



FEBRUARY 2013

WOODROW WILSON CENTER UPDATE ON THE AMERICAS

The Political Economy of Tax Reform in Latin America: A Critical Review

THE TERMS OF THE DEBATE

Efforts to reform tax systems in Latin America may be assessed from many different perspectives. Studies that are restricted to technical, apolitical aspects of tax reform have failed to capture the reality of tax policymaking in many countries. A political economy perspective can better attend to the myriad political features of the tax reform process. The political economy literature itself is quite varied, with different methods, emphases, assumptions, and frameworks. This paper makes a critical survey of political economy literature on tax reform and its distributional effects in Latin American countries (LAC).

Substantial work on tax reforms in Latin America has focused on tax harmonization, the tax gap, fiscal stabilization, and fiscal decentralization, among other issues (see Martner and Tromben 2004; von Haldenwang 2008; Jiménez *et al.* 2010, for a review of these approaches). In addition, the broad income inequality in the region places distributional issues at the center of tax reform processes, and some scholarship has examined the close links between taxation and inequality (e.g., Wibbels and Arce 2003; Zolt and Bird 2005; Sokoloff and Zolt 2006). Most studies, however, have not adequately engaged the question of why the progressivity of the tax systems has not changed significantly in the last decades in countries characterized by political fragmentation and clientelism.

A technical, apolitical approach to the study of tax reform has inhibited a full understanding of the underlying political games and power plays that governments must engage as they seek to change tax structures and redistribute the tax burden in order to improve equality. By contrast, the political economy literature transcends the narrow logic and calculations of revenue-enhancing taxes and focuses instead on the interplay of political actors and institutions that produce given outcomes. Thus, a political economy perspective provides insight as to why the resulting tax structures reflect the political preferences that prevail over time.

SAULO SANTOS
DE SOUZA*

* The author is researcher at the Federal University of Pernambuco, Brazil.



This work provides an overview of a broad series of political issues salient for the study of tax reform. It critically reviews some of the reforms and explores how the political economy debate on taxation can contribute to a better understanding of the outcomes of these reforms. The complex interactions between reforms, political parties, sub-national actors, and tax authorities are addressed as well. Three other connections are explored: a) tax reform and tax structure, b) tax structure and tax burden, and c) burden-shifting and equity.

Section two of this work reviews the methods used in research on tax reforms in LAC. The third section considers the theories on the political determinants of taxation found in the political economy literature on tax reform in Latin America. Some hypotheses

are identified to explain why distributional issues are often neglected in the design of the reforms. Section four looks at how the literature has dealt with the politics of tax reform over the past decades, including a survey of prominent studies on different countries, their taxation systems, and the observed results. Finally, the work reviews the main findings from this body of knowledge and some policy lessons that have emerged.

RESEARCH DESIGNS AND METHODS

This section reviews some of the methods used in empirical studies that deal with tax policy analysis and tax reform. As will be seen, a great deal of academic debate concerning the legal framework of taxation has fully recognized the role of politics in reforms, but opinions

The Latin American Program and its institutes on Mexico and Brazil serve as a bridge between the United States and Latin America, providing a nonpartisan forum for experts from throughout the region and the world to discuss the most critical issues facing the Hemisphere. The Program sponsors research, conferences, and publications aimed at deepening the understanding of Latin American and Caribbean politics, history, economics, culture, and U.S.-Latin American relations. By bringing pressing regional concerns to the attention of opinion leaders and policymakers, the Program contributes to more informed policy choices in Washington, D.C., and throughout the Hemisphere.

The Program's work on democratic governance focuses on questions of improving democratic quality and state capacity, the relationship between democratization and internal armed conflict, the resurgence of populism, and the protection of human rights. It also explores the impact of public policies to promote social cohesion and address the region's persistently high inequalities. The Program's current approach builds on three decades of prior work on democratic governance at the Wilson Center, including path-breaking studies of the breakdown of democratic regimes, transitions from authoritarianism, challenges to the consolidation of democratic rule, decentralization, and the fostering of citizenship and socio-economic inclusion.

We are grateful to the Tinker Foundation for its generous support of this project.

Woodrow Wilson International Center for Scholars
One Woodrow Wilson Plaza, 1300 Pennsylvania Avenue, NW, Washington, DC 20004-3027
tel. (202) 691-4000, fax (202) 691-4001
www.wilsoncenter.org/lap

have diverged sharply on how to address this issue methodologically. Approaches vary across academic works in terms of methodology and coverage, depending largely on data availability and country-specific circumstances.

Most studies first present some stylized facts on tax policy, and then some of the variations and distinctive attributes of the country's tax systems, usually from an institutional point of view. They consider the development of the tax system and describe the main taxes currently collected. They also provide a clear picture of the underlying historical circumstances affecting tax policy approaches, and the historical factors driving different stages of economic development (Mahon 2004 for Bolivia, Mexico and Venezuela; Profeta and Scabrosetti 2007 for Argentina, Brazil and Chile; Benardi *et al.* 2008 for Paraguay and Uruguay). Such retrospective analysis of tax reform initiatives has been seen as necessary to understand the current taxation structure.

Works with a comparative dimension also highlight the impact of political arrangements in different countries (Durand 1994; Ahmad and Brosio 2008; Di John 2008; Stein and Tommasi 2008). As Bird (2003: 2) points out, comparative work has demonstrated that "countries with similar economic characteristics in similar economic situations can and do have and sustain different tax levels and structures, reflecting their different political situations." In addition, the comparative perspective has shown the extent to which LAC tax systems are predominantly regressive, as compared to the progressivity of most OECD countries (see, for instance, Bès 2008; Cominetta 2008; Cornick *et al.* 2008; Ferrario 2008).

The role of taxation in reducing inequality has been the subject of several studies as well. These mapped the effect of direct and indirect taxes on real income distribution by comparing pre- and post-tax income distribution (Filho *et al.* 2007; Goñi *et al.* 2008). The analyses use static

general equilibrium models or micro-simulation models. Research on distributional incidence has also considered economic and demographic information (Engel *et al.* 1998), implicit tax rates (Cominetta 2008), or the socioeconomic context as a whole (Blofield 2011). For the most part, studies have examined the effect of progressive rates on the redistribution of income by using the Gini coefficient¹ (Bird 2003; Sanchez and Espinosa 2005; Mahon 2009; Rezende and Afonso 2010).

