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Tax Policy and Inequality in Latin America

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June 2018

Paper

ACKNOWLEDGEMENTS

The author would like to thank Juan Carlos Gómez-Sabaíni and Dalmiro Morán for their helpful suggestions.

This publication was developed as part of the Latin America Tax Expenditure Research, Advocacy, and Learning (LATERAL) project.

The goal of the LATERAL project is to support civil society work to increase the transparency, equity, and accountability of tax expenditure policies at the country and regional levels in Latin America. Through LATERAL, the International Budget Partnership, partnering with ten Latin American civil society organizations (CSOs), seeks to promote policy reform by shedding light on the impact of tax expenditures on inequality across the region, raising public awareness of the importance of the issue, and pursuing a coordinated advocacy effort both within individual countries and at the regional level.

LATERAL is an innovative, collaborative research, capacity building, and advocacy initiative launched by IBP and CSO partners in 2016. With coordination and assistance from IBP, our ten civil society partners have undertaken analyses comparing tax expenditure policies and practices across the region, and examining the impact of these policies and practices on inequality. The LATERAL project has built an energized regional community, where CSO members learn from and help each other improve research, advocacy, and communication around tax issues.

The LATERAL project partners are:

- ACIJ - Asociación Civil por la Igualdad y la Justicia (Argentina)
- CAD – Ciudadanos al Día (Peru)
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EXECUTIVE SUMMARY

Taxation is an important policy tool for promoting revenue mobilization and economic development. However, it also has important implications in terms of inequality: not only does it determine the amount of revenue available for investing in public services and redistributing resources from high- to low-income citizens, it also determines who in society pays to generate that revenue. Beginning in the 1970s, however, neoliberal thinking under the so-called Washington Consensus shifted emphasis away from a focus on equity toward a focus on efficiency. More recently, as inequality increased in many parts of the world, the redistributive role of taxation has re-emerged at the heart of policy discussions.

There was perhaps no region in the world as affected by these opposing views on tax policy as Latin America.

THE HISTORICAL EVOLUTION OF TAX POLICY IN LATIN AMERICA

Latin American countries had very little autonomy in terms of tax policy during the colonial period. Tax policies set by the Spanish and Portuguese aimed to extract revenue from their colonies. The policies gave preference to the landed elite over the majority of the population and allowed wealth to concrete well into the post-colonial period. After the Great Depression, Latin American countries pursued industrialization and increased tax revenues to support a larger role for the state in economic development.

In the mid-1970s the Washington Consensus heavily influenced tax policy in the region. This shifted the emphasis away from progressive tax systems toward efficiency and the widening of the tax base, under the assumption that tackling inequality could be better achieved through public expenditures. Personal and corporate income tax rates were lowered and trade liberalization, another feature of the Washington Consensus, also drove dramatic reductions in tariffs across the region. Governments adopted value added taxes (VAT) to compensate for the loss in revenue; Brazil (1967) and Ecuador (1970) were early adopters of VAT, with the rest of the region following close behind. The general consensus is that these reforms undermined the capacity of Latin American countries to mobilize revenue and decreased economic stability.

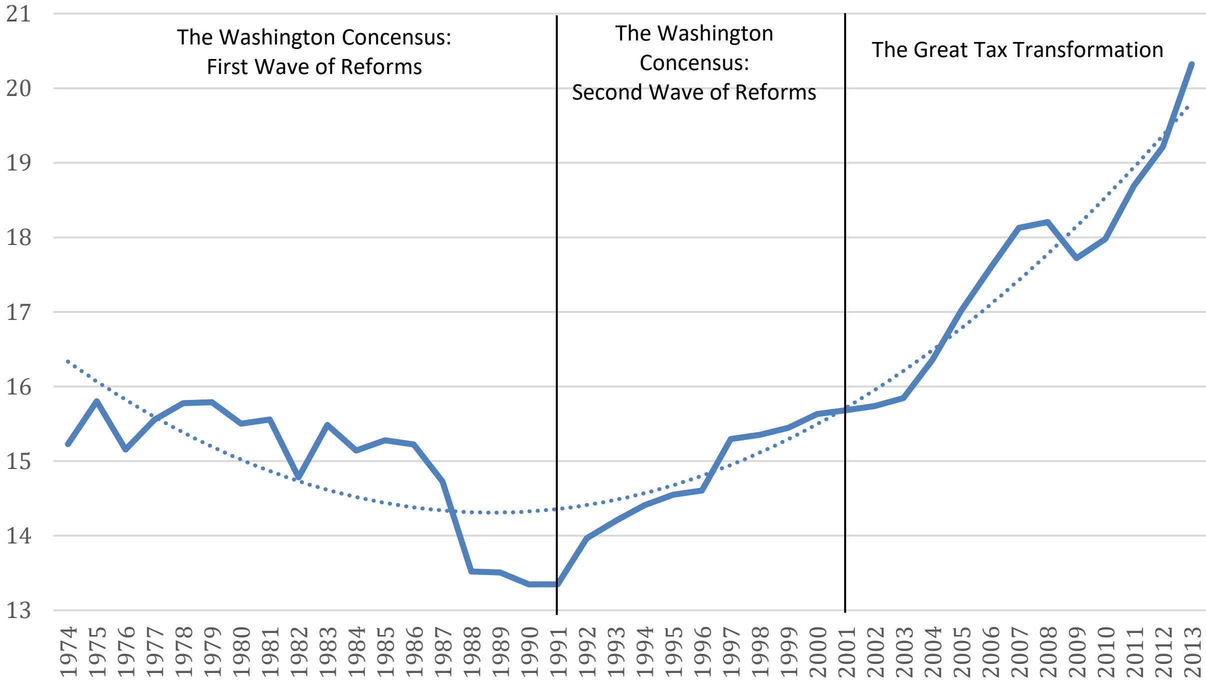
A new wave of tax reforms in the 1990s aimed to respond to these failings, yet the potential for tax systems to play a redistributive role remained off the agenda. The focus of these reforms was to increase resource mobilization by taxing previously excluded sectors, cracking down on tax evasion, and improving tax administration. Governments also began to establish more pragmatic approaches that were tailored to their particular country context.

A third wave of tax reforms in Latin America began in the early 2000s, underpinned by social and political changes in the region. In South America taxation began to play a central role in the policies of newly elected governments

on the left. Crucially, the idea that taxes were not only important for revenue mobilization but also for promoting equality more directly began to take hold. Several governments introduced new taxes and raised tax rates with the aim of tackling inequality. Peru, for example, introduced a progressive income tax and began taxing capital gains and earned interest. Several countries also took steps to better respond to external conditions, including increased taxation of nonrenewable natural resources.

Figure E1 traces the evolution of tax policy in Latin America in terms of revenue mobilization, dividing the period from 1973 to 2013 into three distinct phases. As can be seen, the average tax/GDP ratio fell during the first phase, before markedly increasing from the early 1990s onward, particularly after the third wave of tax reforms were adopted in the early 2000s. Yet the regional average tax/GDP masks important variations between countries. Argentina, for example, recorded the greatest gains (+14.6 points) and, along with Brazil, has a tax/GDP ratio higher than 30 percent. In general, the regional trend has been toward greater resource mobilization, with the exception of slight reductions in Mexico and Guatemala.

FIGURE E1. TAX/GDP RATIO IN THE LATIN AMERICA REGION, BETWEEN 1973 AND 2013



The composition of taxes in the region also underwent important transformation between 2002 and 2013. The average contribution to total revenue from direct taxes rose by more than 6 points, while the contribution from

indirect taxes fell by around 7 points. Despite this positive trend, Latin America's tax systems remain highly dominated by indirect taxes.

TAXATION AND INEQUALITY

Taxation tends to modify the market income distribution. Usually, direct taxes decrease inequality while indirect taxes increase inequality due to their disproportionate impact on lower-income populations. Reforms enacted since the 2000s, including the shift to more progressive tax policy, have contributed to a reduction of inequality in Latin America. The positive trend has been more pronounced in South American countries, such as Argentina, Brazil, and Peru, and less in Andean and Central American countries. In El Salvador and Honduras, where low tax/GDP ratios and high dependence on indirect taxes persist, taxation still tends to increase inequality.

Taxation can also play an important indirect role in tackling inequality by financing public expenditures that promote inclusive development. This includes investments in infrastructure and services, as well as social protection programs that support low-income families. Higher levels of taxation also allow policymakers to increase public spending without jeopardizing macroeconomic stability. The latter has been crucial in Latin America, where greater revenue mobilization in the last 15 years has allowed governments to promote growth and equity.

TAX EXPENDITURES

Tax expenditures are policy tools that governments may use to achieve different economic or social goals. While there is no definitive definition of tax expenditures, they are generally seen as provisions that reduce tax revenues from the preferential treatment of specific taxpayers, activities, sectors, or areas. They are used by governments to achieve different economic or social goals; policymakers can use tax expenditures to shift various actors toward activities that the government deems desirable. For example, concessions could be granted for investments in sectors that are thought to be crucial to economic development. Tax expenditures can also be designed to make the tax system more progressive, such as reducing the VAT on such essential items as food.

While the lack of a clear definition makes precise cross-country comparisons very difficult, the cost of tax expenditures is high in Latin America. The regional average was close to 4.5 percent of GDP in 2012, with even higher ratios among Central American countries. Tax expenditures are mainly concentrated in VAT and income taxes in the trade, education, and health sectors, while many Latin American countries have introduced lower VAT on basic goods.

