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A universal social protection system at the core of a new fiscal pact in Latin America and the Caribbean

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1. Introduction

Latin America and the Caribbean is one of the regions in the world with the lowest tax collection measured as a percentage of GDP. However, recent attempts to carry out tax reforms (of various kinds) have met with resistance. While much of the discussion has focused on who should pay taxes and how much, there has been relatively less debate about the use of such resources. This document argues that the creation of a universal social protection system (USPS) in the countries of the region requires a tax reform that allows for substantially more collection; however, the political success of a tax reform will, in turn, depend on how the proposal is presented to generate enough political support. In this sense, a USPS could be the element that allows the necessary alliances to increase fiscal revenues and also promote the achievement of a society protected against risks, less unequal, and more economically productive. In other words, the USPS could become the core of a new fiscal pact in the region.

This note aims to place the creation of a USPS at the center of the fiscal discussion in the region. To this end, the following section analyzes the importance for the countries of the region to transition to an USPS, to break the trap that combines inequality and low growth, as stated in the United Nations Development Programme (UNDP) 2021 Regional Human Development Report. Trapped: High Inequality and Low Growth in Latin America and the Caribbean. (UNDP, 2021). The third section seeks to highlight the common points of the fiscal systems of the countries in the region in terms of their main sources of inefficiencies and injustices that prevent them from meeting the proposed social protection objectives. The fourth section examines possible paths to increase tax collection in Latin America and the Caribbean. Finally, aspects of political economy related to reforms of this nature are analyzed, and possible strategies to increase their feasibility are proposed. The main source of information on the challenges facing each country consists of a series of studies commissioned by the UNDP Regional Bureau for Latin America and the Caribbean (RBLAC), in which experts from the region delve into the analysis of the characteristics and deficiencies of national tax systems and examine possible specific reforms that each nation could implement to increase taxation by at least 3% of GDP.

2. A Common horizon for social protection in Latin America and the Caribbean

As stated in the 2021 Regional Human Development Report (UNDP, 2021) the region is caught in a double trap that combines high inequality and low growth. These two phenomena interact, creating a vicious cycle that limits the countries’ ability to progress on all fronts of human development. Mainly in response to concerns about inequality and persistent levels of poverty, governments in the region have launched a wide range of social protection policies and programs. However, the report emphasizes that, in general, these policies have not been entirely effective in reducing inequality, and at the same time, they could have unintended effects on productivity and, therefore, on economic growth.

This situation demands a substantial change in the architecture of social protection in Latin America and the Caribbean, and in particular, it requires a transition from a model of segmented and scattered policies to a Universal Social Protection System (USPS). Additionally, the scheme must promote productivity. The UNDP report (2021) presents a detailed discussion of the proposal to implement a USPS in the countries of the region.

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2 The countries included in the study are Brazil, Chile, Colombia, Ecuador, Jamaica, Mexico, Paraguay, Peru and the Dominican Republic.
First, it is necessary to conceive the idea of social protection as a set of measures aimed at responding to the conditions of social insecurity that the specific historical context can generate. In the case of Latin America and the Caribbean, the common social protection regime in the region was established nearly 75 years ago. The common foundation of this scheme consists of three pillars: i) contributory social security programs (mainly financing health services and pensions); ii) regulations to ensure job stability, and iii) minimum wages. That is, it is a system that is linked to formal employment status and is financed with payroll contributions from both companies and workers. This means that large population segments, such as independent or self-employed workers, as well as paid domestic workers and unpaid workers, are excluded from this scheme.

Social challenges have changed significantly over the past decades. Some of the economic crises that the region has experienced in this period have required the implementation of actions aimed at expanding non-contributory social protection systems to cover the excluded population. The goal of these expansions has not been to resolve the deficiencies of the old contributory social security model, but rather to surround it to create a parallel system. The coexistence of these two schemes has not only generated unequal access to social rights (similar workers performing similar work are treated differently by the law), but in some cases, it has also had negative repercussions on productivity and, therefore, on the economic growth of the countries and the region as a whole. In other words, the current social protection regime is leaving many people behind.

Today, more than seven decades after the general architecture of the social protection systems of the countries in the region was conceived, a very different context is presented in which the idea of socioeconomic risk has radically changed. The concept of socioeconomic risk is even different from that which existed just three years ago. Disruption, global uncertainty, and complexity seem the most appropriate way to describe the current challenges and those of the years to come. The gains of the first decade and a half of the 21st century was not enough to turn the region into one predominantly middle-class. Systemic problems, namely inequality, low productivity, and vulnerability, intersected with overlapping crises caused by the COVID-19 pandemic, the conflict in Europe, and climate change. These are crises that force a rethinking of what the drivers of growth and development in the region are and that place the idea of socioeconomic risk and the need for protection in a completely different dimension.

