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THE POLITICAL ECONOMY OF REDISTRIBUTION AND (IN)EFFICIENCY IN LATIN AMERICA AND THE CARIBBEAN[1]

Matias Guizzo Altube, Carlos Scartascini and Mariano Tommasi

Abstract

Predominant views on the political economy of Latin America and the Caribbean tend to emphasize that elite domination helps to understand the high levels of inequality. The contemporary fiscal version of that assertion goes something like "*the rich are powerful and they don´t like taxes, hence we have little taxation and little redistribution.*" That is a good approximation to the reality of some countries, but not of others. There are cases in the region where there are high levels of taxation and non-negligible redistributive efforts. But in some of those cases such redistribution comes hand in hand with macroeconomic imbalances, high inflation, low growth, as well as low-quality public policies. When redistributive efforts are short-sighted and attempted with inefficient public policies, fiscal imbalances lead to inflation and to frequent macroeconomic crises that reduce growth and thwart poverty reduction efforts.

The argument of this paper is that there are various possible political configurations (including elite domination and populism among others) that lead to different economic and social outcomes (including the degree of redistribution and others). We postulate that each configuration of social outcomes emerges out of different political economy equilibria. Different countries in the region will be in different political economy equilibria, and hence will have different combinations of political economy syndromes and of socioeconomic outcomes.

In this paper, we characterize the countries regarding the size of the public sector, how much fiscal redistribution there is, and how efficient this public action is. We summarize various strands of literature that attempt to explain some elements of that fiscal vector one at a time; and then attempt to provide a simple framework that might explain why different countries present different configurations of size, distributiveness, and efficiency.

Keywords: Inequality, Redistribution, Political Economy, Growth, Poverty

JEL Codes: H20, H23, E62, P16

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[1] We are highly indebted to Lucila Porto, who provided excellent research assistance and has been fundamental in developing the theoretical model we sketch here. We received very valuable comments on this paper and the overall research agenda from the coordinators of the LACIR initiative, from discussants and colleagues at the LACIR meetings in Washington DC and Cartagena, at the UNU-WIDER conference in Bogotá, as well as at Universidad de San Andrés, Vanderbilt, Houston, Tulane, and NYU. Some parts of this paper draw freely from joint work with Nora Lustig and Ludovico Feoli at the Commitment to Equity (CEQ) Institute of Tulane University, from where we took the redistribution data. Tommasi acknowledges the financial support of the Inter-American Development Bank. This is a background chapter prepared for the Latin America and Caribbean Inequality Review (LACIR)

HIGHLIGHTS

- Latin America and the Caribbean faces many challenges, including high inequality, high poverty, and low growth.
- The argument of this paper is that there are various possible political configurations (including elite domination and populism among others) that lead to different economic and social outcomes (including the degree of redistribution and others)
- Different countries in the region are in different political economy equilibria, and hence have different combinations of political economy syndromes and of socioeconomic outcomes.
- In this paper, we characterize the countries regarding the size of the public sector, how much fiscal redistribution there is, and how efficient this public action is.
- We summarize various strands of literature that attempt to explain some elements of that fiscal vector one at a time; and then attempt to provide a simple framework that might explain why different countries present different configurations of size, distributiveness, and efficiency.

1. INTRODUCTION

Inequality is a crucial issue in Latin America and the Caribbean. The region's richest 10 percent of the population earns 22 times more than those in the bottom 10 percent, which is twice the ratio in developed countries (Busso and Messina, 2020). Worse than that, according to 2022 data, those in the bottom three deciles live in poverty (32% of the region's total population), and 13% of the people live in extreme poverty (ECLAC, 2022).

The poverty and inequality levels in the region cannot be considered independently of the growth problem the region faces. Between 1980 and 2020, the average per capita growth rate of real GDP in Latin America and the Caribbean was below the world average. Other regions have narrowed the gap with the income per capita of the United States: the typical country in emerging Asia narrowed its gap from 11 percent in 1960 to 58 percent in 2017. Latin America and the Caribbean has not: on average, countries in the region closed only four percentage points, far less than the 47 percentage points achieved by East Asian countries (Cavallo and Powell, 2018). This is particularly important because growth tends to have a much larger impact on poverty than redistribution does. For example, from 2009 through 2014, poverty reduction was estimated in 7.4 p.p., from which 6.2 p.p. were driven by average income growth and only 1.2 p.p. were the result of redistribution (World Bank, 2023). These estimates show that growth plays a critical role in how poverty changes and that all the redistribution efforts may be irrelevant if the average income is left unattended in the policymaking process.

Low productivity and low investment make growth impossible in the region. Private investment in Latin America and the Caribbean is lower than in the rest of the world; the only exception being Sub-Saharan Africa. Public investment is also low by international standards. The comparison with Emerging Asia is the most striking, with an investment gap equivalent to 10 percent of Latin America's annual GDP between 1980 and 2013 (Cavallo, Powell, and Serebrisky, 2020). The region invested only 2.8 percent in infrastructure over the last decade, half of Asia's investment (Cavallo, Powell, and Serebrisky, 2020).

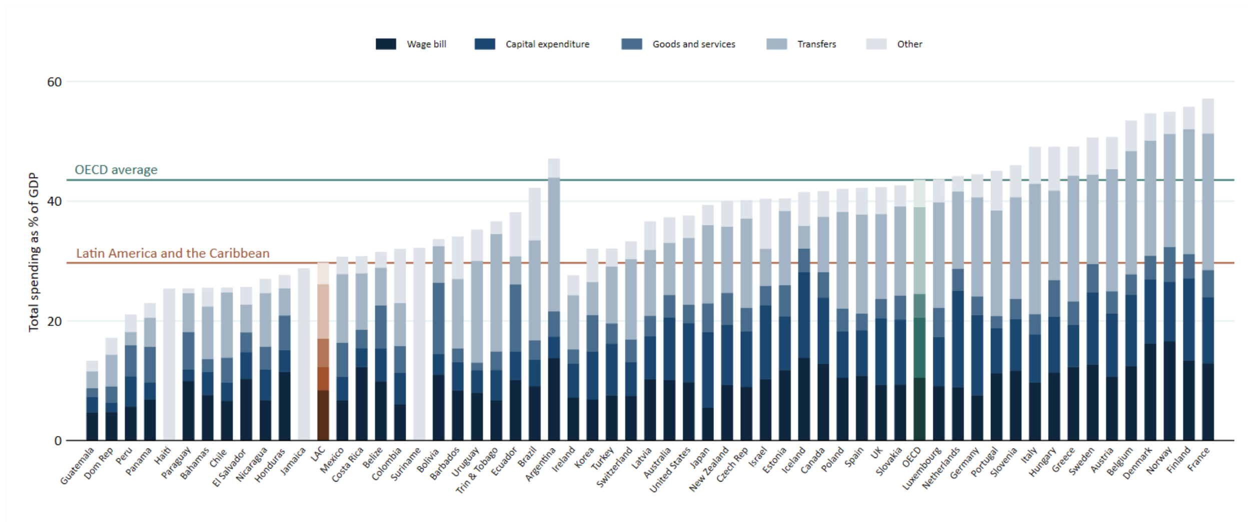
So, Latin American countries today suffer many challenges, with inequality being a crucial one, but not the only one. When looking into the roots of inequality, it is natural to focus on a political economy with an asymmetric distribution of political power. There is support in the literature confirming that this relationship holds in many cases. Perhaps the most salient line of explanation is the work by Daron Acemoglu, James Robinson, and collaborators over the last several decades, arguing that economic elites have been able to sustain political privileges since democratization. The characterization of the political economy of Latin America as a region where elite domination has led to high and relatively sustained inequality is quite accurate for many countries at many points in history. But the story is not a good characterization of the political economy of several Latin American countries today, and it clearly does not encompass all the challenges the region faces – in particular, it is not enough to account for poverty levels in the region.

In the canonical story, elite power translates into inequality in market incomes (through both market and public intervention channels) and insufficient fiscal redistribution to remedy those market outcomes. To introduce some explicit nuances to that story, in this paper, we focus on the latter part of the assertion, the "fiscal version" of the canonical story, which goes something like *"Taxation and fiscal redistribution are too low in the region because of the power of the rich."* That statement might be true in some countries in the region. Yet, it is not true in others: taxation, public spending and redistribution are indeed relatively high in some Latin American countries.

