cepr
CENTER FOR ECONOMIC AND POLICY RESEARCH

Briefing Paper

Is It Time to Export the US Tax Model to Latin America?

John Schmitt

March 2003

John Schmitt is a Senior Research Associate with the Center for Economic and Policy Research. He can be reached at jschmitt@cais.com. The author would like to thank Dean Baker, Heather Boushey, Charles Call, Sarah Gammage, Tim Kessler, and Mark Weisbrot for many helpful comments; and Simone Baribeau for help with some of the data.

CENTER FOR ECONOMIC AND POLICY RESEARCH • 1621 CONNECTICUT AVE., NW, SUITE 500
WASHINGTON, D.C. 20009 • (202) 293-5380 • <WWW.CEPR.NET> • EMAIL: CEPR@CEPR.NET

EXECUTIVE SUMMARY

Compared to developed economies, tax revenues in almost all Latin American countries are extremely low. In practice, these low tax receipts mean that Latin American governments are foregoing a substantial source of potential resources for promoting economic development and reducing poverty.

This paper explores the impact on Latin American government finances of having each country in the region adopt a tax system modeled – both with respect to the overall revenue levels and the degree of progressivity – on the system currently in place in the United States. The resulting additional revenues flowing from the adoption of the US model would be substantial. The extra revenues from the US tax model, for example, would allow most of the countries in the region to double current expenditures on education and health. The additional revenues would also far exceed current levels of foreign assistance. In fact, at the level of Latin America as a whole, the additional revenues from implementing a US-style system would be three times larger than the total foreign assistance provided by all the world's rich countries to all the world's poor countries.

The main obstacles to implementing US-style tax reform in the region are political, not practical. Raising taxes through progressive means would require increasing the taxes paid by the most politically powerful groups in each country. In the best of all possible worlds, providing the extra revenues needed for development through higher levels of foreign aid would be more just, but a pragmatic view suggests that such resources are unlikely to be forthcoming.

Finally, in addition to providing resources critical to promoting growth and reducing poverty, reorienting Latin American tax systems toward raising substantially more taxes in a more progressive way would also have important positive effects on broader efforts to promote transparency and improve governance.

INTRODUCTION

For decades, the International Monetary Fund (IMF), the World Bank, the Inter-American Development Bank (IDB), and other international organizations have implicitly and explicitly promoted the United States as an economic model for Latin America. At various times, policy-makers and economists affiliated with these organizations have urged Latin American countries to deregulate labor markets, liberalize financial markets, open international trade, enforce patents and copyrights, privatize national industries, and take a variety of related actions all designed to remake the Latin economies in the image of the United States.

One item that is curiously missing from the long list of US-inspired policy prescriptions is a US-style tax system. Of all the structural changes that Latin America could carry out, however, none has the potential that tax reform does to accelerate economic development in the region –primarily by providing the resources needed for greater investments in education, health, and basic infrastructure. Currently, tax revenues in Latin America (except Brazil) are low by the standards of developed economies; and, throughout the region, tax systems are strongly skewed toward regressive forms of taxation that place a disproportionate burden on the poor. Implementing a tax regime modeled on the one in the United States would have two important advantages for Latin America. First, almost without exception, a US-style tax system would substantially increase revenues available for a wide range of growth-oriented and poverty-reducing development projects.[1] In fact, simple calculations suggest that the extra revenue available would swamp current levels of foreign assistance to the region from *all* national and multilateral sources. Moreover, these revenues would not only directly contribute extra resources for development, but would also give national governments macroeconomic breathing room to pursue alternatives to the deflationary policies enshrined in the "Washington consensus." A second advantage to a US-style tax system is that it would be significantly more progressive than the tax regimes currently in place in the region. A US-style reform would raise substantial new revenues, but do so by placing a much lower relative burden on the poor.

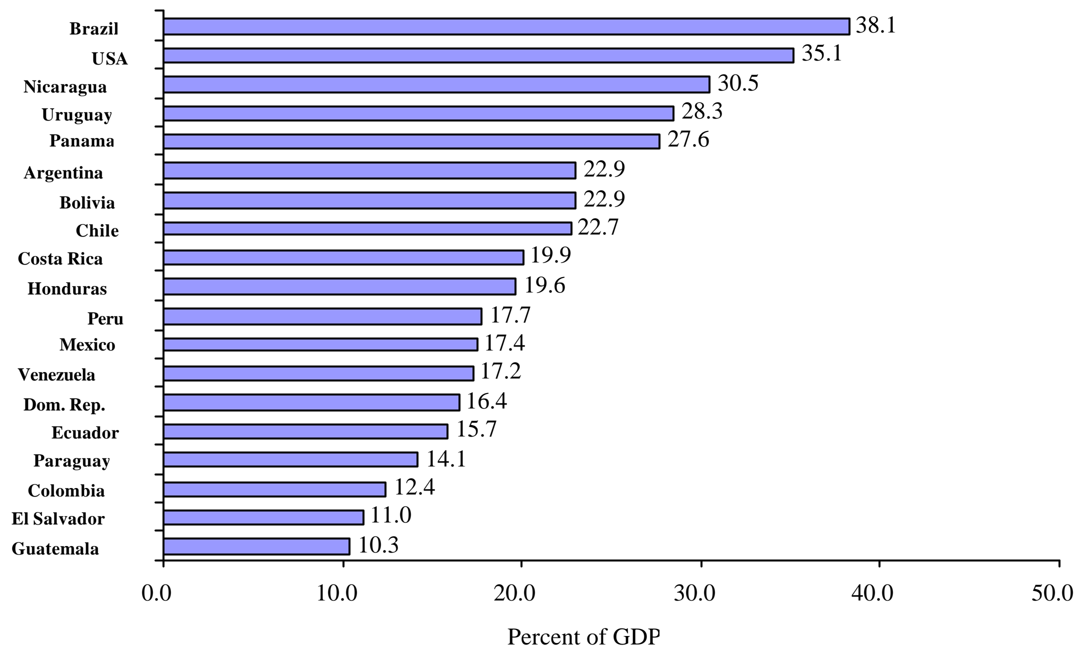
This paper first develops and applies a simple model of the US tax structure to the economies of 18 countries in Latin America.[2] The paper then compares the resulting projected revenues to current tax receipts, current government expenditures, and foreign aid received. Next, the paper considers five possible objections to the proposal. Finally, the paper concludes with some general observations on economic development and a set of specific policy recommendations in the area of tax policy for the region.

