

CHAPTER FOUR

The Middle Sectors, Fiscal Policy and the Social Contract

ABSTRACT

This chapter analyses the links between the middle sectors and fiscal policy. Latin American middle sectors strongly support democracy, but they are critical of how it works, largely due to the perceived low quality of public services delivered by governments. Moreover, the net effect of taxes and transfers for middle-sector families is not large, and they benefit most from in-kind services such as education and health care. If these services are of low quality, the middle sector is more likely to consider itself a loser in the fiscal bargain and less willing to contribute to financing of the public sector. This chapter proposes that in order to strengthen the social contract — particularly with the middle sectors — governments need to improve the quality of public services and carry out tax reforms based on greater transparency and more effective administration.

Implementing the policies we have discussed so far means financing them. Fiscal policy — how revenue is raised and expenditure allocated — constitutes the core of public policy and sets the political equilibrium in a society. In a democracy, voters' preferences for the amount and type of redistribution shape important aspects of fiscal policy and, in turn, fiscal policy influences their perceptions about the level and quality of services delivered by the public sector.

Fiscal policy sits at the heart of the state's relationship with its citizens – all the more so in Latin America, given weak social contracts and consolidating democracies.

Never simply secondary or technical concerns, for most countries in Latin America they are particularly important given that their social contracts are extremely weak or in some cases broken.¹ Throughout the region this is reflected in tax revenues that are low relative to GDP, the corresponding importance in the public finances of non-tax revenues which are often linked to volatile commodity prices, high levels of tax evasion, and a tax structure biased towards indirect taxes. Most governments find themselves unable to raise the resources needed to deliver the level of public services necessary for development; while at the same time the quality of public services such as education and health is low compared not only with OECD countries but their developing peers. The tensions inherent in this weak social contract have come to the fore since the mid-1980s as countries in the region have increasingly embraced democracy.

What then is the role of the region's middle sectors in shaping the social contract and fiscal policy? Do its members demand more social insurance? Would they be willing to pay more taxes to finance more or better public services? This chapter explores these issues, in particular the attitudes of the middle sectors towards taxation and redistribution. It also looks at the other side of the coin: the effects of fiscal policies on the middle sectors. Are they a net contributor or recipient? Which expenditures and taxes redistribute the most? A detailed tax-benefit incidence analysis for Chile and Mexico sheds some light on these issues.

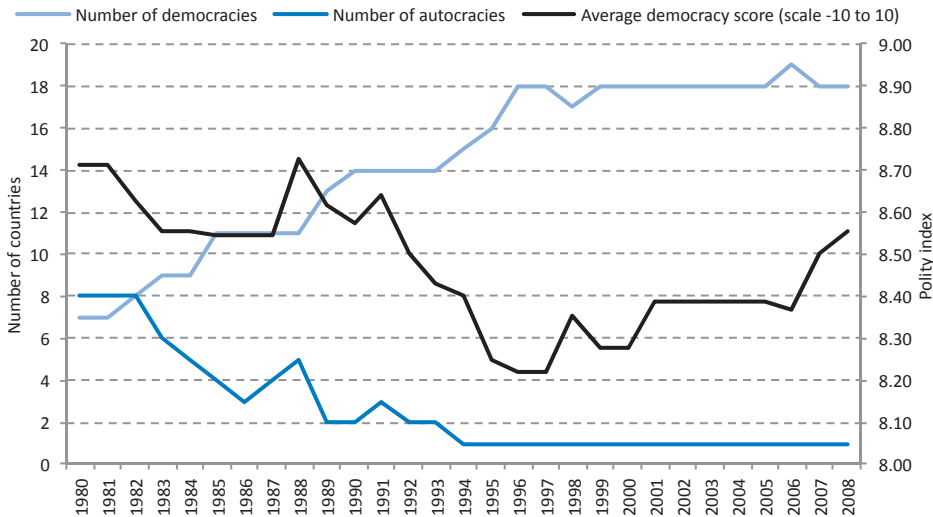
A better understanding of how perceptions on the role of fiscal policies are formed and the practical effects these policies have on income distribution are vital steps in an informed debate on alternative ways to finance and deliver essential services in the region.

ATTITUDES TOWARDS DEMOCRACY AND FISCAL POLICY

The region has been becoming steadily more democratic since the 1980s...

Many analysts have stressed the important role of the middle sectors in the functioning of the democratic system and social cohesion. Latin America has been steadily becoming more democratic since the mid-1980s, according to the "Polity IV" ranking, a widely used data series in political science research (Figure 4.1).² Out of 23 Latin American and Caribbean countries included in this database, 18 were ranked as democracies in 2008, with only Cuba left as an autocracy – whereas in 1980 there were eight autocracies and only seven democracies. From the early to the mid-1990s this expansion was accompanied by a decline in the average quality of democracy, a reflection of the relatively imperfect nature of the new regimes. Since then there has been a fairly steady democratic consolidation in the region.³ There are of course considerable differences across countries – from consolidated democracies such as Costa Rica, Chile and Uruguay (with a Polity score of 10, the same as most OECD countries), to countries such as Ecuador and Venezuela where democratic consolidation is considerably weaker.

Figure 4.1. Democratic consolidation in Latin America and the Caribbean



Notes: Following the criteria of Marshall and Cole (2009) countries are classified as a democracy if their Polity score is equal to or greater than 6.

Source: Based on the Polity IV database, accessed in May 2010.

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Democratic consolidation is often associated with increased demand for social expenditure, as sections of the population that were previously excluded from the decision-making process begin to exert their civil rights. Brazil's transition towards democracy is emblematic, being accompanied by a substantial increase in government expenditure to meet the state's new obligations under the country's 1988 constitution (Figure 4.2). There are potentially important development challenges here: if the state does not gather sufficient financial resources to meet voters' legitimate demands, then its choice is between satisfying them at the cost of unsustainable macroeconomic policies, or leaving them unfulfilled and undermining the democratic system.⁴

...which changes expectations and demands on public expenditure.

How Latin America is navigating this dilemma can be tested by looking at two key indicators of public perceptions: support for the proposition that democracy is the best system; and satisfaction with the actual way democracy functions in their country (Figure 4.3). The picture that emerges is one of preference for democracy in principle, but low satisfaction with how democracy is working. With the sole exception of Uruguay (where over 70% of the population is satisfied), the *majority* of people in every country in the region are not satisfied with the way democracy is currently working.

This does not reflect disillusion with democracy itself, support for which is much higher in most countries. In Venezuela, Dominican Republic, Uruguay, Paraguay and Guatemala more than 70% of the population support democracy. In a second group, though levels are lower, democracy still clearly enjoys the support of the majority. This group includes Nicaragua, Chile, Honduras, Argentina and Peru. In the rear, Bolivia, Colombia, Mexico, Panama, Costa Rica, Ecuador Brazil and El Salvador see support from around just 50% of the population – among this group are the two most populous countries in the region, Brazil and Mexico. Democracy is far from having consolidated either support or satisfaction across the region.

Support for democracy is high, but fewer citizens say it is working well.

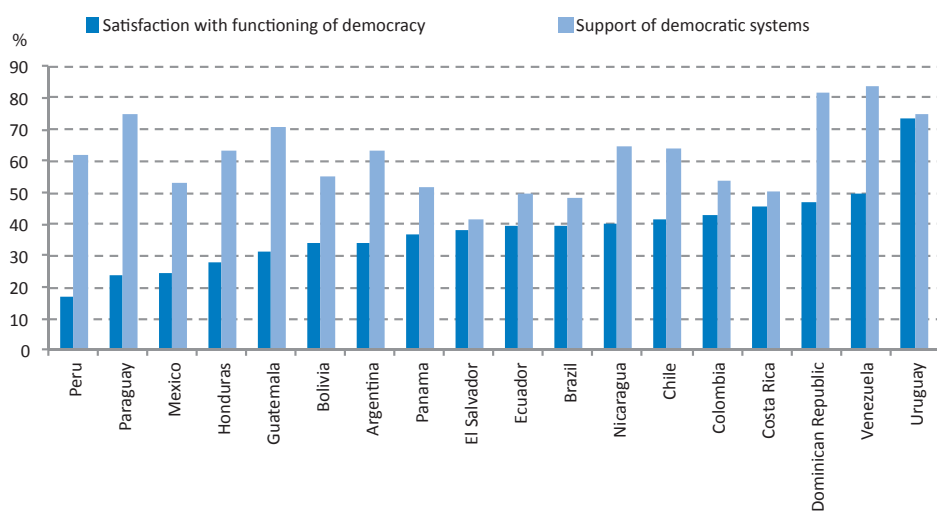
Figure 4.2. Democratic transition in Brazil and government consumption
(percentage of GDP)



Source: Based on the World Development Indicators database.

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Figure 4.3. Satisfaction with and support for democracy by country
(percentage of respondents, 2008)



Notes: Satisfaction with the functioning of democracy refers to answers "very satisfied" and "fairly satisfied" to the question: "In general, would you say you are very satisfied, fairly satisfied, not very satisfied or not satisfied at all with the way democracy works in your country?" Support for the democratic system refers to the proportion of respondents who selected "Democracy is preferable to any other kind of government" from a list of three statements about the organisation of government.

