



Fiscal Policy, Pensions and Informality: the case of Latin America

Ángel Melguizo (IDB/LMK)

Koç University-TUSAID ERF Conference
*The Mirrlees Review: Tax Reform of a Modern
Economy*

Istanbul, May 4, 2012

Fiscal Policy, Pensions and Informality

“Tax Reform for a Modern Economy”, in the context of a:

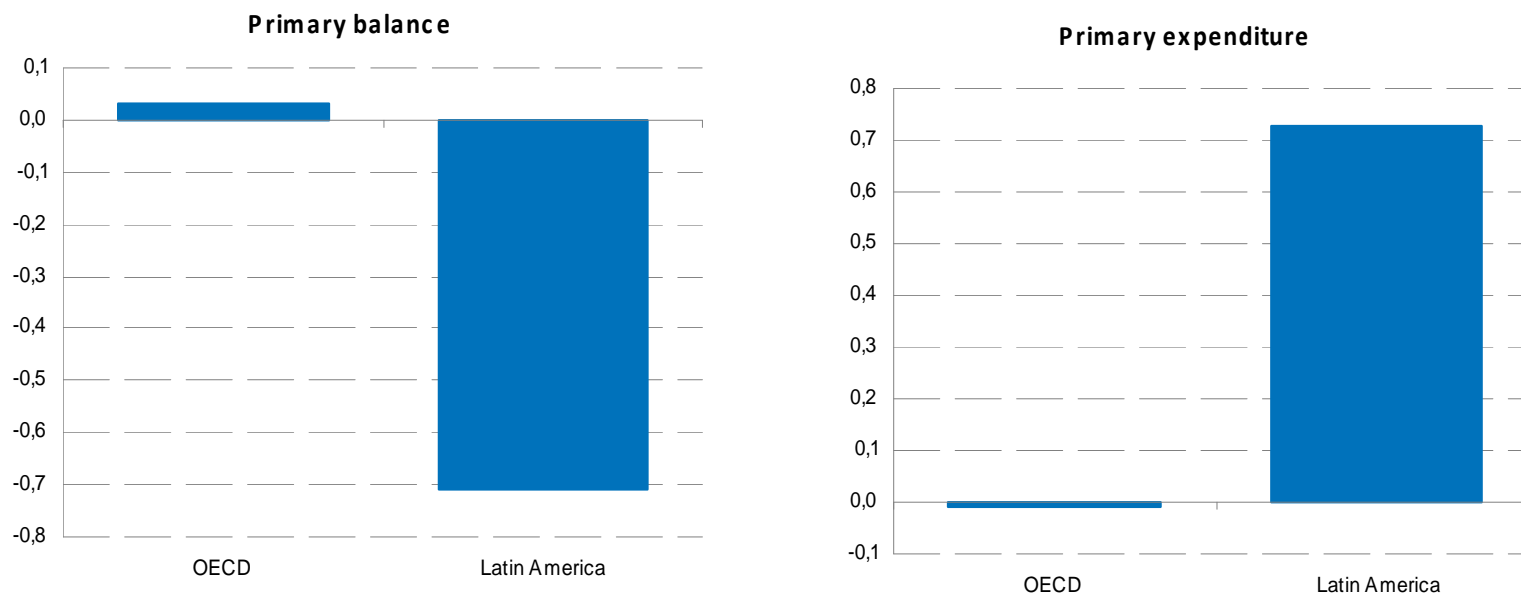
- **Consolidating** democracy
- **Informal** labor market
- Pending **social protection reforms** (pensions, health)
 - Transparent, Global, **Sustainable**
- Increasingly demanding **middle class**

Fiscal Policy, Pensions and Informality: experiences from Latin America

- 1. Risks from **fast responses** to pressing social demands
- 2. The challenging **political economy** of fiscal policy
 - Low taxation and redistribution and weak tax morale
 - Making reform happen
- 3. **Good practices** in fiscal policy-making
- 4. Next decade's challenge: **universal integrated social insurance system**
- 5. The emerging **middle class** and their expectations

1. Risks from fast responses to social demands

Impact of elections on fiscal policy in OECD and Latin America, 1990-2006 (% GDP)



Note: Calculated as the difference between the fiscal variable (as a proportion of GDP) during the election year and prior non-election years

