Tax reforms from a Latin American perspective

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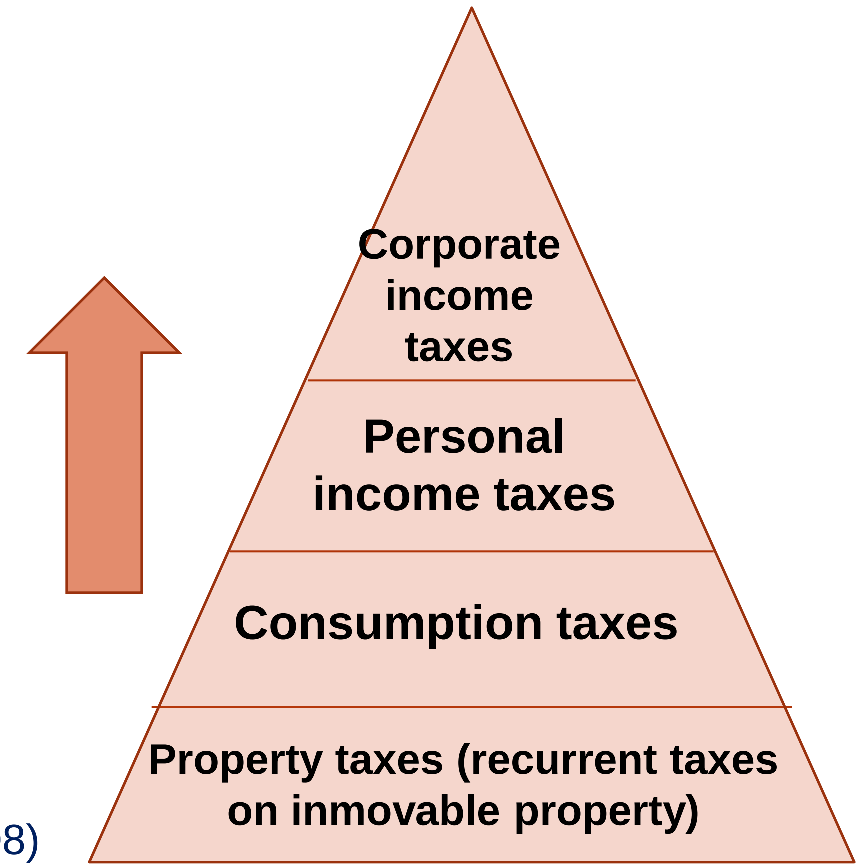
Taxation and growth

Tax Instruments and its effects on economic growth

Negative effect on GDP per capita



Arnold (2008)
Johansson (2008)

- The usual suggestion for developing countries is to promote tax reforms to increase the weight of property and consumption taxes into the tax structures.

- **However, there are other "growth reasons" that explain why these tax reforms cannot be carried out in some Latin American countries.**

