

TC Document

I. Basic Information for TC

▪ Country/Region:	REGIONAL
▪ TC Name:	Fiscal policies for equity in LAC
▪ TC Number:	RG-T4198
▪ Team Leader/Members:	Rasteletti, Alejandro Gabriel (IFD/FMM) Team Leader; Astudillo, Karen (IFD/FMM) Alternate Team Leader; Acevedo Calle, Daniela (LEG/SGO); Ardanaz, Martin Jorge (IFD/FMM); Calderon Ramirez, Ana Cristina (IFD/FMM); Gomez Reino, Juan Luis (IFD/FMM); Gonzalez De Frutos, Ubaldo Jesus (IFD/FMM); Larios, Jose I. (IFD/FMM); Munoz Miranda, Andres Felipe (IFD/FMM); Pessino, Carola (IFD/FMM); Radics, Gustavo Axel (IFD/FMM); Roman Sanchez, Susana (IFD/FMM); Zaltsman, Teodoro Ariel (IFD/FMM)
▪ Taxonomy:	Research and Dissemination
▪ Operation Supported by the TC:	.
▪ Date of TC Abstract authorization:	19 Sep 2022.
▪ Beneficiary:	Ministries of Finance in LAC
▪ Executing Agency and contact name:	Inter-American Development Bank
▪ Donors providing funding:	OC SDP Window 2 - Institutions(W2C)
▪ IDB Funding Requested:	US\$600,000.00
▪ Local counterpart funding, if any:	US\$0
▪ Disbursement period (which includes Execution period):	36 months of execution period and 36 months of disbursement period
▪ Required start date:	December 2022
▪ Types of consultants:	Individuals and Firms
▪ Prepared by Unit:	IFD/FMM-Fiscal Management Division
▪ Unit of Disbursement Responsibility:	IFD/FMM-Fiscal Management Division
▪ TC included in Country Strategy (y/n):	No
▪ TC included in CPD (y/n):	No
▪ Alignment to the Update to the Institutional Strategy 2020-2023	Gender equality; Institutional capacity and rule of law; Social inclusion and equality

II. Objectives and Justification of the TC

- 2.1 **Objectives.** The general objective of this technical cooperation (TC) is to foster improvements in fiscal equity in Latin America and the Caribbean (LAC) countries, by generating new evidence on the redistributive impacts of fiscal policies and on the institutional capacities required for governments to effectively manage equity using fiscal tools. The specific objectives of the TC are to: (i) measure the economic incidence and impact of fiscal interventions on inequality; and (ii) produce recommendations for improving the design of innovative redistributive fiscal policies and for strengthening the institutional capacities of ministries of finance to manage fiscal equity.
- 2.2 **Justification.** Before the COVID-19 pandemic, the LAC region had the highest level of inequality in disposable income in the world, with a regional Gini coefficient of 0.48 (Busso and Messina, 2020). The economic and social crisis caused by the pandemic exacerbated the problem of inequality, increasing it by approximately

6% (IDB, 2021). This was a consequence of the pandemic's greater impact on vulnerable groups and on those with informal employment (Acevedo et al., 2021). Although employment has recovered, the effects of the pandemic on equity and inequality are likely to persist into the medium term, due to heterogeneous losses of human capital in the active and school-age populations.

- 2.3 One of the main causes of the high inequality in LAC is the weak redistributive impact of the social spending and tax systems. This is clearly reflected in the fact that household market income inequality in LAC is very similar to that observed in the developed countries, but disposable income—i.e., household market income after receiving government transfers and paying direct taxes—is much more unequal. This is because government interventions in LAC reduce income inequality by only 5% (as measured by the Gini coefficient), compared with 35% in developed countries.
- 2.4 Most of the gap in the redistributive impact of government interventions relates to public spending, as it accounts for around 70% of the redistributive impact of fiscal policy in developed countries (Izquierdo and Pessino, 2020). The much smaller redistributive power of spending policies in LAC relates mostly to the low levels of social spending, that on average are less than half of those observed in OECD countries. Within social spending, pensions are particularly important.¹ Existing pensions systems in the region increase inequality, as most poor households tend not to have access to a formal pension, as they were more likely to have been engaged in informal work during their active working life, preventing them to have access to a formal pension. This results in richer households receiving most of the pension transfers. For instance, in El Salvador and Guatemala, the two richest quintiles receive about 80 percent of total public pension transfers, while the two poorest quintiles receive only about 10%.
- 2.5 Another important difference between countries in the region and developed countries relates to social assistance spending. These types of programs tend to have a low redistributive impact in LAC, as their funding tends to be low in most countries and their management is characterized by important leakages. The relatively low spending on social assistance programs leads to a generalized under coverage of poor households. In the region, the average coverage by these programs of the extremely poor, moderately poor, and vulnerable populations stands at 56%, 43%, and 28%, respectively (Stampini et al., 2021). Benefits also leak to nonpoor individuals: on average, approximately 40% of the beneficiaries of conditional transfers and 60% of those receiving noncontributory pensions are nonpoor. Such leakages are primarily received by vulnerable households and individuals, but approximately 10% of conditional transfers and 20% of noncontributory pensions are received by middle- and high-income beneficiaries (Stampini et al., 2021).
- 2.6 Another factor that explains the gap in redistributive impact of government interventions in LAC vis-à-vis developed countries relates to tax systems. Tax systems have a low redistributive impact in LAC countries, both because the relative low levels collections form the most progressive taxes, such as the personal income tax and