Figure 1 puts Latin American countries in comparative perspective in terms of the size of the government. The figure clearly shows the heterogeneity within the region in that regard. There are countries, such as Guatemala and the Dominican Republic, that are the lowest spenders in that international sample, but there are also cases, such as Brazil and Argentina, which spend at OECD levels. Figure 2 further explores such heterogeneity, looking into social spending, presenting cases that spend less than 10% of GDP as well as cases spending over 30% of GDP. Clearly, the fiscal reality of Argentina is not the same as Guatemala's, and neither are their political stories. These facts lead us to believe that blanket assertions for "Latin America and the

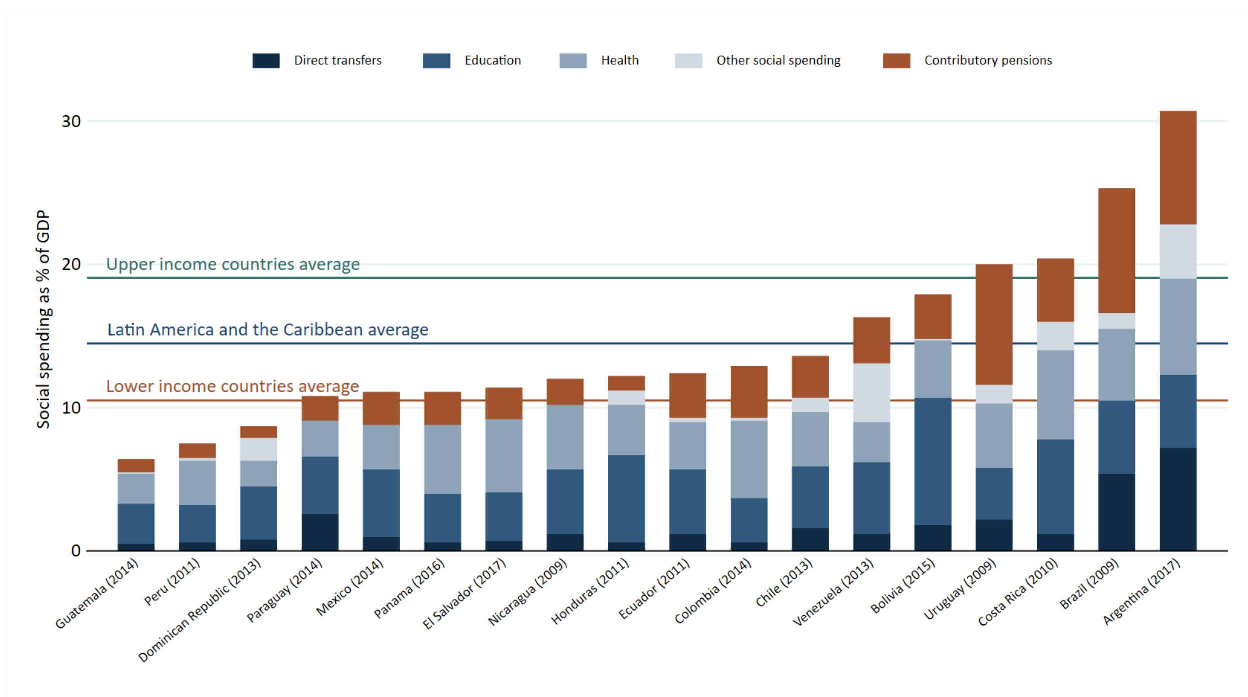
Caribbean" regarding its inability to tax and spend and the political economy behind it should not be generalized; a more nuanced story seems to be warranted.

Figure 1. Total spending by economic classification, 2015-2016



Source: Izquierdo, Pessino, and Vuletin (2018).
Note: For most countries the data corresponds to year 2015 or 2016 or latest available.

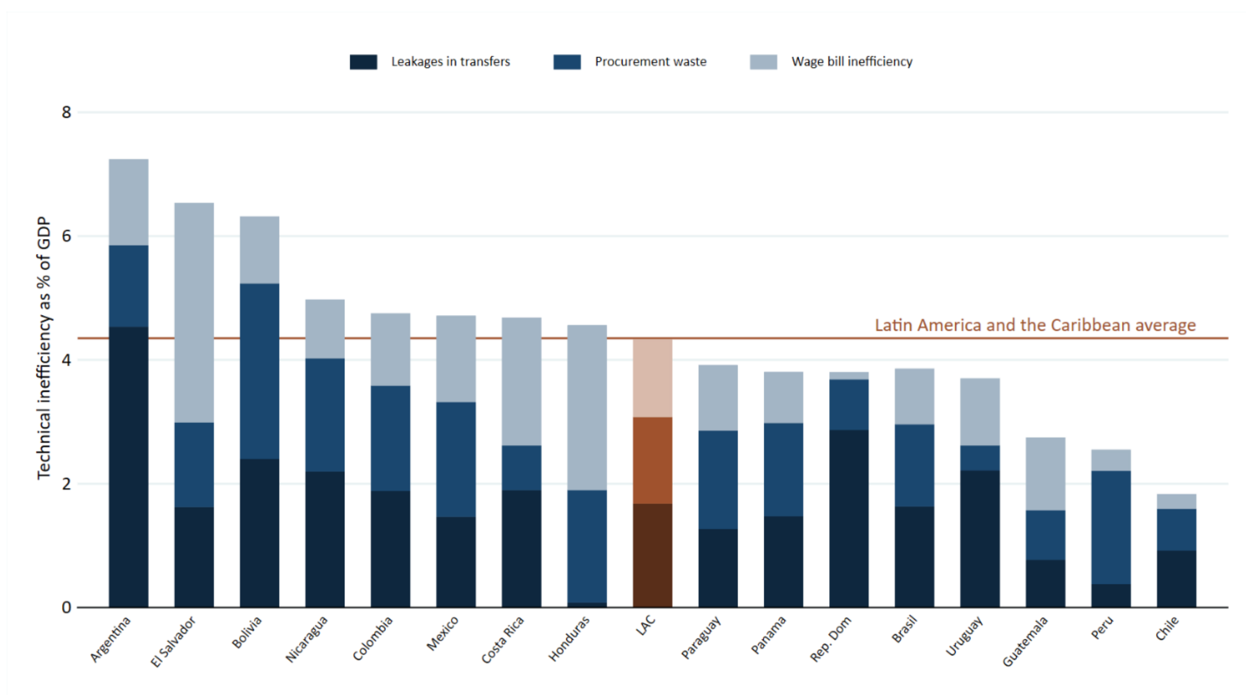
Figure 2. Social spending in Latin America and the Caribbean



Source: Lustig (2020).
Note: Upper-income countries include those classified as high-income and upper-middle income according to the World Bank. Lower-income countries also include those of lower-middle income. None of those averages include Latin American countries.

Redistribution with poor state capacity, inefficient public policies, and unstable macroeconomies dampen the long-term impact on poverty reduction. The region varies greatly also in terms of the efficiency of public spending. In a region where collecting revenues does not come easy, governments should combine inputs to maximize the provision of public services at the lowest cost. Unfortunately, inefficiencies abound. Izquierdo, Pessino, and Vuletin (2018) analyze technical efficiency for various components of government production costs. They argue that most Latin American countries spend inefficiently. Figure 3 shows that the inefficiency can be large (more than 4 percent of GDP on average).

Figure 3. Technical inefficiency in public spending



Source: Izquierdo, Pessino, and Vuletin (2018).
Note: For most countries, the data corresponds to the year 2015 or 2016 or the latest available.

The high inefficiency in public spending that hinders redistribution and growth has been accompanied by a growing bias against capital spending (measured as the decline in capital spending as a share of total primary spending). The bias is greater in Latin America and the Caribbean than in any other region in the world, but heterogeneous across countries in the region (Izquierdo, Pessino, and Vuletin, 2018); and Latin America and the Caribbean is clearly not a region where the government has not been involved in the economy. Barriers to entry are 40% higher in the region than in OECD countries, and government regulations are more than twice as high according to the Doing Business indicators and the Enterprise Surveys conducted by the World Bank.[2] Again, heterogeneity is high. Looking at one of the many indexes included in the Enterprise Surveys, "Senior management time spent dealing with the requirements of government regulation (%)," shows that the average for the region is 13.3% (higher than any other region in the world), with countries like Chile below the average (9.9%) and others like Argentina substantially above (20.5%).

To explain this heterogeneity of Latin American experiences, in this paper, we take a broader view of the political economy of the region, moving away from the one syndrome – one outcome paradigm to a multi syndrome – multi outcome logic. The main issues of Latin America and the Caribbean include other political economy malfunctioning and other poor outcomes. Elite capture is not the only political syndrome present in the region; populism is another one.[3] And there are, as shown, plenty of economic and social maladies present in Latin America and the Caribbean beyond inequality, including low investment, poor growth performance, low-quality public policies, as well as serious macroeconomic imbalances. These maladies are highly correlated with the underlying characteristics of the policymaking process, government capabilities, and the levels of trust individuals have in government officials (Scartascini and Tommasi, 2010; Scartascini, Stein, and Tommasi, 2013; Keefer and Scartascini, 2022).

