

EXECUTIVE
SUMMARY

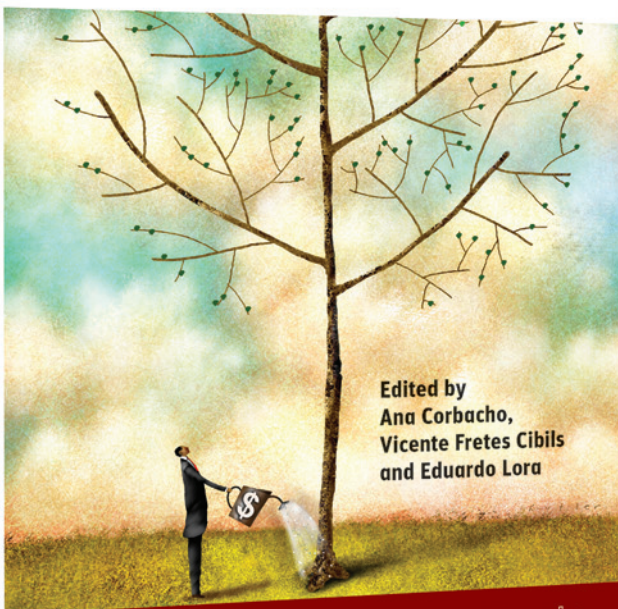
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More than Revenue

TAXATION AS A DEVELOPMENT TOOL

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Edited by
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DEVELOPMENT IN THE AMERICAS



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Inter-American Development Bank

The Development in the Americas (DIA) series is the flagship publication of the Inter-American Development Bank (IDB). Each year the IDB presents an in-depth comparative study of an issue of concern to Latin America and the Caribbean.

This year's edition, titled *More than Revenue: Taxation as a Development Tool*, presents taxation in Latin America and the Caribbean as a missed opportunity. The book argues that taxation in Latin America is largely viewed as a means of generating income to keep the government in business. It lauds the region for progress made in increasing total revenue but notes that most countries in the region still lag well behind other countries with similar levels of development. More importantly, Latin American policymakers have not taken advantage of the potential of taxation to contribute to other important development goals. The weakness of the personal income tax structure has squandered the opportunity to attack the region's serious income inequality. In addition, governments have repeatedly missed the chance to influence consumption and production patterns by using taxes to effect relative price changes.

This executive summary presents the argument for using taxation as a development tool rather than simply a source of revenue. It also touches on some of the problem areas in tax systems including evasion, regressive personal income tax structures, and the failure to use taxes to improve environmental quality and general well-being. Together, this summary and the table of contents of the book provide just a taste of the rich information and valuable policy implications that distinguish this year's edition of the DIA.

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To order *More than Revenue: Taxation as a Development Tool*
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Taxation as a Development Tool

Notable progress has been made in the quality and effectiveness of fiscal policies in Latin America and the Caribbean. Recent growth of tax revenues in the region has been the fastest in the world. However, the region still has a long way to go and most countries' systems are far from exhausting their revenue potential. Moreover, taxation should do more than provide revenue; indeed, it should be designed as a powerful tool for stimulating development. Existing tax structures in Latin America and the Caribbean do not meet this objective.

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. 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. 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 effective tax bases and resulting in low levels of revenue.

This description is not very encouraging, but fortunately it does not do justice to the current state of taxation in the region. True, tax collection is low relative to the per capita income levels of countries. However, the tax burden has increased more in Latin American and Caribbean countries than anywhere else in the world: by 2.7 points of GDP from the early 1990s to the second half of the 2000s. This significant increase in the tax burden has occurred in almost all Latin American and Caribbean countries. Moreover, tax increases have taken place across all tax sources, with the exception of taxes on international trade and excise duties.

“ *More than Revenue* is the encyclopedic output of a large team of Latin American experts that has turned every possible stone to assess why Latin America has not been more successful in creating efficient, productive and equitable tax systems. The reader will be enlightened by interesting results and surprised by not always obvious hypotheses. The book will become a monument to Latin American taxation. ”

—Vito Tanzi, Former Director
Fiscal Affairs Department, International Monetary Fund

In addition, Latin American tax administrations have become stronger in the past two decades. To a greater or lesser extent, they have been given technical and budgetary autonomy, their staffs have been professionalized, their collection function has been beefed up, and they have extensively adopted new information technologies. Nevertheless, large deficiencies in the enforcement of tax obligations remain, helping explain evasion rates of personal and corporate income taxes that average about 50 percent in the 10 countries for which information is available. However, the blame for evasion may be misplaced. Although citizens’ attitudes and administrative inefficiency affect evasive practices, the design of taxes carries much of the blame.