¹ Education and health are also important social spending that affect equity and equality. However, as current spending on education and health do not have an immediate or direct impact on disposable income, most current methodologies do not consider the redistributive impact of these expenditures or consider them in alternative measures of income, such as consumable income.

property taxes.² Furthermore, the tax revenues composition is highly biased towards the value added tax (VAT) and other taxes on goods and services, which are usually considered to be regressive taxes. In addition to the level and composition of revenues, tax codes in LAC present numerous tax benefits that predominantly benefit higher income households in absolute terms. In the case of the VAT, most LAC countries have implemented reduced rates or exemptions on goods that are disproportionately consumed by poor households, with the aim of reducing the tax burden on these households. This tax benefit on goods rather than individuals creates tax expenditures that benefit the entire population instead of just the poor. Indeed, more than 70% of VAT exemptions in LAC benefit nonpoor individuals (Pessino and Alaimo, 2018). In the case of the individual income tax, countries usually offer numerous deductions that account for revenue losses of approximately 1.6% of GDP and almost exclusively benefit higher-income groups. All the above leads to tax burdens being regressive or not very progressive in the countries of the region.

- 2.7 Two other underlying factors also affect the redistribute impact of fiscal policies. The first one is that spending and tax policies do not take into sufficient consideration gender and ethnic equity, two dimensions along which important inequalities are observed in the region. Regarding gender, economic gaps between men and women are huge. Before the pandemic, for every 100 men living in poor households, 112 women were in similar condition. Likewise, 28% of women over 15 years of age had no income of their own, compared to 12% of men in the same range (ECLAC, 2020). The pandemic worsened this situation, drastically reducing women's economic empowerment by further deepening the feminization of poverty. Compared to 93% of men, only 67% of women in LAC participate in the formal workforce and more than 126 million works in the informal sector (UNWOMEN, 2020). While it is known that the tax system can affect women's decisions about where and how much to work, as well as their consumption patterns (Astudillo et al., 2022), little is known about the effects of the tax system on women's decisions and opportunities in LAC. There are also no targeting efforts, including tax incentives that increase opportunities for women, particularly those with lower incomes. Regarding ethnicity, afro-descendant and indigenous populations represent around 58% of people living in extreme poverty in LAC. Afro-descendant households are 2.5 times more likely to live in chronic poverty than non-Afro-descendants (Freire et al., 2018). Meanwhile, indigenous peoples account for 8% of the region's population but constitute approximately 14% of the poor population and 17% of the extremely poor in Latin America.
- 2.8 The second underlying factor that affects the low redistributive impact of spending and tax policy relates to institutional weaknesses in Ministries of Finance, that prevent the correct inclusion of equality in policy design and implementation. Regarding policy design, most ministries in the region do not include fiscal equity discussions on fiscal planning instruments and law proposals. For instance, very few countries in the region include equity analysis on documents explaining the motivations behind the reform or introduction of a law. Something similar is observed in budget proposal documents or medium-term fiscal frameworks. Additionally, Ministries of Finance do not play an active role in the management of fiscal equity. For instance, they do not use all the

² In OECD countries, average revenue from individual income and property taxes stands at 8.1% and 1.2% of GDP, respectively, compared with only 2.1% and 0.3% in LAC.

information they have available for a better targeting of subsidies for energy and public utilities³ or tax benefits.

