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Designing a Fairer Form of Fiscal Consolidation in Latin America

Schoolchildren in Montevideo: Government spending on education and healthcare is reducing income inequality in the region, with particularly strong outcomes in countries like Uruguay (photo: Joerg Boethling/Alamy)

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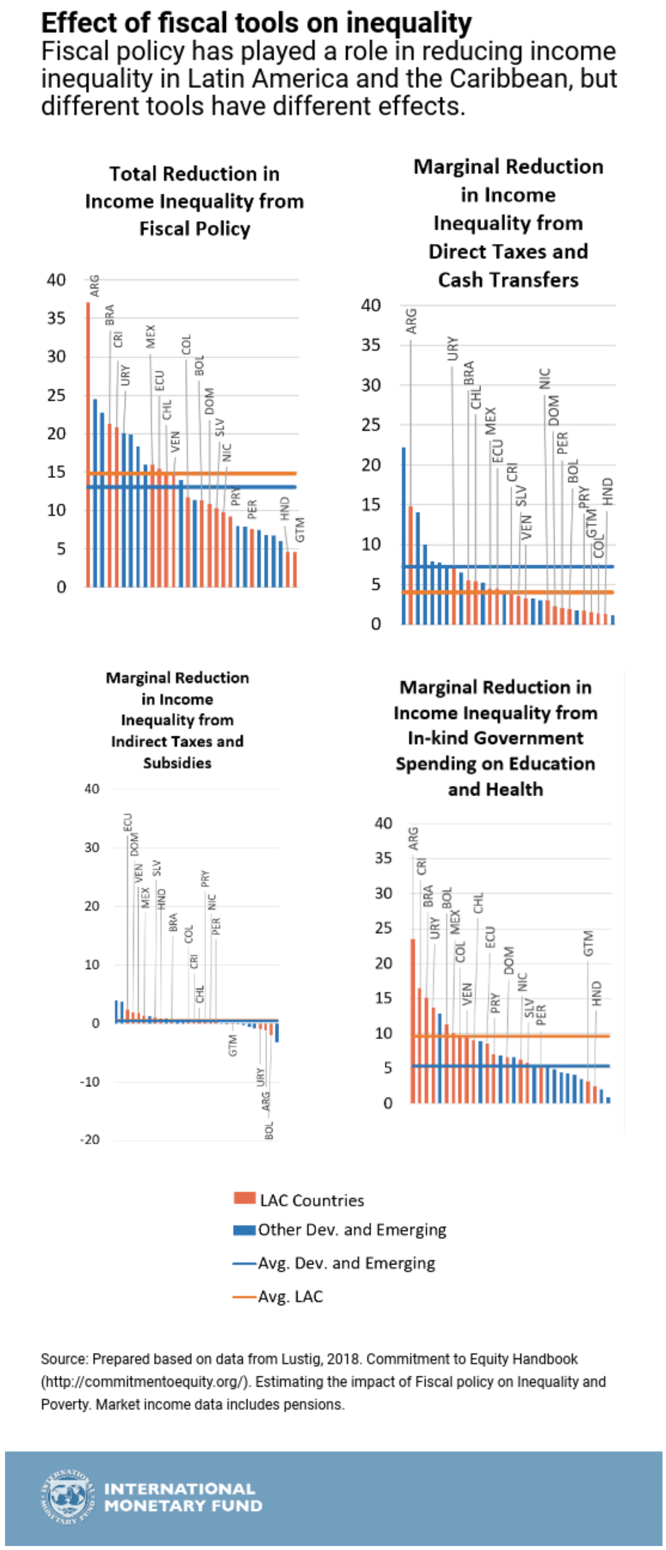
With growth expected to gain momentum in 2018, it is time for countries in Latin America and the Caribbean to focus on building their fiscal cushions, which have deteriorated in recent years as the end of the commodity super-cycle and other factors led to a sharp fall in revenues.

