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DISTRIBUTIONAL EFFECTS OF TAXATION IN LATIN AMERICA: How to make fiscal policy fairer reforms

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Research Article

Distributional effects of taxation in Latin America

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ABSTRACT

This chapter analyzes the incidence on income distribution by a comprehensive array of direct and indirect taxes in ten Latin American countries circa 2018. The study finds that although there is a significant heterogeneity, the redistributive impact is equalizing for direct taxes and unequalizing for indirect taxes. Overall, redistribution through taxes, without accounting for spending effects and interactions, is slightly equalizing for some countries and unequalizing for others, but the burden on the poor is high and even higher than on the rich. This is mainly a consequence of the high share of indirect taxes in the tax structures, and of low personal income tax collection and coverage. The inclusion of the redistributive effect of the corporate income tax contributes to improve redistribution and accounts for better comparison with the redistributive impact in more developed countries, where dividends are taxed heavily with personal income taxes rather than corporate income taxes as in Latin America. High levels of evasion and informality make payroll taxes more regressive in integrated labor markets with high informality, but make indirect taxes less regressive, since the poor pay little or no indirect taxes on some of their purchases.

Key words: taxes; inequality; informality; Latin America

Introduction

Countries in Latin America have high levels of inequality. Before the coronavirus pandemic, the region had the highest levels of income inequality in the world. Then, the economic and social crisis caused by the pandemic further exacerbated the problem of inequality by ~6%, as measured by the Gini coefficient. This increase in inequality was mainly a consequence of the fact that the pandemic had greater impacts on the population with informal jobs and on vulnerable groups (Acevedo et al., 2021). Although employment has recovered since the beginning of 2021, the effects on informality, inequality and equity are likely to last in the medium term because of slow hiring of formal labor in an uncertain and indebted world and because of human capital losses, mainly among the school-age population.

The highly unequal income distribution in Latin America has a variety of causes (Busso and Messina 2020). A very important one is the low redistributive impact of cash transfers and direct taxes (Lustig et al., 2014, Lustig 2022; Pessino and Alaimo 2018). This low impact becomes evident when we compare market income and disposable income inequalities. In Latin American countries, market income inequality is very similar to that observed in developed countries. But when we analyze disposable income, which is household income after receiving direct government transfers and paying direct taxes, Latin American countries become much more unequal than these countries. This is because in Latin America, government interventions in cash transfers and direct taxes only reduce income inequality, as measured by the Gini coefficient, by 5%, while interventions in developed countries reduce it by nearly 38% (Pessino and Alaimo 2018). Even when including contributory pensions as part of market income, the difference is smaller but continues to be significant. While in these countries most fiscal redistribution appears to be driven by public spending, the tax systems have also an impact on income redistribution.

Although several studies examine the redistributive impact of fiscal policy in Latin America and the Caribbean (LAC), to date there is no extensive literature that provides a comprehensive analysis of the incidence of different taxes in the region, including their exemptions, and how the burden differs between taxes and countries.[1] Using microdata sets and administrative data for each country, tax incidence studies allocate tax burdens to individuals and households, obtaining the distribution among them. Drawing on theoretical and empirical literature, these studies make assumptions about the incidence of various taxes. Empirical tax incidence analysis microsimulates the effects of complex tax legislation on prices paid and wages and rents received by each household member. This process seems utterly simple, but in practice can be intricate and complex, even under the most basic and standard assumptions. There are data challenges and conceptual challenges (Gemmell and Morrissey 2005; Lustig 2020).

[1] An exception is Deza Delgado et al. (2020) that analyze the personal income tax in detail, but the comparison is only for Andean countries and does not include the rest of the tax structure.

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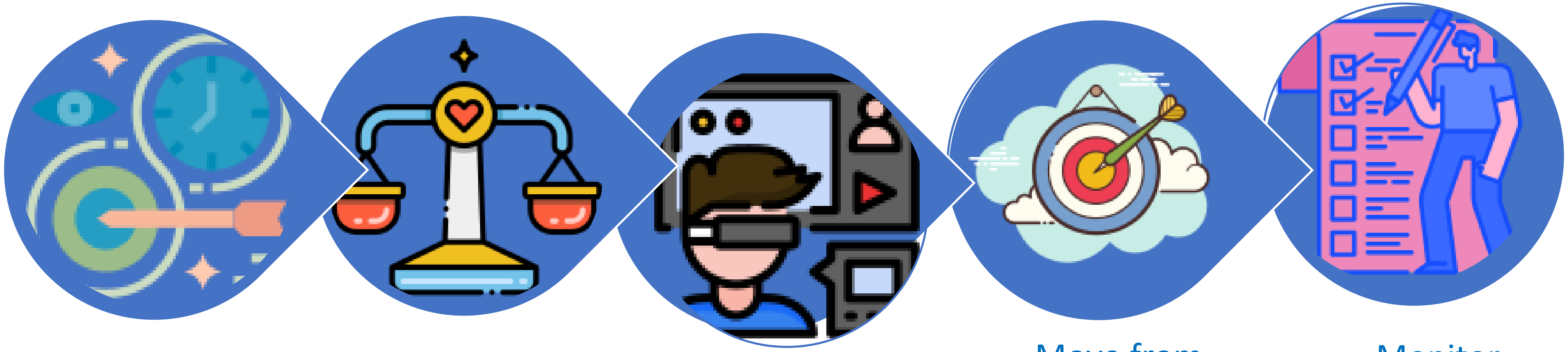
Two main objectives of the presentation:

Assess the impact of the full tax structure on inequality and poverty given structural conditions in LAC

Address how to make fiscal reforms more equitable balancing with efficiency and sustainability

From evidence to implementation: Five Ingredients to make fiscal reform happen



Realistic fiscal baseline

Balance equity and efficiency objectives

Anticipate distributional and fiscal impacts through microsimulation

Move from theory to implementation with good targeting and communication

Monitor, evaluate, and adjust for sustainability of reform

Determinants of redistributive impact of tax systems

Tax Revenue

21.9% LAC vs 35.1 OECD

Tax composition

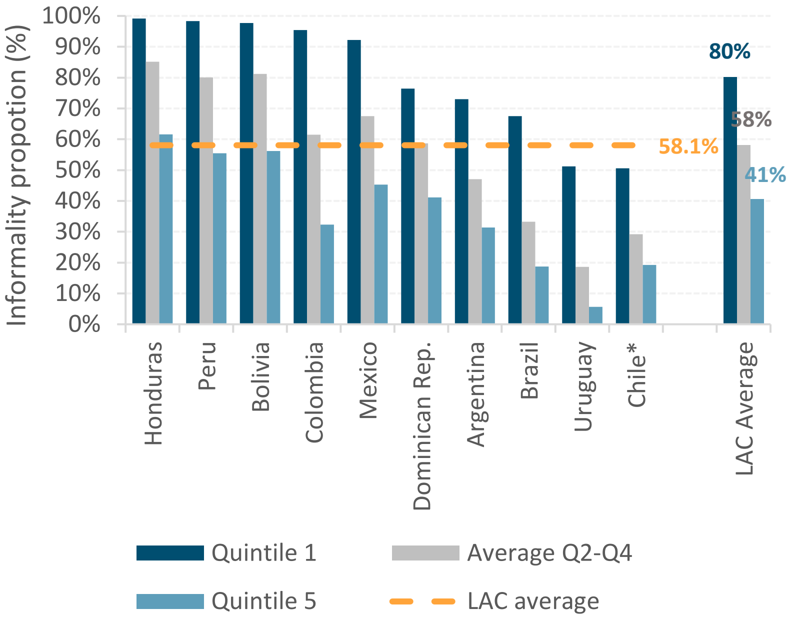
Tax progressivity

Tax As % of Tax Revenues

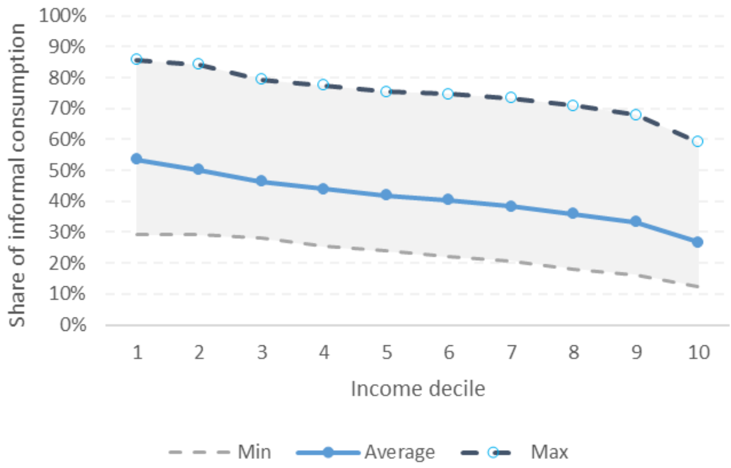
TAX	LAC	OECD
INDIRECT	48.8%	31.7%
DIRECT		
PIT	9.4%	23.0%
CIT	16.1%	10.1%
PIT+CIT	**25.5%**	**33.1%**

High informality affects consumption and payroll taxes incidence in LAC

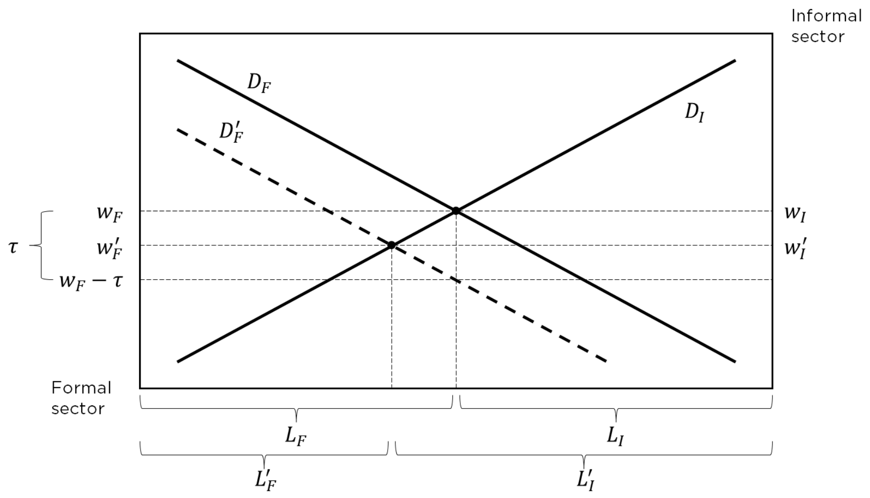
High Labor Informality in LAC
(especially among the poor)



High informality in consumption



High informality implies incidence on informal wages



Pass-through Scenarios

Our “alternative” scenario

Direct Taxes

- **CSS:** Integrated Labor Market: 50% formal labor, 50% informal labor
- **PIT:** 100% formal labor
- **CIT:** 50% Capital, 50% labor

Indirect Taxes

- **VAT:** 100% formal purchases, 20% informal and exempted purchases
- **Cascading Taxes:** Same pass through as in VAT.
- **Excise and Import Taxes:** 100% formal and informal purchases.