- 2.9 Given the fiscal policy and management challenges mentioned above, this TC will seek to develop new tools and methodologies to measure the economic incidence of specific fiscal reforms, as well as the overall impact of existing spending and tax policies on inequality. The TC will also produce recommendations for improving the design of innovative redistributive fiscal policies and for strengthening the institutional capacities of ministries of finance to manage fiscal equity.
- 2.10 **Strategic alignment.** The activities of this TC are consistent with the Second Update of the Institutional Strategy 2020-2023 (AB-3190-2), and it is strategically aligned with the development challenge of social exclusion and inequality, by supporting the development and implementation of tools to measure the redistributive impact of fiscal policy, which will inform and improve policy decisions. These tools will also consider gender and ethnic aspects and they will strengthen institutional capacities for the design and management of redistributive fiscal policies, which aligns this TC with the IDB Institutional Strategy cross-cutting themes of institutional capacity and rule of law and of gender equality and diversity. Likewise, this TC is consistent with the Sector Framework Document on Fiscal Policy and Management (GN-2831-8) which underscores the importance of institutional capacity-building in the public sector to design and implement fiscal policies that improve efficient mobilization and allocation of resources that improve social inclusion and equity. The TC also aligns with the priority area 3: Effective, efficient and transparent institutions of the Strategic Program for Development Financed with Ordinary Capital.
- 2.11 **Contribution to the Bank's operative program.** This TC will coordinate with other on-going projects that support activities aimed at strengthening the redistributive impact of fiscal policies, such as the ATN/OC-18381-RG (Tools to Design Fiscal Transition and Recovery Policies in Response to the COVID-19 Pandemic).⁴ The mentioned TC develops standards and tools that support the governments of the region in the design and implementation of comprehensive economic stimulus plans, assistance programs for the most vulnerable households and firms, and fiscal consolidation plans. It also generates knowledge about the effectiveness of fiscal interventions, to have evidence to support decision-making by LAC governments. The TC will also contribute with future operations supporting fiscal reforms, as the methodologies and studies to be financed will inform the policy advice provided by IDB fiscal specialists to countries in the region.

III. Description of activities/components and budget

³ Subsidies for propane, gasoline, diesel fuel, and electricity predominantly benefit higher-income households, with the highest-income decile receiving five times more subsidies than the poorest one. This is a result of higher levels of consumption in these segments (Llerena et al., 2015). In the case of subsidies for electricity, gas, and water, some countries have differential rate policies that aim to provide lower rates to poorer households. However, this type of targeting is usually based on household records or consumption levels. The use of available fiscal and government records could improve the targeting of these policies.

⁴ This TC also complements the ATN/OC-18118-RG (Support to the Development of Fiscal Policy with Equity as a Response to COVID-19) and the ATN/OC-19495-HO (Support to improve fiscal policy efficiency and equity in Honduras), which include analysis of effects of fiscal reforms on equity. This TC has a stronger focus on methodologies and pilot experiences, to expand knowledge.

- 3.1 Component 1. Fiscal equity analysis (US\$400,000).** The objective of this component is to generate new knowledge on the redistributive impact of fiscal policies in LAC countries. This component will finance: (i) country-specific assessments, to determine to what extent existing tax policies and government spending programs reduce inequality and poverty, (ii) development and implementation of new analytical tools, to analyze the redistributive impact of fiscal policies on certain groups and considering a broader set of effects, and (iii) evaluations to empirically measure the economic incidence of fiscal policies. Regarding the country-specific assessments, the redistributive impact of fiscal policies will be estimated for at least four beneficiary countries using standard static methodologies, based on microdata from household surveys, tax revenue data and budgetary information. In respect of the new analytical tools, new methodologies will be developed or adapted to the LAC context, to assess the effects of fiscal policies on gender and diversity gaps, to model the behavioral responses, to consider general equilibrium or indirect effects, and/or to measure the effects on equality of opportunities. Each of the new tools will be implemented in at least one beneficiary country. Beneficiary countries will be prioritized based on the availability of microdata to implement the fiscal incidence methodologies, the inexistence of a recent fiscal incidence analysis, and on counterpart interest. Finally, regarding policy evaluations, tax and expenditure reforms will be analyzed, to assess the effects on different key prices, to determine their economic incidence of these reforms.
- 3.2 Component 2. Policy and institutional strengthening (US\$125,000).** The objective of this component is to produce policy recommendations and strengthen institutional capacities to increase the redistributive impact of fiscal policies. Regarding policy recommendations, detailed analysis and assessment of different innovative redistributive policies will be performed. These recommendations will be based on microsimulations and some of the new methodologies to be financed as a part of component one of this TC. Regarding institutional strengthening, this component will finance the design and implementation of tools and diagnostics that will allow ministries of finance to include equity analysis in budget documents, medium term fiscal frameworks and on documents explaining the motivations behind the reform or introduction of a law. It will also finance proposals to improve the exploitation of existing administrative data to better target fiscal interventions.
- 3.3 Component 3. Communication and results dissemination (US\$75,000).** The main goal of this component is to discuss with countries and disseminate the results of the TC. Throughout the TC execution, intermediate results will be presented and discussed with beneficiary countries. The knowledge products will be disseminated to the public, if they do not present confidential data or sensitive information to any participating country. Communication and dissemination of results activities will be developed during the execution of the project and financed by it.
- 3.4 Beneficiaries and expected results.** The direct beneficiaries of this TC are the Ministries of Finance, Planning or alike, which will benefit from the studies and methodologies produced, as these will inform public policy. The indirect beneficiaries are the population, which will benefit from the implementation of more redistributive policies. As a result of the activities and products financed by the different components of this TC, an expected result is an increase in the number of countries using solid methodologies to estimate the redistributive impact of fiscal policies. The activities of first component of the TC will contribute to the development of these methodologies,

while activities of second and third components will promote the use of these methodologies and strengthen ministries of finance to appropriate them.

