

Fiscal Policy and the Poor in Latin America
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Inter-American Dialogue

Introduction

Good fiscal policy not only promotes macroeconomic stability and growth, it is also a powerful tool for directly reducing poverty and inequality. Governments around the world have raised and spent funds to build the assets of the poor and to directly redistribute income, with the goal of improving welfare and constructing more prosperous and equal societies. In many countries these efforts have been remarkably successful.

Not all aspects of fiscal policy have the same direct impact on the poor, of course. But several can play a major role in redistributing wealth. These include properly managing revenues, which generate the 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

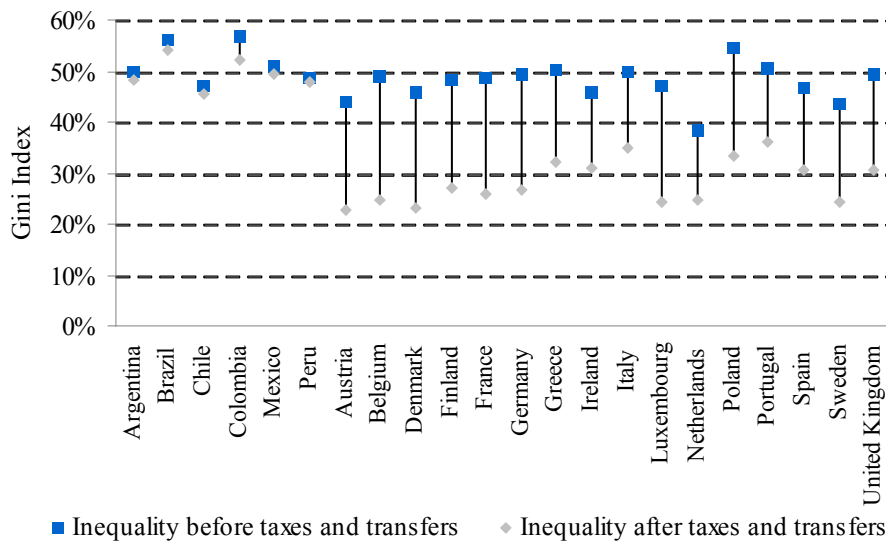
Unfortunately, fiscal policy in Latin America does not have a good record of redistributing wealth to the poor. Governments have seldom generated high levels of revenues. Tax systems have generally been neutral or regressive, failing to shift the revenue burden to rich households. The services provided by government spending have often been of low quality. And government programs have tended to benefit middle- and upper- income groups more than the poor. The combination of inadequate revenues, low-quality services and poor targeting has helped explain why poverty has declined so slowly and why inequality has remained extraordinarily high. The Latin American state has not done a good job of reducing poverty and redistributing wealth.

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 (10-15 percentage points in the Gini index), but only slightly in Latin America.

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² Other dimensions of fiscal policy, such as promoting growth and stabilizing the economy in good times and bad, are also important for the poor. See, for example, Birdsall et al. (2008) chapters 1 & 2 for a discussion.

Figure 1: Redistributive Impact of Taxes and Transfers, by change in Gini Index, Latin America and European OECD (select countries), 2008



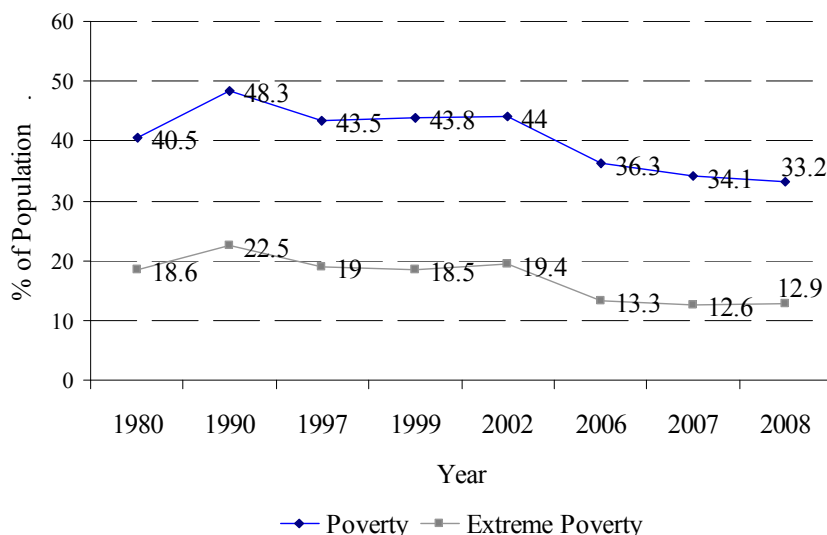
Source: OECD, Latin American Economic Outlook 2009, Figure 4.1, p.122

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

Poverty and Inequality in Latin America

Although far from being the poorest region in the developing world, Latin America and the Caribbean's poverty rates have remained stubbornly high. In 1980, roughly 40% of Latin Americans were poor (defined as not having sufficient income to satisfy their basic needs). By 2000 that figure had increased rather than decreased. Only recently has poverty begun to decline significantly, dropping from 44% to 33% between 2002 and 2008 (Figure 2).

