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Taxation and Equality in Latin America

INTRODUCTION

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Since 2003, levels of inequality in several Latin American countries have improved, sometimes dramatically. Although the region remains the most highly unequal in the world,[2] inequality (as measured by the Gini coefficient) declined by 5 percent between 2002 and 2008 for the region as a whole. Dramatic reductions in inequality in Venezuela and in urban areas in Argentina, Panama, and Bolivia—over ten percent—served to inflate the regional average. For example, while Brazil, Chile, Ecuador, Nicaragua, and Paraguay also registered significant advances, fully half the countries of the region made no significant progress.[3]

There are several explanations for the decline in inequality, some having to do with the dynamics of the labor market (particularly an increase in quality employment and wages), and others with government social expenditures. For the region as a whole, social expenditures as a percentage of GDP increased more than 5 percent between 1990 and 2008, and per capita social spending almost doubled between 1990-91 and 2006-7.[4] Despite wide variations among countries in terms of resources devoted to social programs, there appears to be wide agreement that conditional cash transfers targeted at the poorest sectors of the population contributed significantly to improvements in the distribution of income.[5] Nonetheless, the deficient targeting of government spending continues to be a problem in many countries of the region, diminishing its utility as a tool to reduce poverty and inequality.[6]

Notwithstanding some improvements on the expenditure side, systems for collecting tax revenue in the region remain highly regressive: they have done little to improve inequality and in a number of cases have contributed to its worsening. Although tax revenue as a percentage of GDP increased overall in Latin America and the Caribbean between 2000 and 2008,[7] indirect taxes on goods and services, which affect the entire population regardless of income level, constitute a disproportionate share of total tax income.[8] Indeed, while many countries undertook tax reforms in the 1980s and '90s, most of these were aimed at broadening the

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base and raising the rate of the value-added tax, or IVA.[9] In 1990-92, for example, the IVA represented 3 percent of GDP and 24.4 percent of total tax revenue. By 2005-8, the IVA represented 6.4 percent of GDP and fully 36.2 percent of tax revenues.[10] As noted by the United Nations in 2010,

"The tax structure in Latin America and the Caribbean is still characterized by major shortcomings in terms of efficiency and even more serious problems of equity. As a rule, just a third of all tax revenues collected come from direct taxes, a pattern that persisted during the period from 2003 to 2008 when the tax burden was rising."[11]

High rates of tax evasion magnify the problem, undermining the redistributive effects that taxation can have and contributing to a worsening of inequality. Rates of evasion range from 40-45 percent in countries such as Mexico and El Salvador, to almost 65 percent in extreme cases such as Guatemala and Ecuador. The low probability of enforcement by tax administrations exacerbates tax evasion, as does a culture of non-compliance. The region's high levels of informality—as much as a third to half of the workface in many countries—also contributes to tax evasion.[12]

In a 2011 report, the Organization for Economic Cooperation and Development (OECD) and CEPAL demonstrated a host of disparities in tax collection and the relative distribution of the tax burden between Latin American and Caribbean countries and those of the OECD.

- On average (and with important exceptions in the Southern Cone), tax revenue is just 20 percent of GDP in Latin America, while it is approximately 35 percent of GDP in OECD countries;
- Direct taxes, which by 2011 had fallen to less than one-third of tax collection in Latin America, were lower in Latin America than in Sub-Saharan Africa;
- Personal income taxes constituted 1.5 percent of GDP on average in Latin America, whereas they constituted more than 9 percent of GDP in OECD countries;[13]

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- Most income tax in Latin America is paid by corporations (which can pass the cost to consumers via higher prices on products and services), whereas in OECD countries, the bulk of income taxes are paid by individuals;
- Combined, taxation and public spending have a significant impact on lowering inequality in OECD countries, whereas the impact in Latin American countries is marginal.[14]

In short, the fact that income taxes account for less than a third of the total tax revenues has impacted the way inequality has evolved. While social expenditure has to some extent mitigated disparities in income distribution over the last decade, tax systems continue to further structural inequality in the region.

While the diagnosis of the problem itself is well known, less understood are the factors that make tax reforms feasible and successful. For example, it has been relatively easier to legislate regarding the VAT or adjust tax rates on goods and services, foreign trade tariffs, and corporations. It has been much more difficult to significantly raise personal income taxes, capital gains, or property taxes. Despite a few success stories in the region, most attempts to bring equity to the tax system have failed. There are a number of possible explanations: coalitions that resisted, governments that feared capital flight or reduced investment, politicians afraid of retaliation by important supporters, weak tax enforcement capacities, and outdated judicial and information systems. But these issues and others have not been systematically studied in order to ascertain what makes an egalitarian tax reform more attainable.

