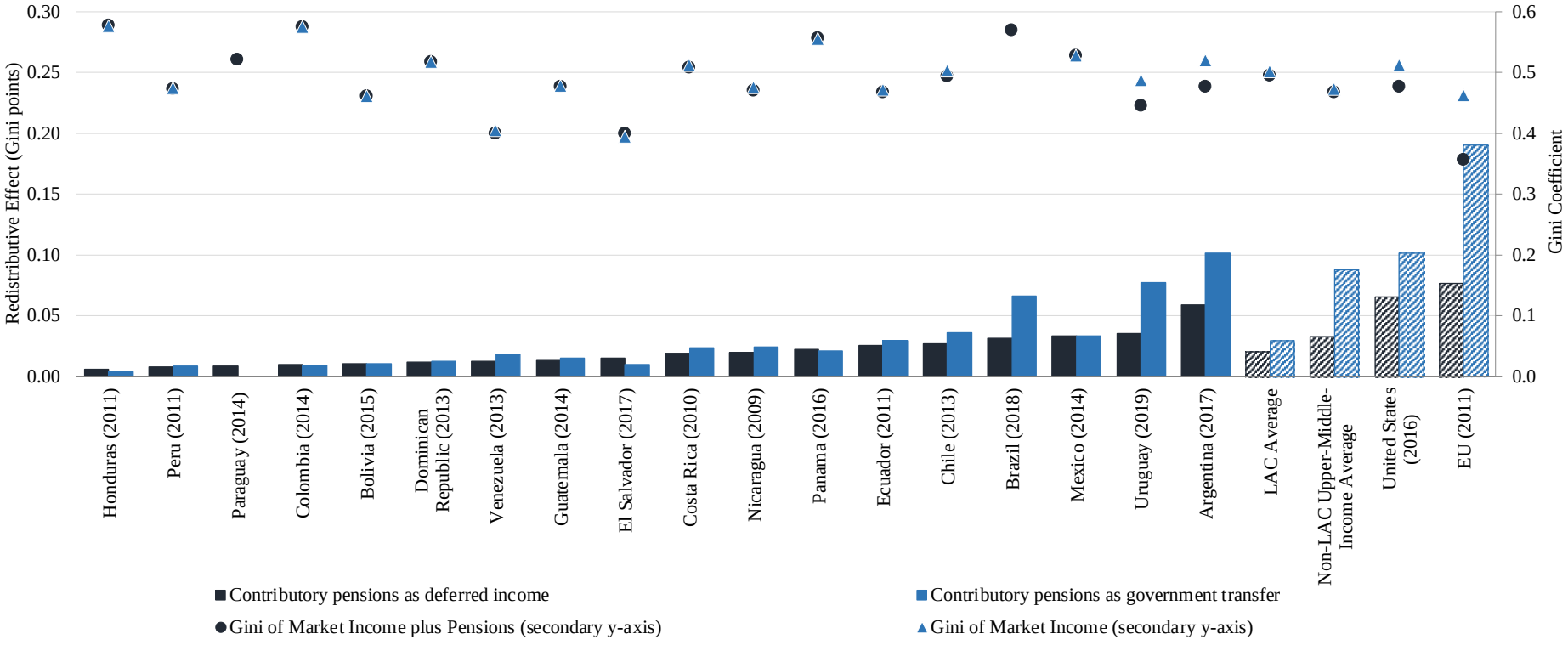
Fiscal Policy and Inequality Over Time

(Scenario PDI)



Source: see bibliographical reference by country at the end of this presentation.

Redistributive Effect: Change in Gini coefficient from Prefiscal to Disposable Income



Notes:
- Information ranked by redistributive effect with pensions as deferred income

Source: see bibliographical reference by country at the end of this presentation.

The Redistributive Impact of Specific Taxes and Transfers

- Fiscal system is equalizing in the 18 countries
  - Direct taxes are equalizing
  - Direct transfers are equalizing
  - Indirect taxes are equalizing in 12 of the countries (surprised?)
  - Indirect subsidies are equalizing in 12 of the countries (surprised?)
  - Pre-primary and primary education spending is pro-poor
  - Secondary education spending is pro-poor in 14 of the countries
  - Tertiary education spending is progressive in relative terms in 15 of the countries (surprised?)
  - Health spending is pro-poor in 7 of the countries