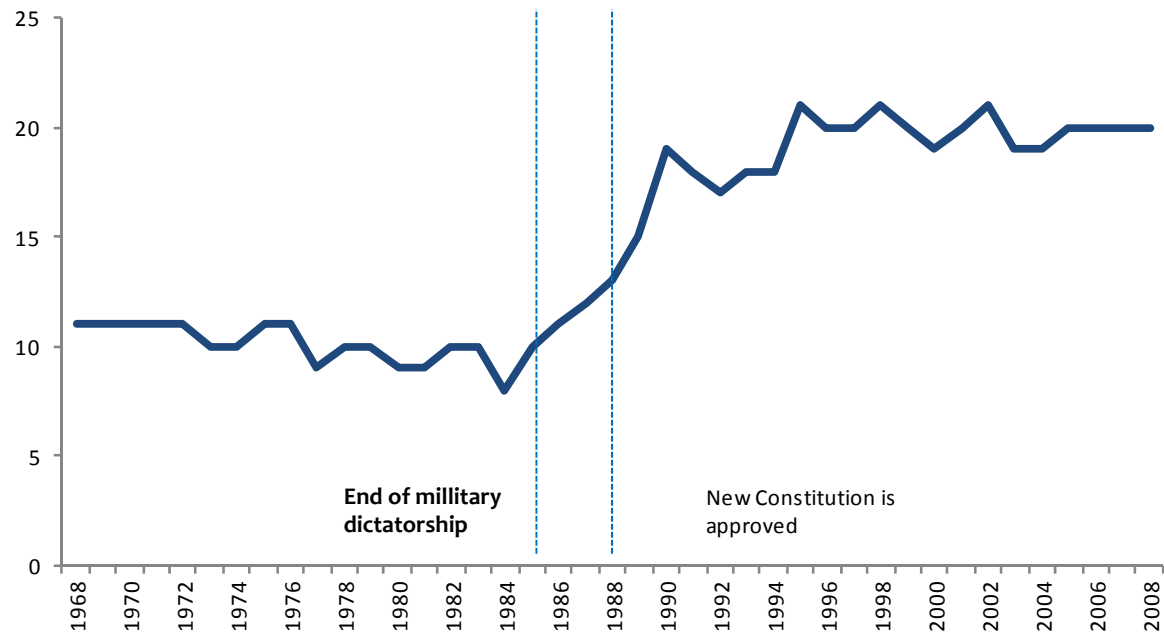
Source: Nieto Parra and Santiso (2012)

Political systems can be vulnerable to electoral-based decisions
(presidential elections are associated with **fiscal volatility** in LAC)



1. Risks from fast responses to social demands

Democratic transition in Brazil and government consumption (% GDP)



Source: OECD (2010b), based on the World Development Indicators database

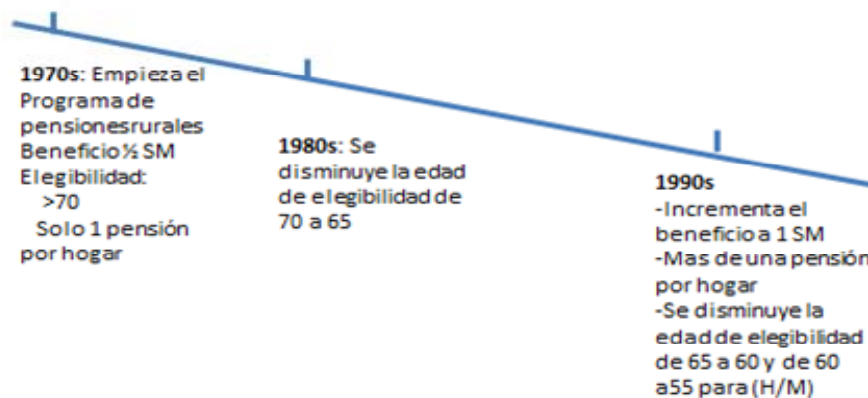
Gradual responses to social demands allow avoiding **permanent economic imbalances** (start with strategic programmes, easy to administrate)...



1. Risks from fast responses to social demands

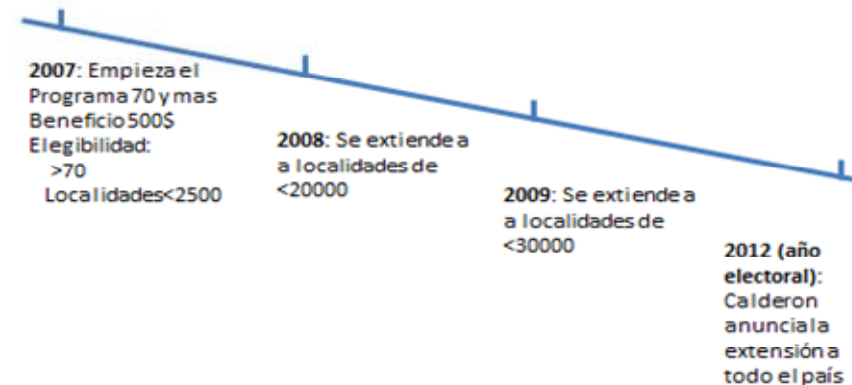
La pendiente resbaladiza de las pensiones no contributivas