The Woodrow Wilson International Center for Scholars and the Universidad de San Andrés in Argentina convened a public conference in May 2011, followed by a private workshop among scholars and practitioners from research centers and international financial institutions based in Washington, D.C. These sessions served to launch a three-year research project to understand more fully the impact of regressive taxation on poverty, inequality, and social structures in Latin America; to examine the political economy of reform efforts in Latin America to make tax structures more equitable; and, in light of the lessons learned about the failure and success of tax reform, to identify politically-viable alternative proposals that would enhance the redistributive impacts of taxation. The results of the 2011 conference are summarized in this bulletin.

The Time is Ripe for Fiscal Policy to Stop Preserving Inequality

Laura Frigenti
The World Bank

Equality and taxation are issues of paramount importance for Latin America and the Caribbean. They 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. Studies by the IMF and World Bank in 2008 found that spending on public health, education and direct transfers to be flat across income brackets, achieving little redistribution.

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 than the 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 U.S.'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.

Economists 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.

Progressive and Regressive Taxation in Latin America: An Overview

Juan Pablo Jiménez
Comisión Económica para América Latina y el Caribe (CEPAL)

Jiménez pointed to data illustrating that Latin America remains the most unequal region in the world, ahead of sub-Saharan Africa. The average Gini coefficient for Latin America is over 0.50. The OECD, in contrast, has an average Gini coefficient of around 0.35. Moreover, even the most equitable Latin American countries have Gini coefficients that are high in comparative perspective. The most important characteristic of income inequality in Latin America is the large proportion of national income captured by the top decile; the income shares of the richest 10 percent range from 25 percent to over 40 percent. Latin America is also characterized by geographical inequities. In many countries including Colombia, Peru and Argentina, the tax base is concentrated within particular subnational regions. Finally, Latin America has the highest levels of informality in the world.

Taxation can be an important policy tool for addressing Latin America's extreme inequality. First, higher levels of taxation can generate revenue to finance public spending on human capital formation and income support for the poor. Second, progressive taxes, especially individual income taxes and property taxes, can contribute directly to redistribution.

However, fiscal policy in general and tax systems in particular do not perform well on equity criteria in Latin America. Taxes and transfers together have little impact on Gini coefficients. One major problem is that tax burdens in the region tend to be very low. Tax revenue as a percent of GDP in Latin America is about half as much as in the OECD; low direct taxes account for most of this revenue gap. The tax burden in Latin America is also low relative to the region's level of development. Countries with higher GDP per capita tend to collect more revenue as a percent of GDP. Yet tax burdens in most Latin American countries fall well below the expected values (notable exceptions include Argentina and Brazil). In addition, macroeconomic volatility in Latin America leads to tax revenue volatility, and fiscal revenues and export prices are highly correlated.

A second problem with Latin American tax systems is that they are regressive. Direct taxes, especially individual income taxes, have the greatest redistributive potential, yet the main source of the gap between the region's potential and actual tax revenue is a shortfall in direct taxes. Income taxes in region fall primarily on corporations rather than individuals, and personal income taxes apply primarily to wage income. Further, high levels of evasion erode the tax base and undermine both vertical and horizontal equity in the tax system. Strengthening property taxes is a pending challenge for sub-national governments; one problem is the need to improve cadastral records. Given these problems, future tax reforms in Latin America must strive to improve vertical equity, horizontal equity, and regional (geographical) equity.

Taxation and Social Justice: Who is Carrying the Burden?

Juan Carlos Gómez Sabaini
Former Deputy Secretary for Tax Policy, Argentina

There are three main characteristics of taxation to be noted in Latin America. First, tax revenue has been increasing in recent years, yet aggregate levels remain insufficient in relation with the demands for social public expenditures. Second, tax systems remain highly unbalanced in their structure. Taxes on consumption dominate tax structures, whereas taxation of personal income and property is weak. Further, as Juan Pablo Jiménez also noted, the majority of income tax revenue is obtained from corporations; only 27 percent derives from individuals. Third, levels of tax evasion are very high. Whereas there is substantial variation in levels of VAT evasion within Latin America, ranging from 11 percent in Chile to 38 percent in Peru, income tax evasion is extremely high through the region. Even in Chile, estimated income tax evasion reaches 47 percent.

