

Fiscal Policy and the Poor in Latin America

IN THIS BRIEF:

Good fiscal policy not only promotes macroeconomic stability and growth, it is also a powerful tool for directly reducing poverty and inequality. Many governments around the world have raised and spent funds to build the assets of the poor and to directly redistribute income, successfully improving welfare and constructing more prosperous and equal societies.

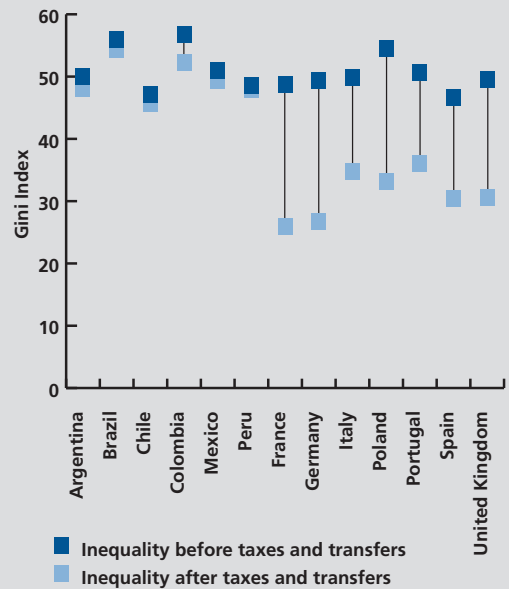
Unfortunately, fiscal policy in Latin America does not have a good record of reducing poverty and inequality. Why? According to the best information available, the combination of inadequate revenues, low-quality services and poor targeting helps explain why poverty has declined so slowly and why inequality has remained extraordinarily high.

Economists generally agree that fiscal policy is about government efforts to influence the economy via revenues and spending. Many agree as well that fiscal policy has three fundamental functions: efficiency, stabilization and redistribution. We will focus here exclusively on the redistributive function of fiscal policy for two reasons: 1) Latin America's extraordinarily high rates of inequality suggest that fiscal policy is not performing its redistributive function properly; and 2) public opinion surveys suggest that Latin American citizens overwhelmingly see the distribution of wealth in their countries as being "unfair" or "very unfair". Clearly, something is amiss.¹

Figure 1 compares the impact of two fundamental tools of fiscal policy—taxes and transfers (e.g. pensions, unemployment insurance and conditional cash transfers)—on inequality in Latin America and Europe. Before considering the effect of direct taxes and transfers, Europe has rates of inequality not terribly different from those in Latin America. After taxes and transfers, however, inequality drops significantly in Europe, but hardly drops at all in Latin America.

In Latin America, fiscal policy is not playing the redistributive role that it does in Europe.

Figure 1: Impact of Taxes & Transfers on Inequality, Latin American and European Countries, 2008



Source: Adapted from OECD, *Latin American Economic Outlook 2009*, Figure 4.1, p.122.

Not all aspects of fiscal policy have the same direct impact on the poor, of course. But several can play a major role in reducing poverty and inequality. These include properly managing revenues, which generate funds that can help the poor, and emphasizing spending that directly targets the poor via services (such as education and health) or transfers (such as pensions, unemployment insurance and conditional cash transfers). Governments that raise sufficient funds and spend them effectively on the poor can significantly reduce poverty and inequality.²

Revenues

The primary role of a country's revenue system, of course, is to raise the funds necessary to finance government operations, rather than to redistribute income.³ But government revenues in Latin America need to be looked at in terms of their impact on redistribution for at least two reasons: 1) tax revenues are low given the region's level of development; and 2) most tax systems tend to be neutral or regressive in terms of income redistribution.

“ Tax evasion is high in most countries...”

Tax revenues are low by OECD standards.

Government revenues average 25 percent of GDP in Latin America compared with 42 percent of GDP in OECD countries.⁴ Taxes, the most important component of revenues in most countries, are significantly lower than would be expected given Latin America’s level of development.⁵

Why are tax revenues low? The problem does not appear to be low tax rates. Latin America’s statutory tax rates for personal and corporate income taxes are only slightly lower than other parts of the world. VAT (Value Added Tax) rates, which are an important source of revenue in Latin America, are close to international norms.⁶ Together, they should provide adequate revenues.

