47. Taxation and inequality: lessons from Latin America

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Latin American policy-makers and society have become increasingly aware of the problems caused by inequality. Although this phenomenon has distant colonial origins and prevails thanks to the resistance of traditional and new elites, the consolidation of democracy during the 1990s and 2000s has encouraged several governments to correct some of these problems by promoting moderate fiscal reforms. Since most studies have focused on the distributive impact of social expenditure and income transfers, this contribution aims to complement these analyses by examining how favourable changes in taxation have contributed to the recent decline in income inequality observed throughout the region.

Introduction

Taxation is considered a useful policy tool, not only to mobilize revenue and to ensure macroeconomic stabilization, but also to promote redistribution. Whether or not this is true for developed countries, the possibility of using taxation to reduce inequality was historically believed to be both conceptually and practically more difficult for developing countries because of their weak administration and their large informal sectors. In addition, the historically fragile social contract between citizens and the state, the low credibility of political institutions, and their strong ties with the economic elite were considered further obstacles to the promotion of equality via taxation in these countries. There was a broad consensus that redistribution in developing nations could be achieved only by action on the public expenditure side.

Yet the past decade has witnessed some interesting lessons from Latin America. From the early 2000s to the present, income inequality has decreased in this region by around five Gini points (Cornia, 2014). Among other factors, taxation has played an important role thanks to the growing emphasis placed by governments on tax progressivity.[1] Although each context is different and has specific peculiarities, this contribution reviews the recent experience of Latin America, and argues that taxation could contribute to reducing inequalities in developing countries.

Taxation during the Washington consensus era (1980s and 1990s)

In the early 1980s, tax design in Latin American countries was affected by recommendations derived from neoliberal theory. In this setting, governments started to pay more attention to economic efficiency and simplicity, and less to equity. As part of this strategy, trade taxes were sharply reduced and replaced by value added tax (VAT) and other consumption taxes. Neoliberal tax reforms also promoted a simplification of personal income tax (PIT) because, as it was argued, of its negative effects on incentives, labour supply and investment. Moreover, the maximum marginal rates of PIT and corporate income tax (CIT) were reduced to between 30 and 40 per cent, and there were some extreme cases, such as Uruguay in 1974 and Paraguay in 1992, where PIT was abolished.

These tax policies failed to achieve their intended aims. The average tax/GDP ratio declined during the 1980s, reached a minimum close to 13 per cent by 1990 and took more than a decade to recover to its previous level of 15–16 per cent at the beginning of the 2000s. Tax policy changes also contributed to macroeconomic instability, which negatively affected economic growth. Finally, neoliberal reforms fuelled income inequality in a region which is historically considered among the most unequal in the world.

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The great tax transformation (2000 onward)

The poor results of these neoliberal reforms, and the process of democratic consolidation, promoted important social and political changes. The growing social demand for redistribution provoked a shift in political preferences toward left parties, while a widespread sense of social responsibility among the middle class laid the foundations for a new social contract. In this framework, the new elected governments implemented a pragmatic set of policies aiming at achieving more inclusive growth. Accordingly, taxation reverted to its original role of boosting development, reducing volatility and promoting redistribution.

Latin American countries introduced a series of reforms aimed at strengthening and modernizing their tax systems, especially focused on income taxation. First, governments eliminated or reduced a long list of exemptions, deductions and tax holidays which had been found to cause large revenue losses and to have a regressive effect on income distribution. Furthermore, some countries incorporated a PIT dual system which combines a progressive tax schedule for labour-based income and a flat tax rate for capital income. Uruguay was the pioneer in the region in 2007; Peru and some Central American countries have followed a similar strategy since 2009. In more recent years, many countries continued to reform different aspects of income taxation, for example Colombia, Chile and Venezuela.

As a complement to these measures, new forms of taxation were introduced. The clearest example of this approach was the adoption and reform of simplified taxation regimes for the small business sector in almost all countries. In addition, some governments introduced a tax on financial transactions. In order to lower the cost of tax collection and reduce widespread tax evasion, most countries promoted further simplification of tax administration and the creation of semi-autonomous revenue authorities.

