

Why is the Tax System so Ineffective and Regressive in Latin America?

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The capacity of a state to collect taxes, especially such direct taxes as income, property and corporate taxes, can reveal its degree of authority and legitimacy vis-à-vis the richer groups of society. If a state dramatically lowers the top rates on direct taxes while relying heavily on consumption taxes to collect revenue, its overall tax structure is likely to be both ineffective and inequitable.

Such features characterize most tax regimes in Latin America. The table shows comparisons across regions in direct taxes as a percentage of GDP. Compared to other regions with similar levels of average income, Latin America collected a relatively low level of direct taxes, i.e., 3.9 per cent versus 6.9 per cent for East Asia and 8.3 per cent for Eastern Europe during 1997-2002 (see table).

Direct taxes in Latin America had declined to 3.9 per cent of GDP from five per cent in the 1970s. Only in 2006 did this ratio manage to climb back up to five per cent. In contrast, South Africa, by far the largest middle-income country in Africa and also a very unequal society, had direct taxes that were almost 15 per cent of GDP in 1997-2002.

Why are tax regimes in Latin America performing so poorly? A major part of the answer: the economic elites, which dominate the political economy of much of the region, do not pay taxes that represent a fair share of their incomes.

There are several reasons. The maximum rates on personal income have been progressively falling at least since the mid 1980s. This trend is based, in part, on the mistaken belief that lowering such rates would broaden the tax base: it doesn't. Moreover, these elites ship a large proportion of their income abroad, where it remains untaxed. Thirdly, in the domestic arena the elites engage in myriad forms of tax evasion.

Wealth is also not taxed effectively in the region. There is negligible revenue from taxes on urban and rural property. For example, wealthy land-owning elites have been able to both block meaningful agrarian reform and avoid paying land taxes.

So, the burden of taxation has been shifting increasingly in Latin America to indirect taxes—mainly to consumption taxes such as the Value Added Tax. As a percentage of GDP, the VAT increased from 2.5 per cent in the 1970s to 5.6 per cent in 1997-2002—a level almost twice as high as that in East Asia, where the VAT accounted for 2.9 per cent.

Consumption taxes tend to be relatively regressive, putting a heavier burden on poorer households because they consume a higher percentage of their incomes. This could be mitigated by taxing luxury items at a higher rate and exempting (or zero-rating)

Direct Taxes as a % of GDP

Region	1997-2002
Latin America	3.9
East Asia	6.9
Eastern Europe	8.3
South Africa	14.6

Source: IMF, *Government Finance Statistics*.

basic goods, such as food. But few states in the region have had success in implementing such differential rates.

Compared to its average level of income, Latin America has a demonstrably low tax-collection 'effort'. Although the region should be collecting tax revenue that is about 24 per cent of GDP, it collects only 16 per cent. And because of the region's weak effort in collecting direct taxes on personal income, property and corporate profits, it has a relatively regressive system.

This is particularly troubling in a region where many countries have some of the highest levels of inequality of income and wealth in the world. The tax system reinforces this high degree of inequality and, if anything, makes it worse.

Political-economy factors are very important in explaining this condition. A state's lack of 'tax capacity' cannot be attributed solely to mistakes in tax policy or weaknesses in tax administration. Ultimately, a tax regime is conditioned by the power balances and struggles among the major social groups in a country, including the relative strengths of political parties that represent their divergent interests.

In most countries in Latin America, economic elites continue to dominate states or circumvent their authority. Thus, they are able to evade taxes, weaken their effectiveness or prevent their deployment.

At the same time, lower-income groups in the region lack, for the most part, political parties that are centralized and effective enough to represent their interests. Hence, states are rarely motivated to impose their authority on economic elites by obliging them to pay their fair share of taxes.

In much of the developing world, political-economy determinants help explain weaknesses in tax systems. In Latin America, such factors are decisive in explaining why its tax regimes continue to raise a relatively low level of revenue and remain noticeably less progressive than elsewhere in the world.