Public Issues

Nr 1,112
May 31st, 2013

www.lyd.org ISSN 0717-1528

International Evidence on Tax Revenues and Analysis of the Proposals

The tax reform idea has burst into the national agenda again in this electoral year. The discussion does not consider that Chile has similar tax burden levels than today's developed countries, when the latter had similar GDP levels per capita, and that this additional revenue, as a result of growth, is the best revenue source for social reforms in the country. Res Pública's recent proposals show that there is still no consensus on this matter.

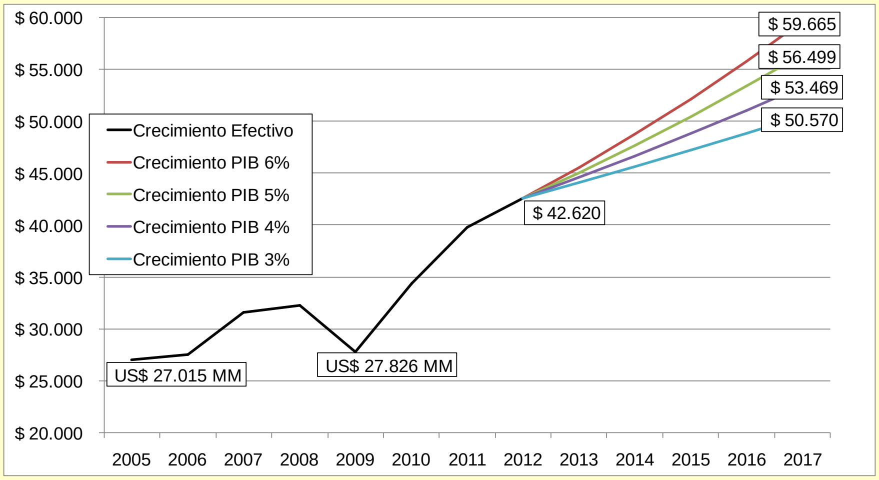
As anticipated during the long and complex discussion concerning the amendments to the tax regime (approved in September of last year by the Law 20.630[i]), they did not settle the dispute at all in relation to an alleged need of major changes to the current taxation system. There is such a limited consensus regarding this point, that even the think tank Grupo Res Pública Chile, in his book "*95 propuestas para un Chile mejor*" (95 Proposals for a Better Chile) introduces two proposals with quite different focuses and objectives, one we consider positive and the other one which impairs economic growth. They are briefly discussed in the final part of the present document.

Among the arguments that are put forward to justify these reforms, beyond the above mentioned document, there is a supposed need for greater public funds to finance increasing spending, mainly on education. In addition, there is a deeply rooted idea that the tax system can, and should, become a powerful redistributive tool and, only in a lesser measure, a search of greater economic efficiency.

The first argument is unsustainable in the light of fiscal data, since the expenditures involved in these projects could be covered by tax revenues derived from higher growth. In fact, the difference between growing at 5% instead of 3% represents extra revenues for US$6 billions.

Chart 1

PATH OF NON-MINING TAX REVENUES (B US$)
(PRODUCT ELASTICITY OF THE NMTR = 1.16)



Source: L&D based on data from DIPRES (Budget Office).

Thus, the underlying idea seems to be that the most developed countries with higher income per capita necessarily have greater tax burden (measured as % of the GDP), a logic which goes back to the observations made by 19th century German economist, Adolph Wagner, currently known as the Wagner's Law. But this principle, whose compliance does not seem generalized, does neither respond to the basic question on the causality in this relationship, which is not evident because there can be effects in both directions.

i. As countries grow and revenues increase, there is greater demand for public goods, so the tax burden is increased to finance them; in other words, the income elasticity of demand for public goods is greater than 1.

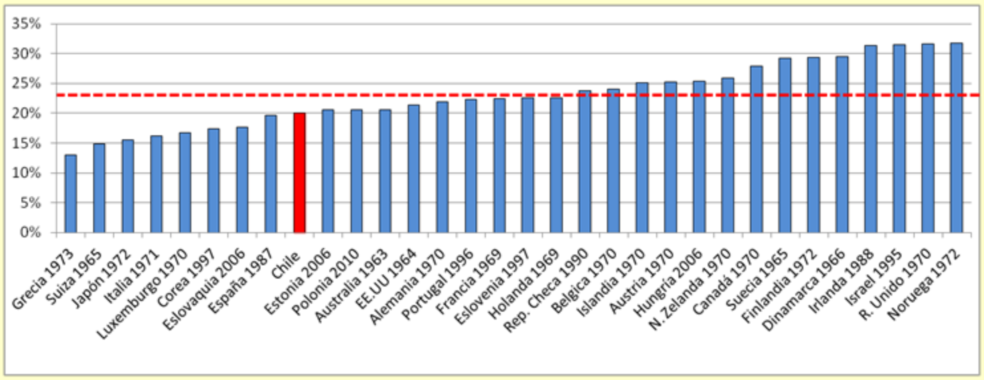
ii. A tax burden based on non-distorting taxes and invested on public goods or activities with positive externalities which foster productivity, such as education, health and infrastructure, can help to increase the product's growth.

