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Taxation and Equality in Latin America

"Time is Ripe for Fiscal Policy to Stop Preserving Inequality"

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*******CHECK AGAINST DELIVERY*******

Good morning. First of all I would like to thank Cindy Arnson, director of the Latin American Program at the Woodrow Wilson International Center for Scholars, and Marcelo Bergman, with the Department of Social Sciences of the Universidad de San Andrés, for including the World Bank in this important discussion.

I am grateful for this chance to discuss two issues of paramount importance for Latin America and the Caribbean. Equality and taxation make for spirited political discussion just about anywhere and certainly no country can claim to have found a balance between the two that pleases all concerned. But for the region in question, it is clear both are off-kilter and far from optimum for our societies to fully prosper.

It is well known that Latin America is the most unequal region in the world in terms of income distribution. While household income inequality has been falling since 1995, it remains high. In fact, the income share of the bottom 10 percent of the population has remained stagnant at 0.9 to 1 percent of total income throughout those 15 years.

Perhaps less known is the fact that, when compared to other regions, Latin America also has one of the lightest tax burdens. With the exception of Brazil, the largest seven countries in the region have a lower share of tax revenue to gross domestic product than expected given their per capita GDP. Moreover, according to the Organization of Economic Cooperation and Development less than 4 percent of state revenue in Latin America comes from personal income taxes, as compared to 27 percent in industrialized nations.

To make up for the inevitable shortfalls, Latin American countries have adopted indirect taxes such as the Value Added Tax or VAT. Although these taxes are efficient from the point of view of production incentives, they are regressive, placing a burden more on those who devote a larger share of their income to basic necessities.

So, that’s the crux of the imbalanced nature of taxation in Latin America: tax revenue is low given the region’s level of development, and the taxation system is preponderantly regressive, requiring more of the poor and less of its wealthiest citizens than other regions.

Meanwhile, overall social spending in Latin America remains relatively low and not particularly progressive either. A couple of 2008 studies by the IMF and World Bank found that spending on public health, education and direct transfers to be flat across income brackets, achieving little redistribution. (which studies? Source?)

Social spending is, in some cases, biased in favor of the rich. In Honduras, for instance, while the poorest quintile receives 1,577 Lempiras in government grants and subsidies , the richest quintile receives 5 ,861.

What's more, the prevalence in most Latin American countries of across-the-board subsidies such as gas, electricity or food subsidies -- that benefit the rich as much, if not more thanthe poor -- often offsets the growing expenditures on targeted programs and basic social services and infrastructure. In Mexico, for instance, targeted subsidies are progressive, but their redistributive effect is more than offset when generalized subsidies are accounted for, resulting in a regressive pattern of overall subsidies.

As you can imagine, the effect of regressive spending atop regressive taxes is persistent inequality. A study of the six largest Latin American countries finds that the distributional impact of the fiscal system is very limited in the region when compared to European countries. In particular, before direct taxes and transfers, the Gini coefficient of many European countries is not very different from the Latin America levels. However, in Latin America direct taxes and public transfers have only a modest impact on the Gini — approximately 1 to 2 Gini points reduction with transfers — while they reduce inequality by about 15 percentage points on average in Europe, two thirds of which can be attributed to public transfers.

Right Time to Fix Fiscal Wrongs

The good news is that today the region in an excellent position to right these fiscal wrongs. Indeed, there may be no better time than the present to change the underlying policies that help to maintain inequality considering the region's current economic strengths.

Latin America and the Caribbean, after weathering the 2008-2009 recession much better than it had previous downturns and outperforming many other regions, is riding a strong economic rebound thanks to an upturn in domestic demand.

The region's quick recovery was also aided by a commodity windfall enjoyed by many countries in the region – a result of the longest and most comprehensive commodity price boom in recorded history. Since 1990, the share of commodity exports going from the region to China has increased tenfold—from 0.8 percent to 10 percent of total commodity exports in 2008.

The region's economic health is a tribute to the reforms undertaken over the last two decades to achieve macroeconomic and financial stability. In turn, this stability has made the region a more attractive destination for investment. By December 2010, gross capital inflows for the seven largest economies in Latin America reached around $330 billion, an increase of almost $80 billion from the previous record achieved in March 2008.

Vulnerable Gains

Interestingly, the current taxation system, which is skewed away from a progressive income tax system, places regional governments at greater risk. Indeed, current economic pluses are vulnerable because of these tax imbalances.

This is particularly clear if you consider what might be called the commodity trap. As national economies benefit from high commodity prices, it is tempting to enrich the government by focused taxing of commodities. It's easy to see why. Taxing mineral resources makes life easier for politicians. It provides a windfall for government coffers, enabling them to dole out benefits for consituents, without having to confront constituents and firms with the cost of those benefits through direct taxation.

A recent study of 30 hydrocarbon-producing countries — including Ecuador, Mexico, Trinidad and Tobago, and Venezuela — found that countries that received large revenues from hydrocarbons from 1992 to 2005 raised less revenue from other domestic taxes. No doubt it was hard to resist the easy money, but the risk, of course, is greater volatility in overall revenues and ultimately unpredictability for what the government can deliver.

Raising taxes progressively is not easy

The demands on politicians and beaurocrats are great and their lives -- challenged by the combination of pervasive inequality, narrow tax base, and relatively light tax burden among those that pay taxes -- are complicated already. To make the bitter pill of higher taxes easier to swallow, governments need increase efficiency. Closing tax loopholes and breaks as well as improving poor tax administration, and cumbersome tax systems are tasks that can no longer be postponed. . More efficiency is likely to revert public distrust about the government's ability to spend wisely, which, for years, has fed a culture of evasion in the region.

Also crucial is for governments to do more to reduce pervasive informality. The size of the 'shadow economy' relative to the formal one in Latin America is estimated to average around 40 percent, the highest figure across world regions, equaled only by Sub-Saharan Africa.

Not least important, is the need to build a national consensus around a more progressive tax system. It is hard to imagine another issue more likely to get bogged down by political squabbles without such agreement.

To no one's surprise, there is no easy route to reform. But we know it can be done. In recent years, both Costa Rica and Uruguay have put in place progressive tax reforms.

Back in the 1980s, Chile's elites showed that those better off are willing to increase their contributions to the state if this will lead to a greater social stability. In 1990, six weeks after the new democratic government was established, Congress passed tax reform that ensured that businesses and high-income earners would pay about two-thirds of the new tax burden. Clearly the newly installed Concertacion government was able to convince the elites that higher taxation was a small price to pay for a better future.

Chile also has not fallen into the commodity trap. Despite immense commodity booms, Chileans have not lost sight of the need to maintain those more stable sources of revenue. By creating the well-known Copper Stabilization Fund, through the years Chileans have wisely invested in education and innovation. The result has been a steady growth that has narrowed the gap between Chile’s per capita GDP and the US’s by 20 percentage points.

The same cannot be said, unfortunately, for most of Latin America and the Caribbean. For more than 100 years, Latin America’s average income per capita has remained barely at 30 percent of the United States. That means 100 years of the region being unable to narrow its wide income gap with its northern neighbor.

Economist at the Bank have dubbed this “one hundred years of growth solitude.” But if fiscal policy begins to do more to redress inequality and promote stronger long-term growth, we are likely to leave such solitude behind.

Thank you.