These three features all limit the redistributive capacity of tax systems in Latin America. The burden of indirect taxes falls more heavily on low-income sectors (relative to their income level), and formal sector workers who are subject to automatic withholding regimes pay more taxes than informal workers. Meanwhile, high-income sectors that receive income from non-wage sources have ample opportunities to evade or avoid taxes. These top sectors also reap the vast majority of benefits from income tax expenditures associated with exemptions and special treatments. Consequently, tax systems in Latin America generally have a negligible impact on the distribution of income, in stark contrast with developed countries, where redistributive effects are much more significant.

Three main factors explain the lack of equity in Latin America tax systems. First, solvency was prioritized above equity following experiences of fiscal collapse and hyperinflation in the 1980s. Reforms emphasized the use of the VAT given its relative administrative simplicity. Second, many experts argued that taxes should be designed to raise revenue as efficiently as possible, and that redistribution should be carried out only through public spending. Third, there has been lack of consensus as to whether or not taxing high incomes more heavily will affect savings, investment and growth. However, now that many Latin American countries have reestablished solvency on the basis of strong VATs, and given the persistence of inequality in the region, it may be time to reconsider whether progressive taxation should be used in addition to redistribution through public social expenditures.

Gómez Sabaini's recommendations for increasing the share of direct taxes and improving horizontal and vertical equity include, first and foremost, expanding the personal income tax al well as the corporation tax base as much as possible, with an eye toward eliminating exemptions for rents, dividends, interest, and capital gains. He also considered the convenience of applying measures in order to move towards a higher share of the personal income tax in respect to the corporation tax as it is observed in the OECD countries. Accordingly, strong initiatives must be taken to reduce income tax evasion and improve the efficiency of tax administration agencies. These reforms will likely entail significant political problems. Rather than advocating major, comprehensive reforms, gradual reforms with clear goals for the long-term may be more feasible. Attention must also be paid to improving institutional capacity, governance, and the rule of law.

Fiscal Equity and Personalized VAT in Latin America

Alberto Barreix & Martín Bès
Inter-American Development Bank

Barreix and Bès emphasized a different approach from the previous two presenters: they advocated focusing on total fiscal revenues, rather than tax revenue alone. Latin American countries obtain non-tax revenue from numerous sources, including natural resources and social security contributions. They include private pension contributions as well as public pension contributions in comparative fiscal revenue tables. From this perspective, Latin American states are not necessarily revenue-poor. In the case of Chile, for example, while tax revenue has been approximately 20 percent of GDP, total fiscal revenue has reached about 32 percent of GDP in recent years, due largely to revenue from state-owned copper production. However, fiscal revenue does condition the level of public expenditure in Latin America. A critical issue for fiscal policy in the region is how natural resources revenues are spent and/or invested; many countries are highly dependent on a small number of natural resource exports.

In terms of recommended tax reforms, Barreix and Bès believe that although the personal income tax is important and its collection should be significantly larger, it has limited potential in Latin America. With major political difficulties, personal income tax revenue in the region could be increased from 1.6 percent of GDP to around 3.5 percent of GDP. Property taxes have even more limited potential, due to the difficulties associated with collection but could reach at least 1 percent of GDP in countries where real estate, particularly agricultural land, is the main source of wealth.

Accordingly, they recommend reforms focused on the VAT. It should be recognized that the VAT raises revenue primarily from upper-income deciles, given the highly concentrated nature of consumption capacity due to income inequality. Efforts to alleviate the regressive character of the VAT by introducing exemptions for basic consumption items backfire, because they destroy the revenue-raising potential of the tax and ultimately benefit upper-income consumers more than low-income consumers in absolute terms. Instead, the distributional effects of the VAT could be improved by a) broadening the VAT base, and b) returning the revenue raised, or even more than compensating, to taxpayers in the bottom deciles. The latter component of such reforms could make use of existing administrative capacities developed for conditional cash transfer programs. In this manner, the VAT could be used to generate additional revenue tied to redistribution. Simulations for the case of Costa Rica, Colombia, Chile, Uruguay and other countries suggest that this type of reform could have significant poverty-reduction effects while enhancing neutrality, which is the main feature of this tax, and favoring its administration. The VAT could be further "personalized" by calculating differential transfers to income deciles based on their corresponding levels of income and consumption for a basic basket of goods and services, and as the extra revenue allows increase further redistribution.

