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FISCAL REDISTRIBUTION TO COMBAT INEQUALITY AND POVERTY IN LOW AND MIDDLE INCOME COUNTRIES[1]

by Nora Lustig[2]

This brief argues:

- Governments should design their tax and transfers system so that the poor do not end up as net payers.
- Efficient regressive taxes when combined with well-targeted transfers can result in a net fiscal system that is equalizing.
- To assess the impact of the fiscal system on people's standard of living, the effect of taxation and spending must be measured not only on inequality but also on poverty

Introduction

The current policy discussion (and literature) on fiscal redistribution in low and middle income countries focuses primarily on the power of fiscal policy to reduce inequality, and much less (often not at all) on the impact of fiscal policy on the standard of living of the poor. Yet, results for twenty-eight low and middle income countries reveal that, although fiscal systems are always equalizing, they often reduce the actual consumption of private goods on the part of the poor. If the policy community is seriously committed to eradicating income poverty, governments will need to explore ways to redesign taxation and transfers so that the poor—especially the ultra and extreme poor—do not end up as net payers. This could become an overriding principle in the design of fiscal systems that could be explicitly added to the frameworks proposed by Atkinson[3] and Stiglitz[4] to build more equitable societies.

Background

In a recent paper, I summarized the results of applying comparable fiscal incidence analysis to twenty-eight low and middle income countries for the time period around 2010. These studies are part of the Commitment to Equity Institute studies at Tulane University.[5] Using the World Bank classification, the group included three *low income* countries: Ethiopia, Tanzania and Uganda; ten *lower middle income* countries: Armenia, Bolivia, El Salvador, Ghana, Guatemala, Honduras, Indonesia, Nicaragua, Sri Lanka and Tunisia; twelve *upper middle income* countries: Brazil, Colombia, Costa Rica, Dominican Republic, Ecuador, Georgia, Iran, Jordan, Mexico, Peru, Russia and South Africa; two *high income* countries: Chile and Uruguay; one unclassified (probably upper middle income): Argentina; and, one advanced economy: the United States.[6] The fiscal policy instruments included in the study were: personal income and payroll taxes, direct transfers, consumption taxes, consumption subsidies and in-kind transfers (in the form of education and healthcare services).

Analysis

While fiscal policy unambiguously reduces income inequality, the same is not always true for poverty. In order to analyze the impact of fiscal policy on income inequality it is useful to separate the "cash" portion of the system (direct taxes, direct transfers, indirect taxes, and indirect subsidies) from the in-kind portion (the monetized value of the use of government education and health services). The results show that the reduction in inequality induced by the cash portion of the fiscal system is quite heterogeneous. Redistributive success is primarily and broadly determined by the amount of available resources and their combined progressivity. Net direct taxes are always equalizing. The latter is not surprising. The effect of net indirect taxes is also equalizing in nineteen of the twenty-eight countries. This result is more surprising.

While the cash portion of the net fiscal system is always equalizing, the same cannot be said for poverty. The results indicate that the ultra-poor in Ghana, Nicaragua and Tanzania, the extreme poor in Armenia, Ethiopia and Guatemala, and the moderate poor in Sri Lanka, Peru, El Salvador, Dominican Republic, Honduras and Bolivia, are net payers into the fiscal system. In the case of Brazil, the cause is the high consumption taxes paid on staple goods. In the case of Peru, cash transfers are too small to compensate for what the poor pay in taxes. Furthermore, as shown in Higgins and Lustig[7], fiscal impoverishment can be quite pervasive and, in low income countries, larger in magnitude than fiscal gains to the poor. In Armenia, Bolivia, Ethiopia, Ghana, Guatemala, Honduras, Nicaragua, Tanzania and Sri Lanka, the headcount ratio measured according to the international extreme poverty line of US$2.50 (PPP 2005 per day) is higher for consumable income (income after net direct and net indirect taxes) than for market income. In these countries, fiscal policy *increases* poverty, meaning that a significant number of the market income poor (non-poor) are made poorer (poor) by taxes and transfers.[8] This startling result is primarily the consequence of high consumption taxes on basic goods.

Turning now to the in-kind portion of the fiscal system, spending on education and health is equalizing, and its contribution to the reduction in inequality is rather large. This result is not surprising given that the use of government services is monetized at a value equal to average government cost. While the results concerning the distribution of the benefits of in-kind services in education and health are encouraging from the equity point of view, it is important to note that they may be due to factors one would prefer to avoid. The more intensive use of services in education and health on the part of the poorer portions of the population, for example, may be caused by the fact that, in their quest for quality, the middle classes (and, of course, the rich) chose to use private providers. This situation leaves the poor with what may be access to second-rate services. Furthermore, if the middle classes opt out of public services, they may be much more reluctant to pay the taxes needed to improve both the coverage and quality of services than they would be if services were used universally.

Conclusion

There are a few lessons that emerge from the analysis. Let us start with those pertaining to the diagnostic of fiscal redistribution. First, the fact that specific fiscal interventions can have countervailing effects underscores the importance of taking a coordinated view of both taxation and spending rather than pursuing a piecemeal analysis. Efficient regressive taxes (such as the value added tax), when combined with generous well-targeted transfers, can result in a net fiscal system that is equalizing. Second, to assess the impact of the fiscal system on people's standard of living, it is crucial to measure the effect of taxation and spending not only on inequality but also on poverty: as the country studies show, the net fiscal system can be equalizing but poverty-increasing.

Regarding policy prescriptions, one fundamental lesson emerges: governments should design their tax and transfers system so that the after taxes and transfers incomes (or consumption) of the poor are not lower than their incomes (or consumption) before fiscal interventions. Leaving out in-kind transfers, the so-called cash portion of the fiscal system should not impoverish the poor (or make the non-poor poor).

About the Author

Nora Lustig[9] is Samuel Z. Stone Professor of Latin American Economics and Director of the Commitment to Equity Institute (CEQ) at Tulane University. She is also non-resident senior fellow of the Center for Global Development and the Inter-American Dialogue, and non-resident senior research fellow at UNU-WIDER.

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Notes

1 Based on Nora Lustig "Fiscal Policy, Income Redistribution and Poverty Reduction in Low and Middle Income Countries." Chapter 9 in Nora Lustig (editor) Commitment to Equity Handbook. A Guide to Estimating the Impact of Fiscal Policy on Inequality and Poverty. Brookings Institution Press, 2016. On-line version ***http://www.commitmentoequity.org/publications/handbook.php***. This research has been possible thanks to the generous support of the Bill & Melinda Gates Foundation.

2 The author is very grateful to Xavi Recchi for excellent research assistantship.

3 Atkinson (2015).

4 Stiglitz (2012).

5 For more information, visit ***www.commitmentoequity.org***

6 The World Bank classifies countries as follows. Low income: US$1,025 or less; lower middle income: US$1,026-4,035; upper middle income: US$4,036-12,475; and high income: US$12,476 or more. The classification uses Gross National Income per capita calculated with the World Bank Atlas Method, September 2016: ***http://data.worldbank.org/about/country-and-lending-groups***

7 Higgins and Lustig (2016).

8 Higgins and Lustig (2016).

9 ***http://www.noralustig.org/***

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CROP Secretariat

P.O. Box 7800
N - 5020 Bergen - NORWAY
Visiting address: Jekteviksbakken 31

Phone: +47 555-89744 / -89703
eMail: crop@uib.no
Website: www.crop.org

Editor: Etienne Nel
Co-editor: Enrique Delamónica
Coordinator: Inge Tesdal

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