Classic Scenario

Direct Taxes

- **SSC:** Segmented Labor Market: 100% formal labor
- **PIT:** 100% formal labor
- **CIT:** 100% Capital

Indirect Taxes

- **VAT:** 100% formal and informal purchases
- **Cascading Taxes:** 100% formal and informal purchases
- **Excise and Import Taxes:** 100% formal and informal purchases

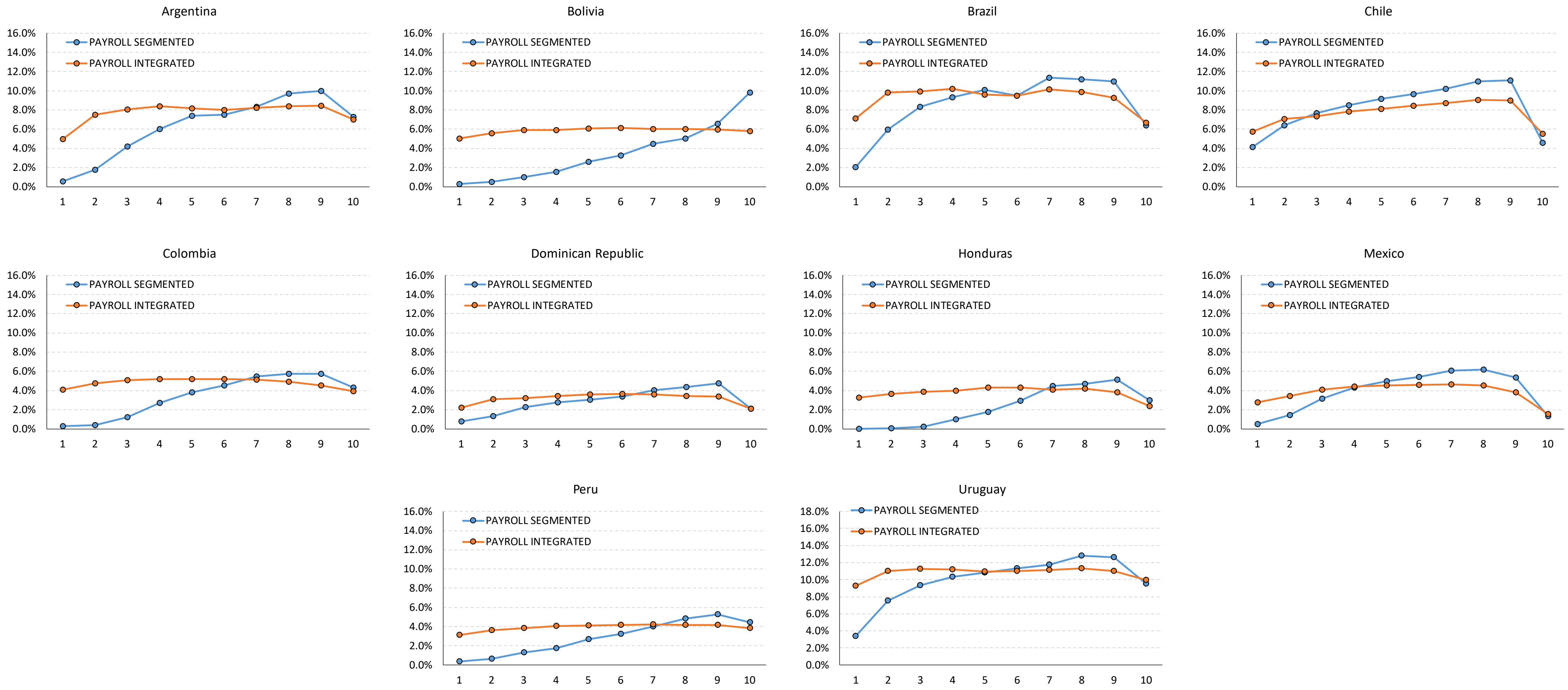
INCIDENCE OF DIRECT TAXES

- Social Security Contributions (SSC)
- Personal Income Tax (PIT)
- Corporate Income Tax (CIT)

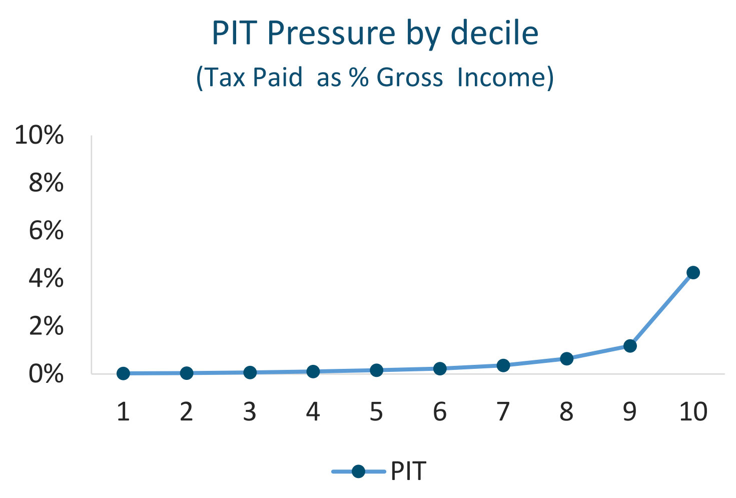
SSC are less progressive if informal workers also bear the burden

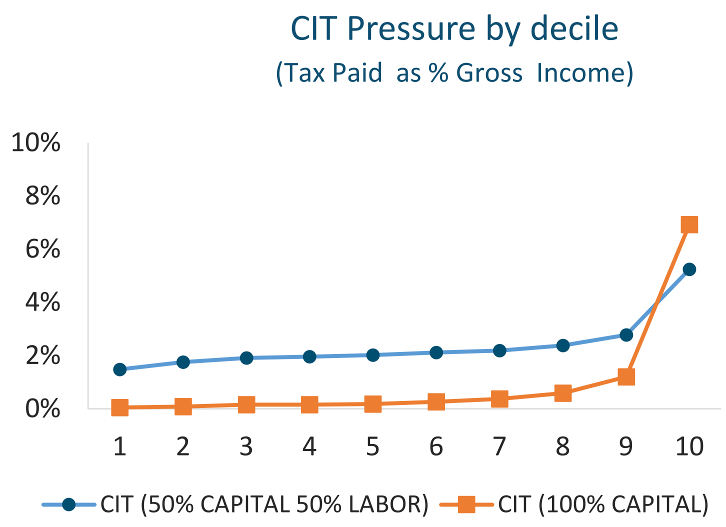
SSC as % of income decile

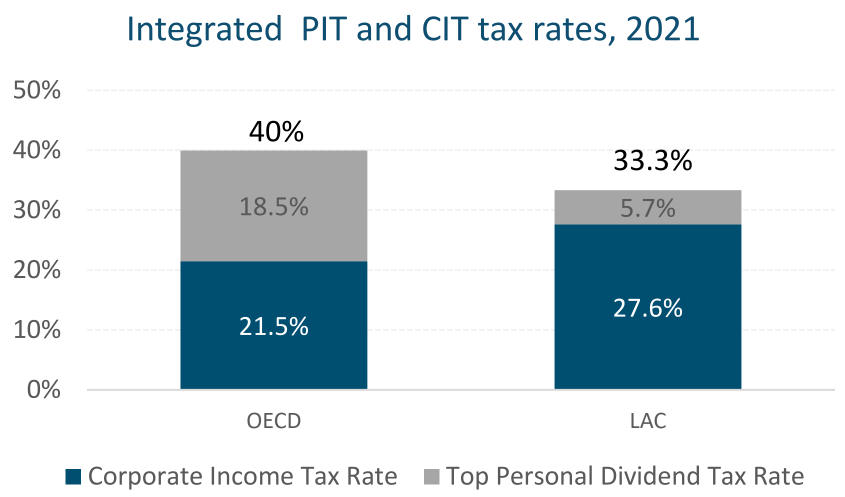
)

