

Diagnosis for a Tax Reform in Chile

Different sectors are asking to review the tax schedule applied in the country.

Before analyzing the proposals, it is essential to review in detail the country's tax burden level, the way taxes are collected and the final destination of these resources. With regard to the first point, it is evident that Chile has a burden within the range of what today's developed countries had when they had similar levels of GDP per capita to those of Chile today.

The benefits of public spending must always be assessed with the costs that tax collection imposes on the society to finance this expenditure.

The extent of these costs depends mainly on the tax burden, the way of collecting and the destination of the collection. These undesirable effects of tax collection, widely recognized in literature, include: compliance costs for taxpayers, management of the *Servicio de Impuestos Internos* (SII, Internal Revenue Service), eluding and evasion costs, and distortions in the people's decisions. The latter is by far the most significant cost, since the modification of relative prices excludes society from the efficient allotment of resources, thus reducing well-being.

Due to the problem's complexity, the way of collecting and the destination of the taxes are usually dealt with separately at the tax burden level, although they are closely related.

The tax burden level in an economy, usually measured as a percentage of the GDP, is a very complicated decision, and probably there is not a single, accepted approach, because in the end, it concerns the size of the State and its interference in every aspect of the life a society is aiming at. We should just observe the strong differences existing between tax collection and GDP ratio in the

OECD countries (Table 1), in order to have an idea of the big differences existing in 2008.

Table 1

TAX REVENUES, OECD COUNTRIES 2008

COUNTRY	NET TAX BURDEN	Including Social Security	COUNTRY	NET TAX BURDEN	Including Social Security
Japan	17.28	28.14	Luxembourg	25.47	35.54
Slovak Republic	17.36	29.31	OECD – Total	25.81	34.81
Turkey	18.16	24.22	Australia	27.05	27.05
Mexico	18.34	21	France	27.09	43.17
United States	19.53	26.06	Hungary	27.14	40.18
Czech Republic	19.96	36.04	Canada	27.57	32.32
Greece	20.32	32.56	Israel	28.2	33.77
Korea	20.73	26.51	Austria	28.42	42.7
Chile	21.05	22.49	United Kingdom	28.89	35.67
Spain	21.14	33.25	Italy	29.79	43.27
Switzerland	22.39	29.07	Belgium	30.25	44.16
Poland	22.93	34.28	Finland	31.04	43.13
Germany	23.07	36.97	Norway	33.69	42.59
Slovenia	23.13	37.18	New Zealand	33.72	33.72
Ireland	23.67	28.75	Iceland	33.97	33.78
Portugal	23.71	35.24	Sweden	34.8	46.29
Netherlands	24.63	39.09	Denmark	47.21	48.17

Source: OECD

We observe that Chile presents a net tax burden in the low part of the scale and below the 25.8% average, but higher than countries like the United States, Japan and Korea. When including social security, in charge of the State in most countries, they show tax burdens which are far superior to Chile.

When comparing with the countries of the region, where there are countries with similar incomes per capita, we observe that the net tax burden, at the central government level, is in the upper part of the sample, being surpassed only by Bolivia and Cuba. When looking at the social security allotments, the scenario remains practically the same, being Chile one of the countries with greater tax burden.

Furthermore, when comparing Chile with developed countries, when they had an income per capita similar to that of Chile today, we observe that the tax burden is at expectable levels (Table 3).

