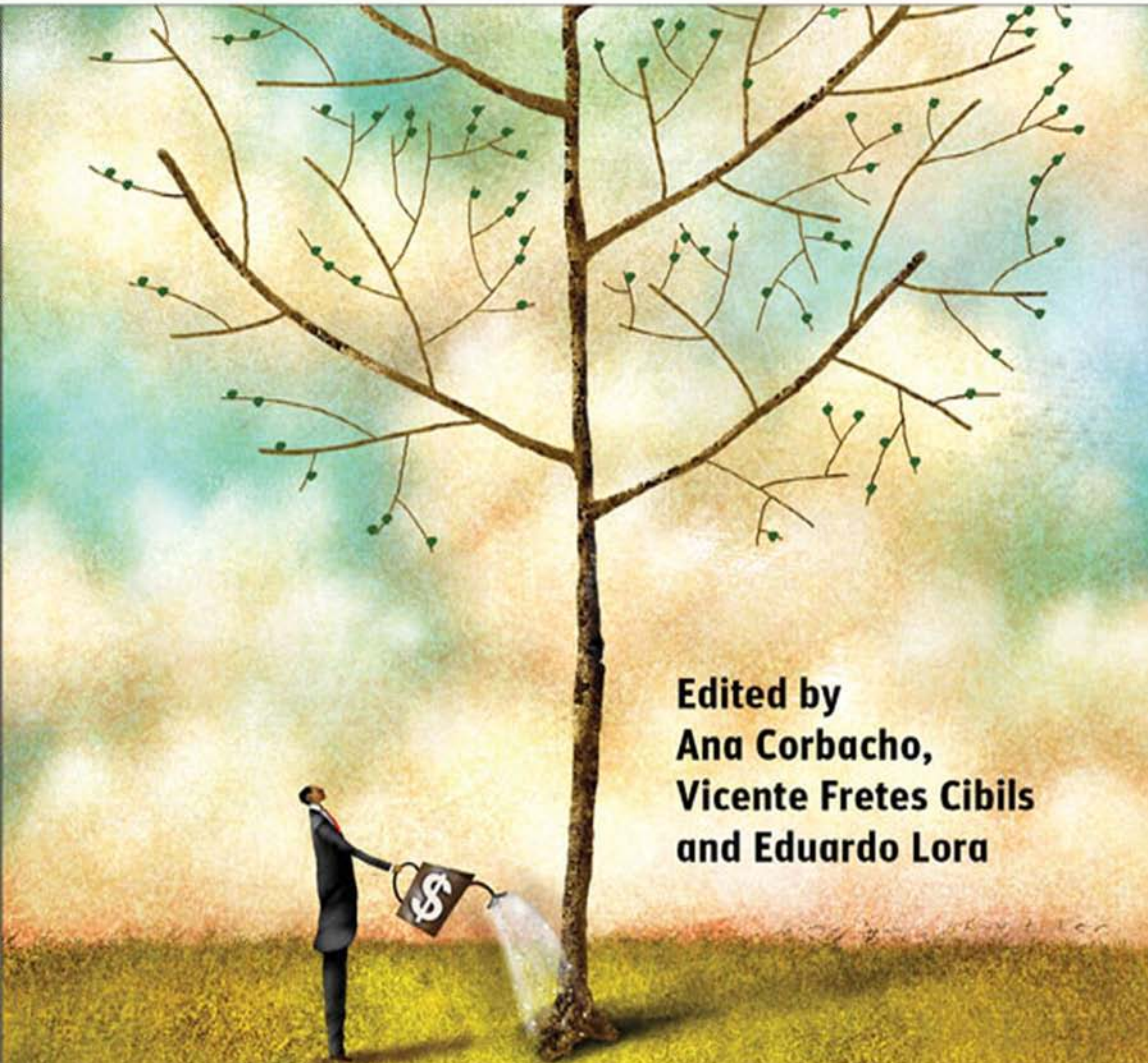
# More than Revenue

## TAXATION AS A DEVELOPMENT TOOL



Edited by
Ana Corbacho,
Vicente Fretes Cibils
and Eduardo Lora

DEVELOPMENT IN THE AMERICAS

IDB

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Inter-American Development Bank

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MORE THAN REVENUE

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# Preface

No major reform is more important for the sustainable and inclusive growth of Latin America and the Caribbean than the one pending in the region's fiscal and tax systems.

We have known this for a long time.

In 2007, the San José Consultation, convened by the IDB to identify the most promising policy reforms, concluded that improving tax institutions and rules represented not only one of the biggest challenges facing the region, but also one of the best opportunities to advance economic and social development.

As a result of robust growth recently enjoyed by most countries and changes in the tax structures in some countries, Latin America and the Caribbean has reduced its public debt ratio and can now devote more public resources to productive investment and poverty reduction programs.