- 3.5 The total cost of TC is US\$600,000, which will be financed by the Bank through Window 2, Priority Area 3: Effective, Efficient and Transparent (W2C) Institutions of the Strategic Development Program financed with Ordinary Capital (OC-SDP).

Indicative Budget			
Activity / Component	Description	IDB OC SPD W2	Total Funding
Component 1	Fiscal equity analysis	400,000	400,000
	Consultancies to measure the redistributive impact of fiscal policies using static methodologies	200,000	200,000
	Consultancies to support the design and implementation of new tools to measure fiscal equity	130,000	130,000
	Consultancies to evaluate the economic incidence of fiscal policies	70,000	70,000
Component 2	Policy and institutional strengthening	125,000	125,000
	Consultancies to support the elaboration of policy analysis and recommendations	75,000	75,000
	Consultancies to support the elaboration of proposals for the institutional strengthening of ministries of finance	50,000	50,000
Component 3	Communication and result dissemination	75,000	75,000
	Dissemination events	40,000	40,000
	Consultancies to support the elaboration of publications and dissemination efforts	35,000	35,000
Total		600,000	600,000

- 3.6 The Fiscal Management Division (FMM) at the IDB headquarters will be responsible for the supervision, monitoring and evaluation of the TC. It will also be responsible for the financial execution of the operation. The TC execution will be monitored and evaluated according to the annual goals and indicators of the results and products that make up the TC results matrix. The foregoing in strict compliance with the provisions of Annex II of document OP-619-4.

IV. Executing agency and execution structure

- 4.1 Given the regional dimension of this TC and the lack of a regional entity with the capacity to implement it, the Bank will be the executing agency through the Fiscal Management Division (IFD/FMM) in close coordination with FMM country specialists.
- 4.2 In line with the criteria established in Annex II of the Procedures for the Processing of TC Operations (OP-619-4), the Execution by the Bank is justified by the regional nature of this program, which will allow effective coordination of the work to be carried out with the ministries of finance. The Bank's execution is justified by the fact that this program involves strengthening the design of fiscal policies to reduce poverty and increase equity. The technical capacity and experience that the Bank has through the Fiscal Division in matters of fiscal management and policy, will allow the expected result of this TC to be achieved, which is to provide the ministries of finance with tools to reduce poverty and inequality through sound fiscal policy.
- 4.3 The activities to be executed under this operation have been included in the Procurement Plan (Annex IV) and will be executed in accordance with the Bank's

established procurement methods, namely: (a) Hiring of individual consultants, as established in AM-650; (b) Hiring of consulting firms for services of an intellectual nature according to GN-2765-4 and its associated operational guides (OP-1155-4) and (c) Contracting of logistics services and other services other than consulting, according to policy GN-2303-28.

V. Major issues

- 5.1 Among the risks of the project are the low appropriation by countries of the studies, tools, models, and solutions developed by his TC. To mitigate this risk, the TC team will coordinate closely with the beneficiary countries and with the country offices, to ensure the relevance of the products for the countries, promoting their appropriation. There is also a risk that the applications and solutions developed and implemented in the field of this TC are not sustainable over time. To mitigate this risk, TC products will be disseminated among countries and FMM will promote the continued use to the tools developed.
- 5.2 There is a risk that difficulties may arise during the development of methodologies, due to timely availability of information. This risk will be mitigated by establishing close contacts and frequent dialogues with the agency's owners of the relevant data, and by hiring professionals with extensive experience in the subject, who guide counterparts in the collection of data.

VI. Exceptions to Bank policy

- 6.1 There are no exceptions to the Bank's policies for the implementation of TC.

VII. Environmental and Social Strategy

- 7.1 This TC will not finance feasibility or prefeasibility studies of investment projects with associated environmental and social studies; therefore, it is excluded from the scope of the Bank's Environmental and Social Policy Framework (GN-2965-23).

Required Annexes:

[Results Matrix - RG-T4198](#)

[Terms of Reference - RG-T4198](#)

[Procurement Plan - RG-T4198](#)