Taxing the Rich in Developing Countries: Lessons from Latin America

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1   Introduction

This chapter describes the experiences of taxing the rich in the developing world. Progressive direct taxes on personal income and wealth could help these countries address their high inequality and raise tax revenue. However, developing countries face specific hurdles in terms of administration and enforcement, including high informality, limited administrative resources, and weak enforcement capacity. We approach this study by focusing on the experience of Latin American (LA) countries for two main reasons. First, it is a region with high inequality where, as we will show, wealthy individuals, are as rich as some EU countries like France and Spain. Second, high-quality administrative data and policy variation have fostered new research examining several dimensions regarding wealthy individuals. The remainder of the chapter is organized as follows. Section 2 presents key stylized facts, while Section 3 discusses the main factors eroding revenue collection and the redistributive capacity of tax systems. Section 4 turns on the top tail of the distribution by documenting the level and income composition of wealthy individuals in LA countries while also discussing their effective tax burden. Section 5 discusses some features of enforcing taxes for affluent individuals when tax capacity is weak, like in LA. Section 6 reviews novel evidence of behavioral responses of the wealthiest to income and wealth taxation based on the experience of LA countries. Finally, Section 7 (in progress) digs into a set of requirements that would be needed to tax the rich in the LA region and, more broadly, in the developing world.

2   Stylized facts: Inequality, Tax Structure, and Redistributive Capacity in Developing Countries

In this section, we present an overview of income and wealth concentration at the top, describe the tax structure, and characterize the redistributive capacity of the tax systems. We leverage well-known databases and standard measures to compare developing and developed

regions.[1]

Latin America is one of the most unequal regions in the world. This fact emerges if we use different indicators to measure inequality. Since this chapter focuses on the top tail of the distribution, we show statistics based on the income/wealth share held by the top 1%. Figure 1 presents the top 1% income and wealth shares across world regions (Panel a) and LA countries (Panel b) for the year 2020. This figure shows three main facts. First, the concentration of wealth in the richest 1% is substantially higher than income concentration, irrespective of the region or LA's country. Second, regions in the developing world, except for North America, have the most unequal levels of income and wealth. In particular, the top 1% income (wealth) group owns 20.6% (35.8%) in the LA region, while in Europe, the share is close to 11.9% (25.6%). Third, despite the high levels of income and wealth concentration observed in the LA region, the averages mask substantial disparities across countries. For instance, Mexico, Chile, and Brazil exhibit large income concentration, whereas Ecuador and Uruguay present relatively low levels, close to the European average. Recent studies suggest that levels of income inequality measured by Gini coefficients have declined in the LA region since the 2000s, partly due to the role of personal income taxation (Clifton et al., 2020). However, the very top of the income distribution seems to have escaped this global trend, with the income shares of the top 1% remaining virtually unchanged in the 2000s (WID, 2022).

Latin America presents a low tax-collection-capacity. Figure 2 depicts total average tax revenues (excluding social security contributions) as a share of the Gross Domestic Product (GDP) across world regions (Panel a) and LA countries (Panel b) for the year 2020, separated into direct and indirect components. Despite the improvements in recent decades (Bachas et al., 2022), the gap in tax revenue between developing and developed regions remains substantial. For instance, the gap as a share of the GDP was almost 8 percentage points between Europe and LA regions.[2] Panel b in Figure 2 also shows substantial heterogeneity in tax-to-GDP ratios across LA countries, ranging from 13.2% (Peru) to 20% (Uruguay) and 23.8% (Argentina).

Direct income tax collection is low in Latin America. A noticeable difference between developed and developing regions is the relative importance of indirect and direct taxes to total tax collection, as Figure 2 shows. While in regions like Latin America, most of the tax revenue is raised by indirect taxes (including domestic consumption taxes and excises), direct taxation (including personal income, taxes on property and wealth, and taxes on corporate income) plays a dominant role in developed regions like Europe and North America. Strik-

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[1]The data on inequality measures comes from the World Inequality Database (https://wid.world/). To characterize tax structures, we based on data from the OECD Database (https://stats.oecd.org/), meanwhile, we use tabulates from Vellutini and Benitez (2021) to present measures of the redistributive capacity of tax systems.

[2]The gap would rise almost 13 percentage points if we include tax revenue from social security contributions.

ingly, the relatively low weight of direct taxation in revenue collection appears to be more homogeneous across LA countries than other patterns previously observed. This pattern has not changed despite the increase in tax-to-GDP ratios observed in the last decades –mainly driven by consumption taxes, such as the VAT (Barreix et al., 2017, Bachas et al., 2022).

Latin America exhibits a weak redistributive capacity of the tax system. Several studies showed that direct taxation in developing countries, particularly in the LA region, is limited in reducing income inequality. This feature is not associated with the level of progressivity of direct taxes but with the meager amount of revenue collected ("policy size") (Hanni et al., 2015, Barreix et al., 2017, Lustig, 2017, Clifton et al., 2020, Bachas et al., 2022). Figure 3 highlights this point by focusing on the case of the personal income tax (PIT). It shows the Reynolds-Smolensky index (gray bars) –a standard measure used in the literature to synthesize the redistributive capacity of a tax policy–, and the two components that this index can be decomposed into: the Kakwani progressivity index (black crosses) and the aggregate average tax rate (black squares).[3] Figure 3 shows different patterns in redistributive capacity across world regions (Panel a) and LA countries (Panel b). First, PIT redistributive capacity is much higher in rich regions than in developing countries. Second, in developing regions, the low redistributive power of PIT can be achieved in different ways –a similar pattern is observed in the developed regions too–. For instance, in the LA region, a key driver of the relatively low redistributive capacity of PIT is the low aggregate average tax rate which counterbalances the observed high progressivity of this tax. Third, Panel b shows that the meager redistributive power of PIT in the LA region masks wide disparities between countries. However, for most LA countries, it highlights the low revenue-raising capacity as a limiting factor for PIT's high progressivity.

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[3]Kakwani (2017) decomposition shows that the redistributive power of taxation depends on both the progressivity of tax schedules and total tax collection as a share of aggregate income ("policy size").

Figure 1: Top 1% income and wealth shares, 2020

(a) **World Regions**
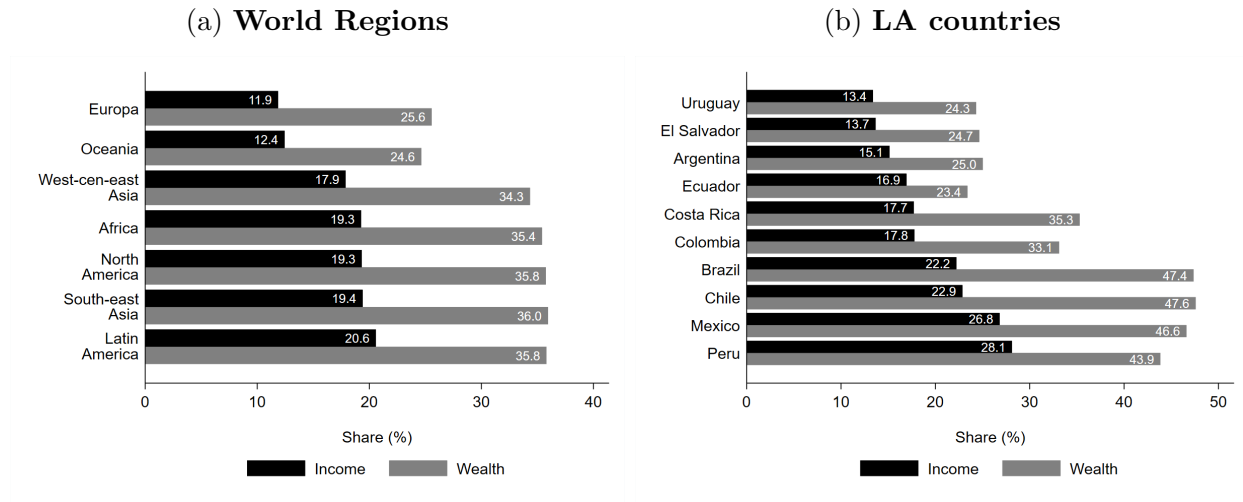
(b) **LA countries**

