

# Responsibility for Sustainable Economic Activities:

## The Situation in Chile

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*Über Nachhaltigkeit muss unter sozialen Gesichtspunkten und mit Blick auf Ungleichheit der Gesellschaft und Demokratie diskutiert werden. Zwar konnte Armut in den letzten Jahren erheblich verringert werden, aber noch immer bestehen große Unterschiede hinsichtlich der Einkommen, vor allem hinsichtlich der Lebenschancen wegen des ungleichen Zugangs zu Bildung, Gesundheit, öffentlichen Verkehrsmitteln und Justiz. Eine umfassende Steuerreform ist nötig. Es gilt Anreize für selbstständige Arbeit zu schaffen und Interessengruppen in Schach zu halten. Dazu bedarf es starker Institutionen. Ziel ist mehr Chancengerechtigkeit, um soziale und demokratische Nachhaltigkeit zu erreichen.*

### **1. Introduction**

Emerging countries have faced the challenge of reducing poverty for several years and, therefore, sustainability of their economic activities has not been a priority. The battle against poverty has not ended and there are still too many people living under poverty in many emerging countries. However, enough progress has been made and new issues and priorities have arisen. Some of them are related to sustainability in the sense of particular environmental concerns, but more generally in the sense of taking into account future generations in many policies and decisions, which we are making today. I think we should discuss sustainability in a broader sense, considering for this purpose not only environmental aspects but also social aspects, inequality and democracy.

### **2. Poverty**

In general, free open market policies have increased economic growth rates in Latin America over the last couple of decades. As a result, income per capita has risen and welfare has improved significantly for most of the population.

In the particular case of Chile, income per capita increased from US\$ 3.000 in 1985 to US\$ 17.000 in 2011. Consequently, as can be seen in Figure 1, poverty decreased dramatically from 38.6 % in 1990 to 14.4% in 2011 and indigence decreased from 13% to 2.8% over the same period of time.

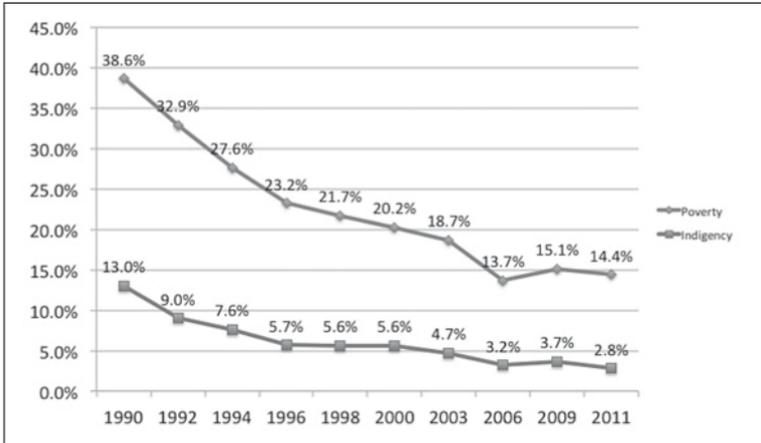


Figure 1: Poverty and Indigence Rates in Chile

It is important to highlight the role of economic growth in reducing poverty, as in the case of Chile its impact has been significant. Larrañaga (1994) estimates that economic growth explains 80% of the poverty reduction in Chile between 1987 and 1992, while Contreras (2001) estimates that 85% of the aggregate poverty reduction – and around 50% and 90% in individual regions within the country – between 1990 and 1996 is attributable to economic growth.

### 3. Inequality

Despite rapid economic growth and poverty reduction, inequality in Chile has remained high and remarkably constant over the last 20 years. As can be seen in Figure 2, the Gini coefficient has remained quite stable over time.

