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Fiscal Redistribution and Income Inequality in Latin America

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Summary. — This paper documents and compares the redistributive performance of Latin American and Western European fiscal systems. Three main conclusions emerge: (i) taxes and transfers widen the difference in income inequality between the two country groups, because (ii) the redistributive impact of the fiscal system is very large in Europe and very small in Latin America; and (iii) where fiscal redistribution is significant, it is achieved mostly through transfers rather than taxes. While the priorities of pro-equity fiscal reforms vary across Latin American countries, overall the prospects for major fiscal redistribution lie mainly in raising the volume of resources available for transfers, and improving their targeting, rather than increasing the progressivity of Latin America's tax systems.

Key words — fiscal redistribution, income inequality, fiscal reform

1. INTRODUCTION

According to the World Bank's *World Development Report 2006*, Latin America ranks at the top among world regions in terms of inequality, second only to Sub Saharan Africa. Inequality in Latin America is pervasive—it extends to every aspect of life, from the distribution of income and assets, to access to education and health services, and political voice and influence.

High inequality is viewed by many as intrinsically bad on moral and ethical grounds. [1] But in addition high inequality can be a powerful drag on development and prosperity, for several reasons. First, for given average income levels, higher income inequality means higher poverty. And the magnitude of this effect is far from negligible: according to Perry, Arias, Lopez, Maloney, and Serven (2006), if Latin America had the levels of inequality found in developed countries, its current poverty rate would be halved. High poverty is not only a tragedy in itself but, as a rapidly expanding literature has argued, it can also be a source of underdevelopment traps in which financial market imperfections and institutional constraints prevent the poor from contributing to the growth process. [2] This in turn retards growth and makes poverty self-perpetuating. Indeed, the international evidence is consistent with this growth-deterring effect of poverty (e.g., Lopez & Serven, 2010).

Second, the other side of the coin is that high inequality also weakens the impact of aggregate income growth on poverty: the more unequal income distribution is, the faster the rate of growth required to achieve a given reduction in poverty. [3] Combined with the mechanism just described, the result is that inequality lies at the core of the vicious circles of stagnation and poverty in which many developing countries appear to be stuck.

Third, high inequality can also be a source of distributive conflict and social tension, which tend to undermine the legitimacy of policies and institutions as well as their stability, and in particular weaken property rights, thus discouraging investment and thereby growth. [4]

These considerations have brought social equity to center stage in the Latin American policy debate. Indeed, recent major contributions to that debate portray social equity as one, or even the, key organizing principle for the region's development strategy, and some retrospective assessments of Latin America's performance under the so-called 'Washington Consensus' of the 1990s blame the reforms' neglect of equity considerations for the region's limited achievements over the 1990s and 2000s. [5] On both counts, equity has become a central concern for development policy across the region, echoing the views of Latin American citizens, who overwhelmingly perceive the distribution of income as 'unfair' or 'very unfair' and believe that the state should take responsibility for reducing the gap between rich and poor. [6]

High income inequality usually reflects an unequal distribution of assets, such as land and human capital. Across countries, asset inequality and income inequality are closely associated—for example, the cross-country correlation between the Gini coefficients of the distribution of income and the distribution of human capital, as proxied by years of schooling, is above .75, while the correlation between the Gini indices of the distribution of income and the distribution of land is around .50 (de Ferranti *et al.,* 2004). And asset distribution is highly unequal in Latin America. For example, the Gini coefficient of the distribution of operational holdings of agricultural land is about .81 for Latin America (Deininger & Olinto, 2000), while in other world regions it hovers

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around .60; similarly, for the distribution of years of schooling, the Gini coefficient is .42 in Latin America, against .27 in industrial countries.[7]

But high inequality can also reflect the failure of fiscal policy to perform its redistributive function—one of Musgrave's (1959) three classic fiscal functions[8]—through appropriate use of taxes and transfers to correct socially-undesirable distributive outcomes arising from market forces, given the prevailing distribution of assets. The evidence shows that most industrial-country governments are highly effective at this redistributive function, but developing-country governments are not, and in fact they are often part of the problem rather than the solution.[9]

If inequality is above socially tolerable levels, as the survey evidence cited above suggests, in general policy action has to take a dual approach. On the one hand, it should target the deep roots of inequality, through interventions aiming to broaden asset ownership and equality of opportunity—for example, by expanding access to education and health. But this is likely to be a long-term process with much of the payoff accruing in the distant future. On the other hand, policy should ensure, through the necessary fiscal reforms, that the fiscal system performs its redistributive function effectively.