Overall, most studies on taxation take either a single country or a comparative perspective, depending on the availability of data and the feasibility of comparison. Only a few studies have used a wider variety of methods to test the impact of progressivity beyond the standard measures of inequality. In this latter body of work, the dependent variable is tax reform. Mahon (2004) observes that the trends in tax reform have been quite similar across the region in terms of lower progressivity, fewer tax exemptions, an increasing role for the VAT, and the modernization of tax administration. According to Lora (2007), reforms introduced in Latin America since the late 1980s have been geared toward enhancing tax neutrality and horizontal equity, although national authorities have been forced to reinstate or raise taxes to preserve fiscal and macroeconomic equilibrium. For Francesco and Gandullia (2007), LAC governments have sought short-term tax policy options and relied to a greater extent on indirect rather than direct taxes. In pursuit of these objectives, tax reform proposals have tended to include broad-based and uniform VAT systems and simplified personal income taxes. Drawing upon the existing literature, tax reform is defined as the legislative passage of initiatives aimed at overhauling the tax system, improve tax revenue collection, enhance tax equity, or a combination of these objectives.

A THEORETICAL BASIS FOR STUDIES OF TAX REFORM

Tax reform, in whatever shape it eventually takes, is clearly as much a political process as it is an economic endeavor. How do politics affect tax policymaking in the region? This question has prompted detailed research on the nuances of transactions among strategic actors and a substantial literature suggesting how the tax system should allocate the tax burden. The goal in this section is thus to provide a theoretical framework for looking at how the political economy literature has evaluated different tax reform efforts.

Studies of taxation differ substantially. At one end of the spectrum, taxation is analyzed from a strictly technical or statutory viewpoint, as though opportunistic behavior were nonexistent. At the other end, political economy researchers consider how the interests of politicians and lawmakers affect reform outcomes. This view incorporates various political constraints on a government's ability to carry out tax reforms, as well as the political processes behind evolving tax structures. Particularly, these studies examine the extent to which political factors matter for both the substance and path of the reforms. The underlying theory is that countries are inclined to reach equilibrium with respect to the nature and scope of their tax system (Bird 2003). Six political constraints are reviewed below: external factors and crises; electoral support; partisan alliances; elite influence; political legitimacy; and political survival.

The Role of External Factors and Crises

An amalgam of domestic and international pressures resulting from conditionality packages has fostered the reform of tax systems all across Latin America (Sanchez 2006). For Francesco and Gandullia (2007), from the 1980s until the mid-1990s LAC governments initiated a set of tax reforms that were substantially influenced by international financial institutions. Indeed, the

International Monetary Fund (IMF), World Bank, and the Inter-American Development Bank (IDB) provided performance-conditional loans to fund tax reforms area. The main goal of these reforms was to increase revenue while providing more stability in the targeted revenue systems. Francesco and Gandullia stress, however, that these measures have come at a price: considerations of burden-shifting and tax equity have been omitted from the tax reform agenda. Mahon (2004) notices, however, that foreign influence on tax reform does not necessarily conflict with domestic approaches, since its main goal is to facilitate such reform. On the other hand, this literature recognizes that LAC countries, once burdened with debt, had to meet the conditions set forth by the institutions offering access to capital.

The concept of crisis is a recurring theme in this literature. For Sanchez (2006), a country's debt crisis and the resulting fiscal crisis makes the offer of external resources powerful and has defined the circumstances in which countries approached international financial institutions. Mahon (2004) adds that because a crisis (most often hyperinflation) creates expectations of widespread economic decline, the probability becomes higher that leaders will begin—and voters will approve—bold reform processes, even at the cost of short-term losses. Other observers of tax reforms in LAC express similar judgments (Tanzi 2000; Lora 2007; Bonvecchi 2010). These studies reason—from a breadth of country-experience—that major modifications to tax structure and administration are possible throughout a crisis. In the flux and urgency of crisis, the political opposition that commonly hinders significant change can be more easily overcome. This literature admits, however, that crisis is neither a necessary nor a sufficient condition to start reforms, given the influence of a range of other institutional and political elements, discussed below.

Electoral Support

In the political economy literature on tax reform, politicians tend to be more often the focus of analysis than bureaucrats. Tommasi *et al.* (2001), for example, seek to explain tax policies as the final outcome of political transactions involving incumbent politicians. The rules of the political game under which politicians are elected and hold office will condition every policy. A median-voter argument can be formulated as follows: as inequality increases, voters prefer higher taxes so long as these taxes are followed by state-enacted redistribution (Alesina and Rodrik 1994). Redistribution would therefore result from voters forming a majority that presses for progressivity. Similarly, Lledo *et al.* (2004) argue that once veto players and institutional constraints are accounted for, political optimality theories can provide a solid basis for addressing the political obstacles to reform.

Accordingly, a focus on the importance of political negotiation in the study of taxation has been spurred in part because the underlying technical works on taxation have not entirely grasped the reality of tax policymaking in many countries. In this vein, Profeta and Scabrosetti (2007) untangle the interactions between economic reforms and politics by recognizing that reforms are often the central platforms for politicians to obtain votes. This is particularly germane in the case of taxation, where reforms appear to be a politically viable and favorable strategy to attain support. In actuality, mobilizing support for tax reform is not easy, and redistributive reform presents even greater challenges. Furthermore, the electorate may be more interested in other issues, such as inflation or security, rather than prioritizing tax policies, including burden-shifting tax reform. In this context, strong interests may be expected to attempt to block increasing taxable income and assets. In many instances, it seems that political pressures towards reforms eventually eschew any resulting net increase in tax burden targeting upper-income groups (Martinez-Vazquez 2001).

Partisan Alliances and Support

It has been argued that the relative strength of political parties in congress can have an effect on the approval of a tax reform, given the possibility of stalemates and conflicts in legislatures (Lledo 2004; Melo *et al.* 2010). According to this view, transitions to democracy throughout Latin America with electoral rules such as proportional representation and multimember districts have given rise to weak parties characterized by clientelism and personalism, and to party systems whose main attributes are fragmentation, polarization, and volatility. These features, combined with presidentialism, have intensified the problems of deadlock between executive and legislature. The only feasible way for executives to get tax legislation passed would thus be to obtain support from legislative allies in exchange for spending programs or tax incentives.