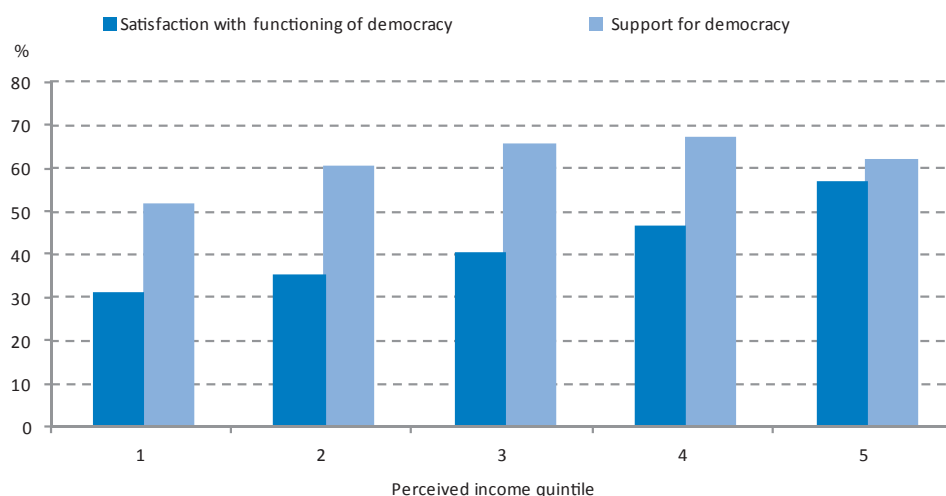
Source: Based on the *Latinobarómetro* survey 2008.

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What part do the Latin American middle sectors play in this? The data available allow analysis across self-perceived income quintiles (Figure 4.4).⁵ Satisfaction with democracy increases steadily with perceived economic status. A person who puts him or herself in the highest quintile is almost twice as likely to be satisfied with the way the democratic system works than a person in the first quintile (57% satisfaction against 31%).⁶ Support for democracy is more nuanced. It is the self-declared middle sectors that value democracy most.

Figure 4.4. Attitudes towards democracy by perceived income quintiles in Latin America

(percentage of respondents)



Notes: See Figure 4.3 for definitions of the variables.

Source: Based on the *Latinobarómetro* survey 2008.

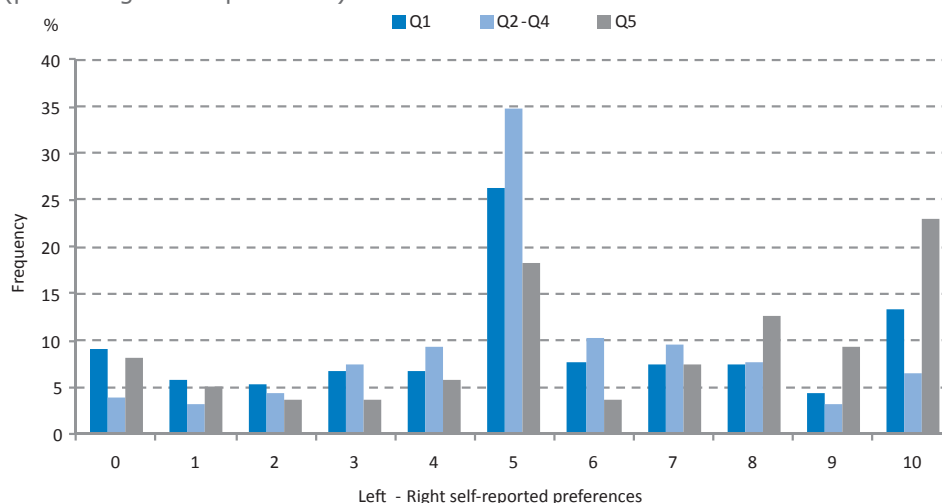
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Political stance can also be analysed by where people place themselves on a left-right scale (Figure 4.5). These positions are often used as an approximate measure of the demand for redistribution, with the left being associated with more redistribution and the right with more economically liberal views.⁷ Two interesting results emerge. First, people who perceive themselves as part of the middle sectors (those in the second to fourth quintiles) tend also to put themselves in the centre of the distribution of political preference. For example, over 54% of these middle sectors put themselves between 4 and 6 (the political centre). The equivalent figure for the disadvantaged is around 41% and for the affluent 28%. Second, the proportion of the middle sectors that place themselves at the extremes (of either left or right) is lower than the disadvantaged or the affluent. This is reflected also by a lower dispersion in political preferences within the middle sectors against the other groups.⁸

The middle sectors tend to hold moderate political views and be supporters of democracy in principle, but not always of how it works in practice.

Figure 4.5. Distribution of political preferences by perceived income quintiles

(percentage of respondents)



Note: Respondents classify themselves on a scale from 0 to 10, where 0 is the extreme left and 10 is the extreme right.

Source: Based on *Latinobarómetro* survey 2008.

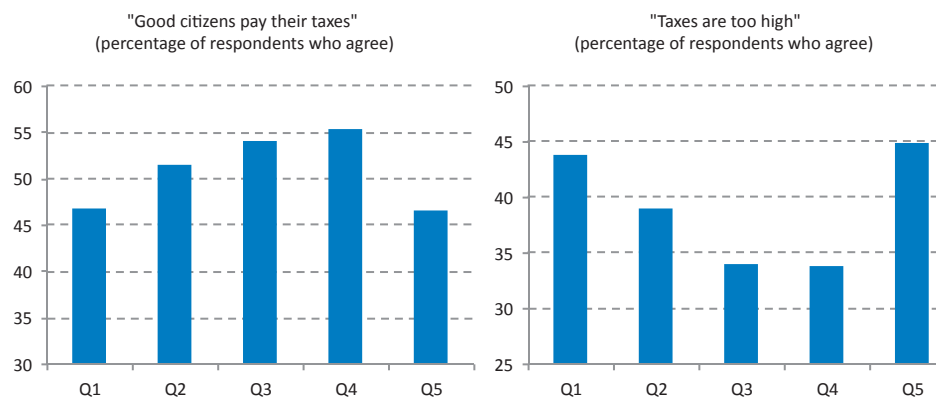
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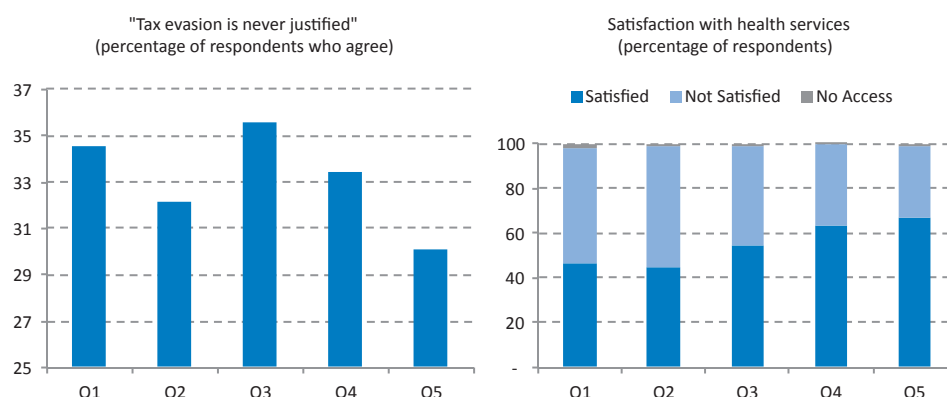
The middle sectors are “dissatisfied customers” of the state: supportive of taxation but unhappy with the services they receive.

The evidence, then, shows the middle sectors in Latin America are in principle supporters of democracy and have rather moderate views on politics, yet remain dissatisfied with how democracy actually functions. Is this dissatisfaction evident in their views on taxation and public services? Figure 4.6 synthesises the main findings. Clearly, the middle sectors display greater “tax morale”: members of the middle sectors are more likely than other members of society to consider that citizens should pay their taxes, are less likely to consider that taxes are too high, and less likely to justify tax evasion. However, they are also less satisfied with the provision of public services, compared to the affluent. In short, members of the middle sectors have a “dissatisfied customer” relationship with the state: while relatively supportive of taxation, they are not satisfied with the services they receive.⁹

Figure 4.6. The middle sectors, taxation and satisfaction with public services

(responses by self-perceived income quintiles)





Source: Based in *Latinobarómetro* surveys 2007 and 2008.

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Engaging the middle sectors – the theory

In principle, the middle sectors should be naturally interested in participating in the social contract. According to the median-voter model (see Downs, 1957) if inequality is high before taxes and public expenditure, as it is in Latin America, democracy should lead governments to raise revenue and effect significant redistribution. However, while democracy may be a necessary condition for this, it may not be sufficient even in theory.