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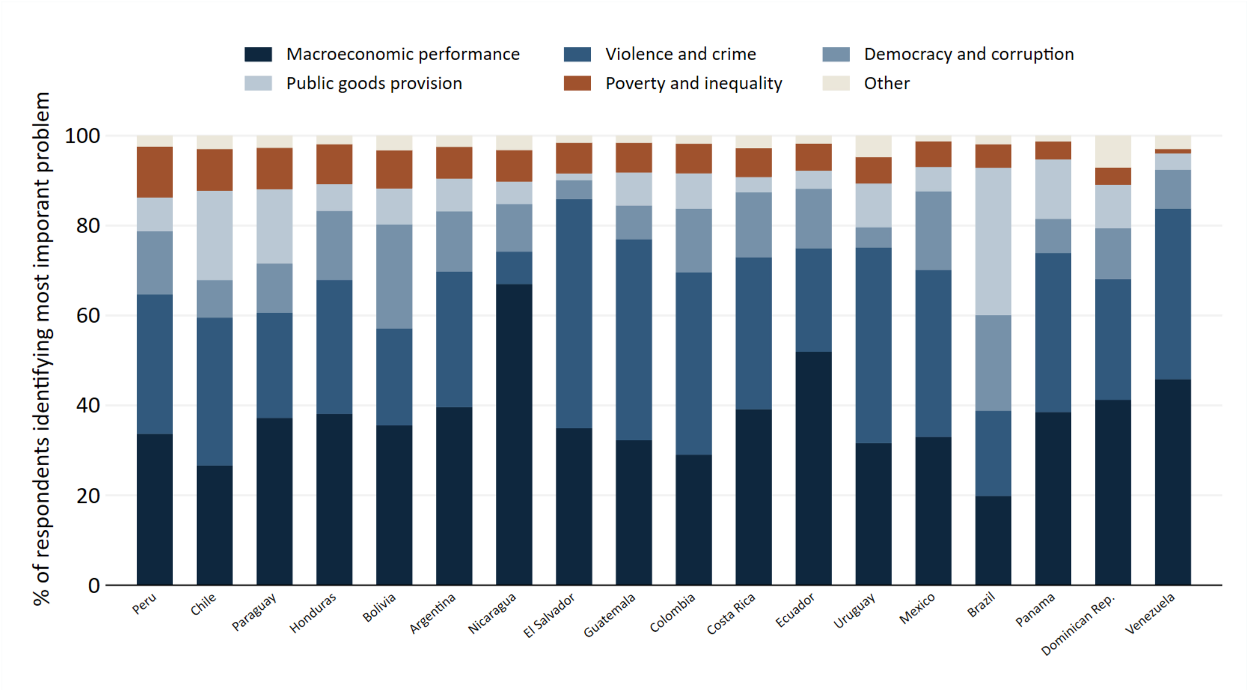
[2] Latest data available. For more information, see https://www.worldbank.org/en/businessready and https://www.enterprisesurveys.org/en/enterprisesurveys.

[3] In some interpretations of the foundations of populism, it is a sort of mirror image of elite domination. "Critiques of elites define populism, which conceives of power relations as a unified, conspiring elite exploiting the good people. Yet, populism itself is inherently elitist, calling for a strong leader to take power and channel the will of the people." (Mangset et al. 2019).

As we can see in the earlier figures, there are cases in the region with high levels of taxation and non-negligible redistributive efforts. But in some cases, such redistribution comes hand in hand with macroeconomic imbalances, high inflation, low growth, and low-quality public policies. When redistributive efforts are short-sighted, fiscal imbalances lead to inflation and frequent macroeconomic crises that reduce growth and thwart poverty reduction efforts. [4]

Individuals in the region understand the importance of these different problems that come together simultaneously. Figure 4 presents what citizens in different Latin American countries consider to be the most important problems. In all cases, issues such as the macroeconomy, crime and violence, and corruption appear more salient than inequality.[5]

Figure 4. Main problems in LAC according to survey responses



Source: Authors' calculations based on Latinobarómetro data from 2008 to 2018.

[4] Lopez del Valle et al. (2021) describe Argentina as fitting this description quite well.

[5] This is in line with the findings of Busso, Ibañez, Messina, and Quigua (2023). They present the most up-to-date analysis of preferences for redistribution in Latin America and find that inequality is a significant concern, but other issues are more important for citizens, such as the economic situation and the degree of corruption.

Note: Answers to the most important problem question in each survey are grouped into the five categories presented. Values are weighted averages of individual responses in all surveys from the complete period of 2008 to 2018 for each country.

Consequently, in addition to inequality and redistribution, we want to incorporate other stylized facts of the region in the analysis, such as low growth, low productivity, insufficient savings and investment, and low quality of public policies. This paper argues that there are various possible political configurations (including elite domination and populism, among others) and that different political configurations lead to different economic and social outcomes (including the degree of redistribution and others). We postulate that each configuration of social outcomes emerges from different political economy equilibria. Different countries in the region will be in different political economy equilibria and, hence, will have different combinations of political economy syndromes and socioeconomic outcomes.

We advance that logic in two ways in the paper. First, we characterize the *fiscal vector* of different Latin American countries and explore some patterns connecting those fiscal variables to other relevant outcomes. Then we take some steps towards an integrated political economy of redistribution and efficiency, first reviewing some branches of political economy that attempt to explain some aspects one at a time, and then suggesting a simplified, yet more general, framework that might explain different configurations of countries as outcomes of different political economy equilibria.

2. CHARACTERIZING DIFFERENT COUNTRY CONFIGURATIONS: THE FISCAL VECTOR

In the context of the issues discussed here and the challenges the region faces, countries can be characterized by: (i) how large the State is (in terms of taxation and spending); (ii) how much they redistribute, and; (iii) how well they do it - this includes issues of macroeconomic sustainability as well as microeconomic effectiveness, relating to the quality and efficiency of public policies, and (more relevant for the distributive concerns of this book) the question of whether

interventions change the lives of the poor in the long run.[6] We somewhat loosely group these characteristics under the heading of "fiscal vector". In this section, we characterize Latin American countries along those dimensions from a comparative international perspective, and connect those measures to other relevant outcomes.

The two traditional measures of government size are revenue and spending. We use data on general government total revenue as share of GDP from the World Economic Outlook (IMF, 2023) to capture size, since revenue is a more direct measure of the distortions introduced to the economy by fiscal policy. We measure redistribution as the percent reduction in the Gini index from the market income distribution (before any government intervention)[7] to the disposable income distribution (after considering direct taxes and subsidies and contributions to and benefits from the contributory social insurance system), i.e., how much direct taxes and subsidies and the contributory pension system reduce inequality from the original income distribution. For countries in Latin America and the Caribbean, and some other developing countries, we rely on data from the Commitment to Equity Standard Indicators (CEQ, 2023; see a rich description and discussion of the methodology in Lustig, 2018), while data on redistribution in the OECD countries is retrieved from the Income Distribution Database (OECD, 2023).[8]

Figure 5.a. looks at the relationship between government size and redistribution. As expected, there is a positive correlation. Higher government size seems to favor higher redistribution. Interestingly, the slope is much higher across regions than within regions. Latin America and the Caribbean seem to be highly ineffective in terms of how much it redistributes, given how much it collects (the slope is almost flat).

[6] See Tommasi (2021) for an elaboration on these issues.

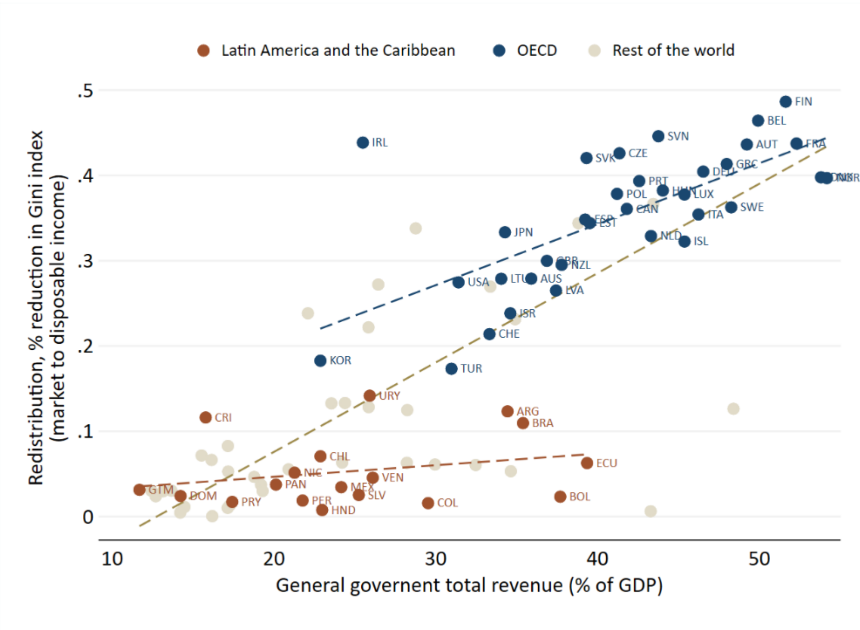
[7] Market income is defined as the sum of factor income (earnings and capital income), employers' contributions to social insurance, and private transfers. The CEQ Institute also considers imputed rent and own production as part of market income.

