

FOUR

More Taxes on the Rich and Better Spending on the Rest

In the 1990s some Latin American governments succeeded in broadening their tax base and improving revenue collection. The emphasis was on improving the efficiency of the tax system to increase revenues, without much regard for the incidence of the tax burden on different income groups. Only Chile made the incidence of government spending measurably more progressive on the expenditure side.¹ Progress thus was limited in making the fiscal system overall—taxes and expenditures—more progressive.

The Tax Side

Most economists endorse the view that tax systems should not bear the burden of income redistribution—that the focus should be on efficiency, with any redistribution handled primarily through expenditures. But although government expenditure is and will continue to be the better instrument to deal with redistribution, it is time in Latin America to consider equity in taxation too, for at least three reasons.

First, most tax systems in Latin America are not good at generating revenue, and their ineffectiveness is a major constraint on using the expenditure side of the budget to reduce the region's high income inequality. Tax revenues average about 18 percent of GDP, well below what might be

1. ECLAC (2005).

expected given average per capita income.² (Brazil is an exception; there taxes are actually too high, at more than 35 percent of GDP.)³ Changes in tax policy and more efficient tax collection could increase revenues while reducing the regressivity in actual tax collections. Raising more revenue would allow for increased spending. That would reduce inequality simply because in Latin America the proportion of government spending transferred to the bottom half of the population is larger than that population's share of national income. For example, although only 10 percent of government spending goes to the poorest 20 percent of families, that poorest 20 percent accounts for only 4 percent of national income. So, increasing the absolute amount of government spending would improve the overall distribution of real income, even without any change in the distribution of spending.

Second, most tax systems in the region are unusually regressive compared with those in OECD nations. They tax an equal or greater portion of the income of poor and middle-income households than of rich households; estimates from one study of Argentina suggest that of the high Gini coefficient of 55.9, as much as 7 points reflects the increase in inequality due to the regressive effect of taxes.⁴ Tax systems are regressive for at least

2. Latin America's tax ratio is from ECLAC-ILPES database, based on 2005 values, except for Brazil, Colombia, and Ecuador (2004), Bolivia (2003), and Uruguay (2002). Data for Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Ecuador, and Uruguay refer to general government (central government, states or provinces, and municipalities); data for the rest are for central government. "For the development level of the countries, average tax burdens ought to be 24 percent of GDP. The primary deficiency in tax collection is for taxes on income and property, which on average amount to only 4.5 percent of GDP; in keeping with the development level of the countries, those taxes ought to generate 8 percent" (IDB 1999, p. 183).

3. Brazil's revenue ratio, though high by international standards, is the result of an overly complex and distortive tax system that depends heavily on cascading federal, state, and municipal indirect taxes with heavy burdens on labor and production. See Pessino and Fenochetto (2007, forthcoming) and OECD (2005a) for further discussion.

4. Pessino and Fenochetto (2007, forthcoming) estimates that in Argentina, the Gini coefficient calculated on the distribution of income before taxes is 48.7; after (personal) income, VAT, and payroll taxes it increases to 55.9. The impact of VAT alone raises the Gini coefficient to 53.5 (personal income taxes alone raise the Gini to 49.9). In 1996 the after-tax Gini coefficient for Chile was 49.6 and the before-tax Gini was 48.8 (Engel, Gale-tovic, and Raddatz 1999). In Central America, the regressivity of tax systems is reflected in higher after-tax Gini coefficients for El Salvador, Honduras, and especially Nicaragua, where the before-tax Gini coefficient was 50.1 and the after-tax Gini was 69.2 in 2000 (Agosin and others 2005).

three reasons: revenues are derived largely from neutral or regressive taxes (value-added tax, other consumption taxes, and single-rate payroll taxes); effective taxation of high-income people is low; and enforcement of corporate and personal income tax regulations is weak.

The value-added tax and other taxes on consumption account for about 60 percent of total revenues in the region; the figure is about 30 percent in Europe.⁵ Despite various exemptions on such basic necessities as food and medicine, the value-added, excise, trade, and other consumption-based taxes tend to be regressive.⁶ They collect a higher percentage from the incomes of the poor than from those of the rich, in large part because the poor spend a larger share of their income than the rich.

Payroll taxes—which are set at a rate of more than 15 percent in most countries—also are regressive.⁷ Although in principle they finance specific health and pay-as-you-go pension benefits and therefore can be thought of as “contributions,” the relationship between the value of the contributions and the benefits has been weak.⁸ The de-linking of contributions and benefits is due in some cases to overgenerous pension benefits (which exceed the contributions plus a reasonable imputation of a rate of return)

5. Tanzi and Zee (2000). Martner and Aldunate (2006) estimates that indirect taxes accounted for about 56 percent of total tax revenues in Latin America and 31 percent of tax revenues in Europe in 2003–04.