Personal preferences towards redistribution stem from numerous sources. Attitudes are affected by individual history, in the form of mobility experiences and perceptions regarding mobility (Piketty, 1995). The organisation of the family matters, as do national and regional cultural and social values (surveyed by Alesina and Giuliano, 2009). Furthermore, the potential beneficiaries of redistributive policies may take into account the effects of taxation on the labour-leisure decisions of their fellow citizens when voting, choosing as a result to limit the size of government and the degree of redistribution (Meltzer and Richards, 1981).

It has been argued that voter perceptions of meritocracy and high social mobility should create support for low levels of taxation and redistribution.

Social beliefs about the degree of fairness in social competition also matter (Alesina and Angeletos, 2005). If a society believes that it is a meritocracy – individual effort determining income – and that everybody has the right and opportunity to enjoy the fruits of individual effort, it will choose low levels of redistribution and taxes. In fact, even the disadvantaged may vote for low levels of redistribution if they think that in the future they or their offspring could progress to the point that they would become net losers under such a policy (Bénabou and Ok, 2001). Societies with high mobility, or more precisely where people think that there is high mobility, may therefore opt for low levels of redistribution. This is the “prospect of upward mobility” (POUM) hypothesis. Conversely, in societies perceived as low-mobility the median-voter model is more likely to hold with a majority voting for more redistribution.¹⁰

All of these factors may be temporary though. Hirschman (1973) spoke of a “tunnel effect” of disadvantaged and middle-sector individuals willing to accept and support high (or even increasing) levels of inequality during the early stages of development. He likened this to people staying in the slow lane of a traffic jam in a tunnel, which they will do only as long as they keep their faith in future progress – that at some point their lane will start to move faster. Government credibility, risk aversion and expectations therefore play crucial roles.¹¹

Where public policies do not reduce inequality of outcomes, this may undermine support for what redistribution there is.

Przeworski (2007) adds an additional and challenging dimension. Even where governments are elected with a mandate to equalise rents and set out to do so, they may fail. Modern redistributive policies mainly aim to equalise human capital by investing in health and education, in contrast to the past's focus on redistribution of land or productive assets. Such redistribution may not result in an equalisation of outcomes since, as Chapter 3 has shown, the same educational system may produce very different outcomes depending on the socio-economic background of the pupils. In other words, equalisation of opportunities may not be enough. Furthermore, if voters are aware of these weak effects, they will attach low value to publicly provided services and hence have low willingness to fund them.

The data

Among the few rigorous empirical studies in this area, Profeta and Scabrosetti (2008) find that democracy in the region has no significant effect on either the level of taxation or its progressivity. One factor behind this is low institutional capacity, especially in tax administration. Another is the low quality of democracy, which remains vulnerable to populism, as well as "termites" who erode the tax base and "devoradores" who capture social expenditure, using the language of Elizondo and Santiso (2009). To this can be added inefficiencies in the tax and expenditure systems, with both tending to benefit the high-income population disproportionately (see Breceda *et al.*, 2008, and OECD, 2008a). Torgler (2005) highlights the low level of tax morale in Latin America, which ultimately undermines willingness to pay taxes. Finally, Gaviria (2007) argues that the high demand for redistribution and the weak support for market outcomes in Latin America in the late 1990s and early 2000s stem from pessimistic views on social justice, equality of opportunities and mobility.

Empirical research does however highlight the crucial part education plays in fostering support for taxation.¹² Latin Americans with higher education (controlling for other socio-economic factors) are less tolerant about tax evasion and are less likely to think taxes are too high. This result highlights a potentially important role for education in fostering social responsibility among citizens.

The evidence undermines the theory: Latin Americans who have benefitted from social mobility (or expect to do so) tend to be supportive of redistributive policies.

The same study supported the view that people who feel they (or those near to them) have benefitted from social mobility or who are more optimistic about future mobility tend to think that good citizens should pay taxes, and that current levels of taxation are not too high. They also tend to disapprove of tax evasion, although this result is statistically weaker. A similar result holds for belief in meritocracy: the proposition that taxes are too high is rejected by the majority of people who think that success depends on hard work rather than connections, or those who believe that a poor person in their country can become rich by working hard.

Together these results do not support the POUM hypothesis for the region. It seems that risk aversion and the demand for social insurance against downward mobility dominate the POUM effect.

The final piece of the jigsaw is the link between better public services, better institutions, and higher tax morale. Satisfaction with health-care and educational provision reinforce the view that good citizens should pay taxes and, in general, reduce the share of the population that thinks that taxes are too high (the results are weaker for pensions). Similarly, satisfaction with the functioning of democracy increases tax morale, as do lower levels of perceived corruption. On preferences for redistribution – unfortunately – no clear result emerges.

Reinforcing the social contract

The social contract may be weak, but these results show how it could be reinforced. A catalyst may be improvements in the quality of public services and institutions – including political reforms¹³ – that foster greater satisfaction with the functioning of democracy. Improvements in those areas should allow for higher levels of taxation in return – the relationship of citizens with their government, after all, is not just one of coercion but also based on trust.¹⁴ This virtuous circle may be consolidated by promoting education which has a positive effect on all the social attitudes measured, albeit one that takes time.

These results can be calibrated against the *ECosociAL 2007* survey. This found that only a minority of Latin Americans think that the disadvantaged or middle sectors have a good chance to progress – meaning access to university, home ownership, or establishment of a business.¹⁵ It also found that households in the region were exposed to many of the risks that can break the social contract and undermine social integration, such as crime, labour insecurity, and poor or absent health-care cover. However, at the same time, Latin American citizens have strong beliefs in the value of effort, in the benefits of education, and in the shared responsibility of the state and the individual – backed by a willingness to pay more taxes to finance social insurance. All in all, the results are an indication of a potential basis for a stronger social contract in Latin America, with the middle sectors playing an important role in its consolidation.

The beliefs necessary for a stronger social contract – shared responsibility, the value of effort, the need for taxes – exist among the region's middle sectors.

FISCAL POLICY AND THE LATIN AMERICAN MIDDLE SECTORS

The middle sectors are often seen as a net contributor to government coffers, not rich enough to avoid paying taxes but too well-off to qualify for targeted social benefits. Is this a true reflection? This section presents evidence on how the tax burden and benefit of public expenditure are distributed across income groups. Our focus is Chile and Mexico and our approach is to derive the net position of families in the middle sectors after both taxes and public expenditure by combining microdata from household surveys with information from national accounts.

An important step forward relative to earlier studies in this area is that we seek to go beyond cash benefits, by including the value of public services provided in-kind. Given that middle-sector households are unlikely to benefit significantly from government cash transfers, in-kind benefits such as education and health care may in fact represent the major part of what they get from the public sector – these components certainly make up the bulk of the benefits perceived by them.¹⁶

Pensions – which are often a large part of public expenditure – are excluded from the analysis. For Chile and Mexico, the main part of the pension system is handled by private pension funds. However, there are also life-cycle issues that make the finances of pay-as-you-go systems difficult to evaluate. It is hard, for example, to separate that part of today's contributions which is a transfer from the active population to the retired population – effectively a tax – from that part which relates to future pensions – a contribution. From the data available it is also almost impossible to evaluate the transfers and subsidies involved in publicly funded pension schemes in the region. We have therefore excluded pensions on the expenditure side and social-security contributions to pension schemes on the revenue side. This is not to deny that they have a direct impact on income and consumption.¹⁷ In general, pensions in the region (both the old and new schemes) tend to be very regressive on static income distribution,

Are the middle sectors net contributors to the state? Finding the answer means extending the traditional analysis to take into account the value of services provided in-kind.

since only a rather privileged part of Latin American societies is eligible to get an adequate contributory pension, and minimum pension coverage is limited (see Chapter 2).¹⁸

Subsidies, including those on items such as fuel and electricity which might be presumed to disproportionately benefit middle-sector households, also fall outside the scope of our analysis.

All in all, the imputed values we look at still cover over two-thirds of total taxes and expenditure. The total taxes and expenditure covered represent respectively 13.2% and 9.3% of GDP in Chile, and 6.0% and 5.0% in Mexico.

Allocating benefits and taxes

Capturing the influence of government services and taxes on household incomes requires enlarging the traditional concept of disposable income, which by itself does not fully describe the living standard of the population. Public services provided in-kind, such as education, health care and social protection, expand households' consumption possibilities. This is an offsetting item to the taxes households pay, which act to reduce their purchasing power.

To capture this value, we have used a tax-benefit incidence analysis, based on actual data about household composition and the operation of government programmes. Chile and Mexico have the data necessary for this.

We have employed a tax-benefit incidence analysis. This enables the computation of tax liabilities and benefits by combining data on household characteristics with institutional records about government programmes. Even where individualising the corresponding benefits relies on imputation techniques (and is therefore subject to error), the great appeal of this technique is the flexibility it allows for the definition of alternative income categories and the assignment of expenditures across households. The methodological annex to this chapter provides more details about this and an in-depth analysis can be found in Castelletti and Gutiérrez (2010).

We compute the combined impact of social spending and taxation by income decile, and analyse this with special focus on the middle sectors. How do their members fare relative to those above and below them on the income scale? Which channels of fiscal policy affect them most? The first step is an assessment of the overall effect of the fiscal policy, followed by a more detailed look at the separate patterns of social spending and taxation.