Figure 2: Poverty in Latin America, 1980 – 2008

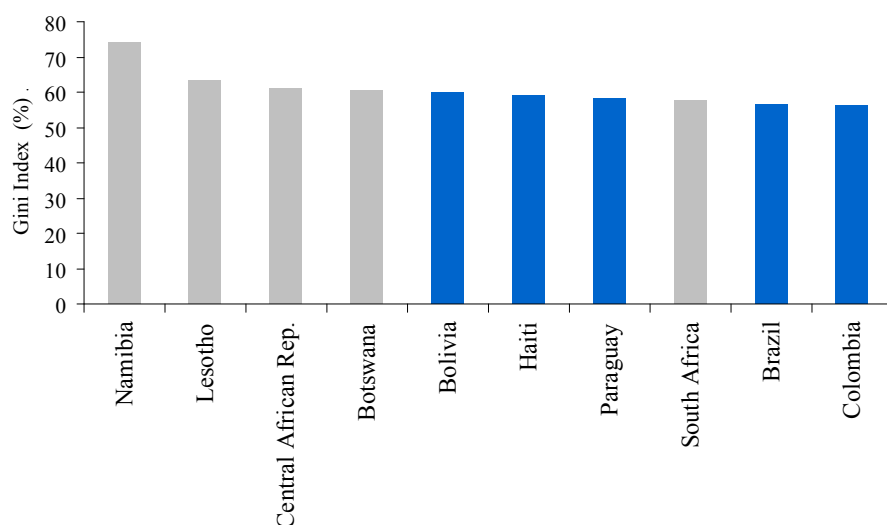


Source: ECLAC, Social Panorama 2008 (Spanish version), Figure I.1, p. 4

Note: Figure includes: Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Ecuador, El Salvador, Guatemala, Honduras, Mexico, Nicaragua, Panama, Paraguay, Peru, Dominican Republic, Uruguay, Venezuela and Haiti. Data for 2008 are ECLAC estimates.

The picture is worse when it comes to inequality. Latin America, along with Sub-Saharan Africa, is the most unequal region in the world.³ Based on the most commonly used indicator of income inequality, the Gini index, five of the world's ten most unequal countries are Latin American (Figure 3). One of them—Brazil—accounts for nearly one-third of the region's population. Even the most equal Latin American countries tend to be more unequal than the most unequal European countries.⁴

Figure 3: The World's 10 Most Unequal Countries, by Gini Index, 2005



Source: World Bank, World Development Indicators 2008, Table 2.8

Note: Author's list based on World Bank data. Data are for most recent year available of the date listed. Countries without data were not included in the list.

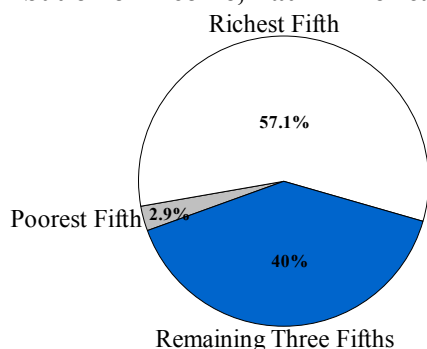
Inequality in Latin America is due substantially to the extraordinary concentration of income at the top of the income scale—and its absence at the bottom. The richest fifth of Latin America's population receives nearly three-fifths of total income, while the poorest fifth receives just 3 percent (Figure 4). In every other region of the developing world, the poor receive a higher share of total income (Figure 5). Although the extent of inequality varies a great deal, virtually every Latin American country for which we have data is highly unequal.⁵

³ Perry and Lopez (2008) pp. 3-4 discuss inequality in Latin America and the Caribbean compared to other regions.

⁴ Goñi et al. (2008) p. 5

⁵ This analysis is based on the most recent Gini Index available for national population in the following countries: Bolivia, Brazil, Chile, Colombia, Costa Rica, Ecuador, El Salvador, Guatemala, Honduras, Mexico, Nicaragua, Panama, Paraguay, Peru, Venezuela, and urban population for Argentina and Uruguay. Gini Indices are based on per capita income and were from CEDLAS and World Bank, Socio-Economic Database for Latin America and the Caribbean. Accessed November 20 2008.

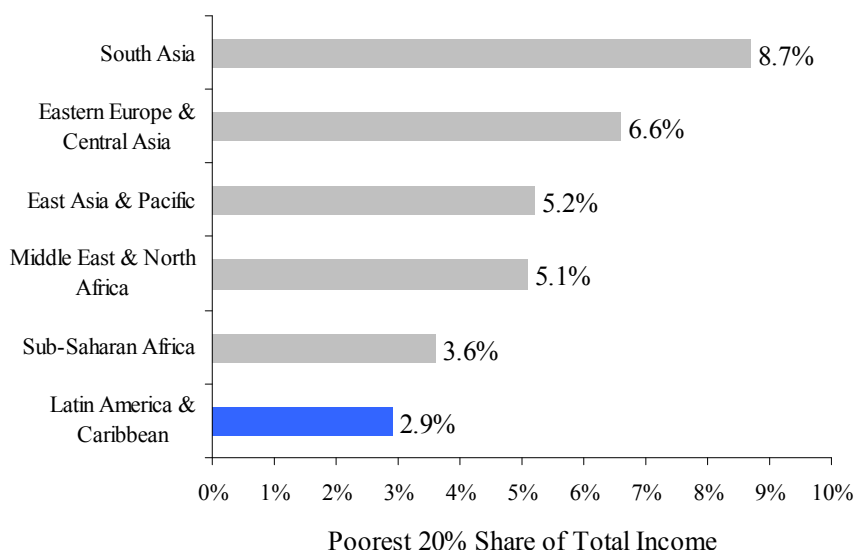
Figure 4: Distribution of Income, Latin America and the Caribbean, 2008



Source: World Bank, World Development Indicators, 2008, Figure 1k

Note: Region is defined by the World Bank.

Figure 5: Poorest Fifth's Share of Total Income, by Region, 2008



Source: World Bank, World Development Indicators, 2008, Figure 1k

Note: Regions are defined by the World Bank.

Inequality has declined slightly in nearly half the region's countries over the past 15 years, including the two largest—Brazil and Mexico.⁶ Although limited in scope, these improvements are a welcome change for a region where inequality has historically been high and rooted in its colonial past.

However, most of the gains have coincided with five years of extraordinary economic growth (which has increased employment among the poor) and an increase in the flow of remittances (which has put cash in the pockets of many poor families). The global economic crisis will almost certainly reduce growth and remittances significantly, putting progress in reducing poverty and inequality at risk. Latin America does not yet appear to have developed a robust strategy for reducing poverty and inequality.

⁶ Analysis based on change in Gini Index for national population in the following countries: Bolivia, Brazil, Chile, Colombia, Costa Rica, Ecuador, El Salvador, Guatemala, Honduras, Mexico, Nicaragua, Panama, Paraguay, Peru, Venezuela, and urban population for Argentina and Uruguay. Gini Indices are based on per capita income and were from CEDLAS and World Bank, Socio-Economic Database for Latin America and the Caribbean. Accessed November 20 2008.