While one of the policy objectives pursued by policymakers through tax expenditures is equality, there are only a few works that analyze the distributional consequences of tax expenditures. One examination of personal income tax expenditures in Ecuador and Chile finds that most of the benefits go to the highest income households. A second examination of Columbia's VAT concludes that tax expenditures reduce the impact on the poor, leading to a more equitable distribution of income.

CONCLUSIONS AND POLICY RECOMMENDATIONS

Latin American tax systems have undergone a series of important changes in the last several decades. Whereas the rise in tax revenue in the 1990s was mainly driven by increases in regressive, indirect taxes, reforms in the last decade have focused on the redistributive role of taxation. This shift has resulted in a reduction in inequality in the region. Yet the reforms can be considered incomplete: indirect taxes still comprise a far higher share of tax revenue in Latin America compared to advanced economies.

Latin American governments should increase the contribution of direct taxes, which is low in comparison to the international norm, and promote revenue mobilization and progressivity by increasing the contribution of property taxation, above all on real estate. Its share on total tax revenue is still low due to the presence of low tax rates, exemptions and several administrative weaknesses, as well as the historical opposition from the economic elite with strong ties to the political power.

Cracking down on tax evasion remains an important priority in the region. Administrative improvements have been very useful in enhancing tax capacities and for reducing tax evasion in the region. Governments should continue to promote administrative improvements and also continue to favor the adoption of new technologies for enhancing tax revenue mobilization.

Latin American governments should reduce their use of tax expenditures. There is growing consensus that they are not useful in promoting economic growth and that they exacerbate both horizontal and vertical equality. Tax expenditures in personal income taxes are regressive by nature and generally benefit those with higher income. And while indirect tax exemptions for basic goods and services are more likely to benefit the poor, the same goals can be better achieved through social protection programs.

Lastly, taxation is not an arithmetical exercise. As with other policies, taxation must be credible and predictable. Linking taxation to development goals and benefits could be a crucial ingredient for the successful implementation of a new tax reform.

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1. INTRODUCTION

Taxation is an important policy tool for promoting revenue mobilization and economic development. However, it also has important implications in terms of inequality. First, tax policy influences market income distribution; its redistributive capacity depends both on the level of tax revenue and the progressivity of tax schedules. Second, taxation generates resources to finance social spending. Historically, however, there has not been a general consensus on the role of taxation, nor the most effective way to promote welfare. In the past, tax policy was considered useful not only for raising revenue but also for promoting more inclusive economic development. The neoliberal revolution in the 1970s, however, heavily influenced tax policy across the world, shifting emphasis from equity to efficiency. The idea was to promote tax neutrality by reducing tax rates on income and widening the tax base. In this setting, public spending was thought to be the only way to promote redistribution. Recently inequality has increased in many countries across the world. As a result, the redistributive role of taxation has reappeared as a central element of policy discussions and research analyzes.

This paper contributes to this debate by focusing on the case of Latin America, the region that has been most affected by these opposing views on tax policy. Indeed, tax reforms in Latin American countries during the time of the Washington Consensus tried to promote efficiency and horizontal equity, even as inequality rapidly increased, reaching a peak in the early 2000s. Yet, tax policy has undergone important changes in recent years. The sizeable increase in the contribution of direct taxes has favored progressivity and helped address inequities in tax systems in the region. Over the same period, Latin American countries have made progress toward reducing inequality.

Following these lines, this paper aims to describe the evolution of taxation and its redistributive implications for Latin America over the last few decades. The paper is presented in the following way: Section 2 describes the different phases of taxation in Latin America; Section 3 discusses the relationship between taxation and inequality; Section 4 reports on tax expenditures in Latin America and their implications in terms of inequality; and Section 5 concludes and presents some policy recommendations.

2. THE HISTORICAL EVOLUTION OF TAX POLICY IN LATIN AMERICA

As explained earlier, Latin America was highly affected by opposing views on the role of taxation. This section briefly reviews this historical trend in the region, with a special look at the evolution of tax revenue and tax composition over the last few decades.

2.1 FROM COLONIAL TIMES TO THE NEOLIBERAL REVOLUTION

Latin American countries had very little autonomy in terms of tax policy during the colonial period. The British tended to levy a relatively low tax burden in the Caribbean, while the Spanish and Portuguese levied several taxes that aimed to extract revenue from the enormous wealth of South America.[1] Moreover, taxation served as "the hypothetical preferences of the large landlords and in reverse order to the preferences of the majority of the population."[2] Both *fazendeiro* and *latifundista* were fiscally untouchable thanks to their strong links with the political elite.[3] Overall, direct taxes accounted for a small share of tax revenue, even in the post-colonial period.[4] As a result, the tax system relied mainly on indirect taxes, while wealth concentration was already seen to be going up dramatically in the early 20th Century.[5]

After the Great Depression, Latin American countries adopted an "import substituting industrialization (ISI) strategy" with the broad involvement of the state in the economy. This new development strategy led to an increase of tax revenue.[6] Although governments tried to reform tax systems by increasing the reliance on direct taxes, these policies were not effective in promoting vertical equity. At the same time, they undermined horizontal equity by introducing several exemptions, incentives, and special fiscal regimes granted to specific agents, firms, industries, or regions.[7] As reported by Bird and Oldman, the "larger part of the income tax is paid by companies, often largely foreign extractive enterprises, so that its importance reflects more the fortunes of world markets than successful domestic tax reform efforts."[8]

2.2 THE FIRST WAVE OF REFORMS UNDER THE WASHINGTON CONSENSUS

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[1] K. Sokoloff and E. Zolt, "Inequality and Taxation: Evidence from the Americas on How Inequality May Influence Tax Institutions," *Tax Law Review* 59 (2006): 167-241.

[2] M. Best, "Political Power and Tax Revenues in Central America," *Journal of Development Economics* 3 (1976): 50.

[3] M. A. Centeno, "Blood and Debt: War and Taxation in Nineteenth-Century Latin America," *The American Journal of Sociology* 102, no. 6 (1997): 1565-1605. *Fazendiero* and *latifundista* are farmers and landowners, respectively.

[4] Sokoloff and Zolt, "Inequality and Taxation," 167-241.

[5] S. Edwards, G. Esquivel, and G. Márquez, eds., *The Decline of Latin American Economies: Growth, Institutions, and Crises* (Chicago: University of Chicago Press, 2007). K. Breceda, J. Rigolini, and J. Saavedra, "Latin America and the Social Contract: Patterns of Social Spending and Taxation" (Policy Research Working Paper 4604, World Bank, Washington, D.C., May 2008).

[6] R. M. Bird, "Taxation in Latin America: Reflections on Sustainability and the Balance between Equity and Efficiency" (International Tax Program Paper 0306, Institute for International Business, University of Toronto, Toronto, 2003).

[7] Inequality can be measured both vertically and horizontally. In the former case, individuals or households are lined up according to (in the vast majority of the cases) economic indicators such as consumption, income, etc. By contrast, horizontal inequality focuses on differences among culturally defined (or constructed) groups with shared identities. Horizontal equity refers to the comparable treatment of similar situated firms or individuals, while vertical equity assesses the distribution of taxes on individuals or firms based on ability to pay. See F. Stewart, "Horizontal inequalities: a neglected dimension of development," in *Wider Perspectives on Global Development*, ed. UNU-WIDER (London: Palgrave Macmillan UK, 2005), 101-35.

[8] R. M. Bird and O. Oldman, "Tax Research and Tax Reform in Latin America – A Survey and Commentary," *Latin American Research Review* 3 (1968): 5-28.

In the mid-1970s developing countries were hit by the neoliberal revolution. While international organizations played a key role in designing the policy agenda in many poor countries, tax policy was one of the most affected areas of reform.[9] The main idea was that taxation harms efficiency.[10] Although taxes were believed necessary and useful to raise revenue, the dominant view was that this might be possible by promoting the neutrality of the tax system and the expansion of the tax base. This resulted in deemphasizing the progressivity of the tax system, under the assumption that equality could be better achieved through public expenditure.[11]

Following these suggestions several countries undertook tax reform. In particular, personal and corporate income tax rates were lowered in order to reduce the supposed efficiency costs and to promote the rationalization and simplification of the tax system.[12] For example, in the 1990s the top personal income tax rate in Argentina was lowered from 45 to 35 percent, while in Brazil it was lowered from 60 to 25 percent. On average, between 1980 and 2000 the top rate on personal income in Latin America decreased by more than 20 points on average, from 53 to 29 percent (see Figure 1).

Under the aegis of the Washington Consensus, governments also promoted trade liberalization. In particular, "the average tariff on imports in South American countries dropped from 55% in 1985 to approximately 10% in 2000, and in the group of Central American countries and Mexico the fall was even steeper, from 66% to 6%."[13] In this context, value added taxes (VAT) represented the most innovative change during this period, compensating for the loss of revenue of income taxes and trade taxes. VAT was initially implemented in Brazil in 1967 and Ecuador in 1970; a few years later it was introduced by the rest of the countries in the region.

[9] Annex 1 reports some of the tax reform recommendations from International Financial Institutions.