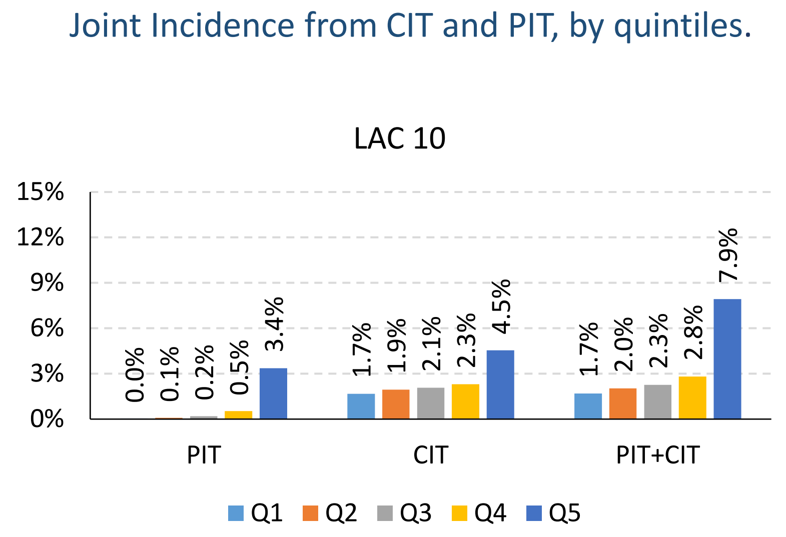


PIT and CIT are highly progressive, and their combined size contributes to equalization

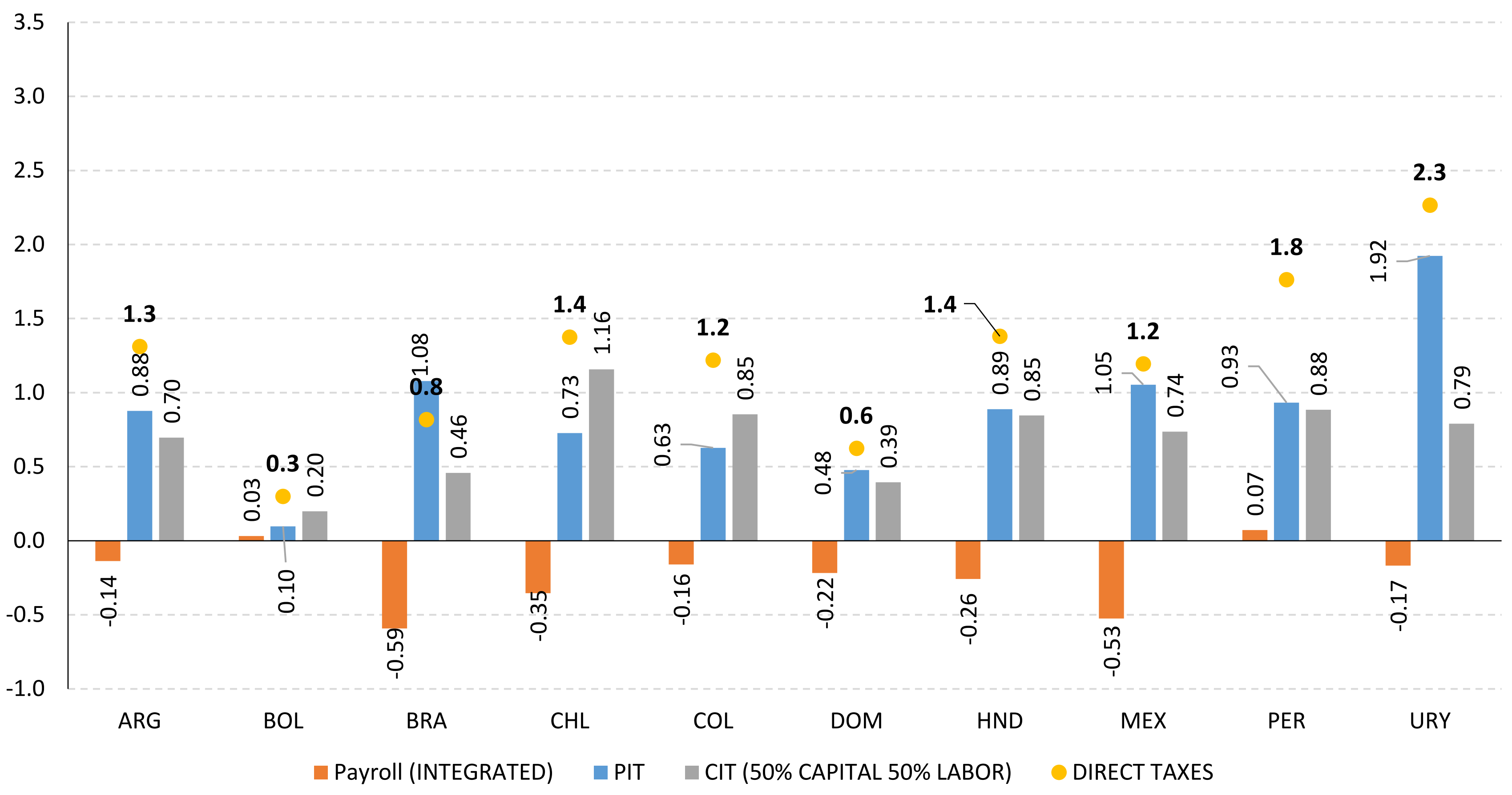








Marginal contribution of direct taxation to decreasing inequality

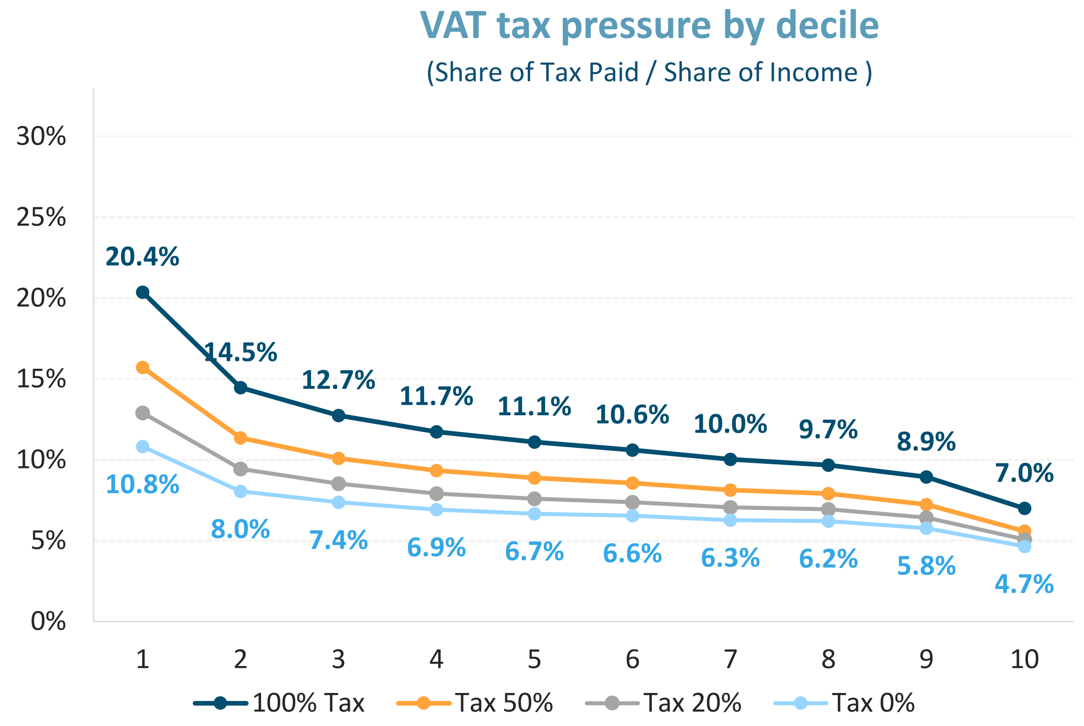


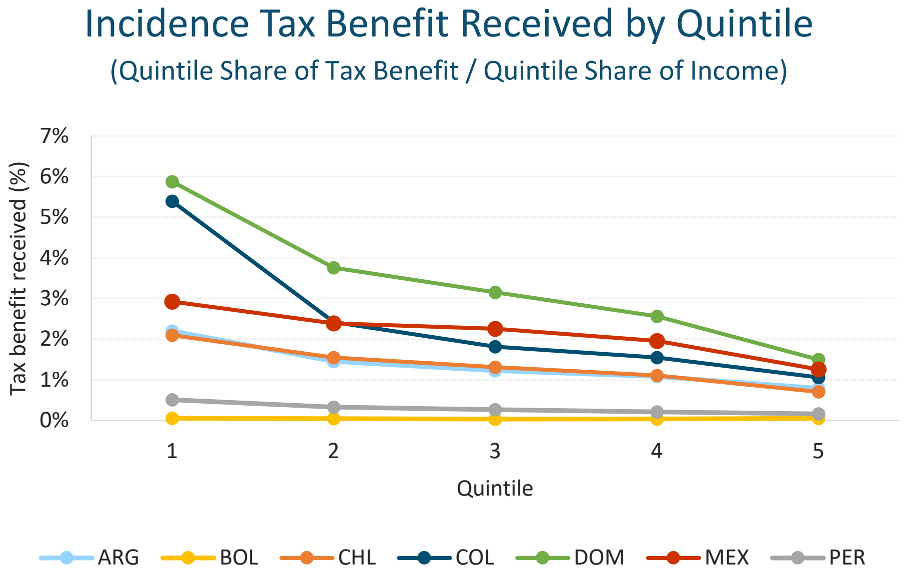
INCIDENCE OF INDIRECT TAXES

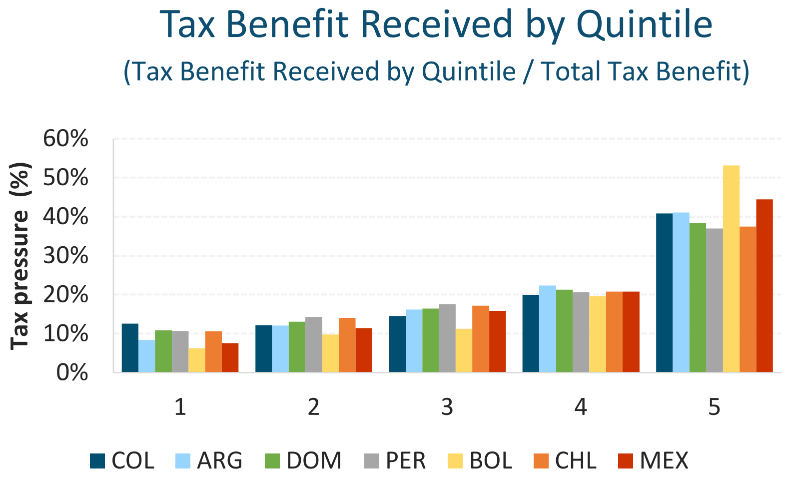
- Value Added Tax (VAT)
- Cascade taxes
- Other indirect taxes (excises, imports)

VAT regressivity diminishes with informal purchases..

