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Improving Tax Policy in Latin America and the Caribbean (LAC): A Balancing Act

by
Felipe Larraín B.
and Pepe Zhang

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The Atlantic Council's nonpartisan **Adrienne Arsht Latin America Center (AALAC)** broadens understanding of regional transformations while demonstrating why Latin America and the Caribbean matter for the world. The center focuses on pressing political, economic, and social issues that will define the region's trajectory, proposing constructive, results-oriented solutions to inform public sector, business, and multilateral action based on a shared vision for a more prosperous, inclusive, and sustainable future.

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Overview

In Latin America and the Caribbean (LAC), the extraordinary economic events of recent years have once again underscored the critical and versatile functions of tax policy as shock absorbers, growth catalysts, and public revenue generators, among other things.

During the worst days of the COVID-19 pandemic, governments used tax relief, cash transfers, and other fiscal instruments of historic proportions to cushion the economy. In Brazil and Chile, the 2020 tax policy response alone matched or even exceeded the entire fiscal package deployed during the global financial crisis of 2008-09.

As the pandemic subsided, the traditional role of tax policy in macrodevelopment and public finance came back into focus with added urgency. Demand for tax reforms and tax policy improvements has grown across LAC countries, whether to finance the legacy of the exceptional stimulus in 2020 and future social spending, catalyze economic and productivity growth, or enable redistributive policies.

The tax and broader economic priorities facing LAC's policymakers have not only evolved since 2020, but often overlapped and at times competed with one another. This tension exacerbates the region's long-standing challenge of addressing and balancing growth, equity, and revenue goals. When and how should governments restore fiscal discipline without prematurely withdrawing support, especially as inflation, war, and other uncertainties complicate the regional and global outlook? Where can governments reduce or increase taxation, while still obtaining satisfactory levels of tax revenue and economic activity? What can governments do to make tax systems more equitable and fair without punishing growth?

Going forward, getting this balancing act right will be more imperative than ever to the region's overall socioeconomic and fiscal success. And tax policy can play a key role. To this end, the paper provides concrete, evidence-based recommendations for improving tax policy design and execution.[1]

The paper starts by contextualizing the urgency of tax and fiscal issues. It then focuses on the role and potential of tax policy to support growth, equity, and revenue goals, both as a short-term countercyclical tool during crises (e.g., during the pandemic) and as a long-term structural strategy in normal times (e.g., post-COVID-19). Finally, the paper adopts a holistic view and discusses two related issues: government spending (i.e., how to better use tax revenues) and the politics of tax reforms.

The paper proposes both general recommendations such as tax code and administrative simplification or stricter enforcement, and recommendations specific to LAC's three main taxes: the value-added tax (VAT), corporate income tax (CIT), and personal income tax (PIT). Some specific recommendations cover directional adjustments and, where applicable, explore their pros and cons and trade-offs, best practices, and other complementary interventions (in the labor market, for vulnerable households, etc.). In essence, the paper serves as a practical guide for formulating tax policy and reforms.

1 The Adrienne Arsht Latin America Center is publishing this as a working paper in order to disseminate the center's research and preliminary findings in a timely manner, while also gathering feedback to further polish the ideas in this publication and inform future work.

Context

At the height of the COVID-19 pandemic in 2020, many LAC governments provided fiscal support of historic proportions to rescue their economies. Measured as a share of gross domestic product (GDP), the size of stimulus packages implemented in 2020-2021 by the region's six largest economies (LAC6)—with Mexico as the only notable exception—far outstripped measures taken during the global financial crisis of 2008-09 *(see Figure 1)*: this included an 12.3 percentage point increase in Chile and an 8.7 percentage point increase in Brazil.

Such extraordinary support, albeit essential to keeping businesses and households afloat, came at a considerable cost. Latin America's average public debt-to-GDP ratio increased from 67.9 percent in 2019 to 77.4 percent in 2020 (IMF n.d.), while average fiscal deficits expanded threefold (from 2.4 percent of GDP to 8.4 percent) over the same period (Fitch Ratings 2021). Although a robust recovery in 2021 helped reduce deficits and stabilize debt-to-GDP levels in many countries, the region's growth momentum has faltered in 2022 and appears weak for 2023.[2]

Strong headwinds—such as domestic inflation, associated rate hikes, and deteriorating external conditions across advanced economies and main trading partners—are impacting LAC's economies and access to liquidity. Governments are facing mounting societal pressure to stabilize prices, which may again lead to increased outlays including subsidies. This uncertain growth and fiscal context forces finance ministries to strike a delicate balance between further support to the economy and fiscal consolidation, one that has been constantly evolving in recent years. In sum, decreased revenues, still-high spending, and limited and costly external financing are collectively straining public budgets, calling for better taxation.

Figure 1: Fiscal Response during Global Financial Crisis (2008-09) and COVID-19 (2020-21):

COUNTRY	2009 FISCAL RESPONSE AS PERCENT OF GDP	2020-21 FISCAL RESPONSE AS PERCENT OF GDP (up to July 2021)	INCREASE (percentage points of GDP)
Argentina	**1.3**	**4.5**	**3.2**
Brazil	**0.8**	**9.2**	**8.7**
Chile	**1.8**	**14.1**	**12.3**
Colombia	**0***	**4.7**	**4.7**
Mexico	**1.7**	**0.7**	**-1**
Peru	**3.5**	**7.8**	**3.8**

NB: Authors' calculation based on 2009 and 2020 GDP. During the 2008-09 crisis, most LAC countries did not engage in intensive fiscal response until 2009.
Data sources: The 2009 is from the International Monetary Fund (IMF), Fiscal Policy in Latin America: Lessons and Legacies of the Global Financial Crisis–Technical Appendix, April 30, 2015, 2, https://www.imf.org/external/pubs/ft/sdn/2015/sdn1506techapx.pdf. 2020-21 data are drawn from the IMF, Fiscal Monitor: Database of Country Fiscal Measures in Response to the COVID-19 Pandemic, October 2021, https://www.imf.org/en/Topics/imf-and-covid19/Fiscal-Policies-Database-in-Response-to-COVID-19.
Colombia is omitted as it did not engage in a stimulus response in the 2008 crisis; see Economic Survey of Latin America and the Caribbean 2009-2010, Economic Commission for Latin America and the Caribbean (ECLAC), 2010, 111.
Figures may not sum accurately due to rounding.

2 Great variation exists across countries in terms of debt levels and directional movements. IMF 2022 showed that while four out of the LAC6 saw a drop in debt-to-GDP ratios from 2020 to 2021—Argentina (from 102 to 89 percent), Brazil (from 98.7 to 93 percent), Mexico (from 60.1 to 57.6 percent) and Colombia (from 65.7 to 64.6 percent)—two saw an increase: Chile (from 32.6 to 36.3 percent) and Peru (from 35 to 36.4 percent).