In broad outlines, it seems that Chile's tax burden level is not misaligned with countries of similar development levels; so, if we take into account the potential harmful effects that a tax burden increase could have on the convergence speed, through the channels traditionally recognized by the literature, it is not advisable to increase it.¹

Table 2

TAX REVENUES LATIN AMERICA 2008 (1)

COUNTRY	NET TAX BURDEN	Including Social Security	COUNTRY	NET TAX BURDEN	Including Social Security
HAITI	10.64	10.64	PANAMA	10.72	16.46
GUATEMALA	11.27	11.53	PERU	15.44	17.23
PARAGUAY	11.76	12.99	ARGENTINA	13.83	18.11
VENEZUELA	13.58	14.34	CHILE	18.45	19.90
EL	13.05	14.65	BOLIVIA	19.03	20.85
SALVADOR	14.93	14.98	NICARAGUA	17.96	22.07
DOMINICAN REP.	13.49	15.51	CUBA	19.07	23.31
COLOMBIA	15.33	15.61	BRAZIL	16.25	23.97
COSTA RICA	12.12	15.99	URUGUAY	17.77	24.18
ECUADOR	15.09	16.25			
HONDURAS					

Source: ECLAC. (1) Central Government.

One of these channels is employment. When imposing a tax on the income derived from work, the latter is less attractive, so individuals would prefer to work less (substitution effect), but it also impoverishes the one who pays the tax and, therefore, he has to work more (income effect). It is an empirical issue to determine which force predominates and which individuals present a greater response.

Another particularly sensitive variable is investment, where literature distinguishes at least two channels presenting distortions, and it should not be overlooked: capital cost increase and internal funds availability.

Thus, the way of collecting becomes the key factor when analyzing the effects of the tax system on the economy, and we believe that there are reform possibilities here. In general, for a given level of tax collection, the higher the marginal rates, the higher the distortion and, therefore, the associated cost of efficiency loss. Something similar happens with complex tax systems which impose high rates on small

product or sector tax bases, instead of broad tax bases with few exemptions at low rates, introducing inefficient and groundless preferences for certain economic activities. Additionally, literature acknowledges that high marginal rates increase the administration costs: eluding and evasion of the taxable system, inasmuch as they increase the attraction of trying to sidestep the system, increasing the return of subdeclaring and eluding.

Concerning these aspects, we may say that the Chilean system has progressed in the right direction in the last 35 years, at least from the point of view of efficiency. In essence, it has moved from an income tax applied on a very narrow base, high marginal rate and complex exemptions, towards a tax more oriented to spending, broad-based and with emphasis on the horizontal equity of taxpayers.

The relevance of these changes lies in the reduction and change of focus of the distortions that the system brings along. A tax system which imposes a tax on income affects both the saving-consumption decision and the leisure-work decision of the individuals. Instead, a system based on expenditure tax will only affect the leisure-work decision.

The first distortion (to saving) is observed in a dynamic context, where individuals will prefer to save less if they know that they will be able to get only a fraction of the future incomes generated by their savings, because they will have to pay taxes on them, biasing their decision in favor of immediate consumption. On the other hand, and as we mentioned earlier, the leisure-work decision will be altered due both to the less relative retribution that a person receives as a consequence of paying income tax, and an excise tax which turns leisure more attractive, since it is not subject to taxation.

Table 3

**INCOME* PER CAPITA AND TAX BURDEN
IN THE YEAR WHEN 15,000 2010 (GK) DOLLARS WERE
ACHIEVED**

Country	Year	GDP per capita*	Net Tax Burden	Including Social Security
Spain	1978	15,058	10.86	21.49
Switzerland**	1948	15,213	14.9	17.5
Japan	1970	16,211	15.2	19.6
Greece	1984	15,131	16.62	25.5
South Korea	1991	15,694	17.1	19.1
Italy	1968	15,196	17.2	27
Portugal	1987	15,329	17.47	24.34
Slovak Republic	2003	15,306	19.28	33.08
Australia	1961	15,064	20.5	20.5
Czech Republic	2000	15,279	20.84	35.31
United States**	1948	15,127	21.4	24.7
Poland	2006	15,120	21.81	33.98
Slovenia	1992	15,540	22.42	39.2
France	1965	15,296	22.43	34.06
Netherlands**	1964	15,749	22.69	32.77
Germany	1965	15,330	23.1	31.6
Belgium	1967	15,140	23.8	33.9
New Zealand**	1956	15,020	24.1	24.1
Canada**	1962	15,482	24.3	25.7
Hungary	2006	15,494	25.23	37.15
United Kingdom**	1963	15,269	25.75	30.43
Austria	1969	15,238	25.98	34.45
Norway	1967	15,725	27.43	32.57
Finland	1970	15,982	28.8	31.6
Denmark**	1961	15,540	28.9	30
Sweden**	1961	15,415	29.4	33.4
Ireland	1984	15,112	30.54	35.73
Simple Average			22.15	29.66
Weighted Average***			20.70	25.97