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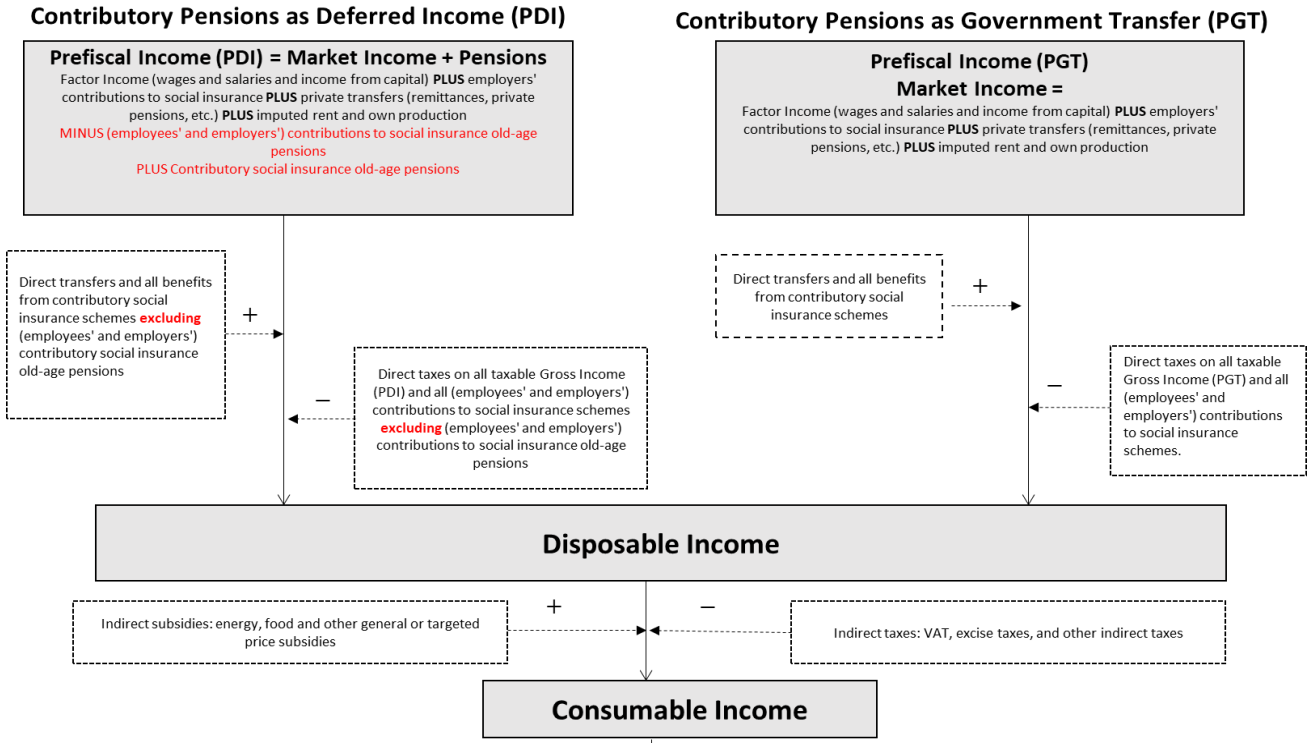
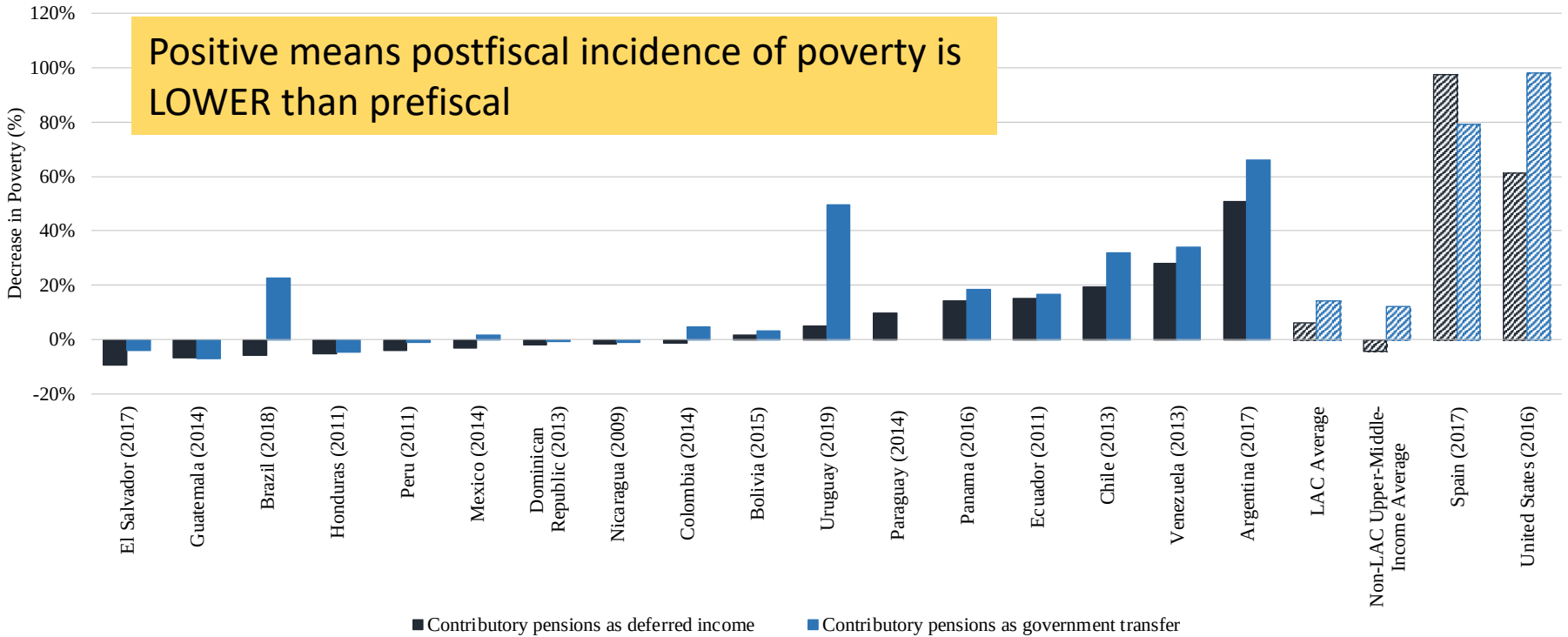
Fiscal Policy and Poverty