How Can Fiscal Policy Help?

Economists generally agree that fiscal policy is about government efforts to influence the economy via revenues and spending.⁷ Many agree as well that fiscal policy has three fundamental functions: efficiency, stabilization and redistribution.⁸ 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".⁹ Clearly, something is amiss.

The two core components of fiscal policy, revenues and spending, play different but important roles in helping the poor.

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.¹⁰ But government revenues in Latin America need to be looked at in terms of their impact on redistribution for at least two reasons.

Government 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.¹¹ Taxes, the most important component of revenues in most countries, are significantly lower than would be expected given Latin America's level of development.¹² Brazil is a notable exception, with tax revenues in excess of 30 percent of GDP--which many economists believe is too high.¹³

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 rates, which are an important source of revenue in Latin America, are close to international norms.¹⁴ Together, they should provide adequate revenues.

A more serious problem appears to be that many taxes are simply not collected. Latin America collects a relatively small portion of the taxes its nominal rates would imply.¹⁵ The shortfall

⁷ See, for example, OECD (2008) *Latin American Economic Outlook 2009*, Chapter 1, for a summary.

⁸ Musgrave (1959) is the standard reference.

⁹ According to a regional public opinion survey, *Latinobarómetro* (2007) p. 36, 48% of respondents said that the distribution of wealth was "unfair" and another 27% said that the distribution of wealth was "very unfair".

¹⁰ See, for example, Bird and Zolt (2003) for a useful discussion on the roles and functions of tax systems in developing countries.

¹¹ See OECD (2008) p. 56, Table 2.1.

¹² See Goñi et al. (2008) p. 10; Perry (2006) p. 95; Birdsall et al. (2008) p. 59

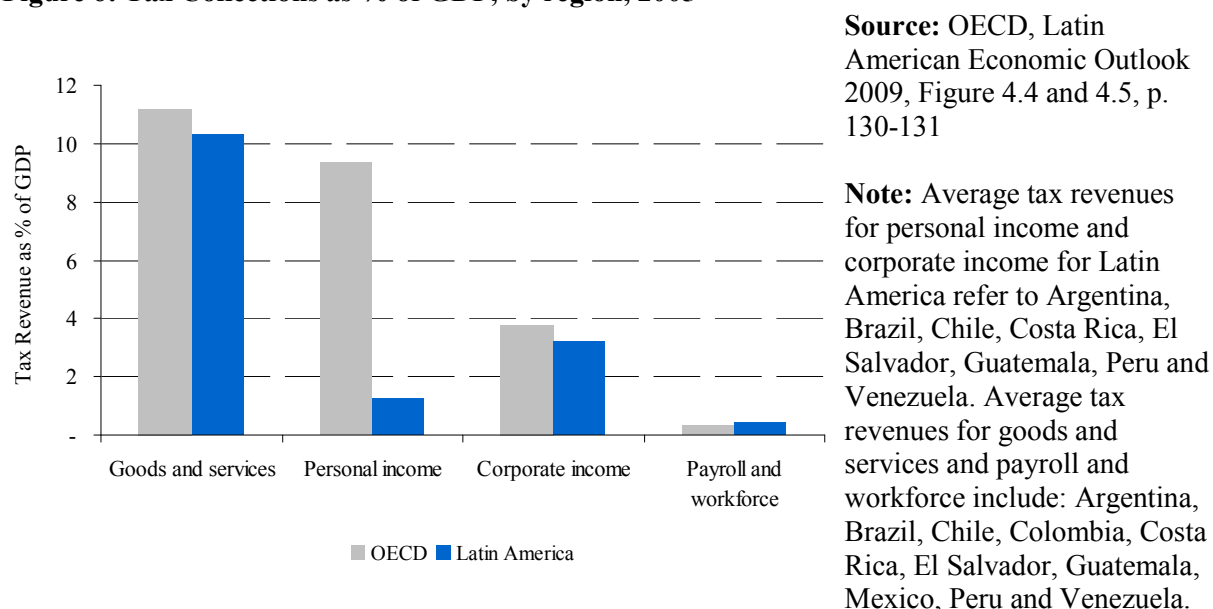
¹³ Birdsall et al. (2008) p. 59

¹⁴ Goñi et al. (2008) p. 11 Table 2 shows tax rates for VAT, Corporate and Personal Income across several regions; Birdsall et al. (2008) p. 61

¹⁵ Goñi et al. (2008) p. 10; Pessino and Fenochietto (forthcoming)

appears to be due largely to a failure to collect personal income taxes.¹⁶ In the OECD countries personal income tax collections constitute over 9 percent of GDP, compared to just over 1 percent in Latin America (Figure 6). Personal income taxes make up 25 percent of total tax revenues in OECD countries, versus just 4 percent in Latin America.¹⁷ Effective tax rates (i.e. based on actual collections) for the richest 10 percent of Latin American households are just 8 percent, compared with nearly 40 percent in the United States.¹⁸ Pessino and Fenochietto (forthcoming) conclude that “evasion in income and wealth taxes is a subsidy to the rich...” (p. 2) and that “reducing personal income tax evasion not only increases collection, but also improves income distribution” (p. 24).

Figure 6: Tax Collections as % of GDP, by region, 2005



Collections are low for at least two reasons. First, tax evasion is high in most countries. Estimates of personal and corporate income tax evasion often reach 40 percent or more.¹⁹ This is because government agencies responsible for collecting taxes tend to be weak, lacking the power and the resources necessary to enforce the law. Few countries even measure tax evasion, or effectively penalize offenders.²⁰

¹⁶ According to Lora (2007) p. 198, in 2000-20003 VAT collections rose to an average of 5 percent of GDP, which are higher than global standards. He cites IDB (1999 chapter 8) noting that “the tax burden from sales taxes, in line with global standards, is 4 percent of GDP.” In the *Latin American Economic Outlook 2009* p. 130, “As a share of GDP, Latin American taxes on goods and services approach levels observed in OECD countries, and are 2 percentage points higher than in Asia-Pacific and North American OECD countries. Figure 4.4 shows that payroll and workforce taxes in both OECD countries and in Asia-Pacific and North American OECD countries average .34 percent of GDP. Payroll and workforce taxes are higher in Latin America, where they average .42 percent of GDP.