6. Pessino and Fenochietto (2007, forthcoming) shows that while various exemptions on food, durable goods, and education reduce the tax burden imposed on the poor, they reduce the burden on the rich even more and make tax systems more susceptible to evasion and cheating. In Argentina, the two richest quintiles receive 76 percent of the exemptions on education and 59 percent of all other exemptions on different goods and services. Those exemptions reduce the tax burden on the poorest quintiles by 25 percent, with the exemptions on food like bread, milk, and meat helping the most. But the cost is several times what they receive: each US\$1 of exemptions in education (which goes mostly to the rich) costs US\$17. In the case of milk, each US\$1 costs US\$5.

7. Economists have generally concluded that in the long run, the burden of payroll taxes falls on workers, not consumers. Brazil collects close to 8 percent of GDP in payroll taxes while Argentina collects about 5 percent of GDP. Payroll taxes are capped in some countries, so the average tax rate declines as income increases. In Argentina, prior to elimination of the cap in 2005, the burden of the full tax (without deducting presumed benefits) represented around 28 percent of the wage of the poorest quintile, 33 percent of the wage of the middle quintile, and 21 percent of the wage of the richest quintile. In Chile, payroll taxation fell significantly as a result of the privatization of pension fund administration (Pessino and Fenochietto 2007, forthcoming).

8. See Levy (2006b) for evidence of a wide wedge between the costs and the value of social security contributions in Mexico.

and in other cases to severe deterioration in the quality of health services and erosion in the real value of pensions as a result of inflation.

Finally, personal income tax rates are progressive on paper because they apply only to high-income taxpayers—as few as 3 percent to 5 percent of all households in some countries. But with few taxpayers affected and the high rates of evasion discussed below, the personal income tax cannot compensate for the inherent regressivity of other taxes. Though statutory marginal rates rise as income rises in most countries, with top rates around 40 percent or higher, effective tax rates are much lower. In Argentina, Chile, and Guatemala in the mid-1990s, for example, effective tax rates for the richest 10 percent of households were a mere 8 percent of income.⁹ In contrast, average effective tax rates on top income earners in the United States are closer to 40 percent, including federal and state taxes.¹⁰ Overall revenue collection can only be poor when households that control more than 50 percent of income contribute so little in taxes.

Why is it that in most countries of the region personal income and other nonconsumption taxes fail to compensate much if at all for efficient but regressive value-added taxes and payroll “contributions”? In many countries, most households with above-average income are exempt from personal income tax because of relatively high minimum personal exemption levels.¹¹ Minimum taxable levels and multiple exemptions and other loopholes combine with underfunded and ineffective tax administration, lax enforcement, and widespread evasion (box 4-1) to minimize the taxes paid by high-income households. Exemptions of income from capital allow many high-income households to reduce their tax burden dramatically. And in some countries it is all too easy to shelter personal income in shadow “corporations” with high expenses.

There is no need to raise personal income tax rates. They already are high and, on paper, highly progressive. However, there is room to reduce overall regressivity and enhance fairness in the region’s tax systems by reducing

9. IDB (1999).

10. Schmitt (2005).

11. Minimum personal exemption levels have increased from a regional average starting at 60 percent of per capita GDP in the mid 1980s to 2.3 times per capita GDP in the 2000s. The minimums are as high as eight times the average income in Nicaragua and four times the average income in Colombia (Bird 2003; IDEA 2007; Stotsky and WoldeMariam 2002).

BOX 4-1. Tax Evasion in Argentina, Brazil, and Chile

Tax evasion rates are very high throughout Latin America and affect all major taxes.¹ The level of personal income tax evasion is estimated at almost 50 percent in Argentina, 55 percent in Brazil, and 56 percent in Chile, while corporate income tax evasion is estimated at about 46, 42, and 35 percent respectively.²

TABLE 4-1. Tax Evasion Rates in Argentina, Brazil, and Chile, 2000^a
Percent

| <i>Tax</i> | <i>Argentina</i> | <i>Brazil</i> | <i>Chile</i> |
|------------------------------------|------------------|---------------|--------------|
| Value-added tax (VAT) | 39 | ... | 20 |
| Payroll tax | 43 | 55 | 17 |
| Personal income tax | 49 | 55 | 57 |
| Corporate income tax | 46 | 42 | 35 |
| Informal economy as percent of GNP | 40 | 39 | ... |

a. Payroll tax figures are for 1999 (1998 for Brazil). Personal and corporate income taxes for Brazil are for 1998. VAT figures for Chile and Argentina are for 1997. Estimates of tax evasion vary widely. For example, the official estimate for VAT evasion in Argentina in 2004 was 25 percent; an independent study's estimates of evasion of VAT and payroll taxes in the country in 2004 were around 29 percent and 52 to 56 percent respectively (Cont and Susmel 2006; Cont 2006).