…and tax expenditure helps the poor but high leakages to the rich





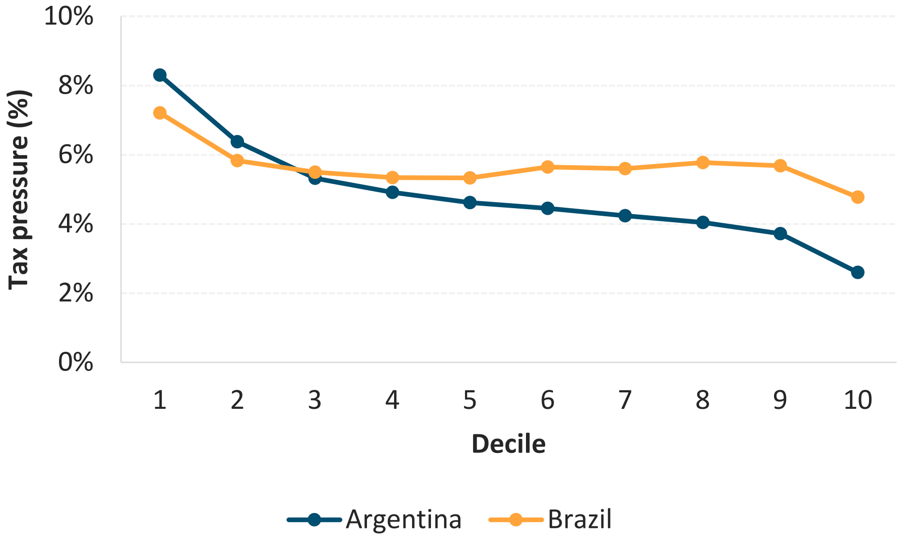


Note: assuming informal purchases equal to 20%

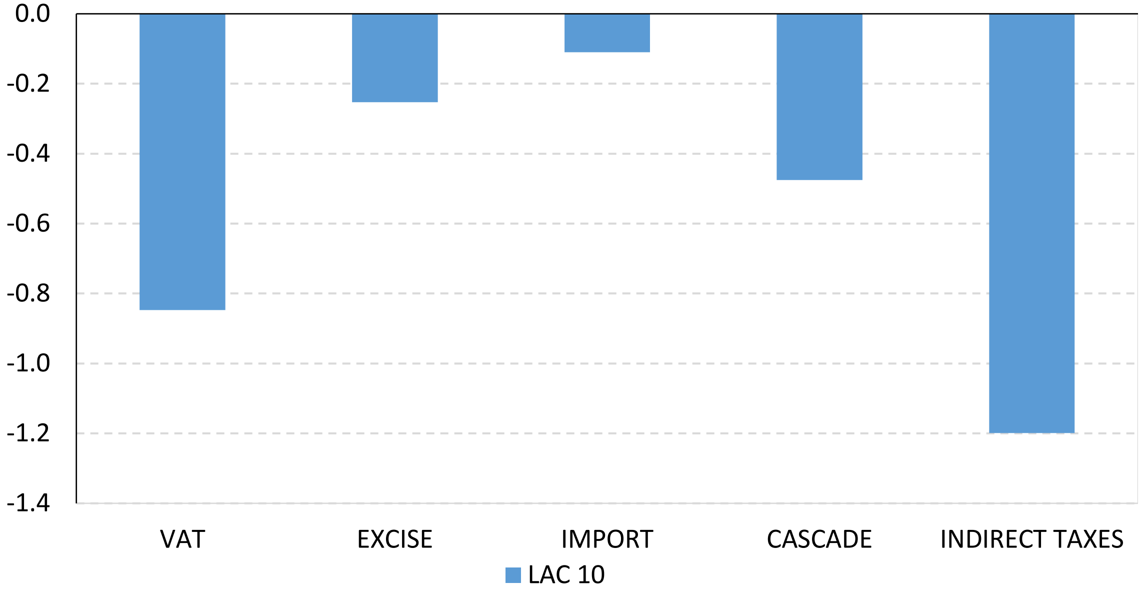
Cascade taxes tend to be regressive contributing to overall contribution to inequality of indirect taxes

Cascade tax pressure by decile

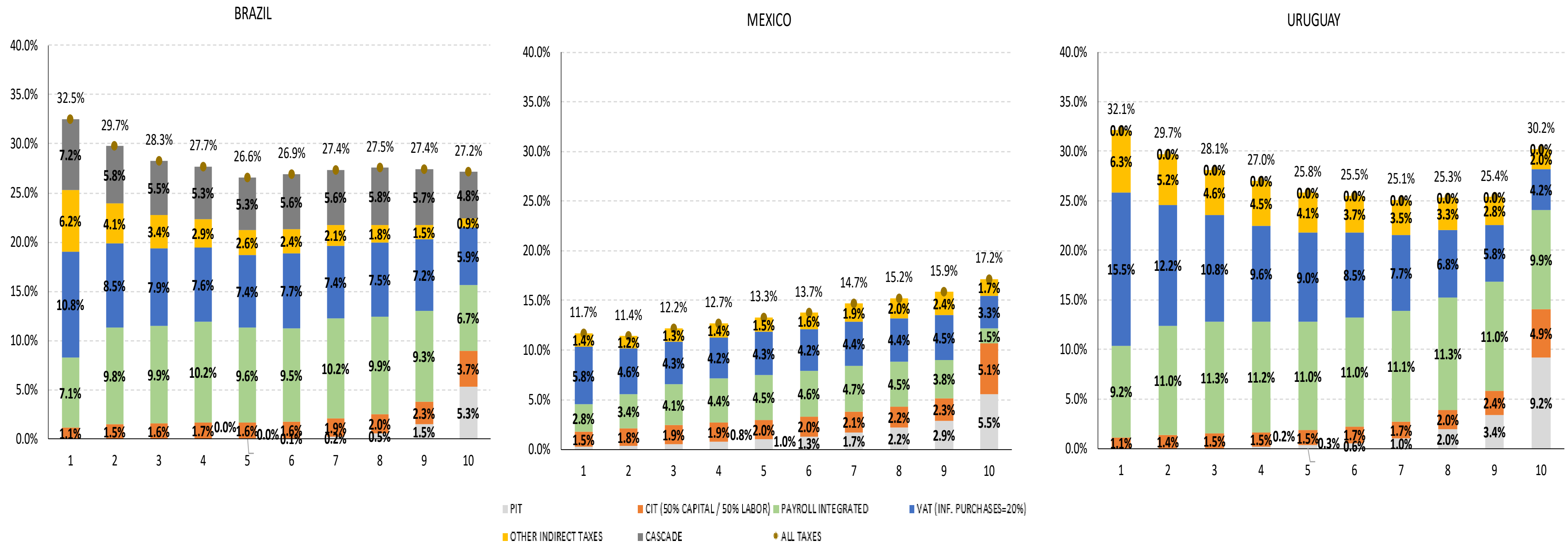
(Share of Tax Paid / Share of Income)



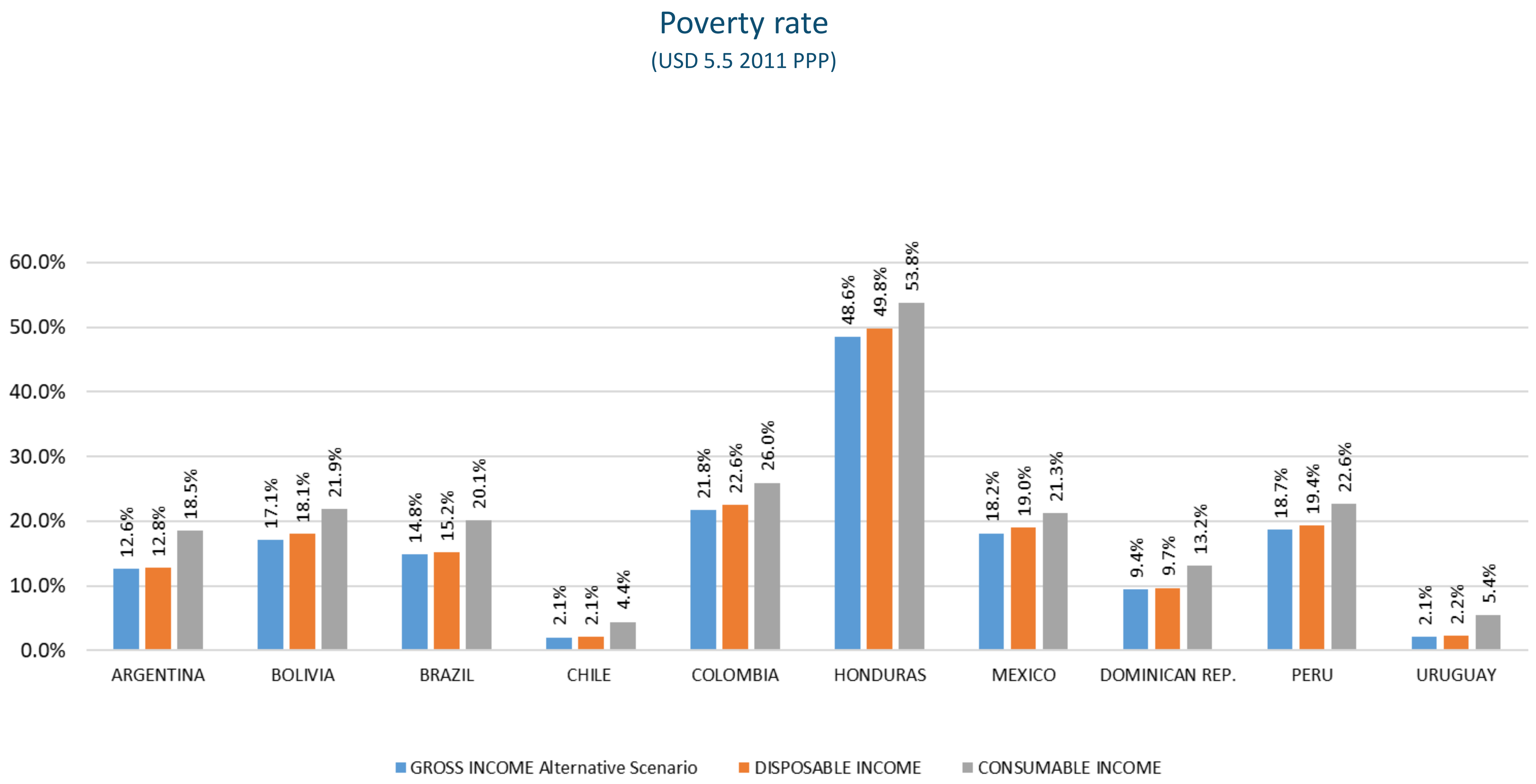
Marginal Contribution to Inequality of Indirect Taxes