The focus of this paper is tax policy, but tax reform cannot be considered independently of government expenditures. Much of the discussion that follows will also consider the role that the government expenditure on public services will play in successful tax reform. Any kind of tax reform designed to raise additional revenues will fail if the population believes that the additional resources will be squandered through corruption or incompetence; targeted toward a narrow section of the population; or, most fatally, used primarily to repay foreign debt.

APPLYING THE US TAX MODEL TO LATIN AMERICA

Some important differences in revenue structures

The US tax system differs from the variety of tax programs in place in Latin America in several key respects. First, tax revenues are much higher, as a share of gross domestic product (GDP), in the United States than they are almost everywhere in Latin America (see **Figure 1**).[3] At the end of the 1990s, for example, total tax revenue in the United States amounted to 35.1% of GDP. In Latin America, only Brazil (38.1%) collected more revenue as a share of GDP than the United States did. In the rest of the region, the tax share of GDP in Latin America ranged from a low of 10.3% in Guatemala to a high of 30.5% in Nicaragua.



Second, while direct comparisons are difficult to make, the US tax system is almost certainly far more progressive than the tax collection regimes currently in force in every country in the region. A definitive conclusion is hard to reach because few countries in Latin America have tax incidence models of the kind that the Congressional Budget Office (CBO) or the independent Institute on Taxation and Economic Policy (ITEP) use to assess the impact of tax policy on the income distribution. Nevertheless, we can still safely conclude that the US system is more progressive because we do know

about the kinds of taxes in use in the United States and in Latin America, and about the typical progressivity or regressivity of each of these types of taxes.

As **Table 1** demonstrates, Latin American treasuries rely heavily on taxes on goods and services, such as value-added, sales, and excise taxes, all of which are typically highly regressive. These types of taxes are typically regressive because the tax rate on goods that are consumed are identical for all income levels. Since lower- and middle-income individuals generally consume a much higher share of their total income than higher-income individuals, lower- and middle-income individuals end up paying a higher share of their income in taxes than higher-income individuals do. Latin American governments raise far less revenue from personal and corporate income taxes, which is the most important revenue source in the United States and one that is fairly progressive, even after tax changes early in the current Bush administration.[4]

TABLE 1
Current sources of central government tax revenue, average of all available years, 1995-2000
(Percent of total revenue)

	Incomes profits, & cap. gains	Goods & services	Social security	Exports	Imports	Other	Nontax revenues
Argentina	14.4	40.4	27.6	0.2	8.7	2.9	8.6
Bolivia	6.8	47.4	11.0	0.0	5.5	10.5	18.0
Brazil	18.4	21.9	35.2	0.0	8.9	4.8	17.0
Chile	17.9	46.2	6.3	--	--	4.3	17.2
Colombia	34.7	42.0	0.0	0.0	7.5	1.1	13.7
Costa Rica	12.0	38.5	28.5	1.1	4.2	0.8	11.5
Dom. Rep.	16.7	33.4	3.9	0.0	12.5	1.0	7.6
Ecuador	--	--	--	--	--	--	--
El Salvador	20.7	40.5	13.2	0.0	3.6	1.8	16.1
Guatemala	--	--	--	--	--	--	--
Honduras	--	--	--	--	--	--	--
Mexico	31.5	57.5	12.3	0.0	2.1	1.8	13.1
Nicaragua	12.1	58.1	13.2	0.0	4.1	0.0	7.7
Panama	19.0	--	17.1	0.4	--	4.0	33.0
Paraguay	--	--	--	--	--	--	--
Peru	20.0	49.4	8.1	0.0	11.6	4.2	14.5
Uruguay	12.9	36.9	29.2	0.1	5.8	9.8	8.4
Venezuela	30.3	29.1	3.3	0.0	11.0	2.5	28.2
United States	55.2	3.5	32.1	0.0	2.1	1.3	6.8

Notes: Averages of available data from World Bank, *World Development Indicators* 2002. Revenue shares do not sum to 100. Central government revenues exclude state, provincial, and local government revenues, included in analysis below. Nontax revenues include revenues from: the sale of oil, gas, and other natural resources; profits from state-owned enterprises; privatizations; and other sources.

Tax systems in the United States and in most Latin America countries also differ in a third respect. The United States raises a substantial share of its total national tax revenue at the state and local level. IMF data suggests that, in Latin America, only Argentina and Brazil collect a comparable share of revenue at the state or local level. (See **Table 2**, which provides a breakdown of tax revenue by federal, state, and local government.)

TABLE 2
Federal, state, and local tax revenues, 1990s
(Percent of GDP)

	Year	Total revenue	Total federal	Federal - Soc. Sec.	Social Security	State	Local
Argentina	1998	22.9	13.8	8.2	5.6	9.1	--
Bolivia	1999	22.9	17.9	16.5	1.5	1.2	3.7
Brazil	1998	38.1	25.9	17.6	8.3	10.1	2.1
Chile	1999	22.7	20.8	19.4	1.4	--	1.9
Colombia	1999	12.4	12.4	12.4	--	--	--
Costa Rica	1999	19.9	19.9	14.1	5.8	--	--
Dom Rep	1999	16.4	16.4	15.7	0.6	--	--
Ecuador	1994	15.7	15.7	15.7	--	--	--
El Salvador	1999	11.0	11.0	11.0	--	--	--
Guatemala	1999	10.3	10.3	10.3	--	--	--
Honduras	1999	19.6	19.6	--	--	--	--
Mexico	1998	17.4	13.0	11.1	1.9	3.3	1.1
Nicaragua	1999	30.5	30.5	25.8	4.7	--	--
Panama	1999	27.6	27.6	20.8	6.8	--	--
Paraguay	1993	14.1	14.1	--	--	--	--
Peru	1999	17.7	16.5	14.7	1.7	0.3	0.9
Uruguay	1999	28.3	28.3	20.7	7.6	--	--
Venezuela	1999	17.2	17.2	16.3	0.9	--	--
United States	1999	35.1	20.6	13.8	6.8	9.1	5.4

Notes: Revenue data from IMF, *Government Financial Statistics Yearbook,* 2001, except the data for Honduras, which were taken, with GDP data, from the *IMF, International Financial Statistics*, various issues. Federal, state, and local revenues exclude international grants and grants from higher levels of government. For Guatemala, in 1993 (the latest year for which data are available), local revenues were about 0.3% of total federal, state, and local revenues. For Nicaragua, in 1993 (latest year), local revenues were about 10.1% of total federal, state, and local revenues. For Paraguay, in 1988 (latest year), social security were about 15.2% of total federal revenues; extra-budgetary accounts were about 0.9%. For Uruguay, in 1997 (latest year), total revenues and grants were about 12.7% of total federal revenue, but the IMF does not distinguish between revenues and grants. "--" indicates that the IMF does not report for these categories. Federal includes extra-budgetary revenues in Argentina (0.5), Bolivia (1.4), Brazil (1.4), Costa Rica (2.2), Dominican Republic (0.2), Panama (1.1), Peru (0.2), and Uruguay (1.7).

