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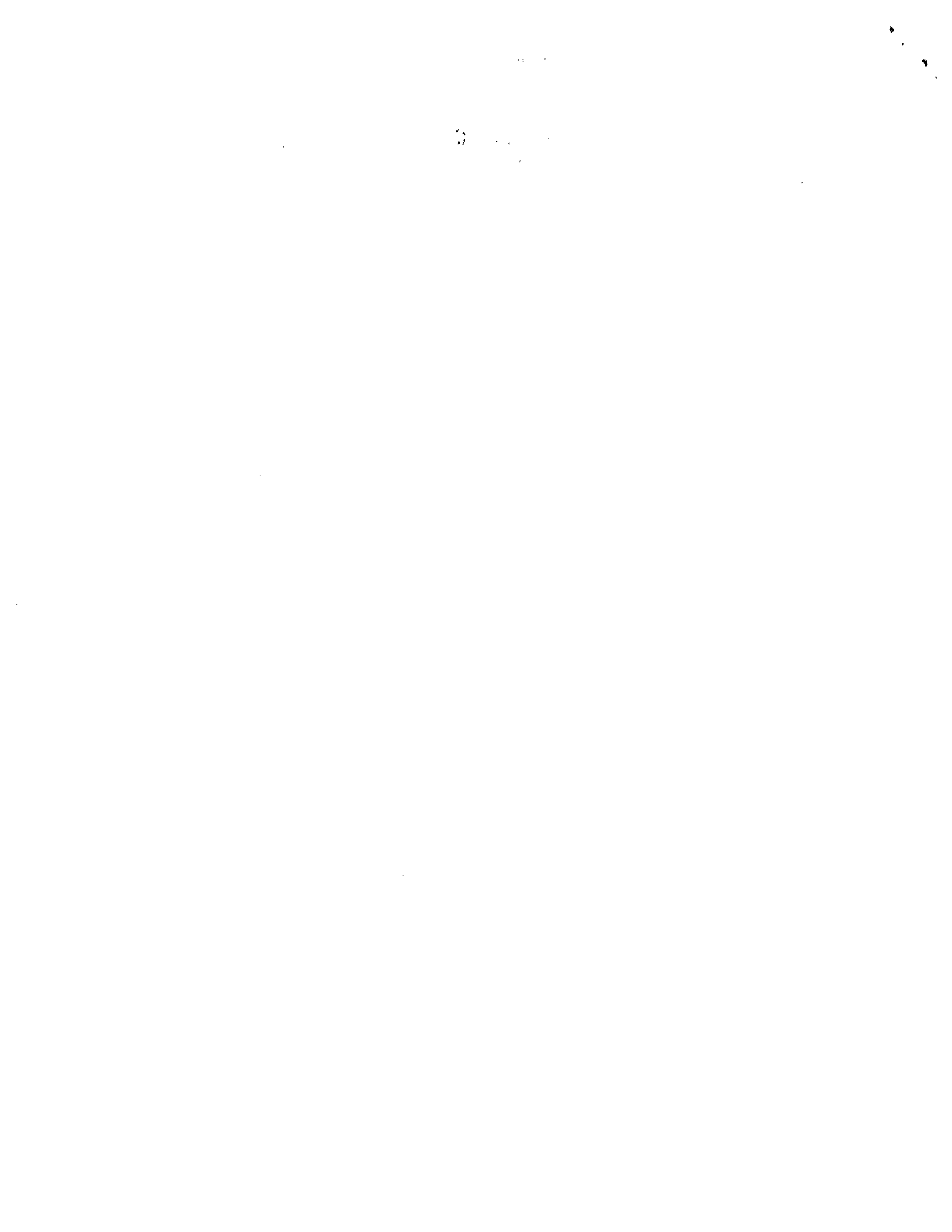
## THE CHILEAN TAX REFORM OF 1990: A SUCCESS STORY

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DRAFT NOTES

NOT FOR QUOTATION

## THE CHILEAN TAX REFORM OF 1990: A SUCCESS STORY\*

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The purpose of these paragraphs is to briefly describe the objectives, political economy and legislative discussion of the Chilean tax reform of 1990. Its technical contents are described only when necessary to understand the underlying politics<sup>1</sup>. The reform financed the social program of President Aylwin's administration (1990-94) and provided the basis for macroeconomic stability of the transition from an authoritarian to a democratic regime.