A more serious problem appears to be that many taxes are simply not collected. Collections are low because of illegal tax evasion and legal tax exceptions (i.e. deductions, exemptions and loopholes).

Tax evasion is high in most countries in Latin America. Estimates of personal and corporate income tax evasion often reach 40 percent or more.⁷ Few countries even measure tax evasion, or effectively penalize offenders. This is because government agencies responsible for collecting taxes tend to be weak, lacking the power and the resources necessary to enforce the law.⁸

The proliferation of numerous and generous tax deductions, exemptions and loopholes also lowers tax collections. Exemptions and loopholes usually favor high-income households and dramatically reduce their tax burden. These legal exceptions mean that the revenues collected in practice tend to fall far short of the rates established by law.⁹

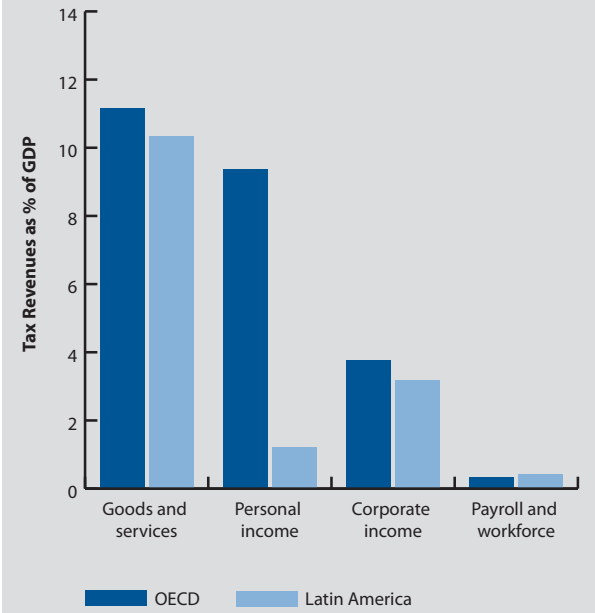
There is, of course, no optimal level for government revenues. Every country is different, and all face a trade-off between the burden implied by taxes and the value of the public goods and services that taxes would make possible. But Latin America may well have overemphasized low taxes (through exemptions and deductions) to the detriment of spending that could help resolve its enormous inequality problem. The region’s relatively low levels of government revenues clearly limit the capacity of the state to spend more on the poor—and thereby to reduce poverty and inequality.

Tax systems tend to be neutral or regressive.

Tax systems in Latin America fail to shift the overall revenue burden from poor and middle-income households to rich households. When direct (e.g. personal and corporate income taxes) and indirect taxes (e.g. VAT) are combined, the poorest fifth of the population often pays a larger percentage of their income in taxes than does the richest fifth.¹⁰

The shortfall appears to be due largely to a failure to collect personal income taxes.¹¹ In OECD countries personal income tax collections constitute over 9 percent of GDP, compared to just over 1 percent in Latin America (Figure 2).

Figure 2: Tax Collections as % of GDP, by region, 2005



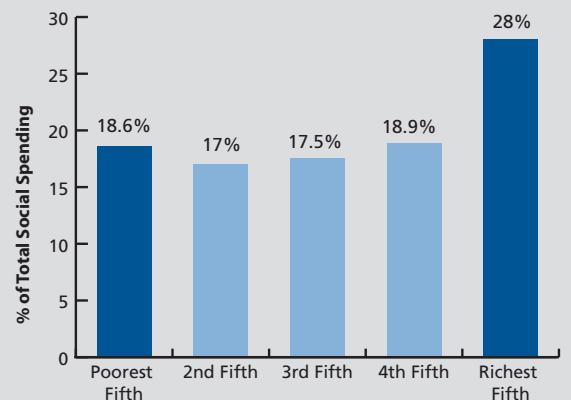
Source: Adapted from OECD, *Latin American Economic Outlook 2009*, Figures 4.4 and 4.5, pp.130-131.

