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Redistributive Impact and Efficiency of Mexico's Fiscal System

John Scott (Centro de Investigacion y Docencia Economica – CIDE)
Commitment to Equity Project (CEQ)
Twitter @noralustig

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Background

Over the last two decades, Mexico has implemented a series of important spending and policy reforms that have significantly increased the redistributive impact of social spending. These include:

- A major reallocation of public spending to social programs over the 1990s, from 25% to 49%.
- The introduction of innovative and effectively targeted transfer programs—in particular, the *Progresa/Oportunidades* CCT program.
- A general pro-rural reorientation of basic education services, health services for the uninsured, and food subsidies, correcting a strong urban bias in social spending prevailing in previous decades.

A second wave of reforms over the last decade has increased public spending on non-contributive social protection programs benefiting the poor, including the introduction and rapid growth over the last five years of basic pension programs (*Adultos Mayores, 70 y más*) and non-contributive health insurance (*Seguro Popular*). These programs have extended the coverage of basic social security significantly, but they have been introduced as ad hoc solutions, rather than in the context of a global reform of the social security system. These benefits are lower and less secure than those offered by contributive social security, but have the collateral effect of subsidizing informal labor. The most progressive spending categories at present include most direct transfers and food programs, basic education services, and health services for the uninsured.

Redistributive Impact of Mexico's Fiscal System

While these reforms have significantly increased the redistributive impact of Mexico's fiscal system, the country still falls well below its redistributive potential, as measured by per capita income, the quality (and redistributive effectiveness) of its best social programs, and the achievements of comparable countries in the region. While Mexico's per capita income is similar to Argentina's and higher than Brazil's, at 10%, social spending as a share of GDP is less than half of Argentina's and 60% of Brazil's. The redistributive effectiveness of this spending in Mexico, measured as the percentage change in the Gini coefficient divided by the percentage of GDP allocated to social spending (1.39) is lower than Argentina's (2.12) and similar to Brazil's (1.37). Thus, the total reduction in inequality that Mexico is estimated to achieve through social spending (14.4%) is 10 and 6 percentage points lower than Argentina's and Brazil's, respectively.

Most of this redistribution is achieved through in-kind transfers under the (strong) assumption that the monetary value of the goods and services being transferred is equivalent to the average cost of provision. Mexico's direct transfer programs are just as effective in reducing extreme poverty (measured by the 2.5 USD PPP poverty line) as Argentina's, and more than twice as effective as Brazil's. However, Mexico spends only 1% of GDP on such transfers, while Argentina and Brazil spend 3.7% and 4.2%, respectively. Thus, while transfers reduce extreme poverty by 58% and 28.5% in the latter countries, they do so by only 15% in Mexico.

Explanation of System Shortcomings

The failure of Mexico's fiscal system to achieve its full redistributive potential is explained by three principal characteristics of the system: 1) a progressive but comparatively unproductive tax system with low levels of indirect tax revenues, 2) low spending on direct transfers, and 3) a significant share of scarce fiscal resources still allocated to instruments with limited redistributive effectiveness.

This unfortunate combination is not accidental. Mexico's tax system is among both the most progressive and least productive in the region. Broad exemptions and explicit subsidies that are often intended to protect the poor too often do the opposite in practice. Examples include:

- Generalized VAT exemptions on foods and medicines.
- A special excise petrol tax that becomes *negative* when the international reference price rises above the domestic government-set price. This has generated an accumulated subsidy of 6% of GDP between 2006 and 2012.
- A negative income tax or employment subsidy for formal sector workers.
- Subsidies to contributory social security systems.
- Subsidies for public tertiary education and public scholarships other than those of *Oportunidades*.

As with any generalized consumer subsidy--especially in a context of high income inequality--most of the benefits from the VAT exemptions and petrol subsidy accrue to higher income groups. Most poor workers are excluded from subsidies to the contributory social security systems and the negative income tax because they are in the informal sector. Subsidies for public tertiary education and scholarships tend to benefit the wealthy, who are more likely to be able to afford the implicit or explicit costs required to access them. It is true that some of the benefits from these subsidies do reach the poor, and are more important to the poor than to higher income beneficiaries, relative to their respective income levels. But what the poor gain from the direct effect of a more progressive tax system is much less than what they lose from the limited transfers such a system is able to finance for them.

The wide range of concentration coefficient values across and within the principal policy dimensions analyzed (education, health, social security, income support, and food programs), and the associated differences in the redistributive efficiency of the principal instruments, reveals significant opportunities to improve the system's overall redistributive impact.

The Economics and Politics behind the Numbers

How can we explain the continued funding of ineffective redistributive instruments at the expense of more effective measures? In some cases, this reflects capture of benefits by organized interest groups. Agricultural subsidies and public sector social security benefits that are far better than those available to formal private sector workers, for example, are legacies of the single-party corporatist regime that dominated or most of the 20th century.

But in most cases, the explanation involves a simple inequality trap: in a context of high (market) income inequality, poor households cannot afford to incur the costs required to access many public benefits. Table 1 summarizes some of these costs and what must be done to resolve them.

Finally, geography and population dispersion, which is exceptionally high in Mexico, acts as a third type of barrier contributing to both income and fiscal inequality.

Table 1: Costs to Access Public Benefits

Cost	**How to resolve**
Explicit or implicit user fees, especially in higher education and hospital services	Shift to tax finance
Social security contributions	Reduce benefits to increase coverage or shift to general, not payroll, tax finance
Opportunity costs associated with labor income forgone in attending tertiary education	Shift from supply side subsidies to well-targeted scholarships
Purchasing power to access subsidized goods and services	Shift to targeted subsidies and direct transfers

Conclusion

Fiscal reforms should always be conceived and implemented integrally, but this is particularly important in the context of Mexico's low revenue/high inequality fiscal equilibrium, or inequality trap. A more equitable fiscal contract would transition the country from generalized subsidies and a truncated contributive social security system to a broad tax base that in turn finances an effective, universal and well-funded system of benefits.