- Brasil: Pensiones Rurales



La pendiente resbaladiza de las pensiones no contributivas

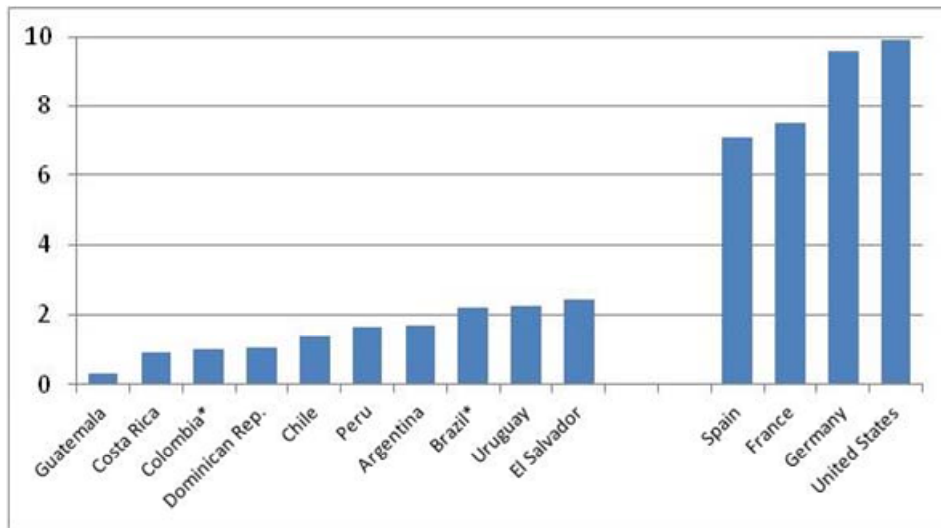
- México



And even so, targeted programmes are vulnerable to the ‘slippery slope’ of non-contributory pensions (more beneficiaries, higher benefits)

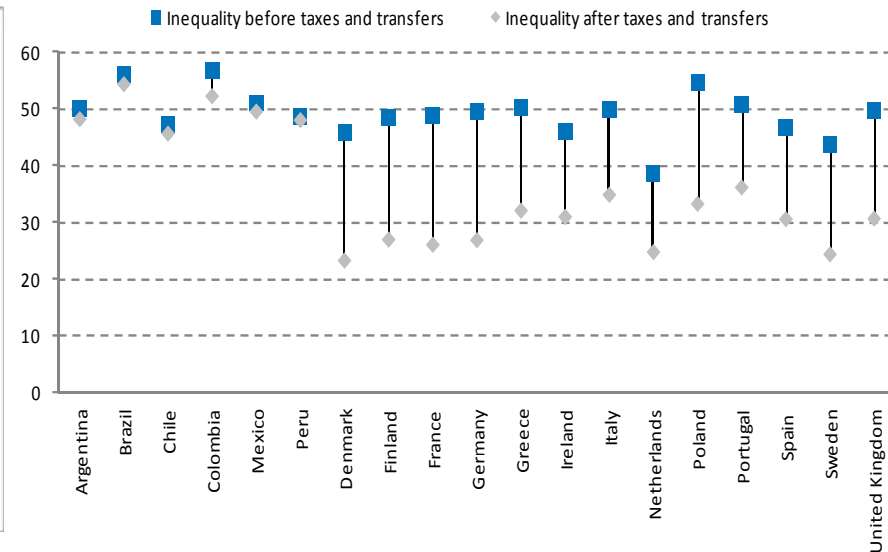
2. The challenging political economy of fiscal policy

Personal Income Tax in LAC vs. OECD, 2008
(% GDP)



Source: CIAT-ECLAC-OECD (2012)

Income inequality pre/post taxes-transfers, 2000s
(Gini coefficient)



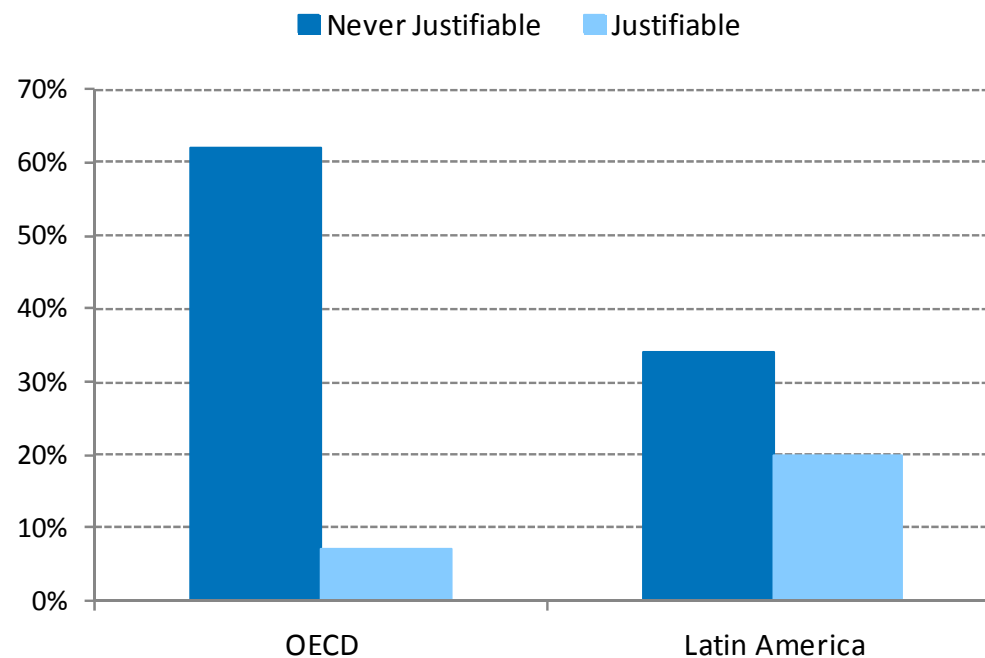
Source: ECLAC-OECD (2011)

Despite the **medium voter** theorem, Latin America has traditionally shown low tax collection (personal income tax), high inequality...



