DEBATES

Tax Policy Changes and Income Inequality in Latin America: Evidence from the Last Decade

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Taxation Approaches During the 1980s and 1990s

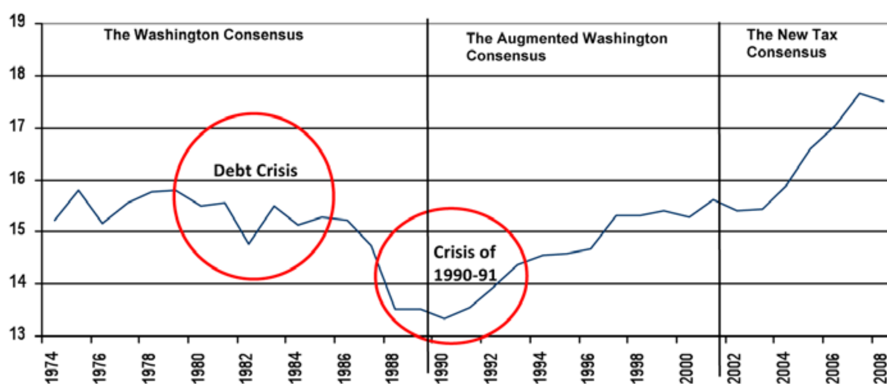
During the 1980s and 1990s, the many neoliberal regimes that ruled Latin America introduced important tax policy changes focusing on the reduction or abolition of direct taxation and the replacement of taxes on international trade with domestic consumption taxes. As a result of these and other policies, and of the crisis that affected the region during this period, the average tax/GDP ratio fell markedly (Figure 1) while GDP growth and inequality worsened (Cornia 2010). Since the late 1990s, however, and particularly since 2002, new policies started to be adopted in the field of taxation. These new measures assigned a greater role to direct and other forms of progressive taxation, reduced regressive excises and, thanks also to improved growth conditions and higher export prices, generated a substantial rise in the regional tax/GDP ratio (Figure 1).

Political Shifts and a New Fiscal Pact

Among the factors explaining the recent shift in tax policy, political changes certainly play a key role. The return to democracy during the 1990s did not, by itself, generate better distributive outcomes, as the traditional elites maintained a prominent role at all levels of government thanks to their usual practices of clientelism, personalism and patronage. However, the majority of the population—including a part of the middle class that traditionally supported conservative parties— grew increasingly disappointed with the slow growth, rising inequality and cuts in social spending of those years and shifted its support to leftist parties more sensitive to distributional issues (Panizza 2005). As noted by Roberts (2012), such a shift was less the result of an ideological realignment of the Latin American population than of retrospective, performance-based economic voting. The shift was also helped by the revival of popular movements and social protests in a number of countries, often with new collective actors—unemployed workers, indigenous groups, and territorially based community organizations—coming to play a far more important role than in the past.

FIGURE 1

Trend in the Average Tax/GDP Ratio in Latin America, 1973 to 2009



Source: IMF data and CEPALSTAT.

The regimes that have arisen on the left are quite varied. Some of them are social democratic, as is the case of Brazil's Partido dos Trabalhadores, and have their roots in organizations of the working class. They have generally evolved into broad coalitions comprising sectors of business and the middle classes, the urban and rural poor, the unemployed and informal-sector workers. In contrast, radical left-populist regimes, which also favor the redistribution of assets nationally and internationally, now dominate the scene in countries such as Venezuela, Bolivia and Nicaragua.

Generally, while the new leftist governments adopted policies more sensitive to the issues of poverty and inequality, they also emphasized the achievement of orthodox objectives such as macro-stability and low inflation—though these objectives were often reached by means of approaches quite different from the past ones. With respect to fiscal policy, the new governments weakened the vicious cycle linking an excessive concentration of power to a lack of legitimacy in tax collection. The new "fiscal pact" established between the state and its citizens made higher taxation acceptable due to the broadening of the political decision-making process and a substantial improvement in the quantity, quality and progressiveness of social services provided by the state.

Tax Policy Changes During the 2000s

Since the early 2000s, taxation has evolved in a pragmatic way towards greater

progressivity and efficiency. Income tax policies, in particular, have undergone a number of changes. For instance, the 2007 Uruguayan tax reform pivoted around a progressive personal income tax. In Ecuador, the 2008 tax reform introduced a progressive income tax, and similar measures were introduced in Peru (in 2009) and other countries. Most governments also eliminated or reduced a long list of tax deductions and tax holidays that were found to produce minimal benefits while causing substantial revenue losses.

As these measures hardly affected the informal sector, new forms of politically feasible taxation were introduced, including a simplified presumptive taxation (as in the case of Brazil's *Simples*), which replaced several taxes and was levied on an estimate of taxable income made on the basis of the level of economic activity. Several countries (including Brazil, Venezuela, Mexico and Argentina) also introduced a surrogate tax on financial transactions as a second-best tool to improve revenue collection on assets and rents, which would otherwise remain untaxed. No changes were introduced in the field of trade taxes, property taxation or in the VAT. However, several governments made a greater use of progressive indirect taxes, as in the case of Ecuador's *Impuesto a los Consumos Especiales*, a tax on luxury items introduced in 2008, and reliance on highly regressive excises diminished.