In this paper we document the redistributive performance of Latin American and Western European fiscal systems. Our use of internationally-comparable data on tax and transfer incidence allows us to adopt a comparative perspective that extends the literature in two dimensions. First, and perhaps the most novel result of this paper, we show that the biggest contrast between the two regions in terms of income inequality concerns the distributional impact of the tax and transfer system. In contrast with industrial countries, in most Latin American countries the fiscal system is of little help in reducing inequality. In other words, weak fiscal redistribution is what really sets Latin America apart in terms of income inequality. This is the combined result of two adverse factors. One is that transfers do help redistribution, but in general not much, especially if only cash transfers are considered. The other is that the scope for active fiscal redistribution is severely constrained by the region's low levels of tax collection, which (with a couple of exceptions) are well below the international norm—a fact that also underlies the shortcomings of Latin America's public sectors in the other classic functions of efficiency and stability.

Second, wherever there is significant fiscal redistribution, it is achieved through transfers—especially in-kind transfers—rather than taxes. This result is consistent with the conclusions of Harberger (2003) and, more recently, OECD (2008), and extends to other Latin American countries the earlier findings of Engel, Galetovic, and Raddatz (1999) for Chile. In addition, however, the paper's quantitative results show that the redistributive impact of transfers can be quite considerable, in contrast with Harberger's conclusion that they were at best moderately more potent than taxes in this regard. In effect, we find that transfers largely responsible for the wide disparity in income inequality between the European and Latin American countries were examined.

From the policy perspective, the finding that the redistributive role of the tax system is in fact relatively minor also means that distributional concerns should not dictate the choice between income tax and VAT-based strategies to raise revenue collection, even for policy makers mindful of equity concerns.

On the whole, the evidence we present shows ample room for enhancing the distributive performance of Latin America's fiscal systems through appropriate fiscal reform—with specific reform priorities determined by country circumstances. Our analysis is subject to some caveats, however. First, we focus on annual rather than lifetime income, thus neglecting intertemporal issues such as redistribution over the life-cycle. This may lead to overstating the level of inequality as well as the regressivity of indirect taxation (Fullerton & Rogers, 1993).

Second, we rely on standard incidence analysis, leaving aside incentive effects of fiscal interventions whose proper consideration would require a fully-specified general equilibrium model. Similarly, our discussion of the incidence of transfers on income inequality focuses on who benefits from spending on *average*, rather than *at the margin,* and thus we ignore possible systematic differences between average and marginal incidence—which could lead us to underestimate the redistributive impact of transfer increases. Third, our analysis only considers the impact of income and consumption taxes and ignores the distributive impact of other taxes (e.g., on international trade) that are relatively important in some Latin American countries (especially in Central America).

Fourth, our analysis is constrained by data limitations, particularly when broadening its focus to include also the distributive impact of indirect taxes and in-kind transfers. This requires combining data from different sources and, for some countries, different years. While we believe this is of little consequence for our qualitative conclusions, these data limitations may introduce some margin of error in the quantitative results. And fifth, our use of Western European countries as benchmark of comparison should also be taken as a reflection of data availability, rather than a normative statement about the desirability (or lack thereof) of the 'European model' as a specific choice between redistributive activism and efficiency costs. Related to this, we do not discuss the political economy barriers, institutional constraints and implementation challenges that Latin American countries would have to overcome should they wish to expand significantly the role of taxes and/or transfers as redistributive vehicles.[10]

The rest of the paper is structured as follows. In Section 2, we compare the distributional impact of taxes and transfers in Latin America and in Western Europe. Section 3 explores in detail why Latin America's fiscal policy is largely ineffective at reducing income inequality. Finally, Section 4 closes with some concluding thoughts.

2. INCOME INEQUALITY AND FISCAL REDISTRIBUTION IN LATIN AMERICA

The centerpiece of our analysis is an assessment of the redistributive performance of Latin America's fiscal systems. For this purpose, we document the facts concerning income inequality across Latin America before and after various fiscal interventions. We use a comparative perspective putting side by side the experience of two groups of countries from Latin America and Western Europe.

The country sample we use for this analysis is determined by the availability of suitable income distribution data. It comprises the six largest Latin American economies,[11] which together account for 75% of the region's population and over 80% of its 2008 GDP, and up to 15 countries from Western Europe. However, not all of the latter countries possess complete information, and, therefore, some of the cross-regional comparisons presented below cover a smaller group of European economies. The Appendix describes in detail the data sources.