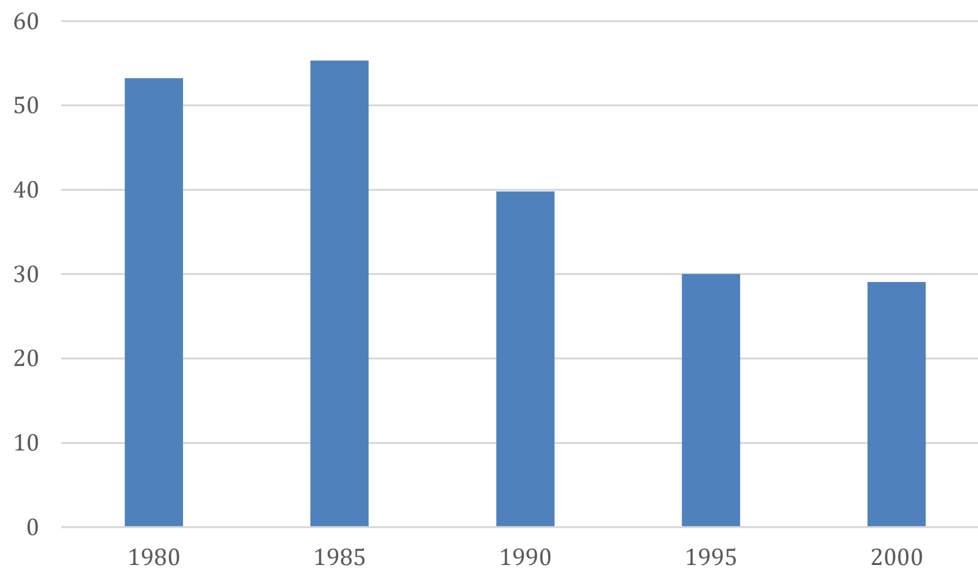
[10] R. M. Bird and E. M. Zolt, "Rethinking Redistribution: Tax Policy in an Era of Rising Inequality," *UCLA Law Review* 52 (2005): 1627–95.

[11] J. C. Gómez-Sabaíni, B. Martorano, and D. Morán, "Taxation and Inequality: Lessons from Latin America," in *World Social Science Report on Inequality* (Paris: UNESCO, forthcoming).

[12] K. S. Peter, S. C. Buttrick, and D. Duncan, "Global Reform of Personal Income Taxation, 1981-2005: Evidence from 189 Countries" (Discussion Paper No. 4228, Institute for the Study of Labor (IZA), Bonn, June 2009).

[13] E. Lora, ed., *The State of State Reform in Latin America* (New York: The Inter-American Development Bank / Stanford: Stanford University Press, 2007).

FIGURE 1. TOP MARGINAL INCOME TAX RATE



Source: R. L. Gwartney and J. Hall, "2016 Economic Freedom Dataset,"*Economic Freedom of the World: 2016 Annual Report* (Canada: Fraser Institute, 2016), http://www.freetheworld.com/datasets_efw.html.
Notes: Data are on Argentina, Brazil, Colombia, Costa Rica, the Dominican Republic, Ecuador, El Salvador, Guatemala, Honduras, Mexico, Nicaragua, and Peru. They refer to the top marginal income tax rate and are computed as a simple average.

However, the results of these reforms were less than positive. Indeed, tax systems in Latin America were characterized by: "(a) a low average tax rate; (b) a tax structure weighted toward indirect taxes with narrow tax bases, multiple rates and many exemptions; (c) a limited tax administration capacity; (d) a mild redistributive impact."[14] Nowadays, there is a general consensus that these reforms failed; in particular, tax reforms implemented during this period undermined the capacity of Latin American countries to mobilize revenue and contributed to increase macroeconomic volatility.[15]

2.3 THE SECOND WAVE OF REFORMS UNDER THE WASHINGTON CONSENSUS

Since the early 1990s governments promoted a new wave of reforms in order to generate more revenue and to promote macroeconomic stability. The strategy was still to mobilize resources mainly through an expansion of the tax base rather than a change in tax rates. In particular, governments extended taxation to sources of income or sectors previously excluded, and tried to reduce tax evasion. However, the potential redistributive role of taxation

[14] V. Lledo, A. Schneider, and M. Moore, "Governance, taxes, and tax reform in Latin America" (Working Paper 221, Institute of Development Studies, Brighton, England, 2004).
[15] A. Cobham, "Tax evasion, tax avoidance and development finance" (Working Paper Number 129, QEH Working Paper Series, Queen Elizabeth House, University of Oxford, Oxford, 2005).

was still off the agenda. Indeed, high tax rates were believed to not only harm economic activity but also to be ineffective in promoting redistribution.[16]

In addition, governments sought to improve tax collection efficiency by introducing some important changes in tax administration. Among the most interesting changes was the shift toward a functional rationalization of tax administrative structures and the adoption of a Semi-Autonomous Revenue Authority (SARA).[17] The introduction of new technologies contributed to the modernization of tax administration and facilitated the process of revenue mobilization.[18] As reported by Cominetta, "…the simplification of the system was indeed accompanied by a noteworthy development in the computerization of the taxation process, which reached … a higher degree than in OECD countries."[19]

At the same time, governments started taking more consideration of their country's individual characteristics, implementing heterodox and more pragmatic tax policies. For example, some countries introduced special units to improve taxation of large taxpayer units (LTU), while others adopted simplified or presumptive systems to facilitate taxation of small taxpayer units. Among the most noticeable cases were the presumptive regime of taxation called *Simples*, which was introduced in Brazil in 1997, and the *Monotributo*, which was introduced in Argentina in 1998. The main objective of these special regimes was to reduce the tax complexity concerning small business, while dealing with the problem of high informality. The introduction of a taxation on financial transactions represented a third interesting example of heterodox forms of tax policy. These taxes were introduced in the time of the crisis due to their capacity to mobilize revenue quickly and at low administrative costs.[20]

2.4 THE GREAT TAX TRANSFORMATION

Social and political changes heavily influenced tax policy in the early 2000s. In South America the new left governments implemented a new policy model in which taxation started to play a central role, not only in terms of revenue mobilization but also for promoting equality. In particular, several governments explicitly introduced measures to deal with high inequality by increasing tax rates or introducing new taxes. For example, one of the main objectives of the 2008 tax reform in Ecuador was to increase the progressivity of Personal Income Tax (PIT)

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[16] D. De Ferranti et al., *Inequality in Latin America: Breaking with History?* (Washington, D.C.: World Bank, 2004).

[17] G. A. Cornia, J.C. Gómez-Sabaíni, and B. Martorano, "A New Fiscal Pact, Tax Policy Changes and Income Inequality: Latin America during the last decade," (Working Paper 2011/70, UNU-WIDER, Helsinki, 2011).

[18] V. Tanzi, "Tax Reform in Latin America: A Long-Term Assessment," (Paper presented at the XXV Regional Seminar on Fiscal Policy, Santiago, Chile, 5-6 March 2013).

[19] M. Cominetta, "Chile," in L. Bernardi et al., eds., *Tax systems and tax reforms in Latin America: country studies* (Paper No. 5223, MPRA, University of Pavia, Italy, March 2007), 18.

[20] Economic Commission for Latin America and the Caribbean. *Fiscal Panorama of Latin America and the Caribbean: Tax Reform and Renewal of the Fiscal Covenant*. (Santiago, Chile: Economic Commission for Latin America and the Caribbean, United Nations, 2013).

and the overall redistributivity of the tax system. "This was done, firstly by creating two additional income tax brackets along with a top marginal tax rate of 35%, and secondly by incorporating new personal income tax deductions for expenses on housing, education, health, clothing, and food."[21] Peru and other countries introduced a dual system of taxation. In particular, the 2009 Peruvian Tax Reform aimed to improve income distribution, introducing progressive taxation of labor income (from 0 to 30 percent). With the objective of broadening the tax base, capital gains and interest started to be taxed, while benefits for used car refurbishment were abolished. However, capital income was taxed according to a low rate of 6.25 percent on 80 percent of capital income in order to reduce, as much as possible, the supposed negative consequences in terms of efficiency.

Central American countries continued to promote a revenue-enhancing strategy. In particular, governments sought to expand the tax base, as seen in the case of the recent tax reforms implemented in the Dominican Republic and Guatemala in 2012 and Costa Rica in 2014. In contrast, the Mexican government tried to reach both objectives of revenue mobilization and equality promotion. On one hand, the government increased the corporate income tax rate by 2 percent (from 28 percent to 30 percent) in 2009.[22] On the other hand, the 2013 tax reform was aimed at broadening the tax base, both on personal and corporate income. Recently, however, a number of Central American countries seemed to follow the strategy of Peru, "setting flat rates of between 10% and 15% on capital income that was previously tax exempt (with exceptions for nonresidents), combined with higher rates on business earnings and progressive rates for labor income."[23]

Latin American countries also implemented specific measures to gain benefits from the evolution of external conditions. During the 2000s several countries, including Argentina and Ecuador, introduced a number of measures to take advantage of the increase in commodity prices and in the demand for primary products. As reported by Gomez-Sabaini and Moran, however, "the wide range of instruments used in the region raises a series of challenges for the identification of the share of total tax revenues that can be attributed to natural resources. Some tax measures explicitly take into account the exploitation of non-renewable resources as a tax base, which makes it easy to associate them with the resource sector even if they are not all classified as taxes. In some cases,

[21] L. Cano, "Personal Income Tax and Income Inequality: New Evidence from a South American Country; Ecuador 2007–2011," (CEPAL Review, 2015), 3.