2.1. Universality at the core

It is necessary to move towards a social protection system that safeguards against risks in a context of high uncertainty. The word system is emphasized to highlight the complementary nature of various public policy measures that, together, could offer a socioeconomic safety net enabling the achievement of more ambitious development goals. It is the system as a whole that must be evaluated, and not the particular policies that make it up. The specific combination of programs that integrate the system and the fiscal design that supports them can depend on the specificities of each country. The UNDP proposal is based on an overall vision and certain general principles that must be considered.

The guiding principle of this reform proposal is universality concerning the relevant population, which should be applied simultaneously in three dimensions: i) the entire population exposed to a particular risk should be covered by the same program; ii) the source of funding should be the same for each program, according to the type of risk covered, and iii) if the programs provide benefits in kind, the quality of these should be the same for all people.

The principle of universality concerning the relevant population can be considered as a guide when evaluating the introduction of new programs, the target population of each program, and which programs should be financed with general tax revenues, company contributions, or worker contributions.
A social protection system built around this principle offers the region a route to increase social spending and strengthens the foundations that allow for the promotion of long-term economic growth. Therefore, such a social protection system constitutes a way to combat poverty, respond to crises, and increase resilience, as well as a path to strengthen social trust and confidence in institutions, which contributes to the legitimacy of these institutions, necessary for the citizenry to be willing to submit to their rules.

3. Current fiscal systems are insufficient to finance a universal social protection system

Achieving universality is impossible without a substantial increase in the tax burden and a reorganization of social spending (UNDP, 2021). The region’s tax performance has historically been limited, mainly due to the fiscal systems’ historical dependence on revenues from the sale of commodities. Although tax collection has increased in recent years, countries in Latin America and the Caribbean register low rates compared to developed countries. In 2021, total tax revenues amounted to 21.7% of GDP, a much lower percentage than the total tax revenues of the countries of the Organization for Economic Co-operation and Development (OECD), which were 34.1% of GDP (figure 1).

Figure 1. Tax revenues in the region amount to an average of 22% of GDP, a percentage much lower than that recorded by OECD countries

There is considerable heterogeneity among the countries of the region in terms of the amount of tax collection, ranging from 12.7% of GDP in Panama to 33.5% of GDP in Brazil (figure 2). One of the main determinants of low tax collection is the composition of taxes: many countries in the region are highly dependent on value-added and consumption taxes. Compared to the OECD, Latin America and the Caribbean register considerably lower revenues from income tax, social security contributions, and property tax but achieve a similar level of collection from consumption taxes.
However, what is collected for each concept in turn depends on two factors: the nominal rate value (what the tax law stipulates) and the collection effectiveness or effective rate. The gap between the recorded collection and the potential collection is, in turn, the result of two possible sources of collection losses: i) tax concessions associated with legal deductions or exemptions, and ii) illegal tax evasion. In the countries considered in this analysis, special regimes and exemptions, along with tax evasion, constitute the main challenges to overcome.

Tax evasion is a significant challenge in the region. The Economic Commission for Latin America and the Caribbean (ECLAC) estimates that in 2018 the equivalent of 6.1% of the region’s GDP was not collected due to tax non-compliance, and notes that, of this percentage, 3.8% corresponds to evasion of corporate tax and personal income tax (ECLAC, 2020). In addition, ECLAC estimates that in several countries of the region, the tax gap for income tax exceeds 50%, meaning that tax authorities collect less than half of the revenues they theoretically should collect.

The data presented indicates that there is a significant margin to improve tax collection in the region, and that there are many aspects to correct. Therefore, a strategic approach is required to progressively implement reforms that enable the creation of a USPS. The strategy includes an
economic dimension focused on collection efficiency and a political dimension whose main goal is to ensure the legitimacy or political viability of the reforms. Both dimensions must go hand in hand and consider the historical trajectory and the situation faced by each country.

4. Possible ways to increase tax revenue in the region

Although the heterogeneity of the region in terms of the characteristics and outcomes of its fiscal systems is significant, some features can be generalized to most countries. This allows for outlining some recommendations that may be more or less applicable to all countries in Latin America and the Caribbean to increase tax revenue with the objective of creating a Universal Social Protection System (USPS). Before listing the ways to achieve higher fiscal income for each main type of tax, three cross-cutting considerations are necessary:

i. The first point to emphasize is that to finance an USPS, it is necessary to consider both the increase in tax revenues and the reorganization of social spending as two sides of the same coin (Scott, 2023). This consideration is important for two reasons. First, it is not possible to evaluate the efficiency and equity of one aspect of public finances — income or expenditure — without considering the other. For example, there may be specific elements of taxation that, analyzed individually, have a regressive nature, but when analyzing the entire income and social spending system, the final balance could be distinctly progressive, with an increase in net benefits for the poorest population. The second reason to consider is political feasibility: it would be inopportune to increase the tax burden on households to continue financing a fragmented and exclusive social protection system like the current one.

ii. Secondly, in terms of efficiency, it is important to put into perspective the effects of fiscal changes on economic behavior, as well as to consider the effects that cash transfers might have on labor incentives. Although the region has a wide margin to improve collection and transfers without generating major distortions, the specific way in which the reform is carried out should not lose sight of these aspects.

iii. Finally, it is necessary to consider the cross-cutting need to create simpler and more modern tax systems, with more efficient fiscal authorities. The Tax Complexity Index (2020) includes ten of the largest economies in Latin America among a total of 69 countries. Six of those countries in the region belong to the quintile of countries that present the highest tax complexity (figure 3).