Estimates suggest that a 30 percent reduction in evasion of VAT, personal and corporate income taxes, and payroll and wealth taxes would generate a 17 percent increase in tax collection in Argentina, 14 percent in Brazil, and 12 percent in Chile.

1. The discussion in this box is based on Pessino and Fenochietto (2007, forthcoming).

2. An average-wage employee in Argentina who is a non-evader pays on average more than 50 percent of his or her income in taxes (including payroll taxes) while an informal worker who complies only with VAT and some property taxes pays only 12 percent. So, of a total tax burden of 24 percent, non-evaders pay 50 percent while full evaders pay around 12 percent.

evasion and eliminating loopholes that tend to favor high-income households. In principle, increasing the actual tax burden on high-income earners could create negative work or other incentive problems, but we believe that any effect would be small. Revenue increases might also be small, but the tax systems would be perceived, finally, as reasonably fair. Similarly, even the fear that taxing income from capital would lead to capital flight

Increasing compliance is no easy task. Implementing a system to improve the collection and cross-indexing of information on potential taxpayers (identifying individual social and fiscal attributes), such as that based on the Social Security number in the United States, would help detect and reduce evasion. Increasing the perceived probability of auditing by implementing an information-crossing system would also have a positive impact on compliance. In the 1980s, Chile became the first country in the region to institute a tax identification number to facilitate the identification of individuals and their transactions and assets. Chile is more advanced than Argentina and Brazil in crossing personal, tax, and social data, which may explain its better tax collection level and expenditure management.

But more progress is needed. In Argentina, the SINTyS project—Sistema de Identificación Nacional Tributario y Social (National Tax and Social Identification System)—was initiated in the office of the chief of the Cabinet of Ministers. Since its start, the project has collected data of relevance in tax administration. But so far there has not been collaboration between the office responsible for tax administration and the SINTyS project office in building a shared database of key information to cross with information on income or wealth taxes. An exception occurred in late 2001, when the tax administration crossed information on deposits or funds sent abroad (which came to light when depositors went to court to demand the return of deposits that had been confiscated by the administration of then President Fernando de la Rúa in the wake of the economic crisis) and used it to detect evasion, catching several noncompliant taxpayers.

States, municipalities, and other subnational government units also need to fight evasion. A first step is to create an incentive for them to do so in the many countries where these units receive fixed transfers from the central government, often independent of their own revenue efforts.

may well be exaggerated. Other factors—unstable prices, poor contract enforcement—are equally probable sources of capital flight. Indeed, compared with the United States, where effective average tax rates already are as high as 40 percent for higher-income households, Latin America is not close to bumping up against the traditional economists' concern that enforced high tax rates will discourage work, innovation, and investment.

BOX 4-2. Politics of Tax Reform

The recent literature on taxation in Latin America suggests that making tax systems more progressive is a major political challenge. In a 2004 World Bank report, *Inequality in Latin America: Breaking with History?* the bottom line was not much of a bottom line: although “there is almost certainly some potential to make tax systems somewhat more progressive . . . the extent to which this is possible will depend on issues of overall political and social consensus as much as on the details of tax instruments.” In a 2003 background paper for that report, “Taxation in Latin America: Reflections on Sustainability and the Balance between Equity and Efficiency,” Richard Bird, a distinguished authority on tax issues worldwide, wrote: “Some specific suggestions are made in [this] paper with respect to how both the efficiency and the equity outcomes of Latin American tax systems might be improved. My general conclusion, however, is . . . somewhat pessimistic. . . . a more democratic and sustainable outcome cannot, as it were, be induced by better fiscal institutions. On the contrary, a more encompassing and legitimate state is itself the key ingredient needed for a more balanced and sustainable tax system.”¹

But might “overall political and social consensus” and a “more encompassing and legitimate state” be in part the product of a more and visibly fair tax regime? Is politics the problem or the solution? Politics was never said to be an impossible barrier to reform of macroeconomic or trade policy or to privatization of state-owned enterprises. There is surely political room to build a constituency favoring, for example, reduced evasion, some property taxes, and—in the interests of job creation—reduced reliance on payroll taxes. The key change may need to come from political leaders who decide to champion tax systems built on the principles of fairness and transparency.