[22] O. Celasun et al., "Fiscal Policy in Latin America: Lessons and Legacies of the Global Financial Crisis – Technical Appendix," Staff Discussion Note SDN/15/06, International Monetary Fund, Washington, D.C., 2015), https://www.imf.org/external/pubs/ft/sdn/2015/sdn1506techapx.pdf.

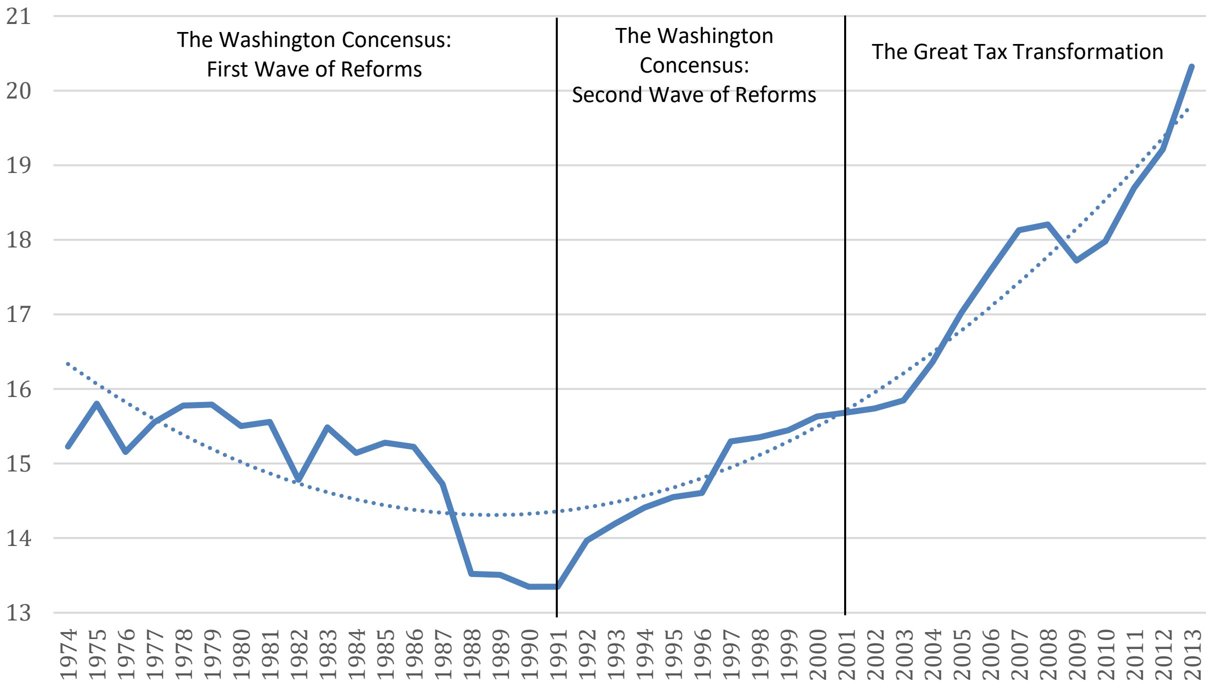
[23] J. C. Gómez-Sabaíni and D. Morán, "Tax Policy in Latin America: Assessment and Guidelines for a Second Generation of Reforms," (Macroeconomics of Development Series No. 133, Economic Commission for Latin America and the Caribbean, United Nations, Santiago, Chile, 2014), 37, http://www.daghammarskjold.se/wp-content/uploads/2014/12/2014-Tax-policy-in-Latin-America_CEPAL.pdf.

the application of criteria to identify a tax can be particularly problematic. As mentioned earlier, the best example is hydrocarbon production rights in Mexico, where there is no general consensus on their classification as a tax."[24]

2.5 RESULTS IN TERMS OF TAX LEVEL AND TAX COMPOSITION

Figure 2 shows the evolution of tax revenue as a share of GDP in Latin America over the period from 1973 to 2013. It confirms that tax reforms implemented in the 1970s and 1980s failed in terms of tax revenue mobilization. Indeed, the tax/GDP ratio fell from 16 percent in the early 1970s to 13 percent in the early 1990s. However, tax revenue started to recover in the following decades thanks to the new measures implemented by governments. In particular, tax revenue as a share of GDP increased by 3 points, to 16 percent in 2002 (Figure 2). However, the most important variation was recorded in the 2000s; in particular, tax revenue increased to 18 percent of GDP in 2008. The arrival of the international crisis partially affected the capacity of Latin American governments to mobilize revenue. Indeed, tax revenue on GDP fell by 0.5 percent between 2008 and 2009, yet it rapidly recovered its upward trend, increasing to 20 percent of GDP in 2013.

FIGURE 2. TAX/GDP RATIO IN THE LATIN AMERICA REGION, BETWEEN 1973 AND 2013



Source: Author's elaboration on data from CEPALSTAT (Economic Commission for Latin America and the Caribbean, United Nations, New York), http://estadisticas.cepal.org/cepalstat/WEB_CEPALSTAT/Portada.asp?idioma=i.

[24] Ibid., 27.

The average tax/GDP ratio in Latin America masks important heterogeneity across countries. On the higher end, Argentina and Brazil have a tax/GDP ratio higher than 30 percent, while in Bolivia, Costa Rica, and Uruguay it is between 20 and 30 percent. On the lower end, the Dominican Republic, Guatemala, Mexico, Paraguay, and Venezuela have tax/GDP ratios below 15 percent. Beyond the differences in tax/GDP ratios, it is interesting to observe that almost all the countries recorded an upward trend in tax revenue in the 2000s. The most substantial improvement in performance was recorded by Argentina (+14.6 points). In Bolivia and Ecuador, the tax/GDP ratio increased by more than 6 percentage points, also thanks to the favorable external conditions. Uruguay also recorded a good performance (+6.8 points), most likely attributable to the tax reform implemented in 2007. The only exceptions to this positive trend were Guatemala and Mexico, which recorded a reduction of the tax/GDP ratio by 0.8 and 1.6 percentage points, respectively.

TABLE 1. TAX/GDP RATIO IN 1991, 2002, AND 2013

	1991	2002	2013		Difference 1991 to 2002	Difference 2002 to 2013
Brazil	23.7	32.1	35.6		8.4	3.5
Argentina	15.1	16.6	31.2		1.6	14.6
Uruguay	21.5	21.5	28.3		0.0	6.8
Bolivia	9.9	17.3	23.6		7.4	6.3
Costa Rica	17.0	20.3	23.0		3.3	2.7
Chile	16.7	18.6	19.6		2.0	1.0
Ecuador	7.1	12.3	19.3		5.2	7.0
Nicaragua	9.8	13.4	19.3		3.6	5.9
Colombia	10.6	15.6	18.9		5.0	3.3
Peru	13.2	14.3	18.6		1.1	4.3
Honduras	14.2	15.6	18.1		1.4	2.5
El Salvador	10.9	13.0	17.2		2.0	4.2
Panama	14.4	13.8	16.7		-0.5	2.9
Dominican Republic	7.3	12.8	13.9		5.5	1.1
Venezuela	19.0	11.2	13.9		-7.7	2.7
Paraguay	8.3	9.0	13.1		0.7	4.1
Mexico	12.2	13.8	12.2		1.6	-1.6
Guatemala	9.5	11.9	11.1		2.4	-0.8

Source: Author's elaboration on CEPALSTAT

A further interesting change is related to tax composition. From 1991 to 2002 the increase in tax revenue was promoted by the growing contribution of indirect taxes. However, a more detailed analysis shows some interesting differences. Indeed, while the contribution from general taxes on goods and services rose by almost 10 points, the contribution from taxes on international trade and transactions decreased by 7 points from 16.5 to 9.5 percent. In contrast, the contribution of direct taxes slightly decreased by 0.5 percent. The most important changes were

related to taxes on income, profits, and capital gains; in particular, their contribution decreased by 3 points, mainly driven by the reduction of the contribution of taxes on corporations and enterprises.

Tax systems in Latin America countries recorded important transformations between 2002 and 2013. Indeed, the average contribution of direct taxes to total tax revenue rose by more than 6 points, from 31.4 to 37.9 percent. This was mainly due to the increase recorded by the contribution of taxes on income, profits, and capital gains (8 points). In contrast, the contribution from taxes on property decreased by 1.7 points, falling below 5 percent. It is also worth noting that the contribution of indirect taxes declined by around 7 points. This was mainly related to the reduction of the contribution of taxes on specific goods and services, international trade, and transactions. In contrast, the contribution of general taxes on goods and services continued increasing up to 44 percent in 2013.

Although the contribution of direct taxes increased in the last period, the tax system in Latin America is still highly dominated by indirect taxes. In 2013, the contribution of direct taxes was close to 38 percent while that of indirect taxes was higher than 60 percent (Table 2).