← Chile

Source: OECD, Banco Central de Chile, Angus Maddison "Historical Statistics", University of Groningen.

*Measured in 2010 Geary-Khamis dollars (GK) according to Angus Maddison Historical Statistics.

**Data for 1965, the most ancient one available at the OECD.

***Weighted by GDP 2010.

In practice, this movement towards imposing a tax on expenditure has been achieved in Chile through indirect excise taxes and an income tax integrated with saving benefits (Table 4).

Table 4

COMPOSITION OF TAX RECEIPTS

	2010		2000-2010
	MUS\$*	% total revenues	% total revenues
1. Income Tax	13,890.80	40.3%	34.10%
First Category	4,082.15	11.8%	13.00%
Second Category	2,839.25	8.2%	7.10%
Complementary Global	-69.66	-0.2%	0.30%
Additional	1,207.26	3.5%	5.90%
40% Rate	375.17	1.1%	0.80%
Payment System	1,233.61	3.6%	0.60%
Foreign Currency	4,122.10	12.0%	5.80%
Payment Conversion**			
2. Valued Added Tax	16,262.82	47.2%	48.30%
3. Special Purpose Tax	3,155.57	9.2%	10.30%
Tobaccos	1,268.93	3.7%	3.70%
Fuels	1,886.64	5.5%	6.60%
4. Tax on Legal Transactions	392.42	1.1%	3.30%
5. Tax on Foreign Trade	512.27	1.5%	3.90%
6. Others	241.09	0.7%	0.10%
TOTAL TAX RECEIPTS	34,454.98	100.0%	100.0%

Source: SII

*Exchange rate: 510.38 observed average 2010. **Corresponds to the payments made in foreign currency, excluding CODELCO.

The VAT preponderance among indirect taxes is clear; until 2010, it was the tax that most contributed to the public treasury, imposing a tax on the majority of goods and services with an even 19% rate, with exemptions in education and health corresponding to investments on human capital and, therefore, it seems highly reasonable to exclude them from a system aimed at imposing taxes on spending. This tax is fair and presents a highly efficient collection, since it does not distort relative prices and it is pretty easy to manage by the taxation authority. Concerning the criticisms for being a regressive tax, since the poorest would consume a greater fraction of their income, they are groundless because today's savings mean greater consumption tomorrow. Therefore, from the distributive point of view, the VAT is a neutral tax.

Table 5

VAT* EFFICIENCY, RATE AND COLLECTION

Country	Efficiency **	Rate	Total VAT collection %	Country	Efficiency **	Rate	Total VAT collection %
New Zealand	88.31%	12.5%	24.3%	Australia	50.79%	10.0%	12.8%
Luxembourg	78.86%	15.0%	16.0%	Germany	50.23%	17.5%	18.6%
Switzerland	71.67%	7.6%	13.1%	Czech Republic	49.94%	19.8%	18.6%
Japan	67.61%	5.0%	9.1%	Sweden	49.89%	25.0%	19.0%
Canada	65.75%	6.3%	9.2%	Hungary	49.08%	21.3%	20.6%
Chile	62.72%	19.0%	35.5%	Portugal	48.26%	20.5%	24.5%
Korea	60.97%	10.0%	16.5%	Spain	46.62%	16.0%	16.6%
Ireland	55.16%	21.0%	24.3%	Belgium	45.59%	21.0%	16.1%
Denmark	54.62%	25.0%	20.6%	France	45.24%	19.6%	16.3%
Netherlands	54.31%	19.0%	19.1%	Poland	44.75%	22.0%	23.2%
Austria	53.94%	20.0%	18.4%	United Kingdom	0.4316239 31%	17.5%	18.2%
Finland	52.77%	22.0%	19.6%	Greece	42.03%	18.8%	22.2%
Iceland	52.40%	24.5%	26.3%	Italy	38.49%	20.0%	14.4%
Norway	52.36%	24.8%	18.1%	Turkey	0.3405734 09%	18.0%	21.4%
Slovak Republic	50.85%	19.0%	24.2%	Mexico	31.92%	15.0%	19.4%