Notes: This figure shows the share of total income and net wealth earned by the top 1 % of adults across world regions (panel a) and LA countries (panel b) for 2020. The black bars display income shares, while the gray bars report wealth shares. Income is defined as pre-tax national income measured after pension and unemployment contributions and benefits paid but before income taxes and other transfers. Wealth is defined as net household wealth among adults, including financial and non-financial assets owned by individuals, net of their debt. The Latin America's average in panel (a) represents the unweighted average of the 10 LA countries included in panel (b).

*Source:* Own elaboration based on World Inequality Database (https://wid.world/). For methodological details, see https://wid.world/methodology/.

Figure 2: Tax Revenue and Tax Structure (Direct *vs* Indirect Tax Revenue), 2020

(a) **World Regions**
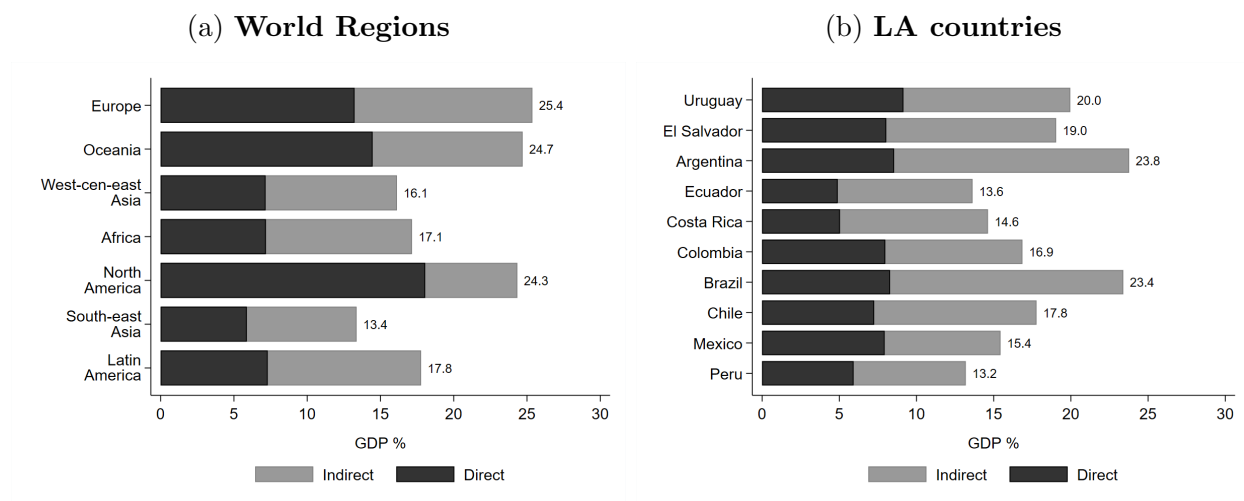
(b) **LA countries**

Notes: This figure shows the tax revenue as a share of the gross domestic product across world regions (panel a) and LA countries (panel b) for 2020, separated by direct and indirect revenue sources. Direct revenue source (in black) includes taxes on personal income, taxes on property and wealth, and taxes on corporate income (items 4000+1000), while indirect revenue (in grey) source is defined as total tax revenue minus social security contributions (item 2000) and direct tax revenue. The Latin America's average in panel (a) represents the unweighted average of the 10 LA countries included in panel (b).

Source: Own elaboration based on OCDE.stats (https://stats.oecd.org/).

Figure 3: Personal Income Tax: Redistributive Capacity as a Function of Progressive Capacity and the Aggregate Average Tax Rate, 2020

(a) **World Regions**   (b) **LA countries**
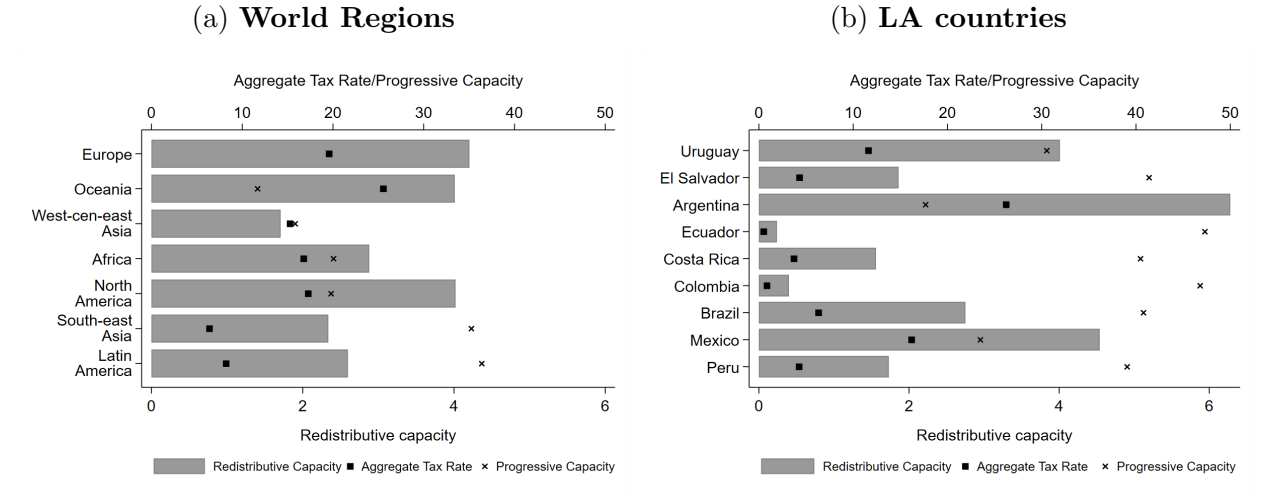
Notes: This figure shows the redistributive capacity of the personal income tax across world regions (panel a) and LA countries (panel b) for 2020. The bottom x-axis displays the Reynolds-Smolensky index of the global redistributive power of the tax system (gray bars). A higher bar-length means higher redistributive capacity. The upper x-axis depicts the two components that the Reynolds-Smolensky index can be decomposed into: the Kakwani progressivity index (black crosses) and the aggregate average tax rate (black squares). The Kakwani progressivity index measures the level of progressivity of the personal income tax schedule, while the aggregate average tax rate captures the total tax collection as a share of aggregate income (see Kakwani 2017)

Source: Own elaboration based on tabulates from Vellutini and Benitez (2021).

