



# **Tax Reform In Latin America**

by

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## **I. Introduction**

Latin American taxation has been one of the enduring and continuing interests in my professional life, an interest that has stretched over a period of half a century. My first published papers on that topic were in the mid 1960s. My most recent ones were published in recent years. I also coedited a book on that topic for the IDB, that was published in 2008, and contributed to another recent book on the same topic. See Bernardi et al. editors, 2008. In addition to this more academic work, I published two popular books, in 2007 and 2010, on Latin American countries. These books contain several references to taxes in several Latin American countries.

Over the last five decades I participated in many tax conferences and tax missions to countries that ranged from large countries, such as Argentina, Brazil, and Mexico, to smaller countries, such as Costa Rica, Haiti, and Jamaica. Because of these activities, I feel that I can claim more than a passing interest, or knowledge, of Latin American taxation.

In my talk today, I shall focus my remarks on two main questions:

First, have there been significant changes, and in the right direction, in the tax systems of the Latin American countries, in recent decades? Second, what has happened to the taxation of income, and especially of personal income?

## **II. Changes in the Tax Systems**

The changes that take place in the tax systems of countries may be significant for *tax levels*, as shares of GDPs, or for the *structure* of the tax systems.

The “Declaration of Punta del Este” that, half a century ago, created the *Alliance for Progress*, mentioned, as one of the important goals to be promoted by that *Alliance*:

“To reform tax laws, demanding more from those who have most...” More specifically, the Declaration stated that it would be necessary to promote: “...the reform of tax structures, including fair and adequate taxation of incomes...”

The *Alliance for Progress* established, in Washington, an office called the “*Joint Tax Program*” that was charged with the task of promoting tax reforms in the Latin American countries. The *Joint Tax Program*, that was financed jointly by the UN, the IDB, and the Organization of American States, became, for more than a decade, the main actor in reforming tax systems in Latin America. It relied on leading tax experts, from Latin America, the United States, and occasionally from Europe, to do its work. Its guiding principles were:

(a) To raise tax levels and to make the tax systems more progressive;

(b) To advise Latin American governments to keep current government expenditure low, in order to generate *budget surpluses* in the current account;

(c) To use the budget surpluses to finance capital spending by the government, in order to create infrastructures that, it was felt, were essential to make the countries’ economies grow;

(d) To promote *private* investment through the use of tax incentives.

Thus, (a) the level of taxation, (b) the revenue from income taxation, and (c) the tax incentives were the main variables to influence, in desirable directions, through the tax reforms. It should be recalled that this was the time when “Harrod and Domar growth models” or the “Solow growth model” were very popular. These models gave prominence to investment (both public and private), as the promoter of growth. They assumed that, countries that invested a larger share of their GDP grew more rapidly than those that invested less, *ceteris paribus*. The government was seen to have an obligation to promote growth, by promoting both public and private investment.

The needed increase in the tax levels was expected to come mainly "...from those who have most..." because of the highly uneven income distribution that prevailed in Latin American countries. That distribution concentrated much of the potentially taxable capacity in the higher percentiles of the income distribution. See Tanzi, 1966 and 1974. The Gini coefficients, for most Latin American countries, have not changed significantly, since that time. They have remained high and generally higher than in other regions of the world, in spite of some reported, recent, improvements in a few countries. See Arnson and Bergman, 2012.

In the early 1960s, the personal income tax was very popular and, in surveys of the US population, it was considered the "fairest of all taxes". It was also highly progressive and was expected to generate a large share of total tax revenue. That thinking, that was prevalent in the United States and in Europe, inevitably influenced the work of the Joint Tax Program. Through various technical assistance missions to Latin American countries, and through other activities, such as conferences and publications of books and reports, the Joint Tax Program tried to introduce, in Latin America, income taxes similar to the individual income tax that, at that time, existed in the United States. However, the progress in this area at that time remained limited, mainly because of political opposition to income taxes and because of administrative difficulties in the countries.