Source: Prepared by L&D with OECD data.

*Average 2005-2008. **Ratio, (VAT collection)/(total consumption*VAT rate).

The special purpose taxes – on tobacco, soft drinks, alcoholic beverages and fuels, except the one imposed on soft drinks -, seem to point at the right direction from the Pigovian tax viewpoint which aims at correcting an externality, transferring the cost to those creating it, by reducing the good’s produced quantity to optimal levels for the society. But although the intention is good, there seems to be no clarity as to the volume of these taxes being the appropriate one to correct the produced externalities. In particular, fuel taxes seem too low to correct them, and surveys of the World Bank and the IMF suggest a tax over CLP\$300 per liter for Chile, and additionally, the gasoline tax is relatively progressive. Moreover, the tax difference that benefits diesel fuel would not correspond to differences in the externalities it generates, but rather to non-economical arguments. And we should also consider that these special purpose taxes are very easy to collect, representing approximately 10% of the tax receipts (US\$2 billion).

Taxes on legal transactions are considered especially harmful since they collect a relatively small amount – 1.1% in 2010 – and they do not correct any externality; they only make credit operations more

expensive, thus particularly damaging small and medium businesses (PYME).

Another big issue is income tax, which imposes an integral tax on people's capital and work incomes and that, through different benefits and exemptions favoring saving, tries to get timidly close to a tax on expenditure. In Chile, taxes are applied to the individual and, therefore, when this tax is paid to the companies it constitutes a credit for the personal tax of their owners.

The 17% tax rate on earnings (temporarily at 20%) is relatively low at international level. The purpose of keeping low rates is to stimulate capital accumulation and economic growth.

Table 6

CORPORATE TAX MARGINAL RATE

Country	Tax Rate	Country	Tax Rate
Japan	39.5%	Austria	25.0%
United States	39.2%	Denmark	25.0%
France	34.4%	Netherlands	25.0%
Belgium	34.0%	Korea	24.2%
Germany	30.2%	Israel	24.0%
Australia	30.0%	Switzerland	21.2%
Mexico	30.0%	Estonia	21.0%
Spain	30.0%	Chile	20.0%
Luxembourg	28.8%	Greece	20.0%
New Zealand	28.0%	Iceland	20.0%
Norway	28.0%	Slovenia	20.0%
Canada	27.6%	Turkey	20.0%
Italy	27.5%	Czech Republic	19.0%
Portugal	26.5%	Hungary	19.0%
Sweden	26.3%	Poland	19.0%
Finland	26.0%	Slovak Republic	19.0%
United Kingdom	26.0%	Ireland	12.5%

Source: OECD

It is worth mentioning that some countries present a significantly lower differentiated taxation for small businesses in order to foster entrepreneurship (Table 7).

Table 7

SMALL BUSINESSES TAX MARGINAL RATE 2011

Country	Tax Rate
Turkey	5.0%
Hungary	10.0%
Korea	11.0%
France	15.0%
Canada	15.3%
Netherlands	20.0%
United Kingdom	20.0%
United States	20.1%
Belgium	24.3%
Japan	24.8%
Spain	25.0%
Luxembourg	27.6%

Source: OECD.

*The definition for "small business" varies according to the country.