We have used two complementary measures to assess the effect of the fiscal system on household income. The first considers an "absolute" approach using as the denominator the total disposable income in each country. The second measure aims to capture the progressivity of the tax/benefit system, accounting for what households receive (or pay) in terms of their income group. While the second measure allows us to understand the redistributive impact of taxes and expenditure (by computing their incidence and progressivity), the first measure is robust to income sub-declaration which is a typical problem at the tails of the distribution in household surveys.

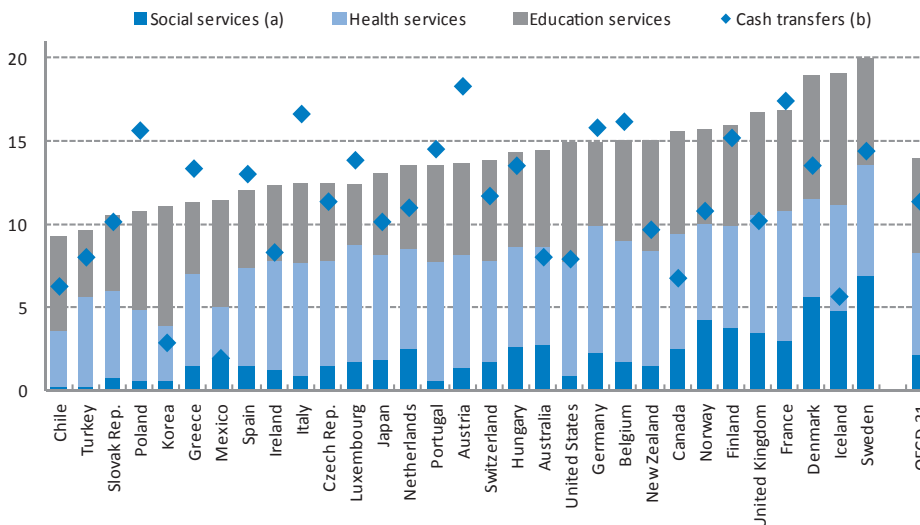
Box 4.1. Latin American benefit systems in a comparative perspective

One of the main features of social policies since the beginning of the 1990s has been the significant effort made by Latin American governments to assign a higher priority to social spending. As a result, resources allocated to social policies such as education, health care and social protection have risen from 8.5% of GDP in 1990-91 to 11.4% in 2006-07 (ECLAC, 2009). However, Latin American social spending is still a long way behind OECD countries, which spend on average 27% of GDP.

On the other hand, most of the evidence regarding the effect of public policy on households' wellbeing relies on indicators of cash income transfers, thus ignoring services provided by governments. The OECD publication *Growing Unequal?* (OECD, 2008a) shows that public services in education and health care reduce inequality in a typical OECD country by a quarter (cash transfers reduce it by a third). A current project on "redistributive impacts of publicly provided services" is being jointly undertaken by the OECD Directorate for Employment, Labour and Social Affairs and the European Commission. It seeks to assess the impacts of education, health care, housing and other services on income inequality and poverty in OECD countries. The results will permit a better comparison of the social-welfare systems between OECD members and the Latin American economies studied in this chapter.

A significant part of public social-welfare expenditures are provided through in-kind services to households, mainly in education and health care (Figure 4.7). Together these constitute 14% of GDP across the total sample. Though there is substantial variation between OECD countries, social expenditure in Chile and Mexico is considerably below levels for the rest of the OECD. In-kind services account for only 9% and 11% of GDP in Chile and Mexico, respectively.

Figure 4.7. Public expenditure on in-kind and cash transfers
(percentage of GDP, 2005)



Note: Countries are ranked in increasing order of total expenditure on all social services. Data for Chile refer to 2006.

a) Social services to the elderly, survivors, disabled persons, families, unemployed, as well as housing and social assistance.

b) Cash transfers to the elderly, survivors, disabled persons, families, unemployed, as well as those in respect of social assistance.

Source: OECD Social Expenditure Database, OECD Education Database.

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Total public social spending also differs in its structure between countries. In many continental European OECD economies a significant part of these resources – more than half – is made up of cash transfers, constituting 13% to 18% of GDP. This type of expenditure in Chile and Mexico is much more limited, reaching only 6% and 2% of GDP, respectively.

For the interested reader, more information on the project on the redistributive impacts of public services can be found in OECD (2008a) and Förster *et al.* (2010).

Pro-poor tax-benefit systems in Chile and Mexico

Net transfers are clearly pro-poor in both countries. For the middle sector the net effect is much smaller, slightly positive in Mexico and slightly negative in Chile.

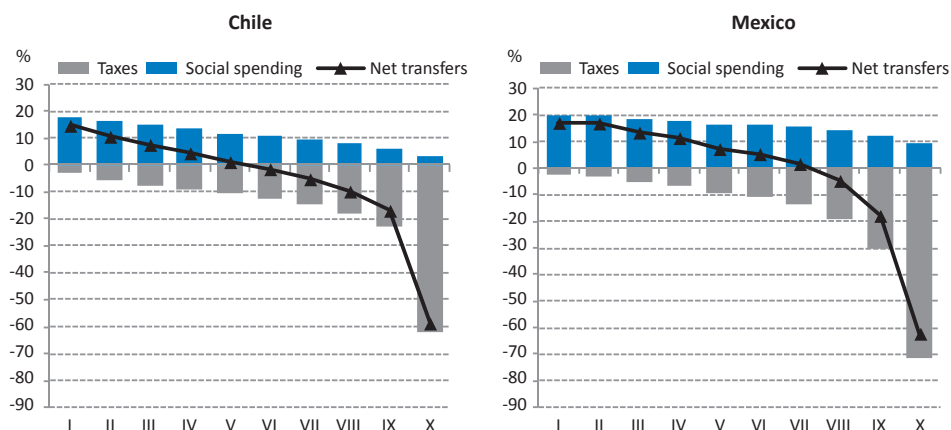
Net transfers in Latin America have a clearly pro-poor profile, providing a significant boost to the income of disadvantaged households (Figure 4.8). At the same time, the more affluent families are net contributors, paying more in taxes than they receive in benefits. On average, the first to fourth deciles in Chile see their disposable income boosted 37.4%, while the ninth and tenth make net payments of 12.9% of their disposable income. In Mexico the corresponding figures are 40.0% and 15.7%, respectively.

For middle-sector households, things are much less clear-cut. Their losses to taxation are close to their gains through social spending. The net effect of fiscal policy for middle-sector families, while positive, is not substantial. Households in the fifth to eighth deciles make on average a net payment of 3.6% in Chile and take a net benefit of 3.8% in Mexico (again as a proportion of their disposable income).

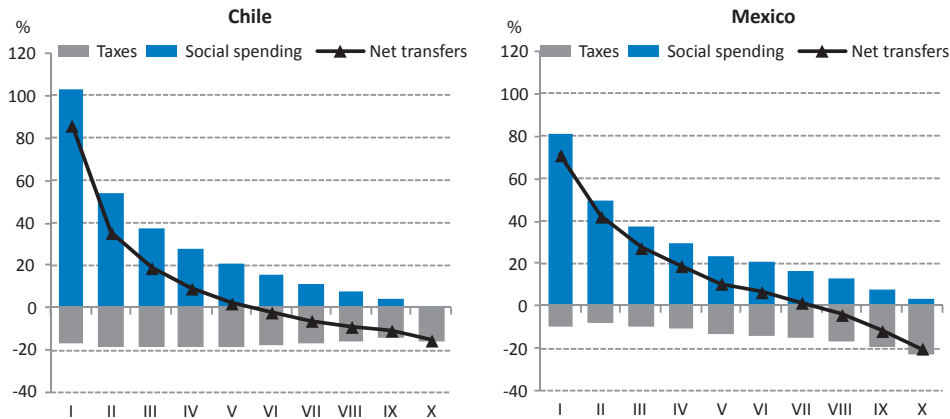
The results reveal an interesting dynamic. The positive net effect of the tax-benefit system on households in the lower deciles increases their income to levels comparable with those of middle-sector families. But the fourth and fifth deciles are left potentially exposed, receiving less in net terms from social programmes than households below them.¹⁹

Figure 4.8. Effective net reception of benefits by household income deciles

(weighted average, percentage of mean disposable income, 2006)



(percentage of decile mean disposable income)



Note: Deciles are defined according to household per capita disposable income including cash transfers.

Source: Based on national household surveys.

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In order to test this further and quantify the impact of the tax-benefit system, we have computed the three indices of social mobility developed in Chapter 1 before and after government action (Figure 4.9).