The large contribution of state and local taxation to the total tax revenues in the United States has important implications for the analysis here. Since state and local tax

systems in the United States, like those in most of Latin American, rely heavily on regressive forms of taxation such as sales, excise, and property taxes, the total US tax system is significantly less progressive than it would be if all revenues were raised through the federal system alone.[5] Since the federal income tax system is fairly progressive and constitutes the most important overall source of tax revenue in the United States, the combined federal, state, and local tax system in the United States, however, remains progressive and certainly more progressive than the current systems in Latin America.[6]

A simple model of US tax structure

The simplest way to gauge the fiscal impact of implementing a US-style tax system in Latin America would be to apply the percentage of total tax revenues in GDP in the United States to each country in the region. As Figure 1 demonstrated, this crude approach suggests large potential increases in tax revenue for almost all of the countries in the region. Since total US tax revenues under 2001 tax law are about 35% of GDP, implementing a US-style system would, roughly speaking, raise extra revenues ranging from about five percentage points of GDP in Nicaragua to 25 percentage points in Guatemala.[7]

The analysis that follows below, however, uses a slightly more sophisticated tax model that takes distributional effects of the US tax system into account. The approach is to match the effective tax rates that apply to different points in the US distribution of income (bottom 20%, next 20%, and so on) to the actual amounts of income earned at the corresponding point in the national income distributions in Latin America.[8] In principle, since the US tax system is progressive and incomes in Latin America are even more unequally distributed than they are in the United States, application of a US-style tax system in Latin American countries would raise proportionally more revenues there than the same system does in the United States.[9] In practice, however, administrative difficulties in implementing an expanded tax collection system –especially at the beginning of such an effort– almost certainly mean that the model will overstate potential revenues in Latin America under a US model. The discussion below of possible objections to the application of the US tax model will return to this issue.

Tables 3, 4, and 5 sketch the steps involved in applying this distribution-based model to the income distributions in Latin America. **Table 3** reports data from the World Bank on the distribution of income in Latin America and the United States. The first four columns show the share of national income (generally at the end of the 1990s) received by each of the bottom four income quintiles; the last two columns show the income received by the next ten percent and the top ten percent of the distribution. The data demonstrate the high level of income inequality in all countries, including the United States, but also show that the United States is generally more equal than Latin America. In the United States, for example, the wealthiest 10% controls 30.5% of national income, the smallest share of any country in the table. The bottom quintile of the distribution in the United States receives only 5.2% of national income, but this is higher than every

country in Latin America except Uruguay (5.5%), with the Dominican Republic close behind, at 5.1%.

TABLE 3
Distribution of income or consumption, by quintile, 1990s
(Percent of total income or consumption)

	Year	Bottom tenth	Income fifth: Bottom	Second	Middle	Fourth	Top	Top tenth
Argentina	1996	1.5	4.3	8.6	13.2	20.8	52.9	35.9
Bolivia	1999	1.3	4.0	9.2	14.8	22.9	49.1	32.0
Brazil	1998	0.7	2.2	5.4	10.1	18.3	64.1	48.0
Chile	1998	1.3	3.3	6.5	10.9	18.4	61.0	45.6
Colombia	1996	1.1	3.0	6.6	11.1	18.4	60.9	46.1
Costa Rica	1997	1.7	4.5	8.9	14.1	21.6	51.0	34.6
Dom. Rep.	1998	2.1	5.1	8.6	13.0	20.0	53.3	37.9
Ecuador	1995	2.2	5.4	9.4	14.2	21.3	49.7	33.8
El Salvador	1998	1.2	3.3	7.3	12.4	20.7	56.4	39.5
Guatemala	1998	1.6	3.8	6.8	10.9	17.9	60.6	46.0
Honduras	1998	0.6	2.2	6.4	11.8	20.3	59.4	42.7
Mexico	1998	1.3	3.5	7.3	12.1	19.7	57.4	41.7
Nicaragua	1998	0.7	2.3	5.9	10.4	17.9	63.6	48.8
Panama	1997	1.2	3.6	8.1	13.6	21.9	52.8	35.7
Paraguay	1998	0.5	1.9	6.0	11.4	20.1	60.7	43.8
Peru	1996	1.6	4.4	9.1	14.1	21.3	51.2	35.4
Uruguay	1989	2.1	5.4	10.0	14.8	21.5	48.3	32.7
Venezuela	1998	0.8	3.0	8.2	13.8	21.8	53.2	36.5
United States	1997	1.8	5.2	10.5	15.6	22.4	46.4	30.5

Notes: Data for all countries except Argentina from World Bank, *World Development Indicators* 2002, CD, series SI.DST. Data for Argentina, which refer to Greater Buenos Aires only, are from Inter-American Development Bank, Economic and Social Progress in Latin America 1998-1999 Report, Appendix Table 1.2, p. 25.

Table 4 shows the effective tax rates in the United States under 2001 tax law for the same categories of the income distribution presented in Table 3. According to the table, taxpayers in the bottom quintile of the US income distribution pay, on average, 16.7% of their income in federal, state, and local taxes; the top 10%, meanwhile, pay about 36.4%.[10] Unfortunately, comparable breakdowns for the Latin American countries analyzed here are not available. As the earlier discussion emphasized, however, if such data were available, for almost all countries the average rates under existing tax systems would be lower at each point in the income distribution (relative to the combined US federal, state, and local system), and effective tax rates would be flat or falling as income rose.

