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Domestic resource mobilization and the redistributive impact of fiscal policies in Latin America

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The Economic Commission for Latin America and the Caribbean is one of the five regional commissions of the United Nations. It was founded in 1948 with the purpose of contributing to the economic and social development of the countries of the region. The Member States of ECLAC include the 33 countries of Latin America and the Caribbean, as well as several Asian, European and North American nations.

Domestic resource mobilization is perhaps the key barrier to realizing the 2030 Agenda for Sustainable Development in Latin America and the Caribbean. The required investments to achieve the Sustainable Development Goals (SDGs) are formidable, especially given the state of region's relatively underdeveloped social protection floors as well as concerns about the quality of healthcare and education systems. Unfortunately for Latin America and the Caribbean this is further complicated by current macroeconomic conditions, characterized by weak GDP growth and the need for fiscal consolidation.

These limitations notwithstanding, there remains significant scope to bolster public revenues in the region and to do so in such a way as to gain further leverage on attaining the SDGs. Domestic resource mobilization should not be seen simply as a means to an end; rather it must be considered endogenous to the development process itself (Hanni and Titelman, 2017). That is, raising public revenues is not neutral in terms of its impact on society or the subsequent evolution of the economy. Policy choices related to resource mobilization, therefore, have important implications beyond generating finance for achieving the 2030 Agenda.

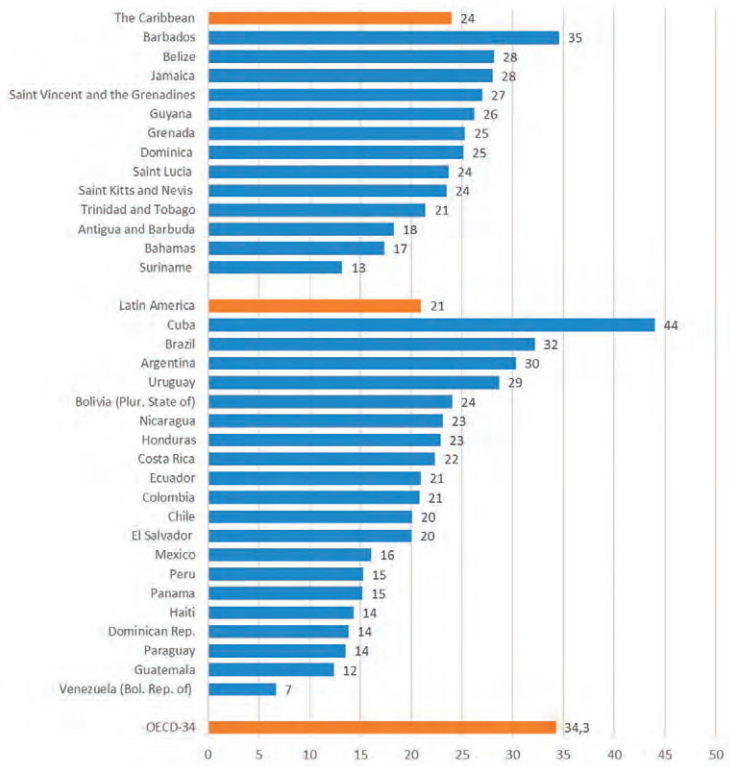
Latin America suffers from some of the highest income concentration and inequality levels in the world, despite gains during the recent decade. In contrast with other regions where inequality rose or remained constant, income inequality fell 9.0% – as measured by the Gini coefficient – in the region between 2000-2004 and 2010-2014. This period was marked by rapid economic growth, bolstered by a positive terms of trade shock brought on by rising international commodities prices and surging demand from developing economies in Asia. However, with the turn of the economic cycle in the region, and the potential for a prolonged period of low growth, governments in the region and their citizens are understandably concerned about how to capitalize on what has been achieved and make further progress in reducing inequality in the coming years.