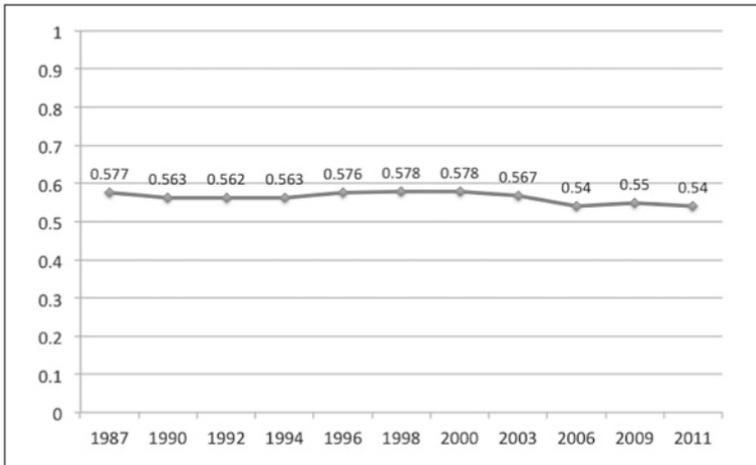


Figure 2: Gini Coefficient in Chile

The Gini coefficient is the most standard measure of inequality and a level around 0.55 before taxes and transfers is particularly high, especially when compared to the average Gini of 0.45 among OECD countries. However, considering income per capita for each income decile in the country might provide a better description of income inequality in Chile as it allows a broader view of the income distribution. Figure 3 shows monthly income per capita for each income decile in Chile in 2011. As can be seen in the figure, the average household income per capita in the top decile is almost 3 times higher than in the second highest income decile. The large difference in income between the richest 10% households and the other 90% explains most of the large income inequality in Chile. As a matter of fact, 76% of the households in the country have an income per capita lower than the average household income per capita in Chile.

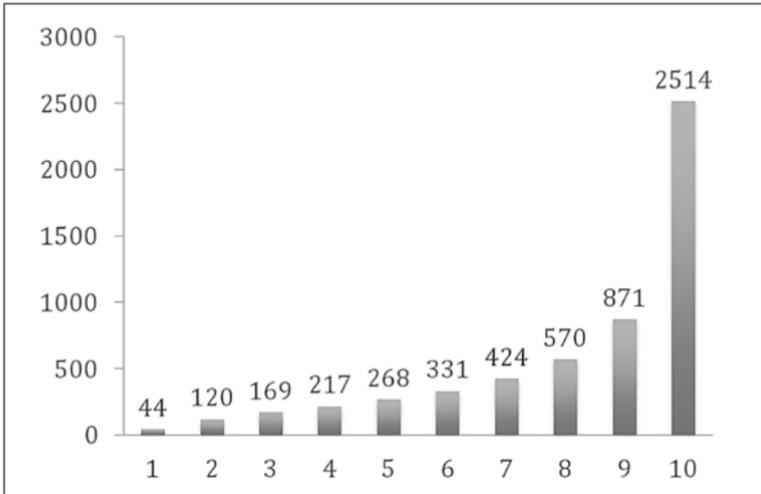


Figure 3: Household Monthly Income Per Capita in 2011 (US\$)

If we compare the income level of each income decile in Chile with income levels of different countries around the world, it is easier to have an even better understanding of the different living standards across income groups within the country. While the top 10% lives with an income similar to the average person in Norway or Singapore, someone in the 5<sup>th</sup> decile lives with an income similar to someone in El Salvador, and a Chilean in the lowest decile has an income equivalent to the average person living in Ivory Coast, one of the poorest countries in the world.

Income Decile	Income per Capita similar to:
10	Norway, Singapore
9	Croatia, Slovakia
8	Argentina, Mexico
7	Kazakhstan
6	Peru
5	Salvador
4	Angola
3	Sri Lanka
2	Congo
1	Ivory Coast

Table 1: Comparison of Income Per Capita by Decile in Chile

Inequality is not only about income; it affects significantly the quality of life and opportunities of many citizens. There exists unequal access to good quality education, efficient and comfortable transport in congested cities, good and timely health services, recreation and green areas and even to justice.

If we want to build a democratic society of equal opportunities we need to address inequality. Reductions in inequality – even at the local level – are likely to enhance social cohesion while also improving individual wellbeing. For example, Ehrlich (1973) and Chiu and Madden (1998) argue that the incentive to commit crimes rises in communities with greater inequality, and Demombynes and Özler (2005) provide empirical evidence of a causal relationship between local inequality and residential burglaries. Frank (1997) shows that U.S. counties with high income inequality have higher median housing prices, higher personal bankruptcy rates, and higher divorce rates. Finally, income inequality may exacerbate ethnic and class conflict and contribute to social strife (Blau and Blau, 1982).