TABLE 4
Effective tax rates in the United States, approximating 2001 tax law
(Percent)

Income group	Federal	State & local	Total federal, state & local
Bottom 20%	5.3	11.4	16.7
Second 20%	12.8	10.3	23.1
Middle 20%	16.7	9.6	26.3
Fourth 20%	20.0	8.8	28.8
Next 10%	25.7	7.7	33.4
Top 10%	29.4	7.0	36.4

Notes: Federal effective tax rates under 2001 tax law from Congressional Budget Office, *Historical Effective Tax Rates, 1979-1997*, Preliminary Edition, May 2001, Table G-1a. Average effective state & local tax rates for 2002 from Institute on Taxation & Economic Policy, *Who Pays? A Distributional Analysis of the Tax System for All 50 States,* 2nd Edition, January 2003, p. 118.

Table 5 presents the results of applying the US total effective tax rates in Table 4 to each of the national income distributions in Table 3.[11] To simplify comparisons, the first column of the table shows an estimate, based on IMF data, of current total revenues under the existing tax system in each country. The second column of the table reports the additional revenue that the country would receive if the same effective tax rates as the United States were applied to the existing national distribution of income.[12] In every case, except Brazil, the resulting increases in revenue would be large relative to national income, ranging from about two percentage points of GDP for Nicaragua (1.9) and Uruguay (2.1) to 12 percentage points or more of GDP for Colombia (19.6), Dominican Republic (14.6), Ecuador (14.8), El Salvador (20.5), Guatemala (21.5), Honduras (12.3), Mexico (14.2), Peru (13.2), and Venezuela (14.0).

If used effectively, these additional revenues could make a substantial contribution to national economic and social development. The scale of additional funds is large relative both to current expenditures and development needs. The third and fourth columns of Table 5 compare the extra revenues with current public spending on education and health. With the exception of Brazil, Nicaragua, Panama, and Uruguay, the additional revenues from a US-style tax system would allow at least a doubling of current public expenditures on either education or health care. In all but five of the countries in the region, the additional revenues would allow the simultaneous doubling of public expenditures on *both* education and health.

While using the additional funds to reduce fiscal deficits would generally have a detrimental impact on long-term economic development, the additional revenues would also be large enough to eliminate the fiscal deficit in every country in the region, except Brazil (where the average deficit at the end of the 1990s was large, and where applying the simple model of the US tax structure would actually lower revenues). These

additional tax receipts are, in most countries, also larger than interest payments on foreign debt (exceptions are Nicaragua, Panama, and Uruguay).

TABLE 5
Relative size of extra tax revenue under the US tax model
(Percent of GDP)

			Comparisons (1995-2000 average)				
	Current	Extra	Public spending		Surplus	Interest on	Foreign aid
	revenue	revenue	Education	Health	or deficit	foreign debt	received
Argentina	22.9	8.0	3.7	1.0	-1.9	3.4	0.0
Bolivia	22.9	7.8	5.3	3.7	-2.5	3.1	8.5
Brazil	38.1	-5.7	4.8	2.9	-7.5	1.7	0.0
Chile	22.7	9.2	3.4	2.8	1.0	2.1	0.2
Colombia	12.4	19.6	3.3	4.5	-4.4	3.0	0.2
Costa Rica	19.9	10.9	4.5	5.0	-1.8	3.3	0.1
Dom. Rep.	16.4	14.6	2.0	1.8	0.2	2.1	0.1
Ecuador	15.7	14.8	3.2	2.1	--	--	1.0
El Salvador	11.0	20.5	2.3	2.8	-0.6	1.9	2.2
Guatemala	10.3	21.5	1.8	1.7	--	--	1.4
Honduras	19.6	12.3	3.8	3.7	--	--	9.0
Mexico	17.4	14.2	--	2.4	-1.0	4.8	0.0
Nicaragua	30.5	1.9	3.5	8.7	-2.5	9.5	31.2
Panama	27.6	3.4	5.0	5.3	0.4	5.8	0.4
Paraguay	14.1	18.0	4.0	1.6	--	--	1.1
Peru	17.7	13.2	3.2	2.4	-0.3	3.0	0.7
Uruguay	28.3	2.1	2.7	2.3	-2.0	3.5	0.2
Venezuela	17.2	14.0	--	2.4	-1.3	3.7	0.0

Notes: Additional revenue calculated by applying US effective tax rates in Table 4 to income distributions in Table 3 and comparing resulting revenues to current revenues from Table 2. Rest of series are 1995-2000 average from World Bank, World Development Indicators 2002, CD: public spending on education (series SE.XPD.TOTL.GD.ZS); health (SH.XPD.PUBL.ZS); service on public and publicly guaranteed debt (DT.TDS.DPPG.RV.ZS); surplus or deficit (GB.BAL.OVRL.GD.ZS) and foreign aid received (DT.ODA.ALLD.CD).

Perhaps the most revealing comparison, however, is with respect to foreign aid. The last column of Table 5 reports the average amount of foreign aid received in each country over the period 1995-2000. The most striking feature is how small foreign aid is as a share of GDP in all but a few of the poorest countries in the region (Bolivia 8.5% of GDP; Honduras, 9.0%; and Nicaragua, 31.2%). In the rest of the region, foreign aid is between 0.0% and 2.2% of GDP, well below the additional revenues available from implementing a US-style tax system.

The emphasis so far has been solely on the extra revenue that a US-style system could generate. As mentioned above, an important secondary benefit –which would apply even in Brazil, where the current tax regime already raises more revenues than a US-style

system would– is that the US model would raise taxes in a more equitable fashion than existing, regressive, regional tax systems.

POSSIBLE OBJECTIONS

Any plan to raise any tax anywhere will encounter some degree of political opposition as well as some administrative constraints. This section considers five possible objections.