[8] Given data limitations on the complete redistributive process and the real inequality reduction in many countries in data sources different than CEQ, we leave indirect taxes and subsidies, as well as in-kind transfers like public health and education aside. This decision is, however, prone to increase the gap in redistribution measures between developed and developing economies, as developing countries tend to concentrate much of their redistributive efforts in these latest stages of the process.

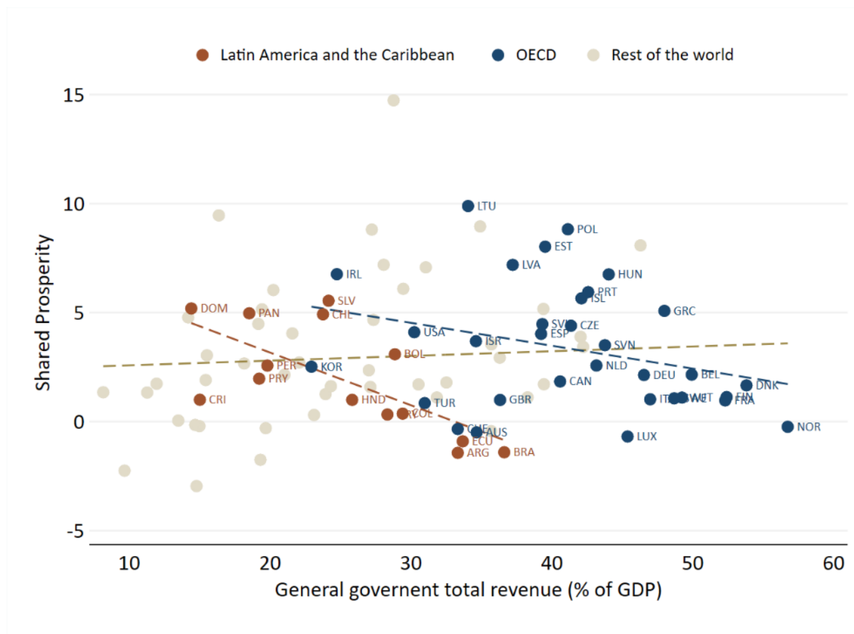
Decomposing the correlation by region is even more enlightening for the correlation between size and *shared prosperity*. Shared prosperity, measured as the annualized growth rate in the average income per capita of the poorest 40 percent of the population in a country, is a concept utilized by the World Bank to measure the extent to which economic growth is inclusive by focusing on income growth among the poorest population relative to the population as a whole. Figure 5.b. points out how important it is to take into account growth and poverty, and not only redistribution, when looking at the role of government taxation (which can be highly distortionary, particularly in developing countries, where most of the revenues come from indirect taxes). While there is a positive correlation across countries between government size and shared prosperity, that correlation becomes negative within regions. These correlations point to the relevance of looking at the way governments spend money.

Figure 5. Government size, redistribution, and efficiency

A. Size and Redistribution



B. Size and Shared Prosperity



Source: Authors' calculations based on the World Economic Outlook (WEO), the Global Dataset on Shared Prosperity (GDSP), the CEQ Standard Indicators, and the Income Distribution Database (IDD).
Note: Redistribution is defined as the percentage reduction of the Gini index from market income to disposable income, considering contributory pensions as government spending. Shared prosperity is defined as the average annual growth rate of income of the bottom 40% of the income distribution from 2015 to 2019 approximately.

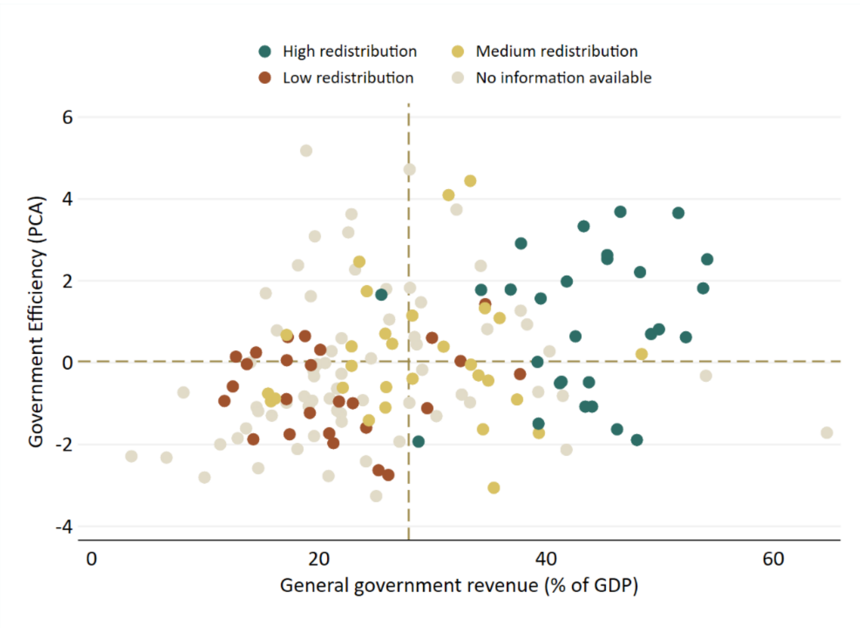
As a proxy for government efficiency (and support for growth), we take the first principal component of four opinion-based indicators from the Global Competitiveness Report of the World Economic Forum: wastefulness of government spending, the burden of government regulations, quality of the education system, and quality of overall infrastructure. Together, these indicators aim to capture some sense of (the perception of) long-term efficiency, as they incorporate how well-executed public spending is, how well-designed regulations are, and how good the quality of the physical and social infrastructure provided by the government is. Therefore, this index attempts to capture how the government spends its resources (and how good the correlation between taxation/spending and redistribution could be) and how much the government favors/hinders growth.[9]

[9] The main reason why we use these indicators has to do with coverage in terms of years and countries. Other potential variables do not capture well the concepts we are trying to capture or have lower coverage in either dimension.

Based on these indicators for government size, redistribution, and efficiency, the resulting sample of 88 countries is divided into twelve clusters using the mean value of government size and efficiency and the terciles of redistribution as the cut-off points.[10] The partition is presented in panel A of Figure 6, while panels B and C highlight observations from Latin America and the Caribbean (LAC) and the OECD, respectively. LAC countries are concentrated in the quarter of low-efficiency small governments and show some variation in their level of redistribution, while the OECD countries gather around high levels of efficiency, large government, and high redistribution.[11] Notice in Figure 6.A that there is only one case with available redistribution data with a small government and high levels of redistribution, as well as only five cases in which redistribution is low despite having a large state, two of which are Latin American countries (Bolivia and Colombia).

Figure 6. Government size, redistribution, and efficiency

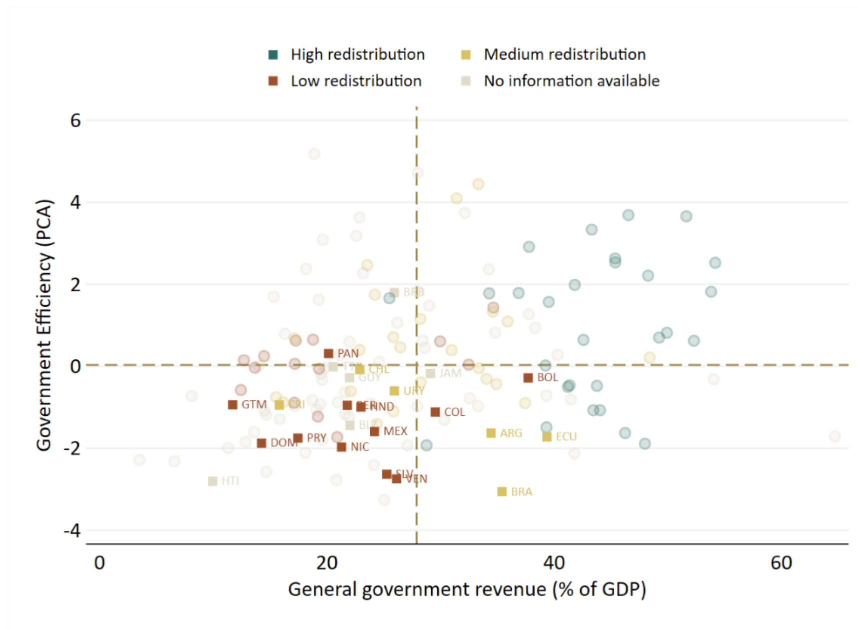
A. Complete sample



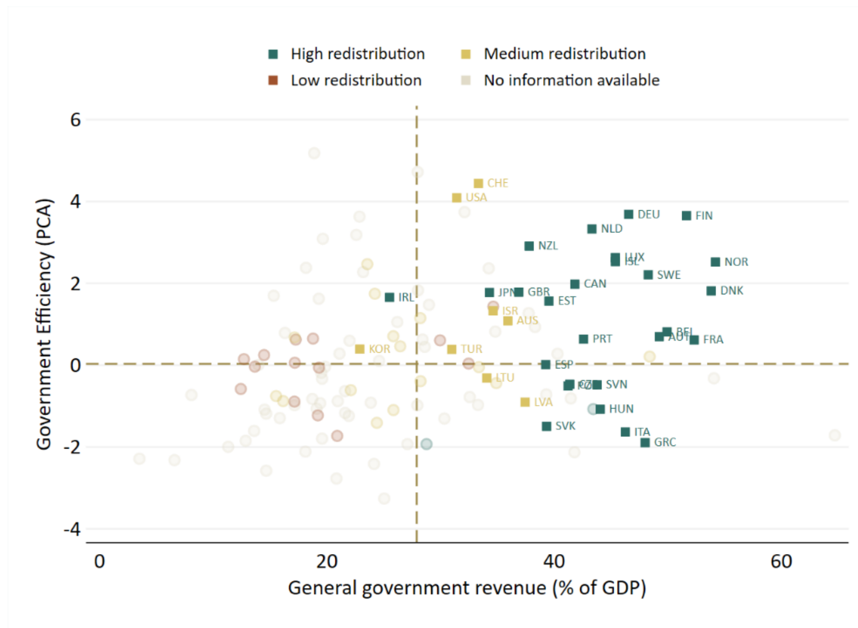
[10] For each country, we take the variable values for the most recent year with available redistribution data. While data from IDD is from 2019 on average, data from CEQ is from 2014, on average.