What Has Been Done, What Needs To Be Done

Nora Lustig
Tulane University

Income inequality in many Latin American countries has been declining since 2000, due partly to a reduction in wage gaps between skilled and unskilled workers and partly to conditional cash transfer programs.[15] However, like others, Lustig emphasized that Latin America remains the most unequal region, and fiscal systems achieve little redistribution. Market income distributions (that is, before taxes and transfers) do not differ dramatically in Europe compared to Latin America, yet taxes and transfers achieve much more significant redistribution from rich to poor in the former region. The problems lie not only in Latin American tax systems—in particular, their lack of progressivity—but also in spending—pro-poor spending is a small share of total government spending.

The Commitment to Equity Assessment (CEQ) (http://econ.tulane.edu/RePEc/pdf/tul1119.pdf) currently being implemented at Tulane University will provide a diagnostic of the impact of fiscal policies (taxes and transfers) on poverty and inequality in Latin America. This project will produce in-depth country analyses as well as an index to rank governments' commitment to supporting a minimum standard of living and reducing inequality through means that are consistent with economic stability, efficiency, and growth. Dimensions of analysis include resource collection and allocation, equity, macroeconomic sustainability, quality of spending programs, and accountability through availability of data and independent evaluation.

The CEQ framework has already yielded interesting results for Argentina, Mexico and Peru. In the three countries, government revenues and redistributive spending appear to be sufficient to potentially eradicate extreme poverty and human capital gaps; however, this goal has not been achieved because too much revenue is allocated to other areas within the public sector and to the non-poor, particularly in the case of Mexico. In all three countries, moreover, safety nets do not provide universal coverage for the extremely poor population, and those excluded from current programs are more likely to be male, urban and slightly better educated.

There are, however, a few caveats regarding the analyses of income distributions and tax incidence in Latin America due to data limitations. Inequality measures and tax and spending incidence calculations rely on data from household surveys, yet the methodologies used to collect the information vary across countries, and it is often difficult to ascertain whether the incomes reported are pre- or post- taxes. Furthermore, household surveys in the region generally do not report how much direct tax families pay or what goods they consume. Without information on consumption, it is difficult to assess the impact of indirect taxes (such as value added taxes), which are often the most regressive taxes. Moreover, the very rich are absent from household surveys. The average of the top two household incomes reported in surveys from Argentina, Brazil, and Mexico in 2006 ranged from US$14,775 to US $70,357 per month. These figures clearly are nowhere near the incomes earned by the wealthy. Latin America's top 30 billionaires earned approximately US$16 million per month in 2007, according to estimates based on data from Merrill Lynch. More accurate analyses of income distributions can be obtained from anonymous tax return data, following methods developed by Alvaredo, Atkinson, Piketty and Saez (The World Top Incomes Database - G-MonD, PSE-Paris School of Economics). Whereas time-series tax return data is publicly available for advanced countries, ministries of finance in Latin America as a rule refuse to make such data available to researchers or lawmakers. This is a major problem, given that income in the region is concentrated not just within the top decile, but within the top 1 percent and even the 0.1 percent of taxpayers. Without better data on top incomes, our assessments of Latin America's true inequality levels and how much the very rich pay in taxes will remain nothing but guesswork.

The Political Viability of Progressive Tax Reforms in Brazil

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Considerations of the political viability of progressive tax reforms in Brazil begin with an initially puzzling concept: the median voter in Brazil and in Latin America more generally is relatively poor and should favor progressive taxation; in other words, there is a political market for redistributive goods. Yet politicians have not pursued progressive taxation; instead, democratization coincided with or preceded reforms that build fiscal capacity based on the regressive VAT and other indirect taxes. Studies have shown that there is no aggregate correlation between governments' political ideology and tax outcomes. In the case of Brazil, the number of veto points in the political system cannot explain the lack of progress on progressive taxation either. The national executive has very strong powers, constitutional reform does not impose prohibitive requirements, and various governments have enjoyed coalitional majorities in congress. Further, subnational veto players could be neutralized; taxation is a multidimensional issue that permits consensus building.

Nor is administrative capacity an impediment to progressive taxation in Brazil; the IADB ranks the country as the best in Latin America on this dimension. Brazil also ranks highly in terms of the rule of law and judicial independence in Latin America.

