Poverty and Inequality Impacts of the 2007 Tax Reform in Uruguay
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In the context of increasing poverty and inequality in Uruguay, a major Tax Reform was introduced (mid-2007) by the government, with the explicit goal of promoting greater efficiency and equity. The Reform’s implementation was to substantially increase personal income taxes with increasing marginal rates. It also reduced VAT and direct taxes on firms, harmonized employer contributions to social security over sectors and eliminated some highly distorting taxes.

In terms of macroeconomic shock, such a policy can be expected to provoke changes in the behaviour of agents, induce reallocation of resources and generate feedback effects on household income, consumption and savings.

In this study, a team of Uruguay researchers aimed to assess the actual impact of the Tax Reform on macro balances, the labour market, poverty and inequality, by taking into account general equilibrium (“second round”) effects that are frequently omitted in public debate.

“Results indicate that the "second round" effects of the Tax Reform are significant: increase of economic activity and employment, reduction of poverty incidence and inequality.”

- Though it actually increases the overall tax burden, the Reform leads to an increase in aggregate activity (around 1% of GDP) and employment. This expansion, in turns, mostly explains a reduction of around 1% in poverty incidence.

- Also, in terms of poverty reduction, the magnitude of the “second round” effects is significantly larger than the direct effect of the introduction of the new personal income tax.

- Reduction in inequality however (Gini coeff. reduced by 1%) results directly from the progressive nature of the personal of the income tax (Households in the richest decile are the clear “losers” from the Reform)

Overall, the “second round” effects tend to reinforce the progressive nature of the Reform’s main component, i.e. the replacement of the previous wage and pensions tax by a dual direct personal income tax (Figure 1).

The reduction, elimination or harmonization of distortionary taxes reduce distortions in goods and factor prices, leading to a better allocation of resources and economic growth. Although personal income taxes can also be distortionary, we find that the Reform is also desirable from the point of view of efficiency, as the previous tax system was even more distorting.

The main redistributive effects come from the direct impact of the new (progressive) personal income tax. Considering that individuals in the lower half of the income distribution currently face a very low effective tax rate, further modifications in marginal income tax rates on income would have limited distributive effects.

Our estimates also indicate that VAT rates could be further lowered in order to make the Reform budget neutral. Under a budget neutral assumption, with further reductions in the VAT rate, the Reform would generate a larger positive effect on economic activity and the best results in terms of poverty and inequality. This suggests that further reductions in VAT rates are desirable both with respect to efficiency and equity.