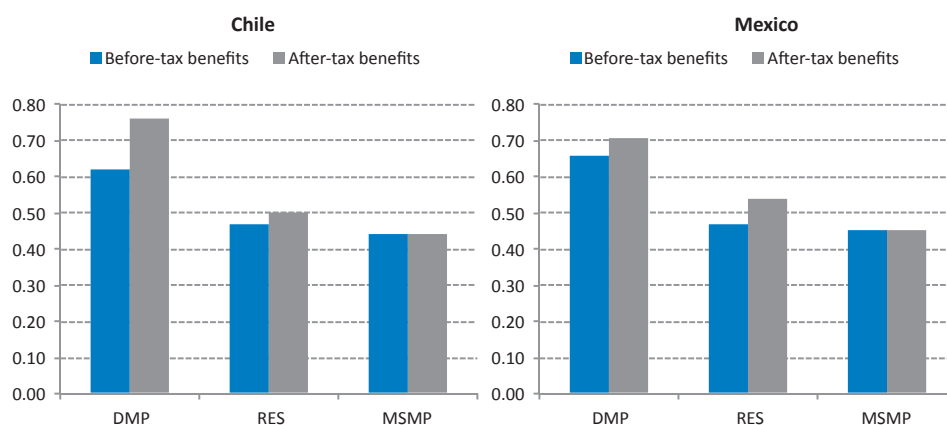
A first question is how public action can help disadvantaged households move up in the income scale; the “Disadvantaged Mobility-Potential Index” (DMP, defined as in Chapter 1) provides an indication of the effort needed. Before government intervention Chile has a DMP index of 0.62, while for Mexico it is 0.66 (recall that DMP ranges between 0 and 1, with higher values indicating greater potential mobility). Both results indicate that it would not need large increases in income to move these households into the middle sectors. The effect of the tax-benefit system is to improve both indices, to 0.76 and 0.71 respectively, highlighting the important impact that the government has for households at this income level.

The upward mobility potential of the disadvantaged is greatly improved by the net transfers they receive.

A second question is the fragility of the middle sectors – given an adverse shock how great is the impact in terms of loss of income? The “Middle Sectors Resilience Index” (RES, again defined in Chapter 1) proxies this (Figure 4.9). It measures the average distance of the incomes of the lower-middle sectors group from 50% of the median income (the lower-middle sectors being those households with income between 50% and 100% of the median). The range of RES is 0 to 1, with higher values here implying that incomes are generally close to the median and hence display a greater level of resilience.

Figure 4.9. Mobility indicators

(before and after government intervention, 2006)



Source: Based on national households surveys.

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The tax-benefit system may provide little protection for those in the lower part of the middle sector...

Before government intervention the index for both countries is 0.47. After taxes and benefits, Chile improves slightly to 0.50 while Mexico increases to 0.54. This result underscores the story told by Figure 4.8; as one moves upwards along the income distribution, the positive impact of the tax-benefit system tends to fade away. It also stresses that the government does not necessarily provide a buffer against adverse shocks for those in the vulnerable segments of the middle sectors. While their initial situation is not exactly bleak, it cannot be argued that they are in a strong position to weather adverse conditions. Nevertheless, it is noteworthy that fiscal policy has on average a positive effect on the resilience of the middle sectors in both countries.

...and does not risk making the upper part affluent.

The mirror-image of the resilience index for households in the upper-middle sectors is the "Middle Sectors Mobility-Potential Index" (MSMP). This tests the strength of households within the upper-middle sectors and how able they are to join the ranks of the affluent. It turns out that fiscal policy has practically a zero effect for Chilean and Mexican households in this group (with the index before and after the government action rounding up at 0.44 and 0.45, respectively). These results have the positive interpretation that fiscal policy does not render the upper-middle sectors more likely to become affluent.

Middle-sector households benefit little from social spending

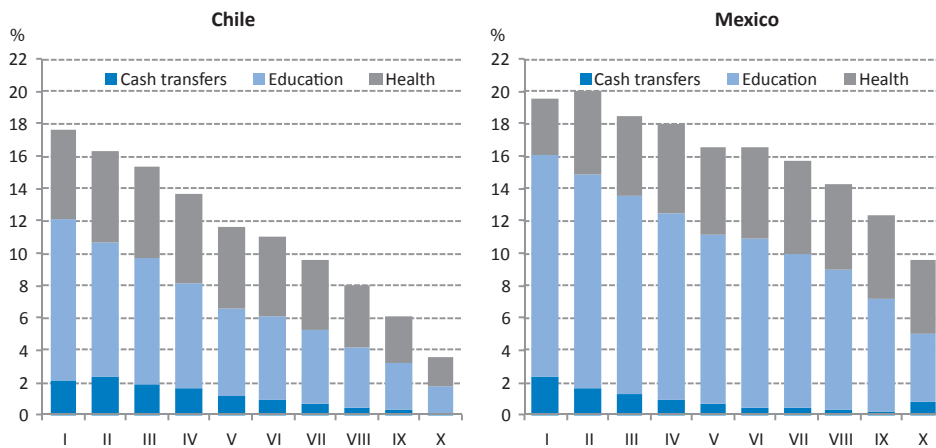
The importance of the public sector to the well-being of the disadvantaged is evidenced by the fact that, on average, public benefits make up about 50% of total resources for low-income households in both the countries we are considering. Middle-sector families benefit much less from social programmes. Access to public education and health-care services by the middle sectors, for example, is demonstrably much more limited (Figure 4.10).

The provision of public support for basic services is strongly affected by the income position of families. More affluent families, who can afford private substitutes, have little incentive to use public services where they have a poor perception of their quality. As Chapter 3 amply demonstrated, this is certainly the case in

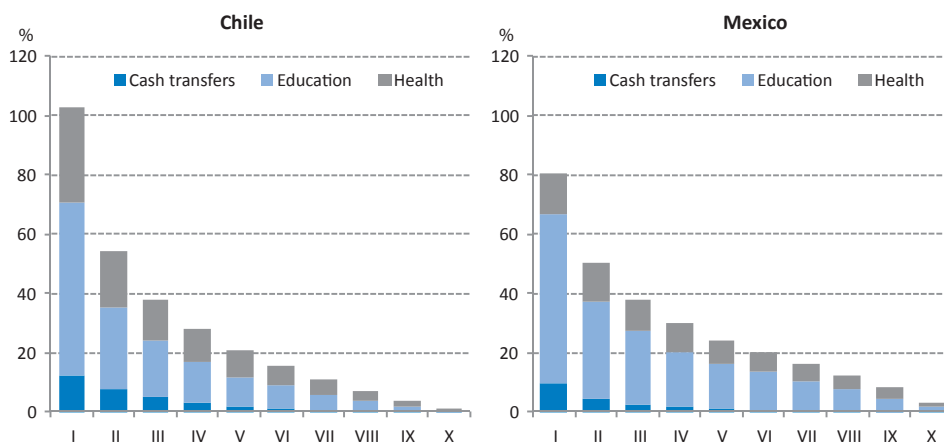
education. Therefore, middle-sector families – who are precisely the group with both the means and incentives to see their children educated – are likely to favour private provision. The same may be true in health care. This highlights a limitation of the tax-benefit analysis which implicitly assumes that public services are of similar quality to the private sector. If the education and health-care services provided by the public sector are of low quality (services that are mostly received by the disadvantaged and middle sectors), then the benefits will be valued less.

Figure 4.10. Effective receipt of benefits by household income deciles

(weighted average, percentage of mean disposable income, 2006)



(weighted average, percentage of decile mean disposable income)



Note: Deciles are based on household per capita disposable income including cash transfers.

Source: Based on national household surveys.

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Splitting out the components finds that the value of public education is the biggest single contributor in the tax-benefit calculation for disadvantaged families

Education is the largest programme in terms of effect, followed by health care. Cash transfers, as expected, play a less significant role for the middle sectors.

(Figure 4.10).²⁰ Educational spending then displays a progressive pattern as incomes decrease. Public education to low-income families is worth an estimated 8.1% of mean disposable income in Chile compared with 4.7% for the middle sectors; and 12.6% in Mexico against 9.8% for the middle sectors. Expressed as a proportion of average income within the relevant deciles, the contrast is even starker: a boost to family budgets of 29.5% for low-income families in Chile against 6.4% for their middle-sector compatriots; and 33.3% against 11.4% in Mexico.

Health care is the second largest programme in terms of effect. Health-care expenditure presents a relatively progressive pattern in Chile and Mexico and accounts for 19.0% and 11.6% of disadvantaged households' disposable income, respectively. The equivalent figures for the middle sectors are 6.1% in Chile and 6.3% in Mexico.