Let me now move to the present, considering the tax levels and the tax structures in that order.

### **Changes in Tax Levels**

A recent and highly informative paper, by J. C. Gomez Sabaini and J. P. Jimenez, prepared at CEPAL (2011), has summarized much of the statistical information available for recent years, in terms of tax levels and tax structures, as shares of GDPs. I shall refer to that paper for parts of my discussion.

As the authors of that paper put it:

“[The] tax burden has increased considerably...” However, they add, “...while some countries, such as Brazil and Argentina, currently have tax burdens exceeding 30% of GDP, others, such as Ecuador, Guatemala, and Paraguay, have tax burdens of no more than 14% of GDP.” Ibid. p. 11. Because of the latter countries’ lower tax burdens, they seem a bit disappointed by the progress made by the Latin American countries in this area.

I do not share their disappointment and would make several pertinent observations on their conclusion.

First, the recent tax burdens, as percentages of GDPs, are at levels comparable or even higher than those that prevailed in the so-called industrial countries until around the time of the Great Depression in the 1930s. For example, in 1929 the tax burden for the US general government was only about ten percent of GDP. In 1940, the tax burden of Sweden, the country that today has the second highest tax burden in the world, was still only around 15 percent of GDP. In 1960 the tax burdens of Spain, Switzerland, Portugal and Japan were still less than 20 percent of GDP. See Tanzi, 2011.

Second, today’s tax burdens in Brazil and Argentina are significantly higher than the tax burden of the United States.

Third, if the tax burdens of the different countries of South America were weighted, by those countries’ populations, they would be seen to have gone up a lot, in recent years. The reason is the large share of Brazil and Argentina’s populations in the total. With this adjustment, it is likely that the tax burden in South America, *for the majority of the population*, and not for the majority of the countries, is now higher than for North America (i.e., than for the population of the USA, Canada, and Mexico combined). We should not forget that it is people that pay taxes not countries!

Fourth, some of the countries with lower tax burdens (Mexico, Chile, Peru, Bolivia and some others) have significant revenue from rents collected from the governments' ownership of natural resources. Because of these rents, they can finance higher spending than indicated by their tax revenues.

Finally, we should never forget that a higher tax burden is not always preferable to a lower tax burden. Whether it is or it is not, depends on the governments' capacity to use well, *in economically productive and socially desirable ways*, the extra tax revenue generated by the higher tax burden. When the additional revenue is wasted in projects with low economic productivity, or in expenditures with low social justification, one should not praise the governments for the extra fiscal efforts. In these circumstances it would have been better to leave the money in the hands of the taxpayers; even more so when the tax systems are not progressive. For elaborations of this argument, see Tanzi, 2008a.

In any case, the comparisons between LAC and OECD countries, as shown in OECD 2011, p. 17, or in Gomez Sabaini and Jimenez, 2011, p. 22, are less revealing than they seem to be. They tell little about the taxation of the *majority* of the *population* (as compared with the *majority of countries* of widely different sizes). We should not give the same weight to Brazil and, say, Honduras. It is now highly likely that a larger share of the population (and not of the countries) of Latin America is subjected to higher tax burdens than in the OECD countries.

### **Changes in Tax Structures**

It would be easy, from a superficial look at the tax systems of the Latin American countries, to conclude that there has been little change in tax structures in the region, over the years. Generally indirect taxes were replaced by other indirect taxes, while the share of income and wealth taxes in total tax revenue changed little. However, the superficial look would provide

a wrong impression. As with icebergs, the changes may often take place below the visible part and, thus, may not be immediately noticeable.

It can be maintained that the changes that took place over the years have made the Latin American tax systems far better than they had been in the past. The reason is that, in terms of allocation of resources, and in terms of providing the countries' governments with better tax instruments for pursuing stabilization policy, through their ability to introduce more easily revenue changes when needed, the reforms in the tax structures made over the years significantly improved the tax systems of many Latin American countries.