Our latest Regional Economic Outlook: Western Hemisphere suggests that fiscal consolidation is now needed in most countries to contain the growth in public debt. However, as the region is expected to post only modest growth rates in the coming years, the key challenge will be how to design fiscal policies in a way that allows countries to preserve the recent gains made toward income equality.

The region has indeed made significant progress to reduce income inequality since the start of the millennium as compared to most other regions, where inequality is now worse than it was in 2000. These gains have been widespread within the region but are more pronounced for South America's large commodity exporters, with much of the broader progress reflecting higher incomes of lower-skilled workers, especially in services (IMF, REO 2018).

Fiscal policy has played an important role in reducing income inequality in Latin America and the Caribbean—albeit less so than in more advanced economies. Overall, fiscal policy is estimated to reduce income inequality by an average of about 15 percent across the region's countries, as its taxation and spending tools redistribute income towards those worse off (Chart 1). While this compares favorably to other emerging markets, the bulk of the impact of fiscal policy on income inequality in the region comes from spending on health and education, not from traditional fiscal instruments like taxation or transfers.

Our findings reveal the following:



- *Fiscal instruments with a direct effect on income (personal income taxes, cash transfers, pensions) have limited redistributive power*: they reduce income inequality by only 4 percent, compared to 8 percent in other emerging markets and 35 percent in advanced economies.

- *Fiscal instruments with an indirect income effect (taxes on goods and services, and indirect transfers like price subsidies or tax exemptions) have virtually no redistributive power in Latin America and the Caribbean*. In many of the region's countries, these fiscal policies are actually regressive as they are composed of targeted price subsidies on things like energy, which disproportionately benefit higher income groups.

- *Government spending on education and healthcare are reducing income inequality in in the region more than taxation and transfers.* This spending benefits the poor proportionately more than those who are better off and reduces income inequality by about 10 percent—about twice as much as in other emerging markets. That said, this is due to particularly strong outcomes in certain countries such as Argentina, Costa Rica, Brazil, and Uruguay, where this type of social spending has proved particularly progressive.

Why Latin America is different

Why are the region's tax systems and the main safety nets less effective in dampening income inequality than similar systems elsewhere? One reason is that their redistributive power reflects not only the progressivity of the fiscal instruments, but also their magnitude.

For example, revenues from personal income taxes, which tend to be more progressive than other types of taxation (IMF 2014), are lower in in Latin America and the Caribbean compared to other regions. This is because the region's relatively high personal income tax rates are effectively eroded by large tax incentives and exemptions as well as the informal economy, all of which narrow the region's tax bases.

In addition to the composition of taxes, the strongly progressive spending on health and education in some countries is rendered less effective due to the relatively limited size of such spending.