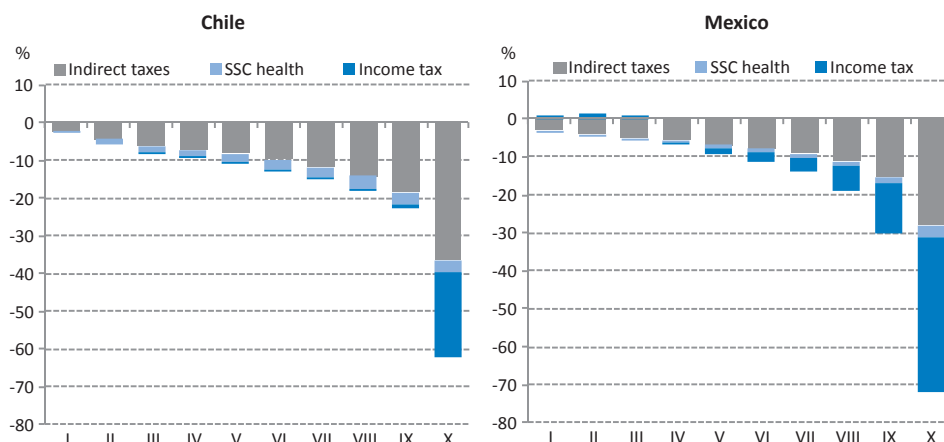
As is to be expected, the bulk of cash transfers go to disadvantaged families – for whom they represent a substantial proportion of disposable income. For the middle sectors, cash transfers play a less significant role given that households in this group are typically sufficiently well-off not to qualify for most types of such assistance. While the effect is positive, it is very small.

Who pays the taxes?

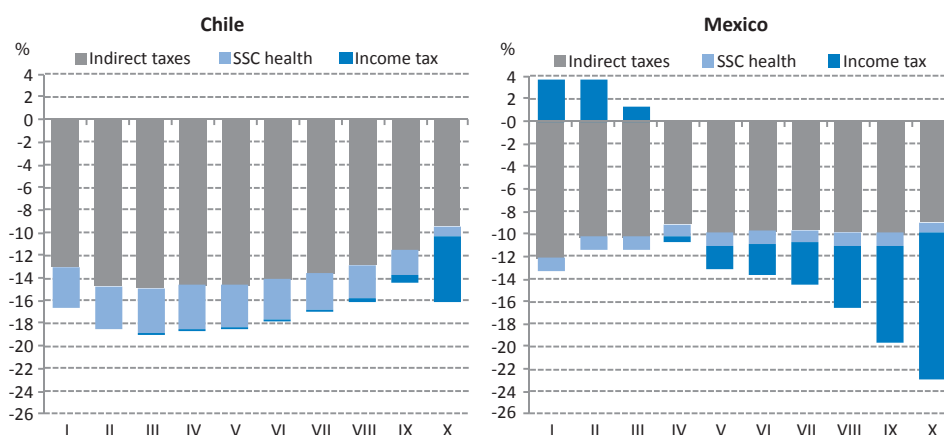
Contrary to the commonly held belief, it is the affluent rather than the middle sectors who pay the bulk of taxation.

Our analysis dismisses the – commonly held – belief that middle-sector families are the ones supporting the heaviest total tax burden (Figure 4.11). Of course, this is relatively large, and there is considerable variation in the total amount of tax paid by particular families within it. But the bulk of the overall tax take (51% in Chile and 53% in Mexico) is generated in the highest deciles, with affluent families being net taxpayers in both countries. This overall behaviour may not be reflected across indirect taxes, health-care contributions and personal income tax. We have analysed the incidence of each of these – though the results should be treated with caution given incompleteness in the data.

Figure 4.11. Tax incidence by household income decile
(weighted average, percentage of mean disposable income, 2006)



(weighted average, percentage of decile mean disposable income)



Note: Deciles are defined based on household per capita disposable income including cash transfers.

Source: Based on national household surveys.

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The indirect taxes are principally VAT and excise duties, the former having the greater take. Such consumption taxes have the greatest impact on the income of middle-sector households, accounting for 13.8% and 9.8% of the mean per capita income for Chilean and Mexican families respectively – personal income tax being mainly paid by the affluent (see also Box 4.2). When measured relative to decile disposable income, indirect taxes exhibit a different pattern in Chile from that in Mexico. While in Chile the top-two and bottom-two deciles pay a lower share of their income than the rest, in Mexico the share of income taken is essentially similar across income groups.

Indirect taxes are the principal burden paid by the middle sector. They pay little income tax if any...

Mexico exempts many goods regarded as essential, such as food or medicine, from VAT in an effort to make the tax less regressive. In practice this proves to be a poorly targeted (implicit) subsidy and the absolute benefits from these exemptions increase with household income.

Social-security contributions for health care present different patterns in the two countries. While they are neutral in Mexico (accounting for about 1% of income in each decile), in Chile they are regressive – something explained by the fact that in Chile households higher up the income scale tend to opt for private insurance.

The top two deciles pay the bulk of the take from income tax. This reflects both the skewing of the income distribution in the region and the fact that more than 60% of income earners have sufficient exemptions to mean they pay nothing.²¹ Their burden is still low nonetheless: 3.3% in Chile and 10.8% in Mexico as a proportion of the mean income in their decile. For middle-sector families, the net effect is even lower, and – given the effect of tax credits on salary – low-income groups, in Mexico at least, have effective negative contributions.

...the bulk of which comes from the affluent.

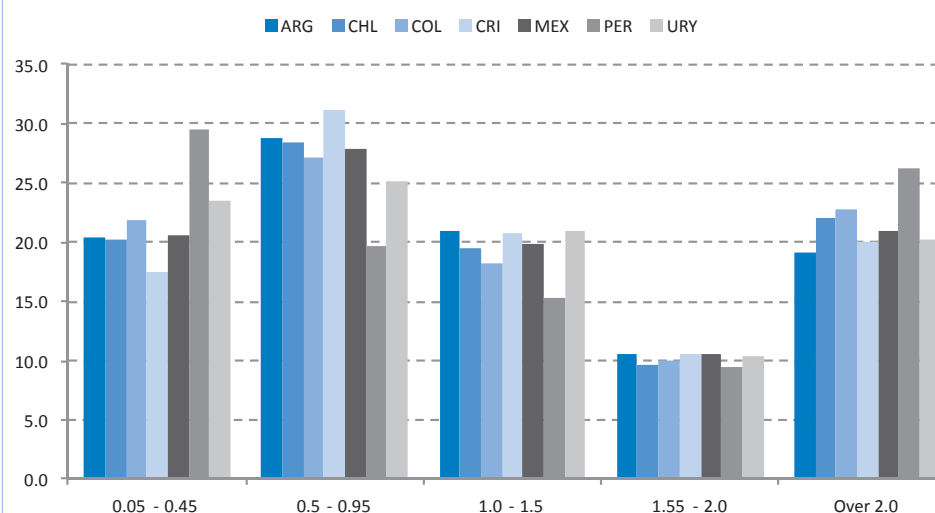
Box 4.2. Who pays personal income tax in Latin America? Not the working middle sectors

Compared with OECD countries revenues from personal income tax in Latin America are very low. Only a small proportion of the population is a net payer of this tax – and almost nobody within the middle sectors. This is the result of the region’s highly concentrated income profile, a tendency to under-report income, and tax codes full of credits and exemptions.

This small tax take is a problem for the region. Of course, it limits the public sector’s potential for redistributive policies. It also has a less obvious impact in removing a useful stabiliser from the economy. Daude *et al.* (2010) estimate that the automatic stabilisers inherent in Latin America’s tax systems are around half the size of their OECD equivalents. To these can be added, from a political economy perspective, the additional legitimacy that a stronger personal income tax would bring to the fiscal systems of the region.

So who does pay this tax? To find out we have modelled its incidence in seven countries of the region, according to the following methodology. First, a distribution of potential tax payers is computed using the latest available national household surveys. These have data from 2005 in Uruguay, 2006 in Argentina, Chile, Costa Rica, Mexico, Peru, and 2008 in Colombia. The “adjusted first-earner income” distribution is then calculated by taking into account household composition, using the OECD methodology for estimating structural balances (Girouard and André, 2005). The analysis is restricted to labour income (whether from employment or self-employment), and the sample is limited to households with at least some income of this type. All households with income above 6 times the national median are grouped together – on average these households earn from 8.6 times the median in Uruguay to 12.1 times in Colombia. Figure 4.12 shows the resulting distribution of households.

Figure 4.12. Distribution of households by income bracket
(relative to national median labour income)



Note: Percentage of households by income level. 1 represents the national household labour income median.

Source: Based on national household surveys.

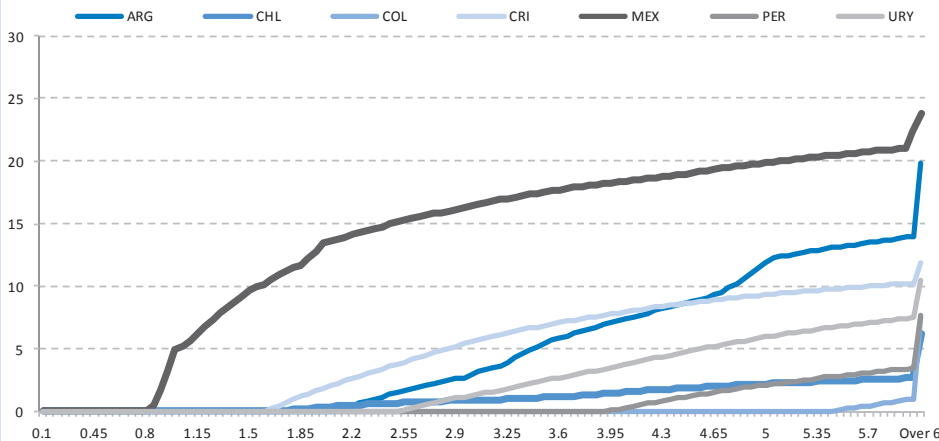
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Given the high levels of informality and income inequality in the region, the conventional OECD analysis (calibrated within OECD countries for those earning from 0.5 to 3 times the median income) is extended to households earning from 0.05 times the median income (so from almost the first peso, sol or real of labour income) to more than 6 times the median income – De Mello and Moccerro (2006) follow a similar procedure in their analysis for Brazil.