1. De Ferranti and others (2004, p. 255). See also Bird (2003, p.2).

Compared with increasing the value-added tax, increasing tax collection from the few high-income earners (say, the top 10 percent) might not raise much revenue in the short run. But that should not be an excuse for inaction. Now that an initial round of tax reforms is in place (establishing and consolidating the value-added tax), the democratic governments of the region should put a premium on making tax systems more visibly fair (box 4-2). Tax systems that are fair—and perceived to be fair by the

majority of the population—make transparent the connection between tax payments and citizenship. An increase in reliance on personal and wealth taxes would help inform citizens at all income levels of the taxes that they pay, raising awareness among Latin Americans about their responsibilities as well as their rights as citizens—bearing in mind that the value-added tax, for all its merits, is an invisible tax (box 4-3). If citizens, particularly the working poor, understood how much they are paying their governments, they might be more easily mobilized to press for public services and for accountability from their elected officials.

More visibly fair tax systems might also make higher ratios of taxes to GDP more politically acceptable (as would, of course, more efficient public spending and less corruption.)¹² And higher tax-to-GDP ratios would allow for increased spending, benefiting the bottom half, by income, of the population.

The key steps to making tax systems both more effective and fair are to

- ◆ Reduce high rates of evasion of all types of taxes (see box 4-1), eliminate loopholes, and lower the thresholds below which income is exempted.¹³ Where top marginal tax rates are punitive for those who actually pay (one example is Brazil), a package of reduced top rates and stiffened enforcement makes sense.
- ◆ Improve tax administration. Doing so is critical to better enforcement.¹⁴ Tax administrations in most countries are weak, inefficient,

12. Public opinion polls show that on average only 23 percent of Latin Americans surveyed in 2003 believed that tax collection was “impartial” and only 15 percent trusted that tax revenues would be well spent by the government. In 2005 about 21 percent of respondents trusted that their tax money would be put to good use (Latinobarómetro 2003, 2005).

13. Pessino and Fenochietto (2007, forthcoming) estimates that eliminating all personal income tax exemptions and privileges would increase collections by 47 percent in Argentina, 62 percent in Brazil, and 40 percent in Chile. They argue against eliminating income tax exemptions indiscriminately, since many promote savings or investment and their elimination could increase capital flight. They recommend eliminating exemptions on indirect taxes that are granted as political privileges, such as exemptions for promotion of particular industries or regions or for communications media, although doing so would not markedly increase revenues. Exemptions on capital, medical, and educational expenses in Argentina and Brazil are most likely benefiting middle- and high-income households and might be worth eliminating, but their effects are more ambiguous and need further research. In Colombia, the fiscal cost of exemptions is calculated at 9.2 percent of GDP; in Guatemala and Mexico, it is calculated at 7.3 and 6.3 percent of GDP respectively (IDEA 2007).

14. Tax administrations in Latin America have not relied much on scientific analysis (theoretical or empirical) of tax noncompliance in designing measures to reduce evasion. In most

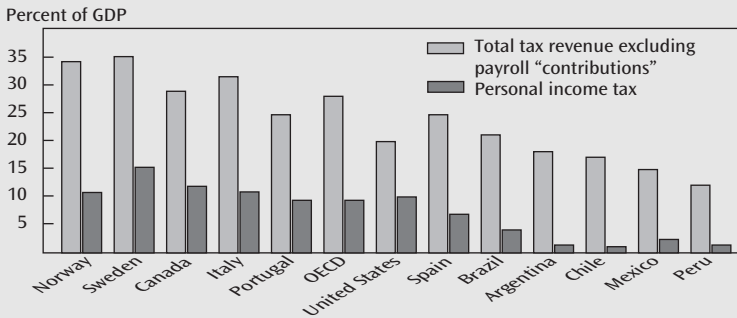
BOX 4-3. Citizens as Taxpayers

Linking citizens’ rights and the payment of taxes is crucial to legitimizing tax reform in Latin America. Because the value-added tax and other consumption-based taxes are folded into the price of goods, consumers may not know that they pay taxes on their purchases. That is also true in other regions, but in Latin America an unusually high proportion of all revenue comes from such taxes. Independent research and policy institutes could help by publishing analyses of how much tax different income groups actually pay.¹

The same problem applies to payroll and income taxes. Many workers need not file individual tax returns, given the minimum income rules. As a result, Latin Americans are rarely conscious of the taxes deducted every month from their paychecks and often are unaware of their pretax income; of what percentage of their wages goes for contributions to pension, health, and other social insurance programs; and of what percentage goes to general taxes.