3   Factors Undermining Tax Collection, Tax Progressivity, and Redistribution

The PIT is one of the most progressive instruments in tax systems and one of the main sources of tax revenue in the OECD countries. However, in LA, pervasive job informality and relatively high exemption thresholds exclude most individuals from paying the PIT. In practice, the PIT is levied on a small proportion of formal high-wage earners—typically located in the top-income decile. This implies that the PIT is *de facto* progressive (except among the top 1%, as discussed below). However, these individuals face very low effective tax rates because the statutory top PIT rates are low and there are sizable tax avoidance and evasion (Barreix et al., 2017). As a result, the average collection of PIT is only 2.2% of GDP in 2020, meaningfully below OECD standards (OECD et al., 2022). In what follows, we review the factors that undermine tax collection, tax progressivity, and the redistributive capacity of the tax system, including the design features (e.g., statutory marginal tax rate, tax base) and non-tax features (e.g., work and business informality, low tax morale, low administrative capacity, evasion). In doing so, we compare LA countries to OECD countries

and focus on the PIT which plays a smaller role in LA's tax structure.

Figure 4 provides an overview of top marginal income tax rates (panel a) and the location of exemption thresholds relative to gross national income per capita (panel b) for LA countries in 2020. The median values in LA and OECD countries are denoted with vertical black and gray lines, respectively. The figure shows that, relative to OECD countries, the PIT in LA bites for higher-income individuals and at much lower top MTRs. The median exemptions-to-per capita-gross-national-income (GNIpc) ratio is sixfold larger in LA than in the OECD (1.4 compared to 0.24), and the median top MTR is substantially lower too (30% compared to 46.6%).

High filing and exemption thresholds *de jure* exclude most formal workers from the PIT. Exemption thresholds have received little attention in the academic literature but are an important policy tool for collection and redistribution (Jensen, 2022). Moreover, recent research suggests that broadening the tax base by including more taxpayers has a "participation dividend," promoting inclusive governance and stimulating political engagement among citizens (Weigel, 2020).

Expanding the PIT tax base may require, first, tackling informal work, an issue we return to later in this section. Indeed, labor informality is pervasive in the region, even before the COVID-19 pandemic (Maurizio, 2021). Second, tax reforms lowering the exemption threshold could bring more individuals into the PIT base and expand tax capacity. The administrative costs of expanding the tax base decrease with the amount of employee information trails by employers. However, lowering the exemption threshold may be politically challenging, and the first statutory tax rates must be set at low levels to avoid overburdening the middle class. Some countries with nominally-defined tax brackets, like Argentina, have chosen to leverage high inflation spells to expand their PIT base. This, coupled with strong formalization in the labor market, resulted in more than doubling the pool of people subject to the income tax—even in the absence of a tax reform (Tortarolo et al., 2020).

In addition to the relatively high exemption thresholds, a plethora of tax allowances further erode the PIT base in LA. As a result, 54% of the average gross wage-earnings went untaxed in LA compared to 14% in the OECD for unmarried individuals (Barreix et al., 2017). In addition, some countries currently have a myriad of non-standard reliefs for personal expenses in education, health, food, clothing, and housing. In Ecuador, for instance, these could represent up to 50% of an individual's income (Bohne and Nimczik, 2018). These tax allowances do not appear to be justified on empirical grounds.

Individuals at the top also have access to less conventional loopholes. Aggressive tax planning through family businesses, particularly, is a pernicious practice in LA. In Chile, for instance, Agostini et al. (2018) recently showed that some taxpayers lower their PIT liabilities by reporting income through small firms subject to special tax regimes (STRs). Importantly, this behavior is highly concentrated among the affluent. While over a third of

taxpayers at the top 0.1% of the income distribution own at least one STR firm, only 2.6% of the taxpayers in the bottom 90% own one. Furthermore, the authors find that the taxable income of high-income taxpayers increased up to 7% following a reform that made STRs less advantageous. The space for such practices in the region is considerable. Simplified tax regimes are present in Argentina, Brazil, Bolivia, Colombia, Costa Rica, Ecuador, Mexico, Nicaragua, Peru, and Uruguay (Coolidge and Yilmaz, 2016, Azuara et al., 2019, Marchese, 2021). While their goal is to facilitate voluntary tax compliance of small enterprises and the self-employed, the Chilean experience suggests that these regimes are prone to abuse by the rich, further undermining tax progressivity.

In addition to tax avoidance, LA countries also suffer from high evasion rates. Although the evidence is still scarce and hard to compare across countries, a recent review by ECLAC (2020) suggests that non-compliance represents 4.3% of regional GDP for PIT and CIT. Moreover, this study estimates that the rate of PIT evasion is 18.7% in Mexico 2016, 27% in Chile, 32.6% in Peru, 33.4% in Panama, 36.3% in El Salvador, 49.7% in Argentina (includes legal entities and individuals), 57.1% in Dominican Republic, 57.3% in Costa Rica, 58.1% in Ecuador, and 69.9% in Guatemala. These levels are much higher among self-employed people with business activities than employees. As a result, the tax gaps between theoretical and actual PIT revenue are large and range from 0.5% of GDP in Chile to 1.7% of GDP in the Dominican Republic. High rates of evasion affect the capacity of LA tax systems to raise revenue progressively, especially since the PIT bites at the upper end of the income distribution and the highest incomes account for a large share of all PIT revenues (IMF, 2015).

LA's poor tax compliance is often attributed to Latin Americans' low tax morale and high perceived corruption. Figure 5 compares the degree of tax morale (panel a) and perceptions of corruption in the public sector (panel b) across selected countries *circa* 2020. In both dimensions, LA underperforms OECD countries. For example, for the median country, almost twice as many individuals believe that evading is justifiable in LA than in OECD countries (15.4% compared to 8.3%). Similarly, the corruption perception index (ranging from 0 to 100) is more than twice as large in LA than in OECD countries (64.5 compared to 29). Ultimately, inducing high-income earners to consent to more progressive taxation will require higher levels of trust in governments and transforming the tax culture (Berens and von Schiller, 2017, OECD/FIIAPP, 2015).

Lastly, informality is a distinctive feature of LA labor markets and businesses, creating additional tax challenges at the top. Although the share of informal workers is low at the upper end of the distribution, intensive-margin informality—in the form of undeclared ("envelope") wages—is pervasive and sizable in the region, as documented by recent research in Uruguay, Mexico, and Brazil (e.g., Bergolo and Cruces, 2014, Kumler et al., 2020, Bergolo

et al., 2021, Feinmann et al., 2022).[4] For instance, a recent large-scale survey of 12,000 workers found that "payments under the table" are widespread and more prevalent among high earners: 26% of formal employees admitted to receiving compensation off-the-books representing 22% of their wage earnings, on average (Feinmann et al., 2022). Moreover, the share of unreported wages increases with income, reaching 30% for the top 5%. Because income tax payments are concentrated at the top, a simulation exercise shows that forgone income tax revenue is large at 6.8%.