### BACKGROUND:

Since the mid 1920s, Chile has exhibited a relatively well-functioning tax system as compared to other economies at a similar stage of development within each historical moment. With some caveats, taxpayers are educated, evasion beyond the informal sector receives a social sanction, corruption exceptionally exists, public institutions linked to the assessment and collection of taxes are in general respected and, in general, the rule of law in tax issues is the norm rather than the exception. However, as in other countries with similar features, the use and abuse of legal loopholes is a national sports. Although elusion arising from tax planning has similar effects than evasion from the perspective of distorting fiscal revenues, resource allocation and equity, it has different implications from the perspective of public ethics and of institutional strength.

Also, the government action financed by these taxes is in general legitimated by the Chilean society, especially in the social area. Social expenditure, which at present represents around two thirds of total public expenditure, is relatively well targeted (as compared to other countries of similar level of development). It provides reliability to the discussion of how to fund it and to the discussion of the compensations to the population that may be negatively affected by specific tax norms. Of the various components of the International Competitiveness Index constructed by the World Economic Forum, where Chile ranks high among the developing world, the best evaluation has to do with those related to governmental issues. Obviously, the domestic discussion on these issues has been messier than the external assessment, especially since the internal debate concentrates on

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<sup>1</sup> For further details and other tax reforms of the 1990s, see Marfán, M.: "El financiamiento fiscal de los años noventa", in Cortázar, R. and J. Vial (1998): Construyendo opciones. Propuestas económicas y sociales para el cambio de siglo, CIEPLAN and Dolmen Ediciones, Santiago, pp. 545-573.

conflicting views in issues where the public sector has a pendent agenda, while the external view is based on a cross section international comparison. The main discussion that has been going on at the national level has to do with the overall size of the government, with strong divisions between right-wing parties that advocate for a crowding-in of the private sector by means of smaller taxes and public spending (plus privatizations and deregulation), and center-left parties which see that the governmental structure should be strengthened to tackle the agenda of modernization and social progress.

It is interesting to notice that pursuing strong macroeconomic policies generates a broader and stronger consensus, so that the discussion on tax issues has been closely linked to the financing of government programs, especially in the social area. This is a crucial feature to understand the Chilean developments on fiscal policy. It is common in other countries –whether developed or not- that the political class cares about fiscal equilibrium but not to the extent of sacrificing a superior goal such as, either smaller governments to crowd-in the private sector or social efforts to compensate market failures, depending on the respective political positioning. In Chile, however, stability, including fiscal discipline, is placed high in the ranking of political priorities of almost all relevant sectors.

Chile is a unitarian country, so fiscal federalism is not an issue. Most taxes are collected and allocated by the Central Government, and only some minor taxes have a municipal destiny. Tax collection of the last decades –excluding contributions to the pension system- has ranged between 19.5% of GDP (1980) and 14.5% of GDP (1990), with the VAT accounting for almost one half of total tax revenues. Historically, tax revenues have represented the main source of government income, although the public sector also obtains current revenues from state-owned firms –especially from CODELCO, the main copper mining firm- and other operational sources.