On the other hand, political parties are particularly relevant as the link between state and civil society, and they can provide support in the legislature needed to legitimate the government's tax measures (Di John 2008). Empirical evidence from developed countries indicates that states run by left-wing parties tend to mobilize higher tax levels and adopt more progressive tax structures than those run by conservative, right-wing parties. Yet while it may be true that prudence is required when making broad comparisons between tax systems in LAC and OECD countries, partisan alliances and cooperation within and across branches and levels of government in both regions are necessary if reforms are to remain effective (O'Donnell 1994).

Elite Influence

Sokoloff and Zolt (2006) ascertain that, at a political level, severe inequality can result when powerful groups minimize their relative tax burdens either by directing the policymaking process to the design of specific tax instruments, or by controlling tax administration so as to permit substantial tax evasion. Similarly, Bernardi

et al. (2007) argue that social inequality may lead to “elite groups” making every effort to introduce tax legislation that pushes a major portion of the fiscal burden onto lower income sectors. Can the opposition of these wealthy elites to reform in an unfair system be overcome? What kinds of political arrangements are likely to lead to socially optimal tax policy choices? The answers to these questions may explain why less-developed economies facing extreme inequality tend to have relatively regressive tax structures.

As a starting point, Fairfield (2010) explores the power of the business sector which is exerted through organized associations or by individual firms and investors. In order to protect the interests of upper-income groups as well as corporations during the reform of the tax system, businesses are keen to engage in deliberate political action. More generally, a bias in tax policymaking favoring business interests can be created through recruitment of business leaders into government, government-business coordination, and partisan linkages. Recruitment into government provides an opportunity for business leaders to take direct part in policymaking by occupying high-level executive branch positions. Cross-sector coordination in the form of regular government consultation and collaboration with a range of business associations can produce incentives to avoid conflict over taxation. Finally, partisan linkages can provide representation of business interests in congress with veto power on taxation matters.

Tax policy is thus shaped by powerful interest groups that lobby to keep the tax burden unevenly distributed. According to this perspective, Profeta and Scabrosetti (2007) observe that political elites are often wealthy and are interested in keeping income taxes down for themselves and for middle classes, as a means to win their support in political competition. Von Haldenwang (2008) adds that the more complex and less transparent a tax system, the easier it is for elites to engage in political lobbying.

Further, as Tanzi (2000) warns, policymakers would need to be immune to political interference in order to successfully carry out a tax reform, even if high-ranked tax officials were part of the political team of the incumbent government. The effects of corruption (e.g., Lledo *et al.* 2004; Bird 2008) and campaign financing (Blofield 2011) have also received attention in these analyses.

Political Legitimacy

The literature also raises the rather different (though related) issue of popular acceptance of a tax system. For Di John (2008), in the context of intense inequality, implementing more progressive taxes may be a more efficient strategy for promoting legitimacy of the tax system than adopting more neutral value-added taxes. Other works support this view. Sokoloff and Zolt (2006) argue that the incidence of taxes (i.e. where the tax burden falls) has an effect on both the distribution of income nationwide and the final configuration of public support for a full range of projects. Torgler (2003), on the other hand, suggests that an uneven income distribution across a population in a country with powerful political groups excludes modern tax reforms that focus on the use of personal income or property taxes.

Other studies highlight the distributional impact of public spending together with revenues when gauging the progressivity of a tax structure (Engel *et al.* 1998; Lonzano 2000; Marquetti 2000; Martner and Tromben 2004). These studies stress the effective role of public expenditure, rather than taxation, as a strategic governance tool for equity. In addition to public expenditure, transfers have also become a significant policy tool. Goñi *et al.* (2008) argue that where redistribution is fairly large, it is for the most part attained through intergovernmental transfers rather than taxes. Therefore, the possibility of substantially improving tax redistribution rests mainly in raising the level of resources committed to transfers and refining their targeting, rather than

attempting to improve the progressivity of the tax structure. Justino and Acharya (2003) add that a real decrease in social and political inequalities can only be accomplished by (i) introducing progressive tax systems, (ii) promoting equality of opportunities, and (iii) reducing discrimination.

Political Survival

For Bird (2008), developing countries face the basic challenge of raising revenue in a way that is not only equitable and economically efficient but that also enables the political survival of policymakers. Because politicians' political survival depends on their constituencies' support, it might be expected that political groups which are more successful in introducing pro-growth reforms remain in power longer, yet the opposite seems to be true.

Martínez-Vázquez (2001) argues that what pushes developing countries to reform their tax structure or tax administrations depends more on politics than the economics of taxation. That is, successful reform efforts depend on abilities such as arranging a coalition in support of the reform while hampering the rise of other coalitions that oppose it. There must be a politically viable way to move beyond the difficulties of reforming a tax system. Overall, Stein and Tommasi (2008) find that politics determines to a large extent the capacity of these countries to design, approve, and implement effective public policies. Ideas and vested interests, therefore, as well as the political institutions within which these elements interact, mold tax policy.

In summary, the current political economy literature on tax reform demonstrates that, in addition to domestic and international pressure, government approaches to tax policy have been in large part shaped by the following political elements:

- Mobilizing electoral support
- The strength of political parties and coalitions in the legislature

- Elite control of tax policymaking or tax administration
- The degree of popular acceptance of tax policy
- Political survival that depends on a winning coalition of supporters

Thus, the political economy approach allows for a lens of analysis that is broader than that traditionally deployed by strictly economic and technical approaches. However, as Wallack and Srinivasan (2006) claim, a theory may be developed without considering its realistic implications, resulting in policy advice that makes sense in theory but may have negligible or even negative consequences in the real world - that is, these models may have clear "microfoundations" but their applicability to actual events is unknown or not obvious. The next section highlights the findings that have emerged from a series of country studies in the literature, and will discuss recent experiences in tax reform in light of the theoretical arguments identified here.