Tax systems are heterogenous from slightly regressive, to neutral to slightly progressive



But tax systems in all countries increase poverty in 4.2 p.p. average making any reform to increase taxes even more difficult



How to make fiscal reforms happen:

Make efficient fiscal reforms fair

1. Diminish tax evasion.
2. Personalized VAT
3. Diminish energy subsidies (negative taxes)
4. Negative Income Tax or Earned Income Tax Credit
5. Not increasing payroll taxation to cut pension deficits
6. Should LAC reduce CIT and how?
8. Transforming Cascading Taxes into VAT

BUT always Improve targeting systems.

Making the VAT more efficient and progressive: What is a Personalized VAT?

A policy that refunds part or all of the VAT paid by low-income households only for purchases made in formal shops in exchange of lifting of products exemptions that benefit mostly the rich.

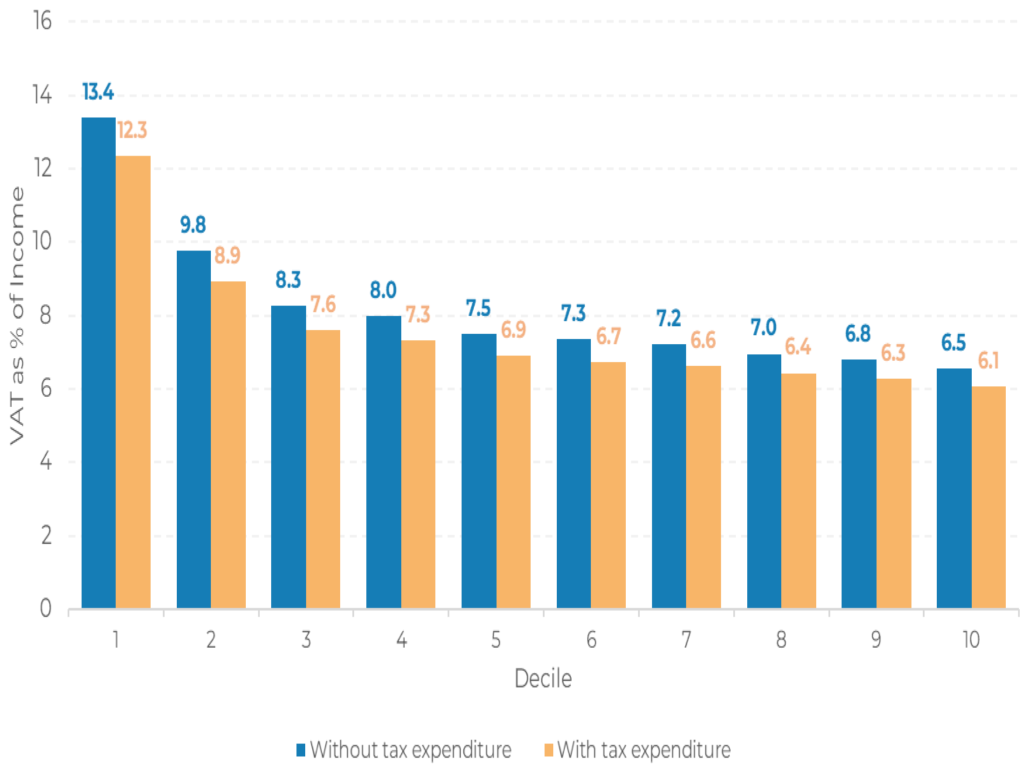
<u>Key Implications</u>

1. **Broader and fairer tax base**
 - achieved **by eliminating reduced or zero VAT rates** on selected goods
2. **Targeted VAT Refunds**
 – refunds go to low income HHs buying formally, encouraging formalization and reducing leakages.
3. Less price distortions and **higher net tax revenue.**

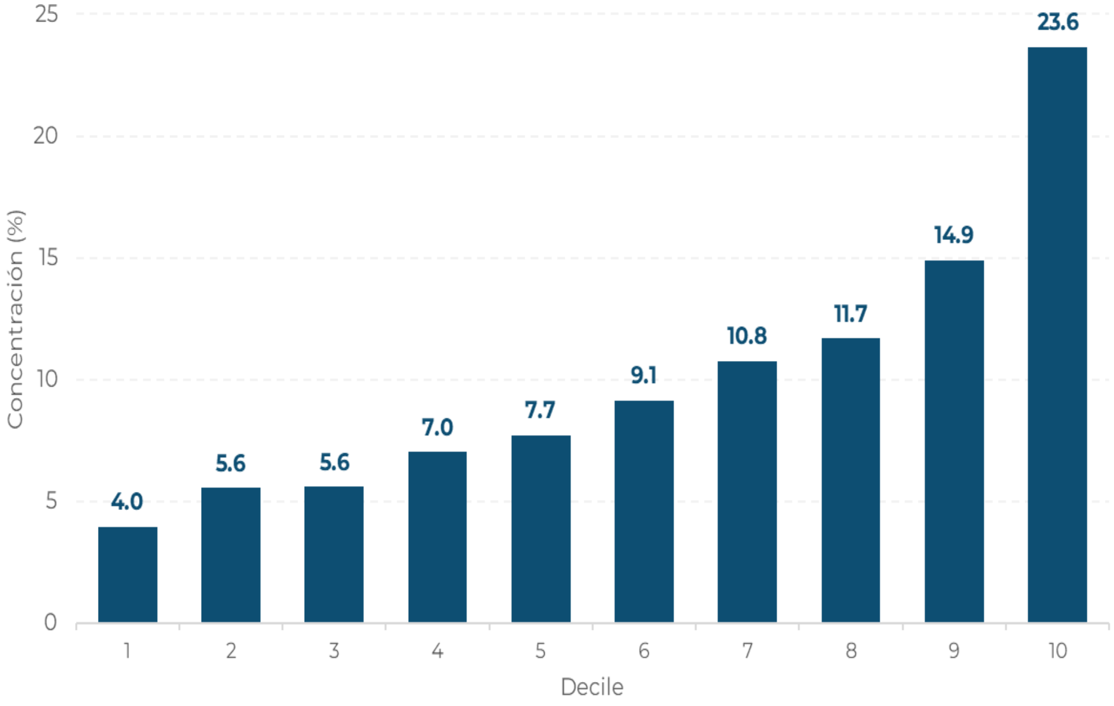
Inefficient Design: VAT Tax Expenditure Benefits the Poor, but Overspends on the Rich

Argentina's microsimulations for 2022

VAT burden by decile, relative concentration
(VAT as % of disposible income



Absolute Benefit or Concentration by decile
(% of total tax expenditure)



Source: Astudillo, Brest, Gomez Reino and Pessino, The Personalized VAT, simulations for Argentina, forthcoming.