Non-registered businesses and tax non-filing among registered firms constitute another form of informality (Brockmeyer et al., 2019). Most microenterprises in most developing countries are informal and typically consist of the owner and one other paid worker (Bruhn and McKenzie, 2014).[5] Although informality and selective non-filing are more frequent at the lower or middle part of the income distribution (Ulyssea, 2020), they create horizontal inequities between taxpayers and, overall, arguably dampen tax morale at the top by fostering a culture of informality.
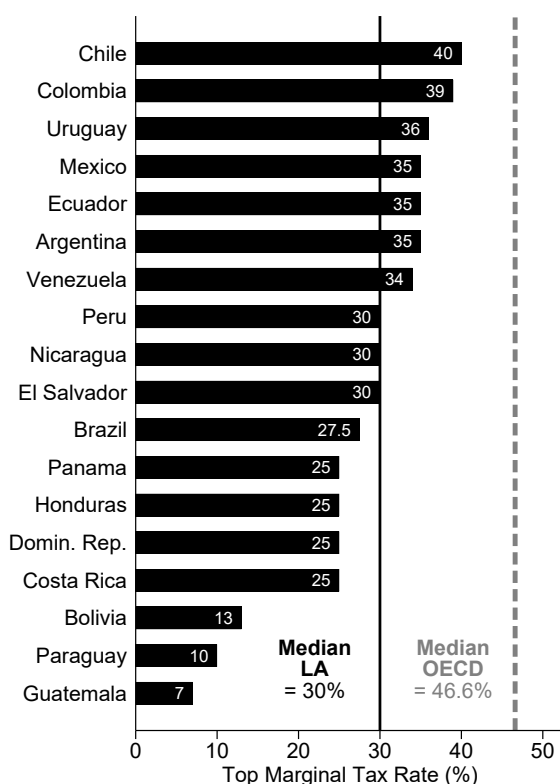
Taken together, the factors highlighted in this section remain important obstacles that limit the ability to tax the affluent.

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[4]Informality decreases sharply with income at the extensive margin. Busso et al. (2021) show that one in four households was informal in the highest quintile of the labor income distribution in 2018 compared to more than half in the second quintile. Informal households are those in which no member contributes to social security. These numbers refer to Argentina, Bolivia, Brazil, Chile, Colombia, Dominican Republic, Ecuador, El Salvador, Peru, and Uruguay.
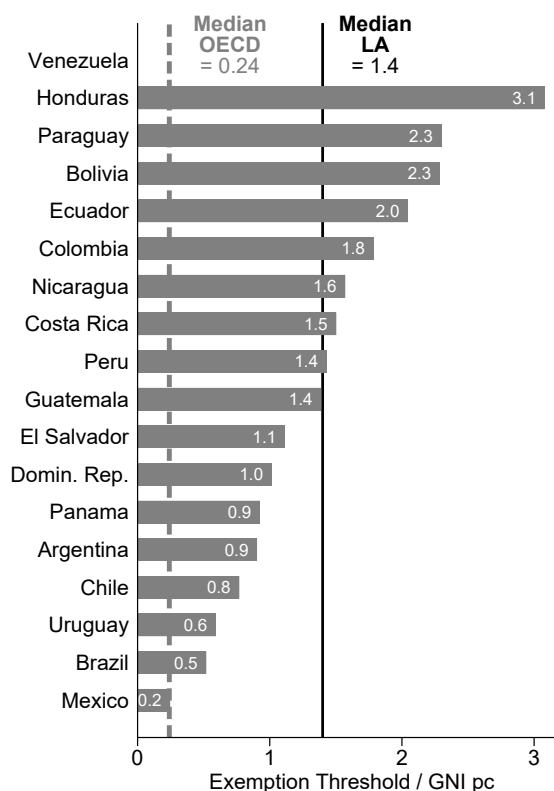
[5]For instance, in Costa Rica, Brockmeyer et al. (2019) estimate that 25% of tax-registered firms, and over 60% of firms that are unregistered but known to the tax authority through third-party reports, did not file their income tax declaration in 2014. In Brazil, de Andrade et al. (2014) show that 72% of businesses in Belo Horizonte were informal in 2009.

Figure 4: Top Marginal Income Tax Rates and Exemptions Thresholds
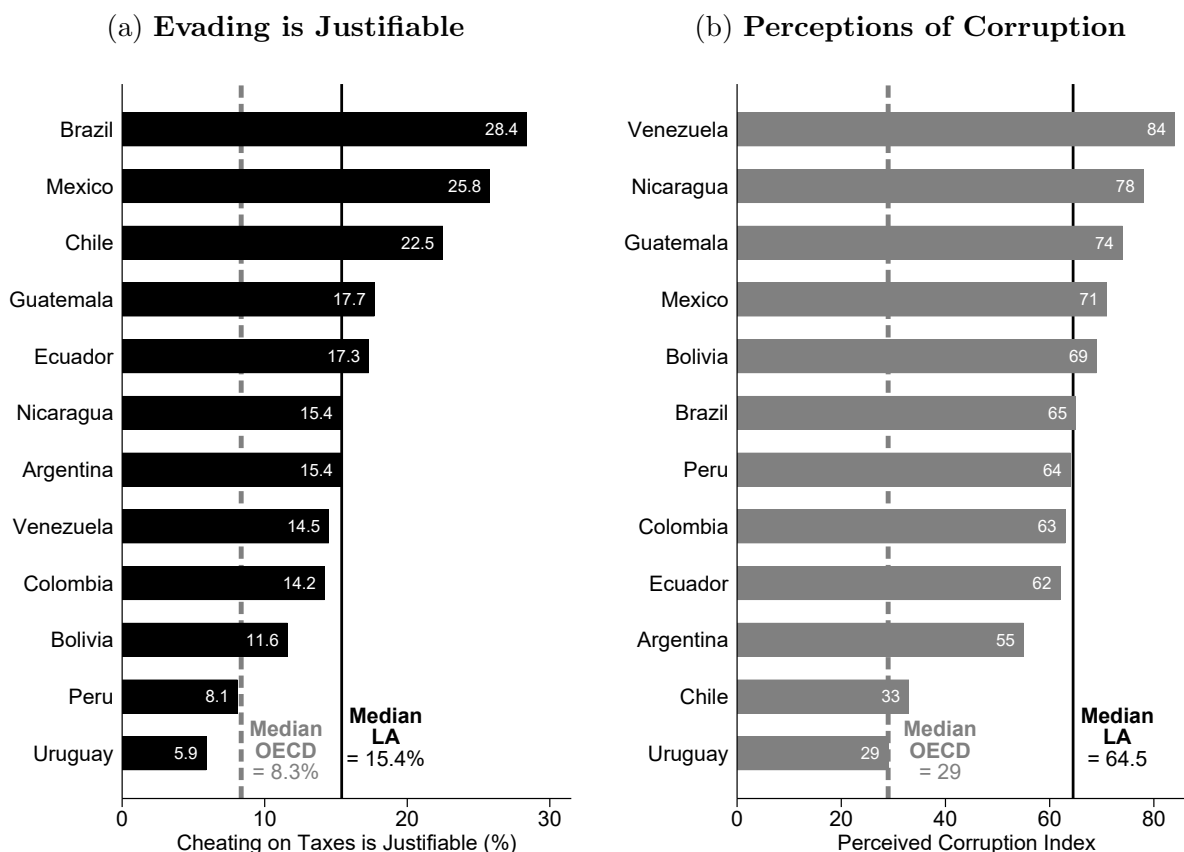
(a) Top Marginal Tax Rates in 2020

