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Commitment to Equity Handbook

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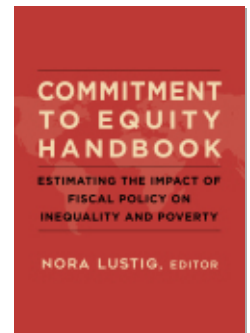
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FOREWORD

François Bourguignon

Since the pioneering fiscal incidence analysis developed by Charles Stauffacher (1941)¹ for the United States in the 1930s and Tibor Barna (1945)² for the United Kingdom in 1937, the quality and richness of data have improved considerably; indicators for measuring income inequality, poverty, and the incidence of redistribution instruments have become more rigorous; and standard practices for evaluating redistribution in developed countries have emerged. The public interest for the issue of redistribution has recently been revived by the observed increase in disposable income inequality in numerous countries. Comparative data on redistribution are now regularly published in Organisation for Economic Cooperation and Development (OECD) reports,³ and household survey-based microsimulation models, pioneered by Guy Orcutt at the Brookings Institution in the late 1950s⁴ and now available in most high-income countries, enable analysts to evaluate the potential impact of each of the many redistribution instruments available to governments.

In the last decade, these methodologies have been extended to, and adapted for, low- and middle-income countries. This has been one of the most important contributions of the Commitment to Equity (CEQ) Institute, founded—as a project, first—in 2008 by Nora Lustig. In the past, numerous isolated attempts had been made to evaluate the incidence in a few middle-income countries of specific aspects of their redistributive systems, including cash transfers, indirect subsidies, public education

Paris School of Economics, September 10, 2017.

¹Charles Stauffacher, “The Effects of Government Expenditures and Tax Withdrawals upon Income Distribution, 1930–39,” in *Public Policy: A Yearbook of the Graduate School of Public Policy*, ed. C. J. Friedrich and Edward S. Mason (Harvard University Press, 1941).

²Tibor Barna, *Redistribution of Incomes through Public Finance* (Oxford University Press, 1945).

³See, for example, “Growing Unequal” (2008), “Divided We Stand: Why Inequality Keeps Rising” (2011), and “In It Together: Why Less Inequality Benefits All” (2015).

⁴Guy Orcutt, “A New Type of Socio-Economic System,” *Review of Economics and Statistics* 39, no. 2 (1957): 116–23.

expenditures, indirect taxes, and the like. But no attempt had been made to construct a framework that would both enable the study of most redistributive fiscal instruments together and be systematically applicable to a variety of developing countries until the CEQ Institute took on this ambitious task. Developing and adapting the micro-based concepts and indicators needed to rigorously evaluate redistribution in a developing country context, researchers at the institute also designed the appropriate tools to compute these indicators and apply them to a diverse array of countries—over forty overall at this stage!

This CEQ Handbook combines what they have learned from a conceptual and an analytical point of view, the practical tools they have developed, and some of the applications of these concepts and methods to a variety of countries and issues. All the questions a research team or a government administration would ask when trying to evaluate the distributional impact of its fiscal revenue and expenditure system as a whole or of a single instrument are answered in this most valuable volume.

Even more, the CEQ Handbook innovates in the discipline of incidence analysis in several major respects and emphasizes several properties of redistribution systems that are often ignored. For instance, an interesting discussion is offered of the concept of “progressivity” of a single fiscal instrument when integrated into a system comprised of many others. Since the impact of a tax or a transfer on inequality or poverty depends on the other fiscal instruments in place, understanding the full context is of obvious importance in the policy debate on that particular tax or transfer. Equally interesting and useful is the use of alternative income concepts to measure the overall inequality and poverty and the demonstration of how different concepts may lead to different conclusions about the distributional incidence of the fiscal system. Thus, a system may be progressive and/or poverty reducing when viewed from the perspective of the familiar concept of “disposable income” but regressive and/or poverty increasing when indirect taxes are added into the picture, as they are in the CEQ “consumable income” concept. The Handbook tackles more complex issues as well, providing, for instance, a thorough consideration of how some combinations of taxes and transfers can modify the income ranking of households or people and lead in some cases to counterintuitive results in measures of redistribution.