[11] An important caveat is that the CEQ sample is not representative of the complete country composition of the world, as some regions like Latin America and Sub-Saharan Africa are overrepresented, and Europe, Central and East Asia, and the Pacific are underrepresented. This probably means that CEQ data focus on a select sample of countries with relatively high levels of inequality and corruption, and low levels of efficiency and institutionalization, and adding data on the OECD countries only partially covers that lack of representativeness.

B. Latin America and the Caribbean countries



C. OECD countries



Source: Authors' calculations based on the World Economic Outlook (WEO), the Global Competitiveness Indicators (GCI), the CEQ Standard Indicators, and the Income Distribution Database (IDD).
Note: Government efficiency is the first principal component of the wastefulness of government spending, burden of government regulation, quality of overall infrastructure, and quality of the education system, from the GCI. Redistribution is defined as the percentage reduction of the Gini index from market income to disposable income, considering contributory pensions as government spending. Highlighted points are those for which redistribution data is available.

To summarize, Latin America and the Caribbean is a diverse region that suffers from many maladies. Inequality is high but so is social and general government spending in several countries. The level of redistribution is higher on average in the region than in other developing countries. Many countries in the region tax very little, but others tax as much and even more than many developed countries. Government efficiency is particularly low and lower than in other regions of the world. Higher revenues are not highly correlated with higher redistribution, and they are correlated with lower poverty reduction and lower shared prosperity. Growth is low in the region because investment and productivity are. These stylized facts warrant coming up with a broader characterization of political economy equilibria in the region. In the next couple of sections, we take some steps towards building a framework for such endeavor.

3. TOWARDS AN INTEGRATED POLITICAL ECONOMY OF REDISTRIBUTION AND EFFICIENCY. BUILDING BLOCKS

We saw in the previous sections that different countries present different configurations of fiscal and socioeconomic outcomes. We believe that in order to explain such configurations we need to find a way to integrate various strands of literature that have addressed some of those outcomes in isolation. In this section, we review several such branches of political economy, and in the next section, we hint at a framework for putting some of those pieces together and discuss some modeling choices.

The Political Economy of Redistribution (or lack thereof)

In its origins in modern political economy, explanations of redistribution developed hand in hand with attempts to explain the growth of government. Romer (1975), Roberts (1977), and Meltzer and Richard (1981) presented the pioneer models of majority voting over simple income tax schedules meant to finance distributive transfers. Meltzer and Richard's has become the workhorse model. In it, all government activity consists of redistribution. Redistribution occurs

by means of per capita lump sum grants financed from a proportional tax levied on earned income. Individuals derive utility from consumption and from leisure. Income depends on an ability/productivity factor, which is distributed heterogeneously across the population. A political economy equilibrium is found in three steps. First, individuals optimize over their choice variable for a given fiscal policy. Based on that optimization, each individual determines his preferred fiscal policy. Last, these preferences are aggregated into a fiscal policy choice via the collective choice mechanism in place. Given the assumed mechanism of majority rule, the model's assumptions are such that the conditions for a median voter result are obtained.

The model has several empirical predictions. The poorer the median voter, the larger the predicted size of government and redistribution. The larger the franchise from below, the poorer the median voter becomes; hence, we expect larger governments and more redistribution. This means that the model predicts increased redistribution as countries democratize.

An extensive literature has explored the connections between inequality and redistribution and between democratization and redistribution, and the results are not too supportive of the basic predictions of the model. The evidence for redistribution rising in inequality is weak. Indeed, data seem to suggest that democracies with high inequality also tend to redistribute less (Alesina and Glaeser 2004, Benabou 1996, Lindert 1996, Moene and Wallerstein 2001, Perotti 1996). Similarly, the empirical literature is far from a consensus on the relationship between democracy and redistribution. Several works have reported a negative relationship between democracy and inequality using specific episodes and datasets (Acemoglu and Robinson, 2000; Lindert, 1994, 2004; Persson and Tabellini, 2003). Other papers point in the opposite direction (Perotti 1996; Gradstein and Milanovic, 2004; Scheve and Stasavage, 2012).

The mixed empirical evidence regarding the predictions of the Meltzer-Richard model has led to an industry of papers and books modifying the assumptions of the model in various directions: multidimensionality, policy influence beyond voting, and others. Iversen and Goplerud (2018) provide an excellent summary of the implications of moving to a multidimensional policy space,

the most natural theoretical extension within the context of voting models. They show how issue bundling, issue salience, and the distribution of preferences can affect redistribution and discuss the role of political institutions in inducing particular outcomes using the logic of structure-induced equilibria (Shepsle, 1979). Grossman and Helpman (2001) is the standard reference on interest group politics, where political technologies (the means to influence policies) go beyond voting. Such models pitch various pressure groups demanding specific redistributive policies in their favor, and redistribution does not necessarily go toward the bottom of the income distribution.

One possible way of summarizing that vast literature, helpful for this paper, is by its sociological emphasis on the collective action (or lack thereof) of main sociological classes: the poor, the middle class, and the rich.

Many important works have explored why **the poor** do not expropriate the rich (Roemer 1998), or, to put it more mildly, demand more redistribution. Different explanations highlight issues of information, preferences, lack of cohesion, and various others, including endogenous turnout (Mahler et al., 2014; Chong and Olivera, 2008), expectations of future mobility (Benabou and Ok, 2001), the presence of other dimensions (such as race or religion) that side-track the poor from redistributive concerns (Alesina and Gleaser, 2004, Austen-Smith and Wallerstein, 2006, Scheve and Stasavage, 2006, De la O and Rodden, 2008). Some of these factors are potentiated by characteristics of (*de jure*) political institutions such as electoral systems (Iversen and Soskice, 2006) or federal arrangements (Dixit and Londregan, 1998; Díaz-Cayeros, 2016; Dunn, 2022).

Other important avenues of thought have explored the role of **the middle class** in the “low-taxation, low-redistribution equilibrium.” De la O, Rossel, and Manzi (2023) underscores one aspect of such role, the “exit” towards the private provision of public services such as education or security. More generally, the middle class could form political coalitions with either the poor or the rich. Which coalition is more likely to form, will depend both on the structure of inequality (how close the middle class is to the poor, Lupu and Pontusson, 2011) and on the formal rules of

the political game (Iversen and Soskice, 2006). A coalition of the middle class and the poor will support high taxation and broad-based redistribution. A coalition with the rich will support low taxation and redistributive programs that benefit the middle class, such as some public utility subsidies, pensions, and free university education (Ferreira et al., 2012). The truncated welfare states that characterized many Latin American countries in the past, and to some extent in the present, could be thought of as one materialization of the latter equilibrium (Holland, 2018).

The set of variations from median voter models more related to the arguments we discuss in this paper (and the one implicit in the LACIR initiative) is one that focuses on the power of **the rich** or on "elite power." This family of arguments has many related variants. One emphasizes the power of "business" and puts the light on two forms of power: structural power and instrumental power, the first related to the power exercised through economic actions and the latter through political actions. In the words of Haggard, Maxfield, and Schneider (1997, p. 38), "capital votes twice: once through the organized pressure it can bring to bear on the political process, again through its investment decisions." [12]

A more historical branch of the political economy of the power of the rich has emphasized the power of "elites." The monumental work of Acemoglu and Robinson (2005) on democratization has the Meltzer-Richard's framework as its workhorse model of democratic politics. As we know, that setup predicts relatively high redistribution after democratization. But another crucial building block in Acemoglu and Robinson's theory of democratization consists, precisely, on exploring various mechanisms by which the rich can invest in *de facto* political power in a democracy. In that enlarged median voter model, the distributive effects of democratization might be quite meager. "Latin America" seems to fit that mold.