All told, since the 1990s, Latin American and Caribbean governments have made great strides in addressing the challenges faced by their tax systems. Although deficiencies have not been completely remedied, progress has been remarkable and a valuable arsenal of experiences and innovations can be used to advance even further. But other problematic characteristics of the region’s tax systems do not receive the attention they deserve. The high level of volatility of fiscal revenue, the low tax effort of subnational governments, and the largely overlooked use of taxes to correct

externalities are notable features of regional tax systems that warrant much greater attention.

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. For this reason, the Inter-American Development Bank (IDB) dedicated the latest edition of its flagship publication, *Development in the Americas (DIA)*, to this issue. **More than Revenue: Taxation as a Development Tool** identifies a new generation of tax reforms as one of the great items of unfinished business in the region.

Although the tax situations in the region vary widely, the book shows that the pro-development tax reforms required by countries in Latin America and the Caribbean must respect five basic principles:

- First, 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.
- Second, 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 wellbeing and equity.
- Third, 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.

- Fourth, institutional agreements and consensus must be reached to ensure that local governments have the 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.
- Fifth, pro-development tax reforms should build tax systems that look to the future. Latin America and the Caribbean enjoys an extraordinary endowment of natural resources. However, environmental taxes or the current design of taxes on commodities do not reflect this situation. To adapt the future to reality, tax systems must create incentives for the more efficient use of finite natural resources and take into account the needs of future generations of Latin Americans.

More than Revenue stresses the need to help convert distortionary, inadequate and regressive tax systems into allies of economic growth, mobility and social equality. It examines both problems and proposed tax reforms that aim to not only generate revenue but fundamentally support the sustained and inclusive development of societies in the region.

An Empty Shell: Personal Income Tax

Personal income tax ought to be one of the pillars of the tax system, but in Latin American countries its revenue potential is largely wasted. In developed countries, revenue from personal income tax is 8.4 percent of GDP, whereas in Latin American countries, this tax generates only 1.4 percent of GDP. (The Caribbean countries take personal taxation more seriously but even their revenue of 3.8 percent of GDP is low compared to the developed world.)

The personal income tax in Latin America has the outward appearance of a real tax, but inside it has been hollowed out. Essentially, Latin American societies have used four devices to transform personal income tax into an empty shell.

The first element is the design of brackets and rates: in Latin America only the rich are not excluded from the income tax base. On average in Latin American countries, taxpayers who earn less than 1.4 times per capita income are excluded from any tax obligation, and only those with (taxable) income of at least 6.5 times per capita income can have *part* of their income taxed at the maximum rate.

A second device that contributes to hollowing out the tax is the excessive generosity of existing tax deductions, which represents on average about 50 percent of effective tax collections. Latin American tax systems allow deductions for a wide range of personal expenses (educational, medical, etc.) even though there is already a relatively high minimum exemption or zero rate bracket, which supposedly serves that function.

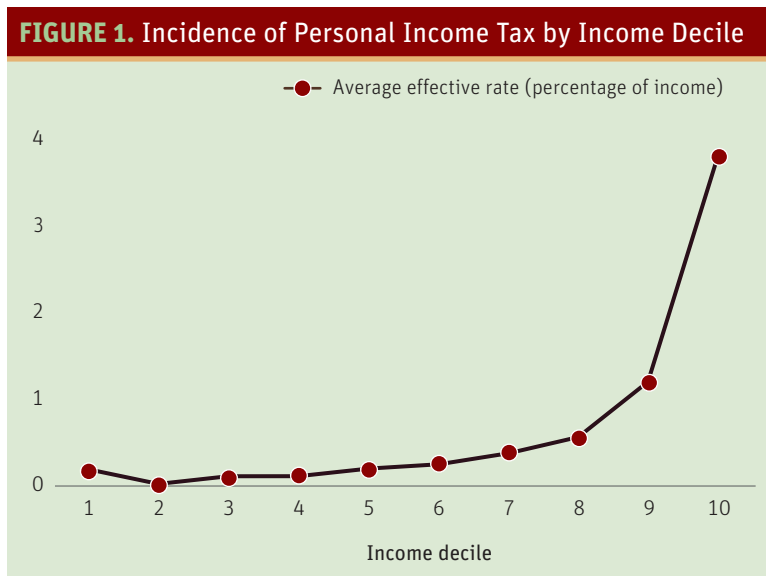
A third mechanism that has also helped to empty the shell is the favorable treatment given to capital income. Because of exemptions or special arrangements for this type of income, in many countries it is hardly taxed at all.