A system based on tax rebates for those with incomes below a given threshold would be more transparent than the current system.² Implementing it would be expensive and demand a very good, efficient tax bureaucracy, something that is scarce in the region. But its merits would more than outweigh its costs.

FIGURE 4-1. Personal Income Tax Revenue in Latin America and in OECD Countries, 2004^a



Sources: ECLAC-ILPES database for Brazil, Chile, and Peru; OECD (2005a) for OECD countries including Mexico; Pessino and Fenochietto (2007, forthcoming) for Argentina.

a. Payroll contributions encompass pensions and unemployment, health, and other such insurance, depending on the country. Figures are for general government, except those for Peru, which are for central government. All data are for 2004 or closest available year.

1. Martinez-Vazquez (2001) suggests that in Mexico, lack of information on the actual distribution of tax burdens has contributed to the lack of voluntary compliance with tax laws because of the general perception that many do not contribute their fair share of taxes.

2. This point is convincingly elaborated in De la Torre (2002).

understaffed, and underfunded.¹⁵ Reforms are needed to increase their ability to effectively audit tax returns, detect errors and evasion, and enforce collection, especially among the wealthy, who tend to wield significant political influence. Such changes require increasing their technical expertise and providing them with political backing.¹⁶ They should also be allowed to recover evaded taxes through administrative channels before resorting to the justice system. The U.S. Internal Revenue Service already does that.¹⁷ Peru's success in tax administration in the 1990s and the experience of Ecuador's internal revenue service indicate that more revenue can be raised without

countries there is no systematic effort to measure tax evasion levels on a consistent annual or biannual basis. Chile is the exception, where the tax administration relies on an annual in-house study of VAT evasion to design tax policy goals (Baer 2006). Many countries, among them Argentina and Brazil, designed so-called simplified regimes based on the popular belief that tax complexity is one of the key reasons for tax evasion. While tax complexity may be a factor, the extent of its relationship with tax evasion in Latin America has never been rigorously studied (Pessino and Fenochetto, 2007 forthcoming). Moreover, there have been very few empirical investigations of any of the reasons for tax evasion in the region. Fenochetto (1999) is among the earliest, most comprehensive tax evasion surveys in the region.

15. In Chile, Brazil, and Argentina, tax administrations cite lack of resources, personnel, and training as obstacles to performing efficiently. Pessino and Fenochetto (2007, forthcoming) shows that among the three, Chile's tax administration is the most productive. While Argentina's tax administration has 1,000 employees per percentage point of GDP collected and processes 277 tax reports per employee, Chile's has 146 employees per percentage point collected and processes 899 reports per employee. In Brazil, the government has resorted to higher taxes or new distortive ones to improve collection instead of focusing on tax administration performance. In many countries, performance is measured by increases in tax collection, leading to incorrect evaluations because an increase in revenue can depend on other factors, like GDP growth, tax legislation, and changes in the tax base.

16. The degree of political independence of tax administrations varies across countries. Chile's tax administration is an autonomous decentralized public agency whose director is appointed by the president. Efforts to decentralize tax administration, to allow directors to be nominated by the president and approved by the Senate, and to establish tenure of six years for the director failed in Argentina in the 1990s. In Brazil, the 1988 constitution abolished tenure for the tax administration's director and staff as part of efforts to reduce job security among public officials. But in this case, the lack of job stability makes the tax administrator easily replaceable and very susceptible to political interference. In Chile, the director has more stability than in other countries. Between 1974 and 1999, Chile's tax administration had just five directors while Argentina had eleven. Note, however, that stability of tenure might not be a good idea in all countries and under all circumstances.

17. For further discussion on this point, see Baer (2006). Tax administrations in many Latin American countries suffer from the inefficiency and slowness of the justice system in penalizing evaders. Even when evasion is detected, an inefficient (and corrupt) judiciary makes it extremely difficult to recover large outstanding debts.

major changes in tax regimes.¹⁸ Chile also has shown that it is possible to achieve high productivity in tax administration.

- ◆ Reduce reliance on high, single-rate payroll taxes. Lowering payroll taxes would increase collection from both payroll and value-added taxes (through reduced evasion) and, along with other policy changes, would reduce the high cost of labor (see chapter 6), in turn reducing the level of informal employment. But to make room for lowering payroll taxes, governments must tackle head on the difficult problem of benefits. In many countries, it would make sense to drop payroll “contributions” for pension and health benefits and finance minimum entitlements from general, progressive taxation.
- ◆ Implement progressive taxes and make tax payments more visible to taxpayers. In addition to better enforcement of the personal income tax, there are at least three other possibilities. One is to tax property (implying investment in municipal tax administration). A second is to tax gross assets; the tax could be treated as a minimum corporate tax, deductible on corporate income tax. Mexico has implemented a reasonably effective minimum corporate tax. A third, more controversial possibility is to establish procedures for taxing income from assets held abroad. That would require bilateral agreements with countries such as the United States to share access to information on assets of nonresidents.