The argument is formalized in Acemoglu and Robinson (2008), attempting to explain why important democratizing changes in formal political institutions did not always lead to much

[12] Recent applications include Fairfield (2015) that examines under what conditions the interests of economic elites prevail in preventing tax reforms in Latin America.

change in the inequality of socioeconomic outcomes. According to them, a change in political institutions alters the distribution of *de jure* political power but creates incentives for investments in *de facto* political power to offset the change in *de jure* power. Their model can imply a pattern of captured democracy, whereby a democratic regime may survive but choose economic institutions favoring an elite. This may come about through the investments made by the elite in building *de facto* political power and through some details of the new democratic institutions that tilt the scale in favor of the powerful. An example of the latter might be the post-Pinochet Chilean constitution, which contained many elements favoring the parties on the right. Ardanaz and Scartascini (2013) provide broader evidence of these mechanisms, showing that legislative malapportionment enables rich elites to exercise disproportionate political influence, blocking progressive tax reforms.

The Political Economy of Redistribution and Growth

In the middle of the past century, Kuznets advanced one of the most influential hypotheses in the social sciences: as an economy develops, market and demographic forces first increase and then decrease economic inequality (Kuznets, 1955). The inverse U-shape Kuznets curve appeared to be consistent with experience at the time it was proposed. However, as inequality has risen in the U.S. and other developed countries, a new wave of research emerged arguing that there is no automatic decrease in inequality at the mature stage of economic development, with Piketty's (2014) "*Capital in the 21st century*" being its most salient exponent.

On the other hand, an important literature has looked into the impact of inequality on growth, with a negative association being the predominant, but not exclusive, finding (Berg et al, 2018). Among the channels connecting inequality to lower growth, an influential early literature emphasized credit constraints and political economy issues. Among the latter, some argued that inequality breeds political instability and political mayhem lowers investment and growth (Alesina and Perotti 1996, Rodrik 1999, Keefer and Knack 2002), while others emphasized democratic voting mechanisms by which greater inequality led to more redistribution, lower

investment, and lower growth (Alesina and Rodrik 1994, Persson and Tabellini 1994, Benabou 1996, Perotti 1996).

Regarding this latter political economy of redistribution and growth, the basic logic is that (a) higher inequality leads to higher redistributive taxation (a la Meltzer-Richards) and (b) this, in turn, has adverse effects on economic growth. Both parts of the logic merit closer attention. As we discussed in the previous section, there are various motives why the logic from inequality to redistribution can be offset. Also, there are several arguments that more redistribution is not necessarily bad for growth (Saint-Paul and Verdier 1996, Bourgignon 2000).

To think about the connection between redistribution and growth, it is useful to decompose the former into taxation and spending. On the taxation side, we concur with Berg et al (2018), who, after a thorough review and analysis, conclude that "it seems hard to improve on the conclusions of Tanzi and Zee (1997), who find some general indication that the relationship between growth and the level of total taxes is negative." Things are more interesting on the spending side, where various authors have argued for channels through which public spending can increase growth. A long and diverse literature could be summarized by saying that some items of spending (such as public investment, public education, and improving financial markets) tend to have a better growth impact than others (such as transfers), and that impact varies across countries and time periods, in a way that some authors have associated with state capabilities and the quality of institutions (see for instance Afonso et al. 2005).

The Political Economy of (In)Efficiency

The last assertion leads us into another relevant literature that has focused on understanding the reasons why government intervention, including redistribution, takes often inefficient forms. Table 1 summarizes a selection of some of the contributions attempting to explain inefficient (redistribution) policies as equilibrium outcomes of the political process.

Table 1

Models of Inefficient Public Policies

UNDERLYING DISTORTION	Paper or book	Political Agency crucial
TIME INCONSISTENCY	Acemoglu 2003	YES
	Acemoglu Robinson 2001	
	Dixit Londregan 1995	YES
	Dixit 1998	YES
	Robinson Verdier 2013	YES
IMPERFECT INFORMATION	Coate and Morris 1995	YES
Non-cooperation in REPEATED GAME	Alesina 1988	
	Spiller Tommasi 2007	
Lack of INSTITUTIONALIZATION	Scartascini Tommasi 2012	
	Caruso et al 2015	
Inefficiency policies today affect the political game tomorrow	Becker Mulligan 2003	
	Drazen Limao 2008	YES
	Besley Coate 1998	YES
POPULISM[13]	Acemoglu, Egorov, Sonin 2013	YES
	Acemoglu, Robinson, Torvik 2013	YES
	Keefer, Scartascini, Vlaicu 2021	YES
	Rodrik 2018	

This rich literature offers several motives for why inefficiency oftentimes comes hand-in-hand with redistribution. The analytical structure often utilized to embed such microfoundations is that of dynamic games of incomplete information. These are either games among contending political parties or societal groups, or games between office holders and societal groups, often having the voters as third players. The last column highlights the cases in which political agency issues, a topic that we address below, are crucial.

[13] Populism is not necessarily an underlying exogenous distortion. It is an equilibrium outcome which might be more likely under some parametric assumptions and that it correlates with some inefficient outcomes in such equilibrium. In the framework we refer to in the next section, there are some equilibria that can be interpreted as situations of (left-wing) populism.

The issue of imperfect voter information is highlighted in many important works, such as Coate and Morris (1995). In their model, citizens face incomplete information both on the effects of policies and on the type of the politician in office, and this leads politicians to implement inefficient but less observable transfers to special interests.[14]

An even larger strand of literature has focused on the dynamic structure of interactions as the microfoundation of inefficient public policies in general and inefficient redistributive policies in particular. In terms of a two-period game, some authors have emphasized the strategic effect of period-one actions on the conditions of the second-period game, while others have emphasized the anticipation effect of expected equilibrium actions of the second period on first-period choices. Models that show that the desire to manipulate future political equilibria can induce inefficient policies include Robinson and Verdier (2013), Besley and Coate (1998), Becker and Mulligan (2003), and Drazen and Limao (2008) and Acemoglu and Robinson (2013).[15]

The Political Economy of Intertemporal Cooperation

Several authors have argued that inefficient policies emerge due to time consistency problems in dynamic games. According to Acemoglu (2003), "parties holding political power cannot make commitments to bind their future actions because there is no outside agency with the coercive capacity to enforce such arrangements;" and according to Acemoglu and Robinson (2001) "when political institutions cannot commit to sustain future policy … inefficient redistribution is a tool to sustain political power."

[14] There are similar models, such as that of Acemoglu, Egorov and Sonin (2013), in which politicians in power implement populist policies in order to signal their type.

[15] This logic has been also applied to explain macroeconomic outcomes such as fiscal deficits and public debt, in terms of the strategies of incumbent politicians who anticipate the opposing party can be in office in the future (Alesina and Tabellini, 1990). See Alesina and Passalacqua (2016) and Eslava (2010) for excellent surveys of the political economy of debt and of fiscal deficits respectively.

In those arguments, as in a good part of the literature, the possibility of committing to more efficient actions through repeated-game enforcement is not considered. If we add such considerations (as in Alesina 1988 or Spiller and Tommasi 2007), the efficiency or inefficiency of redistributive policies will depend on the degree of intertemporal cooperation in the political equilibria in which different countries are.

This logic has been the foundation of several works arguing that various characteristics of political systems (including notably the degree of institutionalization of policymaking processes) can lead to more or less cooperative policymaking styles, and, hence, to more or less efficient public policies. See, for instance, IADB 2005, Stein et al 2008, Scartascini and Tommasi 2012, Caruso et al 2015.

The Political Economy of Agency

We argued above that the positive growth effect of things such as public investment and public education are conditional on state capacities; that is, these public policies are likely to be delivered only if there is good governance. Thinking about these issues requires the introduction of a representative democracy logic in which decisions are taken by politicians and implemented by public employees with their own motivations.

Politicians in power claim that they have a general mandate from the population to search for the policies that are in the national interest, but they have their own agendas. The study of the principal-agent problem in politics has a long pedigree.[16] The main instrument that citizens have to control their elected representatives is the vote, a fairly blunt instrument. The election contract is a fundamentally incomplete agreement, allowing politicians much space to maneuver. Given such opaque contracts, politicians wish to amass considerable resources to allow them to operate freely and try to maximize the resources for the conduct of their business. These resources tend to be used to remunerate favors to the people who helped them win elections,

[16] A good account is provided in Lane (2013).

also using massive propaganda and public resources to convince the principal about their suitability as political agents. Sometimes, the rent-seeking ambitions of political agents lead them to engage in activities such as patronage, embezzlement, and corruption.