2. The challenging political economy of fiscal policy

Tax morale in Latin America and OECD countries
("Do you think cheating on taxes is justifiable?")



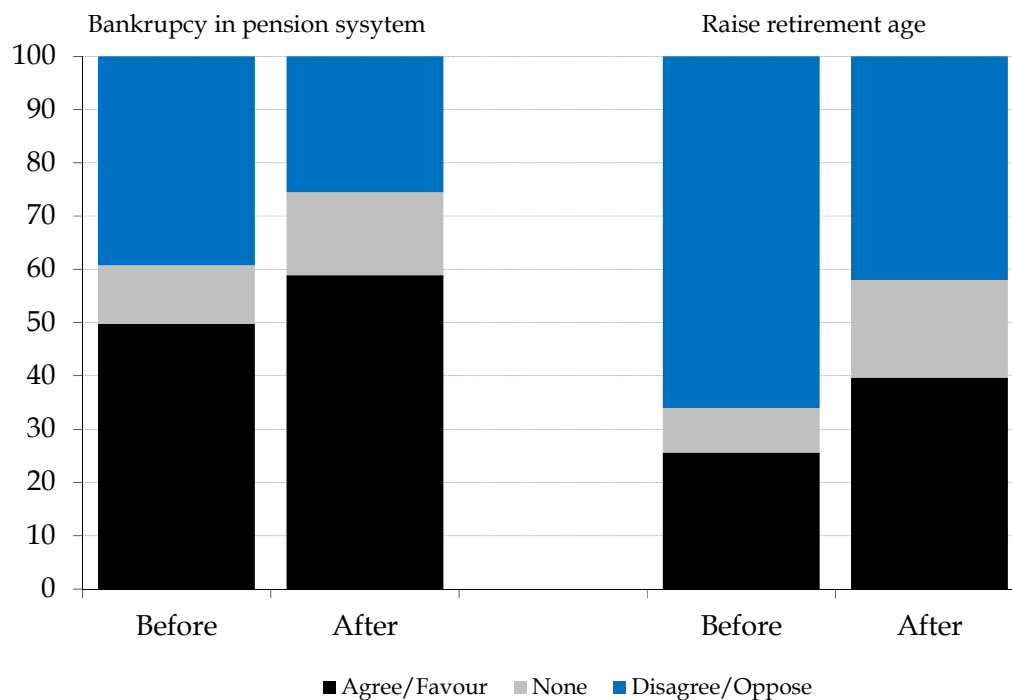
Source: Daude and Melguizo (2012), based on Latinobarometro and World Value Survey

... and a **weak social contract** between citizens and the state
(caution: intra-regional differences)



2. The challenging political economy of fiscal policy

Opinions on pension reform before and after deliberations (%)



Source: Tomorrow's Europe Deliberative Poll (2007)

Some factors 'making pension and tax reform happen':

- Solid research
- Framing the reform
- Transparency and effective communication: fear vs. expectations
- Peer pressure
- Institutions
- Leadership and electoral mandate

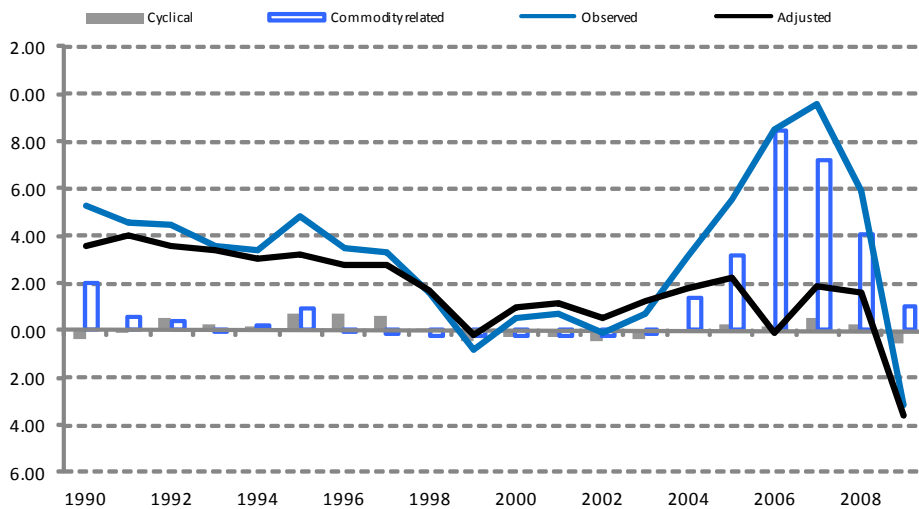
OECD (2010a)