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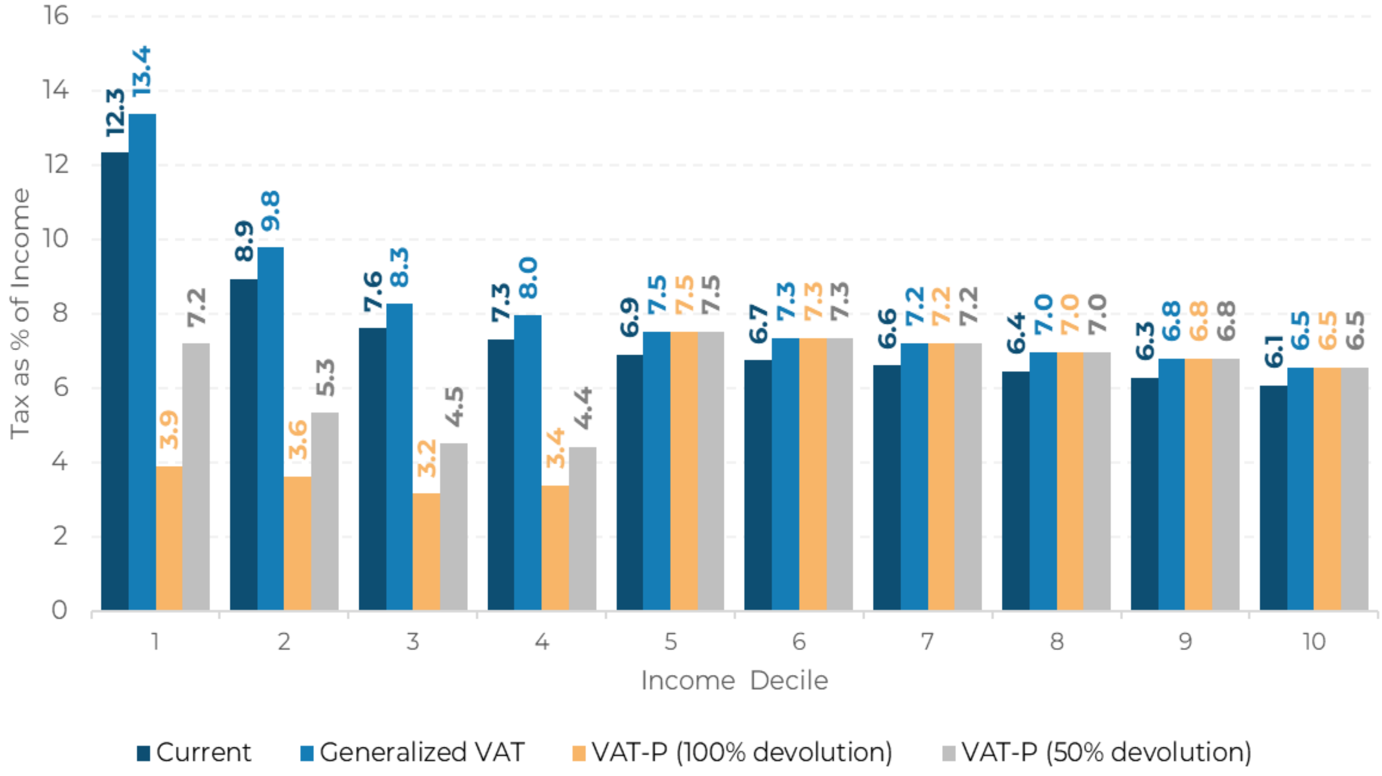
Results of Eliminating VAT expenditure into a targeted transfer to the 40% poorer: VAt-p

VAt tax burden by decile
(% of disposable income per capita)



Gross Tax collection increase:	1.4% of GDP
Devolution:	0.3% of GDP
Net Tax collection increase	**1.1% of GDP**
Extreme Poverty decrease	1.5pp
Decrease Burden in first decile	8.4%
Gini decrease (from 100)	40.7 to 39.7

Source: Astudillo, Brest, Gomez Reino and Pessino, The Personalized VAT, simulations for Argentina, forthcoming.

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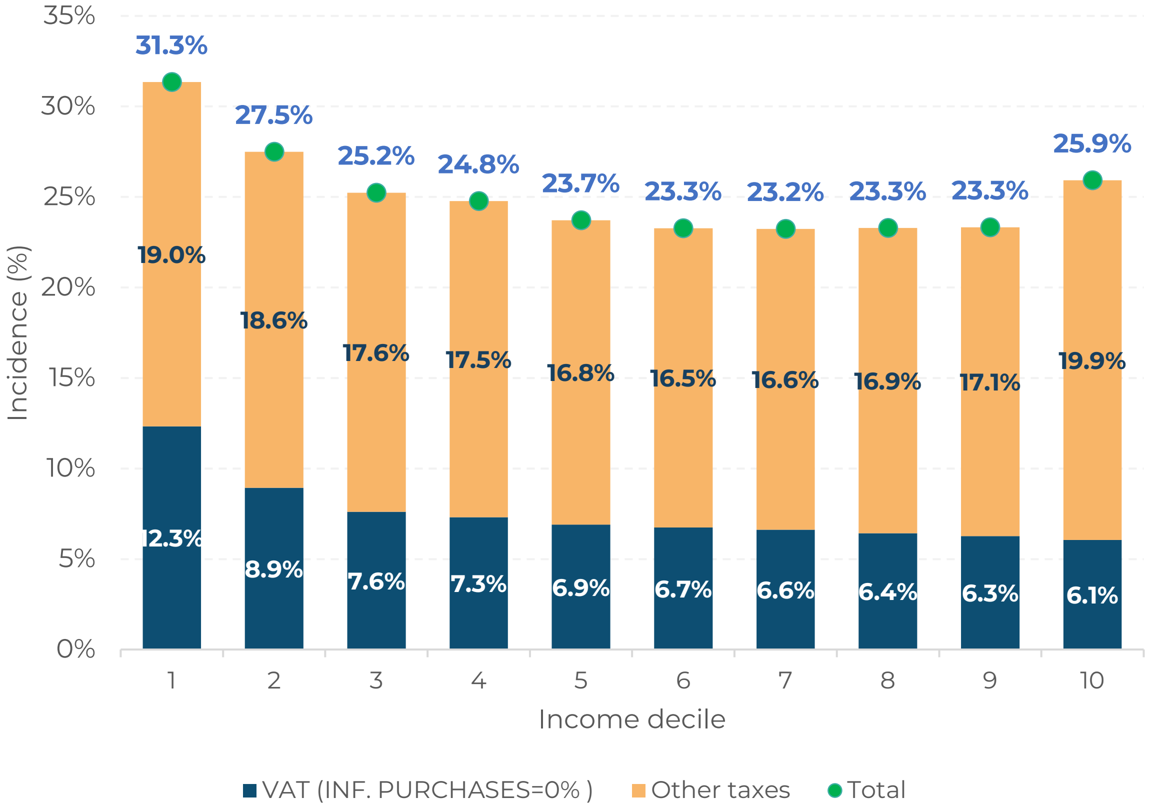
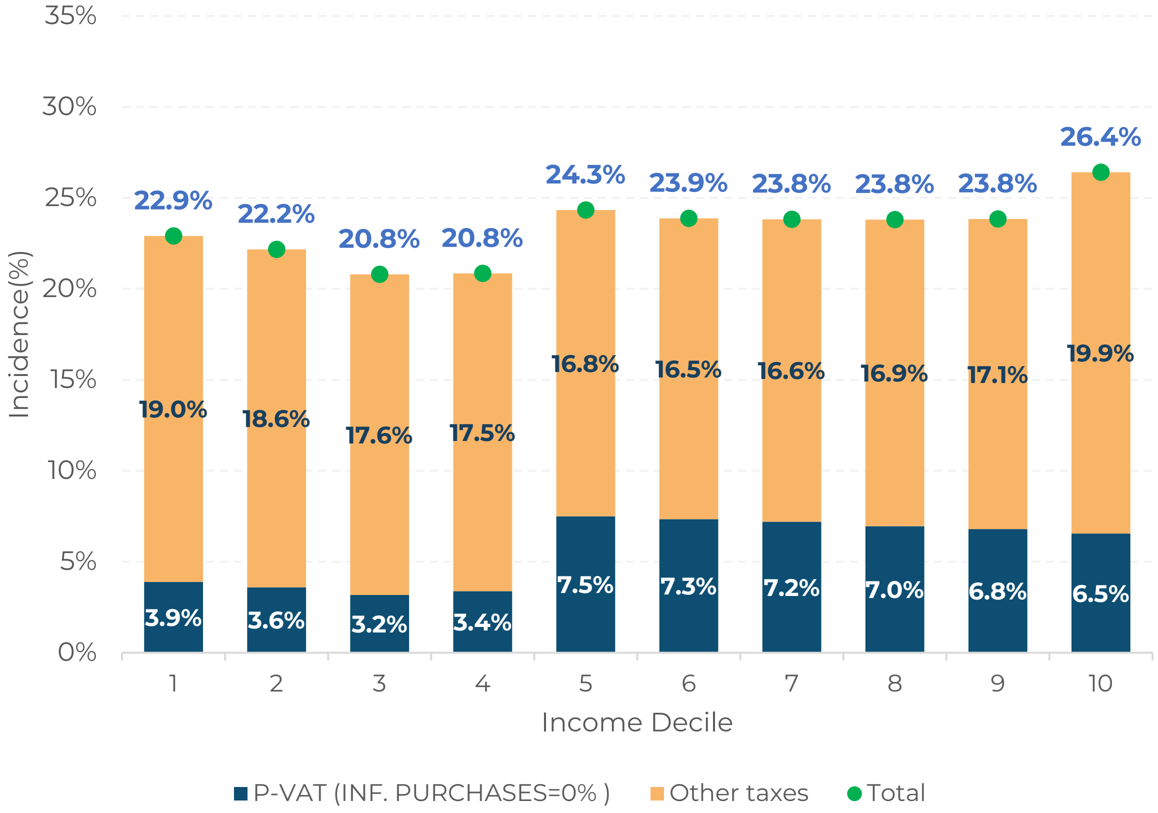
Results of P-VAt on Distribution of Taxes

Current distribution



Distribution with P-VAT



Source: Astudillo, Brest, Gomez Reino and Pessino, The Personalized VAT, simulations for Argentina, forthcoming.

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What are Tax credits for formal labor income?

A policy that gives an income tax credit to low-income workers conditional on working formally. It helps in replacing cash transfers conditional on informality, that create welfare dependence.