A good part of the literature on the political economy of inefficiency, summarized in Table 1, has issues of agency at the core of the political distortions leading to inefficient public policies. Acemoglu (2003) argues that inefficient institutions and policies are chosen because they serve the interests of politicians who hold political power. Dixit's (1998) transaction-cost politics approach emphasizes the low power of incentives in policymaking and the multi-principal agency nature of politics, which makes public policymaking a more difficult realm for the control of agents, leading to many inefficiencies. Besley and Coate (1998) also explore the sources of inefficiency *in a representative democracy*. Coate and Morris (1995) argue that lack of information on the part of the voters leads politicians to favor inefficient "sneaky" redistribution methods. In Robinson and Verdier (2013), inefficient redistribution by politicians becomes relatively attractive in situations of high inequality and low productivity. According to Drazen and Limao (2008), it is the government, and not social actors, that prefers inefficient policies. Acemoglu, Egorov, and Sonin (2013) explore the connection between agency problems, polarization, and populist biases, arguing that the latter is greater when politicians have a greater valuation of remaining in office and when politicians are perceived as more corrupt.[17] Acemoglu, Robinson, and Torvik (2013) argue that voters dismantle checks and balances that could prevent abuses of power and rents in return for redistribution.[18] Keefer et al. (2021) emphasize that low trust among citizens prevents the collective action necessary to control political agents, which might lead, in some cases, to low-quality governments and to populist politicians who advocate ultimately disastrous policies.

[17] These authors have the cases of Hugo Chavez in Venezuela, the Kirchners in Argentina, Evo Morales in Bolivia, Alan García in Peru, and Rafael Correa in Ecuador as motivating examples.
[18] These authors also use Latin American examples to motivate their logic.

4. TOWARDS AN INTEGRATED POLITICAL ECONOMY OF REDISTRIBUTION AND EFFICIENCY: SKETCH OF A FRAMEWORK

We have argued that Latin American countries can be characterized by a variety of different symptoms in terms of their social outcomes, fiscal structures, and politico-institutional functioning. The often-canonical story of Latin America in trying to understand the roots of inequality tends to emphasize elite domination as the key political economy problem. Still, there are many other such problems, including corruption and populism. There are many other undesirable social outcomes such as low growth, low productivity, unstable macroeconomies, inflation, insufficient savings and investment, and low quality of public policies. Our objective in this paper is to suggest a framework in which country situations could be characterized as political economy equilibria, leading to different configurations of the various fiscal outcomes of interest, characterized in Section 2. Each of these configurations would relate to a particular political economy situation, which might be associated with some of the predominant syndromes of Latin American politics.

In the previous section, we selectively reviewed a number of theoretical (and empirical) angles addressing some of those issues, mostly "one at a time." In this section, we propose an agenda to integrate some relevant aspects of these various strands of literature to characterize the type of political economy equilibria each country is (at given points in time) in relation to the outcome variables of interest.

The framework we are suggesting should incorporate the following features.

1. There are elements of conflict but also of commonality of interest among different social actors. In any society, there are many divisive issues. Inequality, the central focus of this initiative, refers obviously to some crucially divisive dimensions, such as the distribution of income. But we should not forget that beyond distributional conflict, there are valence dimensions, that is, a common interest in things such as larger output, economic efficiency, effective public services, and a healthy macroeconomy.

2. Social actors do not decide and implement policies by themselves, but they do so through elected representatives.

3. There are formal institutions (federal arrangements, electoral rules, legislative procedures, judicial procedures) that regulate the access to and exercise of (*de jure*) political power.

4. Social groups do have *de facto* political power in addition to their *de jure* political power.

5. Elected representatives are not perfect agents of their constituents. There are political agency issues relating to outcomes such as corruption, patronage, clientelism, and other distortions connected to state inefficiencies and waste.

6. The political game takes place over time.

7. Repeated interactions open the possibility of cooperation among different social and political actors.

In the rest of the section, we summarize an initial attempt, presented and analyzed in Scartascini and Tommasi (2023), that captures several elements of this logic in a simple model. In that model, there are two social groups: the rich and the poor. There is a very simple economy in which the rich decide on investment, and investment determines output (growth). After economic decisions are made, policy decisions are made in a simplified political system with two political parties, one representing the rich and the other representing the poor.

We assume that political parties solve the collective action within each social group to allow them to behave as unitary actors ("the rich" and "the poor"). Still, they do so at a cost, which we interpret as a political agency cost. The political party that is in power at any moment in time gets to decide a policy of taxation and redistribution, and also its own level of appropriation of output, i.e., of graft. The objective function of political representatives includes the welfare of its constituency as well as its own appropriation, with a trade-off parameter that captures the political agency distortion, that is, the tendency of politicians towards corruption or other uses of public funds not directly benefiting their underlying social constituency.

The political mechanism is such that in each period, with probability $\boldsymbol{p}$, the party of the rich is in power, and with probability $(\mathbf{1} - \boldsymbol{p})$, the party of the poor is in power; and whoever is in power gets to decide policies.[19] We interpret $\boldsymbol{p}$, "the power of the rich", to include the *de facto* power of the rich discussed by Acemoglu and Robinson; as well as their additional *de jure* (institutional) power in a richer bargaining model with instruments such as legislative overrepresentation of certain districts, ballot restrictions and the like.[20] This stage game is repeated infinitely, and the players discount the future.[21]

In Scartascini and Tommasi (2023), we solve the game, identifying the set of the parameter space for which cooperative equilibria can obtain, characterizing the solution for cooperative and non-cooperative equilibria, and providing comparative statics both within and across equilibria.

The intuition of some of these results can be summarized in Table 2, which shows the type of political economy equilibria and the resulting levels of investment and redistribution as a function of two characteristics of the political system: the distribution of power, and the extent to which political agency problems are well controlled. The first row represents those cases considered in the canonical Latin American case of elite domination and low redistribution. The level of investment and, hence economic performance will depend on whether the party or State representing the rich is corrupt (*non-cooperative configuration 2*) or not (*non-cooperative configuration 1*). In the latter case, we will observe high investment and low redistribution; in the former, we will have low investment and low redistribution. The situation in which there is alternation (or balance) of power and politicians are not corrupt is the one in which the *cooperative equilibrium* with good economic performance and reasonable redistribution is more likely. The bottom right corner of the table represents a situation in which a corrupt party,

[19] This very simplified version of models with richer decision-making protocols within period (a la Baron and Ferejhon 1989), allows us to put emphasis on the intertemporal aspects of political negotiation and policy implementation.
[20] It also might subsume the probability that the middle class allies with the rich in a model with a richer social and political structure (as in Lupu and Pontusson, 2011, or Iversen and Soskice, 2006).
[21] In the simplest formulation of the model, we treat the politicians / political parties as myopic, maximizing their one-period payoffs, leaving the rich and the poor as the only long-horizon strategic players in the repeated game.

representing mainly the poor tends to dominate the political system. Such case, resembling left-wing populism in Latin America and the Caribbean, will generate high taxes and redistribution but poor economic performance and (in a slightly broader interpretation) inefficient policies.

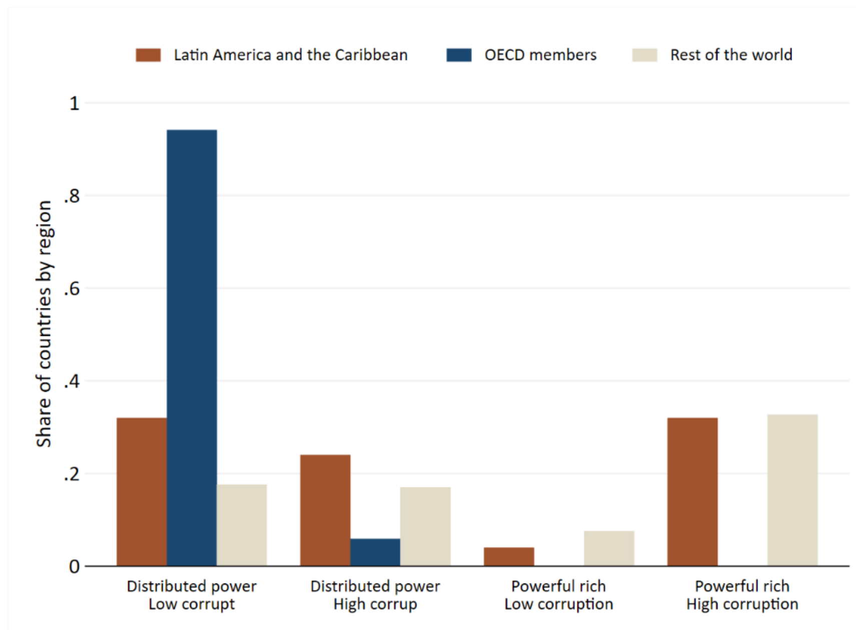
Table 2

Political Economy Equilibria as a function of characteristics of the Political System

	Parties as Agents of Constituency	
Distribution of Power	**GOOD**	**BAD**
The Rich are very powerful	***Non-coop Eq 1*** {high investment, low redistribution}	***Non-coop Eq 2*** {low investment, low redistribution}
Balance / alternation	***Cooperative Equilibrium*** {high investment, reasonable redistribution}	
"Left" Party dominant		***Non-coop Eq 3*** {low investment, high redistribution}

Figure 7 shows that these characterizations can be found in the data. Countries differ in the degree in which power is distributed and how good agency is. OECD countries are more likely to find themselves in the group with balance/alternation and good agency, while Latin American and Caribbean countries are more evenly distributed across the different groups.