As a result, relatively regressive indirect taxes, like the VAT, generate a disproportionately large portion of tax revenues in Latin America, blunting the redistributive potential of tax systems.¹²

Spending

Overall, government spending in Latin America has risen steadily over the past several decades, driven in part by increases in social spending—particularly on education and on social insurance and assistance. But, on balance, more benefits go to the richest fifth of the population, and the poorest fifth receives less than its share (Figure 3).

Figure 3: Share of Social Spending Received by Different Income Groups, Latin America, 1997-2004



Source: Adapted from ECLAC, *Social Panorama 2007*, Figure II.11, p. 111.

By properly spending the revenues they raise, governments can reduce poverty and inequality in at least two ways: 1) providing services (such as education) that build human capital among the poor, and 2) transferring income (such as via pensions, or conditional cash transfers) directly to the poor. Unfortunately, in most of Latin America, both approaches suffer from deficiencies that significantly reduce their impact.

Spending on education contributes little to increasing human capital of the poor.

Government spending on education is a relatively long-term investment, with limited short-term payoff. But it is important because it builds the human capital of the poor, which, once in place, produces a stream of benefits over many years.

Public spending on education as a percentage of GDP has risen steadily in Latin America over the past two decades, and ranks above global averages for low- and middle-income countries.¹³ Nonetheless, public education systems (which, at the primary and secondary levels, largely serve the poor) face two key problems that weaken their ability to reduce poverty and inequality.

First, the quality of education provided by public schools is poor. For example, well over half of students from Argentina, Brazil, Colombia and Mexico scored at or below the lowest level in science (which the OECD characterizes as not being able “to participate actively in life situations related to science and technology”) in the most recent Program in International Student Achievement (PISA) exam. Scores in reading and math were similarly low.¹⁴

Second, public spending on education in most Latin American countries is, on balance, not pro-poor. As Table 1 makes clear, the major equity problem appears at the tertiary level. More than half of the benefits of public spending on higher education go to the richest 20 percent of the population, while less than two percent of those benefits go to the poorest 20 percent. In Latin America, free higher education for all is clearly not pro-poor.

Table 1: Percent of Public Education Spending Going to Richest and Poorest, Latin America, 2006

	Poorest Fifth	Richest Fifth
Education Overall	20.2	20.4
Primary	29.0	7.9
Secondary	13.2	18.3
Tertiary	1.9	52.1

Source: Clements, B., C. Faircloth, and M. Verhoeven. 2007. Public Expenditure in Latin America: Trends and Key Policy Issues. International Monetary Fund, p. 24.

Transfers are low and most are not well-targeted.

Governments can directly redistribute income by transferring funds to the poor via insurance programs (such as pensions) and assistance programs (such as conditional cash transfers). If large enough and properly targeted, transfers can immediately reduce poverty and inequality.

Latin America’s public spending on transfers has risen since the 1990’s, but it still does not appear to be playing a strong redistributive role.¹⁵

Why? Part of the problem is that public transfers in Latin America are low. As a percentage of GDP, Latin America spends less than half what Europe spends on public transfers (Table 2).

Table 2: Public Spending on Transfers (% of GDP), Latin America and Europe (Select Countries), 2006

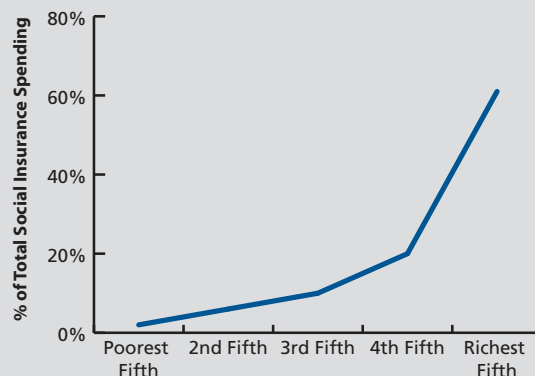
	Europe	Latin America
Transfers	16.3	7.3

Source: Adapted from (a) Lindert, K., E. Skoufias, and J. Shapiro. 2006. Redistributing Income to the Poor and the Rich: Public Transfers in Latin America and the Caribbean. World Bank, p. 17; (b) Goñi, E., J.H. López, and L. Servén. 2008. Fiscal Redistribution and Income Inequality in Latin America. World Bank, Table 5, p. 18.