The Expenditure Side: Pensions and More

Substantial improvement in redistribution can be achieved through sensible government spending. In the interests of equity, more spending on health, education, and public infrastructure such as roads makes sense. Greater spending could benefit not only the poor (as in Mexico’s *Oportunidades* or in Brazil’s *Bolsa Família*; see chapter 3, box 3-2) but also the many other

18. Personnel and technology were at the center of Ecuador’s tax administration reform, initiated in 1998, which established its internal revenue service (*Servicio de Rentas Internas*). Of the 1,700 employees of the old tax administration system, all but five accepted buyout offers and resigned in the wake of the reforms. The newly formed agency was granted institutional autonomy, which limits political interference and enhances its authority. Previously, fiscal agents were unable to win a single tax collection case in court. As a result of reforms, tax collections nearly doubled in three years, from US\$1.4 billion (7.3 percent of GDP) in 1998 to US\$2.3 billion (13 percent of GDP) in 2001 (Drosdoff 2002). Fuentes (2006) discusses recent tax administration reform efforts in Central America.

households whose per capita income is well below the average—in most countries as much as 70 percent of all households.

It is a question not just of more spending but of more efficient spending. Our discussion of other policy areas (education and consumer-driven public services) focuses on radical new approaches to make public spending both more efficient and more fair. One simple way is to spend more on preschool-age children in poor households (see box 4-4). Here we concentrate on a single big-ticket item—pay-as-you-go pensions. Through such pensions, public spending benefits disproportionately households with above-average income.¹⁹

In Latin America the biggest problem plaguing pension systems in terms of their effect on equity is their low coverage—low not just in absolute terms but also in terms of what would be expected given per capita income.²⁰ Across countries, formal coverage does tend to rise with per capita income. But even in Colombia, where per capita income is higher than the Latin America average, less than 25 percent of the economically active population is covered. In Argentina, the figure is nearly 40 percent; in Chile, about 60 percent. In the region overall, pensions are far from universal, and they usually exclude workers in the informal sector and in agriculture.²¹ Effective coverage, furthermore, is much lower because many workers, especially women, fail to qualify for pensions because they never manage to document sufficiently long and continuous employment in formal sector jobs.²²

19. In Latin America, the richest quintile of the population receives on average about 61 percent of net pension benefits (full benefit amount received minus total contributions), while the poorest quintile only receives 3 percent (Lindert, Skoufias, and Shapiro 2006).

20. Gill, Packard, and Yermo (2005); Lucchetti and Rofman (2006). We do not comment here on other valid objectives of pension programs, such as being fiscally sustainable and promoting savings.

21. In nearly half the countries in Latin America, less than 30 percent of the economically active population is covered by a pension system. Between the mid-1990s and early 2000s, the proportion of the labor force with pension coverage fell in nine countries (Argentina, Bolivia, Brazil, Colombia, Chile, Costa Rica, Paraguay, Uruguay, and Venezuela). Across countries, coverage is much higher in wealthier quintiles and urban areas than in poorer quintiles and rural areas. A simple average shows that in seventeen countries fewer than four of every ten persons age sixty-five or older directly receive some type of pension income (Lucchetti and Rofman 2006).

22. For example, in Colombia, where less than 25 percent of the labor force is covered by the pension system, only half of those covered will meet the minimum contribution period required to qualify for a monthly pension; instead, they will receive their accumulated contributions in a lump sum payment at retirement.

BOX 4-4. Investing in Children in Unequal Societies

In unequal societies that have a high level of poverty, investments in disadvantaged children almost automatically reconcile equity and efficiency goals. Early childhood interventions aimed at improving nutrition, health, and cognitive development are crucial to helping children from poor families overcome the disadvantages that too often prevent them from building the most important of all assets—human capital. Efficient government investment in disadvantaged children brings higher rates of return than investment in low-skilled adults.¹ In rural Colombia, the Community Child-care and Nutrition Program, through which poor children received food and childcare from one of the mothers in the community, had a significant effect on the nutritional status of young children (three to five years of age)

1. Heckman and Masterov (2007) and Carneiro and Heckman (2003) make a strong productivity case for investing in early childhood interventions based on evidence from the United States. Garces, Thomas, and Currie (2000) shows the long-term effects of Head Start, a U.S. early childhood development program. Studies of early childhood development programs in developing countries suggest robust benefits for all children, with cost-benefit analyses showing returns of US\$2 to US\$5 for every US\$1 invested. In general, children who participate in an early childhood program show improved health and school achievement—for example, higher enrollment rates in later schooling, less repetition of grades, and less dropping out—when compared with nonparticipants in similar circumstances (World Bank 2005c; Attanasio and Vera-Hernández 2004; Behrman and others 2006; Grantham-McGregor and others 1991; Engle and others 2007; Curi and Menezes-Filho 2006; Morán 2003). Schady 2006 reviews the literature on the impact of early childhood interventions in the United States and discusses evidence from Latin America.