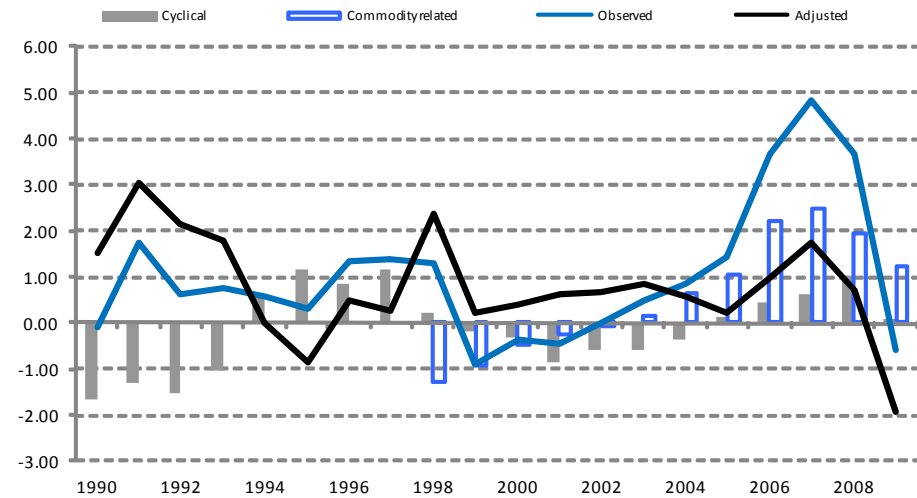
3. Good practices in fiscal policy-making

Adjusted primary budget balance
(Percentage points of GDP)

Chile



Peru



Note: General government primary budget balance is adjusted for deviations of GDP and commodity prices around their trends

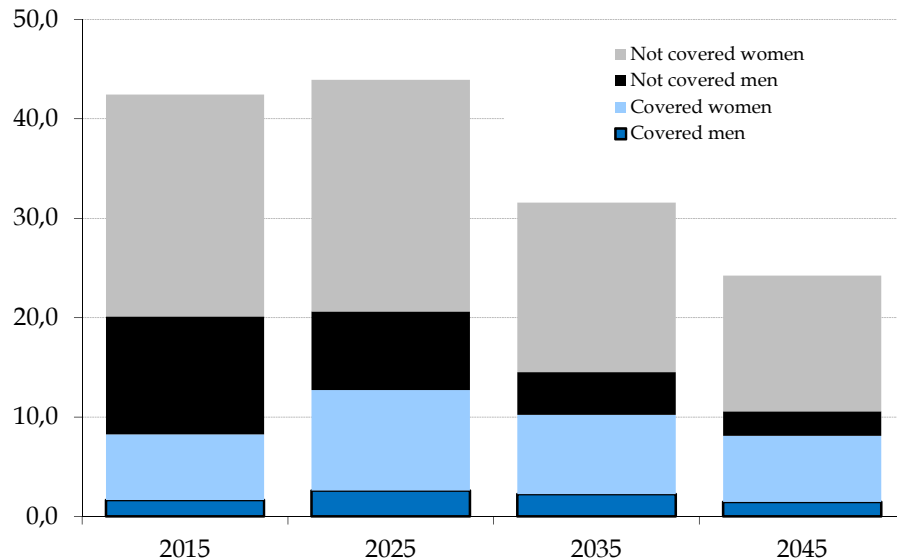
Source: Daude et al. (2011)

Innovative policies based on accumulated experience: fiscal rules, PPPs, conditional cash transfers



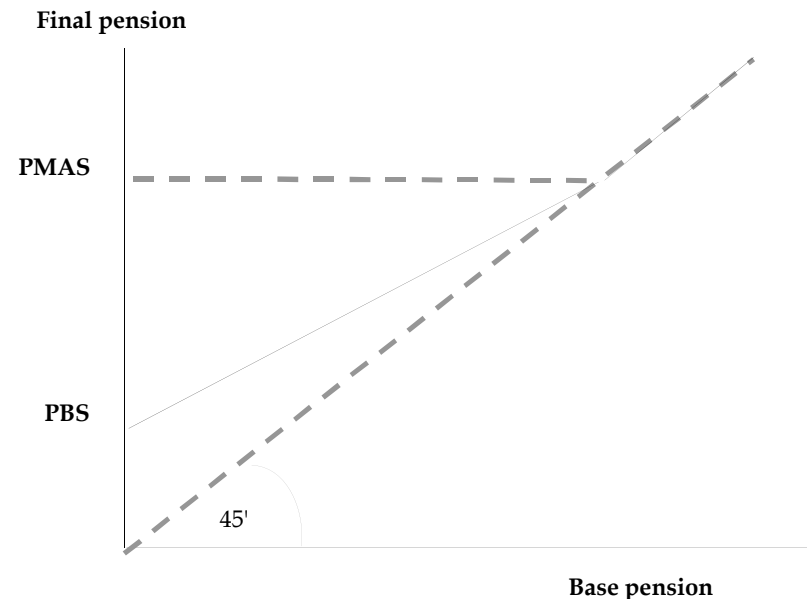
3. Good practices in fiscal policy-making