The tax reform of 1990 was the first main issue discussed by the new Congress and the newly elected Government administration in 1990, after 17 years of an authoritarian regime. The historical moment in which this discussion took place was an important component of the political success of the reform. The previous military administration had introduced an important number of innovations in the tax system, including the VAT, full indexation to the CPI of the tax system, a generous tax treatment for DFI dividends, and a wide base for almost all taxes. Except for forestry, car-building, and a few other exceptions, no explicit industrial policy was imbedded in the tax system. The VAT is applied with a common flat rate to almost all the levied goods and services, the same as the corporate income tax, and the tax on imports in relation to their respective bases. In 1984, a peculiar structure for income taxes was introduced, as the corporate income tax was reduced to 10%, and rebated on personal income taxes on dividends and on the withholding tax on DFI dividends. This structure proved to be potent to stimulate firms to reinvest profits, with an important steady rise in national savings as of 1985, but also introduced a stimulus to tax planning, since the rate levied on reinvested profits turned out to be significantly smaller than the tax on dividends. From an institutional perspective, as of 1980 tax earmarking became unconstitutional, the same as arbitrary tax discrimination. The same constitution left all the initiatives on tax and public expenditure issues exclusively on the Executive, leaving the Legislative Power with the sole role of approving or re-

jecting the Governments' fiscal initiatives. All these features have continued to prevail after 10 years of democracy, and clearly centralize the responsibility of fiscal governance in the Executive.

Fiscal issues, however, were a main component of the debate before the political transition. Besides from the more profound discussion on the political regime, there was a widespread sense that fiscal policy –including tax legislation- did not reflect the priorities of the wide majority of the population. A brief account of the major related events starts with the severe recession of 1982-83 that struck the Chilean economy with devastating social effects –as in most of the Latin American region- after a booming period fueled by external borrowing. The previous fiscal surplus was consumed by the pension system reform of 1980. With the recession, a fiscal deficit appeared as a consequence of the abrupt fall in tax revenues and of worsening terms of trade. In addition, the generalized bankruptcy of the domestic financial sector absorbed additional degrees of freedom as it generated a significant quasi-fiscal deficit in the Central Bank. Mounting unemployment and generalized social distress were allied to a deteriorating social expenditure, while massive protests arose nationwide. In addition to demands for political change, there was an increasing sense of social unfairness, especially with regard to the role of the state in restoring social equilibrium.

Economic recovery was initiated by the mid 1980s, in a context of a strict government expenditure policy, fueled by improving external financial conditions and a reversal of the terms of trade losses, all of which provided a significant fiscal slack. The priority, however, was not to reconstruct the deteriorated social role of the state, but to initiate a vigorous reduction of the size of the public sector beyond the privatization of public firms: In 1984, an income tax reform had an estimated effect of reducing government revenues in 2 percentage points of GDP. In 1988, at the eve of an historical plebiscite, a reduction of the VAT from the prevailing 20% to a 16% rate reduced the concomitant tax collection by 1.4 percentage additional points of GDP. In 1989, another reform reduced corporate income taxes by almost an extra point of GDP. Almost all other taxes were also reduced, including custom duties, taxes on financial transactions, excise taxes, and others. As a proxy of the cumulative fiscal impact, the tax collection diminished from 19.5% of GDP in 1980 –which could be considered a “normal” year for these purposes- to 14.5% in 1990, although this last figure contains part of the extra revenues linked to the reform of that year. Income taxes in particular were halved from 5.1% of GDP to 2.6% during the same period. The widespread disapproval of the extreme priority behind such fiscal performance strongly influenced the reform of 1990.

In spite of these developments, a political assessment of fiscal policy should also value important features of its structure. First, the prioritization of balanced budgets reflected a wider consensus on the benefits of macroeconomic stability. In fact, after two decades of political, economic and social turmoil, stability, in its widest sense, became an important demand over the new political regime, including the necessity of balanced budgets. Also, the bias towards an open economy, reflected in a structure of relatively low and flat tariffs on imports and a tax on FDI dividends aligned with the US corporate income tax was a staple of an emerging agreement on major economic issues.