¹⁷ OECD (2008) p. 59

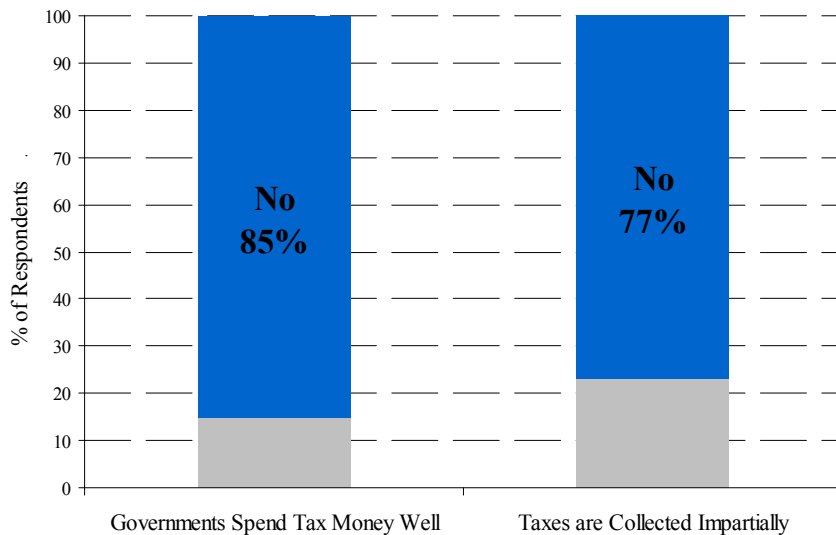
¹⁸ Birdsall et al. (2008) p. 61.

¹⁹ See Birdsall et al. (2008) p. 62 for a useful discussion on tax evasion.

²⁰ Pessino and Fenochietto (forthcoming) p. 21 note “Even though the studies that measure VAT evasion are scarce, the ones that intend to measure income tax evasion are even scarcer.” Also, after further discussion on p. 25 they note that “there is no empirical investigation yet on any of the reasons of tax evasion in Latin America.” Birdsall et al. (2008) p. 65-68 provide a useful discussion on obstacles to tax agencies’ effectively recovering taxes.

Furthermore, citizens tend to perceive tax collection as unfair and do not believe that the government will make good use of taxes they pay.²¹ According to the most recent Latinobarómetro, citizens think tax evasion is at least partly justifiable--and more justifiable than a decade ago.²² Earlier polls found that only 15% of respondents felt that taxes were well spent by governments, and less than a quarter considered tax collection to be impartial (Figure 7). The result is a culture of evasion in which even normally law-abiding citizens routinely break the law when it comes to taxes.

Figure 7: Confidence that the Government Will Spend Tax Money Well and that Taxes are Collected Impartially (% of Latinobarómetro Respondents), 2003



Source:

Latinobarómetro 2003, pp. 52-53

Note: Survey questions were *Tiene Ud. Confianza en que el dinero de los impuestos seran bien gastados por el Estado?*; *Tiene Ud. Confianza en que los impuestos seran recaudados con imparcialidad?* Possible answers were “Yes” or “No”

Also, because the combined tax burden facing corporations (corporate income taxes, the VAT and payroll taxes) is among the highest in the world, many small businesses opt to remain in the shadow economy. Roughly 40 percent of Latin American economies are informal—a rate exceeded only by Sub-Saharan Africa—operating outside the laws established to govern economic activity.²³ Thus a significant proportion of taxes that might theoretically be collected are not.

The second explanation for low tax collections is the proliferation in most tax codes of numerous and generous deductions, exemptions and loopholes.²⁴ Exemptions and loopholes usually favor high-income households and dramatically reduce their tax burden.²⁵ These legal exceptions mean that the revenues collected in practice tend to fall far short of the rates established by law.

²¹ Goñi et al. (2008) p. 12

²² Respondents were asked how justifiable is it to evade taxes. Respondents were answered on a scale of 1 to 10 (1 = never justifiable; 10 = always justifiable) from 1998 to 2008. (Latinobarómetro 2008, p. 42).

²³ World Bank (2005)

²⁴ Goñi et al. (2008) p. 13

²⁵ Birdsall et al. (2008) p. 61

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 additional taxes and the value of the public goods and services that additional taxes would make possible. But Latin America may well have overemphasized low taxes 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—thereby reducing poverty and inequality.

*Tax systems in Latin America tend to be neutral or regressive in terms of income distribution, failing to shift the overall revenue burden from poor and middle-income households to rich households.*²⁶ This is because an unusually high proportion of revenues in Latin America comes from indirect taxes (such as payroll taxes or the VAT) which are usually regressive, and a relatively low proportion comes from direct taxes (e.g. personal and corporate income taxes) which are almost always progressive. Roughly 40 percent of Latin America's revenues come from indirect taxes vs. 26 percent in OECD countries.²⁷

When direct and indirect taxes are combined, the poorest fifth of the population often pays a larger percentage of their income in taxes than does the richest fifth. One recent study found that eight of ten tax systems in the region are regressive.²⁸ Another found that taxation in the region's six largest countries was “roughly neutral overall”.²⁹

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

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 (Figure 8).