Projection of minimum pension beneficiaries in Chile
(No reform scenario, percentage of pensioners)



Source: Melguizo et al. (2009)

New solidarity pillar in Chile



Last-generation pension reforms are taking into account **incentives** very seriously (taxes affect participation, participation eases financing; e.g. Chile, proposals for Mexico)



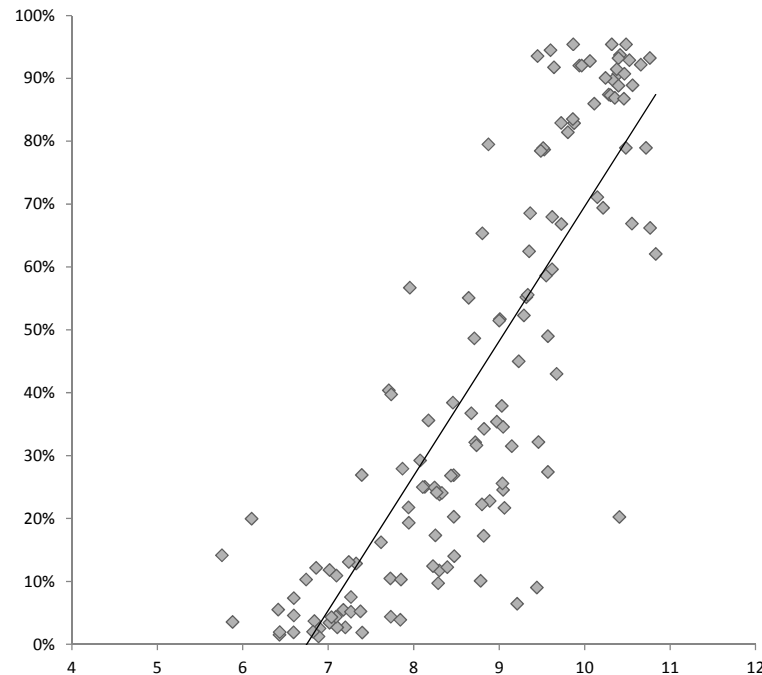
4. Next decade's challenge: universal social insurance

Challenges for public policy-making in Latin America:

- Rebuild **macro 'resiliences'** (institutions), compatible with long-term needs
- Implement ambitious **fiscal and pension reforms** (more/better taxation, fill social protection gaps)
 - **Tackling informality**, but **informality-proof** as well
 - Involve the formal and **informal middle class**

4. Next decade's challenge: universal social insurance

Pension active coverage and per capita income in the late 2000s
(% labor force; GDP pc PPP)



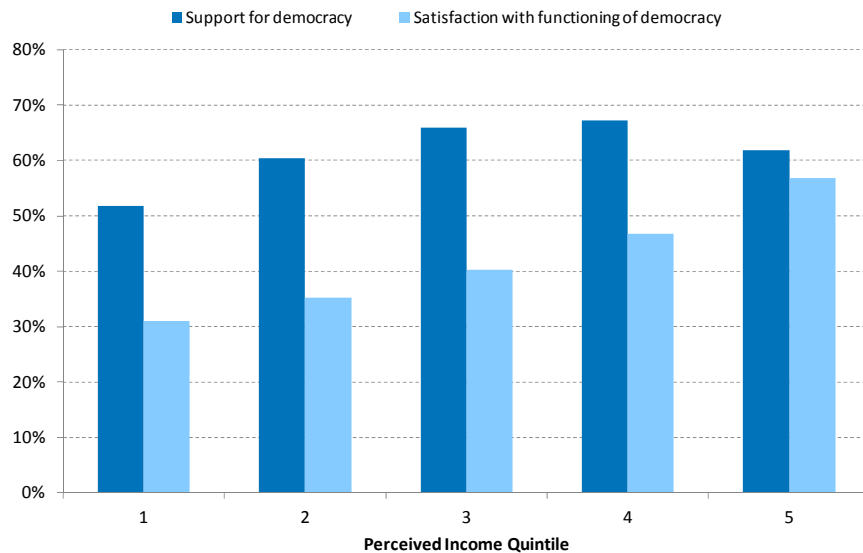
Source: Own elaboration, based on World Bank data

- **Growth helps**, but it is not all (negative **pension and tax** gaps in MEX, PER)
- Reforms have to be transparent, **integrated** (general equilibrium) and **sustainable**. Double dividends (better protection, better taxation)