TABLE 2. TAX COMPOSITION, 1991, 2001, AND 2011

	1991	**2002**	**2013**		**Difference 1991 to 2002**	**Difference 2002 to 2013**
Direct tax revenue	31.9	31.4	37.9		-0.5	6.5
Taxes on income, profits, and capital gains	27.4	24.8	32.9		-2.6	8.1
Individuals	2.7	8.4	11.2		5.7	2.9
Corporations and enterprises	21.9	13.7	19.2		-8.2	5.5
Unallocable	14.3	13.1	10.8		-1.2	-2.3
Taxes on property	4.6	6.3	4.6		1.7	-1.7
Other direct taxes	1.1	2.9	3.2		1.9	0.3
Indirect tax revenues	64.0	67.4	60.7		3.4	-6.7
General taxes on goods and services	33.4	41.9	44.2		8.5	2.4
Taxes on specific goods and services	15.7	15.9	10.4		0.2	-5.5
Taxes on international trade and transactions	16.5	9.5	5.9		-7.0	-3.6
Other indirect taxes	0.5	0.1	0.4		-0.3	0.2
Other taxes	4.1	1.3	1.6		-2.8	0.3

Source: Author's elaboration on CEPALSTAT

3. TAXATION AND INEQUALITY

3.1 THE DIRECT IMPACT OF TAXATION ON INEQUALITY

Taxation tends to modify the market income distribution. Empirical literature confirms that taxation is not neutral. Direct taxes usually decrease inequality, while indirect taxes increase inequality due to the large tax burden on people at the bottom of the distribution (Table 3).

TABLE 3. EMPIRICAL FINDINGS ON TAXATION AND INEQUALITY

Authors	Period	Sample	Empirical findings
Martinez-Vazquez *et al.* 2012	1970-2009	150 countries	Progressive personal income tax (PIT) and corporate income tax (CIT) reduce inequality (for CIT, smaller effect with more globalization). Consumption taxes, excises, and customs duties increase inequality.
Joumard *et al*. 2012	mid 1990s- late 2000s	OECD countries	Income taxes are the most progressive; while consumption and real estate taxes the most regressive.
Paulus *et al*, 2009	mid-2000s	19 European countries	Personal taxes have the largest redistributive impact.
Chu *et al.* 2000	1970s-1990s	19 developing countries	Smaller tax redistributive effect. Income taxes are progressive. Direct/indirect tax change is progressive.
Gemmell & Morrissey 2005	1960s-1990s	6 African countries	Personal income taxes are progressive, corporate taxes have a U-shape effect (regressive and then progressive); property, indirect taxes, and taxes on exports are regressive. Overall tax systems are regressive at low income levels.

Source: Author's elaboration on J. Woo et al., "Distributional Consequences of Fiscal Consolidation and the Role of Fiscal Policy: What Do the Data Say?" (Working Paper WP/13/195, International Monetary Fund, Washington, D.C., 2013).

While these results are largely confirmed for advanced economies, the impact of taxes in developing countries remains less certain. Bird and De Wulf conducted some of the first studies on tax incidence in Latin America in 1973, finding that taxation was (mildly) redistributive only in four countries.[25] Table 4 confirms that the tax system was regressive in the 1990s. In addition, a 2004 study by Lledo, Schneider, and Moore reported that "in no case is the share of income paid by the highest decile above 8 percent of their total income, an actual tax burden substantially smaller than the average tax rate one would anticipate from the steep marginal tax rates found in the tax code. This result is a clear indication of the high levels of tax evasion among upper-income groups."[26] Two

[25] R. M. Bird and L. De Wulf, "Taxation and Income Distribution in Latin America: A Critical Review of Empirical Studies," (Staff Papers 20, no. 3, International Monetary Fund, Washington, D.C., November 1973), 639-82.

[26] Lledo, Schneider, and Moore, "Governance, taxes, and tax reform in Latin America," 14.

more recent studies found that taxation has neutral or regressive effects due to the governments' poor performance in collecting revenue and the high contribution of indirect taxes.[27, 28]

TABLE 4. CHANGE IN REYNOLDS-SMOLENSKY (RS) INDEXES FOR TAXES IN SELECTED LATIN AMERICAN COUNTRIES

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

Source: J. C. Gomez Sabaini, B. Martorano, and D. Moran, "Taxation and Inequality: Lessons from Latin America," *World Social Science Report on Inequality* (Paris: UNESCO, 2016).
Notes: 2009 data for Bolivia refer only to indirect taxes. The overall impact of taxes should be not different considering the small contribution of direct taxes.

However, other studies have found that taxation has contributed to the reduction of inequality recorded by Latin America in the 2000s.[29, 30] This conclusion has been strengthened by the recent analyses of tax incidence that clearly show an important transformation with respect to the past. While taxation was regressive before the 2000s — as shown by the negative signs recorded by the Reynolds-Smolensky indexes in Table 4 — it has become more progressive in the last several years.[31] Moreover, tax incidence studies also confirm that income taxes are

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[27] M. Hanni, R. Martner Fanta, and A. Podestá, "The Redistributive Potential of Taxation in Latin America," (*CEPAL Review* 116, August 2015), 7–26.
[28] E. Goñi, J. Lopéz, and L. Servén, "Fiscal Redistribution and Income Inequality in Latin America," *World Development* 39, no. 9 (2011), 1558–69.
[29] Cornia, Gómez-Sabaíni, and Martorano, "A New Fiscal Pact."
[30] B. Martorano, "Taxation and inequality in developing countries: Lessons from the recent experience of Latin America," (Working Paper 2016/98, UNU-WIDER, Helsinki, 2016).
[31] The Reynolds-Smolensky index provides information of the tax system's ability to promote redistribution. It is based on the difference between the Gini index before taxes and the quasi-Gini (i.e. concentration coefficient of taxes) after taxation. A

progressive, while VAT, trade taxes, and excises are regressive (see Annex 1 for more details). Positive results have been recorded mainly in South American countries, such as Argentina, Brazil, and Peru.[32, 33] However, the redistributive impact of taxation in some Andean and Central American countries has been modest, even though recent reforms have promoted some improvements. Finally, taxation still tends to increase inequality in such countries as El Salvador and Honduras.[34] The main reason is that these countries have a low tax/GDP ratio alongside a high dependence on indirect taxes.

3.2 THE INDIRECT IMPACT OF TAXATION ON INEQUALITY

As reported above, taxation could also have a very important role in financing public expenditures for promoting a more inclusive and less volatile process of economic development.

In particular, taxation generates resources for financing public infrastructure and services, and for promoting job creation, all of which are crucial ingredients for boosting economic growth. Furthermore, it makes resources available to finance social protection, which is essential to support those with low incomes. At the same time, taxation also creates the necessary "fiscal room" that allows policymakers to increase public spending without jeopardizing economic stability.[35] Although macroeconomic stability *per se* is not a sufficient condition to boost economic development, it is a necessary factor for generating the suitable environment for economic growth.

Latin America is an illustrative case: the inability to mobilize national resources, and the excessive reliance on external resources, increased macroeconomic volatility and provoked the recurring crises in the 1980s and the 1990s. Yet tax policy changes recorded in the last 15 years favored a fiscal consolidation in many Latin American countries. In particular, the rapid increase in tax revenue between 2004 and 2007 compensated for the rise of public expenditure, allowing governments to promote growth and equity (Figure 3). This situation also gave Latin

negative value of this index indicates that taxes increase inequality, while a positive value means that taxes promote redistribution and reduce inequality.

[32] G. Cruces and L. Gasparini, "A Distribution in Motion: The Case of Argentina," (Working Paper 0078, Centro de Estudios Distributivos, Laborales y Sociales, Universidad Nacional de La Plata, Argentina, November 2008).

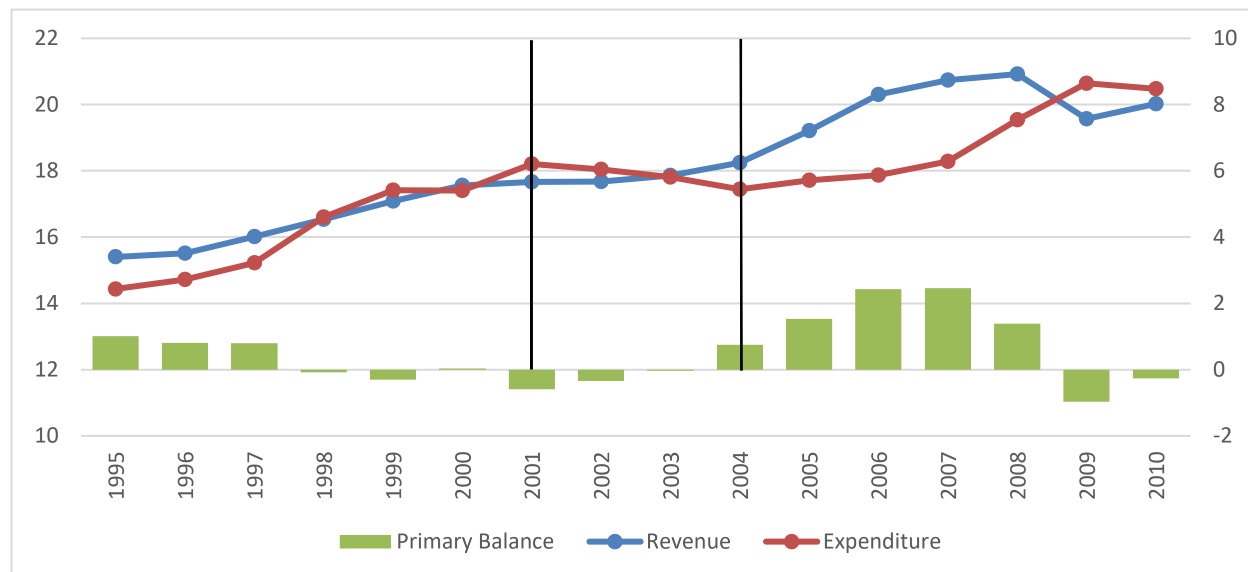
[33] N. Lustig, "El impacto del sistema tributario y el gasto social en la distribución del ingreso y la pobreza en América Latina: Bolivia, Brasil, Chile, Colombia, Costa Rica, Ecuador, El Salvador, Guatemala, México, Perú y Uruguay," [The Impact of the Tax Distribution and Social Spending on Income Distribution and Poverty in Latin America: Bolivia, Brasil, Chile, Colombia, Costa Rica, Ecuador, El Salvador, Guatemala, Mexico, Peru and Uruguay], (Working Paper 37, Commitment to Equity Institute, Uruguay, May 2016).

