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REDISTRIBUTING INCOME TO THE POOR AND THE RICH: PUBLIC TRANSFERS IN LATIN AMERICA AND THE CARIBBEAN

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A recent regional study by the World Bank¹ measures the extent to which publicly-subsidized transfers in Latin America and the Caribbean (LAC) redistribute income. Four factors motivate our interest in this topic: poverty, inequality, perceptions of social injustice in LAC, and the significant share of public resources devoted to these transfers in several countries in the region. Clearly, social policy has other important objectives besides redistribution, including (a) smoothing of income over the life cycle in relation to people's needs; (b) promoting the accumulation of human capital; and (c) ensuring adequate protection against events such as sickness, disability, unemployment, or loss of income. These themes, however, are beyond the scope of this report, which modestly asks: "how redistributive are public transfers in Latin America and the Caribbean (LAC)?"

While there are few doubts about the importance of growth for poverty reduction, growth in LAC has been slow over the past decade, and, barring a few exceptions, existing growth has benefited the poor less than proportionally.² Growth associated with progressive distributional changes will have a greater impact in reducing poverty than without such changes. Moreover, recent evidence suggests that poverty itself may be impeding higher growth rates in LAC. While investments in access to productive assets – such as education, land, property rights and infrastructure – can reduce poverty and inequality in the long run, asset-based strategies take time to implement and improve welfare.³

What about the role of public transfers? Can they promote equity faster and in an efficient manner? How much redistribu-

tion can they achieve? How well do they perform? Do they reduce LAC's high inequality – or exacerbate it? How much do poor people benefit from these transfers? This study analyzes precisely these questions.



Our findings suggest that public transfers *can* be effective instruments to redistribute income to the poor. But they have not often done so. Indeed, Robin Hood works in both directions in LAC, with public transfers redistributing income to both the rich and the poor.

Public Spending on Transfers

Overall, public spending on transfers represents about 5.7% of GDP in LAC. About three quarters of this spending (4.3% of GDP) finance public insurance benefits, with the remainder (1.4%) allocated to social assistance transfers. Although some would object to the treatment of social insurance (e.g., pensions, unemployment insurance) as "transfers" because they are (partially) financed by direct ear-marked contributions, most social insurance programs in LAC incur significant deficits which are financed from general revenues. As such, our study "nets out" average payroll contributions, so as to allow us to assess the redistributive impact of the "pure" public transfer from social insurance (the part financed by general revenues not direct contributions).

Within the region, there is considerable variation in overall spending and the composition of transfer instruments. Some "higher spenders" – such as Argentina, Brazil, Chile and Colombia – devote significant resources (averaging 11.5% of GDP) to social protection transfers. The bulk of this spending

is allocated to social insurance, though these countries also operate fairly sophisticated cash-based social assistance transfer schemes. At the other end of the spectrum, most Central American and Caribbean countries allocate relatively little to social protection transfers (averaging 1.9% of GDP), most of which goes mainly to in-kind social assistance transfers.

Redistributive Impact of Public Transfers

The redistributive power of 56 transfers in eight countries – Argentina, Brazil, Chile, Colombia, the Dominican Republic, Guatemala, Mexico, and Peru – is measured using household survey data by their coverage, size, absolute incidence, simulated impacts on poverty and inequality, and by their distributional characteristic, a statistic derived from taxation literature. The findings are summarized for social insurance and social assistance as follows.

social insurance transfers are regressive in all countries in our sample – and in some cases, so regressive that they exacerbate inequality.

Regressivity applies to net social insurance transfers, which are subsidized by government budgets at the expense of all taxpayers. Our analysis focuses on the incidence of net transfers for pensions – subtracting the share of benefits financed by direct contributions. The basic premise for this is that these “net pension subsidies” compete for tax-financed resources with social assistance and other forms of social spending, with very different redistributive patterns. Moreover, the regressivity of net social insurance transfers has not been helped by any significant degree of progressivity in tax financing. Rather, these deficit-ridden and largely truncated social insurance schemes seem to have created a “Reverse Robin Hood” situation of taking from the poor and redistributing to the rich, thereby exacerbating LAC’s high inequalities.