Although there is evidence that the Wagner's Law is fulfilled, what the following charts suggest is not evident. It seems that the Law does not entail a specific policy recommendation, since there is no clarity if an increasing tax burden precedes, charged as efficiently as possible and correctly invested, and if it is a condition that benefits economic growth and development, or on the contrary, as countries have increasing revenues they can allow themselves a greater provision of public goods financed by a higher tax burden.

According to OECD data, in 2011 the net tax burden in Chile[ii], including the central government and regional governments, represented 20.05% of the GDP. When comparing this figure with countries that are richer today, but when they had just surpassed an income level per capita similar to that of Chile today – approximately US$20,000 per capita adjusted by purchasing power parity (PPP)-, so that we can consider the possibility of complying with the Wagner's Law, we observe that the burden of the country is not especially distant from the mean of these countries corresponding to 23.06%. In view of the available data, particularly before 1996, the income average for the sample of countries is US$23,000 per capita adjusted by PPP, somewhat over Chile's US$20,000 (according to the OECD); therefore, it could also be considered as a reference for coming years.

Chart 2

NET TAX REVENUES / GDP PER CAPITA

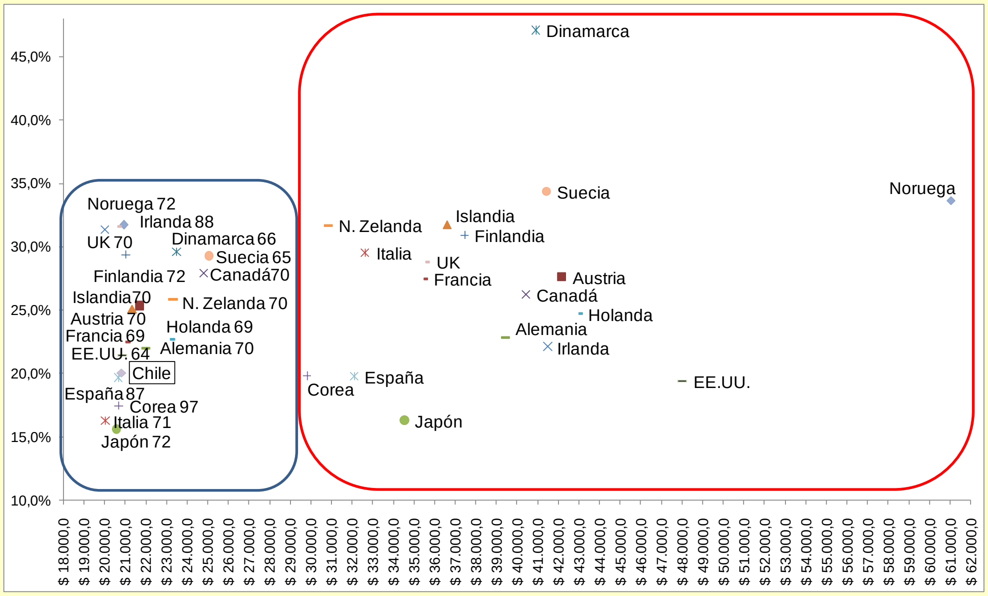


Source: L&D based OECD database, except the U.S.A. (Bureau of Labor Statistics)

Studying the evolution of the net tax revenue of some of these countries is also useful, particularly those which have incomes per capita over US$30,000 PPP, by comparing when they had a similar income as Chile today and their actual condition. In Chart 3, the left rectangle corresponds to the group of countries when their revenues were comparable to Chile, and the right one represents their actual condition. Apparently, the tax burden for higher income levels does not show a generalized trend of substantial increases, but rather moderate ones. In short, each country seems to have a dynamic of their own, which in the end reflects the type of society and the level of state interference they want. While Scandinavian countries foster a more statist model, which requires greater fiscal revenues to finance it, and the case of Denmark deserves special mention because in 2011 the State collected practically 50% of what is produced by concept of taxes, other countries like the United States, Japan and Korea keep their tax revenue levels quite stable, privileging private initiatives.