Lastly, one of the subterfuges for draining personal income tax dry is evasion. About half of potential revenue from personal income tax is lost through evasion.

Paper progressivity

All these subterfuges make income tax very progressive on paper but very weak at raising revenue that could be used for redistributive purposes. It is not unusual for the richest 10 percent of taxpayers to generate 90 percent of total revenue. Yet, the effective rate paid by these taxpayers is very low, not even 4 percent (Figure 1). Since income tax raises very little revenue, it has no capacity to directly improve income distribution, or to finance public expenditure that could be redistributive.

The clearest demonstration that this tax is an empty shell is the number of taxpayers. While in developed countries about half



Source: Own preparation based on Barreix et al. (2006), Barreix et al. (2009), Gómez Sabaini, et al.(2011), and Servicio de Administración Tributaria de México (2008).

“ Tax systems are historical creatures, embedded in specific social contexts. But they are also a result of conscious political choices made by politicians and policymakers. This report offers an empirically sound and analytically rigorous account of the challenges taxation poses to Latin America. It is a valuable source of practical knowledge for all committed to promote economic efficiency and social justice in the region. ”

—Fernando Henrique Cardoso
Former President of Brazil

the population pays personal income tax, in Latin America it covers mainly the top deciles, and in only five countries does it reach those in the third richest decile.

Is There an Answer?

The dual system is the solution adopted by some countries to broaden the tax base and increase revenue from personal income tax. The key to any good tax is to keep it simple. The basic idea of the dual system is to tax labor income at a progressive rate and tax personal capital income at a flat rate that is lower than the maximum applied to labor income (and can even be equal to the minimum rate).

In appearance it is a regressive system (just as, in appearance, the existing system is progressive). However, provided an exempt personal income is established with a rate ladder that is not too steep, the highest labor income can be taxed at effective rates similar to those for capital. More importantly, taxing all capital income in the same way facilitates the use of withholding systems, reduces the risk of evasion and prevents fiscal arbitration (although

depending on the design, it could induce arbitration between capital and labor income).

Many European countries have adopted dual systems. In Latin America, Uruguay was the pioneer in this area, introducing in 2006 a tax with progressive rates on labor income and a flat rate on personal capital income (interest, dividends, profits, rents and capital gains). The maximum rate for labor income is 25 percent, which is also the rate for corporate income tax. Personal capital income pays 12 percent. There is a tax free minimum income that leaves about two thirds of the population outside the system which means that few deductions are needed.

The early results of the Uruguayan system have been very positive. Receipts increased from 0.9 percent of GDP in 2006 to 2.4 percent in 2008. The tax paid by the poorest half of the population dropped from 12.2 percent of receipts to only 3.5 percent, while the contribution of the highest income quintile increased from 60.4 percent to 80.5 percent (and its effective tax rate from 6.2 percent to 11.2 percent). Consequently, there was a substantial improvement in revenue, progressivity and the redistributive impact of the tax. Moreover, after the introduction of the dual system there was no capital flight or fall in investment in the country, as critics of the reform had predicted.

After Uruguay, other countries in Latin America have adopted dual or semi-dual systems (the latter meaning that not all types of capital incomes are treated uniformly). These are (in chronological order) Peru, Nicaragua, Honduras, Panama, El Salvador, Guatemala and Dominican Republic. With moderate rates on tax bases almost without exemptions, these countries have opted for higher revenue, more equity, greater efficiency and simplicity of administration and compliance. The new generation of dual models in the region is a significant step toward filling the hollow shell of personal income tax.

The Unbearable Tolerance of Evasion

Tax collections have increased approximately 30 percent for each dollar of output or income in Latin America in the last 20 years. Most of this increase is due to improvements in tax administration. Tax administrations now boast technical and budgetary autonomy and highly qualified professional staff, while their collection function, focusing on large taxpayers, has been strengthened thanks in part to the widespread use of technology.

However, the challenges facing tax administrations are greater than their achievements. A large number of workers and businesses in the region never have contact with the tax authority. Although some are exempt by law from filing tax returns, most simply hide from the tax administration through the use of avoidance strategies or directly illegal fraud.

Half the potential collection of individual and corporate income tax is lost through evasion, along with over a quarter of the tax revenues that VAT should raise. The main reason is that the probability of being punished for tax evasion is virtually nil. To begin with, few people are registered taxpayers – only 10 percent of the population in Latin America compared with 59 percent in developed countries. Of the registered taxpayers, only 2.8 percent are subject to general audits each year, and an insignificant 0.2 percent are subject to in-depth audits.