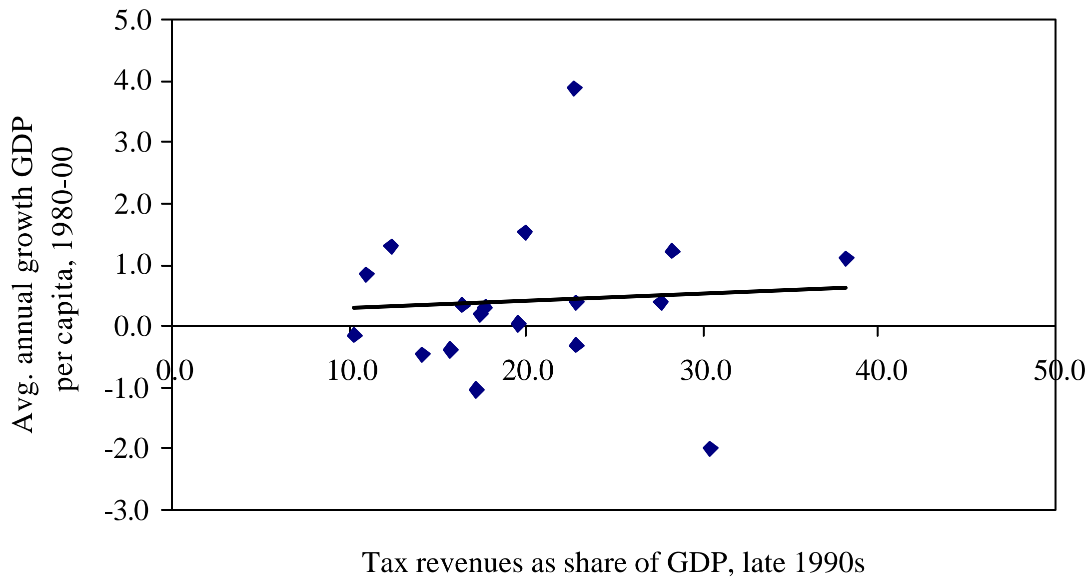
1. Higher taxes would hurt growth.

The impact of taxes on economic growth depends crucially on how the tax revenues are spent. Standard economic theory implies that taxes[13] distort economic decisions and, therefore, in principle reduce economic well-being relative to a world without taxes. This kind of economic analysis, however, largely ignores the expenditure side of taxes. Uncritical application of standard theory predicts, for example, that a country with no taxes would grow faster than one with a "moderate" (for argument's sake) tax burden. Common sense suggests, however, that businesses in the country with no taxes would quickly experience a host of problems such as sending and receiving goods on decaying roads, ports, and airports or finding healthy, educated workers.

In practice, the real impact of taxation on growth depends fundamentally on a variety of factors including the structure and enforcement of the tax system and the expenditures toward which taxes go. In fact, international experience provides no support for the notion that lower taxes mean faster growth. Since the end of World War II, for example, per capita GDP growth has been higher in Europe than it has been in the United States, despite generally much higher tax rates in Europe. In Latin America itself, taxes seem to have no impact on growth rates either. For each country in the region, **Figure 2** plots the average annual growth in GDP per capita between 1980 and 2000 against the corresponding national tax burden at the end of the 1990s. The two variables show no apparent relationship.[14]

If additional tax revenues allow a substantial increase in spending on education, health, and basic infrastructure –all of which would work to improve national labor productivity– higher taxes should promote and sustain growth, not undermine it. In the end, success in an increasingly globalized world almost certainly requires higher, not lower, taxes. As IMF economists Vito Tanzi and Howell Zee (2000) have observed: "[Emerging markets] will probably need a higher tax level, because of the need to pursue a government role closer to that of the industrial countries that have twice the tax burden." (p. 30)

Fig. 2: Relationship between taxes and growth in Latin America



Sources: Author's analysis of Table 2 and World Bank, *World Development Indicators 2002*, Table 2.2.

2. It's not practical: Latin American governments lack administrative capacity.

Most governments in Latin America would certainly face difficulty, at least at the beginning, matching the efficiency of the US Internal Revenue Service or comparable European tax services. As a result, the estimates of extra revenues in Table 5 may be higher than can reasonably be expected, especially in the early stages of reform. Nevertheless, with political will and appropriate administrative reforms, Latin American governments could move steadily from current low tax revenues toward the higher rates currently achieved by the United States – especially if the higher revenues were clearly linked to better education, health, and other public services. In fact, the idea that Latin American countries couldn't possibly succeed in efforts to increase revenues stands at odds with core beliefs of the Washington consensus, which assumes elsewhere that Latin governments are fully capable of: regulating newly liberalized financial markets, private banks, and privatized energy, telecommunications, financial, water, and other companies; implementing and administering vast systems of personal retirement accounts; enforcing software and other copyrights and patents; guaranteeing a fair and effective civil justice system for business law; and undertaking a host of similar kinds of highly sophisticated governmental operations. Tax administration is certainly no more complicated than many of these other tasks routinely assumed to be within the capabilities of Latin American governments. To the extent that administrative capacity is limited, few of the competing demands posed by the Washington consensus offer nearly the medium- or long-term

potential that greater revenues for education, health, and basic infrastructure do for promoting growth or reducing poverty.

The historical experience of the United States may also be instructive in this respect. In 1947, the United States had a GDP per capita in 1996 dollars that was about $10,300 per year, which is less than the World Bank's estimate of GDP per capita (on a purchasing-power-parity basis) in 2000 for Argentina ($12,377), not far ahead of the Chile ($9,417), Costa Rica ($8,650), Mexico ($9,023), Uruguay ($9,035), and less than twice the level for Brazil ($7,625), Colombia ($6,248), the Dominican Republic ($6,033), Panama ($6,000), and Venezuela ($5,794).[15] In 1947, though, the United States already raised 56.6% of its total tax revenue from personal and corporate income taxes, well ahead of comparable figures for Latin America in the first column of Table 1.[16] The fundamental barriers to implementing effective, progressive income and corporate taxes are, therefore, not related to national income levels.[17]

Nevertheless, many obstacles to effective tax administration are certainly at work in Latin America. In the poorest countries, some of these barriers may, in fact, stem from the current low level of taxation itself, which reduces the efficiency of government agencies and the professionalism of civil servants. The way to break this logjam is through a concerted effort, perhaps with international support, to raise taxes sufficiently to ensure adequate funding of government services. An added advantage of such an effort is that a strong and respected tax agency, free of the taint of corruption, would offer important spillovers in financial-market regulation, banking regulation, the civil court system (especially with respect to business law), and elsewhere. The resulting benefits to the business climate could be far-reaching and reinforce a positive tax-fueled growth spiral based on rising labor productivity.

