**Income Inequality and the Tax System in Chile**

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Chile’s income inequality is very high by international standards. In a sample of 155 countries gathered by the World Bank, Chile ranks as the 18th most unequal country, and it is by far the most unequal economy in the Organization for Economic Cooperation and Development (OECD). Not only is inequality high, but it has been persistent over time, with a stagnant Gini coefficient of around 0.52 for the last 25 years.

Taxes and government transfers do not change the country’s income distribution substantially. This is mostly the result of a tax mix relying heavily on a regressive value-added tax (VAT) and less on an income tax that, even if progressive in principle, is in practice eroded by a number of exemptions and preferential treatment. As a result, after-tax income inequality is worse than before-tax income inequality.

The new government of Michelle Bachelet is making substantial efforts to tackle these disparities. A recently approved tax reform that closes loopholes and raises corporate taxes is expected to increase tax revenues by around 3 percent of gross domestic product (GDP). The new resources will be primarily spent in strengthening public education, with the goal of ultimately offering universal free education.

The main goal of my research project is to study several aspects of the Chilean tax system. In particular, this project aims to study the effect of the tax reform on tax compliance and the overall fairness of the tax system. Not only do the particularities of the Chilean tax system constitute an interesting topic for academic research, but also research related to Chile has been scarce, and this project has the potential to fill part of that gap.

One of the main features of the current Chilean income tax is its integration. That is, individuals consolidate all of their income into a comprehensive tax base and pay their tax obligations according to a progressive tax schedule. Corporate taxes (20 percent of accrued profits) and payroll taxes are used as a credit against the personal income tax.

A second distinctive feature is that personal income taxes owed by business owners on top of the 20 percent profit retention are not due, according to the personal income tax schedule, until profits are distributed. Upon distribution, owners pay the personal income tax (with a top bracket of 40 percent), using the full corporate tax as a credit against the personal income tax. If all profits were distributed, two individuals with the same income would eventually pay the same taxes regardless of the source of their income. However, less than 30 percent of corporate profits are distributed each year. This generates horizontal inequity, as individuals with a higher share of their income coming from businesses are able to avoid a higher share of their taxes and thus effectively face a lower tax rate.

The proposed tax reform aims at increasing the effective tax rate by introducing two alternative regimes for corporate tax purposes. Under the first regime, full integration is maintained but the corporate tax will be increased from 20 to 25 percent, and shareholders will be taxed on both distributed and non-distributed profits

With the second regime, shareholders continue to be taxed only on distributed profits, but the corporate tax rate is set at 27 percent. This regime is semi-integrated, so shareholders can use only a fraction of corporate tax payments as a credit for their personal income taxes.

Moreover, the reform expands the tax base by restricting the many exceptions and special provisions through which corporate taxes can be avoided under the current regime.

The reform also introduces several changes to the special tax regime for small and medium enterprises (SMEs). Under the current tax system, SMEs can opt between three different special regimes that share the common goal of providing liquidity and incentivizing investment. However, the evidence shows that these are primarily used by investment societies, mostly owned by the richest citizens, as a tax avoidance mechanism. The new tax system considers only one special regime for SMEs, which is based on cash-flow taxation and is restricted based on the nature of a firm’s investments. The proposal states that 20 percent of profit reinvestments can be used as a credit against corporate taxes if SMEs opt for the fully integrated system, while 50 percent can be used as a credit if the partially integrated system is chosen. Also, the project increases the rate at which investment in fixed capital can be used as a credit against corporate taxes and also includes provisions for accelerated depreciation for small firms. Importantly, the reform also includes general provisions against avoidance.

Traveling to Chile this summer allowed me to become more familiar with the tax-reform debate, strengthen my contacts with academics and experts involved in the discussion of the tax reform, and make progress in accessing the datasets that are critical to conduct this study.

I had the chance to meet with two of the leading experts in Chilean tax reform, and we put together a research team on tax policy. We discussed the tax system extensively as well as the many research opportunities brought about by the reform. After these meetings, we wrote a detailed research proposal that we sent to an agency in order to get funding.

The team designed a three-year plan that includes international collaboration with U.S. academics. Importantly, we presented our research agenda to Chilean tax officials, with whom we discussed ways to gain access to the relevant datasets in the near future.

The many developments related to tax reform in Chile are going to be a fruitful source of knowledge for the literature on tax system design. My colleagues and I are happy to be in a position to evaluate the consequences of the tax reform and use this experience to nourish the political and academic debate.