[34] Cornia, Gómez-Sabaíni, and Martorano, "A New Fiscal Pact."

[35] J. A. Ocampo and R. Vos, "Policy space and the changing paradigm in conducting macroeconomic policies in developing countries," in *New Financing Trends in Latin America: A Bumpy Road toward Stability* (BIS Papers No. 36, Bank for International Settlements, Basel, Switzerland, February 2008), http://www.bis.org/publ/bppdf/bispap36c.pdf.

American countries the opportunity to respond strongly to the recent economic crisis by introducing the necessary measure for promoting the economic recovery and protecting the most vulnerable groups.[36]

FIGURE 3. FISCAL INDICATORS (% OF GDP), BETWEEN 1995 AND 2010



Source: author's elaboration on Martorano (2014) and CEPALSTAT data

4. TAX EXPENDITURES

4.1 THE RECENT EVOLUTION OF TAX EXPENDITURES

Tax expenditures are policy tools that governments may use to achieve different economic or social goals. However, there is no general consensus on the definition of tax expenditures. For example, in Canada they are defined as deviations from the benchmark tax system, and in Japan as "Special Tax Measures" taking exception to the fundamental objective of taxation, i.e., equity, neutrality, and simplicity. In a recent Inter-American Development Bank (IDB) report, tax expenditures are defined as "foregone revenue since they can be considered as the way by which the treasury desists, either partially or totally, from applying the general tax regime to pursue a higher objective of political economy or social policy."[37] In other words, tax expenditures are referred to as the differences between the levels of (potential) revenue related to the tax law structure and the effective amount paid by taxpayers after including deviations from the law. Therefore, they might be considered losses resulting from a differential or preferential treatment of specific taxpayers, activities, sectors, or areas.

[36] Martorano, "Taxation and inequality," (2016).

[37] L. Villela, A. Lemgruber, and M. Jorratt, "Tax expenditures budgets: Concepts and challenges for implementation," (Working Paper Series No. IDB-WP-131, Inter-American Development Bank, Washington, D.C., 2010), 2.

However, the most important problem in the definition of tax expenditures is related to the benchmark against which reductions or exemptions in tax payment obligations can be contrasted. As a consequence, cross-country comparison is quite difficult due to the fact that the quantification of tax expenditures may be completely different according to the alternative methodologies adopted. Obviously, this calls for a standardization of the definition of tax expenditures, which would be very important to advancing understanding of tax expenditures and developing proper international comparisons. In addition, the information that is available on tax expenditures is not enough, especially in developing countries. For example, in Latin America, the first public document was released in Brazil in 1989 (Table 5). In 1998 the International Monetary Fund (IMF) published the first version of the *Manual on Fiscal Transparency*, which included a definition. Over the same period other international organizations started to focus their attention on tax expenditures, trying to analyze and quantify their size. Particular effort was dedicated by the Inter-American Center of Tax Administrations (CIAT), which has established a monitoring of the evaluation of the tax expenditure levels in Latin American countries.

TABLE 5. OFFICIAL MEASUREMENTS AND DATA RELEASED ON TAX EXPENDITURES

	Year in which measurements were institutionalized	Tax expenditure report attached to project budget	Tax expenditure reports are public available
Argentina	1999	Yes	Yes
Bolivia	2013	No	Yes
Brasil	1989	Yes	Yes
Chile	2001	Yes	Yes
Colombia	2004	Yes	Yes
Costa Rica	2011	No	Yes
Ecuador	2010	Yes	Yes
El Salvador	2013	No	No
Guatemala	2002	Yes	Yes
México	2002	Yes	Yes
Paraguay	2015	Yes	Yes
Perú	2002	Yes	Yes
Rep. Dominicana	2008	Yes	Yes
Uruguay	2008	No	Yes

Source: National tax offices and Inter-American Center on Tax Administrations - CIAT, https://www.ciat.org/.

Tax expenditures could take several forms. For example, the IMF's 2001 *Manual on Fiscal Transparency* reports that: "tax expenditures include exemptions from the tax base, allowances deducted from gross income, tax credits deducted from tax liability, tax rate reductions, and tax deferrals (such as accelerated depreciation)."[38]

As policy tools, tax expenditures are intended as useful instruments to achieve several objectives. For example, policymakers could use tax expenditures to provide incentives to agents, firms, sectors, and regions, as well as to attract direct foreign investments.[39] In particular, fiscal concessions could be used as industrial policy tools to enhance investment in key sectors believed to be crucial for development. In other cases, fiscal incentives may be used to promote savings via reductions of tax rates on financial income, financial interest exemptions, or tax base reductions for savings in selected financial tools. Tax expenditures may be designed to promote the consumption of goods or services, which are considered "meritorious," i.e., cultural activities, education, health, housing, or sporting activities. Exemptions, reduced (VAT) rates, or deductions from the taxable base are the typical mechanisms used for this purpose. Lastly, tax expenditures can also be designed to increase the progressivity of tax system. The objective, in this case, is to reduce the tax burden for families with low incomes. For example, introducing some tax exemptions for goods or services that accounted for a large part of poor families spending, i.e., goods included in the basic food basket.

4.2 TAX EXPENDITURES IN LATIN AMERICAN COUNTRIES

In 2012 the impact of tax expenditures in Latin American countries was, on average, close to 4.5 percent of GDP. As explained by Gomez-Sabaini and Moran, "Central America, in general, displays the greatest weaknesses in terms of both the high level of tax expenditures in the countries and the absence of regular, precise measures of the magnitude and composition of the concessions, which would provide the basis for an accurate assessment and analysis of their functioning and utility."[40] Indeed, tax expenditures were higher than 6 percent of GDP in Central American countries (Table 6). In particular, tax expenditures were 6.7 percent of GDP in Guatemala and around 6.5 percent in Honduras. Tax expenditures were also higher than 6 percent of GDP in Uruguay and higher than 4 percent of GDP in such countries as Chile, Ecuador, and Mexico.

However, it is necessary to highlight that, in some cases, these values are affected by the methodological discrepancies in how countries are measuring the impact of tax expenditures. In Chile, for example, these costs include the "estimate deferments deriving from the difference between the marginal corporate income tax rate

[38] Similarly, the OECD confirms that they could take several forms, such as tax base deductions (allowances), deduction in the forms of tax liability (credits), postponing or delaying tax payment (deferrals), tax base exclusions in terms of revenue or transactions (exemption), rates lower than the general rate (rate relief). See OECD, "Tax Expenditures. Reccent Experiences," (Paris: OECD, 1996).

[39] Villela et al., "Tax expenditure budgets."

[40] Gómez-Sabaíni and Morán, "Tax Policy in Latin America," (2014), 62.

and the top personal income tax rate applied to distributed dividends."[41] Excluding these, tax expenditures would be lower than the majority of the Latin American countries, namely almost 2 percent of GDP. Finally, Paraguay and Peru are the two countries in Latin America with the lowest level of tax expenditures (lower than 2 percent of GDP). Some additional statistics are related to the share of tax expenditures as a share of total tax revenue. As explained in a 2014 study by Gomez-Sabaini and Moran, tax expenditures represent a low share of total tax revenue in such countries as Argentina, Brazil, and Peru (around 10 percent), while they make up one third of total tax revenue in countries with a low capacity of tax mobilization, such as Central American countries.

TABLE 6. TAX EXPENDITURES AS A PERCENT OF GDP IN LATIN AMERICAN COUNTRIES

Country	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Argentina	2.21	2.11	2.2	2.14	2.08	1.99	2.47	2.52	2.49			
Brazil	1.69	1.99	2.29	2.77	3.2	3.42	2.98	3.22	3.42			
Chile	4.38	4.05	4.88	5.3	5.08	5.01	5.09	4.45	4.93	4.32	4.52	4.2
Colombia	3.7	3.96	3.52	3.2	3.15	3.2	3.65	3.41	-			
Costa Rica						5.54	5.52	5.62				
Dominican Rep				6.41	6.24	5.5	5.11	5.13				
Ecuador					4.22	4.17	4.67	4.86		4.1		
El Salvador						3.4						
Guatemala								6.7	2.6	2.5	2.5	
Honduras							6.18	6.45			6.7	6.5
Mexico	6.32	5.59	5.38	5.67	3.87	4.29	5.15	4.99	3.87			
Panama								2.27				
Paraguay				1.92	1.82	1.9			1.73	1.92		
Peru	2.07	2.24	2.22	2.05	1.81	2.13	2.04	1.94	-			
Uruguay	4.39	4.23	4.3	5.67	5.69	6.31	6.31	6.4	-			

Source: The majority of data are from Gomez-Sabaini and Moran (2014); data on Chile are from Chile Subdirección de Estudios Servicio de Impuestos Internos (2015); data on Costa Rica, the Dominican Republic, Ecuador, El Salvador, Honduras, Panama are from M. Trigueros, "Gastos tributarios en América Latina: 2008-2012," (Documento de Trabajo No. 2-2014, Dirección de Estudios e Investigaciones Tributarias, Inter-American Center on Tax Administrations - CIAT, Panama City, Panama, March 2014); data on Ecuador 2014 are from Departamento de Estudios Tributarios - Centro de Estudios Fiscales (2015); data on Paraguay are from SET and CIAT, "Estimación de los Gastos Tributarios en la República del Paraguay 2013 -2016," (GIZ / CIAT / SET, 2015), https://ciatorg-public.sharepoint.com/biblioteca/Estudios/2015_estimacion_gasto_tributario_paraguay_giz_set_ciat.pdf.