Brazil's lack of progress on progressive taxation can be explained instead by policymakers' focus on revenue-raising and the success of spending-side redistributive programs. The experience of hyperinflation in the 1980s made the population extremely inflation averse and encouraged policymakers to prioritize fiscal solvency and to emphasize revenue-raising capacity over equity. Policymakers today remain risk-averse in the realm of taxation. Brazil has managed to dramatically increase revenue over the past two decades without emphasizing progressive taxes. Collections amounted to nearly 38 percent GDP in 2005; much of the increase can be attributed to earmarked "social contribution" taxes. As such, Brazil is an extreme outlier within Latin America; its tax revenue as a percent of GDP now exceeds the OECD average. Policy makers do not wish to risk adverse revenue affects that might accompany tax reforms designed to redistribute the burden more equitable. In addition, politicians have few incentives to pursue progressive taxation for the sake of redistribution, given that targeted spending has contributed to a significant reduction of inequality. Bolsa Familia is the most renowned such program. Brazil's Gini coefficient has fallen from 0.59 in the 1990s to 0.55 in 2007. Finally, reforming consumption taxes is a particularly contentious issue given that states administer their own VATs and do not want to relinquish control over this revenue source.

In sum, Brazil has the capacity to enact and administer progressive tax reforms; however, policymakers lack incentives to pursue such reforms. Governments are happy with the high extractive capacity of the tax system and show little concern over its inefficiency and regressivity. At most, we can expect Brazil to make parametric adjustments to its tax system in coming years.

The Political Viability of Tax Reform in Mexico

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In contrast to Brazil, Mexico is a low-tax outlier within Latin America. From 2000-08, fiscal capacity increased in Latin America on average but declined in Mexico from 11.4 percent of GDP to only 9.4 percent of GDP, excluding oil revenue. Among other problems, Mexico's tax system has a VAT with too many exemptions and low productivity, party due to lack of administrative capacity. These tax-side problems are compounded by spending patterns that benefit the rich more than the poor in the areas of education, social security, employment support, and consumption subsidies.

Over the past two decades, Mexico has repeatedly attempted VAT reform, but with little success. In 1995, the VAT rate was increased from 10 percent to 15 percent, but new exemptions were introduced for food, books, and medicines, which led to a reduction in VAT revenue. The period from 2001 to 2010 saw various failed attempts to generalize the VAT. In 2009, the government proposed an innovative 2 percent general consumption tax linked to transfers to the poor, which would have had a net progressive impact. However, congress only approved a 1 percent VAT increase with no changes to the tax base.

Mexico's tax reform failures can be attributed to multiple causes. Organized interests are able to capture policy processes, leading politicians to ignore the interests of the poor median voter. Appeals to the "benefits principle" have also stymied reform. According to this principle, citizens pay taxes in exchange for services from the state. This ideological principle undermines the redistributive logic of taxation. Perhaps most importantly, Mexico suffers from the "oil curse." Easy revenue from this natural resource has eliminated incentives to increase taxes paid by the citizenry, despite the fact that revenue from oil is highly unstable.

Scott argues that in highly unequal countries, raising large amounts of revenue that can be dedicated to social spending on the poor is more important for redistribution than the progressivity of the tax system. He argues that generalizing the VAT in Mexico would benefit the poor even if the current distribution of state expenditures and subsidies remains unchanged, because VAT exemptions disproportionately benefit upper-income consumers, even though they are progressive relative to income. However, he also maintains that Mexico's social spending programs must be reformed to achieve universal coverage among the poor if the country is to make greater progress toward equity. In fact, the reach of indirect taxes among the poor is broader than that of the best-targeted transfer programs (Oportunidades, which still excludes some 40 percent of the poor), such that many poor households pay indirect taxes that contribute to financing benefits for the non-poor, though the average incidence of net transfers to the poor is highly progressive.

The Political Viability of Tax Reforms: The Case of Guatemala

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Guatemala's insufficient tax revenue and low social spending pose major impediments to addressing the country's developmental problems: extensive poverty, malnutrition, extreme inequality, high crimes rates, and inadequate infrastructure. In 2010, tax revenue amounted to only 10.5 percent of GDP; total fiscal income was only 11 percent of GDP. Roughly half of the population still lives in poverty, and the Gini coefficient stands at 0.54. VAT and income tax revenues have increased slightly since the 1990s, but Guatemala nevertheless requires a major fiscal pact to address its persistent and serious tax problem. The new administration of President Otto Pérez Molina, who took office in January 2012, took some initial steps in this direction, promoting two laws—an Anti-Evasion Law and a "tax update" law—that were passed by the Congress in February. The "tax update" law includes provisions that broaden the tax base by raising the income taxes of the wealthiest sectors of the population and exempting those with the lowest incomes from paying taxes. The reforms were projected to raise more than half a billion dollars in tax revenues over the next four years.