These numbers can be misleading because the audits are not random: they focus on taxpayers who show most evidence of sophisticated and substantial tax fraud. This targeting is a bad thing for fat cats who have nowhere to hide but much better for the majority of taxpayers for whom the probability of being sanctioned is even lower.

But this is not all. When fraud or other offenses are detected the penalties are not applied with sufficient rigor. Tax fraud is well defined in Latin American legislation, but judgments are almost nonexistent. On average, in every country in Latin America only

“ This volume offers a remarkably detailed introduction to many of the tax policy issues confronting Latin American economics. It emphasizes that a well-crafted tax system must not only raise sufficient revenue, but must also do so in a way that avoids unnecessarily hindering economic growth. It thereby offers an invaluable guide for policymakers and researchers who are engaged in designing, and studying, tax systems. ”

—James Poterba Mitsui
Professor of Economics, MIT, U.S.A.

three judgments for tax evasion are handed down annually. In a few countries, there has been not a single judgment for tax fraud in the last five years. A note of caution: in Chile, Colombia and Mexico the number of judgments is reasonable and could be increasing.

As a result of this permissive chain, the impact of audits on total revenue is a meager 1.6 percent on average in all Latin America (and much less than that in most countries).

Raising the potential cost of evasion is an essential step, but possibly not enough. The efforts of tax administrations would be more effective if there were more “tax morality.” According to polls taken by Latinobarómetro, only one in two Latin Americans think tax evasion is reprehensible. The factors that undermine tax morality include the unpopularity of the government in power, the belief that the country is not headed in the right direction, and the perception that public entities are not tackling the most pressing social problems, such as security or unemployment.

People’s motivations and fears about paying or evading tax are so varied that a wide variety of stimuli and incentives would be needed to substantially reduce evasion. Unfortunately, many of the factors that affect tax morality are beyond the scope of action of tax administrations.

Think about the Future: Tax Non-Renewable Resources

About half of all tax revenue in Venezuela and Trinidad and Tobago originates in the areas of non-renewable natural resources, such as oil and gas. Bolivia, Chile, Ecuador and Mexico derive more than a quarter of their revenue from these sectors, while Colombia and Peru are approaching these levels.

Since the wealth of the subsoil is owned by the country where it is located, governments have the right to receive the rents on behalf of their citizens. The problem is that governments can try to extract these rents ignoring the future. If governments want to obtain more tax revenue today, there will be an impact on investments in the sector and on tax revenue tomorrow. This is the basic dilemma of taxation of non-renewable resource sectors. Wealthier societies with more democratic and stable political systems can afford to defer tax revenue over a longer period than poor countries, especially those where the group in power is not representative of the entire population and fears losing its privileges.

But beyond this basic dilemma, there are other more subtle dilemmas, which are summarized in something very simple: how to extract maximum rent while altering as little as possible the investment and production decisions of an investor seeking to maximize total profits during the entire possible life of the resource. This will depend essentially on the tax instruments used.

The most common instruments used to tax non-renewable resource sectors are a mix of traditional royalties and corporate income taxes. But these are not the most appropriate tools for confronting the dilemma between rent extraction and efficient resource exploitation.

Royalties greatly affect the method of extraction and the investment decisions of producer companies. If they are based on

unit produced, producers will abandon the mines and wells where production is more expensive, leading to a waste of resources and a loss of tax revenue. And when prices rise, all the extra profits are left in the hands of producers. If royalties are based on the value of sales, the State's share improves as prices rise, but this basis harms the production that requires substantial initial investments, or the production that generates a high level of value. Traditional corporate income tax affects production decisions much less than royalties, but captures for the State only a portion (usually small) of the extraordinary profits resulting from price increases.

The ideal taxation instrument would leave the normal return on investment in the hands of the producer, and transfer all the "pure rent" to the State without affecting production. The closest to this ideal is the R-factor tax or tax on rate of return. Based on potential cash flow and project risks, a normal rate of return is calculated and any profit above that rate is taxed at a high rate. The problem for governments adopting such a tax is to obtain the information needed to set appropriate rates of return for each project (not for the company).

Chile has invented a hybrid system of royalties on the net income of copper producing firms which closely resembles an ideal tax on pure rent. Likewise in Peru the recent reforms will transform the system for taxing copper into something very close to pure income tax.

Taxing only extraordinary rents is the formula for causing the least possible effect on production decisions without sacrificing tax revenue. This system requires clear and stable rules, because they contribute to transparency in relations between private companies and the Treasury and can therefore help protect the rights that all groups of citizens have over these rents, including those of future generations.