3. It's not fair: Aid, not taxes.

Relative to a system where wealthier countries –and particularly wealthier people in wealthier countries– provide generous foreign aid to alleviate poverty and promote long-term development, applying the US tax model to Latin America is certainly not fair. In the absence of large-scale aid, of the sort that the United States provided to Europe after World War II,[18] and, in a political context where the future prospects of large-scale aid are negligible, pragmatism argues in favor of encouraging poor countries to mobilize more of their own resources for development, particularly for education and health expenditures and poverty-alleviation programs, where foreign aid is, in any case, generally not forthcoming.[19] As **Table 6** illustrates, the additional tax-financed funds that would be available to just the 18 Latin American countries analyzed here would amount to over three times more resources than the world's advanced economies currently offer in aid to *all* developing countries. In fact, the resulting extra tax revenues in Latin America would exceed *all net public and private flows from all rich countries to all poor countries*. Tax revenues would have the added advantage of being free of the political strings and development fashions that often make foreign assistance far less helpful for development than it should be.

TABLE 6
Aid versus taxes, 2000
(US$ billions)

(a) All official development assistance	
Bilateral grants	33.0
Bilateral loans	3.0
Contributions to multilateral institutions	17.7
Total	53.7
(b) All private flows to developing countries	
Foreign direct investment	67.2
Other private flows	7.3
Total	74.5
(c) Grants by non-governmental organizations	
Total	6.9
(b) Additional revenue under US tax model	
Total (excluding Brazil)	167.4
Total (a)+(b)+(c)	135.2

Notes: Net official development assistance, private capital flows, and NGO grants to all part I countries (including countries outside Latin America) from all Development Assistance Committee members, from World Bank, *World Development Indicators 2002*, Table 6.8. Additional revenue under US tax model based on author's calculations used to produce Table 5; if Brazil lowered tax revenues to the level implicit in the US model, the Latin American regional total would be $133 billion.

4. It's not fair: The poor in poor countries shouldn't have to pay.

Again, relative to a system based on large-scale aid transfers from rich countries, raising taxes –including taxes on the poor– in Latin America is certainly not fair. But, the poor already bear a significant portion of the tax burden in Latin America because so much of the tax base there relies on regressive taxes. Under a US-style system, Latin

governments would raise more funds, but the relative share of the total burden (if not the absolute level of the burden) borne by the poor would decline.

The crucial issue of fairness, in this context, however, does not depend solely on the progressivity of the *tax* structure. The relevant calculation is the progressivity of the *combined tax and expenditure* system. If substantially increased tax revenues fund education, health, basic infrastructure projects, and direct-poverty alleviation programs that disproportionately benefit the poor, even a regressive tax system based on value-added or similar taxes can be progressive –after the corresponding expenditures are taken into consideration.

A crucial and closely related issue is the effectiveness with which regional governments use new funds to deliver public goods and services effectively. A major political barrier to increasing taxes is the widespread perception that tax revenues will be squandered by incompetent or corrupt public sectors –or used primarily to pay off international debt. In the end, then, the ultimate fairness of a tax system depends most fundamentally on the nature and effectiveness of public spending made possible by the greater revenues. The recent history of Brazil provides a useful example. Brazil raises far more tax revenue as a share of GDP than any other country in Latin America (see Figure 1), but spends less than many other governments in the region on education and health (also as a share of GDP, see Table 5). Relative to the rest of the region, none of the additional tax revenues in Brazil have gone to increasing expenditures in these areas that are crucial to economic development and the alleviation of poverty.[20]

Current low levels of government revenue severely restrict the scope for Latin governments to play a positive role in development and poverty alleviation through intelligent application of subsidies on public goods and services, taking advantage of economies of scale in delivery of many public and private goods and services, and the coordination of consumption of public services, including health and education. Governments can use these and other means to facilitate the poor's access to key goods and services that might otherwise be difficult for the poor and even the middle class to buy in private markets.

5. It's not practical: One size fits all policies are doomed in diverse Latin America.

This is a compelling argument, but, as with the preceding concerns about administrative capabilities, it is applied selectively. If the US tax model is not appropriate for the diverse economies of the region, is the US model any more appropriate for banking, financial markets, copyright and patent law, civil law, or labor-market policies? Almost certainly, the US tax model is *not* appropriate for each and every country in Latin America. The United States has a strongly federal system, with an important share of taxes (especially for education) collected at the state and local level. The state-and-local tax system in the United States is regressive (ITEP, 2002) and incompatible with the political structure and traditions in many Latin American countries. Many Latin economies have large shares of their workforce in low-income self-employment and in

jobs in micro-enterprise that lie outside the currently taxed economy. Incorporating these income earners into the tax-and-benefit system is a challenge under any proposed tax system. Nevertheless, implementing the broad lines of the current US system – higher taxes, raised more progressively – would improve the position of most of the population in every country in the region.

CONCLUSIONS AND RECOMMENDATIONS

In the end, the principal reason why Latin American countries have not adopted US-style tax systems has little or nothing to do with the objections raised in the preceding section. The fundamental barrier to raising more taxes and raising them more progressively is that such action would require increasing the taxes paid by the most politically powerful groups in each country.[21] Moreover, to the extent that the extra revenues flow disproportionately to the poor – in the form of higher expenditures on education, health, basic infrastructure, and poverty alleviation – higher taxes also threaten to lower the relative standing of wealthier and more powerful groups, even if the resulting boost to development leaves all sectors in society better off.

The following four-point plan represents one reasonable translation of the general lines of the US tax model to Latin America. A feature of any successful reform that cuts across these specifics is the need to create political will for tax reform among governments, the general population, and national elites.

1. Latin American governments should implement a national, progressive, income tax – or, if one is already in place– significantly expand the existing system.

IMF and World Bank recommendations on existing income taxes have placed significant emphasis on simplifying and lowering tax rates for top taxpayers (ostensibly, in order to reduce incentives for tax evasion). Rather than taking an ideological opposition to these kinds of reforms, advocates of expanded tax revenue should judge the merits of each of these reforms based on the actual outcomes. Reforms that raise effective tax rates to reasonable target levels for taxpayers at the middle and the top of the income distribution are fine –however tax-policy specifics are tweaked to achieve these higher effective rates. If reforms leave revenues below targets, though, marginal rates should rise until revenue meets agreed targets.

With respect to taxation in developing countries, both the IMF and the World Bank have taken generally positive positions, including support for greater levels of tax revenue. Relative to other economic reforms pushed by these organizations, however, both organizations have typically pulled their punches on taxes, particularly when it comes to implementing progressive measures such as income taxes.[22] National organizations seeking poverty alleviation, many of which find themselves perennially at

loggerheads with the IMF and World Bank, should seize the opportunity to support the IMF and the World Bank's efforts to raise revenues, often over the objection of national elites.