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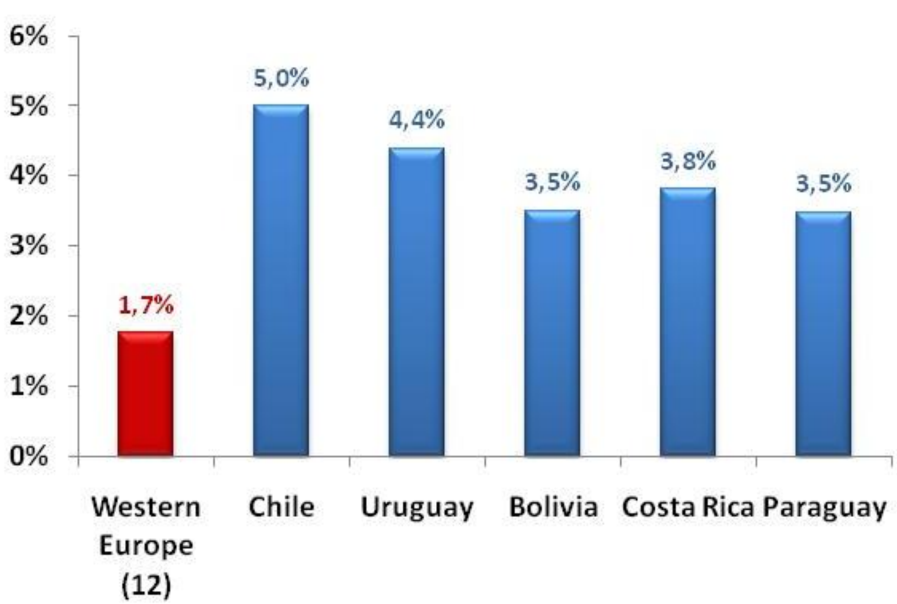
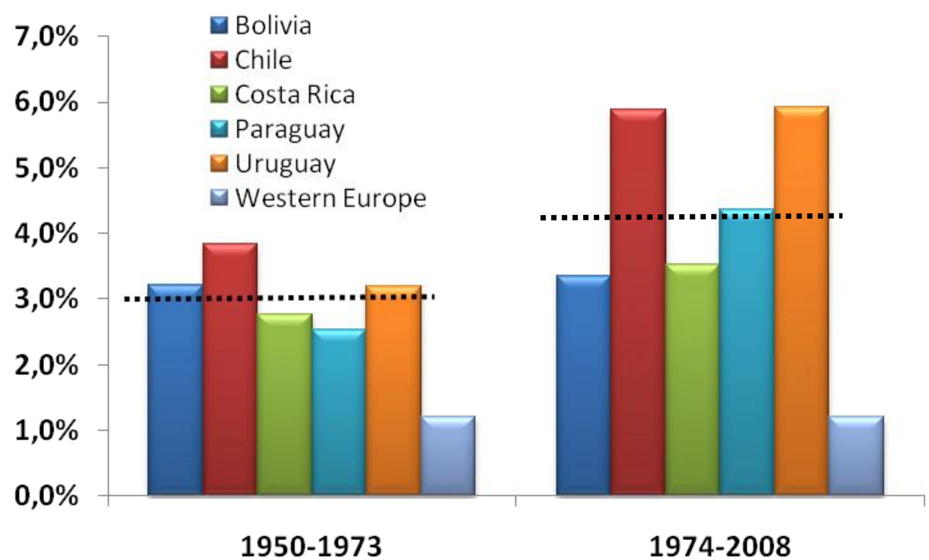
Deep macroeconomic fluctuations

Real GDP Growth Volatility (S.D 1950-2008, in %)



Maddison Tables (2007), OECD & IFS

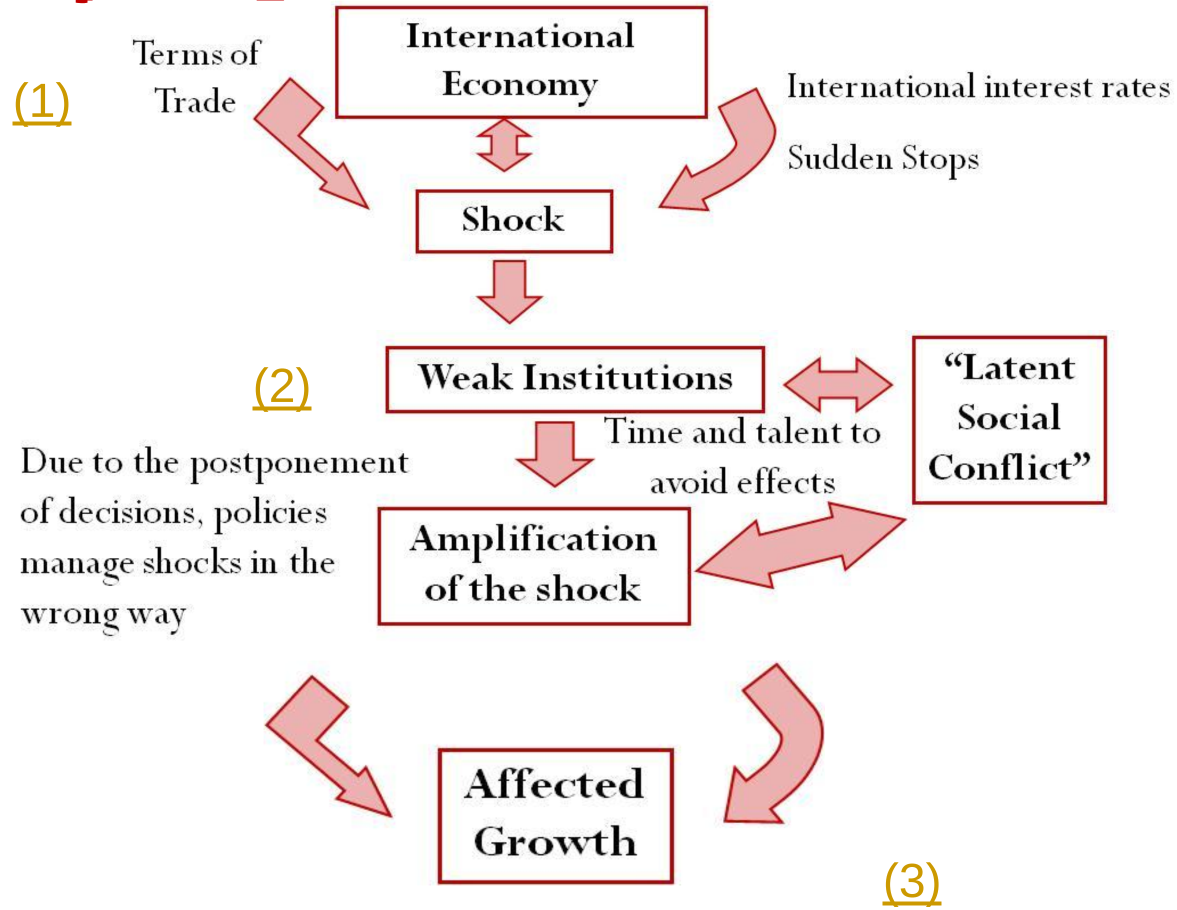
Cycle Average depth (in %)