Better Taxation to Support Growth, Equity, and Revenue Goals

Tax policy has played an important role in affecting LAC growth, equity, or revenue goals of late, whether as part of the short-term emergency response to the pandemic in 2020 (and by eventually financing said response) or as a structural policy lever to spur long-term growth. In both roles, tax policy can be improved through design (e.g., simplified tax code or rate adjustments), execution (e.g., digital disbursements or stricter collection enforcement), and complementary measures (to mitigate adverse side effects on labor markets, for instance).

BETTER TAXATION TO SUPPORT EMERGENCY RESPONSES

During the height of the pandemic, from March 2020 to December 2021, LAC governments used a variety of tax policy instruments to stimulate the economy, including tax deferrals, refunds, suspensions, exemptions, rate reductions, and others *(see Figure 2)*. Some were broad-based efforts, while others targeted either vulnerable populations or essential workers or services.

Although tax policy support did not represent the lion's share of the overall government stimuli in 2020 (e.g., 15.1 percent in Chile and 28.6 percent in Brazil),[3] it was still significant in absolute terms. For example, Brazil's tax policy response to the pandemic amounted to 2.7 percent of GDP—more than three times the size of its total fiscal response to the 2008-09 crisis. In addition, taxation proved a useful mechanism to pilot innovative, unconventional support measures, yielding important lessons for future government programs and policies.

A main feature of emergency tax policy support is its relatively swift approval. In LAC's six largest economies (LAC6), COVID-related tax policy support measures were released either before or simultaneously with emergency cash transfers or other fiscal support. One explanation could be that certain tax measures—such as deferrals or reductions—alleviate cash flow problems by essentially stretching recipients' own money. As such, they may temporarily sidestep political and legislative debates often associated with the use of new or existing government resources, thus resulting in more timely and efficient approvals of tax policy support than larger stimulus measures including cash transfers. This is especially helpful when policy consensus stalls on the scale and intensity of other stimuli (due to circumstances such as a divided domestic political landscape in some LAC countries, the often inconclusive nature of a mild and still evolving economic crisis in its early stages, or the specific constraints of a country's fiscal rules) (ECLAC 2022).

Based on our research and conversations with current and former finance ministry officials, emergency tax policy support can be improved in at least three ways going forward, as illustrated by lessons from the COVID-19 pandemic:

Better identifying, targeting, and reaching the most-affected sectors of the economy in need of economic assistance (including tax measures). Here, digitalization and interagency coordination stand out as two quick wins for LAC governments. By using electronic records and payments and integrating databases of different government agencies and programs (including various highly successful cash transfer programs), countries can simultaneously expand and better pinpoint eligible beneficiaries. Argentina's SINTyS (Sistema de Identificación Nacional Tributario y Social) is one such example. In Brazil, Auxilio Emergencial (AE) leveraged the existing benefits registries and created its own to distribute pandemic relief, automatically delivering AE benefits when they were larger (Lara de Arruda et al. 2022). It also accelerated the creation and adoption of a new type of digital bank transfer "with no operational costs," the PIX (Lara de Arruda et al. 2021). Emergency measures like AE are beneficial in the long run through their secondary and permanent effects, for instance, unified government databases help broaden the future tax base by increasing the number of registered taxpayers while generating greater interoperability among government initiatives.

- **Faster and more efficient disbursements.** Some emergency tax policy measures are more complex administratively than others, e.g., a VAT refund likely involves more transactional and administrative steps than a comparable transitory, across-the-board VAT rate reduction. As a result, the strengthening of government capacity will be fundamental to selecting, implementing, and accelerating the adequate support measures based on specific goals. Other conditions matter as well: the OECD VAT Toolkit cautions that financial intermediary-based withholding mechanisms

3 Calculated from IMF fiscal monitor database, see IMF 2021.

Figure 2: COVID-19 Tax Policy Response in LAC's Big Six Economies (LAC6)

	Tax deferral	Exemption/Reduction	Refunds/Credits	Additional Policies
Argentina	Deferrals in employers' social security contributions (April-May 2020).	Exemption from import duties and statistical tax for medical supplies (April-August 2020). 95 percent reduction in the aliquot of employer social security contributions for a period of ninety days for health workers (April 2020 to December 2021).	Tax aliquots on credits and debits in bank accounts and other operations of 2.5 and 5 percent for health service operations (April 2020 to December 2021). Special tax compensation scheme for those who make sales of essential goods (April 2020 to December 2022).	Special benefits (tax breaks) for police and security at the forefront of COVID-19 response (March-December 2020).
Brazil	2020: Four-month deferral of social contributions paid by firms and employers, three-month deferral of small business taxes, and delayed PIT filling. Deferral of taxes paid by the telecommunications sector and of tax debt payment obligations.	Temporary reduction in taxes (Industrialized Products Tax, and zero import taxes) for listed imported and domestic goods necessary to combat COVID-19 (March-October 2020).		Elimination of the financial transaction tax for approximately nine months (beginning in April 2020).
Chile	Tax deferrals: CIT (April-June 2020 monthly payment suspension); VAT (six- or twelve-month deferral of April-June 2020).	Reduction in tax for SMEs (CIT postponed from March to July 2020), reduction of corporate tax rate to 10 percent (2020-2022).		Suspension of stamp tax for six months (April to September 2020).
Colombia	Delayed VAT and CIT payments until December 2021.	Reduction in tariffs (March-September 2020; April 2021 to July 2022), and VAT exemptions for medical goods (April 2020 to June 2022).	Accelerated CIT and VAT refunds for corporations. VAT refund for lower income families.	No-VAT days (June and July 2020), and elimination of withholding tax for companies in bankruptcy protection. Reduced tariffs on soybeans and corn (April through June 2020). No VAT for internet connection and new trucks. Temporary tax increase on public-sector workers earning more than 10 million pesos per month (about $2,500) (May through July 2020).
Mexico			Accelerated tax refunds (April 2020).	
Peru	Deferral of corporate and personal income taxes (May-December 2020).	Temporary suspension of cost, insurance, and freight tax on medical goods (March 2020-current).		

Sources: see Appendix A

and limited digitalization could reduce the speediness and usefulness of certain VAT interventions by posing additional administrative burdens on businesses and governments (OECD et al. 2021).

- **Time boundary.** Emergency tax and fiscal measures must remain temporary and be scaled back in due course, as a healthy, rebounding economy should gradually prompt shifts in focus toward long-term sustainability in fiscal policy (a topic of the next section). This helps mitigate the enduring impact of the emergency response—often debt financed—on government balance sheets and macroeconomic stability. In an admirable display of such discipline, most major pandemic-specific temporary tax policy measures *(outlined in Figure 2)* were withdrawn as of December 2021 *(see Figure 3)*. Going forward, automatic clauses or stabilizers—triggered by predetermined economic parameters without additional approval from policymakers or legislators—could be useful.