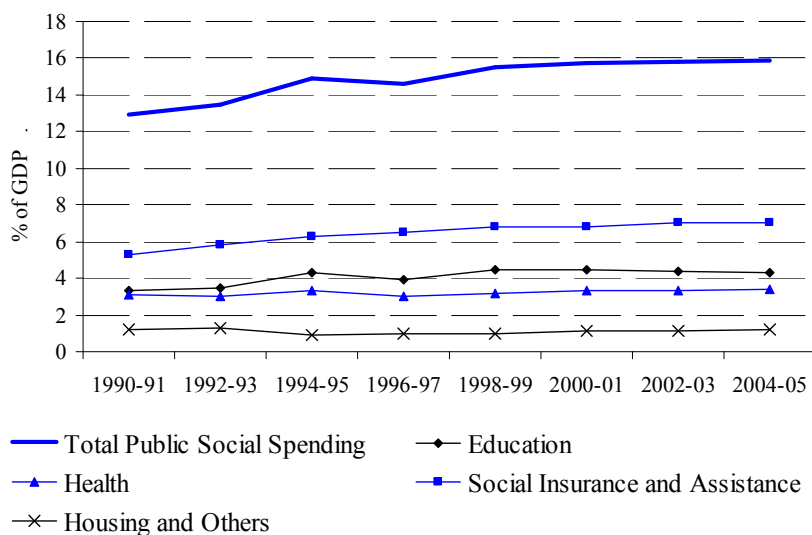
²⁶ Goñi et al. (2008) p. 17; Birdsall et al. (2008) p. 59

²⁷ OECD (2008) p. 18

²⁸ Gomez-Sabatini (2005)

²⁹ Goñi et al. (2008) p. 17; see also Birdsall et al. (2008) pp. 59-61.

Figure 8: Public Social Spending in Latin America and the Caribbean (% of GDP), by Sector, 1990-2005



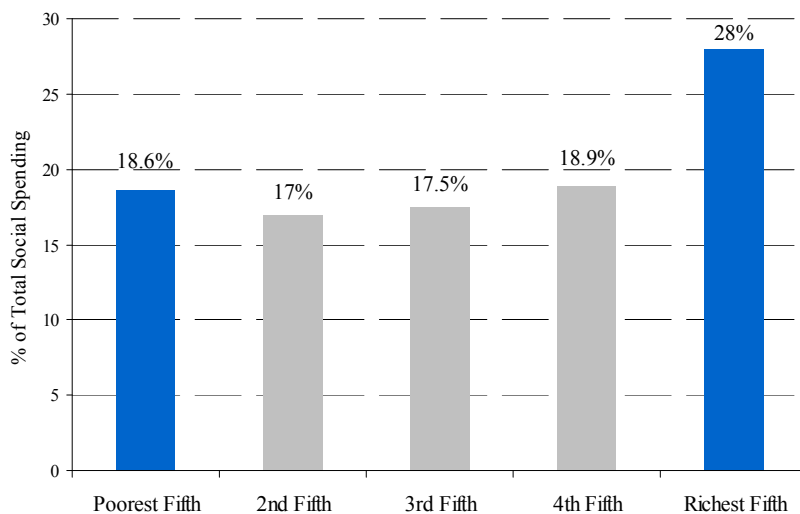
Source: ECLAC, Social Panorama 2007, Tables II.6; II.8; II.9; II.10 (Spanish edition)

Notes : ECLAC calculated the numbers using weighted average for 20 countries, not including Nicaragua. The average includes estimations for years and countries without data.

By properly spending the revenues they raise, governments can reduce poverty and inequality in at least two ways: 1) providing services (primarily education and health) that build human capital among the poor, and 2) transferring income (primarily via pensions, unemployment insurance, conditional cash transfers or school feeding programs) that redistributes wealth directly to the poor.

Unfortunately, both approaches suffer from deficiencies in most of Latin America that significantly reduce their impact. Figure 9 shows how public social spending overall affects different income groups throughout the region. On balance, more benefits go to the richest fifth of the population, and the poorest fifth receives less than its share.

Figure 9: Share of Social Spending Received by Different Income Groups, Latin America and the Caribbean, 1997-2004



Source: ECLAC, Social Panorama 2007, Figure II.11, p. 117 (Spanish edition)

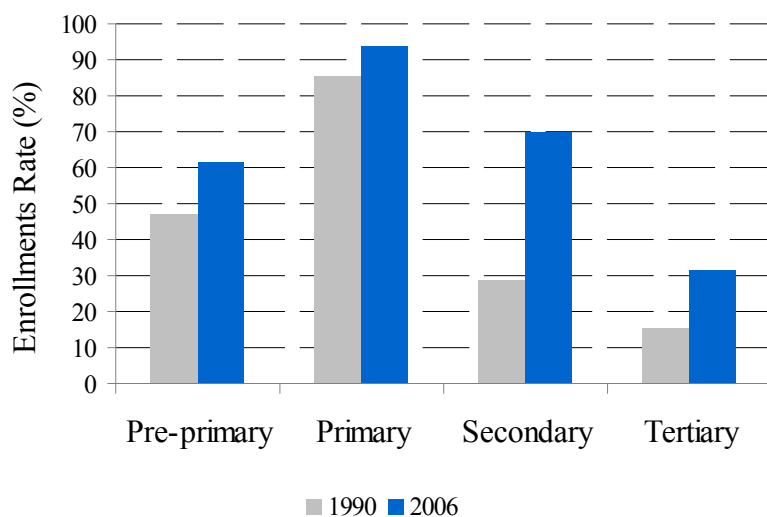
Notes: ECLAC calculated the numbers using a weighted average for the significance of each sector of social spending as part of each quintile's primary income. Social Spending here includes: Education, Health, Social Security, Social Assistance and Housing.

Providing services that build human capital among the poor.

Government investments in education and health can reduce poverty and inequality by increasing the assets of the poor and expanding equality of opportunity. These are relatively long-term investments, with limited short-term payoff. But they are important because they build human capital that, once in place, produces a stream of benefits over many years.

Education. 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.³⁰ Increased spending has allowed all countries to raise enrollments significantly at all levels of education (Figure 10). Today a greater proportion of school-age children attend school in Latin America than at any time in the region's history.

Figure 10: Enrollment rates, Latin America and the Caribbean, 1990-2006



Source: World Bank, Edstats online database

Note: Pre-primary and tertiary enrollments refer to gross enrollment rates, and primary and secondary refer to net enrollment rates.