In addressing the issue of redistribution, the CEQ Handbook puts more emphasis on the role of indirect taxes and subsidies than a typical tax-benefit incidence analysis in a developed country. This is because direct taxation and overall cash transfers weigh much less in total income in low- and middle-income countries, which, in turn, increases the relative importance of indirect taxation and subsidies for redistribution. This change in emphasis is most welcome as indirect taxation and subsidies often hide unwanted redistributive effects. For instance, indirect subsidies to basic goods such as food and energy are seen as key instruments for relieving poverty in many developing countries. They indeed reduce poverty, but as they also benefit the nonpoor by reducing their consumption bill, they prove a rather costly redistribution instrument. Likewise, it is also crucial to investigate whether cash transfers to the poor, which have

gained importance in developing countries, may more than offset the effect of regressive indirect taxes on poverty.

The phenomenon of informality, which differentiates incidence analysis in developing and developed countries, also receives more conceptual and empirical emphasis in the CEQ methodology. In developing countries, numerous small production units escape legislation and thus do not pay labor taxes or make social security contributions. They also evade indirect taxation on the sale of their output—but they pay the value added taxes (VAT) on inputs bought from the formal sector. This formal/informal dualism makes incidence analysis intricate. Some general equilibrium framework is needed to figure out the impact of indirect taxation and subsidies on consumer prices, in order to determine the incidence of taxes on “consumable income.” Informality makes this computation difficult because informality is imprecisely observed. In this respect, it is not clear that the IMF’s or the World Bank’s general equilibrium modules, used by the CEQ to perform that computation, take satisfactorily into account the complication arising from informality. This is a topic that requires further investigation and the CEQ Institute should pursue it in future editions of this Handbook.

There are other valuable additions to standard incidence analysis practice in the CEQ Handbook. One concerns the treatment of pensions and the over-simplifying assumption in many studies and micro-simulation models that pensions paid by the public sector are essentially cash transfers from the public sector—a problem that has plagued OECD incidence analyses for a long time. Of course, this ignores the fact that some of the beneficiaries have contributed during their active lifetime to social security in a kind of forced savings so that their pension may simply be the return on these savings. Making explicit the distinction between contributory and noncontributory pension benefits as suggested in the CEQ Handbook is most helpful. And the same applies to other benefits such as healthcare, which may be granted free of contribution in some cases and as counterpart of contributions in others. Here, too, the differences with respect to standard incidence analysis in developed countries may be substantial.

The inclusion of primary and secondary public educational expenditures in fiscal incidence analysis is another major difference. These expenditures are generally ignored when measuring redistribution in developed countries, possibly because primary and secondary schooling are practically universal and in many countries publicly funded. Their redistributive impact thus seems limited (this is much less true of subsidies to tertiary education). Things are different in most low- and middle-income countries where schooling is far from universal. Considering the cost to the government of public education as a transfer to households with children in public schools may thus be necessary, although it can involve a variety of complications, as the Handbook acknowledges. First, the value placed by parents on the schooling of their children, that is, their “willingness to pay” for schooling, might differ from the cost of pupils in public schools. Second, the current practice ignores differences in school quality, a potentially important source of inequality. Third, and most crucially, it is not clear that an increase in the

cost of schooling, aimed precisely at equalizing quality across schools, could be considered as a net gain in the standard of living of families with children in school and therefore in more redistribution. Although it will be a gain for the child when entering the labor force in the future, it is not certain that this gain will then be shared with parents.⁵ More care should probably be exerted in accounting public spending on education as part of the redistribution system. Recognizing these issues, the CEQ Institute is working on alternative methodologies to measure the distribution of education spending benefits, which will be included in the next edition of this Handbook.

The CEQ incidence analysis methodology is also notable for its attention to the diversity of the redistributive instruments that are available and the extent of their impact on inequality and poverty. In this regard, the *CEQ Master Workbook*, a multi-sheet Excel file that presents standardized results of exhaustive fiscal incidence analyses, should hugely facilitate country comparisons. It not only shows the distributional incidence of taxes and transfers based on a specific core income concept, such as disposable, consumable, or final income, but also provides crucial information for evaluating the actual reach of incidence estimates. It thus informs the metadata of the household survey used for the estimation, including the list of available income components, taxes paid, and transfers received; clarifies the assumptions used to estimate nonreported taxes and transfers; and specifies the amounts of each individual tax or transfer in administrative accounts so as to compare them with the equivalent amounts as reported in the survey or imputed by the analyst, as well as to judge the actual coverage of the incidence analysis and identify potential biases. Finally, combined with a user-written software in Stata (commonly known as “ado files”), a final spreadsheet includes the more detailed original indicators on the progressivity of the various fiscal instruments and their redistributive effectiveness as defined in the theoretical part of the Handbook.