## **A STRATEGIC PILLAR:**

President Aylwin, with the support of a center-left coalition, took office in March 1990 on the basis of a program that, regarding economic issues, was aimed at reconciling economic growth and social justice. To achieve such a goal, it was perceived that a rise in government revenues was unavoidable. That was the main purpose of the reform.

This assessment was especially true in the context of the political transition that was being initiated. Notwithstanding the importance of macroeconomic stability, the design of fiscal policy is much more than a simple financial exercise aimed at balancing the budget. The level and structure of government revenues and expenditures reflect the priorities of the government and the political environment in which it operates. In the context of profound political change, as was the case, it is common that an abnormal pressure on fiscal policy should develop, as had been the case of other nations of the region that had already initiated their transitions and were suffering of unbearable fiscal stress and macroeconomic turmoil. The incoming authorities evaluated that the success or failure of the transition, with effects that would propagate for a long time-span, was directly linked to the feasibility of a revenue increasing tax reform, in order to provide sound financing to tackle the most urgent social needs.

Under normal conditions, it is not politically profitable to be explicit about a tax increase in a presidential campaign. But the needs of a successful political transition that avoided a populist cycle was not a normal condition. Especially in a country with the traumas of the two previous decades. The fact that Aylwin's presidential program stated as its first economic measure a tax increase provided credibility to the rest of its program and capitalized the discontent with the previous policy that downgraded social priorities. Moreover, the program stated explicitly the upper bound of the intended tax rise: Personal income taxes would maintain the minimum exempted income, so no new taxpayers would be added, while the maximum marginal rate would remain at the prevailing 50% (thus implying that the main change would be a shortening of income brackets); corporate income taxes would be risen to 15 or 20% on an accrual basis, depending on the economic conditions; and a number of legal loopholes would be closed in order to avoid the erosion of the intended extra revenue by means of tax planing, especially by the shift from a presumptive to a full accounting determination of income for the larger taxpayers in agriculture, mining and truck transportation. As will be commented later, this last change proved to be the most politically difficult to be approved.

To be explicit about the maximum intended change in income taxes was useful for its acceptance for two reasons. First, advocating for an ambiguous tax rise is a threat and a source of anguish and uncertainty for all taxpayers, implying a political cost for the proponent beyond the actual intended change. Being explicit about how far would the increase go minimizes this cost. Second, it gave an implicit signaling that the previous tax cuts were not going to be fully reverted or surpassed, avoiding, thus, the typical "taxpayers fury" reaction to tax rises.

Before the already elected President took office, it became obvious that these changes would not be enough to provide for the additional 2 percentage points of GDP that had been targeted for the revenue increase. It was agreed within the coalition that the core of the reform should concentrate on direct taxes, but such a revenue target would have implied almost doubling income taxes. Although technically possible, it was thought to be politically unfeasible and economically inconvenient. The logic tax to study for the residual revenue needed was the VAT. That tax had been reduced to  $\frac{3}{4}$  of its original rate two years before and it still provided half of the tax revenues. The final decision was constructed on the certainty that the mix of a VAT rise and the social programs that would become viable was strongly progressive from a distributive standpoint. The prevailing network of social programs had not been dismantled, so it was easy to develop the programs and a communicational strategy aimed at proving that the poor would be better-off by such a mix. This is perhaps one of the most powerful lessons that can be taken from this reform. The VAT does not need to have imbedded compensations in exemptions and special treatments to avoid its regressive effects. If social policy is well targeted and reliable, the compensations can be and should be introduced by means of dedicated expenditure programs. Exempting food products from the VAT will always be more regressive than levying the tax along with a well targeted free nutrition program. The same with respect to health goods and services, education, etc. VAT exemptions are badly targeted and erode revenues that can be used more efficiently in well designed social programs. Anyway, with the rise from 16% to 18% of the VAT (with the concomitant social programs), the main components of the tax reform were ready to initiate their public discussion.