Looking at the evolution of this trend, it is possible to observe that tax expenditures remained stable in the majority of the countries with data available. In contrast, they decreased by around 4 points in Guatemala, from 6.7 percent to 2.5 percent from 2012 to 2015. This could be related to the effects of the 2012 Tax Reform, which sought to reduce exemptions and deductions. Tax expenditures increased in Brazil from 1.7 percent in 2005 to 3.4

[41] Ibid., 63.

percent in 2013, as a consequence of the incentives introduced in relation to the 2014 World Cup and the 2016 Olympics. Moreover, tax expenditures increased in Uruguay from 4.4 percent in 2005 to 6.4 percent in 2012, as a consequence of the effects of the 2007 tax reform which introduced some benefits in relation to the new personal income tax (PIT).

Tax expenditures are mainly concentrated in VAT and income taxation (Table 7). Almost all countries have introduced a lower VAT rate on certain kinds of goods, such as basic goods. In 2012 tax expenditures related to VAT represented around 2 percent of GDP. Their share was particularly high in Argentina, Costa Rica, Dominican Republic, Ecuador, El Salvador, Honduras, Paraguay, and Peru. On the other hand, concessions related to taxation on income represented less than 2 percent of GDP. However, their impact was particularly high in countries like Chile (3.62 percent of GDP) and Guatemala (5.9 percent of GDP).

TABLE 7. TAX EXPENDITURES BY TYPE OF TAX, AROUND 2012

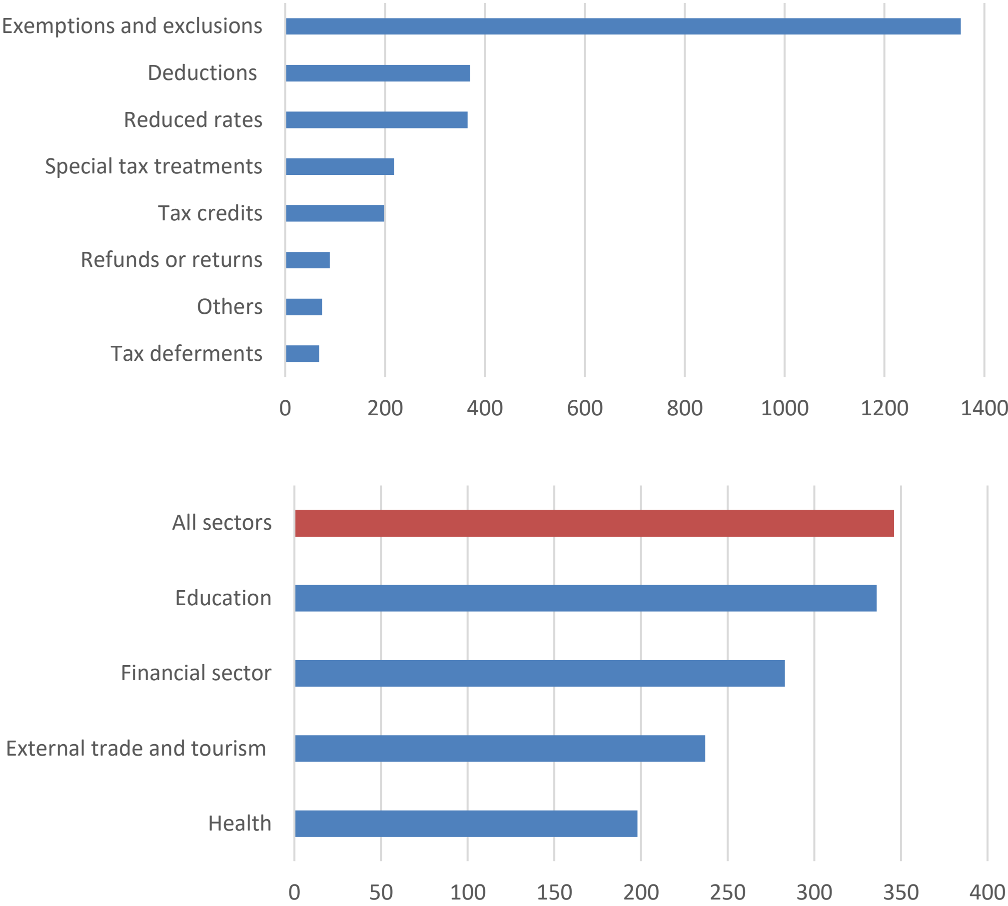
	VAT	**Income taxes**			**All other taxes**	**Total**
		Corporation	*Individual*	*Total*		
Argentina	1.17			0.56	0.78	2.51
Brazil	0.48	0.69	0.7	1.39	1.35	3.22
Chile	0.83	0.85	2.77	3.62		4.45
Colombia	2.51	0.6	0.3	0.9		3.41
Costa Rica	3.54	0.8	1.02	1.82	0.28	5.64
Dominican Rep.	3.23	0.42	0.1	0.52	1.37	5.12
Ecuador (2014)	2.13	1.3	0.7	1.94	0.1	4.17
El Salvador (2010)	1.97	n.d.	n.d.	1.42		3.39
Guatemala (2015)	1.50	n.d.	n.d.	0.70	0.30	2.5
Honduras (2011)	3.44	0.96	0.95	1.91	1.64	6.99
México	1.53	1.39	0.84	2.23	1.23	4.99
Paraguay (2014)	1.36	0.22	0.13	0.35	0.2	1.91
Perú	1.32	0.22	0.15	0.37	0.24	1.93
Uruguay	2.95	1.66	0.63	2.29	1.16	6.4
Average	***2.03***	***0.83***	***0.75***	***1.80***	***0.81***	***4.47***

Source: the majority of data are from Gomez-Sabaini and Moran (2014). Data on Costa Rica and El Salvador are from Trigueros (2014); data on Ecuador are from Departamento de Estudios Tributarios - Centro de Estudios Fiscales (2015); data on Guatemala are from Departamento de Estudios, Análisis y Estadísticas Tributarias – GPD (2015); data on Paraguay are from SET and CIAT (2015)

Figure 4 shows some useful information about tax expenditures implemented in Latin American countries from 2008 to 2012. The most important expenditures took the form of exemptions, exclusions, deductions, and reduced rates, while they concentrated mainly on the education, finance, trade, and health sectors. Tax concessions in the

trade, education, and health sectors were mainly in the form of VAT exemptions. In contrast, they took the form of exemptions on PIT in the case of the financial sector.

FIGURE 4. TAX EXPENDITURES IMPLEMENTED OVER THE PERIOD 2008-2012; FORM OF CONCESSIONS (PANEL A) AND KINDS OF TAXES (PANEL B)



Source: Author's elaboration on CIAT data

4.3 THE CONSEQUENCES OF TAX EXPENDITURES FOR INEQUALITY

As reported above, one of the policy objectives pursued by policymakers through tax expenditures is equality. Unfortunately, there are only few works that analyze the distributional consequences of tax expenditures. In the remainder of this section we present two representative cases.

The first one refers to the distributional implications of tax expenditures related to PIT in Ecuador. Table 8 shows that taxpayers at the top of the income distribution benefitted from concessions that reduced their effective tax rate. In particular, the winners are clearly the highest two deciles, considering that they benefit from about 94 percent of the total concessions. These expenditures represent nearly 5 percent of total revenue and 0.7 percent of GDP. A SII's (*Servicio de Impuestos Internos*) analysis from 2005 shows a similar scenario in Chile, with the richest quintile benefitting from around 98 percent of total tax expenditures.[42] Obviously, these concessions tend to make the tax system more regressive.

TABLE 8. ECUADOR, TAX EXPENDITURE ON PERSONAL INCOME TAX PER DECILE, 2014

	Percentage of total	**Percentage of total revenue**	**Percentage of GDP**
1	0	0	0
2	0	0	0
3	0	0	0
4	0	0	0
5	0	0	0
6	0	0	0
7	0	0	0
8	5	0	0
9	21	1	0.2
10	74	4	0.5
	100	***5***	***0.7***

Source: Ministerio de Finanzas, "Programacion presupuestaria quadrianal, 2016 – 2019," (Quito, Ecuador, 2015).

The second study analyzes the incidence of tax expenditures related to the VAT in Colombia. Table 9 reports that the average VAT share by consumption and income deciles, including or excluding tax expenditures. Overall, Table 9 shows that the VAT is regressive — as expected. In particular, the VAT represents 17 percent of the income of the poorest decile and 10 percent of the income of the second poorest decile. In contrast, it represents nearly 6 percent and of the ninth and only 4 percent of the tenth decile. As a result, VAT makes the income distribution less equal, as shown by the 1.2-point increase recorded by the Gini coefficient after taxes. Yet the same table shows that the impact of the VAT could be even more regressive if we exclude the tax expenditures. In particular, the effect of the VAT on the income of the poorest decile would increase from 17 to 24 percent, while it would increase by less than two points for the income of the highest decile, leading to a further increase of the Gini coefficient by 0.5 points.