Country	Top Marginal Tax Rate (%)
Chile	40
Colombia	39
Uruguay	36
Mexico	35
Ecuador	35
Argentina	35
Venezuela	34
Peru	30
Nicaragua	30
El Salvador	30
Brazil	27.5
Panama	25
Honduras	25
Domin. Rep.	25
Costa Rica	25
Bolivia	13
Paraguay	10
Guatemala	7

Median LA = 30%   **Median OECD = 46.6%**

(b) Ratio Exemptions to GNIpc in 2020

Median OECD = 0.24   **Median LA = 1.4**

Country	Exemption Threshold / GNI pc
Venezuela	
Honduras	3.1
Paraguay	2.3
Bolivia	2.3
Ecuador	2.0
Colombia	1.8
Nicaragua	1.6
Costa Rica	1.5
Peru	1.4
Guatemala	1.4
El Salvador	1.1
Domin. Rep.	1.0
Panama	0.9
Argentina	0.9
Chile	0.8
Uruguay	0.6
Brazil	0.5
Mexico	0.2

Notes: This figure shows the 2020 top marginal income tax rates (panel a) and the exemption floor upon which people become liable relative to gross national income per capita (panel b). The black vertical line displays the median value for LA countries and the gray dashed vertical line corresponds to the median value for OECD countries. For each country, the exemption thresholds correspond to non-married individuals without dependents. In practice, individuals could earn more than the exemption floor and still pay no income tax by claiming family allowances (e.g., children, spouse, disability) or additional deductions (e.g., social security contributions, medical expenses, etc.). For data limitations, the following four countries are not included in panel (b): Venezuela, Turkey, Netherlands, and New Zealand.

Source: Own elaboration based on EY Worldwide Personal Tax and Immigration Guide for 2020 and World Bank national accounts data.

Figure 5: Tax Morale and Perceptions of Corruption (circa 2020)

(a) **Evading is Justifiable**

Country	Cheating on Taxes is Justifiable (%)
Brazil	28.4
Mexico	25.8
Chile	22.5
Guatemala	17.7
Ecuador	17.3
Nicaragua	15.4
Argentina	15.4
Venezuela	14.5
Colombia	14.2
Bolivia	11.6
Peru	8.1
Uruguay	5.9

Median OECD = 8.3%
Median LA = 15.4%

(b) **Perceptions of Corruption**

Country	Perceived Corruption Index
Venezuela	84
Nicaragua	78
Guatemala	74
Mexico	71
Bolivia	69
Brazil	65
Peru	64
Colombia	63
Ecuador	62
Argentina	55
Chile	33
Uruguay	29

Median OECD = 29
Median LA = 64.5

Notes: This figure shows the degree of tax morale (panel a) and perceptions of corruption (panel b) for a sample of LA countries. To measure low tax morale we use the question from the World Values Survey about 'Cheating on tax if you have the chance' which ranges from 0 (never justifiable) to 10 (always justifiable). We calculate the proportion of the respondents who chose 5 to 10. The Corruption Perceptions Index (CPI) ranks 180 countries by their perceived levels of public sector corruption, according to experts and business people. The index ranges from 100 (very clean) to 0 (highly corrupt). We plot 100-index so that higher values correspond to higher perceived corruption. The black vertical line displays the median value for LA countries and the gray dashed vertical line corresponds to the median value for OECD countries.
Source: Own elaboration using data from the World Values Survey Wave 7: 2017-2022 and the 2019 Corruption Perceptions Index from Transparency International.

4 The Top Tails of the Income and Wealth Distributions and Tax Progressivity

One important aspect of the public policy debate about the top tail of the income and wealth distributions is the progressivity of the tax system at the top (Piketty et al., 2020). Evaluating rich individuals' fiscal capacity requires measuring these upper tails well, often requiring combining household surveys with tax and social security records.[6] Indeed, measuring in-

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[6] Household surveys fail to capture rich individuals (due to coverage errors, sparseness, or unit nonresponse), and, even when they are included, their income and wealth information is often missing, underre-

equality using tax data is crucial since capital incomes are considerably less well covered in household surveys, and surveys' ability to capture capital income has worsened in LA over time (Alvaredo et al., 2022, Flores et al., 2022). As a result, tax and survey pre-tax incomes increasingly diverge for top fractiles and, while survey-based inequality estimates report an inequality drop in LA since the early 2000s, tax-based inequality estimates suggest that inequality has stagnated or *increased* (Alvaredo et al., 2022, Burdín et al., 2022).

Unfortunately, tax records are rarely made available to researchers in developing countries. Moreover, tax returns have limitations of their own when measuring inequality. First, their definition of "income" often varies over time and across countries. Second, it often excludes important income components (Piketty et al., 2020). Third, only a fraction of the population files a tax return (e.g., Argentina, Brazil, Colombia, Peru), making it impossible to study tax-based inequality changes in the lower and middle part of the distribution. Fourth, tax evasion and tax avoidance may also vary over time and across countries depending on the strength of tax enforcement and the opportunities to avoid taxes available.[7] As a result, the study of rich or high-net-worth individuals in developing countries remains in its infancy. We, therefore, base our analysis on LA countries where top income and wealth shares are available but highlight the data limitations and considerable uncertainty of existing inequality and tax progressivity estimates.

4.1 How Rich Are They?

Figure 6 combines survey and tax data for 2021 and compares the income needed to belong to the richest 1% and top 0.01% across LA countries. In addition, the figure includes this information for three OECD countries: the US, France, and Spain.

Panel (a) compares the top 1% income threshold. Several key results emerge from this figure. First, the income needed to belong to the richest 1% varies substantially across countries in LA. We identify four groups of countries based on their top 1% income threshold. At the bottom stands Ecuador, with an income threshold of PPP USD 127,000. Next, three countries—Peru, Colombia, and Argentina—have thresholds of PPP USD 164,000–190,000. A third group comprises three countries—Uruguay, Brazil, and Costa Rica—with income thresholds ranging between PPP USD 200,000 and PPP USD 215,000, comparable with France and Spain. Indeed, despite these LA countries having substantially lower GDP per capita, rich individuals are comparable with France and Spain because income is highly concentrated in the region. Lastly, Chile and Mexico stand out with the highest top 1%

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ported, or censored (Piketty et al., 2011, Lustig, 2020). Tax records can mitigate some of these biases thanks to their larger sample size, high response rates, and lower recall bias, affecting measured inequality levels and trends. For instance, the top 1% income share in Brazil is 50% higher when correcting surveys' differential non-response (Blanchet et al., 2022).

[7]While researchers have recently pursued "distributional national income accounts" to overcome some of these challenges (Piketty et al., 2017), similar efforts in developing countries are ongoing (Flores et al., 2022).

income threshold in LA of around PPP USD 310,000, threefold Ecuador's, and higher than all other LA countries, France, and Spain. The only country with a higher top 1% income threshold is the US, and Mexico's and Chile's threshold is around two-thirds of that.

Panel (b) shows that the gap between the US and LA countries widens the higher one climbs the income ladder. For instance, the income at the 99.99th percentile in the US is more than twice the income in Chile and ninefold the income in Argentina, the country with the lowest income at the 99.99th percentile in the LA region.