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3 The 2020 Tax Complexity Index measures the complexity of a country’s tax system based on the estimated complexity of corporate tax applied to multinational firms. This index was developed by TRR 296 Accounting for Transparency, a transregional collaborative research center funded by the German Research Foundation (DFG)
4.1. Income and Profits

As seen in figure 1, the average collection of income taxes in Latin America and the Caribbean is much lower than the average collection in OECD countries. Since financing social protection requires stable and sustained sources of income over time, increasing direct taxation, particularly raising income and profits taxes, should be a priority for countries in Latin America and the Caribbean. Moreover, taxing income will always be more progressive than taxing consumption. In the countries included in the current review of fiscal systems, the low collection of taxes on income and profits, both from companies and individuals, is not due to the existence of low nominal rates, but to low effective collection.

In the region, it is therefore necessary to review and minimize exemptions and special regimes. Many of these instruments do not follow a logic of economic efficiency or equity, and in many cases, they are essentially regressive. In some countries, personal deductions are high and highly regressive, and they also contribute to increasing losses due to evasion. Many opportunities for tax evasion arise as a result of complex fiscal systems with special regimes.

Another major debt of the region has to do with promoting the incorporation of small and medium-sized enterprises into formality through schemes that do not discourage their growth. The tax base must be expanded to all economic units. Although this initially implies collecting taxes from those working in informal labor and informal trade, which could have a regressive effect, ultimately correcting these inefficiencies could benefit the poorest population within the framework of a universal social protection scheme. Formalization also opens the door to the development of economic activities that entail higher productivity.

Beyond commercial informality, there are, of course, many forms of evasion that individuals and legal entities with higher incomes incur, which reduces the resources available for social protection. For example, an important point to improve the collection of income taxes is to establish mechanisms to effectively tax capital gains from the sale of publicly traded shares. Finally, it will also be important to participate in the international initiative regarding the global minimum tax on corporate profits.
4.2. Consumption Taxes

Although consumption taxes are the main source of tax revenue in Latin America and the Caribbean, there are also many exemptions whose main problem is their regressive nature. Expanding the tax base by eliminating exemptions would allow increasing collection to compensate lower-income consumers (Viollaz, 2023).

In turn, the elimination of exemptions would contribute to simplifying the administration of the system and would allow tax authorities to free up resources that could be used to improve mechanisms for detecting evaders.

Another measure could be to expand the range of goods covered by the specific consumption tax, such as those that are harmful to health (for example, junk food or foods with high sugar levels). Their low elasticity makes them excellent collectors, less distorting to the market, and somewhat progressive. However, there is concern about the harmful short-term effect that healthy taxes could have in terms of regressivity. “In particular, poorer households might consume higher-calorie, lower-nutritional-quality foods. However, there is evidence to suggest that this may not happen. For example, a study by the Pan American Health Organization (2015) notes that the introduction of a tax on sugary drinks in Mexico did not produce significant regressive effects, as the demand for that product is elastic (this elasticity was estimated at 1.3)” (Fergusson and Hofstetter, 2022, p. 15).

4.3. Property Taxes

Property taxes have unexploited potential in the region. One of their great advantages is the strengthening of local collection (and, therefore, local capacities) and the other is their naturally progressive logic. It is important to define differentiated strategies for cadastral management that recognize the wide heterogeneity of local administrations and ensure that there are mechanisms for permanent support. In many countries, there is a need to update the cadastral bases and establish mechanisms to ensure their continuous updating. It is essential to build a simple tax structure and incorporate new digital technologies.

4.4. Green Taxes and Others

In general, Latin America and the Caribbean still have a long way to go in terms of green taxes to better reflect the environmental costs of many of the region’s economic processes. Setting carbon prices must become a central element of the strategy that allows countries in the region to transition to net-zero carbon emissions. In general, the collection rates for carbon emissions are very low compared to those in OECD countries. In many countries in the region, there is also talk of eliminating gasoline subsidies and exemptions from vehicle taxes.