#### **4. Taxation**

Government transfers and progressive taxes can play both a significant role in reducing inequality. However, in the case of Chile the tax structure does not play such a role and even increases inequality.

A large fraction of tax revenue in Chile comes from Value Added Tax (VAT), which is efficient because it has lower administrative costs and lower evasion rates than income taxes, but is regressive. As can be seen in Figure 4, around 50% of tax revenue comes from VAT while income taxes, even though growing over time, contribute with a comparatively much lower fraction – around 28% – to tax revenues. Commodity taxes levied on fuels and cigarettes, which are efficient taxes as they reduce negative externalities, represent around 10% of tax revenues.

In the case of income taxes, their limited role in reducing inequality is a result of two facts. First, almost 82% of taxpayers are exempt from income taxes as the threshold income for the first non-zero tax rate bracket is set too high. Second, there are too many loopholes, several of them associated to pressure groups that allow high-income tax payers to legally avoid paying taxes according to their income level. Income

taxes can play a more significant role for income redistribution in Chile and these two issues prevent it from happening.

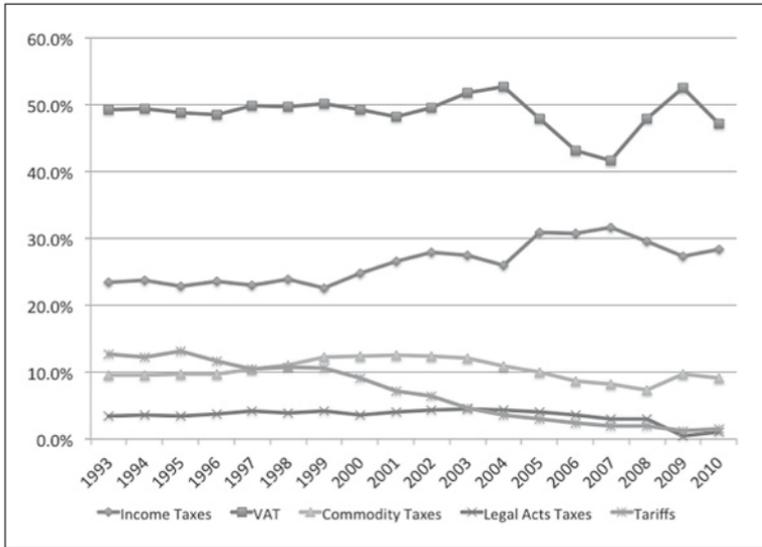


Figure 4: Tax Revenue Composition (%)

Table 2 shows the effects of taxes on income inequality in Chile. The Gini coefficient before taxes is 0.52 and the ratio of income from the highest quintile to the lowest quintile is 17 times. If only the effect of VAT is considered, the Gini increases to 0.54 and the ratio Q5/Q1 to more than 20 times, showing the regressive effect of VAT. If only income taxes are considered, the Gini decreases to 0.507 and the Q5/Q1 ratio to 15.92, showing the progressive effect of income taxes despite its narrow base and many loopholes to avoid them. Commodity taxes are fairly neutral in terms on their effects on inequality, which is the result of the progressive effect of gasoline taxes being compensated by the regressive effect of cigarette taxes. The most striking effect of taxation in Chile is that, when considering the effect of all taxes, income inequality is worse after taxes than before taxes. This is the result of income taxes not playing a significant redistributive role and a tax mix highly dependent on a regressive tax as VAT.

	Gini	Q5/Q1
Before Taxes	0.522	17.04
After VAT	0.545	20.73
After Income Taxes	0.507	15.92
After Commodity Taxes	0.523	17.21
After All Taxes	0.530	19.64

*Table 2: Tax Effects on Inequality*

I am truly convinced that one of the main challenges in Chile today is to do a significant tax reform, with the goal of having a fair, simple and efficient tax system.

## **5. Expenditures and Institutions**

Although economic growth explains much of the poverty reduction over the last couple of decades, government cash and in-kind transfers to poor households have played a significant role to poverty alleviation (Beyer 1997, Valdés 1999, Agostini and Brown 2011).<sup>1</sup> As poverty has decreased over time the focus of the social policy has been improving the targeting of these transfers.