THE DEBATE IN THE REGION: POLITICS AND TAXATION IN LATIN AMERICA

This section explores the most important political and institutional factors influencing the tax reform process in several Latin American countries. It focuses on the circumstances that explain when these factors become an obstacle to the design and implementation of the reforms. The inter-relationship between tax reforms and Latin America's highly skewed income distribution is also investigated. A recurring question in the literature is whether or not the reforms have made inequality even worse. Three taxes are at the heart of this discussion: sales or value added taxes (VAT), income taxes, and payroll taxes.

This section is organized around six issues, with reference to country cases throughout. The first two look at some debates on the economic impact of tax

policies, while the latter four give greater attention to some political determinants of tax reforms. Failures to achieve tax reform are also considered.

Tax Progressivity and Redistribution

Lora (2007) maintains that tax reforms focused on increasing VAT have reduced the progressivity of tax systems, although higher revenues have improved the redistributive capacity of the tax. On the other hand, Profeta and Scabrosetti (2007) find that taxation has not had a redistributive impact in the region, since inequality ex-post has not been much lower than inequality ex-ante. That is, taxation has not been the primary factor contributing to inequality. For instance, Bès (2008) argues that the Argentine tax system cannot be blamed for the country's aggravated income distribution, although neither has it been a factor in redressing this state of affairs. On the opposite side of the debate, Mahon (2009) states that recent tax reforms have worsened inequality, as governments have relied increasingly on indirect (consumption) taxation.

Still other studies diverge from mainstream academic findings. For example, Zolt and Bird (2005) examine whether personal income tax is a reliable tax for redistributive goals, particularly by inquiring whether income taxes can be used effectively to reduce inequality. For them, the distributional effects of taxes that are imposed on sales are of far greater relevance than the effects of personal income tax. Also, Rezende and Afonso (2010) find that the Brazilian income tax on wages inflicts a greater burden on the poor than it does on the rich. In a similar vein, Rodríguez and Andrés (2008) analyze VAT and personal income tax reforms in Mexico as alternative revenue-raising measures to fight poverty. They show that if both taxes were raised by the same rate, the distribution gap would increase more in the case of an income tax reform since the wealthiest households would receive the biggest benefits. Other empirical works

(Avila *et al.* 2001; Sanchez and Espinosa 2005; Bernardi *et al.* 2008a) point out that VAT is progressive (not regressive), as it is paid mainly on good purchased by the wealthy, while a range of basic goods—such as school books, potable water, and basic food items—are VAT-exempt or taxed at lower rates. From this viewpoint, VAT has been reasonably capable of enhancing equity.

Economic Distortion and Raising Revenues

Another issue commonly debated in the literature is that of payroll taxes, particularly personal income tax withholding, which distort the economy by disproportionately falling on wage earners in the formal sector. Johnson (2002) opposes income tax increases on the basis that this tax hinders economic growth, advocating instead for sales tax enhancements. Similarly, Mahon (2009) posits that the choice for consumption taxation is constrained by a very important threat: higher taxes on property or income would induce capital flight. Edwards and Edwards (2000) argue that a reduction of payroll taxes per se cannot reduce unemployment—and thereby inequity—unless it is carried out under the umbrella of a broader reform that involves the decentralization of political bargaining. Thus, despite theories predicting the influence of redistributive policies on the behavior of median voters, little has been done in LAC over the last decades to make tax systems more equitable.

If, on the contrary, it is accepted that governments want to use their tax systems more for revenue raising than burden-shifting, other arguments merit consideration. For instance, Engel *et al.* (1998) suggest a focus on intensifying public spending directed to the poor instead of raising direct taxation. Nevertheless, Durand (1994) recalls that many tax reforms in Latin America resemble bargains that involved raising tax revenue in return for fiscally responsible governments.

In Colombia, two modest reform packages were put forward, in part with the intention of raising revenue to finance the battle against guerrilla warfare (Bernardi *et al.* 2008b); in Chile, reforms were tailored to stimulate economic growth and thereby raise revenue, without attention to distributional consequences (Huber 2005). Shifting the burden has thus taken a back seat to revenue generation.

The puzzling evidence reported above can be reconciled through a political economy perspective on tax reforms. From this perspective, factors such as vested interests, electoral incentives, and populist tax policies have a crucial role to play in the passage of tax reforms—and sometimes in preventing their passage. Examples abound of political factors leading to failure in implementing comprehensive tax reforms.

In Costa Rica, Cornick *et al.* (2008) observe that, after four years of discussion and a resulting proposal (which was neither sanctioned nor rejected), the country still lacked a political agreement to reform the tax structure. In Brazil, Melo *et al.* (2010) notice that the tax system is very complex, as it is influenced by a vast array of interests. Consequently, any reforms would entail high political costs. Since the system is inefficient but yields adequate revenues, the net benefits of efficiency-oriented reforms would be unpredictable and modest at best. The Brazilian case provides an example of how taxation can get trapped in inefficient arrangements because politicians' short time horizons constrain opportunities for beneficial exchange (Wallack and Srinivasan 2006). Profeta and Scabrosetti (2007) suggest that the political cost of raising income taxes, in terms of loss of support from a constituency, may be so high that sitting politicians would rather tax corporations and provide them compensation through a structure of fiscal incentives. Mahon (2009) supports a rather different view by observing that the 2007 rise in corporate taxes

in Mexico should be taken as an indication that there is room to increase taxes without facing substantial political damage.

The political economy approach adds further layers of complexity to these debates over the economic impact of taxes and observed failures of reform. It drops the assumption that reformers are benevolent social planners exclusively in the pursuit of general social welfare. Rather, it recognizes policymakers as politicians first and foremost, motivated by prospects of re-election, the perks of office, etc. (Wallack and Srinivasan 2006). This logic partially explains why incumbent governments in LAC have not engaged in promoting tax reforms that are at the same time economically efficient and evenly distributed across society. In other words, since policymakers in general explore reforms that are politically rather than economically optimal, a tax reform plan will not be politically viable if its distributional effects cannot be negotiated (Lledo *et al.* 2004).