From a more technical standpoint, there was a special care in designing a new system for provisional monthly tax payments, especially for the corporate income tax. The purpose was, on the one hand, to ensure that the additional revenues coming from the rises in the VAT, corporate income taxes and personal income taxes on wage recipients would be available immediately after the approval of the reform. Second, that since the highest proportional rise was in corporate income taxes, a well designed system for provisional payments should avoid “flip-flop” effects that would entangle fiscal policy and could exacerbate the “taxpayers’ fury” in the next income statement period.

Before going to the next section, it is interesting to point out the elements that were not included in the reform:

- a. No taxes affecting the degree of openness to the world economy were raised (import tariffs, taxes on DFI).
- b. The prevailing structure of relatively higher taxes on dividends vis a vis reinvested profits was maintained.
- c. No tax pyramiding or domestic double taxation components were included, which is a staple feature of the Chilean tax system.
- d. No sectoral tax differentiation was considered, especially for the VAT, maintaining, thus, the criteria of a flat rate with a wide base.

## NEGOTIATION AND APPROVAL OF THE REFORM:

With these elements, the Minister of Finance, Alejandro Foxley, gave two crucial steps for the success of the reform. First, since the new administration had inherited an overheated economy, he announced a strong adjustment policy mix, and that the social program would be initiated only after the tax reform had started collecting the extra revenues. This imposed the responsibility for the introduction of social programs to the new Congress. In addition, it provided the (correct) sense that the legitimate demands for solutions of a paramount number of needs would take time and a necessary effort of prioritization (it was said that there was an external debt, an internal debt and a social debt, so almost everybody perceived himself as a creditor). Second, he called the new right wing opposition to join this effort by means of an agreement about the contents of the tax reform and of the concomitant social programs. This last step was both necessary and convenient. It was necessary since Pinochet had designated almost  $\frac{1}{4}$  of the Senators, so the upper chamber had an opposition majority. But it was also convenient, since, in Minister Foxley's view, stability and credibility in major reforms was necessary to ensure a successful and stable transition process. An approval by a wide majority at the Congress was perceived as a goal in itself and as a strong signal of tax stability, so there was a will to pay the costs of an agreement with the opposition.

Renovación Nacional (RN), the main opposition party at the time, accepted the challenge of an agreement, on the basis that the electoral victory of the ruling coalition gave a political validity to a tax rise, and that such a rise was perceived as a necessary condition for a stable and long-lasting transition. Moreover, the government's proposal had the virtue of being fair (all taxpayers were increasing their contributions), and the proposed new taxes were below their peak levels of 10 years before. The main point stressed by RN was that there was that economic growth would also provide additional government revenues through time. So it was not clear to them whether the tax rise should be permanent or transitory, especially in corporate income taxes. In the background, there was the perception that this tax reform should not be the first one of a sequence of tax rises in the future. The final agreement contained most of the skeleton of the administration proposal, but with a commitment of not altering the structure of the taxes being raised for a period of four years, after which the corporate income tax would return to its previous 10% level. Afterwards, the Congress decided that the whole tax structure was to be debated in four years, so all the main increases were approved for that time span only. The practical effect was a strong signal in the direction that the next move would be a tax reduction. RN also endorsed the social programs that would be financed by the tax reform, and requested that the change of the presumptive system of three sectors should be perfected at the Congress, plus some minor changes that are not worth commenting here. Thus, the core of the reform was an increase of the corporate income tax from a 10% rate on distributed profits to a 15% rate on accrued profits, a shortening of personal income brackets (but maintaining the minimum exempted income and the highest marginal rate), a rise in the VAT rate from 16% to 18%, and the closure of a number of legal loopholes.