»Domestic resource mobilization is perhaps the key barrier to realizing the 2030 Agenda.«

A key barrier to progress in the area is the generally weak level of tax revenue obtained by Latin American countries. In 2014 the average tax burden in the region was 21.0% of GDP, compared to 34.4% among OECD countries (OECD/ECLAC/CIAT/IADB, 2016). Even accounting for differing levels of development the region's countries appear to generate lower tax revenues than other countries (ECLAC, 2016). Exceptionally low revenues from personal income tax and social security contributions are a major factor in explaining this result. In turn, the performance of these taxes is reflected in their limited redistributive power. On average personal income tax reduces income inequality by just 2.0% in Latin America, compared to 12.5% in EU-28 countries.

A current snapshot of domestic resource mobilization efforts in Latin America and the Caribbean can illuminate both the challenges the region faces as well as the opportunities that exist. Tax revenues, the principal source of domestic resources to finance sustainable development, have trended upwards in the region, although they remain low, even when taking into account the region's level of development

Figure 1: Latin America and the Caribbean: general government tax revenues, 2017 (Percentages of GDP)



Source: own elaboration, on the basis of data from the ECLAC Tax Revenue Database hosted at CEPALstat and OECDstat for data for the OECD.

(ECLAC, 2016). As figure 1 shows, the tax take in the majority of the countries in Latin America and the Caribbean is well below that of the members of the OECD. There are of course exceptions, with some countries with values near or even above the OECD average. At the same time there are several countries with exceptionally low levels of tax revenues.

»Governments should seek to fully engage their growing middle classes as part of their attempts to mobilize domestic resources for sustainable development.«

Besides its low tax take, the structure of the region's tax take is highly skewed toward indirect taxes, particularly in the Caribbean. These taxes are frequently increased to plug holes in public accounts, given the relative ease to enact changes quickly. Unfortunately, they tend to be either regressive or, at best, neutral, in terms of their incidence on individuals and households. Direct taxation, in the form of taxes on income, property and wealth is exceptionally weak.

In that context, countries in the region should consider enacting tax reforms that generate revenues from the very high end of the income spectrum to fund the public services necessary to jumpstart society-wide cycles of reciprocity. Traditionally a key argument against this course of action has been that increasing the tax burden of the wealthy ultimately results in lower capital investment in the economy and, in turn, lower growth. However, more recent work suggests that this relationship is either very weak or non-existent (IMF, 2017). Moreover, there is growing awareness of the negative impact of income inequality on economic growth.

At the same time, tax avoidance by multinational enterprises (MNEs) is a global problem. Most cross-border trade occurs within MNEs, allowing profit-shifting between fiscal jurisdictions in order to reduce corporate tax liability and at the same time expanding the volume of illicit flows. Illicit trade flows represent more than a hundred billion dollars in Latin American countries. Certainly, global formulary apportionment would significantly reduce profit-shifting if MNEs were treated as a single global corporation. Under formulary apportionment, multinationals are treated as a unitary business and a single taxpayer; its income is calculated by subtracting worldwide expenses from worldwide income, based on a global common accounting system. Each jurisdiction then applies its tax rate to the income apportioned to it by the formula

and collects the amount of tax resulting from this calculation. Without a doubt, this ICRICT proposal (see the excellent documentation on the website ICRICT.com) would eliminate illicit trade flows and significantly reduce tax avoidance in Latin American countries.

Nevertheless, strengthening direct taxation will require addressing the region's frayed fiscal compact. These pacts, either explicit or implicit, outline the rights and obligations of governments and citizens. They can be seen as an agreement between both parties on the amount of taxes to be paid and the services and public goods to be provided. However, given the current state of personal income taxation, characterized by extremely elevated levels of evasion and avoidance, it is clear that the existing fiscal compacts in the region are not meeting expectations. This has also been made manifest in recent years by a rise in public protests highlighting the shortcomings, perceived or real, of public services including health and education.

In this context, the adoption of the 2030 Agenda for Sustainable Development offers the region's countries and their citizens an opportunity to address these concerns and establish a new, stronger, fiscal compact. In particular, governments should seek to fully engage their growing middle classes as part of their attempts to mobilize domestic resources for sustainable development. Research suggests that they often have higher levels of tax morale – despite their dissatisfaction with the quality of public services – but their contribution to the personal income tax remains limited in the region. Indeed, they may be the most likely to heed the call embodied in Article 29 of the Universal Declaration of Human Rights, "Everyone has duties to the community in which alone the free and full development of his personality is possible."