Lastly, many countries adopted reforms to lower the cost of tax collection, reduce evasion, and ensure greater accountability and independence of revenue authorities. These objectives were achieved through a functional rationalization, standardization and specialization of tax administration, and the creation of semi-autonomous revenue authorities. Moreover, special units were created for large and small taxpayers, while standardized withholding was implemented more broadly; the equipment was modernized and the staff was increasingly selected on the basis of merit criteria.

Impact of the Recent Tax Changes

The tax changes introduced during the last decade affected economic growth by improving macroeconomic stability, equity and the provision of public goods. Indeed, the three percent average increase in the tax/GDP ratio achieved over 2002-2009 (Figure 1) appears to have raised the growth rate of GDP by between 0.3 and one percent, contradicting in this way the claims about the supposed efficiency costs of taxation (Cornia et al. 2011). In addition, although taxation in Latin America played a modest or even negative equalizing role until recently, the new tax policies directly affected the distribution of post-tax, pre-transfer income by reducing income inequality by almost one Gini point. It did this while generating precious revenue to increase public expenditure on human capital. Indeed, the Reynolds-Smolensky index, which measures the redistributive impact of tax systems, improved significantly in all countries with available data, though taxation remained regressive in El Salvador, Colombia, Honduras and the Dominican Republic (Cornia et al. 2011).

Limitations of the Recent Tax Reforms and Options for Further Action

While important, the recent tax policy changes need to be intensified in the years ahead, as taxation remains inadequate and regressive, especially in Central America. First of all, in twelve out of eighteen countries of the region the effective tax/GDP ratio is considerably lower than the potential one. Thus, raising the effective tax/GDP ratio to its potential level would generate an important revenue increase in most of the region. Second, making taxation more equitable requires strengthening direct taxation, while reducing the weight of the indirect taxes which still dominate revenue collection. A comparison with other regions suggests there is further room for doing so (Cornia et al. 2011, Figure 11). The increase in direct taxation needs to focus specifically on personal incomes, as at the moment only 10 to 15 percent of the population pays such tax. Reducing this imbalance depends, of course, on the expansion of the formal sector, but also requires ad hoc measures to reduce tax exemptions on capital incomes, and greater use of indirect methods to ascertain the taxable incomes of relatively well-off informal sector and independent workers.

Third, a sizeable reduction in tax evasion constitutes an obvious element of any approach aiming at improving tax equity. A first step in this regard consists in reducing further the exemptions granted during the 1980s and 1990s to attract foreign investments. A second step consists in promoting the registration of informal firms, introducing special regimes for hard-to-tax activities and VAT collection from large firms. In addition, greater emphasis should be placed on the internal efficiency, effectiveness and staffing of tax administrations. Finally, and most importantly, governments have to further strengthen their legitimacy in tax collection by placing a greater emphasis not only on raising additional revenue but also on an expanded, equitable and high-quality provision of public goods.

Conditional Cash Transfer Programs: Assessing their Achievements and Probing their Promise

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Since the mid-1990s, social policies geared at poverty alleviation in Latin America have undergone a significant transformation. Conditional cash transfer (CCT) programs now represent an important pillar in the new paradigm of social protection in the region. Following the widespread enactment of piecemeal safety-net programs that complied with the fiscal austerity of neoliberal economic restructuring, governments in Latin America more recently have adopted strategies aimed at alleviating poverty in the short term and breaking the transmission of intergenerational poverty in the long term. Many countries have also sought to empower women and girls by targeting mothers as program beneficiaries and by allocating greater resources to daughters. In general, CCTs target cash assistance to poor and indigent families provided that their children adhere to behaviors thought to enhance human development, such as attending school regularly and engaging in preventive health care practices, including receiving the core childhood vaccinations. Additional "co-responsibility" requirements vary across the region; some CCTs require parenting classes, prenatal care for mothers, and even breastfeeding.

Mexico's federal PROGRESA and Brazil's municipal Bolsa Escola (school grant) were among the first CCTs to be implemented and to win international acclaim for innovative program designs in the mid-1990s. Since then, CCTs have spread throughout Latin America and the Caribbean at a remarkable pace.[1] Eighteen countries have now adopted such programs.[2] To put this trend in perspective, over twenty-five million families (about 113 million people) or 19 percent of the regional population participates in CCTs.[3] Depending on the program, cash transfers represent between roughly eight percent and 33 percent of household income. The money can be significant enough to put families who live in utter destitution above the level of indigence.[4] There is, however, great variation in the size, scope, and degree of institutionalization of CCTs across countries. Such programs differ significantly in whether or not they enjoy stable funding, are guided by a national plan with provisions for evaluation, and are constrained by a legal framework that specifies mandates and responsibilities.

There are a number of positive outcomes generally associated with CCTs. Several studies have found that most income-subsidy programs have alleviated poverty, increased school enrollment and attendance, promoted the utilization of health services, and led to better nutritional outcomes.[5] Some CCTs have even contributed to lowering economic inequality by raising incomes among the poorest segments of society.[6] An additional downstream benefit concerns the identity documents that such entitlements have motivated many poor people to obtain; these are not only necessary to enroll in CCTs but also confer rights and social protection of other types.[7] What's more, CCTs have produced all of these benefits in a very cost-effective fashion. In the context of total social spending, the amounts allocated to CCT programs generally make up a small percentage of GDP—between roughly 0.4 percent and 0.8 percent.[8] Given the small share of money involved, the positive results associated with CCTs are quite striking. In any event, because most cash transfers are designed to focus resources sharply on the poor, they are widely deemed by economists and development practitioners to be more efficient than many other programs, such as food subsidies.