The effective tax burden is then computed for some 120 representative household types, assuming they differ only in their income level. Figures for Chile and Uruguay were provided by the respective finance ministries, while rates for Mexico were calculated using the OECD Taxing Wages simulator, developed by the OECD Centre for Tax Policy and Administration. For the remaining countries, calculations were based on the legislation in force during fiscal year 2006, a relatively neutral year in cyclical terms. For Uruguay survey figures were updated with the observed CPI up to 2009 to permit the incorporation of the new personal income tax framework introduced from 2008. In those cases where fiscal legislation allows individual and household declaration, the option more beneficial to the tax payer was chosen. (Tax declarations are at the individual level in Chile, Colombia, Peru and Uruguay, and by household in Argentina, Costa Rica and Mexico.) Allowances for both spouse and children were included in Argentina and Mexico.

Figure 4.13 shows the computed average effective rate by income level for each country. It is apparent that personal income tax in all countries of the sample is formally progressive, with average tax rates increasing with income. However, labour-income earners only become net payers of personal income tax at levels well above the national median wage – ranging from 1.7 times the reported household median labour income in Chile and Costa Rica, to 5.5 times in Colombia. The only outlier is Mexico, owing to the interaction of limited exempted income and tax credits. Here net tax becomes payable at about 0.85 times median income.

Figure 4.13. **Average personal income tax rates by income**
(relative to national median labour income, percentage)



Note: On the horizontal axis, 1 represents the national household labour median income.

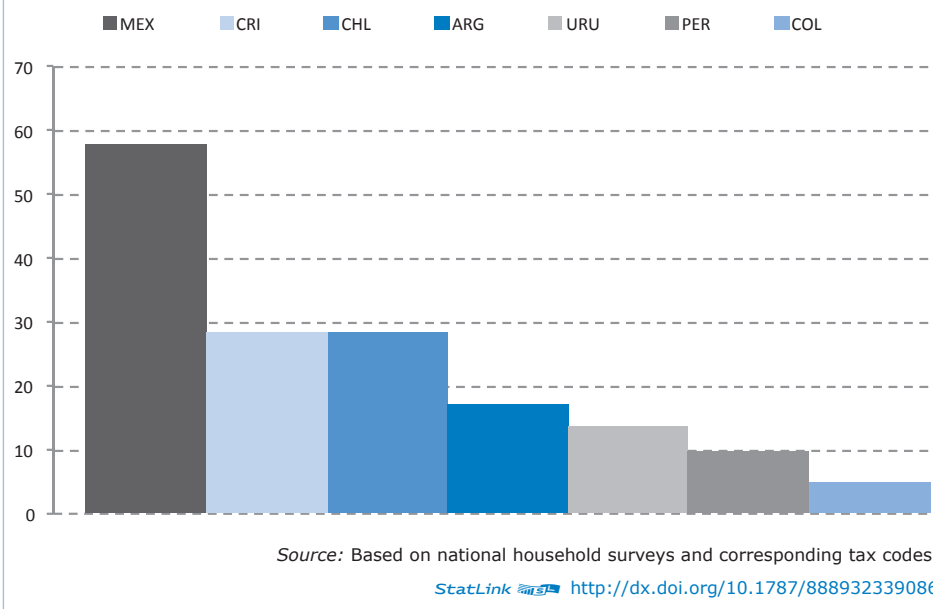
Source: Based on national household surveys and corresponding national tax codes.

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These very high effective thresholds combine with the concentration of households in the lower part of the income distribution to mean that only a very small proportion of households pay net income tax (Figure 4.14). The largest tax base is 60% of households in Mexico, and this dwindles to less than 10% in Colombia and Peru.

Focusing on the working middle sectors, Mexico gets net taxes from about half of this group (those earning from 50% to 150% of the median national household labour income). But south of here *no* working household from the middle sectors pays any net personal income tax – on average at least.

Figure 4.14. Proportion of households which are net payers of personal income taxes



THE WAY FORWARD

The middle sectors in Latin America find themselves in a dilemma. They are a strong supporter of democracy as an idea, but also critical of how democracy actually works. A key source of this dissatisfaction is how public policies influence income distribution, social protection and opportunity creation. The middle sectors have the potential to become an agent of change in the region. Their centrist political values could facilitate the consensus building needed for the sort of structural reforms discussed in Chapters 2 and 3 – and if poverty reduction continues to advance, members of the middle sectors could soon represent an absolute majority in several countries of the region.

But this positive outcome will not materialise automatically. In many countries of the region, a large part of the middle sectors do not see themselves as part of the social contract. Willingness to pay taxes is low, reflecting perhaps the meagre public goods the middle sectors receive. The perceived quality of public services is also low and this drives the middle sectors to seek alternatives from the private sector, even where the extra cost is a significant additional burden on household budgets. This – rational – behaviour can perpetuate exclusion, with the disadvantaged having no choice but to use low-quality publicly provided services and the better-off having their own private arrangements. The social and economic consequences of this are large and enduring.

The current moment is in many ways very timely. Most countries in the region have weathered the international turmoil with increased confidence. Their

renewed strength is due, in many cases, to expanding middle sectors which have served as a source of domestic demand. Poverty has fallen in many countries at a higher pace than during previous expansions, and the mechanisms that lie behind this, such as conditional cash-transfer programmes, have created a new faith in government action among the vulnerable segments of society. At the same time, democracy has advanced on many fronts and policy makers have become more pragmatic about economic policies. Parties of the left and right have alternated in power maintaining policy credibility and without creating panics about abrupt policy U-turns. However, these changes mean that policy itself must change. The successful policies of the past may no longer serve a changed population profile. This is a chance to renew the social contract – explicitly seeking to draw the middle sectors into it.

Because expenditure needs tax to support it, it is tempting to think of tax first. This may be the wrong way round. Given current poor perceptions, the best place to start may be reforms aimed at improving the *quality* of public services, so that current users increase their demand and support for them. This would build a social constituency for expansion of public spending and for the taxes necessary to finance it. A way forward here may be to frame tax reforms that raise more revenue while paying far more attention to the distributional effects. The bedrock for all of this should be continued improvements in tax administration and the transparency of public expenditure and revenues.

METHODOLOGICAL ANNEX

Incorporating the value of government services and cost of taxes into household incomes raises a range of methodological and conceptual questions. Household surveys generally do not contain information on taxes or benefits or, at least, not with the required level of disaggregation, and little consensus exists on the best way of valuing these services and distributing the result across individuals, matters which can importantly affect the results.

The use of incidence analysis techniques is widely exemplified by Euromod (2009) and the OECD (2008a). The work carried on by ECLAC (2007) and the World Bank (Breceda *et al.*, 2008; and Goñi *et al.*, 2008) are regional examples of this technique. Finally, national studies such as the Chilean Planning Ministry (Mideplan, 2007) and the Mexican Ministry of Public Finance and Credit (2008) use this approach to evaluate the outcomes of policies captured by household surveys.

The methodology we have adopted is similar to these examples. The main data sources and methods are described below.

Data sources

Tax-benefit incidence analysis relies on diverse sources of information and uses imputation techniques to splice them together. In order to estimate the impact of taxes and benefits the following information was used:

- **Household surveys:** Individual records from the 2006 National Characterisation Socio-economic Survey (CASEN) for Chile and the 2006 Household Income Survey (ENIGH) for Mexico. Both surveys provide data on income of households as well as information on their economic characteristics that can be used to impute public services and taxes to individuals. In Chile, estimates of the effects of value-added taxes and excise duties drew also on the 2006-07 Family Budget Survey (EPF).
- **Government statements and institutional records:** The analysis covers health and education services, using data on public expenditures at institutional level from the Chilean National Budget Office (DIPRES) and the Mexican Ministry of Public Finance and Credit (SHCP). In addition, the distributive impact of health in Chile relies also on the Satellite Account for Health.
- **Tax records:** Statistics drawn from personal income-tax returns provide another source of information about the tax base. In the case of Chile, specially commissioned data was obtained from the SII, analysing the number of taxpayers, their assessed income, its composition and the taxes paid by income bracket.

In terms of coverage, the analysis covers 72% and 66% of total social expenditures for Chile and Mexico, respectively; while on the other side it includes 69% and 71% of total tax revenues.