4.2   Income Composition and Effective Tax Rates

Unfortunately, there is substantially less information about top percentiles' income composition and effective tax rates. Alvaredo and Londoño-Vélez (2013) was one of the first studies estimating effective tax rates in a LA country. Understanding effective tax rates requires measuring the composition of income, and Colombia appears to be a traditional society, with high-income individuals owning the capital stock and rents and capital income making up the largest income share at the very top of the distribution. Because capital income is taxed favorably, personal income taxation barely affects inequality, and the system becomes regressive at the very top. Indeed, while top incomes face statutory top marginal tax rates comparable to OECD countries, a substantial legal erosion of the tax base reduces the effective tax rate to 7–8% for the top 1% and less than 4% for the top 0.01% of the income distribution.

The evidence from other LA countries is consistent with capital being the predominant source of income at the top. Indeed, capital income also appears predominant in the upper tails of Ecuador, Uruguay, and Argentina (Burdín et al., 2022, Cano, 2018, AFIP, 2020). Because capital often receives preferential tax treatment, effective tax rates fall within the top 1%. Moreover, high-income individuals are disproportionately likely to reduce their taxable income through legal tax deductions and exemptions. As a result, the top 1% in Ecuador paid an average effective tax rate of about 7%, while the richest 0.001% paid less than 2% in personal income taxes.

In addition to capital income, the rich often derive income from businesses and business ownership (Kopczuk and Zwick, 2020, Smith et al., 2019). However, most large businesses are organized as corporations and taxed separately by the corporate tax in most countries. Since corporate ownership of individuals is generally not recorded by administrations, individual owners are rarely identified (Piketty et al., 2020). Moreover, ownership of partnerships and close corporations is opaque. This introduces measurement error in top-income shares and has severe implications for tax capacity and progressivity. Specifically, corporations are generally taxed at lower rates than top personal incomes, so business owners have strong incentives to leave profits in the firm, and independent professionals prefer to incorporate and consume profits without declaring dividends to avoid personal income taxation. For example, luxury

Figure 6: The Top Income Thresholds

(a) Top 1%
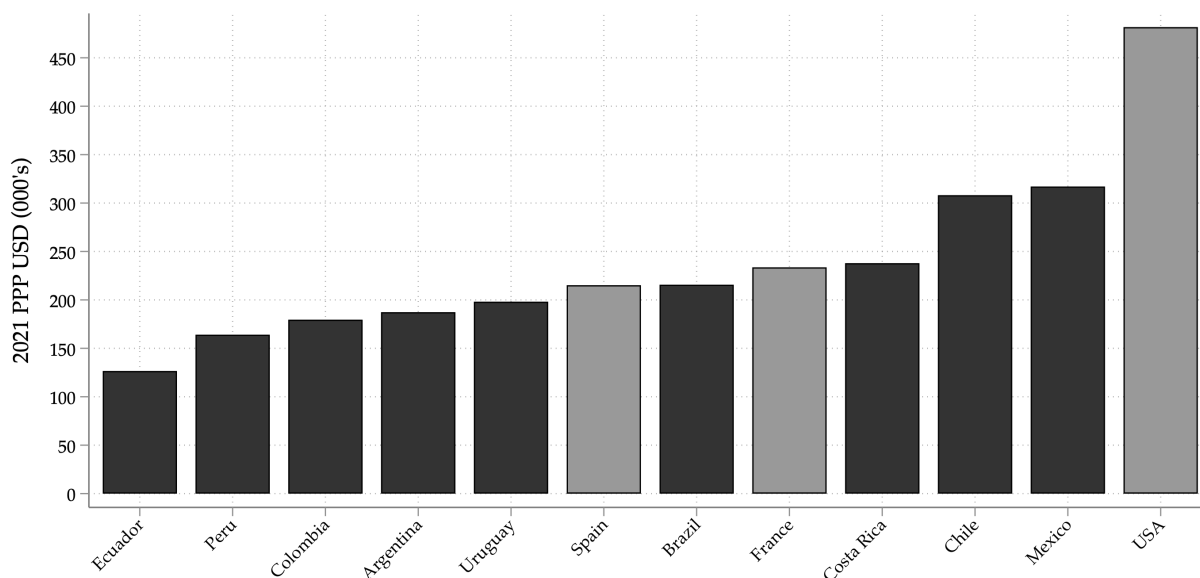
(b) Top 0.01%
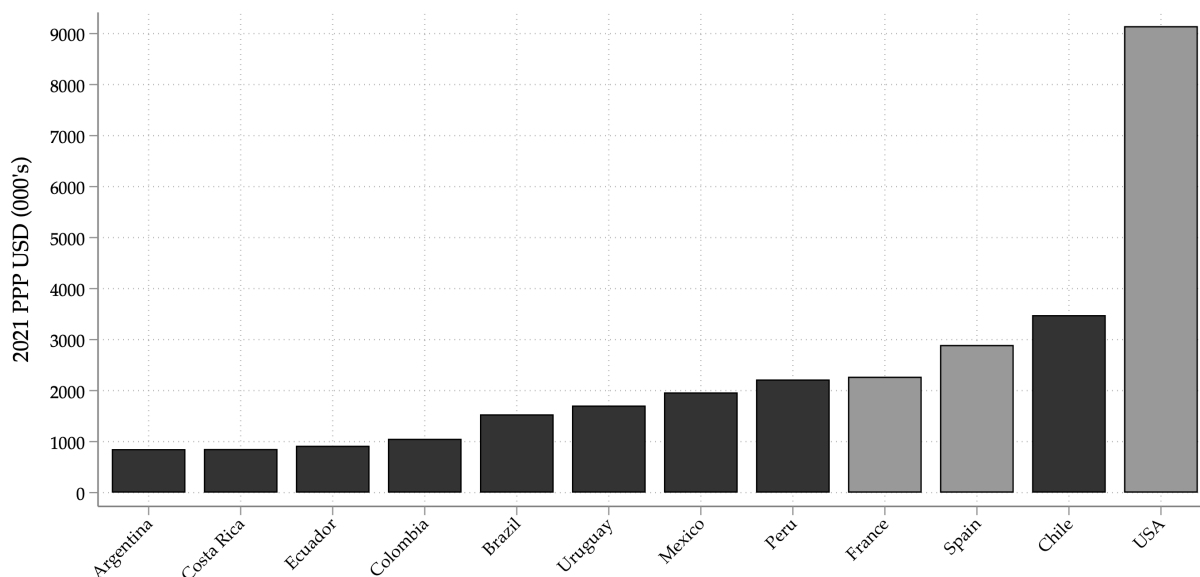
Notes: This figure shows the top 1% income threshold across selected Latin American and more developed countries for 2021. Pre-tax national income is the sum of all pre-tax personal income flows accruing to the owners of the production factors, labor and capital, before taking into account the operation of the tax/transfer system, but after taking into account the operation of the pension system. The central difference between personal factor income and pre-tax income is the treatment of pensions, which are counted on a contribution basis by factor income and on a distribution basis by pre-tax income. The base unit is the individual (rather than the household), but resources are split equally within couples. The population is comprised of individuals over the age of 20.

Source: Own elaboration based on World Inequality Database (https://wid.world/). For methodological details, see https://wid.world/methodology/.

vehicles for personal use may be registered to the firm and distributed profits may be omitted from tax returns.