Key Implications

1. It encourages low-income families to **substitute welfare programs** for formal employment."
   - Increases formality and lowers welfare dependence

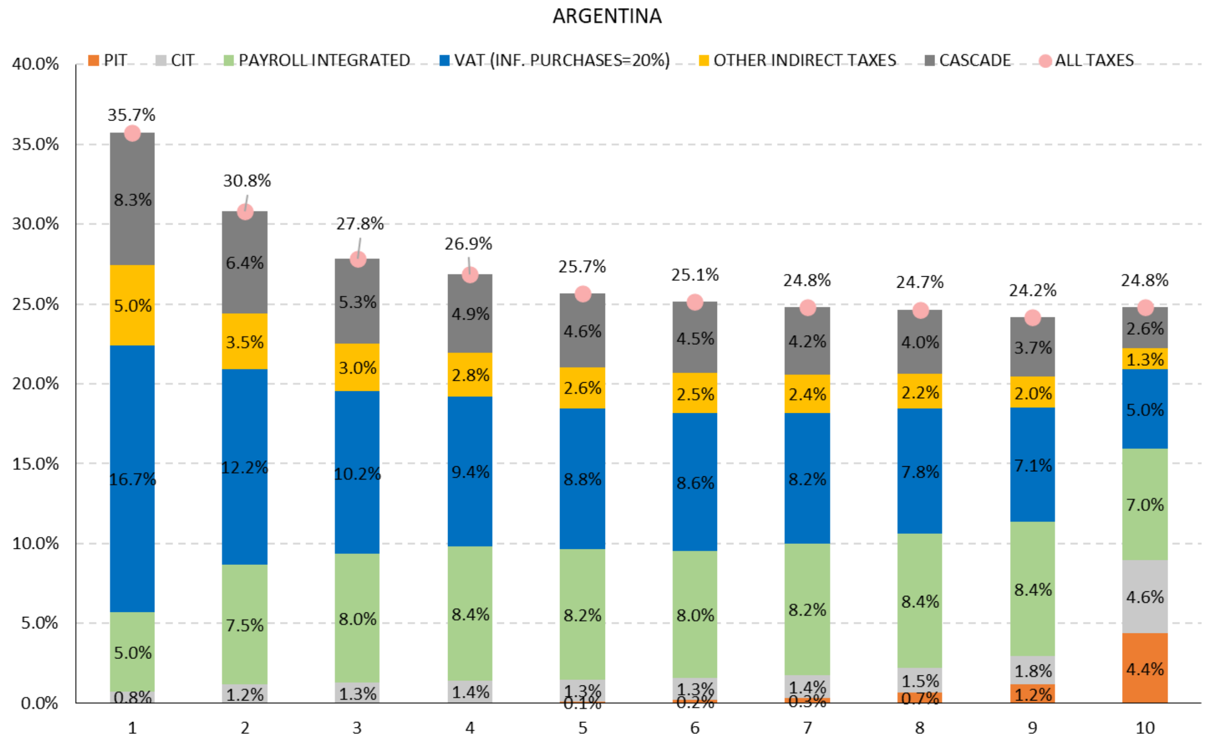
2. • Reduces in-work poverty.

3. Makes the **income tax more progressive** and **broadens tax filing coverage.**

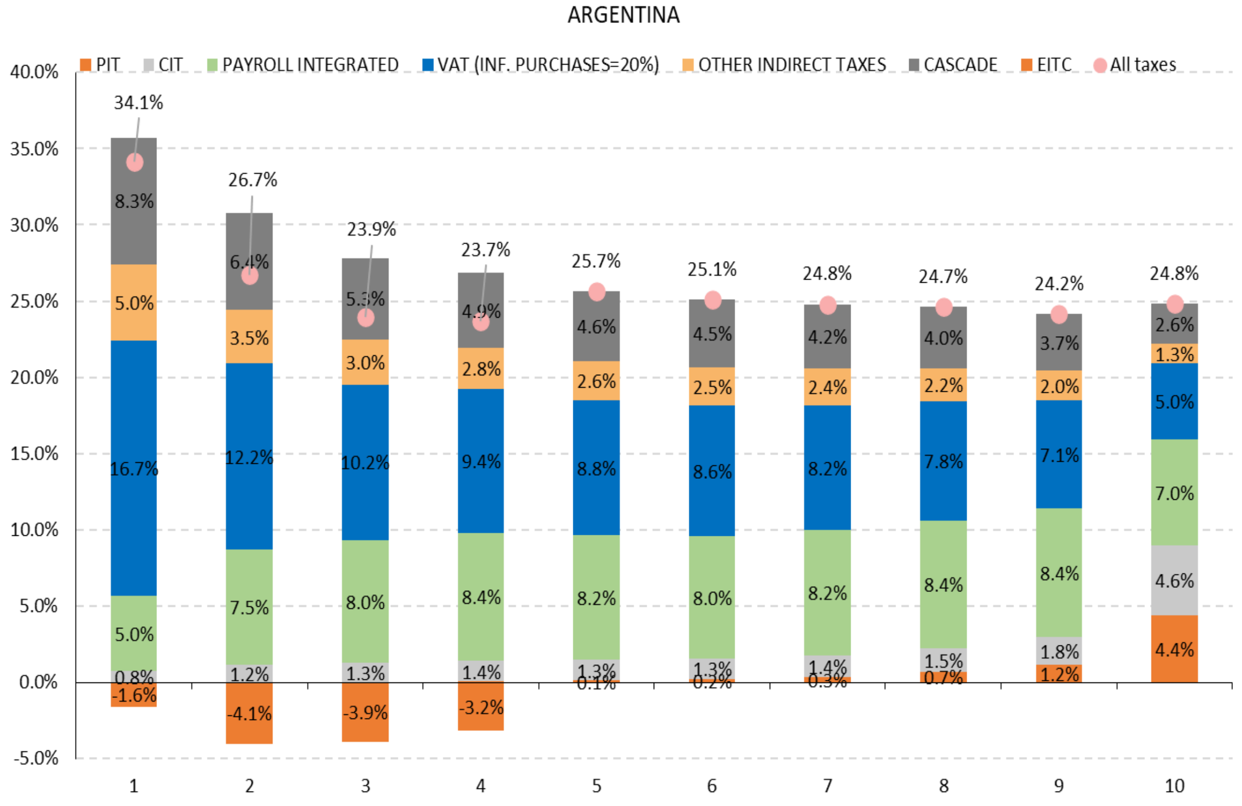
4. Improves the **human capital of the poor.**

Income Tax Credit makes PIT and Distribution of Taxes more progressive

Without EITC

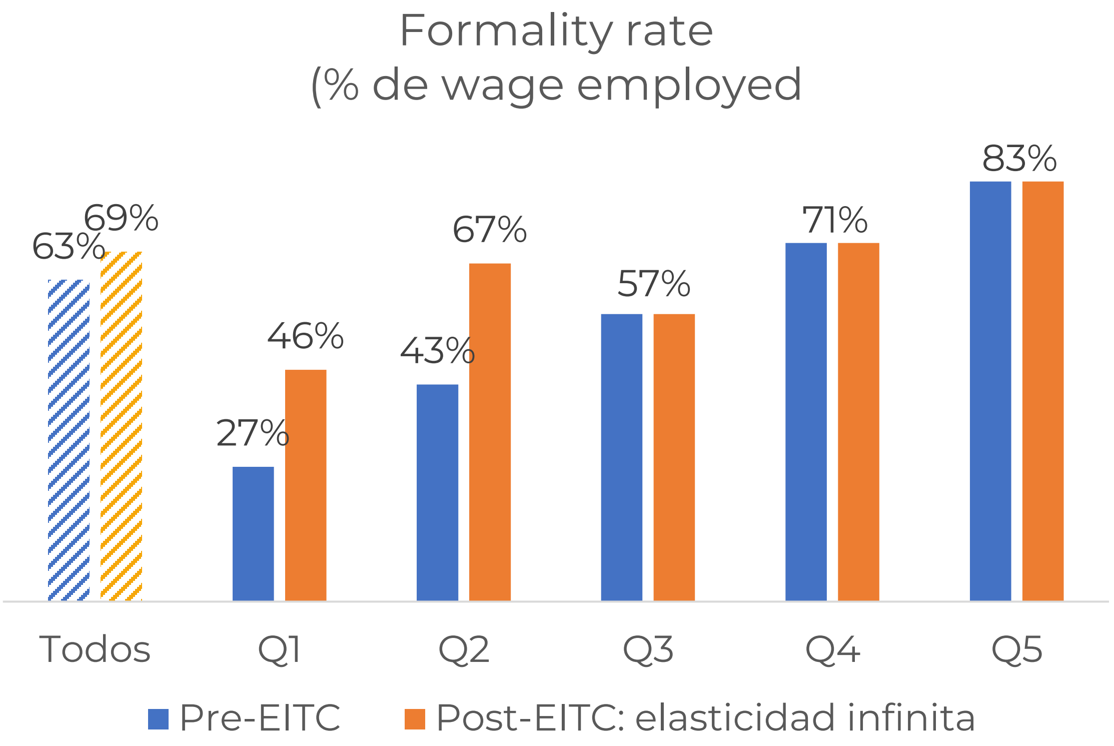


Distribution with EITC



Source: Pessino, The EITC, simulations for Argentina, forthcoming.