When the international crisis unraveled in 2008, many countries in the region had improved their fiscal situations enough to allow them to adopt countercyclical economic policies to alleviate the loss of welfare in their societies.

Notable progress has been made in the quality and effectiveness of fiscal policies, as highlighted in this new edition of "Development in the Americas" (DIA), IDB's annual flagship publication on economic and social policy challenges in Latin America and the Caribbean. Recent growth of tax revenues in the region has been the fastest in the world. However, since the region began at such a low point compared to its level of development, it still has a long way to go. The reason why the region's task is still so great is twofold.

First, given the shortcomings of taxation in the region, most countries' systems are still far from exhausting their revenue potential.

Second, taxes, apart from providing the revenue needed to support the functions of a modern state, must also—indeed preferably—be designed as a powerful tool for stimulating development.

As this book shows, existing tax structures in Latin America and the Caribbean are still far from meeting this objective. This is the main message that we at the IDB would like to convey to the citizens of the continent.

Our practical recommendation for action is also very clear: we must take rigorous and decisive steps to reform and replace our existing tax systems with structures designed to be real instruments of growth and inclusive development. This new generation of tax reforms is one of the great items of unfinished business in our region.

Both our societies and our authorities must understand the nature and scale of the great opportunity ahead of us: reform our distortionary, inadequate, and regressive tax systems to convert them into allies of economic growth, mobility, and social equality. Our continent now has the opportunity to enact tax reforms that not only generate revenue but fundamentally support the sustained and inclusive development of our societies.

Although the tax situations in our region vary widely, the analysis shows that the prodevelopment tax reforms required by our countries must respect five basic principles:

1. *The reforms must include taxes that favor the poor.* The first priority is to improve the progressivity of existing tax systems with an income tax that has fewer exemptions, real redistributive capacity, and that preserves the income of poorer households.
2. *The reforms must establish tax systems that are simpler with broader tax bases.* Most of the region's tax systems are overly complex due to a plethora of exemptions and privileges for certain activities, sectors, or groups of taxpayers. The outcome is usually taxes that severely distort the allocation of resources and result in narrow and fragile tax bases. Shifting to simple tax systems with broad bases that create an environment conducive to innovation and business startups is one of the surest ways to promote higher productivity growth and a sustainable improvement in the region's well-being and equity.
3. *Tax administrations must be strengthened so that all citizens and businesses meet their tax obligations.* Reducing the high rate of tax evasion and creating institutions that guarantee that all economic agents and citizens contribute their share to the collective effort is an essential element of social legitimation and, as such, a requirement for the sustainability of any tax system designed to support development.
4. *Institutional agreements and consensuses must be reached to ensure that local governments have the local resources needed to act as agents of development.* For decentralized spending to be sustainable, the own-source resources of local governments must be strengthened. Much of the great potential of local revenue is still wasted, especially property taxes.

5. *Prodevelopment tax reforms should build tax systems that look to the future.* Latin America and the Caribbean enjoy an extraordinary endowment of natural resources. However, environmental taxes or the current design of taxes on commodities do not reflect this situation. To adapt our future to our reality, our tax systems must create incentives for the more efficient use of the finite natural resources available to all of us and take into account the needs of future generations of Latin Americans. We cannot afford to lose the idea of intergenerational solidarity.

As president of the IDB and as a Latin American, I know that the path to an ideal fiscal reform is neither easy nor unique. Each country must build its own consensus, set priorities, and choose the commitments that can make real improvement of its tax system possible. Each country must negotiate its own fiscal pact.

But I also know that our countries are not willing to continue tolerating fragile, unjust, and vulnerable tax systems that generate high private and social costs in terms of lost growth and opportunity. I am convinced that the countries of the region will recognize that the time has come to tackle these inclusive prodevelopment tax reforms.

The opportunity is now. We must grasp it.

The debate must take place and this book is bound to serve as one of its key references. Since the IDB could not be absent from the discussion, we wanted to contribute with arguments and analytical rigor. With this edition of DIA, *More than Revenue: Taxation as a Development Tool*, we strived to add a meaningful voice to the debate.

Beyond its results and recommendations, the IDB, as a development institution, is ready to support all the partners and stakeholders that decide to take on these crucial reforms.