POLITICAL CONSENSUS VERSUS DEADLOCK

Although theory predicts that political negotiation will create coalitions that support either increased spending or taxation, the literature is rife with examples showing problems within legislatures. Melo *et al.* (2010), for instance, bring to the fore problems of collective action among legislators, including logrolling, the disbursement of pork, and political patronage. These practices generate a market in which the executive and various parties have an opportunity to negotiate for the approval of reforms. An overview of experiences, however, demonstrates that such bargaining sometimes produces stalemate. In Argentina, a finely tuned reform agenda stalled primarily due to Menem's aspirations for a third presidential term, which diverted political capital away from consensus building on the reforms (Bès 2008). In Brazil, any attempt at reforming the tax system would demand a constitutional amendment—which

requires the support of two-thirds of a politically fragmented legislature, in two rounds of voting (Afonso 2008). Mexico provides another example of legislative gridlock. For Alvarez (2008), the competition of multiple parties in Mexico's 1997 Congress led to poor agreements regarding a revenue enhancing reform.

Di John (2008) provides rather different explanation for reform deadlocks in Latin America. The experiences of Chile, Colombia, and Paraguay illustrate that a meager tax effort and a primary reliance on regressive consumption taxes are a by-product of the weakness of the state vis-à-vis upper income groups. In Chile, Boylan (1996: 8) shows that "the reform was tailored far more to the interests of an economically powerful and politically visible business class." In Colombia, power has long been divided between two political parties, both representing powerful landowners' interests. According to Bernardi *et al.* (2008b), these groups intentionally opted to refrain from taxing upper- and middle-income groups in order to reach political consensus. In Paraguay, an important impediment to any reform has been the strong opposition by the wealthy, coupled with the weak political mobilization of citizens living below the poverty line (Ferrario 2008).

Yet another explanation for these deadlocks revolves around the issue of fragmentation. Olivera *et al.* (2010) notice that the combination of high political fragmentation and limited power in the executive branch has curbed the scope of tax reforms in Colombia. With weak and fragmented political parties, even members from the parties with the highest representation in congress managed only to increase tax revenues, with the range of negotiations restricted to whether the increase should be based on VAT or income tax. These limited reform outcomes were also a consequence of national-level politicians more responsive to campaign-financing interests, which have made it politically costly to agree

upon deeper, structural tax reforms. The resulting reform package was, therefore, strongly associated with incentives surrounding the subnational elections: the executive appointed governors in agreement with regional bosses; these governors in turn appointed mayors.

The Problem of Coordination between Federal and State Levels

The discussion above illustrates another weakness of tax reforms studies in Latin America: the scant attention paid to adequate taxation at subnational levels (Ahmad and Brosio 2008). This is a key coordination issue since each subnational politician responds to their own political bases, whose voters may or may not be aware of the links between local- and regional-level tax policy and the outcome of broader reforms (Wibbels 2005). Bès (2008) observes that in many cases governors avoid the politically costly option of increasing the tax burden on their own electorate and instead prioritize the distribution of federal funds through revenue-sharing arrangements. Provincial or state governors are significant players in the national game, as they are frequently party bosses exerting strong influence over national politicians through electoral channels and the party system (Tommasi 2006). In the end, the Latin American cases seem to confirm the general statement of Inman and Rubinfeld (1996) that universalistic legislatures² are unlikely to choose optimal tax systems because the demands of state-level representatives motivate policy.

In Argentina, where the decision-making rules contribute to the formation of large coalitions, Bonvecchi (2010) contends that the gradual reduction in political integration has undermined the national party's ability to coordinate intergovernmental bargaining, while enhancing local bosses' strength to build oversized coalitions. Indeed, the need to form big coalitions in order to pass reforms has driven the central authorities

to accommodate the interests and demands of as many party factions and province bosses as possible in reforms. On the other hand, party leaders with an interest in maximizing their chances at the polls and who therefore favor tax policies that distribute benefits widely, have tended to negotiate and support the passage of reforms yielding limited centralization of fiscal authority. These dynamics help explain the pattern of tax reform in Argentina.

In addition, Melo *et al.* (2010) highlight the difficulties of coordination in overcoming general fund problems in the taxation arena. They argue that in federal countries like Brazil, with a presidency based on a multiparty system where the ruling coalition is established through post-election bargaining, at least two types of general fund problems must be tackled: those concerned with the fiscal performance of state governments; and those pertaining to managing the party coalition. As a result of these challenges, Brazilian policymakers have not addressed the inefficiencies in the tax system. Varsano (2003) shares this view. For him, standardized VAT legislation at the state level in Brazil would mean a loss of tax autonomy for the state. Consequently, though adopting a standardized VAT is desirable in economic terms, a political analysis may prove the proposal impracticable.

The Rise of Globalization: Does Ideology Still Matter?

A study by Schneider (2012) shows that, as a result of globalization, multinational corporations have attempted to advance a reform agenda in Central America that would enable them to expand their business activities in addition to gaining access to political power. The study finds that the greatest changes took place in El Salvador, where a dominant and cohesive group of transnational elites—elites whose key business connections are with agents outside the country—managed

to increase taxes, though not on upper income groups. Under the influence of powerful (although divided) transnational elites, Honduras advanced some reforms as well, most notably by increasing taxes and tax breaks. In Guatemala, a divided, less influential collection of transnational elites initiated a number of reforms, but managed to effect little change. Due to political and institutional obstacles, revenues were increased only marginally through emergency tax hikes, and the government had no success in addressing the issue of inequity across sectors or income groups.

Contrary to globalization theorists, Hart (2010) hypothesizes that, although multinational corporations place significant downward pressure on the corporate tax burden, the ideology of a country's ruling party is still a relevant predictor of taxation in the developing world. For instance, the election of a right-wing party signals a desire among the electorate for less state intervention in the economy, whereas a left-wing party taking office is an indication of political will for state expansion into the economic sphere; either election result should be reflected in the tax policy. The broad applicability of these predictions across Latin America remains unclear, however, given that the market-friendly right has in many cases generated more tax revenue than the intervention-prone left. Hart argues that these rather unexpected outcomes are driven by ideological priorities for equity versus growth. While policymakers on the right augment tax revenues to induce economic growth, the left restricts regressive consumption taxation as a means of moderating the burden for low-income groups.