[42] "Gasto Tributario 2014 – 2016," (Subdirección de Estudios Servicio de Impuestos Internos, Chile, September 2015), http://www.sii.cl/aprenda_sobre_impuestos/estudios/gasto_tributario_2014_2016.pdf.

TABLE 9. COLOMBIA: VAT INCIDENCE

	Consumption		**Income**	
	VAT	*VAT without tax expenditures*	*VAT*	*VAT without tax expenditures*
1	3.8	4.0	17.3	24.3
2	4.5	4.7	10.0	13.9
3	5.6	5.7	9.1	12.2
4	6.3	6.3	8.3	10.9
5	7.1	6.9	7.5	9.7
6	8.5	8.2	7.4	9.6
7	10.1	9.7	7.2	9.2
8	12.3	12.0	7.0	9.0
9	14.9	14.8	6.2	8.2
10	27.0	27.9	4.7	6.5
Total	100.0	100.0	6.5	8.6
Gini before VAT		***0.577***	***0.577***	***0.000***
Gini after VAT		***0.586***	***0.591***	***0.005***

Source: M. Jorratt, *Diagnóstico de la estructura tributaria de Colombia y propuestas de reforma tributaria*, (Inter-American Development Bank, Washington, D.C., 2010).s

5. CONCLUSIONS AND POLICY RECOMMENDATIONS

Tax systems in Latin America have experienced important changes during the last several decades. Until the 2000s governments preferred to implement revenue-enhancing reforms, placing redistribution in a subordinate role. As a result, the rise in tax revenue recorded in the 1990s was mainly driven by the increase in the contribution of indirect taxes, especially VAT. Recently, governments have come back to highlight the redistributive role of taxation. In contrast to previous decades, the increase in tax revenue was driven by the growing contribution recorded by direct taxes and, in particular, personal income taxes. While in the past taxation had a neutral or regressive impact on income distribution, empirical evidence shows that the recent tax changes have contributed to the reduction of inequality in the last two decades. Overall, the experiences of Latin American countries confirm that it is possible to create a tax system to promote revenue mobilization and equality, even in developing countries.

Yet many factors still limit the redistributivity of tax institutions in the region. Indirect taxes dominate the tax systems of Latin American countries: while in OECD countries they contribute around 40 percent of the total tax revenue, in Latin America they contribute more than 60 percent. The contribution of indirect taxes decreased in the 2000s, mainly because the reduction in the contribution of taxes on specific goods and services, as well as

taxes on international trade and transactions. Yet the contribution of general taxes on goods and services is still growing, signaling the central role played by VAT in tax policy for governments in Latin American countries. By contrast, governments should increase the contribution of direct taxes, which are lower than the international norm. While countries with a high tax/GDP ratio could promote a balance between direct and indirect taxes, countries with a low tax/GDP ratio should use direct taxes to mobilize additional revenue to catch up with the international standard. Indeed, the vast majority of Latin American countries — especially Andean and Central American ones — have a lower tax/GDP ratio than other countries across the world with the same characteristics. Excluding Argentina, Brazil, and Nicaragua, this gap might be as high as 5.5 points of GDP.[43] By closing this gap, governments will also have more fiscal room to boost economic development and finance social spending.

Recent studies have demonstrated that there is still room to increase top rates on personal income without producing negative consequences in terms of efficiency.[44] Another important limitation is related to the taxation of capital income. As explained by Tanzi, "it is not clear how much truth there is in the assertion that an increase in the taxation of dividends, interest incomes, rents, capital gains and profits would lead to a (greater) emigration of capital."[45] The dual tax system, through a relatively low flat tax rate on the capital income, could represent a good solution, as demonstrated by some South American countries. However, a more powerful strategy could be represented by greater international and/or regional tax coordination.

Lastly, governments should promote revenue mobilization and progressivity by increasing the contribution of property taxation, above all on real estate. Its share on total tax revenue is still low due to the presence of low tax rates, exemptions, and several administrative weaknesses, as well as the historical opposition from the economic elite with strong ties to political power.

Beyond that, a vigorous and effective prosecution of tax evasion should represent a priority for all countries in Latin America. Tax evasion is still high in many parts of the region, especially in Central America. During the past years, governments have been able to introduce some more pragmatic policies to reduce informality or special regimes for hard-to-tax activities. Administrative improvements have been very useful in enhancing tax capacities and reducing tax evasion in the region. Governments should continue to promote administrative improvements and also continue to favor the adoption of new technologies for enhancing tax revenue mobilization.

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[43] Cornia, Gómez-Sabaíni, and Martorano, "A New Fiscal Pact."

[44] CEPAL and IEF, "Los efectos de la política fiscal sobre la redistribución en América Latina y la Unión Europea," (Colección Estudios no. 8, EUROsociAL, Madrid, Spain, 2014), http://www.sia.eurosocial-ii.eu/files/docs/1412088027-Estudio_8_def_final.pdf. B. Martorano, "From Volatility to Stabilization: Cyclicality of Fiscal Policy in Latin America over the Last Decades," (Working Paper No. 07/2014, Working Papers – Economics, Universita' degli Studi di Firenze, 2014).

[45] V. Tanzi, "Foreword: Tax System and Tax Reforms in Latin America," in *Tax Systems and Tax Reforms in Latin America*, ed. L. Bernardi et al., (Working Paper No. 591, Società Italiana di Economia Pubblica, University of Pavia, Italy, April 2007), 10.

An important issue is related to tax expenditures. There is a growing consensus that they are not useful in promoting economic growth, and do not improve either horizontal or vertical equality. In particular, tax expenditures introduce economic distortions, which in turn affect the functioning of economic systems. Moreover, tax expenditures increase horizontal inequality because taxpayers in similar circumstances are treated differently according to specific deviations from the law. Tax expenditures also affect vertical inequality due to their impact on the different parts of the income distribution. As shown above, tax expenditures in personal income taxes are regressive by nature; this is due to the fact that the tax burden is higher for rich taxpayers under a progressive tax scheme. Therefore, any concession in taxable income will benefit only a small share of people, usually the better off in society. Also, tax concessions on services or goods considered meritorious tend to increase the regressivity of the tax system. Indeed, "they relate to goods and services that are preferentially consumed by households with greater income. In the case of education and health care, for example, the households with the lowest income accede to free services provided by the state, which means that the tax expenditure is concentrated on the higher quintiles."[46] The only exception could be related to exemptions on basic goods and services considering that a good tax system does not have to tax poor people. Yet rich taxpayers also benefit from these tax concessions; the same equality goals could be better achieved through social protection programs.

In addition, tax concessions could generate some problems in terms of administration, especially in developing countries. The implementation of a large number of exceptions to the rule tends to increase the complexity of a tax system and to reduce the capacity of control over the system.[47] Greater uncertainty related to the correct interpretation of tax laws may generate room or opportunities for taxpayers to manipulate their tax payments. Tax expenditures do not require a legislative review and are out of the responsibility of any functional agency, in contrast to spending programs, which are scrutinized in every budget cycle. Furthermore, the use of tax expenditures could generate a situation in which interest groups try to defend their positions. As a result of these factors, we could see an increase in tax evasion and avoidance, as well as corruption.

Overall, taxation is not an arithmetical exercise. As with other policies, taxation must be credible with predictably contained; indeed, uncertainty risks increasing the contrast between different groups of interests, as well as social and political instability. Linking taxation to development goals and benefits could be a crucial ingredient for the successful implementation of a new tax reform. However, increasing tax payments should avoid funding government waste and ensure that policy meets the expectations of taxpayers in terms of the quantity and quality of public services.

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[46] Villela et al., "Tax expenditure budgets," 8.

[47] J. Slemrod, "Complexity, Compliance Costs, and Tax Evasion," in *Tax Payer Compliance: Social Science Perspecti*ves, ed. J. Roth and J. Scholz (Philadelphia, Pennsylvania: University of Pennsylvania Press, 1989).

ANNEX 1: TAX REFORM RECOMMENDATIONS FROM THE INTERNATIONAL FINANCE INSTITUTIONS

TYPE OF TAXES	SUGGESTION
INCOME TAXES	- rationalize multiple tax schedules into one or as few as possible
	- reduce the number of marginal rates applicable
	- raise the lowest marginal rate threshold but remove assorted exemptions and deductions
TRADE TAXES	- convert QRs to tariffs
	- reduce the range of tariffs
	- reduce the average nominal tariff
	- restructure tariffs to rationalize effective protection anomalies
	- eliminate or reduce export taxes
DOMESTIC INDIRECT TAXES	- introduce broad-based sales taxes (usually VAT) at a single rate (plus zero and possibly “luxury” rates)
	- remove “tax cascading” in existing sales taxes
	- remove taxes on intermediates
	- set sales tax and tariffs at same or similar rates
	- narrow the excise base; reduce excessively high rates (e.g., restrict excises to “sin taxes” - alcohol, tobacco, etc.)
PROPERTY TAXES	- rationalize (e.g., update property tax base) or remove
GENERAL	- increase revenue/GDP ratio
	- reduce budget deficits
	- improve tax administration

Source: M. Gemmell and O. Morrissey, “The Poverty Impacts of Revenue Systems in Developing Countries. A Report to the Department for International Development,” (Department for International Development, London, UK, 2002).