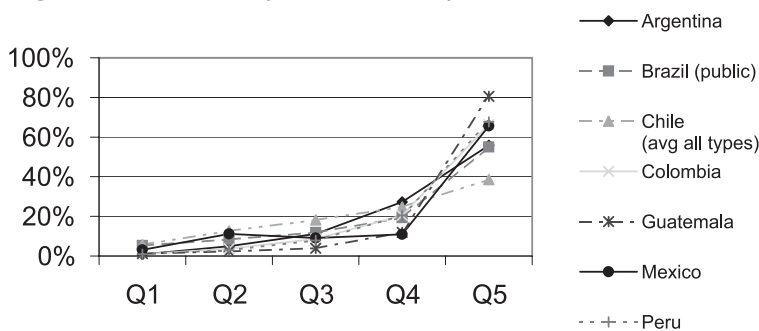
The magnitude of these tax-financed social insurance benefits is huge. Net pension subsidies absorb about 5% of GDP in the higher spending countries, far higher than spending on social assistance, and higher than average public spending on education and health in these countries. Important opportunity costs indeed. The concern, then, is one of equity, efficiency and fiscal sustainability.

The more recent emergence of social assistance only partially offsets this truncation of the welfare state in LAC. True: coverage of the poor can be impressive in some instances. True: absolute incidence is progressive overall, and highly progressive for certain types of social assistance programs (Figure 2). However,

overall spending is low in many countries and unit subsidies are very small, thus muting the redistributive, poverty and inequality impacts of even the most targeted programs.⁴ As such, broad coverage of social assistance has not fully compensated for significant biases in the far more generous (net) social insurance subsidies to the rich.

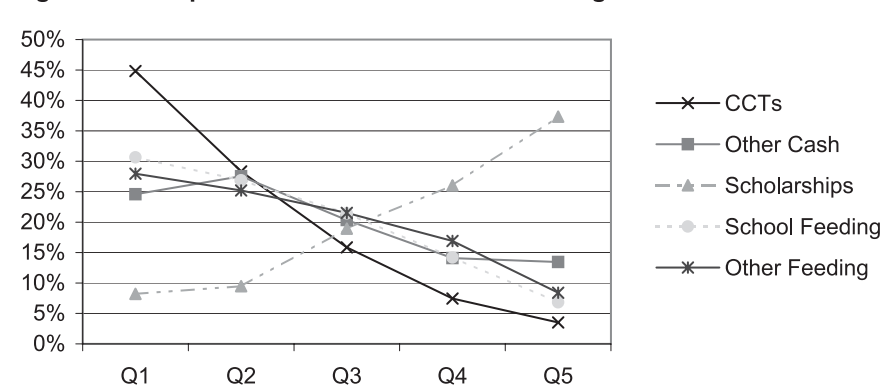
There is considerable variation in redistributive impacts within the class of social assistance transfers. Too many are

Figure 1 - Pensions (Net Subsidies)



The redistributive impacts of social insurance transfers are limited – and even regressive in most instances. Our findings quantify the degree to which Latin America’s “elite” captures public subsidies to existing social insurance schemes. Specifically, those in the top quintile of the population receive about 60% of net social insurance transfers (Figure 1). This regressivity derives from two main “design” factors: a truncation in coverage and relatively generous unit benefits for those in the top quintile (Q5 in the Figures). The persistence of a historical “truncation” thwarts coverage of the poor by design. Specifically, a defining characteristic of social insurance programs in LAC is that they tie eligibility to membership in the formal labor market – which hampers coverage of the poor, who are largely employed in the informal sector. Our analysis confirms this truncation in practice. Moreover, social insurance transfers are typically far more generous (a) for recipients in the upper quintiles; and (b) than social assistance programs – even when contributions have been netted out. As a result of this truncation in coverage and these biases in the generosity of benefits,