As a consequence, the average tax revenue/GDP ratio has risen steadily since the early 2000s, reaching one of its highest historical levels in 2008. After a halt in 2009 due to the global financial crisis, it has resumed a strong upward trend and continued to rise up to a level close to 21 per cent of GDP. Beyond that, these reforms have generated important consequences for tax composition. Indirect taxes still represent the bulk of total tax revenues, in marked contrast to the position in developed countries (*Table 47.1*). Yet taxes on income, profits and capital gains have grown more than other forms of taxation.

However, these general results hide complex regional diversity. Tax revenue in Brazil and Argentina exceeds 30 per cent of GDP, while in most Andean and Central American economies this ratio remains between 13 and 18 per cent of GDP. Furthermore some countries, including Bolivia, Chile, Peru and Venezuela, are endowed with large stocks of natural resources capable of generating substantial additional fiscal revenues.

Table 47.1 **Tax composition evolution in Latin American and OECD countries**

	Year	Taxes on income, profits and capital gains	Taxes on property	Taxes on sales	Excises	Taxes on international trade	Other taxes	Total
Latin America	1991	20.7	4.0	37.9	17.6	17.6	2.1	100
	2001	22.8	5.0	46.3	14.1	10.9	0.9	100
	2011	32.6	3.9	44.2	10.5	7.4	1.5	100
	Variation	57.3	-2.6	16.4	-40.5	-58.3	-29.0	
OECD	1991	50.9	7.5	24.8	12.5	2.8	1.5	100
	2001	50.1	7.4	28.0	12.4	0.9	1.2	100
	2011	49.5	8.0	29.2	11.6	0.6	1.1	100
	Variation	-2.8	7.3	17.8	-7.2	-77.5	-30.3	

Source: Authors' elaboration on ICTD (n.d.).

Changes in tax incidence

These reforms also generated interesting results for income distribution. Cornia and colleagues (2011) have shown that a greater reliance on direct taxes and the reduction in excise duties have promoted the redistributive role of taxation. The Gini coefficient of the distribution of household income has improved on average by 0.4–0.8 points. As pointed out by Gómez Sabaíni and Morán (2014), some recent studies suggest a general but not uniform trend where taxation has become more progressive (or less regressive) in most Latin American countries during the 2000s.

For instance, according to Cruces and Gasparini (2008), the tax system in Argentina became increasingly regressive in the 1990s, but the situation changed after the 2001 crisis. This was mostly due to the introduction of export duties, which have a very progressive redistributive effect.[2] In a similar way, Jorratt (2010) found that the Chilean tax system has become slightly progressive in the past decade, contradicting the results of previous studies that had shown it to be regressive.

Despite some methodological differences, this encouraging change might be attributed to the greater share of progressive income tax, which overcompensates for the regressivity of other taxes, especially VAT and excise duties. In Uruguay, the 2007 tax reform explicitly aimed to improve tax equity, and according to Burdín and colleagues (2014) it has achieved that objective. Martorano (2014) has shown that the new tax on income from employment has improved tax progressivity and lowered inequality by two Gini points.

Table 47.2 summarizes the estimated Reynolds–Smolensky (RS) indices – a commonly used measure of redistribution[3] – in a large body of available tax incidence studies for most Latin American countries, and shows how they have changed from the 1980s and 1990s to the present. Since these results rely on different methodologies and statistical assumptions, they are not strictly comparable. However, it can be observed that in all cases the RS indices turn positive or less negative. This could cautiously be interpreted as a slight but clear improvement in progressivity, caused by the redistributive power of taxation throughout the region.