Figure 7. Distribution of countries according to the parameters of the model



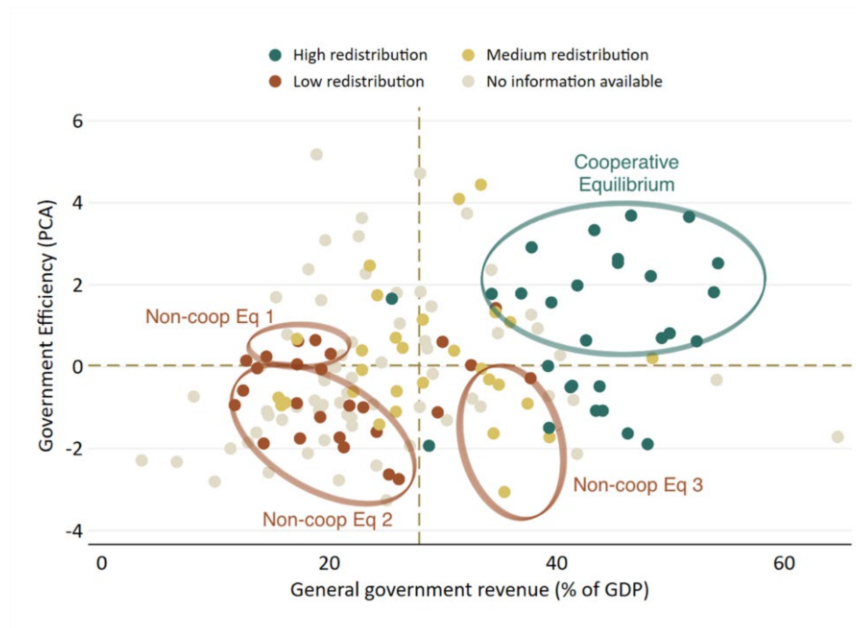
Source: Authors' calculations based on the Varieties of Democracy (V-Dem) database.

Note: Data corresponds to 2019. Concentration of power in the wealthy is a standardized variable in which more negative values represent more evenly distributed political power across socioeconomic groups and more positive values represent more concentration of power in the wealthiest group. The political corruption index incorporates bribery, theft, and embezzlement by members of the executive, legislative, and judicial powers, and other public sector employees. Partitions are made at the average value of each variable.

To suggest that the logic proposed here is a good first step to explain the empirical patterns described earlier, Figure 8 fills in Figure 6, showing that: *non-cooperative configuration 1* corresponds to the North-West quadrant, including countries such as Chile, a country of good economic performance and low amounts of redistribution; *non-cooperative equilibrium 2* corresponds to the South-West quadrant, including countries such as Guatemala, a country of poor economic performance, a small and inefficient state, with little social spending and redistribution; *non-cooperative equilibrium 3* corresponds to the South-East quadrant, including countries such as Argentina, a country of poor economic performance, a large and inefficient state, with abundant social spending and redistribution. The *cooperative equilibrium* corresponds to the North-East quadrant of Figures 6 and 8, representing the typical Northern European society characterized by a large and efficient state, high productivity, and a reasonably

redistributive welfare state. Unfortunately, none of the Latin American cases at this point seems to fit that case.

Figure 8. Set of Political Economy Equilibria



Source: Authors' calculations based on the World Economic Outlook (WEO), the Global Competitiveness Indicators (GCI), the CEQ Standard Indicators, and the Income Distribution Database (IDD).
Note: Government efficiency is the first principal component of wastefulness of government spending, burden of government regulation, quality of overall infrastructure, and quality of the education system, from the GCI. Redistribution is defined as the percentage reduction of the Gini index from market income to disposable income considering contributory pensions as government spending. Highlighted points are those for which redistribution data is available. Highlighted equilibria refer to those presented in Table 4.

5. CONCLUDING REMARKS

In this paper, we have revisited the discussion on the political economy of redistribution (or lack thereof) in Latin America and the Caribbean and attempted to embed it in a broader debate, including other aspects of the region's political economy. We characterized the region and its different countries regarding the size of the public sector, how much fiscal redistribution there is, and how efficient this public action is. We summarized various strands of literature that attempt to explain some elements of that fiscal vector one at a time; and then attempted to

provide a simple framework that, combining elements of several strands of the literature, might explain why different countries present different configurations of size, distributiveness, and efficiency. We believe this constitutes a step forward in the discussion of the political economy of the region.

The initial steps undertaken in this paper need to be complemented in both the empirical and the theoretical front. In terms of the characterization of the fiscal vector, measuring size is relatively straightforward, but the other two concepts are much more multifaceted and harder to grasp conceptually and in terms of data availability.

Regarding the redistribution data, the CEQ methodology provides the most comprehensive analysis of how taxes and social spending affect income inequality and poverty in a country, in a way that is comparable across countries. The problem is that CEQ assessments have only been produced for some countries for some years. On the other hand, the CEQ data is also more granular and complete in terms of the steps of fiscal redistribution (the way to compute the incidence of indirect taxes and spending, spending on education, health, pensions, and the like) than other data sets with wider coverage. We have juggled between quality and completeness of the analysis, and coverage. We chose an intermediate path, but that left us with a particular set of countries and years and with a concept of redistribution that tends to underestimate the degree of redistribution in developing lower-redistribution countries, which tend to do more through in-kind spending and less through direct taxes and transfers. While waiting for more CEQ assessments, future analyses should explore alternative ways of dealing with those methodological trade-offs.

There are even more difficulties with regards to the efficiency data, where no equivalent of CEQ efforts of such depth and amplitude are available. The lack of harmonized objective measures led us to prioritize subjective over objective proxies with limited country-year coverage. On the one hand, extending the country-year coverage of useful efforts such as IADB (2005) or Izquierdo et al (2018) would be very valuable. On the other, focusing on the inequality and poverty

concerns of LACIR initiative, it would be crucial to develop adequate metrics of the intertemporal incidence (or to put it more directly, of the long-term impact on poverty reduction) of public interventions. Doing that presents formidable methodological and data challenges, which are discussed in Tommasi (2021) and World Bank (2022). The most comprehensive analysis of that sort for one country is provided in Hendren and Sprung-Keyser (2020), who use the marginal value of public funds (MVPF) and build from evidence on policies' impacts and costs available for the 133 main social policy changes in U.S. history. Finding a short-cut to move in that direction within current international availability of data and of previous impact and cost-benefit analyses would be of essence.[22]

The model in Scartascini and Tommasi (2023) summarized in the previous section, provides an initial step in terms of the framework we suggest. That simple model provides a prototype, which could be extended to address several of the issues we want to discuss in this agenda.

Part of the results of the model are driven by whether social actors cooperate among themselves or not. It would be interesting to explore such cooperation more directly, perhaps by looking at the degree of trust (i.e., positive beliefs about other social groups) using evidence of the sort explored in Keefer and Scartascini (2022). Such data, regarding trust in government officials could be also used to explore the agency microfoundations of the logic: to what extent different social groups trust their representatives.

Relatedly, in Scartascini and Tommasi (2023) the political rules of the game are characterized very starkly by just two parameters, the probability of the representatives of each group being in power, and the degree of agency distortion. We need to open that black box by modelling some explicit political decision-making procedures which could be related to more realistic *de jure* institutions such as forms of government, electoral systems, legislative rules, characteristics of

[22] Tommasi (2021) provides some tentative suggestions for that endeavor. For instance, given that a large modern literature suggests, and Hendren and Sprung-Keyser (2020) confirm for the U.S., that social spending on children has much higher social rates of return than spending on adults and on seniors, adequately weighting the age composition of spending in CEQ assessments would constitute one step in the right direction.

party systems and the like. Similarly, the additional *de facto* power of business elites (and the way that interacts with *de jure* institutions), should be analyzed in a cross-country comparative perspective.

Another natural set of extensions would be moving from the comparative statics analysis of countries in different equilibria to the comparative dynamics of countries that seem to be moving towards different equilibria.[23] For instance, are Latin American and Caribbean countries condemned to jump from exclusionary to populist polities? How can we attempt to build more inclusionary, yet more efficient, States?

[23] Applying such logic might perhaps help reconcile seemingly contradictory results in two excellent papers in this initiative. Colombia has been undergoing for quite a while a transition from a low-inclusion (low-redistribution) high-efficiency equilibrium to a more inclusive but more fragmented political equilibrium. The fact that the political representatives of the newly included groups tend to promote minor petty causes instead of pushing for broader redistribution and inclusion (Fergusson, Robinson, and Torres, 2023) might be a transitional phenomenon, and it remains to be seen whether this will lead to a more or less institutionalized party system, an important factor in explaining the efficiency of public policies, as emphasized implicitly in our paper and, more explicitly, in the paper by Noam Lupu.

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