Individual incomes are taxed according to a progressive scale with a maximum marginal rate of 40%. This rate is high compared with other countries, particularly in those with incomes similar to Chile (Table 8).

Considering horizontal equity, it is argued that it is unfair for companies to pay 17% (temporarily 20%), while employed professionals are subject to much higher rates. This entails that own-account professionals decide to form corporations and pay taxes as a company. This difference is effective if the company owners decide not to withdraw the profits. If it is not the case, withdrawals are subject to income tax (Global Complementary) according to the businessman marginal rate, deducting the 17% paid by the company.

It is in this matter that we propose changes that assimilate the system even further to a tax on expenditure, and ending with this arbitrary difference.

Finally, the destination of taxes is presented in the literature as an important factor in the administration, eluding and evasion costs of the tax system, since if people perceive that the destination of their taxes is "adequate" and "fair", together with an efficient collection system, the intents to sidestep tax payments will be reduced. In Chile, the SII presents a pretty low collection cost and a good perception by taxpayers (Chart 1).

Table 8

MAXIMUM MARGINAL RATE, INDIVIDUAL INCOME TAX					
Country	Rate	Country	Rate	Country	Rate
Sweden	56.6%	Thailand	37.0%	Armenia	20.0%
Denmark	55.4%	Argentina	35.0%	Egypt	20.0%
Netherlands	52.0%	Ecuador	35.0%	Guernsey	20.0%
Austria	50.0%	Jamaica	35.0%	Isle of Man	20.0%
Belgium	50.0%	South Korea	35.0%	Jersey	20.0%
Japan	50.0%	Malta	35.0%	Pakistan	20.0%
United Kingdom	50.0%	Sri Lanka	35.0%	Singapore	20.0%
Finland	49.6%	Turkey	35.0%	Slovak Republic	19.0%
Norway	47.8%	United States	35.0%	Rumania	16.0%
Ireland	47.0%	Vietnam	35.0%	Costa Rica	15.0%
Iceland	46.3%	Venezuela	34.0%	Czech Republic	15.0%
Portugal	45.9%	Colombia	33.0%	Hong Kong	15.0%
Australia	45.0%	New Zealand	33.0%	Lithuania	15.0%
China	45.0%	Hungary	32.0%	Serbia	15.0%
Germany	45.0%	Philippines	32.0%	Ukraine	15.0%
Greece	45.0%	Poland	32.0%	Russia	13.0%
Israel	45.0%	Guatemala	31.0%	Bulgaria	10.0%
Italy	43.0%	Cyprus	30.0%	Kazakhstan	10.0%
Spain	43.0%	India	30.0%	Paraguay	10.0%
Papua New Guinea	42.0%	Indonesia	30.0%	Bahamas	0.0%
Guinea	41.0%	Mexico	30.0%	Bahrain	0.0%
France	41.0%	Peru	30.0%	Bermuda	0.0%
Slovenia	40.0%	Canada	29.0%	Cayman Islands	0.0%
Chile	40.0%	Brazil	27.5%	Kuwait	0.0%
Croatia	40.0%	Latvia	26.0%	Oman	0.0%
Gibraltar	40.0%	Malaysia	26.0%	Qatar	0.0%
South Africa	40.0%	Panama	25.0%	Saudi Arabia	0.0%
Switzerland	40.0%	Uruguay	25.0%	Arab Emirates	0.0%
Taiwan	39.0%	Estonia	21.0%	Simple Average	29.4%
Luxembourg					

Source: KPMG's Individual Income Tax and Social Security Rate Survey 2010.