Prior to this effort, governments attempted tax reform with little success. The most notable reform initiative, undertaken from 2000-03, was intended to meet the tax revenue and social spending targets established in the peace accords that ended Guatemala's civil war. The Fiscal Pact of 2000 established an integral vision for reform based on broad participation from social sectors. However, the Fiscal Pact quickly deteriorated into a "fiscal war." The governing Frente Republicano Guatemalteco (Guatemalan Republican Front, FRG) held a majority in congress that displayed reasonably high levels of discipline and cohesion; however, the party's anti-business rhetoric contributed to a major confrontation with the private sector. Businesses staged lockouts, denounced the reform in the press, and mobilized social sectors against the reform. The reform was nevertheless approved in congress, but the private sector challenged the constitutionality of the tax increases in the courts. Ultimately, 12.5 percent of the revenue gains were lost due to court rulings in favor of business claimants.

Subsequent governments made little progress on tax reform. The Gran Alianza Nacional (Grand National Alliance, GANA) government had close links to the private sector and managed to negotiate a deal with business that entailed temporary tax increases to stave off fiscal disaster. However, the reform elicited opposition from civil society and labor unions, which did not participate in the negotiation process. The next government, led by the

Unidad Nacional de la Esperanza (National Unity of Hope, UNE), also proposed tax increases, but reform was derailed by divisions within the cabinet and within the governing coalition in congress. Corruption scandals and the onset of global economic crisis lent force to arguments that this was not the time for tax reform. Similar impediments hindered reform initiatives in 2009 and 2011.

The main problems that have prevented tax reform in Guatemala are a fragmented party system, private sector actors with veto power, and constitutional restrictions on taxation. In Guatemala's extremely weak and fragmented party system, parties are short lived, governing coalitions rarely achieve majorities in congress, party discipline is weak, and legislators frequently switch their party affiliations. Maneuvering reforms through congress is therefore very difficult. Meanwhile, private sector actors have strong veto capacity. Business associations have historically demonstrated cohesive opposition against tax increases and have been willing to reach agreements that apply only during the tenure of the government in power, in other words, temporary tax increases. The business sector has blocked reform through a varietyof means, including using disruptive tactics during negotiations, calling strikes, and waging anti-reform campaigns through the media. Campaign financing has likely afforded significant private sector influence in congress in the context of weak party discipline. Finally, the private sector often challenges the constitutionality of tax reforms; Guatemala's constitution places significant limitations on the government's ability to tax.

Given these impediments, a major tax reform in the near future is unlikely. The dire security situation, renewed international donor pressures, and Otto Pérez Molina's initial popularity translated into an early legislative victory on the tax front, with some two-thirds of the legislature supporting the president's tax reform plan within a month of his taking office. Dire revenue needs to confront the country's numerous challenges may force businesses and political actors to accept additional increases, but significant progressive reforms are particularly unlikely. Meanwhile, private sector actors are demanding tax benefits to stimulate the economy, to the point of recommending that the income tax be eliminated.

Colombia's Tax Regime

Natalia Salazar
Fedesarrollo, Colombia

Colombia's tax system is neither efficient nor equitable. Although politicians in congress have expressed support for progressive taxation, in practice, lobbying by economic groups in a context of political fragmentation has led to a proliferation of tax benefits that reduce equity and make administration more difficult. High levels of informality contribute to the problem of insufficient tax revenue; governments have resorted to distortionary wealth taxes, transactions taxes and payroll taxes. Low tax revenue and inefficiency are the main concerns of policymakers today. Tax revenue has lagged behind spending during the past two decades. Colombia has implemented some tax reforms that have increased revenue; however, tax revenue as a percent of GDP remains low even by Latin American standards. Furthermore, initiatives to compensate victims of the conflict in Colombia will require substantial additional revenue.