With the notable expansion in coverage, the CEQ Institute’s Data Center is thus becoming the repository of rigorous incidence analyses conducted on a wide variety of countries according to the methodology described in the Handbook and presented in the Master Workbook format. At present, the CEQ Data Center already has comparative inequality and poverty indicators as well as the structure of redistributive fiscal instruments for over forty countries, including the United States. Quite clearly, the CEQ has the potential for becoming for the distributional incidence analysis of fiscal policies the equivalent of the renowned Luxembourg Income Study (LIS), which releases harmonized microdata from national household surveys, a little along the lines of, but with a broader outreach than, EUROMOD,⁶ a tax-benefit model that includes the twenty-eight members of the European Union. An important difference is that—whenever permissions have been duly granted by the proper authorities—

⁵ A full argument along these lines may be found in François Bourguignon and Halsey Rogers, “Distributional Effects of Educational Improvements: Are We Using the Wrong Model?,” *Economics of Education Review* 26, no. 6 (2007): 735–46.

⁶ See <https://www.euromod.ac.uk/>.

microdata in the CEQ Data Center will be downloadable, which is not the case in LIS, where customer programs are run onsite, or EUROMOD, where users do not have direct access to the data or the computer code used to simulate the fiscal systems. In the CEQ Data Center, whenever authorized, the income concepts and specific taxes and transfers, along with the computer code used to allocate them, will be made available so users can replicate or modify them at will.

This Handbook and the achievement it represents are certainly not the end of the huge undertaking the CEQ Institute began a decade ago. Many improvements of fiscal incidence analysis are under way and will be incorporated in the next edition of this Handbook. Of particular importance is developing ways to combine survey and administrative data, especially on taxes but possibly on transfers too. So is creating tools for the systematic updating of incidence analysis either with more recent data or, perhaps more importantly, changes in the fiscal instruments—an operation that may require some “nowcasting” work so as to make the database temporally consistent with the fiscal reform. Making the whole dataset and full calculation module available for microsimulation work by policymakers, observers, and analysts, so that they can transparently change the rules governing specific fiscal instruments and easily evaluate the distributional consequences, is also crucial. Such microsimulation models, which are now available in most OECD countries, differ somewhat from the pure incidence analysis of the CEQ Handbook in the sense that all taxes and transfers are systematically computed on the basis of official rules. This facilitates the simulation of reforms of the fiscal system, as well as easier updating of the incidence analysis when the government modifies the way some taxes or transfers are calculated. While such models are available in practically all developed countries, the CEQ Handbook and the work at the CEQ Institute have prepared the way for this to become the case in less advanced economies.

Another step that needs to be taken is the inclusion of some basic behavioral response to the existing fiscal instruments and reforms in it. It is not clear that it is so easy to include behavioral responses concerning labor supply or consumption because economic models and the databases used to estimate such models are often weak and in any case results are very imprecise. Nevertheless, an area of first importance is tax evasion and the incomplete take-up of benefits, as both introduce an important wedge between the official rules in fiscal system and their actual impact on personal incomes and their distribution. The CEQ Institute is planning to incorporate models of these behavioral responses into the CEQ basic framework for the next edition of its Handbook.

This CEQ Handbook must thus be seen not only as a significant achievement in and of itself, but also as the successful first stage of an ambitious project that aims to acquire full mastery of redistribution through fiscal policy in low- and middle-income countries. But while the CEQ institute is moving on to broaden the application of its tools and extending their reach, it is crucial that the material in this Handbook receives the attention it deserves from among academics and think tanks, as well as policymakers and all observers of socioeconomic conditions who, like the members of the CEQ Institute, are committed to equity.