A more serious problem in Latin America is that public transfers are not well targeted. Governments tend to allocate the bulk of public transfers to programs that benefit the richest part of the population more than the poorest.

Social insurance programs—chiefly pensions and unemployment insurance—are a major culprit, consuming roughly 85 percent of spending on public transfers, and channeling very little of that money to the poor.¹⁶ As Figure 4 shows, the richest 40 percent of the population receives nearly all (80 percent) of the benefits from pension programs while the poorest 40 percent receives barely 10 percent. Pensions are regressive because they largely exclude workers in the informal sector and in agriculture, who also tend to be the poorest.¹⁷

Figure 4: Share of Public Spending on Pensions Received by Different Income Groups, Latin America, 2006



Source: Goñi, E., J.H. López, and L. Servén. 2008. Fiscal Redistribution and Income Inequality in Latin America. World Bank, p. 20.

Note: Authors’ estimates based on graphs.

The poor targeting of social insurance programs is a major equity problem, because direct contributions do not cover benefit costs—indeed many social insurance programs run huge deficits. In some countries, public sector employees

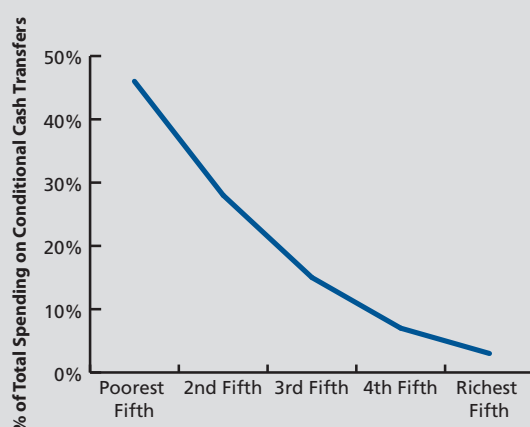
“ Governments tend to...benefit the richest part of the population more than the poorest.”

enjoy extraordinarily generous pension benefits that are funded principally by the government.¹⁸

By contrast, spending on social assistance programs, such as conditional cash transfers (e.g. *Bolsa Escola* in Brazil and *Oportunidades* in Mexico) clearly reaches the poor. As Figure 5 demonstrates, the poorest 40 percent receive 75 percent of the benefits of conditional cash transfer programs. These programs have grown significantly over the past decade. But social assistance accounts for only a small part of spending on public transfers—some 15 percent—compared with the 85 percent that goes to social insurance.¹⁹ Most governments do not give high budgetary priority to social assistance programs.

“Fiscal policy is failing to reduce poverty and inequality in most of Latin America.”

Figure 5: Share of Public Spending on Conditional Cash Transfers Received by Different Income Groups, Latin America, 2006



Source: Goñi, E., J.H. López, and L. Servén. 2008. Fiscal Redistribution and Income Inequality in Latin America. World Bank, p. 21.

“Making fiscal policy pro-poor ... will be fiercely resisted by those who benefit from the status quo.”

Fiscal policy is failing the poor

Overall, fiscal policy is failing to reduce poverty and inequality in most of Latin America. Governments have seldom generated high levels of revenues. Tax systems have generally failed to shift the revenue burden to rich households. Social services have often been of low quality. Pension programs, by far the largest part of public spending on transfers, overwhelmingly benefit the richest fifth of the population. Programs that clearly reduce poverty and inequality, such as conditional cash transfers, account for a relatively small proportion of social spending. Making fiscal policy pro-poor should therefore be top priority for the region's governments. But success will be difficult, requiring major changes that will be fiercely resisted by those who benefit from the status quo.

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