On the other hand, there are taxes on mining and hydrocarbons. Another way to increase direct collection is to exercise greater oversight and control of extractive companies whose economic activities involve a large volume of production, with which their current fiscal contribution is not in line. Such is the case with gold mining in Bolivia or copper mining in Chile.
5. Governance

Tax collection reflects the health of the social pact. Any action aimed at collecting taxes involves a wear on the political capital of any government, and this includes not only the adoption of relevant measures but also the actual actions aimed at ensuring collection. Short-term political-electoral incentives impose a high cost on tax reform for political actors. This explains why in Latin America and the Caribbean, such reform has historically been postponed as long as possible, especially when there are fiscal revenues obtained through other means, particularly from commodities.

Despite the distrust that prevails in the region towards political parties and governments, the vast majority of the population is aware of the importance of paying taxes and using them to generate public goods and help those in greater need. According to data from Latinobarómetro 2020, only 7% of the population believes that no one should pay taxes. In addition, the Latin American and Caribbean population agrees that the responsibility of households to pay taxes increases as income increases. Even among households that consider themselves part of the wealthiest 20% of the population (self-perception), two-thirds agree that the tax rate should be higher for those who earn more (figure 4 and 5).

Figure 4. People in LAC agree that households’ responsibility to pay taxes increases with income

Although the specificities of how to carry out this could generate controversies, these general opinions underlie the social pact of the region.

Political agents responsible for driving tax reforms need to find a way to present the need for better fiscal revenues in an attractive and convincing manner. A necessary element is the logic of exchange. That is, it is fundamental that citizens have clarity about what they will receive in return. That is why solid evidence is needed to inform society about the benefits of the reforms and to show the progress achieved during the implementation of the new policies.

It is precisely at this point that the creation of a USPS has the potential to be the core of a new fiscal pact for the region. As pointed out by UNDP (2021), a USPS has the virtue of simultaneously addressing systemic problems of different kinds, such as inequality, low productivity, and vulnerability to risks. These three expected outcomes of a USPS allow outlining the type of social alliance that could be convened around such a system. It is an alliance in which the economic growth agenda converges with the inequality agenda and the concern to ensure the protection of people in the face of unexpected crises.

The central point on the agenda of the tax transformation of the countries analyzed consists of minimizing exemptions and special regimes as much as possible. The large number of tax benefits that currently exist in the region generates greater pressure on a reduced tax base, which increases the perception that the treatment is unequal and unjust (Ramírez, 2023). By reducing the number of exemptions and special regimes, the goal is not only to increase collection but also to close the avenues of negotiation between economic-political agents and the State. Opening the door to a special regime that benefits a specific social group encourages other groups to seek preferential treatment. If the goal of current governments is to collect more, this series of pressures entails strong political wear and tear. In general, the action of the State gains legitimacy when it is stable and predictable, that is, when it implements measures that are not negotiated on a case-by-case basis. If necessary, for reasons of public interest, to consider compensations in the social or economic plane, it is preferable to design ex-post compensations.
Another way to think about the implementation of these reforms is gradualness. The sense of gradualness implies recognizing that, generally, there is not enough political capital to carry out through a single reform all the necessary changes to achieve an increase in collection equivalent to 3% of GDP. Gradualness, therefore, implies prioritization. There is a paradox in the Latin American and Caribbean political economy: changes are required that increase the legitimacy of the social pact, but the lack of legitimacy limits the possibility of making changes (even if they are desirable and fair) (Fergusson and Hofstetter, 2022). According to this logic, it would be necessary to start by prioritizing achievable reforms that strengthen the message that it is possible to rebuild the impartiality of effective collection. That is, it is necessary to change the image that those who pay taxes are those who do not have the political power to negotiate or evade them.

An advantage of many tax systems in the region is that no major reforms are required to increase nominal tax rates. This discussion would undoubtedly generate significant political wear. Instead, many of the reforms that need to be carried out aim to eliminate the barriers that make it impossible to achieve the collection that is already envisaged in the spirit of the current tax law. Public deliberation could develop less harshly in this second case, supported by the principles of horizontal and vertical equity — by combating non-compliance and exemptions — and by the principle of social justice, in case the progressivity of the system is strengthened.
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Santiago Levy

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Andrés Ham

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Manuel Mera

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Alfonso Capurro, Germán Deagosto, Sebastián Ithurralde and Gabriel Oddone

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Manuel Mera

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Paola Bergallo, Marcelo Mangini, Mariela Magnelli & Sabina Bercovich

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Orazio Attanasio & Ranjita Rajan

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Social Protection Response to COVID-19 in Brazil
André Portela Souza, Lycia Lima, Camila Magalhaes, Gabriel Marcondes, Giovanna Chaves, Juliana Camargo, Luciano Maximo (FGV EESP Clear)

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Leopoldo Fergusson and Marc Hofstetter

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Maria Cecilia Dedios and Felipe Ruiz

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Laura Solís and Jason Hernández
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