Low effective coverage today means a high and growing incidence of people who will fall into poverty during their old age. Moreover, the pay-as-you-go pension systems that are actuarially underfunded—that is, where the expected present value of contributions is less than the expected present value of pension benefits promised under the system—introduce intergenerational inequity, because workers who are currently contributing to the system will have to pay more in taxes or receive lower pension benefits (or both) than those who are currently retired. Because of low coverage and actuarial deficits, pensions systems in most of the region are exacerbating rather than mitigating income inequality.²³

23. Despite formal membership contributions, virtually all public social security regimes in Latin America run significant deficits, which are financed by general tax revenues (for example, about 56 percent of federal social security benefits in Argentina and 89 percent in Peru) (Lindert, Skoufias, and Shapiro 2006).

who had been enrolled since birth, resulting in a relative increase of almost four centimeters in height. Children ages thirteen to seventeen who had benefited from the program were more likely to be in school later. In rural Guatemala, nutritional supplements for preschool children increased their probability of attending school and led to higher completed schooling and higher adult cognitive achievement test scores.²

Democracy, decentralization, and the increasing role of civil society are all increasing effective political demand for public investments in children in the region. To make growing political support more sustainable, advocates of these programs can

- ◆ Push for earmarked taxes to fund child programs. Earmarking, never ideal, may be necessary given the region's political realities.
- ◆ Build on the initiatives of small community groups, civil society, and local governments.
- ◆ Promote a political constituency of consumers by using direct subsidies to poor and working-class families for investment in children. They would then demand good-quality, sustained programs.
- ◆ Build a supplier constituency by hiring and training mothers to start and manage their own small daycare services, while providing public subsidies to help poor neighbors pay for such services.

2. Attanasio and Vera-Hernández (2004); Behrman and others (2006).

Unfortunately, the Chilean-style pension reforms introduced in several Latin American countries during the 1990s seem to have done nothing to expand effective coverage.²⁴ And rather than augmenting coverage by providing a broad-based pension floor for the elderly, the pay-as-you-go pension systems that remain in the region tend to increase inequality by

24. Chilean-style reforms have been introduced in several countries since 1992, including Argentina, Bolivia, Colombia, El Salvador, Mexico, Peru, and Uruguay. In essence, these reforms consist of a shift away from government-administered, pay-as-you-go, defined-benefit pension systems toward systems that rely mainly on the so-called “second pillar”—that is, mandatory, privately administered, defined-contribution pension funds (Gill, Packard, and Yermo 2005; Kay and Matijascic 2006). That this type of reform has failed to widen coverage is illustrated in Chile itself, where coverage has failed to expand beyond 60 percent of the labor force, the same as in the old pay-as-you-go system (Larraín Ríos 2005). For in-depth analysis of pension reform experiences in Mexico, Costa Rica, Brazil, Peru, Uruguay and Argentina, see Kay and Sinha (2007).

offering benefits only or mainly to formal sector workers. The problem of providing coverage to the very poor may require a solution that goes beyond expanding the formal pension system. There will always be many people outside the system who will be deeply poor when they are old. Because coverage of the formal pension scheme will never be sufficient, some type of noncontributory income support program in old age may be the only answer.²⁵

Perhaps the most egregious forms of regressivity in pension systems in the region are found in certain separate pay-as-you-go pension schemes for certain classes of public sector employees—for example, those in the education system, the judiciary, the police, the military, and public enterprises. Because such systems offer overgenerous pension benefits—that is, pensions that vastly exceed what is warranted by accumulated contributions—to a privileged few, they are a huge and hugely regressive drain on public finances.²⁶ In part, the excessive benefits reflect past public sector wage negotiations that were often resolved by agreements to limit current wage increases in return for future pension and other benefits. But those future benefits were never funded; the result has been high and often exploding public sector unfunded liabilities. To protect their benefits, politically powerful groups have resisted incorporation into the general pension system, so taxpayers bear the burden.²⁷ In Brazil, the annual

25. In developed countries, social protection systems often include noncontributory old age income support programs to protect the very poor. In Latin America, with the exception perhaps of Brazil, very little effort has been made in that area. Brazil's rural pension system extends pension coverage to the rural poor through noncontributory mechanisms, financed in part by taxes levied on the sale of agriculture products (ECLAC 2006b).