BETTER TAXATION TO SUPPORT STRUCTURAL POLICY GOALS

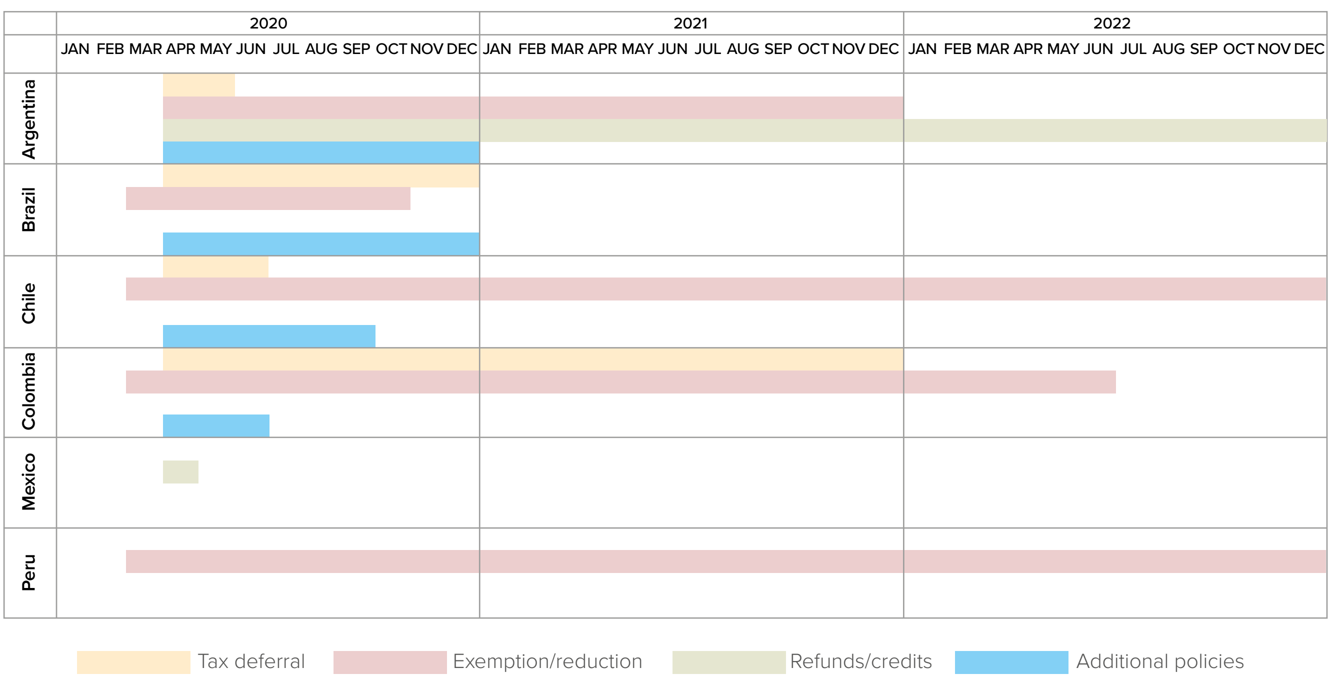
In the long run, governments can improve tax policy to better support economic growth and fiscal health by:

- Reducing tax burden both financially and administratively, especially for corporate income tax and for SMEs.
- Making taxation more fair, equitable, and progressive, including personal income taxes and value-added taxes.
- Navigating the thorny politics of tax reforms successfully.

Lowering the Administrative Burden of Taxes and Improving Enforcement

Tax filing represents a tremendous technical and administrative challenge for firms in many LAC countries, due to complex tax codes. In 2019, preparing and paying taxes was nearly twice as time-intensive in the LAC region (316 hours) as in OECD member countries (164 hours) (World Bank n.d.b). This impacts growth in several ways. For example, the administrative burden of tax filing weighs disproportionately on small and medium-sized enterprises (SMEs). In comparison with larger firms, SMEs often lack the expertise to properly report taxes or the resources to hire external help on taxation matters (Lardizábal and Zhang 2022). This, coupled with high tax rates (described in the next section), and a low trust in governments (OECD, CAF, and ECLAC 2018), makes taxation prohibitively onerous for them, and often not worthwhile given the meager

Figure 3: COVID-19 Tax Policy Response in LAC6 (consistent with Figure 2)



With all tax deferrals and additional tax policies ending by December 2021, and only certain exemptions or credits (e.g., relief on import duties for specific health products) continuing into 2022, the bulk of the tax policy responses to COVID-19 has concluded in the LAC6.

Data sources: This timeline is developed from the data in Figure 2 of this paper.

benefits of being compliant. Complexity-induced tax evasion thus causes many companies and workers to enter or remain in the informal economy, through a well-documented negative correlation between "tax morale"—intrinsic or nonpecuniary willingness to pay taxes—and informality (Kundt 2017).

Another upshot is that informal firms—not appropriately registered in government databases—stand more vulnerable to economic shocks, during which they tend to have a harder time accessing government assistance, despite often being the ones that need it the most. In Paraguay, this problem was mitigated through the implementation of Pytyvõ, a COVID-19 social assistance program targeting the informal economy, which alongside other programs, brought the percentage of households receiving public transfers up to 66 percent from 41 percent (IMF 2022).

To counter the adverse effects of poor, overly complex tax policy design (e.g., lost government revenues, unfriendly business climate, reduced foreign investment, etc.), LAC countries have taken actions to simplify tax codes in recent years. Brazil, for example, has proposed a number of "less is more" tax reforms to streamline and unify taxes and limit tax expenditures (i.e., special exclusions, exemptions, or deductions) (Coelho 2021). Complementary policy actions may include:

- **Procedural and technological improvements** to further lower the administrative burden, including electronic filing or prefilled tax forms, such as those implemented by Chile's Servicio de Impuestos Internos (CIAT 2019; OECD 2017).

- **Offsets against the potential cost of formality**, for example, through the introduction of a well-designed and well-timed earned income tax credit (EITC) that could incentivize formalization and labor force participation of low-wage workers by compensating employers for the tax wedge of formal hirings (Acosta-Ormaechea, Pienknagura, Pizzinelli 2022).[4]

Efforts to improve collection rates should not stop at the design level. With significant tax evasion costing LAC countries on average 5.6 percent of GDP, enforcement must keep up (López 2022). In this regard, tax administrations and collecting agencies can benefit from:[5]

- **Enhanced authority,** for example, through penalties or other enforceable punishment for noncompliance.

- **Additional resources** to conduct more audits, create specialized units or account managers for key taxpayers or segments, or pilot small-scale, innovative experiments to improve collection using, for example, behavioral economics.[6]

- **Training**, whether capacity building for officials or awareness and educational campaigns for the general public.

- **Interagency collaboration**, for example, to expand and update the taxpayer registry by integrating numerous different government databases.

- **International collaboration** to facilitate the exchange of information across borders and jurisdictions consistent with international standards, for example, under the framework of the Punta del Este Declaration subscribed to by fifteen LAC member countries. This is particularly vital to stemming tax evasion by multinational corporations (OECD n.d.a).