Maddison Tables (2007)

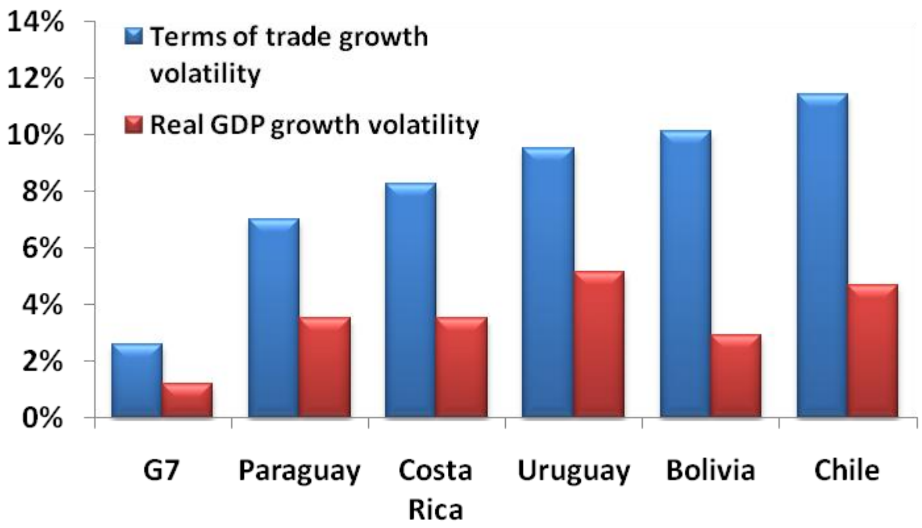
1950- 1973 Average Latin America: 3.1%
1974-2008 Average Latin America: 4.6%

Exogenous shocks, weak institutions and volatility of growth



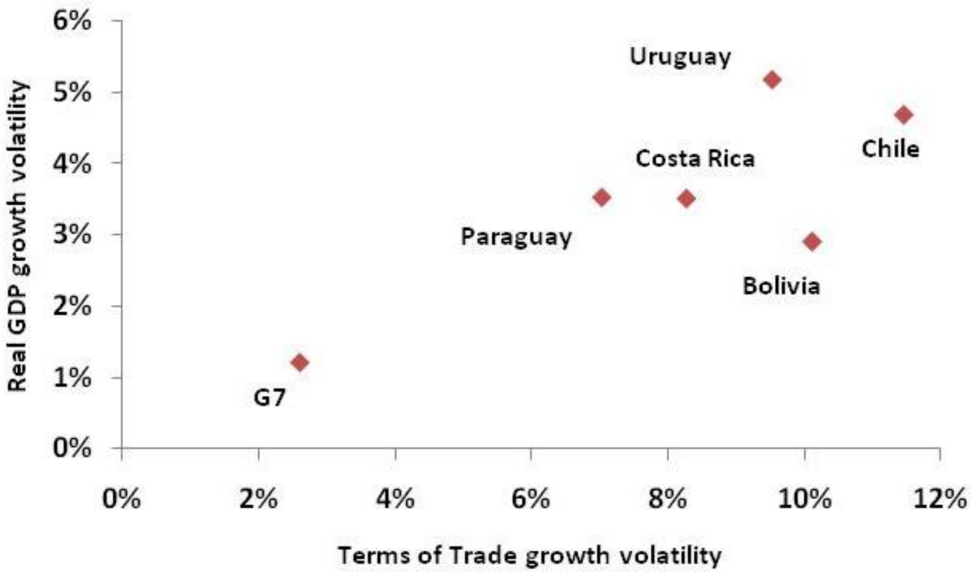
Exogenous shocks are poorly managed because of weak institutions, which are not able to time-distribute negative effects, thus amplifying shocks and contributing further to growth volatility.