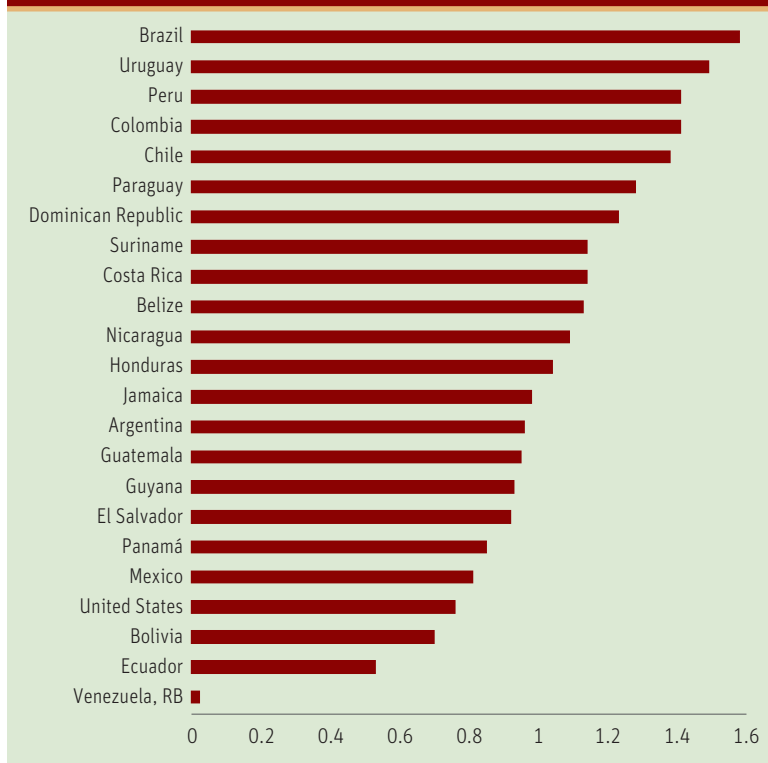
Taxing Urban “Bads” to Protect Public Goods

Many of the problems facing Latin American cities could be solved by forcing those who cause them to pay up. For example, the use of air polluting vehicles causes congestion and accidents and damages roads, but the cost of licensing and traveling depends on the price of vehicles not on the damage they do, while the price of gasoline does not usually include the cost of consumption to society. Rarely is any payment made in proportion to the ills caused to others by generating garbage, or polluting air and water with particles and waste from construction and industry.

Taxes that help correct environmental problems can be a source of revenue. In Europe these taxes collect an average of 2.5 percent of GDP but in Latin America barely 1 percent. The oil producing countries make the least effort to tax these ills: Colombia and Mexico raise only 0.25 percent of GDP, and Venezuela, where gasoline is virtually given away (Figure 2), provides consumers with subsidies of over 5 percent of GDP to use more gas than they would be willing to consume if they at least paid cost. Consumers with higher purchasing power benefit the most from this subsidy, even though the justification for lower gas prices is to protect the purchasing power of the poor.

Gasoline taxes can be a very blunt instrument for attacking problems such as congestion in city centers. Congestion charges are a solution that is literally just around the corner because of the massive spread of electronic technologies such as “transponders,” which keep track of vehicles passing through certain points (for example, entry and exit from city centers or certain freeways). Since tariffs can be adjusted according to the time of day or amount of traffic, this system can be very effective for reducing congestion, as has happened in Singapore and London. In Santiago de Chile, where

FIGURE 2. Gasoline Price at Pump, 2010
(US\$ per liter)



Source: World Bank (2012).

the system was introduced in 2004 on urban expressways operated by private concession holders, travel time between the two extremes of the city has been cut by 40 percent.

Mistaken “distributive” considerations and simple myopic resistance by citizens or certain interest groups can be a bigger obstacle than cost or the technology needed to adopt these solutions in other large cities. What could be more progressive than facilitating lower-income workers’ access to their places of employment by reducing the use of private vehicles and investing the revenue from tolls in better public transport systems?

For other urban problems that seemed impossible to solve, much simpler solutions than congestion charges have been found. Plastic bags, which are an environmental nightmare that clog drainage systems and pollute land and water, are a case in point. Attempts were made to outright prohibit them, distribute free reusable bags, or offer discounts to shoppers who use reusable bags. The only successful effort has been something quite elementary: requiring stores to charge customers for bags. Simply setting a price of 5 cents a bag has reduced consumption of plastic bags by 50 to 80 percent.

Forcing everyone to pay for the ills they cause society should be a socially acceptable policy. Whether through taxes, tolls or other price mechanisms, public goods—such as air quality, road safety or ease of travel—can be protected; in the process, the government can raise revenue to help solve the many ills that erode the quality of life in Latin American cities.



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