In sum, a combination of carrots (tax code and procedural streamlining) and sticks (enforceability and capacity building) helps to augment collection and therefore public finances. These compliance-enhancing measures, in addition to being necessary long-term improvements for tax systems, are convenient and popular in today's political environment. Particularly during economic downturns, governments need to be wary of other revenue boosters—such as rate increases—due to their steeper political costs (see section on navigating the political economy of tax reforms).

Lowering the Financial Burden of Corporate Income Taxes

The tax burden facing firms in the LAC region is not only administrative but financial. In 2021, average corporate income tax in LAC was 2.6 percentage points higher than the OECD's: 25.2 percent versus 22.9 percent (OECD 2021), generally in line with the spread seen in previous years (OECD 2019). While great heterogeneity exists within LAC, lofty CITs are present

4 Such ETICs may be financed by and used in conjunction with pro-growth tax increases.

5 These recommendations draw on our consultations with current and former LAC finance ministry officials, as well as additional research, including Hoekstra, Gonçalves Pereira, and Queijo (2013).

6 For example, the City of Buenos Aires undertook an interesting behavioral experiment by using large companies as collection agents, which yielded positive results (Garriga and Tortarolo 2022).

in many economies, including in LAC6, where the standard statutory rates—ranging from 27 percent in Chile to 34 percent in Brazil—hover above what their income levels would suggest and above the OECD average (Acosta-Ormaechea and Pienknagura Loor 2021; OECD n.d.b).[7]

High corporate taxation could suppress growth by dampening investment and business sentiments (de Mooij, Klemm, and Perry 2021). It also may erode tax morale and foster tax evasion among small firms by pricing them out of compliance as well as larger firms that could pay lower effective rates by resorting to local tax expenditures or international profit shifting (Dom et al. 2022). A vicious cycle arises: the risk of a diminishing—and already concentrated—tax base pressures governments to maintain high rates, which in turn hurts business growth and tax collection (Economist Intelligence Unit 2020). This is particularly concerning in the current juncture, as a multitude of LAC companies still reel from the pandemic's scarring effects. Even by the end of 2021, profits in worst-hit sectors lingered around 20 percent below pre-pandemic levels (Center for Global Development and Inter-American Development Bank Working Group 2022).[8]

From a long-term growth perspective, LAC countries with excessive CITs should consider rethinking and moderating effective rates. This should be meticulously engineered with complementary measures in formalization, compliance enforcement, or within tax policy itself. For example, simultaneously lowering statutory rates and removing tax expenditures can theoretically reduce the considerable gap between statutory and effective rates paid by companies *(see current gap in Colombia in Figure 4 on next page)*, thus achieving comparable fiscal results (i.e., revenue-neutral tax reforms) while simplifying the tax system and stimulating business activities.

Further, from a long-term fiscal health perspective, LAC governments should keep two long-term questions in mind when attempting CIT reductions:

- **Could reforms pay for themselves?** In other words, can a long-term boost to tax receipts—derived from a more dynamic economy powered by tax and other reforms—cover potential short-term revenue losses?

- **How to create a more sustainable tax structure?** For instance, regional governments are overly reliant on the CIT compared to OECD members *(see Figure 5)*. CIT accounts for 15.8 percent of LAC's total revenue versus only 9.6 percent in the OECD (OECD et al. 2022). Such overreliance on the CIT as a source of tax revenue has negatively affected regional growth (Acosta-Ormaechea, Pienknagura, and Pizzinelli 2022).

Making Tax Policy More Equitable, Progressive, and Fair

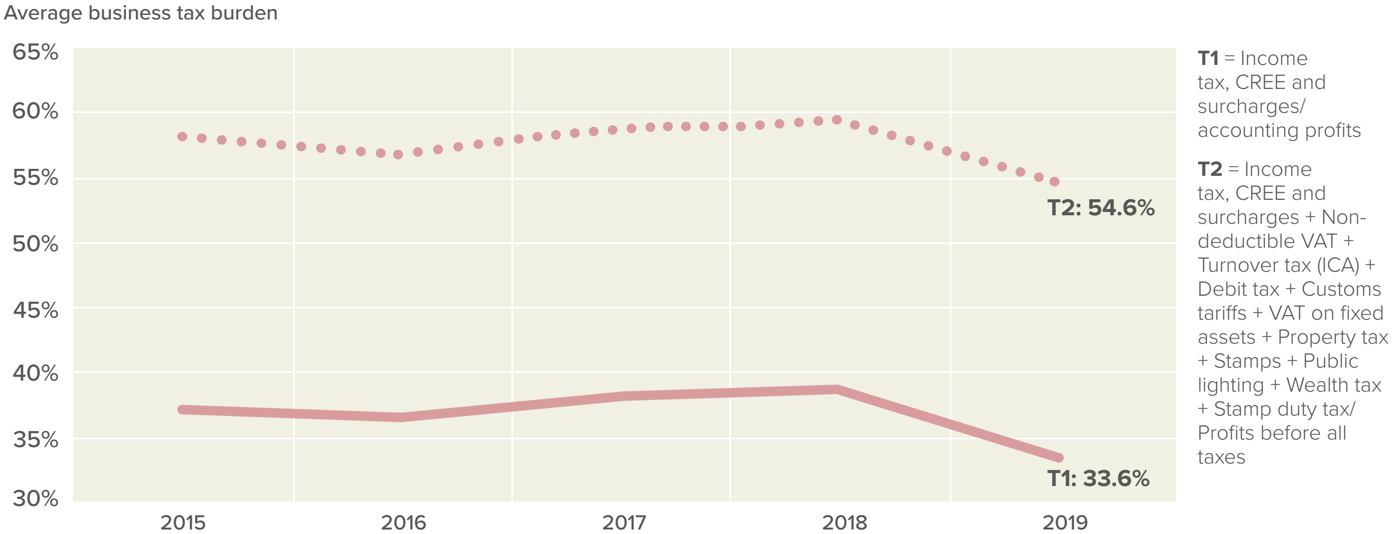
Inequality is among the most serious socioeconomic problems facing LAC. Progressive taxation, through its redistributive features, has become a popular tool to mitigate income disparities in LAC countries. Indeed, recently elected leaders in Colombia, Chile, and elsewhere are prioritizing tax reforms, following on their campaign promises to address societal discontent with deep-rooted inequality.

However, for these reforms to be successful and sustainable, especially in a region with low levels of trust in public institutions, governments must uphold progressivity and fairness through evidence-based policymaking (Keefer and Scartascini 2022). This, in turn, would presume a careful cost-benefit analysis to calibrate the specific types of taxes involved; the scale, direction, mechanisms, and timing of adjustments; and their aggregate and distributional impact. In addition, considering and compensating the secondary, medium-term effects of tax reforms—on labor markets, tax morale, business sentiments, political capital, etc.—would help meet the equity (or fiscal and growth) challenges they set out to tackle.

7 Chile's standard rate of 27 percent was transitorily reduced to 10 percent for SMEs in response to the pandemic; if it had not been reduced, it also would be above the OECD average.