THREE CORE INCOME CONCEPTS

Poverty Reduction: %Δ in Headcount Ratio from Prefiscal to Consumable Income

Country-specific International Poverty Lines

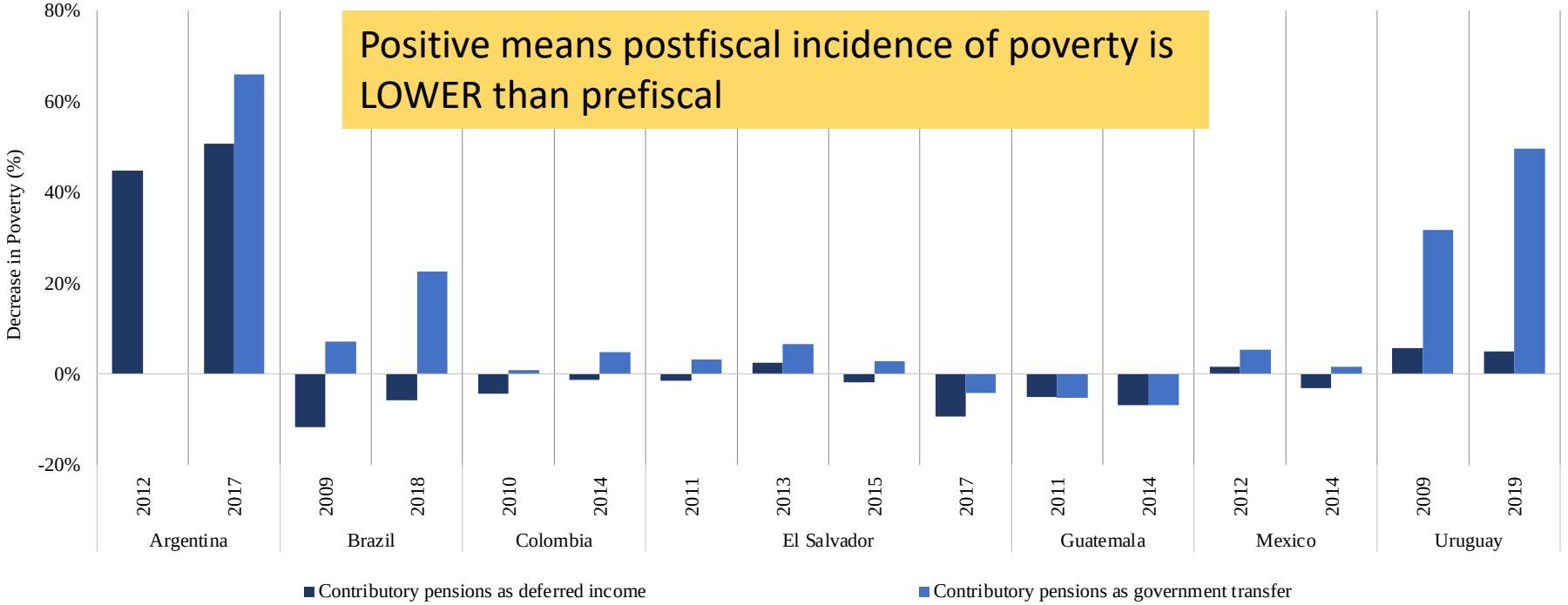


Notes:
- Information ranked by poverty reduction in %.

Source: see bibliographical reference by country at the end of this presentation.

Poverty Reduction Over Time: %Δ in Headcount Ratio from Prefiscal to Consumable Income

Country-specific International Poverty Lines



Source: see bibliographical reference by country at the end of this presentation.

Net Payers to the Fiscal System by Income Groups (in US$ 2011 PPP/day)

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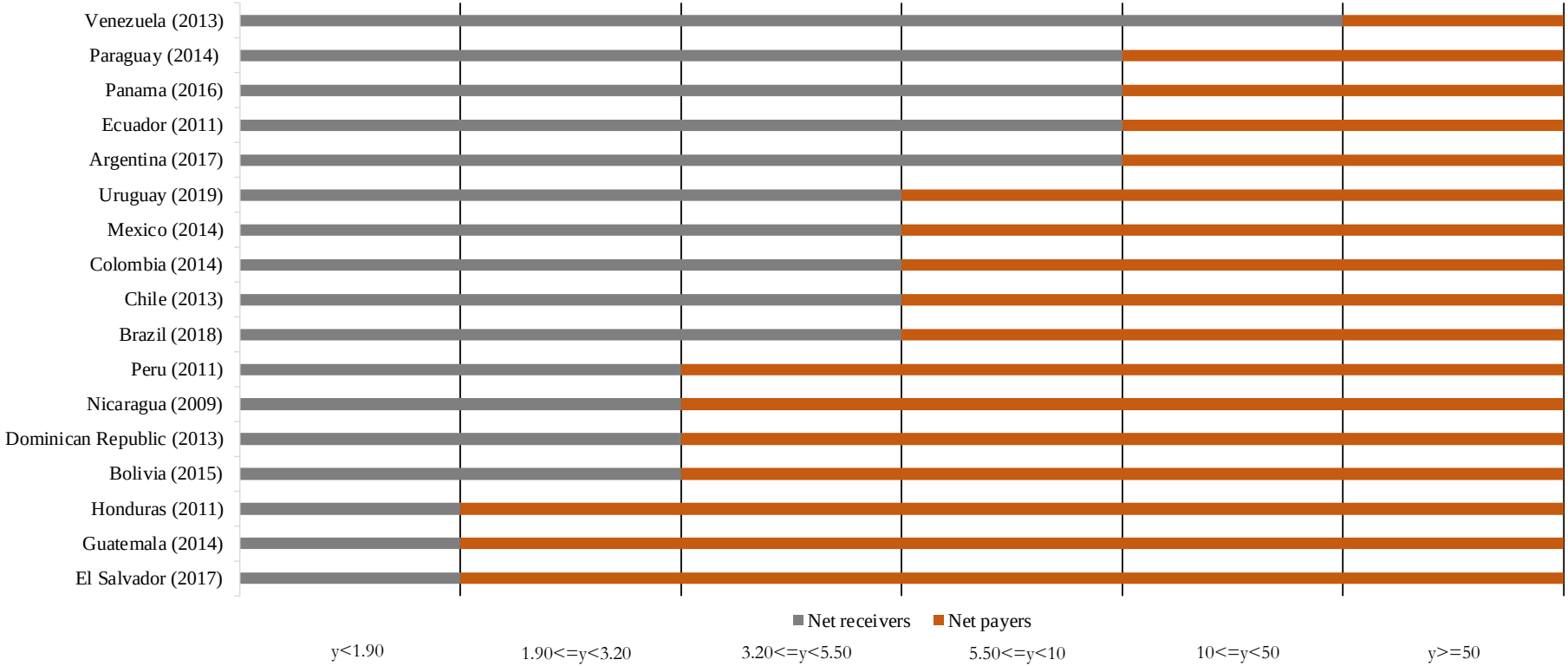
Pensions as deferred income, PDI



Source: see bibliographical reference by country at the end of this presentation.