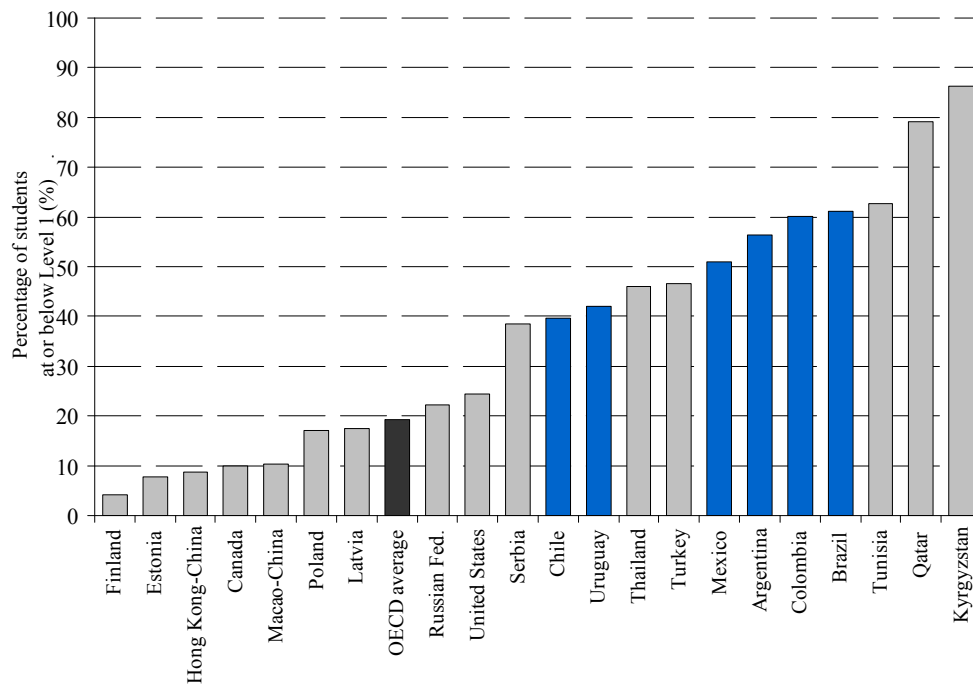
Nonetheless, public education systems (which, at the primary and secondary levels, largely serve the poor) face two key problems that weaken their ability to reduce poverty and inequality.

First, the quality of education provided by public schools is low, and therefore contributes only modestly to increasing human capital. Latin America scores at the bottom on every global test of student achievement. In the most recent (2006) Program in International Student Achievement (PISA) examination administered by the OECD, all six Latin American countries (Argentina, Brazil, Chile, Colombia, Mexico and Uruguay) ranked firmly in the bottom third of the 57 participating countries. In science, only Chile and Uruguay had any students (0.1 percent) at all who reached the highest level, compared with the OECD average of 1.3 percent. By contrast well over half of students from Argentina, Brazil and 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”). (Figure 11) Scores in reading and math

³⁰ PREAL (2006) p. 20

were similarly low. Schools that produce such low level of learning are contributing little to the human capital of their students.

Figure 11: Students at or below the lowest level on the PISA science test, 2006 (selected countries)



Source: OECD, PISA 2006, Volume 2, Data. Table 2.1a, p. 24

Second, public spending on education in most Latin American countries is on balance not pro-poor. To be sure, public spending on primary and secondary education is pro-poor or at least neutral, since most middle- and upper-class families opt out of the public system, sending their children instead to private primary and secondary schools. As Table 1 makes clear, the poorest 20 percent of the population receives 29 percent of the benefits of public spending on primary education. Public spending on secondary education is more evenly distributed, with 13 percent going to the poorest 20 percent of the population, and 18 percent going to the richest 20 percent.³¹

The major equity problem appears at the tertiary level, where governments tend to overspend so as to provide tuition-free higher education for all. Since the vast majority of students from poor families never reach the tertiary level, the result is a massive subsidy to the middle- and upper-classes. 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.

³¹ Only a small proportion of children from poor families manage to get much secondary education. For more discussion on this, see Perry (2006).

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. Working Paper WP/07/21, International Monetary Fund, Table 8, p. 24

These inequities are exacerbated by political dynamics that limit pressure for improvement. Because those with real power to influence schools (mostly middle- and upper-class parents) do not enroll their children in public primary or secondary schools, they escape the failings of the public system and do not become fully energized to press for change. The poor families who do use public schools have little information on how schools are doing, few mechanisms for influencing policy and no tradition of citizen activism. The result is a political vacuum that is filled by organized interest groups--principally teachers unions and university students--concerned with their own interests, and relatively successful in promoting them. The poor are left with third-rate educations in under-funded and poorly managed public primary schools.

Health. Public spending on health as a percent of GDP has increased since 1990, but by less than spending on education.³² On average, spending on health is moderately progressive in Latin America – the poorest fifth receives 24% of total health spending, while the richest fifth gets just 17%.³³ Since richer households often opt for private providers and public health services are largely used as a safety net for low income and poor people, however, it is surprising that public spending on health is not even more progressive.³⁴ Spending on primary care and preventive services appears to be largely pro-poor, whereas spending on hospital services is less so.³⁵

Over the past several decades, the region has made significant progress towards reducing child mortality, but an unacceptably high percentage of people, and especially among the poor, still die from preventable illnesses or health conditions.³⁶ As the Pan American Health Organization's *Health in the Americas* (p. 62) states "Neglected diseases—infectious, parasitic diseases that afflict millions of poor people in Latin America and the Caribbean—are a patent expression of

³² ECLAC (2007) p. 103

³³ ECLAC (2007) p. 143

³⁴ OECD (2008) p. 33

³⁵ ECLAC (2007) Table II.17 p. 144 shows that in Mexico the richest fifth receives 30% of public spending on hospitals, whereas the poorest fifth receives only 3%. In Peru, 24% of spending on MINSA hospitals benefits the richest fifth, and only 5% benefits the poorest fifth. Data for El Salvador and the Dominican Republic show that certain hospital care is progressive in both countries. According to the World Development Report 2004 (World Bank) p. 136 "The beneficiaries of ['free' public] hospitals are usually the non-poor in urban areas."

³⁶ See PAHO (2007) p. 14; 16; 62. "Included under the rubric of neglected diseases are intestinal helminthiasis, schistosomiasis, lymphatic filariasis, leptospirosis, leishmaniasis, cysticercosis, Chagas' disease, and onchocerciasis many... inexpensive medications, health promotion, and environmental sanitation could effectively control and eliminate them."