Mexico provides an interesting study case. Magar *et al.* (2009) highlight the fundamental changes that have taken place in the institutional arrangements governing taxes in Mexico. These changes were consistent with the ideology of the ruling political party. Democratic consolidation and the resulting electoral competition in the

late twentieth century account for these patterns of reform—and sometimes the inertia—in the Mexican tax structure and administration, specifically by prescribing the terms of negotiations in congress. An additional variable explains the rate, degree, and direction of change: the transaction costs attached to bargaining under distinct constitutional and partisan configurations, which followed the emergence of multiparty, divided governments after 1997. As a result, right-wing presidents failed to raise taxes that disproportionately bear on the poor, although they succeeded in enacting taxes that disproportionately affect the wealthy and middle-class.

Democracy and Bureaucracy

A significant portion of the literature shares the perspective that the taxation status quo is the result of governments attempting to take whatever they could, even in a non-democratic environment. There seem to be two different views on the matter. Sachs (2000), articulating one view, asserts that throughout much of Latin America, leaders who lack popular legitimacy have most tenaciously opposed tax reforms. For Mahon (2004), there is little overall correlation between authoritarianism and tax reform, although there was a weak positive correlation between greater authoritarianism under certain circumstances, like Chile under Pinochet, with more success introducing comprehensive reforms. In non-democratic regimes, public officials often adopted an authoritarian stance, resorting to decree powers allowed under states of emergency as a means to overcome the national legislative body. Huber (2005) gives a similar explanation for the Argentine case, where large-scale modifications in the tax system (to increase indirect taxation) were accomplished during the military regime, and a series of follow-on measures have not resulted in significant popular protest. Overall, the widespread democratic transition in Latin America has not significantly reduced the regressive characteristics of the region's tax systems.

Neither has this transition eliminated the influence of political actors within the tax administration. Torgler (2003) points out that high-profile political leaders, top administration officials, and lawmakers enjoy ample discretionary powers where institutions are neither credible nor well-functioning. In Paraguay, for instance, Ferrario (2008) laments the persistence of widely diffused interests that sustains a clientelist, highly politicized public administration and promotes a system of political patronage. Cominetta (2008) assumes that potential improvements in tax efficiencies in Chile are more a political than an economic challenge. Bernardi *et al.* (2007) add that important changes in public administrations may take place during times of crisis, when it is more likely that the political opposition and administrative inertia that typically block effective changes can be overcome. Finally, Bergman (2009) claims that the success of a tax administration is tied more to the environment in which it operates rather than the capacity of administrative enforcement.

Looking at the cases above, it can be concluded that a range of political constraints, coupled with conflicting interests in reform outcomes, have created hurdles that weak governments are unable to overcome, particularly:

- Political patronage and clientelism
- Executive-legislative deadlocks
- Failure to win popular support for the reform
- The weakness of the state vis-à-vis upper income groups
- Difficulties in overcoming coordination problems
- Policy-makers' ideological stance
- Political influence within the tax administration

Clearly, politics is a key variable that continues to influence tax reform in LAC. That said, it is worth noting that some relevant changes are

gradually occurring and, as Tanzi (2000) observes, tax systems of the last decade are different to an important degree from those of the 1980s.

A SUMMARY OF FINDINGS AND FINAL REMARKS

A growing body of literature has addressed the political economy issues that hinder tax reform policies in Latin America. Topics such as globalization and economic crises, on one hand, and democratization, voters' preferences, veto players and institutional constraints, or the rules of the political game, on the other, have become central to any tax reform conversation. At the same time, most studies have shown that income redistribution initiatives and tax reform seem to be poorly connected, and this has generally placed tax policy at odds with broader poverty reduction strategies. Therefore, the political economy literature lists numerous caveats for assessing the outcomes of the reforms.

Additionally, as poverty and inequality persist across the region, and the tax burden falls more heavily on low income populations, most of the literature has stressed that it is not the level of taxation that is important for social equity, but rather the types of taxes that are collected. Yet the opportunity for more progressive taxation has received relatively little emphasis within public policy circles, and Latin American countries are improving their fiscal sustainability on the basis of tax systems in which the burden remains unevenly distributed. Thus, the region's historically low levels of income tax, along with increases in regressive forms of taxation and spending, impede sustainable reductions in poverty and inequality.

The cited literature has examined why countries in Latin America have had such limited success in introducing progressive tax legislation. A range of works support the view that powerful groups have been capable of disproportionately influencing the manner in which tax structures evolved. Other

works put more emphasis on the rules of the political game as critical factors shaping the way the reform agenda has (or has not) been effectively translated into substantial changes to the tax system. Moreover, although it might be argued that authorities in LAC lack the political will to enhance progressivity in their systems, no single factor has completely inhibited the process. Once a reform is launched, a combination of factors—such as political polarization, presidentialism, weak party systems, and powerful lobbies—make tax reform goals more difficult to accomplish.

Despite the fact that raising revenue may be an important pre-condition for sustainably funding social expenditures, scholars suggest that reformers should take a closer look at how each tax affects different income groups. In this context, appropriate recommendations must distinguish between countries with high inequality and those with middle or low inequality. This line of thinking has engendered great concern that increasing direct taxes will crowd out domestic redistribution efforts and thus aggravate inequality. Finally, most analyses have explored ideas for tax system reform that will affect less economic distortion, but will also be politically feasible to implement.

This review of the literature on tax reform presents a nuanced picture and indicates the political factors that can determine different outcomes. Lessons from the literature regarding the potential role of taxation can also help identify the possibilities for maximizing the social benefits of tax reform through the politics. Most importantly, the literature makes clear that the policy debate should not be limited to which system is best in terms of revenue enhancement, or which taxation theory would best fit a country's prevailing political interests, but rather what kind of reforms could be accomplished gradually and transition to more efficient and equitable tax structures.

ENDNOTE

1. High Gini values suggest a concentration of the tax burden on the wealthiest taxpayers, without implying that the system's inequalities have been eliminated. One should look at the post-tax Gini index for a clearer picture of inequality.

2. Universalistic legislatures are highly decentralized legislative bodies that decide according to a "norm of universalism," or more popularly, "pork barrel politics" (Inman and Rubinfeld 1996).