Net Payers to the Fiscal System by Income Groups (in US$ 2011 PPP/day)

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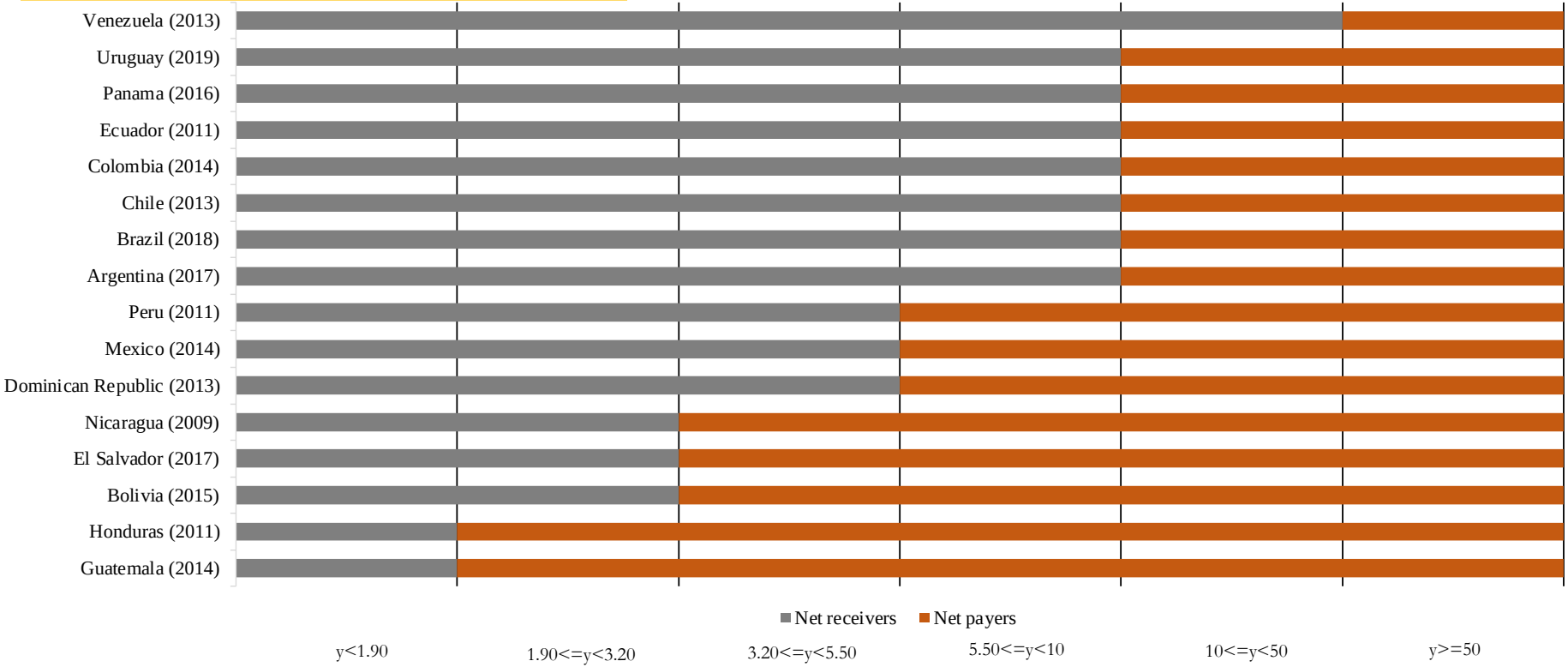
Pensions as government transfers, PGT



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Toward a Characterization of Fiscal Systems in LAC

Redistributive effect rises with social spending – Good news!