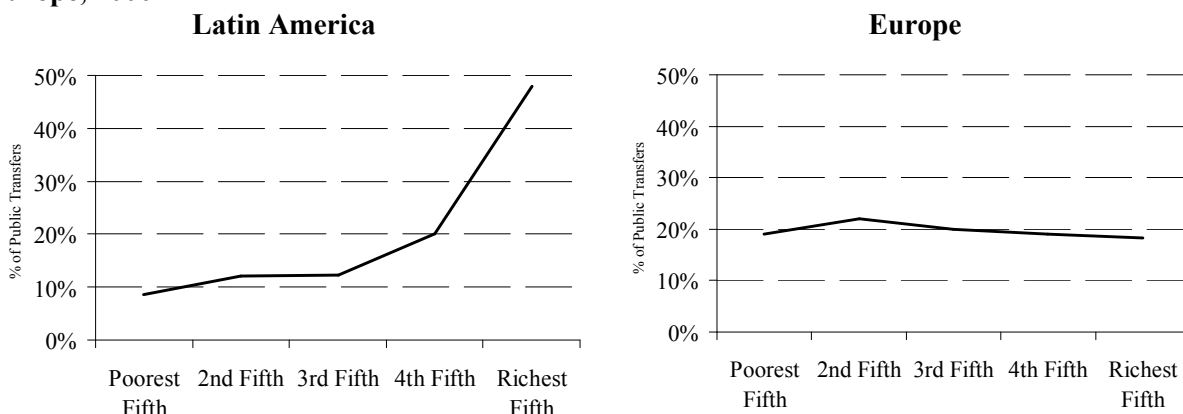
inequities in health.” Serious challenges remain in getting health services to reach rural and isolated areas throughout the region.³⁷

Redistributing wealth directly via transfers

Governments can directly redistribute wealth by transferring funds to the poor via insurance programs (such as pensions and unemployment insurance) and assistance programs (such as conditional cash transfers and school feeding programs). If large enough and properly targeted, these kinds of government spending can have an immediate impact on poverty and inequality.

Unfortunately, Latin America’s spending on transfers does not appear to be playing a strong redistributive role. Figure 12 compares the impact of public transfers on inequality in Latin America and the European OECD countries. In Latin America, the richest fifth of the population receives nearly half the benefits of public transfers, while the poorest fifth receives less than 10 percent. In Europe, the distribution is much more egalitarian: the richest and poorest fifths receive approximately the same proportion (just under 20 percent) of the benefits. Clearly, spending on public transfers in Latin America is largely regressive. Public monies flow overwhelmingly to the richest part of the population, and barely reach the region’s poorest citizens.

Figure 12: Share of Public Transfers Received by Different Income Groups, Latin America and Europe, 2006



Source: Goñi, E., J.H. López, and L. Servén, 2008, “Fiscal Redistribution and Income Inequality in Latin America.” Policy Research Working Paper 4487, World Bank, p. 19

Note: Authors’ estimates based on source graphs.

Why? Part of the problem is that public transfers in Latin America are not large, at least when compared with Europe. As a percentage of GDP, Latin America spends less than half what Europe spends on public transfers (Table 2). Since transfers are a much smaller part of GDP in Latin America, they might be expected to have a much smaller impact on poverty and inequality.

³⁷ ECLAC (2007) pp. 104;106-107. PAHO (2007) pp. 12 & 24 notes that in the Americas, around 100 million people lack access to health services because they live or work too far from facilities, or because they cannot afford to pay for health services.

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

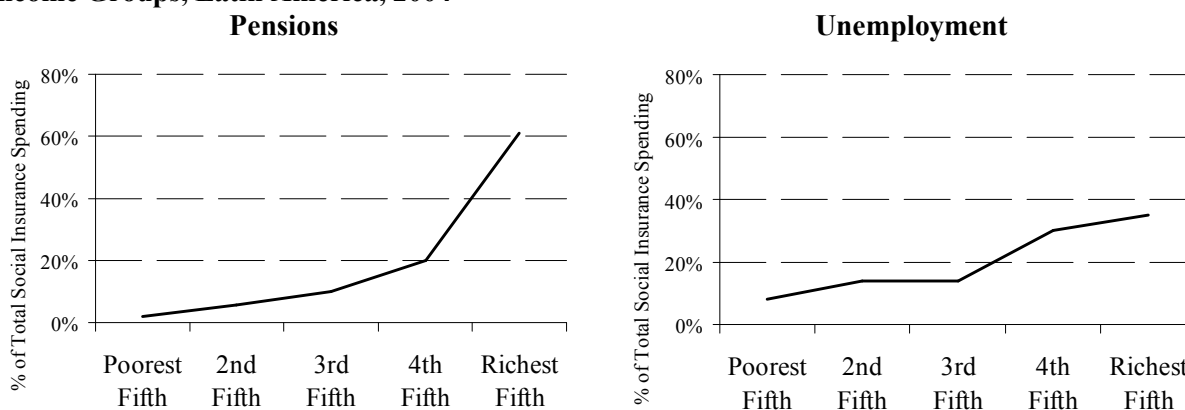
	Europe	Latin America
Transfers	16.3	5.7

Source: (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”. Social Protection Discussion Paper No. 0605, World Bank, p. 18; (b) Goñi, E., J.H. López, and L. Serven, 2008, “Fiscal Redistribution and Income Inequality in Latin America”. Policy Research Working Paper 4487, World Bank.