2. Latin American governments should work to modernize national tax-collection agencies.

Tax-collection agencies should become the central focus of efforts to professionalize civil services, improve transparency, and reduce corruption. Key elements of these administrative reforms would include improving professional recognition and rewards for tax collectors, as well as careful independent monitoring to reduce opportunities for bribery and corruption. A special emphasis on the tax system in broader efforts to improve democracy and transparency is likely to have large spillovers to other areas of national, state, and local governance. As part of the modernization process, a logical place for Latin governments to start would be by instituting or expanding programs to improve "large taxpayers' compliance" (see IMF, 2002).

3. Latin American governments should work at the regional level to discourage – even to penalize – "tax competition" among themselves.

Tax competition punishes individual governments that take steps to raise revenues necessary for long-term development. At its worst, tax competition –especially with respect to corporate income taxes, but also in relation to personal income taxes– could spark a race to the bottom, as countries slash tax rates to attract foreign investors. At the global level, such competition has little impact on the total level of investment (only where it takes place), but such competition threatens to leave all countries without the resources they need for basic government functions and essential public investment for development. Encouraging and coordinating such activity would represent a potentially positive role for international organizations such as the IMF, the World Bank, and the Inter-American Development Bank.

4. Latin American governments should pledge that additional tax revenues will go exclusively to education, health, basic infrastructure, and poverty alleviation.

As the recent "*impuestazo*" protests against proposed tax increases in Bolivia underscore, any attempt to increase taxes will be unsustainable politically if inefficiency or corruption block the delivery of needed services, or if there is a perception that the extra resources will be used to meet international debt payments. To ensure that tax reform succeeds, governments will almost certainly have to ensure that the extra revenues will be earmarked for essential public services such as education, health care, water, and electricity. Just as importantly, governments will then have to succeed in delivering expanded and improved services, in ways that directly benefit the poor and middle class majorities.

Such a plan, inspired by some of the basic principles of the US tax code, has the potential to make substantial resources available for economic and social development in Latin America. With few exceptions, tax systems in Latin America currently fall far short of raising even the relatively low levels of tax revenue raised in the business-friendly United States. All of the current Latin American tax systems raise revenues in a way that is considerably more regressive than the US tax system, which relies heavily on a progressive income tax.

The many problems of applying the US model blindly to the diverse circumstances of Latin America are real. These complexities and concerns also apply equally to other areas of the dominant development paradigm as well, such as financial-market liberalization, deregulation and privatization, labor-market reform, and copyright and patent enforcement. In these other contexts, worries about applying a one-size-fits-all solution rarely give more than pause for thought and are far less justified for scuttling tax-reform efforts along broad US lines. In fact, implementation of a US-style tax reform, complete with a serious modernization of tax-collection agencies, offers large potential spillovers to broader efforts at improving transparency and reducing corruption in the region.

The most compelling reason for adopting a US-style tax system, however, remains the huge potential for raising additional revenue for development. The extra revenues generated from such a system would be sufficient to double current expenditures on health and education in most of the countries in the region. For the large majority of governments, and for the region as a whole, the additional tax revenues would far exceed much smaller and less stable revenues from foreign aid.

NOTES

[1]The United States and Japan have the lowest tax burdens of all of the non-developing economies in the Organization for Economic Cooperation and Development (see, OECD, "Total tax revenue as percentage of GDP at market prices, 1980-1997," http://www.oecdwash.org/DATA/online.htm). According to OECD data, US tax revenue as a share of GDP was about 28% in 1996, compared to about 41% in OECD Europe.

[2] The sample consists of all the Spanish-speaking countries, plus Brazil, in Latin America and the Caribbean for which the necessary data on national income distribution and current tax revenues are available.

[3] The revenue data for Figure 1 are taken from IMF, *Government Financial Statistics Yearbook*, 2001, except the data for Honduras, which were taken, along with all data on gross domestic product, from the IMF, *International Financial Statistics*, various issues. Revenues refer to federal, state, and local revenues excluding international grants and grants from higher levels of government. For Guatemala, in 1993 (the latest year for which data are available), local revenues were about 0.3% of total federal, state, and local revenues. For Nicaragua, in 1993 (latest year), local revenues were about 10.1% of total federal, state, and local revenues. For Paraguay, in 1988 (latest year), social security taxes were about 15.2% of total federal revenues; extra-budgetary accounts were about 0.9%. For Uruguay, in 1997 (latest year), total revenues and grants were about 12.7% of total federal revenue, but the IMF does not distinguish between revenues and grants. "--" indicates that the IMF does not report for these categories. Federal revenue includes extra-budgetary revenues in Argentina (0.5), Bolivia (1.4), Brazil (1.4), Costa Rica (2.2), Dominican Republic (0.2), Panama (1.1), Peru (0.2), and Uruguay (1.7).

[4] In developed economies, social security revenues, which typically take the form of a payroll tax, are generally regressive. In developing countries, however, where a large share of the poorest workers typically does not work at jobs incorporated into the social security system, payroll taxes may be less regressive. "Nontax revenues" are an important source of revenues for many countries. These include funds from state-owned enterprises, especially oil and gas. Modeling the incidence of nontax revenue is difficult.

[5] The federal, state, and local breakdowns of the tax structure can also complicate international comparisons of total tax revenues and progressivity. For purposes of international comparability, IMF and World Bank data typically report revenues collected by the "central government." For many purposes (comparisons of federal government deficits, for example), these data are ideal. For purposes of this paper, however, where total tax revenue available for investment in development is the issue, the most appropriate comparison would use the sum of federal, state, and local revenues. (The IMF also publishes less widely cited data that include state and local government revenues, which I use here.)

[6] To simplify the exposition, the rest of the data and analysis here will take the national, state, and local tax systems together. This oversimplifies the administrative complexity of the US system –something that Latin American governments would certainly not want to emulate– but has no important impact on the central argument concerning the level and progressivity of revenues.

[7] Again, in the region, only Brazil, under tax policies in place at the end of the 1990s, raises more tax revenue as a share of GDP than the United States does.

[8] This assumes that the US tax rates are applied, as is done later, proportionally to national income in each country.