The legislative discussion was initiated in April 1990, a month after the new administration had taken office, and was approved by a wide majority of the two chambers in two months, while the social program was inaugurated in July. An important effort was made to provide simple and reliable public information and to tackle both the legislative discussion and the public debate at the media. Among other components, a lot of material was prepared to show that the mix of the reform and social programs was progressive, non-distortionary, non-contractionary, and that the proposed tax structure was aligned with the practice of most nations. The technical preparation of the legal amendment, initiated a year in advance, was performed by a very skilled group of top-ranked professors of Tax Law at the University of Chile, IRS officials, and more than 100 professionals (accountants, economists, industrial engineers, etc.). The good quality and reputation of the professional team, especially the lawyers, was extremely helpful to avoid a spurious debate mixing technical and political aspects of the reform. It is interesting to point out that even the opponent legislators trusted the skills of the professional team and often asked them to write in a technical way their arguments.

The most burning discussion at the Congress had to do with the closure of legal loopholes, especially the change in the presumptive scheme of the income tax for agriculture. An important lesson is that changes in non-discriminatory taxes with a wide base invite to a debate where national interest dominates. Changes affecting particular vested interests have a more corporatist seal, especially since pressure groups seldom prioritize national interests over their own concerns. To this extent, the choice of concentrating most of the reform in a few taxes with a wide base instead of a cumulus of minor changes affecting different interests proved to be a wise decision. However, that outcome strongly depended on the fact that the inherited tax structure was based on general rules with few exceptions. The removal of those exceptions –as was the case of agriculture– proved to be much more difficult than introducing them. Since the main issue was to shift the larger taxpayers from presumptive to a full accounting determination of income taxes, the discussion concentrated in the threshold to define a large taxpayer and the concomitant measures to avoid simulations. The agricultural lobby argued against the discriminating nature of the measure while the proponents argued that shifting taxpayers towards the general case and promoting horizontal equity couldn't be labeled as discriminatory. There was also a debate about how much revenue increasing was this change, since, as lobbyists argued, agriculture was not so profitable. The proponents argued back stating that the presumptive system implied that the actual rate on marginal profits was zero, so there was a generalized practice of transfer pricing. In addition, if agriculture was not so profitable, then the sector couldn't be worse-off by determining their actual income by means of full accounting. The most difficult discussion, however, arose when lobbyists found specific cases, sometimes very theoretical, where the amendment could have unfair consequences. This is what the technical staff labeled the "old widow effect". That is to say, specific cases of tax unfairness that could generate a sense of social pity within the media and public opinion. The problem was that behind the "old widow effect" there was always a large number of taxpayers which by no means would generate social pity and that would be benefited by the rejection of the proposal. In the absence of expenditure programs to tackle particular cases, the reaction of the proponents was to introduce the necessary changes to avoid the unfair effects, even at the cost of losing neatness in the

final norm. Finally, this change was approved but its application was postponed twice. In 1996, its first year of application, 28% of the taxpayers of the agricultural sector made their income statement by full accounting, representing 74% of the total sales of the sector.

An analogous case was the discussion for removing article 57 bis of the Tax Law, a system that provided huge income tax incentives to individual asset ownership, to the extent of being an important source of tax simulations and that became a fetish for the advocates of horizontal equity. In this case vested interests became so influential, that the extra revenue that such a removal would provide was not worth the political costs, at least in the reform of 1990 (it took 10 years of a series of minor changes to finally remove article 57 bis from the Tax Law).

Finally, the Congress also introduced a tax incentives for contributions to private non-profit organizations aimed at promoting the arts and culture.

#### **THE AFTERMATH:**

Tax revenues increased from 14.5% of GDP in 1990 to 18.1% in 1993, far more than the estimated target<sup>2</sup>. The extra revenue is explained by (a) a more powerful effect of closing legal loopholes and removing exceptions, (b) a simultaneous effort initiated by the Internal Tax Service to reduce evasion and (c) the effect of an elasticity higher than one of tax revenues with respect to GDP growth. Other government current revenues diminished from 6.1% to 5.1%, explained mainly by a drop in copper income, while overall Central government expenditures increased from 21% to 22% of GDP during the same years, explained almost entirely by a larger share of social expenditure. Finally, the fiscal surplus climbed from 0.8% to 2% of GDP.