A more serious problem is that in Latin America 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 80 percent of spending on public transfers, and channeling very little of that money to the poor.³⁸ As Figure 13 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. Unemployment insurance is only slightly less regressive, with the richest 40 percent receiving approximately 65 percent of the benefits, and the poorest 40 percent receiving just 25 percent. Both programs are regressive because they largely exclude workers in the informal sector and in agriculture, who also tend to be the poorest. In some countries, public sector employees enjoy extraordinarily generous pension benefits that are funded principally by the government.³⁹

Figure 13: Share of Public Spending on Unemployment and Pensions Received by Different Income Groups, Latin America, 2004



Source: Goñi, E., J.H. López, and L. Serven, 2008, “Fiscal Redistribution and Income Inequality in Latin America.” Policy Research Working Paper 4487, World Bank, p. 20

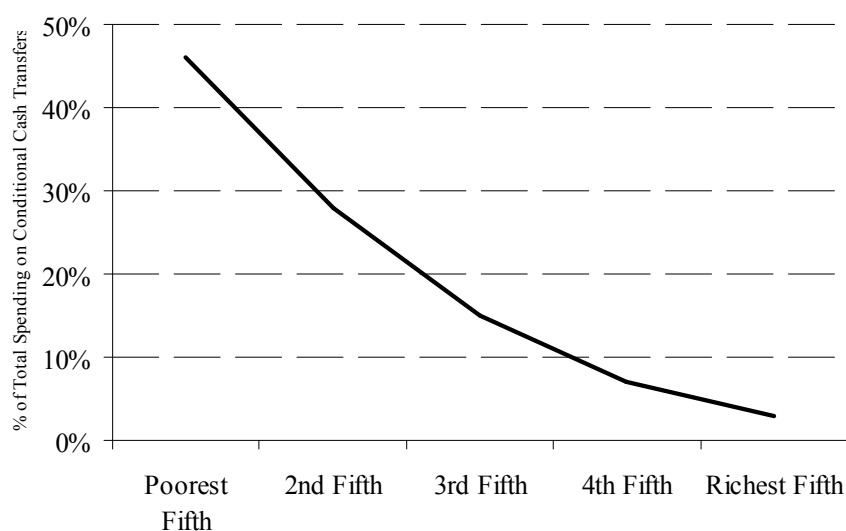
Note: Authors’ estimates based on graphs.

³⁸ Goñi et al. (2008) Table 5, p. 18 citing Lindert et al. (2006).

³⁹ According to Birdsall et al. (2008) p. 72-73 referring to World Bank (2005b) In Brazil, for example, nearly 4 percent of the country’s GDP goes toward making up the deficit in civil service pensions--which benefit just 13 percent of all pension recipients; According to Lindert et al (2006) in Peru, a select group of civil servants has access to a special pension system, the Cédula Viva, which is almost entirely funded from government revenues and is considerably more generous than the national pension system available to all workers.

By contrast, spending on social assistance programs, such as conditional cash transfers (e.g. *Bolsa Escola* in Brazil and *Oportunidades* in Mexico), is strongly progressive. As Figure 14 demonstrates, the poorest 40 percent receive 75 percent of the benefits of conditional cash transfer programs, while the richest 40 percent receive less than 10 percent. These programs, which have grown significantly over the past decade, clearly reach the poor. But despite their good reputation and high visibility, they account for only a small part of spending on public transfers—some 15 percent—compared with the 85 percent that goes to social insurance. Most governments do not give high budgetary priority to social assistance programs.

Figure 14: Share of Public Spending on Conditional Cash Transfers Received by Different Income Groups, Latin America, 2004



Source: Goñi, E., J.H. López, and L. Servén, 2008, Fiscal Redistribution and Income Inequality in Latin America. Policy Research Working Paper 4487, World Bank, p. 21

Note: Authors' estimates based on graphs.

Overall, Latin America is doing a poor job of using public transfers to directly redistribute wealth to the poor. The region spends a relatively small portion of its GDP on public transfers, and allocates most of those funds to programs that do not reach the poor. Public transfers are not playing a strong role in redistributing income in Latin America.

Conclusions and recommendations

Overall, fiscal policy is failing to redistribute wealth in most of Latin America. To be sure, many governments have sought to improve social services, significantly increasing their expenditures and experimenting with new programs. But these efforts—however substantial—appear to have had limited impact. Spending levels are moderate at best. Tax systems do little to shift the revenue burden from the poor to the rich. Public services that might enhance opportunities for the poor, such as education, are of such low quality as to have little impact. 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. This combination of inadequate funding, low quality and poor targeting has led most experts to conclude that fiscal policy is either neutral or regressive in Latin America—failing to redistribute wealth to the poor.

Making fiscal policy pro-poor will require policy changes that are major, extensive and often politically difficult. These include:

Revenues

- Increase revenues from direct personal and corporate income taxes by 1) eliminating loopholes and reducing exemptions; 2) strengthening the power and capacity of government tax collection agencies; and 3) increasing the penalties associated with evasion.
- Reduce dependence on payroll taxes, funding pension and health benefits instead from general revenues.
- Increase the benefits and reduce the cost and complexity of participating in the formal, regulated economy, so as to attract small and micro entrepreneurs currently in the informal sector.

Spending

Education

- Increase public funding for quality public and private pre-school programs that reach the poor.
- Increase public funding for public and private primary and secondary education, focusing specifically on the additional needs faced by poor students, and safeguard that investment with clear mechanisms to monitor how spending affects school performance.
- Shift the balance of public spending on education away from higher education and towards primary and secondary education by providing free tertiary education only to the poor and charging tuition on a sliding scale to those who can afford to pay.
- Set clear goals for what children should learn in reading and mathematics for every grade in primary school, test each child appropriately (at least once a year) and intervene early to ensure that every student achieves the standards.
- Regularly evaluate teacher performance, rewarding good performance with higher salaries and removing those who consistently underperform from the classroom.
- Develop strong school leaders capable of attending to the learning needs of a diverse student body, and give them adequate authority to shape the learning environments of the schools they oversee.

Health

- Expand and improve health education services for the poor, with an emphasis on primary care, preventive services and promoting healthy lifestyles.
- Systematically monitor, treat, and prevent neglected diseases that are more prevalent among disadvantaged populations.
- Set clear basic standards for health care treatment across public and private providers, and educate citizens regarding their rights as patients.

Transfers

- Establish social safety nets that automatically provide income support during economic hard times and automatically withdraw support when economic conditions improve.
- Significantly increase spending on social assistance programs, such as conditional cash transfers, so as to establish an income floor for chronically poor households.

- Eliminate separate public pension schemes for specific groups, combining them into a single, general pension system program that treats all pensioners equally.
- Increase coverage of social insurance programs (pensions, unemployment insurance) by making them available to all workers, formal or informal.

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