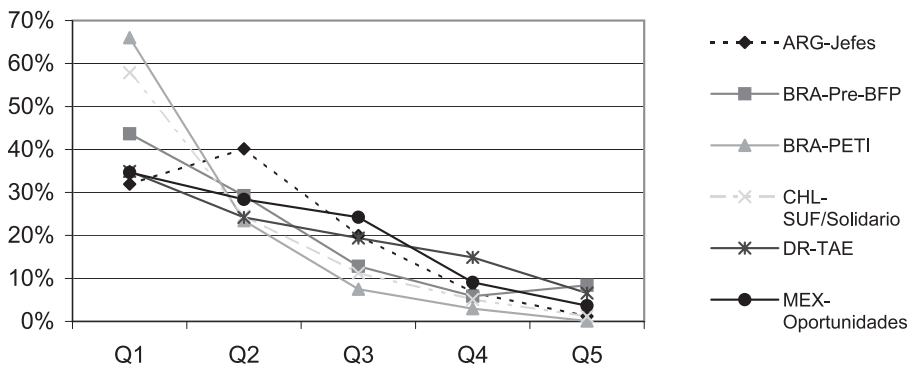
Figure 2 - Comparison of SA Instruments: Strong Performance of CCTs



regressive. These include scholarships and many food-based programs. Governments should reconsider these programs – or at least strengthen their design. They could look to the targeting mechanisms used by conditional cash transfers

protection in LAC – arming them with additional evidence on redistributive impacts, namely:

Figure 3 - Conditional Cash Transfers



(CCTs) – with impressive rewards (Figure 3). The relatively high progressivity of CCTs is likely driven by a clear definition of the poor as the target group and the explicit use of targeting mechanisms to determine eligibility, and not on their conditionalities *per se*. Such design mechanisms could be built into other social assistance programs, for example using a combination of geographic targeting and individual assessment mechanisms to target needs-based scholarships.

“Quo Vadis Latin America?”⁵ Given these findings – and recent trends in LAC – what is the future trajectory for LAC? Importantly, how will LAC’s democracies reconcile the competing forces of: (a) widespread perceptions of dissatisfaction with the social injustice of LAC’s high poverty and inequality (similar to those in Europe) – which, as our paper shows, is often exacerbated by the regressivity of many public transfers (each with their own vested interests); (b) high and growing fiscal pressures, exacerbated by high pensions deficits; and (c) a persistently informal labor market (to a degree far higher than in Europe)?

Barrientos (2004) suggests that one trajectory for LAC is in the direction of more “liberal welfare regimes” (like the United States), with increasing reliance on market welfare production combined with finely-targeted social assistance. On the other hand, there has been considerable debate in several countries (Argentina, Brazil, Uruguay) about an alternative path, towards “minimum universal income” schemes – more along the lines of those in Europe.⁶ Given the need for large fiscal resources to assure such universal minimums, such a scheme would require an overhaul of the welfare state and significant reallocations – perhaps from the existing grossly inefficient and regressive social insurance schemes.

Recognizing that redistribution is only one of many roles for social policy, the findings of this report reinforce the recommendations commonly made in the literature on social

- Reducing pension deficits – and rethinking some highly-regressive social insurance programs – must be a top priority on the policy agendas in LAC. These findings are consistent with recommendations for social insurance from other World Bank publications,⁷ emphasizing: (a) the need to reduce regressive net subsidies for pensions by promoting fully-funded pension plans for those who can afford it (pillar 2 reforms) and (b) reserving subsidized pensions for the poor (better targeting of pillar 1) and moving away from the restriction of such benefits tied to formal sector employment.

- Improving the targeting of social assistance transfers is also a priority in many cases – at least as a short-term measure, short of a more sweeping overhaul of social policy. As noted above, many social assistance transfers are regressive, despite explicit objectives to assist the poor. Yet this study – and others⁸ – clearly shows that better targeting is feasible. The targeting mechanisms used by conditional cash transfers, for example, could be adopted by other social assistance programs.
- In cases where social assistance programs are well-targeted and otherwise effective, countries might also consider the possibility of increasing unit subsidies for better redistributive and poverty impacts – perhaps with eventual savings from further reforms to reduce pension deficits. Yet this raises the issue of potential adverse incentive effects. Although evidence of strong labor disincentives is absent for these programs in LAC, and certain design features would plausibly discourage such effects, policy makers in LAC should more explicitly incorporate design features to reduce potential work disincentives – and researchers should further investigate this potential. Moreover, any potential increase in unit transfers should be weighed against other development priorities.
- But targeting and design improvements to individual social assistance programs are not enough. An adequate mix of instruments is needed to weave a social safety net that (a) promotes other roles of social policy (promotion of human capital, smoothing consumption, and ensuring adequate protection against shocks, in addition to redistribution); and (b) covers a variety of circumstances, including programs tailored to the needs of specific vulnerable groups.