8 Sectors included professional services; business services; retail trade; transportation excluding air transport; air transport; health, legal, education, and social services; communications; construction; wholesale trade; hotels and restaurants; amusement and museums.

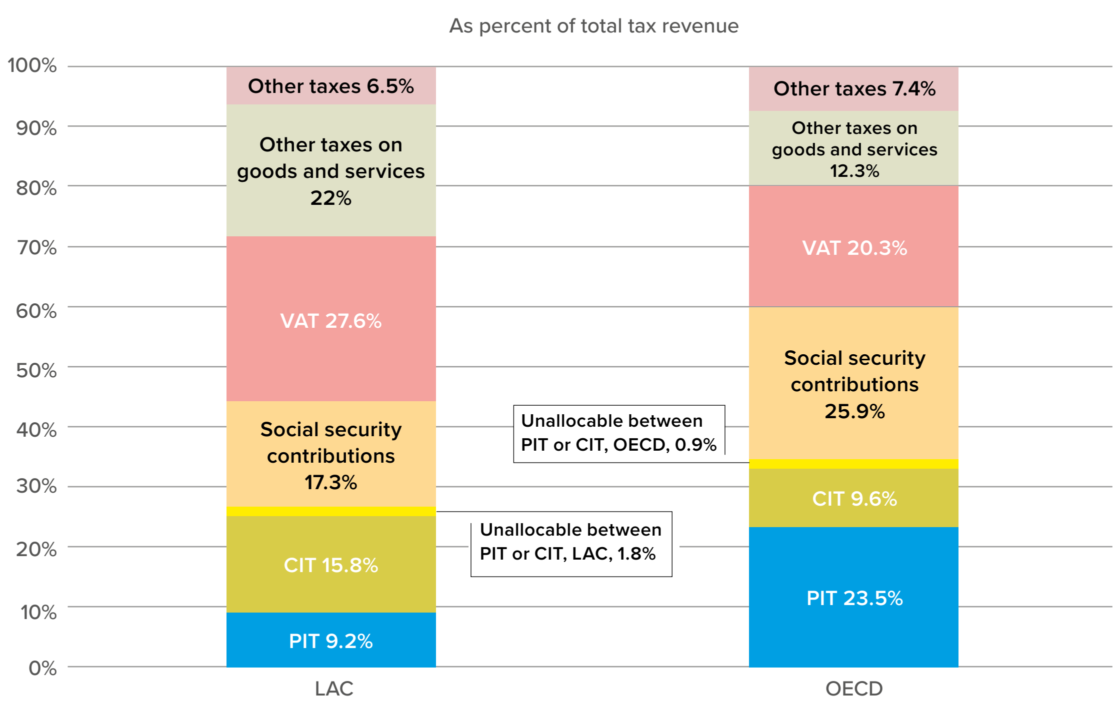
Figure 4: Statutory vs. Effective Personal Income Tax (PIT) in Colombia



This chart shows the major gap between statutory and effective taxes in Colombia, amounting to 21 percentage points.
Data source: Graph reproduced from OECD, DIAN, Ministry of Finance of Colombia (2021), with permission from the copyright holder, DIAN.

Notwithstanding specific goals of the reforms, a sense of fairness can help drive their success (López 2022).[9] Organizations like the OECD have emphasized the importance of "aligning the tax treatment across different economic sectors" (OECD 2022). Unfair or discriminatory tax policy design—for example, through unwarranted special incentives and exemptions—not only distorts markets, but further complicates the administration burden of taxation (discussed above). Where possible, such practices should be curtailed across taxes and LAC countries, including VATs and PITs.

Figure 5: Tax Structure LAC vs. OECD (2018)



Authors' elaboration using OECD data. LAC relies heavily on CIT and VAT as components of overall tax revenue compared to the OECD, which has higher PIT revenues.

9 Specifically, López says, "a successful fiscal and tax reform needed to be underpinned by a sense of fairness: most people will pay more taxes if they perceive that everyone is paying their fair share."

VAT

Tax expenditures (i.e., exemptions, reductions, etc.) are widespread in the VAT, LAC's most important source of tax revenue (Díaz de Sarralde Miguez 2017). However, given its disproportionate impact on lower-income consumers, the VAT is generally considered regressive (see Figure 6), and therefore a prime target for tax cuts in progressive tax reforms (rather than tax hikes, which may be caused indirectly by removing exemptions).

On one hand, the potential regressivity of a VAT hike, or an increase in any consumption tax, should not be taken lightly in today's context of soaring food and fuel prices. This calls for policymakers to actively identify and mitigate the possible adverse ramifications of such base-broadening measures on vulnerable households, which tend to spend much larger proportions of income on daily staples. These ramifications could be significant, for example, in countries like Costa Rica, where the basic basket of goods benefited substantially from VAT exemptions (representing 89.6 percent of its total VAT-related tax expenditure in 2019) (ECLAC 2019).

On the other hand, for the same reasons outlined above, eliminating deductions and exemptions may represent a significant opportunity for certain governments to recoup forgone VAT revenue. Moreover, recent World Bank research suggests that the impact of VAT hikes may be relatively subdued in countries with low current statutory rates, such as Bolivia, Ecuador, Mexico, Paraguay, and a number of Central American countries (World Bank 2022). In any case, to ensure evidence-based progressivity, reforming and improving the VAT will likely require a well-crafted combination of tax policy and complementary—or sometimes compensatory—measures.