Determination of tax burdens and benefits

The boundaries of what items can be imputed to households are not always obvious. Certainly items such as health care and education are good candidates. However, any public expenditure or tax is in theory a candidate, having at least some direct or indirect impact on households' consumption possibilities. For the purposes of this analysis, the approach must be a pragmatic one, with the inclusion of questions on specific programmes in household surveys driving the extent to which we can include such items in the analysis. Though in practice the impact is typically at the level of the individual, we treat it as evenly distributed across household members.

- **Cash transfers:** Since they are generally targeted at people in the lower income strata, in developing countries these programmes are usually among the most visible types of social spending. Household surveys treat them directly, and our calculations take the value that families surveyed declared as received.
- **In-kind transfers:** Following OECD (2008a), the incidence of education is obtained applying the actual-use approach (beneficiaries are those students using the educational services) and for health care the insurance-value approach (imputing the insurance value of coverage to each person based on specific characteristics, such as age and sex). Because of the lack of market prices, the value of the transfer is assumed equal to its production cost. Even when this approach neglects differences across countries in terms of quality and efficiency in the provision of the service and in the value individuals assign to these services, similar assumptions are a regular feature in the specialised literature (including OECD, 2008a; and Euromod, 2009).
- **Direct taxes:** Personal income taxes are estimated for each individual according to their reported income in the household survey, the tax law in force in the survey year and information on effective income tax collection. Some income reported in household surveys is collected on an after-tax basis. Therefore, a first step was calculating the incidence of taxes paid in 2006 to construct pre-tax estimates for these items. "Income taxes" in Chile include the second category (tax on income from dependent employment) and the withholding income tax, and in Mexico they are the taxes on personal labour income, income derived from interest, rents and self-employment activities. Statutory tax rates are then applied in order to obtain the income tax that individuals should pay. These figures are then compared with the effective tax collection. In the case of Chile, tax-return information was available and the amount of income tax that individuals chose to pay was computed as follows. The number of non-filers in each decile was estimated as the difference between the number of individuals in the household survey with incomes high enough to be subject to the income tax, and those who actually filed a tax return, and then imputing these randomly within the survey. Then, for the tax filers the proportion of income tax due that individuals actually paid was estimated from the tax-return information and then distributed in the survey proportionately to the estimations of income tax due.
- **Indirect taxes:** The total tax take for indirect taxes is estimated from the effects that both value-added taxes and excise duties have on the price of final goods. Following Euromod (2009), the total tax liability T_i for commodity i is calculated on the basis of observed expenditures e_i

$$T_i = \frac{\tau_i}{1+\tau_i} e_i \quad \text{being} \quad \tau_i = \frac{t_i(1 + \alpha_i + v_i) + v_i}{1 - (1 + \tau_i) v_i} + \frac{\alpha_i}{1 - (1 + \tau_i) v_i}$$

t_i : VAT rate

α_i : fraction between the excise duty and the producer price

v_i : *ad valorem* tax rate applied on the consumer price

The effect of each tax is then constructed by applying the statutory tax rates and deductions in force for each type of product in the survey and then aggregating these into 17 categories of goods and services. Then, the proportion of indirect taxes that households actually pay is adjusted to the effective tax collection on these items that is transferred to private consumption and then distributed in the survey proportionately to the total tax liability. The amount of indirect taxes that is transferred to private consumption is estimated from the Tax Matrix information in National Accounts.

In the case of Chile, a matching procedure was used to impute household expenditure from the input data (EPF) into the survey on the basis of budget shares for different population groups identified by disposable income and the largest set of demographic variables – age, gender, educational level, professional status, and number of adults and children – common to both datasets.

- **Health-care social-security contributions:** In Mexico contributions include those made in respect of the sickness and maternity insurance within the compulsory scheme (*seguro de enfermedades y maternidad del régimen obligatorio*). In Chile contributions were calculated according to the scale applicable to the different FONASA health groups. These groups are defined by household characteristics such as income level and number of beneficiaries.

Measurement errors and under-reporting

Household and expenditure surveys are an important source of information on the allocation of tax benefits within households. Nevertheless, systematic misreporting of some income sources, such as capital income, income from self employment or income from social transfers, can provide a misleading view of the income distribution and redistribution profiles.

Reconciling household-survey data and national-accounts data is a well-known problem. Macro aggregates from household survey data normally present discrepancies with published national accounts, even though the sample weights are designed to represent the national population. Table 4.A1 illustrates the extent of such discrepancies in recent household budget surveys in Chile and Mexico.

Table 4.A1. Comparison of national accounts and household survey estimates

Country	Household survey	Household income according to survey	Household income according to NA	Discrepancy
Chile	CASEN (2006)	28 722 719	33 817 612	15.1%
Chile	EPF (2006)	24 674 222	33 817 612	27.0%
Mexico	ENIGH (2006)	2 483 230	8 132 999	69.5%

Sources: As noted in the table for surveys, national statistical agencies for national accounts.

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The differences between the surveys and estimates from national accounts highlight potential biases in the totals. In particular, household surveys tend to under-report household incomes. A common approach in the literature has been to adjust aggregate reported household incomes so as to match the corresponding items in national accounts, though no agreement exists on the best way to do this – even assuming that national-accounts aggregates are correct. Assumptions are needed, for example, in order to assign under-reported income across the population and such assumptions can be material to the results, particularly when discrepancies are high. Allocation of income from capital is a good example, since such income in practice tends to be found only among upper-income households.

Following OECD (2008a), we have made no adjustments to household-survey income aggregates and all calculations were based on data gathered directly from published records. In the case of Chile, official data are already imputed using estimates from the national accounts (more details about this procedure can be found in Mideplan, 2006); while for Mexico income is not adjusted in the survey. For the interested reader, this effect is examined in Mexican Ministry of Public Finance and Credit (2008).

NOTES

1. This topic is developed in OECD (2008b).
2. The Polity democracy score relies on experts' assessments along six dimensions which include qualities of executive recruitment, constraints on the executive, and the degree of openness of politics and political competition. See the website of the Polity IV project (www.systemicpeace.org/polity/polity4.htm) for more details.
3. Nevertheless, the average index of almost 8.6 for Latin America and the Caribbean in 2008 is still below the average of 9.6 for OECD member countries (out of a maximum score of 10).
4. Blyde *et al.* (2009).
5. It is important to point out that perceived positions in the income distribution differ significantly from objective positions, with relatively rich individuals self-classifying themselves at lower income quintiles and the poor considering themselves relatively less deprived (see Chapter 1, and also Fajardo and Lora, 2010). However, it can be argued that in political views and actions it is the perceived position rather than the objective one that matters more.
6. The differences between the different quintiles are statistically significant at conventional levels of confidence for both variables.
7. For example Alesina and Angeletos (2005) and Gaviria (2007).
8. The coefficient of variation, a measure of dispersion, is 0.44 for the middle sectors, compared with 0.52 for the affluent and 0.57 for the disadvantaged.
9. Similar results are found for education. See Daude and Melguizo (2010) for more details.
10. It is important to note, though, that for the POUM model to hold, certain premises are necessary: policies should be expected to persist, agents should not be very risk-averse, and those poorer than average should expect to become richer than average. Rodríguez (2004) proposes an alternative explanation for this effect, by which in societies where the rich can influence politics such that they do not pay taxes, the median voter will prefer low levels of taxation to reduce the incentives to rent-seeking.
11. Przeworski (2007) generalises the case, pointing out that those without assets, even if they constitute a vast majority, either do not want to or cannot use their political rights to equalise wealth, incomes, or even opportunities. This may be due not only to their expectation of becoming rich, but also to ideological domination since the media are owned by the elite, or to difficulties the poor face in co-ordinating actions when they have heterogeneous preferences over non-economic aspects of life. In a somewhat similar vein, Chong and Olivera (2008) show that countries with compulsory voting exhibit lower income inequality. Therefore, since developing countries have relatively more unequal distribution of income, the authors support the promotion of compulsory voting by them.
12. See Daude and Melguizo (2010). These results are in line with Torgler (2005).
13. A recent example would be Brazil's *Ficha Limpa* reforms of July 2010.
14. Torgler (2005).
15. Marcel (2008).

16. The quality of these goods therefore has an important impact on the perception of how effectively public funds are used, and so willingness to pay taxes – the virtuous cycle, discussed in the preceding paragraphs. An important limitation of our approach, therefore, flows from the fact that the data in the household surveys do not capture differences in the quality of services, differences which could affect their value. Chapter 3 has shown that in education these differences are often large and could be material to the results presented here.
17. In Brazil, for example, pensions are found to propel households with low or zero market income into high-income groups. For more details see Immervoll *et. al.* (2006).
18. See also ECLAC (2009).
19. It should be noted that poverty headcount levels differ significantly between Chile and Mexico. According to ECLAC (2009), for 2006 13.7% of all households in Chile were poor, while poverty is significantly higher in Mexico (31.7%).
20. Using household surveys, only current income is considered and the results do not capture the dynamic distributive effects of public expenditure. Therefore, the long-run effects of education on wage earnings of the children currently in school are not included.
21. This topic, and how it might be addressed, is discussed in detail in the 2009 edition of the *Outlook* (OECD, 2008b).

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