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Does taxation rhyme with democracy?

(based on the *Latin American Economic Outlook 2008*)

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- ◆ Latin America has put its faith in democracy and the market economy.
- ◆ Efficient, fair and equitable fiscal policy can help foster development and consolidate democracy.

In Latin America taxes and transfers have hitherto had a limited impact on inequality. Although levels of income inequality in Europe and Latin America are quite similar, European democracies manage to reduce inequality substantially through public transfers and taxes. Proportionately, the fiscal-policy induced reduction in inequality is eight times as large in Europe as it is in Latin America. Quantity and mostly quality explain the difference.

Continuing high levels of poverty and inequality top the list of challenges faced by the Latin American region, with some 40 per cent of the population, or more than 200 million people, still living in poverty. The share of gross domestic product (GDP) held by the poorest 10 per cent of the population is twenty times smaller than that of the richest 10 per cent. Per capita GDP growth in the last decade has benefited all but the poorest Latin Americans. Inequality persists at the same level as before and the challenge of widespread poverty remains.

Lack of progress in the fight against poverty and inequality has political as well as economic consequences. Between 2005 and 2007 thirteen elections took place in Latin America, most of them tight races. Alán García in Peru and Michelle Bachelet in Chile won by less than 5 and 7 percentage points, respectively, while Felipe Calderón's victory in Mexico was by less than one percentage point.

In a democracy, citizens express their faith in the state by paying their taxes and the state repays that trust by spending wisely in the interest of all. Less than one in four Latin Americans trusts their government to spend tax revenue well. Fiscal reform can and should help to strengthen legitimacy in the region and thus contribute to the consolidation of democracy.

Since the 1980s, fiscal reform in the region has introduced new institutional strengths and achieved a measure of

success. Fiscal discipline has returned and international markets appreciate that. Reform has failed, however, to raise significantly more revenue or to improve efficiency and equity in public spending and revenue generation.

Today many Latin American countries are in the midst of a new fiscal transition. Chile's President Bachelet says that "our democracies have failed to deliver for the most vulnerable ... and the political consequences are visible today". Many leaders recognise the need to strengthen social cohesion, which is why it is the central theme of the November 2007 Iberoamerican Summit in Santiago, Chile.

Any fiscal transition in Latin America will need to deal with levels of revenue mobilisation and spending, and especially with the quality of expenditure. In the last decade, social spending has increased from 13 to 15 per cent of GDP (or from less than \$450 to more than \$600 per inhabitant). Most of this increase, however, comes from higher social security spending, one of the least progressive forms of social spending in the region: the rich received over 16 per cent of all social spending in social security payments alone, which is more than the poorest fifth of the population received in education, health and social security spending altogether.

The slogan coined by American colonists "No taxation without representation" stresses the importance of voice and participation in decisions about how to spend tax revenue. People assess the taxes they pay in terms of the public services they receive in exchange. The OECD *Latin American Economic Outlook 2008*, demonstrates that the more public spending is financed by taxes, the more accountability people demand – for instance, by seeking greater participation in democratic processes. The very credibility of governments is contingent upon their ability to deliver quality public goods.

Consequently, in OECD countries, taxation and spending are hotly debated issues; fiscal policy is not a purely technical matter. Politics thus shapes the success or failure of fiscal reform and consensus must be reached through an open and transparent public debate. An independent media is facilitates this process and there is a positive correlation between the quality of the media and high tax revenue.

Latin America enjoys some of the most capable and proactive local think tanks in emerging economies and they can powerfully enrich the debate on fiscal issues if they have the independence – financial and intellectual – to make a critical evaluation of policies and proposed reforms.

Latin Americans understand the importance of fiscal policy in a democracy. Now they need to do something about it.



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