Recent evidence from Chile by Fairfield and Jorratt De Luis (2016) sheds light on this phenomenon. Unlike most countries, Chilean corporate ownership information is systematically collected, enabling researchers to link corporate wealth and corporate profits to final individual owners and re-estimate top income shares when accounting for accrued profits and undeclared distributed profits. Adjusting for undeclared distributed profits raises the top 1% income share from 15% to 22–26%. Furthermore, including accrued profits instead of distributed profits further raises the top 1% share to 32–33%. Despite this acute income concentration, the top 1% pays modest average effective income tax rates of 15–16%, both with and without including the corporate tax in the numerator and accrued profits in the denominator.[8]

4.3   Wealth Taxation

A particular feature of several LA countries is their long tradition of taxing the wealth of individuals and firms. Unlike OECD countries, where wealth taxes have been abolished in recent decades (OECD, 2018), several countries in LA—specifically, Argentina, Colombia, and Uruguay—levied annual wealth taxes in 2020 (ECLAC, 2021).[9] Moreover, other countries like Brazil, which do not levy wealth taxes, nevertheless require all income taxpayers to annually report their assets and liabilities because reported wealth serves a supporting role for income tax enforcement.[10]

Notwithstanding, enforcing wealth taxes is challenging. First, there is the usual issue of valuation, as some assets are not reported in tax records at market values (e.g., real estate) and other assets are harder to value (e.g., closely-held stocks in private businesses). Moreover, the enforcement challenges can be severe in the developing world due to a low implementation of third-party reporting, weak property registers, meager resources for tax audits, and considerable self-reporting and avoidance channels. In addition, reported assets can be severely underestimated due to the pervasiveness of the underground economy in many developing countries.

Fortunately, as the next sections show, strengthening the enforcement regime can boost reported wealth and improve tax progressivity even in setting with low baseline tax compli-

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[8]Building on Fairfield and Jorratt De Luis (2016), Flores et al. (2020) use tabulated income-tax declarations to extend Chile's series to 1990 through 2016. Including undistributed corporate profits affects both inequality levels and trends and reverses Chile's reduction in inequality during the democratic years.

[9]In addition, Ecuador introduced a temporary wealth tax in 2022–23 for individuals with more than USD 1 million in wealth. Authorities expect nearly 6,000 individuals to pay this tax.

[10]This implies that several LA countries maintain administrative data on wealth, facilitating the study of the top of the distribution of (reported) wealth. This represents a considerable empirical advantage over countries that do not collect administrative data on wealth, where measuring wealth indirectly has rendered estimates sensitive at the very top (Saez and Zucman, 2016, Smith et al., 2022, Saez and Zucman, 2022, 2020b,a).

ance.

5 Tax Compliance and Enforcement at the Top

Tax evasion is a long-standing policy concern, and enforcing taxes is key for developing a functioning state and economy (Pomeranz and Vila-Belda, 2019, Slemrod, 2019, Besley and Persson, 2009, 2013). This section briefly discusses the weaknesses of enforcing taxes for rich and high-net-worth individuals in settings where, like in LA, tax capacity is weak.

First, the previous section described that many wealthy individuals in LA are capital rentiers and landowners. While land value taxes could raise revenue from these individuals, weak property registers erode the property tax base. Indeed, property taxes are based on outdated cadastral values, and property transactions are rarely used to update cadastral values. As a result, the property tax is thought to be the most underutilized tax in developing countries (Brockmeyer et al., 2022).

Second, governments rely heavily on third-party reported information to enforce taxes, and studies show that verifiable paper trails can be a powerful tool for tax enforcement (Kleven et al., 2011, Pomeranz, 2015). However, using third-party reports for enforcing taxes in the upper tails has its challenges. Crucially, incomplete third-party reporting incentivizes individuals to shift to income or assets not subject to third-party reporting. For instance, wealthy taxpayers in Colombia avoid wealth taxes by misreporting hard-to-measure assets and hiding their wealth in hard-to-track entities in tax havens (Londoño-Vélez and Ávila-Mahecha, 2022).

Indeed, offshoring to tax havens deprives governments of billions of tax revenue (Zucman, 2015). Crucially, offshore tax evasion is pervasive among the richest 0.01% of tax units. While this is true even in the traditionally high-compliance Scandinavian countries (Alstadsater et al., 2019), it appears to be three times more prevalent in Colombia (Londoño-Vélez and Ávila-Mahecha, 2021). Indeed, Latin Americans can be especially prone to evading taxes by hiding income and assets overseas: Alstadsater et al. (2018) estimate that the equivalent of 13% of all Latin America's GDP is held overseas, above the world average of 9.8%, with this share increasing to 25.7% for Brazil, 36.5% for Argentina, and 64.5% for Venezuela. It, therefore, comes as no surprise that a large proportion of beneficial owners appearing in the leaked Pandora Papers were from the LA region—and, especially, from Argentina, Brazil, and Venezuela (ICIJ, 2021).

The pervasiveness of offshore evasion has prompted many countries to conduct a series of enforcement initiatives to improve wealthy taxpayers' tax compliance, including the OECD's Common Reporting Standards and cross-border automatic tax information exchange agreements (TIEAs) to trace taxpayers' foreign income and assets. In addition, many countries have implemented voluntary disclosure programs or tax amnesties to entice wealthy tax evaders to disclose their foreign incomes and assets in exchange for reduced penalties and

no prosecution (OECD, 2015). Recent evidence shows that these enforcement policies have effectively boosted tax revenue and improved compliance.

Londoño-Vélez and Ávila-Mahecha (2021) compares wealthy Colombians who did and did not disclose under the government-designed scheme using difference-in-differences. The policy persistently boosted income and wealth tax compliance. Three years after their revelation, disclosers report 49% more wealth and pay almost 40% more income taxes. Crucially, because wealth tax evasion is highly concentrated at the top of the wealth distribution, improving tax compliance raises revenue from the wealthiest 1%, reinforcing tax progressivity.

Argentina presents another interesting case study of reduced offshore tax evasion significantly boosting tax collection and spending in social transfers. Despite substantial offshore tax evasion and a history of failed efforts promoting foreign asset reporting, a tax amnesty in 2016 finally encouraged wealthy Argentines to disclose assets worth 21% of the GDP, representing one of the world's most effective amnesty programs. Londoño-Vélez and Tortarolo (2022) shows that the amnesty boosted the total wealth reported by the wealthiest 0.1%, enabling authorities to raise revenue by levying taxes on foreign assets and making the tax system substantially more progressive. These results suggest that improving enforcement safeguards the feasibility of progressive taxation in a globalized world, even in settings characterized by high levels of inequality and high baseline rates of noncompliance.

Similarly, Brounstein (2022) shows that tax haven use by individuals in Ecuador is highly skewed towards the top 0.1% of the earnings distribution. Moreover, offshoring to tax havens by wealthy individuals is highly price-sensitive. Leveraging reform-induced variation in the cost of transacting with tax havens, the author shows that dividend outflows to tax havens plummetted following an increase in the outflows tax for dividends sent to tax havens. Moreover, exposed individuals increased domestic reporting by 40% and paid 55% more in income taxes.