[9] In the particular context of this paper, however, the model predicts total tax revenues in Latin American countries that are below the overall levels in Figure 1. In the case of the United States, for example, the distributional model shows total tax revenues equal to about 30% of GDP, compared to IMF overall estimates of 35%. Predicted total tax revenues for the Latin American economies analyzed here all lie above the predicted rate for the United States, but below the IMF's overall estimate for the United States. The predicted model, however, is very close to actual tax revenues from the US National Income and Product Accounts, suggesting that the IMF's figures refer to a broader revenue concept. If the IMF's overall tax receipt estimates for Latin America also follow a broader revenue concept, then the analysis in the rest of the paper will significantly underestimate the extra revenues available by following the US tax model. In any event, the estimates in Table 5 of extra revenues under a US tax system are conservative –by about 5 percentage points of GDP– relative to a straightforward application of the average effective tax rate for the United States in Figure 1.

[10] Table 4 demonstrates the progressivity of the federal tax system –each successive income category pays a higher share of their total income in federal taxes– as well as the regressivity of the state and local tax system –each successive category pays a *lower* share of their income in state and local taxes.

[11] Specifically, the table calculates expected tax revenue under the US system by first dividing total national income (GDP) into the shares implied by the distribution of income in Table 3. Then, the effective tax rate from the US tax system corresponding to each income group is applied to the total amount of national income received by each income group. The sum of the resulting "tax revenues" is the total tax revenue under the US model in Table 5.

[12] Given, first, that few Latin American countries have extensive state and local taxation systems and, second, that state and local taxation in the United States is generally regressive, the exercise of applying the US tax model to Latin economies has an alternative interpretation that is certainly more practical than a literal application of the complex US system to Latin America. In this alternative view, existing, generally regressive, value-added taxes would stand in for the US state and local tax system; while

new or greatly expanded income and corporate taxes would be the regional analog of the US federal tax system.

[13] Except lump-sum taxes, which have other problems, and are rarely used in practice.

[14] The regression line fitted to the 18 data points is, in fact, slightly upward sloping, but the R-squared of the relationship is just 0.004.

[15] The US figure is calculated using the chained 1996-dollar estimate of GDP from Table 1.2 of the Bureau of Economic Affairs, National Income and Product Accounts < http://www.bea.doc.gov/bea/dn1.htm>; divided by the interpolated resident US population from the Bureau of the Census, *Statistical Abstract of the United States: 2000*, Table 1, p. 7. Latin American data are from World Bank, *World Development Indicators 2002*, CD version, series NY.GDP.PCAP.PP.CD.

[16] Calculated as corporate and income taxes over total tax receipts from Bureau of Economic Affairs, National Income and Product Accounts, Table 3.1, rows 1, 2, and 3 (see http://www.bea.gov/bea/dn1.htm).

[17] To the extent that administrative capability independent of political will is at all a factor, the huge advances in computerization since the late 1940s should greatly facilitate Latin American countries' ability to handle the greater administrative challenges posed by progressive personal and corporate income taxes, relative to the situation facing the United States in 1947. Unfortunately, many national and international efforts to increase national tax revenues have focused too much on technological fixes, rather than improving administrative capabilities and incentives.

[18] In fiscal years 1947-50, foreign assistance, mostly to rebuild Europe through the Marshall Plan, exceeded ten percent of total US federal spending. Since the late 1950s, foreign assistance has never exceeded 5% of total US federal spending. (See Congressional Budget Office, 1997.)

[19] In addition to the low levels of aid relative to the needs of developing countries, two other significant limitations of current foreign assistance are that it often requires the purchase of goods and services from the donor country and that much aid, particularly in the poorest countries is earmarked toward debt repayment. For a discussion of "tied aid," by which donor countries require recipients to spend aid in the donor country, see the statistical appendix of the OECD's *2002 Development Co-operation Report*, Tables 23 and 24, available online at <http://www.oecd.org/EN/document/0,,EN-document-15-nodirectorate-no-1-2674-15,00.html>. For national information of the share of total aid dedicated to debt repayments, see OECD, Development Assistance Committee, "Aid at Glance," online at http://www1.oecd.org/dac/htm/aidglancehome.htm.

[20] The recent election of Luiz Inácio Lula da Silva as president of Brazil illustrates some of the central points made here. While Lula inherits an economy in difficult economic

conditions, with an overwhelming foreign debt, the high level of tax revenue available in Brazil (35% of GDP) leaves Lula in a much better position to implement his progressive restructuring of the Brazilian economy than he would have been in if he had come to power in, say, Mexico with its much lower share of tax revenue (17% of GDP). Aspiring politicians on the left may also envy Lula's luck in inheriting a government that already raises a large share of tax revenues –it did not fall on him to raise taxes. At the same time, the increasing need to devote national resources toward paying debt will stand as a significant obstacle to Lula's government's success.

[21] This should be uncontroversial. As economists at the IMF have recognized: "first, that to generate high tax revenue, the top deciles would have to be taxed significantly more proportionally than the low deciles; second, that economic and often political power is concentrated in the top deciles so that richer taxpayers are able to prevent tax reforms that would affect them negatively." Tanzi and Zee, 1999, p. 4.

[22] The IMF and the World Bank have been at the forefront of encouraging meaningful tax reform in the region, often asking regional governments to resolve fiscal problems by raising taxes (especially through expanding the scope of tax coverage) and assisting governments undertaking major tax reforms. The IMF, however, has stopped short of making its loans and imprimatur conditional on substantial tax-revenue increases. Morley, Machado, and Pettinato, 1999, argue, for example, that tax reform in Latin America has trailed behind other types of structural reform.

REFERENCES

Congressional Budget Office. 1997. *The Role of Foreign Aid in Development*. Washington, DC: Congressional Budget Office.

Institute on Taxation and Economic Policy. 2003. *Who Pays? A Distributional Analysis of the Tax System for All 50 States*, 2nd Edition. Washington, DC: Institute on Taxation and Economic Policy.

International Monetary Fund. 2002. *Improving Large Taxpayers' Compliance: A Review of Country Experience*. Occasional Paper No. 215. Washington, DC: International Monetary Fund.

Morley, Samuel A., Roberto Machado, and Stefano Pettinato. 1999. "Indexes of Structural Reform in Latin America," Serie Reformas Económicas No. 12, United Nations Economic Commission on Latin America, Santiago, Chile.

Tanzi, Vito and Howell H. Zee. 2000. "Tax Policy for Emerging Markets: Developing Countries." IMF Working Paper WP/00/35, Washington, DC.