REFERENCES

- Afonso, J. R. (2008) Tax systems and tax reforms in Latin America: Country studies and general issues: Brazil. MPRA Paper N. 9250.
- Ahmad, E. and Brosio, G. (2008) Political economy of multi-level tax assignments in Latin American countries: Earmarked revenue versus tax autonomy. IMF Working Paper WP/08/71.
- Alesina, A., and Rodrik, D. (1994) Distributive politics and economic growth, *Quarterly Journal of Economics*, 109: 465–90.
- Alvarez, D. (2008) Tax systems and tax reforms in Latin America: Country studies and general issues: Mexico. MPRA Paper N. 9250.
- Barreix, A. and Roca, J. (2006) *Sistemas tributarios y reformas tributarias em América Latina*. Uruguay. Mimeo.
- Bernardi, L., Profeta, P., Marenzi, A. and Scabrosetti, S. (2008) Tax systems and tax reforms in Latin America: Country studies and general issues. MPRA Paper N. 9250, University of Pavia, Italy.
- Bernardi, L., Fumagalli, L., and Fumagalli, E. (2008) Tax systems and tax reforms in Latin America: Country studies and general issues: Colombia. MPRA Paper N. 9250.
- Bernardi, L., Barreix, A., Marenzi, A. and Profeta, P. (2007) Tax systems and tax reforms in Latin America. *Società Italiana di Economia Pubblica* working paper 591.
- Bergman, M. S. (2009). *Tax evasion and the Rule of Law in Latin America: The political culture of cheating in Argentina and Chile*. Penn State University Press. 280 pp.
- Bès, M. (2008) Tax systems and tax reforms in Latin America: Country studies and general issues: Argentina. MPRA Paper N. 9250.
- Bird, R. M., Martinez-Vazquez, J. and Torgler, B. (2008) Tax effort in developing countries and high income countries: The impact of corruption, voice and accountability. *Economic Analysis & Policy*, Vol. 38, No. 1.
- Bird, R. M. (2003) Taxation in Latin America: Reflections on sustainability and the balance between equity and efficiency, ITP Paper 0306, University of Toronto.
- Blofield, M. (2011) *The great gap: Inequality and the politics of redistribution in Latin America*. Pennsylvania State University Press.
- Bonvecchi, A. (2010) The political economy of fiscal reform in Latin America: The case of Argentina. IDB-WP-175.
- Boylan, D. (1996) Taxation and transition: The politics of the 1990 Chilean tax reform, *Latin American Research Review*, vol. 31, n. 1, pp. 7–31
- Cominetta, M. (2008) Tax systems and tax reforms in Latin America: Country studies and general issues: Chile. MPRA Paper N. 9250.
- Cornick, J., Thompson, E., and Torrealba, A. (2008) Tax systems and tax reforms in Latin America: Country studies and general issues: Costa Rica. MPRA Paper N. 9250.
- Di John, J. (2008) The political economy of taxation in developing countries: Challenges to practitioners. The World Bank Group in collaboration with DFID.
- Durand, F. (1994) The politics of tax revolutions in Peru, Bolivia, and Argentina. Presented at the Congress of the Latin American Studies Association, Atlanta (March).
- Edwards, S. and Edwards, A. C. (2000) Economic reforms and labor markets: policy issues and lessons from Chile. NBER Working Paper 7646.
- Engel, E. Galetovic, A. and Raddatz, C. (1998) Taxes and income distribution in Chile: Some unpleasant redistributive arithmetic, NBER Working Paper n. 6828.

- Fairfield, T. (2010) Business power and tax reform: Taxing income and profits in Chile and Argentina. *Latin American Politics and Society*, 52 (2): 37–69.
- Ferrario, C. (2008) Tax systems and tax reforms in Latin America: Country studies and general issues: Paraguay. MPRA Paper N. 9250.
- Figari, F. and Gandullia, L. (2007) An outline of tax systems and tax reforms. In Barreix, A., A. Marenzi, and P. Profeta, Eds., *Tax systems and tax reforms in Latin America*. Routledge: Abingdon, UK.
- Filho, J. B., Santos, C. V., and Lima, S. M. (2007) Tax reform, income distribution and poverty in Brazil: An applied general equilibrium analysis. MPPIA WP 2007–26
- Goñi, E., López, H., and Servén, L. (2008) Fiscal redistribution and income inequality in Latin America, Policy Research Working Paper 4487, World Bank, Washington DC.
- Hart, A. (2010) Death of the partisan? Globalization and taxation in South America, 1990–2006. *Comparative Political Studies*, 43(3): 304–328.
- Huber, E. (2005) Gendered implications of tax reform in Latin America: Argentina, Chile, Costa Rica, and Jamaica. United Nations Research Institute for Social Development (UNRISD).
- Inman, R. and Rubenfield, D. (1996) Designing tax policies in federalist economies: An overview. *Journal of Public Economics*, 60: 307–334.
- Jiménez, J. P., Gómez Sabaini, J. C., and Podestá, A. (2010) Tax gap and equity in Latin America and the Caribbean. ECLAC Fiscal Studies No. 16
- Johnson, C. (2002) Una propuesta de reforma tributaria eficiente, *Estudios Públicos*, n. 87, (Winter 2002).
- Justino, P. and Acharya, A. (2003) Inequality in Latin America: Processes and inputs, PRUS Working Papers 22, University of Sussex.
- Lledo, V., Schneider, A. and Moore, M. (2004) Governance, taxes, and tax reform in Latin America. IDS Working Paper 221, Sussex.
- Lonzano, I. E., (2000) Colombia public finance in the 1990s: A decade of reforms, fiscal imbalance, and debt. Paper presented at the POE Structure Meeting on Fiscal Policy Issues, Osaka: September 28th and 29th.
- Lora, E. (2007) Trends and outcomes in tax reforms. In: Lora, E. *The state of state reform in Latin America*. Washington, D.C., IADB-Stanford University Press.
- Magar, E., Romero, V. and Timmons, J. (2009) The political economy of fiscal reform in Latin America: Mexico. IDB Background paper.
- Mahon, J. (2009) Tax reforms and income distribution in Latin America. Prepared for the XXVIII Congress of the Latin American Studies Association, Rio de Janeiro, Brazil.
- Mahon, J. (2004) Causes of Tax Reform in Latin America, 1977–95. *Latin American Research Review*. 39(1): 3–30.
- Marquetti, A. (2000) Participatory budgeting in Porto Alegre, *The Public Sector Indicator*, Vol 17, No 4.
- Martinez-Vazquez, J. (2001) Mexico: An evaluation of the main features of the tax system, International Studies Program Working Paper 01–12, Georgia State University.
- Martner, R. and Tromben, V. (2004) Tax reforms and fiscal stabilisation in Latin American countries. ECLAC Gestion Publica series, 45.
- Melo, M., Pereira, C., and Souza, S. (2010) The political economy of fiscal reform in Brazil: The rationale for the suboptimal equilibrium. IDB working paper 117.
- O'Donnell, G. (1994) Delegative democracy, *Journal of Democracy*, Vol 5 No 1: 55–69.
- Olivera, M., Pachón, M. and Perry, G. (2010) The political economy of fiscal reform: The case of Colombia, 1986–2006. IDB-WP-181.
- Profeta, P. and Scabrosetti, S. (2007) Political economy issues of taxation in Latin America. XIX Congress of the Società Italiana di Economia Pubblica, September.
- Rezende, F. and Afonso, J. R. (2010) Equidade fiscal no Brasil. Instituto de Estudos Fiscales. Inter-American Development Bank: Washington, DC.
- Rodríguez, G. N. and Andrés, C. P. (2008) An applied general equilibrium analysis of fiscal