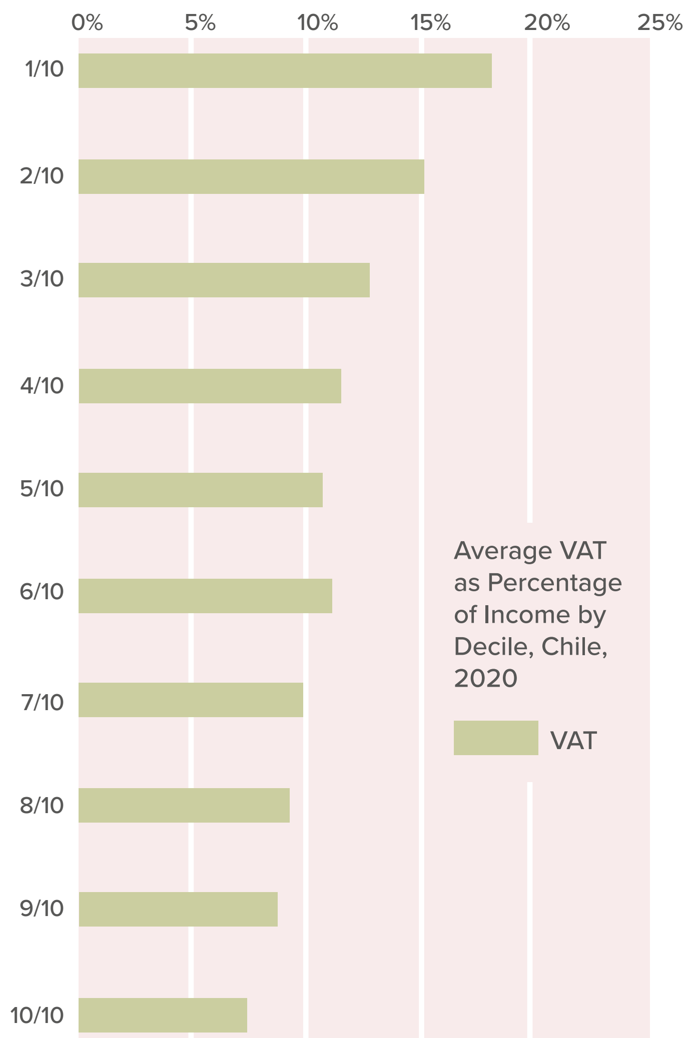
PIT

Tax expenditures also abound in LAC's personal income taxes. In Peru, exemptions or deductions enable top earners to pay 13 percent in the effective PIT rate versus the 30 percent statutory rate (Barreix, Benítez, and Pecho 2017). According to an IMF analysis, if PIT deductions were removed and the top decile of wage earners paid their statutory rates, PIT revenues would double in five of Latin America's largest economies (Acosta-Ormaechea and Pienknagura Loor 2021).[10]

Of LAC's three big taxes (VAT, CIT, and PIT), the PIT is deemed by many governments as the ripest target for progressive tax reforms and rate increases. Proponents of this view argue that well-designed PIT increases would make LAC's tax structure not only more progressive but also more robust. For one, they should help increase the contribution of PIT to tax revenues in LAC countries, which today amounts to 9.2 percent—considerably lower than in OECD countries (23.5 percent, *as shown in Figure 5 on last page*). This, in turn, could alleviate other imbalances in LAC's tax structure—e.g., an unhealthy reliance on the likely growth-retarding CITs and regressive VATs—with likely positive impact for the broader economy.

Conversely, opponents question these potential benefits (and whether they outweigh their costs). Recent World Bank research points to the limited distributional effectiveness of PIT increases, since PIT may already be progressive in many countries given their concentrated tax base, where only the

Figure 6: The Regressivity of the VAT



Note: Authors' elaboration using OECD data. The VAT in Chile is a regressive tax, representing 18.1 percent of the income of the poorest 10 percent of the population but less than 8 percent of the income of the wealthiest 10 percent, according to Alastair Thomas, "Reassessing the Regressivity of VAT," OECD Taxation Working Paper 49, 2020.

10 Specifically, they are Brazil, Chile, Colombia, Mexico, and Peru.

top 10 to 20 percent of citizens pay any PIT (Riera-Crichton, Venturi, and Vuletin 2022). In Chile, for example, less than 25 percent of the people pay PIT, with over 75 percent exempted. Other unwelcome secondary effects of PIT increases include capital flight, labor market shrinkage, and increases in informality—all of which deserves additional attention in today's uncertain economic environment.

As several LAC countries toughen or establish additional tax measures to target high-earners, a similarly contentious issue is the wealth tax. For example, Argentina's one-time pandemic-response wealth tax generated an impressive 223 billion pesos in revenue (US$2.4 billion) in April 2021, a sevenfold increase from its 2018 wealth tax revenue, but the new measure faces legal challenges and strong opposition (Olivera Doll 2021; Kaplan 2021). Regional scholars from LAC raised additional concerns regarding the indirect effects of the wealth tax such as suppressed investment, employment creation, savings, and prices of levied assets, as well as possible evasion or underreporting and the resulting administrative burden for governments (for example, when it comes to nonfinancial assets in Chile which are not reported to audit entities) (González, Larraín, and Perelló 2021; Riera-Crichton, Venturi, and Vuletin 2022).

Finally, PIT or wealth tax proposals have gained relevance and legislative feasibility thanks to factors beyond economics, namely their political attributes or intention, which are often centered directly around narrow groups of affluent populations. The next section will use recent evidence to shed additional light on the political dimension of tax reforms, an inherently crucial and complex ingredient for successful tax reforms.

NAVIGATING THE POLITICAL ECONOMY OF TAX REFORMS

Today's volatile and fluid political environment in LAC has made tax reforms simultaneously more urgent and challenging. Incumbent parties across countries and political lines have lost in the last sixteen elections (excluding Nicaragua) (Naím 2022), reflecting popular discontent with the status quo and acute needs for socioeconomic improvements. While greater government capacity and investment to tackle poverty, inequality, and crime are in high demand, effective domestic resource mobilization and policymaking are in short supply, hampered by political polarization in the forms of fragmented parliaments, stalled constitutional reforms, and other instabilities. Since 2020, proposed tax and economic reforms (or the lack thereof) have triggered major protests in Colombia, Ecuador, Panama, and elsewhere in LAC. This, in turn, heightens risk perceptions associated with LAC countries aboard, making external financing even less accessible or more costly.

A snapshot of the eighteen structural tax reforms proposed in LAC's six largest economies since 2019 confirms the difficulty of tax reforms (*see Appendix B*). Only half of the eighteen reforms involved explicit or significant rate increases in the big three taxes (VAT, PIT, or CIT). Instead, governments turned to less politically costly measures, such as design and operational optimization to improve collection, base-broadening, exemption removals, or capacity building for collecting agencies. Timing and sequencing also matter: five economies out of the LAC6 attempted a tax reform before the GDP recovered to their respective pre-pandemic levels—an important consideration as the region and the global economy now face renewed recessionary pressures (World Bank n.d.a). The threat of higher taxes brought widespread protests in Colombia (Redacción BBC News Mundo 2021), forcing the government to reevaluate its reform and illustrating the difficulty of raising rates during an unstable recovery.

Failure to balance the intertwined economic and political dimensions of tax reforms jeopardizes not only the reforms themselves, but the credibility of the government and the legitimacy of taxation—both of which are already low in the region. Specifically, in a challenging and fast-changing political climate, policymakers need to diligently estimate, revise, and minimize the political cost of tax reforms to the extent possible, whether through design or negotiation. This should be complemented by a communication strategy that clearly and publicly explains the desired objectives, rationale, timing, scope, and magnitude of the reforms (and compensatory measures), in particular potentially unpopular or controversial decisions. And it should be predicated on a realistic assessment of the government's own bottom line and negotiation power. Now more than ever, tax reforms in LAC need to be evidence-based and not only from an economic perspective; they must incorporate the necessary political viability and consensus to survive, adapt, and sustain.

Better Government Spending to Complement Tax Improvements

Any discussion of fiscal policy would be incomplete without taking into account both revenue and expenditure. While this paper focuses primarily on revenue, governments must place equal, if not greater emphasis on spending, given the harsh reality that increasing collection may prove unattainable despite their best attempts. In some countries, the triple challenge of deficit reduction, low collection, and growing societal needs is forcing policymakers to do more with less. This section provides recommendations to achieve this through disciplined, efficient, and high-impact spending, i.e., rebuilding fiscal space and growth by reining in unnecessary or unproductive spending.