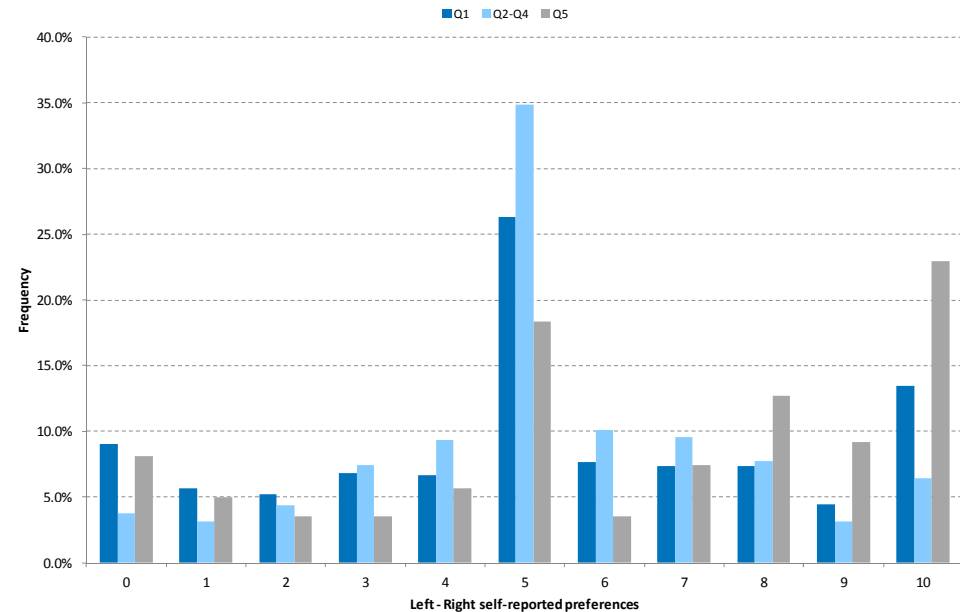
5. The emerging middle class and their expectations

Attitudes towards democracy (% support and satisfaction)



Source: OECD (2010b), based on Latinobarometro

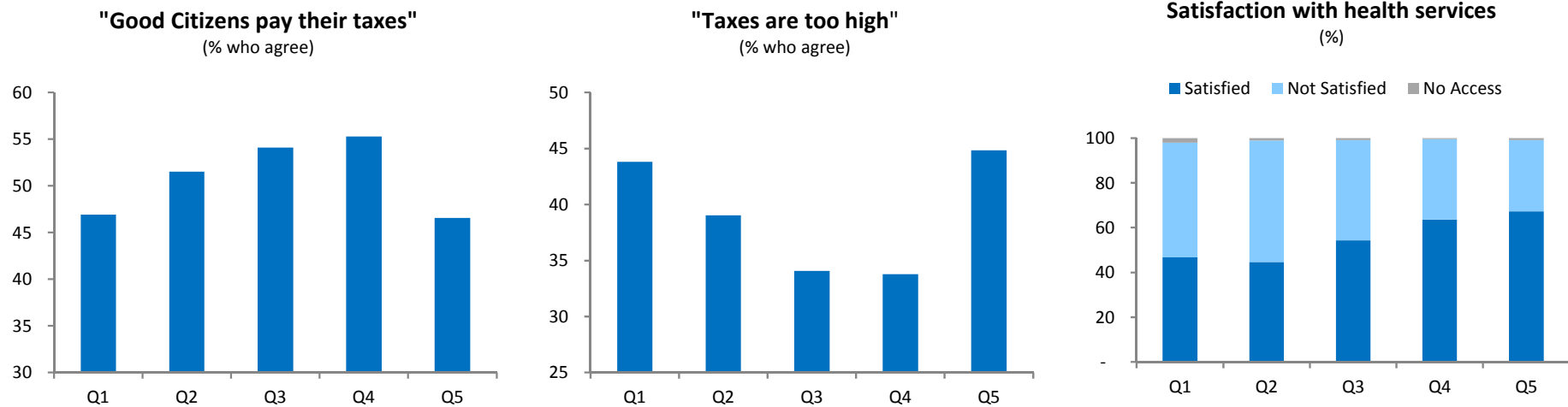
Distribution of political preferences (0 extreme left, 1 extreme right)



Growing **middle sectors** are the main supporters of democracy (but not much satisfied), and politically moderate



5. The emerging middle class and their expectations



Source: OECD (2010b) based on Latinobarometro

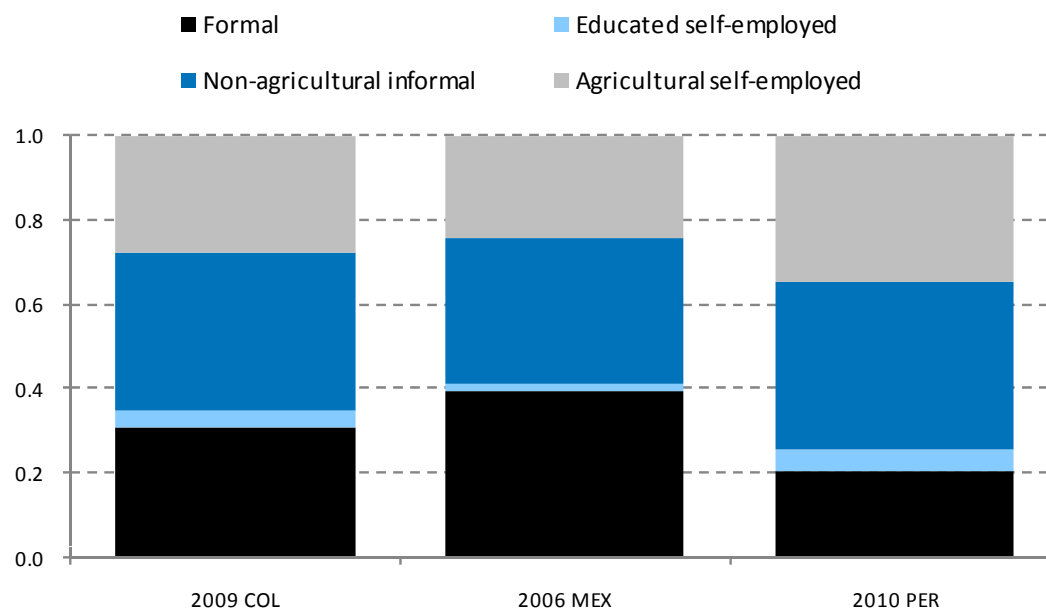
How middle class is Latin America?