The Tax credit Increases Potential formality in average 6pp :20pp for first quintile. Also decreases poverty



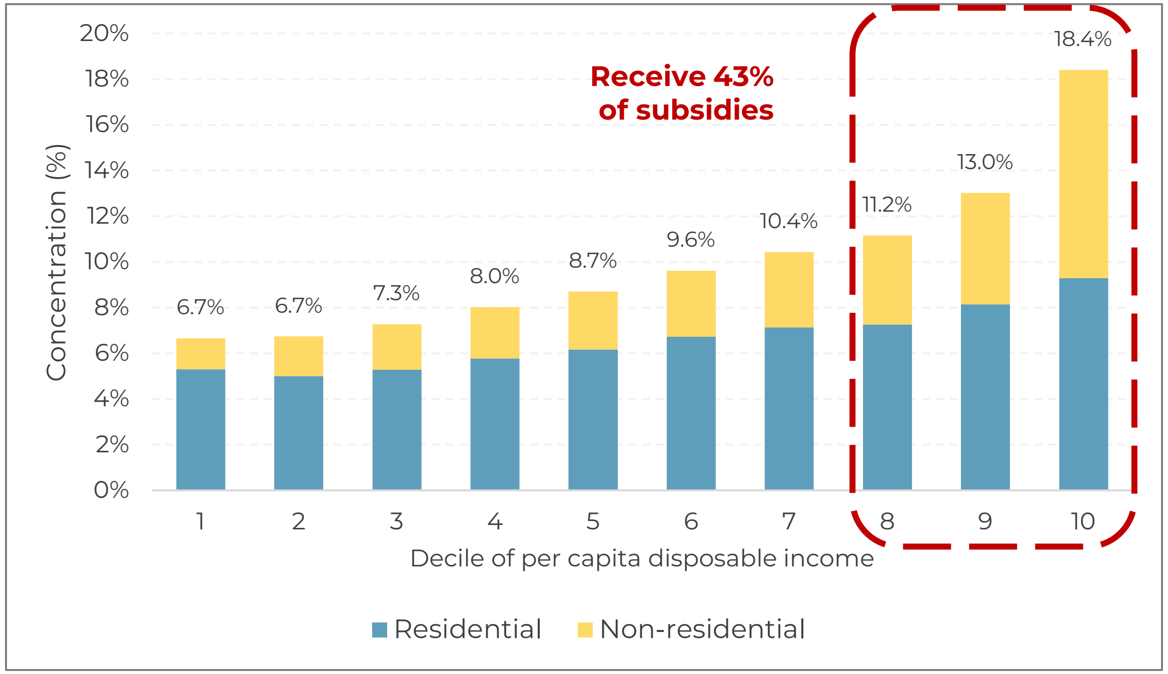
Decreases poverty in about 1pp.

Increase formal labor market experience, human capital, and growth of wages.

Decreases welfare dependence

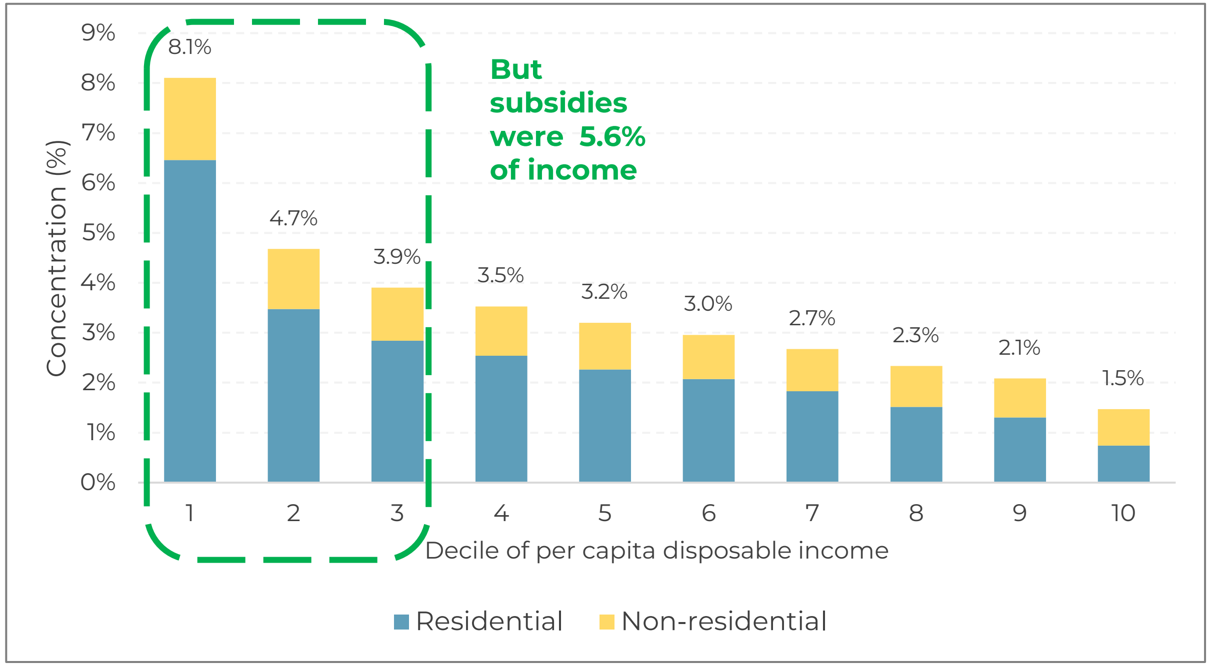
Decreasing energy subsidies in Argentina balancing efficiency and equity

Subsidies by deciles
(as % of total subsidies)



Pro-rich

Subsidies by deciles
(as % of disposable income)



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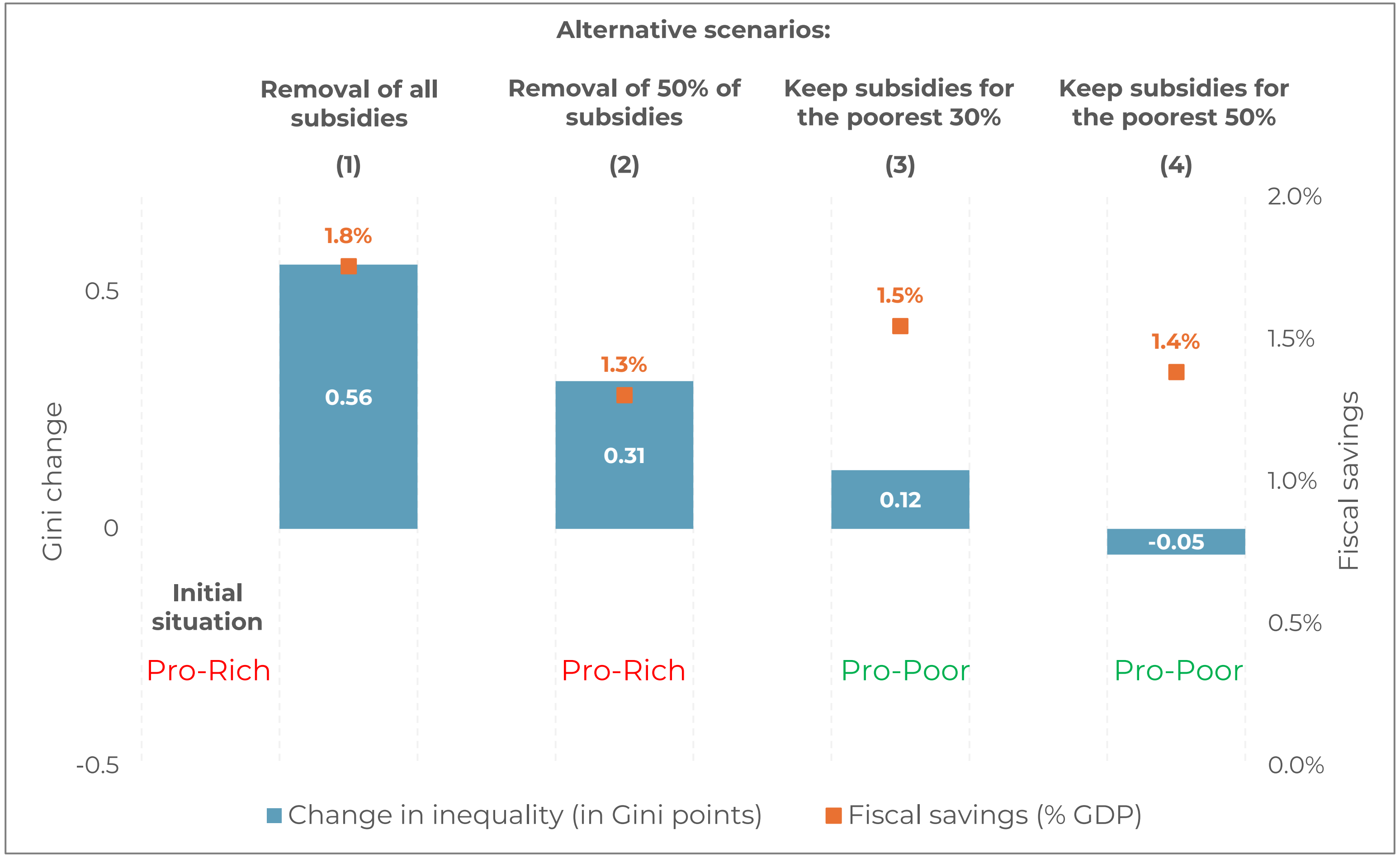
Microsimulations of Subsidy Reductions: The trade off between fiscal deficit and equity



Source: Laboratory of Policies for Fiscal Equity (LAPEF) estimations based on data from ENGHo 2017/8 and EPH 2022

Targeting Methods Depend on Information System Quality

INGREDIENTS FOR EFFICIENT TARGETING SYSTEMS IN LATIN AMERICA

THEY REQUIRE **RELIABLE INCOME INFORMATION** IN REAL TIME

POVERTY CENSUS AND REGISTRIES OF SOCIAL PROGRAMS OR TAX DATA ARE INSUFFICIENT DUE TO LARGE INFORMALITY, WITH **SELF- REPORTING AND LACK OF UPDATING**

FISCAL INTELLIGENCE ECOSYSTEM (EFI) ARE TARGETING EFFICIENT SINCE THEY GATHER **THIRD PARTY DATA** TO UNCOVER INCOME IN REAL TIME

INCLUSION CRITERIA

EXCLUSION CRITERIA

Conclusions

- Tax systems in LAC have low redistributive power
  - Even with informality VAT possess large tax burdens on the poor
  - Low collection of PIT and taxes on wealth but high on CIT compensates
  - Payroll taxes are more regressive with informality
  - Indirect and Labor Taxes increase poverty, and overall taxes dos
- Tax policy could play a larger role in income redistribution and poverty changes
  - E.g. NIT, P-VAT, energy subisidies
- Careful baseline analysis, microsimulations to anticipate winners and losers, and well-targeted implementation make all the difference between a reform that fails and one that delivers fair and feasible fiscal change.