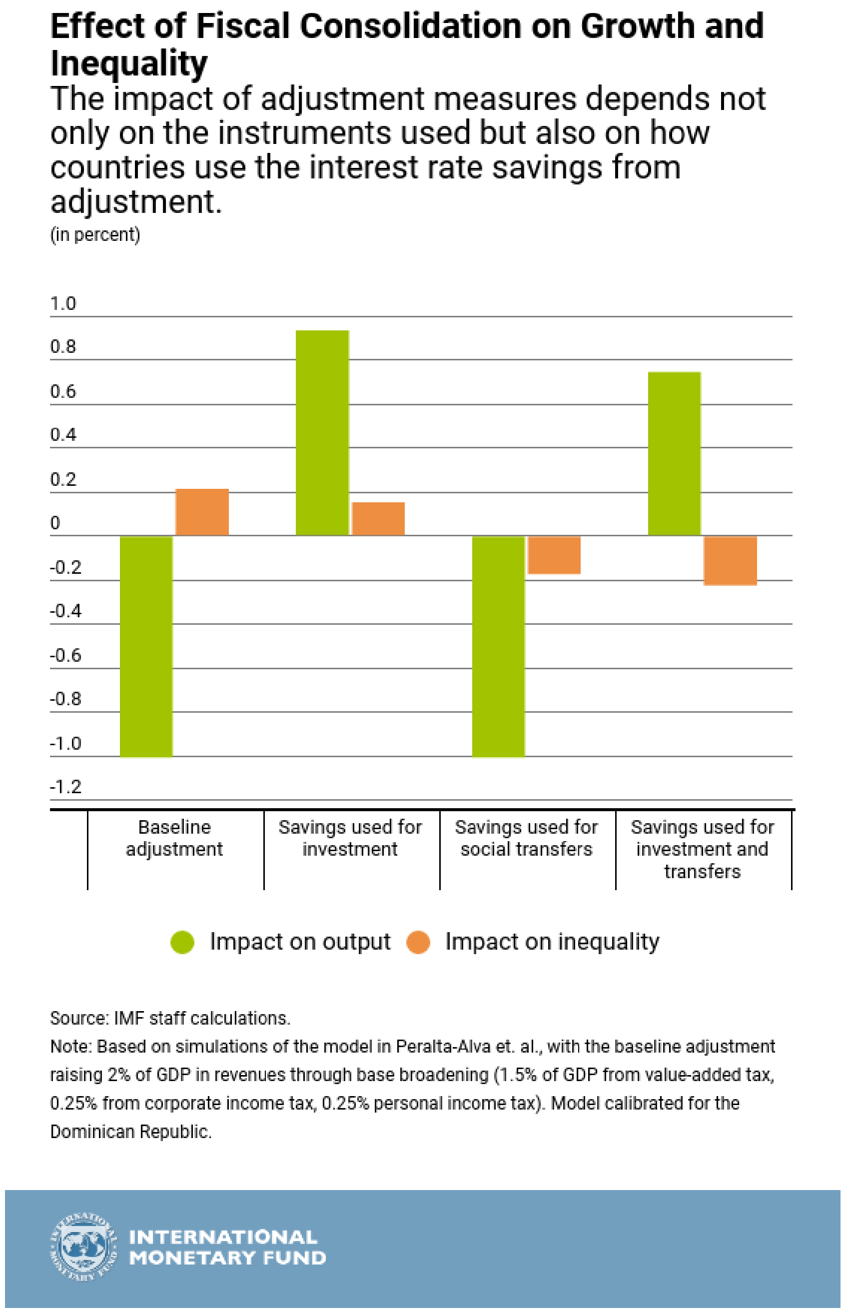
Finally, the large share of nondiscretionary spending in some countries (for example on interest payments) also limits the redistributive power of the region's fiscal policy by reducing the scope for social spending.

Designing fiscal adjustment in the region

What, then, is the appropriate composition of fiscal adjustment to support growth and social objectives in Latin America and the Caribbean? IMF staff have been studying this issue more intensively (IMF 2017). Their findings have helped to deepen and inform Article IV consultations and policy recommendations in such countries as the

Dominican Republic, Guatemala, Honduras, and Bolivia. While there is no one-size-fits-all strategy, the following findings apply to most cases:

- Focusing any efforts to mobilize revenues on increasing the *progressivity* of taxes, by scaling back tax exemptions, avoiding preferential treatments and combating tax evasion and avoidance, especially for higher-income households, will enhance the redistributive power of fiscal policies.
- Increasing reliance on direct taxes, which are progressive, in some cases through a decrease in thresholds to bring more high-income households into the tax net, would help widen the tax base with little distributional costs.
- The economic impact of adjustment measures depends not only on the specific instruments used, but also on how countries use the interest rate savings from adjustment. Investment spending is an efficient instrument to achieve a significant pickup in growth, but it may not contribute meaningfully to a better redistribution of income. Social transfers, on the other hand, may contribute less to improved growth outcomes but are very potent at reducing inequality. An overall package that combines both infrastructure increases and social transfers could therefore be optimal in terms of ensuring beneficial growth and social effects over the medium term (Chart 2 shows an illustration of these effects).



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[The Macroeconomic and Distributional Implications of Fiscal Consolidations in Low-Income Countries]() by Adrian Peralta-Alva, Marina M. Taveres, Xuan S. Tam and Xin Tang.

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