Terms of trade shock



(1)

Terms of trade growth Volatility & Real GDP growth volatility S.D. 1980-2008



Evidence shows positive correlation between the volatility of terms of trade and growth volatility

CEPAL,WEO

Weak institutions

The Global Competitiveness Report 2009-2010
World Economic Forum

(2)

Pillar 1: Institutions

Country	Ranking
Singapore	1
Sweden	2
Denmark	3
Chile	35
Uruguay	40
Costa Rica	47
Ecuador	125
Argentina	126
Paraguay	130
Bolivia	132

From a global perspective, Latin American countries show weaker institutions than developed countries

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How should fiscal policy be set over the business cycle?

- **Standard Keynesian models** imply that fiscal policy should be **countercyclical**: when bad times hit, the government should increase government spending and lower taxes to help the economy "spend" its way out of the recession.
- **Tax-smoothing models** (Barro, 1979) imply that fiscal policy should remain essentially **neutral** over the business cycle (and respond only to unanticipated changes that affect the government's budget constraint).

Talvi & Végh (2000)

procyclical fiscal policy in Latin America

- β: Wald Test (coefficient restriction)
- Null Hypothesis: β below restriction
- Rejection of Null Hypothesis: stronger evidence of procyclical fiscal policy

→

- Less (*) low positive relationship between real gov. consumption growth and real GDP growth

Real Gov. Consumption growth vs. Real GDP growth				
	Weak			Strong
β	0,85	0,9	0,95	1
Bolivia	***	***	***	***
Chile				
Costa Rica	*			
Paraguay	***	***	***	***
Uruguay	***	***	**	*
EU15	**	*		
G7	*			

(***): Indicates confidence at the 99% level

(**): Indicates confidence at the 95% level

(*): Indicates confidence at the 90% level

1961-2008

β restrictions: ad hoc characterization

CEPAL,OECD

Why do developing countries have a procyclical fiscal policy?

- Imperfections in international credit markets that prevent developing countries from borrowing in recessions (Gavin & Perotti -1997-)

- Corrupt governments (Alesina & Tabellini, 2005)

- “Voracity effect” (Tornell & Lane, 1999)

- Social polarization (Woo, 2005)

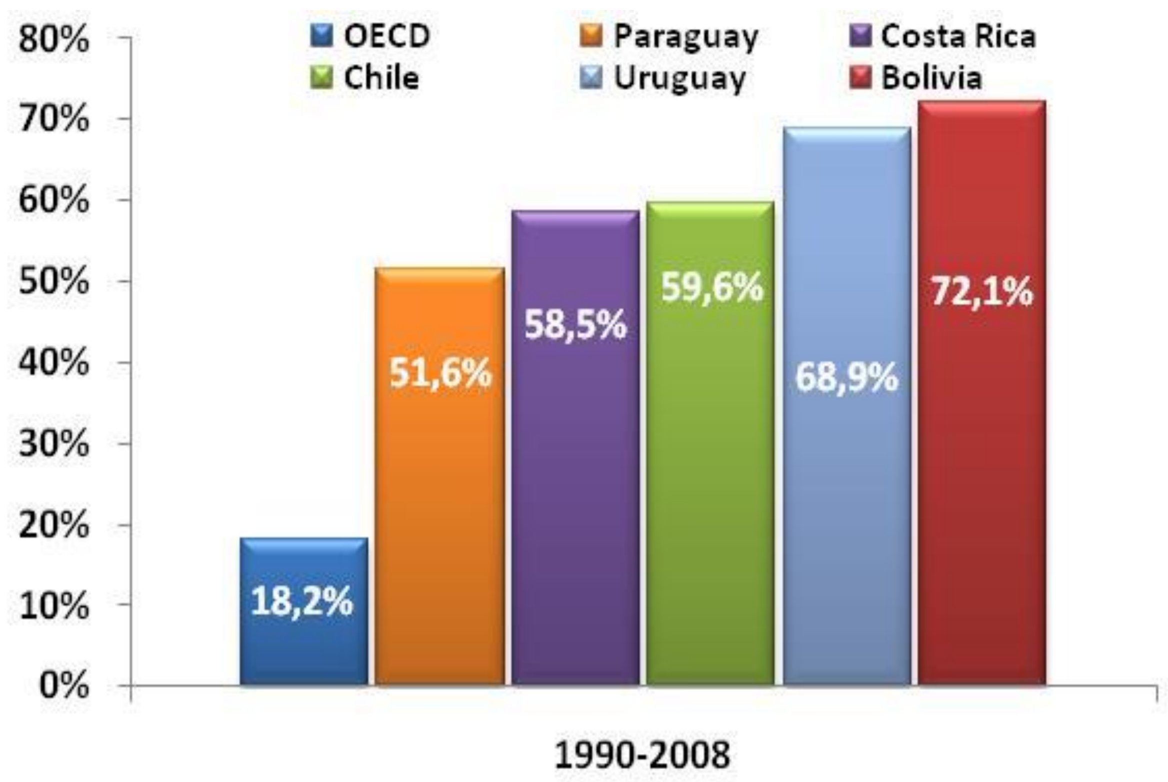
Why is tax collection procyclical in Latin America?