26. Excessive generosity takes the form of a retirement pension that vastly exceeds what is warranted by accumulated contributions. In practice, this is the result of one or more factors: low contribution rates, low retirement age, pensions that are based on the recipient's last salary, and so forth.

27. In Chile, the social security programs for the Armed Forces were left out of the reforms and their administration was maintained under the National Defense Social Security Fund (Caja de Previsión de la Defensa Nacional) and the General Department of Social Security for the Police Force (Dirección de Previsión de Carabineros de Chile). The pension scheme runs at a deficit, and benefits are nearly totally (93–95 percent in 1997) financed by the central revenue budget. Peru has a highly regressive pension system for a select group of civil servants, the *Cédula Viva*, managed by the federal government, which provides significantly more generous benefits than the country's national pension regime, which is open to all workers. In 2004, the public subsidy to the *Cédula Viva* equaled 99 percent of its cost. That same year pension reforms closed the *Cédula Viva* to new entrants and empowered the legislature to reduce current benefits and make it more difficult to raise future benefits (Lindert, Skoufias, and Shapiro 2006).

deficit on the civil service pension system, which covers only 13 percent of pensioners, constitutes around 3.8 percent of GDP.²⁸ In a country struggling to sustain a primary fiscal surplus target of more than 4 percent of GDP, that is a huge fiscal burden—and one that, short of reform, will grow as the population ages.²⁹ Future taxpayers, including poorer workers, will end up subsidizing more privileged workers.

Privileged pension programs for civil servants and the military are essentially a political economy issue. The high costs are well known. Yet the governments that have attempted reforms have so far been limited, after huge and costly political fights, to minor fixes. There is the usual collective action problem: losers are easy to identify (losses are big and concentrated among a politically vocal few) while winners are not (gains are small for each individual and spread out over many beneficiaries). To mobilize those who stand to gain requires making the imbalances clear to everyone—and in some cases embarrassing the losers with public information on the size of their benefits. (Protests erupted in Argentina in 2001–02 when the pension benefits of civil servants were revealed in the press.) When legal contracts bind current taxpayers, at the least the pension rules for the future should be fixed.

With equity as the objective, improved pension policy calls for

- ◆ Expanding coverage to reach more of the poor, while maintaining the financial viability of pension systems and avoiding fiscal damage.

28. World Bank (2005b). The figure refers to the deficit of the combined pension schemes for public sector workers at the federal, state, and municipal levels of governments in 2004. Pensioners in the public sector scheme received R\$1,973 on average in 2003, nearly five times more than their counterparts in the private sector (for federal public servants, the average value of pensions can be up to twenty-five times greater than the average pension for private sector workers). Cash-strapped states and municipalities are obliged under the Federal Responsibility Law to constrain spending on salaries and pensions to below 60 percent of revenues. Expenditures on civil servant pensions often can constitute up to 50 percent of the total payroll of active/inactive employees and 30 percent of the total payroll, imposing an onerous fiscal burden that squeezes out development spending (World Bank 2005b; Ferreira Savoia 2007). Glomm and others (2005) and Glomm, Jung, and Tran (2006) examine the negative impact of Brazil's generous pension scheme and rising pension expenditure on consumption, public investment, and GDP growth.

29. The population in Brazil sixty years of age and older is expected to grow at an annual average rate of 3 percent in the next twenty years, while total population is growing at less than 1.4 percent annually. Although reforms that Brazil pushed through in 2003–04 are a step in the right direction, they save only about 0.2 to 0.3 percent of GDP (World Bank 2005b, 2007a; Ferreira Savoia 2007).

In economies with large numbers of informal and self-employed workers, that might require regulatory adjustments to allow groups of self-employed workers to invest together in the country's private defined-contribution systems.

- ◆ Including minimum benefits for low-income retirees enrolled in the formal pension system, if necessary financed from general revenues. Chile has set up a collective, or solidarity, scheme funded by employers and the state that pays benefits (partial insurance) to workers with insufficient funds in their individual accounts.
- ◆ Considering generic, non-contributory old age income support programs to protect the very poor, financed from general tax revenues.
- ◆ Promoting informed public discussion of the immediate and long-term costs of civil service, military, and state enterprise pay-as-you-go pension programs. That is the first step toward creating the political will and developing legislation to reduce the future tax burden of these programs.