It is interesting to notice that the reform did not affect the dynamism of growth and investment in the subsequent years. On the contrary, the Chilean economic performance of the 1990s has been outstanding, and only interrupted by the recent recession which is too far away from this reform. A recent and interesting econometric study<sup>3</sup> shows that the increase in political rights is the main variable explaining why the 1990s outperform the 1980s, although the deepening of structural reforms, the reduction in inflation and the improvement in external conditions also contributed. In our view, the democratic environment along with a government that was transparent in the limits and commitments of its policies introduced a large dose of credibility and predictability in the rules of the game, encouraging economic agents to bet for the long-run. With respect to tax issues, the way how the discussion and approval went on gave strong signals that the next move would be towards a reduction.

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<sup>2</sup>Actually, revenues from direct taxes increased from 2.6% of GDP in 1990 to 4.2% in 1993, while the VAT revenue increased from 7% of GDP to 8.7% in the same period. It should be considered that the figures for 1990 include some of the additional revenue of the reform.

<sup>3</sup>Jadresic, E. and R. Zahler (2000): "Chile's rapid growth in the 1990s: Good policies, good luck, or political change?". *IMF Working Paper* WP/00/153, Washington D.C., USA.

Three additional tax episodes are worth mentioning:

First, since the core of the 1990 reform was approved for four years only, there was a serious fiscal threat as of January 1<sup>st</sup> 1994. Although 1993 was a year of presidential campaign, the wide consensus on the need of a strong fiscal policy motivated a new political agreement for a tax reform. The Confederación de la Producción y el Comercio (CPC), the main entrepreneurial union, became an important actor this time when it gave clear signals to right-wing parties that although they preferred lower taxes, they prioritized a path of fiscal balance and predictable taxes. Again RN took the challenge and initiated a *negotiation process with Minister Foxley*. The final outcome was an agreement that, in essence, maintained the prevailing higher tax on corporate income, widened personal income brackets and reduced the highest marginal rate to 45% with a transition period, and a reduction of 2 points of the VAT four years ahead<sup>4</sup>. In addition, a number of minor loopholes were to be closed and important changes in the contribution of the private sector to public funded education were introduced. Again, a commitment of tax stability along these lines was agreed for four years –a component highly valued by the CPC. This agreement and the rapid approval of the new reform provided the basis for a strong fiscal policy in the subsequent years. It is worth mentioning that the perception about the structure of income taxes had profoundly changed since 1990. While in 1990 it was perceived that corporate income taxes should be first in line for a future reduction, followed by the VAT and leaving personal income taxes at the end of the line, the rank in 1993 was exactly the opposite. In fact, symptoms of “taxpayers fury” had developed along personal income taxes, that were perceived as misaligned with respect to other domestic taxes and with respect to international standards.

Second, the drop of two points in the VAT rate as of January 1998 introduced a new fiscal challenge. At that time, President Frei’s administration finally proposed to maintain the VAT rate in the prevailing 18%, in exchange of a profound educational reform aimed at increasing by 50% the number of annual lective hours in primary and secondary education.

Third, a recent discussion on tax issues is going on at this moment. On the one hand, President Lagos is trying to pass a law to reduce tax evasion and tax elusion, mainly in income taxes, aimed at collecting 1.5 points of GDP of additional revenue. On the other hand, a group of Senators is trying to find an agreement to shift the income tax structure towards smaller personal income taxes and larger corporate income taxes, with a neutral fiscal effect.

A main conclusion arising from the national debate on tax issues during the 1990s is that consensus on the need of pursuing macroeconomic stability and fiscal balances has provided a good framework for discussing fiscal policy. The demands faced by the state in the new democratic environment were tackled with no concessions in fiscal discipline. Prioritizing stability meant that the discussion regarding social policy was directly linked to its funding.

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<sup>4</sup> For further details, see Marfán (1998), op. cit.

