

Inequality and redistribution: taxes and transfers

International Policy Centre for Inclusive Growth (IPC-IG) and HelpAge International

When it comes to income distribution, the most unequal region in the world is Latin America and the Caribbean—significantly more unequal than other developing regions, on average. Although it has experienced a significant decrease in the level of inequality over the past decade, recent data show a possible slowing down of this progress, associated with the waning economic boom of the last decades, combined with higher fiscal constraints and a rise in public debt. The webinar ‘Inequality and Redistribution: Taxes and Transfers’ explored and highlighted possible solutions for reducing inequality in the region, evaluating the effects of fiscal policies on income distribution.

Michael Hanni emphasised that, in general, studies based on data from Member States of the Organisation for Economic Co-operation and Development (OECD) show that direct taxes and monetary transfers are successful mechanisms to decrease inequality. However, in some Latin American countries, fiscal policies have relatively little impact on income inequality. Mr. Hanni showed that the redistributive impact of personal income taxes in Latin America is close to nil, with a negligible reduction in the Gini index and a small average effective tax rate, which, according to him, are indicative of structural weaknesses in the tax systems of the region. Comparing this effective tax rate to the average rate of European Union Member States reveals the substantially higher effective rates of the latter and better outcomes in terms of reducing inequalities.

In light of these findings, Mr. Hanni simulated different scenarios to investigate the possible consequences of more robust personal income taxes in the region. All results were very suggestive of the redistributive potential of income taxes, and pointed out a third scenario, considering a standardised personal tax based on gross domestic product (GDP) per capita and using the same marginal tax rates for all countries. This scenario, even allowing for a high level of tax evasion, was still able to increase the redistributive effect of tax rates significantly from a relatively low baseline. His second and more refined simulation analysed the potential gains in inequality reduction resulting from using stronger personal income tax to finance monetary transfers. These findings point towards tax reforms having some wiggle room to achieve meaningful improvements in inequality reduction outcomes.

Over the past few years, a number of major structural tax reforms have incorporated inequality reduction as a core component, most notably in Chile and Mexico. These reforms were often bundled with specific public spending plans and commitments to the provision of public services and social protection. Additionally, there is a growing recognition of the need to form a strong fiscal pact in the region, embracing reciprocity between citizens and the government, entailing higher taxes for higher-quality public service provision.

For Rodrigo Orair, it is a difficult task to establish this reciprocity in Latin America. According to him, this scenario is confounded by the apparent fact that the relative burden of financing benefits very often is placed on poor people. On the one hand, poor people benefit almost exclusively from cash transfer programmes and services, to which they contribute through indirect taxes. The benefit uptake for rich people is virtually non-existent, with a very small tax burden and no use of public services. Meanwhile, middle-class taxpayers, who bear the largest portion of the tax burden, are not able to benefit from public services of adequate quality. The resulting dynamic distances middle- and upper-income classes from public assistance programmes, and discourages greater investment from the State into the social protection system for vulnerable populations.

Mr. Hanni finds a relatively greater impact on the provision of basic services such as health and education compared to other fiscal policies. After the few lowest income deciles, many individuals opt out of public services, especially education. This presents a significant challenge for the region: how can policymakers foster the necessary reciprocity to design, finance and sustain robust social protection systems, when so many people opt out of public services? How can taxpayers be persuaded to invest in social protection systems to deliver services from which they will willingly benefit? Mr. Orair also highlights that, even if the proportion of income and GDP were taxed at rates comparable to OECD member countries, it is questionable whether the same quality of public services and amount of resources per capita could be achieved.

There are no easy solutions to inequality, and the redistributive power of fiscal policies remains limited. However, according to Mr. Hanni, simulations show that there is considerable room to increase the efficacy of these instruments. Improving the quality of public services, especially when demand increases during economic downturns, is a key area of concern. For Mr. Orair, the discussion around fiscal adjustments and the role of fiscal policies goes beyond the region of Latin America and the Caribbean and must carefully consider how to achieve gains without saddling poor people with higher fiscal burdens.

References:

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