Lessons from LAC nations' emergency responses to the COVID-19 pandemic (see section on better taxation to support emergency responses) demonstrated that when conditions permit, targeted subsidies and electronic disbursements can reduce wastage while effectively supporting most-affected households and sectors. Whether in a crisis or normal times, this generates budgetary and transactional savings compared to a broad-brush approach.

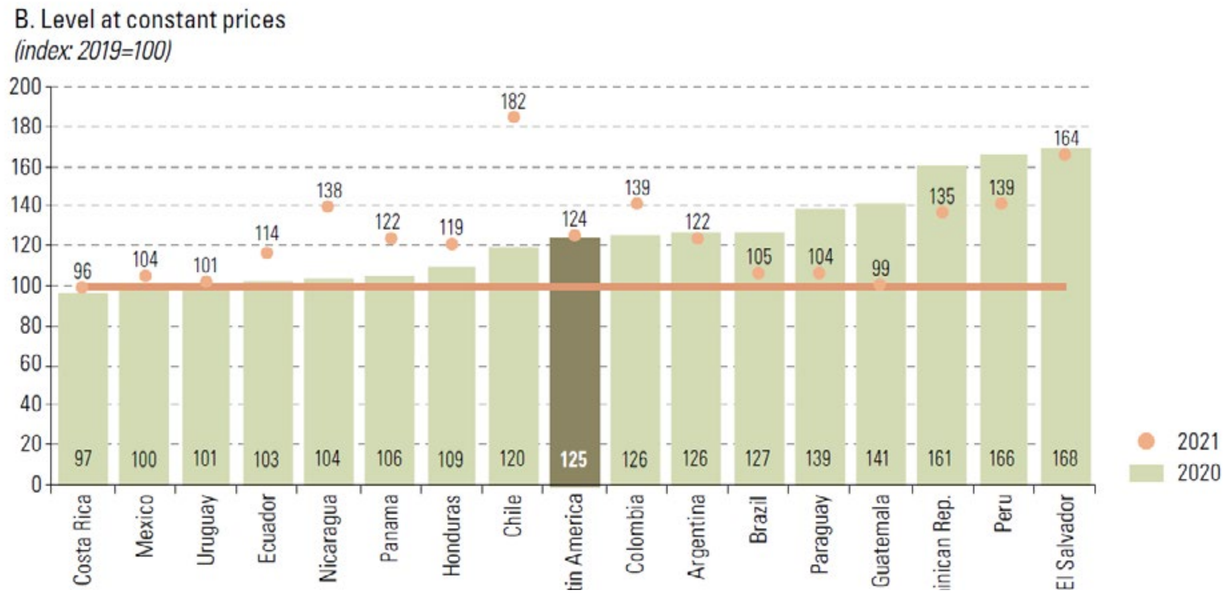
In general, LAC governments have much to gain from greater spending efficiency. Optimized public procurement, civil service, and targeted transfers alone could free up an estimated 17 percent of LAC public spending (Izquierdo, Pessino, and Vuletin 2018). In the case of Chile, streamlining and modernizing social programs, public-sector employment, and public procurement can free up additional resources amounting to at least 1.2 percent of GDP. This would significantly ease pressure on the revenue side of fiscal policy, given Chile's corrected collection gap with the OECD (around 2 percent of GDP) and its current goal of ambitiously increasing collection by about 4 percent of GDP (Larraín Bascuñán and Perelló Pérez 2022; Larraín Bascuñán and Weber 2022).[11]

Another useful fiscal guardrail during crises is to make emergency support time-bound or specify clear exit conditions. Doing so in the conceptualization phase helps to prevent fiscal irresponsibility down the road. As evidenced by LAC experience in the aftermath of the global financial crisis, transitory emergency spending could be perpetuated by inertia or political pressure, thus turning into permanent and often unproductive spending (Goldfajn and Levy Yeyati 2021). The COVID-19 pandemic underscored this still-present fiscal risk: despite the timely withdrawal of many emergency measures (including those described in *Figure 2*), 2021 outlays on subsidies and current transfers remained above pre-pandemic levels in most LAC countries (*see Figure 7 on next page*) (ECLAC 2022).

Finally, LAC governments must remain committed to investing in high-impact areas conducive to medium and long-term productivity and equity improvements. Public expenditure in education and infrastructure, for example, is expected to generate long-term returns through economic growth, which in turn boosts tax revenue. Additionally, well-designed preemptive social spending will be critical to protecting vulnerable LAC populations, many of whom are one shock away from poverty (Jaramillo, Canuto, and Zhang 2021). Such spending could be fiscally friendly if it eventually reduces the cyclical cost of dealing with negative shocks or the revenue losses caused by poverty-induced tax noncompliance. Specifically, this type of spending includes adaptive social protection and disaster risk insurance that can mitigate the immediate impact of future climate, pandemic, and other shocks on households, or robust health systems that have the surge capacity to deliver pandemic vaccines without sacrificing routine vaccination and health services (Betancourt-Cravioto and Zhang 2022). In short, efforts to drive evidence-based progressivity on the revenue side of fiscal policy should also be mirrored on the spending side. Together, they make a powerful combination to spur inclusive growth and fiscal health in the LAC region.

11 This approximation of the tax collection gap between Chile and the OECD average is more precise and realistic than nominal calculations, as it excluded social security contributions and adjusted for structural factors such as income levels and demographic and labor statistics.

Figure 7: Subsidies and Current Transfers Pre- and Post-COVID-19 (2019 and 2021)



Only Guatemala and Costa Rica (two of the sixteen Latin American countries measured) have seen their level of subsidies and transfers fall below pre-pandemic levels as of 2021.

Source: Economic Commission for Latin America, Fiscal Panorama of Latin America and the Caribbean, 2022.

Conclusion

A holistic approach to fiscal policy (for revenue and expenditure, on the short- and long-term, and in coordination with other economic policies) is critical to guiding the economy through its ups and downs—and the often blurred and uncertain transitions in between, such as the period in which LAC countries find themselves at the time of this writing.

In an increasingly shock-prone world, enhanced tax (and fiscal) policy can help better shockproof not only vulnerable populations and businesses, but government balance sheets. Beyond emergencies, LAC governments can use such policy as a tool for stimulating long-term growth and inclusivity, by following the recommendations outlined earlier:

- Lowering the administrative burden of taxes and improving enforcement.
- Lowering the financial burden of corporate income taxes.
- Making tax policy more equitable, progressive, and fair by reducing tax expenditures.

Specifically, LAC policymakers have at their disposal a set of practical options to improve taxation, ranging from rate adjustments and exemption removals to process simplification and collection enforcement. However, choosing the right options—and the right taxes (including the VAT, PIT, and CIT)—is easier said than done, especially in a region where public revenue historically fails to cover spending, and where societal needs and political complications continue to grow. Doing so successfully entails a careful, evidence-based assessment and balancing of the specific goals (i.e., growth, progressivity, revenue, or others), as well as the constraints and secondary effects in play.