However, while simple arithmetic suggests that lower spending on social insurance leaves more room in the government

budget for spending on better targeted social assistance programs, serious consideration needs to be given to the political feasibility and sustainability of such reallocations. Although it is beyond the scope of this paper to explore the underlying forces – political, economic and demographic – behind the existing spending biases, there is clearly some barrier to lowering social insurance transfers (even where they are highly inequitable) and raising social assistance transfers (even where they are progressive) in many countries in LAC. Economic and demographic factors may come into play – as evidenced by the rise in social insurance transfers as a share of GDP with per capita incomes (greater scope for risk pooling with higher incomes) and aging populations – a pattern that is not mirrored for social assistance. Some barriers likely arise from the different political constituencies served by these two classes of transfers, and the vested interests of more organized formal sector workers.

Another possible factor is the possible perceived “legitimacy” conferred on social insurance programs by the fact that they link benefits to contributions (even if only partially).⁹ Even though they are highly regressive and financed to a large part by general tax revenues, social insurance schemes may claim more legitimacy because societies perceive them as “rightfully earned” through contributions.

Perceptions of “legitimacy” could also explain – at least in part — the emerging popularity of conditional cash transfers, whereby societies perceive that the fact that beneficiaries have to comply with a set of “co-responsibilities” (human capital conditionalities) bestows a greater degree of legitimacy on these transfers than pure cash or in-kind handouts. Indeed, conditional cash transfers are promising not only for their redistributive impacts, but also for their demonstrated impacts on human capital and their ability to break the inter-generational transmission of poverty.

Yet these “islands of success” should not remain islands – part of a dual system of social assistance, along side an inefficient and regressive social insurance system as if it were “the elephant in the room” that is not being effectively addressed. No country in LAC has (yet) been able to effectively and convincingly integrate social insurance and social assistance as part of a coherent system of social protection.¹⁰ The duality of these social insurance and social assistance systems creates a patchwork of inefficiencies arising from a lack of policy consistency and coordination, including: gaps and duplications in coverage, increased administrative costs from multiple registry and governance systems, incentives distortions, etc. Many countries have undertaken reforms to improve these systems, but such reforms generally follow parallel tracks. A more integrated approach could bring about the reallocations and efficiency gains necessary for more progressive and inclusive outcomes – as well as possible fiscal savings that could be used for other development priorities, such as investments in improving the quality of education which is crucial for equalizing “opportunities” for redistribution in the long-run.¹¹

As Fiszbein (2004) so eloquently remarks, “*the status quo is clearly unsatisfactory – and citizens of Latin America are saying so quite openly. The potential answers are not simple to design or implement, as they will require solving both technical and political difficulties. In the end, the Latin American experience suggests that it is politically easier to ‘target’ one percent of GDP for social assistance within a regressive tax and social protection system than to make benefits much more inclusive within a more progressive system. The debate is in process, but the end result is still unclear. Quo vadis Latin America?*”



Notes

¹ Lindert, Kathy, Emmanuel Skoufias and Joseph Shapiro. March 2006. “Redistributing Income to the Poor and the Rich: Public Transfers in Latin America and the Caribbean.” The World Bank. Download this Report from <http://www.worldbank.org/lacpoverty>

² Perry, et. al. (2005).

³ De Ferranti et. al. (2004).

⁴ The exception is Argentina’s Household Heads Program, which combines good coverage of the poor with progressive targeting and relatively high unit transfers. As a result, Argentina’s program does yield important impacts on poverty reduction and inequality.

⁵ Fiszbein (2004).

⁶ See, for example, Suplicy (2002).

⁷ Gill et. al. (2005) and Holzmann and Palmer (eds, 2006).

⁸ See, for example, Coady et. al. (2004).

⁹ The authors would like to thank Augusto de la Torre for his thoughtful suggestions on this point.

¹⁰ Fiszbein (2004).

¹¹ World Bank (2005).

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