Chart 3

NET TAX REVENUES AND GDP PER CAPITA



Source: L&D based OECD database, except the U.S.A. (Bureau of Labor Statistics)

Remarks on Res Pública's Tax Proposals

The book "*95 propuestas para un Chile mejor*" recently published by Grupo Res Pública Chile (GRPC)[iii], is a significant contribution to the discussion on national public policies in different areas, among which there is naturally the tax regime. The GRPC document contains two proposals to modify the Chilean taxation system, with very dissimilar aspects, which reflects the diversity of approaches and objectives in tax policy matters; they can be found in Chapter 7 ("*Una reforma tributaria para la eficiencia y la equidad*" – A Tax Reform for Efficiency and Equity) and 12 ("*Impuestos a la renta: una reforma progresiva y eficiente*" – Income Tax: A Progressive and Efficient Reform). Before focusing on the differences and why the proposals of Chapter 7 seem great contributions, while those of Chapter 12 would impair economic growth, it is worth highlighting the positive features of the diagnosis and those that are common to both proposals.

a. Although the proposed solutions and their implications on saving are totally opposed, both proposals recognize the existence of a horizontal inequity in the current tax system, in favor of saving for juridical persons and against natural persons, which certainly must be corrected.

b. The current system distorts the saving decisions of natural persons, many times by imposing a double taxation, because it levies a tax on flows generated by saving earnings that have already paid taxes and whose destination is to finance future consumptions. Thus, it penalizes future consumption.

c. It is highly valuable that individual and corporate income tax are kept integrated, preventing that, in practice, earnings pay taxes twice, and recognizing that it is the owner of the company who should pay for the obtained earnings.

d. It is indispensable to standardize the special income tax regimes for small businesses, making it more simple and accessible and taking into account that the cost of complying with the general system can be unaffordable for them. Moreover, it is necessary to revoke the presumed income regime for activity groups that can currently resort to it, since the grounds that justified its existence before are no longer justifiable.

In income tax matters, the proposals of Chapter 7 respond to these diagnoses by allowing natural persons to have the same saving incentives than the companies, with two alternative proposals: either replacing the current income tax base by a consumption base for individuals, which would radically end with horizontal inequity and distortions against individual savings; or alternatively, keeping the income tax base, but allowing workers to receive their incomes through a partnership, which naturally equals the treatment. We consider that the first alternative is better, even though it entails a structural change of the system, and should be complemented with the corporate tax payment on a consumption base as well.

While the proposal of Chapter 12 addresses the same diagnoses by means of changing the individual taxation on earnings from cash basis to accruals basis, which would possibly end with the discrimination against savings of natural persons, it punishes savings of partnerships, because the tax treatment on earnings distributed to the owners with consumption purposes is equaled to those that are saved to be reinvested. However, while encouraging withdrawals, this proposal would have adverse effects on savings, investment, and employment generation and, therefore, reduce the GDP growth.

Thus, in a general way, the substantial difference lies in the fact that one of the proposals considers unnecessary to encourage savings and investment within the companies, and extend the benefits pro savings to individuals; probably because it has no major effects in the long-run and/or current levels of domestic savings are enough. This idea seems mistaken, especially because there is evidence that small businesses would be the most impaired by such a measure, since they depend on their retained earnings to grow, and furthermore, they are not able to use the tax benefit of the debt, as large companies do when the First Category Tax is raised by modifying their debt-equity ratios, which can be undesirable because it increases their financial exposure level. In addition, and in the light of aggregated figures of domestic savings which are insufficient to sustain growth close to 5% annual, any measure that discourages savings must be carefully analyzed. On the other side, this proposal would create a cash problem to small savers of equity funds in the Pension Fund Administrators (AFP), for example, who would have to face higher taxes on earnings they have not received.

Finally, in relation to the proposal in Chapter 12, it is difficult to quantify its redistributive impact, one of its best qualities but which could turn out being the opposite, since the capital gains tax, due to this impact's capacity to move among economies and sectors in search of greater returns after tax, in practice it often means that those who really end up paying the tax are not capital owners, but rather the workers, especially the most qualified ones. In this manner, a static perspective when assessing the redistributive impact of a capital gains tax can lead to wrong conclusions.

In brief…

A NEW TAX DISCUSSION:

- There is the belief that most developed countries with higher income per capita have necessarily greater tax burden (measured as % of the GDP), a logic related to the "Wagner's Law".
- According to OECD data, in 2011 the net tax burden in Chile represented 20.05% of the GDP. When comparing this figure with countries that are richer today, but when they had just surpassed an income level per capita similar to that of Chile today, we observe that the burden of the country is not especially distant from the mean of these countries, corresponding 23,06%.

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[i] Libertad & Desarrollo. Public Issues Nr 1,057, April 13th, 2013.

[ii] The net tax burden is used, which does not include social security contributions that are considered a requirement to receive the benefits, in order to adequately compare in view of the special characteristics of the Chilean system, where many benefits are given by private entities and citizens make compulsive payments to them and not to the government – which are therefore not considered a tax – to finance these benefits, for example ISAPRE and AFP, for health and pensions respectively.

[iii] www.95propuestas.cl