Finally, as suggested throughout the paper, improving taxation is not merely a technical challenge, but a social, behavioral, and political one. Considering taxation as a social contract between governments and taxpayers, LAC region's less-than-ideal tax morale and collection rates reflect and reinforce low levels of trust in public institutions (OECD, CAF, and ECLAC 2018). Therefore, even for the narrow purpose of revenue optimization, governments in the region will do well to boost their image and credibility, much of which depends on actions beyond the realm of tax policy and economics. While not its focus, this paper offers a launch pad for this conversation and invites government officials and other relevant stakeholders to collaborate around this timely and timeless policy topic.

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Appendix A: Sources for Figure 2 COVID-19 Tax Policy Response in LAC's Big Six Economies

For each nation, the foregone revenue figure comes from the International Monetary Fund (IMF) Fiscal Monitor database, https://www.imf.org/en/Topics/imf-and-covid19/Fiscal-Policies-Database-in-Response-to-COVID-19.

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Appendix B: Major Structural Tax Reforms During the Pandemic

Color Key for LAC6 Tax Reform Initiatives

Tax optimization | Tax optimization and increase | Tax increase | Tax optimization and decrease | Tax decrease

	Date	Country	Status	CIT	PIT	VAT	Other	Goal of Reform
1	2019 (proposed)	**Brazil**	Awaiting plenary vote by Chamber of Deputies as of October 2022.				Fewer taxes and reallocation of resources at the federal level.	Simplify taxes while maintaining revenue.
2	2019 (proposed)	**Brazil**	Awaiting vote in Senate as of October 2022.				Similar provisions to the above but includes resources at state and federal levels and shorter transition time.	Simplify taxes while maintaining revenue.
3	October 2019 (approved; several separate laws.)	**Mexico**	Signed into law December 2019; most elements effective January 2020.			Expanded VAT to digital services delivered to Mexicans from abroad.	Adjusted regulations on a variety of international actors.	No rate changes; implementing a base erosion and profit shifting (BEPS) plan.
4	December 2019 (approved; several separate laws.)	**Argentina**	Passed December 2019.	Froze the scheduled reductions for corporate income tax.	Raised some taxes on personal goods.		Created the tax for an inclusive and supportive Argentina (PAIS tax) of 30 percent on certain purchases and transactions outside of Argentina or related to foreign currency.	Balancing public accounts.
5	2020 (proposed July 2020)	**Brazil**	Still in legislative process in Chamber of Deputies as of October 2022.				Modifies welfare contributions (Social Integration Program (PIS), Contribution for Social Security Financing (COFINS), PIS-Import and COFINS-Import), combining four taxes into one Contribution on Goods and Services.	Simplify taxes while maintaining revenue.

	Date	Country	Status	CIT	PIT	VAT	Other	Goal of Reform
6	February 2020 (passed)	**Chile**	Passed	Creation of a special corporate income tax system, allowing partial crediting against final income tax (100 percent crediting for SMEs).	New 40 percent income tax bracket for high-income Chilean individual taxpayers.	Expansion of VAT to digital services at 19 percent delivered by foreign resident service suppliers, when performed or used in Chilean territory.	Gradual elimination of tax rebates, expansion of expenses deductible for CIT purposes, new permanent establishment definition, new anti-avoidance rule on cross-border debt financing arrangements.	Response to 2018-19 protests.
7	October 2020 (passed; took effect January 2021.)	**Mexico**	Passed				Allows organized crime punishments to be applied for tax fraud.	Strengthening tax authority.
8	June 2021 (proposed)	**Brazil**	Approved by Chamber of Deputies and waiting for Senate consideration as of October 2022.		Modifications proposed to income taxes, social contribution on net profits, tax benefits, and procedural tax law.			Simplify taxes while maintaining revenue.
9	March 2021 (date of passage.)	**Brazil**	Passed				Reduction in federal tax expenditures.	Reducing tax expenditures.
10	May 2021 (withdrawn)	**Colombia**	Withdrawn			Raise VAT on goods, services, fuel.	Elimination of deductions.	Reform to reduce expenditures, raise revenue to maintain investment-grade status.
11	June 2021 (passed, retroactive to January 2021 tax year)	**Argentina**	Passed	Creation of a progressive tax scale on corporate income, with rates of 25, 30, and 35 percent.				Shift from flat to progressive CIT.
12	September 2021 (passed; most changes effective January 2022.)	**Colombia**	Passed	Raises CIT rate to 35 percent from 31 percent, adds 3 percent surtax on some incomes, allows in-kind payments for certain investments.		Three new VAT holidays, changes to VAT on imports.		Adjusted version of May 2021 proposal: raise revenue and cut public expenses.

	Date	Country	Status	CIT	PIT	VAT	Other	Goal of Reform
13	Proposed October 2021 (passed December 2021.)	**Peru**	Partially passed		Income tax rate raised on top 0.5 percent from 29 to between 31 and 35 percent to increase progressivity.		Congress rejected taxes on mining sector profits.	Raise mining taxes to fund social spending.
14	October 2021 (entered into force January 2022.)	**Mexico**	Passed	Changes to regulations on maquiladoras, for restructurings, and tax reporting; more penalties for noncompliance in hydrocarbon sector.				Meeting 2022 budget goals.
15	January 2022	**Mexico**		Simplified tax regime for legal entities held by individuals and grossing no more than 35 million Mexican pesos (about US$1.75 million), allowing cash flow basis taxation and the deduction of acquisitions instead of cost of sales, among other benefits.	The legislation includes a simplified tax regime for individuals grossing no more than 3.5 million pesos (about US$175,000), granting lower income tax rates.			
16	February 2022 (passed; varying dates of entry into force.)	**Chile**	Passed		Elimination of exemptions for 10 percent capital gains tax.	Expansion of VAT for services.	Increased property tax, new tax on luxury goods, elimination of special VAT credit for construction companies.	Finance pension reform.
17	Proposed July 2022	**Chile**	Proposed	Separate taxation of companies and shareholders.	New top bracket of 43 percent.		1 percent wealth tax on assets over US$5 million, new tax on copper mining.	Add wealth tax, reduce exemptions, strengthen administration.

	Date	Country	Status	CIT	PIT	VAT	Other	Goal of Reform
18	Proposed July 2022	**Colombia**	Proposed	CIT is kept at 35 percent, income tax exemptions eliminated; increased income tax on oil and coal companies, but no export tax.	Tax exemptions, progressive tax on high earners.		Introduction of the permanent Net Equity Tax; elimination of deduction of royalties; Free Trade Zone benefits will be conditioned. Elimination of ICT credit and VAT holidays. New taxes on ultra-processed foods and beverages.	Increase revenues to reduce deficit and cover other expenditures.

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