- Risk of **downwards mobility**
- Relatively **outside the social contract**: despite their potential, low taxed and not fully benefiting from education nor health



5. The emerging middle class and their expectations

Informalities among middle-income workers in Latin America
(% urban workers)



Note: Formality is defined as working under a written contract

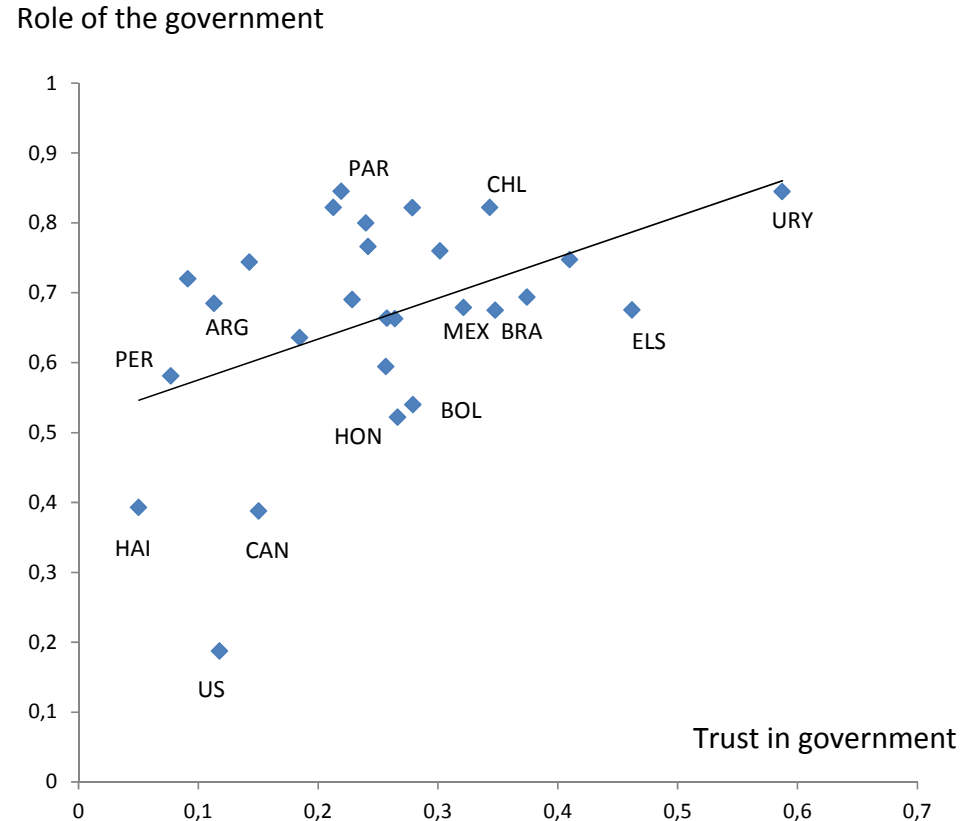
Source: Carranza et al. (2012)

- Informality is **multidimensional** (labor, tax compliance – voluntary and compulsory), and should be **addressed / taken on board**



5. The emerging middle class and their expectations

Trust in government and support for public-provided pension systems
(% who respond 'much')



Source: Own elaboration,
based on LAPOP 2010
database

Their demands for **better and modern social protection services**, **less inequality**, and institutions **free of corruption** evolve very rapidly



Fiscal Policy, Pensions and Informality: experiences from Latin America

- 1. Benefits from **gradual responses** to pressing social demands
- 2. The challenging **political economy** of fiscal policy
 - Low taxation and redistribution and weak tax morale
 - Making reform happen
- 3. **Good practices** in fiscal policy-making
- 4. Next decade's challenge: **universal integrated social insurance system**
- 5. The emerging **middle class** and their expectations



Teşekkür ederiz!

angelme@iadb.org

Ángel Melguizo (IDB/LMK)

Koç University-TUSAID ERF Conference
*The Mirrlees Review: Tax Reform of a Modern
Economy*

Istanbul, May 4, 2012



Inter-American Development Bank / www.iadb.org