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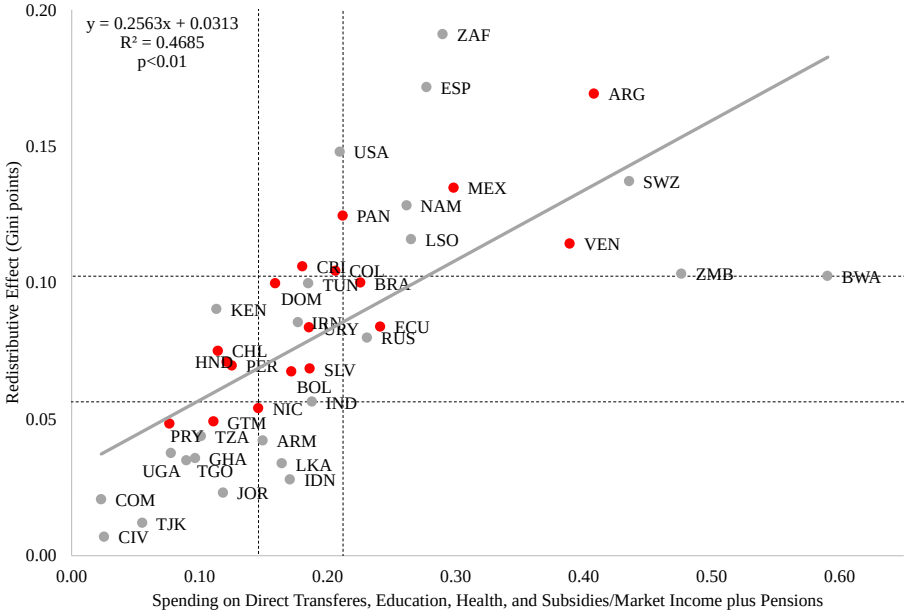
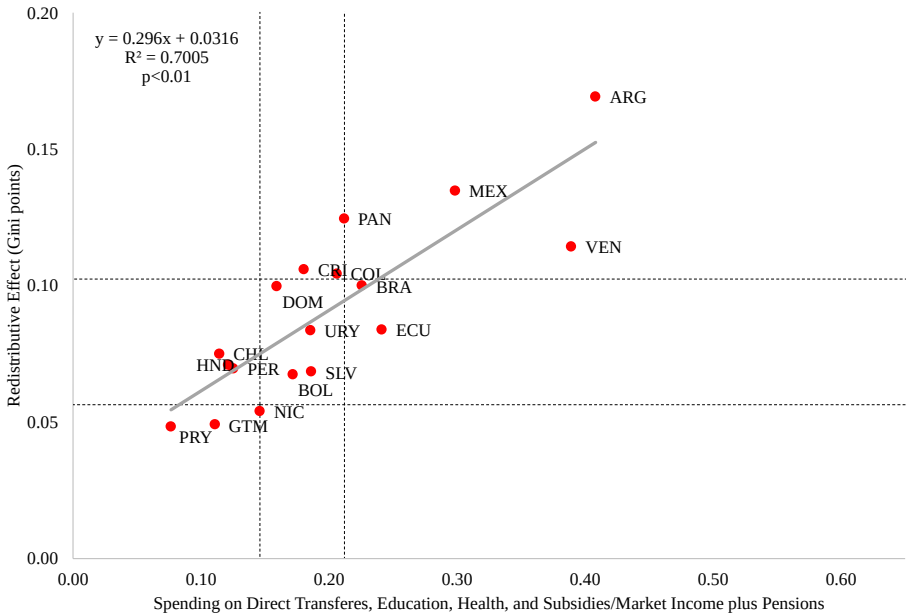
All Countries



LAC



Pensions as deferred income, PDI

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Social Spending/Prefiscal Income vs. Redistributive Effect from Prefiscal to Final Income

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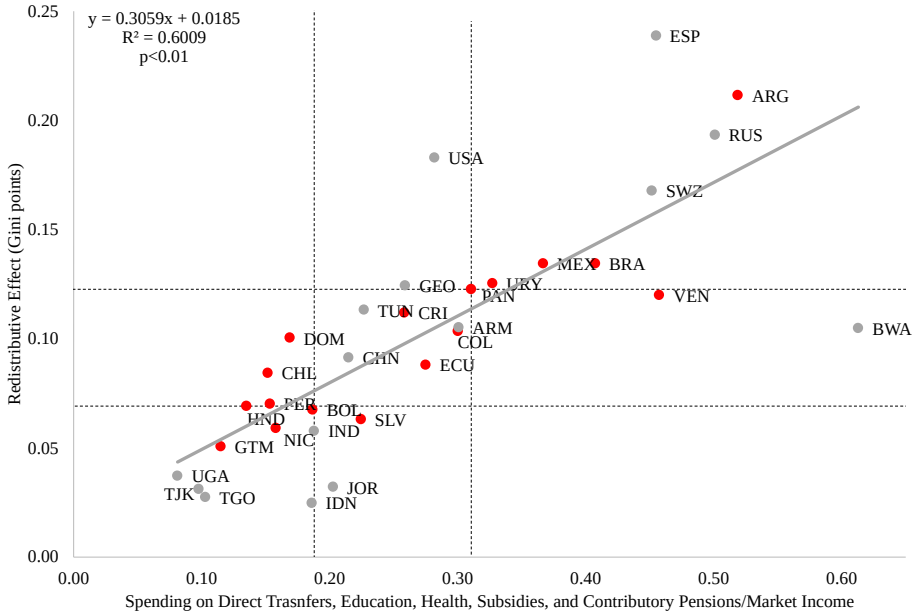
All Countries