Luis Alberto Moreno
President
Inter-American Development Bank

Part I

# The Tax Forest

# 1

# Undressing the Myths

The structure of taxation in Latin American and Caribbean countries is usually described as suffering from four major shortcomings: collection is very low, taxes are barely progressive, tax evasion is rampant, and tax administrations are very weak.[1] These characteristics create a self-reinforcing vicious circle, whose deep historical roots can be found in the distribution of wealth and effective political rights in the region.[2] One of the rent-seeking mechanisms that the most affluent have imposed on the rest of society is the regressive design of the tax structure. Opportunities to evade taxes that vary greatly across income groups compound this perverse structure, shrinking the effective tax bases and resulting in low levels of revenue.[3]

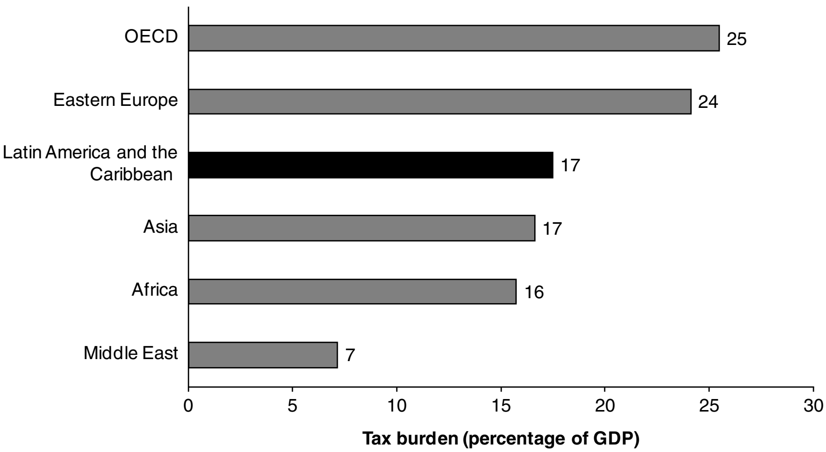
This description is not very encouraging, but fortunately it does not do justice to the current state of taxation in Latin America and the Caribbean. Although these characteristics are valid as stylized facts, they do not apply equally to all countries and are becoming less accurate in light of recent developments in taxation. While they may once have been good descriptions of reality, they are now approaching myths.

## The Myth and Reality of Low Taxation

It is often claimed that Latin American and Caribbean governments collect little tax revenue. This claim is immediately associated with problems such as the concentration of income and the public sector's incapacity to respond to the demand for social spending and public goods of all types, from transportation infrastructure to citizen security. But like all often-repeated claims, this claim obscures a much more complex reality.

True, the tax burden (taking into account all taxes, but not social security contributions and other fiscal revenues) in Latin America is low compared with other regions. In Latin America, national and subnational

**Figure 1.1 Tax Burden as Percentage of GDP, 2008–10 (simple average)**



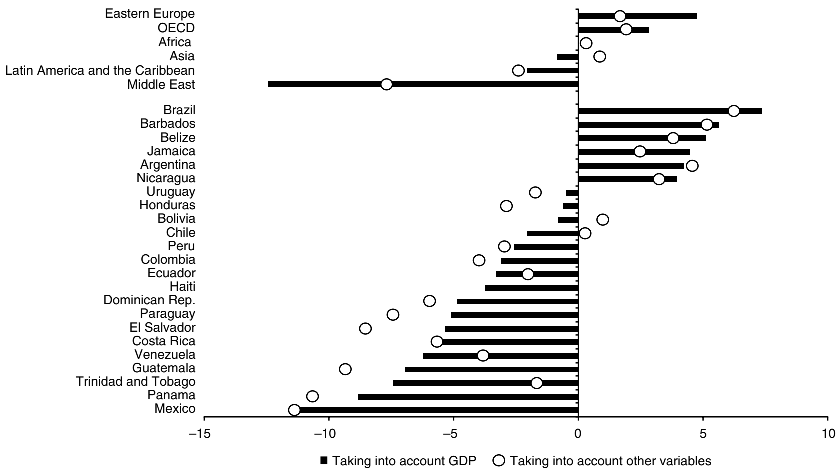

*Note*: The tax burden does not include social security contributions. Africa does not include Angola, Malta, Lesotho, and Swaziland. OECD is the Organisation for Economic Co-operation and Development.
*Source*: Authors' estimates based on IDB and CIAT (2012) and IMF (2011b).

governments collect 17.5 percent of GDP in taxes (figure 1.1). Tax revenue is higher in Eastern European countries (24.1 percent of GDP) and the 32-member countries of the Organisation for Economic Co-operation and Development (OECD) outside of Latin America (25.4 percent). This group will be considered representative of developed countries for purposes of this analysis.[4]

The richer countries generally tend to collect a higher proportion of GDP in tax revenues. Thus, it is not entirely surprising that tax receipts in Latin America and the Caribbean are higher than in Africa and lower than in the OECD. However, taken individually, most Latin American countries collect less tax revenue than might be expected for their income levels. For example, Guatemala, Mexico, Panama, and Trinidad and Tobago have tax burdens close to 10 percent of GDP, well below the typical burdens of other countries with similar income levels. According to the criterion of per capita income level, the tax collection gap is 7 points of GDP for Guatemala and 11.5 percentage points of GDP for Mexico. On average, the 23 Latin American and Caribbean countries considered have a collection gap of about 2 percentage points of GDP (figure 1.2).[5]