In recent decades, remarkable and broadly positive changes took place, especially in indirect taxes. The very high excise taxes on "luxury or non essential products", that had existed in the past and that, except for justifications connected with possible, negative externalities in the use of some of the taxed commodities, had been highly distorting in the allocation of resources, have generally become less important. Import duties (used as highly distorting protective devices for domestic industrial activities) have been largely replaced by, much more allocation-neutral, value added taxes and by lower import duties. Especially the introduction of widely -based value added taxes has represented a tectonic change. It has been far more successful than anyone would have expected three decades ago. See OECD, 2011, Table B, p. 19 for the VAT's revenue data. Let me provide a concrete example of this change.

In 1990, Argentina was collecting less than two percent of GDP from the VAT. When the members of a technical assistance mission to Argentina from the IMF proposed some changes in the Argentine VAT, and estimated that the reformed VAT might raise the VAT revenue from two to six percent of GDP, incredulous Argentine experts derided them! Such an increase was simply not considered a realistic possibility in a country with the tax administration and the tax evasion that Argentina had at that time. See Tanzi 2007. By 2009, Argentina was collecting close to 11 percent of GDP from this tax, and OECD statistics estimate that in Brazil the revenue from this

tax source was even higher, 13 percent of GDP. These are percentages that qualify for world records! They indicate important legislative changes but also, importantly, that the Latin American tax administrations have become far more efficient than they were in the past. Two other countries, Uruguay and Chile, collect around 8 percent of GDPs from the VAT, and several others more than five percent of their GDPs: These revenues come from a tax that did not even exist in Latin America in the decade of the 1960s!.

A value added tax is a much better instrument, for both stabilization policy and for the allocation of resources, than the taxes that it replaced. However, this change is not likely to have made the tax systems more progressive than they were. The reason is that the value added taxes generally replaced taxes that, in spite of their distortions, had been intended to be paid by people at higher income levels, with taxes that are broadly proportional to consumption, being paid by almost everyone. Thus, to some extent the success of the VAT increased the desirability of relying more on personal income taxes, to make the tax systems more progressive.

The dramatic improvements in the share of total tax revenue coming from the value added tax are indirect evidence that the tax administrations of the Latin American countries improved over the years, perhaps more than it is realized. The improvement in the tax administrations has been partly due: (a) to the use of computers; (b) to use of better administrative techniques; (c) to the availability of more resources for the tax administrations; and (d) to reductions in political interference with their work.

There have been, at the same time, increasing difficulties coming from the economic activities that were becoming progressively more global and, because of that, more difficult to tax. For example, the use of transfer prices in cross countries' dealings has created major difficulties for tax administrations. In some of my papers I have identified several of these difficulties and have defined them as "fiscal termites". See Tanzi, 2008b. Therefore, it should not be concluded, from the above, that the tax administrations of the Latin American countries have



become examples of high efficiency. They are facing new challenges. It simply means that they are more efficient now than they used to be decades ago, even though tax evasion remains a problem especially in some countries and has acquired a more global dimension.

The available estimates of tax evasion, as for example those reported in the study by Gomez Sabaini and Jimenez, while useful, should be assessed with caution, because, if taxes are difficult to collect, it must also be equally difficult to estimate how much of the taxes not collected can be estimated. The national accounts, or even the household surveys, that are used to estimate tax evasion, may be in part “cuentos nacionales”, or national “fairy tales”, as the cynics used to say about the national accounts data. They can contain large errors.

Over the years, the tax administrations have experimented with various techniques and organizational changes. Some of these included the use of, (a) “punto fijo” techniques, (b) “large taxpayer units,”, (c) various forms of “simplified taxes” and other presumptive methods to collect taxes, (d) lotteries for taxpayers who pay their taxes, (e) requirement to issue invoices or ask for them, (f) advance withholding payment for some taxes, (g) reorganization of tax administrations by functions, rather than by tax, (h) systemic rotation of tax inspectors, (i) surveys of taxpayers to flash out corrupt tax inspectors in some areas, (k) sharing with the tax administrations the additional tax revenue collected, to create some incentives, and so on. Some of these techniques have been failures; but some have contributed to the good results that have led to the increases in the tax revenue mentioned earlier.