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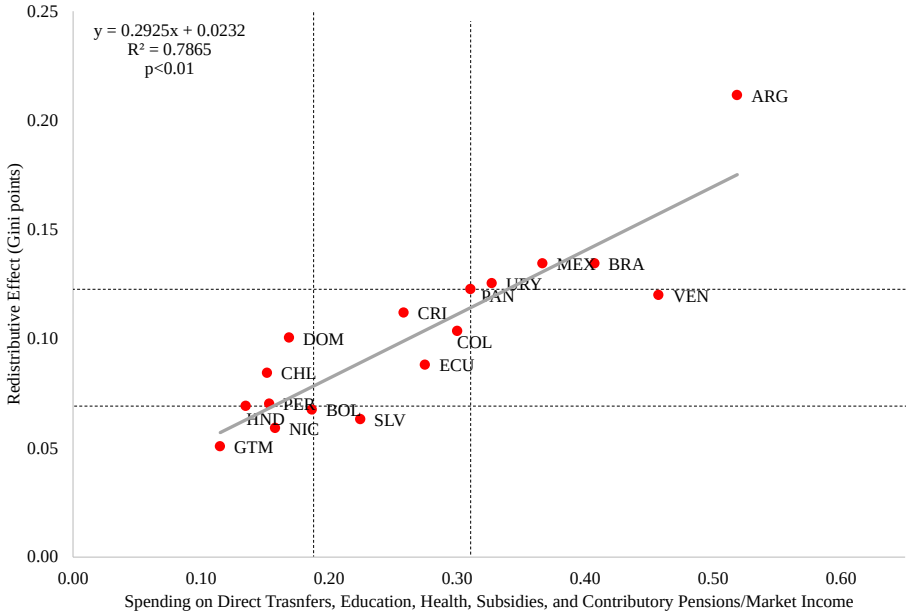
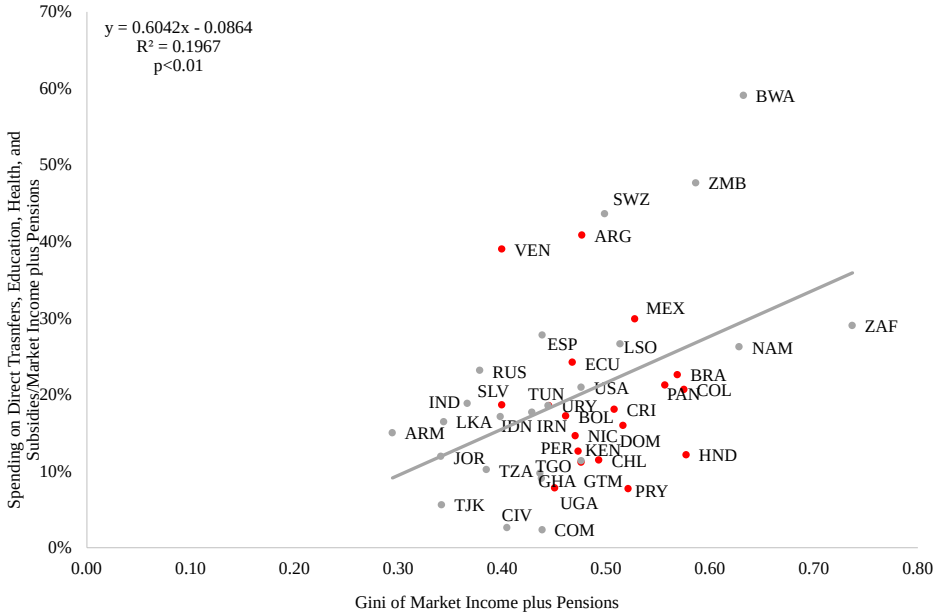


Pensions as gov transfers, PGT

Source: see bibliographical reference by country at the end of this presentation.

LAC: More unequal, less social spending – Bad News!

All Countries



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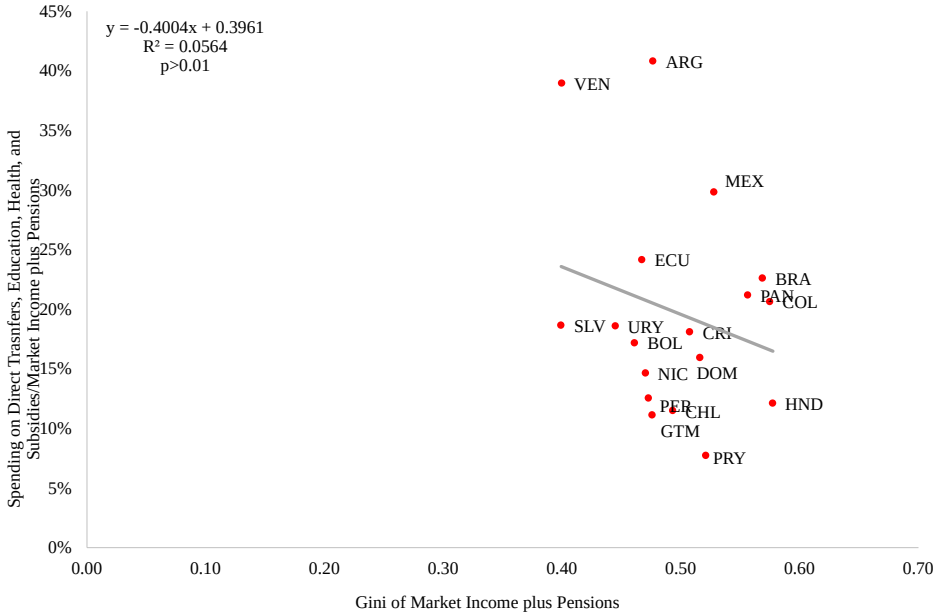

Pensions as deferred income, PDI

Source: see bibliographical reference by country at the end of this presentation.

LAC: More Unequal, More Social Spending/Prefiscal Income?

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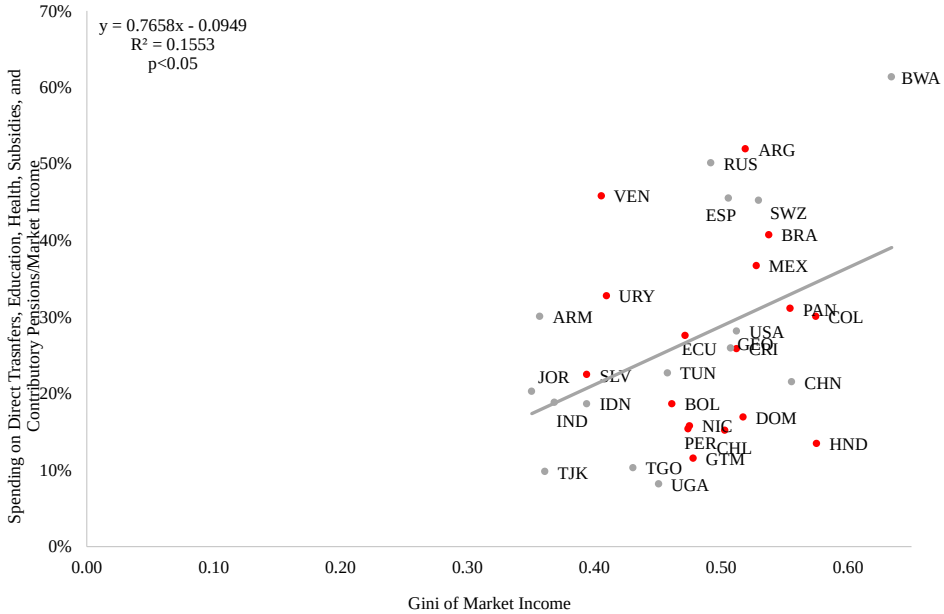
All Countries