Table 47.2 **Change in RS indices for taxes in selected Latin American countries**

Country	Washington consensus era		The great tax transformation era	
	Year	RS	Year	RS
Argentina	1997	-0.020	2008	0.004
Bolivia[4]	2000	-0.011	2009	-0.007
Brazil	1999	-0.007	2009	0.016
Chile	1996	-0.008	2009	0.021
Costa Rica	1988	-0.010	2004	0.012
Ecuador	1998	-0.007	2003	0.007
El Salvador	2000	-0.014	2006	-0.008
Guatemala	2000	-0.008	2006	0.012
Honduras	2000	-0.028	2005	-0.001
Mexico	1989	-0.044	2010	0.017
Nicaragua	1998	-0.052	2001	0.002
Panama	2000	0.000	2003	0.009
Peru	2000	-0.008	2009	0.011
Uruguay	1996	-0.002	2011	0.020

Source: Authors' elaboration on the basis of Cornia et al. (2011) and Lustig (2015). Data for Argentina (2008) corresponds to Gómez Sabaíni and Morán (2014), Bolivia (2009) is from ECLAC and IEF (2014), and Uruguay (2011) is from Burdín et al. (2014).

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Taxation and social spending

Taxation could also influence inequality in an indirect way by mobilizing resources to support social expenditure. And indeed, growing tax revenues have allowed Latin American countries to reform and improve their social protection systems. Almost all governments have introduced well-targeted conditional cash transfer programmes (such as the Bolsa Familia in Brazil and Oportunidades in Mexico) which are able to reach the most vulnerable families, more than 130 million people in 2013. In addition, new social pension schemes were implemented almost everywhere (for instance, Bono Solidario in Bolivia and Previdencia Rural in Brazil), extending protection to about 17 million people (in 2013) not previously covered by social insurance (Robles et al., 2015). Governments also enjoyed the necessary fiscal space needed to provide new cash transfers (such as Bono de Apoyo a la Familia in Chile) or to extend existing tools (such as the Programa de Apoyo Alimentario in Mexico) during the recent economic crisis. These measures have helped to partly overcome the problem of a truncated welfare system that has characterized the region (Lindert et al., 2006), and have helped to promote equity (Azevedo et al., 2013).

Conclusion and recommendations

Despite a large number of reforms, the tax system still shows structural weaknesses in several Latin American countries. Tax revenue is low, especially in Central America, limiting the redistributive capacity of fiscal policy. The contribution of PIT is still limited by the low level of maximum marginal tax rates; the narrowness of the tax base because of different tax treatment for income from different sources (for example, capital-based income may be taxed at lower rates than labour income); and high levels of evasion, particularly of income tax. A recent paper by ECLAC and IEF (2014) showed that there is room to expand the redistributive capacity of tax systems by reducing tax exemptions or by increasing the effective top tax rate. The additional revenue could be redistributed to the lower social classes, for example through cash transfer programmes.

However, Latin American countries have made extraordinary progress over the past decade. In the 1980s and 1990s taxation had a modest or even regressive effect on income distribution, while in the 2000s policy changes have contributed to promoting tax progressivity and redistribution through the tax system. Although each context is different and has specific peculiarities, the experience of Latin American countries provides important lessons. First, taxation could contribute to reducing inequalities in developing countries. Second, there is reason to believe that taxation could conciliate the goals of equality and efficiency as seen, for example, in Uruguay. Last, technological innovation presents a big opportunity for developing countries to improve the work and capacity of their public administration.

Notes

1. A progressive tax is a one in which the tax rate increases as the taxable amount increases. The opposite of a progressive tax is a regressive tax.
2. Progressivity and redistributive impact are different concepts. While the former refers to a greater tax burden as the taxable amount rises, the latter is associated with changes in income distribution once the effect of taxation is taken into account, which is finally related to the effective amount of tax revenue generated by a tax or an entire tax system.
3. The RS index measures the redistributive capacity of taxes. It arises from the comparison of the Gini index (for income distribution) before taxes and the concentration coefficient of taxes (also known as 'quasi-Gini') after their application. A positive value of this index indicates that taxes reduce inequality. A negative value of this index means that taxes increase inequality.
4. Data for Bolivia (2009) refer only to indirect taxes. The overall impact of taxes should not be different considering the small contribution of direct taxes.

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