This may also mean that the tax evasion that is often mentioned by those who write on taxation has in part been neutralized, or at least reduced, *in a macroeconomic sense*, by extra efforts in other areas. For example, taxes evaded on a specific tax law may be partly collected by use of other tax laws that would not have been introduced if there had not been the tax evasion. Therefore, in a macro sense, the revenue lost because of tax evasion in one tax may be made up by the use of other easier to collect taxes. Thus the statutory tax system would change if there

were no tax evasion. But of course, because of the tax evasion, some taxpayers gain or lose more than some other taxpayers while the whole country loses because it ends up with an inferior tax system. Therefore, tax evasion is always a problem of equity, but not always one of revenue losses.

### **III. On the Revenue Contribution of Income Taxation**

Up to the 1980s, the taxation of incomes had changed relatively little in Latin America. High inflation had often had a major, negative, impact on income tax revenue. See Tanzi, 1977. The statistics now available indicate that, in the first decade of the new millennium, when inflation was no longer a problem, there were significant increases, in some countries, in the revenue from income taxes. However, much of the additional revenue came from income taxes on corporations. Income taxes on individuals have continued to contribute little to tax revenue.

A table in the Gomez Sabaini and Jimenez paper (Table 8, p. 27) provides data for the years 2005-2007. The highest revenue, from taxes on the incomes of individuals, was obtained by Brazil – but it was a relatively miserly 2.6 percent of GDP. Mexico and Panama also got revenue of about two percent of GDP. The average for Latin America was 1.4 percent, compared with 9.2 percent for the OECD, and much higher percentages for many of the OECD countries. By contrast, the revenue from corporate income taxes averaged 3.6 percent of GDP, almost the same as in OECD countries, for which it was 3.9 percent of GDP. Chile (with 7.3 percent), Peru (with 5.9 percent), and Brazil (with 5.1 percent) got more than five percent of GDP from their corporate income taxes.

The very low contribution of personal income taxes to total tax revenue, accompanied by low taxes on wealth, almost guarantees that the tax systems of the Latin American countries would contribute little to lowering the (after tax) Gini coefficients. These coefficients continue to

be very high in Latin America. In fact, redistribution *through tax policy* is almost non-existent in the region. See Table 7, p. 27 of the Gomez Sabaini and Jimenez paper.

Redistribution through the spending side of the budget is also low, especially when compared with OECD countries, as various papers by other scholars have shown, even though some recent programs in Brazil, Mexico, Panama, and other countries have started to make some difference. However, the available estimations may even exaggerate the redistribution that exists. There are two reasons for this observation.

The first is that the calculations made for the impact of taxes on Ginis do not take into account the *compliance costs* of taxation that, at least in the United States and in some other advanced countries for which there are estimates, are high and regressive. See Tanzi, 2012a. As shares of the incomes of taxpayers, the compliance costs tend to be higher for lower income taxpayers. The complexity of the tax systems contributes to this result. However, it is difficult to determine whether this result is also valid for Latin American countries, which may rely less on complex personal income taxes.

The second reason, that biases the results on the spending side of the budget, is the *inefficiency* and the *corruption* that often accompanies government spending. See Tanzi, 1974. This reason is likely to be more important in poorer countries. Because of inefficiency and corrupt practices, on the part of those who deliver public services, the real benefits from a government spending or transfer program that the citizens receive, that, in the methodology usually used by scholars, are equated to the budgetary costs and are totally allocated to those who receive the services (school children, patients in health clinics, etc.) are often exaggerated. The real benefits received are likely to be less, and at time much less in real value to the beneficiaries, than the government spending. Those who deliver the services (school teachers, nurses, administrators) may absorb the (often large) difference, by underperforming, or through corrupt

practices. For example teachers or nurses may not show up as often as they are supposed to. See Tanzi, 1974 and 2008, for a discussion and some evidence of this point.