The fact that higher-income countries have higher tax burdens is due, above all, to income tax. Globally, very few low-income countries raise more

**Figure 1.2 Tax Burden Gap, 2007–09 (percentage points of GDP)**

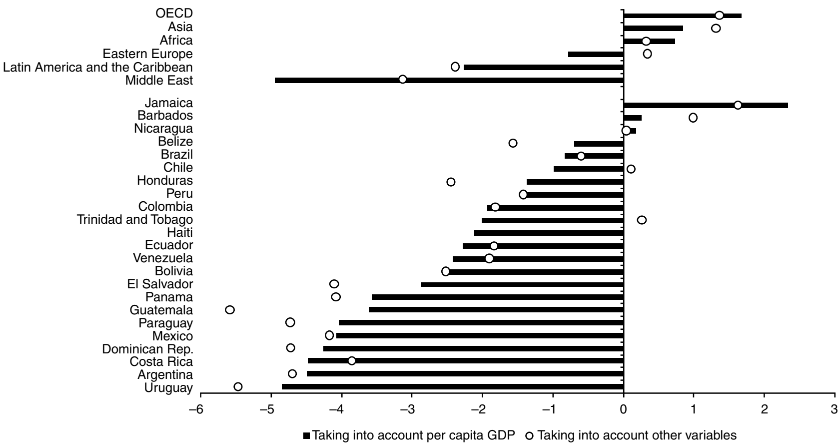



*Notes*: The "gap" is the excess or deficit in tax collection with respect to international patterns, based on GDP and "other variables": the proportion of the population under 15 years of age and over 65, percentage of the labor force that is self-employed, coefficient of exports and imports with respect to GDP, and coefficient of rents from natural resources with respect to GDP. OECD is the Organisation for Economic Co-operation and Development.
*Source*: Authors' calculation based on IDB and CIAT (2012) and IMF (2011b).

than 3 percent or 4 percent of GDP through taxes on personal income and businesses. By contrast, the government of a high-income country usually garners the equivalent of more than 15 percent of GDP from these sources. But the richest Latin American societies enjoy fairly modest income tax burdens. Argentina, Costa Rica, and Uruguay—relatively wealthy and egalitarian societies by the standards of the region—have large income tax deficits (more than 4.5 percentage points of GDP, according to the per capita income criterion). Even Brazil, which has a burden of taxes and social security contributions comparable to that of the OECD countries, has an income tax deficit (figure 1.3).[6]

This low tax effort is not exclusive to central governments. Since the 1980s, Latin America has undergone a rapid process of political and fiscal decentralization, which should have helped raise the tax revenue of subnational governments.[7] However, as discussed in chapter 5, with the notable exceptions of Argentina and Brazil (whose subnational governments collect 5.9 percent and 9.8 percent of GDP, respectively),[8] subnational taxation is very modest. Even countries that have made relatively rapid progress in decentralizing expenditure, such as Colombia (where subnational

**Figure 1.3 Income Tax Gap, 2007–09**




*Notes*: The "gap" is the excess or deficit in collection with respect to international patterns, based on GDP and "other variables": the proportion of the population under 15 years of age and over 65, percentage of the labor force that is self-employed, coefficient of exports and imports with respect to GDP, and coefficient of rents from natural resources with respect to GDP. OECD is the Organisation for Economic Co-operation and Development.
*Source*: Authors' calculation based on IDB and CIAT (2012) and IMF (2011b).

governments obtain only 2.9 percent of GDP from their own taxes), fare poorly. Excluding Argentina and Brazil, the tax burden of subnational governments averages only 0.8 percent of GDP, confirming the assertion that Latin American countries collect very little tax revenue.

One defense of the paltry collections posits that Latin American countries have less need to raise taxes because they have abundant natural resources that can provide tax revenue. Alternatively, low tax receipts may reflect not so much the availability of other sources of revenue as the relatively high importance of "hard-to-tax" activities, such as small businesses. Although these arguments are valid (as shown by the econometric analysis on which figures 1.2 and 1.3 are based),[9] they explain relatively little: the tax gaps (in total or income tax) do not disappear when they are calculated to include these criteria, and in some cases are even higher than when the calculation is based only on the per capita income level.

Thus, it is true that tax collection is low relative to the per capita income levels of countries, even after taking into account various characteristics of the economic structure that may affect taxation. However, this stylized fact can obscure very important distinctive features of taxation in