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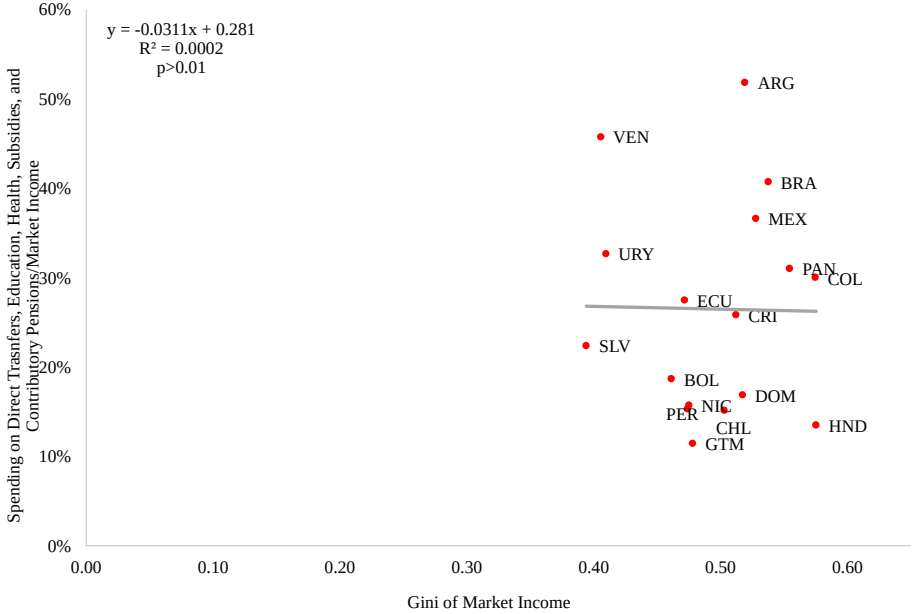

Pensions as gov transfers, PGT

Source: see bibliographical reference by country at the end of this presentation.

LAC: More unequal, less redistribution– Bad News!

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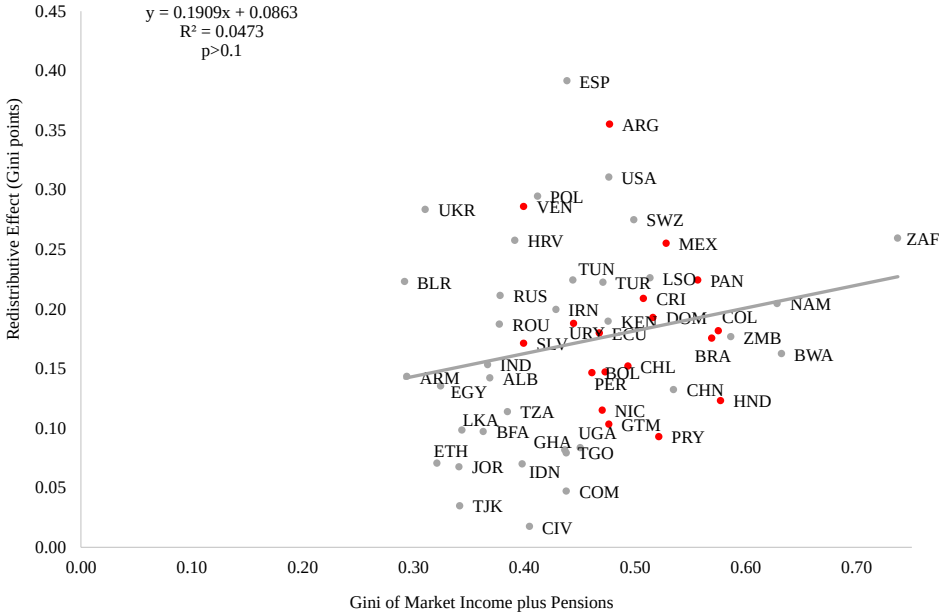
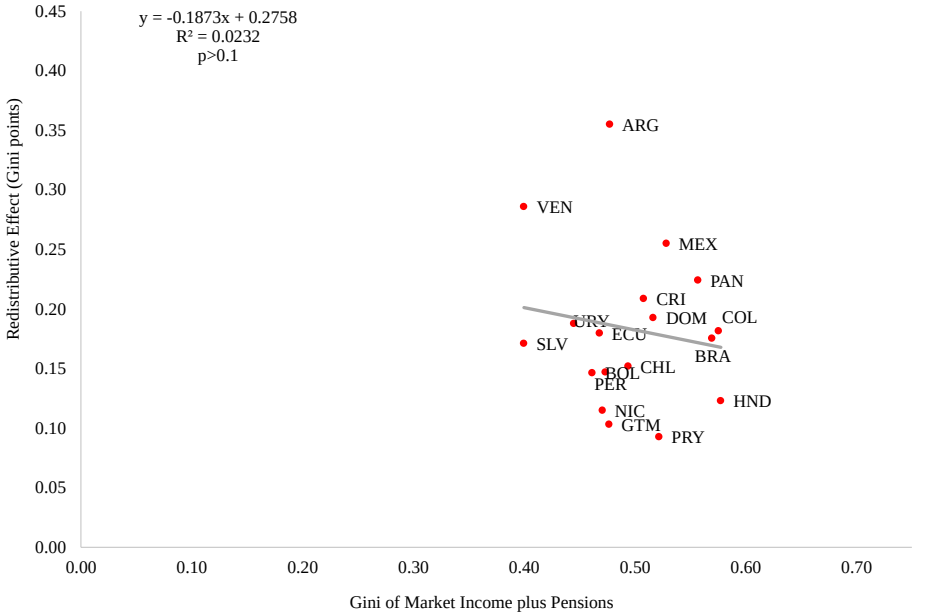
All Countries