1. The volatility of tax revenue is partly explained by **Latin America's grater reliance on volatile non-tax and indirect tax revenue**, which are more volatile than income taxes and social security contributions. Gavin, Hausmann, Perotti & Talvi (1996) (1)

2. **Consumption is usually more volatile than income** due to incomplete financial markets. (2)

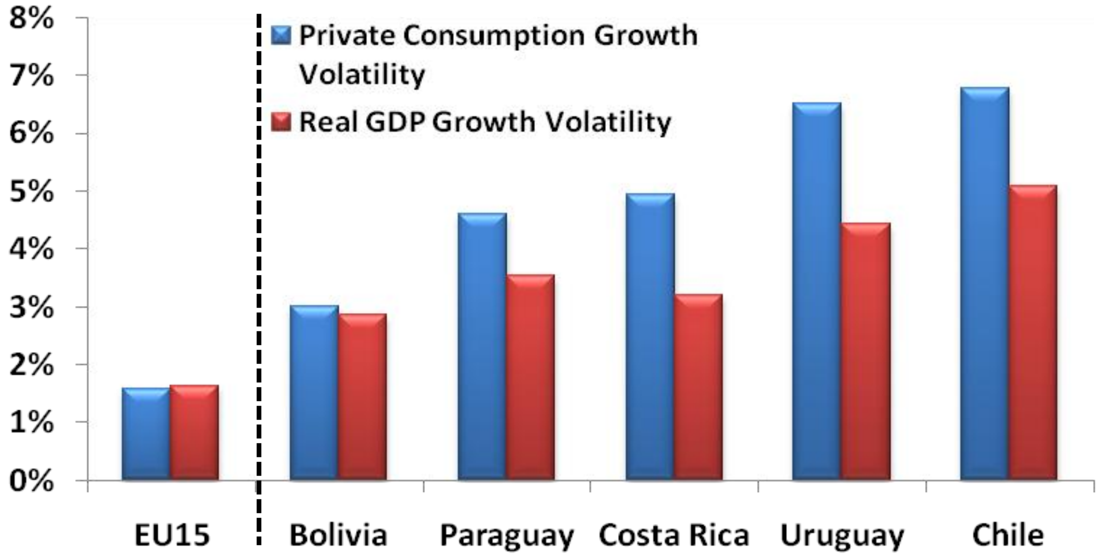
Tax collection is relies heavily on consumption taxes

Taxes on goods & services/Total Tax Revenue
Average (%) (1)



Consumption is more volatile than income

Growth Volatility
S.D. 1961-2008



OECD, CEPAL

	EU15	Bolivia	Paraguay	Costa Rica	Uruguay	Chile
Private Consumption	1,57%	3,00%	4,59%	4,94%	6,52%	6,77%
Real GDP	1,62%	2,85%	3,53%	3,20%	4,43%	5,08%

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Should LATAM countries rely more on indirect taxes?

- A tax **structure levying consumption excessively, may end up promoting volatility of growth rate**, hence further affecting long term growth in some Latin American economies.

- So, why should Latin-American countries -which have strong problems to stabilize their economies- introduce reforms to increase the weight of consumption taxes while:

  a. **these economies already relay heavily on indirect taxes?;**
  b. **further increase on consumption based taxes may exacerbate already procyclical behavior of fiscal policies?**

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