The existence of a pretty positive perception is confirmed in relation to the global acting of the revenue service, which is repeated in several attributes of the SII.ⁱⁱ

Therefore, we believe that substantial improvements can be made concerning the destination of the taxes and the role that society gives to their collection, where taxes can be especially useful and efficient to collect and correct externalities, but very weak when it comes to improve income distribution or correct social inequities. In our opinion, and based on the empirical evidence, it is much more profitable for the society to collect taxes in the most efficient way possible, and therefore be able to finance focalized public expenditure and achieve the distribution level our society is aiming at. Moreover, taxes seem to be a bad tool to look for equity, since it is hard to measure the results and they tend to confuse the costs

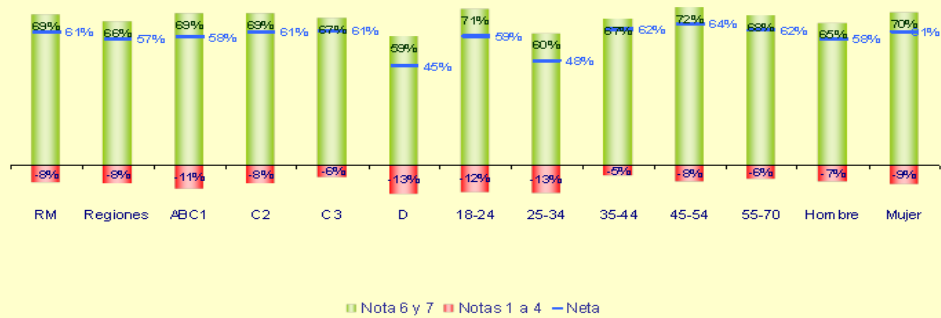
incurred by the society to achieve a certain distribution level and help the most vulnerable ones.

In this perspective, the Chilean tax system has made positive progresses, giving priority to horizontal equity over the vertical one, through rather neutral indirect taxes such as the VAT, which collect much and finance fiscal spending to achieve a greater vertical equity.

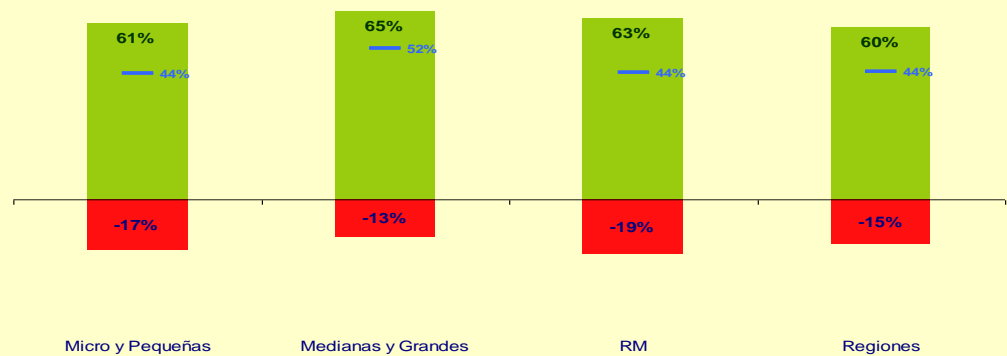
Chart 1

SII GLOBAL SATISFACTION, NATURAL PERSONS AND BUSINESSES* 2008

1) NATURAL PERSONS



2) BUSINESSES



Source: *Estudio de percepción social del sistema impositivo y la administración tributaria chilena*, IPSOS.

*Only those who have contacted the SII in the last 12 months.

Conclusion

Different sectors are asking to review the tax schedule applied in the country. Before analyzing the proposals, it is essential to review in detail the country's tax burden level, the way taxes are collected and the final destination of these resources.

It is evident that Chile has a burden within the range of what today's developed countries had when they had similar levels of GDP per capita to those of Chile today. So, if changes are to be introduced, we suggest that they are neutral in collection issues and focused on collecting as efficiently as possible and reducing distortions and disincentives to economic growth.

ⁱ See, "Tax Reform: Contributions to the Debate". Libertad & Desarrollo, Public Issues Nr 1,029 for a review on the effects of tax increase on the economic activity.

ⁱⁱ *Estudio de percepción social del sistema impositivo y la administración tributaria chilena*, IPSOS.