Turning to the political dimension of tax reform, as in Guatemala, fragmentation of political parties and weak party discipline have created impediments to tax reform in Colombia. Legislators seek to protect particularistic interests; financial support from private sector groups is much more important than party discipline for politicians' electoral prospects. At the same time, legislators have rejected VAT modifications and reductions of the minimum exemption level for the personal income tax on the grounds that such reforms are regressive. There has been political support for wealth taxes and financial transactions taxes; however, Dr. Salazar argues that both of these taxes are distortionary. The Constitutional Court has also been an active actor in tax reform initiatives. A 2003 ruling maintained that applying the VAT to certain previously exempt goods was unconstitutional, because it would negatively affect the minimum vital income for low-income families.

Recent tax initiatives in Colombia include a 2010 tax reform that eliminated the deduction for investment in fixed assets and eliminated the financial transactions tax from 2014 on. In early 2012, the government of President Juan Manuel Santos announced plans for an overhaul of the tax system, to make it more fair and efficient and to gradually increase revenue. Dr. Salazar recommended that tax reform include: broadening the personal income tax base, eliminating corporate tax exemptions and potentially reducing the rate, broadening the VAT with compensations for low-income families and reducing the number of differential rates, and reducing tax evasion. Salazar argued that Colombia's long-term fiscal sustainability depends on structural reform not only to reduce the inefficiencies and inequalities of the tax system but also to increase revenues by about 1.5 percent of GDP.

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Notes

1. We thank Latin American Program Assistant Verónica Colón-Rosario for research assistance in preparing this introduction.
2. Heraldo Muñoz, "Latin America and The Caribbean: Poverty, Inequality, Security, and the State of Citizenship," United Nations Development Program, undated mimeo, 5.
3. Income distribution worsened during this period in Colombia, the Dominican Republic, and Gautemala. See United Nations Economic Commission on Latin America and the Caribbean (ECLAC), *Time for Equality: Closing Gaps, Opening Trails* (Santiago: United Nations, 2010), 172; United Nations, *Millennium Development Goals: Achieving the Millennium Development Goals With Equality in Latin America and the Caribbean, Progress and Challenges* (Santiago: United Nations, 2010), 5.
4. United Nations Economic Commission on Latin America and the Caribbean, *Time for Equality*, 178.
5. CEPAL, *Time for Equality*, 171-85, 204-6.
6. Juan Pablo Jiménez, Juan Carlos Gómez Sabaini, and Andrea Podestá, eds., *Evasión y equidad en América Latina* (Santiago: CEPAL, 2010), 24, 65.
7. Government revenues, including social security contributions, went from 19.8 percent of GDP in 2000 to 22.6 percent in 2008. See United Nations, *Millennium Development Goals*, 7. For many countries, increased income from the export of primary commodities was an important factor in rising tax revenues.
8. Eduardo Lora, "Trends and Outcomes of Tax Reforms" in Eduardo Lora, ed., *The State of State Reform in Latin America* (Washington, D.C.: Inter-American Development Bank/Stanford University Press, 2007).
9. Óscar Cetrángolo and Juan Carlos Gómez Sabaini, eds., T*ributación en América Latina: En busca de una nueva agenda de reformas* (Santiago: CEPAL, 2006).
10. CEPAL, *Política Fiscal y Equidad: Una Mirada Cruzada Entre Europa y América Latina* (Santiago: CEPAL, 2009), 17.

Mexico stood out as the only country in the region in which income tax constituted 60 percent of tax revenues and in which the collection of the IVA was very low. See Juan Pablo Jiménez et.al., eds., *Evasión y equidad en América*, 30.

11. CEPAL, *Política Fiscal y Equidad*, 17.
12. Juan Pablo Jiménez et.al., eds., *Evasión y equidad en América Latina*, 22, 65-7.
13. In Uruguay, the Latin American country with the highest rate of personal income tax, personal income tax was only 2.2 percent of GDP.

The contrast between the relative weight of personal income tax as a percentage of GDP in Latin American versus the OECD also appears in Juan Pablo Jiménez et. al., eds. *Evasión y equidad en América Latina*, 24.

14. OCDE/CEPAL, *Perspectivas Económicas de América Latina 2012: Transformación del Estado para el Desarrollo* (Paris: OECD Publishing, 2011), 78-84, http://dx.doi.org/10.1787/leo-2012-es.
15. Luis Felipe López-Calva and Nora Lustig, eds., *Declining Inequality in Latin America. A Decade of Progress?* (Washington, D.C. and New York: Brookings Institution and United Nations Development Program, 2010).

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