- reforms to fight poverty in Mexico, *Ensayos Revista de Economía*, vol. 0(1), pages 81–115.
- Sachs, J. (2000) Notes on a new sociology of economic development. Pp. 29–43 in Harrison, L and S. Huntington (eds.), *Culture matters: How values shape human progress*. New York: Basic Books.
- Sanchez, F. and Espinosa, S. (2005) Impuestos y reformas tributarias en Colombia, Documento CEDE 2005–11.
- Sanchez, O. (2006) Tax system reform in Latin America: Domestic and international causes. *Review of International Political Economy*, 13 (5): 772–801.
- Schneider, A. (2012) *State-building and tax regimes in Central America*. Cambridge University Press: Cambridge, UK.
- Shome, P. (1999) Taxation in Latin America: Structural trends and impact of administration, *Working Paper WP/99/19*, Washington, D.C.: International Monetary Fund.
- Sokoloff, K. L. and Zolt, E. M. (2006) Inequality and taxation: Evidence from the Americas on how inequality may influence tax institutions. UCLA Law-Econ Research Paper No. 08–08.
- Stein, E. and Tommasi, M. (ed.) (2008) *Policymaking in Latin America: How politics shapes policies*. Inter-American Development Bank: Washington, DC.
- Tanzi, V. (2000) Taxation in Latin America in the last decade. Paper prepared for the Conference on Fiscal and Financial Reforms in Latin America, Stanford University.
- Tommasi, M. (2006) Federalism in Argentina and the reforms of the 1990s. In: Wallack, J. S. and Srinivasan, T. N. (2006) *Federalism and economic reform: International perspectives*. New York: Cambridge University Press, pp. 516.
- Tommasi, M., Saiegh, S., and Sanguinetti, P. (2001) Fiscal federalism in Argentina: Policies, politics, and institutional reform. *Journal of LACEA Economía*, Spring 2001, vol. 2
- Torgler, B. (2003) Tax morale in Latin America. 3rd International Research Conference: Responsive Regulation: International Perspectives on Taxation.
- Varsano, R. (2003) Tax reform in Brazil: The long process in progress. IDB Working Paper 4339.
- von Haldenwang, C. (2008) Taxation, social cohesion and fiscal decentralization in Latin America. German Development Institute, Discussion paper 1/2008.
- Wallack, J. S. and Srinivasan, T. N. (2006) *Federalism and economic reform: International perspectives*. New York: Cambridge University Press, pp. 516.
- Wibbels, E. (2005) Federalism and the market: Intergovernmental conflict and economic reform in the developing world. New York: Cambridge University Press, pp. 276.
- Wibbels, E. and Arce, M. (2003) Globalization, taxation, and burden-shifting in Latin America, *International Organization* 57: 111–36.
- Zolt, E. and Bird, R. (2005) Redistribution via taxation: The limited role of the personal income tax in developing countries. Law and Economics Research Paper Series 05–22, UCLA.

WOODROW WILSON INTERNATIONAL CENTER FOR SCHOLARS

Jane Harman, President, Director, and CEO

BOARD OF TRUSTEES

Joseph B. Gildenhorn, Chair
Sander R. Gerber, Vice Chair

Public Members: James H. Billington, The Librarian of Congress; Hillary R. Clinton, The Secretary, U.S. Department of State; G. Wayne Clough, The Secretary, Smithsonian Institution; Arne Duncan, The Secretary, U.S. Department of Education; David Ferriero, Archivist of the United States; James Leach, Chairman, National Endowment for the Humanities; Kathleen Sebelius, The Secretary, U.S. Department of Health and Human Services

Private Citizen Members: Timothy Broas, John T. Casteen III, Charles Cobb Jr., Thelma Duggins, Carlos M. Gutierrez, Susan Hutchison, Barry S. Jackson

ABOUT THE WOODROW WILSON CENTER

The Center is the living memorial of the United States of America to the nation's twenty-eighth president, Woodrow Wilson. Congress established the Woodrow Wilson Center in 1968 as an international institute for advanced study, symbolizing and strengthening the fruitful relationship between the world of learning and the world of public affairs." The Center opened in 1970 under its own board of trustees.

In all its activities the Woodrow Wilson Center is a nonprofit, nonpartisan organization, supported financially by annual appropriations from Congress, and by the contributions of foundations, corporations, and individuals. Conclusions or opinions expressed in Center publications and programs are those of the authors and speakers and do not necessarily reflect the views of the Center staff, fellows, trustees, advisory groups, or any individuals or organizations that provide financial support to the Center.

ONE WOODROW WILSON PLAZA, 1300 PENNSYLVANIA AVENUE, NW, WASHINGTON, DC 20004-3027



SMITHSONIAN INSTITUTION
OFFICIAL BUSINESS
PENALTY FOR PRIVATE USE, \$300

Presorted First Class Mail
Postage and Fees Paid
Smithsonian Institution

G-94