6   What do we know about how the rich respond to tax changes in LA region?

Understanding the magnitude and mechanisms of the behavioral response of top income earners to taxes is a crucial input to discuss the appropriate tax policy regarding the wealthiest. While the empirical literature is abundant for developed countries, mostly on personal income taxation, research that focuses on developing countries is scarce yet.[11] In this section, we leverage three studies to discuss evidence on behavioral responses of the wealthy in the LA region. Bergolo et al. (2022) and Tortarolo et al. (2020) examine the magnitude and anatomy of responses in the context of personal income taxation, while Londoño-Vélez and

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[11]For a survey of research on responses to income tax reform in the U.S., see Auten et al. (2016). Meanwhile, see reviews by Advani and Tarrant (2020) and Scheuer and Slemrod (2021) on behavioral responses to wealth taxes.

Ávila-Mahecha (2022) focus on the effects of a wealth tax.[12]

Bergolo et al. (2022) combine a reform-induced tax rate variation at the top of Uruguay's labor income tax schedule with micro-data from administrative tax records to uncover behavioral responses of the top 1% labor income earners. While the policy reform increased the top marginal tax rate on labor income, it also amplified the tax rate differential between this tax and other taxes that levied earnings of top income earners, mainly business income taxed at the corporate level. The features of the tax reform variation enable the authors to document responses on three different margins: intensive, extensive, and income-shifting across tax bases. First, they find that top income earners significantly reduce their reported labor income (the treated tax base). The response size is similar for wage earners and self-employed individuals, and it is mostly driven by those at the very top of the earnings distribution. The intensive margin elasticity is close to 0.6, consistent with the average income elasticity before deductions reported in a meta-regression study by Neisser (2021). Second, the authors show a strong extensive margin reaction to the top tax increase. Specifically, the semi-elasticity estimated implies that a 1% reduction in the average net-of-tax rate leads to a 2.5 percentage point decline in the probability of reporting earnings in the treated tax base. The response among top income groups varies according to their employment status. While wage earners react by vanishing from the tax records, the self-employed mostly shift their labor income to other tax regimes. This result leads to the third important finding. Self-employed top income earners show a high income-shifting response by moving their earnings from the labor income tax base to the corporate tax base. This type of shifting behavior is unsurprising given that Uruguay's tax code offers the opportunity of choosing between labor or corporate income taxation to self-employed individuals—as in many developed countries (Kopczuk and Zwick, 2020).

While Uruguay's study—as the bulk of the evidence for developed countries—points to tax avoidance practices as the mechanism high-income earners use to respond to higher income taxation, it does not offer clear insights into the role of *real* responses. In contrast, Tortarolo et al. (2020) focus their research on this topic in the context of a tax reform in Argentina.

The authors exploit a large income tax holiday for high-wage earners jointly with social security records to identify intertemporal real labor responses. The policy reform was approved in 2013 and exempted a group of high-wage earners from the income tax for 2.5 years while leaving in place the tax on other high-wage earners. The eligibility rule was based on whether past wage earnings were below a certain threshold, implying a 0% marginal and average tax rates for workers below the cut-off while remaining unchanged for those above the threshold. Identification leverages this sharp discontinuity in tax incentives at the threshold across otherwise similar high-income earners. The paper documents four main findings. First, tax-exempt high-income workers show a very limited response to the temporary income

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[12]To our knowledge, no other papers beyond those we review in this section present compelling evidence of behavioral responses of high-income earners to personal taxation in LA countries.

tax change and the wage earnings elasticity is 0.017. Second, the small aggregate effect is primarily driven by more flexible components of workers' pay, such as overtime hours. Third, responses are larger for *a priori* more elastic groups of tax-exempt workers, such as job switchers, managers, and executives. Finally, there is evidence of avoidance responses from high-earning new entrants to the labor market who faced no tax if their first monthly wage was below the tax-exempted threshold. This group of workers, mostly in managerial and executive positions, enter strategically with wages below the fixed cut-off to avoid the income tax. Rigidities in the labor market preventing wage earners' real responses to tax changes can rationalize these findings. For instance, the larger effect for job switchers might imply that wage earners faced rigid constraints on hours worked (Altonji and Paxson, 1992), thus limiting their ability to adjust their income as they wish. Moreover, this explanation is consistent with the finding of larger responses in overtime hours from managers and executives, who arguably have more opportunities to adjust their reported (hours) wages. Interestingly, similar results were also found in the context of more developed countries (e.g., Cahuc and Carcillo 2014).

Recently, wealth taxes have regained interest in policy and academic circles to shift the tax burden toward the wealthiest individuals. Arguments for and against wealth taxes turn on behavioral responses and enforceability if taxpayers avoid or evade them. In particular, the weak tax enforcement capacity and the rampant offshore evasion that characterizes LA region as discussed in Section 5, suggest that taxing wealth might lead to strong responses among the wealthiest individuals.

Londoño-Vélez and Ávila-Mahecha (2022) shed light on the behavioral responses to personal wealth taxes in developing countries by studying the case of Colombia, which has a long tradition of taxing wealth. They use tax microdata on individual wealth holdings linked with the leaked Panama Papers and exploit two sources of policy variation: cross-section variation—discrete jumps in the tax liability–and time variation in people's exposure to the wealth tax—four reforms that modified tax duration and rate schedule–. The authors document four main findings. First, wealth tax hikes yield Colombia's taxpayers instantly declining their reported wealth to tax authorities. Authors' calculations suggest that, at most, one-fifth of revenue is lost because of the behavioral response. Second, the adjustment in reporting behavior persists even after the removal of the wealth tax. Third, several pieces of evidence suggest sheltering behavior is a key driver in explaining the overall response to the Colombian wealth tax. Taxpayers misreport wealth items the tax authorities cannot cross-verify, such as (underreporting) business assets not subject to third-party reporting. In addition, the fact that taxpayers did not revert to pre-reform levels of reported wealth after the dissolution of the wealth tax suggests strategic behavior to minimize the risk of detection in case of evasion—because "de-bunching" after the elimination of the wealth tax would signal to the tax authority that the person was evading. Fourth, the authors find

that the wealthiest people hide assets in hard-to-track entities in tax havens as a response to wealth taxation. Specifically, they show that as a response to wealth tax hikes, wealthy taxpayers increased offshoring of their assets to tax havens. Furthermore, once they created an offshore, taxpayers reported owning fewer assets to the Colombian Tax authority.

Taken together, the findings from these studies suggest that rich people in LA react strongly to policy variation in income and wealth taxes. Changes in accounting practices and offshore tax sheltering rather than real changes in economic behavior arise as critical mechanisms the wealthy individuals use to minimize income and capital tax burden.

7   Policy Discussion

This section discusses policy insights on taxing the rich effectively in developing countries based on the lessons drawn from this chapter. Potential items to be addressed in this section include:

- Increase the information to characterize the rich, what they own, how much is worth it, and where is it located.

- Taxation of capital is crucial for tax progressivity. Wealth taxation (IMF promoted it during COVID-19 crisis, Argentina adopted a wealth tax surcharge in response).

- Reforming the labor and capital income tax code (e.g., close loopholes, raise tax rates on rich).

- Establish units within the tax administration dedicated to the taxation of high net-worth individuals.

- Encourage voluntary compliance (e.g., tax amnesties).

- Minimize tax avoidance and evasion with third-party reporting, high audit rates, modern technology, and national and international coordination.

- Better fund and modernize the tax administration to improve enforcement.

- We need more data and more research.

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