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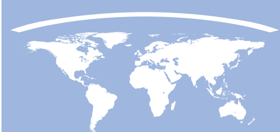

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Taxes in Latin America: Do Wealth and Inequality Matter?

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(Based on the OECD *Latin American Economic Outlook 2009*)

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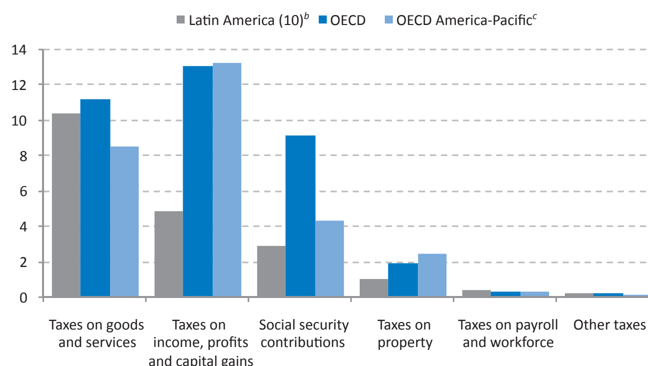
- Taxes do little to reduce high levels of income inequality in Latin America.
- Compared to OECD countries, Latin American countries collect little revenue from personal income taxes; lower average incomes and an unequal income distribution in Latin America explain much of the gap.

To meet pressing development challenges, Latin American states need fiscal resources. The good news is that in the last decade, favourable macroeconomic conditions and the design of better tax systems pushed up fiscal revenues in Latin America. Notably, tax revenues have increased by close to 1.8 per cent annually between 1990 and 2006, reflecting a widespread strengthening of taxes levied on income, profits and capital gains and general goods and services.

While the overall trend is positive, the Latin American average masks considerable variation across countries. According to the OECD *Latin American Economic Outlook 2009*, while some economies in the region have gone a long way to put their public finances in order, other countries face high budget deficits and public debts, striving hard to improve tax collection. Although revenue ratios at the levels seen in OECD countries are not necessarily meaningful targets for Latin America, comparing the region to industrial countries can be useful to assess the effectiveness of different tax policies. A look at the data reveals significant differences between Latin America and OECD countries: the tax-to-GDP ratio in industrialised countries represented 1.8 times the level observed in Latin America in 2005. Moreover, in terms of revenue composition, Latin America collects relatively less from direct taxes, counterbalanced by higher indirect-tax receipts.

Figure 1. **Tax Revenues in Latin America and OECD Countries**[a]

(Percentage of GDP, 2005)



a) Where possible, coverage corresponds to general government, otherwise the statistics are restricted to central government.

b) The Latin American countries covered are Argentina, Brazil, Chile, Colombia, Costa Rica, El Salvador, Guatemala, Mexico, Peru and Venezuela.

c) OECD America-Pacific comprises Australia, Canada, Japan, Korea, Mexico, New Zealand and the United States.

Source: Latin American Economic Outlook 2009, OECD 2008.

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Tax-system performance matters because the redistributive effect of fiscal systems is one of the key dimensions in consolidating fiscal legitimacy in Latin America. Low revenues mean lower spending, which translates into inadequate investment in key areas for human development such as education, health and housing, among others. Moreover, the region continues to lead the world in income inequality. European OECD countries often have levels of income inequality before taxes and transfers that would not seem out of place in Latin America. But their income distributions are much more egalitarian after taxes and transfers, which reduce inequality by nineteen Gini points in Europe, as opposed to only two points in Latin America.

Why do Latin American fiscal systems have so little redistributive impact? Perhaps Latin American electorates are less concerned by inequality than their European counterparts? But recent data from the "World Values Survey" shows that although opinion is more polarised in Latin America, the typical citizen in the region is as concerned as OECD nationals about inequality and the welfare state.

The tax-collection gap between Latin America and OECD countries does not have a single cause but the small base for income taxation of individuals is an underlying factor. In 2005, individual income tax receipts were 8 percentage points of GDP lower in Latin America than in the OECD. The difference in income tax collection alone explains around 50 per cent of the revenue gap.

Low levels of personal income limit the scope for income taxes in Latin America: while they represent 27 per cent of total tax revenues in OECD countries, they just contribute 4 per cent in the region. In many countries, the vast majority of working people – approximately 90 per cent in Brazil, Chile, Colombia and Costa Rica, for example – have earnings below the minimum threshold at which personal income taxes must be paid. Also important is the skewed distribution of income in Latin America, which means that for a given average income, fewer working people in an economy are in the income brackets where they are liable to pay tax.

Tax evasion, meanwhile, is not likely the culprit behind the tax-collection gap. Evidence is spotty, but even if all these losses attributed to evasion were eliminated the impact on the absolute amounts collected would remain limited by the small size of the tax base itself. Nevertheless, measures to limit evasion – in addition to entirely legal means of avoiding tax – could have a political and social impact on legitimacy beyond their fiscal yield.

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