

Inequality

TOWARDS A MORE INCLUSIVE SOCIETY IN COSTA RICA

- ▶ Income inequality in Costa Rica is high by international standards and, in contrast with most other Latin American countries, it has increased in recent years.
- ▶ Redistribution through taxes and transfers is weak due to their small size, low progressivity and poor targeting.
- ▶ Labour market conditions are one of the main factors behind the high level of income inequality. Unemployment and informality are high and rising while labour force participation is low, especially among women.
- ▶ Public education contributes to reduce inequality but could be more effective given the high level of public spending.
- ▶ Health status indicators are generally good but the health system requires a modernisation to deal with concerns about its financial sustainability, management and inequity in access to treatments.

What's the issue?

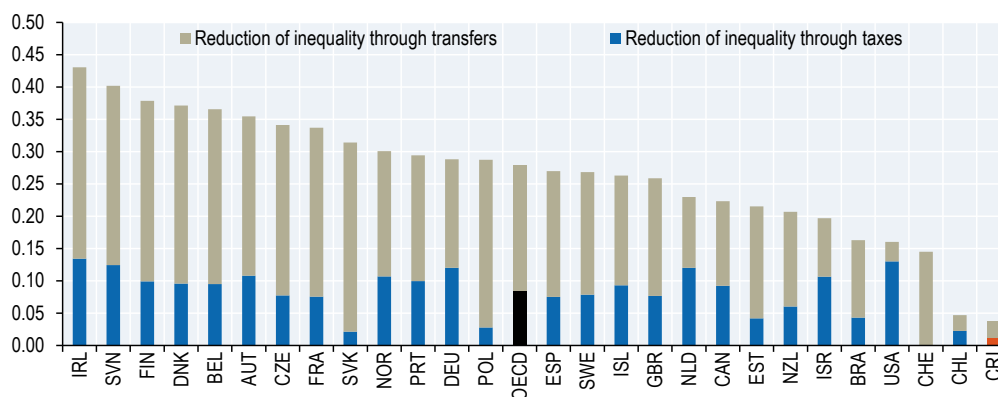
Income inequality in Costa Rica is much higher than the OECD average and high by Latin America standards, despite considerable progress in other well-being dimensions such as health, environment and life-satisfaction. Furthermore, income inequality has been rising in recent years, in contrast with most Latin American countries where it has been falling. In 2015, the average disposable income of the 10% richest households was 32 times higher than that of the poorest 10% (up from 27 times in 2010), much higher than the OECD average of 9.6 times. Measured by the Gini coefficient,

disposable income inequality in Costa Rica was 0.49 in 2015, more than 50% above the OECD average of 0.32.

As in other OECD countries, labour income inequality is a key driver of the high level of income inequality in Costa Rica. Labour income inequality, in turn, is driven by low labour force participation and high levels of unemployment and informality which in Costa Rica are increasingly concentrated among low income groups – even more than in other Latin American countries. Also, in contrast to other countries the public sector

The redistributive effect of the Costa Rican tax and cash transfer system is rather weak

Percentage reduction in the Gini coefficient due to taxes and transfers, working-age population



Note: Data for Costa Rica are preliminary and refer to 2015. Data for all other countries refer to 2012 or 2013.
 Source: OECD Income Distribution Database (<http://oe.cd/idd>); data for Brazil from LIS Database (www.lisdatacenter.org).

contributes to income inequality as the public-private sector wage gap is large.

The tax and cash transfer system helps little to reduce income inequality (see Figure). Altogether, taxes and cash transfers reduce income inequality, measured by the Gini coefficient, by only 4%. While this is close the redistributive effect of the Chilean tax and transfer system, it is below the OECD average of 28% and well below the redistributive effect of the Irish system (43%), the best performing OECD country. As in most OECD countries, cash transfers play a larger redistributive role than taxes.

The weak redistributive impact of the income tax is due to a number of tax expenditures, a large exemption threshold and low tax rates. Current tax reform proposals aim at rising more tax revenues and slightly increasing progressivity by adding income tax brackets. Moreover, the government plans to replace the sales tax with a VAT that includes a refundable system for low income households.

The redistributive effect of cash transfers is limited by their small size and poor targeting. Non-contributory pensions and social programmes account for a slim share of household income. Many middle and high income households are recipients of programmes aimed to the most vulnerable, including family allowances, housing benefits and school meals.

In-kind transfers such as public health and education are quite effective in reducing inequality in Costa Rica, thanks to their universal coverage. Health status indicators are generally good and similar to those in OECD countries. But, there are concerns about the financial sustainability of the health care system and inequity in access to and quality of treatment. Education outcomes are still unsatisfactory, despite a high level of spending, and education quality and outcomes vary considerably across socio-economic groups. Grade repetition is very high and highly concentrated among low-income households.

Why is this important for Costa Rica?

Reducing income inequality would contribute not only to a fairer but also to a stronger economy. Recent OECD research suggests that the long-term increase in income inequality has curbed economic growth in the OECD. Over a 25-year horizon, a 1 Gini point increase is estimated to reduce average GDP growth by around 0.12 percentage point per year, with a cumulative loss of some 3%.

OECD work shows that redistribution of income through taxes and benefits per se does not lower economic growth. Given the low levels of redistribution in Costa Rica, tax and benefit reforms can have both an efficiency and equity role, especially when they are linked to inclusive labour market, education and training policies.

What should policy makers do?

- ▶ Increase the progressivity of direct taxes by eliminating tax expenditures without an economic or social rationale, lowering the exemption threshold and adding new tax brackets to lower income thresholds.
- ▶ Reduce the fragmentation of social assistance programmes and introduce a single list of beneficiaries.
- ▶ Once the fragmentation issue has been solved, gradual reduce benefits as income levels increase to improve targeting while avoiding the creation of poverty and unemployment traps.
- ▶ Facilitate skills acquisition for the unemployed.
- ▶ Improve incentives for employers and workers to stay in or move to the formal economy.
- ▶ Strengthen women's participation in the labour market.
- ▶ Provide early and targeted support to disadvantaged students and reinforce vocational and technical education, including apprenticeships, to curb drop-outs at secondary level.
- ▶ Improve health budget allocation by basing it on needs related to population profiles, rather than on a historical basis.
- ▶ Put a stronger emphasis on preventive and primary care.



Further reading

Gabriel M. and A. Gonzalez Pandiella (forthcoming), "Recent Evolution of Inequality in Costa Rica: A Decomposition by Income Source Analysis", OECD Economics Department Working Paper, OECD Publishing.

OECD (2015), *In It Together: Why Less Inequality Benefits All*, OECD Publishing. <http://dx.doi.org/10.1787/9789264235120-en>

OECD (2011), *Divided We Stand: Why Inequality Keeps Rising*, OECD Publishing. www.oecd.org/social/inequality-andpoverty.htm