The main problem that needs to be addressed regarding government transfers is the long run effects of some of these policies: housing policy created segregated cities and social exclusion; transport investment in cities, mostly in urban highways, reinforces segregation and benefits the top quintile of the income distribution; and cash transfers have reduced incentives to work. Social policy should switch to creating capabilities and opportunities as a focus more than just increasing current income. Implementing a negative income tax associated to formal employment – as the Earned Income Tax Credit in the U.S. for example – would be a first step in the right direction as it creates incentives to work and allows people to leave poverty through their own effort (Agostini et. al. / 2013).

1| *Cowen and De Gregorio (1996) show that even though economic growth has a large effect on poverty reduction (each percent point in GDP growth rate reduced 0.4% points in poverty rate during 1990-94), it is difficult to separate its impact from the impact of government transfers because social policy affects economic growth.*

In addition to social policy, there exist in Chile an important role for other government policies and some institutions in reducing inequality and creating opportunities. More specifically, competition policy is a crucial component of a social market economy because it prevents the abuse of market power and also allows small businesses to compete in the markets. However, it is challenging to implement a strong competition policy in a very unequal society. Inequality comes partially from economic rents from either not very competitive markets or just from anticompetitive practices and interest groups can prevent the implementation of a strong competition policy.

Consumer protection policies and regulatory policies face a similar challenge, as powerful interest groups are very effective in preventing approval of legislation, which would strengthen competition policies.

## **6. Democracy**

In general, there is a large majority in Chile supporting and asking for a tax reform, investing in public education and in good public transport, and stronger competition and consumer protection policies. However, a powerful minority can prevent those changes from happening in a very unequal society. A good example is the diesel tax, which is efficient and reduces pollution and congestion, but its level is too low based on studies showing the magnitude of the negative externality caused by diesel use. Additionally, the diesel tax is recovered up to 80% by the trucking industry and 100% by all other industries. Therefore, the tax is basically zero for almost all industries and is 20% of an already too low rate for the trucking industry. Every attempt to increase the diesel tax or to reduce its recovery rate has been literally blocked by truckers protesting on the major highways. Another example is a law being currently discussed in the Congress, which would allow retail stores, under several regulations protecting consumers' health, to sell non-prescription medicines. The expected effect of ending with the exclusivity for pharmacies is more competition, lower prices and better access to over the counter medicines (there are many counties with no pharmacies in Chile). However, the lobby of pharmacies has been very successful in preventing the approval of this change.

A relevant issue to discuss then, regarding how a democracy works to represent the interest of their citizens and pass legislation benefiting a large majority, is the role of money and interest groups. Institutions

matter to sustain democracy and Chile needs stronger institutions related to campaign financing, lobby regulations, and transparency and conflicts of interest of public servants.

Today there is a perception that small powerful groups are the ones actually governing the country. This perception might be an exaggeration of reality, but it has some truth in it. The consequence is that people stop believing in democracy and in Chile we have seen the last couple of years students and families protesting in the streets. They ask for better education, for access and financing to good quality education, but they also protest against the political system claiming that it does not represent them. The main concern today is, in fact, that in Chile only 48% of people 18-29 years old value democracy as the most preferable form of government.

## **7. Conclusions**

Latin America in general and Chile in particular, face significant challenges to sustain democracy, economic growth, and improve the overall welfare of their citizens.

I think that the first priority today is reducing inequality. Inequality in Latin America is the result of unfair policies and rules and, therefore, this is a matter of justice. Even though there are different conceptions about distributive justice, there is at least one common support I think we can all agree on: equality of opportunities.

Income and wealth distribution in Latin America, in general, is unfair because there are inequalities of opportunities. The playing field is not leveled and, therefore, high-income groups are the winners in a very unfair competition. Income redistribution levels somehow the playing field, and this is very important for the equality of opportunities in the future. Reductions in inequality would also enhance social cohesion while also improving individual wellbeing. High and persistent inequality can destroy a social market economy and also democracy.

Therefore, the challenge is not only about sustainable economic growth. It is not only about environmental sustainability either. It is also about a market economy which is "Socially sustainable" and "Democratically sustainable".

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