Returning to income taxation, a logical question to ask is why the Latin American countries have been so successful in raising revenue from the value added tax, that are not easy to administer, and so unsuccessful in raising revenue from the individual income taxes? The answers that are often given by experts are not totally convincing. They include: (a) the high degrees of informality in the economy; (b) the low incomes and tax bases; (c) the presumed high tax evasion; (d) administrative corruption; and so on. However, this writer is convinced that the answer is, at least in part, elsewhere, and it is a much simpler one. It has to do, first, with the very low shares of total national income, that go to wages and salaries in Latin American countries, and, second, to the low tax rates that are applied on the incomes and, especially, on the incomes that are **not** derived from wages and salaries. See Tanzi, 2008c.

In Latin American countries, the shares of national income received by dependent workers in the form of wages and salaries are unusually low, generally less than 30 percent of the total. These shares are much lower than they are in most industrial countries in which they often exceed 60 or even 70 percent of total income. In Latin America an overwhelming share of national income is received in the form of rents, dividends, interest payments, profits, capital gains, or informal incomes received by individuals who make their living in the informal economy. This is where much of the potentially taxable money is. This is the first part of the explanation, for why individual income taxes are so low in Latin America.

The second part is that, as I have described in some detail in a recent paper, (see Tanzi, 2012b), there has been, in the USA, over the last three decades, a process of *dismantling the* earlier *architecture of the income tax*, that in the past had been based on the Haig –Simon concept of income. The traditional Haig-Simon (or for that matter the Hicks concept) assumed that all incomes regardless of the sources, are the same, because they provide spending options for those

who receive them. Therefore, they should be taxed in the same way, and possibly with progressive rates, on their aggregated, or “global”, total.

In recent decades, starting in the 1970s, the Haig –Simon concept started being attacked, and, over the years, the *architecture of the income tax* was progressively dismantled, because of various, and at times questionable, theoretical arguments. It was replaced by one that made distinctions among different types of incomes, and that gave special treatment to particular forms of incomes, such as dividends, capital gains, “carried trade incomes”, and so on. This change in the architecture of the personal income tax explains how Governor Romney could pay a tax of only 13 percent, on an income of many millions of dollars, and without having evaded the taxes due.

Because of the influence of US thinking on Latin American countries, the change in the architecture of the individual income tax must have influenced their tax systems leading to (a) lower tax rates on income in general (see Gomez Sabaini and Jimenez, 20011, p. 25) and (b) to even lower rates on the share of personal income, generally received by the rich, such as dividends, interest income, capital gains, profits, rents, etc. See Table 4.2, p.116, of Velayos, Barreix and Villela, 2008, for some evidence.

If a smaller share of a total income (30 percent versus 60-70 percent) is taxed at normal rates, and if the larger share (the 60-70 percent) is taxed at very low rates, it should be no surprise that the total tax revenue obtained from taxes on individual incomes will be small. Tax evasion might be of some help, to give this result, but it is unlikely to be the main explanation. It can be theorized that the improvements in tax administrations that took place over the years in Latin America, that could have led to higher individual income tax revenue, over the years, were partly neutralized by the reductions in the tax rates on the incomes of the richer taxpayers. It would be a worthwhile project for CEPAL, or for some other institution, to test this hypothesis.

### **Concluding Remarks**

It has been a pleasure for me to speak at this conference on issues that have fascinated me for half century. There is little doubt in my mind that, over the 50 years, during which I have been interested in Latin America, the Latin American countries have made a lot of progress on their tax policies. However, when I assess the reply to the questions posed in the yearly surveys conducted by **Latinobarometro**, I am not sure that the progress on the spending side has been equally good in spite of some recent worthwhile programs. Let us not lose sight of the fact that taxes should always be collected as equitably as possible, but also that *higher* taxes are more justified when the additional revenue collected are well spent by the governments that collect them. There are some doubts whether this is the case. See Tanzi, 2008.

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