LAC

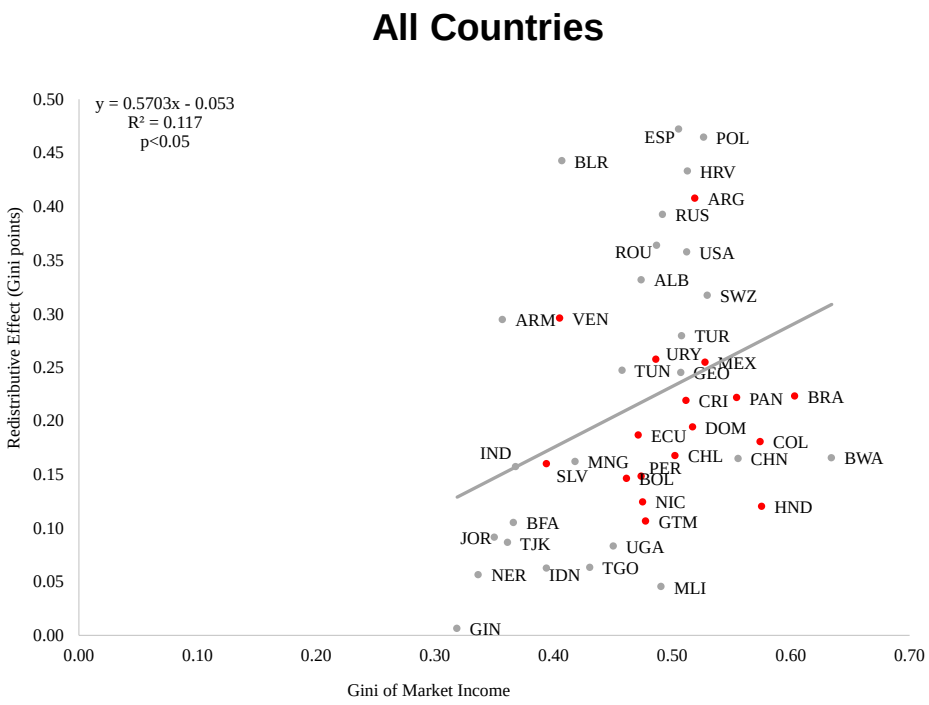


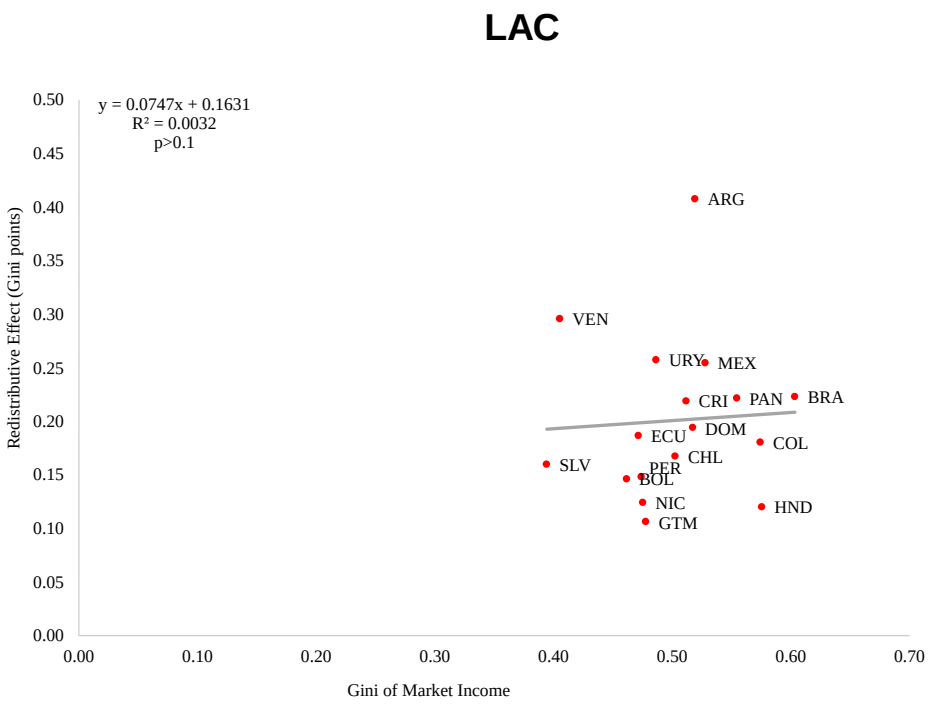
Pensions as deferred income, PDI

Source: see bibliographical reference by country at the end of this presentation.

LAC: More Unequal, More Redistribution?

(Scenario: PGT)





Pensions as gov transfers, PGT

Source: see bibliographical reference by country at the end of this presentation.

In conclusion

- LAC countries are heterogeneous in their inequality and poverty levels, and their fiscal systems are also heterogeneous in their effect on reducing inequality and poverty.
- LAC fiscal systems are always equalizing but can often reduce the purchasing power of the poor.
  - *Warning*: unintended consequence of the domestic resource mobilization agenda can be making the poor worse off.
- Direct taxes and transfers are always equalizing, and indirect taxes and subsidies are often equalizing.
- Spending on education and health is always equalizing and often pro-poor
  - *Warning*: is this favorable result because middle-classes and the rich are opting out of using public schools and public healthcare?
- The more social spending/GDP the larger the redistributive effect.
  - *Warning*: it is possible that high redistributive effects are accompanied by inefficiencies and unsustainable macroeconomic conditions.
- However, in LAC countries, the more unequal not necessarily the more redistribution.

Thank you!

Teams and references by country

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